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Contents

Policy Perspectives and Performance

Agriculture Policy Review, 1995-2000

Leading Issues in the Development Process

Policy Briefs

LIST OF FIGURES

LIST OF TABLES

Policy Perspectives
and
Performance

1. Policy Perspectives and Performance

The year 2002 may be remembered as a remarkable turning point in the nation's history because of the still standing ceasefire and potential for cessation of hostilities with the LTTE. It has been a less remarkable year in the economic arena. Although the precipitous deterioration in all major economic fronts that characterised 2001 has been arrested, it appears that the economy is still not on the path to economic takeoff. In fact, the vulnerabilities of the economy are exposed, and the Government faces major challenges in steering the economy back on track. These include,

- reviving growth by stimulating investment and productivity.
- a significant decline in growth of industrial exports, and manufacturing in general.
- Managing fiscal balances.

Amidst widespread political and policy uncertainty investment levels plummeted to 22 per cent of GDP in 2001 from 28 per cent in the previous year. This was brought about by constant political manoeuvrings by the People's Alliance to maintain a delicate coalition Government, as well as by the debilitating July 2001 LTTE attack on the air force base and adjoining international airport, which had far-reaching effects on international trade, investment and tourism. Overall the economy contracted by 1.4 per cent (the first ever negative growth rate since independence), reflecting a broad economy-wide decline in output. Of particular significance was the contraction in the apparel-dominant manufacturing sector, and, hence, industrial exports. The sector was faced with eroding competitiveness in tight recessionary international markets due to higher energy costs, disruptions to trade, and greater foreign competition. On the fiscal front, a pronounced policy slippage occurred with the budget deficit escalating to 10.9 per cent of GDP from 9.9 per cent the year before. Domestic financing of the deficit mostly pushed up interest rates. Interest rates were held high in 1st half of the year to support newly floated currency. This made the total debt of the Government edge over 100 per cent of GDP.

The United National Front that came into office in December 2001 had a daunting task. Not only had it a massive economic revival to steer, but it was also saddled with an Executive President from the outgoing People's Alliance Government.

The new Government affirmed the central role of the private sector in development, and identified the ongoing conflict with the LTTE and poor infrastructure as major impediments to growth. With the aim of strengthening the rural economy, restoring investor confidence, and revitalising business activity, the March 2002 Budget (see Prospects for an analysis of Budget 2003 presented in November 2003) outlined the following initiatives;

- Granting fiscal incentives to revive investor confidence
- Rationalizing the taxation system
- Solving the power crisis on an emergency basis
- Establishing five economic zones to facilitate the flow of foreign investment
- Improving roads, railways and ports, power and communication systems
- Removing bureaucratic controls that discourage investment
- Providing capital and training to promote enterprise development
- Providing easier access to state owned land by the private sector for production activities
- Rationalizing the existing labour laws
- Introducing a national agricultural policy
- Improving economic infrastructure in the rural areas
- Awarding full ownership rights to farmers who occupy state land on land permits
- Establishing a "National Youth Brigade" to promote vocational skills and income earning activities.
- Providing facilities for improving computer literacy and English language skills
- Enhancing women's welfare

The above policies address the objectives of medium and long-term development. For the short term, the Budget-2002 set forth a strategy to bring down the fiscal deficit by curtailing expenditure and improving revenue mobilization. This was expected to help stabilize the price level and lay the foundation for an economic recovery during the year 2002. Thus, some balance between the short and long/ medium term components was achieved. The medium /long-term policies address a variety of objectives, but it was only in November 2002 that they were organized into a single consistent programme with clearly defined priorities and a time frame. (see "Prospects" for a discussion of "The Future: Regaining Sri Lanka").

In many aspects the new Government has made significant accomplishments. Foremost among them are its efforts to resolve the conflict with the LTTE. A socially and economically fatigued nation desires peace within a unitary state, and has benefited from a respite in hostilities. Only history can judge if this effort is path breaking or folly. However any solution has to be based on some fundamental political decentralization, which should remove all legal obstacles to any citizen's efforts to achieve a better standard of living. Policies based on one particular minority group, however, are only likely to lay the seed for future problems

The UNF Government has also exhibited a commitment to more responsible economic management principles. There have been no efforts to offer quick-fix solutions to fundamental problems that have no such answers. Efforts have been made to trim the budgetary expense, including a reversal of pre-election expansion of the public sector. However, savings on defence expenditures, given the staggered payment structure of such spending, are more likely to be noticeable in future years. Fiscal responsibility along with robust growth are key to managing the growing public debt burden.

In the international arena, the new Government has secured support from key players for its political and economic agenda. A more definitive closer stance has been taken in the relationship with the regional superpower India, as well as the global superpower -- the United States. Negotiations have begun to expand the India-Sri Lanka Free Trade Agreement, the Trincomalee Oil Farm has been leased to Indian Oil, and a free trade zone catering to Indian foreign investment is planned around the port area. The Prime Minister also met with the American President in July 2002, the first meeting of this nature in the last 20 years. A Trade and Investment Framework Agreement (TIFA) was signed with the USA, providing a forum to potentially expand bilateral trade and investment.

The World Bank, the International Monetary Fund, and the wider donor community have also expressed support for the new initiatives in the country. The donor community held the Sri Lanka Development Forum (SLDF) in Colombo in June 2002, the theme of which was "Economic Growth and Poverty Reduction Strategy" and "Relief, Reconstruction and Reconciliation". The World Bank, which sponsored the Forum, stressed that the focus of the SLDF would not be on aid levels but "to help the Government to turn crises into opportunities by introducing change in policies and institutions within a hard budget constraint", and urged development partners to give a "disciplined response that offers knowledge first and foremost, and financial support when meaningful and lasting reforms come about". Whilst recognizing the importance of peace and security for economic prosperity, the Bank stressed the need for speedy implementation of the structural programme pending the securing of peace. The Asian Development Bank too joined the chorus in insisting on more reforms, stating that the progress of the reform agenda would be taken into account in the preparation of the new country strategy.

At the SLDF, the Sri Lanka Government in its efforts to search for new and more inclusive efforts to reduce poverty submitted a Poverty Reduction Strategy Paper (PRSP) outlining a poverty reduction framework based on an assessment of the extent, causes and consequences of poverty in the country. It's major elements were: (i) creating opportunities for the poor to participate in economic growth, (ii) strengthening the social protection system, and (iii) empowering the poor and strengthening governance. The PRSP, which is a comprehensive document covering many areas of the economy, has stressed the need for sound fiscal management as an important prerequisite. The PRSP document, which has recognized both social realities and hard economic decisions, was well received at the SLDF, but the development partners emphasized the need for speedy and unwavering commitment to implementation.

In September 2002, the IMF released the last tranche of US$64 million under the Stand-By Agreement (SBA) entered into in early 2001, acknowledging the Government's success in meeting the performance targets of the SBA. Previously, the IMF has postponed reviews of the SBA due to the political uncertainty in 2001, and the fiscal slippages in the lead-up to the December 2001 election. Sri Lanka is now in a position to apply for a Poverty Reduction and Growth Facility (PRGF), which offers greater concessions of a potentially larger facility with a longer repayment period.

However, these positive efforts have been undermined by some specific shortcomings, as well as by deep-rooted and damaging aspects of the Sri Lankan political economy environment.

On the issue of confidence, the initial burst of business confidence has subsided, and investors have taken a somewhat "wait and see" approach. One aspect of uncertainty relates to the outcome of peace talks, and the more protracted the process the greater the uncertainty. Given the complexity of the issues involved, this is a task that clearly cannot be resolved quickly. However, the back loading of important issues keeps uncertainty high with regard to the success of talks. Both investors and donors want more than a "no war – no peace" scenario before additional significant engagement in the economy.

Another major source of economic uncertainty relates to the President's executive ability to dismiss the Government of the Prime Minister after one year in office. The failure to pass the 19th Amendment to the Constitution, which would have constrained this capacity, perpetuates the uncertainty. Given the strained relationship between these two key players, and downright hostility between the President and some Cabinet members, considerable uncertainty remains as to what new political manoeuvrings may arise. This political uncertainty undermines investor confidence, and stymies much needed re-engagement in the economy by local investors. It is only once local investors become active that foreign investors are likely to follow.

The current electoral system has resulted in coalition Governments, with one or the other two main political parties reliant on small parties to maintain power. This has severely eroded the power of Government to undertake fundamental reforms with short–term costs and larger long- term benefits. Therefore "short-termism" prevails.

Perhaps, it is this "short-termism" that has led to the inaction by all Governments with regard to approving a coal power plant. With a gestation period of 6-8 years, it is perhaps too long a time politically to be an attractive endeavour to a politician. However, given the severity of the power crisis in 2001, the Government could have taken bolder steps to gain support for a coal power plant. Although efforts have been made to promote thermal energy, (and the private provision of power is an increasingly profitable industry), they can be supplemented by pushing for coal power, which is clearly cheaper and, therefore, more beneficial to consumers.

A common feature in economic policy making in Sri Lanka is that often politicians that are supporting a particular policy while in power, argue vehemently against it (usually with no alternative plan) when they are in the Opposition. Inevitably, this creates suspicion and distrust among the general public as to the efficacy of the policy. This points to a lack of ownership on national policies, and belief in their appropriateness for the nation. Too often Governments half-heartedly accept foreign expertise. While foreign technical expertise is important, if there are no local technocrats who are competent and vocal that can carve the policy into Sri Lanka's national context, the effectiveness of such assistance is highly diluted.

Part of the problem is that the nation lacks human capital and technical expertise at the middle-level at policy-making and policy-implementing institutions. Regularly, a few competent senior officials are forced to spread widely to cover too many tasks. They cannot compensate fully for an effective technocracy. For example, immature design and negotiation of international contracts with regard to privatization and energy purchase have proven very costly to the nation. Building a cadre of technocrats will be vital for takeoff.

More specifically, ensuring policy conisstency is vital in economic management. Postponing the implementaion of stated policies -- as in the introduction of the VAT and fertilizer subsidy -- or revision of policy -- as in the implementation of the Port Development Levy -- can lead to loss of investor confidence. It also underlies the need to package reforms and build a constituency of supporters in order to face opposition from affected parties. This is because although a particular group may be hurt by one aspect of the reform, it may also be benefited by another, and, hence, would support the overall package. For example, the Government in the late 1970s cut rice subsidies and simultaneously pushed the Mahaweli project.

In terms of the real economy, a major productivity boost is needed. Peace does not cause growth. Additionally, it would be unwise to rely solely on a post-peace construction boom to drive the economy. A national effort aimed at all sectors of society to harness Sri Lanka's resources in the most productive manner is warranted.

An alarming feature in recent times is the contraction in the apparel-dominated manufacturing sector, and, hence, the slowdown in industrial exports. Promoting productivity enhancements in manufacturing is crucial, especially given the consequent impacts on the services sector as well. The Government should also move to remove barriers to greater diversification of the manufacturing sector by streamlining incentives. This is now being addressed by the Policy Development Committee functioning under the Prime Minister.

The competitive environment and contraction faced by the garment sector is likely to reflect a similar environment to when quotas under the Multi Fibre Agreement are eliminated in 2005. Rationalisation in this sector cannot be avoided. Although the garment sector is a large employer, Government assistance should be restricted to providing technical assistance in enhancing productivity and competitiveness of firms. It should not subsidize the preservation of jobs in loss-making firms that are unlikely to rebound. The inherent and developed skills of garment workers should be easily transferable to other industries. Thus structural unemployment is not likely. The priority of the Government, then, is to create an environment that would stimulate further investment and job creation in expanding sectors.

Similarly, assistance to improve agriculture sector productivity is needed, as is a consistent policy direction. Widespread high protection is not the answer. Sri Lanka cannot afford the costly protection of agriculture prevailing in developed countries. Blanket trade liberalization is also inappropriate. Globalization in itself is not a development strategy. The agriculture sector requires a consistent policy incentive framework with protection and liberalization so that it can make effective long-term investment decisions.

The limitations in the agriculture sector bring into focus the need or greater consistency in the overall trade policy. It is hoped that trade policy will resume in the direction it was taking in the early 1990s toward a pre-defined tariff structure. This should be supported by an Anti-dumping and Countervailing Duty legislation that will ensure fair trade, and be accessible in terms of cost to even small and medium enterprises.

The Government also needs to be cautious about entering into preferential trade agreements as a means of expanding markets for tea exports, in light of declining export revenues from garments. Careful consideration of the impact of these agreements on the import-competiting sector is vital. However, as reported in the State of the Economy 2001, a free trade agreement with Pakistan could be beneficial not only through a potential new tea market, but also through new investment that may come to Sri Lanka to exploit the free trade agreements with *both* India and Pakistan.

Effective infrastructure development is a key supportive policy action to increase productivity. Given the fiscal constraints, external aid should relax its counterpart funds requirements for such projects. Productive public investment in infrastructure cannot be delayed. In this respect, the tendency of most Governments (including this one) to cut capital expenditure to contain burgeoning fiscal deficits has been alarming.

Along with the need to increase private sector productivity is the need to substantially improve public sector productivity. It is not possible to simply boost the latter with a few appointments of leading private sector individuals to key positions in the public sector. Neither is it possible to simply ignore the large public sector. This is a case where there is no alternative but to "reform from within". Privatization is not an alternative! This is crucial to fulfil a much-talked about goal of Sri Lanka becoming a "hub" for international trade and finance. In fact it was the quality of its public institutions that contributed to Venice being the epicenter of international commerce in 17th century Europe, as was the case of London in the 19th century. The same may be said of New York in the post Word War II era and more recently, but to a lesser extent, of Singapore today.

The Government faces a multi-pronged management challenge. Developing a political structure that will ensure the right for all Sri Lankans to a better livelihood must be done alongside sound economic policy management that is supporting expanding opportunities for all citizens. The two are strongly interlinked, and one cannot take precedence over the other.

Anatomy of the 2001 crisis

Indications of an impending economic crisis began to appear as early as the third quarter of 2000,when the estimated agricultural output recorded a decline relative to that of the previous year. A sharp increase in international petroleum prices, a protracted drought, and political uncertainties associated with an impending presidential election gave a further impetus to the declining trend, leading to a general slowing down of economic activity during the second half of 2000. However, the year closed with a growth rate of 6 per cent; but the apparently satisfactory growth rate was merely a reflection of the low base year value of 1999--itself the result of two years of slow growth and the relatively good performance during the first half of 2000.

The downward trend that started in mid-2000 continued into 2001 with even greater intensity. A number of domestic events such as the terrorist attack on the Katunayaka International Airport, and the political crisis that virtually paralysed the administrative machinery over a period of several months created severe uncertainties. These events combined with the global recession exacerbated by the September 11th terrorist attack in the US led to a chain of events that caused considerable set-backs to trade, industry and many other related activities, and, thus, weakened the overall economic outlook. There was general pessimism in the business circles. The Colombo Share Market underwent a marked contraction, associated with a net outflow of foreign portfolio investment. The new share issues and the interest shown by the subscribers reached historically low levels. In the meantime, national priorities had shifted to political issues. As a result, no major initiatives were taken by the Government to restore business confidence. In fact, the failure to present the annual budget in November 2001, the declaration of costly relief measures ahead of the Parliamentary Election, and the Memorandum of Understanding between the Government and the leftist Janatha Vimukti Peramuna added greatly to the confusion. Thus, by the closing months of 2001, new investment activities had come to a standstill, and it was hardly surprising that the year recorded a negative growth of 1.4 percent.

The 2001 economic downturn was pervasive. Domestic production, investment, price levels, imports, exports, public finance, public debt and external debt were all affected adversely. Thus, both agricultural and industrial production declined during the year. The inflation rate (as measured by the Colombo Consumer's Price Index) rose to 14.2 per cent -- a rate more than twice that of the previous year. Export earnings were affected adversely by a shortfall in demand for apparel and garments--Sri Lanka's principal industrial export. Exports of other industrial goods and earnings from tourism were also similarly affected. The latter two developments were a direct consequence of the prevailing recession in the industrial countries and the domestic events mentioned earlier. Expenditure on imports declined even more sharply with intermediate goods recording the highest decline -- an indication of a further fall in manufactured exports during the months to follow.

The economic downturn represented in the above scenario resulted in a loss of employment on a significant scale. Applications made by employers to the Department of Labour to lay off workers increased during the period. The central Government revenue fell short of the target while expenditure exceeded the target so that the deficits -- both current and overall -- widened. Thus, the actual overall deficit exceeded the budgeted target by 2.3 percentage points of GDP, which led to a similar increase in domestic borrowings. One outcome was that the level of public debt crossed the IOO per cent of GDP mark for the first time.

Although there was an improvement in the external trade deficit, this however was not a sign of improving economic health, but rather the result of a sharp fall in imports -- an indication of a contraction of domestic production activity. Thus, the current account deficit did not reach an excessive level; however, the payments on the capital account remained high. As a result, there was a marked depletion of the country's external reserves. Gross Official Reserves in March 2001 was about US$ 960 Million -- lower than the level recorded six months earlier by nearly US$ 230 million. Following this serious deterioration in the external payments position, the authorities considered it necessary to give greater flexibility to the exchange rate, with a view to reducing the apparent imbalance. Thus, in January 200I, Sri Lanka abandoned the managed-float arrangement and adopted a free floating exchange rate system. This new arrangement meant, in principle, that the exchange rate for the Rupee would be market determined. The free float was accompanied by a number of administrative (which were relaxed in mid 2001) and fiscal measures to minimise fluctuations in the merchandise trade and services accounts.

Furthermore, despite the general slowdown in the economy, the Central Bank maintained a tight money policy until about June 2001. This suggests that the policy-makers gave priority to correcting the external imbalance rather than the more fundamental problems of demand management and production shortfalls.

It was significant that under the free float, the expected sharp depreciation of the Sri Lankan Rupee did not materialize. In about a month's time, and after an initial fluctuation, the SLRs / US$ middle rate reached 86.13, which represented a depreciation of about 1.3 per cent. However, the adoption of a free float was in fact a "Prior Action" taken by the Government to qualify for assistance from the International Monetary Fund in the form of a Stand-By facility, the decision to seek such assistance having been taken earlier in the context of the emerging crisis. Thus in April 2001, a Stand-By Arrangement with the IMF was put in place, enabling an immediate replenishment of the external reserves by US$ 131 million.

According to the Memorandum on Economic and Financial Policies (MEFP) submitted to the IMF in March 2001, the Government of Sri Lanka undertook to implement several important measures to correct the fiscal imbalance. These were to be accompanied by supporting monetary policies. Thus, on the fiscal side, a number of revenue measures were contemplated for raising the total revenue collections by about 1.5 per cent of GDP, while the existing plans for awarding salary increases to public servants during the year 2001 were to be abandoned, and Government outlays on other goods and services were to be tightly controlled. In addition, it was also agreed that domestic borrowing for financing the fiscal deficit would be reduced through an increase in privatization proceeds. As a part of the overall adjustment programme, the Government also set out a time-table for revising the key administered prices: those of petroleum products, public transport and utilities. Such price revisions would enable the respective state agencies to cut down their mounting financial losses and reduce large debts owed to the banking system, which had by that time grown to unsustainable levels. Thus, the MFEP appeared to be the beginning of a policy initiative to address the main underlying cause of economic deterioration within the control of policy makers, namely the high fiscal deficit. It involved several bold decisions which, if implemented, would have helped a great deal to turn around the rapidly deteriorating situation. But as events proved later, the political imperatives existing at the time prevented the authorities from carrying through the agreed reform agenda in a consistent manner.

Only a few initiatives to implement MEFP were actually taken. Meanwhile, major slippages occurred in the form of increased expenditure on public service salaries and pensions, further misalignment of key administered prices, and a shortfall in privatization proceeds. No meaningful action was taken either to improve the targeting of the Samurdhi welfare programme as agreed. As a result, there was a further deterioration in the fiscal situation, the overall deficit rising to a highly unsustainable level of 10.9 percent of GDP. Thus, it is significant that none of the critical performance targets envisaged under the MEFP were met in 2001.

A large part of this failure to meet performance targets can be explained by external and domestic factors over which the national authorities had little or no control. But, this is the very reason why more should have been done in the case of others, for instance, by taking timely decisions. Therefore, it is clear that the whole episode left ample room for the donors and the international community to question the credibility and commitment of the national authorities. In this background, it is difficult to escape the conclusion that poor governance emerged as a major impediment to economic development in 2001.

2. Macroeconomic Performance- a Medium-Term Perspective

2.1 Introduction

The economy is currently showing some signs of recovery from the sharpest economic downturn recorded in its post-independence history. The decline in real output of 1.4 per cent in 2001 has been arrested, but take off will require concerted reform.

The greater than anticipated contraction in 2001 is attributed to the combined impact of a variety of conditions on both the internal and external fronts. On the domestic front, poor agricultural production as a result of unfavourable weather conditions, interruptions to power supply with adverse implications for industrial production, the July 24th 2001 terrorist attack on the country's international airport--which impacted heavily on tourism, trade and foreign investment--were serious impediments. Policy slippages and political instability in the second half of 2001 only served to drain investor confidence to perhaps its lowest level in recent years. On the external front, a slowdown in the world economy--heightened after the events of September 11 – weakened demand for Sri Lanka's exports.

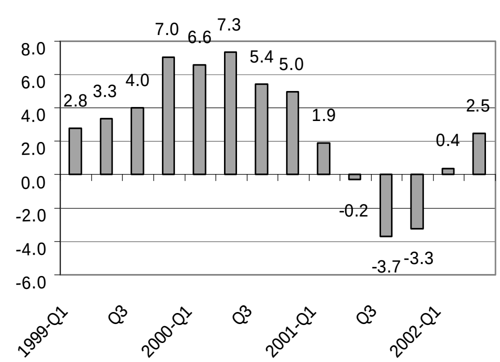
Real output grew by 1.4 per cent in the first half of 2002, which suggests that the worst of the crisis is over. The recovery was driven by resurgence in the services sector, and rebounding agricultural growth. Better weather conditions and a lack of terrorist disruptions to the economy have facilitated the recovery. Of concern however, is the continued contraction in the manufacturing sector, reflecting the depressed state of the garment industry. In fact, the manufacturing sector output is below what its levels were in 2000. (Table 2.1).

Table 2.1
Half yearly growth rates*, by sector: 2001-2002

	1st half 2001	2nd half 2001	1st half 2002	1st half 2002 (from 2000)
Agriculture, forestry and fishing	-2.8	-3.3	3.2	0.3
Mining and quarrying	4.7	-3.2	-6.0	1.8
Manufacturing	0.6	-7.8	-2.4	-1.8
Construction	5.5	-0.6	-0.5	5.0
Services	1.4	-2.4	2.7	1.3
GDP	0.9	-3.5	1.4	2.2

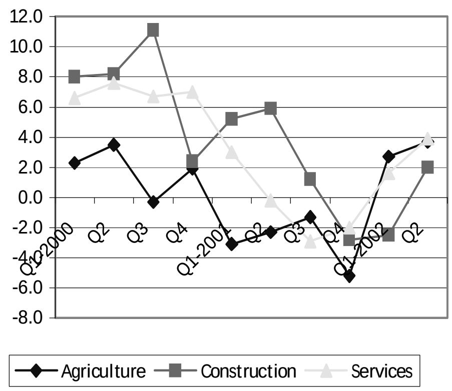
Source: Central Bank of Sri Lanka.
* Calculated as the percentage change in real output of six months, compared to th e real output at the same time in the previous year.

Figure 2.1
Quarterly GDP growth rates, 1999-2002



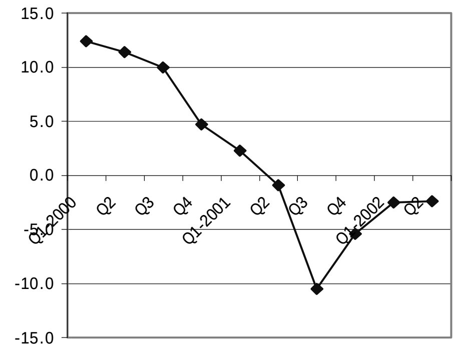
Source: Central Bank of Sri Lanka.

Figure 2.2
Some recovery-sectoral growth rates



Source: Central Bank of Sri Lanka.

Figure 2.3
The problem-manufacturing contraction



Source: Central Bank of Sri Lanka.

It could be argued that the contraction in GDP in 2001 was not unique to Sri Lanka in the context of a sharp downturn in global economic performance. Nevertheless, the severity of the contraction does point to significant and fundamental imbalances in the country's macroeconomic front. As such, this section provides a medium term perspective on the real economy, looking at the economic outturn from 1995 to the second quarter of 2002. Development in the second half of 2002 and the short-term outlook are covered in the "Prospects" chapter. The following sections analyze output growth by sector, the fiscal outturn, interest rates and exchange rates, inflation, and the balance of payments.

2.2 Output Growth

Agriculture

Agriculture suffered in 2001 due to the failure of the North-East monsoon. The sector recorded a negative growth of 3.7 per cent, the worst year of contraction since the drought-hit performance in 1996. An upward trend in tea production since the privatization of plantation management in 1992 was reversed, along with a decline of almost 6 per cent in annual paddy production.

The longer term trend in agricultural output in Sri Lanka has been unimpressive. Table 2.2 shows trends in each of the main sub-sectors at constant prices, using a three year rolling average (to reduce the effect of year-to-year variations in output that are caused by weather). It reveals a slight improvement in underlying growth from 1998, but is insufficient to provide a stimulus to the rural economy. Agriculture's contribution to GDP has grown by only 1.5 per cent per annum over the period 1995-2000.

Tea production, which has maintained the strongest growth at 4 per cent per annum over the period 1995-2000, contracted by 3.4 per cent in 2001. There was a significant reduction in real average costs

Table 2.2
Agriculture's contribution to GDP: 1995-2001* (Rs. Million)

	Tea	Rubber	Coconut	Paddy	Other	Total
1995	9593	3737	12693	25939	71758	124981
1996	9947	3841	13318	24317	73202	125650
1997	10411	3859	13330	23051	74783	125973
1998	10865	3753	12975	22726	75360	125679
1999	11202	3578	13361	25393	75932	129465
2000	11587	3363	13980	27288	76615	132834
2001	11791	3242	14252	27308	77168	133762
Growth Rate (%)						
1995-2000	4.0	-2.6	2.4	2.3	1.5	1.5
2001	-3.4	-1.8	-9.7	-5.7	-2.0	-3.7

Notes: * Three year rolling averages at 1996 constant prices.
Source: Central Bank of Sri Lanka, *Annual Report*, various issues.

of production following the privatization of management in 1992 (by 25 per cent between 1992 and 1996 at 1990 prices). While restructuring of privatized plantations companies may have contributed to the reduction in real costs of production, much of the increase in output was almost entirely in low-grown teas, a substantial share of which is smallholder and not estate production. Between 1995-2000, production of low growns recorded an increase of 6 per cent per annum compared to 1.8 per cent and 2.8 per cent per annum for high- and medium-growns, respectively. As a result, the share of low growns has increased its share from 48 per cent to over 54 per cent of total tea production. The lower overhead costs associated with smallholders may also have contributed to the decline in real production costs. With the exception of 1999, these developments have been helped by favourable prices for tea at the Colombo auction.

In the case of rubber, the performance has been poor over the last few years. Production has contracted by an annual rate of 2.6 per cent in the period 1995-2000. A substantial reduction in the area under tapping in the early 1990s saw a significant increase in the average yield rising to its highest in 1996. Since then, however, there has been a sharp decline of nearly 25 per cent in the average yield, accompanied by falling prices. The rubber sector has also experienced a decline in the real cost of production in the latter half of the 1990s.

Coconut production, which had been unremarkable for much of the 1990s, picked up sharply in 1999 to post an average annual growth rate of 2.4 per cent for the period 1995-2000. The increase in production has been accompanied by a significant improvement in the average export price since 1996. A reduction in output of nearly 10 per cent, combined with a sharp increase in coconut oil production following high tariffs on edible oil imports, exerted upward pressure on domestic coconut prices. The import of copra had to be permitted to contain the price increase.

In non-plantation agriculture, the paddy sector has had a mixed performance. Output has been more consistent in recent years, rising above the heavily drought hit low of 1996 by the end of the decade. The decline in paddy production in 2001, accompanied by import restrictions by way of licensing requirements, contributed to raising the price of paddy. Towards the end of the year, importation of rice on a duty free basis was allowed in order to lower prices. The experience of both the coconut and paddy sectors in 2001 point to the need for a consistent tariff policy regime for agricultural products in Sri Lanka. The ad hoc implementation of protective measures, and resultant volatility in the market, can prove more harmful than beneficial to producers and consumers alike.

Half yearly figures of agricultural output for 2002 indicate a positive growth rate of 3.2 per cent--*albeit* from a sharp contraction of 2.8 per cent in the first half of 2001 (Table 2.1 and Figure 2.2). The recovery was driven largely by the improved performance of paddy production (growing at about 10 per cent) compared to the depressed output in the previous *Maha* season. Plantation agriculture, on the other hand, continued to suffer from the vagaries of weather, contracting by 2.8 per cent in the second half of 2002. This contraction mainly reflected the dismal performance of the coconut sector, still suffering the lagged effect of the drought. Tea production that declined in the first quarter, rebounded with a 10 per cent growth in the second quarter with improved weather conditions to register a marginal increase in the second half of 2002, compared to the same period in 2001. A bright spark has been the growth in the rubber sector in response to higher prices, with production increasing from 43.8 million kilograms in the first half of 2001 to 46.7 million kilograms in the same period in 2002.

Manufacturing

Manufacturing output has recorded an annual average growth of 7.5 per cent in the period 1995-2000. However, this figure masks undue volatility in growth performance in more recent years. Manufacturing output rebounded to a more normal growth of 9.1 per cent in 1997 after a significant downturn in 1996 as a result of a severe power interruption. Output growth contracted in the next two years as the lagged effects of the East Asian crisis impacted on Sri Lanka's export sector. While the sector recorded a sharp recovery in 2000 as a whole with a growth rate of 9.2 per cent, the signs of a significant downturn began to emerge from the fourth quarter. Output growth continued to slow down in the first half of 2001, and began to contract in the second half to record a negative growth of 4 per cent for the year as a whole. This was driven primarily by an 8 per cent contraction in the dominant textiles and wearing apparel category.

The downturn in the manufacturing sector can be attributed to a host of related factors. The gradual slowdown in the global economy towards the end of 2000 began to exert an adverse effect on the demand for Sri Lanka's garment exports. A significant depreciation of the rupee from mid-2000 led to higher import costs of raw materials, exacerbated by the imposition of a 40 per cent import duty surcharge from February 2001. Higher electricity and telecommunication charges imposed in mid-2000 and a further 25 per cent surcharge on electricity bills introduced in March 2001 were added burdens on the industrial sector. As the macroeconomic environment deteriorated, the industrial sector was faced with rising domestic interest rates and accelerating inflation.

In the second half of the year, the industrial sector was further burdened by an unfolding--*albeit* not entirely unexpected--energy crisis that resulted in interruptions to power supply. The adverse impact of the terrorist attack on Sri Lanka's international airport and a worsening international economic environment in the aftermath of the September terror attack in the U.S only served to weaken industrial sector performance.

Manufacturing sector output contracted further in the first half of 2002 by 2.4 per cent as recovery in manufactured exports continued to be weak. Again, the contraction reflected output declines in the garment industry (by over 8 per cent in the first half of 2002). Diamond processing and ceramic products also were adversely affected by the failure of the world economy to rebound, and in the case of the ceramic industry, increasing energy costs at home. On the positive side, steady growth was recorded in food, beverages and tobacco, and a recovery marked the chemicals and rubber product industries.

Services

Output growth in the services sector has been the most consistent in the recent past. Posting an annual average growth rate of 5.7 per cent during the period 1995-2000, the services sector has come to account for nearly 53 per cent of the country's GDP. Much of the growth has been driven by the telecommunications, banking and retail trade sub-sectors. Despite the relatively strong performance of the services sector in more recent years, it was also subject to considerable turmoil in 2001 and recorded a negative growth of 0.6 per cent for the year. The most severely affected sub-sector was tourism, (contracting by 16 per cent), once more proving extremely vulnerable to external shocks. Wholesale and retail trade the largest sub-sector also contracted by as much as 6.5 per cent in response to declines in external trade.

It is encouraging that following three quarters of consecutive negative growth, the services sector registered two quarters of positive growth in 2002. Services sector output grew marginally by 2.7 per cent in the first half of 2002 driven primarily by a 19 per cent expansion in the telecommunication sub-sector. The commercial banking sector also grew significantly, benefiting from interest rate decreases, which were more apparent in deposit rates than in lending rates. The ongoing peace initiative also provided an impetus to the domestic trade and transport sectors.

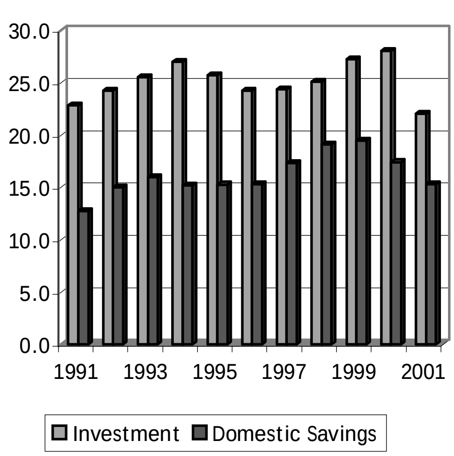
2.3 Savings and Investment

Investment levels over the last ten years have been on average about 25 per cent of GDP, but fell dramatically in 2001 (Figure 2.4), with the public investment component showing a declining trend. These levels are significantly lower than the investment levels in East Asian countries, especially prior to the crisis period where levels of investment were of the order of 40 per cent of GDP. Imports of capital goods have also not been growing at the rate of total imports.

Foreign investment inflows have also been meagre and have been declining in the last couple of years. The main East Asian investors came to the country for the garment quota allocation under the Multi-Fibre Agreement. Investment from the US, EU and Japan has been small, but there is likely to be an increase in Indian investment due to the India-Sri Lanka Free Trade Agreement, the departure of Indian investors from troubled Nepal, the lease of the oil terminal in Trincomalee to India Oil, and the prospect of an export processing zone catering primarily to Indian investors by the Trincomalee port. Further liberalization of FDI in the Budget 2002 is noteworthy, but FDI flows will increase only if reform is considered credible, and will escalate if the relaxation of the security situation appears longstanding.

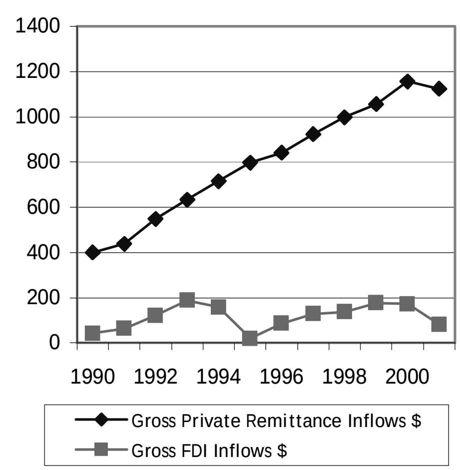
Domestic savings have been about 16 per cent of GDP, and Sri Lanka has increasingly relied on remittances from its workers abroad to bolster its *national* savings by about 7 percentage points of GDP. Gross inflows of private remittances over the last five years, primarily from the Middle East, amounted to US$5250 million over 1997-2001, and was 7 1/2 times greater than the gross flows of FDI, which totalled only

Figure 2.4
Domestic savings and investment



Source: Central Bank of Sri Lanka.

Figure 2.5
Importance of private remittances



Note: FDI inflows do not include privatization proceeds.

Source: Central Bank of Sri Lanka.

about US$700 in the same period (Figure 2.5).

The Savings-Investment gap is reflected in persistent current account deficits, which vary mainly with the trade deficit. Although the level of domestic savings may be difficult to expand for a poor country, the quality of investment that the savings have gone to must improve. The savings at the Employees' Provident Fund and Employees' Trust Fund have been captured to finance the burgeoning fiscal deficit, restricting scarce funds available for investment. The potential exists to stimulate savings at home among the higher income groups through pension reform.

2.4 Fiscal Policy

Reining in persistent and high fiscal deficits has become one of the most challenging macroeconomic issues facing the nation. Despite repeated attempts at fiscal consolidation enunciated in budgetary proposals over the 1996-2000 period, fiscal deficits averaged 8.8 per cent of GDP, reaching 10.9 per cent of GDP in 2001. Without exception, actual expenditure has tended to overshoot the forecast target, while total revenue collected has fallen short of the anticipated amount. Although the deterioration of the security situation led to escalating defence expenditure, 6.2 per cent of GDP in 2001, Government expenditure on interest payments on pensions, which support inefficient public corporations and a bloated bureaucracy, have kept expenditures high. Attempts to rationalize the public sector workforce have been lacklustre, and have fallen prey to electoral politics.

With the transition to the Goods and Services Tax (GST) in 1998, there has been a consistent shortfall in revenue collected. The non revenue neutrality of GST and initial administrative adjustments associated with the transition largely explain the shortfall. On the expenditure front, with defence expenditures and interest payments on debt continuing to absorb a large share of Government resources, room for expenditure cuts has remained limited. Where the opportunity has existed--in rationalization of public sector institutions and workforce--there has been a lack of policy commitment over the years. 2001 was no exception. The expected increase in tax revenue failed to materialize in the context of a stagnant economy and subdued consumer confidence.Tax relief measures offered in

Table 2.3
Fiscal targets and actual outcome, 1999-2001

	1999		2000		2001		2002
	Forecast	Actual	Forecast	Actual	Forecast	Actual	Forecast
Expenditure	24.5	25.2	26.3	26.7	26.9	27.4	26.1
Revenue	18.5	17.7	18.7	16.8	18.3	16.5	17.5
Deficit	-6.0	-7.5	-7.6	-9.9	-8.5	-10.9	-8.5

Source: Central Bank of Sri Lanka, *Annual Report*, various issues.

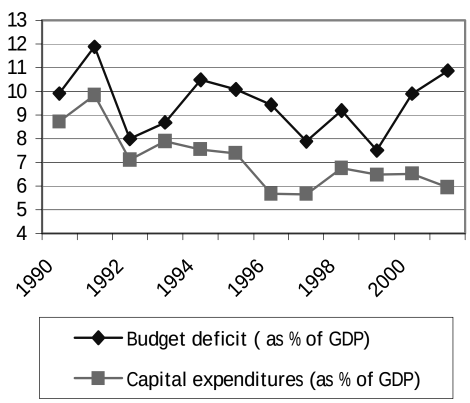
October 2001, including the reduction of the NSL rate from 7.5 to 6.5 per cent, affected the achievement of revenue targets.

On the expenditure front, slippage in containing current expenditures exacerbated by an increase in public sector salaries and pensions in October 2001 resulted in actual expenses exceeding the target for the year. In the event, the deficit was curtailed to 10.9 per cent of GDP by a significant reduction in capital expenditure allocation from 7.4 per cent to 5.9 per cent of GDP.

In order to contain deficits, capital expenditures have often been cut, resulting in a strong negative impact on infrastructure development--both physical and social--and, hence, medium term growth prospects. Besides, motives to contain overall expenditure, as current expenditure was less amenable to being slashed, took the form of capital expenditure being curtailed due to implementation delays especially with respect to foreign aid projects. In fact, whereas budget deficits have tended to overshoot the targets, capital expenditures have consistently been below budgetary targets (Figures 2.6 and 2.7).

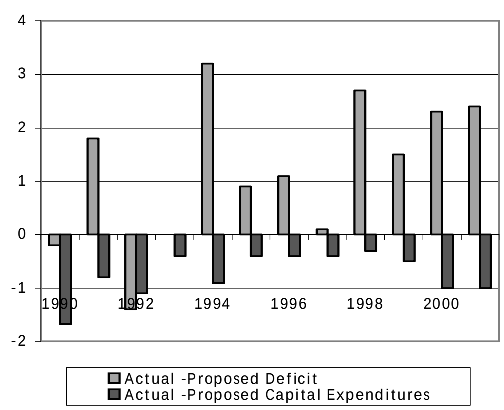
The budget for 2002 once again attempts to re-establish some measure of fiscal consolidation with a target deficit of 8.5 per cent of GDP. This is on the assumption that revenue will increase to 17.5 per cent of GDP, and that expenditure will be curtailed to 26.1 per cent of GDP. The introduction in August 2002 of a two-band Value Added Tax (VAT) is expected to generate additional revenue of Rs 3.5 billion. In the context of complications that may arise from the changeover to the VAT, subdued economic activity and the expansion of exemptions, the likelihood of realising this revenue goal is unlikely. In total, tax and non-tax revenue is projected to increase by 20 per cent in 2002, whereas for the last four years the increase in total

Figure 2.6
Capital expenditures and fiscal deficits



Source: Central Bank of Sri Lanka.

Figure 2.7
Budget targets and outcomes:
Capital expenditures and fiscal deficits



Source: Central Bank of Sri Lanka.

revenue has averaged 9 per cent per annum.

On the expenditure side, current expenditure is expected to fall to 21 per cent of GDP in 2002; but past experience does not bode well for meeting this target. Without exception, actual current expenditure has tended to exceed the forecast. Sharply reduced capital expenditure at a proposed 5.4 per cent of GDP has allowed the budgetary target to be scaled down, but the likelihood of achieving the overall fiscal target remains tenuous at best.

In fact, the data for the first half of 2002 indicate that compared to the first half of 2001, the budget deficit actually increased by 0.4 percentage points! (Table 2.4). This was due to reduced tax collection, and a slight *increase* in current expenditure. The only item consistent with the budget was the drastic drop in capital expenditure--with its deleterious impact on necessary infrastructure development.

Table 2.4 Fiscal outturn - 2002/2001

	1st half 2001 %GDP[1]	1st half 2002 %GDP[1]	1st half 2001 Rs. mn	1st half 2002 Rs. mn
Revenue	**19.5**	**18.5**	**119330**	**125622**
Tax	*17.0*	*15.5*	*103741*	*104944*
Income taxes	2.4	2.1	14382	13944
GST/turnover taxes	4.1	3.8	24844	26033
National Security levy	3.6	3.2	21799	21684
Excise tax	4.0	4.0	24317	27035
Stamp Duties		0.3	4227	2007
Port & Airport Development Levy		0.1	0	726
Debits Tax		0.0	0	0
Import duties	2.2	2.0	13633	13247
Motor vehicle and other licence fees	0.1	0.0	539	268
Non-tax	*2.6*	*3.0*	*15589*	*20678*
Expenditure	**29.6**	**29.0**	**180810**	**197097**
Current	*23.4*	*23.8*	*143200*	*161650*
Capital and lending	*6.2*	*5.2*	*37610*	*35447*
Current balance*	**-3.9**	**-5.3**	**-23870**	**-36028**
Overall balance**	**-10.1**	**-10.5**	**-61480**	**-71475**

Source: Ministry of Finance and Planning.
* Revenue minus current expenditure.
** Revenue minus total expenditure.
Note: 1/ %GDP: calculates shares of GDP using GDP data for the relevant six-month period.
The share of GDP figures above do not correspond exactly with Central Bank annual figures, because the latter use current GDP at *marke*t prices, which is not available publicly on a quarterly basis. These estimates of GDP are based on quarterly real GDP at *factor* prices, inflated by the consumer price index. These figures are likely to overestimate the size of the deficits slightly, but due to their consistency are useful in recognizing trends.

Tax collection was not only less than anticipated by the Budget 2002, but also below the outturn in the respective period in 2001 (as a share of national output). Lower taxes from income, GST, NSL and import duties were somewhat compensated by increases in non-tax revenue. Current expenditures failed to be contained. An analysis of developments on the expenditure side is not possible because disaggregated data on expenditures have not been available since the beginning of the year 2002.

2.5 Debt

The net result of accumulated fiscal deficits has been that Sri Lanka has come to be burdened with a considerable debt overhang, with total outstanding debt amounting to 103 per cent of GDP in 2001 (Table 2.5). The accumulation of a large debt burden can act as a major drag on medium-term GDP growth prospects. The Government's debt service payments on interest--at an estimated 7.4 per cent of GDP for 2002--is at its highest over the last two decades. Debt servicing on interest is estimated to absorb nearly 42 per cent of total Government revenue in 2002, allowing even less room to restructure fiscal expenditures. Privatization proceeds ideally should be used to retire debt rather than finance current fiscal deficits if Sri Lanka is to restore a sound macroeconomic platform in the medium term.

Domestic financing of the deficit continued to remain high, with the expanded deficit and failure of the privatization programme to generate expected revenue of 1.7 per cent of GDP. To minimize pressure on interest rates, the Rupee loan programme was used extensively among others, thus reversing a policy of market based borrowing adopted in recent years. In addition, the Government resorted to raising funds directly through the two State owned banks--outside the normal debt-financing programme--raising concerns about transparency in debt management. Financing of the deficit in 2002 may continue to pose difficulties in the event of a higher than anticipated deficit and failure to generate forecast privatization proceeds of Rs 21 billion.

Table 2.5
Outstanding debt and debt servicing (% of GDP)

	1997	1998	1999	2000	2001	2002[a]
Outstanding Debt						
Total Debt	85.8	90.8	95.1	96.9	103.6	101.2
Domestic	43.6	45.5	49.1	53.8	58.3	57.0
Foreign	42.3	45.3	45.9	43.1	45.3	44.2
Interest Payments on Debt						
Total Debt	6.2	5.4	5.6	5.7	6.7	7.4
Domestic	5.5	4.7	4.8	5.0	6.0	6.7
Foreign	0.7	0.7	0.8	0.7	0.7	0.7

Note: a. Budget Forecast.
Source: Central Bank of Sri Lanka, *Annual Report*, various issues.

Table 2.6
Deficit financing

	1997	1998	1999	2000	2001	2002[a]
Budget Deficit	7.9	9.2	7.5	9.9	10.9	8.5
Foreign Financing	1.9	1.7	0.7	0.4	1.4	1.7
Net borrowings	1.1	1.0	0.1	...	1.0	1.2
Domestic Financing	3.4	7.0	6.8	9.4	8.8	5.5
Market borrowings	4.5	7.1	6.8	9.2	8.8	5.5
Non bank	4.7	5.2	4.4	4.7	5.3	6.8
Bank	-0.2	1.9	2.5	4.5	3.5	-1.2
Privatization proceeds	2.5	0.4	...	...	0.6	1.3

Note: a. Budget Forecast.
Source: Central Bank of Sri Lanka, *Annual Report*, various issues.

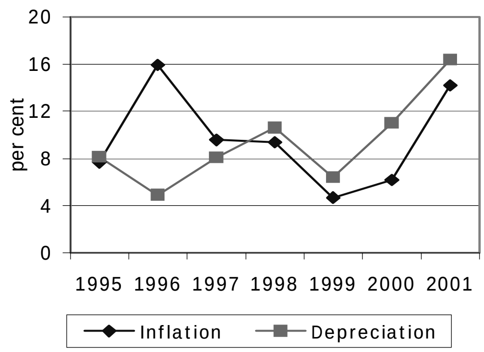
2.6 Inflation

Sri Lanka has been successful in gradually bringing down the rate of inflation from nearly 16 per cent in 1996 to 6.2 per cent in 2000, albeit assisted by favourable trends in global inflation. The rate of inflation for Asian economies as a group declined from 7.7 to 1.8 per cent over the same period. Inflationary pressure picked up significantly in mid-2000 in response to a one-off increase in the price level as a result of increases in utility rates and tax hikes (National Security Levy, surcharge on import duties). In addition, the lagged effects from significant depreciation of the rupee from mid-2000 contributed to rising inflationary pressure in 2001 (Figure 2.8). With a fiscal deficit of 10.9 per cent, the prospects of reining in inflation to 9.5 per cent--as spelt out in the budget for the year--was always going to be difficult. The rate of inflation for the year stood at 14.2 per cent as measured by the CCPI.

An economy in recession typically exerts a deflationary bias, and the gradual easing of inflationary pressure in early 2002 suggests some evidence of this. Nevertheless, the persistence of double digit inflation (estimated at 10.7 per cent in June 2002) prompted the Government to offer a series of relief measures to consumers in July 2002. These include a decision to exclude the imposition of VAT on a select list of essential consumer items and on pharmaceutical products. The relief measures also include a reversal of policy with regard to the loss recovery charge imposed on petroleum/diesel prices. While these measures may result in a marginal reduction of inflationary pressures in the short-term, the longer-term prognosis suggests a stubborn upward pressure on prices.

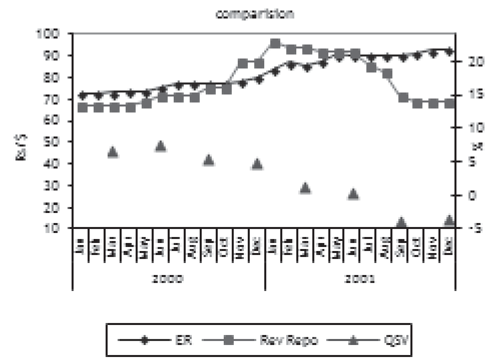
Inflationary pressure can be expected to remain high over the course of the year for a variety of reasons. Inflationary pressure will remain high as a result of deficit financing requirements, which could well be exacerbated if further losses are incurred by public enterprises as a result of a lid on price increases. Increases in utility rates will result in an one-off increase in the price level. In addition, if demand for imports picks up with the

Figure 2.8
Exchange rate movement and inflation: 1995-2001



Source: Central Bank of Sri Lanka, *Annual Report*, various issues.

Figure 2.9
Monthly exchange rate and interest rate movements: 2000-2001



Source: Central Bank of Sri Lanka, *Annual Report*, various issues.

expected turn-around in economic activity, downward pressure on the rupee will intensify given that there will be a time lag before export earnings recover. Of course, any substantive increase in oil prices--of which there are emerging signs in the context of unrest in the Middle East --will mean added pressure on external payments and downward pressure on the rupee. In all, inflation can be expected to be in the region of 10 per cent.

2.7 Monetary Policy

The rupee came under increasing pressure in mid-2000 as the decline in Sri Lanka's external reserves, which had been contracting gradually since the end of 1997, accelerated. Attempts directed at widening the bands proved ineffective in managing the exchange rate, given that the country had insufficient accumulated reserves to defend the currency. Finally, the Central Bank stopped announcing its buying and selling rates in advance on January 23, 2001 and the rupee was allowed to float. A series of administrative measures referred to as "temporary precautionary measures" were put in place to smooth out volatility in the currency, which were then gradually relaxed over time. In addition, a tight monetary policy--fuelled by deficit financing requirements towards the end of 2000--continued to be maintained into 2001 to provide some measure of indirect support for the exchange rate (Figure 2.3). While capital inflows in the case of Sri Lanka are not particularly interest-rate-sensitive, particularly of a closed capital account, de facto liberalization would have seen some movement of capital out of the country if not for the high interest rate regime.

The monetary authorities were in effect compelled to perform a balancing act in the face of rising inflation and downward pressure on the currency. Nevertheless, the implication was that as Sri Lanka's GDP growth contracted sharply from mid-2000, a tight monetary policy offered little support to ease borrowing for investment

Table 2.7
Export earnings growth in US$ (%)

	1995	1996	1997	1998	1999	2000	2001
Total agriculture	13.2	19.4	9.0	1.3	-10.7	2.9	-6.2
Tea	8.7	31.8	15.5	6.9	-18.3	9.5	-0.4
Rubber	47.5	-4.0	-25.4	-45.3	-22.9	-14.8	-16.0
Coconut	29.6	10.2	5.4	-20.4	40.3	-9.4	-31.2
Other agriculture	-0.7	1.4	8.5	16.5	-1.2	-8.5	-11.2
Industrial	14.7	7.9	12.8	3.9	0.8	17.0	-12.4
Garments	13.7	5.5	19.4	6.3	2.5	19.8	-13.1
Total exports	13.8	10.8	11.9	2.3	-1.5	16.4	-12.0

Source: Central Bank of Sri Lanka, *Annual Report*, various issues.

purposes or encourage consumption spending. As the downturn in the economy became more visible towards the second quarter of 2001 and import expenditure shrank, excess liquidity in the market allowed a loosening of monetary policy, and interest rates were allowed to slide accordingly. However, at that point, investor confidence had plummeted to, perhaps, its lowest in recent years, and there was very little likelihood that investors would take up the opportunity in a climate permeated with policy and political uncertainty. Domestic credit from the banking system to the private sector fell sharply in 2001 to record a growth rate of 8.9 per cent in contrast to an average of 14.5 per cent per annum for the period 1995-2000. While total investment as a ratio of GDP declined from 28 per cent in 2000 to 22 per cent in 2001, the sharpest decline was seen in the share of private sector investment. A steady increase in private sector investment observed in recent years was reversed, and it declined from 21.5 per cent of GDP in 2000 to just 16.2 per cent in 2001.

While the relatively low interest rate regime observed in the last quarter of 2001 has continued in the first half of 2002, private sector borrowing has remained fairly muted. Domestic credit to the private sector expanded by only 4.8 per cent during January-July 2002 compared to a rate of 6.3 per cent in the same period last year.

The relatively subdued economic recovery has meant less pressure on the rupee, recording a nominal depreciation of 3.3 per cent against the US dollar in the first six months of 2002. During the same period , the rupee depreciated by 11.5 per cent against the Euro, and appreciated marginally by 0.4 per cent against the Indian rupee.

2.8 External Sector

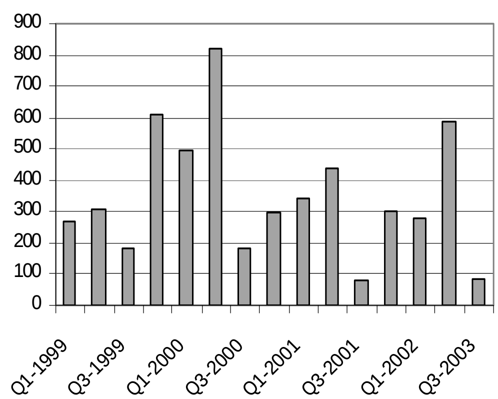
Sri Lanka's export sector has been battered by adverse developments in both the domestic and global economy. Export earnings showed strong growth during 1995-97 primarily as a result of very favourable international tea prices (Table 2.5). In the aftermath of the East Asian crisis however, the export sector contracted sharply in 1999. A strong recovery in 2000, buoyed by a healthy global economy, has once more given way to one of the worst years for the export sector in the country. Total export earnings contracted by as much as 12 per cent in 2001, reflecting an all-round poor performance.

While the global downturn, particularly the slowdown in the US economy, certainly impacted negatively on the demand for Sri Lanka's exports, the domestic policy environment was also not conducive to retaining international competitiveness. Interruption to power supply, increases in utility rates, high interest rates, and rising inflation were distinctly unfavourable trends in the domestic economy. The terrorist attack on the international airport and subsequent surcharges on port and air cargo consignments dealt a crushing blow to the export sector. In the face of rising inflation, the priority appears to have been to support exchange rate stability. This holds wider implications for the competitiveness of Sri Lanka's export and import competing goods sectors, if there is appreciation in the real exchange rate. The real effective exchange rate estimates of the Central Bank appear to suggest a real appreciation of around 2 per cent in 2001.

After a sharp increase in import expenditure of over 22 per cent in 2000, largely the result of high international oil prices, import expenditure in 2001 contracted by 18 per cent. Lower import expenditure was the result not only of lower oil prices, but also due to contraction in economic activity in the country. There was a 10 per cent contraction in expenditure on textile imports in intermediate goods, while capital import expenditure fell by as much as 38 per cent. Reflecting the deteriorating external environment, the downward trend in Sri Lanka's terms of trade since 1998 continued into 2001. The decline at just under 2 per cent in 2001 was relatively mild in comparison to a terms of trade deterioration of 6 per cent in the previous year.

The significantly lower import expenditure assisted in narrowing the trade deficit to 7.3 per cent from 10.7 per cent in 2000. Largely as a result of this, the deficit on the current account of the BOP declined to 2.3 per cent from 6.3 per cent in the previous year. This was despite a contraction of over 15 per cent in tourism earnings, and, more worryingly, a decline

Figure 2.10
Trade deficit Q1-1999/ Q3-2002
($million)



Source: Central Bank of Sri Lanka.

Table 2.8
Trade performance 2002/2001 ($ million)

	1st half 2000	1st half 2001	1st half 2002
Exports	**2471**	**2432**	**2012**
Agricultural	*475*	*458*	*443*
Tea	327	359	332
Coconut	39	19	14
Industrial	*1913*	*1864*	*1490*
Textiles and apparel	1321	1264	987
Other (non-petroleum) industrial products	544	567	472
Gems	*43*	*46*	*44*
Imports	**3786**	**3211**	**2875**
Consumer goods	*605*	*624*	*562*
Intermediate goods	*1936*	*1815*	*1700*
Petroleum	432	398	353
Textiles	759	692	646
Investment goods	*749*	*617*	*534*

Note: 2000 data for investment goods excludes $298 million for imports of aircrafts.
Source: Central Bank and Ministry of Finance and Planning.

in inward private remittances of US$ 35 million.

The Government envisaged an improvement in the balance of payments in 2001 with an overall surplus of US$ 140 million (assuming a total capital inflow of over US$ 650 million) on the basis of expected privatization proceeds of US$ 275 million and Government borrowing of US$ 200 million. The realised overall balance improved to US$ 220 million, despite a sharp drop in FDI to just US$ 82 million from US$ 173 million in the previous year, and net privatization proceeds being limited to US$ 90 million. The improvement in the overall balance came primarily from loan capital to the Government and a sharp increase in net short-term capital inflows to commercial banks. At the end of December 2001, Sri Lanka's gross official reserves stood at US$ 1338 million, up slightly from the total of US$ 1048 million at the same period in the previous year.

Export sector performance has continued to remain weak in the first half of 2002, with total export earnings contracting by 17 per cent during January-June 2002 compared with the same period in 2001. This reflected a decline in agricultural, industrial and gem exports. Export earnings from garments have seen the sharpest contraction of 22 per cent. Garments exports during the first half on 2002 were only 75 per cent of their levels over the same period in 2000.

At the same time, import expenditure has continued to contract in 2002, falling by over 10 per cent in the period January-June, following an even greater contraction of 15 per cent in the same period in 2001. The sharpest decline has

Table 2.9
External payments, 2000-2001 (US$ million)

	1st half 2000	1st half 2001	1st half 2002
Current Account	**-931**	**-316**	**-425**
Trade Balance	-1316	-779	-863
Services Account	13	113	81
Income Account	-162	-142	-125
Private transfers	521	480	468
Official Transfers	13	11	14.8
Capital & Financial A/C	**460**	**269**	**163**
Financial A/C Long term	317	183	143
-Government ,net	53	131	78
-Private ,net	179	52	65
Financial A/C Short-term	116	43	-6
Overall Balance	**-196**	**7**	**110**
Tourist arrivals ('000)	**206**	**227**	**173**

Source: Central Bank.

been in investment imports (over 13 per cent), signalling that the Sri Lankan economy is yet to indicate signs of renewed economic activity on a sustained basis.

2.9 Conclusion

A key lesson that is underscored by Sri Lanka's dismal economic performance in 2001 is that the country's structural imbalances on the macroeconomic front continue to constrain policy flexibility to meet internal and external shocks to the economy. High and unsustainable fiscal deficits with accompanying inflationary pressures left little policy flexibility to provide a stimulus through either expansionary fiscal and/or monetary policy measures. While signs of a gentle recovery in the global economy is becoming more discernible, the improvement is expected to be fairly modest, and is unlikely to provide a strong stimulus to domestic economic activity. A forecast growth rate in the region of 3 – 4 per cent for Sri Lanka in 2002 is certainly within its grasp, if only for the reason that the economy will be rebounding from a very low base performance in the previous year. The bigger challenge the country faces as it pursues a settlement to its civil conflict will be to ensure that the recovery is sustained and picks up pace over the next 2-3 years.

3. International Environment

3.1 Introduction

The global economy in 2002 has been characterized by moderate growth and the persistent threat of recession. Attempts at recovery were strong in the early part of the year, but the vigour of the rebound dissipated amidst increased uncertainty, with some analysts even fearing a double dip recession. The latest data from the US and the EU indicate that consumer confidence and demand are decelerating, which is disappointing at the time when investment remains on hold due to the continued fallout from the corporate accounting scandals, misstatement of earnings and uncertainty regarding the war with Iraq.

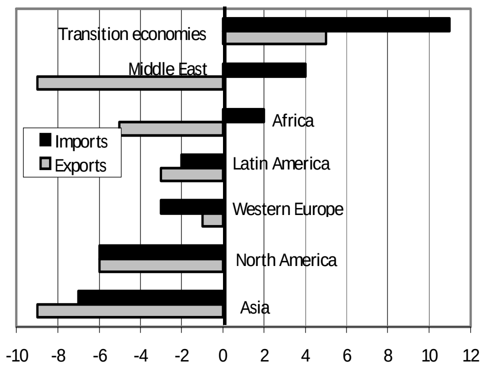
Although the recession in 2001 was mild compared to the downturn in 1991, world output growth slowed to 2.5 per cent in 2001 from 4.7 per cent recorded in 2000. The deceleration was a result of slowdown in the US economy, interrupted recovery in Japan and weak growth in the European Union. The economic downturn has been widespread, affecting virtually all regions and countries. The global slowdown was brought on by the bursting of the IT bubble, run up of oil prices in 2000, tightening of monetary policies in advanced countries between 1999-2000 and increasing linkages between countries. The September 11,2001 terrorist attacks in the US intensified the downturn.

In order to mitigate the downturn, monetary policies in the developed countries were significantly eased. The US for example, lowered its interest rates eleven times during 2001 to a low level of 1.75 per cent (the lowest in 40 years) in order to avert a recession. Similarly, the EU and the UK brought down their interest rates during the year. Japan further lowered its interest rates to an almost zero level. American fiscal policy has also been expansionary with increased defence spending and tax cuts.

Although the first half of 2002 figures were promising, with the EU and East Asia benefiting from US demand growth, data since then give mixed signals at best, and most likely reflect an economic stagnancy. No doubt the uncertainty resulting from corporate malfeasance and opaque accounting have widened risk spreads and increased the cost of capital. Foreign investment into the US has dropped significantly (see Figure 3.1). A significant indicator of the faltering American recovery was the November 2002 Federal Reserve interest rate cut (the first in about a year) by a half percentage point to 1.25 per cent.

Although the European Central Bank did not respond with a similar immediate drop in interest rates, it is expected to do so in December. The EU is facing economic stagnancy, with the euro zone as a whole growing by a mere 1 per cent. The strain on the European economies is apparent as reflected in the postponement of the balanced budget requirement of the Growth and Stability Pact that governs European monetary union, from 2004 to 2006 for Germany, France, Italy and Portugal. Further, Portugal exceeded the stipulation in the Pact that budget deficits could

Figure 3.1
Growth in world merchandise trade by region, 2001 (% change)



Source: WTO, Director General's Report, November 2002.

not exceed 3 per cent of GDP- by registering a budget deficit of 4.1 per cent of GDP. Germany, and possibly Italy and France, may also exceed the 3 per cent ceiling in 2002, as they scramble to provide a fiscal stimulus to their stagnant economies. In fact, the Pact was viewed as a straightjacket, (even "stupid" in the words of the head of the European Commission, Romano Prodi) forcing Governments to adopt austerity budgets when they needed to be greasing their economies instead.

Worldwide, not just in the US and the EU, economies are revising downward their growth forecasts for 2002. The weak demand in the US economy and the possibility of a war with Iraq stifle recovery. At a regional level, the Bali bombings are also likely to have an adverse impact on investor confidence in the South-East Asian region, as reflected by Singapore reducing its growth forecast from 3-4 per cent to 2-2.5 per cent. The global economy is facing increasing levels of uncertainty and the outlook for 2003 does not look much better than 2002.

This section looks at developments in the international economy and how they affect the Sri Lankan economy. Firs,t it looks at the growth in developed and emerging markets, and then looks at global trends in trade and capital flows. Next, it considers the policy developments in the multilateral trading environment, as reflected in the WTO's Doha Development Agenda. Lastly, it directly considers the impact of global developments on the Sri Lanka economy.

3.2 Developed Countries

Global economic growth was robust in 2000 and was sustained by the strong performance of the US economy. However, the most recent phase of expansion in the US, which began in the second quarter of 1991, ended in March 2001. A drastic correction in the high tech sector caused the stock market to tumble in the US and contributed to a sharp economic downturn, which was exacerbated by the September 11,2001 attacks. The US growth rate in 2001 fell to 0.3 per cent from 3.8 per cent recorded in 2000. Due to an aggressive macroeconomic stimulus (interest rate cuts, tax rebates, extra expenditure by the Government in the wake of the terrorist attacks), the US economy is expected to grow by 2.2 per cent in 2002. Although, during the first quarter of 2002, output growth was surprisingly strong, the pace of the recovery has decidedly slowed.

In the EU, falling demand for its exports weakened its growth considerably in 2001. GDP growth fell by half in 2001 from 3.5 per cent in 2000. The slowdown has been comparatively less than that of the US, though it varies across the member countries. Countries, which were less involved with ICT, especially the four largest economies of France, Germany, Italy and the UK were less affected than countries such as Finland,

Table 3.1
Selected indicators of global economic conditions, 1998-2002

		1998	1999	2000	2001	2002
Economic Growth (% change)						
World		2.8	3.6	4.7	2.2	2.8
Advanced Countries		2.7	3.3	3.9	0.8	1.7
US		4.3	4.1	4.1	0.3	2.2
Japan		-1	0.7	2.2	-0.3	-0.5
EU		3	2.7	3.4	1.6	1.1
Developing Countries		3.5	3.9	5.7	3.9	4.2
Developing Asia		4	6.1	6.7	5.6	6.1
Transitional Economies.		-0.8	3.6	6.6	5	3.9
Growth in Trade Vol. (%)						
World Trade		4.2	5.3	12.4	-0.1	2.1
Advanced	Export	4	5.2	11.7	-1.3	0.9
	Import	5.9	7.8	11.6	-1.5	2.1
Developing	Export	4.8	4.3	15	3	4.8
	Import	-0.8	1.3	16	2.9	6.4
Sri Lanka	Export	0.1	5	18.3	-8	..
	Import	12.4	0.2	12.9	-10.7	..
Commodity Prices (US$)						
Oil		-32.1	37.5	57	-14	0.5
Non-fuel		-14.7	-7.1	1.8	-5.5	4.2
Inflation Rate (%)						
Advanced Countries		1.5	1.4	2.3	2.2	1.4
Developing Countries		10.6	6.9	6.1	5.7	5.8
Interest Rates (LIBOR) on deposits of						
US		4.9	4.8	6	3.5	1.8
Japan		0.2	0	0.2	0	0
EU		4	3.1	4.5	4.2	3.4
Exchange Rates (US$ nominal exchange rates)						
Euro		...	1.067	0.924	0.895	0.874
Yen		130.9	113.9	107.8	121.5	131.2
Capital Flows (US$ Bn.)						
Net Official		36.8	29.8	12.8	50.1	41.7
Net private		63.2	33.3	4.0	28.6	42.2
Direct Investment		130.2	131.9	126.1	149.5	119.3

Source: IMF, *World Economic Outlook*, September 2002.

Ireland and Sweden, which are on the forefront of ICT in the EU. Recovery in the euro area in 2002 is broadly similar to the US, but the pace slightly slower. The EU is expected to grow by 1.1 per cent for the year as a whole. The year 2002 also marked a significant milestone in the economic integration process in the EU, as the single currency, the EURO was smoothly introduced in the 12 member countries of the European Union from 1 January 2002.

The economic slowdown in the US and the EU was accompanied by reversal of growth in Japan, which displayed initial signs of recovery in 1999-2000. The recovery, which was driven by growth in the US, upturn in Asian economies and a surge in capital expenditure of Japanese corporations, faltered as the external environment turned unfavourable, and new domestic corporate investment expenditure halted. Growth was barely visible in the first half of 2001 and unemployment stood at 5.6 per cent by end of 2001-the highest since 1953 when official unemployment records were kept. The Japanese economy slid back into recession by the third quarter of 2001, registering a negative growth of 0.4 per cent for the whole year. In the latter part of 2001, falling stock prices further affected the already low confidence in the economy. Although exports are recovering as result of a weaker yen, recovery remains fragile. Deflation has become an entrenched feature of Japan's economic problem, further reducing demand, and the extra money being pumped into the ailing banking system has failed to increase lending and spending in the economy.

In 2002, Japan has shown three consecutive quarters of positive GDP growth (by a quarter on quarter measurement basis) – however, economic growth in the last two quarters has been largely driven by an accumulation of inventories following massive reductions in previous quarters. Although overall annual GDP growth is likely to be positive but less than 1 per cent, declines in exports and capital spending in the third quarter of 2002 are not encouraging.

3.3 Emerging Markets

The global slowdown affected all developing countries. The rate of economic growth in the developing countries fell from 5.7 per cent in 2000 to 4 per cent in 2001, largely due to an adverse external environment. Countries heavily dependent on ICT-related exports suffered from slowdown in the industry. Countries exporting commodities saw low prices falling to much lower levels, and countries relying on foreign finance experienced reduced inflows of capital.

Economic growth in Asia slowed down in 2001 with countries in East Asia like Singapore and Taiwan falling into recession. Other countries such as Malaysia and Korea, which are also highly dependent on the ICT sector and have a large exposure to the US and Japanese markets, suffered considerably. The Hong Kong economy continued to suffer. On the other hand, China grew by an impressive 7.3 per cent in 2001, largely due to strong domestic demand, particularly public investment. Growth in China is expected to remain relatively resilient at 7-8 per cent. The change in the Chinese political leadership is not likely to bring a change in the direction of economic policy.

South Asia too experienced a slowdown due to the deteriorating external environment and other factors such as political uncertainties, an increased oil bill and poor weather conditions. South Asia was particularly affected by the war in Afghanistan in terms of war risk premiums on shipping in the region, which adversely affected trade in the latter part of 2001 and reduced tourist arrivals to the region. Indian growth remains strong, although the Reserve Bank of India did downgrade its 2002 GDP forecast from 6-6.5 per cent to 5-5.5 per cent in November 2002.

In the Middle East, growth in 2001 has been adversely affected by lower oil prices, despite attempts to shore up prices by restraining supplies, as well as the deterioration in the security situation in the region. Saudi Arabia and Kuwait have registered a slowdown, but the Jordanian economy is expected to grow by about

5 per cent. Turkey, which was afflicted by a serious financial and currency crisis in 2001, is gradually recovering from the severe recession. However, the economy remains vulnerable to adverse shocks.

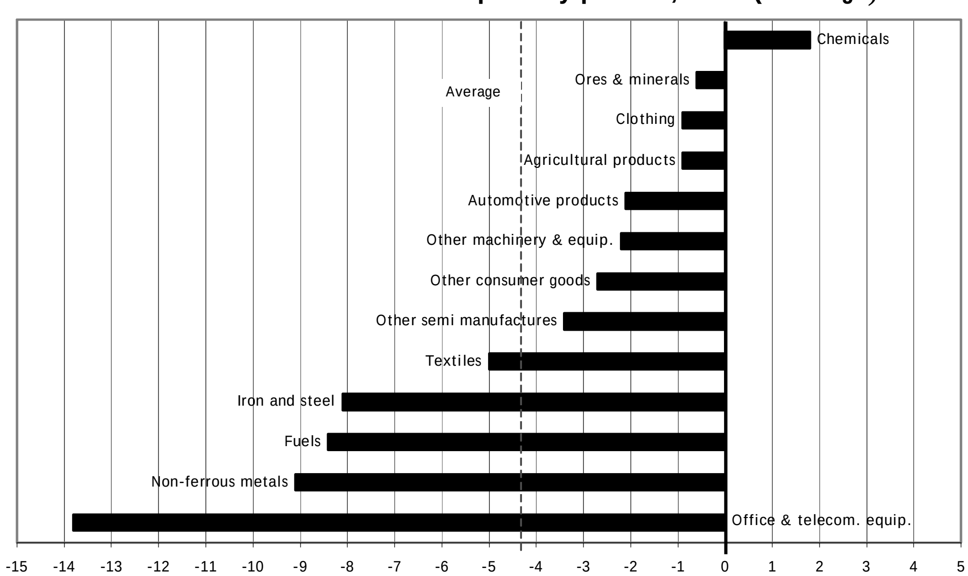
In Latin America, growth fell to 0.7 per cent in 2001 (from 4.0 per cent in 2000) as a result of a deceleration in the region's major economies and the deepening crisis in Argentina. Causal factors include weaker demand for exports, the poor external financial environment and the fall in commodity prices. Mexico and other Central American countries, which are closely linked to the US economy, suffered from the slowdown in the US. In 2002, economic activity in the three largest economies are mixed, with Mexico slowly pulling out of recession (2002 GDP forecast at 1.5 per cent) and Brazil likely to register a 1 per cent growth in 2002 due to a slowdown in the growth momentum. Argentina on the other hand, remains mired in a depression- with output likely to decline by as much as 15 per cent. Ongoing political uncertainty in Argentina does not bode well for investor confidence and a recovery anytime soon.

In contrast to most regions, growth in the Commonwealth of Independent States has been relatively unaffected by the global slowdown, falling slightly to 6.2 per cent. This was underpinned by solid growth in Russia and Ukraine. Activity in central and eastern European economies has also held up well, aided by robust domestic demand and foreign direct investment into the region.

3.4 Trade and Capital Flows

Growth in world trade declined sharply to a negative 1.5 per cent in 2001 (the first contraction since 1982) from 12.4 per cent

Figure 3.2
Growth in world merchandise exports by product, 2001 (% change)



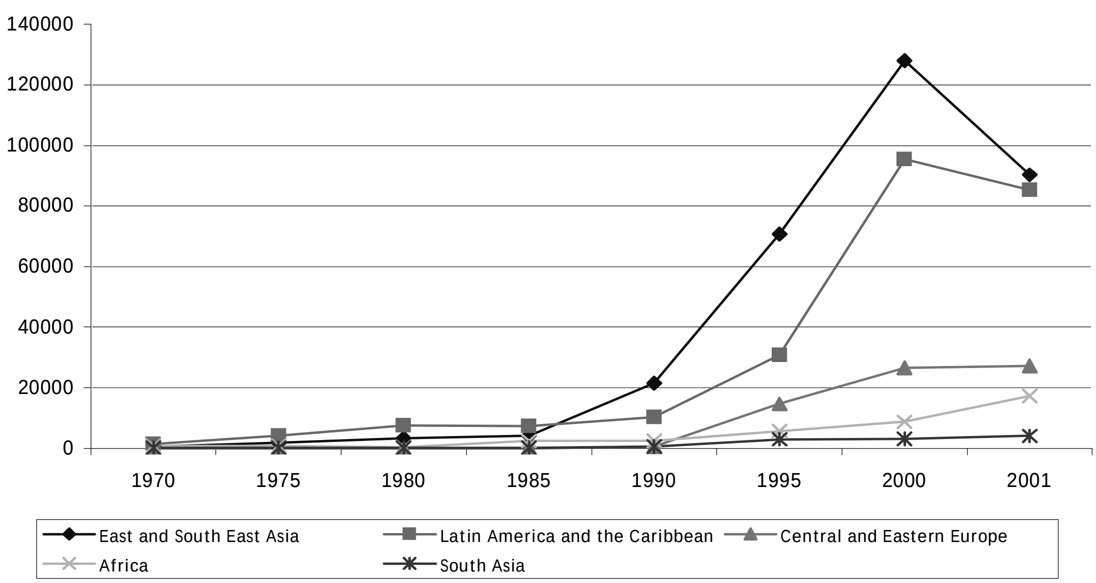
Source: WTO, Director General's Report, November 2002.

recorded in 2000, thus posing a major challenge for the world economy and in particular for trade-dependent developing countries, such as Sri Lanka. Growth in exports and imports was positive only in transitional economies (Figure 3.1). Exports of all product categories registered a decline in 2001, except for chemicals, which reflected a growth in pharmaceutical product exports (Figure 3.2). It is expected that there will be a marginal recovery in 2002, but much of it is expected to be concentrated in the second half of the year.

The decline in international trade was accompanied by a decline in international prices of commodities, manufactured goods and oil in 2001. Weak prices for most commodities and manufactured goods reflected over supply in commodity production and manufacturing. Non-fuel commodity prices fell by 5.5 per cent in 2001, compared to an increase of 1.8 per cent in 2000. Production restraints and low inventory levels of oil in the US contributed to a sharp rise in prices in 2000 by nearly 57 per cent but they declined by 14 per cent in 2001 reversing the upward trend seen in the past two years. Oil prices rose in 2002 and they will remain sensitive to political developments in the Middle East as well as the severity of winter in the northern hemisphere, among other factors. Volatility in the oil market can become a significant potential risk to the ongoing recovery underway.

International financial markets were adversely affected by the sharp downturn in the US, interrupted growth in Japan and slow expansion in Europe. Following Sept 11 events, there was considerable uncertainty in the financial markets and risk aversion on the part of private capital, which made access to capital markets difficult for developing countries. Although stock markets recovered following the September 11 attacks,

Figure 3.3
Direct investment inflows into emerging markets, 1970-2001 (millions of US $)



Source: World Investment Report 2002, UNCTAD.

they have slid in 2002, with a sharp drop in the third quarter of 2002, amidst uncertainty caused by accounting scandals in the US, starting with the collapse of Enron. The financial crisis in Argentina has had a limited effect on the rest of the world and contagion has so far been contained.

Foreign direct investment tumbled in 2001 after reaching record levels in 2000. Dramatic declines in inflows were registered the US and the EU (see Table 3.2). However, FDI into Africa almost doubled to reach US$ 17 billion in 2002, but the increase was concentrated in South Africa. Among the other few nations to register significant increases in FDI were Mexico, China, Singapore and to a lesser extent India.

In foreign exchange markets, the US dollar strengthened against all other currencies in 2001 despite the slowdown in the US economy. While the Japanese yen has been volatile throughout the year and weakened considerably against the dollar, the EURO and British Sterling have been relatively stable and depreciated only moderately. However, with the resurgence of the US economy in early 2002, and the slump in the US stock market, the US dollar has begun to

Table 3.2
Foreign direct investment inflows, 1970-2001 (Millions of US dollars)

	1970	1975	1980	1985	1990	1995	2000	2001
Bangladesh	-	-	(a) 9	(a) -7	3	2	280	78
Cambodia	(a) 0	(a) 0	(a) 1	-	-	162	179	(p) 113
China	-	-	57	1,659	3,487	35,849	40,772	(a) 46,846
Hong Kong, China	(a) 50	(a) 377	(a) 710	(a) -267	(a) 3,275	(a) 6,213	61,938	22,834
India	(a) 45	(a) 85	(a) 79	(a) 106	(a) 237	2,151	2,319	3,403
Indonesia	83	476	180	310	1,092	4,346	-4,550	-3,277
Malaysia	94	350	934	695	2,611	5,816	3,788	554
Maldives	-	(a) 2	(a) -0	(a) 1	6	7	13	(a) 12
Myanmar	-	(a) 3	(a) 0	-	161	277	255	(p) 123
Nepal	-	-	(a) 0	(a) 1	(a) 6	(a) 8	0	(a) 19
Pakistan	23	25	64	47	250	719	305	385
Philippines	-25	98	-106	12	550	1,459	1,241	1,792
Republic of Korea	66	57	6	234	789	1,776	9,283	3,198
Singapore	93	292	1,236	1,047	5,575	8,788	5,407	8,609
Sri Lanka	0	0	43	26	43	65	178	172
Taiwan	62	34	166	342	1,330	1,559	4,928	4,109
Thailand	43	86	189	164	2,562	2,068	2,813	3,759
Viet Nam	(a) 0	(a) 4	(a) 0	(a) -0	180	1,780	1,289	1,300
European Union	**5,127**	**9,879**	**21,317**	**15,879**	**90,213**	**114,439**	**808,519**	**322,954**
United States	**1,260**	**2,560**	**16,918**	**20,490**	**48,422**	**58,772**	**300,912**	**124,435**
Mexico	**323**	**609**	**2,090**	**1,984**	**3,374**	**9,552**	**14,706**	**24,731**

Note: (a) estimate; (p) preliminary data.
Source: World Investment Report 2002, UNCTAD.

weaken against the Yen and EURO. The dollar reached parity with the Euro in July 2002 for the first time since February 2000.

Notwithstanding the global slowdown in 2001, official development assistance (ODA) has been on a declining trend since 1999. ODA is unlikely to rise except for emergencies, such as that affecting Afghanistan or for natural disasters. The substantial amount of the ODA pledge to Afghanistan in January 2002 was a major development, given the increasing paucity of aid worldwide.

3. 5 Doha Development Agenda

The Fourth Session of the Ministerial Conference of the World Trade Organisation (WTO) held in Doha, Qatar in November 2001 launched a new work programme to deal with the challenges facing the multilateral trade environment. The last attempt to launch a new global trade round in Seattle in 1999, ended in a welter of recriminations. Differences between rich and poor nations, and among some of the rich nations themselves, set against a background of massive, sometimes violent, street protests, spelled the doom of the December 1999 Conference. Just a few months before the Doha meetings, the odds looked stacked against any agreement given the rapidly slowing world economy. Ironically, the acceleration of the global economic slowdown, and the terrorist attacks of September 11th provided a significant incentive for the rich countries to offer the sort of concessions needed to strike a bargain. In fact, though the outcome at Doha does not technically launch a new round of trade negotiations, but only a work programme, there is a clear emphasis that it is to be a “development” agenda- i.e., to support developing countries.

The Doha Conference adopted a) a Ministerial Declaration, b) a Declaration on Implementation-related Issues and Concerns, c) a Declaration on TRIPS Agreement and Public Health. In spite of the concerns expressed by many delegations on the processes adopted at the Doha Ministerial meeting, most delegations said that the outcome of Doha was positive with some benefits to all members. A significant feature of this Conference was that the developing countries managed to have their voices heard. The Like Minded Group (LMG) of developing countries with the bigger nations such as India, Brazil, South Africa, Egypt, Malaysia and Pakistan in the forefront, were successful in obtaining redress for their grievances, to an extent not thought possible. With China now also a member of the WTO, developing countries will gain further strength.

Critics however say that the success at Doha was more apparent than real, and that differences were not sufficiently addressed. The Doha Agreement is said to be so vague, that it lays itself open to different interpretations by different countries. The delegations at Doha may also have given themselves insufficient time - a mere three years- to conclude their work, when the Uruguay Round negotiations took over seven years. The Work Programme is to be concluded not later than 1st January 2005. If the negotiations succeed, there could be gains for the developing countries. They should gain better access to rich country markets for textiles and agricultural products. They would find it easier to benefit from drug patent exemptions, when public health needs justify them, and they have been promised assistance in navigating through the intricate rules that make up the world trading system. However, for these benefits to materialize, the richer countries will have to deliver on their commitments. Both the U.S.A. and European Union have made concessions more than what they would have preferred, in order to obtain consensus.

TRIPS and the Public Health Triumph

Trade Related Aspects of Intellectual Property (TRIPS) was the major victory for developing countries. Unlike traditional liberalization where both liberalizer and trading partner gain, TRIPS involves a one-way transfer of royalties from user (poor) countries to producer (rich) countries. Western nations led by the U.S.A. and Switzerland, home to many multinational drug companies, felt that patent protection under TRIPS should not be weakened, saying that drug companies should not be discouraged from investing in research into new medicines. However, the text, which emerged whilst affirming its commitment to the TRIPS agreement, stated that 'it does not and should not prevent WTO members from protecting public health'. The Ministers recognized the gravity of the public health problems afflicting many developing and least developed nations, especially those resulting from HIV / AIDS, malaria, tuberculosis and other epidemics.

Most importantly, each country has the right to determine what constitutes a national public health emergency. Countries could override patent protection on drugs, when public health needs justify it. This flexibility would provide for parallel imports and compulsory licensing. The former occurs when there are price differences for the same product in different markets, and imports from the low–price country are allowed for resale in the high-price country, without the permission of the patent holder. The latter is the authorization given by a Government to produce a patented product, without the approval of the patent holder, though the holder is due "adequate compensation". The benefits of compulsory licensing will accrue to countries that have manufacturing capacities in the pharmaceutical sector.

Geographical Indications and Bio-Diversity

This sector witnessed some positive developments at Doha. The Ministerial Declaration recognized the possibility of extending protection of geographical indications to other products (e.g., Ceylon tea and Basmati rice) beyond just wines and spirits. There was greater acknowledgement of the need to protect traditional knowledge and folklore, and bio-diversity through the possible harmonization of TRIPS with the Convention on Bio-Diversity, and similar treaties.

Anti-Dumping

The United States also gave ground by agreeing to discuss anti-dumping. The American view was that it was no more than agreement to clarify existing rules, but other countries may aim to improve the current set of rules.

Agriculture -- Breakthrough?

Agriculture remains distorted by protection and domestic subsidies. While average tariffs on manufactured goods have declined from 40 per cent to 4 per cent over the past fifty years, agricultural tariffs have remained at around 40 per cent. The OECD countries spend more than US$ 300 billion a year supporting their farmers- that is as much as the entire national product of sub-Saharan Africa. The Agreement called for:

- substantial improvements in market access

- reductions of, with a view to phasing out, all forms of export subsidies
- reductions of support that distort trade

Special and Differential Treatment (SDT) to developing countries was recognized as an integral part of the negotiations, and developing countries were allowed flexibility in promoting food security and rural development. Subsidies to peasant farmers that existed on September 1, 2001 could be continued.

Uruguay Round Implementation Issues -- Acknowledged

Many developing countries were unaware of the full implications of the WTO Agreements they committed themselves to in the Uruguay Round, and faced serious problems in implementing the agreements. They were weary on embarking on new negotiations without first solving implementation issues of the Uruguay Round. Over 100 issues relating to implementation and the inherent asymmetries and imbalances within the WTO Agreements, were brought up in the 2 years prior to the Doha meeting. By the end of the Doha meetings, only about 40 were settled. The Declaration states that negotiations on outstanding implementation issues shall be an integral part of the Work Programme.

Special and Differential Treatment -- Prominent

In Doha, developing countries made strong and successful arguments that special and differential treatment should be made more precise, effective, operational and mandatory. The Ministers agreed that all special and differential treatment provisions be reviewed with a view to strengthening them. Special and differential treatment for developing countries was glossed over in the Uruguay Round negotiations, though provided for in Part IV of the GATT, and reaffirmed in the Declaration launching the Uruguay Round.

Textiles -- Little Headway

Developing countries failed to achieve an acceleration of trade liberalization specified in the Agreement on Textiles and Clothing (ATC), as industrialized countries maintained they were technically observing the stipulations of the ATC. Under implementation issues, developing countries expected some concessions, such as the most favourable "growth on growth" methodology when calculating quota expansion. This would have allowed the pre-specified growth rate of the quota to be based on the *current* level of imports, instead of the *initial* base quantity of the bilateral quota agreement. The only concession was for small suppliers- they were granted the "growth on growth" methodology, and where possible, elimination of quota restrictions. This would have benefited Sri Lanka only in the European Union and Canadian markets where she is a small supplier. (However, quota restrictions have already been suspended under the Memorandum of Understanding signed with the European Union).

An important concession obtained was that anti-dumping investigations would not be initiated for two years, in respect of textiles and clothing exports of developing countries, previously subject to quotas. This was proposed to prevent the elimination of one form of protection (quotas) being immediately replaced by another instrument of protection (anti-dumping duties).

Market Access

Developing countries gained market access for non-agricultural products. Member countries agreed to negotiate a reduction/ elimination of high tariffs including reduction or elimination of tariff peaks and tariff escalation (i.e., increases in tariff rates according to the stage of processing which penalizes developing countries trying to process their exports).

Small Economies

Agreement was reached on a Work Programme to examine issues relating to the trade of small economies and their further integration into the multilateral trading system, without explicitly creating a sub-category of WTO members. Sri Lanka was active in getting such a Work Programme inserted into the Ministerial Declaration, though there is no guarantee that Sri Lanka will be classified as a small economy since there is currently no clear definition of small economies.

Services

The Ministers recognized the work initiated in January 2000 under Article XIX of the General Agreement on Trade in Services (GATS), and the large number of proposals submitted by members on a wide range of sectors and issues, as well as on the movement of natural persons. Participants were to submit initial requests for specific commitments by 30 June 2002, and initial offers by 31 March 2003.

Electronic Commerce

The Ministers took note of the work done since 1998, and agreed to continue the work on electronic commerce. The work up to now, demonstrates that electronic commerce creates new challenges and opportunities for trade at all stages of development. Members were directed to maintain their current practice of not imposing customs duties on electronic transmissions.

Technical Cooperation and Capacity Building

The Ministers confirmed that technical cooperation and capacity building are core elements of the development dimension of the multilateral trading system. WTO assistance shall be designed to assist developing, least developed and low-income transitional economies, to adjust to WTO rules and disciplines, implement obligations and exercise the rights of membership.

Least Developed Countries (LDCs) -- Trouble for Sri Lanka?

The Ministers recognized that the integration of the LDCs into the multilateral trading system required meaningful market access, support for the diversification of their production and export base, and trade-related technical assistance and capacity building. The Ministers affirmed the objective of duty free, quota free, market access for products originating from LDCs. This could lead to reduced market share for Sri Lankan exports.

Singapore Issues -- Postponed

Negotiations on the four ‘Singapore issues’ of trade and investment, trade and competition, trade facilitation, and transparency in Government procurement, will begin only after ‘explicit consensus’ by all WTO members. Thus, the 1996 Singapore Declaration made at the WTO Ministerial meeting of that year, will remain. These four issues will be taken up for consideration at the next WTO Ministerial meeting to be held in Mexico in 2003. This decision was a setback for the European Union in particular. For both investment and competition policy, the European Union wanted broad rules that would govern the multilateral system. However, more than half of WTO members do not even have competition authorities, and the United States is concerned that any multilateral competition rules would undermine its domestic laws. A multilateral investment agreement will indeed be challenging, given that even OECD countries failed to come to such an agreement within the OECD several years ago.

Where all four 'Singapore issues' were concerned, the Conference affirmed the need for enhanced support for technical assistance and capacity building in these areas, for developing and least developed countries. Further work in the respective Working Groups would continue until the next Ministerial meeting, where a decision by 'explicit consensus' would be taken on all four issues. However, there is bound to be different interpretations of how 'explicit consensus' can be reached.

Labour Standards -- Postponed

In spite of opposition by many developing countries to the linkage of trade with non-trade issues, such as core labour standards, it still remains in the Ministerial Declaration. There was however no commitment beyond the 1996 Singapore Ministerial Declaration, and work would continue in the International Labour Organization.

Environment -- in!

The European Union was in the forefront of promoting trade and environment issues, and succeeded in getting this item on the agenda of the Work Programme. The main focus of the negotiations would be on the relationship between existing WTO rules, and specific trade obligations set out in multilateral environmental agreements (MEAs). However, developing countries are suspicious that the European Union wants to use environmental issues as a protectionist device. They recall that a discussion on 'counterfeit goods' in the GATT, ended up as the TRIPS agreement in the Uruguay Round. It is said that the European Union was able to obtain a stronger text on environmental issues, in return for the phrase 'with a view to phasing out all forms of export subsidies' in the text on Agriculture.

Export Subsidies and the US$1000 Threshold

Sri Lanka, as a country whose per capita income is less than US$ 1000, is currently in Annex VII of the Agreement on Subsidies and Countervailing Measures (SCM). These countries can grant (generally WTO illegal) export subsidies, for example to Board of Investment (BOI) enterprises. However, these export subsidies have to be phased out when a country reaches a per capita income of US$1000. Under Implementation Issues, it was decided that the calculation of the US$ l000 threshold should be based on constant 1990 US dollars, and a country should exceed this for three consecutive years to be ineligible. According to this formulation, Sri Lanka could continue with her current subsidies until approximately 2010, as the national per capita income is US$660 in constant 1990 dollars, as against US$840 at current prices.

"Development Box" and Net Food Importing Countries -- out!

In the Committee on Agriculture, a group of developing countries including Sri Lanka were pressing for the inclusion of the concept of a 'Development Box' and also addressing the problems of Net Food Importing Developing Countries (NFIDC) as an integral part of the negotiations. The 'Development Box' called for broad flexibility, rather than specific policies that would assist low-income farmers. They could for example, be exempt from WTO commitments on increasing market access for imported staple food that they also produce. These countries could also negotiate higher tariffs or use safeguards to protect their staple foods. However, the concept of a 'Development Box' did not find its way into the text which was adopted, nor were there references to the NFIDCs.

Beyond Doha

The Doha Development Agenda has restored some confidence in the multilateral trading system. There appears a greater urgency as well to promote trade, as there exists a perception (stated by the Americans) that greater trade and resulting higher incomes will stem the growth of marginal elements in poor countries taking up terrorist activity. However, the outcome of Doha and the launch of a new round of multilateral trade negotiations is not clear.

- The continued proliferation of preferential trade arrangements (PTAs), estimated at 240 currently in force, is testimony that all bets are not on the WTO! The European Union and the Latin American countries have been active supporters of PTAs, but more recently, it appears to have spread to some countries in Asia including Japan and Singapore -which were once staunch defenders of multilateralism. China and the ASEAN countries have also agreed to consider moving toward a free trade area, embracing 1.7 billion people and two-way trade worth 1.2 trillion dollars. In the U.S.A, the Bush Government continues to be very supportive of a Free Trade Area of the Americas. However, since the Bali bombings, it has also explicitly stated an interest in establishing bilateral free trade agreements with individual Asian nations. These agreements pose a systemic threat to the multilateral trading system by discriminating against outside countries and creating a complex network of trade regulations.

- The increased protection in the United States also was a major setback for global trade negotiations. The March 2002 US imposition of tariffs of around 30 per cent on steel imports precipitated strong trade tensions with the European Union, Japan, Russia, Australia, Republic of Korea, and China. Further, the May 2002 decision to increase farm subsidies by US$ 51.7 billion over the next six years has caused an uproar in many countries. It jeopardizes the Doha Work Programme, since reduction of farm subsidies was an important component of the Doha Declaration and since major trading nations are involved in the trade dispute over steel.

- Although the discussion on labour standards, competition policy, and Government procurement has been postponed, some developing countries are wary of a trend in WTO negotiations. They cite that in the GATT, the trade offs were market access in exchange for market access. However, since the Uruguay Round, the trade offs have been between market access promises for developing countries, in exchange for giving up their flexibility in domestic economic and development policy making.

3.6 Implications for Sri Lanka

The poor economic performance of Sri Lanka in 2001 reflected adverse global conditions during the year as well as the uncertain political and economic environment, which prevailed in the country.

Global Outturn - The global slowdown exposed the vulnerability of the economy to external developments. The country is highly vulnerable due to its high trade/GDP ratio (over 70 per cent) and concentration in a few export products and markets. The country is over dependent on garment exports, which is the country's single largest item of export (garment exports accounted for over 50 per cent of total exports in 2001). Exports markets are also not diversified, with the EU and US markets alone accounting for 41 and 27 per cent respectively, of Sri Lanka's total exports in 2001.

Consequently, the global slowdown led to a sharp fall in Sri Lanka's trade, with exports falling by 12.8 per cent and imports dropping by 18.4 per cent in 2001. The fall in exports was due to declines in textiles and garments, other industrial products and agricultural exports. The garment industry, which grew strongly in 2000 suffered from low demand throughout 2001. The US is the largest buyer of garment exports from Sri Lanka and accounts for about 60 per cent of the country's garment exports. Although garment exports to the US improved somewhat in the first half of 2001, it fell sharply in the second half of the year mainly due to the slowdown in the US. The garment industry also faced stiff competition from countries in the Sub-Saharan Africa and the Caribbean region due to duty free concessions for garment exports extended to these countries by the US under the African Growth and Opportunity Act (AGOA), which was signed in May 2000. Garment exports to the EU, which accounts for about 30 per cent of Sri Lanka's total garment exports, fell in 2001 despite the removal of quota restrictions on Sri Lanka's textiles and garment imports from January 2001. The general decline in trade volumes was accompanied by decline in prices for the country's agricultural commodities as international prices for tea, coconut and rubber fell during the year. One of the favourable developments from the global slowdown was the drop in oil prices during 2001, which had a significant positive effect on the balance of payments position of the country. However, oil prices have been rising towards the end of 202, due to the oil strike in Venezuela.

Trade was severely disrupted by the terrorist attacks on the Katunayake International Airport in July 2001 and the consequent imposition of a high war risk premium on ships and airlines to the country. Terror in the US on September 11, 2001 and the later war in Afghanistan aggravated the situation,

Lower World Interest Rates - The reduction in interest rates in developed countries, which was undertaken to address the threat of a prolonged global slowdown, helped to reduce interest payments of the country on the external debt and reduce the deficit in the income account of the balance of payments by 8 per cent. However, most of Sri Lanka's debt consists of official concessional loans (over 70 per cent), with fixed low interest rates and as such, the effect of falling interest rates has been limited. Nevertheless, external debt stock fell by 5 per cent in 2001 but this was due to the fall in private sector debt and the depreciation of the yen against the dollar (about one-third of the country's debt is yen denominated and the depreciation of the yen reduced Sri Lanka's external debt by about US$ 100 million).

Sharper reduction in imports than in exports during the year reduced the trade deficit as well as the current account deficit significantly. Together with developments in the capital account, a small surplus of US$ 220 million was recorded in the balance of payments thereby reversing the worsening of the balance of payments position experienced over the last two years. The country's external reserves rose by 5 per cent to US$ 2,238 million in contrast to the severe drain of reserves experienced in 2000. But this adjustment came at a significant cost to the economy, in terms of slower growth and risk of slow growth in the future due to the large drop in imports, especially investment goods.

Preferential and Multilateral Liberalization Efforts - Sri Lanka continued to strengthen its bilateral, regional and extra-regional ties in 2001. Sri Lanka implemented the second phase of concessions granted under the India-Sri Lanka Free Trade Agreement (ILFTA) by further extending concessions to India in 2001. Sri Lanka pursued the initiative to enter into a Free Trade Agreement with Pakistan. Necessary steps were taken to draw up and finalise the Agreement, which would be somewhat similar to the ILFTA agreement, albeit with some modifications. Towards this end, a technical committee was set up and a preliminary ground work was initiated, with the exchange of request lists, offering lists and no-concession lists. Both countries have worked out a 'Road Map', which stipulates a specific time frame for the finalization of the Agreement and its Annexes. The free trade deal was delayed as a result of political uncertainty in the country, while Pakistan was swept up in events related to the war in Afghanistan.

Sri Lanka continued to participate in sub-regional cooperation initiatives through the Bangkok Agreement (BA) and Bangladesh, India, Myanmar, Sri Lanka, Thailand Economic Cooperation (BIMST-EC). The decision of the five Bay of Bengal countries to move towards a free trade area, which was taken up in 2000, was further pursued in 2001 with member countries deliberating on the possible approaches towards an FTA. During the year, Sri Lanka relinquished its role as the lead country for the tourism and fisheries sector and took over the reins from India as the lead country in the technology sector and the coordinating country in the sub-sector of processed foods, gems and jewellery for the next three years.

The Bangkok Agreement, which has been ineffective in expanding trade among the member countries for the past 25 years is likely to be revitalized with the accession of China (in April 2001), which will boost intra-regional trade, and the decision taken to launch a third round of trade negotiations. During the year, Sri Lanka participated at other fora such as the IOR-ARC and Group of 15 (G-15).

At the regional level, economic cooperation was pursued through SAARC and the 11th SAARC Summit was finally held in Kathmandu in January 2002 after a lapse of 3 years. The Summit provided further impetus to regional economic cooperation, with a vision of a phased and planned process eventually leading to a South Asian Economic Union. It was decided to finalise the text of the Draft Treaty Framework of a South Asia Free Trade Agreement by the end of 2002. They also directed that in moving towards the goal of SAFTA, the Member States expedite action to remove tariff and non-tariff barriers and structural impediments to free trade. Following the Summit, the First Meeting of the Inter-Governmental Group on Trade Liberalization to Initiate the Fourth Round of SAPTA took place in 2002. Request lists were exchanged amongst the member countries. It is anticipated that the

Fourth Round would go well beyond the Third Round in terms of product coverage and the deepening of tariff concessions.

Sri Lanka has increased its trade relations with the United States by signing a new Trade and Investment Framework Agreement (TIFA), which creates a joint council that provides a forum for discussion of bilateral trade issues. There has also been talk of a free trade agreement with the United States in order to improve access for its leading exports – garments – and to face the challenges of a quota free environment with the abolition of the Multi-Fibre Agreement by the end of year 2004. While initially there was no indication from the US that such an FTA was a likely next step, the American response after the Bali bombings, increases the probability of such a scenario. The US trade representative suggested that they would combine the emphasis on the continental Free Trade Area of the Americas (FTAA), with bilateral FTAs with Asian economies. Such an agreement with Singapore is close to completion.

The EU granted quota free access to imports of textiles and garments from Sri Lanka to EU with effect from 1 January 2001. In return, Sri Lanka has reduced the tariff level from 25 per cent to 10 per cent on carpets and floor covering. Sri Lanka is also trying to obtain tariff preferences from the EU.

At the multilateral level, Sri Lanka was amongst the 142 member countries participating in the fourth WTO Ministerial Meeting, which was held in Doha in November 2001. However, its commitment was questioned by the conspicuous absence of the Minister in charge of trade and commerce and other senior officials. Since Sri Lanka was the coordinator of the SAARC countries at the time, the absence of the Sri Lankan Minister led to the cancellation of the SAARC Commerce Ministers' meeting in Doha. The lesson from Doha was that, with adequate preparation and commitment to a position on issues, developing countries do have a substantial voice at the WTO. Sri Lanka must maintain a strong commitment to being adequately prepared for global trade negotiations.

Agriculture Policy Review

1995-2000

4. Domestic Agriculture Policy Review, 1995-2000

4.1 Introduction

The agricultural sector continues to play an integral part in Sri Lanka's economy. The entire agricultural sector accounted for nearly 20 per cent of GDP, while employing over one-third of the labour force. Despite continuous Government assistance, agricultural growth over the last several years has been lacklustre (less than 2 per cent per year over the last decade) compared to growth in the industrial and services sectors. Agricultural productivity also remains low, raising concerns that comprehensive reform is needed in agriculture to enhance growth prospects of the overall economy.

Since the plantation sector has received much attention and undergone restructuring and privatization, here the focus will be on domestic agriculture, which accounts for about 3.5 per cent of GDP. The domestic agricultural sector includes paddy, other field crops (grains, oil seeds, pulses, and root crops), fruits and vegetables, and sugar. Detailed analysis will be restricted to the paddy (rice) sector, and three other field crops (OFC) -- potatoes, big onions and chillies.

The Government's conflicting aims of having low food prices for consumers and high producer prices have led to gross policy inconsistencies and ad-hoc policy changes that have discouraged long-term new investment in agriculture. For example, the paddy sector has become increasingly unprofitable, as farm-gate prices of paddy have not kept up with the rising cost of paddy production.

The ensuing sections provide a brief description of the patterns of domestic production and import trade of paddy, potatoes, big onions, and chillies during the 1995–2000 period. Next, to grasp an understanding of the current situation, the paper reviews in detail agricultural policies and the regulatory environment in the domestic agricultural sector. It focuses on trade policy, credit policy, polices regarding fertilizer, irrigation and seed, investment incentives, and the role of State agencies in agriculture marketing. Thirdly, the paper discusses the constraints facing greater private sector investment in the domestic agricultural sector. It concludes with several recommendations for improving the policy and the regulatory environment, with the aim of achieving a higher growth in the domestic agricultural sector. A brief look into the plantation sector is facilitated by a case study of policies facing the coconut oil industry.

4.2 Profile of Domestic Production and Imports

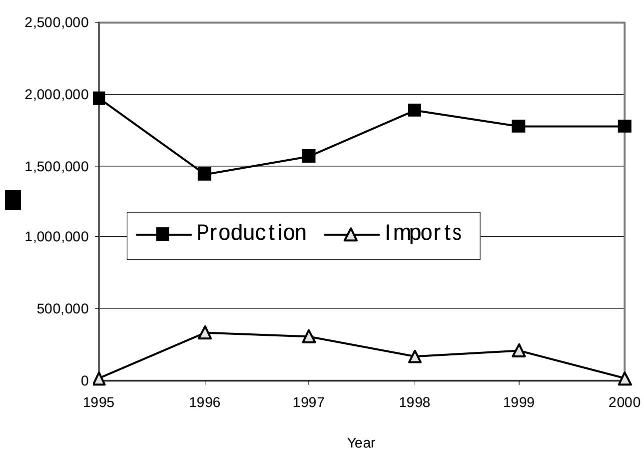
4.2.1 Paddy

The rural economy in Sri Lanka revolves around paddy cultivation. Paddy production increased slightly between 1995 and 2000 (Figure 4.1). The highest paddy production of 2.8 million metric tons (MT) was recorded in 1999. An exception was 1996, during which there was a significant fall in paddy production due to the severe drought that prevailed during 1995. The average paddy yield for the decade was 3.55 tons per hectare (MT/Ha). There was a slight improvement in the average yield during the decade. The current paddy production meets 95 per cent of the domestic rice requirement.[1] Paddy is cultivated in all districts of the country and is done in small scale. The average paddy farm size has become smaller over the years, with 72 per cent of paddy farmers owning less than 2 acres.

Of the total extent cultivated under all crops, paddy accounts for over 40 per cent in both Yala and Maha seasons.[2] Sri Lanka produced 2.8 million MT of paddy in 2000. The gross paddy extent sown in 2000 was 892,000 Ha, while the net paddy extent harvested was 736,000 Ha.[3] In both Yala and Maha, the gross extent sown in the wet zone declined by 30 per cent between 1990 and 2000. In the dry zone, while the gross extent sown in Maha increased by 10 per cent, the gross extent sown in Yala decreased by 38 per cent during the same period. Sri Lanka's average paddy yield in Maha increased by 6 per cent, from 3.58 MT/Ha in 1989/1990 to 3.80 MT/Ha in 1999/2000. The average paddy yield in Yala increased by 21 per cent, from 3.27 MT/Ha in 1990 to 3.96 MT/Ha in 2000.

Paddy farming in Sri Lanka has become an unviable and unprofitable enterprise over the years mainly due to the rise in the cost of production without a corresponding rise in the domestic price of paddy. Based on costs of production data published by the Department of Agriculture (DOA), the nominal cost of production per hectare of paddy increased by 130 per cent between 1990 and 2000, but the gross nominal income from a hectare of paddy increased only by 58 per cent. In real terms, the cost of production increased by 17

Figure 4.1
Rice production and imports



[1] 1 MT of paddy = 0.7 MT of rice.

[2] Maha season extends from September/October through March/April and Yala season extends from April/May through August/September.

[3] Total gross extent sown is also known as the asweddumized area. The net extent harvested is the difference between the gross extent sown and the cultivated extent abandoned due to various reasons such as pests, floods, and droughts.

per cent,[4] while the gross real income from a hectare of paddy declined by 19 per cent over the decade.

In terms of quantity, the nominal cost of producing a kilogram of paddy increased from Rs.3.86 in 1990 to Rs.8.64 in 2000. This is an increase of 124 per cent. In real terms, however, this is an increase of only 13 per cent. On the other hand, the nominal price of a kilogram of paddy increased only by 53 per cent between the two years, from Rs.6.70 in 1990 to Rs.10.26 in 2000. This is a 22 per cent decrease in real terms. Costs of production data also reveal that the net real income per hectare of paddy declined by 76 per cent, from Rs.11,930 per hectare in 1990 to Rs.3,557 per hectare in 2000, both measured in 1990 rupees.

Some paddy farmers have responded to the decline in profitability by shifting away from full-time paddy farming altogether, particularly in the wet zone. Those still engaged in paddy farming in the wet zone do it mostly as a part-time occupation. Paddy has always been less remunerative in the wet zone than in the dry zone, particularly due to lower yields in the wet zone. Rapid urbanization and greater availability of off-farm employment opportunities in the wet zone also have contributed to the decline in the paddy extent in the wet zone.

Although this is not an exhaustive study on the causes for the decline in the profitability of paddy production, it makes clear the fact that the farm-gate price of paddy has not kept up with the rise in the cost of production of paddy over the past several years. While much attention has been paid to the issue of the rising cost of paddy production, little or no attention has been paid to the fact that there has not been a corresponding rise in the farm-gate price of paddy relative to the rising cost of paddy production.

Three issues are raised in this connection. First, assuming that paddy farmers apply economically optimal rates of inputs, then the scope for reducing the cost of paddy production is limited, given that factor prices, to a great extent, are determined exogenously. The only way through which they can become more efficient is by increasing the paddy yield. Given the fact that Sri Lanka's average paddy yield is considerably higher than most of the other countries in the region, is it reasonable to expect that paddy farmers will be able to increase their yields significantly in the near future? Second, Sri Lanka annually imports about 8 per cent of its domestic rice requirement. What is the impact of these imports, if there is any, on the farm-gate price of paddy? Third, are farm-gate prices of paddy and the wholesale price of rice determined by the interaction of supply and demand forces alone? Stated differently, do (or don't) rice millers exert any influence in the price determination mechanism in the purchase of paddy and the sale of rice?

[4] Nominal figures were deflated by the Wholesale Price Index (1990 = 100) to obtain real figures.

4.2.2 Other Field Crops

The domestic production of high value cash crops or other field crops (OFC) such as potatoes, big onions, and chillies decreased considerably over the past decade. Since 1996, local producers of these crops have faced a difficulty competing with cheaper imports of these commodities as a result of the relaxation of import restrictions. Frequent *ad hoc* adjustments in tariff rates have discouraged a large number of producers who have shifted away from the cultivation of these crops altogether. Since 1997, the Government has placated OFC producers and maintained some degree of protection, imposing a tariff rate of 35 per cent on imports and having the Cooperative Wholesale Establishment (CWE) buy these commodities at designated prices. The Central Bank of Sri Lanka (CBSL) in 1999 introduced a forward sales contract scheme as an alternative to State intervention in agricultural commodity marketing.

Since the removal of high import restrictions in 1996, local potato production has faced stiff competition from cheaper imports, resulting in a sharp decline in domestic production. In 1998, 115,000 MT of potatoes were imported, with more than 86 per cent coming from India and Pakistan (Figure 4.2). This amount accounted for 80 per cent of the total domestic requirement.

As in the case of potatoes, chillie production also decreased between 1990 and 2000, from 39,000 MT in 1990 to 14,000 MT in 2000, while chillie imports increased from 8,000 MT in 1994 to 23,000 MT in 2000 (Figure 4.3). Chillie production declined sharply between 1996 and 1998 as a result of the removal of import restrictions in 1996. Sri Lanka's cost of production of chillies is much higher than that of other countries in the region, particularly India. India, for example, produces high yielding seed varieties at a much lower cost. The low cost material inputs and lower wage rates have given India a comparative advantage in these crops. Due to the increased production in India, import prices of chillies have declined significantly during the past several years.

Figure 4.2
Potato production and imports

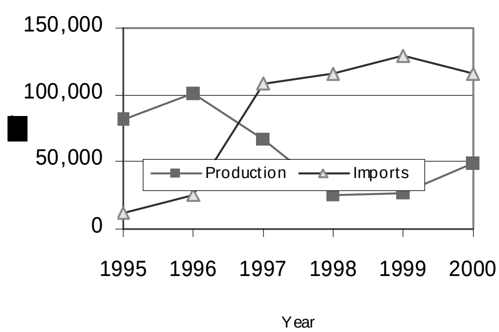


Figure 4.3
Chillie production and imports

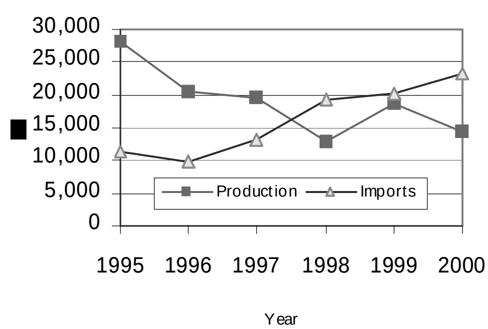
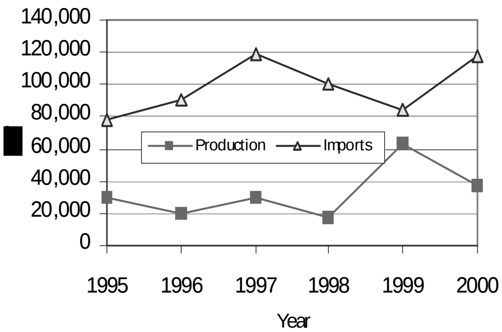


Figure 4.4
Big onion production and imports



The domestic production of big onions showed a declining trend between 1994 and 1998. In 1994, 43,000 MT of big onion were produced domestically, but, following import liberalization in 1996, production dropped and hit a low of 17,000 MT in 1998 (Figure 4.4). Although the domestic production in 2000 was higher than during the 1995-98 period, it still met only 23 per cent of the domestic requirement.

4.3 Profile of Policies and the Regulatory Environment

4.3.1 Import Policy

The Government's attempt to achieve the conflicting objectives of ensuring low food prices for consumers and high commodity prices for producers have led to several ad-hoc tariff policy changes. The complete import duty structure and total tax incidence for the four crops under consideration is presented in Table 4.1.[5] The table clearly shows the *ad-hoc* nature

Table 4.1
Tariff changes on import of domestic agricultural commodities

Rice	Customs Duty (%)				TT/GST (%)	DL/NSL[a] (%)	Total Tax Incidence (%)[b]
Period	Statutory Duty	Duty Waiver	Effective Import Duty	Surcharge			
Jan 01,1995 - Feb 7,1995	35 or Rs.7/Kg	0	55	0	Ex	4.5 [c]	65.7
Feb 08, 1995 – Apr 14, 1996	35	0	35	0	Ex	4.5	44.59
Apr 15, 1996 – Jan 30, 1997	35	35	0	0	Ex	4.5	7.63
Jan 31, 1997 – Nov 20, 1997	35	0	35	0	Ex	4.5	44.59
Nov 21, 1997 – Jan 31, 1998	35	35	0	0	Ex	4.5	7.63
Feb 01, 1998 – Nov 05, 1998	35	0	35	0	Ex	4.5	44.59
Nov 06, 1998 – Oct 23, 1999	35	0	35	0	Ex	5.5	46.28
Oct 24, 1999 – Dec 31, 1999	35	25	10	0	Ex	5.5	19.56
Jan 01, 2000 – May 10, 2000	35	0	35	0	Ex	5.5	46.28
May 11, 2000 – Jul 16, 2000	35	0	35	0	Ex	6.5	47.96
Jul 17, 2000***	35	0	35	0	Ex	6.5	47.96

Notes: Average CIF value of rice was Rs. 12.87 per kilogram in 1995. "Ex" implies exempt from tax, TT implies Turnover tax, DL implies Defence Levy, NSL implies National Security Levy, and *** implies licence required for import. Superscripts a, b, and c imply the following: (a) DL became known as NSL effective January 01, 1996, (b) two per cent stamp duty is included, and (c) DL was changed from 3.5 per cent to 4.5 per cent on July 01, 1995.

Total Tax Incidence was calculated as follows (all the rates are in per cent, specific taxes were changed to per centages):

Customs duty = CIF value * effective customs duty rate; TT = (CIF value + Customs duty)* 1.25* (TT rate/100); DL or NSL = (CIF value + Customs duty) * 1.25* (DL/NSL rate/100); Surcharge = CIF value * customs duty rate * surcharge rate; Total Tax Incidence = Customs duty + TT (or GST) + DL or NSL + Surcharge; GST was introduced on April 1, 1998 replacing the TT. All four crops under consideration were exempt from GST.

Sources: Central Bank of Sri Lanka Annual Report; Sri Lanka Customs; Department of Inland Revenue; Gazettes of the Government of Sri Lanka.

[5] Farmers do not pay TT and NSL. Therefore, they get an implicit protection equal to the difference between the total tax incidence and the sum of customs duty and surcharge where applicable.

Potato	Customs Duty (%)						
Period	Statutory Duty	Duty Waiver	Effective Import Duty	Surcharge	TT/GST (%)	DL/NSL[a] (%)	Total Tax Incidence (%) [b]
Jan 01, 1995 - Feb 07,1995***	35% or Rs. 12/Kg	0	89	0	20	4.5 [c]	148.88
Feb 08, 1995 - July 1996***	35	0	35	0	06	4.5	54.72
July 1996 - Dec 03, 1996	35	0	35	0	Ex	4.5	44.59
Dec 04, 1996 - Jan 31, 1997	35	15	20	0	Ex	4.5	28.75
Feb 01, 1997 - Nov 27, 1997	35	0	35	0	Ex	4.5	44.59
Nov 28, 1997 - Jan 31, 1998	35	15	20	0	Ex	4.5	28.75
Feb 01, 1998 - Nov 05, 1998	35	0	35	0	Ex	4.5	44.59
Nov 06, 1998 - May 10, 2000	35	0	35	0	Ex	5.5	46.28
May 11, 2000 - Nov 29, 2000	35	0	35	0	Ex	6.5	47.97
Aug 30, 2000 - Dec 07, 2000	35	0	35	35% Surcharge	Ex	6.5	60.22
Dec 08, 2000 - Dec 31, 2000	35	0	35	Rs. 20/Kg	Ex	6.5	211.96

Note: Average CIF value of potato was Rs. 12.19 per kilogram in 2000.
Sources: Central Bank of Sri Lanka Annual Report; Sri Lanka Customs; Department of Inland Revenue; Gazettes of the Government of Sri Lanka.

Big Onion	Customs Duty (%)						
Period	Statutory Duty	Duty Waiver	Effective Import Duty	Surcharge	TT/GST (%)	DL/NSL[a] (%)	Total Tax Incidence (%)[b]
Jan 01, 1995 - Feb 07, 1995***	35% or Rs.9/Kg	0	81	0	20	4.5 [c]	138
Feb 08, 1995 - July 1996***	35	0	35	0	20	4.5	78.34
July 1996 - Dec 03,1996	35	0	35	0	Ex	4.5	44.59
Dec 04, 1996 - Jan 31, 1997	35	15	20	0	Ex	4.5	28.75
Feb 01, 1997 - Nov 27, 1997	35	0	35	0	Ex	4.5	44.59
Nov 28, 1997 - Jan 31, 1998	35	15	20	0	Ex	4.5	28.75
Feb 01, 1998 - Nov 05, 1998	35	0	35	0	Ex	4.5	44.59
Nov 06, 1998 - May 10, 2000	35	0	35	0	Ex	5.5	46.28
May 11, 2000 - Dec 31, 2000	35	0	35	0	Ex	6.5	47.97

Note: Average CIF value of big onion was Rs. 11.14 per kilogram in 1995.
Sources: Central Bank of Sri Lanka Annual Report; Sri Lanka Customs; Department of Inland Revenue; Gazettes of the Government of Sri Lanka.

Chillies	Customs Duty (%)						
Period	Statutory Duty	Duty Waiver	Effective Import Duty	Surcharge	TT/GST (%)	DL/NSL[a] (%)	Total Tax Incidence (%) [b]
Jan 01, 1995 – Feb 08, 1995***	35% or Rs. 20/Kg	0	41	0	20	4.5 [c]	86.18
Feb 08, 1995 – July 1996***	35	0	35	0	20	4.5	78.34
July 1996 - Dec 03, 1996	35	0	35	0	Ex	4.5	44.59
Dec 04, 1996 – Jan 31, 1997	35	0	35	0	Ex	4.5	44.59
Feb 01, 1997 – Nov 27, 1997	35	0	35	0	Ex	4.5	44.59
Nov 28, 1997 – Jan 31, 1998	35	0	35	0	Ex	4.5	44.59
Feb 02, 1998 – Nov 05, 1998	35	0	35	0	Ex	4.5	44.59
Nov 06, 1998 - May 10, 2000	35	0	35	0	Ex	5.5	46.28
May 11, 2000 – Dec 31, 2000	35	0	35	0	Ex	6.5	47.97

Note: Average CIF value of Chillies was Rs. 48.42 per kilogram in 1995.
Sources: Central Bank of Sri Lanka Annual Report; Sri Lanka Customs; Department of Inland Revenue; Gazettes of the Government of Sri Lanka.

of tariff policies adopted during the period under investigation. Sri Lanka has been unilaterally making these changes in tariff rates ignoring the fact that these rates are bound under the WTO rules.[6] Moreover, these commodities are in the negative list of the India-Sri Lanka Free Trade Agreement.[7]

Due to the severe drought that prevailed during the latter part of 1995, paddy production during 1996 was low. The Ministry of Agriculture, Lands, and Forestry (MALF) projected the excess demand for rice in 1996 to be between 500-600 thousand MT. Thus, importers were allowed to import rice to meet the excess demand, but since imported rice prices were higher than the local prices, the quantity of rice imported was lower than expected. Therefore, the 35 per cent import duty on rice was waived initially for six months, effective April 1996, and later extended up to January 30, 1997-December 1996. The duty waiver on rice imports resulted in a large quantity of rice being imported during 1996.

Paddy production increased slightly in 1997 after paddy cultivation in 1996 was severely affected by the drought. The domestic production was still lower than the average production recorded for the previous decade, which caused an increase in rice prices in the domestic market. In order to lower the domestic market price of rice, the Government liberalized rice imports again by waiving the 35 per cent duty on rice imports on November 20, 1997. This zero tariff regime was in effect until the end of January 1998. In the next two years, three major tariff changes were made (see Table 4.1), and in July 2000, the import of rice was brought under a licensing scheme.

The requirement to obtain import licences for the import of potatoes, big onions, and chillies continued until the middle of 1996. In July 1996, the Government liberalized the import of these commodities or freed them from the licensing requirement. The import duty on these commodities remained at 35 per cent, but a 20 per cent turnover tax that had been in effect was removed in July 1996. In December 1996, the import duty on the three commodities was lowered from 35 per cent to 20 per cent in order to reduce their domestic prices.

In the case of potatoes and big onions, the effective import duty of 20 per cent remained valid until January 31, 1997. Between February 01, 1997 and November 27, 1997, the effective import duty on potatoes and chillies was 35 per cent. On November 28, 1997, a duty waiver of 15 per cent was introduced on both commodities. In the case of potatoes, the

[6] Under Chapters 1-24 of the HS system of coding, Sri Lanka has bound tariffs on almost all agricultural products including rice, big onion and chillies falling at 50 per cent except for certain domestic food crops including potatoes and some varieties of beans that have been bound at 100 per cent with the Initial Negotiation Rights given to countries of the European Community. Sri Lanka is yet to enact laws with regard to anti-dumping, countervailing and safeguards actions.

[7] India-Sri Lank Free Trade Agreement, which was signed between the two countries in 1998, came into effect in March 2000.

new effective duty rate of 20 per cent was operative only until January 31, 1998. However, the effective rate on big onion was also valid until January 31, 1998. On February 1, 1998, the 15 per cent duty waiver on big onion was removed, making the effective duty rate 35 per cent again. This remained effective until the end of 2000. Since February 1, 1998, the effective import duty rate on potatoes has been 35 per cent. Heavy lobbying by local potato farmers forced the Government to impose a 35 per cent surcharge on potato imports in August 2000 on top of the existing 35 per cent duty. In December 2000, the 35 per cent import duty was changed to a specific duty of Rs. 20 per kilogram. The ad-valorem surcharge was changed to a specific surcharge to avoid under invoicing by the importers.

The effective duty on chillies has remained at 35 per cent throughout the post December 1996 period. As a result of the good Maha harvest of 1996 and increased imports, the domestic price of chillies declined considerably. With the objective of protecting local chillie farmers, the Government in 1997 introduced a minimum producer price scheme for some crops including chillies. The CWE was delegated with the responsibility of intervening in the market whenever the market price went below the minimum producer price. The Government in November 1997 extended this scheme by two more years.

4.3.2 Credit Subsidies

In 1995, the Government took a decision to write off all past due loans of farmers who had repaid 25 per cent of the total loan. This restored the eligibility of farmers who were otherwise disqualified to apply for new agricultural loans. Also, through the two State banks and local commercial banks, concessionary credit was provided to farmers at low interest rates. Unlike in previous years during which the CBSL refinanced the credit, the Government in 1995 provided an interest subsidy for refinancing the credit.

Further, in 1996, the Government introduced the New Comprehensive Rural Credit Scheme (NCRCS) under which interest subsidies are granted by the two State banks on short-term and long-term cultivation loans. Approximately 70 per cent of the total allocated credit is granted to paddy producers, while the balance is given to the OFC producers. During the 1996-97 period, the money was lent at an

Table 4.2
Interest subsidy (Rs. Million)

	1995	1996	1997	1998	1999	2000
Total Loans Granted under NCRCS	668	590	479	463	503	153
Interest Subsidy	50	44	35.9	46.3	50.3	15.3
Interest subsidy as a percentage of total government expenditure	0.019	0.017	0.013	0.014	0.015	0.003

Source: Central Bank of Sri Lanka Annual Report.

annual interest rate of 16 per cent with an interest subsidy of 7.5 per cent. In 1998, loans were given at an annual interest rate of 12 per cent with an interest subsidy of 10 per cent.

The interest subsidy on cultivation loans has declined over the past few years (Table 4.2) due to the significant drop in loan disbursement to the agriculture sector. Poor performance of the non-plantation sector and default in loan repayments have discouraged State banks from giving new cultivation loans. Cultivation loans given to farmers who were unable to repay their debts were written off several times in the past.

4.3.3 Fertilizer Subsidies

The most important subsidy granted to the agricultural sector is the fertilizer subsidy, which is considered an essential component of the new planting and re-planting subsidy package for perennial crops, paddy and OFCs.

The fertilizer subsidy that had been in place since the 1970s was removed in 1989, but it was re-introduced in 1994. The fertilizer subsidy applies to four major fertilizer ingredients: urea, sulphate of ammonia, muriate of potash, and triple super phosphate. The subsidy reduced the retail price of major fertilizers by 30 per cent. The fertilizer subsidy was revised in 1995 due to the increase in prices of urea and triple super phosphate. Under the new scheme, upper expenditure limits on subsidies paid to importers were determined. These ceilings were readjusted from time to time depending on the changes in the world market price of fertilizers. In September 1997, the fertilizer subsidy scheme was further revised making it applicable only to urea. Seventy five per cent of urea users are paddy farmers. In 2000, the fertilizer subsidy payment exceeded the initial budgetary allocation of Rs. 1,500 million by Rs. 200 million (Table 4.3).

4.3.4 Irrigation Subsidies

The irrigation subsidy is another important indirect subsidy granted primarily to the paddy sector in the form of free irrigation water. Estimated annual costs of operation and maintenance in 1995 for different irrigation schemes are as follows: Rs. 1556 per hectare in rehabilitated major irrigation schemes outside Mahaweli area; Rs. 1331 per hectare in newly constructed major irrigation schemes in Mahaweli area; Rs. 600 per hectare in rehabilitated minor irrigation schemes (World Bank, 1996).

In order to irrigate small farms (0.5 - 1 acre) in the dry zone during the inter-seasonal period between Yala and Maha,

Table 4.3
Fertilizer subsidy (Rs. Million)

	1995	1996	1997	1998	1999	2000
Fertilizer Subsidy	1300	1500	1900	2200	1500	1700

Source: Central Bank of Sri Lanka Annual Report.

the Agricultural Development Authority (ADA) of the MALF in 1999 introduced the agro wells program. During the inter-seasonal period, most farmers cultivate vegetables, and other short- term crops using water from agro wells (Table 4.4).

The ADA introduced another subsidy program in 2000 known as the "Micro Irrigation Subsidy Program" to help farmers purchase pipelines for agro wells. At the inception of this program, a farmer was given Rs.20,000 by the ADA on condition that he makes a mandatory contribution of Rs.10,000. Under this scheme, a total sum of Rs. 10.9 million was disbursed among small farmers in 2000.

4.3.5 Seed Policy

In 1996, a new seed and planting materials policy was approved by the MALF with the objective of establishing seed enterprises with the participation of the private sector to produce and market seed. To facilitate the implementation of the new seed policy, the National Seed and Planting Materials Committee (NSPMC) was set up under the MALF with the participation of the private sector. The NSPMC completed the preparation of the Seed Act in 1998. The Seed Act is yet to be tabled before the Parliament. The NSPMC held a training program on seed production for private sector seed producers in 1998. In addition, the Government decided to give incentives to produce high quality seed. In the 1998 budget, provisions were made to give incentives to private seed producers. As a result, the Hingurakgoda seed paddy farm was privatized in 1998. Duty free import of seed and planting material was already in place. The Government also allowed the import of seed cleaning machines, sorting and grading machines, seed packing machines, and seed testing equipment free of import duty. In 1999, the Government granted Rs.100 million to five seed producing centres in the major rice producing districts of Ampara, Polonnaruwa, Kurunegala, Anuradhapura and Hambantota to strengthen their activities. Preliminary work on the privatization of the Pelwehera seed farm was completed in 1999.

4.3.6 Investment Incentives

Through various market development and incentive schemes, successive Governments have attempted to promote the production and export of agriculture products and agro-based industries. The Export Development Board (EDB), the Board of Investment (BOI), and a number

Table 4.4
Irrigation subsidies through agro wells program (Rs. Million)

	1995	1996	1997	1998	1999	2000
Subsidy received by ADA	0	10	25	28	35	35
Subsidy Released to Farmers	9.05	20.7	26.5	42.5	31.4	25.4

Source: Ministry of Agriculture.

of ministries offer several programs aimed at identifying export markets while playing an important role in facilitating and increasing trade awareness.

A combination of exemptions including income tax, customs duty, and foreign exchange controls is conferred on a company by way of signing an agreement with the BOI under section 17 of the BOI Law. Investment in areas such as the production and processing of non-plantation agricultural produce, research on high quality seeds and seed production, cultivation under poly-tunnels and drip-tunnels using advanced technology, and the development of marketing infrastructure such as storage facilities entitles the investor to these concessions. In addition, an investment of Rs.10 million employing 20 or more people is entitled to a 10-year tax holiday. In the case of agricultural projects, the minimum area to be cultivated is 5 hectares. If these criteria are met, the project will be entitled to the duty–free import of all project-related imports. However, if the quantity exported is less than 50 per cent of the total output, duty exemption on plant, machinery, and other project-related equipment shall apply only during the project establishment period. Export oriented industries would enjoy duty exemption on raw materials imported for the purpose of export processing. For agricultural sector investments, many items have been exempt from duty under the Customs Ordinance and are, thus, available to all projects irrespective of their export orientation.

The exemption from the GST (and now VAT), the NSL, and the Excise Tax is not conferred on a company by virtue of signing an agreement with the BOI. Furthermore, the Government is encouraging agro-based exports and agricultural investment by providing an array of fiscal incentives to prospective investors. The BOI and the Department of Inland Revenue offer a range of investment incentive schemes aimed at encouraging investment and export-oriented manufacturing activities.

4.3.7 Interventions in Agricultural Marketing

Mainly due to oversupply, farm-gate prices of some farm produce fall to non–remunerative levels during the harvesting period. Lack of proper storage facilities, poor cultural practices, post harvest handling, and liquidity constraints faced by farmers also contributed to this situation. Several State agencies such as the PMB, CWE, and the State Trading Corporation (STC) were set up in the 1970s to address the problem of agricultural marketing. In order to avoid adverse effects on farmers' income though the drop in prices during the season, these agencies introduced various measures such as establishing purchasing agencies and offering guaranteed prices. These measures, however, did not generate the expected results. Even if prices were guaranteed, the limited capacity of the procurement agencies did not allow them to absorb a significant percentage of the season's total production. This often created uncertainty in the farming community. Those who could not sell their produce to Government purchasing centres had to accept any price offered by the private traders. Despite low profitability, various reasons still compel farmers to grow the same crop every season. Recently, the Central Bank has introduced forward sales contracts as a market-based alternative to interventions of State agencies in agricultural marketing.

Cooperative Wholesale Establishment (CWE)

The CWE is the principal State Trading Agency involved in buying and selling of major agricultural commodities today. The main objective of the CWE is to stabilize food prices and assure food security. The CWE has over 40 wholesale depots and 120 retail outlets. Although the CWE purchases agricultural commodities from local producers, it also imports many of these and various other food commodities. Food commodities imported by the CWE include rice, lentils, onions, chillies, potatoes, sugar, canned fish, and dried fish. CWE's import share of each commodity is presented in Table 4.5. Of the three major food items imported -- potatoes, big onion and chillies -- CWE's import share has declined considerably with the exception of year 2000 during which it imported large quantities of these three commodities. CWE's import share of sugar and rice increased over the 1995–2000 period. In mid 2000, the Government imposed licensing requirements on the import of rice and a surcharge on the import of potatoes. The private sector has the largest market share in all commodities in which the CWE trades. There are a few large private traders that operate as cartels.

The Government intervenes from time to time through the CWE in stabilizing farm-gate prices of selected commodities. Regardless of import prices, the CWE purchases farm produce of selected crops at designated prices. As there is no set policy on the quantity to be purchased, there were instances in the past where surplus stocks rose. In 1997, for example, while the price of imported potatoes was Rs.20 per kilogram, the CWE purchased potatoes from domestic producers at Rs.35.00 per kilogram. This resulted in a huge loss to the CWE. Since the PMB halted its operations in 1996, the CWE was often delegated with the responsibility of

Table 4.5
CWE's Imports as a percentage of total imports

Commodity	1995	1996	1997	1998	1999	2000
Table Potato	11	6	3	2	0.6	0.4
Dry Chillies	18	5	0	1	0.5	0
Big Onion	8	7	5	5	7	4
Rice	0	8.8	7	8	31	40
Sugar	5	4	7	6	8	9

Sources: CWE and Sri Lanka Customs.

Table 4.6
CWE's local purchases as a percentage of marketable surplus

Commodity	1995	1996	1997	1998	1999	2000
Table Potato	0.33	0.62	0.14	0	0.75	3.5
Dry Chillies	0.83	10.3	10.0	0.6	2.0	1.0
Big Onion	2.1	5.4	5.4	0.2	4.2	6.0
Paddy (As a % of total production)	0.5	0.3	0.1	0.9	1.1	3.4
Paddy (As a % of marketable surplus)	0.80	0.48	0.16	1.44	1.76	5.44

Note: CWE purchases both paddy and rice. Marketable surplus of potato, big onion and chillie is over 98 per cent of the total production. However, the marketable surplus of paddy varies from district to district. Based on data from the Ministry of Agriculture, the marketable surplus of major paddy producing districts are as follows: Kurunegala 50 per cent, Ampara 83 per cent, Polonnaruwa 86 per cent, and Anuradhapura 60 per cent. For our calculation, a marketable surplus of 60 per cent was used as the national average. Based on above numbers, it is evident that the amount of paddy purchased by the CWE is not significant.

Sources: CWE and Sri Lanka Customs.

purchasing paddy at designated prices. The Government provides the CWE and Multi-purpose Cooperative Societies (MPCSs) with concessionary credit through the State banks with a treasury guarantee to carry out these activities. More often than not the CWE has incurred huge losses in these operations.

CWE was the only importer of wheat grain, and the price of wheat flour was controlled by the Government. Wheat milling for the CWE was done by the Prima Milling Plant (a private company based in Trincomalee), and the flour was distributed through the Food Commissioner's Department. Until recently, the CWE had the exclusive right for the import of wheat grain and controlled the domestic price of wheat flour. The Government lowered the prices of wheat flour and bread in 1994 at an estimated subsidy cost of Rs. 5-6 billion a year during 1995 and 1996. While the formal market-interventionist role of the CWE gradually diminished over time, it can play a vital role in food security and in the event of civil unrest, floods, shortages during festive seasons, or hoarding.

Table 4.7
Activities of the PMB

Year	Total Paddy Production (MT)	Total PMB Purchase (MT)	Purchase of PMB as a % of Total Paddy Production
1990	2,538	31	1.2
1991	2,389	44	1.8
1992	2,340	7	0.3
1993	2,570	46	1.8
1994	2,684	120	4.5
1995	2,810	282	10.0
1996	2,061	1	0.0

Source*:* Central Bank of Sri Lanka Annual Report; PMB Statistics.

Paddy Marketing Board (PMB)

The PMB was established in 1971 with the main objective of ensuring remunerative prices to paddy producers and providing rice to consumers at reasonable prices. The PMB owned 359 stores in 1971. Although very active during the 1971-77 period, the role of the PMB gradually diminished during the post 1977 period. The PMB terminated its operations in 1996.

Throughout the period of its existence, the PMB operated a Guaranteed Price Scheme to ensure a minimum price for paddy. As the average farm-gate price of paddy was above the guaranteed price during the 1989-1993 period, the PMB was unable to purchase more than 2 per cent of the country's annual paddy production each year during this period (Table 4). With the aim of protecting paddy farmers from unusually low farm-gate prices, the PMB purchased a larger quantity of paddy in 1995. But as the PMB had to sell this rice at prices below cost, it incurred a loss of Rs.150-200 million. Due to poor maintenance of stores, corruption, and weak processing and distribution systems, the PMB failed to provide consumers with good quality rice. A combination of these factors led to its demise in 1996.

State Trading Corporation (STC)

At present, the STC does not play a significant role in agricultural marketing. About 90 per cent of STC imports comprise of items such as mamoties, generators, sprayers, sprinklers, tree-holding machines, equipment used in irrigation and chemical mixtures. Although the STC enjoyed monopoly rights for the import of over 90 agriculture-related and other items in the past, it now has exclusive rights only for the import of three chemical

Tables 4.8

Number of forward sales agreements signed by August 2001

Sponsor	Paddy	Maize	Seasame	Big Onion	Other Crops	No. of Agreements	Value of Agreements (Rs.Million)
1. Ruhuna Dev. Bank- Matara	956	_	144	_	_	1100	62
2. Rajarata Dev. Bank- A'pura	87	147	290	167	67	758	17
3. Kandurata Dev. Bank- Matale	208	_	_	739		947	12
4. Uva Dev. Bank	19	173	55			247	10.5
5. Wayamba Dev. Bank	_	_	62	_		62	2.9
6. Sabaragamuwa Dev. Bank	_	_	130		190	320	7
7. Seylan Bank	1100	608		12		1720	84
8. Peoples Bank	_	47	272	_	_	319	4.4
9. Bank of Ceylon	_	_	_	102	68	170	12
10.Co- op Societies	33	194				227	3.5
11.Uva Initiative	_	_	_	_	217	217	7
12.Isuru Project	_	_	_	_	27	27	2
13.NGOs	_	_	_	125	_	125	4
TOTAL	2403	1169	953	1145	569	6239	228.3

Source: Central Bank of Sri Lanka.

compounds that have been classified under security reasons.

Forward Sales Contracts

As an alternative to the Government intervention in agricultural commodity marketing, the Central Bank of Sri Lanka introduced the forward sales contract scheme in 1999 under the "Govi Sahanaya" program. A forward sales contract is a binding, legal agreement between a buyer and a seller whereby the seller agrees to make delivery of an agreed quantity of a commodity of specified quality at an agreed price on a future date.

In a forward sales contract, the seller is guaranteed a remunerative price for his produce while the buyer is assured of the supply of a quality product. A facilitator, usually a bank, helps in bringing a buyer and a seller together and in determining the contract price. The key element -- the contract price -- can be determined based on the cost of production, the farm-gate price, or the border price of the commodity of concern. Choice of the most appropriate method depends on the commodity itself and various other factors such as the variation of farm-gate prices and retail prices.

There are many advantages of a forward sales contract to the three parties involved. Advantages to the seller are (a) stable and a higher price for his produce, (b) a guaranteed market for his produce, (c) an incentive for making new investment and adapting new technology, and (d) the possibility of using the contract as collateral for obtaining bank loans. The main advantage of a contract to the buyer is the stable supply of produce. The main advantage to the facilitator is the commission it charges for the mediator role it plays. A contract also gives the facilitator an opportunity to expand its customer base and to ensure loan recovery.

Table 4.8 documents the use of the forward sales contract scheme since its inception in 1999. A total of 6,239 contracts were signed during the 1999-2001 period. The value of these contracts is Rs. 228.3 million. It is encouraging to note that among all the banks involved, Seylan Bank, which is the only private bank to be involved in the scheme, has been the most active in terms of the number of contracts and the value of these contracts. Although many crops are covered under the scheme, paddy, maize, and big onion accounted for more than 75 percent of the total number of contracts.

4.3.8 Other Policies

In 1995, the Spices and Allied Crops Marketing Board was established to improve the product quality and marketing and to guarantee a higher income to the producers of other export crops (OEC).[8] In December 1996, the MALF launched a country-wide food drive called "Waga Lanka" as a response to the Food and Agriculture Organization prediction that there would be a global food scarcity in 2005. The objectives of the program were

[8] OEC include spices such as cloves, cardamom, cinnamon, pepper, nutmeg, mace, and cocoa and coffee, and other agricultural produce such as unmanufactured tobacco, arecanut, betel leaves, cashew kernels and essential oils.

(1) to commercialize subsistence farming, (2) to adopt integrated farming techniques for year round cultivation, and (3) to enable farmers to increase their bargaining power. Furthermore, the cultivation insurance scheme for paddy, other field crops, betel and sugar cane, and the livestock insurance scheme continued under the Agricultural Insurance Board (AIB). In addition, a pension and social security scheme for farmers and fishermen was made available by the AIB in 1996. In 1996, the MALF revamped the farmer organizations that had been set up under the Agrarian Services Act. Furthermore, the MALF decided to set up Farmer Companies (FCs) to market, transport, and distribute farm products.[9]

In 1998, the MALF began to design policies related to the domestic agricultural sector based on policies documented in the National Policy Framework (NPF) that was prepared by the MALF in 1995. The policies mentioned in NPF include (1) providing high quality seed and planting materials to farmers, (2) consolidating agricultural extension services, and (3) getting both private and non-governmental organizations involved in developing the non-plantation agricultural sector with the Government playing the role of a facilitator.

The Government in 1999 continued its attempt to reduce its direct involvement in the non-plantation sector by (1) reducing production of crops, seed and planting materials in Government farms, (2) taking steps to liberalize agricultural extension services and crop insurance, and (3) introducing the forward sales contract (FSC) scheme as an alternative to Government intervention in agricultural commodity marketing (CBSL, 1999). In 1999, the Agricultural and Agrarian Services Act was enacted with the aim of improving agricultural insurance activities. Under the new Act, AIB was renamed as the Agricultural and Agrarian Insurance Board (AAIB). The new Act allows both the AAIB and private companies to undertake crop insurance activities. Also, in 1999, the agricultural extension service of the Department of Agriculture (DOA) introduced a fee based private extension service as a pilot project under the Second Perennial Crop Development Project funded by the Asian Development Bank.

In 2000, the MALF identified six areas for further reforms with the aim of increasing productivity and output. They are (1) research, (2) extension, (3) supply of seed and planting materials, (4) private sector participation in commercialization of agriculture, (5) commodity marketing, and (6) institutional reforms. The MALF took a decision to re-organize agricultural research to be demand driven. In order to optimize the use of funds available for agricultural research, priority areas were

[9] FCs were set up in 1996 with the following objectives: (1) to help farmers get remunerative prices for their farm products, (2) to provide farmers with inputs on easy terms, (3) to increase production and improve the quality of farm products, and (4) to communicate farmers' needs stronger as a pressure group influencing policy decisions by the government. FCs handle almost all the crops produced by farmers. There were only 3 FCs in 1997, while in 1999 there were 111 FCs in the country. However, of 85 registered FCs at present, only 22 are in operation.

identified with the help of the Council for Agricultural Research and Policy (CARP). Following the successful privatization of the Hingurakgoda seed farm in 1998, a major portion of the Pelwehera seed farm was leased to the private sector. The plant Quarantine Act was revised, but it is yet be tabled before Parliament. In addition, the Agrarian Services Act was updated to regularize the ownership of land, create a class of farmers that own land, and strengthen farmer level organizations.

4.4 Constraints to Investment in Agriculture

The various support and incentives have been ineffective in generating a dynamic agriculture sector due to several constraints facing the investor community.

4.4.1 Infrastructure Constraints

- Acquiring productive lands for agricultural projects is difficult due to procedural delays and many other restrictions. Eighty per cent of the country's land mass is owned by the Government. Numerous Government agencies such as the Urban Development Authority, the Ministry of Agriculture, the Department of Railways, the Department of Land Commissioner, and many other ministries have the proprietorship over most of the Government owned lands.

- Obtaining an adequate quantity of good quality raw materials in a continuous manner.

- Lack of suitable technology in both agriculture and agro industry. Although the liberalization of trade and investment policies have improved the access to imported agro processing technologies, many investors are either unaware of these technologies or unable to modernize their existing plants.

- Some of the lands that have been made available for agro-based investments do not have access to irrigation water, electricity, good roads, and markets.

- Low labour productivity, rising labour costs, and shortage of trained technicians.

- There are several agencies involved in granting permission and other various administrative activities related to investment projects. These activities result in high transaction costs and personal biases.

- Access to high quality seeds and planting materials is restricted due to procedural delays, and lack of technology for quarantine.

- Agricultural commodity market is unplanned and highly disorganized. Poor market places and infrastructure have an adverse effect on the overall investment in the agricultural sector.

- Research and extension systems for high value crops are not well developed and it is not demand driven. These services still target only the traditional crops preferred by the Ministry of Agriculture and related Ministries. This situation has not helped in attracting investment in agriculture, particularly for higher value crops.

- The security situation restricted the agricultural diversification program of the northern and eastern areas of the country. Marketing and transport sectors have to bear an additional cost owing to frequent loading and unloading that must be done at security check-points.

4.4.2 Legal and Regulatory Constraints

- No 46 of the Agrarian Services Development Act of 2000 requires written approval from the Commissioner-General of Agrarian Services before such paddy lands can be cultivated with any crop other than paddy.[10]
- Rigid labour laws, frequent labour disputes and strikes, and the large number of public holidays pose a major challenge for all industries in general.
- Although the Seed Act was drafted two years ago, it is yet to be tabled before Parliament. Certain restrictions stipulated in the Plant Quarantine Act contribute to low investment in the agricultural sector.
- Unwieldy customs procedures.

4.5 Policy Recommendations

Improving the policy and regulatory framework towards achieving higher growth in the domestic agricultural sector will involve progress in the following arenas.

- End ad-hoc changes in tariff rates, which are not conducive to the long-term growth of the domestic agricultural sector. Such changes create uncertainty in the market and discourage new investors/producers. A consistent tariff policy will help develop the sector. Closer coordination between relevant ministries is essential in this regard.
- Maintain a uniform ad-valorem tariff rate for all four crops making the total tax incidence 50 per cent or less, consistent with the existing WTO rules. Eliminate all non-tariff barriers such as licences and other quantitative restrictions. Removal of non-tariff barriers is essential to ensure a faster growth in the domestic agricultural sector.
- Phase out the involvement of State trade agencies such as the CWE and MPCSs in procurement, trade and sale of agricultural commodities allowing the private sector to play an effective role in the development of agricultural marketing.
- Set up at the national level private companies and farmer organizations as stakeholders to undertake purchasing and marketing of agricultural commodities.
- Encourage the use of forward sales contracts among the farming community. Although the FSC scheme is still in its infancy, it has already produced encouraging results.
- Reduce post-harvest losses due to improper packing, handling, and transport, which are significant.
- Liberalize the importation of some seed and planting materials currently banned. Action should be taken to strengthen

[10] Agrarian Services Development Act No. 46 of 2000 (page 25) states "(1) Paddy lands which have been identified by the Commissioner-General as paddy lands from which the maximum production can be obtained by the cultivation of paddy shall be cultivated with paddy during every season in which paddy can be cultivated thereon. (2) Where paddy cannot be cultivated during any season in an extent of paddy land, which has been identified above, due to a natural or other cause an agricultural crop which is not a perennial crop may be cultivated on such paddy lands after obtaining the written permission of the Commissioner-General, and (3) In the case of paddy lands from which satisfactory production can be obtained by the cultivation of any crop other than paddy, such paddy land may be cultivated with half yearly crops other than paddy after obtaining the written permission of the Commissioner-General. For the purpose of cultivating long-term crops in such paddy lands, the written permission of the Commissioner-General shall be obtained prior to the commencement of such cultivation."

quarantine procedures and reduce delays related to granting permission for import.

- Continue Government involvement in research, breeding, varietal testing and registration of seed and planting materials.
- Commercial production, sale and distribution of seed and planting materials should be undertaken by the private sector. Privatize all Government seed farms that are involved in commercial seed production.
- In order to promote investments in large-scale commercial agriculture take necessary steps to make land allocation easy.
- Avoid writing off of cultivation loans. This situation disturbs the rural credit market, as most of the private lending institutions are reluctant to release agriculture loans to the farming community. In many instances, farmers avoid repaying cultivation loans obtained from the banks hoping that the Government in the future will write off these loans. Moreover, farmers tend to treat these loans as direct cash subsidies from the Government.
- Revise existing labour regulations that are too restrictive. Current labour laws adversely affect employment and international competitiveness of agro-based industries. Stringent labour laws scare away potential investors.

4A. Case Study: Agricultural Policy Implications on Sri Lanka's Coconut Oil Industry

4A.1 Introduction

The coconut sector presents an example of the Government's inconsistent policy intervention in the plantation sector. Shortfall and surplus conditions in coconut production have led to varying tariff policies that have sent mixed signals to the coconut oil industry. A combination of increasing demand for desiccated coconut (DC) and falling prices of non-coconut edible oils, led to Government policies that saw a significant decline in the coconut oil industry. However, in the presence of surplus coconut production, a policy turnaround was made and coconut oil production was promoted. This kind of policy inconsistency does not provide the necessary signals that investors need to make long-term decisions that are healthy for the coconut oil industry in particular, and the coconut sector in general.

The country continues to supply fresh coconuts and coconut oil to the domestic market, with value added coconut products constituting the bulk of exports. Sri Lanka accounts for less than 0.2 per cent of the world coconut oil exports. The high cost of production of coconut oil compared to vegetable oils, palm oil, groundnut oil and other edible oils, and tariff reductions granted on edible oil imports from time to time in the past, have made the coconut oil industry uncompetitive in Sri Lanka. The availability of cheaper imported vegetable oils also resulted in a decline in the quality of the coconut oil sold in the domestic market since it is adulterated with these other cheaper edible oils in an effort to be price competitive.

On the other hand, the desiccated coconut (DC) industry has been performing well since the mid-1990s, progressively absorbing much of the domestic fresh nut production and leaving small quantities for coconut oil production. In early 1997, in response to a rise in demand for desiccated coconut in the international market, and facing low domestic nut production, the Government lowered import duties on other edible oils. By making local coconut oil less competitive *vis-à-vis* other imported edible oils, this policy reduced demand for coconuts from the oil industry and enabled DC millers to expand production. While growers benefited from higher prices for fresh nuts, a large number of oil mills were forced to terminate production.

However, since mid-1999, the local nut production had been increasing in excess of what could be absorbed by the desiccated coconut industry. Therefore, in order to overcome the fall in prices of fresh coconut, the Government attempted to resuscitate the withered coconut oil industry. To enhance the competitiveness of coconut oil producers as a short-term measure, the Government added a tax surcharge on imports of edible oils.

In the latter part of 2001, nut production declined and prices rose. Both coconut oil and DC millers have caused a tight supply market, and the DC millers have been particularly hurt by the loss of their traditional markets due to the higher cost of production.

The paper comprehensively analyses the competitiveness of the coconut oil industry. Third, it discusses the impact of edible oil imports in the Sri Lankan coconut oil industry. Fourth, it reviews the impact of desiccated coconut industry in the coconut oil industry. Finally, the paper addresses some key areas for improving the coconut oil industry while addressing a consistent policy framework for maintaining a sustainable growth in the coconut sector.

4A.2 Lack of Competitiveness of the Sri Lankan Coconut Oil Industry

Coconut Production

Coconut production has been increasing by over 2 per cent annually since 1995, and the result was a surplus in production by the year 2000. Even though the crop is highly sensitive to weather, other factors also synchronized to increase the production. The extent under cultivation and yield per acre has increased over the years. Growers have benefited from the use of fertilizer and crop-animal husbandry, as well as from technical and advisory services from the Coconut Cultivation Board and the Coconut Research Institute.

The impression has been that the extent of land cultivated under coconut is shrinking due to subdivision of lands into small building blocks for real estate development and industrial development activities in the country. On the contrary, it has actually increased by about 40,000 hectares (Ha) during the period 1996 to 1999 (Waidyanatha, 2000). Most of the non traditional areas are now producing more coconut than required for household consumption, and prices are often cheaper than in the traditional areas, due to the lack of processing industries in these areas to absorb the excess production.

Coconut production is likely to increase over the coming years, to approximately 2700-3000 million nuts per year as against an average of less than 2500 million nuts in the last decade. If the harvest exceeds more than 2700 million nuts at any given time, the excess fresh nut production cannot be absorbed either by the coconut oil industry or the DC industry. As Table 4A.1 highlights, the domestic coconut consumption (as nuts) is about 60 per cent of the total production in 2000, 19 per cent is used in the DC industry, 10 per cent in the coconut oil industry and the excess production was about 10 per cent.

The 11 per cent increase in nut production in 2000, had a significant downward impact on prices. Therefore, the Government intervened to resuscitate the coconut oil industry, thus promoting absorption of

Table 4A.1
Industry utilization of coconut production, (million nuts)

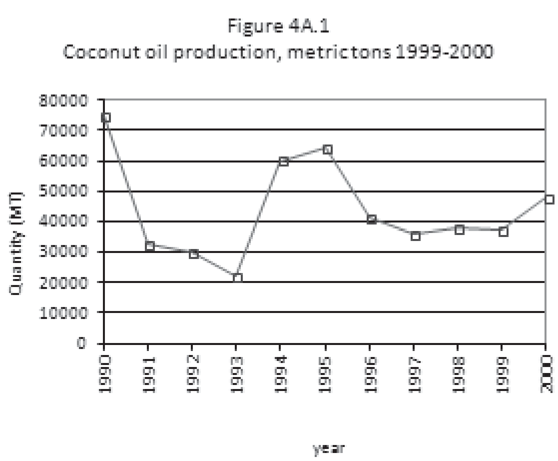
Year	Coconut production	Domestic consumption	Desiccated coconut industry	Coconut oil industry	Other industry	Excess of production
1990	2532	1530	376	598	28	nil
1991	2184	1552	335	260	37	nil
1992	2296	1635	365	242	54	nil
1993	2164	1668	269	176	51	nil
1994	2622	1687	380	480	57	nil
1995	2755	1716	465	516	77	nil
1996	2546	1720	425	328	56	nil
1997	2630	1744	524	289	56	nil
1998	2522	1779	361	304	78	nil
1999	2783	1650	480	300	80	273
2000	3000	1800	580	300	40	300
2001[a]	2796	1872	408	566[b]	n.a	n.a

Note: Other Industries include Copra, fresh nut exports, and coconut cream and milk powder exports.
(a) indicates estimates. (b) Coconut oil industry absorbs considerable portion of industrial coconut production.

Source : Coconut Statistical Year Book, 1998.
Domestic consumption extracted from Annual Reports, Central Bank of Sri Lanka.

excess nut production and maintaining market prices of fresh coconut.

In the later part of 2001, there was an unprecedented rise in coconut prices due to a drop in production, posing a critical problem for both industries and edible coconut market.



Source: Coconut Statistical Year Book, various Issues and Annual Reports Central Bank of Sri Lanka.

Coconut Oil Production

Coconut oil production recorded 74,804 metric tons (MT) in 1990 but plummeted to 22,000 MT in 1993, as coconut production dropped sharply from 2500 to 2160 million nuts. However, Figure 4A.1 reveals that after 1995, while average nut production exceeded 2500 million, coconut oil production recorded less than 50,000 MT. In 2000, coconut oil production was increased by 27 per cent by utilizing 10 per cent of the total nut production.[1]

The drop in coconut oil production is attributed to i) the absorption of local fresh nut production by the DC industry and ii) increased competition from cheap imported

[1] To produce one kilogram of coconut oil, 8 fresh nuts are needed.

edible oils. Although, the fresh coconut production declined in 2001, the coconut oil industry has performed better, being heavily protected through import duties on other edible oil imports.

Cost of Production of Coconut Oil

The cost of production of fresh coconut itself has increased. To compete with current edible oil prices, the coconut oil producer has to buy a nut at around Rs 3.50. Even at that price per nut, the cost of production of coconut oil exceeds more than Rs 40,000 per metric ton (MT). At the same time, the CIF price of soya oil and palm oil are about Rs 28,000/MT. The cost of production of palm oil is about Rs 19,200/MT, and the cost of production has been steadily declining during the last five years.

Sri Lanka's coconut oil industry cannot compete with palm oil in the international market at current yields, as their cost of production is relatively higher. The coconut oil yield per acre is one fourth of the palm oil yield. The oil extraction power of the oil palm is, on average, four to five times higher than that of the coconut palm at the low technology level. At the high technology level, this disparity is even higher.

Oil Extraction Power

- One acre of coconut (at 3000 nuts/acre)
  = 0.34 tons of coconut oil
- One acre of palm oil (Indonesia)
  = 1.40 tons of palm oil (Malaysia)
  = 1.48 tons of palm oil

Cost of Production

- Cost of production of coconut oil
  = US $[2] 500 MT
- Cost of production of palm oil
  = US $ 240 MT

In 1996, the Government phased out the Business Turnover Tax (BTT) for the coconut oil industry, but introduced the Good and Services Tax (GST) in April 1998. The GST, at 12.5 per cent, in addition to the 6.5 per cent National Security Levy (NSL), increased the price of a metric ton of coconut oil from around Rs 42,000 per ton, to about Rs. 52,000 per ton. But, palm oil is imported at Rs 28,000 per ton CIF Colombo, which is around Rs 35,000 per ton at the retail level.

Unable to compete, most of the coconut oil producers resorted to a series of mal-practices in order to survive. To avoid all these tax liabilities, coconut oil millers did not show the actual amounts produced and their profit margins. The coconut oil millers who continued to remain in production could not compete with those who operated unregistered oil mills. The coconut oil industry recorded profits mainly by mixing coconut oil with cheap edible oils or by using by-products of the desiccated coconut industry called parings, for coconut oil extraction.

Capacity Utilization of Coconut Oil Mills

A large number of coconut oil mills have been closed over the past decade. The number of mills decreased from 980 in 1987

[2] In 2000, US $ 1 = Rs. 80.00.

to 158 in 1999, of which only some 36 mills appear to be in regular operation, and 120 are functioning on an irregular basis. The low capacity utilization is attributed to:

- Non-availability of raw materials due to wide fluctuations in the coconut harvest.
- Competition from cheap imported vegetable oils.
- Primitive, low productivity oil extraction methods.
- Non-availability of labour. Difficult to re-attract labour in good times once they have migrated out of the sector during lean times.
- High maintenance costs for irregularly used machinery. Oil extraction machinery made of iron corrode when only used during peak production times. This leads to reduced efficiency of these machines, additional cleaning costs and potentially lower quality, unhygienic final products.

Productions and Price Trends

The world market prices of coconut oil remained high until 1999. This was mainly because of a shortage in the supply of nuts from major producer countries and a drop in the supply of substitute edible oils. The major coconut oil producing countries had experienced adverse weather conditions during this period and its impact was reflected in the high price of coconut oil in the international market.

Since mid-1999, coconut oil prices have shown a declining trend in the world market. The main coconut oil producer in the world -- the Philippines -- has recovered and stabilized its coconut oil production in the latter half of 1999. The main palm oil producer, Malaysia has reduced the export duty on palm oil by 20 per cent and now levies only a 10 per cent duty on exports. This situation has spurred palm oil exports by reducing palm oil exports by reducing palm oil prices by 35 per cent per MT in the world market in June 1999. During the same period, Sri Lanka's import duty on palm oil was reduced by 30 per cent. This combined effect led to a significant reduction of Sri Lankan prices of imported of palm oil.

Coconut plantation sector development was mainly driven by high fresh nut prices.

Table 4A.2
World market prices of selected vegetable oils (US$/MT)

Year	Coconut Oil (Philippines, CIF Europe)	Soya Oil (Dutch/CIF, Exchange)	Palm Oil (Malaysia CIF, Europe)	Palm Kernel Oil (Malaysia CIF, Rotterdam
1993	450	n.a	409	437
1994	617	616	535	631
1995	670	625	675	652
1996	765	551	532	730
1997	647	564	545	649
1998	654	620	659	689
1999	700	435	435	680
2000	456	337	310	449
2001	313	355	279	306

Note: 2001 data from Coconut Statistics Division, CDA.
Source: Coconut Statistical Year Book, APCC, 2000.

Coconut plantation sector development was mainly driven by high fresh nut prices. The poor prices reported at the farm-gate level were partly due to unethical trade practices of dealers. Prices remained at Rs. 2 per nut during the period 1980/90 and increased to Rs. 3.50 per nut in the early half of 1990. When the fresh nut price was high at Rs.7.00 during the period of 1996/99, the retail price was around Rs. 12.00 to Rs. 14.00, where the profit margin exceeded 50 per cent. The average producer price of coconuts for the years 2000 and 2001 as much lower than the prices in the years 1998 and 1999. During the first quarter of 2000, the fresh nut prices recorded Rs. 3.50/4.00 at the farm gate level, whereas the retail price at main markets was Rs. 10.00 or more, leading to profit margins exceeding 100 per cent. But in the first six month of 2001, the average farm gate price was Rs. 4.71 and the retail price was around Rs. 8.00 to 9.50. From July 2001, the producer prices started to rise and recorded Rs. 10.00 in December, by which time the retail price in the market was around Rs. 18.00.

Coconut Oil Consumption

Coconut oil is used primarily as cooking oil in the household sector and accounts for more than 95 per cent of total cooking oil consumption. Per capita consumption of coconut oil per month increased by 16 per cent during the period 1987 to 1997. The highest per capita consumption is recorded in the estate sector at about 4.3 litres per annum, while the rural and urban sectors both recorded about 3.1 litres per annum. However, in the urban sector, there is an increasing trend in consuming other edible oils such as palm oil, vegetable oil, and soya bean oil. The share of non-coconut edible oil consumption has increased by 15 per cent during the 1986-96 period.

Table 4A.3

Total expenditure on oil consumption, by sectors

(per person per month)[3], (%)

	Coconut oil	Other cooking oil
Urban	60	40
Rural	88	12
Estate	98	2

Source: Consumer Finance and Socio Economic Survey, 96/97.

There has also been a transition away from coconut oil and toward palm oil by domestic industries producing soap and edible fats. The high cost of coconut oil, lack of continuous supply and cheap palm oil imports through import duty waivers have permitted the soap industry to permanently migrate from coconut oil to palm oil.

As far as the raw materials for the production of edible fats are concerned, there is very little coconut oil used. Edible fats are essentially industrial fats used for industrial purposes such as for the bakery industry and confectionery industry. Coconut oil is used as a raw material for margarine production and is used in equal proportion with imported oils for consumer margarine, but not used or used in very small amounts for industrial margarine. Most raw

[3] Average food expenditure per person for Month by Sectors. It is calculated under total expenditure incurred for oil consumption.

materials used in the production of edible fats, namely palm oil, palm stearin and palm olein are imported from palm growing South East Asian countries.

4A.3 Impact of Tariffs Changes on Edible Oil Imports

The objective behind granting tariff waivers on edible oil and copra imports was that during times of shortages of coconut supply to the desiccated coconut industry, it would help overcome this shortage with imported copra being used for the production of coconut oil, and an overall reduced demand for coconut oil. When the prices of coconut oil were on an upward trend, the Government intervened to soften prices on a number of occasions. The support provided to the DC industry at the cost of the oil industry by way of *ad hoc* duty waivers on edible oils adversely affected the coconut oil industry. While imports of edible oils surged after 1996, demand and supply of coconut oil contracted. However, since April 2000 there has been a policy reversal with increased duties on edible oils to promote the coconut oil industry, leaving oil

Table 4A.4a
Total tax incidence on coconut oil import

Period	Custom Duty: Statutory Duty	Custom Duty: Duty Waiver	Custom Duty: Effective Import Duty	Custom Duty: Surcharge	TT/GST	DL/NSL	Total Tax Incidence
Nov 9, 1995 - Jun 11, 1996	35	20	15	0	0	4.5	22.62
Jun 12, 1996 - Jan 15, 1997	35	20	15	0	0	4.5	22.62
Jan 16, 1997 – Nov 19, 1998	35	20	15	0	0	4.5	22.62
Nov 20, 1998 – Feb 14, 2000	25	0	25	0	0	5.5	33.87
Feb 15, 2000 – onwards	25	0	25	0	0	6.5	35.12

Table 4A.4b
Total tax incidence on palm oil imports

Period	Custom Duty: Statutory Duty	Custom Duty: Duty Waiver	Custom Duty: Effective Import Duty	Custom Duty: Surcharge/ Specific Duty	TT/GST	DL/NSL[a]	Total Tax Incidence[b]
Nov 9, 1995 - Jun 11, 1996	35	0	35	0	20	4.5[c]	68.62
Jun 12, 1996 - Jan 15, 1997	35	30	5	0	7	4.5	21.37
Jan 16, 1997 – Nov 19, 1998	35	15	20	0	12.5	4.5	43.24
Nov 20, 1998 – Feb 14, 2000	35	30	5	0	12.5	5.5	29.49
Feb 15, 2000 – Apr 26, 2000	25	20	5	0	12.5	6.5	30.74
Apr 27, 2000 – Jan 17, 2001	25	0	25	25% surcharge	12.5	6.5	57.02
Jan 18, 2001 – Dec 31, 2001	25	0	25	Rs. 20 per Kg	12.5	7.5	156.56

Note: c.i.f value of palm oil is Rs. 21.54 Kg

a. Defense levy was called National Security Levy from 01 January 1996. (b). Stamp duty of 2 per cent is included. (b) Defense Levy was changed from 3.5 per cent to 4.5 per cent on 01 July 1995.

Total tax incidence was calculated based on the following formulae (all the rates are in per cent, specific taxes wer changed to percentages):

Custom duty = CIF value * effective custom duty rate
Turnover Tax (TT) = (CIF value + Custom duty)* 1.25* (Turnover Tax rate/100)
Defense Levy (DL){or National Security Levy (NSL)} = (CIF value + Custom duty) * 1.25* (NSL rate/100)
Surcharge = CIF value * custom duty rate * surcharge rate
Total tax incidence = Custom duty + Turnover Tax {or GST}+ DL {or NSL} + Surcharge
GST was introduced on April 1, 1998 replacing the Turnover Tax.

Sources: Central Bank of Sri Lanka, Annual Report, various issues; Department of Customs; Department of Inland Revenue; Various Gazettes of the Government of Sri Lanka.

producers uncertain regarding their duration. (see Table 4A.4 for changing tariff rates).

In June 1996, when coconut production dropped and prices rose, the Government intervened to control the coconut oil price by reducing the import duty on edible oils from 35 per cent to 5 per cent. Similarly, the import duty on copra was also reduced to the same degree. In January 1997, the import duty waiver was reduced on edible oils other than coconut oil from 30 per cent to 15 per cent, thus raising the effective rate to 20 per cent. However, again in 1998 a duty wavier was granted and it was maintained until April 2000.

The quantities of edible oil imports varied with the tariff changes during the recent past. At the same time, importers promoted local consumption of edible oil imports by adopting various measures. Some of these include attractive bottling and labelling, easy access to a wide range of convenient packaging, effective publicity by emphasizing health assurance, and combining quality products with affordable retail prices.

However, there was a policy reversal and tariff revision in April 2000 when the Government decided to eliminate tariff waivers on the import of edible oil, with the objective of expanding the copra and coconut oil industry. In addition, the Government decided to impose a 25 per cent surcharge on all edible oil imports. Again in January 2001, it revised the existing import duties and increased the duty on edible oil imports for consumption purposes by 157 per cent in January 2001.

Tariff waivers also create a discriminatory situation among domestic industries. Manufacturing industries import palm oil, palm stearin oil, rape oil and tallow oil as an industrial raw material in the production process, and receive special tariff concessions from the Ministry of Industries. The soap industry, edible fat industry, and the confectionery industry use special types of edible oils or palm oil. The import duty of 10 per cent is applicable to industrial sector imports of edible oils and it is exempted from the surcharge of Rs. 20 per kg as well.

It is important to note that the statutory and or the effective duty rates alone only show a part of the picture of the import duty structure. This makes the calculation of the effective total tax incidence all the more important. The table clearly shows the *ad-hoc* nature of tariff policies adopted during the period under consideration.

The Government's attempt to achieve the objectives of ensuring low prices for consumers and high commodity prices for producers by adopting *ad-hoc* tariff policies can hold serious implication for coconut based industries. Sri Lanka has been unilaterally making these changes in tariff rates, ignoring the fact that these rates are bound under the World Trade Organization.

4A.4 Impact of the Expanding Desiccated Coconut Industry

Following a trend from the early 1970s, the growing desiccated coconut (DC) industry has steadily increased its consumption of fresh nuts. With world DC demand and prices remaining high during the last few years, other coconut related industries such as copra and coconut oil production became less profitable.

During the period of shortfalls in coconut production especially from 1996 to 1998, DC millers found it difficult to compete with oil millers and purchase sufficient volumes of nuts for operation at full capacity. DC producers induced the Government to grant a duty waiver of 30 per cent on both edible oils and copra as against the nominal rate of 35 per cent. During the period 1996 to April 2000 duty waivers ranging from 15 per cent to 30 per cent were granted to copra and edible oils other than coconut oil.

When a surplus of coconut production was experienced in late 1999 and 2000, interest groups started lobbying to resuscitate the coconut oil industry to curb the falling price of fresh coconut. Therefore, the Government removed the duty waivers in April 2000 and imposed a surcharge on edible oil imports. Meanwhile, the DC production has shown a downward trend in the second quarter of 2000, due largely to low prices in the world market.

4A.5 Policy Recommendations

Avoid *Ad Hoc* Tariff Changes

Tariff policy has lost credibility as a signal of the Government's long-term policy towards the industry. Frequent ad-hoc import duty changes induce parties to make investment choices that maximize short-term profit, as the policy uncertainty discourages making long- term investment decisions. The Government should maintain consistent and predictable policies (including trigger mechanisms in times of shortfall and surplus) to create an environment conducive for domestic industries to grow and to be competitive in the local and international market.

Improve Product Quality

Since the consumers are unable to identify the good quality coconut oil, they tend to refrain from using coconut oil available in the market. Coconut oil extracted from the desiccated industry wastes called parings has a high content of Free Fatty Acid (FFA) of around 5 to 6 per cent, which is unsuitable for domestic consumption. The coconut oil produced for domestic consumption normally contains less than 1 per cent FFA.

The second problem is the quality decline due to the adulteration with other cheaper imported edible oils in order to be price competitive. The imported vegetable oils are mixed with oil extracted from parings or desiccated wastes, and retailed in the local market as "coconut oil".

Table 4A.5

Types of edible oil and the levels of cholesterol formed

Phase	Total Cholesterol (mg/dl)	LDL-C (mg/dl)	HDL-C (mg/dl)	Ratio Total to HDL-C
Coconut and Coconut Oil phase	179	132	43.4	4.1
Corn oil and Cow milk powder phase	146	100	25.4	5.7

Source: Waidyanatha. U.P.De. S, 2001, " Coconut oil and Cholesterol" article published in the editorial column in the Daily News, 31 January 2001.

The third quality issue results from corrosion of iron-made machinery, due to low capacity utilization.

Health Perspectives

Many believe that coconut oil causes grave heart problems. This myth propagated by the other edible oil dealers was even accepted by local medical authorities and highly publicized in the past. Until such time this cholesterol factor is eliminated from the minds of the consumer, one could only expect a progressive reduction in the consumption of coconut oil in the Sri Lankan households with adverse implications for the industry as a whole.

A medical research paper published in 1989 (Table 5) indicated that the levels of all three categories of cholesterol were higher in the coconut phase, but the HDL-C (Good) cholesterol was 71 per cent more in the coconut phase than in the corn oil phase, as compared to LDL-C (Bad) cholesterol which was only 32 per cent more. Although the total cholesterol level was higher in the coconut phase, it was well within the tolerable range. The most important aspect is the ratio, which was in the low risk range during the coconut phase, but not in the corn oil phase. Further during frying, polyunsaturated fats become dangerous fats, but saturated fats like coconut oil are far more resistant to oxidation and are ideal for frying.

Consumer Preference and Publicity

The business promotion strategies of edible oil dealers have been very powerful after the market has been introduced to various types of edible oil during the recent past. Media publicity was activated vigorously in order to increase the market demand for imported edible oils. The main arguments adduced to support the market promotion of edible oils are that they are cholesterol free, good quality products without adulteration, nicely bottled for convenient handling, and affordable market price, etc. At the same time, there were a series of negative publicity stunts carried out by the palm oil importers regarding coconut oil. Meanwhile, there was the existence of poor quality coconut oil which itself would have turned the consumers away from the product. The result was that quality conscious consumers shifted from coconut oil to edible oil.

Studies have shown that the low-income groups of the population are the main users of coconut oil, which is cheaply available in the market. Different grades of coconut oil can command different prices. Consumers will then know what they are buying, and once more convenient and attractive packaging is introduced, it may not be difficult to lure them away from the imported edible oils.

Research Contribution

The research contribution to the development of the coconut oil industry is dismally poor. The oil millers continue to use very primitive mechanisms to extract coconut oil. Copra is the main raw material used for oil extraction in Sri Lanka. But there are new oil extraction techniques which are used by other coconut oil producing countries. The machines used for oil extraction are also outdated and of low efficiency. The productivity levels are far below the world average. This situation has severely eroded the profit margins in the industry.

4A.6 Conclusion

The local coconut oil producers were unable to compete with the imported edible oils, as their cost of production was relatively higher. The support provided to the DC industry at the expense of the oil industry by way of *ad hoc* duty waivers on edible oils adversely affected the coconut oil industry in the past. However, although the coconut oil industry is not a profitable venture, it absorbs considerable quantity of nut production to maintain the price stability of fresh coconut in the local market. It should, therefore, not be the Government's policy to provide short-term financial assistance, but to assist the industry by investing in areas such as research for quality improvement, developing new varieties, education of farmers with scientific methods etc. -- activities which may be inadequately provided by the private sector. All market strategies, such as efficiency in production, assurance of quality, acquiring market access, promotion of new products, community education programmes, and forward contracts etc. must emerge within the industry. The Government should not interfere in the market with temporary relief measures, but should implement clear, transparent and predictable policies allowing the industry to make long-term investment decisions.

Leading Issues in the Development Process

5. Small and Medium Enterprises: Problems and Prospects

5.1. Introduction

The role of small and medium scale enterprises (SMEs) in developing and emerging economies has assumed a major significance in recent years as Governments have viewed them as a vehicle for broad based industrialization and employment growth.

SMEs are considered to be the backbone of an economy as they are more dynamic, innovative and have a higher labour absorption rate than many of their corporate counterparts. Over the years they have emerged as strong agents of economic growth and sustainable development. Their ability to create employment at low investment costs, produce basic consumption goods using domestic raw materials, raise incomes for the larger segments of the lower income population, and enhance productivity has made SMEs an important sector that needs to be encouraged and developed.

With Sri Lanka's liberal trade regime and, in particular, the India- Sri Lanka Free Trade Agreement, the manufacturing sector is likely to face greater foreign competition. It is likely that SMEs will be more vulnerable to the forces of trade liberalization than many of their larger counterparts. As a result, supportive measures for the development and growth of this sector need to be adopted. This is particularly important because the country still has no anti-dumping duty and countervailing duty legislation that can address unfair trade practices.

SMEs are increasingly becoming an important segment of the industrial sector in Sri Lanka. A study conducted by the United Nations Development Programme (UNDP) estimates that SMEs in Sri Lanka with fixed assets of Rs. 16 million or less account for 90 per cent of total establishments, 70 per cent of employment, and 55 per cent of gross value added in the private sector.[1]

The current Government industrial policy views facilitating the expansion of the SME sector as a vital element in enhancing the existing industrial base, export performance, job creation, and income generation in both rural and urban areas.

The following sections look at the importance of forming a national definition for the SME sector, and, in spite of data limitations, assesses the SMEs' contribution to the local economy. Next, the available institutional support for SMEs is discussed, and the remaining problems facing this sector are listed. Policy recommendations to foster SME profitability and a look at

[1] The JICA study (2001).

prospects for the sector conclude this study.

5.2 Defining SMEs

The most common definitions of SMEs are based on a firm's asset value and the number of employees, but there is no single uniformly acceptable definition. This is because a small firm, for example in the light engineering industry, is likely to have higher levels of capitalization, sales and employment, than a small firm engaged in the car repair trade. As a result, definitions tend to vary by industry and by country. However, most countries do have a national definition for SMEs, which facilitates data collection and hence sector analysis.

Sri Lanka, however, lacks a national definition for SMEs, with different institutions using different definitions. The two most prevalent local SME definitions are;

- Enterprises with fixed assets, excluding land and buildings, no greater than SL Rs. 20 million. [National Development Bank (NDB)]
- Enterprises engaging 10-99 persons. [The Department of Census and Statistics (DCS)]

The lack of a national definition hinders a clear assessment of developments in the sector, which is crucial for appropriate policy design, implementation and evaluation. The data provided by the DCS on SMEs is outdated[2] and do not follow a consistent format over different years. This problem needs to be addressed without delay if targeted policy action is to be implemented successfully in specific industries.

In choosing a suitable SME definition, it would be appropriate to rely on more than one criterion. For example, the European Commission has adopted a definition such that to be classified an SME, an enterprise has to satisfy the criteria on the number of employees and one of two financial criteria, i.e. either the turnover total or the balance sheet total (see Table 5.1). The thresholds for the turnover and the balance sheet total are adjusted regularly, to take account of changing circumstances. In addition, it must be independent. This

Table 5.1
European definition of SMEs

	Medium-sized	Small-sized	Micro-enterprise
Maximum number of employees	250	50	10
Maximum turnover (in million Euros)	40	7	-
Maximum balance sheet total (in million Euros)	40	5	5

[2] Data is only given for the period 1990-1997 with the year 2000 publication reporting data for 1997.

means that one firm (or a group of several firms) falling outside the definition of an SME, may own no more than 25 per cent of the enterprise.

5.3 SMEs' Role in the Economy

Given the aforementioned limitations in data collection, and that a large proportion of SMEs are in the informal sector, it is estimated that in the year 2000 there were at 50,000 registered and 125,000 unregistered small and medium manufacturing units in Sri Lanka. SMEs are believed to contribute almost 18% of industrial output, 17% of value addition, and 24% of industrial sector employment. SMEs in services account for 17% of services output, while a recent survey conducted by the Asian Development Bank (ADB) estimated that 22 percent of firms are involved in exporting, either directly or through sub contracting linkages. Most of the service-oriented SMEs are in the engineering sector, while those that concentrate on export are engaged in the textile and apparel sector.

Looking solely at the manufacturing sector and based on the number of firms, there has been a decrease in the share of SMEs and large scale enterprises over the 1993-97 period, with micro/cottage sized enterprises growing significantly in importance (see table 5.2). Over half of all firms were SMEs in 1993, but this share dropped to about one-third by 1997. Consequently, there has been a decrease in the total output share of SMEs.

Of the 33.5 per cent of firms in 1997 that were manufacturing SMEs, 10 per cent were engaged in the food and beverages and tobacco sector, and 11.1 per cent in the textile, wearing apparel and the leather sector. The other major sectors in which SMEs contribute are in sectors of metal products, construction material, printing and paper products, agricultural and chemical products.

Despite the decrease in the number of establishments, the SME share, by the number of persons employed in manufacturing, has increased by 9 percentage points between 1993 and 1997. This may indicate that the existing SMEs have a higher labour absorption rate than previously. Even though SMEs do create employment opportunities, the labour absorption rate of large-scale industries has been higher at 67 per cent in 1997.

Table 5.2
Manufacturing output and employment by firm size: 1993/1997

	No of Establishments		Persons Engaged		Total Output	
	1993	1997	1993	1997	1993	1997
Micro	22.5	61.4	0.9	9.7	1.9	0.2
SME	54.9	33.5	14.0	22.9	15.0	11.7
Large	22.1	5.1	85.0	67.4	83.8	88.1

Source: Department of Census and Statistics.

Nevertheless, SMEs play an important role in job creation, particularly by providing employment opportunities for comparatively low skilled labour. The 1994 mission statement of the International Labour Organization (ILO) reported that 75 per cent of the labour force in Sri Lanka was employed in the small-scale sector (including the agricultural sector). However, the 1997 World Bank survey highlighted that within 8 years of receiving an SMI loan only 20 per cent of the SMEs survived.[3]

SMEs hold great potential for rural industrialization, but the 1997 World Bank study analyzing the regional spread of the various SME loan schemes found that 50 to 60 per cent of the total credit available has been granted to SMEs in the Western and North Western province. Colombo, Gampaha, Kalutara, Puttlam, Kurunegala and Kandy were the most favoured cities for lending. The reason for concentration of SME activity in urban centres as against rural areas may be due to urbanization, coupled with market potential, diffusion of technology, availability of skills and the development of industrial towns that create the necessary industrial environment for SME development. Apart from these major cities, there has been very little credit allocated to other rural areas.[4]

5.4 Institutional Support

The local institutional framework consists of a number of different institutions that extend various support services to SMEs. There is a need to establish a single authority to coordinate the activities of the many service providers and ensure that the services provided are of a given standard.

5.4.1 Government Incentives

- An advanced technology scheme offers duty free importation of approved machinery and equipment for new and existing enterprises, and also tax exemptions on incremental profits to encourage the use of advanced technology.

- Businesses engaged in the manufacture and export of non traditional products, export trading and export of services are eligible for concessionary rates of tax and are exempted from import duties and excise duties on imported and local items.

5.4.2 Financial Support

SMEs in Sri Lanka have access to long-term financial facilities, however, concessionary rates and simplified procedures have been lacking. A long-term financial scheme was in operation between 1979 to 1996, where the World Bank and the ADB sponsored a Small and Medium Scale Industry (SMI) lending scheme. Four lines of credit were introduced under this which assisted 15,000 projects and generated 137,985 employment opportunities. A similar SMAP scheme was also introduced with assistance from the ADB. Two other credit lines SMILE I and II were introduced by the Japan Bank for International Corporation.

[3] Williams T " Impact of Credit on Small and Medium Scale Industries in Sri Lanka" IPS publication, P8.

[4] National Development Bank 1998, as quoted in the paper by Thushara Williams.

The SMILE II credit line is still functioning along with SMEC and Vika Sitha schemes sponsored by Hatton National Bank.

Financial support for SMEs are provided through the Central Bank of Sri Lanka and various other development and commercial banks in the country. The Central Bank functions mainly as a credit guarantee and bears the exchange rate risks of many of the sponsored SME loan schemes that have been flowing in since 1979. The Development Finance Department of the Central Bank conducts various management programmes to encourage the development of this sector.

The DFCC, as a development bank, has over the past 25 years focused its attention on the SME sector by providing various term loans, working capital, and leasing facilities to entrepreneurs. Apart from providing finance, the bank also provides various forms of business advice and training programmes for managers to encourage sound business practices.

The Hatton National Bank stands out among commercial banks in providing various lending schemes for SMEs. Almost all of the SME loan schemes such as SMAP, SMI (I-IV), SMILE I and II, SMEC and Vika Sitha have been channelled through this bank. Such sponsored loan schemes often provide either concessionary interest rates or longer repayment periods.

5.4.3 Technical Support

Technical support is provided through the Industrial Development Board (IDB) in the form of infrastructure facilities (implemented under the "Isuru Uyana" industrial estates programme), technical assistance, market and production advice, as well as management training and consultancy services (provided through the "Center for Entrepreneurship and Consultancy Services" programme). However, the IDB lacks the necessary expertise, manpower and facilities to extend these services to cater to all eligible SMEs in rural areas.

The National Institute of Business Management (NIBM) conducts training programmes to educate managerial and supervisory staff of SMEs in modern management and productivity aspects.

The Industrial Technological Institute (ITI) is an inter-disciplinary research institute that is dedicated to the promotion of industrial development through research, consultancy and other technical services such as engaging in activities connected with technology transfers, the adaptation of technologies, and development of new technologies. It focuses its attention on six main divisions -- agro and food technology, chemical and environmental technology, materials technology, process and plant engineering, calibration, and measurement and electro-technology.

5.4.4 Production and Marketing

Small and Medium Enterprise Development (SMED) is a project of the Federation of Chambers of Commerce and Industry in Sri Lanka (FCCISL) in collaboration with the Friedrich-Naumann-Stiftung of Germany

(FNSt). This project commenced in 1989 with a view to develop and promote the SME sector in the country. The main objective of SMED is the development and promotion of a market economy in Sri Lanka through the improvement of the competitive performances of individuals, small and medium enterprises, as well as the strengthening of the organizations which represent the SME sector.

SMED has launched two important projects,[5] consisting of the Sub-contracting and Partnership Exchange (SPX) and the Triple Bottom Line (TBL). The objectives of SPX is to promote subcontracting by identifying, selecting and upgrading the manufacturing capacities and capabilities of local companies -- in particular SMEs, which can act as subcontractors for domestic and foreign companies. [6]

SMED identifies the needs of various sub-contracting firms and provides services to ensure that these identified SMEs meet the required quality and on-time-delivery procedures of the main contractors. The SPX system is operated through a computerized data bank with detailed information on the technical characteristics (including machinery details) and the type of products offered by the sub-contractors. Many opportunities for local SMEs are anticipated through international sub-contracting, starting with the launch of a web portal with India that would enable Indian firms to seek suitable sub-contracting firms from Sri Lanka.

The objective of TBL project is to improve the three main bottom lines of an industrial organization i.e., financial, environmental and social commitments. Such a project would benefit SMEs who are engaged in the export market, such that they are in a position to meet the international guidelines that are required to engage in trading with foreign markets.

Management and Information support is provided through the Export Development Board (EDB) in terms of the promotion of product development and export market information services for SMEs under the "Export-oriented SMI Development in Provinces" scheme.[7] EDB undertakes market research to identify export market opportunities, export marketing, promotion of Sri Lankan products in overseas markets, and training of exporters or officials. SMEs are given special concessions and assistance in terms of cost of printing brochures, cost of air fares, and stall space at various local and international trade fairs and exhibitions. FCCISL organizes an "Entrepreneur of the Year" award scheme to recognize outstanding entrepreneurs for their contribution towards the socio-economic

[5]These projects have been established with the participation of the Ministry of Constitutional Affairs and Industrial Development and is a component of the UNIDO Integrated Industrial Development Support Programme for Sri Lanka.

[6] Presently the SPX project concentrates on five manufacturing sectors, which consist of rubber products, plastic products, electrical and electronic products, engineering products, and coir product sectors.

[7] This service is restricted to the Central and Western provinces only.

development of Sri Lanka at micro, small, medium, large, extra large sectors on provincial and national levels, covering the agriculture, industry, and services categories.

5.5 Problems Facing the SME sector

5.5.1 National Policy

An SME development survey report by the ADB showed that 71 per cent of business owners consider the economic and political instability to be a constraint . The ethnic conflict in the Northern and Eastern provinces has limited market opportunities for SMEs.

The present tax regulations (VAT) and the threat from the informal sector makes it difficult for many of these firms to become price competitive. High cost of raw materials as a result of taxes on imported inputs and inadequate supply of quality raw materials also increases the production costs for SMEs.

Current EPF and ETF regulations discourage sub-contracting arrangements. The regulations are such that if the sub-contractor has not paid the required EPF/ ETF contributions, the parent company is held liable and responsible to pay such statutory dues. This has become a disincentive for encouraging sub-contracting schemes as many parent companies are reluctant undertake such responsibilities.

Labour legislation with regard to the Termination of Employment Act and the Industrial Disputes Act, results in the reluctance of firms to hire additional employees and the job security that is provided by these acts has negative effects on work ethic, worker development, productivity, and wage growth.

5.5.2 Infrastructure

Lack of adequate infrastructure facilities such as electricity, water, telephones and road access in many of the rural areas has prevented the start up of many SMEs.

5.5.3 Financial

Many SMEs face high interest rates due to the high risk of defaults associated with these firms, and the insistence of collateral in the form of land by lending institutions. This has led SMEs to rely on their own funds, leading to low levels of resource availability for expansion. A survey carried out by the Central Bank of Sri Lanka suggests that 61 percent of the entrepreneurs have experienced bank borrowing difficulties. Another constraint facing many of the rural SMEs is the regional concentration of loans disbursement, since most of the loans granted were in the Western and North Western provinces of the country.

Many SMEs also face the threat of Parate Execution[8] by banks, which has reached record high levels in the recent years. But

[8] The power of Parate Execution is the recovery of loans by banks where the Board of Directors of a bank can pass a resolution to sell mortgaged property by public auction when default occurs on account of principal or interest or both.

due to the nature of forced transactions, the value realized at the auctions are far below the market value with a no win situation for both banks and the client. When a business is experiencing difficulties, an attempt should be made to first revive the business by restructuring its operations instead of closing it down immediately, as this tends to dampen the entrepreneurial spirit and discourage business start-ups.

5.5.4 Business Development Services

Most SMEs (especially in the rural areas) argue that have not received any business development services (BDS) from Government agencies, institutions and NGOs. There is also limited co-ordination between the various institutions that provide such services to SMEs, and in some instances the technical or training programmes provided to managers/ workers are believed to be outdated.

A study done by the ADB mentions that most of the BDS programmes are characterized by "one shot" interventions with budget and manpower constraints not allowing return visits and further support at a latter stage. The outreach and participation rates of these programmes are also believed to be poor, especially in rural areas.

Technical

SMEs often produce low quality products, and as a result face difficulties in obtaining sub-contracting arrangements from large firms. The lack of knowledge, finance and the use of out dated production techniques are the main contributory factors. The lack of technical skills in terms of skilled labour, and research and development activities are other constraints faced by this sector.

Marketing

SMEs find it difficult to expand their markets and exploit available market opportunities due to the lack of market information of both domestic and foreign markets and the necessary marketing strategies. This coupled with low levels of technology has constrained SMEs' ability to face competition from local and foreign goods.

Managerial

The lack of entrepreneurial and management skills is one of the main factors that have hindered the growth and resulted in the failure of many SMEs world-wide. Inappropriate management decisions, the lack of knowledge and expertise, and the unwillingness to expand due to the fear of losing control of one's business are some of the hindrances to SME development.

SMEs lack information on business start-up avenues. They lack the necessary market information and business advice on choosing the most profitable sector to enter. One visible feature is that many entrepreneurs adopt a "copy cat" approach when choosing to enter a particular industry. This is the tendency to emulate the most successful ventures with little market research on the viability of such a project.

5.6 Policy Recommendations

Subsidies are not necessary for SME development. Instead the Government needs to perform a supportive role and provide an appropriate policy and regulatory environment for them to flourish. The Government should provide management, technical and marketing advice to SMEs. The growth of SMEs depends upon how they respond to changes in the market place. Therefore, in order to be competitive in local and international markets, they need to be innovative, dynamic, productive, cost efficient, and be able to target and exploit niche markets. To do so, management should be educated on current market trends, have all the necessary market information, should know the importance of research and development, and should have the knowledge and ability to adopt new technological methods in the production process. The Government should identify the sectors where SMEs have the most market potential and encourage the setting up of firms in these industries.

The key objective of SME policy should be to facilitate the diffusion of new ideas and products. In recent years, small firms have been an increasing source of new innovations and, given the role that new technology is thought to play in economic development, small high technology firms are seen as major contributors to wealth.

There is a need to have targeted initiatives like in Korea where there is discriminatory support to units that showed the capacity to grow into medium and large-scale industries. SMEs in certain industries are picked and various BDS are provided to ensure that after a certain period, firms in that sector are able to survive and grow. This would have a greater impact instead of applying policies across the board. A criterion whereby units are chosen on the basis that i) they are able to act as sub-contractors to large domestic or foreign firms or ii) that their products have the potential for import substitution or can be exported in the immediate future, could be adopted. Therefore, a sub-sectoral policy framework, which is designed to make interventions and support facilities more effective, is required.

SME policy should be focused on increasing competition, strengthening the production chain (by providing inputs to large firms as sub-contractors), diversifying, and creating employment.

- There is a need to develop existing historical clusters and help promote the formation of industrial clusters in certain industries. This would not only enhance intra firm performance through economies of scale, but may also generate other diverse industries that support cluster industries.

- Need to motivate lending institutions to provide loans to this sector based on the concept of profit-oriented lending rather than security-oriented lending.

- Strengthen the regional banking structures and steps need to be taken to make loans easily accessible to SMEs. Loans for SMEs should be disbursed by financial institutions in close proximity to SMEs spread throughout the country as they would better know the credentials of the entrepreneurs concerned. Regional development banks can play an active role in this regard.

- "A one stop shop" to be set up on a regional basis to provide SMEs with a complete package of assistance and services.

- Training of workers and managers with the appropriate skills is necessary to increase efficiency and productivity at the work place.

- Enhance and encourage the development of R & D institutions to encourage SMEs to be engaged in the production of more innovative products and processes. In this instance the State could provide certain incentives for SMEs to undertake such efforts.

- Set up trading houses that would do the necessary marketing of the products on behalf of the SMEs, and allow them to concentrate on the production process. This has been successful in certain industries such as handicrafts, where Laksala performs the role of a trading house. The other advantage of trading houses is that they contribute towards increasing the quality of products by introducing certain product specifications.

- In terms of the parate executions, banks should conduct a comprehensive investigation when the business goes bad for the purpose of assessing the actual reason for the default. Steps need to be taken to revive the business by providing support services (management, technical) by selling the security and attempting to recover part of the monies owed.

- Business incubators are seen as an ideal concept to promote new business start ups and to strengthened the survival rate of many of these enterprises. These incubators offer a range of services to emerging entrepreneurs. Since these services are only offered for a limited time period, these businesses are faced with the pressure to grow or close.

- Encourage sub-contracting linkages with domestic and/or foreign large firms. Such linkages promote the development of this sector through increase in national participation in production activities, thus increasing employment opportunities, encouraging the development of regional enterprises through decentralization of industrial activities; linkages also encourage them to be competitive since they are able to gain expertise from the main contracting firm.

5.7 Prospects

The SME sector plays an important role not only in terms of employment creation and industrial growth, but also in terms of income distribution and poverty alleviation. The future prospects for this sector is bright with the Government, private sector and various multilateral institutions taking an interest in encouraging its growth and development. Since SMEs are the major source of job creation it is argued that during times of high unemployment, such firms should be the focus of policies both to increase the number of firms and to add to the number of jobs within each firm.

The SME sector will be boosted by an assistance package by the Asian Development Bank (ADB). This consists of loans totalling US$86 million and a partial credit guarantee to support commercial co-financing of up to US$90 million. This programme which is known as the Small and Medium Enterprise Development Programme is aimed at enhancing the business environment, strengthening business capabilities, and improving access to finance for SMEs. It will also use information technology to improve access to markets and technology to enable banks to reduce lending costs.

The recently announced budget proposals have various incentives to encourage industrial growth and SMEs. Firstly, the Government has made changes to the corporate tax structure, with those companies with a taxable income of less than Rs. 5 million to be taxed at a lower rate. It is believed that this would stimulate investment in SMEs, especially in the agricultural and agro based industries in rural areas. Under the new income tax provisions, research and development (R&D) and staff training expenses would be made deductible for income tax purposes.

The Government aims to establish a Capital Goods Entitlement Credit Scheme to endow capital assets to marginalized persons with entrepreneurial skills, which is to be implemented with the assistance of the rural and other development banks and financial institutions. A Rural Economy Resuscitation Fund will be established for the purpose of providing assistance to entrepreneurs engaged in the provision of small and medium scale economic and social infrastructure facilities in the rural areas. The Government also hopes to provide greater facilities for the marketing of goods produced by rural small-scale industries. In order to accelerate rural industrialization, the Government also proposes to provide the necessary seed capital in the form of infrastructure and technical support for private sector enterprises to start up in rural areas.

The Budget 2003 also includes an Agro-Enterprise Development Fund, which will assist small and medium scale farmers to improve agricultural practices, introduce new crops and new technology, and maintain village tanks.

The amendments to the Termination of Employment Act and the Industrials Disputes Act are also welcome changes for SMEs. The future prospects for the development of this sector is bright due to the various proposals mentioned above. However, this is only the beginning. Further policy support measures need to be adopted to create a thriving SME sector.

Even though some of the policy recommendations made above go against the Government's free market non-interventionist principles, it should be noted that this sector is unlikely to survive if a targeted support oriented approach is not adopted by the Government. Further, the prevalent market and information imperfections justify intervention even in a classical *laissez-faire* framework. To become a dynamic, innovative and employment-creating sector, then certain support services need to be provided to ensure this sector is able to survive and grow in a competitive environment. Assistance for these enterprises should be provided for a pre-determined period and not indefinitely.

Sri Lanka is in need of a systematic strategy within which suggested polices can be implemented at the national and regional level. This should be made a priority if we wish to expand the industrial base, encourage these small and medium industries to be competitive locally and internationally, and reap the positive economic benefits in terms of employment creation and reducing rural poverty.

6. Poverty: Issues and Options

6.1 Introduction

Despite numerous and costly efforts by the State over the last 50 years, between 25 to 40 per cent of the population still remain in poverty.[1] Further, 45 per cent of the population live on an income below US$2 per day, and 6.6 per cent have an income below US$ 1 per day.[2] Although the incidence of poverty has reduced by 2.1 percentage points over the 1985 to 1995 period, population growth has meant that the absolute number of poor has not decreased over time. Furthermore, low accrual of economic benefits to the poor is indicated by the stagnation since independence in the share of total income (around 1.5 per cent) accrued by the bottom decile of the population. Regional poverty statistics also show a wide variation in degree of deprivation between the districts and provinces of the country, even though numerous State driven development programmes are spread throughout the country to reduce regional disparities.

The reduction in poverty incidence in the country is less than anticipated, given the heavy State investments in human capital development and provision of basic needs as well as other efforts to stimulate economic growth. For instance, the Government has invested in universal free education and health, as human capital development was considered one of the important pre-requisites for economic growth and social equity. Various forms of other subsidies such as on food prices, transport, credit, irrigation water and agricultural input subsidies, and income supplements continued in different degrees and over time since 1948. Land distribution for landless and provision of low-cost housing facilities were all part of the State's effort towards an equitable distribution of resources. Apart from asset distribution and subsidies/income supplements, the State also attempted to create employment opportunities by providing subsidized credit, developing infrastructure, and encouraging direct foreign investments in the country. A large number of integrated rural development (IRDP) programmes were implemented in the country with the dual purpose of infrastructure enhancement in the rural areas as well as creation of employment opportunities.

However, in the past, development programmes in the country did not have poverty reduction as an explicit goal. Any degree of poverty reduction was an

[1] Poverty defined using consumption indicators. See Table 1 for details.

[2] Introduced in the World Development Report (2000), this measure has become attractive for its intuitive appeal and ease of cross-country comparisons, and not for any inherent quality in detecting poverty accurately.

implicit outcome assumed to result via various developmental efforts in the country. It is only since 1989 that the State began to emphasize on the need to reduce poverty, and specific planned action was attempted.

Since 1989, the earlier household income supplement programme such as food ration and stamps was transformed in to a broader "Poverty Alleviating" programmes for the country. The country since then witnessed two such programmes -- Janasaviya and the current Samurdhi programme. Both programmes retained the household income supplement components from the earlier schemes and added on a micro credit and savings, micro-enterprise development, social mobilization, nutritional welfare, and some local infrastructure development components. The existing Samurdhi programmes needs to be a time-bound social security scheme rather than being an approach to alleviating poverty. This is because, although large costs (about Rs.9 billion per year) are incurred, poverty alleviation programmes' contribution to reducing poverty remain very limited.

The ensuing sections track issues in poverty by first looking at the incidence of poverty using the various indicators available. It discusses how the very inadequacy of the indicators affects the fight against poverty, and draws attention to areas for improvement with regard to poverty measurement and monitoring. This section then looks at poverty changes over time, and tries to explain the country's unimpressive record in poverty reduction. It then considers the recently developed Poverty Reduction Strategy Paper (PRSP) and the challenges ahead in alleviating poverty .

6.2 Tracking Poverty

The assessment of changes in poverty status of the population is important for several reasons. First, the main tool in poverty reduction is through higher economic growth -- monitoring of distribution of economic gains within population groups will indicate the extent to which policies discriminate against certain populations or economic sectors. Therefore, monitoring of poverty and characteristics of the poor will enable the Government to formulate new policies or re-direct the present economic policy matrix to ensure that the poor are integrated to economic development processes.

Second, large investments are made by the State in social welfare programmes with universal coverage mainly to ensure a more equitable distribution of resources through access to basic services by the economically and socially deprived population segments. Hence, tracking changes in the level of deprivation in the population will show the effectiveness and shortcomings of the implementation of such programmes, thus permitting necessary changes to be instituted.

Thirdly, poverty alleviation in the country is attempted through targeted intervention programmes as well. Even though poverty cannot be resolved through programmatic interventions alone, these interventions are expected to assist the poor in the short-term until economic benefits through growth accrue to them. Therefore, once again tracking beneficiaries of such programmes will increase targeting accuracy.

Although numerous studies since the 1960s have assessed poverty levels for the country, lack of comparative statistics prevented assessment of change in poverty status over time or tracking progress in poverty reduction in Sri Lanka. Further, the lack of a comprehensive official poverty line also led to continuous experimentation in assessing poverty levels.

Noting this gap in information, the Department of Census and Statistics and other researchers have, in the recent past, re-analyzed the existing national household survey data sets to compile comparable indicators to assess poverty changes. Even though recent analyses permit temporal assessment of poverty, percent prevalence of poverty still varies with each analysis as shown in the following section. Different poverty prevalence, in turn, sends mixed signals to policy-makers with regard to progress in poverty reduction and leads to uncertainty on effective efforts the State should promote to reduce poverty.

6.2.1 Poverty Indicators

At present, the national, district and provincial poverty levels have been estimated utilizing a household income-expenditure survey, which is conducted five yearly, by the Department of Census and Statistics. Although a second national household survey in the country is conducted by the Central Bank of Sri Lanka every ten years (Consumer Finance survey), information from this survey has not been used for estimating poverty regularly. However, it remains a major source that can be utilized to estimate poverty levels and characteristics of the poor.

In order to highlight the variation in poverty statistics, this section examines the poverty assessment through three separate indicators. All three indicators given in Table 6.1 are formulated by using the same set of data generated every five years by the Department of Census and Statistics. The analyses show that even small variation in poverty definitions give a significant variation in poverty prevalence. The three main national poverty measurements are based on

- The level of household food energy intake (FEI).
  Two classifications: - "nutritionally-at-risk"[3] poor "ultra-poor"[4] or the poorest.
- The level of both food and non-food expenditure (EXPD)
  Two classifications: - "lower" poverty line "higher poverty line" (20% "higher' expenditure than above).

[3] Nutritionally-at-risk - Households whose food ratio (food expenditure to total expenditure ratio) is equal or less than 80 per cent, but achieves less than or equal to 80 per cent of their food requirements.

[4] Ultra Poor - Households whose food ratio is more than 80 per cent, but achieves less than 80 per cent of their food energy requirement.

- Both expenditure on food and food energy intake (EXPD +FEI)

6.2.2 Incidence of Poverty

Only the latter two poverty indicators are available with the latest data collected during 1995/96. The expenditure based (EXPD) lower poverty line and the expenditure and nutrition combination indicator (EXPD+FEI) suggest similar poverty incidence of 25.2 per cent and 26.7 per cent respectively. Using the higher poverty line suggests that almost 40 per cent of the population is poor. All these measures indicate a greater poverty incidence in rural and estate sectors, compared to the urban areas (see Table 6.1).

However, when all three measures are available, as in 1990/1991, the proportion of population in poverty from the three indicator vary significantly -- from 5.4 per cent being ultra-poor to 35.3 per cent being below the high poverty line. According to the FEI (nutritionally at risk), EXPD (lower poverty line), and EXPD +FEI, the share of the population that was poor was 14.4, 22.4 and 30.4 respectively. There is also considerable variation in

Table 6.1
Prevalence of poverty

Poverty Indicator	Survey Period	Percent Poverty Prevalence			
		Sri Lanka	Urban	Rural	Estates
FEI - Nutritionally-at-risk	1980/81	23.8	26.6	23.5	19.5
FEI - Nutritionally-at-risk	1985/86	22.4	24	23.1	9.2
FEI - Nutritionally-at-risk	1990/91	14.4	19	14	5.8
FEI - Ultra Poor	1980/81	5.5	5.8	5.7	1.8
FEI - Ultra Poor	1985/86	2.9	3.2	2.9	1.8
FEI - Ultra Poor	1990/91	5.4	4.4	5.9	3
EXPD - Low Poverty Line	1985/86	27.3	16.4	31.7	14.3
EXPD - Low Poverty Line	1990/91	22.4	18.3	24.4	12.6
EXPD - Low Poverty Line	1995/96	25.2	14.7	26.9	24.9
EXPD - High Poverty Line	1985/86	40.6	26.8	45.6	30.9
EXPD - High Poverty Line	1990/91	35.3	28.4	38.1	27.5
EXPD - High Poverty Line	1995/96	39.0	24.9	41.3	45.3
EXPD + FEI	1990/91	30.4	18.2	34.7	20.5
EXPD + FEI	1995/96	26.7	13.7	28.7	26.1

Notes: Poverty line is derived from using the Cost of Basic Needs method, which includes the cost of food bundle that satisfies energy needs and the cost of non-food consumption of those who can afford to meet their food energy needs. High poverty line is 20 per cent higher than that of low poverty.
EXPD+ FEI data - Source: Income and Expenditure Survey, Dept. of Census and Statistics, Colombo (2002). Poor are defined as those households that spend over 50 per cent of household's expenditure on food and obtain the minimum food energy value required per adult equivalent food intake.

FEI data - Source: Nanayakkara, A.G.W. (1994) Poverty Analysis in Sri Lanka, Dept. of Census & Statistics Mimeo, Colombo.

EXPD – 1985/96 & 1990/91 data – Source: Datt, G and Gunawardena, D (1997) Some Aspects of Poverty in Sri Lanka 1985-90, Policy Working Paper 1738, World Bank.

EXPD - 1995/96 data - Source: Gunewardena, D, (2000) Consumption Poverty in Sri Lankan, 1985-1996: A Profile of Poverty Based on Household Survey Data, Mimeo, April 2000.

poverty incidence by sector when the different indicators are compared. In terms of magnitude, the comparing second (EXPD) and third (EXPD+ FEI) indicators show that in 1990/91 rural poor accounted for 24.4 per cent (lower poverty line) and 34.7 per cent respectively. Further, the first indicator (FEI) suggests the greatest incidence of poverty is in urban areas (19 per cent), while the other two indicators suggest it in the rural sector.

6.2.3 Issues with Poverty Indicators

Since the magnitude of poverty over time shows a wide variation depending on the indicator used, utilizing any of the three sets of indicators for policy and programme designing creates difficulties as its not possible to know which of the three sets is most accurate. Some of the basic characteristics relating to the indicators are:

- The magnitude of poverty level is dependent on the indicator/cut-off point utilized for analysis.
- As all poverty indicators utilized thus far are primarily based on food expenditure, the level of poverty is very sensitive to fluctuations in food prices at the time the survey is conducted.
- All indicators utilized in the past to select the poor are limited to money-metric and quantitative measurements only.
- None of the given indicators permit easy and accurate identification of the poor at ground level. All indicators rely on household income and/or expenditure; however, securing accurate information on either is difficult and does not permit confirmation.
- The multi-dimensionality of poverty is not captured by any of the given indicators, and thus will limit information required for designing programmes/ interventions to cater to the needs of the poor.
- The given indicators provide only limited information on the varying severity of poverty within the population.
- Further, a lack of panel data prevents tracking long-term poverty trends in a consistent manner.
- Selection of the poor for interventions depends on the reliability and verifiability of poverty indicators at household level, which in turn has a bearing on effectiveness of poverty alleviation programmes.

Given these concerns, there are four major avenues the Government should pursue:

Develop a Multi-dimensional, Composite Indicator

Firstly, a need exists to develop either a composite or a series of indicators to capture multi-dimensionality of poverty. Such sets of indicators should also take into account the regional (district/provincial) variation in poverty characteristics as well. Poverty thus defined should become the official poverty line so that future poverty monitoring and regular evaluation of effectiveness of State expenditure on the poor becomes possible. The set of indicators developed for the above purpose ideally must permit transparency in identification of the poor and be relatively easy to implement and verify.

Institutional Responsibility

The responsibility of developing a set of multi-dimensional, reliable and verifiable indicators to identify the poor and assess poverty should rest with the Department of Census and Statistics as the main institute for generating national level data from household surveys, and as the institute with the competence to undertake such a task. The Department of Census and Statistics should liaise with other institutions engaged in poverty monitoring to permit exchange in information on easily monitored indicators as well as to take into account community level experiences in poverty monitoring.

More Frequent Disaggregated Data Collection

Secondly, the Department of Census and Statistics can only conduct such a survey every five years. The reason for the given frequency is related to resource availability at the institution and also perhaps the cost-effectiveness of a more frequent collection of data.

However, information on poverty is required more frequently at a disaggregated level as an input for decentralized planning. Therefore, second level of data gathering is required at the Divisional Secretarial Level (DSD). Information gathering is already in place at the DSD level but needs to be supplemented with additional information pertaining to poverty. Divisional Secretary divisions can achieve this with the assistance of divisional levels staff, which include extension services and Grama Niladhari staff as well as school children and NGOs in the area. The multi-dimensional poverty indicators can be provided by the Department of Census and Research Institutes, which will be used for poverty assessment at DSD levels.

Such periodic assessment at the DSD level can feed directly to a more efficient allocation of resources through improved planning to assist the most deprived. Further, this data can be aggregated to monitor sub-national and national level progress in poverty reduction.

Peer/community Monitoring Mechanisms

Furthermore, once a verifiable set of indicators to identify the poor is developed and information gathered, a peer/community monitoring mechanism at the village level needs to be established to ensure that non-poor are not included and "graduated" poor are removed from State interventions. Such transparency in turn will assist to minimize mis-targetting of State interventions to the non-poor as well as reduce political and other biases in both identification of the poor and in resource allocation.

6.2.4 Changes in Poverty Incidence

Changes in poverty incidence over selected periods across the three indicators show the variation in the change in magnitude and direction of poverty incidence. Based on the nutritional intake classification, national poverty incidence has declined from 23.8 to 14.4 per cent during the period 1980/81 to 1990/91. This was reflected broadly with drops in urban, rural and estate poverty incidence by 7.6, 9.5 and 13.7 percentage points respectively.

As shown in Table 6.1, the FEI indicator reflects a reduction in poverty by 9 percentage points for the period of 1985/86-1990/91 whereas the EXPD (lower poverty line) shows a reduction of 4.9 percentage points. Except for the ultra poor, the indicators suggest that the 1985/6 to 1990/91, period was a time of reduced poverty.

However, the indications on the direction of poverty incidence during 1991-1996 are conflicting with the EXPD measures reflecting a rise in poverty, while the EXPD +FEI indicator shows poverty actually reducing over that 1991 to 1996 period.

At a sectoral level, the EXPD set of indicators show the incidence of urban and rural poverty has declined by 3.7 and 8.6 percentage points respectively, whilst estate poverty has increased by 4.4 percentage points during the ten years from 1986 to 1996. The EXPD+FEI indicator confirms this trend over the sub-period 19900/91- 1995/96.

Restricting the focus to one indicator over time allows a deeper analysis. Information provided in Table 6.2 indicates poverty reduction over the 1986-1996 decade. The changes in poverty over time is examined using information from the second set of indicators -- EXPD (lower poverty line).

In the given decade, the highest reduction in national poverty prevalence is observed at 4.9 per cent during the period of 1985 to 1990 -- similarly for rural and estate sectors. At the national level, the highest *annual* percentage point reduction in poverty is therefore also recorded for the period 1985 to 1990 (except for the urban sector), with an average of 0.98 percentage points reduction per annum for the country, the rural sector recording its highest of 1.46 percentage points per annum in the same period. However, the annual change in poverty levels is low for the decade of 1985 to 1995. For instance, the average annual change in poverty over the last decade (1985-1995) is only 0.24% per year, the rural sector recording the highest of 0.48 percent per annum for the same decade.

Table 6.2
Change in poverty levels (+ indicates reduction in poverty)

Sector	Change in Poverty Levels (%*)			Annual Change in Poverty Level (%*)		
	1985 to 90	1990 to 95	1985 to 95	1985 to 90	1990 to 95	85 to 95
Sri Lanka	4.9	-2.8	2.1	0.98	-0.56	0.24
Urban	-1.9	3.6	1.7	-0.38	0.72	0.17
Rural	7.3	-2.5	4.8	1.46	-0.5	0.48
Estate	1.7	-12.3	-10.6	0.34	-2.46	-1.06

Note: * percentage points - It is noteworthy that despite an average GDP growth rate of 5.3 per cent for the period 1990-1995 period (Central Bank 2000)[5], annual and five yearly reductions in poverty is negligible.
Source: Tudawe, P.I. (2002) Identification of the poor: Implications for Policy, Mimeo, Institute of Policy Studies.

[5] Annual Report of 2000, Central Bank of Sri Lanka.

Assuming that annual reduction in poverty is 0.24 percentage points per annum, using 2002 population estimates approximately 39,323 persons move out of poverty each year. Taking the 1995 national level lower poverty incidence of 25.2 per cent and annual increase in population of about 300,000 new births, about 75,000 population is added each year to the poor group. The overall number of persons then moving into poverty annually increases by 35,677 per annum.

By taking account of the fact that the urban, rural and estate populations comprise 14.6 per cent, 80 per cent and 5.3 per cent of the total population, the estimated number of individuals in poverty (by the 1995/96 lower poverty line) is 362,572 in the urban sector, 3,631,058 in rural areas, and 224,028 in the estate sector.

6.3 Reasons for Unsatisfactory Poverty Reduction

Inadequacies in the Dual Approach to Poverty Reduction

Reduction in poverty is attempted through economic growth and programmatic attempts through poverty alleviation programmes. The low annual reduction in the incidence of poverty as well as overall reduction in poverty over time (Table 6.2) imply that benefits expected to accrue to the poor from growth and programmatic approach have differentially accrued more benefits to the to non-poor than the poor. Poverty alleviation programmes were not as effective as expected, mainly due to "leakages" and high administrative costs. The existing Samurdhi programmes needs to be a time-bound social security scheme rather than being an approach to alleviating poverty. This is because, although large costs (about Rs.9 billion per year) are incurred, poverty alleviation programmes' contribution to reducing poverty remains very limited.

Including the Poor and Excluding the Non-poor

In both poverty alleviation programmes as well as earlier income supplement programmes, the household income remains the main criterion for the selection of poor, for which accurate information, as highlighted before, is difficult to obtain. Apart from the difficulties in selecting on household income, introduction of numerous political and other biases have led to problems in the selection process of poor. Such biases have led to the selection of the non-poor at the cost of excluding a similar proportion of the poor from the programmes.

Further, administrative and other difficulties in removing the non-poor and the poor who graduate from poverty, and inclusion of new poor into the programme have contributed to the reduced impact from poverty alleviation programmes. This has resulted in large amounts of funds in such programmes being mis-spent and/or mis-allocated away from the poor.

According to available data, in the current poverty alleviation programmes nearly one third of the recipients are the non-poor, and about 40% of total expenditure accrues to the non-poor (Tudawe 2002)[6] due to poor targeting. Since a larger segment of population was serviced through such efforts, available resources have been "spread too thin" and prevented the assistance to the poor being linked to the cost of living index. The deterioration of real value of per capita assistance given to the poor over time adversely affected the progress of poverty alleviation.

Inadequacies in Poverty Monitoring Information

Since data to the contrary was limited, policy-makers until recently assumed that State interventions would benefit the poor, and often did not try to assess effectiveness of subsidies and other interventions on the poor. Further, since many of the development programmes entertained poverty reduction only as an implicit goal, information on effectiveness of these programmes in reducing poverty was often not maintained. Since poverty reduction was not an explicit goal, the main data generators in the country were not required to undertake tracking of poverty. Therefore, poverty statistics were not available until recently.

Inadequate monitoring of progress of the poor has resulted in the inability to identify constraints that prevent the poor from moving out of poverty and provide required assistance to ensure that they "graduate" from poverty before the end of the programme. An effective monitoring system would have revealed if a poor person has been receiving such benefits for long periods without improvement in status. Such identification should then lead to an inquiry as to reasons and necessary measures to assist in increasing employment opportunities.

Inadequate Provision of Social Development Services

The outcome of State interventions on human capital development through free education and health did not address the poor sufficiently, since the

- Highest level of under-nutrition is observed in the lowest income decile
- Poorest of the poor are the least educated among the employed
- Poorest has the largest number of members in the family
- Poorest are landless, hired labour with low-skilled, low wage employment

The given observations question the efficiency of the free health and education systems in catering to the needs of the poor and increasing their human capital. The resource constraints of the poorest households appear to restrict such households from taking full advantage of the free education, in particular due to the hidden costs in education. Further, the differential quality in facilities available to the poor may, especially in education and health in rural and estate areas, also contribute to the poor reaping less than expected benefits from such State services. The wide spatial variation in State services in terms of low availability

[6] Tudawe, P.I. (2002) Identification of the poor: Implications for Policy, Mimeo, Institute of Policy Studies.

and accessibility in turn leads to the households remaining poor for long periods of time. For instance, a study on selected rural villages show that in 1988 the village Dambemada, 90 percent of the villagers were poor and 10 percent were of average means; whilst in 1998, 85 percent were poor. In this village signs of inter-generational poverty are apparent, where the poor had remained poor for over 15 years. (Tudawe 2002).[7]

Uniform Programmes do not Distinguish Between Different Poverty Groups

The inability to distinguish the severity of poverty and the reason for poverty has led to designing of uniform programmes that do not appropriately address the differential issues faced by the different poverty groups. The poverty alleviation programmes take little note of the differential skills and ability among individuals that are in varying degrees of poverty. The programmes, for instance, are not able to cater to the special needs of long-term poverty groups such as the chronically poor where poverty is inter-generationally transmitted.

Further, they do not specifically address different forms of temporary poverty, which may occur at different stages of the life cycle. People may i) become poor at different stages of growing up (such as with loss of parents and/or assets), ii) become poor as an adult due to inadequate income generating opportunities or loss of physical assets or illness leading to disabilities, iii) become poor as an elderly with limited income and ill health, iv) become or remain poor as a disabled person due to lack of opportunities for education and employment.

The present State initiatives are only able to address these different problems in a very limited manner, partly due to inadequate resources but also due to reduced efficiency in allocating of resources to the needy. The inability of the State to clearly identify those in need and provide assistance only to such groups is a factor that contributes to the present status. However, unless divisional level identification of such groups and service gaps are not strengthened with the assistance of NGOs and COBs, the problem will remain, as it cannot be effectively conducted from the central level.

Inadequate Support for Income Generating Activities

Inadequate support for income generating activities and opportunities for marketing of goods so produced has been a major constraint and drawback in sustaining State sponsored income-generating activities.

Reluctance to Change Policy

Although some information was available from occasional evaluations that certain State interventions and expenditure were ineffective in reaching the poor, political pressures often led to maintenance of

[7] Tudawe P.I. (2002), Chronic Poverty and Development Policy In Sri Lanka: Overview Study, Chronic Poverty Research Centre Working Paper No. 9, University of Manchester, England.

"status quo" of many of the State interventions despite contrary evidence on effectiveness. Maintenance of ineffective programmes led to inefficient allocation of scarce State resources. For instance, the wide regional variation in poverty incidence shows that State interventions need to be more spatially targeted to deprived areas.

6.4 Poverty Reduction Strategy-Design, Implementation and Monitoring

Developing countries as well as funding agencies having realised that poverty cannot be resolved by *ad hoc* measures in policies and programmes, and now formulate a Poverty Reduction Strategy. The Poverty Reduction Strategy paper (PRSP) is drawn up by each country to offer a comprehensive policy matrix to assist in poverty reduction by addressing some of the structural issues that permit poverty to persist.

Sri Lanka's PRSP, like other analyses before it in the past in the country, identifies i) inadequate growth, ii) armed conflict, iii) limited access to education and other basic services, iv) various constraints in the agricultural sector including lack of a land market, v) environmental degradation and vi) social exclusion and powerlessness of the poor, as some of the issues that contribute to persisting poverty. The document also identifies a number of governance issues including politicisation of the State interventions in poverty alleviation, inadequate rural development, incomplete decentralisation, public sector reforms, low empowerment of the poor, and slow urbanisation as contributory factors to current poverty levels in the country.

The PRS advocates a supportive macro-economic environment to secure adequate economic growth so that the poor will benefit. Simultaneous implementation of efforts to increase human capital development such as through education and health, provision of basic services such as water and sanitation facilities, social protection, and servicing the under-serviced urban settlements are advocated. Empowerment of the poor through increased accessibility to law, micro-credit for the poor for risk management, eliminating gender discrimination are also given emphasis.

Detailed operationalisation of functions required to ensure that expected outcomes are reached are also provided in the document, although clear linkages on benefits from macro economic growth reaching the poor, apart from the usual "trickle-down effect", needs further strengthening. This is particularly important since past experiences show that leaving economic growth benefits to reach the poor via "trickle-down effect" alone has been limited.

The document brings together issues that are pertinent to reducing poverty. Most of these issues are known and various attempts have been made to address them in the past by each successive Government. The success of achieving the objective of the PRSP, therefore, as in the past, depends on the effective implementation of the given plans with a high degree of efficiency with minimum non-economic distortions.

However, it should be noted that some of the issues identified by the PRS such as capacity building of the public sector, decentralization of activities to the provinces, and community mobilization and empowerment are pre-requisites to ensure success of implementation of PRS itself. Emphasis on empowering the community, the poor in particular, is important in order to increase the demand by the community for quality services from service providers. However, past State attempts at empowerment through social mobilization activities, especially through Janasaviya & Samurdhi that were operational since 1989, has been slim -- a modified approach to resolve this issue also needs consideration.

Therefore, until some of the pre-requisites are met, there is likely to be a time lag in implementing most of the activities listed in the document in an effective manner, and thus observing some of the expected outcomes.

The PRS has recognized the need for close monitoring of activities of the PRS. The development of goals, targets and indicators to monitor progress are given emphasis. The need for peer/participatory monitoring to increase accountability and efficiency is given due recognition. Further, monitoring and evaluations leading to extraction of lessons learned, and this information feeding into future planning and strategies are also considered.

The design and implementation of these monitoring systems and feedback mechanisms for corrective action will be integral to the success of the PRS. A well decentralized monitoring system with information flows at both local levels as well as central level for requisite management controls is essential. Development of such a system remains a challenge since, although various monitoring mechanisms have been in-built to the public sector services in the past, the effectiveness of such monitoring has been very limited. The limitation is largely due to monitoring being confined to physical assessment alone with little attention to social impact. Furthermore, as discussed before, an effective link to peer monitoring and feed back systems can assist the public sector in increasing the efficiency of resource utilization at the regional and village level.

6.5. Challenges for the Future

The country faces two major challenges in poverty alleviation:

1. Formulating a comprehensive policy-matrix to support higher and sustained economic growth
2. Provision of equal opportunities to all so that equitable distribution of social and economic benefits can be accrued to the population, and implementing an effective social security net for the economically vulnerable

Considering that the country has adopted open economic policies, the role of the

State is that of a facilitator and regulator to assist economic growth and not of an implementer as has been in the past. Limited resources available to the State will require re-allocation of resources away from the more advantaged areas to less advantaged areas. Shifting resources away from more advantaged areas can be achieved by privatizing certain services for which communities in such areas can afford to pay. The removal of "urban bias" in allocating State funds as well as addressing issues of "good governance" and "efficiency" will play a role in the State becoming an effective facilitator for higher growth.

The second challenge to the State is to primarily ensure that all citizens, especially the poor, have access to equal opportunities. This can be achieved by ensuring that access to services is equal -- this will require differential interventions for the more deprived areas. Past experience shows that the uniform "programme approach" to poverty reduction has had limited success mainly due to non-economic factors that has affected programme implementation. Also economic benefits through growth reaching the poor, has been less than anticipated largely due to limited opportunities available to the poor to take advantage of areas of economic growth.

A social security net for the poor remains a requirement in the short and medium term to ensure provision of minimum needs until equal opportunities are in place. Although provision of social security has been attempted in the past under different guises, the high "leakage" to non-poor due to problems of identifying the poor remains a challenge to be addressed.

An improved mechanism to increase accuracy in identifying the poor for social security benefits through development of easily operationalized indicators together with an effective participatory/peer monitoring system is required to ensure only the poor remain as beneficiaries. The State alone cannot undertake this function, but requires the cooperation of the peer population as well as NGOs/CBOs.

Therefore, in order to address the problems of poverty a results-oriented multi-pronged approach is required to deal with the multi-dimensionality of poverty. A comprehensive inter-sectoral approach is required so that building of human, physical, natural, financial, social and political capital of an individual/household is encouraged, and equal access to services is provided without regional, urban, political or other biases. Therefore, unless a comprehensive policy-mix with increased efficiency can be implemented to ensure rapid economic growth in conjunction with equitable distribution of resources to create equal opportunities for all, the observed high incidence of poverty is likely to remain in the country for the next half a century.

7. Wage Bargaining in the Plantation Sector

7.1 Introduction

Plantation crops comprise an important part of the Sri Lankan economy. It is both a major foreign exchange earner and an employment provider. In 2000, the value of the tree crop exports, comprising 18 per cent of total exports, was second only to textiles and garments in terms of the gross value of exports. The contribution of the plantations sector to the tree crop production in 2000 comprised roughly 40 per cent of the total tea production and 29 per cent of the rubber production. Besides, the sector is the largest single employer. The estates have a resident population of approximately 850,000 and provide employment to 280,000 persons, amounting to more than 4 per cent of the labour force.

Although in the recent past, the ratio between labour costs to material and other costs have come down, plantation crop production still remains highly labour intensive. Given the nature of production, efficient functioning of plantations requires a reliable supply of labour throughout the year. However, production in the plantation crop sector continues to be plagued by industrial unrest. In particular, strikes (see table 7.1) have either stopped or slowed down work in the plantations causing loss of production and revenue. For example, according to the Employers Federation of Ceylon, the strikes during 1998 and 1999 alone caused a revenue loss of Rs. 400 million. Almost all of these strikes were brought on by demands for better wages. For instance:

- worker unrests in April 1996, which resulted in wage increases of 15 per cent;
- strikes that took place before wage revisions in 1998;
- the “go slow” movement that took place prior to the wage settlement in June 2000, which took the form of a “prayer” campaign; and
- the *satyagraha* campaign in March 2001, which resulted in a supplementary wage agreement that revised the wage settlements granted in the June 2000 collective-agreement.

The following sections describe the wage setting mechanism in the plantation sector, and discuss problems with the current collective bargaining process. The concluding section offers some possible policy measures that would address these issues.

7.2 Wage Setting and Wage Forms in the Plantation Sector

Wages in the plantation sector are guided by the laws stipulated by the Wages Board Ordinance, which include legislation relating to payment of salaries and wages, hours of work, leave, superannuation benefits, and other terms and conditions relating to employment. Collective agreements -- which have the force of law

Table 7.1
Strikes in the plantation sector versus other sectors

Selected Years	Plantation sector			Other sectors			% of strikes in Plantations	% of man days lost in Plantations
	No. of strikes	Workers involved	No. of man days lost	No. of strikes	Workers involved	No. of man days lost		
1990[a]	108	63,751	183,612	8	2,186	10,054	93	95
1991[a]	111	56,856	99,237	19	6,906	9,841	85	91
1992[a]	86	47,712	244,703	17	2,301	26,608	84	90
1993[a]	26	4,559	8,007	23	3,321	13,389	53	37
1995[b]	94	29,518	82,484	89	33,855	211,035	51	28
1996[b]	137	50,982	220,131	87	24,215	168,786	61	57
1998[b]	63	15,486	88,319	59	27,875	181,826	52	33
1999[b]	42	16,018	41,195	83	26,328	263,051	34	86

Source: (a) E. Franklyn, G. Amerasinghe (1998), "Employee Relations and Industrial Law in Sri Lanka"; (b) Department of Labour, Administration Report, various issues.

in Sri Lanka -- between the employers and the workers also play an important role in wage determination in the sector.

The wage rate in the plantation sector as of April 2002, comprise of a money wage, a piece rate wage, a price share supplement, and an incentive payment that relates to attendance. The Wages Board Ordinance specifies a minimum wage for the plantation sector. The other wage components are arrived through a collective bargaining process between the Employers' Federation of Ceylon and the plantation workers' unions. The companies also make incentive payments based on daily productivity. In addition to the daily money wages, the plantation workers also receive various allowances -- such as holiday pay -- and several non-wage benefits relating to housing, medical and child care facilities, and other welfare facilities.

7.3 Factors Influencing Wage Negotiations

Four main factors come into play in wage negotiations in the plantation sector. These are: a) living standard of the workers; b) wage rates in competing occupations; c) the ability of the employer to pay; and iv) trade unions in the sector.

7.3.1 Living Standard of the Workers

Wage setting, especially among the low-skilled and the unskilled segments of the labour force, is often concerned with keeping a wage level that enable the workers to at least maintain their existing living standards. This is usually done by wage indexing – i.e., increasing the wages with inflation so that the real wages of the plantation workers do not overly decline over time.

Several problems are associated with regard to adjusting plantation wages to account for inflation. First, there is no proper inflation index that is relevant to the plantation sector. In Sri Lanka, inflation is most commonly measured by the Colombo Consumer Price Index (CCPI), which takes a basket of goods consumed by individuals in Colombo as the basis for measuring inflation. Since consumption patterns in the plantations are quite different from those in Colombo, the CCPI is not a representative wage deflator for the plantation sector. Second, there is no consistent mechanism to adjust plantation sector wages for inflation. In the past, in addition to inflation related wage adjustments of collective agreements, wage increases in the public sector have also brought on demands, often influenced by politicians, for wage adjustments in the plantation sector. This has been the cause of industrial disputes as these demands often contravene wage agreements reached by collective bargaining.

Real Wage Trends in the Tea and Rubber Industries

As seen in the following table, real wage rates for the plantation sector, deflated using CCPI, has deteriorated over the last decade. However, this trend is not unique to the plantation sector. Similar trends are seen in the other sectors that come under the Wages Boards in the country.

Real Wage Indices for Tea workers in Privatized Companies (1993 = 100)

		Tea		Rubber		Workers in Agriculture (f)	Workers In Wages Boards Trades (h)
Year		Money Wage (Rs/day)	Real Wage Index	Mney Wage (Rs/day)	Real Wage Index	Real Wage Index	Real Wage Index
1993		72.24	100	72.24	100	100.0	100.0
1994		72.24	92	72.24	92	94.3	95.8
1995		72.24	86	72.24	86	88.7	92.4
1996		83.00	85	83.00	85	83.4	86.4
1997		83.00	77	83.00	77	81.6	83.4
1998		101.00	86	95.00	81	84.2	85.6
1999		101.00	82	95.00	77	81.7	83.9
2000	(a)	107.00	82	98.00	75		
2000	(b)	115.00	88	106.00	81		
2000	(c)	121.00	93	112.00	86	78.90	80.9
2001	(d)	116.00	78	98.00	66		
2001	(e)	121.00	81	112.00	75	71.1(g)	74.9(g)

Notes: (a) For attendance below 85 per cent. (b) For attendance between 85 and 90 per cent. (c) For attendance over 90 per cent. (d) For attendance below 75 per cent for tea and for attendance below 70 per cent for rubber. (e) For attendance above 75 per cent for tea and for attendance above 70 per cent for rubber. (f) Combined index for workers in agriculture, in industry & commerce and in services. (g) Provisional. (h) Combined index for workers in agriculture, in industry & commerce and in services.

Source: Author's calculation based on "Economic and Social Impact of Privatisation of Plantations", Programme Support Group, 2000.

7.3.2 Wage Rates in Competing Occupations

The available information on wage rates in competing industries is extremely scarce. At the negotiating table, most often the wage rates of unskilled agricultural workers and wages paid to contractual workers of smallholder estates are compared to estate wage rates. However, for several reasons, the wage rates given to contractual agricultural workers cannot be directly compared to wage rates in the plantation sector. First, compared to year around work available at the plantations, the contractual agricultural work is available only for short periods of time (e.g., during harvesting time). Further, these jobs are available at times when the demand for labour is high and, therefore, the wage rates are also high. This is because agricultural work is seasonal and is guided by climatic conditions that are common to all farms in an area. Second, plantation workers, especially resident plantation workers, enjoy added non-wage benefits that are not available to contractual workers. According to calculations made by Sivaram (2000)[1] the non-wage benefits enjoyed by plantation workers in monetary terms are as high as 41 per cent of their wage rate.

7.3.3 Employer's Ability to Pay

In order for the plantation companies to increase wages while not eroding profits, labour performance must increase with time. Only then would the industry be sustainable in the long run. The labour performance of the workers is measured by several factors: a) labour productivity, that is the efficiency with which the workers perform their tasks (in the tea and rubber sectors, daily labour productivity is measured by the amount of green leaf or latex collected by a worker in a day); b) labour outturn, that is the regularity with which workers report to work when it is offered.

The ability of the employer to pay the workers is mainly determined by the market price of the commodity and the cost of production. The companies have little control over the market price. The price share supplement was intended as a variable wage component that was paid to workers so that profits enjoyed by the management is shared with the workers.[2] However, presently it is given to workers as a fixed wage rate.

Given the nature of wage forms, which are mostly not linked to labour performance (see Table 7.2), the cost of production can be brought down mainly by improving labour performance -- in particular increasing factor productivity and attendance. As can be seen in Table 7.2, the over-norm payments and the attendance incentive are the only two components of the wage that are linked to individual productivity.

[1] Sivaram, B (2000), "Labour Management and Planning" in Plantation Management in the New Millenium, Programme Support Group ed. B. Sivaram.

[2] Originally the price share supplement was calculated based on the net sales average of the previous period.

Table 7.2
Structure of wages for tea and rubber workers *

	June 2000 Agreement (Rs.)	March 2001 Supplementary Agreement (Rs.)
Tea Industry		
Daily wage (with EPF & ETF)	101	101
Price share supplement	6	15
Attendance incentive given to workers with attendance		
More than 75 per cent	-	5
85 – 90 per cent	8	-
Over 90	14	-
Rubber Industry		
Daily wage (with EPF & ETF)	98	98
Attendance incentive		
More than 70 per cent	-	14
85 – 90 per cent attendance	8	-
Over 90 per cent attendance	14	-

Note: * In most tea and rubber estates workers are expected to harvest a minimum quantity per day– called a norm. As an incentive to encourage workers to be productive, workers who bring in harvests that are above norm are given an extra payment per kilogram of extra production. These norms and incentive payments vary across estates and are not included in the above table.

Source: Author's compilations.

Most estates specify a minimum quantity of latex or green-leaf tea that a worker must produce. This amount of production is usually referred to as the "norm". This norm varies across estates depending on the agricultural productivity of the estate, but on average is about 18 kilograms per day. Incentive payments for individuals bringing in latex or green-leaf in excess of the specified norms were in existence for quite sometime.

Despite this, in practice many workers do not produce the specified norm. As seen in Table 7.3, the average green leaf collected per person-day for the 444 estate-months (i.e., monthly averages over the year 1998 for 37 randomly selected estates) under consideration varied widely. For roughly 50 per cent of the estate-months, the average production is below 16 kilograms. Most often the management cannot directly penalize the workers for producing below norm given existing labour legislation conditions. During the February – March 2001 strikes, some workers in tea estates brought back as little as three kilograms of green leaf, but were entitled to the full day's wage.

Table 7.3
Sample labour productivity patterns

Average green leaf kg. Per man-day	Number of estate-months (% of total)
Below 10	52 (11.7)
10+ to 12	60 (13.5)
12+ to 14	49 (11.0)
4+ to 16	66 (14.9)
16+ to 18	55 (12.4)
18+ to 20	67 (15.1)
20+ to 25	54 (12.2)
25+ to 30	25 (5.6)
30+	16 (3.6)
Total	**(100)**

Source: Arunatilake, Nisha (2000), "Effectiveness in Welfare Programmes in Improving Estate Profitability", IPS.

The wage component relating to attendance was first started with the June 2000 agreement. However, in the supplementary wage agreement that followed in March 2001, much of this incentive was taken away, and instead a price share supplement was paid to workers. The attendance bonus earlier given to workers at least with 85 per cent attendance was now given to workers with more than 75 per cent attendance in the tea industry and more than 70 per cent attendance in the rubber industry. Since the price share supplement is given to all workers, irrespective of their attendance, mostly workers, who reported to work less regularly benefited more from the new supplementary wage agreement.

Table 7.4 shows the average monthly labour attendance outturn for the same sample of 444 estate-months considered in Table 7.3. As can be seen, in more than 25 per cent of estate-months the average outturn was below 70 per cent. This implies that the attendance of a high proportion of the workers is below 70 per cent.

Table 7.4
Labour attendance outturn patterns

Out-turn (%)	Number of estate-months (% of total)
Below 50	20 (4.5)
50+ to 60	16 (3.6)
60+ to 70	76 (17.1)
70+ to 80	142 (32.0)
80+ to 90	159 (35.8)
90+	31 (7.0)
Total	**444 (100)**

Source: Arunatilake, Nisha (2000), "Effectiveness in Welfare Programmes in Improving Estate Profitability", IPS.

Low attendance causes two types of problems to the management. It lowers agricultural productivity not only on days on which workers are not available for work, but also for days after that. For example, in tea estates if leaves are not plucked regularly, the tea leaves mature and the tea bushes need to be pruned before resuming plucking as only young tea leaves are suitable for manufacturing. Second, given that non-wage benefits are given irrespective of attendance patterns, low attendance increases the cost of provision of welfare benefits per unit of output.

7.3.4 Trade Unions in the Plantation Sector

The industrial relations in the plantation sector cannot be discussed independently of the trade unions in the sector. According to a survey conducted by the Employers Federation of Ceylon in 1996, 71 per cent of the workers in the plantation sector were members of trade unions. Of these, 29 per cent were members of the Ceylon Workers Congress (CWC) and 15 per cent were members of the Lanka Jathika Estate Workers' Union (LJEWU). Both the CWC and the LJEWU are affiliated to mainstream political parties and as such their actions are often governed not only by the interests of the plantation workers, but also by the political agenda of their leaders. For this reason, in the past, several strikes in the plantation sector have occurred solely or partly with political objectives.

7.4 Problems with the Collective Bargaining Process

Proponents of collective bargaining find them an attractive means of determining wages and conditions of work as they are arrived through joint negotiations between parties directly affected by the agreements. These are often seen to be more conducive to industrial peace since they are negotiated on a voluntary basis rather than dictated by a central authority.

However, in practice the collective bargaining process does not always succeed in bringing industrial peace. The law stipulates that once a collective agreement is reached, it is effective for two years. Although a collective agreement was reached on the 20th June 2000, by August 2000 the unions were asking for a wage hike, which by February 2001 turned into an industry wide strike.

Several reasons contribute to the failure of collective agreements in this sector:[3]

Incentives for Employers

Employers find collective agreements unattractive because labour unions had little to offer other than industrial peace. Even this often does not last over the duration of the agreement. Until recently, although employers were interested in linking productivity and rationalization of working arrangements to wage increases, unions were not agreeable to them. It is only at the 2000 wage agreement that productivity and attendance were linked to wage increases for the first time.

Incentives for Unions

Conversely, trade unions are interested in wage agreements only if they can negotiate attractive wage increases for their members. Given high inflation rates, however, entering into long-term (at present the legally stipulated length of an agreement is two years) binding wage agreements restrict the ability of unions to bargain for wage increases as need arises. The situation is made more complex by competition among the unions –which are judged by their ability to secure attractive wage rates-to increase membership.

Legal Enforceability

Although collective wage agreements have legal status in Sri Lanka, in the past the agreements have been broken with little legal consequences. This is partly because problem solving through legal means often is costly and time consuming, and employers prefer to find fast, pragmatic solutions rather than wait for the legal system to step in.

Political Influences

Politicization of unions has been a major cause of industrial disputes in the plantation sector. However, given that the plantation workers for the most part are not highly educated and do not have the capacity or the expertise to provide strong

[3] See for example Franklyn Amerasinghe (1998) “Employee Relations and Industrial Law in Sri Lanka”.

leadership to organize and fight for their rights, plantation workers are dependent on outsiders whose actions are most often guided not only by the interests of the workers, but also by their political agendas to provide leadership. Interference by politically motivated individuals has also been a problem in sustaining industrial peace through wage agreements. Also, campaign promises made by misinformed politicians have been the cause of violations of wage agreements.

Limitations of Centralized Bargaining

The bargaining process in Sri Lanka is centralized, and takes place between worker unions and the Employers' Federation of Ceylon (EFC), who represents the employers. One problem with centralized bargaining is that the differences between companies' ability to pay and differences in labour market conditions in different geographical areas are not taken into account when setting wages. When the wage settlements are made centrally, most often companies who are not able to pay a higher wage bring the wage levels down for the whole industry, causing labour supply problems for the more efficient companies and companies operating in areas where wage rates are high. A centrally decided wage level may restrict the ability of the employer to adjust to local labour market conditions.

Table 7.5
Labour performance indicators by agro-climatic zone

		Sample size	Average	Minimum	Maximum
Low Grown					
Out-turn (%)	- resident	24	64.2	44.0	98.0
	- overall	60	68.5	17.0	84.5
Labour Productivity (Green Leaf kg. Per plucker man-day)		60	22.8	0.21	41.7
Uva-Up					
Out-turn (%)	- resident	36	69.6	56.6	80.0
	- overall	72	70.0	41.0	92.7
Labour Productivity (Green Leaf kg. Per plucker man-day)		72	16.2	8.1	33.2
Uva-Mid					
Out-turn (%)	- resident	12	78.8	63.0	95.0
	- overall	48	80.3	63.0	95.0
Labour Productivity (Green Leaf kg. per plucker man-day)		48	14.8	7.2	26.2
Western-Up					
Out-turn (%)	- resident	192	82.8	53.0	98.0
	- overall	192	82.3	52.0	98.9
Labour Productivity (Green Leaf kg. Per plucker man-day)		192	15.7	1.7	29.4
Western-Mid					
Out-turn (%)	- resident	48	73.4	35.8	90.0
	- overall	72	71.5	35.8	90.0
Labour Productivity (Green Leaf kg. per plucker man-day)		72	15.1	8.0	24.2

Source: Arunatilake, Nisha (2000), "Effectiveness in Welfare Programmes in Improving Estate Profitability", IPS.

Labour theory points out that when there are wide regional disparities in labour market conditions, centrally decided collective agreements create labour market imbalances. As seen in Table 7.5, the labour productivity and attendance outturn differ considerably across different agro-climatic zones, and it is more efficient to allow plantation sector wage rates to differ across geographical areas to allow for these differences. Unless worked-out carefully, however, non-uniform wage rates could cause industrial disputes and demands for wage adjustments among workers getting lower wage rates.

Lack of Information

One key factor that impedes the bargaining process in Sri Lanka is the lack of information. The publicly available information on labour markets and living conditions in the plantation sector is very limited. Although a wealth of information is available at the estate level and with various Government departments, they are widely dispersed and not easily accessible. Nor are they available in formats that are; directly relevant for use in the wage setting process. In the absence of such easily available information, the negotiations are carried out on ad hoc demands, which are sometimes not realistic, and as a result create breakdowns in agreements.

For example in the June 2000 wage agreement, the fraction of workers who benefited by the attendance incentive was quite low. As a result, in the supplementary wage agreement the incentive payment for attendance needed to be revised substantially. With better information on the attendance patterns of estate workers, both the companies and the worker unions could have worked out an incentive payment scheme that is beneficial to all in the first round of negotiations.

7.5 Policy Implications

Given the importance of the plantation sector to the Sri Lankan economy, its dependence on its massive workforce, the disturbing trend of wage-related industrial disputes, and their resulting huge economic costs, it is essential to set a process in place so that negotiated wage rates are efficient for the employers and fair to the workers, and are sustained for the duration of the agreement. The limitations of the current wage bargaining process need to be addressed so as to minimize wage related disputes.

Addressing the Information Problem

In order for the bargaining process to be more effective, it is essential that all players involved have a common agreed upon perception on the factors that are relevant for wage setting in the sector. For this to happen, it is best if a process can be set in place to collect and collate information and have it accessible to all parties involved so that bargaining takes place in a common setting. Any disagreements pertaining to the information can be resolved before bargaining begins, so that all players operate within the same parameters and the bargaining process is not unduly lengthened due to disagreements on facts.

Addressing the Centralized Bargaining Problem

Given the scenario of labour shortages in some areas and the difficulties in attracting workers for estate work, an efficient wage model will allow companies to differentiate wages depending on the market situation in the areas they operate and their ability to pay. However, wide disparities in wage rates have the potential to trigger unfounded demands for wage increases. Given that, rather than allowing companies to determine the total wage rate at estate level, they could be allowed to pay an incentive payment over and above the settled wage rate to attract workers. This would ideally be determined at the estate level, taking into account labour market conditions in the area concerned and company specific parameters.

Addressing the Politicization of Unions

Given the current political environment in the country and the limited capacity the workers have to organize on their own, it will not be possible to divorce politics from the industrial relations scene in the near future. Strengthening worker organizations, improving the capacity of the workers to organize into common interest groups and improving worker-manager relationships could play a major role in reducing political influence on union activity. Further, workers should be educated on industrial relations activities and the economic and political structure of the country so that they are able to recognize their rights as workers in the sector as well as their responsibilities towards developing the sector.

Collective bargaining as a wage settlement mechanism and a means of preserving industrial peace has not been able to achieve its objectives in the recent past. Continued Politicization of the unions in an unstable political environment in the country, inexperience on the part of both the employers and the worker organizations in bargaining effectively, and lack of easily accessible information relevant to wage setting have led to the breakdown of agreements. These problems, for the large part, could be resolved, and the wages in the sector can be made more effective by making information more accessible, educating workers and introducing flexibility in the wage structure to allow for regional and company wise differences. Resolving these problems could improve the effectiveness of the bargaining process and foster industrial peace.

8. Effective Governance

8.1 Introduction

Sri Lanka's post-independence experience underlines the manner in which the pace and quality of the country's economic and social development is conditioned by the effectiveness of its governance. Empirical evidence shows the degree to which the effectiveness of the functioning of the different institutions of governance has, at different times, either positively contributed to the country's ability to achieve growth or has impeded it. Hence, the positive or negative contribution made by the level of effectiveness of governance should figure in any review of the performance of the economy and of the progress of social development.

As previous reports on the state of the economy have repeated, ineffective governance remains a primary cause for the poor performance of the economy and the slow pace of social development, as well as the continuing state of social unrest that is the outcome thereof. The need for enhancing the effectiveness of governance has been evident throughout the recent past. It is, however, only at the turn of 2002 that the need for reform has received some recognition in policy pronouncements.

Reforms in governance need to be underpinned by a clear agenda. This clarity must also extend to the locus of responsibility for the formulation and implementation of such an agenda. Finally, towards the end fourth quarter of 2002, the policy document "The Future: Regaining Sri Lanka" was unveiled, which provides an indication of the policy direction of the Government. The policy statement provides a good sense of the role the Government aims to play in the development process, and outlines a new structure of implementation and policy monitoring. Steering Committees will be responsible for implementing the Government's "Action Programme" and oversee reform progress in the areas of ;

i) macro and the trade policy ,
ii) employment and labour,
iii) human resource development,
iv) finance and investment ,
v) infrastructure development,
vi) IT/Telecom development ,
vii) private sector productivity,
viii) agriculture,
ix) tourism, and
x) public sector reforms.

These Steering Committees would report on reform progress to a "Programme Management Committee", which in turn would report to the "Economic Policy Committee" chaired by the Prime Minister. An ambitious "National Operations Room" that would facilitate successful implementation and monitoring of policies is also envisioned.

However, besides some institutional reform, such as the development of the Revenue Authority and acknowledging the importance of increasing public sector productivity, this document is scant on details on reforming the public sector. Thus, as this Government attempts to implement its agenda, it will be useful to be conscious of some fundamental issues influencing effective governance in Sri Lanka.

An appropriate starting point for the designing of an agenda for reform of governance is to identify the key conditions that should be met if Sri Lanka is to have the effective governance required to satisfy its needs of economic and social development. The reform agenda should be drawn from a specific identification of such key conditions -- not from preferences of individuals or from the experience of other countries.

The level of effectiveness of governance is correlated to the degree of the Government's responsiveness to current and future citizen aspirations. Such aspirations are not static, but continue to evolve and change as contextual economic and social factors change and the citizens become aware of such changes. It is, thus, essential that the structures and processes of governance are continuously open and sensitive to the changes in aspirations and are equipped to proactively gather information thereon.

The remaining sections look at the role of Government, civil society organizations and the private sector in contributing towards effective governance in Sri Lanka

8.2 Role of the Government

Effective governance requires the continuous reconciliation of economic and social imperatives as they emerge from the changing context in the country with the concerns that tend to dominate political activity. In the post-independence Sri Lankan polity, narrow political concerns have tended to be the dominant factor in economic and social management. The line where politics ends and the needs of effective economic and social management begin has, more often than not, been blurred. This situation calls for correction. The processes of formulation of public policies, programmes and projects in Sri Lanka continue to be of low quality. This arises mainly from the adoption of uni-dimensional approaches to policy formulation instead of comprehensive approaches; the narrow partisan, political pre-occupations that tend to influence the process; bureaucratic biases, as well as the lack of competent policy analysts engaged in the process. Whilst these gaps have been articulated over and over again in the public discourse as well as in the literature, there have been no serious attempts to improve the processes of public policy formulation. Some of the areas that need to be addressed are:

Consistent Signals of Scope and Limitations of Government Interventions

Effective governance can only result if it is based on a clear definition of the scope and limitations of the interventions of the

Government in the implementation of economic and social development policies and the nature of such interventions. Currently there are no such transparent definitions. This results in the ordinary citizen being confused, civil society organizations being unsure of their precise roles in the economic and social sectors, the private sector not being clear about its space within these sectors, and the bureaucracy being bereft of any direction as to what functions and tasks it should perform from time to time. It is necessary, therefore, that transparent decisions be arrived as to what the Government does and -- even more important -- what it does not do. The process of arriving at such decisions must necessarily be participatory -- ensuring the maximum participation of the civil society organizations and of the private sector. It is equally important that there is the widest dissemination of the outcomes of such processes, with optimal opportunity for the expression of the views of the citizens thereon. Throughout such exercises it is relevant to recognize that the scope and limitations of the role of the Government does not remain static, but changes over time as the economic and social context changes.

Allocation of Functions

The rational allocation of functions and tasks at different points in the governance structure is a *sine qua* non for effective governance. Such rationality in allocation needs to observe both inter-level-differentiation as amongst the three levels of governance (the Centre, the Province and the Local Community), as well as differentiation within each level. Both these are conspicuous by their absence in Sri Lanka today. At the Centre, the narrow allocation of ministerial responsibilities amongst a plethora of ministries impedes the achievement of intra-sectoral synergies as well as inter-sectoral coherence in public policy management , thus adversely affecting economic and social development. As between the Centre, there is an unacceptable level of duplication and overlapping in the Province and the Local Government Institutions, with the avoidable excess of public expenditure that such duplication and overlapping generates, as well as unacceptable delays in the conduct of public business.

A critical instrument for ensuring responsiveness to citizen aspirations -- which is essential for good governance -- is the effective devolution of the responsibility and authority for the performance of public functions and tasks. Whilst the devolution of responsibility and authority has been on the statute books for almost a decade and a half, it has been ineffective. From the experience thus far, it is possible to identify several measures that could be taken to make devolution effective. These include:

- The availability of consultative institutional arrangements at the three levels of the polity for the provision of citizen-inputs and for progress monitoring, in respect of public policies, programmes and projects.

- The strengthening of the role of the representative institutions (Local Government Institutions, Provincial Councils and the Parliament) in ensuring responsiveness of public policies, programmes and projects -- at their stage of formulation to the articulated aspirations of citizens.

Effective governance also demands that there be optimal horizontal consultation amongst the various institutions of the Government (such as ministries and departments) in the process of decision-making as regards the formulation and implementation of public policies. Currently, this is a major lacuna in the conduct of public business. Over the post-independence half-century, the number of public agencies proliferated and inter-agency consultation tended to decline or was restricted to lip-service. Intra-party rivalries amongst lead political cadres contributed to an avoidance of inter-ministerial consultation, with the departments and agencies within the different ministries following the trend. No effective institutional arrangements are yet available to ensure that inter-sectoral co-ordination takes place at the policy making and implementation stages.

Lack of Efficient Human Resources

Another major contributor to the ineffectiveness of governance in Sri Lanka is the inability of the public sector cadres to harness skilled, efficient and experienced human resources. Public sector employment has come to be the least sought after avenue of employment for the better-equipped entrants to the employment market. The relatively unattractive benefit packages, the inadequacy of the challenges offered to holders of office (other than that of survival till the age of retirement), and the direct political control that is sought to be enforced on staff are but some of the negative factors that inhibit capable persons from seeking public sector employment. The inadequacy, as well as the irrelevance of post-entry training and development also adversely affect productivity. Post-entry training and development in the public sector has degenerated into a mere ritual.

Consulting Civil Society Organizations

The above discussion confirms that decision-making in governance, as regards policy-making and implementation, should be in continuous consultation with civil society. This requires that there be institutional arrangements and processes at every level of governance to ensure this continuous interface with organizations of civil society. Such consultations and interface would have the required credibility only if the process was transparent and the citizens are continuously aware of the details of the specific consultations.

8.3 Role of Civil Society Organizations

It is not only the institutions of Government that need to be equipped for the interface with civil society organizations. It is equally important for the civil society organizations to be appropriately equipped for the responsibility. For this to happen several pre-conditions need to be satisfied.

One such pre-condition is maximum transparency in the functioning of the civil society organizations in regard to such matters as objectives, time-specific agendas of action; membership; amounts and sources of funding, details of expenditure of funds, and processes of decision making. Too often a veil tends to be drawn over such matters in the case of several civil society institutions, which regard themselves as "private clubs".

A second pre-condition is optimal and continuous interaction between the citizens and the civil society organizations. Too often the average citizen perceives civil society organizations as being elitist and removed from them. It is equally common to find civil society organizations developing their agendas by themselves -- without reference to the citizens -- guided by technical considerations. The outcome is a loss of confidence in civil society organizations on the part of the average citizen who perceives them as alien implants that pursue their own agendas, and not as their representatives. The absence of consultation leads to an attenuation of legitimacy.

Structure

Given these realities, it is pertinent to pose the issue of the structure of civil society organizations in Sri Lanka. Hitherto, they have tended to take one of two forms. One is that of narrowly focused (often single-issue based) organizations at the local community level. The problem in the preoccupation with single issues is such that, even at the level of the local community, these organizations fail to act in concert and to exploit the synergies that exist amongst the different issues that they pursue. The other structure is that of networks of branches of civil society organizations, which derive their agendas from the national headquarters and seek to implement them with minimal interaction with local communities.

Capacity Enhancement

Recent experiences have underscored the important role that civil society has to play in ensuring appropriate Governmental responsiveness to citizen aspirations. This role can be effectively performed through informed articulation and questioning of the Government by the civil society. Hence it is important that civil society organizations be well informed both on issues of development management as well as on the minutiae concerning the functioning of governance, be non-partisan, and be effective in action. The Sri Lankan reality as regards civil society organizations is, however, different. They remain ill-equipped to perform this role. It is, therefore, important for the future of effective governance that the civil society organizations critically and impartially review their own performance and undertake programmes of capacity enhancement.

Considering the importance of the availability of an active inter-relationship between the institutions of governance and organizations of civil society as a means of enhancing the effectiveness of governance, it is relevant to explore whether the current situation could be improved. One possibility that should be pursued is that of community level organizations networking at the local level to pursue integrated agendas as well as to federate at regional and national levels in the pursuit of such agendas.[1]

What is critical for the future effectiveness of governance in Sri Lanka is that the civil society organizations, as a group, acquire capability to be active participants in the structures and processes of decision making, be transparent in their functioning to be acceptable in the perceptions of the citizens, and acquire strength in their interface with the Government through effective networking.

8.4 Role of the Private Sector

The active participation of the private sector, particularly the corporate sector, is an essential ingredient in enhancing the effectiveness of governance. Several steps would contribute to the enhancement of the quality of this participation. These would include the adoption of a more outward looking and broader conception of issues, enhancing the research capacity of private sector organizations on issues of governance, as well as a move away from a metropolis-centredness in the approach to issues.

The preceding discussion points to the complexity of the reform agenda that must be the basis of any reform in the polity and its structures, processes and personnel. The longer the delay, the greater is the loss of public support and confidence. The reform process is, nevertheless, arduous in that a wide range of interests have to be reconciled, a complex web of vested interests have to be neutralized, and broad support constituencies have to be built up.

[1] The Sanasa movement of co-operative societies provides an example of the possibilities of such federation.

Policy Briefs

9. Sovereign Ratings

9.1 Introduction

Sovereign ratings play an important role in determining the terms and the extent to which countries have access to international capital markets. They serve as a summary measure of sovereign risk or a country's likelihood of not defaulting; that is the ability or the willingness of a country to meet its debt service obligations in the future. In recent years, the demand for sovereign ratings has increased dramatically, and the increased transparency and reduced investor uncertainty offered by sovereign ratings have enabled many Governments to gain access to international bond markets.

Sovereign risk matters theoretically because it may be an important obstacle to economic growth. The argument is that if investors had no fear that their lending would be expropriated, capital would flow from capital-abundant (and hence low return) countries to capital-scarce poor countries where the yields are high. In the process, income convergence would occur. In reality, this does not occur, and, in fact, capital moves in the reverse direction as money invested in the USA, UK or Switzerland is safe from expropriation. Sovereign ratings are important as they reduce information uncertainty and could stimulate these capital flows.

At present, nearly one hundred countries have been assigned ratings by various credit rating agencies. These ratings help Governments obtain wider access to investor capital, and secure lower-cost funding and enhanced financial flexibility. Sovereign ratings also affect the ratings of a large number of other borrowers including private sector companies of the host country. This is because agencies in general do not assign ratings to public or private sector borrowers that are higher than their home country's sovereign rating. This is known as the "Sovereign Ceiling" principle.

Sri Lanka's need for a sovereign rating and the willingness of the authorities in obtaining a rating is still a controversial issue, and this section provides some background to the main issues.

9.2 The Development of the Sovereign Ratings Business

The history of Sovereign Credit Ratings goes back to the beginning of the twentieth century when the international bond markets were very active. By 1929, Moody's Investors Service, a leading credit rating agency, was reported to have rated bonds issued by approximately fifty Governments. However, the demand for sovereign ratings decreased with the onset of the Great Depression, and after World

War II, the international bond market came to a standstill.

In the 1970's, however, international bond markets revived, but the demand for ratings was very low. For instance, before the 1980s, there were only 15 Governments that had access to U.S capital markets. As most of these were industrialized countries, their risk assessments were quite straightforward and the majority of ratings were at the highest quality levels (AAA/Aaa). Since 1985, many emerging markets found it favourable to borrow in international capital markets and, hence, this led to an increase in demand for credit ratings. Today, however, as ever more sovereigns have been credit rated (many of whom have lower quality credit ratings), the median rating has dropped to the lowest possible investment grade: BBB-/Baa3.

9.3 Credit Rating Agencies

The major ratings agencies are Moody's, Standard and Poor's, Duff and Phelps (DCR) and Fitch IBCA -- the latter two merged in March 2000 to form Fitch Ratings. A country may usually obtain ratings from one or more credit agencies. The different agencies use different terminology to classify ratings, as seen in Table 9.1.

The most creditworthy and the least risky sovereigns are assigned ratings of AAA/Aaa, while the least creditworthy and the most risky sovereigns are rated DDD/Daa. Countries belonging to the latter group would have difficulties in borrowing in the international capital market and, hence,

Table 9.1
Comparison of rating by major agencies

	Moody's	Standard & Poor's	Fitch Ratings
Investment Grade			
Overwhelmingly high credit quality	AAA	Aaa	AAA
	AA+	Aa1	AA+
	AA	Aa2	AA
	AA-	Aa3	AA-
Strong credit quality	A+	A1	A+
	A	A2	A
	A-	A3	A-
Satisfactory credit quality	BBB+	Baa1	BBB+
	BBB	Baa2	BBB
	BBB-	Baa3	BBB-
Sub Investment Grade (Below Investment Grade)			
Moderately speculative	BB+	Ba1	BB+
	BB	Ba2	BB
	BB-	Ba3	BB-
Highly speculative	B+	B1	B+
	B	B2	B
	B-	B3	B-
Substantial risk of default	CCC	Caa	CCC
Default grade	DDD	Ddd	DDD

Source: Standard and Poor's.

may depend heavily on official loans from multilateral institutions and individual Governments. Moreover, borrowers with below-investment grade ratings would generally have to pay additional premia to cover the increased risk of default.

9.4 Determinants of Sovereign Ratings

In assessing the creditworthiness of a country, various economic, social and political factors need to be evaluated. These factors broadly include the degree of political stability, quality of economic policies, fiscal and external balances, level of indebtedness, debt service record and so on. Box 1 lists the various factors used by Standard & Poor's, in their assessments of sovereign risks.

Measuring sovereign risk is complex, in part because some of the criteria are not quantifiable. In addition, the indicators used as measurements of these criteria

Standard and Poor's Sovereign Ratings Methodology Profile

Political Risk

- Form of Government and adaptability institution
- Extent of popular participation
- Orderliness of leadership succession
- Degree of consensus on economic policy objective
- Integration in global and financial system
- Internal and external security risks

Income and Economic Structure

- Living standards, income and wealth distribution
- Market versus non-market economy
- Resource endowment and degree of diversification

Economic Growth Prospects

- Size and composition of savings and investment
- Rate and pattern of economic growth

Fiscal Flexibility

- General Government operating and total budget balances
- Tax competitiveness and tax raising flexibility
- Spending pressures

Public Debt Burden

- General Government financial assets
- Public debt and interest burden
- Currency composition and structure of public debt
- Pension liabilities
- Banking, corporate, other contingent liabilities

Price Stability

- Trends in price inflation
- Rates of money and credit growth
- Exchange rate policy
- Degree of Central Bank autonomy

Balance of Payments Flexibility

- Impact of fiscal and monetary policies on external accounts
- Structure of the current account
- Composition of capital flows

External Debt and Liquidity

- Size and currency composition of public external debt
- Importance of banks and other public and private entities as contingent liabilities of the sovereign
- Maturity structure and debt service burden
- Level and composition of reserves and other public external assets
- Debt service track record

Source: Standard and Poor's Ratings Direct Website.

credit rating agency to another. This situation has led to agency disagreement and public controversy over the ratings assigned for a particular country. Such disagreements, however, tend to be smaller for the countries with high ratings, and larger for those with lower ratings. Cantor and Packer (1995)[1] found that Standard & Poor's and Moody's have agreed 67 per cent of the time on ratings assigned for high quality credits. For below investment grade sovereigns, however, the two agencies have agreed only 29 per cent of the time. This is because below investment grade sovereigns are largely comprised of developing countries whose political and economic conditions are relatively unstable and involve greater complexities in measurement.

9.5 Should Sri Lanka go for a Sovereign Rating?

The need for Sri Lanka to adopt a sovereign rating and the willingness of the Government to obtain a rating still remains a controversial issue. Establishment of DCR Lanka Credit Rating Limited[2] in 1999 to promote the overall development of the domestic financial market was an important step taken towards obtaining a sovereign rating for the country. Among the factors creating disincentives towards getting a sovereign rating are:

i) Sri Lanka does not need one because the Government has relied heavily on official loans from multilateral organizations and developed countries for its long-term financial needs.

ii) In 1997, Sri Lanka successfully raised US$ 50 million through a Floating Rate Note (FRN) even without an official country rating. The Note was issued at a relatively low cost of LIBOR plus 1.5 per cent interest. Moreover, in recent years the Government has been able to raise the required funds from the domestic financial market. For instance, in November 2001, the Government raised US$ 158.5 million by issuing dollar denominated Sri Lanka Development Bonds (SLDBs). The main subscribers included Hatton National Bank, Commercial Bank, Citibank and non-resident Sri Lankans. The maturity period was two years and the margin above LIBOR was varying. (The Central Bank argues that had the Government tapped the international market, it would have had to pay a higher rate of interest, as there is no sovereign rating for the country.)

iii) Obtaining a sovereign rating is costly as it involves large payments to the credit rating agencies.

iv) Once a rating is assigned to a country, upgrades are difficult to obtain and the process of adjustment is slow. In 1997, favourable conditions in the international financial markets, the country's good track record of servicing foreign debt, and strong economic performance during the time suggested the possibility of getting a high quality sovereign rating. The only adverse factors were the civil

[1] Richard Cantor and Frank Packer, "Sovereign Credit Ratings", Current Issues in Economic and Finance, Vol.1, November 1995.

[2] It is a joint venture between the US-based Duff and Phelps Credit Rating Company, International Finance Corporation, the Central bank of Sri Lanka and 14 other local shareholders.

war in the North and East and the political instability of the country. Nevertheless, the slowing down of the economy after 1999 -- with increased budget deficits, outstanding external debts and negative economic growth in 2001 -- has become an obstacle for obtaining a high quality rating for Sri Lanka.

v) Agencies make upward *and* downward revisions of ratings. When an agency makes a change in the ratings, it becomes visible to the entire financial community. A country may not appreciate opinions on its solvency registered publicly (e.g. Malaysia in the mid-late 1990s), and negative changes could precipitate adverse "herd-like" behaviour of capital flows.

Sri Lanka, however, will not be able to rely on multilateral institutions and the domestic capital markets for its long-term financial needs for too much longer. Concessionary loans may dry up in the medium–term as per capita income rises.[3] As the economy grows and financial needs expand, access to international markets becomes crucial. In addition, establishing sovereign ratings is important in improving the private sector's access to international financial markets. Today, the Government is expecting the private sector to play a major role in the country's development process, but undertaking long-term investments is constrained by the inadequacy of long-term funds and the high costs of borrowing. Unless reform is carried in these areas, obtaining a good sovereign rating is an important first step for private companies in obtaining international ratings as it facilitates borrowing from the international market.

9.6 Crying for Argentina – Lessons for Lanka?

The timing of when to seek a rating depends largely on economic performance and reform, as well as on political stability of the country. However, there is a need for Sri Lanka to obtain a sovereign rating is there, at least in the medium-term. Nevertheless, it is critical not to overplay the importance of foreign capital and maintaining a good sovereign risk rating at the expense of domestic constituencies. Perhaps this is the lesson to be learnt from Argentina's default of US$132 billion in debt in December 2001. Effective economic management and governance are still critical for development.

Dani Rodrik argues that the Argentine economic strategy in the 1990s was based on a simple idea: that reduction of sovereign risk is the quickest and surest way to reach the income levels of the rich countries. This relies on the fact that

- Economic growth requires foreign capital
- Foreign capital requires removing sovereign risk
- Removing sovereign risk requires sound financial management in Argentina (with a currency board being the necessary commitment mechanism/straight jacket).

[3] A country becomes ineligible for concessionary aid when its per capita income touches the "magic" US$925 mark.

However, it would turn out that removing sovereign risk takes more than monetary policy restraint, and a commitment to pay external creditors. Initially, the plan of reforms leading to a sharp reduction in "Argentina risk" worked, with large increases capital inflows and robust growth. However, Argentina was hit with a series of external shocks—the Mexican peso crisis of 1995, the Asian crisis in 1997-98, and the Brazilian devaluation of January 1999, which severely affected the competitiveness of the Argentinian economy. The currency board regime severely restricted the capacity of the Government to respond to these shocks. Economic growth turned negative in 1999 and Argentina's country risk was rising (with consequently high premiums on interest rates), even with the March 2001 return to power of the architect of Argentina's reform strategy -- Domingo Cavallo.

Cavallo's goal was to instil confidence in financial markets to bring down the debilitating high interest rates. However, when Cavallo's early policies failed to stimulate growth, he launched an austerity programme (characterized by sharp reductions in Government expenditures), in an economy already with an unemployment rate of 20 per cent. Despite Cavallo's credibility with the international credit markets, sovereign risk increased. International markets realized that although the upper echelons of power appeared to be more committed to external creditors than domestic players (like public employees, pensioners, provincial Governments, and bank depositors), the people of Argentina would not tolerate this. Indeed, the markets turned out to be correct.

The lessons for Sri Lanka may be that:

- While getting a sovereign rating is good, the Government's priority should not be on getting an investment-grade rating in credit markets at the expense of its obligations to its domestic constituencies.
- Credibility with international creditors and local constituents comes from effective governance and not from reducing the capacity of the Government to act, and, as such, reform in the public sector continues to be a priority.

10. Indo-Lanka Free Trade Agreement - An Update[1]

10.1 Current Status

The potential of the Indo Lanka Free Trade Agreement (ILFTA) after two years of operations still remains largely unexploited. Although both the total bilateral trade between India and Sri Lanka and trade under the ILFTA have increased over the last year, it has not achieved much dynamism. The value of exports under the ILFTA[2] in rupee terms increased from Rs.658.4 million in 2000 to Rs.1081.4 million in 2001 (Rs.1260.9 million from Jan - Dec), which is a growth of 65 per cent. The share of exports under ILFTA was 15.6 per cent of the total exports to India in 2000 and it increased to 20.1 per cent in 2001, indicating satisfactory growth.

Meanwhile, when all exports are considered, India's share has increased since 1998. This was 0.75 per cent in 1998, 1.05 in 1999 and 2000, while the share increased further in 2001 to reach 1.51 per cent. The growth of exports to India also recorded a significant improvement from 27 per cent in 2000 to 49 per cent in 2001. However, this growth cannot directly be attributed to the ILFTA since Sri Lanka's exports to India witnessed sharp fluctuations since 1995,[3] and the short time-frame of the operational life of the agreement is inadequate to make judgments. With regard to the rate of growth of imports, there was a growth of 26 per cent in 2000, and this declined to 18 per cent in 2001.

The top ten export items under the ILFTA consisted of 62.8 per cent of total exports under the agreement in 2001. In the first year of operations, the share of the top ten products was highly concentrated at 80.5 per cent. This reduction in the concentration of exports of the top ten items indicates the gradual diversification and expansion of the export base under the agreement. Waste paper remains the highest export item in both years. In-depth analysis of the exports to India under the ILFTA shows that exports are mainly primary products with little value addition, which could be partly attributed to the nature of concessions offered under the agreement itself.

Tea and garments exports under the ILFTA are subject to a quota of 15 million

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[1] The main sources of data are Sri Lanka Customs and Department of Commerce (DOC) Rules of Origin Certificates (ROO). In compiling the data, especially with regard to the ROO Certificates, there were data limitations, and some of the data from the two sources did not tally. Therefore, this study has identified these practical data problems and has attempted to clean the data at the initial stage of utilization.

[2] Since 2000 data refers to ten months (March to December), 2001 also refers to the same period in order to gain equality in comparisons of the two years

[3] The growth rate in total exports from 1995-2001 was 54 per cent, 40 per cent, 12 per cent, -10 per cent, 46 per cent, 27 per cent, and 49 per cent respectively.

kilogrammes and 8 million pieces per year, respectively. Both these quota items remain under-utilized in the two years of operation. For the year 2000, these quotas were pro-rated to 6.7 million pieces for garments and 11.2 million kg of tea as the quota was operational only for 10 months. With regard to garments, only a sample shipment was exported in 2000 and in 2001[4] Rs.16.2 million worth of garments were exported to India. The share of total garments exported to India remains at a low level despite the concessions offered under the ILFTA. In 2000, export of garments to India as a percentage of total garment exports of Sri Lanka was 0.0034 per cent, while in 2001 there was a slight increase to 0.0084 per cent. India still remains a less attractive destination for garments despite the concessions offered under the agreement. With regard to tea exports too, the utilization of the quota is low. In 2000, the volume of tea exported was only 423 million metric tones (3.7 per cent of the operational quota), and in 2001, this was further reduced to 336 million tones (2.2 per cent of the quota). This dismal performance of quota utilization is despite the quota system operating on the basis of "first-come-first-served" principle. A comparative figure of the total exports of tea to India is also on a low level. In 2000, the tea exported to India as a percentage of the Sri Lanka's total tea exports was 0.20 per cent which increased marginally in 2001 to 0.54 per cent.

In the second year of operation there were 67 new items (classified by 6 digit Hs Code)[5] exported under the agreement *vis-à-vis* the first year, which constituted 20.3 per cent of the total exports of the FTA in 2001.

Table 10.1
Top 10 Export items under the ILFTA- 2001

HS Code	Description	Export Volume (Kg.Mn)	Export Value (Rs.Mn)
470710	Recovered (waste and scrap) paper or paperboard which are unbleached kraft paper or paperboard or corrugated paper or paperboard	25.7	225.1
680221	Marble, travertine and alabaster	3.1	91.5
470790	Other unsorted waste and scrap	6.9	89.7
841850	Other refrigerating or freezing chests, cabinets, display counters, show-cases and similar refrigerating or freezing furniture	0.05	78.9
740319	Other refined copper and copper alloys, unwrought	0.7	72.6
720429	Other ferrous waste and scrap; remelting scrap ingots of iron or steel.	5.9	57.3
130190	Other Lac, natural gums, resins, gum-resins and oleoresins (for example, balsams).	1.4	54.6
740400	Copper waste and scrap.	0.5	51.5
847100	Automatic data processing machines and units thereof; magnetic or optical readers; machines for transcribing data on to data media in coded form; and machines for processing such data, not elsewhere specified or included.	0.001	39.4
780199	Other unwrought lead.	0.9	31.3

Source: Compiled using DOC Rules of Origin Certificates.

[4] Refers to the full year from January to December.
[5] Source: DOC Rules of Origin Certificates.

Though 67 new items entered the agreement in 2001, not all products were completely new export items. 43 items were bilaterally traded before, and these merely entered the ILFTA in 2001 in order to gain tariff concessions. On the other hand, 24 items were not bilaterally traded before and introduced to Sri Lanka's exports to India in 2001. Therefore, 34 per cent of the new products were not bilaterally traded before. Among the new items, those with the highest export values were: other refined copper and copper alloys-unwrought, prefabricated buildings, refined copper and copper alloys-unwrought, copper bars, rods and profiles, and trisodium phosphinates. The rate of increase in the number of new items exported to India utilizing the concessions offered under the agreement is an encouraging sign. Thus, it is important to promote the export base under the agreement, and also to promote products of high value content rather than concentrating on low value added primary products.

Table 10.2 sets out the distribution of Sri Lanka's exports under the ILFTA on a chapter wise basis. The highest contribution is from paper products, which recorded a share of 43 per cent in 2000 and 29 per cent in 2001. This could be attributed the significant level of concessions offered in the agreement under the zero duty and 50 per cent preference categories for paper products. Similarly, base metal also contributed significantly to trade under the agreement, increasing its share from 19

Table 10.2
Chapter-wise breakdown of the total exports to India under the ILFTA

Chapters	Description	2000 (Rs.Mn.)	%	2001 (Rs.Mn)	%
01-05	Live animals and animal products	1.1	0.17		
06-14	Vegetable products	85.8	13.93	118.2	9.4
15	Animal and vegetable fats and oil				
16-24	Prepared food items	42.6	6.92	34.4	2.7
25-27	Mineral products			2.1	0.2
28-38	Chemical products	10.3	1.67	43.1	3.4
39-40	Plastics and rubber	0.7	0.12	1.6	0.1
41-43	Leather products	0	0	1.8	0.1
44-46	Wood products	0	0	0.02	0.0
47-49	Paper products	267.5	43.44	371.8	29.5
50-63	Textile articles	0.7	0.12	31.9	2.5
64-67	Footwear	1.7	0.28	3.2	0.2
68-70	Stone, plaster, cement	10.2	1.66	113.3	8.9
71	Pearls	0.2	0.04	0.8	0.06
72-83	Base metal	117.7	19.11	302.6	24.0
84-85	Machinery & Mechanical goods	68.2	11.07	150.7	11.9
86-89	Transport equipment	0	0	8.7	0.7
90-92	Optical, photographic equip.	0.4	0.06	0.29	0.1
93	Arms and ammunition	0	0	0	0
94-96	Misc. Manufactured articles	7.2	1.18	74.0	5.9
97-99	Works of art	1.3	0.22	0.9	0.1
	Total	**615.8**	**100**	**1259.5**	**100**

Source: Compiled using DOC Rules of Origin Certificates.

per cent in 2000 to 24 per cent in 2001. With regard to base metals, all concessions are subject to 50 per cent tariff preference. Machinery and mechanical goods, which receives the highest number of concessions under zero tariff preference, has recorded a significant level of export in both years with a contribution of 11 per cent. The lowest contribution in 2001 was from wood products, optical and photographic equipment, arms and ammunition, plastic and rubber products, mineral products, leather products, footwear, pearls, and transport equipment. Together these contributed less than 1 per cent of total exports.

Among the impediments of the operations of the ILFTA, non-tariff barriers in India has become one of the key constraints for Sri Lanka to achieve the maximum benefits of the agreement. There are instances where Sri Lankan exporters have complained about cumbersome and non-transparent inspection procedures on the part of the Indian Customs authorities. Lack of awareness about the agreement and the relevant concessions, non acceptance of the Certificate of Origin issued by the Sri Lankan authorities to fulfill the Rules of Origin criteria, and the irregularities in the customs valuation have been identified as the main barriers to trade under the ILFTA.

The majority of Sri Lanka's exports to India fall under the Residual List and amounted to 54 per cent of the total exports to India in 2000, and 49 per cent in 2001 (Table 10.3). The exports under the zero duty concession list increased from 20 per cent in 2000 to 36 per cent in 2001. Meanwhile, in 2001, 1.5 per cent of the total trade was under the negative list.

As opposed to Sri Lanka's exports, imports from India are subject to a higher negative list. Forty four per cent of the Indian imports were under Sri Lanka's negative list in 2001. Meanwhile, 42 per cent of imports came under the residual list, which will become duty free in eight years after the commencement of the agreement. In the share of the zero duty items too, there is significant difference in the two cases. Less than 1 per cent of imports from India fall under this category as opposed to 36 per cent of exports from Sri Lanka in 2001.

Table 10.3
Share of different categories in total exports to India[6]

Year / Category	2000	2001
Total Exports to India (Rs.Mn.)	4217.2	6265.6
Zero Duty (%)	20.13	36.18
Textiles -50% (%)	7.88	5.23
Negative list (%)	2.26	1.51
Tea -50% (%)	7.04	2.09
Garments (%)	17.00	0.28
Residual List (%)	54.11	49.44

Source: Compiled from Sri Lanka Customs Data base.

10.2 Impact of the Indian Budget-2002/03 on the ILFTA and on Sri Lanka

1) Beneficial Moves

- Customs duty reduction of the items under the residual list of the agreement from 50 per cent to 90 per cent. Under the agreement India agreed to

[6] This table analyses total bilateral exports and not ILFTA exports *per se*.

allow 50 per cent duty reduction in existing duties on 2799 items imported from Sri Lanka.

- India to increase its customs duty on tea on other countries from 70 per cent to 100 per cent, while the duty on Sri Lankan tea under the FTA will remain at 7.5 per cent and falls under a quota of 15 million kg per year.
- Reduction of the customs duty peak from 35 per cent to 30 per cent.
- The general duty on pepper, cloves and cardamoms has been increased from 35 per cent to 70 per cent, while these commodities enjoy a duty concession of 90 per cent under the ILFTA.
- The general rate of pulses (HS Code 0713), which gets 90 per cent duty waiver under the ILFTA, has increased from 5 per cent to 10 per cent. This is a further advantage to the Sri Lankan exporters with the other global players.
- A move that is likely to encourage higher Indian investment in Sri Lanka is allowing companies to invest up to US$ 100 million abroad on an annual basis, which is an increase from the previous US$ 50 million. Indian companies pursuing joint ventures abroad by market purchases could also do so without prior approval up to 50 per cent, which is an increase from the current limit of 25 per cent. This could be an additional encouragement for the investment under the ILFTA, which has not been significant up to date.

Table 10.4
Share of different categories in total imports from India

Year/category	2000	2001
Total Imports from India (Rs.Mn)	45477.65	53750.1
Negative list (%)	41.20	44.53
Zero Duty (%)	0.93	0.66
50% concession (%)	11.68	12.73
Residual List (%)	46.14	42.04

Source: compiled from Sri Lanka Customs Data base.

2) Negative Moves

- The general customs duty on natural rubber has been raised from 35 per cent to 70 per cent (HS Codes – 40011000, 40011001, 40011002). Sri Lankan exporters receive no preference as these items are in the negative list of India under the ILFTA. Further, the Indian Government has restricted the entry of imported natural rubber to two ports at Calcutta and Vishakhapatanam followed by mandatory registration of importers with the Indian Rubber Board.
- The reduction in the general duty rate indicates increased competition for Sri Lankan exporters to India. Nevertheless, Sri Lanka still has a competitive advantage over the other international players due to the concessions given under the ILFTA. Therefore, these concessions should be utilized and exploited quickly.

10.3 Outcome of the ILFTA Joint Ministerial Committee Meeting[7]

Tea

- Market Access -- Sri Lanka granted export of Indian tea for home consumption on payment of the prevailing MFN duty and subject to ISO 3720 minimum standard, conform to chemical and biological standards as prescribed by the Sri Lankan Authorities for all teas, exclude all banned pesticides as notified by the Sri Lankan Authorities, and in respect of other pesticides should conform to the Maximum Residual Limits.

[7] The Joint Ministerial Committee Meeting was held 6th–7th June 2002, which was followed up by a meeting of the Senior Officials from both countries on 4th-5th July 2002

- Entry Ports- India extended two more entry ports for tea with immediate effect namely, Mumbai and Vishakhapatnam

Garments

- Deepening of Tariff Concessions on 51 items -- India deepened the specific duty concession on 51 tariff lines at 6 digit H.S. Level. India agreed to increase the specific duty tariff concession, wherever applicable, on requested tariff lines from 50 per cent to 75 per cent. However, *ad valorem* duty concession on these lines will continue at 50 per cent.
- Conditional removal of the restriction on 6 million pieces of garment quota- India agreed to increase the quota by 2 million pieces in respect of which fabric of non-Indian origin is used when Sri Lanka fully utilizes this quota. Therefore when the quota is increased, the breakdown of the 8 million pieces quota will be 4 million pieces of Indian origin and 4 million pieces of non-Indian origin.
- Entry Ports -- Calcutta and Mumbai were extended as additional entry points for Sri Lankan garments.
- Removal of 1.5 million pieces stipulation -- India to increase the level from 1.5 million to 2 million pieces per category per annum.

Cement

- The margin of preference on cement from India was increased to 35 per cent from the present level of 20 per cent.

Other Issues Addressed

- Issues pertaining to customs valuation, where exporters are facing problems especially with regard to importation of garments from India.

On the Agenda

- Discussions are underway on the issue of joint marketing of tea by both countries.
- Feasibility study to be undertaken by the Tea Boards of the two countries on the future market of tea in Colombo.
- India to consider re-classifying knitted gloves under India's Residual List. In the event of full utilization of the quota, this request will be considered.
- The two parties will further analyze and identify specific sectors as envisaged under Article VII (2) of the FTA on the reduction of the domestic value addition and the value addition under the Cumulative Rules of Origin. This issue to be taken up by the Joint Working Group.
- The draft MOU between the Export Inspection Council (EIC) and Sri Lanka Standard Institution (SLSI) have suggested the following:[8]
  a. EIC to be the sole agency which SLSI would recognize.
  b. The inspection of the consignments -- initially maximum of 25 per cent of the consignment to be inspected and this to be reviewed after one year.
  c. To review the already existing system of EIC with regard to food certification and to cover all food items under the purview of the MOU subject to the implementation of Hazard Analysis and Critical Control Point (HA/CCP), Good Manufacturing Practices (GMP), Good Hygiene Practices (GHP) schemes in the industry.
- The concept of "FTA II and Beyond" to be discussed and a Task Force to be appointed.

[8] The MOU to be signed within one month to be operational with effect from 01st January 2003.

11. War Risk Insurance

The 2001 terrorist attacks at the Bandaranayake International Airport (BIA) on July 24 and the attack at the World Trade Center and the Pentagon on September 11 brought to the forefront the issue of war risk insurance and war risk premiums (WRP). After the Katunayake attack, the global hull (ship) underwriters perceived the Colombo port as the next terrorist target and declared it a war risk zone. The "held cover" status which was confined to the Northern and Eastern parts of the country, was extended to the entire island in August. The additional war risk surcharges that were imposed debilitated the country's foreign trade, with a drop in total cargo handled, the number of import and export containers, and the extent of transhipment at the Port of Colombo.

11.1 What is a War Risk Premium?

The basic marine or aviation insurance policy is used to cover either the ship owner (or the shipper or the buyer) or the airline supplying the goods. There are, however, certain special risks that underwriters do not cover under the basic policy. The exclusions range from war, hostilities (whether war is declared or not), and hostile detonation of nuclear weapons, riots, terrorist acts, sabotage, requisition, and hijacking. The war risk policy covers all of the war risk perils excluded under the former policy. Presently, aviation and marine insurance rates are decided by the respective war rating committees based in London with insurers and reinsures the world over following their rates.

There are two committees that regulate the London Insurance market -the Joint War Committee (JWC) and the War Risk Rating Committee (WRRC). Whilst the JWC regulates the hull market, WRRC is in charge of cargo. The WRRC by their circular issued on 6th August 2001, declared that for sailing or flights on or after 1600 hours GMT on 7th August 2001, the entire country be brought under "held cover". Held cover status is one where the underwriters (insurers) are free to levy an additional premium as war risk. As for ships (hull insurance), Sri Lanka has appeared in the London Market War Risk Warranties for the past several years. On 2 November 1995, the WRRC of the Institute of London Underwriters (ILU) rated Sri Lanka as a high risk country following heavy military operations in Jaffna. Although the Northern part of the country was considered as a war risk trading area for a considerable time, the underwriters did not consider it necessary to impose an additional premia.

Sri Lanka was featured among the excluded war risk zones in the world which are, Iraq, Angola, Israel, Lebanon, Libya, Eritrea, Somalia, Congo, Liberia, Sierra Leone, and Yugoslavia. The classification of Sri Lanka before this declaration was that, in regard to cargo only the North of

Sri Lanka (latitude 7 degrees) was under "held cover". However, since 7th August the entirety of Sri Lanka was brought under "held cover".

The WRRC assesses the risk based on information and perception. Therefore, the main factors that contributed to the imposition of the war risk surcharge on Sri Lanka were, the attack at the BIA, numerous misconceptions about the security situation in Sri Lanka and the depressed insurance market.

11.2 How it was Applied

Following the airport attack, individual hull underwriters charged an additional premium between 0.10 per cent to 0.25 per cent per port call at the Port of Colombo. In other words, individual underwriters on average charged a WRP of US$500 for a 20 foot container and US$1000 for a 40 foot container (Sri Lanka Ports Authority).

With regard to the aviation sector, the insurers increased the premium between Rs.5-10 million per call on every airliner calling at Colombo. The price of an airline ticket on average increased by 10 per cent while the additional insurance premium per flight to Colombo was US$110,000 per flight.

With the provision of the US$50 million guarantee by the Government of Sri Lanka (GOSL), the WRRC on the 23rd August reduced the additional premia by 85 per cent to 0.075 per cent of the hull value per call as against 0.5 per cent and 1 per cent imposed in early August [per container wise reduction ranged from US$350-US$700 on a Twenty Foot Equivalent Unit (TEU) and US$500-US$1000 on a Forty Foot Equivalent Unit (FEU)]. However, there was no fixed war risk rate. Some shipping lines continued to charge US$350 per 20-foot container although some reduced it to US$50 and some refrained from charging at all. Again in November 2001 the WRP was further reduced by 33 per cent to 0.05 per cent.

Meanwhile, the members of the Insurance Association of Sri Lanka (IASL)[1] did not increase the cargo war rate from the previous rate of 0.0275 per cent (the rate without the WRP). This applied to all cargo underwritten by the association (mainly local underwriters). This means that those who insured cargo locally were not affected by the decision taken by the WRRC.

The US$50 million aggregate deductible/ or guarantee that was put up by the GOSL to cover facility placed in Lloyds lapsed in March 2002 and the guarantee was released to the GOSL with the agreement of insuring underwriters. But, Sri Lanka still remains an "excluded" area for war risks under the marker exclusion clause. Due to continuous lobbying by the Sri Lanka Shippers' Council (SLSC), the WRP has been withdrawn by some of the shipping lines

[1] IASL members are Asian Alliance Insurance Company Limited, Ceylinco Insurance Company Ltd., Co-operative Insurance Company Ltd., Eagle Insurance Company Ltd., Hayleys AIG Insurance Company Ltd., Janashakthi Insurance Company Ltd., National Insurance Corporation Ltd., Sri Lanka Insurance Corporation Ltd., Union Assurance Ltd.

as of May 2002. Some lines still continue to charge the WRP while some do not. At present, the discretion of charging the WRP is entirely left to the individual underwriters. The most important fact is that the WRP on Sri Lanka has not been fully taken off and the country still remains an excluded area.

11.3 How it was Abused

The WRP was abused by several lines in order to earn windfall profits and to discriminate against Sri Lanka's exporters and importers. It not only affected the Sri Lankan economy adversely, but it was implemented in the most discriminatory and disorderly manner by some shipping lines. The rates charged by different lines varied in a mysterious manner showing the exploitation by the foreign lines and insurers. One of the fundamental issues with regard to the WRP was the lack of transparency in the process by which underwriters determined risk. There is no common formula in calculating the WRP. Even though the Sri Lankan authorities repeatedly claimed that the Port of Colombo was 22 miles away from the BIA where the terrorist attack took place, the underwriters continued with the WRP for several months.

There was no uniformity either in the effective dates and levels of surcharge. The dates range from 30th July to 11th August. The insurance premium on a vessel is based on its market value (depending on the size, age and condition of the vessel), but the two powerful shipping cartels serving Sri Lanka (IPBCC and Tans Pacific Stabilization Agreement) fixed the WRP at uniform rates without taking into account the market based value of the vessel. Feeder vessels imposed WRP of US$150 from 2nd August, and APL rate was US$350 per TEU and US$700 per FEU effective from 7th August. Member lines of IPBCC imposed a surcharge of US$350-750 from 11th August.

There were also costly delays in transmitting the reduction in the WRP rate by different shipping lines. Though Lloyds of London agreed to reduce the WRP from 0.25 per cent to 0.075 per cent to be effective from 10.55 a.m. BST on 20th August, none of the main liners implemented it immediately. This resulted in an additional war risk surcharge being payable by exporters and importers and resulted in uncompetitive Sri Lankan exports in the global market.

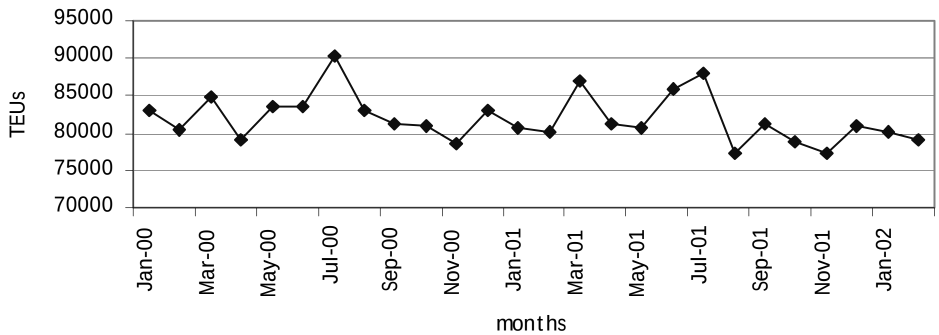
11.4 Economic Impact

An adverse implication of the imposition of the WRP on Sri Lanka was the drastic reduction in the number of transshipment containers and the vessel arrival at the port of Colombo. As a result of the increase in the freight charges, five main liners[2] bypassed Colombo port since August 2001, causing a significant loss to Sri Lanka's trade. With regard to transshipment cargo, many bypassed Colombo and diverted to competing neighboring ports like Singapore, Malaysia, Salalah and Anden,

[2] The five main liners are UniGlory Service, UniGlory/Cosco, Hyunda NYK Slots, Hyunda/SCI and Wan Hai/OOCL KMS Service.

Figure 11.1

Monthly handlig of import and export containers[3] (TEUS) at the Port of Colombo - Jan 00 Feb 02



Source: Compiled using Sri Lanka Port Authority Data.

while local importers and exporters had to bear the increased cost of the WRP.

A significant drop in the import and export TEUs handed at the Port of Colombo was evident after the July attack. The immediate effect from July to August 2001 was a drop of 12 per cent in the import and export TEUs, while after September it has gradually picked-up.

The shock of the July attack was mostly felt on the transshipment containers. The decline from July to August was 17 per cent and it further decreased again by 17 per cent in September 2001.

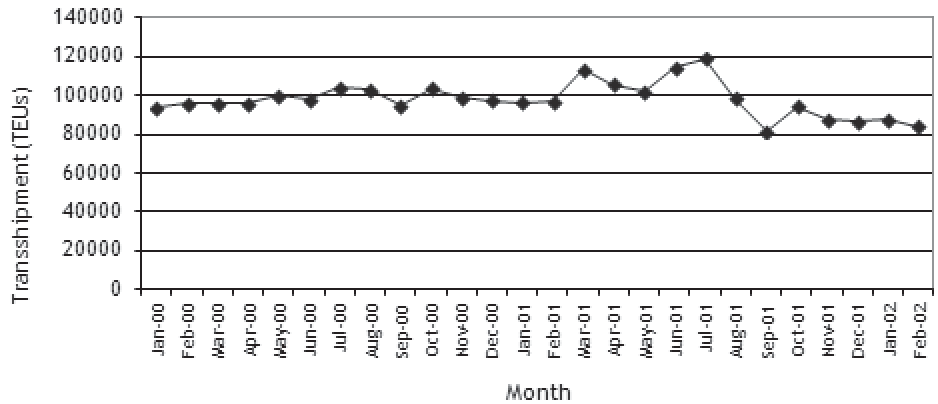
Tourism was one of the most adversely affected after Sri Lanka was declared a war zone. The travel advisories in western countries informed the tourists to be cautious when traveling to Sri Lanka and warned holiday makers against non-essential travel to Sri Lanka. This significantly affected the tourism industry.

11.5 Double Standards After September 11

The irony of the double standards in the world trading system were exposed by the discriminatory treatment of the global underwriters towards the U.S.A. and Sri Lanka following terrorist attacks. Immediately after the attack on the Katunayake airport, Sri Lanka was rated as a "war risk" country by the London based underwriters and thereby imposed an unfair WRP. On the other hand, for the U.S.A. there was no such treatment even though the attack and damage was much greater. With the US retaliation against Afghanistan, the London based underwriters, have applied WRPs for ports in Egypt, Syria, Lebanon, Algeria, the Red

[3] Total export/ import containers include the total laden and empty cargo containers.

Figure 11.2
Changes in the trans-shipmentat the Port of Colombo (TEUS)



Source: Compiled using Sri Lanka Port Authority Data.

Sea and, Pakistan. As a result, most of the sea-borne trade in West Asia was adversely affected. Pakistan was one of the worst affected countries in this regard. Unprecedented war risk insurance premiums were imposed on all cargo shipments to and from Pakistan. For example, some shipping companies charged a WRP of US$150 per TEU and US$300 per FEU from 5th of October. On the other hand, Indian cargo has been spared from the levy of this surcharge despite the fact it is located on the same coast of the Indian Ocean. Therefore, it is a blind discrimination against Pakistan and unjustified as neither its territorial waters nor its air space were declared as war zones.

With regard to air services, since hijacked passenger planes were used in the attack on America, all civilian aircrafts, belonging to all airlines in the world, were put under a blanket policy of high insurance premium and limited liability coverage.

11.6 Moving Ahead

It should be noted that though there was a very high WRP on Sri Lanka immediately after the airport attack, eventually the rate came down as a result of the negotiations led by the Government and the private sector lobby against the WRP. It is vital for the GOSL to project the image of the Port of Colombo as a safe destination and thereby promote it as a hub destination in South Asia. It should lobby and try to remove Sri Lanka from "excluded" area on a official level from the London based underwriters, and thereby remove the WRP completely.

12. Tradeable Environmental Credits and the Sinharaja Forest

12.1 Introduction

The present controversy on the proposal of trading environmental credits with the U.S. Government to be enacted under the Tropical Forest Conservation Act (TFCA) of the U.S.A for debt service by Sri Lanka, has riled environmental activists and many public institution officials. Sri Lanka can choose between one of the following debt relief mechanisms: debt buyback or debt swap with a third party. In these schemes, a portion of a nation's external debt is bought by a third party at substantial discount. The debt is then cancelled. In return, the country promises to protect several million hectares of forests. Large conservation organizations like the US-based Conservation International (CI), Rainforest Alliance and World Wildlife Fund (WWF) have been actively promoting such transactions. The local institutions involved in the negotiations are the Ministry of Finance, the Treasury, the Ministry of Forestry and Environment, the Wild Life Department and the Forest Department. The local forests considered under the TFCA are the Sinharaja rainforest,[1] Peak Wilderness and Horton Plains, and the Namunukula and Knuckles Forest Ranges, which together comprise over one quarter of Sri Lanka's total forest cover.

12.2 What are Tradable Environmental Credits?

Known also as debt for nature swaps, tradeable environmental credits (TECs) are financial credits issued by industrialized countries to host countries in exchange for environmental protection. The definition of a debt swap (or conversion) is laid out as the cancellation of external debt in exchange for a debtor Government's commitment to mobilize domestic resources (in local currency or another set) for an agreed purpose, which can extend from nature to health or education related projects (UNSO, 1997).

The evolution of this concept dates back to the early 1980s when the developing world faced a debt crisis, and default seemed imminent. Around the same time, many conservationists argued that the large amortization and the interest payments owed by highly indebted countries were causing irreversible damage to their resource bases. This was because to finance these payments, they were forced to produce and export ever-increasing amounts of natural resource-based products such as crops, cattle, timber, minerals and petroleum.

[1] Due to its unique diversity, the Sinharaja forest was declared a Man and Biosphere Reserve (MBR) in 1978 and became a National Heritage Wilderness Area in 1988. This forest was declared a World Heritage site by UNESCO in 1989.

Many commentators have argued that there is significant correlation between foreign debt and natural resource degradation (Shilling, 1992; Occhiolini, 1990). Shillings (1992) argues that the debt crisis and the environmental degradation stems from the same root. The desire for better standards of living has resulted in a need for more investment and more inputs, which in turn places a greater strain on the natural resources base. At the same time, the increased consumption in the short term tends to reduce savings in many developing countries, thereby raising their demand for external borrowing and exploitation of natural resources (using natural capital to supplement current income). It was in 1984 that Thomas Lovejoy of the World Wildlife Fund now the World Wide Fund for Nature proposed the debt-for-nature swap.

12.3 Models of Debt Swaps

There are two types of swaps:

a) Bilateral swap -- a creditor Government cancels debt owed by a debtor Government in exchange for the debtor setting aside an agreed amount of counterpart funds in local currency for environmental protection.

b) Third party model -- an organization (e.g. an NGO) solicits debt donations or purchases debt at a discount from face value from a creditor, and negotiates separately with the debtor Government for cancellation of the debt in exchange for project funding for conservation.

Steps involved in a debt for nature swap:

i) The donor (usually an NGO) negotiates with the debtor country the framework for the swap.

ii) The donor purchases the debt from the creditor usually at a discounted price. At this point the donor becomes the titleholder and is in a position to convert the debt.

iii) According to the framework negotiated in step (i), the debt is converted into local currency, bonds or assets in the debtor country. The amount converted into local currency is actually deposited by the debtor country as payment to the donor. This amount is always equal or higher than the market value (which the donor paid the creditor), but less than the actual face value of the original debt.

iv) These assets are then used by the appointed local implementing body for the conservation project as designated in the original agreement. (Hansen and Svarrer, 1998)

12.4 The Global Scorecard -- the Good, the Bad and the Ugly

Swaps provide a long-term source of funding which facilitates the implementation of conservation programmes with long time horizons. Many indebted developing countries possess valuable nature reserves and forests where environmental management is most necessary. However, since they rarely have the funds and/or the interest to finance such endeavours, nature swap agreements are useful.

Although theoretically attractive, the debt for nature swap has its drawbacks.

- The amount of debt paid off is so small in relation to the total owed by third world countries to developed countries, that it becomes virtually irrelevant.
- Agreements tend to overlook the needs of indigenous people. Current regulations prevent traditional land-use management systems, which would have a significant impact on their survival.
- Given that debtor countries have extremely scarce resources, expenditures on debt for nature swaps may reduce the availability of financial resources for other important projects.
- Since they are agreements between Governments, the input of civil society groups has been insufficient.

The very first swap initiated was in 1987 by the Bolivian Government and Conservation International (CI). Under this swap agreement, CI obtained US$650,000 worth of debt from Citibank (the original lending institution) for a discounted price of US$100,000. In return the Government of Bolivia undertook to provide maximum legal protection to the Beni Biosphere Reserve, create three adjacent reserves and provide US$250,000 for the management activities of the reserve. But being the very first of this nature, the swap faced controversy and delay due to lack of open participation by the relevant organizations in Bolivia, some misperceptions of the agreement, and, of course, the newness of the programme itself (Resor, 1997).

Since then, debt for nature swaps have been arranged or explored in many developing countries including Ecuador, the Philippines, Zambia, Jamaica, Guatemala, Venezuela, Argentina, Honduras, and Brazil.

- In 1988, the WWF purchased Philippine debt worth US$390,000 for a discounted value of US$200,000 to which the Central Bank of Philippines redeemed the full face value of US$390,000 in pesos during a two-year period. By this, the Philippine Government no longer owed the money to the commercial banks, but instead had to use it within the country for conservation projects.
- In 1989, the WWF purchased US$2.2 million worth of Zambian debt at a cost of 20 per cent. Initially this swap seemed very successful as the purchase rate was very low. But due to poor planning and the rapid devaluation of the Zambian Kwacha, the WWF was compelled to use the local currency proceeds in less than one year, thus undermining the planned impacts of the swap. But in 1993, the Government of Zambia established an orderly conversion of debt. Under this scheme, NGOs purchase debt at 11 per cent and receive a dollar equivalent of 16.5 percent from the Zambian Government. Though the multiplier is 1.5 (16.5/11), the programme was well structured so that NGOs were able to finance swaps with a high degree of certainty and reliability.
- In 2000 Bangladesh entered into a swap agreement with the U.S. under the TFCA. This agreement allowed Bangladesh to save over $10 million in U.S. dollar payments over 18 years. In return for the cancellation of this debt, Bangladesh will

set aside $8.5 million (dollar equivalent) in local currency to endow a Tropical Forest Fund with a mandate to protect and conserve Bangladesh's mangrove forests and Bengal tigers.

12.5 The Sri Lankan Context and Controversy

The Ministry of Forestry and Environment is still considering the swap that would write off US$400 million of debt. According to the TFCA, once an agreement is signed, a tropical rain forest fund and administrative board will be established with the TFCA secretariat at the USAID. The board will consist of U.S. and beneficiary Government officials, representatives of NGOS, as well as local scientific, academic and/or forestry organizations. Although Sri Lanka had already committed itself to an Asian Development Bank funded seven-year forestry plan, under the US tropical forests conservation plan, the four forests would be at least 70 per cent managed by the US.

The main issue has two components:

1) The issue of patent rights to research findings. The impression is that the Agreement will allow U.S. institutions to carry out research in the forest. The concern is that this will lead to some form of legitimate "biopiracy." Sri Lanka is one of the richest countries in terms of biodiversity, with a large number of species of plants and animals. In fact, American and Japanese companies have shown great interest in acquiring genetic material from plants found in Sri Lankan forests, and have already filed 45 patents for medicinal plants found here. Thus if American research in Sri Lankan forests lead to significant discoveries, this could lead to massive returns, over several years, for the American patent holders.
2) Sri Lanka's debt is mostly of a domestic nature. The remaining external debt is primarily multilateral. Thus the restructuring of some American debt is unlikely to have a significant impact.

Putting these two points together in a cost-benefit sense, it seems that for $400 million dollars today (Sri Lankan benefit), Sri Lanka is giving up potential gains from doing her own research and reaping patent rewards of billions of dollars that could be continuous income to the country. In other words, the forests are extremely undervalued. From the American perspective, the cost is US$400 and the benefit is the potential billions of dollars that come from patented research of pharmaceutical and other bio-chemical industries. It clearly looks like a better deal from the American perspective! Unfortunately, the low local research capacity suggests that local research breakthroughs may not be immediately forthcoming, but not pursuing the swap at least maintains the ability to reap these gains in the future.

Other relevant issues include:

- An ADB fund of US$26 million has been allocated for a forestry master plan and that should be sufficient to conserve the local forests. Further, the forest is protected through the National Environment Act and the Fauna and Flora Protection Ordinance, and the Forest Department is vested with powers to protect the forest.

- There needs to be a concurrent programme that addresses the needs of indigenous people.

12.6 The Bottom Line

The basic structure of the deal has moderate benefits and potentially huge costs in terms of lost income for Sri Lanka, while it has massive potential gains for American firms and relatively small costs. The only way such a swap would be acceptable to Sri Lanka is if the potential benefits of American research was shared *unevenly* in favour of Sri Lanka.

The key then would be to negotiate a favourable benefit sharing mechanism. However, the country's track record on negotiating international contracts has been immature at best, and more often just dismal. The lack of sophisticated expertise suggests the country would be better off without such a debt for nature swap involving the forest areas.

If the Government did pursue a swap, the deal must have full transparency and relevant safeguards. For example, any contract would have to ensure that i) once an important discovery is made, continuous extraction should not take place from within the forest, but the necessary resource be domesticated, and ii) there is no conversion of the forest or parts of it, for plantations etc. Further, the extent to which samples may be removed from the country should be documented.

While inherently debt swaps are useful tools, the case of Sri Lankan forests involves particular issues that make the standard debt reducing benefits of the deal insufficient. A debt for nature swap to say protect elephants, or a debt swap for education or health projects would be less complicated. The appropriate response, then, to the current proposal would be, "thanks but no thanks".

13. A Multi-Utility Regulator: Balancing Economies of Regulation and Diseconomies of Political Interference

13.1 Introduction

What are the prospects for effective and efficient regulation by the proposed Public Utilities Commission (PUC) -- Sri Lanka's model for a multi-utility regulator? The rationale for economic regulation of public utilities is based on the prevalence of market failures.[1] Recently, the literature on the economics of regulation has also focused on the incidence of regulatory failure, bringing to light such concepts as i) X-inefficiency;[2] ii) the "Averch-Johnson effect", where rate of return regulation (i.e. where a regulator designates an allowed rate of return) may lead to over-investment;[3] iii) informational asymmetries between the regulator and the regulated; and iv) the risks of political and regulatory capture. In current practice, competition is strongly preferred to State regulation, except in the case of a natural monopoly, with regulation being used only in the interim period until competition arrives.

The challenge for policy makers is to design an effective and efficient regulatory structure that maximizes social welfare, while minimizing both the direct costs of administering a regulatory system and the indirect compliance costs of overlapping jurisdictions. In the case of Sri Lanka, policy makers have the additional challenge of ensuring that the system minimizes regulatory risk and is conducive to private participation in infrastructure.

The most critical factor for regulatory agencies to be effective is that they be insulated from undue political interference, but still be held accountable. However, where Government ownership is a factor, as is the case in public-private partnership arrangements in the utilities sector, absolute independence is not possible. The issue, then becomes one of achieving "workable independence"[4] -- difficult in the context

[1] See, for instance, Newbery, D. (1999), *Privatization, Restructuring and Regualtion of Network Industries*, Cambridge, Mass.: MIT Press; and Levy, B. and P. T. Spiller (1994), 'The Institutional Foundations of Regulatory Commitment: A Comparative Analysis of Telecommunications Regulation' *Journal of Law, Economics and Organization*, vol. 10, no.2.

[2] "X-inefficiency" is the extra cost a firm incurs because the firm's managers don't try as hard as managers of unregulated firms to drive costs to their lowest possible level. The unregulated firm's profits fall if managers allow costs to rise. Regulators may allow the regulated firm to pass its higher average costs along to customers by raising prices.

[3] The Averch-Johnson Effect is that rate of return regulation controls the profits the firm earns **as a per cent of the allowed rate base (value of investment)** and, because profits depend on the rate base, the firm has an incentive to increase the size of its rate base. In choosing between capital and labor, an unregulated firm would consider the marginal products of capital and labor and the prices of capital and labor. A regulated firm considers the marginal products of capital and labor, the prices of capital and labor, **and also the additional profits the regulators will allow it to earn if its rate base rises.**

[4] Samarajiva, R. (2002), "Utility Regulation and Competition Policy in Sri Lanka: Prospects for Change" in M. Knight-John (ed.) *Competition Policy and Utility Regulation: The Sri Lankan Experience*, Colombo: Law & Society Trust.

of ineffective governance as in Sri Lanka. Methods of getting to workable independence include procedures for accountability in regulatory bodies, the financial autonomy of these agencies, and the process of winning legitimacy in the eyes of stakeholders through channels for user participation and influence, and commitment to the public interest.

The policy shift towards a multi-utility approach to regulation is essentially an attempt to get to a better system of regulation than in the past. Sri Lanka's experience with single-utility regulation, as seen in the cases of the telecommunications regulator -- the Telecommunication Regulatory Commission (TRC) -- and the bus transport regulator -- the National Transport Commission (NTC) -- has been disappointing. Some of the principal weaknesses in these structures are a lack of independence, shortage of funds and skilled staff, and poor regulatory governance. The thinking behind the establishment of the PUC, which is to initially regulate the water and electricity sectors with provision to add on other utilities as the reform process progresses, is that it would enhance economies of regulation and reduce diseconomies of political interference.

13.2 What's in and What's Not

The economies of scope in the regulatory process relate to the degree of commonality in the object of regulation (e.g. rights of way), the degree of commonality in the form of regulation (e.g. price caps), and the assumption that public hearings, cost studies etc. are substitutable across sectors. Based on this premise, a discussion paper on a "Consolidated Strategy for Regulating Infrastructure in Sri Lanka" prepared by Frontier Economics for the Government of Sri Lanka in February 2002, recommends that the water and electricity sectors be combined under a multi-utility regulator. They have several similar features such as a relatively large public-owned element with contractual limitations on competition, the need to determine acceptable revenues for service providers, and the fact that private investment is likely to be in the form of long-term contracts.

The rail and airport sectors, which have very little private participation at this stage, are to be accommodated under the PUC if and when private investment in these sectors increases. Telecommunications regulation is to continue under the TRC based on the fact that the main focus of regulation in the planned convergence model for telecom, internet, broadcasting and cable -- access, interconnection, and the allocation of spectrum resources -- is very different from regulating the water and electricity sectors. The bus transport sector is also excluded from the PUC as policy makers are of the view that the current constitutional controversy would hinder the multi-sector reform process. This stems from the fact that transport is a devolved area, and conflict may arise in regard to the division of powers between the NTC -- representing the center -- and the provincial councils -- representing the regions.

Whilst these concerns do have technical and practical validity, the rationale for excluding the broader energy sector, including the petroleum and LPG sectors, from the multi-utility regulator on the grounds that these sectors are characterized by competition is questionable. At present, there is no regulator for the broader energy sector, and recent media reports of the Ceylon Petroleum Corporation -- the incumbent State operator and the dominant player in the fuel market -- drafting a Petroleum Product Law that would limit the fuel retail market to three players is cause for concern.

PU -- On the Positive Side

- **Addresses the Pressing Problem of Scarce Regulatory Expertise in Sri Lanka's Regulatory Institutions**

  The multi-utility regulator attempts to minimize costs by exploiting economies of scope from the commonalities of regulatory inputs. The proposed organizational structure for the PUC is skills-based, with departments defined according to skills profiles -- such as economists, engineers, lawyers -– and project teams combining staff from different departments being formed to address particular regulatory issues. This then eliminates the need for a full complement of staff per single sector regulator.

- **Institutional Safeguards in Place**

  The PUC structure contains significant institutional safeguards for regulatory independence and provides for considerable financial autonomy. The five-member Commission is to be appointed by the Minister of Policy Development in concurrence with the newly formed Constitutional Council in an attempt to move away from partisan politics. These Commissioners are to be appointed on staggered terms, cannot be removed without Parliamentary approval with specified reason, are to serve on a part-time basis, and are subject to conflict of interest rules. Accountability of the Commission is to be to Parliament through the submission of annual reports and approval of budgets. While Government monies will be used as start-up funds, the PUC will maintain its own fund through license and operator fees.

PUC- On the Negative Side

- **Overlapping Jurisdictions**

  The issue of overlapping jurisdictions arises in the relationship between utility regulation on the one hand, and competition policy and law on the other, which is currently administered by the Fair Trading Commission (FTC) and is expected to come under the proposed Consumer Affairs and Fair Trading Authority (CAFTA). At present, there is little interaction between the sectoral utility regulators and the competition authority, mainly because of the sluggishness of these institutions. However, the potential for conflict over the jurisdictions of these entities cannot be ruled out given the ongoing controversy over the mandates of CAFTA and PUC with regard to monopolies, mergers, and anti-competitive practices and the tension between the line ministry and agencies responsible for the implementation of competition policy and those responsible for multi-utility regulation. Apparently, the turf mentality that characterized the sector-based approach to reform and regulation still prevails.

The public policy procedure followed in developing the strategy for multi-utility regulation must be praised for being significantly more transparent and structured, compared to the characteristic *ad hoc* approach to policy development and implementation. However, whether or not the new structure will be less susceptible to political pressure remains to be seen. The design of the PUC contains the necessary formal safeguards for independence. Nonetheless, the sufficient conditions for regulatory efficacy come from the legitimacy of the regulatory agency in the eyes of stakeholders; legitimacy won over time not by statute or institutional design, but with strong and credible regulatory leadership and demonstrated regulatory expertise.

14. VAT it was and VAT it is

14.1 What is VAT?

The valued-added tax (VAT) is a tax on value addition, in the process of supplying goods and services. When a manufacturer purchases goods to be used in the making of his product, the difference in value between the inputs and the final output is referred to as value added. The tax is then applied to such value added when the output is sold. Sri Lanka has adopted a VAT effective from August 1, 2002, replacing the Good and Services Tax (GST) and the National Security Levy (NSL). The GST was essentially a value-added tax, whereas the NSL was a sales tax, with the traditional cascading effect. The new VAT has three tax rates: 0 per cent, 10 per cent and 20 per cent. Other characteristics included:

- **Destination/Origin Principles-** Taxing imports and exempting exports is called the destination principle. Sri Lanka has adopted this with the objective of taxing consumption rather than production. Taxing in the opposite direction is known as the "origin principle", in which case the tax falls on production and not on consumption.

- **Exemptions-** Some goods and services are exempt from VAT. However, they may still carry an inherent element of VAT if they contain taxable components. For example, aspirin may be exempt from VAT but the packaging it comes in is subject to VAT. In this instance the end product (aspirin), though exempt, carries a part of the tax burden. This explanation applies to local manufacturing. However, if ready packed aspirin were to be imported, both the medicine *and* packaging would be exempt from VAT. The implication is that there is no level playing field between local manufacturers and importers.

- **Examples** of exempted **goods** include the supply or import of rice, rice flour, wheat, wheat flour, bread, liquid milk, infants' powdered milk, text books, pharmaceuticals and kerosene. Exempted **services** include electricity less than 30kwh per consumer, public passenger transport, the supply of library and educational services, and the operation of banking and financial services. Wholesale/retail activity has also been excluded from the original VAT apart from if the wholesaler or retailer is a manufacturer or an importer. For this reason, the tax as applied at its inception in Sri Lanka is not a full-blown VAT.

- **Zero-rating** refers to instances where products or services are taxed at zero per cent. In contrast to exemptions, zero-rating not only relieves the manufacturer of tax at the point of sale, but also provides him with a refund of the VAT paid on his inputs.

- **The lower rate of tax** (10 per cent) will be charged on such items as electricity exceeding 30kwh per consumer, agricultural machinery, construction services, hotel services, petrol, diesel, LP gas, aviation fuel and certain food items.

- **Imports vs. Exports-** VAT is also charged on imports. However, imports that are used in the production of exports are subject to rebates of the VAT. (i.e., the tax paid by the importer/manufacturer is reimbursed). Since VAT is a tax on domestic consumption, all exports are zero-rated and, hence, VAT does not adversely affect competitiveness in the world market.

14.2 Measurement of VAT

There are many ways of computing VAT. In Sri Lanka it is done by multiplying the value of inputs by a tax rate and subtracting it from the product of the value of final output and the tax rate. This is also referred to as the Invoice Method, which is known to be the most simple and effective. A numerical example would make it clear:

14.3 VAT vs. a Cascading Tax

VAT is favoured because of its simplicity and non-discriminatory features as opposed to a cascading tax like a sales tax, wherein tax upon tax is imposed as a product passes from manufacturer to wholesaler to retailer. Cascading occurs whenever taxable goods are produced using taxable inputs (eg. heat, office supplies etc). Therefore, tax cascading effectively increases prices at each stage from production to final sale to the consumer and more so when many transactions take place, which introduces distortions in the cost structure of various products or services. A value added tax removes tax on business inputs and eliminates sales tax cascading through an input credit mechanism.

Table 14.1 shows the cascading effect of a sales tax and contrasts it to a VAT, allowing the magnitude of both taxes to be 10 per cent. It shows two important points:

- Consumer prices are higher with an equivalent cascading tax.
- Revenue collection is greater with a cascading tax.

Manufacturer A

	Value (Rs.)	Tax (10%)	
Supplies (Output)	6, 500, 000	650, 000	Output tax *less* Input tax =VAT
Purchases (Input)	4, 000, 000	400, 000	
Value Added Tax paid by A		250, 000	

NB. If we assume that manufacturer A is last in the production line, so that the final value of the good is Rs.6,500,000, then *total* VAT collected through the various stages of value addition is 650,000 (which is 10 per cent of the final price).

Table 14.1
Comparison of VAT of 10% operating in the Wholesale / Retail sectors of the Economy with a cascading tax of 10 per cent

	VAT - Credit Invoice Method				Cascading Tax		
Stage of Production	**Sales (Rs.)**	**VAT (Rs.)**	**VAT on Purchases (Rs.)**	**Net. VAT (Rs.)**	**Sales**	**Cascading Tax (Rs.)**	**Sales-Cascading Tax (Rs.)**
Raw Materials	100 x 10%	10	0	10	111.11	11.11	100
Add Profit Mark-Up 20%	20	-	-	-	37.03		
1st Processor	120 x 10%	12	10	2	148.13	14.81	133.33
Add Profit Mark-Up 16.66%	20	-	-	-	43.78		
Distributor	140 x 10%	14	12	2	191.91	19.19	172.72
Add Profit Mark-Up 28.6%	40	-	-	-	82.31		
Retailer	180 x 10%	18	14	4	274.22	27.42	246.8
Total	**Retail Price**				**Retail Price**		
	180			18	274.22	27.42	

Note: Calculating Cascading Tax Sales value at the *next* stage of production is found by multiplying the sales value at the *previous* stage by one plus the profit mark-up, and dividing by 0.9.

Price of Raw Materials

Profit Mark-Up of 20 %

$$\text{Thus the sales price of the 1st processor} = \frac{111.11 \times (1 + 0.2)}{0.9}$$

$$= 148.13$$

14.4 Why VAT? A Comparison of GST and NSL with VAT

The adoption of VAT instead of GST and NSL is designed to make tax administration simple with one tax taking the place of two. Experience in other countries shows that this would simplify the tax system, reduce leakage, minimize costs of compliance and administration, and increase the revenue of the Government. It can also be expected that the simplification of the tax system would reduce tax evasion and opportunities for corruption.

Under the new tax system the supply of goods and services will be taxed at 0 per cent, 10 per cent, or 20 per cent depending on their class category. This is supposed to work out to less than the cumulative effect of GST and NSL (see Table 14.1). Previously GST was charged at 12.5 per cent on the bill price, and NSL was charged at a further 6.5 per cent on the cumulative total of bill price plus GST. It is this tax cascade in the NSL that VAT will eliminate. The table below illustrates the differences in price paid by a consumer under the present and previous tax systems. It is drafted for the six possible combinations of GST and NSL.

Price of Selected Commodities Before and After the Tax Reform:

It may be observed from table 14.2 that pharmaceuticals fall in price (see row e of category IV) if a VAT rate of 0 per cent is applied, but rise in price if a rate of 10 per cent is charged. The amended Bill has provided pharmaceuticals to be zero-rated. Hence we may expect a fall in the price of medicines. Likewise, the price of bread and wheat will remain the same as before, as these were also exempt before. Rice, liquid milk, infants' powdered milk, and kerosene should fall in price (row e, category IV) as they are relieved of NSL and zero-rated under VAT. On the other hand, the price of tea, coconut oil, potatoes, chilies, onions, lentils, dried fish, powdered milk, petrol and diesel will rise (row e, category IV) as they are charged at a VAT of 10 per cent as compared with the previous NSL of 6.5 per cent. The price of water (other than in sealed containers) will also rise (see row e, category VI) as it was earlier exempt, but now comes under a VAT levy of 10 per cent.

14.5 Revenue Implications

The Central Bank of Sri Lanka has estimated the budgeted revenue from GST, NSL and VAT in 2002 to be Rs.105 billion.[1] This is equal to 6.6 per cent of Sri Lanka's GDP and constitutes 44 per cent of tax revenue. However, due to the two month delay in implementation, the reduction of the tax rate on some products, and removal of some items from the tax base altogether, the revenue collected may fall short of this. The Government is estimated to lose Rs.292 million in tax revenue from pharmaceuticals, Rs.21 million on the sale of eggs, and 119 million on the import of spices.[2]

Table 14.2
Comparative treatment of selected commodities under GST, NSL & VAT

	GST @ 12.5% & NSL @ 6.5%		VAT @ 10%	Goods / Services in this Category		VAT @ 20%	Goods / Services in this Category
	Rs.		Rs.	Supply of education services not exempt		Rs.	Supply of telecommunication services, supply or import of cement, poultry, meat of bovine animals, swine, sheep, goats, yogurt, butter, sweet biscuits
a) Value of Supply	83.11	VAT	83.11		VAT	83.11	
b) Add GST @ 12.5%	10.39	@ 10%	8.31		@ 20%	16.62	
	93.5		91.42			99.73	
c) Add NSL	6.5		-			-	
d) Price Paid by Consumer	100		91.42			99.73	
	GST @ 12.5% & NSL @ 0.5%		**VAT @ 10%**	**Goods / Services in this Category**		**VAT @ 20%**	**Goods / Services in this Category**
	Rs.		Rs.	Motor cycles, bicycles, supply or import of motor coaches and chassis of motor coaches with 28 or more seating capacity used for public passenger transport.		Rs.	N/A
a) Value of Supply	88.44	VAT	88.44		VAT	88.44	
b) Add GST @ 12.5%	11.06	@ 10%	8.84		@ 20%	17.68	
	99.5		97.28			106.128	
c) Add NSL	0.5		-			-	
d) Price Paid by Consumer	100		97.28			106.13	

[1] What will VAT do to you? Seminar by C.J.P. Siriwardane, Central Bank of Sri Lanka.

[2] Daily News, July 30th 2002.

III	**GST @ 12.5% & NSL @ 0%**		**VAT @ 10%**	**Goods / Services in this Category**		**VAT @ 20%**	**Goods / Services in this Category**
	Rs.		**Rs.**	Supply of electricity more than 30 KWh, supply of services by hotels, guest houses, restaurants, supply of construction services		**Rs.**	All other goods and services not mentioned in the exempt, zero rated or concessionary schedules.
a) Value of Supply	88.89		88.89			88.89	
		VAT			**VAT**		
b) Add GST @ 12.5%	11.11	@ 10%	8.89		@ 20%	17.78	
c)	100		97.78			106.67	
d) Add NSL	0		-			-	
e) Price Paid by Consumer	100		97.78			106.67	
IV	**GST @ 0% & NSL @ 6.5%**		**VAT @ 0%**	**Goods / Services in this Category**		**VAT @ 10%**	**Goods / Services in this Category**
	Rs.		**Rs.**	Supply or import of pharmaceutical products, unprocessed agricultural products, supply or import of rice, rice flour, liquid milk, infants' milk powder, supply of selected financial services, supply or import of crude oil, kerosene, supply or import of machinery, medical and surgical instruments, wheel chairs, hearing aids etc., Books (other than news papers, magazines and periodicals).		**Rs.**	Supply or import of tea, selected spices, coconut oil, potatoes, onions, chilies, basic rubber products, vegetable seeds (other than seed paddy), planting materials, supply or import of sugar, dried fish, supply or import of powdered milk, condensed milk, eggs, lentils, fertilizer, petrol, diesel, aviation and bunker fuel, LP gas < 15Kg.
Value of Supply	93.5		93.5			93.5	
		VAT			**VAT**		
Add GST @ 12.5%	0	@ 0%	0		@ 10%	9.35	
	93.5		93.5			102.85	
Add NSL	6..50		-			-	
Price Paid by Consumer	100		93.5			102.85	
V	**GST @ 0% & NSL @ 0.5%**		**VAT @ 0%**	**Goods / Services in this Category**		**VAT @ 10%**	**Goods / Services in this Category**
	Rs.		**Rs.**	Supply or import of Agricultural tractors and machinery.		**Rs.**	
Value of Supply	99.5		99.5				
		VAT			**VAT**		
Add GST @ 12.5%	0	@ 0%	0		@ 10%		
	99.5		0				N/A
Add NSL	0.5		-			-	
Price Paid by Consumer	100		99.5				
VI	**GST @ 0% & NSL @ 0%**		**VAT @ 0%**	**Goods / Services in this Category**		**VAT @ 10%**	**Goods / Services in this Category**
	Rs.		**Rs.**	Gold, Wheat, Wheat flour, Bread, supply of selected public transport services, supply of electricity less than 30 KWh, supply of selected educational services, supply of health care services, supply lease or rent of selected residential accommodation		**Rs.**	Supply of water (other than in sealed containers or bottles), Supply of electricity between 30-90KWh.
	100		100			100	
		VAT			**VAT**		
Add GST @ 12.5%	0	@ 0%	0		@ 10%	10	
	100		100			110	
Add NSL	0		-			-	
Price Paid by Consumer	100		100			110	

Note: Figures used are arbitrary and do not reflect real prices -- they are merely tools for the comparison of price behaviour before and after the imposition of VAT).

Source: Author's calculations.

Some analysts argue that the VAT implementation delay had the advantageous aspect of allowing the successful revenue generator -- the NSL -- to carry on slightly longer. Likewise, taxes to be paid on the importation of goods have fallen by a considerable amount because of the abolition of the stamp duty and the reduction in customs duty from 40 per cent to 20 per cent.

14.6 Legal Challenge to the VAT Bill

The Consumer Protection Society (CPS) challenged the constitutionality of some clauses of the Bill.

1) There is no mention of the intended 10 and 20 per cent rates. In theory, this implies that the Minister can, by Gazette notice, vary these rates arbitrarily at a future date (Clause 2(1)). Further, the Bill provides that any such order made by the Minister must be laid before Parliament for approval within three months of the date of its publication. This gives the Minister a three-month grace period and, as there is no time limit by which Parliament must express its approval or disapproval, it could allow such orders to remain in force indefinitely.

2) There are arbitrary features in the classification of items for VAT levy in the original Bill. Whilst a number of items considered essential to society such as eggs, dried fish, sugar, diesel, LP gas and water were to be taxed at the lower rate (10 per cent), the supply or importation of pearls, diamonds and other precious metals is totally exempt from VAT. Not surprisingly, the taxing of water in a Third World country has been and remains a bitterly contentious issue. Petitioners have also expressed disapproval at the levying of the higher rate (of 20 per cent) on stationary and exercise books. Similarly, the imposition of VAT on newspapers and periodicals is deemed to be an infringement of the right to freedom of speech and expression.

3) Clause 20(6) of the Bill would have allowed suppliers subject to VAT to supply goods/services to persons not subject to VAT, and present the recipient with a consolidated invoice that did *not* disclose the price of the goods or services and the VAT component separately. It was argued that this provision would leave room for much abuse and injustice to the consumer. Petitioners wanted this clause to be deleted and demanded that consumers be given the benefit of the same type of invoice as required between two tax registered persons.

14.7 The Supreme Court Amendment

Clause 2(1) of the Bill has now been amended to include the numerical values of the two tax rates of 10 per cent and 20 per cent respectively. Similarly, Clause 20(6) has been amended whereby a registered supplier is now obliged to issue to a non-registered recipient an invoice giving the consideration of such supply *and* the tax charged. This enables consumers to recognize the tax component of a particular good or service. With respect to the classification of items, the amended Bill provides for the exemption of eggs, pharmaceuticals, books, agricultural tractors and implements (all of which were earlier under the 10 per cent levy).

14.8 Concluding Remarks

The VAT has been applied ever more widely because it avoids many of the negative features of other forms of taxation, particularly the cascading effects of sales taxes. In contrast, it taxes each stage of value addition only once at the stage where it is added. The VAT eliminates the cascading effect of the NSL. Further, under a Credit Invoice VAT, each purchaser will have every incentive to demand an invoice from a seller in order to claim a credit for the VAT paid. This allows for a mechanism that is self-regulating and makes tax collection easier.

When compared to the VAT as applied in several other countries, however, it is clear that Sri Lanka has not exploited the full potential of this tax. An advantage of the VAT (for example, over the turnover tax), provided it has a single rate –- something Sri Lanka lacks -- is the VAT's neutrality insofar as production efficiency is concerned: it taxes productive inputs equally and does not promote distortion of production choices. Moreover, the consumption type of VAT does not distort the choice between consuming now and consuming later in favour of the former, as does income tax. Thus, it does not penalize capital accumulation and economic growth. However, these superior attributes of VAT require a broad tax base with only a single rate and a minimum of exemptions, neither of which is true in the case of Sri Lanka. It would, therefore, greatly benefit Sri Lanka if her tax base were broadened by including exempt wholesalers and retailers into the tax system, and if the two tax rates of 10 per cent and 20 per cent were replaced with a single rate. Budget 2003 went in this direction by removing some exemptions and bringing the wholesale and retail sectors with a turnover threshold of Rs.1.8 million per annum under VAT. Banks and other financial institutions were also brought under VAT at the 10 per cent rate commencing 1st January 2003.

Prospects

15. Prospects

The official outturn for 2002 is estimated to be between 3.0 per cent and 3.5 per cent, with a forecast 5.0 - 5.5 per cent in 2003, under an optimistic scenario. The forecast of 3.0 - 3.5 per cent growth for 2002 is based on a recovery in the manufacturing sector in the third quarter, favourable weather conditions keeping agriculture growth positive, increased trading activity with the North-East, and tourist arrivals bolstering the services sector.

The reasonable positive growth in 2002, of course, is a function of the numbers game -- the very low base comparator output levels in 2001. Comparing real output levels to those in 2000, output growth in 2002 is likely to reflect barely a 1.5 - 2.0 per cent growth over the two year period.

Following four quarters of manufacturing contraction, third quarter 2002 data reflect a 6 per cent growth in manufacturing, with the overall industry sector registering a positive growth of 3.1 per cent. The positive development has made manufacturing output levels for the January - September period on par to the levels of 2001. Given the significant contraction in Q4 2001, we can expect a marginal positive average annual growth of manufacturing -- less than 1 per cent. Underlying the manufacturing upturn in the third quarter was an 8.0 per cent growth in the apparel sector, which offers signs that the industry is rebounding even though overall annual growth is likely to be close to zero (the sector contracted by 8.5 per cent in the first half of 2002). If the positive development of the 3Q 2002 was not an anomaly, but the beginning of a positive trend, we can expect manufacturing to grow significantly in 2003.

The construction industry should also post a marginally better growth after contracting in the latter half of 2001 and the first half of 2002. Delayed infrastructure projects and investor uncertainty contributed to this stagnancy. However, if a lasting peace is established, this sector could register a boom with a flurry of activity in the North-East and increasing infrastructure reconnecting the North–East to the rest of the country.

The drivers of growth in 2002 are the services and agriculture sectors. Given the favourable weather conditions (and the disastrous conditions in 2001), Q4 2002 agriculture growth should be significantly positive, contributing to an overall annual expansion of 4.0 - 5.0 per cent. While rubber production was maintained, coconut production dropped by 15 per cent, comparing the January - September period of 2001 and 2002.

The services sector, which already registered a recovery in the first half of 2002 (2.7 per cent growth compared to 1.3 per cent in the same period in 2001), and a significant 8 per cent growth in the third quarter, should continue its momentum, to register an annual growth of 5.0 - 5.5 per cent. The telecommunication and banking sectors continue to be dominant forces of growth in this sector. Unfortunately, tensions in the Middle East dampened the shipping and tourist potential in the country. Container handling during January - September 2002 is 2.5 per cent lower than the respective period in 2001. Similarly, tourist arrivals at 277.3 thousand is lower than 283.2 thousand during January – September 2001. The third quarter, however, does reflect a resurgence in arrivals from 66 thousand during July - September 2001, to 104.2 thousand during the same period in 2002.

This strength is expected to continue in 2003, and the services sector should be boosted by a more dynamic tourist and transportation sector if terrorist activity at home and abroad does not flare up.

The inflation outturn in 2002 is in the vicinity of 9.0 per cent according to the Colombo Consumers Price Index (CCPI), a significant drop from the annual average of 14.2 per cent in 2001. January - November average figures suggest an 8.8 per cent inflation rate compared to 13.5 per cent during the same period in 2001. The newer Colombo District Consumers Price Index (CDCPI) indicates a 7.1 per cent inflation rate in 2002, down from 10.4 per cent in first eleven months of 2001. Depreciation of the rupee against the US dollar was 3.6 per cent by November 2002 from the end of 2001. Exchange rate stability is likely to continue into the early months of 2003, with increased depreciation as the economy recovers.

On the external front, the trade deficit is likely to expand. Comparing the January – September period in 2002 to the same period in 2001, exports contracted by 8.3 per cent, while imports dropped by only 4.8 per cent. The largest dollar decline in exports was in the textiles and apparel sector -- approximately US$200 million. A positive note that bodes well for economic revival is that investment imports have been expanding in the third quarter of 2002. The current account deficit is likely to expand driven up by the trade deficit, but ameliorated by higher private remittances (US$873 million, up from US$849 during January-September in 2001).

According to the available data, the Government's fiscal targets (even the revised ones) are far from reach. On the revenue side, the lower economic activity has kept income taxes lower than in 2001 (as a share of GDP) as well as the collection from NSL/GST/VAT. Inevitable initial adjustments in the VAT collection process suggest a lower revenue collection from these latter type of taxes.

Expenditure restraint has only been on capital expenditures, thus delaying necessary infrastructure projects. The Government has failed to rein-in current expenditure, and, in fact, it has expanded. The growth of ministries only adds to the expenditure burden. The available figures for the first half of the year suggests an increase in the deficit by 0.4 percentage points, compared to the first half of last year. While the revival of economic activity will have a positive effect on revenue collection, it appears the deficit will remain high at about 10 per cent of GDP.

The outlook for 2003 strongly depends on the stance taken on the current uncertainties in the domestic and international environments. The point estimates are under continuous review, so the emphasis should be placed on the assumptions and analytic framework.

The underlying assumptions in the international environment is no war or a limited military operation in scale and duration that does not provoke greater retaliation, and does not place oil supplies in jeopardy. Further, the US economy should register higher growth as a new Bush economic team gears up to stimulate the economy in the run up to the 2004 US Presidential elections. Given the dominance of the Republicans in both the House of Representatives and Senate, relevant legislation such as tax cuts should pass.

The possible outbreak of war in the Middle East will have adverse effects on Sri Lanka. Looking at the impact of the Gulf War in 1991 points to the key factors that would be affected. Oil prices would rise, affecting overall domestic activity directly, as well as indirectly though reduced demand for our exports abroad. Other suppliers may meet the actual withdrawal of Iraqi oil from the world oil market, but the potential disruption to supply lines infrastructure could have significant effects on prices. Besides a general disruption to trade and tourism, the Middle Eastern tea market and the remittances from Sri Lanka workers in the area would be adversely affected.

On the domestic front, we assume ongoing negotiations on the peace initiative. The breakdown of talks, resumption of terrorist activity, and mass protests against the terms of a negotiated peace will reduce investor confidence and hamper growth. The continuation of talks and its eventual success in terms of being economically efficient and acceptable to the masses would, however, usher in a new dynamic growth path.

The political uncertainty, *vis-à-vis* the peace talks as well as the relationship between the President and the UNF Government remain high. However, the presentation of the Budget 2003 in November 2002 and the policy statement "The Future: Regaining Sri Lanka" by the UNF Government offer greater policy certainty and consistency.

While Budget 2003 does not present a watershed in the country's development path, it is broadly consistent with the government's stated objectives of fiscal consolidation to reduce the public debt, stimulation of investment, more balanced growth in a geographic sense, and provision of some relief to low income groups (see details in Box 1). The Budget 2003 released in November 2002 revised upward the forecast for the 2002 deficit by 0.4 percentage points to 8.9 per cent of GDP, and envisions the 2003 fiscal deficit decreasing to 7.5 per cent of GDP. Projected revenues for 2003 are 17.1 per cent of GDP (compared to the actual 16.5 per cent in 2001), and expenditures are to fall to 24.6 per cent (compared to the actual 27.4 per cent of GDP in 2001).

In recent years, the numbers presented in the budget have become exercises in wishful thinking, or at least represent the most optimistic scenario. Though useful for gauging policy direction, it is difficult to give great credibility to the numerical point estimates.

The government's policy statement "The Future: Regaining Sri Lanka" outlines four major challenges facing Sri Lanka and provides an action plan to address them. These challenges are:

- Creating jobs (2 million)
- Overcoming the public debt crisis
- Harnessing resources for reconstruction
- Increasing incomes by stimulating investment and productivity

It is reassuring that the government has focussed on job creation, which needs to accompany increasing productivity and investment. Budget proposals to stimulate investment through a Rs. 6 billion Indian credit line, as well as benefits for venture capital companies should provide a positive stimulus. The spirit of entrepreneurship needs to be fostered in the country, especially with respect to SMEs, agriculture, tourism, and other services.

The government must be careful that it directs resources to job creation and not to wasteful job preservation. Along with job creation comes job destruction. Instead of trying to preserve jobs in declining loss-making industries, the focus should be to create *new* jobs in expanding sectors.

The size of the public debt is excessive and continues to grow, perpetuated by large fiscal deficits. The situation is graver if we consider that the standard debt measure does not reflect the full magnitude of what the government owes. Looming in the near-term are the commitments made in the form of pension payments to an aging population that is not accounted for in the typical debt figures.

In terms of absolute levels, the Sri Lankan debt of US$16 billion is paltry compared to say Argentina's US$144 billion prior to default. However, with a public sector debt of 104 per cent of GDP, it is substantially larger (relative to GDP) than the Argentine debt of 55 per cent of GDP at the end of 2001 when the country defaulted on its debt in January 2002. However, the debt situation in the two countries varies significantly in a couple of ways. First, the majority of Sri Lanka's debt is domestic, and much of that is taken from sources of public capture (like national retirement schemes), and, thus, interest rates have been below market rates. Further, the external debt is mostly on concessional terms to the government, with an average interest rate of less than 2.0 per cent. Second, two thirds of the debt has a medium to long–term maturity. In contrast, the Argentine debt was mostly secured at international market rates, with a short-term maturity. Beyond the nature of the debt, the two years of recession in Argentina made repayments not feasible.

This highlights the fact that growth slowdowns are a major contributing factor to debt crises. Thus, in trying to address the debt problem, the government must not pursue myopic fiscal adjustment programmes that reduce growth-enhancing public expenditures. The government faces an inter-temporal (not a single period) budget constraint, and must find funding for projects with very high rates of social return.

This does not detract from the importance of fiscal consolidation for debt sustainability. As Sri Lanka liberalizes its financial sector, the government has increasingly moved towards more market-based instruments of financing, which imply higher interest rates. In terms of restricting spending, like governments before it, this one unfortunately relies on curtailing capital expenditures to reduce overall spending. However, it does acknowledge the need to increase public investment in the medium term as seen in its projections. The failure to contain current expenditures reflects the continued difficulties of all government to seriously reform the public sector and its process. There is no *prima facie* reason to expect this government to be more committed than any other to this leviathan of reform tasks. Positive efforts in this direction will be a boon to the citizenry. The government is counting on a significant cut in defence spending to reduce the deficit. While this may be the case in the medium–term once a sustainable peace is attained, in the short–term strategic sense the extent to which defence expenditure may be cut is limited.

Given the revenue shortfalls in a lacklustre economy, the government has rightly widened the net of the tax base. In particular, the VAT now includes the financial sector, wholesale and retail trade, and some formerly exempt items. There is likely to be a cascading effect of having the VAT apply on both the wholesale and retail trade. While the banking sector balks at the tax incidence, the sector should still do well as the investment environment fostered by the government should provide increased business opportunities and profits for the financial community. The private sector laments all tax increases. This would be muted if the government made sure these secured resources are effectively used for efficient public service delivery instead of wasteful expenditures and corruption.

Consistent with the revenue-raising imperatives, the tariff structure was amended to introduce a 2-10 per cent range for formerly duty–free items. As a short–term measure, this step is defensible, but this extra revenue should not be an excuse to delay reform in tax collection and reduction in wasteful expenditure. However, this adds to the complexity of the tariff schedule (worsened by bilateral free trade agreements), when it should be going towards greater simplicity and a pre-defined tariff (an important and stated goal of the government).

The budget also calls for removing restrictions of current and capital account transactions. Given the small size of the economy and the uncertainties in the domestic environment, any liberalization must be limited and narrow in scope. The country does not have the capacity to deal with the ill consequences of fully liberalizing the capital account. While the stock market may boom with inflows of foreign capital during times of high investor confidence, the flows will also dissipate overnight with a loss in such confidence. All liberalization is not good liberalization, and caution and selectivity is needed here.

The budget and the policy document both point towards greater emphasis of developing regions outside the greater Colombo area, and indeed the Western Province. Five regional economic zones are going to be established, along with five regional development ministries. Funds have been allocated for Provincial Specific Development Programmes (PSDP) under Provincial Councils, and there was a slight increase in the decentralized budget of parliamentarians. Special incentives are also envisioned for those producing outside the Western Province. While a lasting peace involves some decentralized structure, the specific design requires careful thought.

Decentralization has become an important feature of governance reforms in the developing world, not only as a means to increase government efficiency and responsiveness, but also as a means of diffusing social and political tension by offering local cultural and political autonomy. The theoretical benefits of devolving political decision-making to local level entities are based on more efficient public service delivery due to better information and political accountability. On the other hand, central governments are better at exploiting scale economies and managing the economy when spillovers across jurisdictions occur.

However, these traditional arguments, which are valid in developed countries, need to be refined in a developing country context. First, the central government has to make sure that structures of local political accountability are in place, and that the local governments are not at the mercy of the local power elites. In effect, the minorities in those areas need the central government to ensure their protection and relief. Second, the extent of financial control given must not erode the central government's capacity for macroeconomic stabilization. Third, sufficient human talent has to be directed to local entities to attain the necessary technical and administrative capacity.

Thus, it is unlikely that a transplanted framework from a developed nation will work. Institutions rarely travel well. For example, calls for using the Canadian model as a blueprint must be viewed with extreme caution. It has been contended that their system would have led to the separation of Quebec from Canada, if not for the geographical accident that the trade- dependent province is situated in the middle of the country and does not have its own port. This is inconsistent with designing a mechanism to support a unitary Sri Lankan nation state.

An appropriate regime requires a degree of autonomy in selective areas where greater local participation is efficient, and central control where a national player is most productive.

The inflow of foreign aid also poses economic management challenges for the government. Firstly, donors have been reluctant to commit to large sums of support without clearer signs of a sustainable peace. However, developing the North–East might provide a great impetus to peace. Moreover, the issue arises as to the LTTE's role in the government's reconstruction efforts. It is unclear whether the priorities of the government outlined in the Relief, Reconstruction and Reconciliation policy document are shared by the LTTE, and to what extent cooperation with the LTTE is desirable. Clearly, this is connected to issues of resolving the appropriate scope and level of general decentralization.

In the event of peace and large inflows of aid, the government will also be challenged to deal with the traditional "Dutch Disease" problem -- that is that aid inflows would appreciate the real exchange rate. Appropriate monetary and fiscal responses would need to address the adverse effect on the tradeable sector, and the concentration of resources on non-tradeables (like the construction industry).

The outlook for the Sri Lankan economy is positive, with GDP growth expected to be in the region of 5.5 per cent in 2003. This would result from a more robust international economy, continued recovery from a low production base in the last two years, increased economic activity in the North-East, and increased investor confidence in a climate of on-going peace negotiations and responsible economic management. However, this growth may not be achievable if: (a) war breaks out in the Middle East, or (b) the President dissolves Parliament and calls for a General Election, or (c) the on-going peace talks are derailed and war re-commences in the North and East. A combination of two of the above factors or all three of them would make the situation worse.

The challenges facing any government are enormous as the fate of the country is clearly at a crossroad. An effective government has to set an incentive environment that stimulates investment and productivity, while securing a peace that society finds acceptable. Peace alone is insufficient -- the design of the new political and economic framework must be economically viable and efficient, and perpetuate a robust growth path for a unitary Sri Lanka.

Table 15.1

Current data

	Latest Cumulative Data			Latter Half of the Year		
	Coverage	**2002**	**2001**	**Coverage**	**2002**	**2001**
Macroeconomy Variables						
Overall GDP Growth	Jan-Sept	2.7	-0.9	July-Sept	5.3	-4.2
Agriculture Growth	Jan-Sept	2.5	-2.3	July-Sept	1.2	-1.5
Industry Growth	Jan-Sept	-0.6	-0.8	July-Sept	3.1	-6.6
Services Growth	Jan-Sept	4.5	-0.4	July-Sept	8	-3.8
Manufacturing						
Construction						
Tea Production (Mn Kg)	Jan-Nov	281.1	268.1	Jul-Nov	121.9	109.4
Rubber Proudction (Mn Kg)	Jan-Oct	75.8	74	Jul-Oct	30.8	30
Coconut Proudction (Mn Kg)	Jan-Oct	2074	2397.5	Jul-Oct	836	1021.9
Inflation -CCPI	Annual	9.6	14.2			
Inflation -CDCPI	Annual	6.8	10.3			
Repo Rate	end Dec	9.75	12	end June	11.5	18.5
Wt Av Prime Lending Rate	end Dec	12.09	14.3	end June	14.04	21.88
International Transactions	(US $ million unless otherwise stated)					
Trade Balance	Jan-Nov	-1274	-1136.4	July -Nov	-411	-357.4
Exports	Jan-Nov	4203.5	4426.2	July -Nov	2191.5	1994.2
- Agricultural	*Jan-Nov*	*862.5*	*862.9*	*July -Nov*	*419.5*	*404.9*
- Industrial	Jan-Nov	3220.8	3396.2	July -Nov	1730.8	1532.2
of which Textiles and Apparel	Jan-Nov	2146.8	2314	July -Nov	1159.8	1050
- Mineral	Jan-Nov	84.7	81.5	July -Nov	40.7	35.5
Imports	Jan-Nov	5477.5	5562.6	July -Nov	2602.5	2351.6
- Consumer Goods	Jan-Nov	1069	1037	July -Nov	507	413
- Intermediate Goods	Jan-Nov	3291.8	3199.4	July -Nov	1591.8	1384.4
- Investment Goods	Jan-Nov	1012.8	1014.4	July -Nov	478.8	397.4
Tourist Arrivals ('000)	Jan-Nov	315	313	July -Nov	142	86
Tourist Earnings	Jan-Nov	221.6	197.9	July -Nov	112.6	54.9
Private Remittances Inflows	Jan-Sept	873	849	Jul-Sept	306	283
Gross Official Reserves	end Nov	1524	1338 (Dec)	end June	1440	1114
Exchange Rate (in SL Rupees per unit of foreign currency)						
US dollar	end Dec	96.64	93.16	end June	96.1	90.69
Euro	end Dec	100.31	82.27	end June	94.96	76.61
Indian Rupee	end Dec	2.02	1.93	end June	1.97	1.93
Japanese	end Dec	0.81	0.71	end June	0.8	0.73
Sterling Pound	end Dec	154.91	135.06	end June	146.88	127.69

Source: Central Bank of Sri Lanka.

Government Budget Highlights - 2003

The objectives of Budget 2003 appear to be

- fiscal consolidation to reduce the public debt,
- stimulating investment,
- more balanced growth in a geographic sense, and
- providing relief to low income groups and improving quality of life

Individuals budget proposals are classified under the four categories, with the understanding that a particular proposal may affect more than one objective, and its placement in a particular category is a subjective decision on its main influence.

Fiscal Consolidation

Public Debt Management : An independent Public Debt Management Office to be established and a comprehensive Public Debt Management Law to be enacted.

Revenue Raising Proposals

Disposal of idle assets other than land and buildings of the government ministries.

A further tranche of government holdings of Telecom shares to be sold.

Franchises to be issued to 2-3 petroleum importers.

Minority stakes in hotels and other small commercial companies to be disposed.

Taxation of public officers and employees of international organizations on their incomes from other sources is under discussion.

Changes and simplification of income tax procedures

Bank debits tax made applicable to all accounts. Rate remains at 0.1 per cent. However, the tax will not apply to withdrawals up to Rs. 20,000 per month.

Banks and other financial institutions brought under VAT at the 10 per cent rate.

Wholesale and retail sectors brought under VAT with a threshold limit of Rs. 1.8 million per annum.

Items currently exempt from import duty made dutiable with rates varying from 2 to 10 percent. Exclude *inter alia* wheat and crude oil.

The 20 per cent surcharge on import duty will not be eliminated, but will be phased out gradually.

Ports and Airports Levy of 0.75 per cent on imports for re-export after processing to be reduced to 0.5 per cent.

Liquor license fees to supermarkets, grocery stores and similar outlets having a turnover of Rs 72 million will increase.

A tree tax on kitul trees tapped for toddy.

In the telecommunications sector, (i) the general value added taxation principle to be applied to gross interconnection payments, (ii) a review of the current fee structure for radio frequencies, and (iii) a charge on the number blocks.

Embarkation tax to be increased by a levy of US$ 5 per ticket.

Expenditure Reductions

Rationalizing the public sector cadre.

Stimulating Investment

Reducing corporate income tax rate to 30 per cent for companies having a taxable income of over Rs 5 million. Half the savings to be placed in a HRD Endowment Fund. Other companies to continue on 20 per cent .

Assistance to the private sector for creation of jobs: Rs 6000 million to be made available on concessionary terms to the large, medium and small industries in specified sectors to purchase machinery and equipment from India.

No imports of road vehicles and agricultural or construction machinery older than 10 years will be allowed.

A concessionary rate of 20 per cent for existing Venture Capital Companies. New Companies will have an additional five-year tax holiday and qualifying payment relief.

For Unit Trusts and Mutual Funds, tax liability will be limited to 10 per cent. Withholding Tax on dividend and interest income if they invest in specified areas. Otherwise a tax rate of 20 per cent will be applied. Unit Trust holders will not be taxed again on the same income.

The tax free limit applicable to the withholding tax on interest earnings raised to Rs 108 thousand.

A levy of 1 per cent on the turnover of Tourist Board licensed institutions. Proceeds to be earmarked for supporting the Hotel School.

Non-resident companies will be subject to a Remittance Tax of 10 per cent in place of the current system.

Human Resource Development Fund: In addition to the funds to be transferred from the existing Skills Development Fund, Rs. 1 billion to be provided from credit lines to purchase of equipment.

Investment in Infrastructure Development: Improvement of roads, development of ports in the South and East, expansion of the international airport will be undertaken.

Road Fund: To be established under an Act of Parliament and managed by a board comprising representatives of private and public sectors. A special levy on all road vehicles will bring the funds, which will be used for road repair and maintenance work.

Infrastructure and Corporate Restructuring Fund: Existing holdings of the PSIDC (US$ 10 Million) to be transferred, and two tranches of US$ 75 Million to be mobilized.

Agro-Enterprise Development Fund: This fund will assist small and medium scale farmers to improve agricultural practices, introduce new crops and new technology, and maintain village tanks. Other functions include assistance to establish a hybrid seed industry and develop improved crop varieties through tissue culture.

Paddy marketing: A farm gate price of Rs. 13 per kg of paddy to be maintained.

A Tea Sector Association: This new institution will take over the regulatory and market development functions hitherto managed by the Government. It will also develop “Ceylon Standards” to differentiate Sri Lanka products from other teas.

A Forum of the Sri Lanka Apparel Association: A private-public partnership to be created to oversee the 2005 transition. The initial capital to be provided by the Government.

Gem and Jewellery Trade Promotion Council: Being established as an apex body to assist in the re-positioning of the industry. Functions include encouraging the banks to establish gem-trading branches for specialized industry financing. Government will extend support for establishment of a gemstone laboratory and industry certification.

Rationalization of import tariffs in the medium term: Recommendations of the Tariff Advisory Council to be implemented

Reform of the legal framework: Commercial laws are being modernized. New laws to be presented in Parliament shortly.

Financial Institutions: Credit rating and publication of such rating to be made mandatory for all deposit taking institutions and all debt instruments other than Government issues.

International transactions: The existing restrictions on current transactions to be removed and capital account transactions to be liberalized.

Balanced Regional Growth

Regional Economic Zones: A special BOI incentive package for new investment and expansion of existing enterprises in seven selected groups of production activities. For purposes of incentives, two separate regions have been identified. Region I is the Western Region and Region II covers the rest of the country. More attractive incentives offered to Region II in terms of tax holidays, tax rates and qualifying criteria.

Decentralized Budget: the annual allocation given to MPs to be increased from Rs. 3.5 million to 5 million.

Economic upliftment of the rural sector: Rs. 600 Million identified for the existing development projects and to start new projects.

Rural Economy Resuscitation Fund: Rs. 200 Million to be allocated. The fund has been established to assist the development of SMI and the on- going projects including those in the fisheries sector.

Economic Centres: Five more Economic Centres to be opened, in addition to those at Meegoda and Embilipitiya.

Affordable housing finance for the low and middle income groups: Rs 3 billion refinance facilities and Rs 300 Million interest subsidy to the commercial banks to lower the cost of mortgage credits to the public. Aim to provide low cost housing loans to low-middle income households. Size of loan should be less than Rs. 500 thousand.

Improving the Quality of Life

The rate of personal income tax will be reduced from 35 per cent to 30 per cent and not 25 per cent as envisaged earlier. A series of changes in the rates and rules applicable to income earners. Include those providing relief to wage earners and the self employed.

Duty free allowance for migrant workers returning after one year or longer to increase from US$ 1500 to US$ 1750.

State land in the urban areas not required for public purpose to be sold to private sector for development, including establishing middle class housing schemes.

Women's Development: In each of the funds established, there will be a separate window for women to access funds

Sports Development: All Maha Vidyalayas that have maintained a high standard in sports to be given additional financial support for improvement of training and sports equipment.

Recreation facilities for young people: Equipment worth Rs 1 Million to each electoral division to commence Youth Centres.

Appendices

Diary of Events

July 2001-June 2002

Economy

July 2001

- Following a sharp depletion of water levels in hydro reservoirs and amidst high petroleum prices, the Ceylon Electricity Board imposed an island wide power cut of one and half hours duration effective 2nd July. The country was divided into four zones, and cuts were imposed on a staggered basis.

- The Department of Census and Statistics conducted a Census of Population and Housing on 17th July after a lapse of 20 years. The 2001 Census covered only 18 out of 25 Districts due to the security situation in the North and East.

August

- Effective midnight 17th August, the Lanka Marine Services (Pvt) Ltd decided to sell marine fuel oil in line with the prices prevailing in Singapore. The new prices were: Lanka fuel oil-U.S. $ 145 per metric ton, Marine gas oil-U.S.$ 220 per metric ton and Marine diesel oil- U.S.$ 211 per metric ton.

- Following an attack by the L.T.T.E on the Katunayake Airforce base and the International Airport on 24th July, landing charges were waved for all foreign aircrafts that bring more than 200 passengers to the country. This was to remain in force until 31st December 2001. The estimated revenue loss was around Rs. 20 million a month. In the immediate aftermath of the attack a number of airlines either suspended or curtailed operations to Colombo.

- An additional war risk premium, was imposed on vessels calling Colombo by Lloyds Underwriters of London in August 2001,immediately after the Katunayake Airforce Base and the International Airport was attacked by the L.T.T.E was removed on 8th March by the underwriters Lloyd of London.

September

- The Ceylon Electricity Board extended the power cut to eight hours from 15th September.

October

- The Central Bank of Sri Lanka reduced the overnight Reverse Repurchase Rate from 15.00 percent to 14.00 percent and Repurchase Rate from 13.00 percent to 12.00 percent effective from 17th October. The Statutory Reserve Requirement on all rupee deposits was reduced from 11 percent to 10 percent effective 19th October.

- The Ceylon Electricity Board reduced the power cut to an hour a day from 27th October

November

- The Ceylon Petroleum Corporation (C.P.C) reduced kerosene prices by Rs.2.00 per litre effective 15th November. The new prices were: Lanka Super Kerosene Rs.17.40 per litre and Lanka Industrial Kerosene Rs.19.70 per litre.

- Low grown tea of Galaboda Group fetched an all time record price of Rs.382 per Kg.

December

- The Port tariff rates for all imports and exports, including essential goods, were reduced with effect from 1st December. Under the revised rates, tariff on flour and fertilizer were reduced from U.S. $ 51.75 per ton to U.S.$ 38 per ton and for textiles from U.S. $ 145.50 per ton to U.S. $ 80 per ton.

- Prices of diesel were reduced by Rs. 1 per litre. The new prices of auto diesel were: Lanka ordinary diesel Rs.26.50 per litre, and Lanka super diesel Rs.31.80 per litre.

- The Central Bank of Sri Lanka reduced the Bank rate from 23 percent to 18 percent effective December 27th. The margin between the Bank's discount and rediscount rates was also reduced.

January 2002

- Laugfs Lanka Gas Pvt.Ltd reduced the price of a domestic L.P.gas cylinder by Rs. 50 to Rs.359 with effect from 9th January.

- The Government decided to issue licences to the private sector to import limited quantities of rice to curb the escalation of rice prices.

- As a part of the Government's 100 day programme the state sector banks agreed to suspend Parate Executions for a period of six months in respect of loans taken by micro industries and individuals.

- The Ceylon Electricity Board increased the daily power cut to two and half hours with effect from 15th January.

- The Government announced the continuation of the 40 percent surcharge on imported goods, which was imposed on 20th February 2001. The surcharge would be effective till 31st March 2002.

February

- The Finance Minister presented a Vote on Account on 5th February in Parliament for the allocation of funds to meet he Government expenditure for one month.

- The Government stipulated a guaranteed price of Rs.13.50 per kilo for paddy.

- Consequent to the changes effected in the excise duty levied on tobacco, the price of cheaper brands of cigarettes was reduced by 50 cents per cigarette, and the price of expensive brands was increased by 50 cents per cigarette.

- The Government imposed an import duty of Rs.7.00 per kilo of imported rice to safeguard the local paddy farmers. The 40% import surcharge was removed.

- Sri Lankan Airlines agreed to grant a concession of 20 to 30 percent on airfares to Middle East job seekers, effective from 1st February.

- The government withdrew the National Security Levy on wheat, wheat flour and bread effective 22nd February.

- The Ceylon Petroleum Corporation (C.P.C) reduced the prices of petrol by Rs. 1 per litre and of diesel by 50 cents per litre, effective for 30 days, commencing 25th February

- The Government imposed an import duty of Rs. 20 per kilo on imported potatoes.

March

- With further deterioration of water levels in all four major reservoirs, the

Ceylon Electricity Board extended the power cut to 5 hours effective March 1st. (2 1/2 hours during the day time, and another 2 1/2 hours in the night).

- The Central Bank increased the limit on the daily net open position (n.o.p) of commercial banks from 10 percent of Capital and Reserves to 15 percent. The limit on the duration of foreign exchange forward contracts was extended to one year to improve the flexibility and stability in the foreign exchange market.

- The Government approved the following emergency measures to curb the escalation of rice and coconut prices.

  a) The immediate release of 40,000 metric tons of rice imported by the C.W.E to the market in retail packs of 1 kg. at Rs.26.50 per pack.

  b) Special arrangements were made with the Co-operatives, C.W.E and the Mahaweli Authority, to purchase paddy at Rs. 13.00 per kg.

  c) Immediate loans to creditworthy paddy traders and millers.

  d) Immediate release to the market of 40,000 metric tons of edible oil imported under a special duty waiver.

  e) Importation of a limited quantity of copra under duty concessions.

- The Central Bank reduced the overnight Repurchase (repo) and Reverse Repurchase (reverse repo) rates by 50 basis points, from 12.00 percent to 11.50 percent and from 14.00 percent to 13.50 percent respectively, effective 20th March.

- Shell Gas (Lanka) Ltd reduced the price of a 12.5 kg domestic L.P. gas cylinder by Rs.30 per cylinder effective 18th March.

- The UNF Government's maiden budget was presented by the Finance Minister K.N. Choksy P.C. on 23rd March in Parliament. The budget also proposed to replace the Goods and Services Tax (G.S.T) and National Security Levy (N.S.L) with a Value Added Tax (V.A.T). Other proposals included abolishing the stamp duty, introduction of a debit tax, and an introduction of a Port and Airport Development Levy.

- Import duties on red onions, Bombay onions and chillies (which were at 35 per cent) were changed to Rs. 5.00 per kg, Rs. 6.00 per kg and Rs. 30.00 per kg respectively. The 10 per cent import duty on maize was removed

April

- The Ceylon Electricity Board (C.E.B) announced an increase of 35% in electricity tariffs, effective 1st April.

- The Ceylon Petroleum Corporation (C.P.C) increased the prices of petroleum products by Rs.2 a litre, from midnight 22nd April effective for 30 days. The price increases were due to the increase in crude oil prices in the international market, and the depreciation of the Sri Lanka Rupee against the U.S. Dollar.

- The Ceylon Electricity Board (C.E.B) lifted the morning power cut with effect from 22nd April, and the 2 1/2 hour power cut in the evenings was reduced to two hours because of the on going G.C.E. A/L examination.

- The Postal Department increased the postal rates effective April 25 -- ordinary postal rates increased by 25 per cent and commercial postal rates by 60 percent.

- The Stamp Duty was removed on 30th April.

- The import duty surcharge was reduced from 40 to 20 per cent, effective 15th April.

May

- The power cut was totally removed effective 15th May, following heavy rainfalls in catchment areas, which increased generation capability.

- The Ceylon Petroleum Corporation (C.P.C.) increased the price of kerosene oil by Rs. 1.50 per litre, diesel and petrol by Rs. 2 each per litre, effective from midnight 22nd May.

- A Port and Airport Development Levy of 1.0 per cent (imports for export purposes were fixed at 0.75 per cent) came into effect.

June

- A debit tax of 0.5 per cent was introduced on 1st June.

- The Public Enterprise Reform Commission (P.E.R.C) commenced privatising the Sri Lanka Insurance Corporation (S.L.I.C) by appointing a team led by Price Waterhouse and Coopers to advise on the sales process.

- The Ceylon Petroleum Corporation (C.P.C) increased the price of auto diesel and petrol by 50 cents per litre, and kerosene by 40 cents per litre, effective from midnight 21st June.

- The privatisation of Sevenagala Sugar Industries Ltd. (S.S.I.L) was concluded on 23rd June. Daya Apparel Export (Pvt) Ltd. bought 90 per cent of the shares for Rs.550 million.

- The Minister of Commerce and Consumer Affairs led a delegation to India for the meeting of the Joint Inter Ministerial Committee on the Indo-Sri Lanka Free Trade Agreement.

Financial Market

December 2001

- The Colombo Stock Exchange (C.S.E) recorded some buoyancy following the Parliamentary Election of 5th December.

February 2002

- With the signing of the M.O.U between the Government and the L.T.T.E, the C.S.E recorded a mild recovery.

- The Government's remaining 19 percent stake in Talawakelle and Malwatte Plantation Companies was sold at the trading floor of the C.S.E fetching Rs.111.7 million.

March

- The Colombo Stock Exchange (C.S.E) introduced two new sectors -- Health Care and Telecommunication -- in its sector classifications, which resulted in five companies being reclassified.

April

- The Central Bank of Sri Lanka delegated the function of clearing of cheques to Lanka Clear Ltd., which is a limited liability company.

May

- At the C.S.E, the All Share Price Index (A.S.P.I) recorded its highest level in four years -- 685.1 points on 29th May, while the Milanka Price Index (M.P.I) rose to 1196.3 points -- the highest point since its inception.

June

- At the trading floor of the C.S.E on 3rd June, the Milanka Price Index (M.P.I) rose to 1200 points.

Labour and Employment

August 2001

- The Cabinet decided to absorb all state sector casual employees, (approximately 40,000) who have completed 180 days service to the permanent cadre.

November

- All government teachers were paid an interim allowance of Rs.1,200 from November.

- An interim allowance of Rs.1,000 was paid to all Sri Lanka Ports Authority employees effective 1st August, in addition to the allowance of Rs.2,000 already paid to them.

June 2002

- The Sri Lanka Private Bus Operators Association staged a countrywide bus strike on 11th June to agitate over an increase of bus fares.

Infrastructure Development

September 2001

- Shell Renewable Lanka Ltd (S.R.L.L) signed an agreement with the Board of Investment (B.O.I) providing for the supply of solar powered electricity to 12,000 households in several districts over a period of two years. The investment in this venture is Rs.100 million.

October

- G.T.L Global Park, the first and largest logistics centre in South Asia, was opened in Seeduwa on 18th October. The B.O.I approved U.S.$ 9 million joint venture will house 365,000 square feet of warehousing space in a 13 acre site.

November

- The first phase of a gas-steam power plant at Kelanitissa was commissioned on 14th November, adding 110 megawatts of power to the National Grid.

December

- Tokyo Cement Group, through its subsidiary Samudra Cement Company Lanka (Pvt) Ltd., opened a modern bagging plant with an initial capacity of 600,000 tons per annum at the Colombo port.

January 2002

- The solar power panel installed at the Worldview Global Media office at Battaramulla with capacity to supply 25 K.W daily was connected to the national grid on 11th January.

February

- Aggreko International in Dubai signed a contract with the C.E.B to supply a total of 100 M.W power at four substations in Colombo, namely Kosgama (40.M.W), Kotugoda (25 M.W), Peliyagoda (20 M.W) and Ambatale (15 M.W) where the power supplied is mainly consumed by the Colombo water treatment facility.

March

- The Cabinet endorsed the continuation of the Upper Kotmale Hydro Power project supported by the Japan Bank of International Cooperation. The project, which is expected to be completed in 2008, will generate 120 M.W.

- MTN network, the second largest telecom operator in the country whose holding company is Telekom, Malaysia, received an eight year syndicated loan of US $ 21 million , and the underwriters were Citibank N.A, includes a partial credit guarantee for commercial co-financing up to US $ 90 million.

- The Government of India agreed to provide Sri Lanka with 300,000 metric tons of wheat over a twelve month period in terms of an agreement reached between the two countries at the conclusion of the Hon. Prime Minister Ranil Wickramasinghe's three day official visit to India.

February 2002

- The S.I.D.A., World Bank and Sri Lanka Government signed an agreement related to co-financing of the Central Bank Strengthening Project. The S.I.DA has provided Swedish Kroner 10 million (U.S. $ 1 million) for the project.

- The G.O.S.L and the U.N.I.C.E.F signed a new programme of co-operation for the period 2002-2006 to provide financial and technical assistance to the tune of Rs.2.4 billion (U.S.$ 27 million) to protect the rights of children and women, covering the areas of early childhood, learning years and adolescence, as well as protection of children and women.

March

- The Government of Sri Lanka and the A.D.B signed a loan agreement for a sum of U.S.$ 200 million, in respect of a four pronged Poverty Reduction Partnership Program aimed at improving rural economies.

- The O.P.E.C Fund for International Development signed a U.S. $ 5 million loan agreement with Sri Lanka to finance a multi-faceted rural development scheme.

- An agreement was signed between the Governments of Japan and Sri Lanka, providing Japanese Yen 506,000,000 (approximately Rs. 359 million) to purchase laboratory and engineering equipment for the University of Moratuwa, and a further Yen 3.5 million (approximately Rs.2.5 million) under the Japanese Government Debt Relief Grant Fund.

- The World Bank, U.N.D.P and the Government of Sri Lanka signed an agreement, endorsing the release of U.S.$ 1 million from the World Bank's Post Conflict Fund in two tranches to enhance the U.N.D.P sponsored Landmines Action Project.

- The Japan Bank for International Cooperation (JBIC) extended a 33,265 million Yen (U.S.$ 251 million) loan to Sri Lanka to help develop the country's hydroelectric power system.

April

- A M.O.U between the Government of Sri Lanka and the Asian Development Bank was signed on 8th April to provide for U.S. $ 700 million in project financing and U.S.$ 11 million in technical assistance for Sri Lanka economic development during the period of 2003-2005.

- On 16th April, the International Monetary Fund (IMF) released U.S.$ 60 million (S.D.R 48.3 million, approximately Rs.5.7 billion) to Sri Lanka, being the second and third instalment under a 14 month Standby Arrangement, bringing the total disbursements to U.S.$ 190 million.

May

- According to the European Commission (E.U.) press release on 6th May , the E.U has pledged assistance worth Euro 3.35 million in respect of two projects to facilitate the return and reintegration of Internally Displaced Persons(I.D.P) in Northern Sri Lanka.

Commercial Bank of Ceylon, N.D.B, N.S.B, and the D.F.C.C.

- The train service in the Batticaloa Line was extended up to Valachchenai on 19th March. This rail line had been extended up to Welikanda in January.

May

- A new contract to supply additional power of 100 M.W at four substations, namely Seethawaka (40 M.W), Mathugama (20.M.W), Aniyakanda (8 M.W), and Walangoda (12 M.W) was awarded to Aggreko International based in Dubai.

June

- The Indian Oil Corporation (I.O.C) and Ceylon Petroleum Corporation (C.P.C) signed a Memorandum of Understanding (M.O.U.) on 12th June, to the effect that the C.P.C will divest 100 C.P.C owned retail outlets in favour of the I.O.C and will assist the I.O.C in re-assigning the franchise outlets. Further the I.O.C would take over the tanks at the Trincomalee Oil Farm on a long-term lease.

Foreign Direct Investment

April 2002

- On 19th April, the Government relaxed the restrictions on Foreign Direct Investment (F.D.I), permitting foreign companies to own up 100 percent of the equity in the sphere of infrastructure development, banking, finance, stock brokering and insurance.

Foreign Aid

July 2001

- The 440 Crore Indian credit line formalised in early 2001 became operational on 6th July. This would facilitate Sri Lanka to import Indian equipment, particularly capital goods, worth U.S.$ 100 million.

- Letters were exchanged between the Government of Japan and Sri Lanka to extend the Japanese Government's grants for food production with the total aid extended moving up to Rs.33 billion. The year's tranche under this programme was 600 million Yen (approximately Rs.447 million).

November

- Asian Development Bank (A.D.B) approved a loan of S.D.R 19.3 million (U.S.$ 25 million) for the Southern Province Rural Economic Advancement Project. (R.E.A.P).

- The Government of Sri Lanka and the A.D.B. signed a loan agreement for US$ 25 million in respect of the North-East Community Restoration Project.

- The World Food Program (W.F.P) approved food assistance worth Rs.2,970 million (U.S. $ 33 million) in support of a five-year country programme targeting eight food insecure districts, and a relief and recovery program of food assistance in the North and East.

December

- The Government of Sri Lanka and Japan signed an agreement to provide for a grant of 481 million Yen (approximately. Rs.356 million) for the improvement of the Nuwara Eliya water supply system.

- The A.D.B. announced a U.S.$ 86 million aid package to Sri Lanka consisting of a US$ 20 million policy loan to support reforms, a US$ 60 million investment loan to finance small and medium enterprises (S.M.E), and US$ 6 million for consulting, contract and procurement. The Package

June

- At the request of the Sri Lanka Government the F.A.O agreed to provide emergency agricultural assistance to 22,000 drought stricken families in the Southern, Uva and Sabaragamuwa Provinces.

- Sri Lanka's donor community held the "Sri Lanka Development Forum" in Colombo for the first time on 5th and 6th June. The response of the 80 delegates, representing 39 countries, was positive towards the Government's economic policies, reform program and poverty reduction strategies.

- The United Kingdom Government agreed to provide Sterling Pounds 6.8 million of new financial support to Save the Children Fund and Oxfam for improving the livelihood and security of those affected by the ethnic conflict.

- The International Development Association (I.D.A.) has approved a credit of U.S.$ 75 million and a grant of U.S.$ 8 million under the Global Environmental Facility (G.E.F) for a project to improve the quality of rural life in Sri Lanka, and promote private sector power generation using renewable energy resources.

Governance

July 2001

- The Government decided to hold a referendum on the need for constitutional changes on 21st August. Parliament was prorogued from midnight 10th July till 7th September.

August

- The Government announced the postponement of the Referendum scheduled for 21st August. The new date fixed was 18th October.

September

- The Janatha Vimukthi Peramune (J.V.P) and the Peoples Alliance (P.A.) signed a M.O.U to extend J.V.P support to the Government from opposition ranks without an active part in governance.

- A nineteen member new Cabinet was sworn in response to the above-signed M.O.U., where it had been agreed to reduce the number of Cabinet Ministers to twenty.

- Parliament passed the Draft Bill for the amendment of the Constitution (17th Amendment) for the establishment of a Constitutional Council and four Independent Commissions with two thirds majority.

October

- Eight People's Alliance Parliamentarians including four Ministers crossed over to the opposition.

- The Parliament was dissolved at midnight of 10th October. Nominations for the subsequent General Elections were accepted during 20-27th October.

December

- The United National Front (U.N.F.) led by the United National Party (U.N.P.) returned to power at the Parliamentary General Elections held on 5th December. The key results: U.N.P 109 seats, P.A. 77 seats, and the JVP 16 seats.

- The United National Party (U.N.P.) leader Mr. Ranil Wickramasinghe was sworn in as the 17th Prime Minister of Sri Lanka on 9th December.

- The New Cabinet of Ministers of the U.N.F Government was sworn in with 25 Cabinet Ministers, 28 non-Cabinet Ministers and 9 Deputy Ministers.

- New Parliament had its first sittings on 19th December.
- The Hon. Prime Minister left for India in his first official visit since assuming office.

January 2002

- The Hon. Prime Minister made a Policy Statement in Parliament on 22nd January.

February

- Eight new Cabinet Ministers were sworn in on 28th February.

March

- At the Local Government Election held on 20th March to elect representatives for 222 local bodies, the United National Party captured the power of 217 local bodies. The President appointed 10 members to the Constitutional Council on 22nd March, which is to set up under the 17th Amendment to the Constitution.
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May

- The U.N.P captured the power of all remaining 17 local bodies at the Local Government Elections held on 20th May.

June

- Hon. Prime Minister Ranil Wickramasinghe paid an official visit to the European Union and held discussions with the Members of the E.U and later held discussion with the British Prime Minister Tony Blair in Britain.
- The Constitutional Council intimated to Members of Parliament, Civil Society Organizations, and Professional Bodies to recommend members for the four Independent Commissions: Elections, Police, Public Service and the Judiciary.
- The Hon. Prime Minister made his second official visit to India on 9th June, and held discussions with the Indian Prime Minister.
- The Government announced suspension of recruitment to the public service, provincial public service, local authorities, public corporations, statutory boards, and all government owned companies.
- The Government abolished the Criminal Defamation Law, providing enhanced freedom for journalists to practice their profession without the threat of imprisonment.

Defence and Security

July 2001

- Following the lapse of emergency powers, consequent to the Government losing its majority in Parliament, the President issued fresh orders to proscribe the L.T.T.E under the provision of the Prevention of Terrorism Act (P.T.A), invoking Section 12 of the Public Security Ordinance and the Prevention of Terrorism Act No 48 of 1979.
- The Government of Norway appointed its Deputy Foreign Minister Vidar Helgesen to head the team that would henceforth facilitate the process towards a negotiated political settlement to the ethnic problem in Sri Lanka. The other members of the team included Norway's Ambassador in Sri Lanka John Westborg, Erik Solheim and Kjersti Tromsdal of the Norwegian Foreign Ministry.
- The L.T.T.E attacked the Air Force Base at Katunayake and the International

Airport. They blew up eight military aircrafts including one MIG 27, two Mi-24 helicopter gun ships, and three Chinese K8 advanced training aircraft. Three of Sri Lankan Airlines' passenger aircrafts including two A340s and one A330, were also destroyed. The attack was mounted in the early hours of Tuesday 24th July.

October

- The United States re-designated the L.T.T.E as a foreign terrorist organization along with 26 other extremist groups.

November

- Canada designated the L.T.T.E as a banned terrorist organisation.

December

- The L.T.T.E announced a one month unilateral ceasefire from Christmas eve.

- The Government reciprocated by announcing a cessation of hostilities from midnight on Christmas eve for a period of one month.

January 2002

- A three member Norwegian delegation comprising Deputy Foreign Minister Vidar Helgesen, special envoy Erik Solheim, and a Foreign Ministry Official arrived in Colombo to meet Sri Lanka government leaders with the objective of moving the peace process forward.

- The L.T.T.E extended its unilateral ceasefire for another month from midnight 24th January to midnight 24th February. The Government reciprocated by extending the truce observed by security forces by a further month.

February

- The Norwegian Deputy Foreign Minister arrived in Colombo in a bid to finalise a permanent ceasefire.

- The Jaffna-Kandy road (A9 Road) was reopened up to Killinochchi.
- A UN Disarmament Team arrived in the island to help Sri Lanka recover illegal arms.

- The Government of Sri Lanka and the L.T.T.E signed a Memorandum Of Understanding (M.O.U) on a ceasefire from midnight of 22nd February. The Sri Lankan Prime Minister placed his signature in Vavuniya, and the leader of the L.T.T.E signed the agreement in Mulathivu on the previous day.

March

- The Hon. Prime Minister making a special statement in Parliament on 4th March on the M.O.U between the Government and the L.T.T.E said that "the armed forces will be kept on constant alert due to the high level of mistrust between the two parties".

- The Hon.Prime Minister paid a goodwill visit to Jaffna on 14th March.

- The Government requested the U.N Secretary General to send a mission to Sri Lanka to assess the ground situation.

- The L.T.T.E theoretician Anton Balasingham arrived in Kilinochchi, directly flying from Male by a chartered seaplane for the purpose of consulting the L.T.T.E. leader.

- Armed Tamil political parties excluding the L.T.T.E handed over their arms and ammunition to security forces personnel in keeping with the ceasefire agreement.

April

- The Sri Lanka Monitoring Mission (S.L.M.M), formed to monitor the compliance with the provisions of the Ceasefire Agreement, commenced its activities by establishing temporary headquarters in Colombo, and District Level Monitoring Committees in Ampara, Batticaloa, Jaffna, Vavuniya and Tincomalee.

- The L.T.T.E leader held a press conference in Kilinochchi on 10th April. Addressing a packed press conference attended by over 200 local and foreign media personnel, the leader of the L.T.T.E announced that the L.T.T.E is prepared to seriously consider renouncing the armed struggle for Ealam if a solution acceptable to the Tamil people is put forward.

- Sri Lanka Muslim Congress and the L.T.T.E signed an agreement to solve the problems faced by the Muslims living in the Northern and Eastern provinces.

- The United States assured Sri Lanka on 19th April that giving legal recognition to the L.T.T.E at home would not ease international pressure on the rebels who are listed by the U.S Government as a terrorist group.

May

- The Government of India extended its 1992 ban on the L.T.T.E for another two years.

June

- The Sri Lanka Monitoring Mission (S.L.M.M) extended its mandate to the sea by deploying its first team off the Trincomalee coast.
- A curfew was clamped in the Mutur area on 25th June, and in the Valachchenai area on 26Th June following a clash between a group of Muslims and L.T.T.E cadres.

General

November 2001

- The Ministry of Education and Higher Education launched a National Policy to introduce Information Technology to the school curriculum.

March 2002

- The Government of Sri Lanka accepted the Marlborough House Statement issued on suspending Zimbabwe from the Council of the Commonwealth for one year.

April

- The first ever Sri Lankan manufactured car named " Micro" was launched. The car is aerodynamically designed with seating capacity for five, and dual facility for gasoline and L.P. Gas.

- For the first time in eight years, a U.S naval ship, the guided missile destroyer U.S.S Hopper (DDG 70), docked in Colombo harbour for a ten hour refuelling stop.

Appendix A: Macroeconomic Indicators

Table A1: Socio-economic indicators

1. Basic indicators	Unit					
Area:	sq. km.	65,606				
Mid Year Population (2001):	('000)	18,732				
Population growth rate (2001)	%	1.4				
Life expectancy at birth (1999)	Years	71.9				
Infant mortality rate (1999)	per 1000 live births	17				
Gross school enrolment ratio (1999)(a)	%	70				
Adult literacy rate (1999)	%	91.4				
Human development index (HDI) (1999)	Value	0.735				
Human poverty index (HPI) (1999)	Value	18				
		1997	**1998**	**1999**	**2000**	**2001 (e)**
2. Output, labour force and employment						
GNP at current market prices	Rs. bn.	880	1002	1090	1233	1377
GDP at current market prices	Rs. bn.	890	1018	1106	1258	1400
GDP at current factor cost prices	Rs. bn.	804	913	995	1125	1253
GDP per capita at current market prices	US$	814	839	825	856	837
Labour force(b)	mn.	6	7	7	7	7(c)
Labour force participation (b)	%	49	52	51	50	48(c)
Unemployment (b)	%	11	9	9	8	8 (c)
3. Real output growth						
GDP	%	6.3	4.7	4.3	6	-1.4
Agriculture, forestry, and fishing	%	3.0	2.5	4.5	1.8	-3.0
Mining and quarrying	%	3.8	-5.4	4.1	4.8	0.7
Manufacturing	%	9.1	6.3	4.4	9.2	-4.0
Construction	%	5.4	7.1	4.8	4.8	2.5
Services	%	7.1	5.2	4.2	7.0	-0.5
4. Prices and Wages						
CCPI (annual average)	% change	9.6	9.4	4.7	6.2	14.2
GCCPI (annual average)	% change	7.1	6.9	3.8	3.2	11.0
WPI (annual average)	% change	6.9	6.1	-0.3	1.7	11.7
Implicit GNP deflator	% change	8.7	8.4	4.4	6.7	13.0
Real wage rates						
Workers in wages boards trades	% change	-1.7	2.7	-2.1	-3.6	-8.2
Government employees	% change	0.5	0.9	-4.5	1.9	5.9
5. Consumption, Investment, and savings						
Consumption	% of GDP	82.7	81.1	80.5	82.6	84.7
Gross domestic capital formation	% of GDP	24.4	25.1	27.3	28.0	22.0
Gross domestic savings	% of GDP	17.3	19.1	19.5	17.4	15.3
Gross national savings	% of GDP	21.5	23.4	23.5	21.5	19.5
Foreign savings	% of GDP	7.1	6.0	7.8	10.6	6.7
6. Government finance						
Revenue	% of GDP	18.5	17.2	17.7	16.8	16.5
Expenditure and net lending	% of GDP	26.4	26.3	25.2	26.7	27.4
Current expenditure	% of GDP	20.8	19.6	18.7	20.2	21.5
Capital expenditure & net lending	% of GDP	5.8	6.7	6.5	6.4	5.9
Current A/C balance	% of GDP	-2.2	-2.4	-1.0	-3.4	-4.9
Budget deficit						
Primary deficit	% of GDP	1.7	3.8	1.9	4.2	-4.1
Overall deficit (before grants)	% of GDP	7.9	9.2	7.5	9.9	10.9
Public debt						
External	% of GDP	42.3	45.3	45.9	43.1	45.3
Domestic	% of GDP	43.5	45.5	49.1	53.8	58.3

Contd..../-

	Unit	1997	1998	1999	2000	2001(e)
7. External Trade						
Terms of trade index	% change	6.8	14.2	-5.0	-6.1	-1.7
Import price index	% change	2.4	-2.2	-3.5	8.1	-3.6
Export price index	% change	9.3	11.6	-8.5	1.5	-5.2
Import volume index	% change	12.3	12.4	0.2	12.9	-10.7
Export volume index	% change	10.6	0.1	5.0	18.3	-8.0
8. External finance						
Trade balance	% of GDP	-8.1	-6.9	-8.7	-10.8	-7.4
Current account balance	% of GDP	-2.6	-1.4	-3.6	-6.4	-2.3
Capital & Financial account balance	% of GDP	4.2	3.4	3.8	3.7	3.2
Foreign direct investments	% of GDP	1.0	1.1	1.5	1.5	0.9
Foreign portfolio investments	% of GDP	0.1	-0.2	-0.1	-0.4	-0.1
Import capacity	months of imports (d)	6.4	5.9	5.2	3.5	4.5
External debt	% of GDP	62.3	61.6	63.5	61.0	61.8
Debt-service ratio	% of exports	13.3	13.3	15.2	14.7	13.3
9. Exchange rates (year end)						
U.S.A.	Rs./US$	61.29	67.78	72.11	80.06	93.16
U.K.	Rs./UK Pound	101.60	112.62	116.72	119.37	135.06
Japan	Rs./Yen	0.47	0.59	0.71	0.70	0.71
Fed. Rep. of Germany	Rs./DM	34.24	40.36	37.09	38.00	42.07
India	Rs./Rs. Indian	1.56	1.59	1.66	1.71	1.93
SDR	Rs./SDR	82.69	95.44	98.87	104.31	116.97
10. Money supply						
Narrow money supply (M1)	% change	9.8	12.1	12.8	9.1	3.2
Broad money supply (M2)	% change	15.6	13.2	13.4	12.9	13.6
Domestic credit	% change	7.8	11.9	19.9	26.9	14.0
External banking assets	% change	43.5	16.7	-3.4	-31.9	10.9
11. Interest Rates						
Treasury bills						
3 months	% per annum	10.0	12.0	11.8	17.8	12.9
12 months	% per annum	10.2	12.6	12.8	18.2	13.7
Call money rates	% per annum	11.0	11.3	9.3	17	12.0
Average prime lending rate	% per annum	12.9	15.0	13.5	20	14.0
Commercial banks saving	% per annum	10.0	9.2	9.1	9.9	10.8
NSB saving	% per annum	10.8	10.5	9.2	8.4	8.4
Commercial banks fixed deposits	% per annum	15.3	13.0	12.5	15	14.5
NSB fixed deposits	% per annum	11.0	11.5	11.5	15	13.0
12. Share market indicators						
Annual turnover	Rs. bn.	18.3	18.2	14.8	11.0	14.1
Companies listed	No.	239	240	237	239	238
Market capitalization	Rs. bn.	129.4	117	113	88.8	124.0
Net purchases by non-nationals	Rs. mn.	716.0	-1517.0	-902.0	-3364	-1025
Share price indices						
CSE all	Index, 1985=100	702.2	597.0	573.0	447.6	621.0
CSE sensitive	Index, 1985=100	1068	923	938.0	698.5	1,031.0

Notes: (a) combined first, second, and third level gross enrolment ratio.
(b) Excluding Northern and Eastern Provinces.
(c) Average of first three quarters.
(d) Imports of goods, services, & income.
(e) Provisional.

Sources: IPS database.
Central Bank of Sri Lanka, Annual Report, 2001.
Colombo Stock Exchange, Annual Report, 2001.
UNDP, Human Development Report, 2001.
Dept. of Census and Statistics, Quarterly Report of the Sri Lanka Labour Force Survey, various issues.

Table A2: Gross domestic product (GDP), mid-year population (POP), per capita GDP (PGDP), and their growth rates, 1981-2001

	1996 Prices		POP	Growth Rates		
	GDP Rs. mn.	PGDP Rs.	Thousands	GDP	PGDP	POP
1981	359864.2	24156.8	14897.0	5.8	4.7	1.1
1982	378112.9	24893.9	15189.0	5.1	3.1	2.0
1983	396867.0	25743.8	15416.0	5.0	3.4	1.5
1984	416915.0	26727.0	15599.0	5.1	3.8	1.2
1985	437582.1	27630.4	15837.0	5.0	3.4	1.5
1986	456316.2	28312.7	16117.0	4.3	2.5	1.8
1987	462949.6	28295.9	16361.0	1.5	-0.1	1.5
1988	475441.7	28665.2	16586.0	2.7	1.3	1.4
1989	486140.6	28926.6	16806.0	2.3	0.9	1.3
1990	516152.7	30374.4	16993.0	6.2	5.0	1.1
1991	539954.8	31307.2	17247.0	4.6	3.1	1.5
1992	563061.9	32350.6	17405.0	4.3	3.3	0.9
1993	602171.5	34177.4	17619.0	6.9	5.6	1.2
1994	636061.5	35603.8	17865.0	5.6	4.2	1.4
1995	670742.2	37033.0	18112.0	5.5	4.0	1.4
1996	695934.0	37998.0	18315.0	3.8	2.6	1.1
1997	739763.0	39875.1	18552.0	6.3	4.9	1.3
1998	774796.0	41269.6	18774.0	4.7	3.5	1.2
1999	808340.0	42448.1	19043.0	4.3	2.8	1.4
2000	857035.0	44270.6	19359.0	6.0	4.1	1.7
2001(a)	844612.0	45089.3	18732.0	-1.4	1.8	-3.2

Notes: (a) Provisional.

Source: Central Bank of Sri Lanka, *Annual Report*, various issues.

Table A3: Structure and growth of output, 1992-2001

	Unit	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001(a)	1992-2001(b)
1. Structure of output												
Agriculture, Forestry, and Fishing	% of total output	21.3	20.9	20.5	20.0	22.4	21.7	21.3	21.3	20.4	20.1	21.0
Agriculture	% of total output	18.0	17.6	17.3	17.0	17.6	17.0	16.6	16.6	15.9	15.5	16.9
Tea	% of agriculture	9.1	11.2	11.3	11.1	8.4	8.8	8.7	8.5	8.9	9.0	9.5
Rubber	% of agriculture	2.6	2.6	2.5	2.4	3.3	3.0	2.7	2.6	2.3	2.4	2.6
Coconut	% of agriculture	11.7	10.5	12.2	12.5	10.5	10.5	10.0	10.4	11.1	10.4	10.9
Paddy	% of agriculture	23.2	24.2	24.5	24.8	16.2	17.5	20.4	20.8	20.4	20.0	21.2
Mining and Quarrying	% of total output	2.3	2.4	2.5	2.4	2.0	2.0	1.8	1.8	1.7	1.8	2.1
Manufacturing	% of total output	18.5	19.1	19.7	20.4	16.2	16.6	16.9	16.8	17.4	16.9	17.9
Export Processing	% of manufacturing	11.2	11.0	11.4	10.9	14.4	13.6	12.7	12.6	12.0	11.9	12.2
Factory Industry	% of manufacturing	81.1	81.7	81.5	82.1	77.9	78.7	79.7	79.7	80.6	80.7	80.4
Small Industry	% of manufacturing	7.7	7.4	7.2	7.0	7.8	7.6	7.6	7.7	7.4	7.4	7.5
Services	% of total output	57.8	57.5	57.4	57.1	59.4	52.8	53.0	53.5	53.3	54.1	55.3
	Unit	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001(a)**	**1992-2001(b)**
2.Real output Growth												
Agriculture, Forestry, and Fishing	% growth	-1.6	4.9	3.3	3.3	-4.6	3.0	2.5	4.5	1.8	-3.0	1.4
Agriculture	% growth	-2.4	5.0	3.8	3.3	-5.1	2.9	1.8	4.4	1.7	-3.7	1.2
Tea	% growth	-25.7	29.6	4.4	1.6	5.1	7.1	1.1	1.3	7.8	-3.4	2.9
Rubber	% growth	2.1	1.8	1.0	0.9	6.3	-5.4	-9.0	1.0	-9.7	-1.8	-1.3
Coconut	% growth	5.1	-5.8	20.6	5.1	-7.6	3.3	-3.2	9.1	8.0	-9.7	2.5
Paddy	% growth	-2.0	9.6	4.7	4.7	-26.7	11.2	18.3	6.6	-0.3	-5.7	2.0
Mining and Quarrying	% growth	-6.0	11.9	6.0	3.4	8.9	3.8	-5.4	4.1	4.8	0.7	3.2
Manufacturing	% growth	8.8	10.5	9.1	9.2	6.5	9.1	6.3	4.4	9.2	-4.0	6.9
Export Processing	% growth	-12.6	8.4	13.0	4.4	1.0	3.5	-1.2	3.8	4.2	-5.3	1.9
Factory Industry	% growth	13.0	11.3	8.8	10.0	7.3	10.3	7.6	4.5	10.4	-3.9	7.9
Small Industry	% growth	5.1	5.6	6.2	7.1	6.3	7.0	6.5	4.8	5.5	-3.5	5.1
Services	% growth	5.6	6.4	5.4	5.1	5.5	6.9	3.7	9.8	2.3	2.2	5.3
GDP	% growth	4.6	4.3	6.9	5.6	5.5	3.8	6.3	4.7	6.0	-1.4	4.6

Notes: (a) Provisional; (b) Average annual growth rate.
Source: Central Bank of Sri Lanka, Annual Report, various issues.

Table A4: Industrial production, 1985-2001

	1985	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001(a)
1. Value added, current prices (Rs. mn.)													
Food, beverages and tobacco	6166	12065	15070	18668	21704	24373	29507	32891	35585	40452	44503	49031	54,282.0
Textile, wearing apparel and leather products	2594	7167	8542	14630	18994	19916	24895	31148	40581	47482	55263	69451	71,263.0
Wood and wood products (including furniture)	420	485	571	677	831	1081	1177	1250	1258	1313	1390	1554	1,639.0
Paper and paper products	543	1019	1167	1397	1912	2301	2458	2580	2633	2578	2664	2808	3,103.0
Chemicals, petroleum, coal, rubber and plastic products	1402	2428	3199	3989	4723	5758	6898	8957	10745	14274	13832	17771	19,245.0
Nonmetallic mineral products (except petroleum and coal)	1089	4742	4905	5918	7163	9272	9726	10537	11600	12463	13817	14240	16,010.0
Basic metal products	38	194	248	263	279	356	347	450	598	710	777	959	1,131.0
Fabricated metal products, machinery and transport equipment	1055	2746	3247	3629	3608	4344	4547	4809	5924	6779	7367	7714	8,731.0
Manufactured products n.e.s.	59	138	1092	1196	1532	1838	2319	2763	3157	3426	3799	3965	4,154.0
Total	13366	30984	38041	50367	60746	69239	81368	95385	112011	129477	143412	167493	179,559.0
2. Composition of industrial production, %													
Food, beverages and tobacco	46.1	38.9	39.6	37.1	35.7	35.2	35.6	34.5	31.7	31.2	31.0	29.3	30.2
Textile, wearing apparel and leather products	19.4	23.1	22.5	29.0	31.3	28.8	30.6	32.7	36.2	36.7	38.5	41.5	39.7
Wood and wood products (including furniture)	3.1	1.6	1.5	1.3	1.4	1.6	1.4	1.3	1.1	1.0	1.0	1.0	0.9
Paper and paper products	4.1	3.3	3.1	2.8	3.1	3.3	3.0	2.7	2.4	2.0	2.0	1.7	1.7
Chemicals, petroleum, coal, rubber and plastic products	10.5	7.8	8.4	7.9	7.8	8.3	8.5	9.4	9.6	11.0	9.6	10.6	10.7
Nonmetallic mineral products (except petroleum and coal)	8.1	15.3	12.9	11.7	11.8	13.4	12.0	11.0	10.4	9.6	9.6	8.5	8.9
Basic metal products	0.3	0.6	0.7	0.5	0.5	0.5	0.4	0.5	0.5	0.5	0.5	0.6	0.6
Fabricated metal products, machinery and transport equipment	7.9	8.9	8.5	7.2	5.9	6.3	5.6	5.0	5.3	5.2	5.1	4.6	4.9
Manufactured products n.e.s.	0.4	0.4	2.9	2.4	2.5	2.7	2.9	2.9	2.8	2.6	2.6	2.4	2.3
Total	100	100	100	100	100	100	100	100	100	100	100	100	100.0

Note: (a) Provisional.
Source: Central Bank of Sri Lanka, *Annual Report*, various issues.

Table A5: Major agricultural crops, production and prices, 1980-2001

	Tea			Rubber			Coconut		Paddy	
	Production	Price		Production	Price		Production	Price (a)	Production	Price (b)
	Mn. Kg.	Colombo (net) Rs/Kg.	Export (f.o.b) Rs/Kg.	Mn. Kg.	Colombo (RSS 1) Rs/Kg.	Export (f.o.b) Rs/Kg.	Mn. Kg.	Rs./Nut	000 Mt	Rs./Bushel (c)
1980	191.0	17.7	33.4	133.0	10.6	21.4	2026.0	3.2	2133.0	50.0
1981	210.0	17.7	35.1	124.0	10.0	21.8	2258.0	2.5	2230.0	57.5
1982	188.0	22.5	35.0	125.0	10.2	17.7	2521.0	1.8	2156.0	57.5
1983	179.0	37.0	52.5	140.0	14.0	22.8	2312.0	2.4	2484.0	62.5
1984	208.0	46.5	77.2	142.0	14.4	26.2	1942.0	4.8	2420.0	62.5
1985	214.0	35.4	60.6	137.5	15.9	21.3	2958.0	2.6	2661.0	70.0
1986	211.0	30.3	44.5	137.8	16.6	23.8	3039.0	1.5	2588.0	70.0
1987	213.0	38.1	53.0	121.8	19.9	27.6	2291.0	2.6	2128.0	70.0
1988	227.0	41.6	56.0	122.4	24.4	37.3	1936.0	4.0	2477.0	80.0
1989	207.0	52.2	66.9	110.7	22.6	36.2	2484.0	3.4	2063.0	80.0
1990	233.0	65.7	91.8	113.1	22.9	35.5	2532.0	3.6	2538.0	110.0
1991	241.0	57.1	84.1	103.9	23.6	34.6	2184.0	4.8	2389.0	136.0
1992	179.0	60.5	82.0	106.1	29.3	37.7	2296.0	6.5	2340.0	136.0
1993	231.9	68.9	91.2	104.2	35.5	44.3	2164.0	6.3	2570.0	155.0
1994	242.2	65.1	91.3	105.3	50.4	51.8	2622.0	5.7	2684.0	155.0
1995	245.9	72.2	102.3	105.7	72.0	83.7	2755.0	6.1	2810.0	155.0
1996	258.4	103.9	139.6	112.5	67.9	79.8	2546.0	9.4	2061.0	155.0
1997	276.9	119.4	158.4	105.8	56.7	75.4	2631.0	9.6	2239.0	155.0
1998	280.1	134.3	184.9	95.7	49.7	67.7	2552.0	9.7	2692.0	155.0
1999	283.7	115.3	162.4	96.6	45.3	54.0	2828.0	10.0	2868.0	155.0
2000(d)	305.8	135.5	184.4	87.6	55.0	66.9	3096.0	7.4	2860.0	155.0
2001(e)	295.1	143.9	208.9	86.0	55.0	66.4	2796.0	7.1	2694.0	155.0

Notes: (a) Average export price of the three major coconut products only.
(b) Guaranteed Price.
(c) 20.9 Kg. of paddy = 1 bushel of paddy.
(d) Revised.
(e) Provisional.

Source: Central Bank of Sri Lanka, *Annual Report*, various issues.

Table A6: Labour force participation of the household population, all island, 1991-2000

	Household Population (10 yrs. & over)	Labour Force	Labour Force Participation	Labour Force			
				Employed		Unemployed	
	No. Mn.	No. Mn.	Rate	No. Mn.	Rate	No. Mn.	Rate
1991							
q1	11.7	6.0	51.1	5.1	85.9	0.8	14.1
q2	11.7	5.8	49.7	4.9	84.7	0.9	15.3
q3	11.8	5.8	49.1	4.9	84.5	0.9	15.5
q4	11.9	5.9	49.3	5.1	86.3	0.8	13.7
1992							
q1	11.9	5.8	48.8	5.0	85.9	0.8	14.1
q2	12.1	5.8	48.1	4.9	83.4	1.0	16.6
q3	12.1	5.7	46.9	4.8	85.7	0.8	14.3
q4	12.2	5.9	48.9	5.2	86.7	0.8	13.3
1993							
q1	12.3	5.9	48.4	5.1	85.3	0.9	14.7
q2	12.3	6.1	49.5	5.3	86.4	0.8	13.6
q3	12.3	6.0	49.1	5.2	87.0	0.8	13.0
q4	12.3	6.1	49.5	5.2	86.2	0.8	13.8
1994							
q1	12.5	6.0	47.7	5.1	86.4	0.8	13.6
q2	12.4	6.2	49.6	5.4	87.0	0.8	13.0
q3	12.5	6.1	49.2	5.3	86.3	0.8	13.7
q4	12.6	6.0	48.1	5.3	87.9	0.7	12.1
1995							
q1	12.7	6.1	47.8	5.3	87.5	0.8	12.5
q2	12.7	6.1	47.8	5.3	88.1	0.7	11.9
q3	12.8	6.1	47.9	5.3	87.3	0.8	12.7
q4	12.8	6.2	48.3	5.4	88.0	0.7	12.0
1996							
q1	12.8	6.3	49.2	5.6	88.7	0.7	11.3
q2	12.8	6.2	48.5	5.5	88.5	0.7	11.5
q3	12.8	6.2	48.6	5.5	88.4	0.7	11.6
q4	12.8	6.2	48.5	5.5	88.9	0.7	11.1
1997							
q1	12.9	6.2	48.5	5.6	89.3	0.7	10.7
q2	12.9	6.2	48.4	5.6	89.8	0.6	10.2
q3	12.9	6.2	48.3	5.6	89.6	0.6	10.4
q4	12.9	6.2	48.5	5.6	89.6	0.6	10.3
1998							
q1	12.9	6.6	51.6	5.9	89.5	0.7	10.5
q2	12.9	6.6	51.0	6.0	90.5	0.6	9.48
q3	12.9	6.2	48.3	5.6	89.6	0.6	10.4
q4	12.9	6.2	48.5	5.6	89.6	0.6	10.3
1999							
q1	12.9	6.7	52.3	6.2	91.4	0.6	8.6
q2	13.1	6.5	49.5	5.9	91.5	0.6	8.5
q3	13.2	6.7	50.8	6.1	90.9	0.6	9.1
q4	13.5	6.8	50.2	6.1	90.8	0.6	9.2
2000							
q1	13.5	6.9	50.8	6.3	92.0	0.5	8.0
q2	13.5	7.0	52.0	6.5	93.0	0.5	7.0
q3 (a)	13.5	6.7	49.4	6.2	92.0	0.5	8.0

Notes: From the second quarter of 1991 to the third quarter 2000, data excludes the Northern and Eastern Provinces.
Source: Department of Census and Statistics, *Quarterly Report of the Sri Lanka Labour Force*.

Table A7: Gross domestic fixed capital formation, 1980-2001

	Private(a)	Public(b)	Private(a)	Public(b)	Private(a)	Public(b)	Private(a)	Public(b)
	(Rs. Mn., Current market prices)		As % of GDP		(at 1996 prices) (c)		(Growth in real terms)	
1980	16136.0	4709.0	24.3	7.1	88191.9	25737.2	44.7	4.6
1981	19153.0	4126.0	22.5	4.9	86876.0	18715.1	-1.5	-27.3
1982	25413.0	4866.0	25.6	4.9	101490.1	19433.0	16.8	3.8
1983	29379.0	5963.0	24.2	4.9	102386.4	20781.2	0.9	6.9
1984	32483.0	7075.0	21.1	4.6	96706.3	21063.2	-5.5	1.4
1985	30690.0	7767.0	18.9	4.8	90542.8	22914.5	-6.4	8.8
1986	32692.0	9634.0	18.2	5.4	91122.2	26852.8	0.6	17.2
1987	34536.0	11216.0	17.6	5.7	89958.6	29215.2	-1.3	8.8
1988	37156.0	12805.0	16.7	5.8	86801.6	29914.3	-3.5	2.4
1989	39943.0	14306.0	15.9	5.7	85114.8	30484.7	-1.9	1.9
1990	57910.0	12507.0	18.0	3.9	102852.2	22213.3	20.8	-27.1
1991	68368.0	15838.0	18.4	4.3	109412.4	25346.3	6.4	14.1
1992	86407.0	13632.0	20.3	3.2	125717.4	19833.8	14.9	-21.7
1993	105305.0	20570.0	21.1	4.1	139953.2	27338.1	11.3	37.8
1994	136649.0	17611.0	23.6	3.0	166094.3	21405.8	18.7	-21.7
1995	147280.0	23595.0	22.1	3.5	165105.2	26450.7	-0.6	23.6
1996	160181.0	23328.0	20.9	3.0	160181.0	23328.0	-3.0	-11.8
1997	186950.0	29923.0	21.0	3.4	172077.9	27542.6	7.4	18.1
1998	221754.0	35409.0	21.9	3.5	188219.5	30054.3	9.4	9.1
1999	266518.0	35210.0	24.1	3.2	216505.3	28376.5	13.1	-5.9
2000	311460.0	41132.0	24.8	3.2	237212.5	31326.7	9.6	9.5
2001(d)	266429.0	42004.0	19.0	3.0	179655.4	28323.7	-24.3	-9.6

Notes: (a) Private Sector and Public Corporations, (b) Government and Public Enterprises.
(c) Current Series deflated by GDP Deflator (d) Provisional.

Source: Central Bank of Sri Lanka, *Annual Report*, various issues.

Table A8: Saving and investment, 1983 - 2001

	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001(a)
As % of GDP																			
Gross Domestic Savings	13.8	19.9	11.9	12.0	12.8	12.0	12.2	14.3	12.8	15.0	16.0	15.2	15.3	15.3	17.3	19.1	19.5	17.4	15.3
Net Factor Income From Abroad	-2.6	-2.2	-2.1	-2.2	-2.2	-2.4	-2.3	-2.1	-2.0	-1.8	-1.2	1.4	-1.1	-1.5	-1.1	-1.3	-1.8	-2.2	-2.0
Net Private Transfers	5.3	4.6	4.4	4.4	4.7	4.6	4.7	4.5	4.5	4.8	5.4	5.4	5.2	5.1	5.2	5.4	5.6	5.9	6.0
Gross National Savings	16.4	22.2	14.2	14.3	15.3	14.2	14.6	16.8	15.2	17.9	20.2	19.1	19.5	19.0	21.5	23.4	23.5	21.5	19.5
Foreign Savings(b)	12.4	3.6	9.6	9.3	8.0	8.5	7.1	5.4	7.6	6.3	5.3	7.9	10.4	8.9	7.1	6.0	7.8	10.6	6.7

Notes: (a) provisional.
(b) net imports of goods and non factor services.
Source: IPS Database, Central Bank of Sri Lanka, *Annual Report*, various issues.

Table A9: Summary of government fiscal operations, 1990-2001

(% of GDP)	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001(b)
Revenue	21.1	20.5	20.2	19.7	19.0	20.4	19.0	18.5	17.3	17.7	16.8	16.5
Grants	2.1	2.1	1.9	1.6	1.4	1.4	1.0	0.8	0.7	0.6	0.4	0.4
Expenditure												
Current expenditure	22.3	22.5	21.1	20.5	21.9	23.1	22.8	20.8	19.7	18.7	20.2	21.5
Capital & net lending	8.7	9.6	6.4	7.6	7.5	7.4	5.7	5.7	6.8	6.5	6.5	5.9
Current account balance	-1.2	-2.0	-0.9	-0.8	-2.9	-2.7	-3.8	-2.2	-2.4	-1.0	-3.4	-4.9
Primary deficit	-3.5	-5.7	-1.2	-2.4	-3.9	-4.3	-3.1	-1.7	-3.8	-1.9	-4.2	-4.1
Overall deficit (before grants)	-9.9	-11.6	-7.3	-8.4	-10.5	-10.1	-9.4	-7.9	-9.2	-7.5	-9.9	-10.9
Financing the budget deficit												
Foreign financing	5.7	7.3	3.7	3.6	3.5	4.5	2.3	1.9	1.7	0.7	0.4	1.4
Net borrowings	3.6	5.2	1.7	2.0	2.0	3.2	1.3	1.1	1.0	0.1	0	1.0
Grants	2.1	2.1	1.9	1.6	1.4	1.4	1.0	0.8	0.7	0.6	0.4	0.4
Domestic financing	4.2	4.3	3.7	4.9	6.5	5.1	6.5	3.4	7.0	6.8	9.4	8.8
Market borrowings	4.1	4.2	4.4	4.4	6.6	5.0	5.1	4.5	7.1	6.8	9.2	8.8
Bank	0.1	0.0	-0.5	-1.2	0.2	1.1	1.7	-0.2	1.9	2.5	4.5	3.5
Non-bank	4.0	4.1	5.0	5.7	6.4	3.9	3.4	4.7	5.3	4.4	4.7	5.3
Other borrowings	0.1	0.2	-0.8	0.4	-0.1	0.1	1.3	-1.1	-0.1	-0.1	0.3	0.1
Privatization proceeds (a)	-	-	-	-	0.5	0.4	0.6	2.5	0.4	-	-	0.6

Notes: (a) Since 1994, privatization proceeds have been shifted from the capital expenditure and net lending category to the financing section.(b) Provisional.

Source: Central Bank of Sri Lanka, *Annual Report*, various issues.

Table A10: Money supply and underlying factors, 1983-2001

	Unit	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
1. Financial Depth											
Narrow Money Supply	M1/GDP	12.1	10.9	11.6	11.8	12.8	14.6	14.0	12.3	12.5	11.8
Broad Money Supply	M2/GDP	30.6	28.2	29.8	28.3	29.7	30.6	30.3	28.1	29.7	30.5
2. Monetary Expansion/Contraction											
Narrow Money Supply	% growth	25.4	14.1	11.5	12.9	18.4	29.1	9.1	12.1	17.7	7.4
Broad Money Supply	% growth	22.1	16.6	11.5	5.1	14.7	16.5	12.5	18.5	22.1	17.4
3. Causal Factors											
3.1 External Banking Assets	Rs. Mn.	3154.7	9950.9	9183.2	9180.2	9291.2	7058.5	4732.0	3419.0	12258.0	20940.0
	% growth	28.8	215.4	-7.7	0.0	1.2	-24.0	-33.0	-27.7	258.5	70.8
3.2 Domestic Credit	Rs. Mn.	49293.0	49926.2	59226.1	64108.5	75565.5	96867.0	102321.2	115964.3	127751.2	144003.0
	% growth	16.3	1.3	18.6	8.2	17.9	28.2	5.6	13.3	10.2	12.7
3.2.1 to Government	Rs. Mn.	17533.1	14554.4	20347.6	22546.1	27047.9	36064.5	36118.0	35358.0	35392.0	33065.0
	% growth	2.2	-17.0	39.8	10.8	20.0	33.3	0.1	-2.1	0.1	-6.6
3.2.2 to Private Sector	Rs. Mn.	31759.9	35371.8	38878.5	41562.4	48517.6	60802.5	66203.2	80606.3	92359.2	110938.0
	% growth	25.8	11.4	9.9	6.9	16.7	25.3	8.9	21.8	14.6	20.1
3.3 Other Liabilities	Rs. Mn.	-15190.9	-16449.8	-20000.4	-22428.5	-26521.9	-35979.6	-30619.8	-28838.0	-29435.0	-35150.0
	% growth	6.0	8.3	21.6	12.1	18.3	35.7	-14.9	-5.8	2.1	19.4

Contd…/-

	Unit	1993	1994	1995	1996	1997	1998	1999	2000	2001
1. Financial Depth										
Narrow Money Supply	M1/GDP	11.9	12.2	11.3	10.2	10.7	10.5	10.9	10.5	9.8
Broad Money Supply	M2/GDP	32.1	33.1	34.2	33.0	35.9	34.6	36.0	36.0	36.0
2. Monetary Expansion/Contraction										
Narrow Money Supply	% growth	18.6	18.7	6.7	4.0	9.8	12.1	12.8	9.1	3.2
Broad Money Supply	% growth	23.4	19.7	19.2	10.8	13.8	9.7	13.3	13.0	11.4
3. Causal Factors										
3.1 External Banking Assets	Rs. Mn.	48119.0	64467.0	66532.0	61861.0	89292.0	93724.0	83892.0	59448.0	82966.0
	% growth	129.8	34.0	3.2	-7.0	44.3	5.0	-10.5	-29.1	39.6
3.2 Domestic Credit	Rs. Mn.	150696.9	173795.6	223798.3	252317.0	272733.0	311626.0	374120.0	469084.0	513457.0
	% growth	4.6	15.3	28.8	12.7	8.1	14.3	20.1	25.4	9.5
3.2.1 to Government	Rs. Mn.	26993.0	28148.0	35214.0	48537.0	46365.0	58591.0	85881.0	134484.0	161735.0
	% growth	-18.4	4.3	25.1	37.8	-4.5	26.4	46.6	56.6	20.3
3.2.2 to Private Sector	Rs. Mn.	123703.9	145647.6	188352.0	203780.0	226368.0	253035.0	288239.0	334600.0	351722.0
	% growth	11.5	17.7	29.3	8.2	11.1	11.8	13.9	16.1	5.1
3.3 Other Liabilities	Rs. Mn.	-38679.0	-46590.0	-61794.0	-60978.0	-73768.0	-89176.0	-99936.0	-123863.0	-145696.0
	% growth	10.0	20.5	32.6	-1.3	21.0	20.9	12.1	23.9	17.6

Notes: Data have been reclassified starting from 1990. For more information, see Annual Report 1995, Central Bank of Sri Lanka.
Source Central Bank of Sri Lanka, *Annual Report*, various issues.

Table A11: Interest rates, 1988-2001 (%, end of period)

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Bank rate	10.0	14.0	15.0	17.0	17.0	17.0	17.0	17.0	17.0	17.0	17.0	16.0	25.0	18.0
Treasury Bills, Yield rates														
3 Month	18.9	18.1	17.4	16.3	17.7	18.1	18.7	19.3	17.5	10.0	12.0	12.1	17.8	12.9
12 Month	-	19.1	18.4	17.4	19.0	19.4	19.4	19.0	17.4	10.2	12.6	12.8	18.2	13.7
Repurchase rate	-	-	-	-	-	16.5	20.0	16.5	12.8	11.0	11.3	9.3	17.0	12.0
Call Money rate														
Maximum	21.0	25.0	32.0	19.0	27.0	28.0	28.0	102.0	31.0	20.0	16.5	14.3	32.0	13.5
Minimum	16.0	13.0	10.0	14.0	13.0	16.5	14.0	16.0	13.0	9.0	11.3	9.8	20.3	12.3
Weighted Average Prime Lending Rate	16.9	18.0	18.6	19.6	20.2	20.4	17.8	20.0	18.4	14.2	15.1	15.2	21.5	14.3
Commercial Bank Saving														
Maximum	11.0	14.0	14.0	14.0	14.0	14.0	13.0	13.0	13.0	11.0	10.0	10.0	10.0	12.0
Minimum	5.0	5.0	5.0	6.5	6.5	5.5	5.5	5.0	4.5	3.0	2.0	2.0	2.0	4.0
NSB Saving	12.0	14.0	16.2	14.0	14.0	14.0	14.0	12.0	12.0	10.8	10.5	9.2	8.4	8.4
Commercial Bank Fixed Deposit (one year)														
Maximum	15.5	20.5	21.0	20.0	20.0	17.0	17.0	17.0	17.8	15.3	13.0	12.5	15.0	14.5
Minimum	9.0	11.0	11.0	10.0	13.5	13.5	10.0	10.0	12.0	8.5	9.0	9.0	9.0	9.5
NSB Fixed Deposit (one year, paid on maturity)	13.0	15.0	17.0	17.0	17.0	16.0	14.0	16.0	15.0	11.0	11.5	11.5	15.0	13.0

Source: Central Bank of Sri Lanka, *Annual Report*, various issues.
Central Bank of Sri Lanka, *Bulletin*, various issues.

Table A12: Basic indicators of the general price level, 1982-2001

	CCPI		GCCPI		WPI		GDPD	
	(1952=100)	% Change	(1989=100) Jan-June	% Change	(1974=100)	% Change	(1996=100)	% Change
1982	416.1	10.8	-	-	283.3	5.5	25.0	13.6
1983	474.2	14.0	-	-	354.1	25.0	28.7	14.6
1984	553.1	16.6		-	444.7	25.6	33.6	17.1
1985	561.2	1.5	-	-	377.1	-15.2	33.9	0.9
1986	606.0	8.0	-	-	366.0	-2.9	35.9	5.8
1987	652.8	7.7	-	-	414.9	13.4	38.4	7.0
1988	744.1	14.0	-	-	488.7	17.8	42.8	11.5
1989	830.2	11.6	103.8	-	532.9	9.0	46.9	9.6
1990	1008.6	21.5	124.6	20.0	651.1	22.2	56.3	20.0
1991	1131.5	12.2	138.9	11.5	710.8	9.2	62.5	11.0
1992	1260.4	11.4	152.0	9.4	773.0	8.8	68.7	10.0
1993	1408.4	11.7	164.8	8.4	831.8	7.6	75.2	9.5
1994	1527.4	8.4	172.6	4.7	873.4	5.0	82.3	9.3
1995	1644.6	7.7	179.3	3.9	950.7	8.9	89.2	8.4
1996	1906.7	15.9	202.5	12.9	1145.1	20.4	100.0	12.1
1997	2089.1	9.6	220.1	8.7	1224.3	6.9	108.6	8.6
1998	2284.9	9.4	235.2	6.9	1298.7	6.1	117.8	8.4
1999	2392.1	4.7	244.1	3.8	1295.3	-0.3	123.1	4.4
2000	2539.8	6.2	252.0	3.2	1317.2	1.7	131.3(a)	6.7
2001	2899.4	14.2	279.6	11.0	1471.2(a)	11.7	148.3(a)	13.0

Notes: CCPI: Colombo Consumers' Price Index GCCPI: Greater Colombo Consumers' Price Index WPI: Wholesale Price Index GDPD: GDP Deflator.
(a) Provisional.

Source: Department of Census and Statistics,
Central Bank of Sri Lanka, *Annual Report*, various issues.

Table A13: Wage rate indices, 1982-2001 (December 1978 = 100)

	Workers in Wages Boards Trades (a)		Government Employees (b)	
	Nominal	Real	Nominal	Real
1982	175.8	101.1	187.8	108.0
1983	188.8	95.5	215.7	109.0
1984	228.8	98.8	246.6	106.6
1985	247.9	105.8	284.3	121.2
1986	261.3	103.2	297.4	117.5
1987	277.7	101.8	297.4	109.1
1988	335.8	107.9	390.9	125.4
1989	338.1	112.0	421.8	121.9
1990	453.5	107.6	476.8	113.2
1991	518.8	109.7	534.6	113.2
1992	590.0	112.0	557.6	106.0
1993	685.8	116.6	675.5	114.8
1994	712.4	111.7	735.5	115.4
1995	740.3	107.8	792.5	115.4
1996	825.4	99.0	862.4	103.5
1997	849.1	97.3	906.5	104.0
1998	953.3	99.9	1001.4	104.9
1999	977.6	97.8	1001.4	100.2
2000	1000.4	94.3	1084.7	102.1
2001 (c)	1057.6	87.3	1310.8	108.1

Notes: The wage rates used in the calculation of index numbers are minimum wages.
(a) Combined index for workers in agriculture, industry and commerce, and services.
(b) Combined index for non-executive officers and minor employees.
(c) Provisional.

Source: Central Bank of Sri Lanka, *Annual Report*, various issues.

Table A14: Sri Lanka's direction of foreign trade, 1984-2001

	Unit	1984	1985	1986	1987	1988	1989	1990	1991	1992
1. Exports to Selected Countries and Groupings										
U.S.A	US$ Mn.	280.9	283.2	318	355.2	367.3	400	492.5	559	837.6
U.K.	US$ Mn.	86.1	82.6	69.8	75.2	80.9	88.4	115.1	126.2	170.2
Germany	US$ Mn.	70.9	69.9	83.3	101.1	104.3	95.4	126.7	148.8	211.8
Japan	US$ Mn.	62.4	65.4	67.1	67.2	84.9	89	102.4	101.6	128
EC	% of total exports	17.3	20	23.7	21.7	23.7	25.4	25	27	32.8
Germany	% of exports to EC	28	26.6	29.1	33.4	29.8	24.1	25.5	27	26.3
UK	% of exports to EC	34	31.4	24.4	24.9	23.1	22.3	23.2	22.9	21.1
ASEAN	% of total exports	1.9	4.5	3.3	3.2	4.7	3.9	3.9	5.5	2.4
Singapore	% of exports to ASEAN	75	74.5	78.4	72.2	63.8	59.6	63.7	59.8	56.5
Malaysia	% of exports to ASEAN	12.9	20	11.7	2.7	3.1	2.3	3.3	23.6	7.7
SAARC	% of total exports	4.6	4.1	4.9	3.9	6.2	5.5	3.6	3.0	2.3
India	% of exports to SAARC	19	12.4	20.6	11.6	20.9	11.5	29.1	20.8	20.3
NAFTA	% of total exports	21.6	24	28.7	27.8	27.2	28.4	27.2	30	36.4
USA	% of exports to NAFTA	89	89.7	91.7	91.6	91.3	90.3	91.3	91.4	93.5
Canada	% of exports to NAFTA	9.3	7.8	6.6	6.3	5.6	5.8	5.4	5.2	4.3
APEC	% of total exports	32.1	37.3	41.8	40.5	42.5	41.2	39.5	43.7	47.6
USA	% of exports to APEC	59.8	57.7	62.8	62.8	58.5	62.4	62.8	62.7	71.5
Japan	% of exports to APEC	13.3	13.3	13.2	11.9	13.5	13.9	13.1	11.4	10.9
Singapore	% of exports to APEC	1.2	1.1	1	0.9	0.7	0.6	0.5	0.4	0.3
2. Imports from Selected Countries and Groupings										
Japan	US$ Mn.	307.6	282.3	318.9	304.2	305.1	295.4	325.4	358.4	415.6
India	US$ Mn.	111.4	74.7	79.3	83.5	91	64.2	118.1	220.1	301.9
Hong Kong	US$ Mn.	59.1	57.5	85.5	129.8	116.6	109.9	120.4	212.5	241
U.S.A.	US$ Mn.	164.2	129	117.5	114.1	152.7	137	207.7	174.5	159.4
U.K.	US$ Mn.	86.9	96.4	102.9	140.4	126.5	125.2	137	166.3	172.8
Taiwan	US$ Mn.	50.5	57.3	95.3	106.1	105.3	116.1	1555.8	207.4	214
EC	% of total imports	13.9	14.2	14.7	17.6	17.5	16	14.4	15.2	14.7
Germany	% of imports from EC	32.7	33.9	29.6	24.7	26.2	20	21.7	22	24.7
UK	% of imports from EC	32.3	33.2	35.5	38.5	32.3	35.2	35.5	36	33.5
ASEAN	% of total imports	8.8	6.7	8.6	10.8	10.1	12.7	12.8	13.8	15.1
Singapore	% of imports from ASEAN	59.6	54.1	42.2	44.8	41.1	33.4	29.7	32.3	44.8
Malaysia	% of imports from ASEAN	25.8	20.8	24.6	26.3	27.4	21.5	33.2	33.4	24.1
SAARC	% of total imports	6.8	5.7	7.3	6.7	8.1	5.5	6.9	10.3	11.8
India	% of imports from SAARC	85.4	63.5	54.9	60.2	50.1	52.1	64.1	70.3	72.7
NAFTA	% of total imports	9.9	8	7	6.4	8.6	6.8	8.5	6.3	5.2
USA	% of imports from NAFTA	85.8	79	84.5	86.3	78.8	90.1	91.4	91.3	87
Canada	% of imports from NAFTA	14	20.9	15.2	13.2	21	9.7	8.3	8.3	11.6
APEC	% of total imports	46.1	43.5	51.3	51.8	53.1	52.9	55.7	58.5	57.1
USA	% of imports from APEC	18.5	14.5	11.6	10.6	12.8	11.6	13.9	9.8	8
Japan	% of imports from APEC	16	13.8	16.2	14.7	13.6	11.7	12.1	11.8	11.9
Singapore	% of imports from APEC	11.4	8.3	7.1	9.3	7.8	8	6.9	7.6	11.9

Contd.../

	Unit	1993	1994	1995	1996	1997	1998	1999	2000	2001(a)
1. Exports to Selected Countries and Groupings										
U.S.A	US$ Mn.	1006.8	1115.3	1353.5	1395.8	1666.4	1890.2	1791.8	2192.5	1925.9
U.K.	US$ Mn.	203.5	285.4	345.3	388.6	525.4	530.4	604.2	736.7	576.4
Germany	US$ Mn.	227.5	222.5	254.3	239.3	230	231.9	215.7	230.2	198.5
Japan	US$ Mn.	148	165.3	200.4	256.4	234.2	196.1	159.1	229.7	185.8
EC	% of total exports	31.2	31.3	31	29.4	35	33.6	35.3	33.4	32.1
Germany	% of exports to EC	25.5	22.2	21.6	19.8	17.1	17.9	16.2	15.2	15.9
UK	% of exports to EC	22.8	28.4	29.3	32.2	39	41	45	48.5	46.1
ASEAN	% of total exports	2.9	3.9	3.7	2.8	3.4	3	3.1	3.5	2.9
Singapore	% of exports to ASEAN	58.6	60.6	52.3	52	43.7	38.1	37.9	38.7	51.4
Malaysia	% of exports to ASEAN	4	4.6	15.7	23.5	16.6	10.1	6	5	5.9
SAARC	% of total exports	2.5	2.7	2.7	2.6	3.1	3	3.8	4.2	4.4
India	% of exports to SAARC	27.6	27.2	31.3	39.6	37	33.2	33.7	30.6	49.8
NAFTA	% of total exports	37.1	36.8	37.3	35.6	45.5	51.5	49.8	50.5	51.9
USA	% of exports to NAFTA	94.9	94.4	95.4	95.6	95.3	95.4	95.1	95.4	95.1
Canada	% of exports to NAFTA	3.4	4.3	3.5	3.1	3.2	3.1	3.1	3.1	3.4
APEC	% of total exports	48.7	49.6	50.1	48.7	59.8	58.9	56.3	57.8	59.4
USA	% of exports to APEC	72.3	70.1	71	69.8	72.4	83.4	84.1	83.5	83.1
Japan	% of exports to APEC	10.6	10.4	10.5	12.8	10.2	8.6	7.5	8.7	8.0
Singapore	% of exports to APEC	0.2	0.2	0.1	0.1	0.1	1.9	2.1	2.3	2.5
2. Imports from Selected Countries and Groupings										
Japan	US$ Mn.	452.6	526.6	498.6	497.3	479.3	5559	560.9	646	336.9
India	US$ Mn.	342.9	404.4	469.2	561.9	559.8	539.4	511.6	600.1	709.3
Hong Kong	US$ Mn.	312.4	316.6	357.4	354.1	411.3	411	459.1	515.9	500.3
U.S.A.	US$ Mn.	131.3	284.7	172.7	198.3	186.6	229.5	216.2	254.9	265.6
U.K.	US$ Mn.	184.8	247.6	242.6	251.7	282.4	304.8	251.1	311.4	220.6
Taiwan	US$ Mn.	225.7	250.2	286.4	287.8	372.1	378.7	347.1	390.1	322.8
EC	% of total imports	15.8	16.3	15.3	15.4	17.6	23.3	19.4	18.8	17.6
Germany	% of imports from EC	21.9	21.8	20.5	18.4	20.5	20.2	15.8	16.5	16.3
UK	% of imports from EC	29.2	31.8	29.8	30.1	31.6	30.3	29.1	32.8	26.0
ASEAN	% of total imports	14.5	13.2	12.8	12.6	14.7	19.6	21.1	21	18.9
Singapore	% of imports from ASEAN	35.8	37.2	36.6	37.7	38.3	36.8	48.2	46.7	44.8
Malaysia	% of imports from ASEAN	29.5	28.8	31.1	26.7	22.3	22.8	18	20.5	22.7
SAARC	% of total imports	10.7	10.3	10.2	11.9	13.1	15.1	14.2	14	16.9
India	% of imports from SAARC	80.1	82.7	86.1	86.9	83.9	83.3	81.4	84.8	86.5
NAFTA	% of total imports	3.7	6.3	3.6	4.3	5.7	7.1	5.5	6	6.0
USA	% of imports from NAFTA	89.4	95	91.3	84.6	64.7	75	89	84.1	91.5
Canada	% of imports from NAFTA	10.1	4.6	7.9	10	19	13.6	9.3	15.6	8.2
APEC	% of total imports	55.7	55.4	50.2	50.4	61.9	45.9	53.4	54.9	54.3
USA	% of imports from APEC	5.9	10.8	6.5	7.3	5.9	11.6	9.1	9.2	10.1
Japan	% of imports from APEC	11.3	11	9.4	9.2	9.4	28.1	23.6	23.2	12.8
Singapore	% of imports from APEC	9.3	8.8	9.3	9.5	9.1	15.7	19.0	17.8	15.6

Note: (a) Provisional.
Sources: International Monetary Fund, *Direction of Trade Statistics*, various issues.
Central Bank of Sri Lanka, *Annual Report*, various issues.

Table A15: Structure of commodity imports, 1983-2001

	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
1.Consumer Goods										
Value (US$ Mn.)	378.9	317.6	385.2	437.4	469.1	548.2	581.5	709.4	782.1	734.6
Growth	22.3	-16.2	21.3	13.6	7.2	16.9	6.1	22.0	10.3	-6.1
% of Total Imports	19.6	17.0	19.4	22.5	22.8	24.6	26.1	26.4	25.5	21.0
1.1 Food										
Value (US$ Mn.)	228.4	196.0	217.4	240.8	253.4	321.1	364.4	390.0	404.9	419.7
Growth	33.5	-14.2	10.9	10.7	5.2	26.7	13.5	7.0	3.8	3.7
% of Total Imports	11.8	10.5	10.9	12.4	12.3	14.4	16.4	14.5	13.2	12.0
1.2 Other										
Value (US$ Mn.)	150.5	121.6	167.7	196.7	215.7	227.1	217.1	319.4	377.2	314.9
Growth	8.4	-19.2	38.0	17.3	9.7	5.3	-4.4	47.1	18.1	-16.5
% of Total Imports	7.8	6.5	8.4	10.1	10.5	10.2	9.8	11.9	12.3	9.0
2. Intermediate Goods										
Value (US$ Mn.)	1039.2	1050.5	1079.8	1021.5	1175.7	1267.8	1255.4	1391.7	1553.3	1884.4
Growth	11.1	1.1	2.8	-5.4	15.1	7.8	-1.0	10.9	11.6	21.3
% of Total Imports	53.7	56.2	54.3	52.5	57.2	56.8	56.4	51.8	50.7	53.8
2.1 Petroleum										
Value (US$ Mn.)	468.5	419.9	404.4	224.6	296.0	246.5	232.4	358.7	311.5	318.0
Growth	-20.6	-10.4	-3.7	-44.5	31.8	-16.7	-5.7	54.4	-13.2	2.1
% .of Total Imports	24.2	22.5	20.3	11.5	14.4	11.0	10.4	13.3	10.2	9.1
2.2 Textiles										
Value (US$ Mn.)	115.8	116.9	139.9	226.8	274.6	276.5	276.9	335.8	498.2	765.5
Growth	11.2	1.0	19.6	62.1	21.1	0.7	0.1	21.3	48.3	53.7
% of Total Imports	6.0	6.3	7.0	11.6	13.4	12.4	12.4	12.5	16.3	21.9
3. Investment Goods										
Value (US$ Mn.)	513.3	478.4	382.4	376.8	384.9	379.8	333.4	584.4	720.1	850.9
Growth	-7.8	-6.8	-20.1	-1.5	2.2	-1.3	-12.2	75.3	23.2	18.2
% of Total Imports	26.5	25.6	19.2	19.3	18.7	17.0	15.0	21.7	23.5	24.3
4. Total Imports										
Value (US$ Mn.)	1936.2	1868.9	1989.8	1947.4	2055.6	2233.2	2225.6	2689.0	3061.1	3503.4
Growth	-3.9	-3.5	6.5	-2.1	5.6	8.6	-0.3	20.8	13.8	14.5

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	1993	1994	1995	1996	1997	1998	1999	2000	2001 (a)
1.Consumer Goods									
Value (US$ Mn.)	774.5	930.6	982.0	1030.0	1084.0	1128.0	1131.0	1261.0	1126.0
Growth	5.4	20.1	5.6	5.2	4.9	4.0	0.3	11.5	-10.7
% of Total Imports	19.3	19.5	18.5	19.0	18.5	19.2	18.9	17.3	18.9
1.1 Food									
Value (US$ Mn.)	415.9	483.9	522.0	597.0	642.0	596.0	551.0	566.0	545.0
Growth	-0.9	16.4	7.8	14.3	7.5	-7.2	-7.6	2.7	-3.7
% of Total Imports	10.4	10.2	9.8	11.0	11.0	10.1	9.2	7.8	9.1
1.2 Other									
Value (US$ Mn.)	358.7	446.6	461.0	433.0	442.0	532.0	581.0	696.0	581.0
Growth	13.9	24.5	3.1	-5.8	1.8	20.6	9.2	19.8	-16.5
% of Total Imports	8.9	9.4	8.7	8.0	7.5	9.0	9.8	9.5	9.7
2. Intermediate Goods									
Value (US$ Mn.)	2154.4	2425.0	2900.0	2971.0	3235.7	3108.0	3168.0	3916.0	3430.0
Growth	14.3	12.6	19.6	2.6	8.9	-3.9	1.9	23.6	-12.4
% of Total Imports	53.7	50.9	54.6	54.6	55.2	52.8	53.0	53.5	57.4
2.1 Petroleum									
Value (US$ Mn.)	309.2	296.3	386.9	479.9	539.5	345.0	500.0	901.0	731.0
Growth	-2.8	-4.2	30.6	24.1	12.4	-36.1	44.9	80.2	-18.9
% of Total Imports	7.7	6.2	7.3	8.8	9.2	5.9	8.4	12.3	12.2
2.2 Textiles									
Value (US$ Mn.)	865.1	1038.1	1158.5	1168.8	1386.9	1397.0	1320.0	1471.0	1320.0
Growth	13.0	20.0	11.6	0.9	18.7	0.6	-5.5	11.4	-10.3
% of Total Imports	21.6	21.8	21.8	21.5	23.6	23.7	22.4	20.1	22.1
3. Investment Goods									
Value (US$ Mn.)	1046.8	1366.5	1189.0	1203.0	1324.0	1477.0	1565.0	1737.0	1081.0
Growth	23.0	30.5	-13.0	1.5	10.0	11.3	5.9	11.0	-37.8
% of Total Imports	26.1	28.7	22.4	22.1	22.6	25.1	26.2	23.6	18.1
4. Total Imports									
Value (US$ Mn.)	4011.3	4767.3	5311.1	5439.0	5864.0	5889.0	5979.0	7320.0	5974.0
Growth	14.5	18.8	11.4	2.6	7.7	0.4	1.5	22.4	-18.4

Notes: (a) Provisional.
Source: Central Bank of Sri Lanka, *Annual Report*, various issues. IPS database.

Table A16: Structure of commodity exports, 1982-2001

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
1. Agricultural Exports										
Value (US$ Mn.)	560.1	618.6	887.5	700.4	562.7	592.2	632.1	611.7	721.0	641.4
Growth	-11.4	10.4	43.5	-21.1	-19.7	5.2	6.7	-3.2	17.9	-11.0
% of Total Exports	54.3	58.0	60.4	52.5	46.3	42.4	42.8	39.3	36.3	32.3
1.1 Plantation Crops										
Value (US$ Mn.)	464.5	533.6	810.5	624.1	481.3	509.6	531.3	518.7	617.7	538.5
Growth	-13.6	14.9	51.9	-23.0	-22.9	5.9	4.3	-2.4	19.1	-12.8
% of Total Exports	45.1	50.0	55.2	46.8	39.6	36.5	36.0	33.3	31.1	27.1
1.1.1 Tea										
Value (US$ Mn.)	304.7	352.5	619.7	441.9	330.3	361.8	386.7	379.1	494.8	431.9
Growth	-9.0	15.7	75.8	-28.7	-25.3	9.6	6.9	-2.0	30.5	-12.7
% of Total Exports	29.6	33.1	42.2	33.2	27.2	25.9	26.2	24.3	24.9	21.7
1.1.2 Rubber										
Value (US$ Mn.)	111.6	121.2	129.8	94.5	93.6	99.5	116.5	86.3	76.9	63.8
Growth	-25.6	8.6	7.1	-27.2	-0.9	6.3	17.1	-25.9	-10.9	-17.0
% of Total Exports	10.8	11.4	8.8	7.1	7.7	7.1	7.9	5.5	3.9	3.2
1.1.3 Coconut Kernel Products										
Value (US$ Mn.)	48.2	59.9	61.0	87.7	57.4	48.3	28.2	53.3	46.0	42.8
Growth	-8.3	24.3	1.9	43.7	-34.5	-15.9	-41.7	89.2	-13.7	-7.0
% of Total Exports	4.7	5.6	4.2	6.6	4.7	3.5	1.9	3.4	2.3	2.2
1.2. Minor Agricultural Crops										
Value (US$ Mn.)	71.8	63.1	54.7	50.2	53.5	58.2	80.5	66.8	79.9	82.4
Growth	-1.1	-12.1	-13.4	-8.1	6.6	8.8	38.3	-17.0	19.5	3.2
% of Total Exports	7.0	5.9	3.7	3.8	4.4	4.2	5.5	4.3	4.0	4.1
2. Mineral Exports										
Value (US$ Mn.)	41.3	48.1	32.8	31.8	42.2	61.3	82.2	74.7	87.0	61.9
Growth	0.3	16.6	-31.9	-3.0	32.6	45.3	34.1	-9.1	16.4	-28.8
% of Total Exports	4.0	4.5	2.2	2.4	3.5	4.4	5.6	4.8	4.4	3.1
3. Industrial Exports										
Value (US$ Mn.)	397.4	374.9	507.8	526.3	566.7	679.4	712.9	789.8	1036.1	1237.3
Growth	4.8	-5.7	35.5	3.6	7.7	19.9	4.9	10.8	31.2	19.4
% of Total Exports	38.6	35.1	34.6	39.5	46.6	48.6	48.3	50.7	52.2	62.3
3.1 Textile & Garments										
Value (US$ Mn.)	168.3	201.4	297.4	293.0	343.7	438.0	448.3	489.1	628.1	803.9
Growth	7.2	19.7	47.7	-1.5	17.3	27.4	2.4	9.1	28.4	28.0
% of Total Exports	16.3	18.9	20.3	22.0	28.3	31.4	30.4	31.4	31.7	40.5
3.2 Petrolium Products										
Value (US$ Mn.)	157.6	114.0	129.3	142.7	84.2	88.0	71.2	62.2	99.2	79.5
Growth	-10.1	-27.7	13.4	10.4	-41.0	4.6	-19.1	-12.7	59.5	-19.9
% of Total Exports	15.3	10.7	8.8	10.7	6.9	6.3	4.8	4.0	5.0	4.0
4. Total Commodity Exports including Petroleum										
Value (US$ Mn.)	1030.8	1066.6	1468.2	1333.0	1216.1	1396.9	1475.4	1558.4	1983.9	1987.5
Growth	-5.7	3.5	37.6	-9.2	-8.8	14.9	5.6	5.6	27.3	0.2
5. Total Commodity Exports excluding Petroleum										
Value (US$ Mn.)	873.2	952.6	1338.9	1190.2	1132.0	1308.9	1404.2	1496.2	1884.7	1908.0
Growth	-4.9	9.1	40.6	-11.1	-4.9	15.6	7.3	6.6	26.0	1.2

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	1992	1993	1994	1995	1996	1997	1998	1999	2000(a)	2001(b)
1. Agricultural Exports										
Value (US$ Mn.)	604.7	655.3	702.1	829.0	961.0	1060.0	1088.0	947.0	1005.0	932.0
Growth	-5.7	8.4	7.1	18.1	16.1	10.3	2.6	-13.0	6.1	-7.3
% of Total Exports	24.6	22.9	21.9	21.8	23.5	22.9	22.9	20.6	18.2	19.3
1.1 Plantation Crops										
Value (US$ Mn.)	468.1	514.9	546.8	660.9	801.3	882.1	878.1	738.0	806.0	755.0
Growth	-13.1	10.0	6.2	20.9	21.2	10.1	-0.4	4.6	9.2	-6.3
% of Total Exports	19.0	18.0	17.0	17.4	19.5	19.0	18.5	16.0	14.6	15.7
1.1.1 Tea										
Value (US$ Mn.)	339.8	412.7	424.2	481.0	615.0	719.0	780.0	621.0	700.0	690.0
Growth	-21.3	21.4	2.8	13.3	28.2	17.0	8.5	-20.4	12.7	-1.4
% of Total Exports	13.8	14.4	13.2	12.6	15.0	15.5	16.4	13.5	12.7	14.3
1.1.2 Rubber										
Value (US$ Mn.)	67.5	64.0	72.5	111.0	104.0	79.0	44.0	33.0	29.0	24.0
Growth	5.8	-5.3	13.3	53.8	-6.6	-24.4	-44.3	-25.0	-12.1	-17.2
% of Total Exports	2.7	2.2	2.3	2.9	2.5	1.7	0.9	0.7	0.5	0.5
1.1.3 Coconut Kernel Products										
Value (US$ Mn.)	60.8	38.3	50.1	69.0	81.0	82.0	56.0	84.0	77.0	41.0
Growth	42.2	-37.0	30.9	37.1	17.7	2.0	-31.8	50.0	-8.3	-46.8
% of Total Exports	2.5	1.3	1.6	1.8	2.0	1.8	1.2	1.8	1.4	0.9
1.2. Minor Agricultural Crops										
Value (US$ Mn.)	113.1	120.7	129.2	134.0	132.0	145.0	170.0	165.0	155.0	136.0
Growth	37.3	6.7	7.0	3.5	-1.4	9.9	17.7	-2.9	-6.1	-12.3
% of Total Exports	4.6	4.2	4.0	3.5	3.2	3.1	3.6	3.6	2.8	2.8
2. Mineral Exports										
Value (US$ Mn.)	62.7	75.7	86.9	87.0	96.0	90.0	60.0	64.0	97.0	86.0
Growth	1.3	20.7	14.7	-0.1	10.3	-6.7	-33.1	6.7	51.6	-11.3
% of Total Exports	2.5	2.6	2.7	2.3	2.3	1.9	1.3	1.4	1.8	1.8
3. Industrial Exports										
Value (US$ Mn.)	1763.2	2102.3	2398.9	2870.0	3006.0	3436.0	3607.0	3551.0	4283.0	3710.0
Growth	42.5	19.2	14.1	19.6	5.0	14.3	3.2	-1.8	20.6	-13.4
% of Total Exports	71.7	73.4	74.8	75.4	73.4	74.1	74.9	77.0	77.6	77.0
3.1 Textile & Garments										
Value (US$ Mn.)	1214.0	1412.4	1551.9	1853.0	1902.0	2274.0	2460.0	2425.0	2982.0	2543.0
Growth	51.0	16.3	9.9	19.4	2.9	19.6	8.2	-1.4	23.0	-14.7
% of Total Exports	49.3	49.3	48.4	48.7	46.4	49.0	52.0	52.7	54.0	52.8
3.2 Petroleum Products										
Value (US$ Mn.)	63.2	78.8	80.1	85.0	104.0	97.0	73.0	74.0	98.0	68.0
Growth	-20.5	24.6	1.7	5.9	22.4	-6.3	-25.9	1.4	32.4	-30.6
% of Total Exports	2.6	2.8	2.5	2.2	2.5	2.1	1.5	1.6	1.8	1.4
4. Total Commodity Exports incl. Petroleum										
Value (US$ Mn.)	2460.8	2863.7	3208.6	3806.6	4199.0	4736.0	4871.0	4684.0	5620.0	4885.0
Growth	23.8	16.4	12.0	18.6	10.3	12.8	2.9	-3.8	20.0	-13.1
5. Total Commodity Exports excl. Petroleum										
Value (US$ Mn.)	2397.5	2784.9	3128.5	3721.7	3991.0	4542.0	4725.0	4536.0	5424.0	4749.0
Growth	25.7	16.2	12.3	19.0	7.2	13.8	4.0	-4.0	19.6	-12.4

Notes: (a) Revised.
(b) Provisional.

Source: Central Bank of Sri Lanka, *Annual Report*, various issues, IPS database.

Table A17: Tourism, 1982-2001

	Unit	1982	1983	1984	1985	1986	1987	1988	1989	1990	199
Tourist Arrivals	No.	407230	337530	317734	257456	230106	182620	182662	184732	297888	31770
Excursionist Arrivals	No.	6632	7208	8638	9882	6266	2417	6108	4064	3954	266
Tourist Nights	000	4048	3179	2818	2365	2513	2414	2305	1970	3225	363
Earnings	Rs. Mn.	3050.4	2896.1	2669.5	2233.3	2300.1	2415.2	2438.3	2739.7	5303.3	6485.
	US$ mn	146.6	125.8	104.9	82.2	82.1	82.0	76.6	76.0	132.0	156.
Receipts per tourist	US$	36.2	39.6	37.2	34.8	32.7	34.0	33.3	38.6	41.1	42.
Average Duration	Nights	10.0	9.6	8.9	9.2	10.9	13.2	12.6	10.7	10.8	11.
Accommodation											
Rooms	No.	7539	8852	9627	9826	9794	9921	9977	9459	9556	967
Beds	No.	15001	17605	18970	19352	19301	19322	19432	18464	18669	1894
Occupancy Rate	%	47.8	35.9	35.6	32.7	32.9	31.5	32.1	31.0	47.2	48.
Sri Lankan Nationals											
Arrivals	No.	162034	180729	212365	220094	220614	217127	245065	258950	306367	23742
Departures	No.	216466	244955	274418	239272	229386	257760	298583	285510	296884	31037
Employment											
Direct	No.	26776	22374	24541	22723	22285	20338	19960	21958	24964	2687
Indirect	No.	37486	31234	34357	31810	31199	28473	27944	30741	34950	3762

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	Unit	1992	1993	1994	1995	1996	1997	1998	1999	2000(a)	2001(b)
ourist Arrivals	No.	393669	392250	407511	403101	302265	366165	381063	436440	400414.0	336794.0
xcursionist Arrivals	No.	5651	6093	8413	10556	12863	18265	27629	28335	44518.0	60008.0
ourist Nights	000	4055	4148	4251	4024	2947	3680	3944	4479	4056.0	3435.0
arnings	Rs. Mn.	8825.6	10036.8	11401.6	11551.6	9559.1	12980.0	14868.0	19297.3	19162.2	18863.3
	US$ Mn.	201.4	208.0	230.7	225.4	173.0	216.7	231.5	274.9	252.8	211.1
eceipts per tourist	US$	49.7	50.1	54.2	56.1	57.9	58.6	59.5	61.4	62.3	63.1
verage Duration	Nights	10.3	10.6	10.4	10.0	9.8	10.1	10.4	10.3	10.1	9.9
ccommodation											
Rooms	No.	10214	10365	10742	11255	11600	12370	12772	12918	13311.0	13626.0
Beds	No.	19907	20242	20929	21680	22040	22944	23373	24216	24953.0	25595.0
ccupancy Rate	%	55.3	57.0	56.6	52.6	40.3	49.1	52.8	57.6	52.3	42.1
i Lanka Nationals											
Arrivals	No.	339109	375740	422367	459441	488055	482850	481793	521073	514448.0	487356.0
Departures	No.	420749	416246	448437	504420	494258	530712	518050	496963	524212.0	505341.0
mployment											
Direct	No.	28790	30710	33956	35068	31963	34006	34780	36560	37943.0	33710.0
Indirect	No.	40306	42994	47538	49095	44748	47608	48692	51184	53120.0	47194.0

Notes: (a) Revised.
(b) Provisional.

Source: Ceylon Tourist Board, *Annual Statistical Report*, various issues.

Table 18: Monthly tourist arrivals

	1990	1991		1992		1993		1994		1995	
	No.	No.	Growth	No.	Growth	No.	Growth	No.	Growth	No.	Growth
January	26592	28932	8.8	35730	23.5	42726	19.6	45402	6.3	45987	1.3
February	26368	28080	6.5	38859	38.4	40116	3.2	41067	2.4	42591	3.7
March	26946	27153	0.8	33399	23.0	37953	13.6	41277	8.8	40074	-2.9
April	22788	20541	-9.9	28410	38.3	29589	4.1	28080	-5.1	33756	20.2
May	18286	17745	-3.0	21024	18.5	22368	6.4	21777	-2.6	24672	13.3
June	18050	17394	-3.6	23157	33.1	20412	-11.9	21399	4.8	22416	4.8
July	26410	30645	16.0	33771	10.2	32904	-2.6	35370	7.5	35994	1.8
August	26786	28824	7.6	40143	39.3	32796	-18.3	32817	0.1	35814	9.1
September	22438	24762	10.4	29838	20.5	27495	-7.9	31062	13.0	30828	-0.8
October	23060	25173	9.2	32079	27.4	30621	-4.5	33216	8.5	30603	-7.9
November	24596	28272	14.9	35967	27.2	35103	-2.4	33306	-5.1	28365	-14.8
December	35568	40182	13.0	41292	2.8	40167	-2.7	42738	6.4	32001	-25.1
Total	297888	317703	6.7	393669	23.9	392250	-0.4	407511	3.9	403101	-1.1

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	1996		1997		1998		1999		2000		2001 (a)	
	No.	Growth	No.	Growth	No.	Growth	No.	Growth	No.	Growth	No.	Growth
January	30957	-32.7	32652	5.5	37224	14.0	44379.0	19.2	43311.0	-2.4	44187.0	2.1
February	29550	-30.6	35010	18.5	35283	0.8	41526.0	17.7	43287.0	4.2	46575.0	7.6
March	26442	-34.0	34098	29.0	32256	-5.4	41022.0	27.2	40110.0	-2.2	44290.0	10.4
April	20376	-39.6	26907	32.1	25578	-4.9	34443.0	34.7	33642.0	-2.3	36906.0	9.7
May	17655	-28.4	22407	26.9	20394	-9.0	25212.0	23.6	23404.0	-7.2	26924.0	-15.0
June	19668	-12.3	23160	17.8	22410	-3.2	26184.0	16.8	21825.0	-16.6	28323.0	29.8
July	25380	-29.5	30867	21.6	29529	-4.3	33288.0	12.7	33267.0	-0.1	28566.0	-14.1
August	24765	-30.9	32034	29.4	31446	-1.8	39081.0	24.3	34422.0	-11.9	15717.0	-54.3
September	23211	-24.7	29793	28.4	31653	6.2	33915.0	7.1	31035.0	-8.5	11758.0	-62.1
October	23511	-23.2	28314	20.4	31767	12.2	35112.0	10.5	26658.0	-24.1	12904.0	-51.6
November	24921	-12.1	31995	28.4	38421	20.1	41952.0	9.2	32469.0	-22.6	17344.0	-46.6
December	35829	12.0	38928	8.6	45102	15.9	40326.0	-10.6	36984.0	-8.3	23300.0	-36.9
Total	302265	-25.0	366165	21.1	381063	4.1	43644.0	14.5	400414.0	-8.3	336794.0	-15.9

Note: Monthly growth figures reflect percentage changes compared to the same month in the previous year.
(a) Provisional

Source: Ceylon Tourist Board, *Annual Statistical Report*, various issues.

Table 19: Tourist arrivals by country of residence, 1991-2001

	1991		1992		1993		1994		1995		1996	
	No.	Growth	No.	Growth	No.	Growth	No.	Growth	No.	Growth	No.	Growth
th America	9615	18.9	12615	31.2	13635	8.1	15612	14.5	14565	-6.7	12462	-14.4
anada	3306	35.9	4104	24.1	4062	-1.0	4920	21.1	5469	11.2	4689	-14.3
S.A.	6039	6.8	8511	40.9	9573	12.5	10692	11.7	9096	-14.9	7773	-14.5
stern Europe	192054	13.4	246393	28.3	251934	2.2	253899	0.8	250152	-1.5	167343	-33.1
ermany	65226	10.3	85443	31.0	95430	11.7	93528	-2.0	79698	-14.8	45075	-43.4
nited Kingdom	31011	42.2	34602	11.6	42474	22.8	47766	12.5	63582	33.1	52095	-18.1
ance	36801	11.1	40227	9.3	34779	-13.5	30522	-12.2	30996	1.6	21480	-30.7
aly	18897	-1.8	25572	35.3	18267	-28.6	18069	-1.1	18378	1.7	11988	-34.8
etherlands	11244	29.1	17538	56.0	15387	-12.3	12219	-20.6	14274	16.8	10995	-23.0
a	96654	-3.3	114162	18.1	106668	-6.6	116352	9.1	118323	1.7	102558	-13.3
apan	23403	4.5	28797	23.0	20421	-29.1	19497	-4.5	18180	-6.8	11724	-35.5
dia	20352	55.9	25941	27.5	32433	25.0	44142	36.1	47448	7.5	42822	-9.7
akistan	10392	36.7	11481	10.5	12369	7.7	10188	-17.6	11325	11.2	11748	3.7
stralasia	9747	9.3	12363	26.8	11823	-4.4	12033	1.8	10254	-14.8	8763	-14.5
ustralia	8802	8.3	10995	24.9	10242	-6.8	9681	-5.5	9066	-6.4	7626	-15.9
ner(a)	9633	-16.9	8136	-15.5	8190	0.7	9615	17.4	9807	2.0	11139	13.6

Contd.../

	1997		1998		1999		2000(b)		2001(c)	
	No.	Growth	No.	Growth	No.	Growth	No.	Growth	No.	Growth
th America	15951	28.0	17529	9.9	18477	5.4	17319	-6.3	15983	-7.7
anada	6477	38.1	7542	16.4	7905	4.8	7503	-5.1	7609	1.4
S.A.	9474	21.9	9987	5.4	10572	5.8	9816	-7.2	8374	-14.7
stern Europe	212052	26.7	238959	12.7	275796	15.4	260824	-5.4	203984	-21.8
ermany	59814	32.7	74058	23.8	77259	4.3	70584	-8.6	60405	-14.4
nited Kingdom	62997	20.9	66432	5.5	80919	21.8	84693	4.7	67830	-19.9
ance	25392	18.2	26874	5.8	34458	28.2	25992	-24.6	20949	-19.4
aly	14424	20.3	15867	10.0	19815	24.9	16833	-15.0	12074	-28.3
etherlands	15957	45.1	22977	44.0	29670	29.1	22618	-23.8	12569	-44.4
a	113565	10.7	99702	-12.2	114375	14.7	91521	-20.0	89732	-2.0
apan	13374	14.1	13785	3.1	16332	18.5	10226	-37.4	9237	-9.7
dia	47010	9.8	37356	-20.5	42315	13.3	31860	-24.7	33924	6.5
akistan	11439	-2.6	10782	-5.7	11421	5.9	10005	-12.4	8562	-14.4
stralasia	11712	33.7	12159	3.8	15159	24.7	18228	20.2	13105	-28.1
ustralia	10392	36.3	10329	-0.6	13218	27.9	16443	24.4	11457	-30.3
ner(a)	12912	15.9	13092	1.4	12633	-3.5	12522	-0.9	13990	11.7
al	366165	21.1	381063	4.1	436440	14.5	400414	-8.3	336794	-15.9

Notes: (a) Latin America & the Caribbean, East Europe, Africa, and Middle East.
(b) Revised
(c) Provisional

Source: Ceylon Tourist Board, *Annual Statistical Report*, various issues.

Table A20: Balance of payments, 1991-2001

	Unit	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001(a)
1. Trade balance	US$ Mn.	-997.1	-1044.6	-1147.6	-1558.7	-1504.5	-1343.8	-1225.0	-1092.0	-1369.0	-1798.0	-1157.0
	% of GDP	-11.1	-10.8	-11.1	-13.3	-11.5	-9.7	-8.1	-6.9	-8.7	-10.8	-7.4
2. Services balance	US$ Mn.	88.2	145.8	162.6	179.8	152.1	105.0	159.1	145.0	147.0	38.0	108.0
	% of GDP	1.0	1.5	1.6	1.5	1.2	0.8	1.1	0.9	0.9	0.2	0.7
3. Income, net	US$ Mn.	-179.4	-178.4	-124.9	-162.0	-170.0	-197.0	-160.0	-180.0	-254.0	-305.0	-280.0
	% of GDP	-2.0	-1.8	-1.2	-1.4	-1.1	-1.5	-1.1	-1.1	-1.6	-1.8	-1.8
4. Net private transfers	US$ Mn.	398.6	459.2	557.3	622.6	675.0	709.8	788.1	849.0	887.0	974.0	938.0
	% of GDP	4.4	4.7	5.4	5.3	5.2	5.1	5.2	5.4	5.6	5.9	6.0
5. Net official transfers	US$ Mn.	71.1	64.1	56.2	58.5	60.8	49.0	44.5	52.0	26.0	24.0	22.0
	% of GDP	0.8	0.7	0.5	0.5	0.5	0.4	0.3	0.3	0.2	0.1	0.1
6. Current account balance	US$ Mn.	-618.6	-553.9	-496.4	-867.1	-753.9	-677.0	-393.0	-226.0	-563.0	-1066.0	-370.0
	% of GDP	-6.9	-5.7	-4.8	-7.4	-5.8	-4.9	-2.6	-1.4	-3.6	-6.4	-2.4
7. Capital and financial A/C	US$ Mn.	858.9	661.8	1106.2	1077.1	699.0	459.0	602.0	413.0	373.0	443.0	585.0
	% of GDP	9.5	6.8	10.7	9.2	5.7	4.2	4.2	2.6	2.4	2.7	3.7
Capital account (Rs Mn.)	US$ Mn.	135.3	121.9	108.6	113.1	117.2	95.6	87.1	80.0	80.0	50.0	197.0
Financial account	US$ Mn.	723.6	539.9	997.6	964.0	581.0	363.0	515.0	334.0	293.0	393.0	389.0
8. Long-term	US$ Mn.	543.3	410.0	635.9	745.5	502.0	381.0	716.0	398.0	435.0	304.0	164.0
Foreign direct investment	US$ Mn.	63.7	121.3	188.8	158.2	19.7	86.0	128.6	137.0	177.0	176.0	172.0
Private long-term (net)	US$ Mn.	-24.3	26.5	186.5	316.3	91.0	2.0	47.0	2.0	196.0	82.0	-257.0
Government long-term	US$ Mn.	504.0	262.2	260.7	271.1	358.0	259.0	239.0	203.0	62.0	47.0	249.0
9. Short-term	US$ Mn.	180.3	129.9	361.7	218.5	79.0	-18.0	-201.0	-64.0	-142.0	88.0	225.0
Foreign portfolio investment	US$ Mn.	32.1	25.6	67.8	27.0	-1.7	6.4	13.0	-24.0	-13.0	-45.0	-11.0
10. Other (b)	US$ Mn.	71.6	113.0	37.2	67.2	157.4	98.1	27.3	-116.1	-	174.0	71.0
11. Overall balance	US$ Mn.	290.0	190.0	661.0	240.0	52.0	-68.0	163.0	37.0	-263.0	-522.0	220.0
	% of GDP	3.5	2.3	6.4	2.0	0.4	-0.5	1.8	1.4	-1.7	-3.1	1.4

Notes: (a) Provisional.
(b) Valuation adjustments, errors, and omissions.

Source: Central Bank of Sri Lanka, *Annual Report*, various issues.

Table A21: Exchange rates behaviour, 1991-2001 (End of period values)

Currency	Unit	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Nominal Exchange Rates												
U.S.A.	S.L. Rs./ US$	42.58	46.00	49.56	49.98	54.05	56.71	61.29	67.78	72.12	80.06	93.16
Japan	S.L. Rs. /Yen	0.34	0.37	0.44	0.50	0.53	0.49	0.47	0.59	0.71	0.70	0.71
U. K.	S.L. Rs. /Pound	79.58	69.43	73.50	78.05	84.25	95.86	101.60	112.62	116.72	119.37	135.06
Germany	S.L. Rs. /DM	28.02	28.57	28.74	32.16	37.76	36.46	34.24	40.36	37.09	38.00	42.07
India	S.L. Rs. /Ind. Rs.	1.64	1.75	1.58	1.59	1.54	1.58	1.56	1.59	1.66	1.71	1.93
Real Exchange Rates Index (1990=100)												
U.S.A.	Index, 1990=100	94.52	92.16	90.19	84.96	88.38	81.82	80.71	79.54	81.56	90.24	98.32
Japan	Index, 1990=100	102.87	96.59	102.00	104.31	100.93	79.65	70.58	79.72	89.42	82.47	73.72
U. K.	Index, 1990=100	99.39	78.36	77.20	77.45	80.79	81.35	79.39	80.92	81.04	79.98	79.49
Germany	Index, 1990=100	97.51	90.57	81.61	84.73	94.00	77.34	67.92	71.95	62.52	62.35	62.28
India	Index, 1990=100	74.10	79.77	69.03	71.10	70.01	64.70	60.92	59.77	61.87	63.95	66.28

Source: Central Bank of Sri Lanka, *Annual Report*, various issues.
International Monetary Fund, *International Financial Statistics Yearbook*, various years.

Appendix B: Capital Market

Table B1: Sri Lanka's capital market structure

	1997	1998	1999	2000	2001(a)
1. Equity Market:					
Market Capitalization	129,400	117,000	112,782	89,000	124,000
of which Central Depository	57,400	48,400	51,270	40,416	63,166
2. Debt Market:	377,233	441,582	519,003	634,497	744,578
(i) Private	12,550	22,100	26,424	30,854	36,237
(ii) Public	364,083	419,482	492,579	603,643	708,341
(a) Short-term (TBs)	115,000	120,000	125,000	135,000	171,000
(b) Medium & Long term	249,083	299,482	367,579	468,643	537,341
3. Total debt and equity (Rs. Mn.)	506,643	558,582	631,785	723,497	868,578
As a percentage of GDP (%)	56.90	55.00	57.12	57.53	62.03
Of which actually traded through the Central Depository	58,150	52,700	55,627	44,379	69,341
As a share of Total (%)	11.3	9.4	8.8	6.1	8.1
4. Foreign participation in the Central Depository as a per cent of market capitalization (%)	20	16	15	11	21

Note: (a) Provisional.

Source: Colombo Stock Exchange, *Annual Report*, **C***entral Bank Annual Report*, **various issues.**

Table B2: Recent Development in the Share Market 1993-2001

	1993	1994	1995	1996	1997	1998	1999	2000	2001
1. Number of Companies Listed	201	215	226	235	239	240	237	239	238
New Listings	12.0	15.0	14.0	9.0	6.0	6.0	4.0	5.0	2.0
De-listings	1.0	1.0	3.0	0.0	2.0	5.0	7.0	3.0	3.0
2. Number of Companies Traded		203	215	214	224	224	226	228	225
3. Market Capitalization Rs.Bn.	123.8	143.2	106.9	104.2	129.4	117	112.8	89	124
US$ Bn.	2.5	2.9	2	1.8	2.1	1.7	1.6	1.2	1.4
4. Price -earnings ratio times, year end	19.6	16.3	11.2	10.7	12.5	9.0	6.6	5.2	7.5
5. Number of shares traded No.Mn.	351	506	315	227	515	634	486	449	747
Domestic No.Mn.	300	335	185	133	337	425	357	350	607
Foreign No.Mn.	124	171	131	94	178	208	129	99	140
6. Trades No. '000	232.3	404.4	186.3	98.2	206.3	329.0	205.7	160.0	159.7
Domestic No. '000	206.4	364.2	165.3	87.8	189.8	312.0	193.6	150.0	152.8
Foreign No. '000	25.9	40.2	21.0	10.4	16.5	17.0	12.1	10.0	6.8
7. Turnover: Rs.Bn.	18.6	34.5	11.2	7.4	18.3	18.2	14.8	11	14.1
US$ Bn.	0.4	0.7	0.2	0.1	0.3	0.3	0.2	0.1	0.2
Domestic Rs. Bn.	14.5	20.7	5.9	3.4	10.5	11.8	9.3	7.9	11.4
Foreign Rs. Bn.	7.7	13.8	5.4	4.1	7.8	6.4	5.5	3.1	2.6
8. Liquidity- Turnover / Market Capitalization ratio (%)	17.8	24.0	10.5	7.1	14.1	15.5	13.1	12.4	11.3
9. No. of New Issues No.	12	21	17	8	5	6	4	4	_
10. Total No. of shares Issued Mn.	42	190	100	64	50	24	29.2	80	_
11. Value of shares Issued Rs.Bn.	1.1	4.6	2.1	2.2	0.5	0.3	0.4	0.1	_
12. Central Depository:									
Domestic Rs. Billion	_	32.9	24.7	25.2	32.1	29.8	33.9	30.9	18.8
Foreign Rs. Billion	_	26.3	17.3	16.2	25.2	18.6	17.2	9.5	5.1
Total Rs. Billion	_	59.2	42.1	41.4	57.4	48.4	51.1	40.4	23.9
Percentage of Market Cap.	_	41%	39%	38%	44%	41%	45%	45%	19%
13. Non-national activity									
Net Purchases Rs. Mn.	3240.0	1334.0	-90.0	352.0	716.0	-1560.0	-950.8	-3364.6	-1024.8
Purchases Rs. Mn.	9295.0	14473.0	5389.0	4224.0	8218.0	5645.0	5050.1	1445.0	2111.9
Sales Rs. Mn.	6055.0	13139.0	5479.0	3872.0	7502.0	7205.0	6000.9	4809.9	3136.7
14. Price Indices									
All Share 1985 = 100	979.0	986.7	663.7	603.0	702.2	597.3	572.5	447.6	621.0
Growth % Change	61.7	0.8	-32.7	-9.1	16.5	-14.9	-4.2	-21.8	38.7
Sensitive 1985 = 100	1442.4	1438.8	990.5	897.7	1068.0	923.0	937.5	698.5	1031.0
Growth % Change	74.5	-0.2	-31.2	-9.4	19.0	-13.6	-6.2	-25.4	47.6

Note: 1000 Million = 1 Billion
Source: Colombo Stock Exchange, Annual Report, Various Issues.

Table B3: Market Concentration
(% of total market capitalization)

Company	2001
John Keells Holdings	8.95%
Ceylon Tobacco	4.68%
Commercial Bank	3.99%
DFCC Bank	3.92%
Hayleys	3.77%
NDB	3.11%
Nestle Lanka	2.29%
Sampath	2.25%
Aitken Spence	2.25%
HNB	2.09%
Total	37.30%

Source: Colombo Stock Exchange, Annual Report, various issues.

Table B4: New equity listings – 1999, 2000 & 2001

Company	No. of Shares Offered	Issue Price Rs.	No. of Shares Subscribed by Public	No. of Shares Devolved to Underwriters	Date Listed
		No .of issues	No. of shares	Value (Rs.)	
Banks, Finance & Insurance		1	19,499,993	233,999,916	
Hotels & Travels		1	2,404,400	24,044,000	
Plantation		2	7,305,400	142,635,000	
Total		4	29,209,793	400,678,916	
1. New Listings 2000					
Ceylinco Insurance Co Ltd	4,200,000	15	4,200,000	_	14.09.2000
Hapugastenne Plantations Ltd	20,000,000	10	10,246,021	9,753,979	18.08.2000
Hayleys Ltd	3,000,000	10	3,000,000	_	23.10.2000
Hayleys Photoprint Ltd	1,000,000	10	1,000,000	_	15.09.2000
Hotel Sigiriya Ltd	1,116,000	10	1,116,000	_	19.04.2000
Mercantile Leasing Ltd	9,559,669	15	3,495,263	6,064,406	27.06.2000
Metropolitan Resource Holdings Ltd	6,610,800	20	6,610,800	_	07.02.2000
Sunshine Travels Ltd	2,850,000	10	2,850,000	_	07.09.2000
Udapussellawa Plantations Ltd	7,600,000	12.50	3,910,238	3,689,762	18.08.2000
Value (Rs.)	713,271,035				
Issues (No.)	9				
2. Rights Issues 2001	No. of Issues	No. of shares	Value(Rs.)		
Banks, Finance & Insurance	2	13,759,669	206,395,035		
Diversified	1	3,000,000	30,000,000		
Hotels & Travels	2	3,966,000	39,660,000		
Plantations	3	34,210,800	427,216,000		
Trading	1	1,000,000	10,000,000		
Total	9	55,936,469	713,271,035		
3. New Listings 2001 by Sector					
Alufab Ltd.	2,009,700	10/-	2,009,700	Nil	29-Mar-01
Ceylinco Housing & Real Estate company Ltd.	2,973,300	12/-	2,973,300	Nil	11-May-01
Gestetner of Ceylon Ltd.	703,125	25/-	703,125	Nil	06-Aug-01
Hayleys Ltd.	4,000,000	15/-	4,000,000	Nil	01-Aug-01
Royal Palms Beach Hotels Ltd.	10,000,000	8/-	10,000,000	Nil	20-Jun-01
Value (Rs.)	213,354,725				
Issues (No.)	5				
4. Right Issues 2001 by Sector	No.of Issues	No. of shares	Value(Rs.)		
Diversified	1	4,000,000	60,000		
Hotels & Travels	1	10,000,000	80,000,000		
Land & Property	1	2,973,300	35,679,600		
Manufacturing	1	2,009,700	20,097,000		
Stores & Supplies	1	703,125	17,578,125		
Total	5	19,686,125	213,354,725		

Source: Colombo Stock Exchange, *Annual Report*, various issues.

Table B5: Structure of Debt Market (Rupees Billion)

	1997	1998	1999	2000	2001(a)
1. Private Debt:					
(a) Commercial paper(year end)	1.20	4.30	4.35	3.96	6.18
(b) Certificates of Deposit	11.20	14.10	17.50	21.28	22.85
(i) Commercial Banks	10.70	13.20	16.50	19.09	21.65
(ii) Finance Companies	0.50	0.90	1.00	2.19	1.20
(c) Debentures (Listed)	0.20	3.70	4.50	5.80	7.32
Total Private Debt	12.60	22.10	26.35	31.04	36.35
2. Public Debt:					
(a) Short Terms					
(i) Treasury Bills	114.99	119.99	124.99	134.99	170.99
(ii) Central Bank Securities	0.01	_	_	_	_
(b) Medium & Long Term					
(i) Treasury Bonds	10.00	48.92	104.88	204.12	229.17
(ii) Rupee Securities	239.48	250.57	262.06	263.89	292.81
(iii) Certificates of Deposit Total Public Debt	364.48	419.48	491.93	603.00	692.97
3. Total Debt	377.08	441.58	518.28	634.04	729.32

Note: (a) Provisional.
Source: Central Bank of Sri Lanka, Annual Report, various issues.

Table B 6: Listed Debentures 1999-2001

Issuer	Issued (No.)	Par Value (Issue price)	Interest (p a)	No. Subscribed	Date Listed Subscribed
1. Listings 1999					
Vanik incorporation Ltd	3,630,160	100	15.00%	4,000,000	14.01.99
Vanik incorporation Ltd	369,840	100	14.20%		14.01.99
Mercantile Leasing Ltd	2,200,000	100	14.00%	2,249,634	09.04.99
People's Merchant Bank	1,500,000	100	13.50%	1,500,000	08.06.99
Sampath Bank	49,307	1000	13.50%	49,307	10.09.99
Sampath Bank	423,971	1000	14.20%	423,971	10.09.99
National Development Bank	500,000	1000	13.45%	573,810	29.10.99
2. Listings 2000					
Sampath Bank	26,722	1000	12.32%	26,722	06.01.00
Seylan Bank Ltd	1,139,050	100	13.35%	1,139,050	18.01.00
Seylan Bank Ltd	2,860,950	100	14.20%	2,860,950	18.01.00
Eagle Insurance Ltd	10,000,000	10	14.50%	10,000,000	14.01.00
Sri Lanka Telecom Ltd	261,241	1000	14.00%	2,145,718	05.05.00
Sri Lanka Telecom Ltd	1,226,779	1000	14.50%		05.05.00
Sri Lanka Telecom Ltd	11,980	1000	13.00%		05.05.00
Eagle Insurance Ltd	3,00,000	10	14.50%	3,000,000	11.04.00
3. Listings 2001					
Suntel Ltd	7,000,000	1000	22.00%	700,000	19.01.01
Suntel Ltd	150,000	1000	22.25%	150,000	19.01.01
Suntel Ltd	150,000	1000	22.50%	150,000	19.01.01
Eagle Insurance Ltd	9,000,000	10	23.00%	Dividend Debenture	26.03.01
Seylan Bank Ltd	3,000,000 with an option to issue a further 3,000,000	100	15.00%	803,900	21.06.01
Seylan Bank Ltd	6,000,000	100	16.00%	3,703,250	21.06.01
Seylan Bank Ltd	6,000,000	100	floating	883,450	21.06.01

Source: Colombo Stock Exchange.

Themes of the "Sri Lanka: State of the Economy Reports"

1992	Macroeconomic Policy
1993	Export Sector
1994	Agriculture Sector
1995	Poverty Alleviation
1996	Workers' Charter
1997	Private Sector Expansion
1998	Demographic Change and Social Safety Nets
1999	Free Trade in South Asia
2000	Plantation Sector
2001	Competition Policy and Regulations
2002	Agriculture Sector