SRI LANKA

State of the Economy

2005

INSTITUTE OF POLICY STUDIES
99, St. Michael's Road, Colombo 3, Sri Lanka

National Library of Sri Lanka-Cataloguing-In-Publication Data

Institute of Policy Studies
Sri Lanka State of the Economy 2006 / Institute of Policy Studies .- Colombo: Institute of Policy, 2005
186 p.; 10 c.m.

ISBN 955-8708-47-X   Price:

i. 330 DDC 21   ii. Title
1. Economics

ISBN 955-8708-47-X

Price

Please address orders to:
Institute of Policy Studies
99 St Michael's Road, Colombo 3, Sri Lanka
Tel: +94 11 2431 368, 2431 378 Fax: +94 11 2431 395
Email: ips@ips.lk
Website: www.ips.lk

This report was prepared by a team led by Dushni Weerakoon under the overall guidance of the Executive Director of the Institute of Policy Studies - Saman Kelegama. The research team consisted of Nisha Arunatilake, G.D. Dayaratne, Deshal de Mel, Roshani de Silva, Dinusha Dharmaratne, Tharindu Gajaweera, Ayodya Galappattige, Asha Gunawardena, Wimal Hettiarachchi, Douglas Jayasekera, Shantha Jayasinghe, Ruwan Jayatilaka, S.A. Karunaratne, Mathew Kistler, Malathy Knight-John, Amrit Rajapakse, Parakrama Samaratunga, Paul Steele, Manoj Thibbotuwewa, Ganga Tilakaratna, Apsara Thurairetnam, Shelton Wanasinghe, and Bilesha Weeraratne. We are grateful to Indika Siriwardena and Deepika Nawavickrama for data support, Manu Tissera-Gunesekera and D.D.M Waidyasekera for editorial support and Asuntha Paul for formatting. The views expressed in this publication are those of the research team and do not necessarily reflect those of the Institute of Policy Studies.

Contents

Policy Perspectives and Performance

Tsunami: Policy Issues, Lessons and Challenges

Leading Issues in the Development Process

Policy Briefs

Prospects

Appendices

LIST OF FIGURES

LIST OF TABLES

LIST OF BOXES

LIST OF ABBREVIATIONS

ASEAN	-	Association of South East Asian Nations
ASPI	-	All Share Price Index
BIMSTEC	-	Bay of Bengal Initiative for Multi Sectoral Technical and Economic Cooperation
BOP	-	Balance of Payments
CBO	-	Community Based Organization
CBSL	-	Central Bank of Sri Lanka
CEB	-	Ceylon Electricity Board
CEPA	-	Comprehensive Economic Partnership Agreement
CFA	-	Ceasefire Agreement
CPC	-	Ceylon Petroleum Corporation
CRB	-	Cooperative Rural Bank
ECB	-	European Central Bank
EPF	-	Employees Provident Fund
ETF	-	Employees Trust Fund
EU	-	European Union
FAO	-	Food and Agricultural Organization
FDI	-	Foreign Direct Investment
FMRA	-	Fiscal Management Responsibility Act
FTA	-	Free Trade Agreement
GATT	-	General Agreement on Tariffs and Trade
GDP	-	Gross Domestic Product
GNP	-	Gross National Product
GOSL	-	Government of Sri Lanka
GSP	-	Generalized System of Preferences
GSTP	-	Global System of Trade Preferences
ILO	-	International Labour Organization
INGO	-	International Non Governmental Organization
IPO	-	Initial Public Offering
IRDP	-	Integrated Rural Development Project
ISFTA	-	India-Sri Lanka Free Trade Agreement
LDC	-	Least Developed Countries
LGI	-	Local Government Institution
LTTE	-	Liberation Tigers of Tamil Eelam
MDG	-	Millennium Development Goals
MFA	-	Multi Fibre Arrangement
MFI	-	Micro Finance Institution
MFN	-	Most Favoured Nation

MLI	-	Milanka Index
MOU	-	Memorandum of Understanding
MPCS	-	Multi Purpose Cooperative Society
NAFTA	-	North American Free Trade Agreement
NAMA	-	Non Agricultural Market Access
NDTF	-	National Development Trust Fund
NEER	-	Nominal Effective Exchange Rate
NGO	-	Non Governmental Organization
OBA	-	Output Based Aid
ODA	-	Overseas Development Assistance
OECD	-	Organization for Economic Cooperation and Development
PC	-	Provincial Council
PO	-	Partner Organization
PSFTA	-	Pakistan-Sri Lanka Free Trade Agreement
PTA	-	Preferential Trade Agreements
RDB	-	Regional Development Bank
REER	-	Real Effective Exchange Rate
ROO	-	Rules of Origin
SAARC	-	South Asian Association for Regional Cooperation
SAFTA	-	South Asian Free Trade Agreement
SEMA	-	Strategic Enterprise Management Agency
SLT	-	Sri Lanka Telecom
SME	-	Small and Medium Enterprises
SMI	-	Small and Medium Industries
SSCP	-	Sethusamudram Shipping Canal Project
TAFREN	-	Task Force for Rebuilding the Nation
TCCS	-	Thrift and Credit Cooperative Societies
TEWA	-	Termination of Employment of Workers Act
THRU	-	Tsunami Housing Reconstruction Unit
TPA	-	Trade Promotion Authority
TRCSL	-	Telecommunications Regulatory Commission of Sri Lanka
UNCTAD	-	United Nations Conference on Trade and Development
VAT	-	Value Added Tax
WLL	-	Wireless Local Loop
WTO	-	World Trade Organization

Policy Perspectives and Performance

1. Policy Perspectives

Sri Lanka suffered its worst natural disaster on December 26 2004 that was to claim more than 36,000 lives, displace another 800,000, cause extensive losses to livelihood and inflict widespread damage on infrastructure along the country's coastline, particularly, along the Eastern, Northern and Southern coastline. While the immediate negative economic impact of the tsunami on the Sri Lankan economy is likely to be limited to a reduction in GDP growth in the range of 0.7-1.0 per cent, it will have less visible, but critically important, socio-economy wide effects. Indirect and secondary impacts – such as the destructive effects on established market and social institutions and networks, on livelihood opportunities, and on perceived inequities in the regional distribution of reconstruction efforts – can have significant implications for longer term growth, poverty reduction, socio-political harmony, and other development objectives.

As in most natural disasters in the developing world, the victims in Sri Lanka were disproportionately the poorest socio-economic groups, especially those involved in fishing and on the margins of the tourist economy. Even where development finance is available there will be difficult questions about how to restore livelihoods that were, to start with, vulnerable to income disruption. Simply restoring the status quo before the disaster is clearly not enough if the reconstruction and rehabilitation efforts are to address the broader conditions of poverty in the country.

The economic challenges for an effective recovery are immense. Previous experiences of natural disasters globally suggest that after a brief deceleration in growth, economic growth can rebound as a result of the stimulative effect of reconstruction. The scale of the rebound, however, depends critically on the prior macroeconomic or structural strength (or vulnerability) of the economy to such a 'shock'. In this respect, the prior degree of exposure of the Sri Lankan economy was relatively high. The country was already grappling with a progressive decline in economic growth from the second quarter of 2004 and a deteriorating macroeconomic environment prior to the tsunami disaster.

Election related uncertainties and the ensuing policy vacuum contributed to a slowdown in economic activity. Pre-election pledges on providing employment and subsidies took a toll on government finances once in office. Elected as it was on a platform that appeared to suggest a departure in certain policy areas – such as on privatization/ deregulation – meant that movement towards implementing a reform programme has been slow. The inability to get the peace process – stalled since April 2003 – off the ground and delays in renegotiating the economic programme with multilateral financial institutions meant that Sri Lanka could not benefit much from donor aid in 2004.

Domestic policy constraints were exacerbated by unfavourable developments in the external sector in the form of continuing high international oil prices. The most visible, and potentially the most destabilizing manifestation of a weakening macroeconomic environment was a persistent build-up of inflationary pressure from mid-2004. Inflationary pressure was fuelled on multiple fronts. On the current account, a widening trade deficit continued to put downward pressure on the exchange rate; efforts to support the rupee – indicated by the decline in gross official reserves from US$ 2.3 billion at the beginning of 2004 to US$ 1.9 billion by November 2004 – proved largely ineffective in stemming a depreciation of the currency by 8.5 per cent against the US dollar in the same period. While Sri Lanka's rate of investment improved in 2004, it has been on the back of increased foreign borrowing by the commercial banking sector – given limited access to foreign currency in the domestic market – raising the country's foreign private debt exposure. On the fiscal account, government borrowing remained high as the cost of subsidies built up; transfers and subsidies increased from 4 per cent of GDP in 2003 to 5.2 per cent 2004. The end result has been credit growth to the government at over 20 per cent, fuelling inflationary pressure further. The acceleration in inflation in recent months has been brisk. At an annualized rate, inflation for the first 7 months of 2005 already stands at over 12.8 per cent.

Rising inflation and signs of a progressive slow down in economic growth – GDP growth for 2005 has already been revised down to an anticipated rate of 5.3 per cent – presents the government with a policy dilemma. A significant hike in interest rates will slow down the growth momentum further. On the other hand, if interest rates remain unchanged for the most part, allowing real rates to fall, this will cushion the initial impact on output, but at a possible risk of higher inflation later, and hence eventually a sharper slowdown. Rising inflation, however, poses more severe risks for the sustainability of medium-term economic growth. Inflation also hurts the poor disproportionately more than it does the rich.

Monetary authorities have been slow to respond despite evidence to suggest that inflationary pressure is unlikely to abate in the coming months. The benchmark rates were revised upwards by only 50 basis points in November 2004 despite signs of accelerating inflation since mid-2004. A marginal increase of a further 25 basis points in May 2005 was followed more appropriately by another upward adjustment of 50 basis points in June 2005. The most pervasive risk perhaps is that in an environment of heightening inflationary expectations, monetary policy may need to be tightened more than when inflationary expectations are low. The Sri Lankan economy still has plenty of slack according to the usual measures; the unemployment rate stands at 8.5 per cent, industrial capacity utilization is 85 per cent. Nevertheless, if workers and firms expect inflation to increase, they will seek higher wages and prices in anticipation.

If a substantial gap is allowed to develop between the rate of inflation and interest rates over a prolonged period of time, it can lead to misallocation in resources that is harmful for any economy. Exceptionally low cost of capital distorts economies by encouraging firms to invest in labour-saving machinery rather than hire new workers. Holding interest rates too low creates excesses – credit and investment will rise too rapidly and households will save less and spend more. It can also encourage investment in riskier assets – including in the stock market – as investors search for higher yields amid falling interest rates. There is already growing evidence of such excesses in the Sri Lankan economy: a sharp increase in credit growth to the private sector in excess of 20 per cent, with an estimated 40 per cent of the increase for consumption spending; and a boom in the Colombo stock market unsupported by major indicators of economic fundamentals.

There is little to suggest that inflationary pressure will ease over the coming months of its own accord. The global economy is anticipating the current trend of high international oil prices to continue. For Sri Lanka, the post-tsunami environment where higher inflows of foreign capital are expected, is likely to further complicate monetary policy management. A surge in capital inflows can potentially create a 'Dutch Disease' effect of leading to an appreciation of the real exchange rate. Following the initial aid inflows in early January 2005, the rupee rallied sharply to appreciate by nearly 6 per cent against the US dollar. While this early appreciation no doubt held an element of overshooting fed by unwarranted expectations, there is the potential for an appreciating real exchange rate. The downside of a real appreciation is that it makes Sri Lanka's exports less competitive in the international market. A measured response would be required to ensure that there is no excessive credit creation – that will allow the real exchange rate appreciation to take place through higher domestic inflation – as a result of capital inflows. The monetary authorities have been conducting open market operations to take some of the liquidity off the system as capital has flowed in. To a large extent, this process has been facilitated by the nature of captive sources of funding available to the government. However, there will be a limit to how far such an exercise can be carried out without offering returns commensurate with the rate of inflation.

The constraints on monetary policy point to the need for fiscal policy consolidation. An environment of high inflation and low interest rates may offer a short term reprieve to fiscal policy management – it makes government borrowing cheaper and eases debt service payments – but is much more harmful for the health of the economy in the longer-term. While aid assistance will take significant pressure off government finances in the reconstruction phase, Sri Lanka will still be looking to finance an underlying fiscal deficit in the range of 8 per cent. The additional injection of expenditures for the reconstruction makes it even more critical that the government is prepared to take measures to increase revenues and restrict expenditures so that the economy does not overheat.

Even with a substantial donor commitment towards the additional expenditures, the post-tsunami financing needs are unlikely to have a 'budget neutral' impact. There was a welcome increase in tax revenue in 2004 and overall revenue collection appears to be on target for 2005. On the expenditure side, however, some reshuffling is likely in order to supplement aid inflows: recurrent expenses may not be covered in the over reliance on short-term capital funding for projects; additional expenditures or a partial reallocation can lead to postponement of planned investments. In turn, it could lead to widespread, but largely non-transparent, reallocations of resources. The added budgetary pressures from the tsunami should not be used to explain away fiscal problems partly attributable to other causes, thus deflecting pressure for policy change and implying efforts to address other underlying causes of budgetary difficulties might be postponed.

Structural problems lie at the root of Sri Lanka's fiscal difficulties, not least of which is the burden on the Treasury of being a subsidizer and employer of last resort. Absorption of over 40,000 unemployed graduates to the public service without implementing public sector reforms in tandem adds a burden on both government expenditures and productivity of the public sector. A heavy burden on subsidies has been incurred in 2004 in the face of a stalled reform programme to restructure public utilities. It does not help that subsidies often go to those who do not need them while on the other hand, those who most need it often miss out on social and pension spending. The State as a provider of subsidies and employment is not sustainable in the face of competing demands to improve long-term investment in health care, human capital and infrastructure.

Departures from the model of the State as a provider towards that of a regulator have raised many new questions about the divisions between public and private and what remains as uniquely the role of the State. There is evidence to suggest that a country's internal economic integration – the development of its human capital and market institutions – can be stimulated by government involvement. The State also has a key role to play in ensuring an equitable and efficient operation of the market to limit damaging externalities with regard to health, welfare, income distribution and the environment that markets, left alone, can generate.

But certain public activities can be delivered by a diversity of actors, both public and private, and may require that an appropriate combination of the two is adopted. Policy proposals to rationalize public enterprises without the flexibility to attract new capital from the private sector (both local and foreign) or to restructure the labour force will not be entirely productive. In the same vein, while the State has a role to play in focusing investment on job-creating sectors in competitive and productive areas, it must also provide an attractive regulatory environment for employment generation. Reforms undertaken under intense pressure from trade unions, such as the amendments to the Termination of Employment of Workers Act (TEWA) gazetted in March 2005 that launched a new compensation formula, may prove counterproductive. It included an increase in the maximum payable compensation to 48 months of salary. As the compensation is to be given to employees in addition to gratuity, EPF, and ETF payments, employers may hesitate before taking on new workers if retrenchment proves too costly.

Besides reforms in the labour market, reforms to Sri Lanka's education sector remain mired in political rhetoric. Education reforms have received varying levels of policymaker support in Sri Lanka where public funding has been synonymous with free supply and access to higher education. However, the growing demand for qualifications in business, commercial law, computing, etc., are likely to drive a greater number of students towards higher education in the future. Given this rising demand, strategies for reforming the management and financing of higher education have to be re-considered and discussed: what the possible effects are of private participation on equity and efficiency; what trade-offs emerge in policy design; and what kind of activities can be delegated to private parties and what should be provided by the government, etc.

The near paralysis in implementing structural reforms remains a cause of concern. Sri Lanka is likely to face testing times ahead in generating employment and foreign exchange earnings in the industrial sector in the new quota free international trade regime in garments. Preferential access to markets – through free trade agreements or special incentives schemes such as the generalized system of preferences (GSP) – can increasingly offer only short-term relief. Current trends towards expansion of preferential treatment combined with efforts to further reduce tariffs under the Doha Round negotiations of the World Trade Organization (WTO) will contribute to preference erosion over time. The ability of an industry to remain competitive will be the key determinant of performance. This requires a certain degree of flexibility to restructure its labour force or to access basic infrastructure facilities at a cost that does not erode international competitiveness.

In such circumstances, the importance of a conducive domestic policy environment cannot be over-emphasized. The Sri Lankan political and policymaking establishments have fallen short of expectations. Efforts to implement structural reforms need a concerted political will. Although the country's two major political parties are committed to raising the long-term growth rate, and broadly agree on how to achieve that, given that each defines itself in opposition to the other leads to policy paralysis over time. One clear example is the vacillation between alternative governments in implementing measures to strengthen electric power generating capacity in the country. The end result has been spiraling energy costs that undermine the international competitiveness of the country's industrial sector.

A government's responsibility is to ensure a consistent economic policy framework, an environment that facilitates private sector participation and a semblance of political stability in the country. The lack of political stability seen in more recent years is likely to continue to undermine Sri Lanka's economic prospects. While the country's electoral system appears to invariably ensure that coalitions have to be formed, it leads to political instability that deters private investors. Coalition governments have their strengths; balancing divergent views and accommodating regional and sectoral views more effectively. But they also impose constraints; governments increasingly have to grapple with political obstacles to reform which can surface in coalitions with smaller parties that advance the interests of narrower constituencies. Perhaps most alarmingly, Sri Lanka is increasingly seeing a shortening of the time horizon of governments in power which can further induce incumbent governments take a very short-term view on policy reform.

Political stability is vital if the autonomy and the capacity of the State to respond to the rehabilitation and reconstruction needs of the tsunami affected areas is not to be constrained. The quality of the governmental response will determine to a large part whether a catastrophe becomes a major political and social crisis. The dislocation of large population groups has important impacts on social and political stability, including the emergence of new pockets of vulnerable groups amongst the urban poor. And as in most natural disasters in the developing world, the victims in Sri Lanka were disproportionately the poorest socio-economic groups. They remain the most vulnerable to natural hazards that transform into human and economic disasters. Their vulnerability comes from widespread poverty, poor land use regulations, degradation of the environment resulting from mismanagement of the environment, inefficient public policies, and lagging investments in infrastructure.

The importance of political and institutional factors in managing an effective recovery cannot be over-emphasized. Despite the best efforts, many shortcomings of the existing government institutions were highlighted in the immediate aftermath of the tsunami. There are challenges in maintaining accountability and transparency where provincial governments are in charge of many aspects of local expenditures; as a matter of political necessity, there may be pressure for aid to be channelled to unaffected areas. The sheer number of donors and programmes following a major disaster can also create a complex web of aid transactions that is difficult for donors and recipients to manage.

Centralized government-directed management systems as opposed to localized and decentralized ones may offer alternative approaches to ensuring financial and political stability. Centralized decision making processes that fail to ensure adequate consultation and local buy-in – whether on moving settlements away from the coast, changing building codes or amending fishing regulations – increases the chances that impoverished victims may chose to drift to cities seeking employment. Local communities should be consulted as much as possible to ensure that the structure of economic governance does not exclude their voice and influence. The tsunami relief and reconstruction effort has brought into sharp focus the need to strengthen the capacity and capabilities of local government entities.

A sound governing structure to carry out the reconstruction will be an important element in accessing the donor funds already pledged. The government has been successful in taking the initial step of having funds committed. It must now ensure accountability and transparency in aid disbursement, and a commitment to fight any signs of corruption in the reconstruction process. Sri Lanka will also have to improve on its aid utilization rate; that might, however, prove easier than anticipated in the tsunami reconstruction process given that the government is likely to face limited conditions on the provision of counterpart funds.

Sri Lanka must also have realistic expectations about how much funds will actually be forthcoming. International experience suggests that substantial gaps emerge between pledged and actual aid disbursement following a major disaster despite the best intentions on the part of donors. In part, this can reflect management constraints – such as procedural difficulties, procurement delays, lack of local counterpart finance, etc. In part it also suggests that disaster related external assistance may not be entirely additional beyond the initial year of impact. While the immediate response involves some new money, rehabilitation needs are often met by switching aid money between uses rather than increasing total aid to the affected country. Thus, total aid commitments may increase in the year of a major disaster, but they tend to fall back after the crisis to reflect longer-term trends in aid inflows. Some of the bilateral aid that comes in is also likely to be 'tied' – used to buy anything from food products, telecommunications, transport and technical advice from the donor country – estimated to cut the value of aid to recipient countries by 25-40 per cent. It is important the country not squander the opportunity presented by the generous offers of assistance, keeping in mind that donor attention can shift away as quickly by other priorities than rebuilding crisis-struck areas.

For an effective recovery, much will depend, therefore, on how the government manages the reconstruction in tandem with the implementation of a credible medium-term economic programme. Measures and policies must take account of the specific economic, political and institutional realities of the country – the particular problems in the Northern and Eastern Provinces, the needs of poor not directly affected by the tsunami, etc. – and be consistent with the fundamental policy objectives of sustainable growth, equity and poverty alleviation.

Economic growth has lifted living standards, but expectations have risen even faster. Delays in implementing reforms will in the long term further undermine growth prospects for the Sri Lankan economy. A failure to deliver results – be it to meet the most visible short-term humanitarian needs of the tsunami affected population or more general demands for goods and services and livelihood opportunities – will have important impacts on social and political stability in the country.

These inter-connected issues – the domestic and global economic developments and their impact on the country's garments industry, policy measures to address industrial restructuring, and implications for reforms in the telecommunication services sector; improving the livelihood opportunities of the poor through rehabilitation of the tsunami affected regions, and implementation of microfinance programmes; issues of equity in the public and private sector domains such as in the delivery of public education, or privatization of agricultural extension; means of strengthening local capacities through more effective decentralization, etc., – will be taken up in more detail in the rest of the report.

2. Economic Performance

2.1 Introduction

In the face of several adverse developments, the Sri Lankan economy was able to post only a modest growth rate of 5.4 per cent in 2004 compared to a growth rate of 6 per cent achieved in 2003. The slowdown in the growth momentum was reflected in a general weakening of the country's macroeconomic performance overall. While investment levels improved during 2004, there was no corresponding increase in domestic savings leading to an increase in the external deficit. A depletion of external reserves saw the exchange rate depreciate against major currencies. Economic performance was also marked by an increase in inflation, a combined result of cost push and demand pull factors. The negative growth in the agricultural sector and the lower-than-average growth in the industries sector are likely to have impacted adversely on employment and poverty levels.

While a number of factors beyond the control of policy decisions - such as adverse weather conditions that impacted negatively on agricultural output and continued high international oil prices - contributed to the deterioration in economic performance, so too did inadequate policy responses. Little progress was made on economic reforms, particularly restructuring of government owned enterprises. Hesitation on the part of the government to pass on high fuel costs meant heavy borrowing for the purpose of subsidies that added to inflationary pressure in the economy. On a more positive note, the ceasefire agreement (CFA) between the Government of Sri Lanka (GOSL) and the Liberation Tigers of Tamil Eelam (LTTE) held - albeit with incidents of violations - thus maintaining a degree of peace in the country.

The year itself ended with the country experiencing a natural disaster of unprecedented scale causing a massive loss of life and economic assets - an event likely to have serious repercussions on the economic prospects both in the short and longer term. The anticipated growth forecast for 2005 has been revised downward to 5.3 per cent in view of the adverse impact of the tsunami on economic output. However, with pledges of generous external assistance, the country has the potential to rejuvenate itself with the planned reconstruction programme. If effectively implemented - forestalling risks of overheating the economy and consequent price inflation and external imbalances - through prudent macroeconomic management, it is possible to accelerate Sri Lanka's growth momentum during the next 2-3 years.

However, growth prospects will be conditioned by several external and internal factors. Sri Lanka's export oriented garments industry will face the risk of erosion of its market shares in a quota-free environment. Sri Lanka will also have to grapple with high cost of energy due both to escalating world petroleum prices and poor management of the domestic power industry. On the domestic front, whether the reconstruction phase will allow any subsequent growth momentum to be sustained will depend on the government's commitment and ability to improve the policy environment through effective implementation of an economic reform programme.

2.2 Output Growth

Sri Lanka's average annual growth rate of GDP at 5.1 per cent during the three year period ending 2004 is not adequate to meet the country's development objectives of reducing levels of poverty and unemployment. Growth has been driven primarily by the services sector which grew at an average annual rate of 7.2 per cent, contributing more than 75 per cent to the overall increase in output during this period. Agriculture and industries sectors recording average annual growth rates of about 1.1 per cent and 3.9 per cent, respectively, made up the rest.

The most significant feature of the growth pattern is that the services - in particular, trade, port services and other transport, telecommunications and financial services - have now emerged as the most dynamic activities. While the industries sector contributed 20 per cent to the overall increase in GDP during the three years ending 2004, the manufacturing sub-sector has recorded a particularly impressive growth rate. One contributory factor has been the presence of relatively

Box: 2.1
Restructuring State Owned Enterprises: The Temasek Model?

Despite the privatization of a total of 53 commercial state owned enterprises (SOEs) over the period 1994-2003 in Sri Lanka, there still exists a further 68 such enterprises under the purview of the government. In 2004, the government established the Strategic Enterprise Management Agency (SEMA) charged with the task of overseeing the restructuring - as opposed to privatization - of such public commercial enterprises. Twelve strategic public enterprises have been brought under the oversight of SEMA since its establishment.

There appears to be an attempt to model the SEMA restructuring exercise of SOEs along the lines adopted in Singapore. Temasek Holding (Private) Ltd. was established by the government of Singapore in 1974 as part of an attempt to manage public investment in state enterprises. Control of selected enterprises - where the government retained voting shares of 20 per cent or more - was transferred to Temasek to operate as registered companies as any other private business enterprise. As such, accountability to corporate shareholders has ensured that such enterprises (referred to as Government Linked Companies) have largely operated as running profitable concerns.

The extent to which the Temasek model can be replicated in Sri Lanka under the oversight of SEMA remains unclear. It would require that the management of such enterprises is given a relatively free-hand in the restructuring exercise and permitted to run as profitable operations. The Singapore model is built around the concept of transfer of share capital to Temesek Holdings. However, no such share ownership is vested with SEMA while some of the enterprises (e.g., Department of Railways) do not even have share capital. Effectively, it means that SEMA cannot be held accountable for performance unlike in the Temasek model. If the government continues to remain as the major shareholder - as in many of the enterprises currently under SEMA - restructuring will continue to be dogged by political intervention and lack of accountability. Reforms currently under way through Performance Contracts (introduced to the two state owned commercial banks) have shown some positive outcomes in terms of improvements on performance, but such partial reforms are still a far cry from attempting to emulate the Temasek model.

Table 2.1
Average Growth Rates and Contributions to Increase in GDP (2002-2004)

Sector	Average Growth Rate (%) 2002-04	Contribution (%) 2002-04	Average Growth Rate (%) 2003	2004	2004 (q1)	2005 (q1)
Agriculture	1.1	4.3	1.6	-0.7	-0.3	0.5
Industry	3.9	20.5	5.5	5.2	5.8	6.9
Services	7.2	75.2	7.9	7.6	9.5	5.3
Trade, hotels & restaurants	6.4	27.3	7.8	6.0	9.7	-1.2
Financial services	9.4	15.9	10.6	6.6	9.8	6.1
Post & telecom	24.5	19.2	23.9	31.3	31.1	34.8
GDP	5.1	100.0	6.0	5.4	6.4	4.8

Source: Central Bank of Sri Lanka, *Annual Report* and *Monthly Economic Indicators*, various issues.

slow moving agricultural processing and cottage industry activities. However, even the output in the factory industry sub-group which now dominates the manufacturing sector has been growing at less than 5 per cent per annum during the last three years. The electricity, gas and water sector which had in the past been one of the more dynamic sub-sectors has shown negative growth during 2004, reflecting basically the poor performance of the power sector. This is a matter for concern; an outcome of slippages in public sector management that needs urgent attention before it becomes a serious impediment to economic growth all round.

Even though a decline in the relative position of agriculture can be expected as per capita incomes rise, in Sri Lanka's case the weak performance of the sector appears to be related to other factors as well. During the three year period ending 2004, production of coconuts actually declined while production of paddy fluctuated without showing any sustained growth trend. Production of tea increased in 2004 relative to the previous year but it is still below the peak reached in 2002, while that of rubber has shown some dynamism in response to a boom in international prices.

Thus, the contribution of the major crops to the overall agricultural production has been minimal. The modest growth achieved during the recent period has come basically from the miscellaneous group of 'other agricul-

Table 2.2
Selected Indicators of Production in Agriculture and Industry

Sector / Sub-sector	2000	2001	2002	2003	2004
Tea (mn kg)	305.8	295.1	310.0	303.3	308.1
Rubber (mn kg)	87.6	86.2	90.5	92.0	94.8
Coconuts (mn nuts)	3096	2769	2392	2562	2557
Paddy (metric tons)	2860	2695	2859	3071	2609
Value of industrial production[a]	213.0	204.6	210.5	220.0	233.4

Note: a. Rupees billion at 1990 constant prices.
Source: Central Bank of Sri Lanka, *Annual Reports*, various issues.

ture' that includes vegetables, fruits, subsidiary food crops, minor export crops and animal husbandry. The fisheries sub-sector which suffered a major set-back due to the civil conflict during the last two decades has recorded only a nominal growth during the last three years. It was one of the more severely affected sectors by the tsunami disaster in December 2004 and its contribution to economic growth in the immediate future remains uncertain.

2.3 Employment and Income

The Quarterly Labour Force Survey (QLFS)[1] estimated that in 2004 Sri Lanka's labour force and employment were approximately 8.0 million and 7.3 million, respectively. The labour force participation rate has shown a tendency to increase very slowly and now stands at about 50 per cent. The participation rate for women is about half that of men.

The findings of the Central Bank's Consumer Finances and Socio-Economic Survey 2003/2004 reveal that a large majority of the employed people - about 70 per cent - are in the 'informal sector'[2] which means that they may not be enjoying the protection traditionally provided by the elaborate system of labour laws in Sri Lanka by way of job security, trade union rights and retirement benefits. While the presence of such large numbers in the unprotected segment may offer some degree of flexibility to the labour market they also tend to be the most vulnerable to loss of livelihoods in the absence of recourse to some form of safety nets. Informal sector workers, for example, were the most severely affected by the tsunami disaster, increasing the likelihood of greater levels of poverty unless their livelihood opportunities are restored as quickly as possible.

During the latter half of the 1990s, overall employment has been increasing at a rate higher than that of the labour force; at present, around 91 per cent of the labour force is categorized as employed. Of these, about 47 per cent and 13 per cent are employees in the private and public sectors, respectively. An additional 29 per cent are self employed and the balance constitutes the unpaid fam-

Table 2.3
Trends in the Labour Force, Employment and Unemployment

	Thousands		Average Growth Rates[a]	Percentage Share	
	2000	2004	1997-2002	2000	2004[a]
Labour Force	6827	8003	2.1	100	100
Employment by main sector	6310	7319	2.6	92.4	91.4
Agriculture	2274	2485	...	33.3	31.0
Industry	1491	1607		21.8	20.1
Services	2545	3227	5.3	37.3	40.3
Unemployment	517	684	...	7.6	8.5

Notes: (...) indicates no significant change.
a. Average of the quarterly values of the first three quarters.

Source: DCS, *Quarterly Labour Force Survey*.

1 The estimates are for the second quarter. Starting in the second quarter of 2004, the survey sample has been increased again to cover the whole country for the first time after 1990. However, due to changed coverage, these estimates are not strictly comparable with those for the preceding period.

2 This of course includes those employed in traditional agricultural and fishing activities.

ily workers and employers. The distribution of employed population among the main sectors of the economy broadly conforms to the sectoral pattern of GDP growth; the services sector absorbing the largest share as indicated in Table 2.3. However, there are wide differences in output per employee between agriculture and non-agriculture,[3] reflecting perhaps the peculiar nature of most agricultural employment such as seasonality, underemployment and low profitability of many traditional agricultural pursuits. The average labour productivity in the 'growth sectors' of industry and services is more than double that of agriculture. While the agriculture sector overall may indicate evidence of having reached its limit in labour absorption, diversification of the sector into more dynamic niche activities will be an important factor in generating more productive employment in the sector.

The QLFS estimates indicate a break in the declining trend in the rate of unemployment in 2001; and thus, by the third quarter of 2004 it had climbed to 8.5 per cent - nearly 1 percentage point higher than the value observed in 2000. This reversal is in part a consequence of the negative growth experienced in 2001 and the failure of the labour intensive industries to generate adequate dynamism in the recent period. It is possible that the statistics drawn from the QLFS on which the unemployment indicators are based are unsuitable for comparisons over time due to recent changes in its geographical coverage. However, the fact that unemployment in Sri Lanka tends to be concentrated among certain groups - such as young people, women and those who have gone through secondary and higher education - makes the current rate of unemployment too high to be complacent about. It may become a serious impediment to achieving peace and social stability. Therefore, its reduction should justifiably be regarded as a prime objective of development policy.

According to the national income estimates, Sri Lanka's per-capita GNP crossed the US$ 1000 threshold in 2004. Average per capita incomes nevertheless hides wide differences in income levels of various groups - differences that explain to some extent the prevalence of poverty in the country. The income distribution pattern revealed in the most recent Consumer Finances and Socio-Economic Survey (CFSS) of the Central Bank of Sri Lanka suggests that income is heavily skewed towards the higher income categories. However, this is not a new development and Sri Lanka's case is neither unique nor unusual; the uneven distribution of income where the richer groups enjoy a large share of the total income while the poorer groups have to contend with a disproportionately small share appears to characterize underdevelopment in many parts of the world. Nevertheless, it is important for reasons of socio-political stability to ensure that appropriate development policies are designed to reduce its severity.

The relatively high income inequality is also reflected in inter-province income differences revealed in the CFSS. The average income indicators (household and income receiver based) for each of the nine provinces shows that a relatively large disparity exists between the Western Province and the rest of the country. Thus, the pattern of GDP growth, labour productivity and income distribution at present tend to enhance the higher incomes and living standards concentrated in the Western and adjacent provinces where the more dynamic sectors of services and industries are located, while low incomes and

---

[3] GDP (at current Factor Cost Prices) per employee in agriculture, industry and services during 2004 works out to be Rs. 129,000, Rs. 300,000 and Rs. 309,000, respectively.

poverty generally characterize the remote areas of the country where agriculture, fishing and other primary activities predominate.

2.4 Investment and Savings

After a sharp drop in the investment/GDP ratio in 2002 indicating a slowing down of investment activity in both private and public sectors, there has been only a slow recovery. In 2004, the estimated fixed capital formation reached 25 per cent of GDP which is still lower than the average reached during the latter half of the 1990s. Since the share of public investment has been declining relative to GDP during the recent period as a consequence of budget constraints, and direct foreign investment is still an insignificant share of the total, it is domestic private investment that is increasingly determining the overall investment performance in the country. In 2004, the share of domestic private investment (including that of public corporations) in total fixed capital formation was about 91 per cent with the major shares going into building and other construction (59 per cent) and plant and machinery (25 per cent).

The movement of the domestic savings ratio followed a pattern similar to that of the investment, albeit with a moderate annual fluctuation. There is no simple explanation for the behaviour of the savings ratio during a given period. In the long run, given Sri Lanka's specific income distribution pattern - a significant concentration of incomes at the higher end, the potential for higher rate of savings exists. However, it appears that this potential has not been fully realized perhaps due to the intervention of short-term factors such as poor overall growth performance of the economy, lack of dynamism of the export sector, the large size of the public sector deficit (Table 2.5) among others. Financial savings which account for about a third of all domestic savings is also likely to have been affected adversely by the prevailing negative real (deposit) interest rate for much of 2004 (Table 2.7).

2.5 Fiscal Policy and Public Debt

Sri Lanka failed to consolidate its fiscal situation in 2004 with the budget deficits - current and overall - exceeding the targets set in the approved estimates by considerable mar-

Table 2.4
Selected Indicators of Investment and Savings

	2000	2001	2002	2003	2004
As % GDP					
GDFCF[a]	28.0	22.0	21.2	22.1	25.0
Private investment	21.5	16.2	16.5	16.8	19.8
Public corporations	3.3	2.8	2.6	3.0	2.9
Government	3.3	3.0	2.0	2.3	2.2
FDI	1.0	0.5	1.1	0.9	1.1
Domestic savings (%)	17.4	15.8	14.4	15.9	15.9
National savings (%)	21.5	20.3	19.5	21.6	21.6
Inflation rate[b]	6.2	14.2	9.6	6.3	7.6
Average deposit interest rate (%)[c]	9.9	10.8	7.5	5.3	5.3

Notes: a. Gross Domestic Fixed Capital Formation.
b: Colombo Consumer Price Index.
c. Average Weighted Deposit Rate (AWDR).

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

gins. This led to higher-than-planned borrowing from domestic sources and diversion of financial resources from capital projects, further reducing the share of public investment. The poor performance in the fiscal area may be attributed to slippages in the implementation of several overdue institutional reforms, both in the areas of revenue and expenditure and the added burden on the budget caused by a number of newly introduced relief measures of doubtful value.

The current account which has been continually in deficit during the last 16 years failed to meet the deficit target again in 2004. Since even a small deficit in the current account means that the government has to borrow in the market to meet a part of the regular payments such as salaries and pensions, contractual services and interest on public debt, the presence of a continuing and significant current account deficit is a significant indication of underlying structural weaknesses in fiscal management. The size of the overall deficit of between 8-9 per cent of GDP itself is excessive when compared to other developing countries. As in the case of the current account deficit, the target set in the annual budget has rarely been met and in the absence of committed policy reforms, fiscal consolidation is set to remain elusive.

Budgetary targets set for 2005 have been revised following the tsunami disaster to take account of expenditures required for the reconstruction effort. According to estimates of the CBSL, the new revenue and expenditure targets will be 16.9 and 26.5 per cent of the revised GDP instead of the pre tsunami targets of 17.1 and 24.6 per cent. Thus, the overall deficit is expected to be close to 9.5 per cent of GDP, but the likely higher inflow of foreign financing is expected to reduce the domestic financing to 3.6 per cent. However, it is anticipated that the current account deficit is likely to be higher by at least 0.3 percentage points of GDP. Thus, the overall effect of the tsunami disaster on the public finances is that despite a temporary relief provided by an increase in foreign concessionary finance, the fiscal consolidation process has received a further set-back.

2.5.1 Revenue and Expenditure

Of the two basic components of government revenue, tax revenue accounts for about 90

Table 2.5
Selected Indicators of Public Finance

As % of GDP	2001	2002	2003	2004	2005[a]	2005[b]
Revenue	16.7	16.5	15.7	15.4	17.1	16.9
Current expenditure	21.6	20.9	19.0	19.2	18.4	18.5
Capital expenditure	5.9	4.6	4.7	4.3	6.2	8.0
Total expenditure	27.5	25.4	23.7	23.5	24.6	26.5
Current a/c balance	-4.9	-4.4	-3.3	-3.9	-1.3	-1.6
Overall balance	-10.8	-8.9	-8.0	-8.2	-7.6	-9.6
Domestic borrowing	8.8	8.0	4.5	5.8	4.6	3.6
Foreign financing (grants + concessionary loans)	1.4	0.6	2.9	2.2	2.5	
Total public debt	103.2	105.6	105.8	105.5	100.8	

Notes: a. Budget 2005 estimates.
b. Post-tsunami revised estimates.

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

per cent of the total and non-tax revenue accounts for the rest. The marginal reduction in the revenue/GDP ratio in 2004 compared to that of 2003 was caused mainly by a shortfall in non-tax revenues. Tax revenue actually increased as a percentage of GDP in 2004 and there are welcome signs that the improvement is continuing into 2005 (Box 2.2). Nevertheless, more can be done to ensure that the tax system and its administration are operating at a satisfactory level of efficiency. In fact, a number of problems have been identified and reforms to overcome them are already under consideration.

At present, according to provisional data for the year 2004, the main classes of taxes that constitute government revenue are as follows: value added tax (VAT) contributing 42.8 per cent of total tax revenue, excise duties (23.4 per cent), corporate and non-corporate income taxes (14.7 per cent), import duties (14.6 per cent) and other taxes (4.6 per cent). One significant feature of this composition is the relatively large share of indirect taxes. This means that the tax system is generally regressive and thus imposes an excessive burden on low income groups.

Despite the heavy reliance on indirect taxes, the overall yield has generally lagged behind increase in production and incomes in the economy, the tax buoyancy ratio being 0.82[4] - much lower than the ideal ratio of 1.0

Box 2.2
Budget 2005: Revenue Generation

In the first half of 2005, government revenue has increased by an impressive 22 per cent to Rs. 175 billion compared with Rs. 143 billion in the corresponding period of 2004. While a year-on-year comparison does not give an entirely accurate picture of the increase in revenue generated due to changes in revenue measures, the performance nevertheless is encouraging.

	Jun 04 (Rs. mn.)	Jun 05 (Rs. mn.)	Growth (%)	Budget 2005 (Rs. mn.)	% Collected end June 05
Tax revenue	129308	154713	19.6	351119	44.1
Income tax	15609	20959	34.3	55361	37.9
PDL	3265	4709	44.2	11428	41.2
VAT	56726	67845	19.6	142690	47.5
Excise tax	32397	33973	4.9	76865	44.2
Import duties	18797	21335	13.5	54815	38.9
Other	2514	5892	134.4	9960	59.1
Non-tax revenue	13718	20285	47.9	37923	53.5
Total revenue	143026	174998	22.4	389042	45.0

Source: Ministry of Finance and Planning.

Tax revenue which constitutes 90 per cent of revenue generation had grown by a healthy 20 per cent in the first six months of 2005. The improved tax revenue has been attributed to measures taken to address loopholes in the income tax system and the tax amnesty of 2003, improvements to refund procedures under the VAT, increased import duties (and cesses), etc. With 45 per cent of the envisaged total revenue of Rs. 390 billion set out in the Budget of 2005 already netted in the first half of the year, the government appears optimistic in meeting its full revenue generation target for the year.

[4] This is a rough estimate based on time series data for the period 1999-2004.

needed to ensure a healthy responsiveness to economic growth. There are several reasons contributing to low buoyancy not least of which is that the tax base has remained rather narrow. This is true of both direct and indirect taxes. Large sectors of the economy have been exempted from various production and sales based taxes on social welfare considerations. Many individuals and institutions avoid paying taxes due to weaknesses in tax laws and tax administration. Furthermore, there are many tax concessions, tax holidays and amnesties granted as incentives for investment and export activities. The relatively low share of income tax in the total tax revenue also appears to be inconsistent with Sri Lanka's specific income distribution pattern where there is a high concentration of income among the rich.

While the issue of low share of income taxes has received policy attention as evident by the 2004 budget, the government set aside a proposal made by the previous government to establish a unified revenue authority, due primarily to intense opposition to the proposal by trade unions and officials of the three departments. It is seeking instead to bring about changes within the existing institutional structure with a proposal to set up a more flexible mechanism to coordinate the activities of the several revenue departments in the form of a revenue board.

Total government expenditure in 2004 amounted to 23.5 per cent of GDP. Of this, 82 per cent was on current expenditure, the main components of which were outlays on provision of goods and services, interest payments and transfers and subsidies. Current expenditure has been on a declining trend relative to the GDP since 2000, primarily due to a gradual reduction of defense related purchases and a moderation in interest payments on government debt. A significant feature of the current expenditure in 2004 was the sharp escalation of transfer payments. There was a 59 per cent increase in transfers

Box 2.3
CEB Debt

The Ceylon Electricity Board (CEB) and the Ceylon Petroleum Corporation (CPC) in 2004 exerted considerable pressure on government borrowing. Total net domestic borrowing of the government increased to Rs. 117 billion (5.8 per cent of GDP) compared to the original target of Rs. 65 billion (3.2 per cent of GDP). The outstanding banking debt of public corporations rose by Rs. 5 billion to Rs. 41 billion in 2004.

Capital transfers to public corporations in 2004 increased to a record Rs. 19.1 billion as opposed to an approved estimate of Rs. 9.3 billion. Transfers for current expenditure were Rs. 20.4 billion as against the approved estimate of Rs. 15.9 billion.

The CEB is estimated to have posted a loss of Rs. 15 billion in 2004 and owe nearly Rs. 30 billion in short term debt to the banks. Its total accumulated debt is estimated at over Rs. 80 billion by end 2004 - equal to the average annual inflow of foreign aid to Sri Lanka.

The failure to revise prices in line with costs in an environment of continuing increases in international oil prices is a key reason for the operational losses of the CEB and the CPC. While price revisions would enable them to cut current losses, recapitalization is needed to ensure long term solvency. The Asian Development Bank (ADB) and the Japan Bank for International Cooperation (JBIC) together have US$ 60 million in loans outstanding linked to reforms in the power sector.

to households between 2003 and 2004. The increases were on account of inadequate adjustment of several administered prices to reflect actual costs, enhanced provisions for school uniforms and fertilizer subsidies. The fuel subsidy alone is estimated to have cost the Treasury Rs. 16 billion in 2004, required to cover the cost of selling of petrol, diesel, kerosene, and other related items below the automatic pricing formula. Transfers to some of the loss-making public enterprises such as the Sri Lanka Railways and the Department of Posts also contributed to the overall increase in current expenditure. The inability to rein in current expenditure has inevitably resulted in a decline in capital expenditure, undermining the long-term growth prospects for the country. The capital expenditure/GDP ratio fell further to 4.3 per cent of GDP in 2004.

2.5.2 Public Debt

A series of high budget deficits if maintained over a number of years must inevitably produce an unsustainable stock of public debt that will complicate fiscal and monetary management. In Sri Lanka, the stock of public debt has been in excess of 105 per cent of GDP is since 2002. This is a clear signal that not only measures to reduce the debt burden directly are needed but also that efforts towards fiscal consolidation - to bring the deficits down to levels that can be managed without recourse to expansionary finance - is urgently required. However, some policies followed more recently, particularly those involving permanent new commitments of current expenditure suggest a general lack of commitment to addressing the serious problem of public debt.

While the stock of debt outstanding now exceeds the annual GDP, the annual debt service payments absorb nearly 15 per cent of the GDP. Of this, nearly 85 per cent is on account of domestic borrowing usually made at the prevailing commercial rates while the balance - the debt service payments on foreign borrowings - are mostly at concessionary rates. There has been a significant easing of government debt service payments during 2004 from the high levels reached during the previous two years. This was the result of a drop in debt service payments on domestic debt - facilitated by low interest rates - and amortization payments on foreign debt.

The bilateral donor community has pledged a moratorium on debt repayment amounting

Table 2.6
Public Debt Indicators

	2001	2002	2003	2004	2005[a]
Domestic debt (Rs. bn.)	816.0	948.4	1020.0	1143.4	1183.9
Foreign debt (Rs. bn.)	636.7	722.0	843.9	996.1	935.9
Total debt (Rs. bn.)	1452.7	1670.3	1863.8	2139.5	2119.8
Amortization payments (Rs. bn.)	84.8	167.8	219.5	180.8	n.a
Interest payments (Rs. bn.)	94.3	116.5	125.1	119.8	n.a
Total debt service (Rs. bn.)	179.1	284.4	344.6	300.6	n.a
Debt/GDP (%)	103.2	105.6	105.8	105.4	n.a
Debt service/govt revenue (%)	76.4	108.6	124.6	96.5	n.a
Debt service/GDP (%)	12.7	18.0	19.6	14.8	n.a

Note: a. As at end March 2005.

Source: Central Bank of Sri Lanka, *Annual Report* (2004) and *Monthly Economic Indicators*.

to over US$ 300 million as part of the post-tsunami reconstruction and rehabilitation assistance. The effect of the flow of such assistance will probably be to reduce the foreign debt servicing obligations temporarily during the next 1-2 years. Even though it may not help to reduce the level of the government's outstanding foreign debt directly, it is an advantageous arrangement in that it offers the Treasury untied funds which could either be used to support capital projects or pay off a part of the outstanding debt, either domestic or local.

2.6 Inflation, Monetary and Capital Market Developments

The declining trend in consumer price indices observed since 2001 reversed from the second quarter of 2004. Since then, the rate of inflation has been moving up progressively indicating a resumption of inflationary pressures in the economy. By May 2005, the rate of increase of most consumer price indices had moved into double digit figures.

Both cost push and demand pull factors have impacted on the price level. The most important cost impact came from the sustained increase in world petroleum prices which also indirectly affected the price levels of several other key imports such as fertilizer. There were also significant price movements in several imported food items such as wheat, milk powder, rice, sugar and fruits during this period. The depreciation of the Sri Lankan rupee and the upward revision of taxes (mainly VAT on imports) also gave added impetus to rising import prices. Furthermore, the drought that prevailed during the latter part of 2003 and most of 2004 caused shortfalls in local food production. Rice and coconut - two of the staple food items - were thus affected.

Among the factors that contributed to increased aggregate demand were the recurring high budget deficits, increase in public service salaries (at least on two occasions during 2004 without any corresponding increases in productivity) and increases in transfers to loss making public corporations. Such transfers were partly due to the non-adjustment or inadequate adjustment of certain administered prices such as those of petroleum and electricity.

Financing of these expenditures were reflected in a sharp rise in monetary aggregates. Total domestic credit - the most important component of total money supply which had been increasing at an average rate of 7.0 per cent since 2001 - underwent a sharp increase of 22.4 per cent in 2004. The increase in domestic credit was driven by high demand

Table 2.7
Interest Rate Movements

Percentage change[a]	2001	2002	2003	2004	2005[b]
91 day Treasury bill rate	12.92	9.92	7.35	7.25	
Overnight Repo rate	12.00	9.75	7.00	7.50	8.25
Overnight Reverse Repo rate	14.00	11.75	8.50	9.00	9.75
Average Weighted Deposit Rate (AWDR)	10.78	7.47	5.27	5.31	5.43
Average Weighted Prime Lending Rate (AWPLR)	14.25	12.17	8.95	10.17	10.50
Overnight SLIBOR	12.88	10.67	7.73	9.66	9.71

Notes: a. Calculated using end-of-period rates.
b. Week ending June 17, 2005.

Source: Central Bank of Sri Lanka, *Annual Report* (2004) and *Monthly Economic Indicators*.

from both the government and private sector which jointly accounts for about 95 per cent of the total credit disbursed. During the first 4 months of 2005, the flow of credit disbursed continued to remain relatively high. This is an indication that inflationary pressures in the economy have not abated and may in fact increase given the likelihood of a period of heightened activity in the aftermath of the tsunami disaster. Furthermore, anticipation of upward adjustments of one or more administered prices may also set off inflationary expectations which are likely to be realized.

The movements of both narrow money and broad money aggregates during 2002-03 were largely in line with the increase in GDP allowing a gradual movement towards greater price stability and easing of market interest rates. However, with the rapid increase in inflation since mid-2004, policy rates were adjusted upwards by 50 basis points in November 2004 marking the start of a tighter money policy regime followed by an upward revision of 25 basis points in May 2005. However, the delayed response was not very effective and came far too late to curb inflation. During the period 2004-2005, the real interest rates were negative in general acting as a disincentive to financial savings. In view of continued high growth in monetary aggregates the CBSL started to conduct open market operations more aggressively from early 2005, mopping up excess liquidity in the economy. As a result, its holdings of Treasury bills were reduced, thus bringing down the level of net credit to the government from the banking system. Policy rates were also revised up by another 50 basis points in June 2005.

2.6.1 Share Market Developments

Despite a weakening of economic fundamentals during 2004, share market activity underwent a significant improvement, particularly during the latter part of the year. The share price indices continued to rise steadily until the tsunami disaster at end December 2004. However, after an initial dip there was a resumption of the upward movement in share market indicators on the strength of renewed confidence generated by an immediate inflow of foreign funds and anticipated longer-term economic regeneration from reconstruction activity. During the 12 months ending March 2005, the All Share Price Index (ASPI) increased by about 37 per cent and by May 2005 had exceeded 1900 - the highest level ever. The Milanka Index (MLI) repeated this trend with a less dramatic movement. The turnover of share transactions also reached historically high levels during the first six months of 2005 even though foreign sales generally exceeded foreign purchases indicating a small net outflow of funds.

This dynamism of the share market may be attributed to several reasons, including the continuation of the CFA; less than anticipated policy reversals with the change of government; strong performance of the tourism sector in the lead up to the tsunami disaster; and a large share issue of the Lanka IOC during November 2004 which gave rise to considerable activity in the share market. An important contributory factor no doubt was the negative real returns on fixed instruments operating for much of 2004 and into 2005, providing an attractive incentive for investors to dabble in the stock market.

2.7 The External Sector

After three successive years of relatively satisfactory performance, the balance of payments (BOP) situation deteriorated in 2004 with an increase in the current account deficit to 3.2 per cent of GDP and a negative position in the overall balance.

2.7.1 External Trade and the Current Account

The increased imbalance observed in 2004 was a result of a widened trade deficit caused primarily by a surge in import payments which pushed the imports/GDP ratio to 39.9 from 36.6 per cent in the previous year while the corresponding ratio for exports increased only marginally to 28.7 per cent. In 2004, the dollar value of Sri Lanka's exports grew by 12.2 per cent, an improvement on a growth rate of 9.2 per cent achieved in 2003. The overwhelming share of industrial exports in total exports (78 per cent) determines the movement of export earnings as a whole. Industrial exports increased by 13 per cent, the major contributions coming from textiles and apparel, machinery, equipment and rubber based products. The rate of increase during the first quarter of 2005 was slightly lower (about 11 per cent per annum) but the composition of the increment remained the same. Sri Lanka's garments industry has seen a marginal increase in export earnings in during January-April 2005 by growing at 10.1 per cent compared to a growth rate of 9.4 per cent over the same period last year. Agricultural exports which account for about 19 per cent of all exports increased at 10.4 per cent in 2004 but slowed down to about 5.6 per cent during the first quarter 2005. Here, the largest contribution to the increase came from tea followed by coconuts. The contributions of rubber and minor agricultural products to the increase were relatively small.

In terms of imports, the dollar value increased by 19.5 per cent in 2004 compared to a growth rate of 9.3 per cent in 2003. In volume terms, imports increased by only 9.0 per cent, the balance being the effect of increased unit prices. The increase in the average unit price of imports was directly related to sustained increase of world petroleum prices which also affected price levels of other key imports such as fertilizer. An important contributor to the increase in import volumes was rice. Increased imports of rice, wheat and other food items were necessitated by the shortfalls in local production caused by the drought during the year. In November 2004, the government intervened to curb the sharp increase in imports via introduction of a cess of 10 to 20 per cent on imports of 'non-essential' goods. Earlier, certain restrictions on the imports of high value vehicles had also been imposed in the form of higher excise duties and 100 per cent deposit requirement Available data suggests that the growth of imports slowed down con-

Table 2.8
Balance of Payments: Selected Flows

	2001	2002	2003	2004	2005[a]
Percentage increases					
Exports	-12.8	-2.4	9.2	12.2	11.8
Imports	-18.4	2.2	9.3	19.9	6.5
Services receipts	42.2	-6.4	11.3	8.2	n.a
Tourism earnings (gross)	-15.5	16.4	34.3	21.5	8.0
Private transfers (net)	1.0	11.5	9.8	12.0	28.0
As % of GDP					
Trade deficit	7.2	8.5	8.4	11.1	
Current a/c deficit	1.4	1.4	0.4	3.2	
FDI	0.5	1.1	0.9	1.1	

Note: a. Based on first 4 month's data in 2005.

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

siderably during the first quarter of 2005. Thus, total value of imports during the first quarter 2005 was only 5.4 per cent higher than the value of imports during the first quarter 2004.

The trade deficit in 2004 was US$ 2243 million - higher than that of the previous year by US$ 704 million. During the first quarter 2005, the trade deficit showed a significant decline compared to that of 2004. However, in view of the heightened economic activity associated with the post-tsunami reconstruction activity, the demand for imported materials may rise during the latter half of the year. Therefore, it is possible to expect a further widening of the trade deficit.

Services receipts showed a fairly moderate increase to record a surplus in 2004. The main contribution to inflows comes from transportation and travel. Transportation includes port services which has been one of the more dynamic sub-sectors in the economy during the recent period. Tourism had been showing a healthy improvement in 2004 with arrivals reaching a peak of 566,200 bringing in gross earnings of about US$ 413 million - an increase of 21.5 per cent from the previous year. However, the industry became a major casualty of the tsunami disaster. Thus, during the first two months of 2005, tourist arrivals declined sharply. While there were signs that the industry was on the way to a partial recovery by the end of the third quarter of 2005, tourist arrival figures are subject to some dispute with travellers on tsunami related work and Indian business travellers arriving under the visa-free arrangements counted as 'tourists' and bloating the numbers.

Private transfers - remittances sent in by Sri Lankans working abroad - has become a major source of foreign exchange earnings and has contributed significantly to easing BOP constraints. The gross inflows (US$ 1564 million in 2004) was equivalent to 7.8 per cent of GDP - higher than the value of all agricultural exports taken together and more than a third of the value of all industrial exports. After a healthy growth of 12 per cent in 2004, the growth rate of net private transfers increased to 27 per cent per annum during the first four months of 2005. This high rate is likely a temporary phenomenon connected to the flow of assistance to tsunami survivors and, therefore, may settle to a more moderate rate during the course of the year.

The net receipts on services, income and private transfer accounts taken together, though positive, could offset only part of the trade deficit and consequently, the current account deficit increased sharply to US$ 648 million or 3.2 per cent of GDP in 2004 compared to 0.4 per cent in 2003.

2.7.2 Capital Account and Foreign Debt

On the capital account, foreign direct investment showed a healthy increase as did the medium and long term inflows to the private sector. Net foreign direct investment increased during the year to reach a level of US$ 217 million. Similarly, net private long term borrowings which were negative during the previous year increased to a positive US$ 18 million. However, there was a net outflow of US$ 112 million in short- term capital. Inflows to the government declined compared to the previous year; capital transfers consisting mainly of grants declined from US$ 74 million in 2003 to US$ 64 million in 2004. A similar trend was observed in the case of long-term inflows consisting primarily of foreign aid loans. These declined by US$ 129 million to a level of US$ 430 million in 2004.

The net short-term capital movements were outward so that at the end of the year, the overall balance emerged as a negative US$ 205 million. This inevitably led to a depletion of the country's external reserves and a

Table 2.9
External Debt, Debt Servicing and Exchange Rates

	2001	2002	2003	2004	2005
Medium & long term debt (Rs. bn)	730.2	844.7	970.4	1119.0	n.a.
External debt of the government	634.2	722.0	843.9	996.1	n.a.
Short-term debt	49.6	58.1	59.9	67.7	n.a.
Banking sector external liabilities	104.2	96.8	101.1	149.5	n.a.
Total external debt[a]	779.9	902.8	1029.9	1186.8	n.a.
External debt/GDP (%)	55.4	57.0	58.5	58.5	n.a.
					n.a.
Debt service payments (Rs. bn.)	72.6	74.7	73.1	84.8	n.a.
Amortization	49.9	54.0	50.5	59.6	n.a.
Interest	22.7	20.7	22.6	25.3	n.a.
Debt service ratio[b] (%)	13.2	13.1	11.6	11.5	n.a.
Exchange rate[c]					
US dollar	93.16	96.72	96.74	104.60	100.29
Euro	82.27	101.38	121.60	142.32	121.45
Yen	0.7091	0.8164	0.9044	1.0179	0.92

Notes: a. Sum of medium and long term debt plus short term debt.
b. Covers all debt servicing including debt owed to the IMF. The denominator is exports of goods and services.
c. Rupees per unit of foreign currency. All end-of-period Exchange Rates, except in the case of 2005 where it is the rate reported during the week ending June 17, 2005.

Source: Central Bank of Sri Lanka, *Annual Report*, and *Monthly Economic Indicators*, various issues.

fairly significant depreciation of the currency. External reserves improved in December 2004 primarily as a result of an inflow of funds to the government as bilateral lines of credit. Developments during the first four months of 2005, suggest a modest improvement in the external payments situation with an inflow of funds related to post-tsunami rehabilitation and reconstruction.

Sri Lanka's medium and long-term external debt (disbursed) ratio equivalent to 58.5 per cent of GDP in 2004 remained steady compared to the previous year. Debt servicing still remains at a manageable level given that debt owed by the government, consisting mainly of foreign concessionary borrowings (foreign aid loans) constitutes the largest share of the country's external debt stock.

However, since almost all external debt is denominated in respective foreign currencies there is a high foreign exchange risk. For example in 2004 more than 40 per cent of the increase in external debt expressed in US dollar terms arose due to the depreciation of the dollar against other currencies such as the euro and the yen. In addition, the depreciation of the rupee against the US dollar also adds a substantial amount to the rupee value of debt and calls for exercising prudence in borrowing from foreign sources even when the terms are concessionary.

During 2004, after an initial fluctuation, the nominal exchange rate of the rupee depreciated against major international currencies with the overall depreciation during the year standing at 8 per cent. In sharp contrast, during the first 6 months of 2005 there has been a nominal appreciation against the US dollar amounting to about 5 per cent, largely in anticipation of significant foreign aid inflows to support the post-tsunami reconstruction pledged by the donors. According to estimates of the CBSL, the 5 currency basket tracking movements of the Nominal Effective Exchange Rate (NEER) depreciated by

10.3 per cent while the Real Effective Exchange Rate (REER) depreciated marginally by 1 per cent in 2004. The latter suggests only a marginal improvement in Sri Lanka's export competitiveness.

2.8 Conclusion

In 2004, Sri Lanka's economy experienced a set back from the relatively good performance observed during the previous year. GDP growth was slower, inflation re-emerged and the BOP deficit increased. The tsunami disaster which occurred at the end of the year no doubt has major implications for economic growth, employment and poverty alleviation. The negative impacts may be mitigated to some extent due to the availability of generous external assistance. A significant recovery of agricultural production on account of more favourable weather conditions, continued strong performance of the garments exports sector and early recovery of tourism can bolster the country's growth prospects.

However, the country faces significant challenges not least of which is stability on the political front. Sri Lanka's structural reform programme made little headway for much of 2004, compounded by the implementation of some debatable policies and lapses in economic management. Fiscal and monetary policies have not been successful in arresting the excessive growth of domestic credit and thereby the demand pressures in the economy. Unrealistic pricing policies intended to give short term relief to people have threatened the financial viability of key public utilities. They have placed unnecessary burdens not only on the government budget but also on credit institutions. Decisions on implementation of key projects have been unduly delayed. So are the decisions on restructuring and divestiture of government owned enterprises. Essential institutional reforms have not been properly addressed. All these factors, including election related uncertainties contributed to the country's relatively modest economic performance in 2004. The events in 2004 have once again shown how vulnerable the economy of Sri Lanka is to adverse external developments. The best safeguard against such developments will be continued commitment to improve the domestic policy environment.

3. International Environment

3.1 Introduction

Global growth momentum peaked in 2004 enjoying one of the strongest years of growth. Strong global performance in 2004 was underpinned by solid growth in the US and rapid expansion in China, India and Russia. However, adjustments to global imbalances – high oil prices and a ballooning US current account deficit – is expected to pose risks of disorderly exchange rate movements or interest rate increases that can threaten global output in 2005. Most recent estimates anticipate that global economic growth will cool slightly in 2005; overall economic growth of 5.1 per cent in 2004 is expected to slow down to 4.3 per cent in 2005.

Persistent high international oil prices have increasingly become a downside risk to the global economy. High oil prices have been a feature of the world economy in the past six months, with prices rising sharply through mid-October 2004. Prices fell back subsequently, but have since rebounded sharply. Oil prices are 70 per cent higher in real terms than they were two years ago. While in September 2004, the IMF had been forecasting an annual average oil price of 37.30 dollars per barrel in 2005, it raised that forecast to 46.50 dollars in March 2005. With the price exceeding US$ 60 at end June 2005, it is expected to average around 51.90 dollars for the year. It is estimated that continued high prices will trim at least 0.25 to 0.50 percentage points off growth this year.

This chapter will deal with developments in the global economy, and their implications for Sri Lanka. It looks at the growth performance of the developed and developing countries, and also developments in commodity and financial markets. It also looks at developments in international trade, and the progress of the Doha Round of WTO trade negotiations. Finally, it examines the implications of these developments for the Sri Lankan economy.

3.2 Trends in the Global Economy

Despite the strong overall global performance in 2004, there are divergences across regions, and world growth has been imbalanced. Growth has been strong in the US and China, while the performance in Europe and Japan were disappointing, reflecting faltering exports and weak domestic demand. The result of this lopsided growth is that the external deficits of the US are growing even bigger. The widening current account gap of the US has a mirror image in the current account surpluses of developing countries like China and India, and other developed countries like the euro area and Japan.

3.2.1 Output Growth

Among developed countries, the US economy has continued its strong performance registering a growth rate of 4.4 per cent in 2004, fuelled by strong domestic demand. The expansion is likely to slow down in 2005, with some worrying signs emerging. The current account deficit has continued to widen to 5.7 per cent of GDP for 2004, despite the significant nominal effective depreciation of the dollar over the past three years. The fiscal deficit of the US as a percentage of GDP is now the largest among the major advanced economies, with the exception of Japan. Larger budget deficits

Table 3.1
Selected Indicators of Global Economic Conditions

	2003	2004	Current Projections 2005	2006
World output	4.0	5.1	4.3	4.4
Advanced economies	2.0	3.4	2.6	3.0
United States	3.0	4.4	3.6	3.6
Euro area	0.5	2.0	1.6	2.3
Germany	-0.1	1.7	0.8	1.9
France	0.5	2.3	2.0	2.2
Japan	1.4	2.6	0.8	1.9
United Kingdom	2.2	3.1	2.6	2.6
Other advanced economies	2.5	4.4	3.4	3.9
Newly industrialised Asian economies	3.1	5.5	4.0	4.8
Other emerging market and developing countries	6.4	7.2	6.3	6.0
Africa	4.6	5.1	5.0	5.4
Sub-Sahara	4.2	5.1	5.2	5.6
Central and eastern Europe	4.6	6.1	4.5	4.5
Commonwealth of Independent States	7.9	8.2	6.5	6.0
Russia	7.3	7.1	6.0	5.5
Developing Asia	8.1	8.2	7.4	7.1
China	9.3	9.5	8.5	8.0
India	7.5	7.3	6.7	6.4
ASEAN-4[a]	5.4	5.8	5.4	5.8
Middle East	5.8	5.5	5.0	4.9
Western Hemisphere	2.2	5.7	4.1	3.7
	4.9	9.9	7.4	7.6
World trade volume (goods and services)				
Imports				
Advanced economies	3.6	8.5	6.5	6.3
Other emerging market and developing countries	8.9	15.5	12.0	11.0
Exports				
Advanced economies	2.8	8.1	5.9	6.8
Other emerging market and developing countries	10.7	13.8	9.9	9.7
Commodity prices (US dollars)				
Oil	15.8	30.7	23.2	-5.9
Nonfuel (average based on world commodity export weights)	7.1	18.8	3.8	-5.1
Consumer prices				
Advanced economies	1.8	2.0	2.0	1.9
Other emerging market and developing countries	6.0	5.7	5.5	4.6
London interbank offered rate (per cent)[b]				
On US dollar deposits	1.2	1.8	3.3	4.1
On euro deposits	2.3	2.1	2.3	2.9
On Japanese yen deposits	0.1	0.1	0.1	0.4

Notes: a. Includes Indonesia, Malaysia, the Philippines, and Thailand.
b. Six-month rate for the United States and Japan. Three-month rate for the euro.

Source: IMF *World Economic Outlook*, May 2005.

will produce a larger trade deficit and increase the vulnerability of the dollar. Renewed sharp increases in the current account and fiscal deficits threaten the momentum of US economic growth. By June 2005, the Federal Reserve had raised its federal funds rate for the ninth time since June 2004 to 3.25 per cent. Despite the sustained tightening – albeit at a measured pace – real interest rates only recently have risen above zero. A further oil shock, weakening dollar and an expanding US budget deficit will reinforce each other to generate much higher inflation and interest rates. Growth in the US is projected at 3.6 per cent for 2005; in fact, in the first three months of the year, growth at 3.1 per cent was the slowest in two years.

The relatively loose US monetary policy has also been exported through a fall in the dollar. To offset the impact of a stronger euro on growth, the European Central Bank (ECB) has been forced to hold the euro area's real interest rates negative as well. The stronger euro has impacted on GDP growth in the euro area where growth slowed noticeably in the second half of 2004 as the contribution of net exports turned sharply negative. Growth remains reliant on global developments, particularly in Germany, where external demand accounted for three-fourths of growth in 2004. For the year, GDP growth in the euro area remained fairly flat at 2.0 per cent. Unemployment in the euro area also remains a persistent problem at 8.9 per cent, while in Germany, France and Spain it has reached double digits. Outside the euro area, economic performance in the UK was robust with a growth rate of 3.1 per cent in 2004 with domestic demand being the main driver of growth. While the UK is expected to grow by 2.6 per cent in 2005, the growth forecast for the euro area has been revised down to 1.6 per cent.

Japan saw strong growth in the first quarter of 2004, prompting a growth forecast of around 2.5 per cent for 2005. However, a sharp deterioration to near zero growth in the remainder of the year saw growth predictions for 2005 being slashed dramatically. Weaker global demand for IT products has undermined exports and private sector investment growth. Consumption demand remains subdued and the Japanese economy is yet to free itself from a deflationary liquidity trap. Growth in the Japanese economy is expected to dip from 2.6 per cent in 2004 to 0.8 per cent in 2005.

GDP growth in emerging Asia picked up to 8.2 per cent in 2004, the highest since the Asian financial crisis. This was despite high oil prices, bird flu and a series of natural disasters. Economic growth in emerging Asian economies is expected to decline slightly to 7.4 per cent in 2005. One key factor for the projected decline is a slowdown in China's growth, falling from 9.5 per cent in 2004 to 8.5 per cent in 2005; the Indian economy too is expected to register a slowdown from 7.3 per cent in 2004 to 6.7 per cent in 2005. Emerging Asian economies remain more vulnerable to oil price increases as their economies are more energy intensive given their strong manufacturing base.

In Latin America, the strength of the recovery has exceeded expectations with region wide growth at 5.7 per cent in 2004 at its highest since 1980. Growth has been driven by domestic demand rather than a more favourable external environment. In sub-Saharan Africa, real GDP growth accelerated in 2004 to 5.1 per cent, the highest in almost a decade. Growth has been underpinned by the strength of the global economy, including high oil and commodity prices, increased apparel exports, improved domestic macro-economic policies, progress with structural reforms, and the ending of several protracted armed conflicts. Oil exporting countries in West Asia have experienced a substantial increase in export earnings over the past two years, as oil prices and oil production have risen. These revenues, together with sound financial policies and progress with structural reforms, have supported strong growth which averaged 5.5 per cent in 2004. Growth in the non oil producing countries has also benefited from the strong growth in the oil producers. From a global perspective, the behaviour of the West Asian oil producing countries could have a bearing on how the current constellation of external imbalances unwinds. The combined current account surplus of these countries was larger in dollar terms than that of developing Asia last year.

3.2.2 International Trade and Commodity Markets

On the back of higher oil and commodity prices and the strong global economic growth, global trade increased by 9 per cent in real terms in 2004, the best annual performance since 2000. However, a slow-down in overall economic growth that began in the second half of 2004 and expected to continue into 2005 is likely to decelerate world merchandise trade growth to 6.5 per cent in 2005. In 2004, the dollar value of world commercial services increased by 16 per cent, stimulated by a strong recovery in transportation and travel services.

Developing countries saw their share in world merchandise trade rise sharply in 2004 to 31 per cent, the highest since 1950. Asia's merchandise trade growth was sustained by strong US import demand and intra-Asian trade, helped by a recovery in electronics trade in 2004. China became the largest merchandise trader in Asia (overtaking Japan), and has emerged as the third largest exporter and importer in world merchandise trade.

However, this period of buoyant international trade rests on a somewhat unstable foundation. Weak consumer demand in Europe and Japan has meant that world trade is significantly reliant on US imports. Fortunately, emerging markets, and China in particular, have generated increased domestic demand. Nevertheless, any significant slowdown in US consumer demand will mitigate this since Asia's economy is particularly reliant on the US market. Demand in Europe and Japan needs to pick up if world trade is to avoid a hard landing in the event of a notable decline in US economic growth.

The current cyclical expansion in commodity prices since the bottoming out in October 2001 is second only to the upswing of 1972 to 1980. The overall index of primary commodity prices – led by oil and gas – increased by about 11 per cent in US dollar terms between July 2004 and March 2005. Overall, non-energy prices rose by 3 per cent in US dollar terms over the same period. Oil prices in April 2005 were at record levels reflecting the global demand for crude oil, temporary supply shocks, heightened global uncertainties, and limited spare capacity among OPEC producers. While the demand for oil has been led by the US, China and India, the current upswing has been triggered by China's rapid industrialization and under-investment in the resource industries (especially oil and gas and base metals).

Oil prices remained above US$ 50 a barrel throughout the second quarter of 2005 – normally a period of seasonally weak demand – and barring a sharp downturn in global growth, prices could increase again in late 2005 as demand for OPEC oil reaches a capacity ceiling. Recognizing this possibility, OPEC will boost output by half a million barrels as of July 1. In reality however, only Saudi Arabia and the United Arab Emirates will be able to significantly increase output. Pressure of rising demand from growth of the world economy, especially China and India, combined with limitations on known resources is expected to keep prices high. Prices over US$ 50 a barrel are expected to prevail in the medium-term.

3.2.3 Inflation and Financial Market Developments

Inflation and inflationary pressures remain relatively subdued with few signs to date of significant second round effects from higher oil prices. The flood of global liquidity has not, as in the past, pushed inflation in the prices of goods and services. Several structural factors, such as the IT revolution, deregulation and competition from cheaper Chinese goods, have helped to hold down inflation – and hence interest rates – in rich economies. The increased credibility of monetary authorities in curbing inflation also means that they need to raise interest rates by less than in the past to choke off inflationary pressures.

Nevertheless, inflation is creeping up. The euro area's average rate of consumer price inflation rose to 2.5 per cent in the year to May 2005, up from 1.6 per cent in February and well above the 2 per cent ceiling set by the European Central Bank (ECB). The US 12 month inflation rate for May 2005 was 3 per cent, up from 1.7 per cent two months earlier. There is evidence that rises in headline inflation tend to spill over into wages faster in Europe than in the US because of its less flexible labour markets. On the other hand, the less slack there is in an economy, the bigger the risk that higher oil prices will feed quickly into wages. The recent strong pace of growth in the US means that the euro area still has more spare capacity and the risk of wage increases smaller. With some amount of monetary tightening underway in both the US and euro area, inflation is expected to remain moderate in the near future. However, inflationary pressures will gradually increase as already evident from signals in the bond market of a worrying rise in inflation expectations in both regions.

While the global recovery was supported by favourable financial market conditions, they are not entirely stable. Given the fact that the EU and Japan have limited leverage in monetary policy to stimulate consumer demand, (Japan has interest rates of zero per cent and the ECB has maintained a 2 per cent interest rate and is unlikely to reduce this in the near future), the condition of financial markets in the US have widespread implications for the rest of the world. The Federal Reserve has gradually increased short term interest rates to around 3.25 per cent, but this has had little impact on long term interest rates. The latter are the key in determining US consumption. Low long term interest rates have maintained the housing market bubble, with mortgage rates continuing to drop, upon which US consumers have based their spending spree, absorbing imports from the rest of the world. It is expected that long term interest rates will continue with this trend as investors are likely to be influenced by the credibility of the Federal Reserve in controlling inflation and rising short term interest rates.

Most importantly, the heavy investment by Asian central banks in US long term securities has helped keep long term interest rates low. Asian banks have been investing in US dollars to prevent the dollar from sliding and thereby harming Asian exports. Export earnings in Asia are thus invested back in the US which keeps long term interest low and fuels further import absorption in the US. This cyclical pattern, however, may prove to be unsustainable. The record US current account deficit will place increasing pressure on the dollar and force Asian central banks to consider diversifying their foreign reserve holdings (the world held 76 per cent of its reserves in dollars in 2000 but by 2003 the proportion had slipped to 68 per cent). A sharp fall in demand for dollars would hold adverse implications for the global economy. A weak dollar will reduce American import demand directly, and lower demand for long term dollar securities will raise US long term interest rates and burst the housing market bubble.

However, the OECD expects the cycle to continue further. There remains political pressure for Asian economies to subsidize exports with low exchange rates, and a collapse of the dollar will erode the value of their vast dollar foreign reserves. However, it remains to be seen how long this cycle can hold. The measured response by the US Federal Reserve in raising short term interest rates may encourage US savings and slow down import absorption thereby contributing to a gradual adjustment of the value of the dollar. Increasing interest rates are however bad news for developing nations as borrowings will be more difficult to fund.

Stock markets in the major economic powers have been steady and buoyant though less so than five years ago. Surprisingly, despite a poor growth performance, stock markets in the EU have outperformed those of the US in the recent past. Japan's stock market remains stable though not exceptionally strong.

There was a strengthening of net capital flows to emerging markets in 2004 despite a sustained tightening of US monetary policy. Factors supporting these flows include a still favourable global financial environment, the continuation of global economic recovery, and growing confidence in the policy performance of the key emerging market economies. In fact, private capital flows to emerging markets moved to levels that have not been seen since before the Asian crisis of 1997/98. Private capital flows to developing nations increased by 32 per cent in 2004 to US$ 280 billion, the highest on record since 1997. However, disparities remain in the proportionate share of recipient economies with China attracting the largest amount of foreign direct investment (FDI) for any country, amounting to US$ 60 billion in 2004. FDI flows between developing nations has also been on the rise. More than one-third of FDI from developing countries is estimated to have gone to other developing countries. Overseas Development Assistance (ODA) also increased by 4.6 per cent in real terms in 2004, with Norway being the most generous donor contributing 0.9 per cent of its GDP. Furthermore, at the G-8 Summit in July 2005, the EU pledged to double aid to 18 African developing nations by 2015.

3.3 The WTO and the Doha Development Round

Attempts by the EU and Japan in particular to insist on the inclusion of the four Singapore issues – trade facilitation, trade and investment, trade and competition policy and transparency in government procurement – for WTO negotiations at the Cancun Ministerial Conference of September 2003 saw stiff resistance from some developing countries. A compromise solution to 'un-bundle' the four issues (excluding investment and competition for the time being) failed to gain the necessary support of developing countries who saw little progress being made in the crucial area of agriculture, particularly the issue of agricultural subsidies by developed countries. The failure of the Cancun Ministerial was viewed as a threat to the entire Doha Round negotiations.

In a bid to restart the process, in December 2003, 45 developing countries tabled a formal paper in the WTO calling for three of the Singapore issues to be dropped from the WTO agenda. They indicated a willingness to continue to review the implications of only trade facilitation, without a commitment to start negotiations on it. There were nevertheless fresh attempts to include government procurement alongside trade facilitation on to the negotiating agenda at the March 2004 meeting of the WTO General Council. Informal discussions between the 147 WTO members in April 2004 failed to arrive at a consensus to re-start negotiations and the prospects for the Doha Round appeared dim. However, in a surprise move, the WTO General Council reached agreement on July 31, 2004 on a 'framework' (July Package) to resume the Doha Round of trade negotiations. The major breakthrough was a commitment by developed countries to eliminate export subsidies on agriculture. The Framework Agreement of July 2004 (July Package) saved the Doha Round from almost certain collapse.

The Doha Work Programme, adopted by the WTO General Council July 2004 covered five main areas. They were; (i) agriculture, (ii) non agricultural market access (NAMA), (iii) services, (iv) development issues, and (v) rules (including trade facilitation). Of the five, agriculture and NAMA were the most contentious. The intention of the negotiators in Geneva was to prepare an agreement in time for the forthcoming December 2005 WTO Sixth Ministerial meeting in Hong Kong of a detailed negotiating framework so that countries could spend 2006 in negotiating the actual tariff and subsidy reductions. In order to achieve this, the WTO was aiming to have a first draft of a negotiating framework ready by July 2005 but this failed to materialize. Part of the urgency to finish the round by the end of 2006 arises from the fact that the fast track authority granted to the US President by Congress under the Trade Promotion Authority (TPA) will expire on 1st July 2007. The TPA permits the US President to negotiate a deal and submit to Congress for a simple 'yes' or 'no' vote, without the possibility of amendment. After the expiration of the TPA, the US administration will no longer be able to submit a Doha round agreement to Congress for such a 'yes' or 'no' vote.

The negotiations up to now have been at the technical level, but it is the intention to raise the stakes by giving it a political impetus, since progress since August 2004 has been slow. For the Doha Programme to have a 'final' result by 2006, the Hong Kong meeting will have to show concrete progress on modalities for agriculture and NAMA, a critical mass of offers in services, significant progress in rules and trade facilitation, and a 'proper reflection' of the development dimensions.

In agriculture, the July 2004 decision aims at the elimination of all forms of export subsidies. However, there are many unresolved issues, including market access (the formula, special products and special safeguard mechanism for developing countries, sensitive products mainly for use by developed countries); domestic support (the redefinition of the Blue Box, the need to control box-shifting, the reduction rates for the Amber Box subsidies); and export subsidies (the end dates for subsidies, the equivalent disciplines for export credits, etc). The Group of 20 recently called for all export subsidies to be eliminated in 5 years. The formulae proposed (Swiss versus linear) for tariff reduction aims at substantial improvements in market access with tariff reductions to be made from bound rates. Higher tariffs will be subject to deeper cuts, with flexibilities in sensitive products. Developing country members will have flexibility to designate an appropriate number of products as special products (SP), based on criteria of food security, livelihood security, and rural development needs. In addition, developing country members would have access to a special safeguard mechanism (SSM). The Group of 33 (which includes Sri Lanka) called for the exception from the duty reduction for SP and for a very strong SSM.

The major developed countries claim they have made significant concessions in agriculture, especially citing the agreement to end export subsidies. Developing countries on the other hand do not necessarily view developed countries' agriculture commitments as significant yet given that a date for ending export subsidies is yet to be agreed on and negotiations are still underway in expansion of Blue Box subsides and the tariff reduction formula. Moreover, there are concerns that developing countries may be asked to reduce their agricultural import tariffs even before developed countries agricultural subsidies are ended or significantly reduced.

NAMA issues (the choice of tariff reduction formula or approach, the treatment of binding, the sectoral approach) as well as how to deal with preference erosion and non-tariff barriers remain complex. The framework for establishing modalities developed prior to the Cancun Ministerial meeting in September 2003 were largely retained, with a few modifications through an introductory paragraph. This paragraph identifies the areas within the framework text on which further work has to be done. As a result, strong tariff reductions formulae have been proposed which will reduce higher tariffs through deeper cuts.

However, there is still disagreement on the nature of the formula, and whether a sectoral approach will be adopted. Some larger developing countries object to having to cut their tariffs steeply and bind them, all at once. There is also some concern on the erosion of current trade preferences. The framework text also allows a small number of developing countries, including Sri Lanka, not to undertake tariff reductions through the formula. However, these countries are required to bind their tariffs at the average of bound tariff rates for all developing countries. Developed countries by and large prefer to drastically slash their industrial tariffs through a non-linear formula and a tariff eliminating sectoral approach. For developing countries, binding almost all their tariffs will take away the flexibilities and policy space for industrial development.

In the area of services, the framework text agreed on a new deadline for improved offers by end May 2005. However, there does not seem to be a strong commitment to undertake very ambitious liberalization in this sector, as evidenced by the limited number and low quality of market opening offers. The three most popular services sectors in terms of improved offers are the financial, telecom and business sectors. While developed countries are aggressively seeking to open up many sectors in the developing countries, the latter for the most part remain cautious. Several developing countries also want to see progress in developed countries' commitments in Mode 4 (movement of natural persons), but so far there has been little progress on this. While Sri Lanka had made some initial offers on further liberalization of financial services, telecommunications and tourism, these have not been followed up with further offers.

While continuing concerns amongst developing countries regarding the incorporation of trade facilitation under the work programme of the WTO surfaced during the negotiations of the July Package, nonetheless an agreement was reached on the launching of negotiations on trade facilitation with a view to arriving at an agreed multilateral framework at the conclusion of the Doha Round. The compromise arrived at included that the other three 'Singapore issues' (trade and investment, trade and competition policy and transparency in government procurement) will not form part of the work programme set out in the Doha Declaration and therefore no work towards negotiations on any of these issues will take place within the WTO during the Doha Round. With a view to simplifying and harmonizing international trade procedures, the negotiating group on trade facilitation has agreed on a work plan which aims to clarify and improve relevant aspects of certain WTO articles.

The July Framework has also recognized the need for S&D treatment for developing and least developed countries, support for capacity building and infrastructure development, and addressing concerns related to cost implications of proposed measures. While developed countries have tabled some proposals already, developing countries have been quick to point out that the proposals submitted so far do not contain any definitive S&D treatment, financial or technical assistance components as mandated by the July Package. Sri Lanka too has extended strong support to developing country positions on S&D treatment on on-going negotiations on trade facilitation.

In development issues, the core of the problem is S&D treatment for least developed and developing countries. There is a reference to small, vulnerable economies such as Sri Lanka without, however, creating a sub-category. Technical assistance and capacity building, considered as the core of the development dimension of the Doha Round has long been neglected. Many developing countries are concerned that the 'development dimension' including the principles of S&D treatment and less than full reciprocity have been inadequately treated so far in the agriculture and NAMA negotiations. On implementation issues, there has hardly been any progress and the focus has instead shifted to the issue of extension of geographical indications.

Thus, on the substance of issues leading up to the Hong Kong Ministerial, there is a clear difference of perception between developed and developing countries on the nature and effects of the WTO rules and what the Doha Programme is supposed to achieve in terms of balance and development goals. In particular, there are differences of basic perspectives on agriculture and NAMA, and the lack of any progress so far on the development issues of S&D treatment and implementation. Developing countries generally view the existing rules in the WTO overall to be imbalanced against their interests. They want a re-balancing of existing rules to take place, and to have a strong development dimension in the new agriculture, NAMA and services negotiations.

3.4 Sri Lanka and Global Economic Developments

Sri Lanka, with its dependence on a limited number of export products – garments and tea account for 63 per cent of exports – and a limited number of markets – the US and EU account for 93 per cent of garments exports – is vulnerable to developments in the world economy. A slowdown in economic growth in the major advanced economies, and the possible decline in the growth of world trade, may impact adversely on Sri Lanka's external sector.

A major source of concern is the impact of the ending of the 30 year old Multi Fibre Arrangement (MFA) at the end of 2004 which has resulted in the removal of the quota system governing trade in textiles and clothing (T&C) from developing countries to developed country markets, namely, Canada, the EU, Norway and the US. The freeing of restrictions for T&C represents an opportunity for low cost producing countries to gain from global competition with the main beneficiaries expected to be China, India and Pakistan. While large shifts in trading patterns are not expected to happen overnight and countries have had 10 years to prepare for the eventual transition to a quota free trading environment in T&C, a number of smaller economies will face significant challenges.

While it may be still too premature to make any firm predictions, there has been a surge of low priced Chinese exports to the US and EU in the first quarter of 2005. There are already calls from affected US and EU manufacturers to activate the safeguard mechanisms, provided for in China's accession to the WTO and which are valid until 2008. The US invoked China's textile provision in December 2003 and imposed restraints on several categories of garment imports from China for a period of 12 months. In response to EU investigations into the impact of a surge in Chinese imports of garments, China announced that it will limit the growth in 10 textile and clothing products to the EU to 8.5-12 per cent a year in the period June 2005 to end 2007.

Sri Lanka, like many other relatively small garments exporters, benefited from the MFA. While it is not yet clear how sourcing strategies will change, affected countries will need to take measures to increase their competitiveness and seek niche markets. It is likely that the larger Sri Lankan exporting firms which have introduced new technology and marketing strategies will remain competitive. They are well placed to expand the supply of specialty products such as women's lingerie. The impact on the small and medium sized companies is less clear. Their survival may lie in the ability to forge alliances with more competitive producers at all stages of the production chain to achieve greater integration.

Preferential market access – such as provisions under the EU GSP (Generalized System of Preferences) scheme due to compliance with labour standards – may assist to a degree. While Sri Lanka has been receiving additional preferences since February 2004 due to its compliance with labour standards, it is also eligible for the EU GSP-plus scheme to receive further additional preferences from July 2005. The requirement is compliance with 27 international conventions relating to governance, human rights, environment, and labour standards in addition to fulfilling SAARC Cumulative Rules of Origin. While the EU GSP-plus scheme will grant duty free access to around 7200 products (90 per cent of exports) constraints for eligibility – such as rules of origin requirements – remain and will be addressed only from 2006 onwards. Sri Lanka is also seeking duty free access for exports to the US as a tsunami affected country. Duty free access is provided by the US to 33 Central American, Caribbean and African countries. It has been proposed that this facility be extended to 14 LDCs in Asia and Oceania and Sri Lanka.

Given the prevalent view that a country that focuses on WTO negotiations alone while others do not, risks seeing a reduction in its competitiveness, Sri Lanka has been actively pursuing the bilateral, regional and multilateral paths simultaneously. The most significant progress made by Sri Lanka in the area of bilateral/regional trade agreements in 2004 was to operationalize the long delayed Framework Agreement on the Pakistan-Sri Lanka Free Trade Agreement (PSFTA) signed in August 2002. The finalization of the annexes to the agreement was delayed due to protracted negotiations over certain sensitive agricultural products. With the enforcement of the agreement in June 2005, it is estimated that nearly 70 per cent of items traded between the two countries will be covered, facilitated to a degree by the heavy concentration of trade in select items between the two countries.

Under the agreement, Pakistan will grant duty free entry on 206 products with specific quotas for a limited number of other products. These include duty free entry for 10,000 metric tons of tea, preferential margins on 1200 metric tons of betel leaves, 3 million pieces of apparel, and on ceramics.

Pakistan has agreed to eliminate customs tariffs on 4680 tariff lines over 3 years while retaining 540 items on its negative list. Sri Lanka in turn will grant duty free entry to 102 products, 6000 metric tons of basmati rice, and 1000 metric tons of potatoes. Sri Lanka has a longer phase-out period to eliminate customs duties on 4527 tariff lines over a five year period while retaining a larger negative list of 697 items. Sri Lanka's negative list includes many agricultural products such as rice, fish products, milk foods, yogurt and sugar. A significant feature of the agreement is that the rules of origin are to be administered in a flexible manner in that the change of HS code will be at the 6 digit level, rather than the 4 digit level which prevails in most other agreements. Pakistan has also not insisted on any conditions – regarding the source of yarn, fabric, etc. – in the import of apparel from Sri Lanka.

Despite the fact that exports to Pakistan account for approximately 1 per cent of total exports of Sri Lanka, there is some room for improvement in trade for select commodities. In particular, Pakistan is the third largest market for tea in the world. While it is at present dominated by Kenya with CTC teas, there is a possibility for Sri Lanka to obtain a greater market share for its orthodox tea with the margin of preference granted under the FTA. However, it will require a significant marketing effort on the part of Sri Lanka to encourage consumers in Pakistan to switch back to orthodox teas.

The India-Sri Lanka Free Trade Agreement (ISFTA) which became operational in March 2000 has made steady progress in further promoting bilateral trade in goods between the two countries. There has been a significant expansion of trade to total US$ 1.8 billion by 2004. While exports from Sri Lanka have grown faster, the trade balance still remains in favour of India. Nevertheless, the import-export ratio has declined to 3.5:1 in 2004 in India's favour from 11:1 in 2000. In addition to copper products, furniture and confectionary, a number of new products, such as vanaspati oil, memory modules, medicaments, printing ink, cosmetics and toiletries, glue, plastic products, etc. have found markets in India. In 2004, preferential exports as a percentage of total exports from Sri Lanka to India stood at 70.5 per cent.

Although the ISFTA does not cover investments, the economic and political confidence underlying the agreement could well have contributed to stimulating bilateral investment. India was the third largest foreign investor in Sri Lanka, with investment flows from India to Sri Lanka on the capital account counterbalancing to some extent the trade imbalance. Nevertheless, in the long run Sri Lanka will have to be mindful of the fact that the flow of profits back to India could weaken this effect. Moves to widen and deepen the Indo-Lanka FTA to a Comprehensive Economic Partnership Agreement (CEPA) also gathered fresh momentum in 2004. The CEPA is intended to include services and investment apart from broadening and deepening goods liberalization under the ISFTA. A roadmap to this end discussed at the first round of technical negotiations has involved the setting up of three joint study groups to broadly lay down the scope and contents of the CEPA. Negotiations are expected to continue on services, financial markets, trade facilitation, economic cooperation and investment and to be concluded by end 2005.

Despite progress on the bilateral front with Sri Lanka's key South Asian partners, negotiations on the South Asian Free Trade Agreement (SAFTA) due to come into effect on January 2006 remain subdued. Some progress has been made in the tariff liberalization schedule with the decision of the Committee of Experts (COE) to impose an upper limit of 20 per cent of tariff lines (at HS 6 digit) as the maximum ceiling allowable for developing countries of SAARC for inclusion in the sensitive list. Least Developed Countries (LDCs) have been offered a higher ceiling of around 25 per cent. Given that at the start of negotiations the percentages mooted were 5 per cent for developing countries and 10 per cent for LDCs, South Asian countries appear to have abandoned a more aggressive approach to goods liberalization and opted to take a less riskier – and perhaps a less effective – approach. The other more important outstanding issues under negotiation include the rules of origin, a revenue compensation mechanism and technical support measures for the LDCs. With the now familiar postponement of the SAARC Heads of State Summit scheduled to have been held in January 2005, there is the ever present threat that the negotiations will not be completed in time to operationalize the SAFTA treaty by January 2006.

Negotiations within BIMSTEC (Bay of Bengal Initiative for Multi Sectoral Technical and Economic Cooperation) are proceeding as scheduled to cover areas for 'focused' cooperation, primarily in areas of trade and investment, transport, tourism, communication, technology, energy and fisheries. The agreement on goods is expected to come into force in July 2006. In the case of trade in services and investments, the negotiations are expected to commence in 2005 and be concluded by 2007. While Thailand and Myanmar are viewed as gateways to ASEAN through BIMSTEC, efforts to negotiate a bilateral EPA (Economic Partnership Agreement) with Singapore – the ASEAN country with which Sri Lanka has the closest economic links in trade, investment and tourism – have, however, not progressed beyond the initial contacts. It is noteworthy that India and more recently Pakistan are also moving in the same direction by negotiating EPAs with Singapore.

The third round of negotiations – the Sao Paulo round – under the GSTP (Global System of Trade Preferences) is to commence around February 2006. The GSTP is an inter-regional arrangement for exchange of trade preferences among developing countries of Asia, Africa, and Latin America. The number of developing country participants after the first two rounds was 44, of whom 12 were from Asia, including Sri Lanka. It is likely that many more developing countries will participate in the third round.

The confluence of economics and politics drive the current criss-crossing of preferential trade agreements (PTAs), not only in Sri Lanka but globally as well. By the end of 2004, nearly 300 PTAs had been notified to the GATT and the WTO of which 176 had been notified after 1995. Of these 150 are currently in force, and an additional 70 are estimated to be in operation although not yet notified. By the end of 2007, if PTAs reportedly planned or already under negotiation are concluded, it is estimated that the total number enforced might well approach 300.

Whether PTAs are welfare enhancing either for its members or for non-members remains a disputed topic, but what is not in dispute is that the multiplication of PTAs has only added to the controversy. Multiple preferential rates are being applied to multiple trading partners (often with different timelines) with complex and inconsistent rules of origin, incurring a heavy administrative burden. Proponents of PTAs are increasingly pushing forward the concept of 'competitive liberalization' arguing that PTAs provide a spur to liberalization on multiple fronts. These PTAs are seen as testing grounds for new multilateral trade policy disciplines. While there may be some truth to this proposition, PTAs can undermine the multilateral system. The current hesitation of many developing countries enjoying GSP or PTA preferential access to developed country markets to support MFN tariff reductions under the Doha Round negotiations is a case in point. MFN tariff reductions erode the value of their preferences. An equally important element that has arisen with the growth of PTAs is the increasing tendency on the part of preference givers to demand significant reciprocity in the form of 'non-trade' measures such as undertakings on labour standards. Such requirements may become not merely templates for future PTAs but may also encourage their eventual inclusion in the multilateral rules.

3.5 Conclusion

The external environment is likely to be less favourable to Sri Lanka in 2005. An anticipated slowdown in global growth momentum, but more particularly perhaps the slowdown in the US economy can impact adversely on Sri Lanka's export sector. The uncertainties related to the elimination of quotas affecting the country's single largest export earner – garments – compounds the situation. Continued high international oil prices and rising global interest rates will place heavier pressure on the country's external payments position. In view of an anticipated weakening in the external sector environment, the onus falls more heavily on the government to ensure a competitive domestic economic environment to strengthen the ability of the export sector to access foreign markets and attract more FDI into the country. Preferential access through trade agreements should be pursued but not at the expense of beneficiaries becoming over-reliant on preferences to remain competitive.

Box 3.1
Fair Globalization

The report "A Fair Globalization: Creating Opportunities for All" prepared at the invitation of the Governing Body of the ILO by a 26 member World Commission on the Social Dimension of Globalization aims to shift the perspective on globalization from a narrow preoccupation with markets to a broader preoccupation with people. While the key characteristics of globalization have been recognized as the liberalization of international trade, the expansion of foreign direct investment, and the emergence of massive cross-border financial flows, globalization has also set in motion a process of far reaching changes that are affecting every day life. New technology supported by more open policies, have created a world more interconnected than ever before. This spans not only growing interdependence in economic relations, but also social and political interaction among organizations and individuals across the globe.

While the potential for benefits is immense, the current process of globalization is generating unbalanced outcomes, both within and outside countries. The problems identified, however, are not due to globalization per se but deficiencies in governance. Essential market supporting and regulatory institutions are lacking, making the system prone to market failures; the rules and institutions that do exist are unfair towards poor countries, both in the ways they have been drawn up and in their impact.

National Governance: In a world of nation states, the governance of globalization is bound up with governance at the national level. To take advantage of the opportunities of globalization and ensure they are widely and fairly distributed among different groups within nations, there is a need for effective political and legal institutions, strong economic and technological capabilities, and policies which integrate economic and social goals. More generally, well governed countries whose domestic policies take into account the needs of other countries, will be more effective partners in bringing about a fair and more inclusive process of globalization.

The basis for good governance is a well functioning democratic political system that ensures representative government, responsive to the needs of the people. In addition to the holding of regular, free and fair elections, this implies respect for human rights in general, for basic civil liberties such as freedom of expression and association. The need for good governance also extends to the formal institutions required for the efficient and equitable functioning of a market economy. The basic requirements include a sound financial system, the regulation of markets, mechanisms for ensuring transparent and socially responsible corporate governance, and an effective system of delineating property rights and for enforcement of contracts.

The Commission was of the view that an important issue is the pace and sequences of the liberalization process. In contrast to the 'Big Bang' approach - involving liberalization across the board - it is now generally recognized that the supporting institutions and regulatory frameworks for a market economy need to be developed gradually, and require strong administrative capacity.

Global Governance: Global governance is the system of rules and institutions established by the international community to manage political, economic and social affairs. The Commission is of the view that collaborative global action is necessary in such areas as financial contagion, communicable diseases, cross-border crimes, security concerns, tax havens and tax competition. There is also a need to develop institutional arrangements to support and supervise global markets.

Serious problems with the current structure and process of global governance include the vast inequality in power and capacity of different nation states. Developing countries, especially the least developed countries, are in a weak bargaining position. Non-state actors have come to play a larger role in global governance; there has been a growth of private self regulation at the global level, such as the harmonization of accountancy standards, and the focus on corporate social responsibility, with an emphasis on such issues as environment and labour standards.

A 'democratic deficit' in global governance - unequal decision making in the UN Security Council and the Bretton Woods institutions is compounded by a lack of coherence in global decision making, as negotiations on global governance take place in compartmentalized sectors such as trade, finance, health, social affairs and development assistance. Decisions taken in one field can affect outcomes elsewhere and such weaknesses have contributed to the uneven social and economic impact of globalization. Any reform of global governance must be inspired by a vision of fair and inclusive globalization.

- The Commission stresses that multilateral rules for trade - agricultural protectionism, the barriers to trade in textiles and clothing, and the non liberal nature of the agreement on intellectual property rights - should be balanced and fair. The need for affirmative action in favour of countries that are latecomers and do not have the same capabilities as those which developed earlier should be borne in mind under WTO provisions on Special and Differential Treatment.

- The current global financial system is highly imperfect, dominated as it is by financial interests of industrialized countries. While reforms have mainly focused on crisis prevention measures, such as greater disclosure of information, attempts to develop early warning systems, and the formulation of international standards and codes in financial sector supervision, developing countries have not been adequately involved in the design of these new standards and codes.

- Core labour standards as defined by the ILO provide a minimum set of global rules for labour in the global economy, and respect for them should be strengthened in all countries. Decent work - or better working conditions - for all should be made a global goal to be pursued through coherent policies within the multilateral system.

- A major gap in the current institutional structure for the global economy is the absence of a multilateral framework for governing the cross border movement of people. The cross border movement of people is now widespread - including more than 10 million people a year over the past decade - as well as a greater coverage of countries. The pattern of migration is clearly linked to increasing globalization. Declining costs of transportation and the advent of cheap mass travel have greatly facilitated this movement. From the perspective of developing countries, the absence of a multilateral framework for the cross border movement of people reflects yet another gap in the rules governing the global economy.

The Commission has made many, reommendations including a greater commitment to the target of 0.7 per cent of GDP as ODA; strengthening efforts at resource mobilization at the international level; establishing a fairer system of voting rights at the Bretton Woods institutions, giving increased representation to developing countries; and conducting efforts at the WTO in a more democratic manner.

Tsunami: Policy Issues, Lessons and Challenges

4. Tsunami: Policy Issues, Lessons and Challenges

4.1 Introduction

The tsunami disaster, which caused over 36,000 deaths, displaced some 800,000 people and resulted in widespread damage to infrastructure and livelihoods, is the single largest natural disaster in Sri Lanka's recorded history. The impact fell most heavily on the coastal regions of the Eastern, Southern and Northern Provinces, and disproportionately on the poorest socio-economic groups. According to most estimates, Sri Lanka will need approximately US$ 1.5-2 billion to effectively implement a recovery and reconstruction strategy. As the relief phase of the catastrophe winds down, attention must focus on the medium-term reconstruction and rehabilitation phase of recovery of the Sri Lankan economy. From a longer-term developmental point of view, it is critical that measures and policies are put in place that are based on a sober and realistic assessment of the nature and likelihood of future natural disasters, drawing on the lessons to be learnt from this disaster as well as the international experience of natural disaster management. This chapter examines these facets in some detail: Section 2 assesses the impact of the tsunami; Section 3 discusses issues of housing and shelter; Section 4 looks at the livelihoods issues; Section 5 at governance and management of the reconstruction process, including aid issues; Section 6 assesses the need for a future disaster prevention and risk management strategy; and Section 7 concludes.

The situation report after 6 months shows much progress, but also areas where serious challenges remain especially in terms of housing.

Box 4.1
Situation Report after Six Months

- 36,600 dead or missing, with the majority being women and children.
- North and Eastern Provinces accounted for two thirds of deaths and 60 per cent of displacement.
- Of the 47,000 estimated transitional shelters required, good progress is recorded with over three quarters completed, but some are substandard and will have to be rebuilt.
- Of the 50,000 pre-built houses required for those in the buffer zone, progress remains slow with only about 10 per cent (or 5280) under construction and only a few hundred completed. Land and sand are the main bottlenecks.
- Of the rebuilding outside the buffer zone, progress is good with 30 per cent (or 22,000) of the estimated 70,000 households claiming their first grant instalment for rebuilding.
- 881,000 beneficiaries are receiving the Rs. 375 food and cash weekly coupon for the Multi-Purpose Cooperative Societies (MPCSs).
- The disbursement of the Rs. 5000 household cash grant provided through the state banks was extremely effective for January and February. It was then delayed for four months until the end of June as eligibility criteria changed and it now reaches an estimated 234,000 beneficiaries.
- For fishery livelihoods, some success is reported in repairing and replacing damaged vessels. However, in some places there are more smaller craft now than prior to the tsunami. Currently these craft are not fully used due to shortage of engines and nets, but serious over-fishing in the near shore could result leaving fishers poorer than before.
- By the end of June, 4154 applicants had received Rs. 1940 million (US$ 19 million) through the Susahana scheme of the state banks. 4437 people had received Rs. 158 million (US$ 1.58 million) through the National Development Trust Fund scheme.

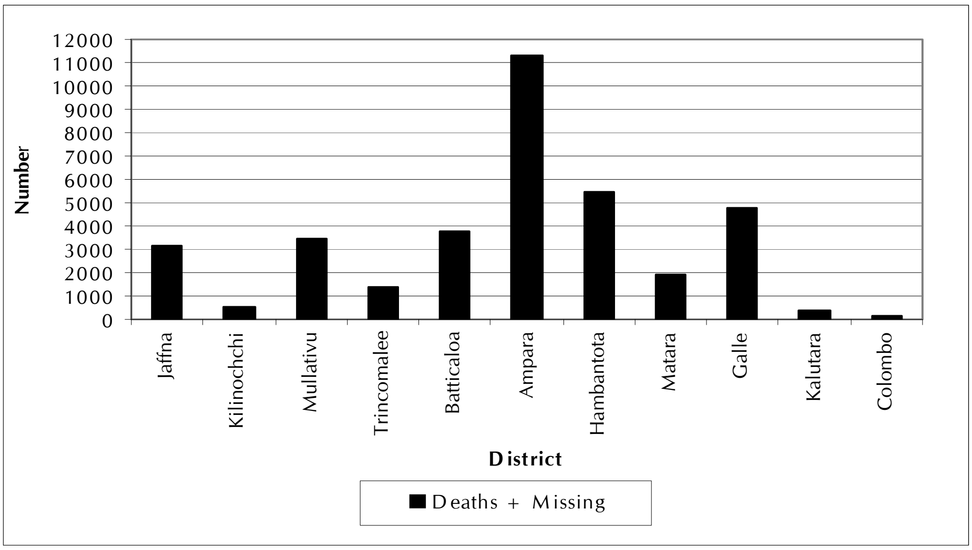
4.2 Impacts

Sri Lanka was hit by the devastating tsunami on 26 December 2004 following a massive earthquake off the coast of Sumatra, Indonesia. Over 36,600[1] people were killed and over 800,000 people displaced - totalling almost 4 per cent of the population. The human impacts of the tsunami include those who died or were injured, those who lost their loved ones, those who lost their houses, or property and those who lost their livelihoods or whose employment was indirectly affected. The death toll was quite severe with 30,957 people listed as dead with an additional 5644 missing, making a grim total of 36,600. The majority of total deaths were of women. Deaths amongst heads of households were lower compared to the death toll of children and the elderly. This may make livelihood recovery less difficult.

The impact of the tsunami across religious, ethnic, livelihood and income groups is extremely uneven. While the economic impact of the tsunami to the national economy is likely to be limited to less than 1 per cent of GDP, it may have significant impacts in terms of increasing poverty, particularly among already impoverished groups such as small scale fishers and the inhabitants of the Northern and Eastern Provinces. Certain groups such as women and children remain especially vulnerable.

Thirteen of the country's 25 districts were affected, but the Northern and Eastern Provinces were particularly hard hit, accounting for over two-thirds of the deaths and almost 60 per cent of the displacement. The pattern of death and displacement were slightly different; Ampara, for example, suffered one-third of the deaths (dead and missing), while Galle suffered a quarter of the displacement. The Northern and Eastern Provinces saw 500,000 people still displaced by the tsunami at end January 2005 comparable to the estimated 362,000 people registered (as of June 2004) as internally displaced by the conflict. The severity of the tsunami disaster in the North and East is compounded by con-

Figure 4.1
Tsunami: Dead and Missing (as at end January 2005)



Source: TAFREN, Ministry of Finance, NPD (February 2005), Rebuilding Sri Lanka Action Plan.

[1] This includes the figures for both missing and dead.

flict-related problems and the economic marginalization that has resulted. The majority of the conflict-related internally displaced persons are still registered in the Northern and Eastern Provinces, although there is also a large Muslim community in Puttalam evicted by the LTTE in the 1990s. Infant mortality is more than double in the North and East compared to the rest of Sri Lanka; maternal mortality is three times as high; and almost 50 per cent more children are underweight in the North and East compared to the rest of the country.

There were many low income households in the affected districts prior to the tsunami; with over a half of households earning less than Rs. 5000 per month before the tsunami. Loss of means of livelihood - boats and nets, places of business, tools and other assets - as a result of the tsunami is immense. This includes both the owners of these assets and those who were hired as labourers. There are also those who were indirectly affected - those whose markets have been disrupted and whose customers have died or been displaced. Finally, there are many who lost their few savings - their gold, jewellery or cash. The main livelihood sources of the most affected areas are fishery ranging from 35-65 per cent of households depending on the location.

4.3 Shelter and Housing

In terms of displacement, initially the tsunami displaced about 800,000 people following the destruction and damage of 119,000 houses. The figure of the displaced had fallen to 516,150 by mid-June 2005 as people who return to their homes even if they are destroyed or damaged are removed from the statistics. The initial 169,000 people living in schools and tents have now largely been moved to transitional shelters, but living conditions still remain cramped and difficult. The other 333,000 people (or two-thirds of the displaced) living with host families (relatives or friends) are also often in very over-crowded accommodation, with much potential for conflict and tension.

The housing situation for the tsunami-affected in Sri Lanka has moved forward - albeit haltingly - in the first 6 months of 2005. As of mid-June 2005, it was estimated by TAFREN that 35,193 transitional shelters were completed, with another 7455 under construction. Shelters are only being provided for the estimated 47,000 affected households in the buffer zone.[2] Unfortunately, some of these shelters are of substandard quality, considered not strong enough to withstand the coming monsoon rains and winds.[3] So a considerable portion of the 35,000 existing shelter units will need to be replaced at the same time as the new ones are constructed. With organizational capacity throughout the reconstruction effort strained, the process of replacing and upgrading shelters takes time and scarce resources. The substandard shelters are partly the result of the rush to move people out of tents; lack of experience, particularly on the part of some of the smaller agencies and individuals and some improvement in the standards expected so that the shelters can be used for over a year if necessary.

4.3.1 Buffer Zone

Following the immediate tsunami relief operation, it has become clear that permanent shelter is probably the main priority for tsunami survivors. The issue has been affected by the government's decision to enforce a 'no-build' coastal buffer zone of 100 metres in the south and west and 200 metres in the

[2] Data from different sources (e.g., TAFREN, THRU, UN, etc.) show slight differences on number of shelters required and rate of completion. The number of shelters required has also increased as renting households and extended families have also required shelter.

[3] The exact number that are substandard is also subject to some discussion with the government stating about 20 per cent at end June 2005, while some NGOs and donor agencies suggest the figure to be around 40 per cent. The exact modalities for inspection and improvement are now under discussion.

north and east coasts of the country. The larger distance in the north and east has been justified due to the generally more extensive intrusion of the sea on this coast and the higher risk of cyclones on this coastline (e.g., the 1978 cyclone). Buffer zones and setbacks are ways to create space between human development and the coast, and they are widely used in several other countries as shown in Table 4.1.

The government moved swiftly to declare the buffer zone, and contrary to some perceptions, independent surveys suggest 60-75 per cent of those within the buffer zone are in principle willing to move due to fear of the sea. This desire to move has been increased by the on-going fear caused by many false tsunami alarms in coastal areas and the official evacuation on the night of March 28th that has generated a sense that a tsunami may not simply be a once-in-a-lifetime event. However, the desire by the majority to move does not mean that they are satisfied with the relocation sites so far identified by the government. Criteria identified as requirements for lands to be suitable and relocation acceptable by the affected people include the following: that it has limited impact on livelihoods; it would not undermine community cohesion; good houses and facilities are provided at the new site; and that the new lands are not flood prone or affected by wild elephants.

There are those who challenge the blanket nature of the buffer zone - for example in areas where there are elevations. In addition, the fact that the buffer zone only applies to damaged houses, exempting undamaged houses and damaged hotels seems inconsistent. Indeed, much of the seaside of Galle Road in Colombo falls within the buffer zone. If the rationale for the buffer zone is public safety, then it should presumably be applied uniformly to all structures. One defence of the government's approach is that during this time of acute housing shortage it would seem perverse to be knocking down undamaged houses, and as the tsunami houses are being rebuilt using scarce foreign funds, the government is entitled to decide their best use. If no buffer zone was declared and there was another tsunami or cy-

Table 4.1
Examples of Buffer Zones and Setbacks in Other Countries

Location	Distance	Restrictions	Purpose
Maui, Hawaii	7.5-45m	Permit needed for any development project. All buildings must ensure public beach access and natural environment is preserved.	To guide the conservation and development of land and water resources within the coastal zone in light of competing demands for limited and sensitive coastal resources.
Nevis, Caribbean	37-91m	Piled structures permitted within the 37-91m zone. All major hotels must be outside 91m.	To protect against storm surges and beach erosion.
Denmark	100m, 300m,3km	100m no-build in summerhouse areas, 300m no-build in rural areas, and 3km protected area where development must be carefully planned and essential in nature.	To provide public access to nature and recreation, protect nature, restore damaged coastal ecosystems and prevent large-scale erosion.

clone that destroyed rebuilt houses, the government would inevitably be blamed. The buffer zone for rebuilt houses therefore seems justifiable, but the question remains whether it should vary according to topological features. Here again the government's defence was that it needed to act fast before people moved back, and a uniform approach was the fairest and quickest way to do so. This again seems justifiable, and as international experience shows, several other countries have no-build-zones within 100-200 metres of the coastline.

The main challenge to the buffer zone seems to be whether it is practicable. This is firstly in terms of finding land to resettle those who are moved (addressed in later sections). Secondly and related to this, whether houses can be built fast enough to resist the inevitable pressure to allow people to move back to the buffer zone, which is already happening in some areas. The government has also lost the public relations battle by failing to make a clear and convincing rationale for the buffer zone and allowing alternative theories to fill the void - such as concerns that the buffer zone is intended to force poor people off the coast to make way for hotels. The government must urgently embark on an information campaign to explain the buffer zone and its rationale illustrating its similarity with experience elsewhere.

4.3.2 Pre-built Houses: Relocation from the Buffer Zone

In the buffer zone where construction is not allowed, the TAFREN guidance of 15 March 2005 states that the government "will identify land closest to the affected village and provide houses to the affected families. As far as possible, the relocation process will attempt to keep communities intact". The following assistance policy will apply to households within the buffer zone:

- No reconstruction of houses (partially or fully damaged) will be allowed within the buffer zone.
- All affected households will be provided with a house built with donor assistance on land allocated by the state. *Households will not be required to demonstrate ownership to land*.
- The new homes will be built in line with guidelines issued by the UDA and will have a floor area of 500 sq. ft. and would be provided with electricity, running water, sanitation and drainage facilities.
- The proposed houses in urban and rural settlements will have facilities such as road systems, recreation, etc.

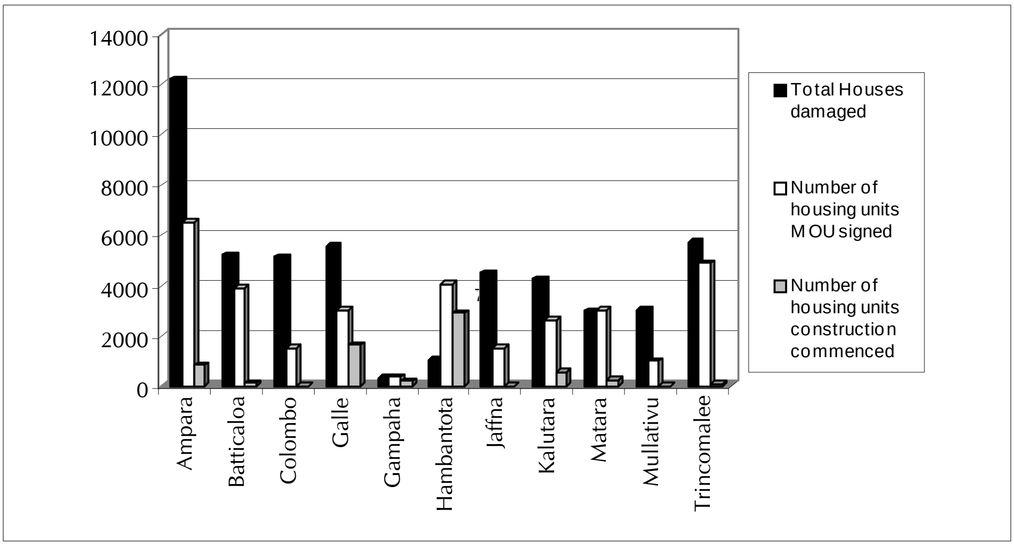
Within the buffer zone, owners of damaged houses will be allowed to keep their land for agriculture and will be offered free land and houses at an alternative site. Undamaged houses and hotels (even if damaged) will be allowed to remain in the buffer zone. For residents within the buffer zone, the government is planning to assist not only landowners, but all residents (including encroachers) with some form of housing. This would require an estimated 50,000 permanent houses. The government unit charged with this task is the Tsunami Housing Reconstruction Unit (THRU) based in the Urban Development Authority (UDA). The THRU has been signing Memoranda of Understanding (MOU) with so called 'donors' who have offered to construct houses.

These donors are international and national NGOs and some private companies. The MOU states that "the donor shall bear the cost of construction of the housing units which has been estimated to be around Rs. 400,000 per single storey detached type housing unit including the cost of basic amenities such as water, electricity and sewage within the house". The MOU also states that the house must have a minimum of 500 square feet with two bedrooms, a living room, kitchen and toilet; and that construction must be in keeping with planning guidelines, design specification and standards given by the UDA. The donor must employ a contractor registered with the Institute for Construction Training and Development (ICTAD) or any other government construction agency. The government has not yet decided on the tenure for the pre-built houses which is creating confusion, and already some NGOs are withholding freehold title on the houses they construct. This is counterproductive and the government should immediately announce its decision to provide freehold for those relocating to pre-built houses.

The type of pre-built housing will depend on the land available. If there is adequate land, the preferred option is single storey detached houses on individual land plots of about 10 perches. As land becomes more limited, the proposals by order of preference include the following: (i) single storey attached houses with individual gardens; (ii) two-storey attached terraced houses with individual gardens (town-houses); and as a last resort (iii) condominiums (limited to ground plus 2 or ground plus 3). Donors will construct houses according to UDA guidance and site plans by NHDA and UDA. Most site plans are being prepared by architects visiting from Colombo with minimum consultation with users, which may create problems if, for example, low income families can only afford to cook with wood, but appropriate ventilation is not provided. It is estimated that 75 per cent of households cooked with biomass (firewood, paddy husks, etc.) prior to the tsunami and this needs to be taken into account in housing design. There are also potential problems of insufficient space available and appropriate design, for example to separate wells from latrines.

By mid-June 2005, 42,000 housing units have been assigned to donors in 387 different sites. Construction had begun on a total of 5281 of these relocated houses. However, in many cases this construction is only the laying of the foundation. As indicated in Figure 4.2 only in Matara and Hambantota have MOUs been signed to cover the required number of damaged houses. Indeed, Hambantota

Figure 4.2
Progress with Pre-built Houses



Source: TAFREN, June 2005.

is an anomaly with almost four times as many houses required now pledged to be built. Elsewhere, construction is lagging, although the government optimistically hopes to rapidly increase the pace of construction once the initial land bottlenecks have been overcome.

4.3.3 Rebuilding In-situ: Living Outside the Buffer Zone

The government has agreed to provide grants and loans for households outside the buffer zone to rebuild in the same place. The grants are provided through the state banks with funding from the World Bank, ADB, Swiss Development Corporation and other donors. According to TAFREN guidance of 15 March 2005, the following criteria will apply to households outside the buffer zone:

- All affected households outside the buffer zone that are able to demonstrate ownership of land will be entitled to a grant by the State. Households that do not have ownership to the land are not entitled to this assistance.

Extent of damage	Fully damaged	Partially damaged
Definition	House is more than 40 per cent damaged	House is less than 40 per cent damaged.
Assistance policy	Grant of Rs. 250,000 disbursed in 4 stages.	Grant of Rs. 100,000 disbursed in 2 stages.

The difference between fully and partially damaged is determined on a points system judged by a Verification Committee. In addition, households that have successfully utilized the grant will be eligible to apply for a concessionary loan of Rs. 500,000. The loans will be disbursed through the Bank of Ceylon and People's Bank. The borrower will have to demonstrate repayment capacity and offer security acceptable to the lending institution. It has now become clear that there is considerable inequity in providing the same sum of money to rebuild houses with broken windows as against those houses that have suffered greater damage (even though the damage is less than 40 per cent). The government is, therefore, discussing a new one-off payment of Rs. 50,000 to those who have less than about 20 points according to the damage verification system. All landowners who live outside the buffer zone are guaranteed payments towards new houses. As of mid-June 2005, 22,794 households had received their first grant through the People's Bank and the Bank of Ceylon.

4.3.4 Challenges in House Reconstruction

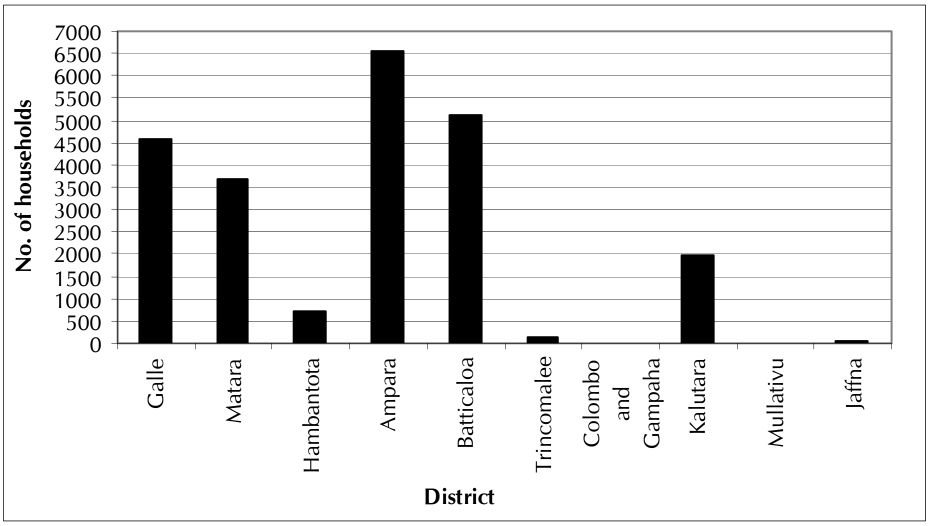
This section highlights five of the main challenges facing the reconstruction process:

- Identification of suitable land
- Cost effective supplies of sand (for cement)
- Labour shortages
- Lack of management capacity and
- Lack of process for matching beneficiaries with pre-built houses.

A major constraint for pre-built houses for those being moved from the buffer zone is availability of land. The government has a strong preference for using government land as it avoids potentially protracted negotiations with private owners over land values.[4] However, much of the available state land is only 1-5km away from the coast, while surveys suggest that most people prefer to be within 200m to 1km of the coast. Another problem is that some of the available government land is on marshy lands, or in jungle areas where there are wild elephants. Prior

[4] A proposed Bill which includes provisions to speed up land acquisition powers for the tsunami houses is awaiting discussion in Parliament.

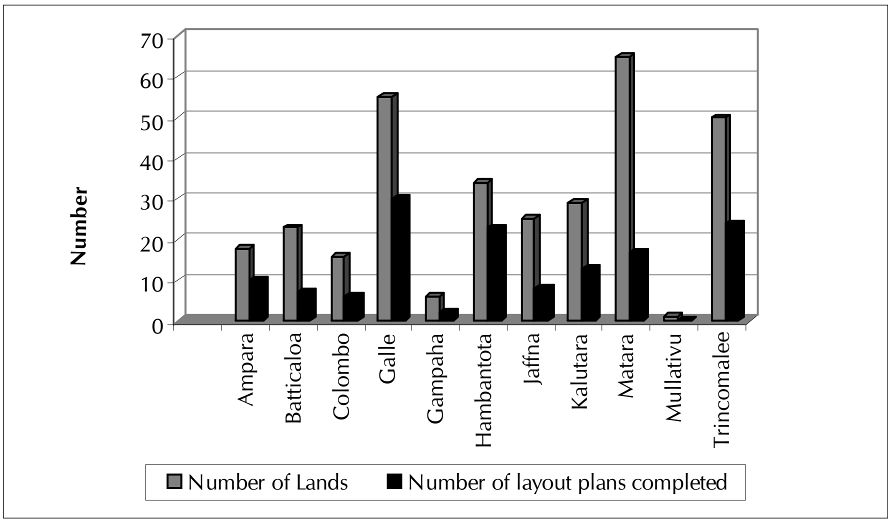
Figure 4.3
Construction Status: Direct Cash Grant Assistance



Source: TAFREN, June 2005.

to house construction, sites may have to be filled and levelled, with drainage, access roads and electricity provided. In some cases where government land is very limited, it is accepted that private land will be the only option and will be purchased based on the valuation given by the government. This is complicated by the fact that land prices inside the buffer zone have collapsed in value, while value of land outside the buffer zone has increased dramatically by as much as 5-10 times. The land sizes identified vary significantly (Figure 4.4), so that Galle and Matara have many land sites, compared to Ampara and Batticaloa which have much fewer larger sites.

Figure 4.4
Identified Land Sites



Source: TAFREN, June 2005.

However, land need not be such a constraint if there is proper dialogue drawing on the local knowledge of the affected households, and the land negotiating process is led by those familiar with the private property market and local conditions. Already some affected villages have identified land where they would like to be re-housed. The example of Loadstar (Box 4.2) which has already purchased four sites of private land for rebuilding shows that the obstacles can be overcome.

After land, the major physical constraint faced in housing reconstruction is availability of sand for cement, already in short supply and rising in price. River sand is in short supply and its removal is largely restricted as is sand from lagoons. Removing both river and lagoon sand is particularly counter-productive as they are part of the natural processes which helped to mitigate the force of the tsunami in some areas. Possible solutions include imports, quarry dust and washed off-shore sand. Off-shore sand is the easiest and cheapest solution. In the UK much of the aggregate for construction is from off-shore sand and this has not caused any durability problems over the past 60 years of use. Detailed tests by the University of Moratuwa conclude that the main concern is the chloride level but "it may be concluded that free drained sea sand will have chloride levels that are generally at the acceptable level, although some care should be taken if seawater is lost through evaporation". Dredgers could provide sand on to Sri Lanka's beaches at strategic points where house construction is expected (e.g., Galle, Hambantota, Batticaloa, Kalmunai) and can also contribute towards saving on transport costs. The government must issue licences for these

Box 4.2
Best Practice Rebuilding in the Southern Province

Following the tsunami, few local organizations had immediate access to readily available local knowledge and large scale finances. Loadstar Pvt. Ltd., a Belgian-Sri Lankan joint venture was in a strong position operating five factories, including its main rubber factory at Midigama in the Southern Province, employing 1600 people. With volunteers from its local labour force and private donations from Belgium, Loadstar immediately established the Solideal Loadstar Rehabilitation Fund (SLRF) with an initial commitment of US$ 2 million. The company helped call in the Belgian army to assist with clearing debris in the coastal area from Madaha to Galle and set up four emergency camps for 300 families.

The company is now building permanent houses and provides an example of some of the best quality and fastest rebuilding in the country. The villagers of Pelana South in Weligama depend primarily on fishing, coir and lace making for their livelihood. Loadstar has almost finished building 25 small two-floor houses for those outside the buffer zone located on their own land. The houses were designed following extensive consultation with the beneficiaries. For those inside the buffer zone who have to move, the company plans to build over 500 more houses. Four sites have already been purchased from private land owners including one site with space for over 200 houses which is now being levelled. For all the houses, furniture will be provided along with water supply and electricity. Although the company acknowledges it cannot heal the emotional loss from the tsunami, they are determined to try to make people's living conditions physically better than before the tsunami.

Source: www.belconsulrehabfund.org

dredgers to start delivering sand. This would need to include possible sites where off-shore mining is permitted and where the sand could be deposited.

Another major constraint is that of potential labour shortage and need for reputable contractors. Building an estimated 50,000 houses will require a major increase in skilled and unskilled labour, and increase in contracting firms. It is estimated that at least 100,000 workers will be required. This will include about 13,000 masons, 2000 carpenters, 2500 painters and nearly 54,000 unskilled labourers. There is an urgent need to start training tsunami labourers and other affected people in building skills through vocational training institutes, National Youth Council and other organizations. There are also concerns about the shortage of reputable contractors and ensuring that professional design standards are upheld. The Sri Lankan Institute of Architects has warned of quantity taking precedence over quality and has raised concerns that the homes of today should not be the slums of tomorrow. There are already reports of newly built houses sinking in the ground, walls that cannot withstand pressure and inappropriate roofing materials being used.

The scale of management challenges in housing construction is immense; almost 12 times as many houses as the 5000 houses built by the government in a normal year have to be met (the private sector also builds about 15,000 in a normal year). The huge increase in housing stock compared to a normal year will place major demands on the UDA and the NHDA. Even though many donor organizations will undertake the actual house building, the UDA and the NHDA will be required to coordinate and monitor progress, in some cases provide common infrastructure to the sites, and handle the vexed issue of housing allocation. There are also cases of many donors agreeing to take on rebuilding with limited past experience and some donors with sites for rebuilding having still failed to start the process.

So far, the government has not agreed a process or criteria for matching beneficiaries with the land and houses available. The MOU between the donors and the THRU states that "the selection of recipients of the housing units in the housing project will be the responsibility of the Government of Sri Lanka which will make the selection in consultation with the Divisional Secretaries and other State Agencies and groups associated with disaster relief activity". One concern is that this approach does not allow any role for the affected people themselves. Preliminary discussions with affected people suggest that this process is complicated as there are a range of different preferences depending on livelihoods, degree of damage, community cohesiveness and extent of local organization. Based on their livelihoods, fisherfolk, farmers and those working in tourist sites (e.g., Hikkaduwa and Pottuvil) prefer to be closer to the sea, while causal workers are less concerned about proximity to the coast. Based on the degree of damage and loss suffered, many traumatized people do not want to stay in old houses which are within 100-200 metres of the coast. Organizational characteristics are important as well as organized communities (e.g., mosque committees of Ampara such as Karaitivu and Nintavur) have identified nearby lands that they want the government to buy so they can move to these locations.

4.4 Relief and Restoring Livelihoods

4.4.1 Food and Cash

The initial cash relief effort was largely successful with almost all of those entitled receiving (through the Divisional Secretary) Rs.15000 for deaths and Rs. 2500 for lost cooking equipment. Almost all the 800,000 tsunami affected households received the initial two payments of the Rs. 5000 monthly grant paid through the People's Bank (and in some places the Bank of Ceylon) which kept branches open on the weekend to process the claims. Generally, the Rs. 175 food rations (available through the MPCSs) have been available, but in some places there have been limited varieties of food (e.g., vegetables) for the weekly Rs. 200 cash coupon and the rice has been of low quality. In terms of food supplies, there is a need to monitor availability and quality of food from the co-operatives in tsunami affected areas. There are also different rules for the distribution of the rations and the Rs. 5000 grants from area to area. In some cases, rations are given to a family, in other areas to individuals, and sometimes the criteria has varied from a lost family member, or lost house or lost livelihood. For this reason, it seems that more ration cards have been issued than affected families. By end June 2005, 881,000 beneficiaries were receiving the Rs. 375 cash and food ration.

The Rs. 5,000 grant scheme initially proved very effective in reaching most of the affected population and where the reach of the state banks was limited, such as the North, alternative arrangements have been made. The scheme has also assisted people with little engagement in the formal financial sector to start deposits (which were mandatory to receive the funds). However, after the first two payments for January and February 2005 the scheme ground to a halt as the Ministry of Finance ordered Divisional Secretaries to revise the lists of eligible beneficiaries to remove those in the public and private sector with an income after the tsunami. It took four months to draw up new lists of those eligible to receive the grant based on changing government circulars. This created added confusion, uncertainty and anger among the tsunami affected households which led to major demonstrations in several districts. By the end of June, payments began after the four month break to the new list of 234,000 eligible beneficiaries.

Thus, having initially been one of the government successes of post tsunami relief, the revisions to the Rs 5000 grant would seem a major error. The new criteria seem to often be unfair as even households with a permanent post tsunami income have suffered a major loss of wealth in terms of property and possessions. The government circulars announcing the revised criteria for the Rs. 5000 grant are too broad and offer significant discretion to the local Divisional Secretary leading to wide variations in interpretation, delays and long back logs of appeals. Clearly, the government has reduced costs by revising the criteria for recipients, but the money is available anyway from donors for tsunami recovery and this would be equal to just 5 per cent of the total pledged by donors. Now that bank accounts have been opened this cash grant transfer system is extremely cost effective compared to the high transactions costs that many other tsunami livelihood projects include - with often as much as 30 per cent administrative overheads.

In a number of locations, the larger international NGOs in particular have introduced cash for work programmes in areas such as clearing of rubble and rebuilding of transitional shelter. Typically, the wage rate offered is Rs. 300-350 for men and women which is close to the average daily wage rate for men, but higher than the usual wage rate for women. There are also areas where wage rates are considerably higher such as Rs. 500. The advantages of this cash for work is that it does bring cash into the local economy while addressing the shortage of labour to clear debris and put up transitional shelters. However, this approach has faced some resistance, especially from local NGOs, who feel it undermines the voluntary approach to collective action through shramadana. Local

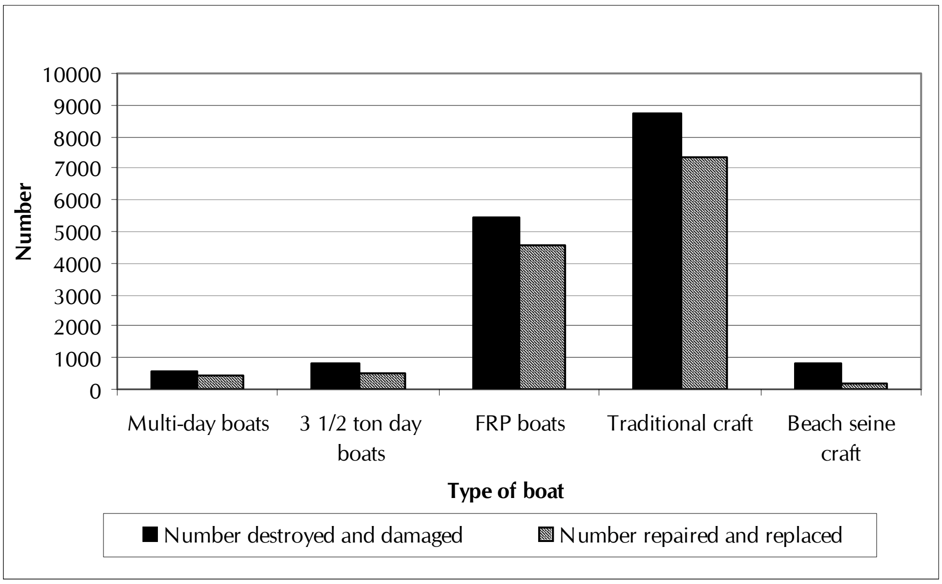
NGOs may also lack the funds to pay these wage rates. Another concern is that cash for work only benefits the able bodied who can undertake the labour. The old, young, sick and disabled and carers (who find it difficult to leave their children) should not be forgotten and alternative arrangements must be made for their needs.

4.4.2 Fishery Related Livelihoods

It is estimated that at least one-third of the affected households were those of fisherfolk. In some areas this figure is much higher, for example, in the Jaffna District the figure is close to 90 per cent. An estimated 16,500 boats and one million nets were damaged or destroyed. Following the ceasefire in 2002 there was a major expansion of fishing in the Northern and Eastern Provinces. The fishing industry includes a wide range of vessels, fishing techniques and practices. Fishing is practised in both the sea and coastal lagoons with fishermen often moving between them, while some fishermen also practise agriculture and other activities. In the sea, fishing vessels include a small raft (theppam), wooden dugout or fibreglass outrigger, large wooden or fibreglass sea canoe (oru), fibreglass day boat with outboard or inboard engines, and multi-day boats. In addition, wade fishing takes place using cast nets, and beach seining where a large net is pulled in from the shore. Other types of fishing gear include drift nets, pole and line (for tuna), trammel nets, cast nets, hand line and long line, purse seines (illegal but still in use) and brush parks (kottu). This wide variety of nets suggests that replacing lost equipment is a complex task that must be done with close dialogue with the affected fishermen. Unlike many other assets, nets and boats can generate an immediate income. In the rich fisheries round Ampara, fishermen can earn Rs. 500-1000 per day from the beach seine nets known as *kalaveli*.

To restore fisheries requires boats, engines and nets. Many fishers use several nets to

Figure 4.5
Number of Boats Damaged and Repaired



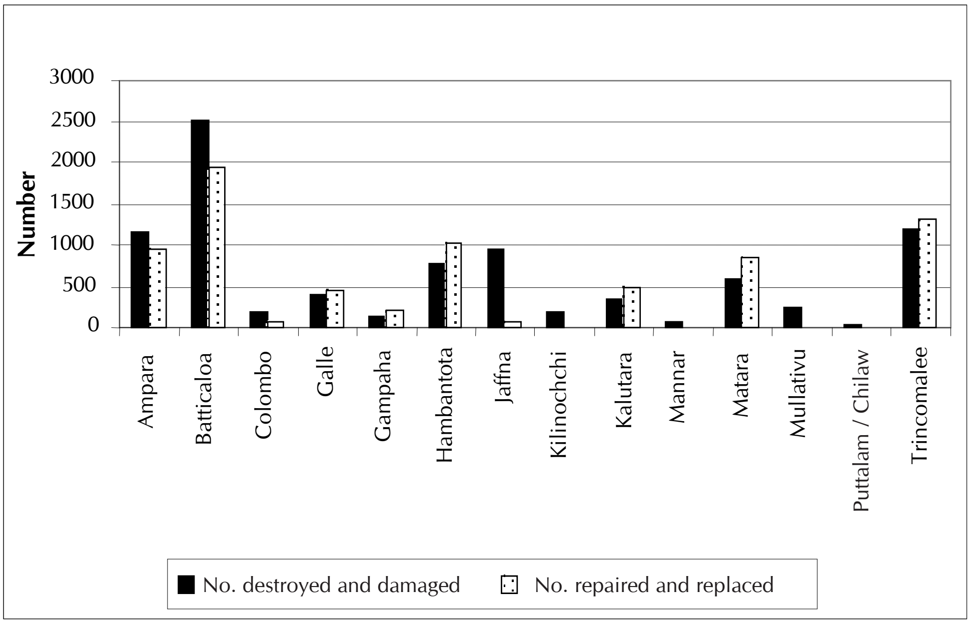
Source: FAO, June 2005.

catch different species. Fishing vessels have been replaced quite rapidly, indeed with more smaller vessels than before the tsunami in some locations, potentially leading to over-fishing. However, access to engines and nets are still a problem. There has been considerable success in replacing lost craft with between 60-85 per cent of the vessels replaced depending on the vessel type. Typically, the smaller boats have been repaired and replaced fastest with over 80 per cent restored countrywide compared to the more expensive multi-day and 3.5 ton boats which indicate a replacement of between 60-70 per cent.

However, the replacement of smaller craft has been quite uneven. In the southern areas such as Kalutara, Hambantota and Galle, as well as Trincomalee, the number of traditional craft already exceeds the pre-tsunami levels. Available data also shows that many NGOs are planning to continue providing boats which in some places could lead to a doubling of pre-tsunami fishing effort, especially in the near shore coastal areas which were already subject to over-fishing prior to the tsunami. As a result, efforts are underway to encourage a reduction in the distribution of small craft. Some NGOs have been responsive such as Sewa Lanka which cancelled an order for 2000 traditional canoes.

While the replacement of boats and nets has been generally rapid, only an estimated 50 per cent are being used due to lack of engines and nets. It is estimated that about 1700 engines have been repaired. While another 6000 engines have been ordered, by end June 2005 only 450 had actually been delivered. In terms of nets, an order has been issued for 46,000 nets - mostly from international suppliers - but the suppliers can only provide half the order due to the post tsunami surge in demand.

Figure 4.6
Number of Traditional Fishing Craft



Source: FAO, June 2005.

4.4.3 Microfinance and Support for Small and Medium Enterprises

While fisheries have been relatively well served by the relief effort, it is clear that many other livelihoods have received less attention. Often these livelihoods such as coir and lace making are more important for women so their slower recovery may impact more on female headed households. There are also growing tensions between fishers and other livelihood groups due to the perception that the fishing industry has received greater attention. Many tsunami affected households were engaged in micro-enterprises with as many as 25,000 micro-enterprises estimated to have been were damaged. In addition, there are an estimated 15,000 tsunami survivors involved in self-employment and informal sector activities, such as food processing, coir industry, carpentry, toddy tapping and tailoring. Many of these workers urgently need funds to replace lost or destroyed assets such as equipment and stocks.

Boats and fishing equipment are generally being provided free of charge as equipment, and housing will also be funded separately. However, for other livelihood needs, credit is the most favoured distribution mechanism. A host of microfinance proposals are under preparation to fill this gap. Prior to the tsunami, Sri Lanka had a relatively well served micro-finance sector. This includes both commercial and rural banks serving smaller customers (e.g., Cooperative Rural Banks and Regional Development Banks), and the more grassroots approach to micro-finance where a group will operate a revolving credit fund (e.g., Sanasa, Sarvodya SEEDs). To support a strong repayment culture, most microfinance organizations are being encouraged not to switch to grants. Where grants are necessary, for example for housing and food, they are best provided not by microfinance organizations but alternative institutional mechanisms.

The Central Bank has been implementing the Susahana scheme through the two state banks. Through the provision of Rs. 5000 to affected families, the People's Bank has an impressive data base of those affected and the resultant new accounts. The National Development Trust Fund is also offering similar terms through its partner organizations. The Susahana loan is provided with no repayment required for the first year and interest at a fixed rate of 6 per cent thereafter. By end June 2005, 4154 applicants had received Rs. 1940 million (US$ 19 million) through the Susahana scheme of the state banks and another 4437 people had received Rs. 158 million (US$ 1.58 million) through the NDTF scheme.

Despite claims to the contrary and its stated intention to also reach micro-entrepreneurs, the Susahana lending schemes have been set up so that they are very difficult for small micro-entrepreneurs to access. There are constraints in passing on information to those in the camps and helping with application forms. Guarantors are required who have a permanent income above a certain threshold level. Collateral is required, for which land within the buffer zone is not acceptable. Loans will only be given for businesses registered before the tsunami, which rules out many smaller unregistered businesses and stops people taking up new livelihoods in response to their changed circumstance post tsunami, such as the death of the main earner, disability or new responsibilities to care for some family members. The terms of the Susahana need to be urgently reviewed to ensure that they can start to reach the poorer micro-entrepreneurs. There are also non-financial services required to help the poor develop new skills and access markets so that they can put microfinance to good use. Finally, there may be problems accessing credit for those who are not already members of revolving credit societies.

While there is much interest in providing new loans, a pressing issue is how to handle old loans. In general, individual banks and microfinance institutions are being left to negotiate this on a case-by-case basis as they have the best knowledge of a client's needs and ability to repay. Typically, microfinance organizations only forgive loans in the event of death or permanent disability, but many recognize that the tsunami presents a situation where it is not willful defaulting. However, there are concerns that borrowers face many unforeseen risks such as drought, floods or political volatility and risk. In this context, some microfinance organizations prefer to avoid using the tsunami to create a precedence for loan forgiveness. Instead, the preference is for loan rescheduling allowing the client time to return to a normal positive cash flow. Loans can even be provided to replace lost assets and increase future earnings. This can often be in the long term interest of the client as loan defaults will make it harder to access future credit. However, where clients take a long time to repay (e.g., over 18 months), it may be necessary to continue to pursue these loans, but to write the loans off as an accounting entry in order to keep balance sheets transparent.

4.4.4 Tourism Related Livelihoods

In the short run, the tsunami has dealt yet another blow to Sri Lanka's volatile tourist industry, just as it was gearing up for a record season. About a half of the 105 large and medium scale hotels in the affected areas were partially damaged and 8 hotels were fully damaged. About a quarter (or 58 of the 242 registered hotels) in the country were affected. In terms of rooms, about 3500 out of a total of 14000 rooms in medium to large scale hotels were not in operation by late February 2005.

The larger and medium scale tourist hotels and guest houses generally had insurance cover for natural catastrophes including earthquakes and this was interpreted as providing tsunami liability. An estimated US$ 150 million was paid out as liable claims and the bulk of this was to the hotel industry. This suggests that some hotels were able to cover the costs of their reconstruction. However, most hoteliers did not have cover for the consequential impacts of the disasters such as cancellations, etc., and have had to bear these costs in full. Since the tsunami, insurance companies are including tsunami cover as part of their natural catastrophe cover. In turn, this has led to about a one-third increase in the cost of insurance, rising from 0.1 per cent of the value of assets to about 0.13 per cent. For a medium sized hotel worth about US$ 3 million, this would be an increase in premiums of about US$ 900 while for a large hotel worth about US$ 15 million the increase in premium would be US$ 4500.

The tsunami is likely to have more medium-term impacts on future tourist arrivals and occupancy rates. The tourism sector had reached its historic high in 2004 at 565,000 arrivals. The two biggest markets - the UK and India - each topped 100,000 for the first time. Tourist arrivals were expected to reach 600,000 in 2005, with 150,000 arrivals during the first 3 months of the year. This estimate has now been revised downwards to 425,000 arrivals in 2005 and 575,000 in 2006 - although some feel this is still too optimistic. Around 40 per cent of the foreign guest night stays in Sri Lanka are spent along the beaches of the island's southern and eastern coasts. For some of the hotels in the affected regions that were not damaged occupancies are high as tourists are replaced with aid workers, etc., at least on a temporary basis, while in other undamaged coastal hotels the occupancy is under 10 per cent. Hotels in the interior are also registering lower occupancies due to the drastic downturn in tourist arrivals, but Colombo hotels are full with regular business travelers and tsunami related visitors.

For the coastal beach industry, the tsunami could provide an opportunity, as with the fisheries industry, to rebuild the industry in a more planned and sustainable fashion. Most hotels have already started reconstruction work. The Ministry of Tourism is assisting the tourism sector with a major 'Bounce Back Sri Lanka' campaign which combines public relations with the development of world class coastal tourist facilities. The industry is also receiving duty free import privileges for necessary equipment for reconstruction, and the Central Bank has a loan facility available through the major banks for small and medium scale enterprises (SMEs) which covers the tourism industry. Confidence in the industry is indicated by continuing work on a number of luxury hotels. The Tourist Board has taken steps to offer new Tourist Zones where land and other infrastructure will be provided. The Tourist Board aims to develop 15 tourist zones at a cost of US$ 12 million each with donor funding. The zones identified are Kalpitiya, Wadduwa, Beruwela, Bentota in the west coast; Hikkaduwa, Galle, Unawatuna, Koggala, Matara, Hambantota and Tangalle on the south coast and Yala, Arugam Bay, Passekudah and Nilaveli on the east coast. The balance between up market boutique hotels and more traditional mass scale hotels is still under debate given the recognition that mass market tourism serves livelihoods of many in the country.

4.5 Governance and Management of the Reconstruction Process

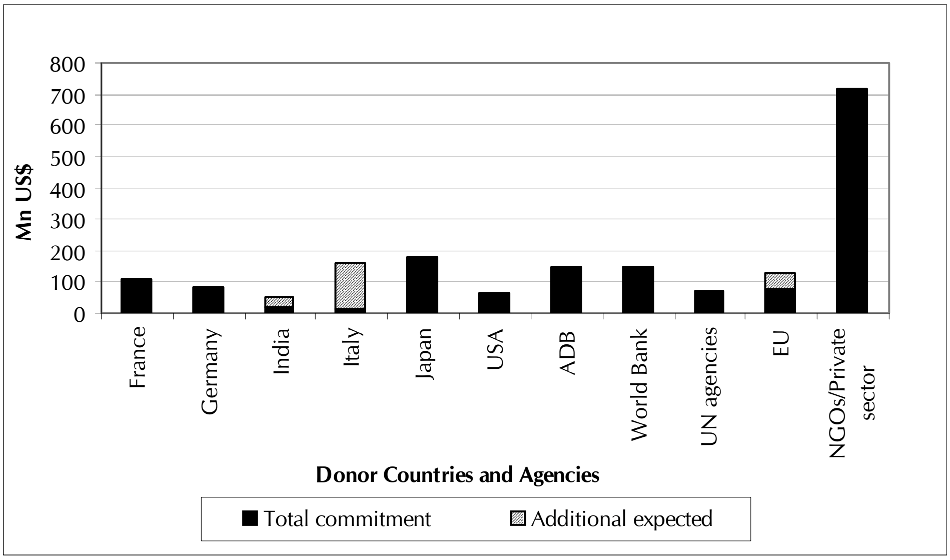
Unprecedented funds for reconstruction have been committed by international donors and by voluntary and private sources from Sri Lanka and abroad. The major challenge is to develop systems and processes for using these funds rapidly and equitably. The objective is to restore tsunami affected areas so that people are at least as well off as they were before the tsunami, and preferably to 'build back better' and overcome the considerable pre-tsunami poverty levels.

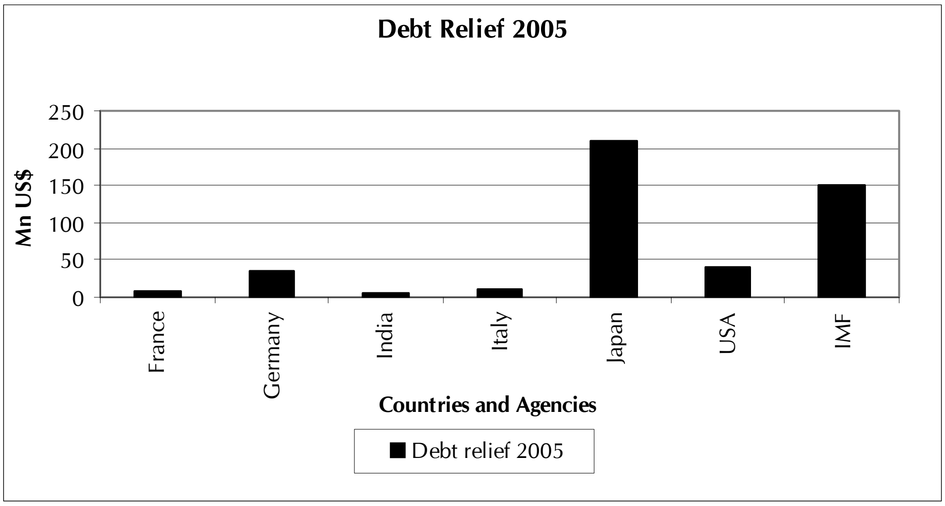
4.5.1 Managing Aid Flows and Harmonizing Donor Aid Procedures

Due to unprecedented international and national pressure, donors have been unusually swift to convert aid pledges into firm commitments and then disbursements. In total, an estimated US$ 2.2 billion was committed by donors for tsunami reconstruction at the Kandy Donor Conference in June 2005.

While the Sri Lankan government has raised some concerns about aid pledges being converted into commitments, there are also constraints regarding the ability of the government to spend the aid which is committed. Sri Lanka has a poor track record in aid absorption. However, aid utilization which hovered in the region of 15 per cent in the latter part of the 1990s has since shown an improvement to around 18-20 per cent. Several administrative factors including slow procurement procedures, lack of counter-part funds and lack of effective financial monitoring and management can slow down the rate of disbursement. Part of the fault also lies with donors whose complex and competing project cycles (e.g., separate off budget project accounts) prevent a more strategic approach to expenditure and accounting. Procurement and monitoring should be harmonized as set out in the internationally agreed Paris declaration on aid harmonization. The tsunami provides a key opportunity for both government and donors to move towards a more harmonized approach to funding with joint accounting procedures that promote accountability to the Sri Lanka public and not just to donors. The government should be commended for their strong stand in requesting that the donors undertake a joint needs assessment by World Bank (WB), Asian Development Bank (ADB) and Japan Bank

Figure 4.7
Donor Assistance for Tsunami Recovery





Source: World Bank, May 2005.

for International Cooperation (JBIC) which encouraged donors to take a coordinated approach. This harmonized approach needs to extend into implementation with the cooperation of other key players such as international NGOs.

4.5.2 Improved Collaboration and Cost Effectiveness of Donors and NGOs

There is also a need to reduce the initially highly competitive behaviour on the part of donors and NGOs, and to ensure that larger international NGOs (INGOs) do not crowd out Sri Lankan NGOs. At the district level, coordinating committees have often been set up to try to limit the 'humanitarian free-for-all' and overcome the climate of mistrust that occurred as many agencies, often new to Sri Lanka, descended onto the tsunami areas. The Sri Lankan experience is different compared to many international reconstruction efforts as so much of the funds are controlled by the INGOs - often more than through the large aid agencies. With their own funding secure, many international NGOs face few incentives to improve coordination.

In the scramble among INGOs and agencies for attention and funds, many Sri Lankan NGOs were crowded out, and an uncoordinated process developed for priority setting. There is already deep mistrust in several locations between local NGOs who have often been working in the area for many years and some INGOs and agencies who arrived in the area after the tsunami. While some INGOs and agencies may have expertise in large scale disaster relief (such as transitional shelter), there has often been a lack of consultation and engagement with local NGOs who have a much greater appreciation of local conditions and sensitivities. INGOs and international agencies often compete to work with the same local NGO partners stretching their capacity, while at the same time undermining the staff capacity of these local NGOs by offering higher salaries to staff who move jobs.

The cost effectiveness of donors can also be undermined by 'tying' aid to purchases from the donor country. Finally, INGOs and agencies often have high overheads and administrative costs of at least 30 per cent which are inflated by the excessive use of highly paid foreign consultants who may have very limited experience of Sri Lanka.

4.5.3 Communication, Dialogue and Transparency

The reconstruction process must be primarily demand driven, serving local needs. Recovery programmes, therefore, need to consider all interventions from the point of view of the affected population. The affected people want as little bureaucracy and simple accessible procedures. The decision to use the state banks for the Rs. 5000 allowance as well as micro-credit and housing funds is a good example of this. Coordination is vital and there are concerns that each of the 50 or so government ministries is keen to launch their own tsunami relief schemes. There are attempts to coordinate livelihood assistance being offered by the Ministry of Fisheries, Ministry for National Enterprise and Ministry of Rural Industries, but this coordination needs to be extended across other ministries as well.

Communication and information remains critical with many government officials unaware of the current government policies, while tsunami affected households often have limited knowledge of their rights and entitlements. Posters on relief were put up along the south coast and the media have been carrying announcements from TAFREN, but many people in the camps lack access to the media. There is a need for GNs, the state banks, cooperatives and other channels to be used to provide information to people in languages they can understand. Even of the broad aspects of the policy are understood, the details of implementation are stated in changing government circulars to which the people have no access. This leads to much anger, distrust and confusion - which could be overcome by publishing the contents of the relevant circulars. Even when people are aware, they need to understand the motivation for the policy. For example, some people in the North and East see the larger 200 metre buffer zone compared to the 100 metre in the South and West as discriminatory and have not been given any scientific rationale to explain it. There is also a need for much more listening and discussion with the affected people by government and politicians - in the development of policy, in the selection of lands for housing, and in the provision of boats and other equipment.

4.5.4 Governance and Accountability

An effective reconstruction process requires that appropriate decision making powers be given to the local level. The District and Divisional Secretaries working with Grama Niladharis (GNs) become the front line in the reconstruction process. The GNs are the key officials for filling in application forms for damage, etc. and are the village level government officials. The GNs paperwork is then forwarded to the Divisional Secretary and finally the District Secretary (also known as the Government Agent or GA). The GNs approval is required for access to the monthly Rs. 5000 allowance and GNs played the initial role in distribution of relief (but this is now done through the MPCS). This key role of local officials must be given greater recognition with enhanced administrative support and maximum appropriate decision-making powers at this level. The issue of land in the North and East is especially important as these were key to the eruption of the conflict. Ill-informed or rushed decisions could exacerbate existing conflicts. Provincial Councils and Pradeshiya Sabhas could be given a greater role. In most cases, a District level Disaster Coordinating Committee chaired by the District Secretary has been set up. But in some cases politicians have been appointed above the DS to manage District level activities, and this can complicate matters especially if the politicians are not familiar with the area.

To balance these stronger local powers, there must be tough action taken against local officials who fail in their duties, for example, a complaints procedure against ineffective or corrupt GNs. There does seem to be a tougher stance against corruption than in the past led by the re-functioning Bribery Commission. Several GN officers and other officials have been suspended and several enquiries are pending. The Ministry of Public Administration lacks effective systems to monitor GNs and respond to complaints, but there are plans to improve its capacity for investigations.

Government policy is only as good as its implementation and the monitoring of the progress of reconstruction is vital. The government initially took important steps to monitor receipt of the Rs. 5000 allowance and when the results were disappointing took action to keep the relevant banks open on all holidays. This pro-active approach to monitoring and prompt action in response must be continued in other areas - the allocation of micro-credit, housing funds, new houses and lands, and boats and nets. NGOs and the media working with the affected people also have an important role to play in monitoring government programmes and holding it accountable for its promises and for effective progress during the reconstruction phase. The Disaster Relief Monitoring Unit of the Human Rights Commission is playing a useful role, but needs to be strategic in its approach acting as an overarching monitor of relief and reconstruction progress.

Transparency and accountability of funds is another area that needs attention. Long running recommendations to strengthen financial oversight by the Auditor General's Department and Parliament through the Public Accounts Committee (PAC) are important. There is a need to strengthen the limited mandate and capacity of the Auditor General's Department. Parliamentary financial oversight mechanisms remain weak as they tend to handle old issues, lack interaction with the public and have limited access to expertise. Transparency International (TI), for example, has proposed a special Parliamentary Committee to oversee the foreign aid inflow and expenditure. To improve public interaction, TI proposal aims to provide access to the public and media to cover proceedings and follow up on any matter under their purview. The high profile public proceedings of the Parliamentary Select Committee on Disaster Management provide a good model. An important sign of progress is the pro-active approach of the Bribery Commission now that the Commissioners have been appointed. Transparency also needs to improve for funds handled at the local level. The media also continues to play a key role in tracking tsunami funds and their use. However, transparency is not enough without accountability. If any corruption is unearthed over the tsunami funds, action should be taken, including resignation by those holding public office.

The reconstruction process also needs effective dispute resolution mechanisms given that it is riddled with potential conflicts; conflicts about who is eligible for what in terms of land, housing, food, boats, nets, etc. Public officials are in positions of enormous power in allocating assets and funds. Widespread disputes have already appeared and will inevitably worsen as time passes and the larger grants, such as for housing, are implemented. There is a pressing need to introduce a whole host of effective dispute resolution mechanisms and appeal processes for such grievances to be aired and hopefully resolved. There are already moves underway to expand the mediation boards to deal with land and property and this may also apply to decisions by local officials.

4.6 Disaster Prevention and Risk Management

A comprehensive risk management strategy includes preparedness, detection, mitigation and public response before the disaster occurs. It is widely acknowledged that few of these aspects existed in Sri Lanka prior to the tsunami. However, while there is considerable public concern and political attention to limit damage from a future tsunami, it is important not to rush into sudden decisions without carefully evaluating all possible options to reduce future disasters. The costs involved in some of the approaches are significant and there is no point in developing an overly complex, expensive system that falls into disuse over time. A cross party Parliamentary Select Committee chaired by the Opposition reviewed these issues with public, televised proceedings and produced a comprehensive report. Unfortunately the Committee's report came out just after the passage into law of the Sri Lanka Disaster Management Act. This Act strengthens the existing National Disaster Management Center by setting up a National Council for Disaster Management chaired by the President and including all the major Ministers and Provincial Chief Ministers. The Act also provides for natural disasters to be declared, and requires all Ministries to draw up national disaster management plans to be approved by the Council. While it raises the profile of disasters, the Act takes an excessively top down, unprioritized and bureaucratic approach to disaster management and makes no mention of disaster management plans by Provincial Councils or Pradeshya Sabhas. The report of the Parliamentary Select Committee rectifies some of these failings giving a much stronger emphasis to local government, but with the passage of the Act it is not clear if the Committees recommendations will ever be implemented.

A tsunami is only one possible risk in the context of growing climate variability. The second major Sumatran earthquake on March 28, 2005 which many world experts had expected would produce a tsunami suggests that the events of December 26th may not be a one-off with a long period before the next such event. Regardless of future tsunami's, there is a scientific consensus that Sri Lanka faces an increased risk from climate variability related to global climate change. The east coast of Sri Lanka has experienced cyclones in the past and these and other climate extremes such as floods and droughts are likely to increase. More powerful monsoons associated with storm surges are already increasing in frequency. A few limited areas of the west coast experienced cyclone conditions in early March 2005. This suggests that responding to the tsunami should be accompanied by broader concerns with disaster management.

Disaster mitigation refers to reducing potential human and physical damage through, for example, by land use planning, coastal protection and building design. This could include protecting and reintroducing natural barriers to sea surges (such as sand dunes and mangroves), moving important infrastructure away from the coast, and limiting coastal land use. Even prior to the tsunami, coastal land use within 300 metres of the sea was covered by a series of 'set backs' administered by the Coast Conservation Department, but these were often ignored. Housing and building design can include simple cost effective measures to reduce the damage from future natural disasters. For example, houses can be built with apertures to allow water to flow through and rising water to drain rapidly away. Roofs can also be built at a particular angle and fastened securely to the walls to reduce the likelihood that they will be blown off during a cyclone or other strong winds. In the reconstruction of some of the coastal hotels, the redesign includes guest rooms on the first floor leaving the ground floor for service areas.

Disaster preparedness refers to the need for the government and public to be aware and able to take appropriate action in the event of a tsunami or other such disaster. This includes agreed emergency planning by political authorities, relevant scientific agencies, armed forces and emergency services, such as police and hospital authorities, as well as the media. This would need to cover hazard detection and monitoring, relevant evacuation plans and other precautionary steps, and swift action to respond to the aftermath of the disaster. It requires planning and disaster awareness and education. While for now people are acutely aware of the threat, this public awareness may fade in a few years.

A public warning system is urgently needed, even as discussions and implementation continue for a more long term disaster reduction strategy. The fact that on 26th December the tsunami hit Sri Lanka's south coast over one and a half hours after the Pacific Tsunami Warning Centre issued a tsunami warning, and even one hour after the tsunami struck the east coast, suggests the need for an effective warning system. There are many aspects of an early warning system; from the scientific detection of the original earthquake to communicating with vulnerable people to move to safer ground. All aspects need to be considered and often the weak link is communication, especially if people are asleep. Bangladesh has considerable experience with the use of sirens and evacuation to high concrete shelters. These proved their success in the 1990s when the death toll from the floods was much lower than the catastrophic 500,000 who died in 1976 when little protection was in place. The events of March 28th 2005 showed that the government, media and public can ensure quick evacuation, but there is a need for a clearer system of warnings. The government has now taken steps to put in place a more a more streamlined clear line of authority.

4.7 Conclusions and Key Recommendations

Those most affected by the problems of reconstruction are those households forbidden to rebuild within the buffer zone, who are also those who suffered most deaths and psychological trauma. While in principle many are willing to move, delays in providing new housing and restrictions on accessing loans has made difficult to recover livelihoods. Villagers living farther away from the sea have benefited from having land on which to rebuild houses, supported by government funds and in some cases NGOs. Unfortunately, buffer-zone refugees who had land now have almost nothing, as the price of land in the buffer-zone has dropped significantly. Local banks have been prevented by the government to accept this land as collateral, making it very difficult to apply for loans needed to restart livelihoods. In the longer run, some may benefit by having better houses and facilities than they lived in before the tsunami. But over the last 6 months and possibly next two years, the people who faced the tsunami first, while often willing to move, must now wait longer, walk further, and face greater challenges in restoring their livelihoods.

The tsunami has place a major strain on Sri Lanka's limited public sector implementation capacities. In many ways, the GNs and Divisional Secretaries at the front line responded commendably in the first two months. During the relief operation, key decisions were taken rapidly and implemented effectively. However, the second stage of reconstruction has proved less effective and delays are now widespread. The four month delay in payment of the Rs. 5000 cash grants caused by revising the list of those eligible is excessive and counter-productive. Commendable micro-credit programmes launched by the state banks and NDTF have only reached limited numbers, many of them not poor. And in the most important area of land, site selection has been top down, while site plans and internal boundary demarcation has been slow and consultation with beneficiaries limited. Off-shore sand mining has yet to properly begin after six months, despite the fact that it was clear from the beginning that sand shortages would be a major constraint in the rebuilding process. While making commitments to financial transparency, the government has placed very little information in the public domain on which funds have been received and on what they have been spent.

The tsunami has highlighted the need to develop appropriate disaster warning systems, government and civic institutions that can cope with natural disasters, and realistic and cost effective measures to minimize costs arising from natural disasters.

The following key recommendations are proposed to overcome the most serious remaining challenges:

- A public information campaign is required to explain the buffer zone and its rationale based on similar approaches in other countries.
- Identification of suitable lands for those being moved from the buffer zone can be speeded up by soliciting their assistance to identify such sites.
- A tender should be urgently offered for the private sector to provide off-shore sea sand for rebuilding to appropriate locations along the coast.
- The government, donors and beneficiaries must determine criteria for matching pre-built houses with those relocated from the buffer zone and prepare residence lists for each site displayed in public locations to avoid future conflict once permanent shelter is completed.
- Design of pre-built shelter must be done with the future residents to ensure compatibility with their cultural, social and economic position.
- The government should immediately publicize its intention to provide full title to those relocated and moving into the pre-built houses.
- The Rs. 5,000 grant should once again be made available to all affected families for the six instalments.
- The state banks should quickly amend the terms and conditions of the *Susahana* loan as currently it is very difficult for poorer micro-entrepreneurs to access funds.
- The Ministry of Fisheries should urgently review excessive distribution of smaller fishing boats in some locations, and prevent further distribution in these areas.

- The government should make publicly available the criteria for its cash and housing grants and tsunami bank loans instead of keeping these as internal circulars which leads to lack of accountability, arbitrary discretion and corruption.
- The Ministry of Finance could promote fiscal transparency and reduce corruption by placing detailed information on tsunami funds received and what they have been spent on in the public domain through the media and relevant web sites.
- Government, donors and NGOs should ensure harmonized aid financing and management procedures (e.g., procurement, accounting, monitoring, etc.).
- The recommendations of the Parliamentary Select Committee on Disaster Management emphasizing local government should be included in the implementation of the Disaster Management Act.

Leading Issues in the Development Process

5. Equity in Public Education in Sri Lanka

5.1 Introduction

Education achievements in Sri Lanka are praiseworthy in many respects. Formal public education in the country is accessible - both geographically and financially - to most. It is provided free of charge through an extensive network of schools, numbering more than 10000 and spread throughout the country. Mainly due to efforts by successive governments to promote education, Sri Lanka's literacy rate of 91.8 per cent and a grade one enrolment rate of over 95 per cent are better than those in similar South Asian and developing countries. Furthermore, these statistics are comparable between males and females.

However, despite these accomplishments inequalities in the educational achievements across different geographic and socio economic sections of the population and problems with the quality and relevance of the education have plagued the system in the recent past. These differences in educational achievements have in turn contributed to national problems of unemployment, youth unrest, violence, and long-term poverty observed in the last several decades. In the following sections, the chapter examines the probable reasons for observed differences in school quality across the country.[1] Section 2 looks at issues of equity in the educational sector. Section 3 describes the education administrative structure in the country. Section 4 examines the need for out of pocket expenditure on education and its effect on education inequality. Section 5 introduces the objectives of the new education reforms and examines the success of some aspects of these reforms in reducing inequalities in education and improving quality of education. Section 6 concludes.

5.2 Issues of Equity

Inequalities in the educational sector have resulted in making the school admission process highly competitive. Parents compete to enrol their children into popular schools in urban centres. Stringent admission criteria, especially for grade one admission, have limited the options available to parents to admit their children to a good school legally. Many parents resort to illegal measures to get their children admitted to good schools. This has made the grade one admission process a time consuming and costly exercise often resulting in lawsuits that damage the ethical/moral attitudes of affected children in the long term.

Anecdotal evidence and descriptive analysis on school quality shows several problems in deployment of resources in the current system. Table 5.1 provides province and sector-wise distribution of resources in 429 schools across the country. As seen, there are wide variations in the availability of physical and human resources across government schools in the country. In the province-wise distribution of resources, the most developed province in the country - the Western Province - performs better than the national average in almost all the indicators considered. More under-developed provinces such as the Uva Province and the Northern and Eastern Prov-

[1] The scope of the discussion will be limited to quality differences in public schools.

inces perform less well. The differences in the distribution of resources are even more striking in the sector-wise analysis of resources. In this analysis, the performance of the urban sector is far better than that of the other sectors in most indicators, except for student-teacher ratios and the availability of separate desks and chairs for all students. The poorer performance in the urban sector in these two indicators is probably due to congestion of students into schools in urban areas due to availability of better resources in these schools. In addition to discrepancies among provinces and sectors, anecdotal evidence suggests wide differences in resource availability within provinces and sectors. However, the issues concerning quality differences within sectors are difficult to address due to data limitations.

These differences in the availability of resources at the school level are reflected in the education outcomes of students. According to estimates by the National Education Research and Evaluation Centre, compared to 51 per cent of primary school children from the urban sector, only 34 per cent of primary children from the rural sector achieved mastery of first language skills. The comparable statistics for numeracy skills are also better for the urban sector (52 per cent) compared to the rural sector (35 per cent). Similar differences are seen in the results of national level examinations.

5.3 Administrative Structure and Distribution of Resources

Since the enactment of the 13th Amendment to the Constitution in 1987, the provinces were given more power in the administration and management of education in the country. Since the transfer of powers to the peripheries, the earlier three-tier structure of education in the country changed into the present five tier administrative structure consisting of the Ministry of Education (ME) at the Centre, Provincial Ministry/Provincial Departments of Education, Zonal Education

Table 5.1
Availability of Physical and Human Resources in Government Schools
(by province and sector)

	Province									Sector		
	Sri Lanka	Western	Central	Southern	Northern/Eastern	Wayamba	North Central	Uva	Sabaragamuwa	Urban	Rural	Estate
Good roof (%)[a]	92	98	96	94	96	85	85	94	82	95	93	73
Classes are held in separate classrooms (%)	44	72	53	37	27	19	15	37	47	71	39	60
Separate desks and chairs for all students (%)	60	62	65	55	28	72	48	58	74	53	61	71
Available teachers as a percentage of teacher entitlement (%)[b]	92	97	92	95	82	98	89	84	93	96	93	77
Student teacher ratio	22	20	22	19	31	41	18	21	22	24	21	15
Sample size	429	77	57	53	99	20	30	30	42	85	329	15

Notes: a. Roofs made of tiles or asbestos sheet were considered as good.
b. Number of teachers teaching in the school as a percent of the number of teacher entitlements.

Source: Author's calculations based on the Sri Lanka Integrated Survey 1999/2000 data.

Offices, Divisional Education Offices, and Schools. In this system, most schools - usually referred to as 'provincial schools' come under the purview of the provincial authorities. However, a handful of schools denoted as 'national schools' are directly managed by the ME.[2] In 2002, there were 9829 government schools; of these 9509 were provincial schools, while 320 were national schools.[3]

Differentiating schools as 'national' and 'provincial' based on facilities provided has contributed towards increasing discrepancies between schools. In the early 1980s, a small group of schools were denoted as national schools based on strict eligibility criteria that took into consideration availability of facilities and the quality of education. However, since then several schools have been promoted to the level of national schools, although they do not conform to the same standards. National schools tend to receive better resources, as they are supposed to be developed as model schools. However, the admission process to the national schools, especially at the primary levels, are similar to the admission process to other schools such as distance to school and the parent being an alumni of the school. These criteria tend to favour children of well-to-do parents. As most national schools are located in urban areas, where housing is expensive, mostly children of well-to-do parents qualify to enter these better quality schools according to the distance criteria. Second, as parents who were alumni of these schools tend to be well-to-do, again children from richer households are more likely to qualify to study at these schools.

Although with the devolution of powers to the provinces, improvements in the equitability of the delivery of education was expected, anecdotal evidence suggests that decentralization did not, due to various reasons, improve the quality of education available across the country. First, although education was decentralized, the function of provincial departments of education was limited mainly to administrative tasks. Policies regarding education are formulated and implemented mainly under the supervision of the ME at the Centre. Although education development plans were initiated at the zonal levels taking into account the special needs of different education zones, most were not implemented due to financial limitations. As a result, despite policies that attempted to ensure fair distribution of educational resources across the country, availability of resources at the school level remains inequitable. Second, the increment in the layers of authority without clearly defined functions has resulted in inefficient outcomes such as confusion, added costs, increased level of administrative work and delays in decision-making.

The following sections discuss in more detail issues concerning deployment of resources across schools.

5.3.1 Deployment of Teachers

At present newly recruited teachers are deployed from the Centre according to deficits and excesses in teacher supply in schools. However, in this process the actual need of teachers for different subjects at the school levels does not receive adequate consideration resulting in teacher shortages for specific subjects.

Many schools, especially in rural areas have difficulty in retaining teachers. As shown in

[2] The Ministry of Education is the main Cabinet ministry responsible for education in the country. In addition, there is a non-Cabinet level ministry; namely, Ministry of Skills Development, Vocational and Technical Education. Both these ministries are commonly referred to as the Ministry of Education, henceforth in the paper.

[3] In addition to these, there are 561 pirivenas and 66 private schools (registered before 1960), 33 non-fee-levying assisted private schools and 33 fee levying autonomous private schools. Recently there has been an emergence of yet another type of private school – English medium international schools, some of which are approved and registered by the Board of Investment in Sri Lanka.

Table 5.1, available teachers as a ratio of teacher entitlements vary widely across provinces and sectors. These percentages are particularly low for the Northern and Eastern Provinces due to the ongoing ethnic conflict in that area and for Uva Province which has historically being the most underdeveloped province in the country. They are also low for schools in the estate sector. The problem is more severe for retaining subject teachers teaching English language, science, and mathematics. Teacher vacancies are also high for Tamil medium teachers.

Since 2002, the funding allocations for salaries were based on actual cadre rather than the approved cadre. As many schools in difficult rural areas are faced with a severe teacher shortage, these schools get less funding. Ideally, incentives should be given to encourage teachers to serve in difficult areas. Although a recent scheme attempted to solve this problem by giving an additional allowance to teachers as an incentive for serving in a difficult area, this initiative was later discontinued. More recently, a new policy was introduced requiring new teachers joining the ME to serve in a difficult area for 3 to 5 years depending on the level of difficulty. Although this has alleviated the teacher shortages somewhat, it has created a set of new problems including high turnover of teachers in difficult areas and lack of commitment from teachers. Also, as experienced teachers transfer out, teachers in difficult areas tend to be new and inexperienced. Further, teachers who qualify for transfers waste time at various educational offices competing for limited vacancies in popular schools creating productivity losses.

Sometimes the problems created by teacher shortage have made it difficult for schools to conform to national education policies:

- It is recommended under the education reforms that students have the same teacher for grade one and two. However, by the time students move into the second grade, their first grade teacher has been transferred.
- Although a school may have the required number of teachers, there may be teacher shortages for specific subjects. For example, there are insufficient numbers of teachers for the science, mathematics, art, dancing and music subjects.
- Education reforms require that the Sinhala language be taught in all Tamil schools, and the Tamil language be taught in all Sinhala schools. However, this requirement cannot be fulfilled due to the lack of teachers.

5.3.2 Distribution of Funds

The provincial and national schools receive funds through different channels from the Ministry of Finance. Recurrent expenditure for national schools is directly funded through the ME. Recurrent expenditure for the provincial schools is sent to the provincial education authorities through the Finance Commission. It is then channelled through to provincial schools through the zonal education authorities. The capital expenditure for both national and provincial schools is given to the central ME as a block grant. The ME in turn allocates this grant among schools. Funds are allocated for capital quality inputs according to Norm Based Unit Cost Resource Allocation Mechanism (NBUCRAM). However, funds allocated for the construction of new buildings, rehabilitation and such work has no clear mechanism and depends upon various unknown factors.

Estimates show that the per student recurrent expenditure available for national schools is higher than those available for provincial schools. These disparities between funding available for national and provincial schools are perpetuated partly because budgets are prepared according to historical allocations. Although plans are made to overcome these differences in resource availability in schools, severe limitations in the availability of funds have limited the implementation of such proposals.

In determining the recurrent education budget proposals, in theory, the divisional education authorities in consultation with the school authorities and principals assess the needs of the schools. However, in practice, the involvement of school principals in the budgetary process is limited to providing statistics on student and teacher populations. The budget estimates are prepared by various levels of the education administration at different stages in accordance with guidelines provided by the Finance Commission and the Treasury. In this bottom-up process, budget proposals are rationalized and prioritized at each stage. Although inputs from the bottom level are sought at the initial stages, the needs at these grass root levels are mostly not reflected in the final budget as they get diluted in the process. In some schools, school development societies, teachers and students get involved in making decisions regarding budgets. However, this is an exception, not the norm.

The amount of the capital budget for the year is decided by the Finance Commission based on the requirements proposed by zonal level authorities and the availability of funds determined by the Treasury. Once the Provincial Council is informed of the amount it will receive for the provincial schools, it prepares a prioritized list of activities to be carried out. The needs of the national schools are prioritized directly by the ME. When deciding the capital budget, allocations are made according to a set of norms prepared by the ME. When making a decision regarding the capital budget for the provinces, several factors are taken into consideration: past performance, actual needs, the capacity, requests made in proposals, the policies of the Finance Commission and any other relevant factors. The lack of up-to-date statistics is a cause for concern as it makes the assessment process difficult and less accurate.

The amount of capital funds received is often not sufficient for the maintenance of schools. Although funds are provided for maintenance of school buildings, due to crisis situations at the national level such as floods, funds are not available for damages caused by localized causes. For example in the Ratnapura district, although school buildings damaged by floods were provided funds for rebuilding, a school building damaged by the falling of a tree was not given funds. Further, a majority of available funds are spent on essential recurrent expenditure such as teacher salaries (on average about 95 per cent of the recurrent budget of provincial governments are allocated for teacher salaries). As a result, funds available for capital expenditure and development - such as continuous teacher training - is limited.

5.4 Out-of-Pocket Expenditure on Education

Despite large scale government spending on education, out-of-pocket expenditure on education is also quite high, and increasing over time. Estimates show that as much as 27 per cent of total spending on education comes from private sources. A recent IPS study estimates that on average, a child in the richest expenditure quintile spends Rs. 6210 annually on education, while a child in the poorest expenditure quintile spends Rs. 1455 annually on education. Given that Sri Lanka's official poverty line is Rs. 1423,[4] this shows that on average, the annual expenditure on education of a child in the poorest expenditure quintile is equivalent to roughly a month's per capita consumption expenditure.

[4] A person whose real per capita monthly total consumption is below Rs. 1423 in 2002 in Sri Lanka is considered to be poor (Department of Census and Statistics).

A significant portion of private spending on education is on out-of-school-tuition. There seems to be an over-dependence on private tuition to supplement publicly provided education in the country. This is mainly due to the highly competitive examination oriented curriculum system in the country and the low quality of teaching in most schools. This trend is disadvantageous, especially to children from poorer expenditure quintiles who are less able to afford this cost.

Other main items of private spending include, books, stationery and clothing. A recent IPS study on school participation concludes that despite attempts by the government to help parents with the out-of-pocket expenditure on education through various welfare schemes, high costs of education coupled with low benefits arising from low quality of education delivery - especially in the rural areas - and the low relevance of formal education in the labour market have resulted in the children of poorer households not participating in schooling.

5.5 Can the New Education Reforms Overcome Inequalities in Education?

The 'New Educational Reforms' proposed in 1997 and implemented since 1998 planned several amendments to the education policy in the country to improve access to better quality education for all. In 2001, a set of initiatives were undertaken to speed up the implementation of the 1997 reforms. These include: school based assessment, quality inputs, development of schools on a fast track, student welfare societies, education for peace and social harmony, counselling and career guidance, teaching English and foreign languages, information technology, teacher performance appraisal, and strengthening the management of schools.

The two main goals of the reforms were to arm students "with necessary knowledge, skills and attitudes to make them productive citizens" and "to create future generations with correct values, compassion and care towards fellow citizens and to live with tolerance towards each other". The reforms concentrated on five main areas: improving quality of education, providing education opportunities for all, developing practical and technical skills, provision of education training opportunities for all teachers, improving management and provision of resources.[5]

The next sections describe some initiatives taken to improve quality and relevance of education since the introduction of the new reforms, and their success in achieving the intended outcomes and improving equity in the education system.

5.5.1 School Based Assessment

The school based assessment was introduced to move away from an exam oriented evaluation system to one where children are assessed to help them develop into more balanced personalities. The main objectives of the school based assessment programme was to improve students' learning process, improve teachers' teaching process, improve assessment process in order to make teaching and learning more efficient and effective, and to transfer the school environment from an evaluation culture to an assessment culture. Under this programme, teachers are expected to identify abilities and inabilities of students and work along with them to help them master various learning tasks introduced in the classroom.

The school based assessment changes were carried out in Advanced Level classes in 1998, and primary reforms were introduced as a pilot project in the Gampaha district in 1998. These assessments in all other schools

[5] Ministry of Human Resource Development, Education and Cultural Affairs (2003), *Education for All: National Action Plan for Sri Lanka*.

in the primary and secondary streams were started in 1999. After the introduction of this scheme, these assessment scores for each child for each subject were reported - after standardization - along with the grades for O/Level and A/Level examinations.

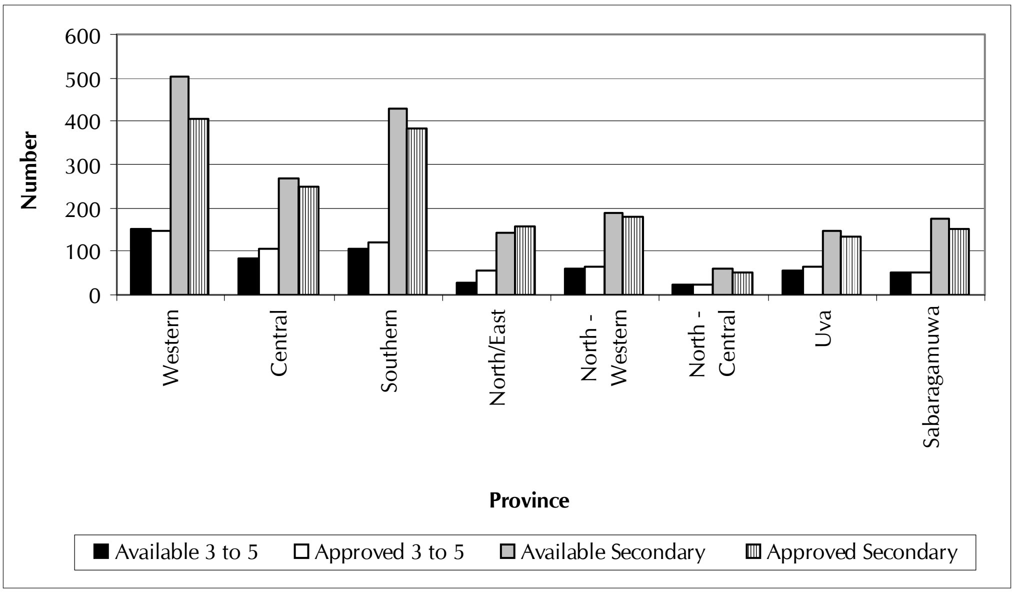
Although the objectives of this scheme were well founded, the scheme faced many obstacles in implementation. Under this scheme, the work-load for the teacher increased substantially with no added benefits. The teachers were required to maintain achievement records for all students and monitor their development throughout the school year in a number of areas. Also, teachers were expected to train to carry out school based assessments during the weekends. Given the fact that in some popular schools class sizes can be larger than 40, the scheme encountered considerable resistance from teachers' unions as they were required to undertake a much heavy work-load with no added benefits. The problem was most severe for schools with teacher shortages.

5.5.2 Teaching English and Foreign Languages

Since year 2000, much emphasis was given to promote English language proficiency of students from a young age. In the earlier system, English was introduced to students only from grade 3. It was proposed to introduce activity based oral English in grades 1 and 2 in order to familiarize students with English from a very young age, and to teach English as a second language from grade 3 onwards. The main obstacle faced by the programme was the training of more than 50,000 primary school teachers to teach English. Although much effort and money was spent on training teachers to teach English, the standard of English among the teachers remained low.

Another initiative to promote English was to teach some subjects in the English medium from grade 6 onwards. Although many parents welcomed this initiative, again lack of competent teachers to teach in English was a major obstacle that limited the success of

Figure 5.1
Available and Approved English Teacher Cadres-National Schools (as at 01/06/2004)



the project. As a result, only about 340 schools were able to introduce English medium instruction in a limited number of classes.

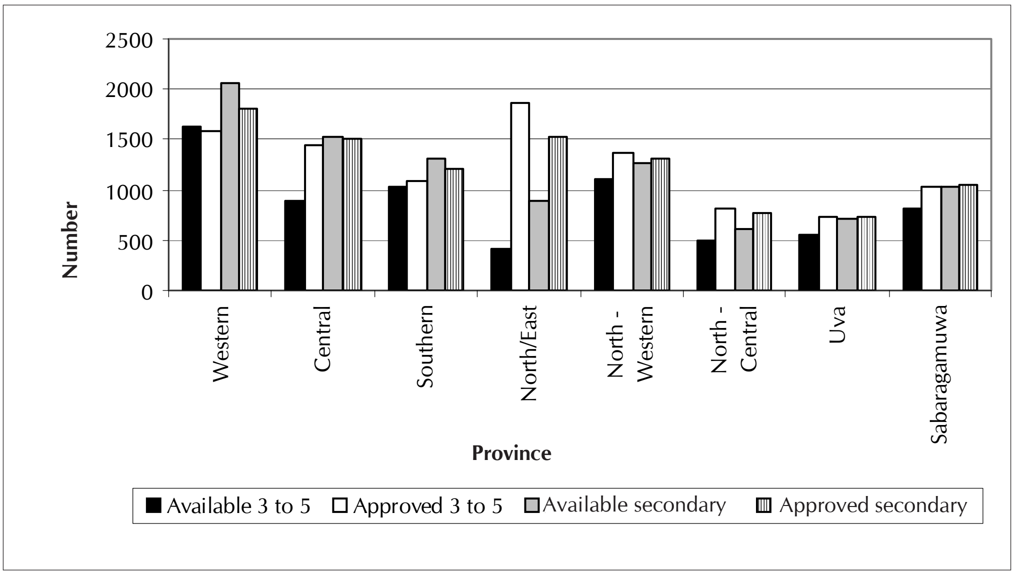
Another initiative introduced 'general English' as a subject in Advanced Level classes. However, although students in these classes understood the importance of English, they were reluctant to take time away from studying for the highly competitive A/L exams to study English as English language skills did not influence their chance of entering university.

Figures 5.1 and 5.2 show the approved and available cadres of English teachers for national and provincial level schools in 2004 by province. As evident, there are wide discrepancies in the available and approved cadres of teachers across the country. The deficits in national schools tend to be less pronounced than those in provincial schools and the teacher shortages are more apparent at the primary levels. The more developed Western, Central and Southern Provinces have teacher surpluses while less developed provinces, and particularly the North and East Provinces have a more severe shortage of English teachers. These patterns in English teacher availability across the country shows that the schools in less developed provinces - particularly provincial schools - are less likely to benefit from the new reforms on promoting English language due to problems with teacher shortages.

5.5.3 Information Technology

To prepare the younger generation of the country to meet the demands of an increasingly globalized world it was deemed necessary to promote computer literacy and the use of computers as a tool in learning. To achieve this goal - with the assistance from the World Bank and the ADB - more than 1200 computer centres were set up in schools across the country. There are plans to increase this number by another 1400 computer centres in the near future. In addition, some schools have procured computers on their own, and the ME has also provided a lim-

Figure 5.2
Available and Approved English Teacher Cadres-Provincial Schools (as at 01/06/2004)



ited number of computers to around 600 schools.

The main obstacle challenging the success of this project is the lack of funds for maintenance of the computer centres, and as with the earlier two projects, the lack of competent teachers to train students in the use of computers. One proposal to overcome the problem of lack of funds was to make the computer centres income generating centres in the evenings. However, managing such centres for income generating purposes requires managerial skills at school levels. Such skills are not available for all schools. Also, the opportunities available to schools in rural areas to develop school computer centres to generate incomes are far less than those available to schools in urban centres.

A further problem faced by the programme is the lack of access to electricity and telephone facilities by some schools. Roughly a third of the schools in the country - especially in rural areas - do not have access to electricity. So far computers have been provided only to schools with electricity. Although attempts were made to expose children in underprivileged schools to computers by using mobile computer laboratories, the success of these attempts were limited, as such limited interactions with computers were not sufficient to achieve computer literacy.

5.5.4 Education Quality Inputs Scheme

Under the Education Quality Inputs (EQI) scheme, in order to improve the availability of resources at the school level, schools were authorized to make decisions regarding identification and procurement of educational quality inputs. Educational quality inputs are defined to be 'all materials, equipment, instruments and services used to add the quality of education to the students in the learning process and by the teachers in the process of imparting knowledge'. Since the first quarter of 2000, schools were authorized to procure consumable quality inputs - such as chalk, chemicals, stationery, etc. - and procure services to repair and maintain capital goods - such as computers and typewriters. Since 2003, schools are also authorized to procure a number of capital quality inputs. A fixed percentage of capital and recurrent budgets are assigned for financing the procurement of quality inputs. Except for a few budget items such as special chemicals, science equipment and capital requirements for children with special needs, all other quality input needs are identified and purchased by the schools according to guidelines provided by the Finance Commission.

Although according to anecdotal evidence, since the commencement of this programme, there was an improvement in the availability of educational inputs at the school level, due to various reasons the intended equitable and efficiency outcomes were not obtained. Utilization of funds made available to the schools was not satisfactory in most schools. Some schools were unable to use the funds due to various procedural and procurement related problems. For example, guidelines require that quotations from three suppliers should be obtained before making purchases. Schools with limited access to markets find this difficult and expensive to comply with. Also, efficiency of fund utilization was not equitable due to differences in the ability of school authorities to identify needs of quality inputs and their ability to procure these needs through the identified, somewhat complex, process. The problem is further aggravated due to the existing teacher shortage problem in rural areas, and limitations in access to infrastructure in these areas. For example, anecdotal evidence suggests that underprivileged schools with teacher shortages have reduced capability to identify and obtain education quality inputs.[6] Some schools lack proper storage facilities in which to store quality inputs, especially in small schools. In such an environment, although allocation of funds is equitable the ability of the schools to utilize the funds is not equitable. Although, some additional funds are available for schools in difficult areas, these are often not sufficient to address the problems described above.

As close to 75 per cent of recurrent expenditure is spent on teachers' salaries and a further 20 per cent on textbooks and uniforms, the per cent of budget allocated for educational quality inputs is less than 5 per cent of recurrent expenditure. As a result, at present the schools have autonomy of financial decision making only over less than 5 per cent of expenditure allocated for their use. As such, even if these funds are properly utilized, the schools are unable to significantly influence the inequalities in the system.

5.5.5 Programme on School Improvement

The ME is hoping to further increase the decision-making powers of the schools by the introduction of the Programme on School Improvement (PSI) through the establishment of School Development Boards (SDB) in 2006. The idea is to involve parents, teachers, past pupils and well-wishers in the running of schools through school development boards. Among other goals, it is envisioned that the school development boards will achieve the following: i) prepare plans for the development of schools; ii) improve effective utilization of resources provided by the government and generated by the community; iii) improve the performance in curricular and co-curricular activities; and iv) match needs of the school to investments in teacher training.

In theory, the introduction of PSI will improve identification and procurement of educational resources at school level as schools will have more autonomy. However, in practice, the final goal of improving access to a good quality education for all will not be achievable through PSI if problems similar to those experienced under the EQIs hinder the implementation of the programme. For example, under the PSI programme the function of school principals will change from an administrative role to a managerial role. Whether principals in all schools have the ability and the training for undertaking these new responsibilities is questionable. Also, smaller schools in more remote localities will have limited capabilities and opportunities to prepare school development plans and generate funds for the betterment of schools. Such limitations in the implementation of the programme will result in further widening the divide between the popular schools in urban centres and smaller schools in rural areas if sufficient attention is not paid in the programme design to rectify these problems.

5.6 Discussion and Conclusion

Although compared to other countries in the region Sri Lanka's achievements in education are commendable, the inequities in the education system has increasingly concerned policymakers in recent decades. A host of reasons, including complex administrative structure, problems with deployment of teachers and other resources, inadequate funding for the sector, inefficient usage of funds and improperly planned implementation of policies have contributed to the existing inequities in the system.

[6] The "Guidelines on Procurement and Delivery of Education Quality Inputs" instructs schools lacking in technical know how to get the assistance of other more able schools in the vicinity, when making procurement decisions. The transaction costs involved for these schools will be larger.

Complex administrative structures with overlapping functions have removed the beneficiaries from the decision making process, making resource allocation inefficient and unequal. Further, it has increased the administrative work-load of bottom level officials, especially school principals, taking them away from more productive use of their time. To reap the full benefits of devolution, the administrative functions of the different layers should be streamlined, and existing capacity at the periphery must be developed so that they can be given more decision making powers regarding education in their respective areas.

Allocation of financial resources across schools has resulted in inequitable outcomes due to several reasons. Budgets are prepared according to historical trends rather than according to actual needs due to procedural shortcomings and budget constrains. This has resulted in perpetuating historical discrepancies. Although attempts have been made to provide educational resources according to unit cost criteria, scarcity of resources and problems with implementation has limited the success of these attempts. Also, in the allocation of resources across schools, considerations have not been made to adjust costs according to differences across geographical areas. This has deepened already existing disparities between the schools in privileged and under privileged areas. The existing practice of top-down policy making and implementation has ignored the needs of individual schools. There is an urgent need to identify the problems at the grass-root levels and address them accordingly.

Financial inadequacies have constrained essential development activities - such as continuous teacher training and development of education facilities such as laboratories and libraries - of the sector. Particular attention needs to be paid to improve availability of funds for the sector. Some initiatives aimed at improving availability of funds seek to introduce income generation at school level. Such solutions may not be viable for smaller schools in remote areas. As such, attention must be given to funding these schools through other sources in order to eliminate discrepancies. In addition to increasing the availability of funds, attention must also be paid to more efficient use of funds.

The present system of teacher deployment has resulted in wide discrepancies in the availability of qualified teachers across educational districts. There is an urgent need to give special attention to fulfill teacher requirements with qualified and experienced teachers in remote areas, and to upgrade access to facilities in these schools. Existing initiatives introduced to overcome teacher shortages have resulted in limited success. New innovative policies should be adopted to improve availability of qualified teachers in remote areas. If the existing systems are unable to train teachers at required numbers, in the medium term attention should be paid to alternate ways of recruiting teachers until training capacities are improved and expanded to meet the demands of the system. Some approaches used by other countries to fulfill immediate teacher vacancies can be adopted to overcome the teacher shortage problem in the medium term - such as recruiting teachers from other countries, training mid-career professionals to be teachers and recruiting retired teachers. Also, special incentives must be given taking into consideration the needs of the teachers so that they are willing to serve in difficult areas. Financial incentives alone in this respect will not be sufficient as the competition to serve in urban areas is also fuelled partly by needs of the families of teachers such as schooling children.

Along with eliminating teacher shortages, teacher training and teacher evaluations must be given special attention. Anecdotal evidence suggests that the quality of teaching has declined over the years. Teachers should be given special incentives to improve delivery of education. Although recently introduced education reforms have attempted to introduce teacher evaluations and teacher appraisal systems, these faced many obstacles in the implementation process due to improper planning and resistance from teacher unions. However, these obstacles should not be viewed as reasons to remove these important programmes from the system. Instead, attempts should be made to overcome these difficulties.

Some schemes that are being proposed - such as the EQI and the PSI schemes - aim to decentralize education decision making to the school level as means of improving quality. The success of the proposed PSI heavily depends on the abilities of the local and school level authorities, parents and communities to properly manage schools coming under their purview. However, given that the existing capacity at the schools and communities vary widely, implementation of these programmes without paying attention to differences between schools and their location could deepen existing differences between schools. The success of this programme will depend on how well its implementation strategy is designed. As with other policies, special attention must be given to small schools and schools in remote areas as they tend to have the least capacity to manage on their own.

Although goals of the new educational reforms are praiseworthy in their attempts to improve equity and quality across schools, improper implementation strategies have limited the success of the reforms in many areas. Most importantly these have failed to adequately take into consideration existing differences in schools resulting in increasing further the existing anomalies. Many of the initiatives under the new education reforms do not address fundamental problems of inequity between schools - such as teacher availability and limited access to infrastructure. As a result, privileged schools continue to benefit more from the new initiatives increasing the discrepancies between schools. Special attention and funding should be provided to upgrade the smaller schools and schools in remote areas in order to improve quality and equity of education across the country.

6. Private Rural Agricultural Extension in Sri Lanka: Pros and Cons

6.1 Introduction

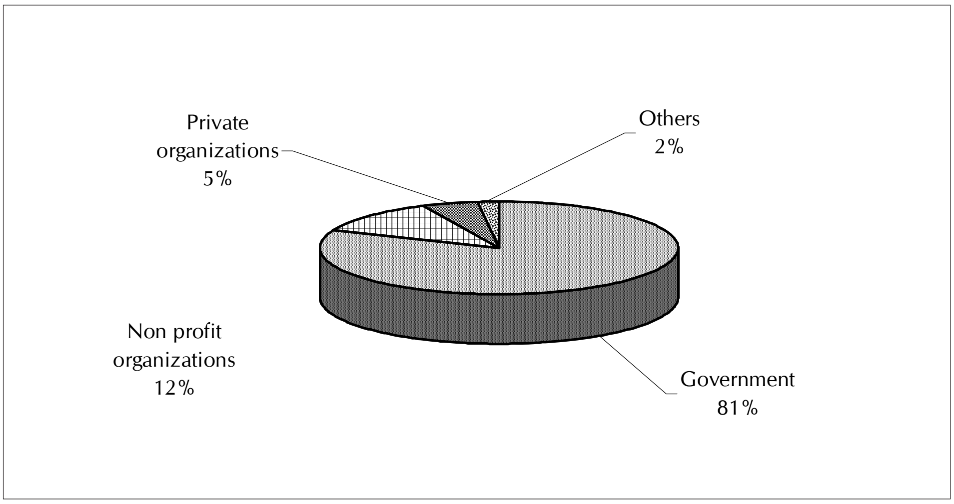
Agricultural extension, with a largely unrecorded history, has been a significant social innovation and important force in agricultural development. Although the use of the word 'extension' began in England in 1850, the first practical attempt was made as 'university extension" in 1867. This activity developed quickly to become a well established movement before the end of the century. The growth and success of these activities in England laid the foundation for the initiation of similar activities elsewhere in the world.

Extension is often regarded as a combination of communication activity (transmission of technical information to farmers) and educational activity (development of skills to make use of the technical information). While governments have tended to play the major role, there has been an increasing role of private participation in agricultural extension. Participation of both the public and private sectors raise important policy issues of affordability, effectiveness, equity, etc. This chapter attempts to assess the pros and cons of private rural agricultural extension in Sri Lanka. Section 2 offers an overview of the Sri Lankan agricultural sector. Section 3 looks at agricultural extension in Sri Lanka. Section 4 examines the concept of private extension while Section 5 assesses the debate on public-private extension. Section 6 concludes.

6.2 The Sri Lankan Agricultural Sector

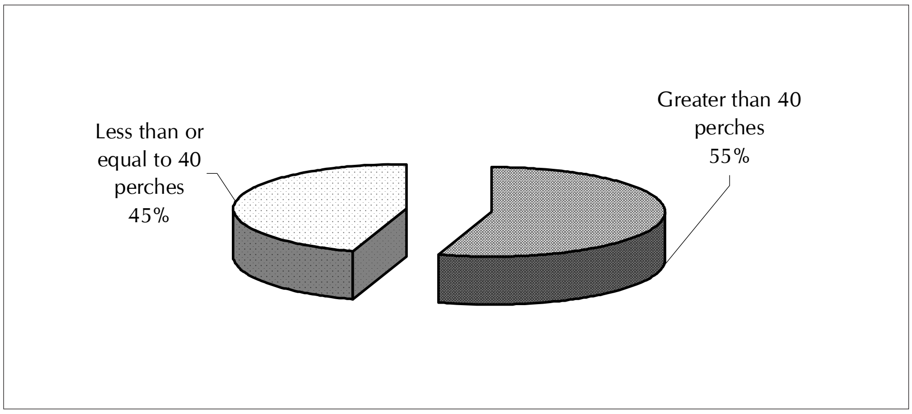
Governments have traditionally taken the lead role in the provision of agricultural extension services because of the important contribution agricultural extension makes to agricultural development (Figure 6.1).

Figure 6.1
Distribution of Extension Organizations Internationally



Source: World Food and Agricultural Organization (FAO) database.

Figure 6.2
Share of Agricultural Holdings in the Smallholding Sector



Source: Department of Census and Statistics, Agricultural Census 2002.

In assessing the most viable agricultural extension system for a country, it is important to have a clear understanding of its domestic agricultural sector. In Sri Lanka, there are a large number of small and less educated farmers who are not willing to pay or are unable to pay for extension services. About 3.3 million agricultural holdings are in the smallholding sector where the individual holding size is less than 20 acres in extent. Out of the 3.3 million, about 45 per cent are less than 40 perches (Figure 6.2) and their agriculture produce is mainly for household consumption.

The Agricultural Census of 2002 shows that the increase in the number of smallholdings is greater than the increase in extent (Table 6.1) and it clearly indicates the increase in smallholdings is due to land fragmentation. The average holding size has decreased from 1.98 acres/holding to 1.16 acres/holding from 1982 to 2002. The majority of small farmers are located in remote, underdeveloped and unfavourable areas where it is usually unprofitable for private sector to conduct business.

Land scarcity[1] has been a predominant phenomenon in both the agricultural and non agricultural sectors. This is very significant not only in urban areas but also in rural areas dominated by agriculture. Scarcity of land associated with increasing smallholdings and

Table 6.1
Change in the Number of Smallholdings and their Extent

	1982	2002	Difference
Number of holdings	1,790,947	3,264,678	1,473,731
Extent (acres)	3,547,326	3,784,282	236,956
Average holding size (acres)	1.98	1.16	0.16

Source: Department of Census and Statistics, Agricultural Census 2002.

[1] At present per capita arable land is about 0.15ha (it is estimated that of 6.5 million total land area, only about 50 per cent is considered to be arable due to unsuitable terrains, inland water bodies and forest cover) while in 1870, per capita land area was 2.7ha with the population of approximately 2.7 million.

decreasing average farm size badly affect the rural agricultural sector. The inability to achieve scale economies and increasing input prices keep the productivity of most of the agricultural crops at a very low and stagnant level. Due to falling investment and resulting low productivity, rural farm income and the labour force involved in agricultural sector has been on the decline. This tends to increase the incidence of poverty in rural agricultural areas. Income from agriculture accounts for only 23 per cent of total rural household income indicating that off farm employments provides the major portion (Figure 6.3).

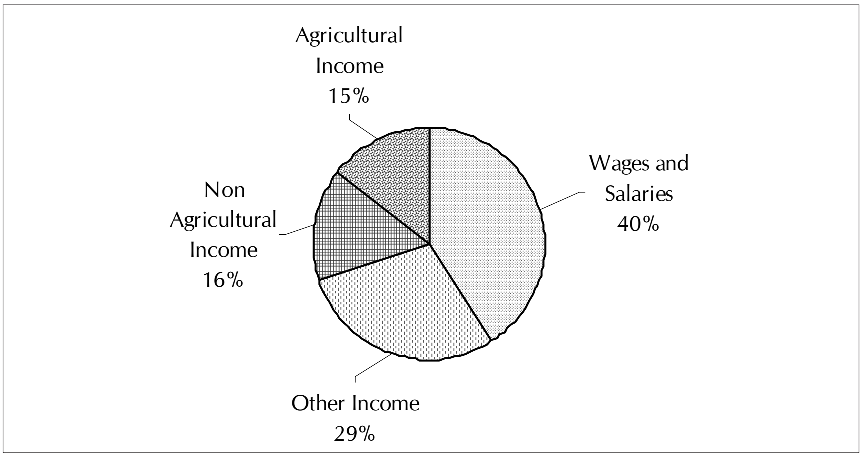
6.3 Agricultural Extension in Sri Lanka

Agricultural extension service in Sri Lanka has developed over the years as an evolutionary process, gradually expanding its scope and functions. The earliest recorded attempt to assist farmers commenced around 1880. After that the responsibility for agricultural extension was vested with Government Agents (GAs). In 1904, an initiative was made to improve the peasant agriculture with the establishment of the Ceylon Agricultural Society (CAS) which undertook extension work with GAs. In 1921, the CAS was absorbed into the Department of Agriculture (DOA).[2] In the early 1930s an Agricultural Officer (AO) oversaw the extension activities in each province with 37 Agricultural Instructors serving under them island wide.

Food security concerns - connected in part to experiences of the Second World War - encouraged the government to revise its policy direction, paying more attention towards agricultural extension. In 1951, many young people were absorbed to the mainstream of agricultural development through the Young Farmers Clubs Movement. A number of female demonstrators were appointed in 1952 to work with farm women. At the time, national level planning was very limited and most extension programmes were planned and executed at the divisional level.

In 1955, the farmer demonstration plot method was replaced with more objectively designed 'Method and Result Demonstra-

Figure 6.3
Rural Household Income by Source of Income (2002)



Source: Department of Census and Statistics, Household Income and Expenditure Survey 2002.

[2] In the early 1920s, the agricultural extension service was developed as a part of the Department of Agriculture (DOA) established in 1912.

tions' and the Yaya scheme of seed production was initiated. Extension organizations underwent a major change in 1957 with the appointment of the Divisional Agricultural Extension Officers (DAEOs) for all provinces. Under this programme, Village Level Extension Officers (Krushi Viyapthi Sevaka) were recruited to carry out extension programmes at the village level. While extension work earlier concentrated mainly on rice production, by the early 1960s, the production of other field crops was also brought under the programme. In 1964, agricultural extension took a new turn with the establishment of a separate Extension Division in the DOA under a Deputy Director, exclusively for extension activities. With that, there was a very clear single line of command from the Director (Agriculture) to KVS at the extension service. To encourage participation of farm women, the Farm Women's Agricultural Extension (FWAE) was inaugurated in 1970.

Although the extension organization was getting progressively strengthened, there were many drawbacks such as lack of mobility of village level extension workers, poor planning and monitoring (supervision) of extension programmes and the urgent requirement of improving the training component. These deficiencies led to a reorganization of the extension system with the financial assistance of the World Bank under the Agricultural Extension and Adaptive Research Project (1980-1984). As a result, the Training and Visit (T&V) Extension System was introduced in 1980. This system has been operating up to the present day with some modifications from time to time with changes in requirement and demand.

The Extension Division of the DOA - the largest extension agency in Sri Lanka - has not been functioning adequately with the removal of over 2000 front line extension workers (KVSNs)[3] in 1990 with devolution of authority under the 13th Amendment to the Constitution in the latter part of 1980s. Consequences of this decision resulted in a collapse of the extension services at the village level. The DOA continued to focus on the domestic food crop sector, while the other government and semi-government institutions[4] provided extension services for other crops and livestock sector.

Extension, education, training and media services were integrated at the national level to form an umbrella organization called the Technology Transfer (TT) division in the DOA. In the early 1990s, extension activities of four government institutions, namely; DOA, Department of Animal Production and Health (DAPH), Department of Export Agriculture (DEA) and Coconut Cultivation Board (CCB) were integrated with World Bank assistance to form the Integrated Agricultural Extension Approach (IAEA). In 1999, the agricultural extension system was reformed to establish the Second Agricultural Extension Project (SAEP) with a view to strengthening extension services of the food crop sector.

The major objective of agricultural extension in Sri Lanka has been to improve the quality and living standard of the farming community by assisting them to obtain higher incomes, leading to the overall development of the country and agricultural development in particular. Various specific functions and strategies have been adopted under different regimes for that purpose as listed below.

[3] These grassroots level extension workers of the DOA were transferred to the Ministry of Public Administration as Grama Niladharis (GNs).

[4] The major institutions involved in agricultural extension are DOA, Department of Animal Production and Health, Department of Export Agriculture, Coconut Cultivation Board, Tea smallholdings Development Authority, Rubber Development Department, Tea Research Institute, Rubber Research Institute, Coconut Research Institute, Mahaweli Authority of Sri Lanka, Cashew Corporation, Sugarcane Research Institute, Livestock Development Board and Department of Fisheries and Aquatic Resources.

- Media and information dissemination:
  - Processing agricultural information and disseminating them to farmers.
  - Production of mass media programmes.
  - Publication of leaflets, posters, magazines, etc. for farmers and technical bulletins for officers.
- Increasing the adoption rate of recommended farm practices and thereby increasing agricultural productivity and net farm income.
- Training and education:
  - Training the staff of the DOA to improve job performance and competence.
  - Conducting middle level agricultural education programmes at the Schools of Agriculture.
  - Conducting routine farmer training programmes and vocational training programmes in agriculture for farmers, farm women and youth.
- Carrying out agricultural extension programmes to increase productivity and income of the farmers in the Inter-provincial Irrigation schemes.
- Coordination of special extension programmes within provinces to facilitate the national programme.
- Assisting in developing the National Annual Implementation Programme and providing feedback to the Ministry of Agriculture.
- Facilitating the preparation of implementation programmes at district level and providing feedback to researchers on field problems.
- Assisting farmers in obtaining credits, seed and planting materials.
- Facilitating and motivating farmers to undertake small scale agro-industries.
- Implementation of the provisions of the Pesticides Control Act, Soil Conservation Act and Plant Protection Act.

6.4 Concept of Private Extension

Privatization of agricultural extension service[5] refers to the services rendered in the area of agriculture and related aspects by extension personnel working in private organizations or firms for which farmers are generally expected to pay a fee.[6] This service can be a supplementary or an alternative to public extension services.

6.4.1 Private Sector Extension Service in Sri Lanka

At present, private sector extension services are not sufficiently developed to supplement or supplant the public sector service in Sri Lanka. The only sector where agricultural extension has been privatized is in the perennial crop sector. Agricultural extension activities undertaken by NGOs such as Survodaya and CARE International form only a part of their overall community development programmes.

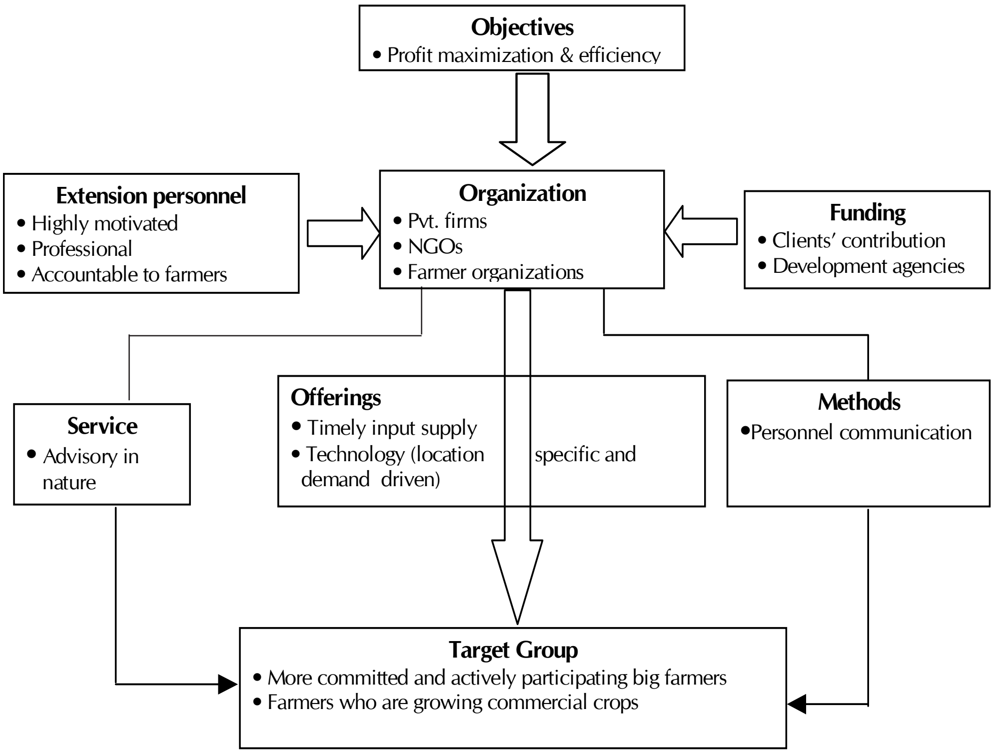
Also, some medium and large scale private firms such as Ceylon Tobacco Company (CTC), CIC Company and Baurs Limited provide advisory services to their clients on a small scale. They have their own technology and are not dependent on public extension service. The CIC has its own extension service that works effectively fulfilling farmers' needs through continuous improvement of technological know-how and achieving a healthy rate of growth and profitability. The CTC and Plenty Food Company also provide their own extension services to tobacco and soya farmers respectively, from providing seed to buying the product.

---

[5] This concept emphasizes three aspects, namely; involvement of a private organization/firm; expectation of a fee from clients; and role of supplementary/alternative to public extension service.

[6] In some instances, this service can be free especially when development NGOs or farmer organizations are involved.

Figure 6.4
Expected Elements of a Private Extension System



With a view to improving efficiency and making agricultural extension activities more competitive, a fee based extension service was introduced to the Sri Lankan agricultural sector as a pilot project under the Second Perennial Crop Development Project funded by the Asian Development Bank (ADB). The CIC and two other companies undertook the contract of providing fee based extension service for the first time in Sri Lanka (Box 6.1).

6.5 Public-Private Debate

There is an ongoing debate in search of better institutional arrangements - i.e., mainly on the use of the private sector either for supplanting or supplementing public services. The primary focus on what configuration of organizations (both public and private) is needed and what arrangements of division of responsibilities between them provide the most effective and efficient outcomes.

It is important to focus on issues of excludability and rivalry - major elements of the market failure - in deciding whether extension services are mainly public or private goods. Excludability occurs when farmers who are not willing to pay for a service and can, therefore, be excluded from using and obtaining its benefits (as in the case of tailor-made information). Rivalry occurs when one farmer reduces the availability of a service to others by using it (such as services embodied in commercial products). Rivalry and excludability are high for private goods

Box 6.1
MAs Tropical Food Processing (Pvt.) Limited

The company signed the contract in April 2001 for fruit and spices in the Matale district. It has two graduate extension officers covering 11 DS divisions in the Matale district. Of a total of 23,000 farmers, only 1800 have been registered with the company. The company has attended to only 200 farmers who require services for obtaining loans from banks. No extension or technical advice have been given to any of the farmers since they do not have the capacity to deliver such services.

Environmental and Management Lanka (Pvt.) Limited

The contract for the project was signed in February 2001 for flowers and foliage. The company employs three extension officers to cover 9 districts. They have a list of 300 clients.200 clients have requested assistance with project proposals to obtain bank loans and another 100 farmers have requested technical advice which is given by the company at a cost of Rs. 250 per visit.

CIC Agri-Business (Pvt.) Limited

In 2001, the company got involved in providing advisory services under the ADB funded Second Perennial Crop Development Project in 4 key districts in Sri Lanka. 991 farmers have been directly promoted by CIC under this project with an additional 334 farmers obtaining services from the company. Ten trained advisory agents were engaged in this activity attending to loan facilities, advisory services, training, market development and contract farm management. The results of the contract period reflect a great deal of success in terms of increased number of clients, developed extent, increased investments, use of higher technologies, productivity improvement and income and employment generation. The most significant achievement seems to be the introduction of a fee for advisory services for the first time without any resistance either socially or politically.

Source: Hector Kobbekaduwa Agrarian Research and Training Institute.

and low for public goods. Services with high excludability and low rivalry are considered as toll goods. The value of these goods to users is not diminished due to the use by the others, but some farmers can be excluded from access. Common pool goods are characterized by low excludability and high rivalry (Table 6.2).

Information embodied in inputs or equipment such as improved seed or machinery, or disembodied information on agricultural practices are the two types of production factors delivered by any extension service. Information embodied in inputs or equipment has high rivalry and tends to be a private good. There are two broader types of disembodied agricultural information: 'general, non-excludable information' (e.g., market information, cropping patterns, etc.) which tends to be a public good, and 'specialized, excludable information' (e.g., fertilizer recommendations for a specific field or farm operation) which tends to be a toll good.

The characteristics of an information service determines whether it is best supplied by the public sector, private sector or collectively. These should be carefully considered in deciding the most suitable method for delivering. As such,

- information closely associated with market goods (e.g., purchased inputs) is generally best left to the private sector;

Table 6.2
Extension Products by the Nature of Economic Characteristics of Information

	Excludability	
	Low	**High**
Rivalry Low	**Public Goods** ■ Mass media information ■ Time insensitive production, marketing and management	**Toll Goods** ■ Time sensitive production, or management information e.g: fertilizer recommendation for a specific information field
High	**Common Pool Goods** ■ Information embodied in locally available resources or inputs e.g: common grazing lands, water bodies ■ Long term self pollinated seeds ■ Bio diversity	**Private Goods** ■ Information embodied in commercially available inputs (purchased inputs) ■ Client-specific information or advice. e.g: hybrid seeds, machinery, chemicals

Source: World Bank (1994), "Public and Private Agricultural Extension: Beyond Traditional Frontiers", Discussion Paper No. 236.

- information associated with toll goods can be effectively provided by combined public and private sector efforts;
- information relative to management of common pool goods (forests, common grazing lands, water when it is not already subject to quota rules) is usually best provided by cooperative or voluntary institutions; and
- only when market and participation failures are high should information provision be financed by the public sector and, even in these cases, the public sector might well finance private sector delivery.

6.5.1 Arguments and Present Trends for Private Sector Extension

- Loss of creditability in the existing extension system caused by inability of the service providers to reach the larger number of clients and scarcity of facilities and low strength of delivering has resulted in a preference for greater private sector involvement. This has been further aggravated by some characteristics of public extension services such as demand driven nature with limited focus on farmers needs and aspirations, crop-wise institutionalization[7] and lack of ancillary services such as inputs delivery (fertilizers, seeds, etc.), market information, credit and marketing.[8]
- The general acceptance of so called privatization is that certain government activities could be performed more efficiently by the private sector than by public sector. They deliver higher quality services more efficiently and effectively for their own future existence.
- Private extension may provide more client oriented/farmer oriented (Demand driven) service replacing the traditional supply driven extension delivery system of the public sector. Therefore it is focused on identifying problems and producing results rather than simply engaging in activities.

[7] Public extension service in Sri Lanka is crop-wise institutionalized, as extension is provided by many different institutions. But, the farmers in Sri Lanka cannot be distinguished strictly by crops and enterprises such as exclusive paddy farmers, strictly livestock farmers, etc. Thus, such an institutionalized system may not be good for integrated farming systems like we have in our domestic agricultural sector.

[8] The state sector is an incomplete service provider and it is not capable of providing an efficient service package to the clients.

- A private extension service can look at the farmers' needs practically as a composite need as they have a less compartmentalized set-up unlike in public institutions. They would look at the whole process holistically as farm advisory services.
- Private extension has a positive effect of moving beyond the farm gate into an involvement in the entire production-processing-transporting-marketing chain unlike state sector extension services.
- With escalating budget deficits, the idea of providing extension and other services as a free public service is presently becoming increasingly impracticable. Private extension is more cost effective than public extension due to low overhead charges. It will drastically reduce the burden on the government budget by supplying extension services privately.
- Changing cropping trend and emergence of contract farming which assures farm gate market for farm produce is likely to enhance private extension service in recent years eg: Plenty food (Soya) and CTC (Tobacco). The key for the mutual trust between these organizations and the farmers has been the provision of technical guidance and constant supervision along with the best quality inputs to ensure benefits to both sides.
- Government policies have shown a preference for privatization of extension (as well as other input delivery service) since late 1970's following change in earlier policy environment. Such a policy environment is essential for establishing a successful private sector extension service.

6.5.2 Consequences of Private Extension Services

In the context of sustainable agricultural development, agricultural extension has a very crucial role to play. The tasks and responsibilities of extension service should be broad based and holistic in content and scope, and go beyond agricultural technology transfer. Simply transferring and disseminating appropriate agricultural technologies and good farm practices to farmers is not sufficient. Extension agencies, services, and workers need to exercise a more proactive and participatory role initiating and facilitating mutually meaningful and equitable knowledge-based transactions among agricultural researchers, trainers, and primary producers. Obviously, this paradigm entails a supply driven extension service that reflects the public need for sustainable and equitable development rather than private consultancy services primarily suitable for farm profit maximization.

On the other hand, the main argument for private extension cost effectiveness is also questionable in a country like Sri Lanka which has more small scale and subsistence farmers. Many small private firms providing extension services - unlike those in one government monopoly - will not be sustainable due to the inability to achieve scale economies. The trend toward agricultural development services that cater primarily to large scale farming will be detrimental to small scale subsistence farming. The private sector is most likely to provide extension services only in areas where they can achieve reasonable direct or indirect returns. The selective participation of the private sector will be confined to commercially produced high value crops and biased towards catering to the needs of medium to large scale farmers who can afford paid extension service. It will create inequities and will leave some unserved areas for government and non-governmental organizations to undertake.

Moral hazard problems are also associated with the use of some of these modern technologies. When firms are not using quality control measures or industry standards, the government will have to necessarily intervene to protect buyers from misleading private activities, especially when it is difficult to visibly differentiate good/bad seeds, adulterated/pure chemicals, etc. The private sector is also less likely to be concerned with safeguarding national food grain production as well as environmental issues like sustainable agriculture and soil and water conservation measures. Market failure may arise when current generations place insufficient value on the preservation of resources for the future. Private extension services are not capable of overcoming such market failures and thereby achieving sustainable development.

Further, most of the extension activities are considered to be public services in nature because of their diffusive characteristics (such as general information). The private sector has no incentive for providing such services due to limited possibilities of charging fees. Although entrepreneurship and location specific knowledge are essential prerequisites for sustainable development, they will be lost under private sector extension provision. Agrarian human capital development[9] which often gives very high returns to investments and develops agrarian economies may also suffer under private sector involvement.

Even though the usual argument about private sector efficiency is appealing prima facie, it is only private (financial) efficiency. Social or economic efficiency is not guaranteed when there are unequal endowments and externalities. Private goods sometimes are subjected to market failure, whereby the operation of private markets does not provide certain services at a socially optimal level and where external costs/benefits accrued by others than the service provider.

Privatization may also have some disadvantages like weaknesses in research opportunities, lack of international marketing information and training opportunities. Also, they will be less responsive to government policy direction, and there may be linkage problems with public applied research organizations, other external groups and government departments. Finally, there is evidence that public investment in extension yields higher returns than investment in irrigation and price supports in many cases. Extension can also yield secondary benefits by lowering agricultural prices.

6.6 Conclusion

To improve cost-effectiveness, sound strategies and favourable and explicit agricultural extension policies are needed. Modern strategic planning and quality management approaches should be utilized in restructuring and developing extension organizations and institutions and thereby the total system of extension. More innovative methods must be developed to systematically identify farmers' problems and requirements, and to formulate an agricultural research agenda based on such requirements and problems.

Situational analysis and political and technical determinations of funding and delivery arrangements to provide agricultural extension services have to be considered on an individual country basis rather than on a global scale. Many extension reforms are facilitated by systems of contracting extension services. Contracted extension services are likely to spread further as agriculture becomes more commercialized and competitive, and as public budget allocations decline. As in most countries, Sri Lanka is still in the early stages of experimenting with contracted extension services and there is much to learn as to how these systems can be made more efficient and sustainable.

Privatization of agricultural extension may not be an alternative to public extension since public sector has got a comparative advantage in disseminating location specific, system based and sustainable technologies. The private sector may have a greater advantage in highly technological and commercial aspects, input supply and other services. But the Sri Lankan agricultural sector is characterized by a large number of small scale and poor farmers who are not willing to pay and are unable to achieve paid extension services

[9] The private sector is less likely to be concerned with issues such as human resource development, gender issue (women's empowerment), off-season employment development, etc.

which in turn may not allow privatization of agricultural extension services to be successful. Existing infrastructure and extension can be strategically used to improve the efficiency and effectiveness of the public extension system. This can be achieved through the following means:

- upgrading extension services giving more intensive training to the existing cadres on modern technology and better delivery mechanisms;
- introducing more demand driven and location specific technologies for the extension system in Sri Lanka;
- introducing better quality personnel to the system like university graduates and experienced agriculturalists;
- shifting extension activities from political agendas to more farming community interests, and also from a top down approach to a bottom up approach;
- identifying priority areas of extension and operating bottom up and flexible approaches to improve farmers participation; and
- adopting continuous monitoring and evaluation mechanisms for the staff engaged in extension services, especially for the field level extensionists who are working at the grassroots level.

Private extension systems can be employed to play a complementary role so that all farmers get the necessary support at the right time, right cost and in the right form. It will also provide more decentralized, farmer participatory and flexible (with ownership rights to clients) services. Intervention of private sector along with the public sector in delivering extension services will necessarily increase the efficiency of the existing agricultural system. Coexistence of both public and private extension services will provide an appropriate extension approach and thereby make the Sri Lankan agriculture sector more efficient and effective in fulfilling its basic objectives of contributing to the overall development of the country.

7. WTO Commitments on Telecommunications Services Liberalization and Telecommunications Interconnection in Sri Lanka

7.1 Introduction

The telecommunications industry's potential to spur socio-economic growth has prompted extensive reforms in telecommunications markets globally. These international trends are also reflected in changes to Sri Lanka's telecommunications sector since the 1980s, with the restructuring of the state-owned telecommunications entity, the deregulation of value-added services and the liberalization of the domestic fixed-access sector. As in several other developing countries, Sri Lanka liberalized the domestic segment of its telecommunications market before introducing competition in international telephony. In addition, liberalization and the setting up of a regulatory body preceded the partial privatization of the incumbent operator.

In line with its commitment to liberalization, Sri Lanka is a signatory to the WTO Agreement on Basic Telecommunications Services (Table 7.1) and has fully adopted the Telecommunications Reference Paper (Box 7.1) that sets out the regulatory principles for the effective implementation of this agreement as well as the Annex on Telecommunications Services.[1] The Reference Paper deals with issues such as the provision of essential facilities, competitive safeguards, interconnection procedures, universal service obligations, publicly available licensing criteria, independent regulators and the allocation and use of scarce resources. On paper, policy (Sri Lanka's National Telecommunications Policy of 1996) and legislation (Sri Lanka's Telecommunications Act No. 25 of 1991 and its successive amendments) governing the sector are in line with the country's WTO commitments.

However, Sri Lanka's adherence to the regulatory principles set out in the Reference Paper has tended to be weak in practice, rendering a gap between global and domestic regulatory governance and leading to the perception amongst stakeholders in the policy and regulatory space that these WTO commitments are of little substantive significance. This chapter addresses the management of Sri Lanka's interconnection commitments under the Reference Paper. Section 2 will provide a brief background of Sri Lanka's telecommunications sector and of the interconnection regime, and describe the socio-economic consequences arising from the weak management of interconnection. Section 3 details the information on interconnection received from key market players by way of interviews, including the roles played by various interest groups in perpetuating, influencing and finding solutions to the interconnection problem. Section 4 discusses the political-economy factors underpinning the poor management of WTO commitments on interconnection. Section 5 concludes.

7.2 Evolution of Sri Lanka's Telecommunications Industry

Telecommunications sector reforms in Sri Lanka have had a positive impact on the industry and on the Sri Lankan economy. As

[1] The Telecommunications Annex elaborates a framework of principles and rules affecting the regulatory environment governments establish vis-à-vis telecommunications network operators and other basic service providers. The Annex provides notes and supplementary provisions to the General Agreement on Trade in Services (GATS).

Table 7.1
Sri Lanka: Schedule of Specific Commitments

Modes of supply: (1) Cross-border supply (2) Consumption abroad (3) Commercial presence (4) Presence of natural persons

Sector or Sub-sector	Limitations on Market Access	Limitations on National Treatment	Additional Commitments
2. Communication Services c) Telecommunication Services			
International basic voice telecommunication services	(1) Monopoly guaranteed for Sri Lanka Telecommunication Ltd (SLT) until 31 December 1999. Government of Sri Lanka (GOSL) proposes thereafter to issue an additional licence, depending mainly on satisfactory progress having been made with respect to tariff rebalancing. (2) None (3) Monopoly guaranteed for SLT until 31 December 1999. Government of Sri Lanka (GOSL) proposes thereafter to issue an additional licence, depending mainly on satisfactory progress having been made with respect to tariff rebalancing. Foreign equity participation of up to 35% involving a strategic partner permitted in SLT. Foreign equity participation in telecommunication providers is determined under BOISL related provisions described in the horizontal section of GOSLs schedule of specific commitments (4) Unbound except as indicated in the horizontal section	(1) None (2) None (3) None (4) Unbound except as indicated in the horizontal section	Sri Lanka subscribes to the attached commitments on regulatory disciplines.
Domestic local and long-distance basic telephone services covered Mobile cellular services	(1) None (2) None (3) Four operators' licences. This number will be reviewed by the GOSL in the year 2000. Foreign equity participation in these enterprises determined per the horizontal section (4) Unbound except as indicated in the horizontal section	(1) None (2) None (3) None (4) Unbound except as indicated in the horizontal section	
Wireless Local Loop (WLL) to provide basic telephony, data transmission, payphone, voice mail and facsimile.	(1) None (2) None (3) Two operators' licences. Duopoly will be guaranteed for five years. In addition SLT will be permitted to provide WLL services in 800 MHz Band. Foreign equity participation in these enterprises determined per the horizontal section. (4) Unbound except as indicated in the horizontal section	(1) None (2) None (3) None (4) Unbound except as indicated in the horizontal section	

Cont......... Table 7.1/-

Sector or Sub-sector	Limitations on Market Access	Limitations on National Treatment	Additional Commitments
Public payphone services	(1) None (2) None (3) Five service providers. This number will be reviewed on economic needs criteria. Foreign equity participation in these enterprises determined per the horizontal section. (4) Unbound except as indicated in the horizontal section	(1) None (2) None (3) None (4) Unbound except as indicated in the horizontal section	
Radio paging services	(1) None (2) None (3) Five operators' licences. Changes based on economic needs criteria. Foreign equity participation in these enterprises determined per the horizontal section (4) Unbound except as indicated in the horizontal section	(1) None (2) None (3) None (4) Unbound except as indicated in the horizontal section	
Data Communication Services	(1) None (2) None (3) Six operators' licences. No new licences for facilities-based operators until 1998. Foreign equity participation as per horizontal section. (4) Unbound except as indicated in horizontal section	(1) None (2) None (3) None (4) Unbound except as indicated in horizontal section	
Other:Satellite-based services:			
GMPCS services supplied through own gateways	(1) Unbound (2) None (3) Issuing of licences is under consideration. Foreign equity participation in these enterprises determined per the horizontal section. (4) Unbound except as indicated in the horizontal section	(1) None (2) None (3) None (4) Unbound except as indicated in the horizontal section	

Box 7.1
Reference Paper

Scope

The following are definitions and principles on the regulatory framework for the basic telecommunications services.

Definitions

Users mean service consumers and service suppliers.

Essential facilities mean facilities of a public telecommunications transport network or service that

(a) are exclusively or predominantly provided by a single or limited number of suppliers; and

(b) cannot feasibly be economically or technically substituted in order to provide a service.

A major supplier is a supplier which has the ability to materially affect the terms of participation (having regard to price and supply) in the relevant market for basic telecommunications services as a result of:

(a) control over essential facilities; or

(b) use of its position in the market.

1. Competitive safeguards

1.1 Prevention of anti-competitive practices in telecommunications

Appropriate measures shall be maintained for the purpose of preventing suppliers who, alone or together, are a major supplier from engaging in or continuing anti-competitive practices.

1.2 Safeguards

The anti-competitive practices referred to above shall include in particular:

(a) engaging in anti-competitive cross-subsidization;

(b) using information obtained from competitors with anti-competitive results; and

(c) not making available to other services suppliers on a timely basis technical information about essential facilities and commercially relevant information which are necessary for them to provide services.

2. Interconnection

2.1 This section applies to linking with suppliers providing public telecommunications transport networks or services in order to allow the users of one supplier to communicate with users of another supplier and to access services provided by another supplier, where specific commitments are undertaken.

2.2 Interconnection to be ensured

Interconnection with a major supplier will be ensured at any technically feasible point in the network. Such interconnection is provided:

(a) under non-discriminatory terms, conditions (including technical standards and specifications) and rates and of a quality no less favourable than that provided for its own like services or for like services of non-affiliated service suppliers or for its subsidiaries or other affiliates;

(b) in a timely fashion, on terms, conditions (including technical standards and specifications) and cost-oriented rates that are transparent, reasonable, having regard to economic feasibility, and sufficiently unbundled so that the supplier need not pay for network components or facilities that it does not require for the service to be provided; and

(c) upon request, at points in addition to the network termination points offered to the majority of users, subject to charges that reflect the cost of construction of necessary additional facilities.

2.3 Public availability of the procedures for interconnection negotiations

The procedures applicable for interconnection to a major supplier will be made publicly available.

2.4 Transparency of interconnection arrangements

It is ensured that a major supplier will make publicly available either its interconnection agreements or a reference interconnection offer.

2.5 Interconnection: dispute settlement

A service supplier requesting interconnection with a major supplier will have recourse, either:

(a) at any time or

(b) after a reasonable period of time which has been made publicly known to an independent domestic body, which may be a regulatory body as referred to in paragraph 5 below, to resolve disputes regarding appropriate terms, conditions and rates for interconnection within a reasonable period of time, to the extent that these have not been established previously.

3. Universal service

Any Member has the right to define the kind of universal service obligation it wishes to maintain. Such obligations will not be regarded as anti-competitive per se, provided they are administered in a transparent, non-discriminatory and competitively neutral manner and are not more burdensome than necessary for the kind of universal service defined by the Member.

4. Public availability of licensing criteria

Where a licence is required, the following will be made publicly available:

(a) all the licensing criteria and the period of time normally required to reach a decision concerning an application for a licence and

(b) the terms and conditions of individual licences.

The reasons for the denial of a licence will be made known to the applicant upon request.

5. Independent regulators

The regulatory body is separate from, and not accountable to, any supplier of basic telecommunications services. The decisions of and the procedures used by regulators shall be impartial with respect to all market participants.

6. Allocation and use of scarce resources

Any procedures for the allocation and use of scarce resources, including frequencies, numbers and rights of way, will be carried out in an objective, timely, transparent and non-discriminatory manner. The current state of allocated frequency bands will be made publicly available, but detailed identification of frequencies allocated for specific government uses is not required.

shown in Table 7.2, fixed phone tele-density has risen from 0.73 in 1991 to 5.0 as at September 2004, while mobile penetration has increased from 0.01 to 10.2 over the same period. Moreover, investment in the telecommunications sector over the past two decades has amounted to an estimated US$ 1.3 billion; and, the telecommunications sector remains one of the highest growth sectors in the economy expanding over the years from 19.3 per cent in 2002 to 24.5 per cent in 2003.

Reforms in Sri Lanka's telecommunications industry began in the early 1980s, with the de-linking of posts and telecommunications services. Private participation in the industry began in 1989 with the entry of a mobile operator. These reforms were complemented by the enactment of telecommunications legislation in 1991, transforming the then incumbent operator to a government corporation and creating a single-person regulatory authority.

In 1996, this legislation was amended facilitating the creation of a five member regulatory agency – the Telecommunications Regulatory Commission of Sri Lanka (TRCSL). That year also saw further steps in the liberalization process with two wireless local loop (WLL) operators being licensed to operate in the area of domestic fixed telephony. The incumbent operator was partially privatized in 1997 with the sale of 35 per cent of its shares and the assignment of management control to Nippon Telegraph and Telephone (NTT) of Japan. Consequently, after an Initial Public Offering (IPO) in late 2002, NTT retained 35.2 per cent of shares, while the public, employees and the government received 11.8, 3.5 and 49.5 per cent of equity, respectively.

As present, the telecommunications industry in Sri Lanka has three fixed operators, four mobile operators, six facilities based data operators, 23 non-facilities based data operators, two public payphone operators, four paging service operators, one trunked mobile radio network operator, one leased line service operator and 32 external gateway operators (EGOs). While the incumbent Sri Lanka Telecom Ltd. (SLTL) dominates the fixed wireline sector, there is a duopoly[2] in the fixed wireless sector. Market shares in the fixed wireline sector are divided amongst the incumbent and the two WLL operators – Suntel and Lanka Bell – with SLTL controlling 85 per cent of the market and Suntel and Lanka Bell holding 9 and 6 per cent, respectively. The mobile sector meanwhile, remains fairly competitive with four operators, Lanka Cellular Services, Mobitel, Dialog GSM and Celltel, having market shares of approximately 3, 15, 60 and 22 per cent, respectively.

Table 7.3 sets out the structure of interconnection in three periods - when the WLLs entered the market in 1996, after mediation and regulatory determination for the fixed access sector in 1998 and after regulatory determination for the fixed-mobile sector in 1999.

The 1998 directive (see Table 7.3) was implemented by the WLLs whilst the incumbent appealed the regulatory decision in courts. The WLLs however, succeeded in obtaining a restraining order on the incumbent based on allegations that it was blocking calls originating from their networks. Subsequently, interconnection became more problematic with the by-passing of the incumbent's international gateway by other telecommunications operators resulting in a massive loss of

[2] According to the provisions of the amended Act of 1996 however, the incumbent SLTL was permitted to provide WLL services within the specific frequency band of 800MHz.

Table 7.2
Telecommunications Services Connectivity

Service	Operator	Subscriber Base								
		1996	1997	1998	1999	2000	2001	2002	2003	2004(Q 3)
Tele-density (%)	Fixed	1.4	1.8	2.8	3.5	4.0	4.4	4.7	4.9	5.0
	Mobile	0.4	0.6	0.9	1.3	2.2	3.6	4.9	7.3	10.2
	Total	1.8	2.4	3.7	4.8	6.2	8.0	9.6	12.2	15.2
Data communication	Internet & email	2,504	10,195	18,984	25,535	40,497	62,159	75,000*	85,000*	87,500*
Public pay phone booths		3,002	3,682	4,761	5,799	8,222	6,801	6,681	6,440	5,938
Radio paging		10,721	10,829	10,511	10,300	7,009	6,178	3,541	2,851	920*
Trunk mobile radio							504	579	137	175

Note: * Provisional.

Source: Telecommunications Regulatory Commission of Sri Lanka.

revenue to the incumbent. In response, the incumbent entered into a collusive memorandum of understanding (MOU) with the WLLs providing financial incentives to abstain from facilitating by-pass. Numerous requests by the regulatory authority that it be shown this document have been ignored raising doubts on the legality of the arrangement amongst the three operators.

As indicated in Table 7.3, mobile operators had a particularly unfair interconnection deal prior to the 1999 determination. Although the 1999 determination addressed some of the anti-competitive elements embedded in the previous regime, the proposed implementation of a calling-party-pays (CPP) system is still pending. Under the current system of mobile-party-pays (MPP), mobile operators pay SLTL for calls terminated on its networks while SLTL does not pay mobile operators for calls terminated on mobile networks; mobile users therefore, have to bear the cost of this termination charge in the form of incoming call charges. Mobile operators have called for the implementation of the CPP system on the basis that this is the emerging international standard and that MPP schemes result in low call completion rates due to users keeping their phones switched off to avoid incoming call charges. Fixed telephony operators on the other hand oppose implementation, arguing that a CPP system will pose a greater burden to fixed-access users. Although the TRCSL announced that a CPP regime would be implemented in March 2004, considerable opposition on the part of fixed telecom operators has led to delays on this front.

Following in the steps of most other developing countries, Sri Lanka liberalized its domestic market before introducing competition in international telephony. As part of the privatization process and under licence granted by TRCSL, the incumbent was the sole provider of international telephone services until August 2002. Although the issuing of 32 EGO licences in March 2003 marked the end of this exclusivity period, the absence of an effective interconnection regime has resulted in little progress being made in terms of actual connectivity in this segment. For instance, of the 32 licensed EGO operators only six non-affiliated players have working interconnection agreements. As such, whilst international call charges fell considerably with the opening of the market, further price reductions have been stymied with the delay in providing interconnection to the new entrants.

In 2003, the regulator implemented a set of Interconnection Rules to address gaps in the domestic legislation with respect to interconnection as well as to facilitate an interconnection regime that would fulfil Sri Lanka's WTO commitments that interconnection be provided on non-discriminatory terms, in a timely fashion and at cost-oriented rates that are transparent and sufficiently unbundled. Prior to the promulgation of the new rules, interconnection among connectable operators and the disclosure of operators' interconnection regime to the TRCSL was not mandatory. The new rules made both these compulsory while also enabling the regulator to fix charges on a cost oriented basis in instances where operators fail to negotiate an interconnection agreement. The rules also include a provision to resolve interconnection disputes - all disputes are referred to the TRCSL which must make a determination within 30 days of receipt of the complaint.

However, there are lingering problems with international traffic by-pass and with the provision of transit traffic facilities to EGOs. Given that by-pass was a major problem and led to a substantial loss of revenue, International Traffic By-pass Control Rules were promulgated in 2003 and all operators were given source identification numbers and required to submit reports of international traffic on a monthly basis to the regulator. In addition, a By-pass Prevention Task Force comprising officials from the Attorney's General's Departments, the Police and the TRCSL was set up to eliminate this illegal conduct and the subject Minister was empowered to suspend an operator's licence pending an inquiry. In spite of these measures however, by-pass estimated at around 30 to 40 per cent of the international traffic terminated in Sri Lanka still continues, largely due to the arbitrage opportunities that can be derived from the Incoming Local Access Charge (ILAC). EGOs are required to pay an ILAC to the Telecommunications Development Fund (TDF) - a universal service fund operated by the regulator - and to the public switched telecommunications network (PSTN) operators that terminate the call. Currently, the ILAC is 0.11 dollars per call minute terminated in Sri Lanka, with 0.0380 dollars to the TDF and 0.0720 dollars to the PSTN operators. With the floor price for calls to Sri Lanka ranging from 0.09 - 0.12 dollars, there is sufficient incentive to by-pass the international gateways.

The issue of transit traffic is also linked to the ILAC, with a lack of agreement on how to split this payment between transiting operators stalling indirect interconnection to EGOs. The barrier to transit traffic is also an obstacle to 'grey operators' obtaining an EGO licence and commencing legal international telecommunications services. Whilst the regulator came up with a possible solution with a proposal to establish a national point of interconnection, there has been little or no progress in this area.

Table 7.3
Interconnection Arrangements

Year		Fixed to WLL	Fixed to Mobile	WLL to Mobile	WLL to WLL	Mobile to Mobile
	Local	Sender-Keeps-All (SKA) principle	Treated as large customers and charged above cost national retail rates for interconnection; no discounts for international calls; limited points of interconnection; Mobile Party Pays scheme	SKA principle	SKA principle with operators splitting costs on a 50:50 basis	SKA principle
	National	SKA principle				
1996	International	WLL operators granted 35% rebate on the collection rate for outgoing calls originating from their networks: payment for incoming international calls; cost of physical links fully borne by the WLLs				
	Local	SKA principle replaced by the Mutual Compensation Arrangement (MCA)*	Same terms as above	SKA principle	SKA principle with operators splitting costs on a 50:50 basis	SKA principle
	National	SKA principle replaced by MCA*				
1998	International	WLL's to remit 80% of SLTL's collection rate to SLTL for all calls originating from the WLL's network; SLTL to pay "National Extension Fee" of SLR 9.50 per minute incoming international calls terminated in the WLL networks ; WLL to provide physical interconnection links and bear full costs of installing and maintaining the apparatus up to the interface units ; SLTL to provide interface units				
	Local	Same terms as those in 1998 determination	Interconnection charges same as those between fixed and WLL operators*	SKA principle	SKA principle	SKA principle
	National	Same terms as those in 1998 determination				
1999	International	Same terms as those in 1998 determination	Discount of 20% on SLTLs collection rate for international calls; mobile operator to bear full cost of installing and maintaining apparatus up to interface unit: SLTL to provide interface unit.			

Notes: SLTL tariff band charges for local call termination (SLR/minute) during peak: 0.6, standard 0.4 and economy 0.2. Charges for national transit and termination (SLR/minute) during peak: 1.50, standard 0.75 and economy 0.38.

With interconnection being most critical to facilitating a competitive telecommunications market, the lack of a working interconnection agreement and perceptions of weak regulatory governance as seen in the inability to install an effective interconnection regime has stymied the reform process, investment and performance in the sector. The initial peak in investment, particularly in fixed sector investment during the 1996-1999 period can be attributed to the fact that the industry had just opened its gates to liberalization. However, a declining trend in the period after 1999 - investment declined from US$ 303 million in 1999 to US$ 103 million in 2001 to US$ 87 million in 2002 - is reflective not only of the global telecommunications bust but also of regulatory uncertainty in Sri Lanka.

Moreover, regional imbalances in telecommunication penetrability and accessibility are very disconcerting. As Table 7.4 shows, fixed line users are concentrated mainly in the Colombo metropolitan area with rural areas having only marginal levels of access to telecommunication facilities. Meanwhile, the extremely low rate of internet penetrability is also worrisome with merely 4.4 per 1000 people having access as at 2003. Fibre optic cables that provide reliable telecommunications services do not exist outside the Western and Central Provinces, and some pockets of the Northwestern and Sabaragamuva Provinces.

7.3 The Players and their Roles

Interviews conducted with key market players on whether or not the new interconnection rules are being followed remains open to debate.[3] According to the regulator, the seven PSTN operators signed an agreement to implement these rules as at March 2004. However, according to a leading mobile operator, these rules, particularly the call termination charges, have been shelved and the seven telecommunications operators have signed an MOU on interconnection amongst themselves. This MOU is a response to the three fixed operators refusing to pay the mo-

Table 7.4
Telecommunication Services Access
(Regional Breakdown)

Province	Population (%)	Fixed 1 lines (%)
Western (Colombo)	29	64
Central	13	9
Southern	12	7
North Western	12	6
Sabaragamuwa	10	4
Eastern	8	3
Uva	6	3
North Central	6	2
Northern	6	1

Source: Zita, Ken and Kapur, Akash (2004), "Sri Lanka Telecommunication Brief" (http: topics.developmentgateway.org).

3. The respondents totalled eight and included representatives from the Department of Commerce, the Telecommunications Regulatory Commission, fixed operators including the incumbent, mobile operators, data operators, the Attorney General's Department, and consumer organizations.

bile termination charges set out in the rules unless costs were passed to consumers. Although the regulator did not consent to this, the mobile operators 'empathized' with the fixed operators' concerns and agreed to negotiate a 'sender-keeps-all (SKA)' arrangement. As such, the current fixed-mobile interconnection arrangement is a temporary SKA arrangement until the end user tariffs can be adjusted to include the interconnection costs recommended in the rules.

Meanwhile, in the case of termination charges in the fixed sector, one of the key WLL operators maintains that while there is no formal written interconnection arrangement amongst them, the three operators have agreed to continue with the conditions of the 1998 TRCSL determination despite it being past its expiration. This interviewee also pointed out that the termination charges between the mobile operators and the dominant operator are an 'asymmetrical revenue sharing arrangement' that is more favourable to the incumbent and clearly indicative of the power the incumbent wields over other operators in the industry.

The rules of 2003 enhanced the regulatory role played by the TRCSL not just by providing a dispute resolution mechanism but also by affording it with the power to decide termination charges on a cost-oriented basis. All market players acknowledge the TRCSLs role in resolving disputes and its right to determine interconnection charges when operators fail to agree. Under the new rules, the regulator is able to scrutinize more closely the interconnection agreements between operators. The dominant operator for example, has to submit a Reference Interconnection Agreement (RIO) before an interconnection regime can be approved and implemented.

There is general concurrence among the key market players however, that the regulator is still a weak entity in need of much more clout. The regulator's power for example, is greatly undermined by the fact that in most cases operators do not abide by the rules. Operators oppose the regulator not so much by legally appealing against the directives but rather by opting to ignore and not follow the directives issued by the regulator. Although the TRCSL can enforce the implementation of a determination by prosecuting for not complying with a directive, this is scarcely a practical option given the time and resource costs associated with the legal system in Sri Lanka. Market players point out that the efficacy of the TRCSL is undermined by the fact that there is a dearth or non-existence of individuals in authoritative positions capable of using commitments and regulations to steer the industry forward. The lack of specific knowledge, strategy and commitment has also contributed to this downfall in regulatory governance. Stakeholders also emphasise that the regulatory authority is a highly politicised entity influenced to a great extent by politics and politicians.

While there are conflicting opinions on the extent to which Sri Lanka has met its WTO commitments, most market players agree that on paper at least, Sri Lanka's WTO interconnection commitments have been met. The Interconnection Rules of 2003 in particular, attempt to incorporate some of the commitments that Sri Lanka had thus far failed to include in the amended Telecommunications Act No. 25 of 1991. Players are quick to point out however, that these commitments are to a greater extent limited only to words. As the regulator points out, these new rules were imperative because the interconnection rules preceding this did not provide adequate power to the regulator. For example, even after Sri Lanka initially made the commitment to ensure the transparency of its interconnection arrangements, there were instances where operators had interconnection agreements which were kept completely outside of the control and purview of the TRCSL.

One example of this lack of transparency can be evidenced in the fact that although the dominant operator admits in its Initial Public Offer (IPO) document of 2002 to signing an agreement with the WLL operators in order to avoid illegal traffic termination, when the regulator requested that the operator submit this agreement for approval, SLTL failed to so. Regulators emphasize that this type of non-compliance and cloudy interconnection agreements would not be possible under the new rules as operators have to submit all interconnection agreements to the TRCSL for approval. However, the regulator emphasizes that adherence to WTO commitments requires greater cooperation on the part of telecommunications operators.

Since opinion on the extent to which these commitments have been met is mixed, it is needless to say that market players have differing opinions on the impacts these rules have had on the industry, on consumers and the economy in general. The incumbent, for example, believes that Sri Lanka's WTO commitments have been met for the most part and as a result, the industry has improved as a whole; liberalization has resulted in consumers' access to lower prices, better quality of services and innovative product offerings. However, this operator emphasises that there currently exists a trend towards consolidation and the need for smaller players to exit the market; as such, regulators should accept these trends and thereby create avenues to make it possible for these market occurrences to happen.

Mobile operators state meanwhile, that while there has been growth in the industry, improved regulatory governance will stimulate further growth. Leading WLL operators, however, hold that foreign investment, which depends on consistent policies, on regulatory issues and on the seriousness with which these policies are implemented, has fallen drastically due to the lack of both these factors in Sri Lanka's telecommunications industry. Network rollout and expansion, both of which require huge investments, have slowed as a result of this fall in investment and consumers are the ones who suffer as a result of this for it is ultimately they who receive poor quality services. Further, WLL operators maintain that the overall economy suffers as a result of ineffective regulatory governance and the sector in particular has seen a reduction in activity due to these factors.

Sri Lanka's move towards opening up the international market was a massive step forward in the liberalization process. As mentioned above however, only a handful of EGO operators have been given interconnection. According to a leading data operator, the only players who benefited from the opening up of the international telephony market were the seven PSTN operators. According to this interviewee, the seven PSTN operators formed a cartel amongst themselves to provide interconnection in the international telephony segment. The non-PSTN operators that did gain interconnection were able to do so primarily due to 'political connections'. This data operator also states that the incumbent refused to sell any interconnection facility to them despite Sri Lanka's WTO commitment to provide interconnection to all licensed operators and that a complaint to the regulator regarding this issue went unheeded.

7.4 Political Economy of Sri Lanka's Telecommunications Industry

The exclusions granted to the incumbent telecommunications operator at the time of privatization resulted in the entrenchment of its market power. Anti-competitive behaviour on the part of the incumbent flourished in an environment of weak regulatory governance. The fact that of the 32 licensed operators, only a few non-PSTN operators have interconnection agreements thus far seems to reflect the dominant operator's intransigence with respect to interconnection and highlights the power that it wields within the industry and over all market players. While the incumbent points out that the delay in the process is due to issues with bank guarantees, this delay is also indicative of the upper-hand that the incumbent has over other operators when it comes to the ownership of bottleneck facilities.

Poor regulation is not merely a matter of inept regulators; instead it is an outcome of the changed opportunities for rent extraction for politicians and their favoured bureaucrats following privatization. This political economy explanation appears to be consistent with the close ties between the regulator and the incumbent - with former employees of the incumbent being hired to senior positions in the regulatory authority; and, with various anti-competitive regulations insulating the incumbent from competitive pressures.

A fundamental hurdle in the telecommunications industry with respect to establishing a fair interconnection regime is the incumbent's control over bottleneck facilities and the dominance this affords to this player. Cellular companies for example, were initially confronted with burdensome termination charges while the WLL operators have had a number of interconnection disputes with the incumbent. Meanwhile, despite Sri Lanka's WTO commitment to provide interconnection on a non-discriminatory and reasonably priced basis, non-facilities based operators (particularly ISPs) have had great difficulty accessing SLTLs backbone. It is likely that the dominant position of the incumbent and opportunities for cross-subsidization increased with the incumbent's acquisition of a mobile operator.

There appears to be the implicit collusion among the three fixed line and four mobile operators. Whether this agreement is couched under the term 'MOU' or directly hailed as a 'cartel', all market players acknowledge its presence. There is little doubt that weak regulatory governance accounts for the existence of this arrangement among the operators. Despite the 2003 Interconnection Rules' best attempts at increasing the regulator's strength, regulatory governance in Sri Lanka is still very feeble, with the TRCSL remaining a highly politicized entity. The structure of the regulatory body itself does not allow for regulatory independence given that the same individual serves simultaneously as the Secretary to the Ministry and the Chairman of the Commission. The fact that the Ministry has the authority to approve or reject licensing decisions also compromises the regulatory body's level of independence.

7.5 Conclusion

Sri Lanka's WTO commitments dictate that interconnection be provided on non-discriminatory terms, in a timely fashion and at cost-oriented rates that are transparent and sufficiently unbundled. However, as discussed, implementing fair interconnection has remained challenging. Reasons for the absence of a WTO compliant interconnection regime range from the technical to the political. Technically, the failure to implement a fair interconnection regime was due to a gap between the Telecom Reference Paper and the amended Telecommunications Act of 1991. However, on paper at least this gap between domestic and global regulatory governance has been addressed with the promulgation of the Interconnection Rules of 2003.

As pointed out however, interconnection still remains challenging in Sri Lanka despite the existence of the rules. Clearly, the interconnection problem is a symptom of a larger political economy nexus linking rent-seeking behaviour, privatization and anti-competitive regulatory practice. As such, any technical solutions to the interconnection problem will have limited impact on the final outcome in this analysis. Conceptualizing the problem in this manner goes back to the point of privatization - to the objectives of privatization and to the sequencing of regulation and privatization. In the case of SLTL, the fiscal objectives of privatization - maximizing proceeds - overrode telecommunications sector performance objectives. Moreover, the regulatory authority was not a party to the privatization consultations and was mandated to enforce 'competition' in the sector on the one hand whilst protecting an international monopoly on the other. In addition, the politicization of the regulatory authority and capture of the regulator by the incumbent allowed for continued rent extraction and for the insulation of the incumbent from competitive pressures.

The lessons that emerge are better expressed in the form of research questions. A straightforward policy recommendation would be to take a balanced approach when privatizing - to give due consideration to sector performance objectives - to include the regulator in reform decisions from the outset and to insulate the regulator from political and regulatory capture. The relevant questions however are: what incentives can be put in place to encourage policy decisions conducive to good regulatory governance in an environment such as in Sri Lanka where governance remains poor and where civil society pressures are relatively mild. As reflected in this analysis, WTO commitments were insufficient to bring domestic regulatory governance in line with international best practice. Does this imply that international best practice and WTO commitments are merely an academic exercise in countries with weak domestic governance and that such countries should look for alternative governance benchmarks? Whilst answers to these questions are beyond the scope of this chapter, it is hoped that they will prompt further reflection and analysis with a view to getting deeper insights on the problems of regulatory governance in Sri Lanka.

8. Microfinance Sector in Sri Lanka: Current Status and Issues

8.1 Introduction

In recent years, microfinance has attracted a great deal of international attention as an effective instrument for poverty alleviation. In recognizing its role in combating poverty and achieving the Millennium Development Goals (MDGs), the United Nations General Assembly has designated the year 2005 as the International Year of Microcredit. The objective is to raise public awareness of the importance of microfinance, support sustainable access to financial services, and promote innovation and new partnerships to expand the outreach of microfinance.

There is no universally agreed definition for microfinance. It can vary from one country to another, within the same country, and from one institution to another. The Asian Development Bank (ADB) defines microfinance as 'the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to poor and low income households and, their micro enterprises'. It covers not only credit but also savings and other financial services such as insurance. The significance of microfinance lies in its innovative methods of providing credit to the poor, such as the usage of social collateral (e.g., group guarantee) instead of physical collateral, peer pressure and peer monitoring and the progressive lending approach. Moreover, the social mobilization process that involves awareness building and formation of self-help groups is another distinguishing feature of many microfinance programmes.

In Sri Lanka, provision of microfinance services to low income households has a long history dating back to the early years of the twentieth century. Currently there exists a wide range of microfinance providers in the country. Nevertheless, the effectiveness of microfinance in reducing poverty and creating sustainable employment activities for the poor is still not clear in Sri Lanka. There are a number of issues and constraints in the microfinance sector of Sri Lanka that need to be studied. Hence, the focus of this chapter will be to look at the status and various issues of the microfinance sector in Sri Lanka. Section 2 will briefly discuss the evolution of microfinance sector; Section 3 will look at various microfinance providers and programs in Sri Lanka; the outreach of microfinance sector is looked at in Section 4, while section 5 will look at the regulatory framework for microfinance institutions (MFIs); Section 6 will provide some concluding remarks.

8.2 Evolution of Microfinance Sector

The history of microfinance in Sri Lanka begins in the colonial era with the enactment of the Cooperative Credit Ordinance in 1911. The Thrift and Credit Cooperative Societies (TCCS) were the pioneers in the provision of financial services to low-income groups. However, in the initial decades of their establishment, even the TCCSs served mainly the financial needs of the middle-income populations rather than those of the poorer groups. By about the 1950s, the need to provide credit facilities to the rural poor had emerged as an important issue. Several rural economic surveys had revealed the severity of the problem of rural indebtedness, dependence of the rural poor on moneylenders and traders for credit at exorbitant interest rates, and the exploitative relations that had developed in the rural economy.

It was in this context that the government began to intervene in the provision of rural credit, particularly credit for peasant farmers of paddy and subsidiary crops. Since 1960s, rural credit/agricultural credit schemes were implemented by the government using the multi-purpose cooperatives as channels of credit delivery. At first, the People's Bank and later the Bank of Ceylon were involved in the provision of credit facilities. However, these government-sponsored micro credit schemes suffered from a number of problems such as high costs due to subsidized interest rates, low repayment rates and high loan defaults that led to an eventual cancellation of loans.

Establishment of Cooperative Rural Banks (CRBs) as banking windows of the Multi-Purpose Cooperative Societies (MPCS) in 1963 was another important government initiative. The CRBs were involved in providing various financial services under the supervision of the People's Bank. The CRB network expanded rapidly throughout the country, reaching over 1500 banks under 306 MPCSs by 2002.

The 1980s and 1990s were very eventful decades in the development of the microfinance industry in Sri Lanka. The developments were particularly important in two areas: mainstreaming of microfinance as a major development strategy and growth of new institutions providing microfinance facilities. The enactment of the government's *janasaviya* programme[1] in 1989 was a benchmark in the history of microfinance in Sri Lanka. Until the late 1980s, Sri Lanka did not have any programme that was explicitly targeted at poverty alleviation. Instead, the focus was on public provision of education and health services, food subsidies, land settlement, etc. Since the late 1980s, poverty alleviation became a major plank in Sri Lanka's development policy framework. This policy change was accompanied by a shift of emphasis from general subsidies to targeted income transfer programmes, and the adoption of participatory methodologies and bottom-up development approaches to help the poor to help themselves. The objective was to help the poor to raise their production and productivity and facilitate their participation in the economic growth process. Many of these efforts sought to improve the access of the poor to credit, as the lack of capital was considered a major constraint that depressed the productivity of the poor.

The expansion of microfinance activity in the 1990s has embraced all sectors namely governmental, non-governmental and cooperative sectors. In the governmental sector, new initiatives include the establishment of the Janasaviya Trust Fund (JTF) in 1991 (which is presently known as the National Development Trust Fund) with World Bank/ IDA funds to serve as an apex lending institution for poverty alleviation programmes, Regional Development Banks in 1986 for lending to the rural population and Samurdhi Banking Societies in 1997. In addition, most Integrated Rural Development Projects (IRDPs) which operated at district levels carried a credit component to lend to the poor. Furthermore, a large number of Non-Governmental Organizations (NGOs) and Community Based Organizations (CBOs) entered the microfinance sector after 1990.

8.3 Microfinance Providers in Sri Lanka

As already mentioned, a wide range of institutions and programmes including banks,

[1] *Janasaviya* was established by the government in 1989 with the dual objective of short-term income-supplementation and long-term employment creation of low-income households. This had several components including provision of credit facilities to low income households, improving nutrition, and small enterprise development.

NGOs, CBOs and Cooperative Societies have entered the field of microfinance during the last couple of decades. These institutions vary largely in terms of their sources of funding, clientele, coverage, legal and organizational structure, main activities and financial services provided to individuals/ households. These providers of microfinance can be broadly categorized into three groups: (i) formal institutions; (ii) semi-formal institutions; and (iii) informal sources. Formal institutions include both state-owned and private commercial banks and development banks like Sanasa Development Bank and Regional Development Banks (RDBs). Semi-formal institutions include various NGOs, CBOs, cooperative societies (e.g., TCCSs and MPCSs) and banking societies like the Samurdhi. Moreover, there exist a number of informal sources such as Rotating Savings and Credit Associations (ROSCAS), and moneylenders providing micro credit facilities particularly in rural areas. Nevertheless, Microfinance Institutions (MFIs) are defined to include only the institutional sources, i.e., formal and semi-formal institutions providing microfinance services as their major or an important part of their business.[2]

Table 8.1 shows the savings and credit operations of some of the major microfinance institutions including the CRBs, RDBs, TCCSs and NGOs like Sarvodaya (SEEDS)[3] and Janashakthi Bank (Hambantota). As indicated, Co-operative Rural Banks (CRBs) have mobilized the largest volumes of savings, amounting to over Rs. 20 billion in 2003. The total amount of loans granted during this year was only Rs. 4.2 billion which is approximately 21 per cent of the total savings. The amount of savings mobilized and the loans granted have increased in 2003 compared to the amounts in 2002. The bulk of savings of CRBs are deposited in commercial banks and other financial institutions, implying a resource transfer from rural to urban sector. Regional Development Banks (RDBs) and TCCSs have mobilized a large sum of savings in recent years. In contrast to the CRBs, RDBs and SANASA, the two NGOs (SEEDS and Janashakthi Banking Societies) have a relatively lower amount of savings compared to their loan disbursements. Legal constraints on NGOs such as prohibition of savings mobilization and lack of regulation and supervision may have contributed to lower savings by NGOs.

As shown in Table 8.1, micro credit loans are granted for diverse activities including agriculture, animal husbandry, housing, trade, etc. Agricultural loans have accounted for a relatively higher proportion of the total disbursed loan amount of each institute. Moreover, a significant amount of loans has been granted for small industries, commerce and building construction. Table 8.1 does not include data for the Samurdhi Banking Societies (SBSs) which act as savings and credit associations of the government's samurdhi programme. This is one of the largest microfinance programmes currently operating in the country. By 2004, there were over 40,000 SBSs operating in almost all the districts in the country.

8.3.1 Role of the Central Bank

The Central bank of Sri Lanka (CBSL) has a major role in regulating the operations of the banks as the 'banker of the bankers'. The role of the CBSL in microfinance is not only as a policy institution but also as an implementer and programme formulator. It plays an important role in promoting the rural financial sector. The bank has been

[2] Note that this is somewhat different to the ADB definition that defines MFIs as institutions whose major business is the provision of microfinance services (ADB, 2000). The reason for this deviation is that, in Sri Lanka, there are a large number of NGOs, commercial banks, etc., that are involved in microfinance as an important part of their activities, but not necessarily as their major business.

[3] Sarvodaya Economic Enterprise Development Services (SEEDS).

Table 8.1
Savings Mobilized and Loans Granted: Selected Microfinance Institutions (Rs. million)

	Co-operative Rural Banks(CRBs)		Regional Develop-ment Banks		Thrift and Credit Co-operative Societies (SANASA)		Sarvodaya (SEEDS)		Janashakthi Bank Hambantota		SANASA Develop-ment Bank	
	2002	**2003(a)**	**2002**	**2003(a)**	**2002**	**2003(a)**	**2002**	**2003(a)**	**2002**	**2003(a)**	**2002**	**2003(a)**
Total Savings (b)	18,688	20,052	6,344	-	4,175	4,490	547	752	65	69	1,495	1,696
Savings	13,477	14,371	4,102	-	1,228	1,326	486	636	28	29	380	578
Special savings	-	-	-	-	1,508	1,689	16	28	17	20	6	4
Fixed deposits	5,211	5,681	2,242	-	599	629	45	88	1	1	943	939
Shares	-	-	-	-	840	846	-	-	19	19	166	175
Total Loans Granted (c)	3,327	4,206	6,285	8,133	2,768	2,921	991	1,250	382	432	648	1,161
Agriculture	850	207	1,438	2,325	436	462	101	131	308	343	7	7
Animal husbandry	101	273	64	92	90	101	29	39	-	-	-	-
Fisheries	33	27	47	70	-	-	-	-	15	16	-	-
Small industries	280	112	912	919	138	249	192	252	29	31	12	22
Building construction, electrification and water supply	185	1,877	-	-	1,114	1,080	353	452	-	-	58	250
Projects/ Commerce	226	396	499	732	285	302	186	209	-	-	209	521
Others	1,652	1,314	3,325	3,995	705	727	130	167	30	42	362	361

Notes: a. Figures for 2003 are provisional; b. Total savings at the end of the year; c. Total loans granted during the year.

Source: Central Bank of Sri Lanka, *Annual Report* (2003 and 2002).

involved in rural financial sector develop programmes that operates through several institutions like the People's Bank, Bank of Ceylon and RDBs. The CBSL was involved in refinancing this programme until 1994 and since then, the government has been involved in refinancing the project. In 2003, about Rs. 1.2 billion worth of loans have been disbursed under the NCRCS.

In addition, there are two other credit programmes carried out by the CBSL, namely the Small Farmers and Landless Credit Project (SFLCP), which is widely known as the 'ISURU' programme; and the Poverty Alleviation Microfinance Project (PAMP). ISURU is a poverty alleviation project executed by the Regional Development Department (RDD) of the CBSL in four selected districts of Galle, Kandy, Matara and Puttalam. It came into operation in 1990. The IFAD (International Fund for Agricultural Development), CIDA (Canadian International Development Agency) and the Government of Sri Lanka (GOSL) are funding the programme. PAMP is a replication of the SFLCP in six other districts of Badulla, Kurunegala, Nuwara-Eliya, Matale, Kalutara and Hambantota. This project was initiated 2001. The project is funded by JBIC (Japan Bank for International Cooperation) and executed, and implemented by the RDD of the CBSL.

8.3.2 Apex Lending Institution: NDTF

The National Development Trust Fund (NDTF), formerly known as the Janasaviya Trust Fund (JTF) was established in 1991 by the GOSL with the assistance from the World Bank and the government of Germany to serve as the apex lending institution for poverty alleviation programs. The main objective of the NDTF is to alleviate poverty by increasing employment and income generating opportunities among the poor. It functions as a non-profit oriented organization.

In 2003, initiatives were taken to transform the NDTF to a 'company limited by guarantee' with the objective of enhancing the operational efficiency of the organization. While other donor agencies like the ADB also urged this initiative, due to various legal issues that arose in the transformation, the NDTF currently operates as two parallel entities, i.e., a trust and a company. The trust is presently involved in recovering loans while the company is engaged in loan disbursement and 'credit plus' activities. While the trust operates as a self-sustained unit from the revolving fund, the company is financed through external funds.

The NDTF operates through a network of over 200 Partner Organizations (POs) around the country that act as intermediaries between the NDTF and the beneficiaries (poor households). The selection of the POs is made according to a set of pre-determined criteria. To be a PO of the NDTF, an organization has to be a voluntary NGO, a cooperative organization, a limited liability company or a bank involved in microfinance activities. In addition, these organizations are required to have at least one-year experience in microfinance with a loan recovery rate of 90 per cent or else, two-years of experience with a recovery rate over 70 per cent. NDTF funds to its POs take the form of 'refinance' - that is, POs can reimburse the loans issued to their clients for micro enterprises and other income generating activities. The NDTF lends at a rate of 7 per cent per annum and encourages the POs to on-lend to the beneficiaries at around the market rate.

Table 8.2 shows the performance of NDTF as at end 2004. There were 216 POs registered with the NDTF of which 146 were NGOs. The total loan disbursement to these POs was about Rs. 362 million. This amount has increased significantly during the last five years from about Rs. 87 million in 1999. The loan recovery rates have remained around

Table 8.2
Performance of NDTF (at end 2004)

Category of POs	No. of POs		Refinancing of Loans		Outstanding Loan Balance (end year)		Percentage of Recovery (%)	
	2003	2004	2003	2004	2003	2004	2003	2004
NGO	148	146	153	98	231	221	76	89
TCCS	17	19	5	6	118	114	32	51
RDB	6	6	126	239	132	236	100	99
SANASA								
Development Bank	1	1	0	5	23	10	100	100
Other banks	4	4	1	0	1	0.5	100	100
Cooperative societies	39	40	7	14	27	31	55	50
Total	215	216	292	362	532	613	80	-

Source: NDTF, Central Bank of Sri Lanka *Annual Reports*.

80 per cent in recent years. However, there are large variations in the recovery rates of different POs. The recovery rates of the banks including the Sanasa Development Bank, RDBs and other banks are very high while the loan recoveries of other POs like the co-operative societies and TCCS have continued to remain at a lower level. As per NDTF sources by end of April 2005, the overdue loans (loans with no recovery for over 6 months) have amounted to approximately Rs. 40 million.[4] There are number of reasons contributing to the high level of overdue loans. Nearly 45 per cent of the NDTF loans have been provided for agriculture related activities. Therefore, natural calamities such as droughts and floods have been a major factor affecting loan recoveries. In addition, attitudes of the poor, particularly to consider agricultural loans as grants or subsidies, is another factor affecting loan recoveries of the NDTF. Political factors including frequent changes in government and promises to write-off loans have also contributed to such adverse implications on 'credit culture'.

At present, the NDTF carries out three main projects supported by the ADB. The NDTF has a major role in the Rural Financial Sector Development Project (RFSDP) of ADB. The responsibilities of the NDTF in this project are to co-ordinate and monitor the credit delivery system, and administrative functions associated with refinance applications and loan disbursement requests. Approximately US$ 2 million has been disbursed under this project. Furthermore, as a part of the RFSDP, an emergency credit programme (worth of US$ 7 million) is carried out by the NDTF to support the enterprises that have been destroyed by the tsunami disaster. The other two projects supported by ADB are the North-East Coastal Community Development Project (NECCDP) and Aquatic Resources and Quality Improvement Project. For the latter project, only institutional support is provided by the ADB.

[4] However, this figure includes only the overdue amounts of the company. The total overdue loans amount to a much higher value once the overdue loans of the Trust are taken into account.

Box 8.1
Microfinance Programmes on Post-tsunami Recovery

Microfinance can play a vital role in helping the tsunami-affected communities by providing financial services to rebuild/re-commence their livelihood activities. A number of bodies including various ministries, multilateral organizations, banks and NGOs are engaged in providing microfinance services to the affected households and entrepreneurs. Of many initiatives, there are two major programmes executed by the CBSL and the NDTF. The programmes are aimed at rebuilding the lives of the tsunami affected households by providing them with financial assistance to start up micro-enterprises or productive activities.

The 'Susahana loan scheme' was executed by the RDD of the CBSL, with the objective of providing credit facilities to restart micro, small and medium scale enterprises affected by the tsunami. Credit is provided to the eligible sub-borrowers through participatory financial institutions (PFIs) which are commercial banks, development banks, finance companies and leasing companies registered with the CBSL. The programme is funded by the CBSL and GOSL. The CBSL will refinance up to 100 per cent of the loan amounts disbursed by PFIs. The PFIs that borrow at an interest rate of 3 per cent, lend to the tsunami affected entrepreneurs at a rate of 6 per cent per annum with a grace period of one year and a repayment period of 3 to 8 years. The eligible sub-borrowers are the existing borrowers and the new borrowers identified by the PFIs. Sectors such as commerce, industries, fisheries, import and export, agriculture, tourism and transport are eligible to apply for the loans. The Susahana loan scheme, which commenced in January 2005, has made satisfactory progress during the last few months. By mid May 2005, a total of 3,069 loans amounting to Rs. 1489 million have been disbursed to affected entrepreneurs in tsunami affected districts. In addition, a large number of loan applications are currently being processed by these lending institutions.

The second major programme is the special emergency credit programme of tsunami microfinance carried out by the NDTF. It is implemented through POs of the NDTF and the national level MFIs like the People's Bank, and RDBs. The NDTF refinances the MFIs at 2 per cent and the MFIs are to provide credit to sub-borrowers at 6 per cent, leaving the MFIs a margin of 4 per cent to cover their costs. As at end of March 2005, this credit scheme had a clientele of 3,928 and had disbursed about Rs. 103 million from the total allocated amount of Rs. 318.5 million.

8.4 The Outreach of Microfinance in Sri Lanka

In analyzing the effectiveness of microfinance in alleviating poverty, it is crucial to look at the outreach of MFIs. It is argued that microfinance can play an important role in poverty alleviation only if the extent of outreach is reasonably large. On the contrary, if MFIs are restricted to only few geographical locations or serve only a small fraction of the population or a small fraction of the poor, their importance in poverty alleviation efforts would be limited. The outreach of the microfinance sector can be looked at in numerous dimensions such as extent and scale of outreach, spatial outreach (i.e., whether a given MFI operates in many geographical locations) and depth of outreach (i.e., whether the MFIs have reached the poorest of the poor).

In Sri Lanka, it is known that there are a large number of MFIs operating throughout the country. Supporting evidence has been found from a recent study carried out by the IPS covering about 1500 households from 50 Grama Niladari (GN) Divisions across 17 districts in the country (except the North and East). The findings show that about 80 per cent of the GN divisions have access to at least three microfinance-providing institutions, with an average of about four MFIs in a GN division.

Nevertheless, the spatial outreach of MFIs was found to vary largely from one institution to another. It is interesting to find that the government's Samurdhi credit and savings programme, despite a number of other weaknesses, operates in almost all the GN divisions in the country. The TCCSs and MPCSs have also shown a significant spatial outreach. Nevertheless, the majority of NGOs (with very few exceptions) have relatively lower spatial outreach, where many of them operate in less than 10 per cent of GN divisions in the country. Furthermore, private commercial banks are also found to have a limited geographical coverage.

There are number of factors that limit the spatial expansion of many MFIs, particularly to remote rural areas. First, remote areas are often associated with poor or inadequate infrastructure facilities such as roads, transportation, electricity and communication networks. Second, many remote areas offer only limited opportunities for non-agricultural activities that often limit the number of clients a MFI can serve. Poor infrastructure in these areas raises unit cost of operating businesses including microfinance services. As a result, extending outreach (spatially) to remote areas could often lead to higher unit costs of lending and hence, can have adverse impacts on an institution's viability. Moreover, excessive expansion of MFIs is also associated with difficulties in monitoring their clients.

Among all the dimensions of outreach, the most important is the depth of outreach - i.e., whether microfinance is reaching the poorest groups. Several studies on microfinance have shown that many MFIs largely serve the 'better-off poor' and the vulnerable non-poor categories rather than the poorest groups. This finding was supported by the recent IPS study. There are number of reasons why MFIs may not reach the poorest groups. The demand for credit from the extreme poor may be limited as they often lack capacity for undertaking micro-enterprises, owing to lack of skills, technical know-how and marketability of products. The existing demand for credit by the poorest groups is often for consumption needs. On the other hand, many MFIs may not be willing to serve the poorest groups as they are considered 'risky' and have less capacity to pay back loans. These poor groups that are excluded from formal and semi-formal financial institutions often have to rely on various informal sources of finance such as money lenders, shop keepers, friends and relatives to meet their financial needs.

8.5 Regulatory Framework of Microfinance Institutions

The need for a sound regulatory framework for the microfinance sector has become an issue of great concern in recent years. Regulation of MFIs is important as it ensures financial soundness of the institutions and helps to build the confidence of donors, funders, members, and the depositors. It is also important for MFIs to have some flexibility in making decisions on interest rates to be charged and financial services/products to be provided, etc. Thus, a comprehensive regulatory framework maintaining a balance between such factors is vital for the efficient functioning of the microfinance sector.

Currently, regulation and supervision of the microfinance sector exists within a fragmented and complicated structure. There is no single body to regulate and supervise the operations of all the MFIs. Instead, there exist several ministries, departments and government Acts that control the operation of MFIs. The requirements of each of these regulatory bodies are different, making the current regulatory framework even more complicated. For example, regulations applied to the non-banking institutions like NGOs and cooperatives are considerably different to government sponsored programmes and banks involved in microfinance.

8.5.1 Regulation of Non-Bank MFIs

In Sri Lanka, the non-bank MFIs are mainly of two types: NGOs and cooperative societies (e.g.,TCCSs). A NGO type of a MFI can be registered under three main Acts: (i) under their own special Act of Parliament; (ii) under the Companies Act of 1982 or (iii) under the Societies Ordinance of 1891. Nevertheless, there is no compulsory requirement for an NGO to register under any Act/Law. However, NGOs not registered under any of these Acts may find it difficult to attract funds from external sources.

According to the existing regulatory framework, NGOs are not permitted to mobilize savings from either their members or from non-members.[5] Nevertheless, there exists a number of controversial issues regarding this. The NDTF, the apex lending institution for MFIs as well as government credit programmes such as SFLCS of CBSL encourages NGOs to mobilize savings from their members. By contrast, in 1992 Sarvodaya was prosecuted for collecting savings, and was required to return those savings to the depositors/members. Such controversies discourage NGOs from getting involved in microfinance activities. Savings is a major component of microfinance and is an important source of funds to many MFIs. Savings can also be used as collateral for loans taken by members. Therefore, it is important to amend laws that restrict savings mobilization by the MFIs. However, at the same time, a more rigorous and systematic regulatory framework that helps to enhance the depositors' credibility and ensures the institutions' viability is needed for the NGOs sector.

The cooperative societies have another set of rules for their regulation. TCCSs in Sri Lanka are engaged in mobilizing deposits at competitive rates of interests and they invest them in community-based lending programmes. The operation of TCCSs is governed by the Cooperative Societies Law of 1972 as amended by Act of 1983 and 1992 and they are regulated by the Department of Cooperative Development. The corporative societies have to be registered with the registrar of cooperative societies. Under the law, they are permitted to accept deposits and on-lend only to members. They can also set their own interest rates but if the credits are granted on external funding, they have to keep the interest margin on or below 4 per cent.

8.5.2 Regulation of Banks

On one hand, there are many banks - both state-owned and private - that have entered the field of microfinance in recent years. On the other hand, a number of microfinance institutions - NGOs and cooperatives - are currently seeking to establish banks as it will involve a number of advantages such as receiving deposits from the public, increasing their credibility with investors and depositors and increasing the ability to expand their operations. Having a regulated bank also helps MFIs to provide a broad range of financial services to their members and non-members.

[5] As per the Banking Act of 1988 and the Finance Act of 1988, an institution has to be licensed as a bank or a finance company to be eligible for collecting deposits – whether from the members, non-members or in the form of compulsory savings that many MFIs need as a precondition for obtaining loans.

However, there are number of legal and financial requirements that need to be satisfied by any MFI that wishes to become a bank. The minimum capital requirement for a commercial bank is Rs. 2500 million while that for a licensed specialized bank is Rs. 1500 million. These minimum capital requirements have increased in recent years and are currently too high for many MFIs that wish to become a bank. Moreover, all the banks in Sri Lanka, whether commercial, development or licensed specialized banks are subject to prudential regulation and supervision by the CBSL. Moreover, all the commercial banks engaged in microfinance activities are operated and regulated under the Banking Act of 1988 (amended in 1990, 1995 and 2005).

In addition to the above regulatory mechanisms, the NDTF also acts, as a 'second-tier institution' that imposes various conditions on its POs. It requires the POs to achieve certain standards, prepare annual reports and financial reports, and to have their annual accounts audited by an external auditor recommended by the NDTF. Self-regulation is another approach to establish performance and reporting standards, which can be promoted through an apex body or a forum of MFIs. In Sri Lanka, a forum of MFIs was established in 1995 by the UNDP with over 50 members including a number of NGOs, donor agencies, the CBSL and the Bank of Ceylon. However, it has not been very active in recent years due to a number of reasons such as lack of funds and commitment.

A number of attempts have been made more recently by successive governments to lay the foundation for setting up a sound and effective regulatory framework for the microfinance sector in Sri Lanka. This need has also been stressed by various multilateral agencies providing financial and technical assistance to improve the microfinance sector. However, so far these attempts have not been able to be transformed into a concrete plan of action due to various reasons such as an unfavourable political environment due to frequent changes of government. Hence, a single authority/body replacing numerous and diverse bodies and laws that are currently related to the regulation of the microfinance sector is an urgently felt requirement.

8.6 Conclusion and Policy Implications

Despite a long history of providing microfinance services in Sri Lanka, there exists a number of issues related to the microfinance sector that need substantial attention. As already pointed out, Sri Lanka has a wide network of microfinance providers ranging from banks, cooperatives, NGOs and CBOs. Nevertheless, the spatial outreach of MFIs varies largely from one institution to another with private banks and NGOs having limited operations in remote rural areas. One of the major constraints for the spatial expansion of many MFIs is the poor infrastructure facilities in rural areas, such as poor roads and transportation facilities, and lack of electricity and communication networks. Poor infrastructure often raises the unit cost of operating microfinance services. As a result, extending outreach to remote areas could often lead to higher unit costs of lending and hence, can have adverse impacts on the financial viability of the institution. Therefore, implementation of a carefully designed development programme aimed at removing these bottlenecks is crucial to improve the outreach of MFIs in remote rural areas.

Furthermore, many MFIs tend to serve the non-poor groups rather than the poor and the poorest groups. Such low depth of outreach is a result of both the demand and supply side constraints such as low demand for credit (for productive purposes) by the poorest groups and, their lack of credit worthiness and poor capacity to pay back loans. Thus, it is important that the MFIs extend their activities to reach the poor and the poorest groups. In extending the services to these disadvantaged groups, it is crucial to understand the nature of credit demand by these groups. The demand for credit by the poor often goes beyond credit for investment or income generation activities to include asset building and various consumption and emergency needs. However, most of the existing microfinance programmes today have overwhelmingly focused on micro-enterprise promotion and have not been able to address the credit demand by the poor and the poorest groups for other important needs that help them to reduce their vulnerability and poverty. Thus, it is important that MFIs take into account the differences among microfinance clients amongst various income groups and their needs in designing more effective microfinance instruments that could benefit the poor and the poorest groups.

In addition, it is important to note that the poor often lack the necessary skills and technology required for economic activities and have limited access to markets. As a result, even when the poor are capable of borrowing from MFIs and starting up micro-enterprises, sustainability of these activities becomes an issue. Thus, it is important that MFIs facilitate or become directly involved in providing various 'credit plus' services such as skill development/training, marketing facilities to enable their clients to create sustainable income generating activities.

Some MFIs like CRBs and TCCSs mobilize much higher amounts of savings than the amount of total loans. The excess savings are often deposited in commercial banks and other financial institutions implying a resource flow from rural to the urban areas which otherwise might have been invested in productive sources in rural areas where the poor can benefit. Hence, it is important to increase the opportunities in the rural sector so that the mobilized savings from rural areas can be invested in the rural sector itself, benefiting the rural poor.

As already discussed, the current regulatory structure for the microfinance sector in Sri Lanka is a rather fragmented framework. In the current framework, microfinance providers are regulated and supervised by various departments, ministries and laws. Thus, there is a need for a single regulatory body that can regulate and supervise all the microfinance providers in the country. Furthermore, amendments to the existing conditions constraining savings mobilization by the NGOs is crucial for the expansion and increased effectiveness of the microfinance sector.

Excessive government interference is another issue affecting the microfinance sector. Interference by the government through the provision of concessionary loans and interest subsidies often has distortionary effects on the microfinance sector. Writing-off of loans, particularly agricultural loans by the government often leads to adverse implications on the 'credit-culture' that is a critical element for the success of microfinance programmes.

9. EU Labour GSP Concessions: Benefits for Sri Lanka?

9.1 Introduction

In 2004, Sri Lanka became eligible for deeper tariff concessions under the labour incentive of the Generalized System of Preferences (GSP) scheme of the European Union (EU). This was an important development in the evolving labour-trade linkage in Sri Lanka's international trade relations. While Sri Lanka stands to gain from additional preferential treatment vis-à-vis its competitors, particularly in the area of garments exports, it also raises concerns about the increased momentum to link non-trade issues as conditions for granting preferential treatment. This chapter attempts to examine the significance of the issues and implications of the EU Labour GSP concessions to Sri Lanka. Section 2 discusses the evolving nature of linkages between trade and labour standards. Section 3 examines Sri Lanka's experience with the EU GSP labour related concessions, with special reference to Sri Lanka's garments exports to the EU. Section 4 looks at other issues concerning the EU GSP scheme while Section 5 concludes.

9.2 History of Linkages between Labour and Trade

Labour and trade have a longstanding nexus, which could be traced back to the establishment of the League of Nations in 1919 and the General Agreement on Tariffs and Trade (GATT) in 1948. At the establishment of GATT, the Havana Charter noted the importance of the "maintenance of fair labour standards, particularly in the case of production for export, since otherwise one country's product may be undercut by those of another in which labour is unfairly exploited". Though this charter was never ratified and as a result the GATT treaty did not include labour rights issues, the fact remains that the link between labour and trade was acknowledged at important stages in the process of international trade development.

Within the context of the World Trade Organization (WTO), the most important was efforts to bring labour standards into the WTO negotiating agenda by developed countries at the Singapore Ministerial Meeting of 1996. Not surprisingly this was strongly resisted by developing countries. The text of the Ministerial Declaration while renewing the commitment of member states to the observance of internationally recognized core labour standards also concurred that "the International Labour Organization (ILO) is the competent body to set and deal with these standards, and we affirm our support for its work in promoting them…We reject the use of labour standards for protectionist purposes, and agree that the comparative advantage of countries, particularly low-wage developing countries, must in no way be put into question". However, it has become increasingly apparent that labour standards are being introduced at the bilateral and regional level through preferential trade initiatives.

The growing trend of including labour standards provisions in bilateral agreements is evident in the US Trade and Development Act 2000, which embraces the African Growth and Opportunity Act (AGOA) and the US-Caribbean Trade Partnership Act (CBTPA). Conditions under the AGOA for US trade preferences includes respect of core labour standards and the implementing of ILO Convention No. 182, which bans worst forms of child labour. The CBTPA stipulates the necessity of compliance with core labour standards - the right to organize and collectively bargain, and the establishment of minimum wages, maximum hour standards and use of child labour. Further, agreements such as the US-Jordan and US-Cambodia Free Trade Agreements (FTAs) have provisions on labour standards. At the regional level, the North American Agreement on Labour Co-operation - more commonly known as the labour side-accord attached to NAFTA - includes labour concerns within an economic context.

9.2.1 EU GSP Scheme

The United Nations Conference on Trade and Development (UNCTAD) recommended the creation of the Generalized System of Preferences (GSP) in 1968 under which developed countries would grant autonomous tariff preferences to developing countries. Such a scheme required a waiver from the non-discriminatory concept of Most Favoured Nation (MFN) principle of GATT Article I and was therefore granted under the Enabling Clause adopted in 1971. Under the Enabling Clause, trade preferences have to be non-discriminatory, non-reciprocal and autonomous. No discrimination against developing countries is permitted except in favour of the Least Developed Countries (LDCs). Preferences must also be one-way meaning that they must not require beneficiary countries to grant reciprocal preferences. The EU was the first to implement a GSP scheme in 1971 and currently maintains five different GSP arrangements: general arrangements, special incentives arrangements for the protection of labour rights, special incentives arrangements for the protection of the environment, special arrangements for the LDCs, and special arrangements to combat drug production and trafficking.

The GSP systems of both US and EU have incorporated labour standards as conditions for eligibility for preferences. US specifies that if a country has not taken or is not taking steps to 'afford internationally recognized workers' rights to workers in the country' the country may not benefit from the preferences. The EU GSP legislation specifies that developing countries which do not observe the minimum international standards identified by the EU may be deprived of preferential access to the EU market.

9.2.2 Advantages and Disadvantages of Linkages between Labour and Trade

As evident from the above discussion, the labour-trade linkage dialogue has gathered momentum over the years and as a result two camps holding opposing points of view have emerged. The following section sheds light on the diverse points stressed by the two camps.

- Generation of greater market access: The labour-trade linkage has created greater market access for developing countries through numerous trade agreements and systems such as the NAFTA, US-Jordan FTA and the EU GSP scheme. The reduction in tariff rates in recognition of the promise to maintain labour standards promotes greater market access for producing countries under reduced tariff rates, such as the EU labour GSP concessions to Sri Lanka and Moldova.
- Broader distribution of benefits of trade liberalization: The labour-trade linkage can indirectly broaden the distribution of gains from trade and subsequent alleviation of poverty. However, there is scant empirical evidence to support this view where the evidence tends to suggest that such results are more the exception than the rule. However, the inclusion of conditions on labour rights and labour standards into trade agreements has the potential to improve distribution of income and alleviation of poverty. Further, labour standards have the capacity to redress the balance of power between the employer and employee to be fair by both parties.

- Potential to protect developing countries from South-South competition: Presently, manufacturing of many export products has been shifted to low wage developing countries from high wage developed countries. Thus, the labour-trade linkage protects a developing country which exercises labour rights and standards from competing developing countries which may manufacture without practicing such labour concerns.

Other supporting arguments are based on concerns such as obtaining support from developed countries, i.e., for rolling back agriculture subsidies, technical assistance and aid flows to support improved policy and enforcement of their labour rights covered in trade agreements.

- Possible protectionism by developed countries: One of the prominent demerits of the labour-trade linkage widely highlighted is the possibility of using labour standards

Box 9.1
India-EU GSP Dispute

The EU under its GSP drugs arrangement scheme granted Pakistan an extra textiles quota in 2002. The EU offered this concession to Pakistan under the WTO's Enabling Clause which authorizes members to operate the GSP notwithstanding the Most Favoured Nation (MFN) obligation of GATT 1994. Under the Enabling Clause a country is permitted to grant preferential treatment to goods of a particular country or a group of countries without extending it to other WTO members.

In December 2002, India requested the establishment of a WTO Panel to determine whether provisions under the EU GSP scheme on labour rights, environment protection and combating the production and trafficking of illicit drugs is compatible with WTO rules. India argued that the Enabling Clause does not permit discrimination among the countries which can be offered GSP privileges. In October 2003, the Panel ruling agreed with India that under a GSP programme, preferential tariff treatment has to be extended to developing countries as a whole and different developing countries cannot be treated differently. Under the Enabling Clause and in particular the 'non discrimination' principle, identical tariff preferences under GSP schemes should be provided to all developing countries.

The EU filed an appeal in January 2004. The subsequent WTO Appellate Body (AB) report overturned the Panel's finding in favour of the EU. The Appellate Body held that the term 'non discrimination' should not be interpreted to require that GSP donor countries provide 'identical' tariff preferences to 'all' developing countries, which are at different levels of development. This is subject to the condition that such preferences have a development objective and other conditions are met. The AB also held that conditionality (conditions on the basis of which preferential treatment is extended) under the GSP programme should be transparent, objective and non-discriminatory for countries similarly situated.

Nonetheless, the AB found that the EU failed to demonstrate that its 'drug arrangements' are based on objective and transparent criteria that would allow all developing countries similarly situated to qualify for the preferences under the drug arrangements. On this basis, from July 1, 2005 the drug clause is to be abolished.

Both India and the EU have claimed victory based on their own respective interpretations of the AB report. India may claim victory on the basis that the AB found the drug arrangements regime to be inconsistent with GATT and the Enabling Clause. But the EU may also claim victory given the ruling in favour of GSP donor countries being permitted to differentiate amongst developing countries, provided that other conditions are met.

Table 9.1
Core Labour Conventions

ILO Convention No.	Convention
29	Forced Labour Convention (1930)
87	Freedom of Association and Protection of the Right to Organize Conven tion (1948)
98	Right to Organize and Collectively Bargain (1949)
100	Equal Remuneration Convention (1951)
105	Abolition of Forced Labour Convention (1957)
111	Discrimination (Employment and Occupation) Convention (1958)
138	Minimum Age Convention (1973)
182	Worst Forms of Child Labour Convention (1999)

as a protectionist measure by developed countries.

- Labour standards only in the formal sector: The labour-trade linkage has limited potential in impacting the work force of an economy, as the social clause can only be exerted over the formal sector. This could lead to the creation of a disparity in terms of labour standards within the workforce of a country.

9.3 Sri Lanka's Experience in the Labour-Trade Nexus: The EU Labour GSP

Sri Lanka's first experience in terms of labour-trade linkage has come through the EU GSP scheme where it extends tariff preferences for compliance with good labour standards. Sri Lanka has been eligible for the special social clause concession since February 2004 due to ratifying and adhering to ILO Conventions, as required by the EU (Table 9.1).

Table 9.2
EU GSP Concessions for Sensitive Products

Products	GSP General Arrangement Concession	GSP Social Clauses Concession	Total GSP Concession	Final Applicable Tariff Rate
Sensitive products	3.5 p.p.*	5 p.p.	8.5 p.p.	CCT rate **- 8.5p.p.
Textiles and Garments	20 %	20 %	40 %	CCT rate - 40 %
Specific duties, except CN*** code 2207	30 %	30 %	60 %	CCT rate - 60 %
Specific duties for CN code 2207	15 %	15 %	30 %	CCT rate - 30 %

Notes: * p.p refers to percentage points.
** CCT Rate: Combined Custom Tariff Rate
*** CN code 2207 refers to Undenatured ethyl alcohol of an alcoholic strength by volume of 80 per cent or higher; ethyl alcohol and other spirits, denatured, of any strength as identified by the HS code 2207.

Source: GSP Manual 2002.

Box 9.2
GSP Plus

For the next 10 years, the EU Trade Commission has proposed a revised GSP scheme with three arrangements (general arrangement, GSP plus - incorporating labour and environment clauses and the EBA clause). This system is designed to be simpler, more transparent and more stable.

In order to benefit from the new scheme, countries are required to demonstrate that their economies are poorly diversified (five largest sectors of its GSP-covered imports to the EU are more than 75 per cent of its total GSP-covered imports), and therefore dependent and vulnerable. GSP-covered imports from that country must also represent less than 1 per cent of total EU imports under GSP. Beneficiaries of the new scheme should also have ratified and effectively implemented the 16 core conventions on human and labour rights and 7 (out of 11) of the conventions related to good governance and the protection of the environment. At the same time, beneficiary countries must commit themselves to ratifying and effectively implementing the international conventions which they have not yet ratified. In any case, the 27 conventions have to be ratified by the beneficiary countries by 31 December 2008.

From being eligible for concessions due to favourable labour standards being maintained, Sri Lanka was given deeper tariff cuts under the EU GSP scheme. As such, sensitive products enjoyed a total duty reduction of 8.5 percentage points of the MFN rate, textile and garment exports enjoyed a total duty reduction of 40 per cent, while certain other products saw a total tariff reduction of 60 per cent (while items under the CN 2207, are presently eligible for a total tariff reduction of 30 per cent off the MFN rate). Table 9.2 gives a summary of the EU GSP concessions for Sri Lanka.

In order for Sri Lanka (or any other country) to benefit from the GSP concessions of the EU, the scheme requires three main conditions are met. They are: (i) origin criterion, where the good must originate in the beneficiary country as defined in the EU GSP rules of origin (ROO); (ii) transport criterion, where goods must be transported directly to the EU from the beneficiary country; and (iii) documentary evidence criterion, where the goods must be accompanied by proof of their originating status, which is the certificate of origin.

For exports to be qualified as originating as per the EU rules of origin, the products should be either wholly obtained in the beneficiary country, or the non-originating materials contained in the final product must have been 'sufficiently' worked or processed in that country. The determination if a product has been subjected to 'sufficient' working or processing is based on one of the three criteria: (i) the change of 4 digit Harmonized System (HS) of Coding heading criterion; (ii) the value criterion; and (iii) specific process criterion. Under the first criterion on change of heading, a product is considered sufficiently worked or processed when the 4 digit HS Nomenclature is different from that of all of the non-originating inputs used in the production process. Under the second criterion, the value addition in the originating country should be greater than a specified percentage, for the product to be considered to have originated within the beneficiary country. The third criterion refers to a situation where specific operations or stages in the production process of the final product have to be carried out in the beneficiary country. This criterion is mostly applicable in exports of textiles and apparel articles. The value criterion and specific process criterion for apparel articles are summarized (Table 9.3).

Table 9.3
Conditions for Select Exports to be Considered 'Sufficiently Worked or Processed'

Chapter	Description	Specific Process	Value Criterion
Chapter 61	Articles of apparel and clothing accessories, knitted or crocheted: - obtained by sewing together or otherwise assembling, two or more pieces of knitted or crocheted fabric which have been either cut to form or obtained directly to form - other	Manufactured from yarn Manufactured from -natural fibres, man-made staple fibres, not carded or combed or otherwise processed for spinning, or - chemical materials or textile pulp	-
Chapter 62	Articles of apparel and clothing accessories, not knitted or crocheted	Manufactured from yarn	In most cases manufactured from fabric which does not exceed 40 per cent of the ex-works* price of the product.

Notes: * ex-works price means the price paid for the product ex-works to the manufacturer in whose undertaking the last working or processing is carried out, provided that the price includes the value of all the materials used, minus any internal taxes which are, or may be, repaid when the product obtained is exported.

Source: Compiled using Annex 15 of the *Guide for Traders on GSP Rules of Origin*.

9.4 Issues Concerning the Labour GSP Scheme of the EU

The objective of the EU GSP Scheme is to extend preferences to developing countries. However, in implementation the GSP mechanism entails mixed implications, including that of preference erosion. The issues of market access versus market restriction are analyzed with respect to the experience of the apparel industry in Sri Lanka. Apparel exports are selected due to the significance of apparel exports in Sri Lanka's export composition to EU given its importance in the EU market. In 2004, apparel exports accounted for 53 per cent of Sri Lanka's total exports to EU.

9.4.1 Increasing Market Access versus Decreasing Market Access

The GSP scheme and the special incentives under the labour clause are viewed as providing an opportunity for Sri Lanka to increase its market access to the EU. Due to the difficulty in obtaining actual prices and tariff rates, a hypothetical example is depicted in Table 9.4 to indicate the generation of greater market access through deeper tariff cuts.

Despite the reduction of tariffs, the GSP scheme has an inherent mechanism of effectively restricting market access. The implementation of the GSP scheme the EU requires the benefiting country to adhere to conditions and criteria discussed earlier. The practical difficulties in fulfilling the rules of

Table 9.4
Example of Greater Market Access with Deeper Tariff Cuts

Country	Price of Apparel Article in US$	EU Tariff Rate (10 %) US$	GSP Concession	Final Price (US$)
Country X	100	10	10 - 2 = 8 (a)	108
Sri Lanka	100	10	10 - 4 = 6 (b)	106

Notes: a. Concession for general arrangement 20 per cent off MFN rate.
b. Concession for general arrangement + labour incentive = 40 per cent off MFN rate.

origin criteria for instance means that market access may remain as restrictive as without the preferential treatment.

The non-fulfillment of ROO is a prominent factor that restricts market access, and leads to poor GSP utilization rates by Sri Lanka. The annual average GSP utilization rate of apparel exports for the period 1997-2003 was only 11.6 per cent. This statistic reflects the GSP utilization rate performance with respect to the GSP concessions under the general arrangement. Since the ROO for the general and the labour incentive arrangement are similar, a comparable trend in utilization levels could be expected for the labour GSP as well.

Given the high import dependency of Sri Lanka's apparel production, meeting the rules of origin requirement is difficult. The import content of the fabric taken up in Sri Lankan manufactured garments is mostly 60 per cent of the ex-works price of the garments, which conflicts with the value (ad valorem) requirement under the ROO of the EU GSP scheme. In this context, the significance of the imported input component in the production acts as a deterrent for benefiting from GSP preferences. The requirement for double transformation – firstly, manufacturing of fabric with the use of imported yarn and finally, producing apparel with fabric, proves difficult given the low level of development of backward linkage industries of the apparel industry in Sri Lanka. However, the proposed GSP-plus is expected to relax the stringent ROO requirements, and proposals have been forwarded for the introduction of a single transformation requirement instead of double transformation.

Regional cumulation provision for SAARC countries is often regarded as a means of improving utilization rates of the GSP Scheme. However, in the context of Sri Lanka's import structure of inputs for the apparel industry, the contribution from the SAARC region is not very significant. As shown in Table 9.5, the share of imports from India and Pakistan are around 6 per cent and 2 per cent, respectively. Another issue faced by the Sri Lankan apparel producers concerns the exports of apparel products for niche markets in the EU. Such products often require fabrics imported from Hong Kong, Korea, Indonesia, China, Taiwan, etc. rather than those of SAARC origin. The significance of textile inputs from non-SAARC countries is reflected in Table 9.5.

The proposed super regional cumulation (the consideration of two regional groupings together for ROO requirements) between SAARC and ASEAN for EU GSP rules of origin is expected to redress this issue to an extent, if the two regional groupings are considered by the EU for super cumulation. However, the super regional cumulation also will not be able to provide much support to Sri Lanka's given its top import origins of textile inputs are Hong Kong, South Korea

Table 9.5
Imports of Textile Inputs to Sri Lankan Apparel Industry (2002)
(US$ million)

Country Name	Woven	Knitted	Other	Accessories	Total	As % of Total
Hong Kong	158.5	38.4	34.23	40.9	272.1	29
South Korea	117.4	5.6	8.9	9.8	141.6	15
Taiwan	93.6	21.9	10.0	7.0	132.5	14
China	54.1	3.2	2.0	1.8	61.0	6
India	48.6	0.5	1.2	2.5	53.0	6
U.S.A	37.8	1.7	7.6	1.6	48.7	5
United Kingdom	14.5	3.9	9.1	8.7	36.3	4
Indonesia	25.6	0.5	0.8	0.4	27.3	3
Thailand	16.5	1.4	5.9	1.1	24.9	3
Japan	20.2	1.0	0.4	1.2	22.7	2
Pakistan	21.6	0.6	0.1	0.1	22.5	2

Source: Sri Lanka Customs Data.

and Taiwan, which are not members of ASEAN.

9.4.2 Preference Erosion

An issue of increasing importance in view of the on-going non-agricultural market access (NAMA) negotiations at the Doha Round is that of preference erosion – a decline in the competitive advantage of exporters in foreign markets due to preferential trade treatment. Some instances where preference erosion takes place includes elimination of preferences by export partners, expansion in the number beneficiaries of preference and the lowering of MFN tariff rates without lowering preferential tariffs proportionately.

Considering the fact that EU GSP labour concessions are preferences extended to Sri Lanka and Moldova only, the broader picture of the GSP concessions indicates a degree of preference erosion for Sri Lanka. For instance, within the SAARC region Bangladesh benefits from the 'everything-but-arms' (EBA) clause to enter the EU market duty free while Pakistan benefits from the drug clause[1] by accessing the EU market at zero duty.

In a broader context, the benefits of the GSP scheme are impeded by three factors: (i) reduction of MFN custom duties tend to automatically reduce the average preference margin; (ii) WTO level international agreements aimed at abolishing custom duties on selected products[2] eligible for the GSP; and (iii) the rising number of bilateral and regional free trade agreements.

There are further criticisms levelled against schemes such as the GSP. While GSP was to be granted unilaterally by developed countries, in reality developing countries find themselves burdened with obligations unrelated to trade such as labour standards. Thus, it can be argued that preferences are no longer unreciprocated. While the recent WTO Appellate Body finding (Box 9.1), overturning part of a panel ruling in the GSP case brought by India against the EU seems to establish that there is at least some limitation on what developed countries can demand as conditions to receiving

[1] Until July 1, 2005.

[2] Such as coffee since 2001 and electronic products and information technology since 1996.

Table 9.6
EU GSP Scheme Applicable to Selected Countries

Country	General Arrangements	LDCs/EBA	Labour Clause	Environmental Clause	Drug Clause[c]
Bangladesh	Yes	Yes	No	No	No
China	Yes[a]	No	No	No	No
India	Yes[b]	No	No	No	No
Pakistan	Yes[b]	No	No	No	Yes
Sri Lanka	Yes	No	Yes	No	No

Notes: a. Excluded are certain iron or steel products, while tariff preferences have been removed for certain products of animal origin, grains, seeds, fruits and plants, chemicals, articles of leather and fur skins, clothing, footwear, glass and ceramics and base metals.
b. Tariff preferences have been removed for leather and articles of leather and fur skins, textiles.
c. The Drug Clause will cease to exist after July 1, 2005.

Source: Extracted from Fernando, L., and P. Wijmenga (2002), "EC-Sri Lanka Joint Study on Sri Lankan Trade" and modified.

preferences. Nevertheless, simply by allowing discriminating conditions among GSP eligible countries, non-trade conditions such as labour standards can be advanced incrementally in the world trading system.

Moreover, the development needs of the grantee country tend to be subsumed where grantor country interests determine the product coverage and the preference margins in the GSP schemes. The requirement of double transformation of apparel exports from Sri Lanka is one such instance. Perhaps grantee countries should also ensure that pursuing offers of preferential market access does not undermine the incentive and ability to strengthen their competitiveness.

9.5 Conclusion

The EU labour GSP concessions extended to Sri Lanka has multifaceted implications;

- Greater market access for Sri Lanka's exports to the EU.
  - However, the GSP utilization rates remain low due to the restrictive nature of the scheme's ROO. The proposed regional and super cumulation arrangements to improve this situation too would have limitations in practice.
- Benefits of Good labour standards would ideally trickle down to the worker, and result in better distribution of gains of trade.
  - However, this does not guarantee an across-the-board improvement in labour standards, as it does not capture the informal and the non-trade sectors of the economy.
- The labour GSP would minimize the effect of South-South competition on Sri Lanka's export competitiveness in the international trade environment.
  - However, Sri Lanka may experience a degree of preference erosion due to other EU GSP arrangements (provided recipients comply with the ROO requirements).

It is evident that the Labour GSP scheme of the EU is a mechanism that operates on the premise of the long standing labour-trade linkage. However, the practical application of this labour-trade linkage exhibits a degree of distinction between potential benefits and actual benefits. As such, though the EU GSP has extended tariff concessions to Sri Lanka under the labour clause, the extent of realization of the benefits remain limited.

Box 9.3
GSP Efforts for Tsunami Recovery Efforts

As an effort to assist countries ravaged by the Boxing Day Tsunami, the EU considered implementing the GSP plus concessions 3 months earlier than scheduled (by April 1, 2005). Under this, Sri Lanka would have been considered for the special GSP plus arrangement of the EU, which grants zero duty for all GSP eligible goods provided that compliance with 27 international conventions prescribed by the EC is achieved at the time of application. However, the lack of consensus within the EU, such as the controversy regarding the threshold limit of 12.5 per cent of EU imports (which would graduate China from the scheme) versus 10 per cent of EU imports (which would graduate India as well) delayed the implementation process to the original date of July 1, 2005.

10. Industrial Restructuring

10.1 Introduction

Industrial restructuring can be rather broadly defined as a process of change in the industrial sector of a national economy. This definition lends itself to a wide range of possibilities ranging from, *inter alia*, restructuring at the level of the enterprise in terms of ownership, management, production capacity, etc., restructuring of a particular industry, changes in inter-industry linkages, and structural changes in the industrial sector at the aggregate level. Despite the various methods used, what is important is that the industrial structure of the economy becomes sufficiently flexible to adapt to the dynamic shifts in comparative and competitive advantage in an economy, whilst ensuring optimal technical and allocative efficiency.

Industrial restructuring has become a necessary component of government policy in recent years, due to the emergence of several sick and uncompetitive enterprises in Sri Lanka. A 'sick enterprise' is broadly defined to be an enterprise making substantial losses for three consecutive years, which cannot be revived without restructuring or removing external impediments. Such industrial sickness and business failures are often the results of the normal competitive process in a market economy, by which uncompetitive enterprises are pushed out due to the entry of more efficient firms, leading ultimately to the production of lower cost or better quality goods. This is known as the process of 'creative destruction' and should normally be left in the hands of market forces. However, industrial sickness can also arise due to market rigidities, unfair trading practices, infrastructure bottlenecks and failures in policy co-ordination and mismanagement in the economy. This latter set of problems are due to market failures, and therefore can be addressed through government intervention to give enterprises the flexibility to restructure their operations and re-use their capital effectively.

The tools used by the government to influence industrial restructuring range from macroeconomic policies such as monetary policy, fiscal policy, and trade policy; to sector specific policies, such as subsidies provided to boost the growth of capital intensive industries. This chapter studies the problems facing sick and uncompetitive enterprises in Sri Lanka, and discusses the ways and means by which governments can intervene in the restructuring process, utilizing a range of policy options. The chapter is organized as follows: Section 10.2 gives an overview of the industrial sector in Sri Lanka; Section 10.3 identifies the level of industrial sickness in the economy; Section 10.4 analyses the exogenous reasons for industrial sickness; Section 10.5 discusses the endogenous reasons for industrial sickness; and Section 10.6 concludes.

10.2 Overview of the Industrial Sector in Sri Lanka

Table 10.1 shows the GDP share of the three major economic sectors (agriculture, industry and services) for selected years. The data shows that the industry sector, comprising of manufacturing, mining and quarrying and construction, has been an important component of the economy during this period. However, the sectoral structure of GDP indicates a marginal change away from industrial activities over the past 15 years. The

Table 10.1
Sectoral Composition of GDP in Sri Lanka (%)

Sector	2004	2000	1995	1990
Agriculture	18	20	20	26
Industry	26	27	27	26
Services	56	53	53	48
Total	100	100	100	100

Note: The definition of Industry includes manufacturing, mining and construction.
Source: Central Bank of Sri Lanka, *Annual Report*, various issues.

industry sector's share of GDP has remained at 26 per cent between 1990 and 2004. In contrast, the services sector has demonstrated the fastest growth during this period, achieving a sectoral composition of 56 per cent in 2004 making it the largest contributor to national income.

10.2.1 Regional and Sectoral Spread of Industries

An overview of the industrial structure in Sri Lanka is given in Table 10.2 which shows the total number of industrial establishments in the country classified according to region and size of enterprise. The data shows that approximately 92 per cent of industries in the country are small scale with less than 10 employees. The remaining 8 per cent account for the large and medium scale enterprises in the country. However, as shown in Table 10.2 in terms of employment, it is the large and medium scale industries that account for the largest percentage of the industrial workforce (72 per cent), compared to that of the small scale industries (28 per cent).

At the regional level, Table 10.2 shows that Colombo and Gampaha (located in the Western Province of Sri Lanka) have the most number of industrial establishments, accounting for 20 per cent and 18 per cent of large and medium scale enterprises, and 10 per cent and 13 per cent of small scale enterprises, respectively. These two districts also have the largest number of employees in the large, medium and small scale industrial sectors. Following this, the Southern Province (comprising Galle and Matara) and the Central Province (comprising Kandy and Nuwara-eliya) have the largest number of industrial establishments in the country. The location of many industrial enterprises in these three provinces could be largely due to the development and availability of infrastructure in the form of roads, railways, ports, telecommunications, water and electricity, as well as the accessibility of financial capital for industrial investment. Furthermore, it could be a reflection of the higher population densities in these areas. Despite these reasons, the pattern clearly reflects the unequal level of industrial development in the country.

The number of enterprises in Sri Lanka, summarized according to major industrial divisions is shown in Table 10.3. The data shows that approximately 45 per cent of all industrial establishments are concentrated in two sectors; namely, food, beverages and tobacco and textile wearing apparel and leather. These two industry divisions also account for approximately 62 per cent of the labour force employed in the industrial sector. Table 10.3 indicates that the other sectors do not account for a significant amount of production or employment in the industrial sector of the Sri Lankan economy.

The industrial sector that has been described above is beset by a number of difficulties at both the aggregate and sector specific level which prevent it from achieving the growth

Table 10.2
Number of Industrial Establishments and Persons Engaged by District in Sri Lanka (2004)

District	Medium and Large Industries (Persons Engaged ≥ 10)		Small Industries (Persons Engaged ≤ 10)	
	No. of Establishments	Persons Engaged	No. of Establishments	Persons Engaged
Colombo	1,996	169,366	12,089	34,146
Gampaha	1,818	213,754	15,516	40,339
Kalutara	611	52,593	6,454	15,732
Kandy	645	36,803	8,100	19,447
Matale	193	11,991	3,321	6,995
Nuwara- Eliya	234	19,252	1,746	3,752
Galle	444	35,052	5,682	13,504
Matara	273	18,416	5,033	10,455
Hambantota	84	12,674	3,893	7,318
Jaffna	113	2,224	2,684	6,933
Mannar	20	336	413	1,083
Vavuniya	37	1,177	567	1,417
Mallaitivu	36	630	492	1,456
Killinochi	25	732	441	1,188
Batticaloa	120	2,752	1,898	4,764
Ampara	174	5,297	3,682	8,627
Trincomalee	38	2,998	1,487	3,254
Kurunegala	877	48,384	16,943	37,868
Puttalam	737	25,491	5,930	16,451
Anuradhapura	205	12,656	4,581	9,653
Pollonaruwa	221	11,152	2,489	5,002
Badulla	201	10,607	3,142	6,639
Moneragala	60	5,506	2,261	4,352
Ratnapura	534	29,744	5,916	12,521
Kegalle	265	18,241	6,666	12,727
Total	9,961	747,828	121,426	285,623

Note: Based on information obtained from the most recent Industrial Census carried out by the Department of Census and Statistics. The last Industrial Census in Sri Lanka was carried out in 1983.

Source: Department of Census and Statistics, Industrial Census 2004.

and development objectives set out in the policy framework published by the Ministry of Industrial Development in 1995.[1] One of the problems is the emergence of a number of sick and uncompetitive enterprises in the manufacturing sector. As mentioned before, the competitive forces of a market economy are the reasons for sickness in many industries. However, there are certain industries which have become uncompetitive due to market failures in the economy which require effective restructuring through government intervention to continue the development of the industrial sector. It is these industries that the following sections deal with.

[1] Ministry of Industrial Development (1995), *New Industrialization Strategy for Sri Lanka*.

Table 10.3
Number of Establishments and Persons Engaged by Industry (2003)

Industry Division	No of Establishments		Persons Engaged	
	No.	%	No.	%
Other mining	6248	4.8	36948	3.6
Food, beverages & tobacco	38248	29.1	181182	17.5
Textile, wearing apparel & leather	19916	15.2	463829	44.9
Wood, wood products & furniture	6372	4.8	27844	2.7
Paper products, printing & publishing	2367	1.8	27232	2.6
Chemicals, petroleum, rubber & plastic	6786	5.2	76228	7.4
Non- metallic mineral products	18240	13.9	70642	6.8
Basic metal industries	526	0.4	10315	1.0
Metal products, machinery & equipment	12749	9.7	57868	5.6
Other manufacturing industries	19147	14.6	75208	7.3
Electricity, gas & steam	152	0.1	889	0.1
Water works & supply	636	0.5	5266	0.5
Total	131387	100.0	1033451	100.0

Source: Department of Census and Statistics, Industrial Census 2004.

10.3 Identification of Sick Industries

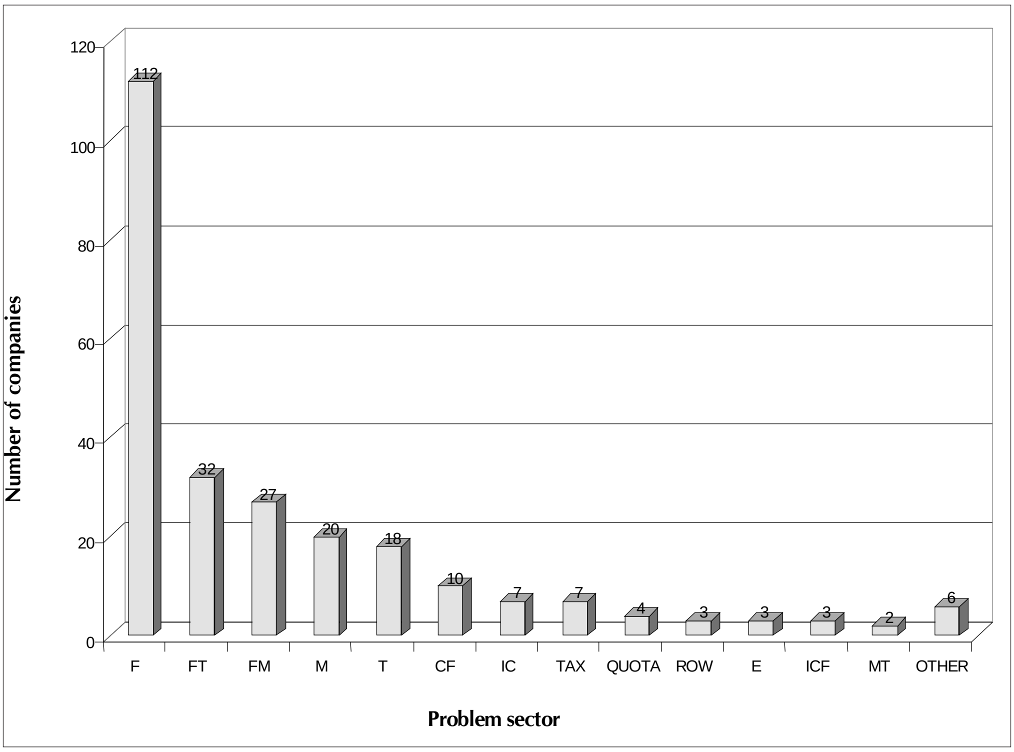
It is not easy to identify sick enterprises in Sri Lanka, separating industries struggling due to market failures from outmoded sunset industries that are at the last stages of their lives. The lack of comprehensive and up-to-date information in this regard also compounds the problem and is a major obstacle to any study on the difficulties confronting Sri Lanka's industrial sector.

For the purposes of this discussion, information on sick industries was obtained from the then Ministry of Enterprise Development, Industrial Policy and Investment Promotion (MEDIPIP) which undertook a study on uncompetitive enterprises in Sri Lanka through a postal survey in December 2003.[2] This survey got a response from 258 industrialists with a fairly representative overview of sick and failing firms in the country. However, one shortcoming of the data is that most of the respondent firms appeared to be large or medium scale enterprises, given the fact that they employ 10 or more workers in their industries. As 92 per cent of enterprises in Sri Lanka are small scale (as determined earlier in Table 10.2), this category is not adequately represented in the survey.

Figure 10.1 depicts the sick industries that were surveyed according to the various problems faced by the industrialists. The data indicates that the top three constraints faced by industrialists is the lack of finances to fund capital expenditure, purchase raw materials and repay bank loans (financial problems); the shortage of funds to upgrade technology and purchase new machinery (finance and technology problems); and the lack of funds to penetrate new markets and face stiff competition from imported goods in the domestic market (finance and marketing problems); altogether accounting for 68 per cent of all industries that were surveyed. The inability to secure market share due to competition from cheap imports, insufficient quotas to carry on production (this relates specifically to the garments industry), and high taxes levied on raw material imports or locally manufactured goods, were some of the other problems facing sick industries.

[2] The survey was conducted through an advertisement that the MITIP placed in the newspapers on 10th December 2003. The ad requested industries that ran the risk of closure due to financial or other problems to provide details to the MITIP, with a view to obtaining assistance from the government. Firms undergoing difficulties were asked to provide information to the Ministry such as the number of employees, nature of problem faced, and additional investment required to restructure their enterprises.

Figure 10.1
Number of Difficulties Related to the Problem Sector



F:	Financial problems	FT:	Financial and technology
M:	Marketing problems	FM:	Financial and marketing problems
T:	Technology problems	TAX:	Problems with high taxation
E:	Electricity problems	QUOTA:	Insufficiency of garment quotas
CF:	Competition and finance problems	ROW:	Lack of raw material
IC:	Import competition problems	ICF:	Import competition and financial problems
MT:	Marketing and technology problems	OTHERS:	Other problems affecting industries

The constraints cited by firms in this survey however, differs in some aspects from the survey of enterprises that was carried out by the World Bank and Asian Development Bank (ADB) in 2004.[3] The World Bank and ADB study indicated that the top five difficulties facing urban enterprises in Sri Lanka was the high cost and non availability of electricity; economic and regulatory policy uncertainty; macroeconomic uncertainty; cost of finance; and restrictive labour regulations in the country. In the case of rural firms, the main difficulties faced by them were transport problems; the high cost of finance; non accessibility of finance; low demand for products; and the cost and non accessibility of electricity.

However an important similarity between the two studies (the respective surveys conducted by MEDIPIP and World Bank/ ADB) is that the cost and access to finance has been identified as a key constraint faced by most firms. Moreover financial constraints appear to be faced by both urban and rural enterprises, and considered a difficulty that permeates the whole industrial sector. However, in interpreting these results it is important to keep

[3] The data and information collected in this Survey was published in a report titled "Sri Lanka: Improving the Rural and Urban Investment Climate (2005)".

in mind that in many cases financial difficulties may in itself not be the problem, but rather the outcome of other factors which prevent industries from becoming competitive. For instance, the poor utilization of resources, wrong direction and polices put in place by industrialists, government restrictions, bad management, and lack of education and training, could lead to financial difficulties and result in firms turning into uneconomic units.

The difficulties confronting the industrial sector can be broadly classified into two categories; namely, exogenous factors and endogenous factors. The exogenous problems relate largely to government polices and the overall structural framework for industrial growth, whereas the endogenous factors relate to the management practices of enterprises, which can be controlled by the individual firms. The following sections discusses both categories and also describes possible policy options that can be undertaken by the government to help enterprises that are sick maintain their competitiveness and develop the industrial sector as a whole.

10.4 Exogenous Reasons for Industrial Sickness and Possible Policy Options

10.4.1 Weak Macroeconomic Environment and Policy Framework

A stable and predictable macroeconomic environment is fundamental in maintaining the competitiveness of a country's industrial sector. One of the weaknesses in Sri Lanka's industrial policy is that macroeconomic policy for the most part has done little to increase business confidence and entrepreneurship in the economy. It has often been characterized by a short term outlook, and unsustainable budget deficits which in turn have required tight monetary policy aimed at curbing inflation. This has resulted in high interest rates and a crowding out of private sector activity. Weaknesses in the macroeconomic environment have also been reflected in exchange rate policy that is likely to have sent confusing signals about the profitability of resource allocation to enterprises and investors, and led to a subdued supply response, making it difficult for enterprises to implement productivity and competitiveness strategies in the industrial sector. Hence in order to ensure industrial development it is important that the government maintains macro economic stability to as great an extent as possible, and puts in place polices that remain consistent, coherent and continuous over a period of time.

10.4.2 Uncoordinated Industrial Polices

The lack of co-ordination between sectoral industrial policies is another reason for the relatively disappointing performance of the industrial sector. Industrial policy in Sri Lanka has always come under the purview of a number of different ministries. Currently industries are handled by the Ministry of Industrial Development and Investment Promotion, the Ministry of Advanced Technology and National Enterprise Development, as well as the Ministry of Small and Medium Enterprise Development. Between 2002 and 2003, under the previous regime there were seven different ministries overlooking the industrial sector. As a result, there has been little co-ordination between the ministries in the development of policy, which tends to militate against the development of a healthy industrial sector.

What may be required therefore is the creation of a rational institutional structure to perform regulatory responsibilities and provide the support services required for industrial sector growth in a co-ordinated manner. Such a structure would also prevent the duplication of work undertaken by the various institutions responsible for implementing industrial policy and curb potential turf battles in the bureaucracy. However, to succeed, this body would ideally need to have a light bureaucratic structure, a mix of top government analysts and private sector mangers, and the direct support at the highest level of government to implement key reforms.

10.4.3 Underdeveloped Infrastructure Network

Another factor that prevents enterprises in Sri Lanka from becoming competitive is the lack of a sound infrastructure network, comprising of electricity, water, telephones, roads, railways and port facilities. Enterprise success is dependent on the provision of these key facilities, which are in shortage particularly in the rural areas of the country. Electricity in particular is considered one of the most serious obstacles to doing business with more than 40 per cent of urban manufacturing firms and nearly 25 per cent of rural firms citing this as a major problem.[4] Where electricity is available, the cost is high as shortfalls in hydro sources have been met with expensive emergency power generation. This has led to Sri Lanka having some of the highest commercial power tariffs in the region. Furthermore, supply is generally unreliable, exposing firms to frequent outages and raising their production costs.

Transport problems are also another key infrastructure bottleneck faced by both urban and rural enterprises, with road quality being cited as the biggest constraint, followed by access to roads and lack of available transport.[5] This has prevented many firms from having easy access to markets to procure raw materials and inputs and also transport finished goods. Such bottlenecks inevitably feed into uncompetitive pricing, missed foreign buyer deadlines, poor country reputation and cancellation of repeat ordering, leading to adverse consequences on the country's industrial sector.

As infrastructure requires heavy capital expenditure, solutions to these problems would obviously require strategies being implemented at the national level involving long term planning. With regard to electricity in particular, the government has recognized the crisis faced by the sector in terms of both capacity and financial management and is in the process of implementing key reforms. Another solution would be to provide infrastructure facilities for industrial development, particularly for SMI's through the introduction of industrial estates (IE). However, when exercising this option, it has to be kept in mind that the IE program has had a long history in Sri Lanka, and the end results have often been places without proper infrastructure facilities and a high rate of under-utilization. Hence, if IE's, zone parks, and other premises are developed, it is important to ensure that they cater towards the infrastructure needs of the enterprises that will utilize them.

10.4.4 Rigid Legislative Framework

There are several aspects of the current legislative framework of Sri Lanka that can be viewed as constraints on the development of the industrial sector. One piece of legislation that deserves special emphasis is the existing Loan Recoveries Act of 1990, commonly known as Parate. This law provides banks with powers to sell movable and immovable property secured as collateral to recover debt, without recourse to courts of law, making it difficult for financially troubled enterprises to continue operations. It also puts entrepreneurs and employees of firms at an undue disadvantage to banks and lending institutions. On this basis, it is recommended

---

4 According to the Survey conducted by World Bank and ADB in 2004.

5 Ibid.

that this law be amended, and provision made to afford the opportunity for sick industries to reconstruct if possible. However, it has to be also borne in mind that repeal of these laws can considerably raise the risk of collateral based lending by banks, which would ultimately result in a shortfall of loans, particularly to the small and medium industrial (SMI) sector. Review of this legislation, therefore, has to be considered carefully when guiding the process of industrial restructuring, and alternative mechanisms for the protection of banks should be drawn up if they are repealed.

Another set of regulations in Sri Lanka that are considered inflexible and arbitrary, are those relating to the labour market. The Termination of Employment of Workers Act of 1971 (TEWA) in particular is considered one of the most restrictive legal provisions, and one that hinders smooth business operation. Under TEWA employers are not allowed to involuntary lay off workers who have served more than six months in the firm. The permission of the Commissioner of Labour is required in this regard, and in many cases firms have to pay extremely high compensations for workers that have been asked to leave. The discretionary and opaque administrative process for obtaining authorization to lay off workers is also of particular concern to firms, as it creates uncertainty within the business environment. Adding to the uncertainty is the length of procedures, as many cases drag on for years while employers explain their financial status to justify the lay offs. In 2003, however, the government did move to reform labour laws, with amendments to the TEWA. While the details of the proposed reforms still remain under discussion, it includes the introduction of a formula for employee severance payments, imposition of strict limits on the duration of labour tribunal cases, and the establishment of an unemployment benefit system for workers. If enacted, these amendments could go a long way towards making the labour market in Sri Lank more flexible.

10.4.5 Protection of Specific Industries

Government policy in many countries has been strongly influenced by the political economy argument for infant industry protection. The basic thrust of this theory is that industries need temporary protection while they are growing to help them achieve economies of scale and meet international competition later on. In the case of sick firms, industrialists often blame competition from imported goods for the failure of their enterprises, and lobby policymakers to ensure some form of protection in the form of subsides, tariffs or quotas.

Given the prevalence of market failures such as imperfect capital markets and imperfect information which prevent the growth of new industries, there may be a case for short term protection of certain industrial sectors in the economy. However, any protection strategy should take into account the country's overall development priorities in terms of industrial efficiency, employment generation etc. Therefore, it would be preferable if the protection is based on a sound cost benefit calculation that takes into account factors such as the availability of raw materials, relative factor intensity, cost of production and relative contribution to economic growth and job creation. The protection should also ideally be granted to industrial sectors on a temporary basis and be gradually phased out according to a predetermined schedule.

10.4.6 Unfair Trade Practices

Unfair trade practices faced by domestic enterprises also make it difficult for businesses to market their goods, affecting the viability of many manufacturing enterprises. Such practices typically consist of methods such as the dumping of foreign products into the local market, leakage from BOI firms, importation of used goods and parts at low prices, under invoicing and smuggling. These have been identified as a cause for industrial sickness in Sri Lanka particularly in enterprises that manufacture bicycles, furniture, and electronic and electrical goods.

The following measures can be utilized to counter unfair trade practices. The importation of used items at low prices which causes loss of business to local firms can be reduced by enforcing strict safety and quality standards for such goods. In the case of BOI products that are leaked into the local market, particularly in the case of the garments, textiles and leather products sector, high penalties can be enforced for malpractice and existing rules and regulations strengthened to restrict non compliant enterprises. Moreover, under-invoicing and smuggling can be countered by proper and strict administration of customs regulations and the imposition of heavy fines for malpractice.

Predatory dumping[6] by foreign firms can be combated by enacting an effective anti-dumping law. However, most often this issue is considered to be rather tenuous. In many cases, dumping is thought to be the result of firms adopting marginal cost pricing rather than the outcome of anti-competitive practices. However, according to the recommendations of the 1991 Second Presidential Tariff Commission which was formed to address allegations of dumping in Sri Lanka it was suggested that in cases where there is sufficient evidence of dumping, which is found to have a detrimental effect on local industries, policy makers could introduce specific duties on the suspect product.

10.5 Endogenous Reasons for Industrial Sickness and Possible Policy Options

10.5.1 Lack of Development Finance

In Sri Lanka, development financing to the industrial sector has been somewhat limited as the two state owned commercial banks in Sri Lanka, the Bank of Ceylon and the People's Bank dominate the financial sector, together controlling almost half the banking assets. Both have high levels of non performing loans that have persisted despite repeated capitalizations and management improvements. Their inefficiencies have led to high intermediation costs that are reflected in large spreads. This in turn has led to high costs of borrowing across the banking sector, since the more efficient private banks have chosen to charge similar high rates of interest due to profit motives. Furthermore, most commercial banks are very conservative with regard to their lending, focusing mostly on the safety, and security and profitability objectives of their shareholders.[7] This has inevitably led to a shortfall in lending, particularly to the SMI sector.

One way of making credit available would be to set up a new organization or restructure an existing one and attach to it the provision of long term finance to the industrial sector, prioritizing the needs of firms that can contribute towards the country's development, in particular the SME bank that was set up in March 2005. To begin with, the bank could lower the minimum sum loan scale by half to target the small and medium industrial sector. It could also undertake project based lending rather than firm based

6 This refers to a situation where a foreign industry sells a product in the domestic market at prices low enough to drive domestic industries out of business.

7 Even though there are Development banks in Sri Lanka they operate mostly on the lines of commercial banks. The DFCC bank for instance although set up initially with the task of proving long term finance to the SME sector, has avoided loans to small firms altogether since its inception.

lending, which is less risky. However, when undertaking these measures, it is important to have qualified managers and introduce training schemes for bank staff on assessing SME credit. Otherwise it will simply create another layer of bureaucracy resulting in a waste of resources that will not contribute towards improving the competitiveness of the industrial sector.

Another solution would be to facilitate private and foreign capital flows for industrial restructuring through various mechanisms, such as equity capital raised through the stock market, foreign direct investment, and modes of privatization such as divesture, management agreements, joint ventures, etc.

10.5.2 Inability to Adapt to Modern Technology

The inability of many firms in Sri Lanka to upgrade and enhance modern technology and machinery due to various reasons such as lack of finance, shortage of skills and access to knowledge, etc., is a serious constraint on the growth and development of the industrial sector. Up-to-date technology can decrease production costs, improve the quality of output, create a range of product designs and permit cheaper subsequent expansions of plant and machinery in the future and thereby improving the competitiveness of manufacturing firms. The inability to initiate measures that foster and encourage such technological growth have often resulted in failing and uncompetitive businesses.

There are many ways in which the technological capacity of firms in Sri Lanka can be upgraded. One is through FDI, whereby technology is transferred through the imports of goods with high technology content, and know-how brought in through the exchange of consultants, scholars, capital goods, suppliers, etc. Sri Lanka can provide the environment for such foreign investment by following an open economy regime and by providing incentives for firms to invest in certain technology and capital intensive sectors. Another way in which the government can play a valuable role is to ensure that such technology is obtained by domestic firms at low costs. Currently, the Board of Investment (BOI) operates a scheme in which industries that manufacture industrial tools or machinery for the local market qualify for concessions. The government can operate other similar schemes for firms investing in technological development by giving subsidies or providing protection.

10.5.3 Inadequate Manpower Development

The mere acquisition of technology is often not enough to encourage technology growth. Adaptive technology (the learning process) has to follow, and for this purpose skill development is very important. Although Sri Lanka has quite high standards of general education, with regard to vocational education - secondary education aimed at preparing pupils directly for a trade or occupation, generally considered of great significance for national technology development - it ranks very low compared to other countries in the South and East Asian region. Hence there is a shortfall of skilled and trained technicians and managers in the industrial sector which can make enterprises uncompetitive in the long run.

One way in which the government can invest in more training for workers in sector specific skills is to combine with private sector companies to set up an apprenticeship scheme, whereby workers get trained in the skills that can improve enterprise competitiveness and effectiveness. A scheme of this nature is at present operated by the government in conjunction with the private sector, known as the Skills Development Fund, which offers job training and skills upgrading opportunities to young workers. Other approaches that could be utilized include partial cost recovery of service approaches for turning around ineffective public sector training institutions, assistance for industry associations to launch training centres, an information campaign to educate firms about skills gaps and tax deductions scheme for enterprise level training investments.

10.5.4 Weak Marketing and Promotion Strategies

Domestic enterprises in Sri Lanka that functioned under a protectionist umbrella for many years had little need of improving their competitiveness by way of an effective marketing plan. However, such enterprises are not able to function in an open economy setting which requires, among other factors, sound marketing intelligence and product development skills. For instance, Sri Lanka has not been able to carry out effective marketing strategies abroad despite being an export oriented economy. The Export Development Board (EDB) has largely confined itself to organizing marketing missions, buyer/seller meets and assisting exporter's efforts in identifying and promoting markets. Such arrangements are not sensitive to the dynamic changes that take place in the foreign market place and to the special needs of small industrialists, making it difficult for firms in Sri Lanka to compete effectively with those abroad.

In this regard, sub-contracting arrangements can provide a mechanism by which the deficiencies or skills gap related to the marketing function is remedied by a main contactor who carries out such tasks on behalf of smaller firms. In Sri Lanka, Export Production Villages (EPVs) promoted and sponsored by the EDB could make use of this concept to resolve the marketing difficulties that are faced by many firms.

10.6 Conclusion

The previous sections have emphasized the significance of industrial restructuring and rehabilitation in the development of a healthy industrial sector. The inaccessibility of affordable finance was identified as a major difficulty facing many owners of sick enterprises. Such lack of funds have been largely attributed to the unsatisfactory performance of targeted lending to the industrial sector because of supply and demand side constraints in the financial sector, and the shortfall of soft loans internationally. However, this chapter emphasizes that the underlying causes for difficulties faced by sick firms are not just the lack of finances, as suggested by the data, but other factors as well. These include the lack of a coordinated strategic industrial policy, weak macroeconomic policy framework, unfair trade practices consisting of smuggling, dumping and under-invoicing of imports, lack of skills development and, obsolete technology. In this regard, suitable policy responses to these obstacles, by the government, have also been described.

Overall, it is suggested that the government target the entire set of problems confronting the industrial sector in Sri Lanka, and not just the symptoms emanating from sick firms if it wants to build healthy enterprises that can contribute towards economic growth and development in the long run. Whilst certain industry friendly measures such as specific lending to the SMI sector, trade protection and polices against unfair trade practices are advocated, the ultimate goal of the government should be the build up of productive firms in Sri Lanka that can compete effectively in the international market.

11. Contributing to More Effective Devolution

11.1 Introduction

The enactment of the 13th Amendment to the Constitution in 1987 was expected to yield an effectively functioning devolutionary polity that would both bring governance closer to the people as well as enable individual communities, in their local context, to self-administer the delivery of public goods and services that are of direct relevance to them. These expectations have, however, not been fulfilled 18 years down the line.

The objective of the discussion in this chapter is twofold. First, to assess the experience of the functioning of the Provincial Council (PC) system since its establishment in 1988 with the view of understanding the reasons that have contributed to their lack of effectiveness. Second, based on an understanding of the reasons, to offer a more relevant policy approach aimed at achieving an effective devolutionary system. Thus, the discussion on the post-1988 experience will assess: (i) the negative influence of the pre-1988 history and culture of Sri Lankan governance on the successful introduction of a devolutionary polity; (ii) failures in the sharing of governance responsibilities between the centre and the provinces; (iii) ineffectiveness of fiscal devolution; (iv) inappropriateness of the systems and processes of human resources management; (v) prevalent levels of accountability and transparency and the effectiveness of the role played by civil society; and (vi) structure of the PCs and their relationship with other institutions of governance within the provinces.

11.2 History and Culture of Governance in Sri Lanka

The politico-administrative management system that was inherited at the time of independence in 1948 was a centrally controlled system with a measure of bureaucratic deconcentration at the level of Administrative Districts. In the post-1947 period, the function of central control was assumed by political structures in the centre in the form of ministries.

Over the post-1948 period, the ministries at the centre were seen as helpful instruments for the following:

- consolidating the influence base of their holders so that it would serve as an instrument for the future advancement of their political careers;
- attempting dedicated exercises in introducing and consolidating ideological agendas of political groups holding office at a given point of time; and
- furthering the influence of specific ethnic, religious and social groups over the economy, the polity and the society.

The repeated increase of the size of the central legislature during the post-1947 period brought an increased number of political cadres to the centre. All these aspired for a share of the political, social and economic access opportunities that would be integral to the holding of ministerial office at the centre, with the implicit all-country visibility and influence.

It is in this context that the introduction of the 13th Amendment in 1987 occurred. It has to be seen not as an outcome of a detailed process of analytical search for a devolutionary restructuring of the country's governance. Rather, it was a knee-jerk response to a perceived need to find an instrument that would bring to an end the negative consequences of the militancy of an aggrieved ethnic group. As the initiative that triggered this step came from India, it is not a surprise that the institutional and process model that was used was the Indian model as interpreted by the centre in India. The copying of models was not accompanied by any serious and transparent assessment as to their appropriateness for the specific political, social and economic environment that prevailed in Sri Lanka.

Nor was any serious attempt made to explain the why, what and how of the radical change of the political processes and institutional structures that would result. The citizens, naturally, made their own assumptions. So did the political actors who sought political positions in the new institutions as well as those established in the pre-existing institutions. The same applied to the bureaucracy. The political and bureaucratic culture remained in the old mindset - inherited from the colonial period and conditioned by the 1972 Constitution.

The political and bureaucratic elite cadres at the centre, from the very inception of the 13th Amendment, saw in the PCs a threat to their exercise of political power - which carried with it the ability to influence and manipulate economic and social decisions and to impose ideological agendas across the country that had been built up from independence.

However, a frontal counter action to the new development carried risks - considering that the 13th Amendment was envisaged as a solution to the inter-ethnic issues that had led to continued political, social and economic instability as well as considerable loss of human life. This encouraged the political and bureaucratic cadres at the centre to continue to maintain the façade of a devolutionary system whilst denying it substance. Three approaches have been used as instruments for this purpose over the past decade and a half: manipulating the sharing of governance responsibilities between the tiers of government; the management of control over fiscal devolution; and the exercise of control over the management of public sector human resources.

11.3 Sharing Governance Responsibilities

It is clear that a transparent and widely comprehended system of sharing governance responsibilities is fundamental to an effective devolutionary polity. Such a system is the foundation on which a devolutionary polity should be based. To be effective, it should:

- be in accordance with the perceived and articulated aspirations of different groups of citizens in relation to the management of different governance responsibilities;
- match the levels of capacity developed over time by the citizens, available at the levels of the local community and of the aggregates of such communities;
- be appropriate to achieve expected results in terms, for example, of the speed, the quality and the cost-effectiveness of the delivery of public goods and services;
- facilitate and empower the direct participation of citizens in the governance processes at all levels of the polity - local, regional, national.

The designing of a system to share responsibilities presents added complications when it has to be undertaken in the context of the disaggregating of roles, responsibilities and functions that had historically been centralized. In the case of Sri Lanka, centralization had been the norm for the first four decades after independence. The post-independence political and bureaucratic institutions had evolved around this centralized role. Also the individual and group privileges of political and bureaucratic cadres had developed based on this trend towards centralization.

Thus, the attempt undertaken in 1987 was beset with difficulties. The situation was made more complex by the reality that devolution was attempted as a response to disaffection - coupled with civil strife - on the part of an ethno-linguistic community that was concentrated in the north and east of the country. In the balance of the country, it would be correct to assume that there was no strong, overt demand for devolution of governance responsibilities.[1]

The overwhelming role played by India in seeking to find a solution to the issues of ethnic dissatisfaction meant that the system of sharing of governance responsibilities that was introduced followed what was perceived as being the Indian model up to then. This resulted in the adoption of a central list of functions, a provincial list of subjects as well as a concurrent list of subjects. There was no serious attempt made to precisely define the responsibilities of each of the different levels of the polity in regard to each function. The outcome has been a serious level of confusion in regard to the management of the specific functions.

The experience of the past 18 years points to the manner in which the allocation of functions between the centre and the provinces has facilitated the perpetuation of centralization. A clear example of this is the inclusion, at the head of the Reserved List of Functions, of a function designated as "National Policy on All Subjects and Functions", which gives the centre exclusive powers for the formulation of policies and, thus, precludes the PCs from participation in this responsibility. This 'authority' has been consistently used by the centre to impose centralization in governance.

Given this state of confusion, the centre was able to impose its will in regard to the exercise of authority in regard to the different functions. The centre had the benefit of experience in the exercise of authority, it had the real control over the allocation of financial resources, it exercised effective control over the key segments of the bureaucracy, and it had the real control over the processes of the different political parties. It was able to ensure that what was intended, and publicly articulated, as a devolutionary system became, in the reality of implementation, an arrangement of a partial de-concentration of governance functions to the PCs.

Examples of this strategy are found in the categorization of a set of national schools, of national and teaching hospitals, the designation of national public health campaigns, the constitution of structures such as the Road Development Authority and the Urban Development Authority, and the launching of island-wide and uniform programmes in poverty reduction. The 'setting of national policy' has been constantly used to justify the progressive re-centralization of governance functions with the full backing of public sector trade unions which, in effect, have a strong supportive vested interest for re-centralization.

The setting out of the allocation of functions should have been based on a detailed investigation and a clear definition of the governance functions that really needed to be carried out by the centre - in the context of capacity that had been and could be developed

[1] The strong centrally directed colonial administrations had erased memories of whatever degree of shared governance that would have existed in the pre-colonial periods.

at the two sub-national levels. Such an objective investigation would have led to the centre being entrusted with responsibilities related to such core issues as the defence and the security of the country and the conduct of its external relations; the developing of cohesive macro economic and social policies; to matters related to inter-provincial law, order and security. Such comprehensive and detailed investigations failed to be carried out.

The allocation of functional responsibilities under the 13th Amendment also totally ignored the needs at the level of local government institutions (LGIs).[2] This was counterproductive in that such a comprehensive approach could have resulted in a more realis-

Box 11.1
Governance Capacity at the Local Level for Disaster Recovery

The six months since the tsunami of December 2004 has been characterized by high expectations on the part of those affected of speedy recovery from the disaster. However, it is evident that the expectations of those affected - in terms of re-housing, of restoration of livelihoods, of access to public services, etc. - have yet to be fulfilled. A major lesson emerges from this relatively disappointing experience in attempting to manage post-tsunami disaster recovery; it is the evident decline over recent decades of the effectiveness of governance capacity at the level of the local communities.

Disaster management involves four phases: (i) the continued planning for the prevention of disasters; (ii) rapid response to the disaster and its outcomes; (iii) mitigation of the immediate negative impacts of the disaster; and (iv) recovery involving the returning of the affected community to a state of normalcy. It has to be remembered that the key focus in disaster management is not only on economic concerns but also on the prevention of social disorganization. Hence, developing governance capacity for disaster management needs to focus on several steps.

The first such step is the carrying out of needs assessment. This has to be based on accurate information and data and not on intuition or guess work. The second step is that of the making of decisions as to the actions that should be taken. This is an activity that should not be taken unilaterally within bureaucracies and political institutions but with the maximum involvement of the stakeholders. The third step is the removal of the roadblocks that may hinder the implementation of the action steps that are decided upon with stakeholder involvement. This is to ensure optimal co-ordination of all stakeholders within the recovery pipeline. These would involve government agencies, NGOs, other voluntary groups and government institutions at entry points to the country as well as other service providers. Co-ordination as envisaged is not something that can be enforced but something that has to be created. Such co-ordination should lead to operational integration within the delivery pipeline that alone would lead to effective disaster management.

The successful achievement of the steps indicated above calls for appropriate governance structures and appropriate governance processes as well as appropriately trained personnel. It is evidently clear from the experience of the post-tsunami period that neither the structures and processes nor the appropriately trained personnel are available to the GOSL. Given the reality that the next disaster cannot be predicted nor that structures, processes and trained personnel cannot be created overnight, Sri Lanka has to accord the highest priority to evaluate its readiness for effective disaster management and to take the steps that are required to bridge the gaps on an urgent basis.

---

2. The Municipal Councils, the Urban Councils and the Pradeshiya Sabhas.

tic and cost-effective allocation of functional responsibilities.

It has been repeatedly pointed out that the emergence of the PCs as a tier of governance results in a duplication of public expenditure. However, there never has been a planned programme to contract the political and administrative structures at the centre based on an objective rationalization. There has been no control over the number and size of structures of political institutions - as, for example, the Cabinet or the Parliament - or of the multiple administrative institutions at the centre. The non-rationalization of the centre has burdened the country with irrelevant political and bureaucratic institutional structures, expenditure on unnecessary political and bureaucratic cadres as well as on institutions and processes that serve no logical purpose.[3]

11.4 Fiscal Devolution

What passes for a system of fiscal devolution in Sri Lanka is an ad hoc set of practices that has evolved over the post-1987 years. They have not been the outcome of a comprehensive and systematic study and analysis, and several negative features abound. There is an unequal relationship that has evolved in the fiscal equation between the centre and the provinces. This is heavily conditioned by the provinces being highly dependent on the centre for the expenditure resources required for the responsibilities handed over to them under the 13th Amendment.

There continues to be a lack of precision and clarity in regard to the assignment of revenue responsibilities to the PCs. The few revenue sources that have been assigned to them are neither high yielding nor elastic.[4] Even in situations where the centre provides the PCs with financial resources for specific sectoral activities, there has been a failure to establish a system of agreed 'unit costs' of service delivery[5] on which the allocation of the necessary resources could be based.[6]

Experience has shown that the institutional arrangement that was set up to oversee and to manage fiscal devolution - the Finance Commission - also suffers from several inadequacies. To begin with, its mandate is limited to being a recommendatory body rather than one whose decisions become mandatory. The PCs have no representation in its composition.[7] There is no mandatory binding of its decisions in regard to resource allocation, the process of decision-making or on the formulation of the annual national budgets. In its composition, the Finance Commission is highly dependent on the Executive at the centre.

11.5 Human Resources and their Management

An effective system of devolution must place the authority and responsibility for human resource management on the levels of governance that carry the responsibility for the delivery of public services and goods. This implies that the PCs[8] should, independently, recruit and manage the human resources that

---

3 It is interesting that the Sunset Principle, which was recommended by the Administrative Reforms Committee in 1987, has never been applied to these administrative institutions.

4 Considering the attitude of the government at the centre in regard to the allocation of revenue sources, it is difficult to escape the impression that there has been a preference to create and manage a situation of continued dependence of the PCs on the centre in regard to their financial needs.

5 The delivery of primary and secondary education and of health care services provides examples.

6 Such 'unit costs of service delivery' should, obviously, be based on differences of expenditure needs as amongst different spatial areas of the country.

7 Instead, there is provision for ethnicity to be the basis of the appointment of the three non-official members - a requirement that runs counter to logic, given the task responsibilities of the Finance Commission.

8 The local government institutions have not been devolved with any specific functions as a result of the 13th Amendment.

are required. This responsibility would include the determination of required cadres, their selection and recruitment, their deployment and oversight, as well as their career development. This has not happened in Sri Lanka. The key staff of the PCs continues to be provided by the All-Island Services that are controlled by the centre. This has meant that the PCs are, at best, temporary users of such staff that are provided to them on loan. They hardly have any say in the assignment of staff for their use. They have no influence on the career paths of such staff or in their capacity development to suit the needs of each PC.

Given that the capacity development of personnel in any specific organization must be geared to the goals and objectives of such an entity, it follows that the activities designed and implemented for the capacity enhancement of different cadre groups within each province must be designed for the needs of each province. It is also equally necessary that the personnel concerned must continue to serve the province so that the benefits of training accrue to enhance performance of the province. This does not occur given the use of the All-Island Combined Services to provide the personnel requirements of the provinces.

The net outcome is that the PCs have no real role in what is a critical element in management - the management of the human resources that are used in the discharge of their governance responsibilities. The PCs are dependent on the centre for the supply of the required human resources. This situation further weakens the PCs and exacerbates the negative impacts of the defects of fiscal devolution.

The Chief Executive Officers of the provincial administrations - the Chief Secretaries - are appointed by the President at the centre. Experience has indicated that the respective PCs have had no real influence on the selection of Chief Secretaries. Owing their selection and appointment and future career advancement to the government at the centre, they naturally tend to be guided by the perceptions of the centre in regard to critical issues such as the sharing of governance responsibilities, sharing and management of financial resources and the management of human resources. The reality that the appointments as Chief Secretaries occur in the mid career streams and that their subsequent career advancement lies at the centre has a pervasive influence in their commitment to the specific aspirations of the relevant province.

11.6 Accountability and Transparency

A pre-condition for ensuring the efficient and effective delivery of public goods and services and for good governance would be the existence of effective accountability of the PCs - inclusive of their members and their staff - to the citizens in their respective provinces. It requires that the activities of the PCs are subjected to the optimum level of transparency that would enable the citizens to monitor and to question the members and the staff of each PC on their performance. Such monitoring must, necessarily, cover effectiveness of delivery in terms of time, of costs and of quality. Also it pre-supposes that processes are available for the citizens to carry out such monitoring as well as for the enforcement of appropriate penalties where the monitoring reveals failures.[9]

Experience shows that such transparency does not exist. The operations of the PCs have continued to be conducted within facades of secrecy. This was the norm of governance in Sri Lanka at the time the PCs came in to being. The centralized government had inherited this as the culture of Sri Lankan gov-

[9] These would include the enforcement of recall in the case of elected members and disciplinary actions in the case of staff.

ernance from the colonial regime. As could be expected, this, in turn, became the culture of the PCs. It is no surprise, therefore, that there is no institutional mechanism and processes to enable citizens to periodically question the members of the PCs. The PCs do not publish periodic reports on their performance. Nor do they publish periodic expenditure statements. The citizens have no opportunity to question such data, even if they were published.

The existing electoral system adopted for the PCs - based on a system of proportional representation - does not enable the citizens to hold current office bearers to account for their performance. The weaknesses in the current system include the absence of individual accountability of the respective candidates, the absence of a direct relationship between the individual representative and the voters, the absence of a nexus between the PCs and related LGIs, and the fact that the party affiliations of the Sri Lankan electorate being based mainly on emotive factors than on the rational analysis of policy options.

11.7 Intra-provincial Institutional Structure

The political and administrative institutional structures within the province have also had an influence on the viability of the devolutionary polity. The very size of the PCs is one aspect that bears review. This review should be undertaken in the context of several related factors.

The first such factor is the nature of the tasks and functions that should realistically rest with the PCs. In this regard, a critical factor was the failure of the arrangements under the 13thAmendment to assign an appropriate task role to the LGIs. By the time the devolutionary polity was being planned, the citizens at the level of local communities had acquired credible levels of micro management capability. Unfortunately this factor was not taken into account in the assignment of responsibilities. The developments in communication technology and in transport are also related considerations that should have influenced these decisions. If such a step had been taken, the major responsibility as regards the micro management of the delivery of public goods and services could have been assigned to LGIs.

The failure to establish a clear functional, accountability or representational nexus between the PCs and LGIs was another negative aspect of the resultant institutional arrangements. As a consequence, the two sets of institutional structures have continued to proceed on parallel paths - with overlapping and duplication of expenditure and with resources being wasted on superfluous supervisory personnel. In this connection, it is relevant to consider the grant of independent constitutional status to LGIs.

Another outcome of the above situation is the preoccupation of the PCs with micro management of the delivery of public goods and services.[10] The resulting confusion as to responsibilities has also led to conflicts between PCs and LGIs. The PCs have also lacked a structure of Executive Committees.[11] The outcome has been a lack of focus of attention of different members of the PCs on specific policy areas, and an absence of their professional specialization on such areas. As a result, discussions at PC meetings have tended to be on generalities with a trend of evolving into mere debating forums.

[10] Such as the provision of school education, of primary and secondary health care, of public transport and communication, of water supply etc.

[11] Sri Lanka had an example of Executive Committees within the State Council – the Central Legislature of the country from 1931 to 1947 – from which valuable lessons could have been drawn.

Adding to the negative aspects of the functioning of the PCs is the failure to build transparency into their processes. The citizens of the relevant PCs do not have a clear insight into the decisions that are made, the reasons for such decisions, the outcome of the relevant decisions or any contributory reasons for the specific outcomes. Thus, they have no yardstick with which to evaluate the members or employees of the PCs. This absence of transparency has been a major contributory factor to their low performance.

11.8 The Road to the Future

Even given the disappointments experienced during the past decade and a half in regard to the poor levels of effectiveness of the devolved polity, it is still possible to reverse its negative features and to forge towards a more effective system of devolution. It is, however, realistic to recognise that two critical pre-conditions would need to be satisfied.

The first pre-condition is that there should be an unreserved commitment on the part of the lead role actors in the political system to the transformation of the Sri Lankan political system and its structures and processes to a devolved system. Analysing the experience of the past decade and a half, it is clear that there has not been such a commitment. Even where lip service has been paid to the idea of devolution, it has, more often than not, been accompanied by reservations and caveats. The prospects of loss of individual and group privileges as well as of difficulties in the unilateral imposition of group ideological agendas have tended to be a deterrent to the emergence of a positive consensus within the political system in favour of devolution.

Thus, the obstacles to be overcome in developing an adequate commitment to a devolutionary polity on the part of the wide range of political groups found in Sri Lanka are daunting. A first possible approach would be to promote and facilitate inter-political group discussions amongst all political groups aimed at providing an understanding of devolution. Such discussions would best suit their objective if they do not lead to inessential publicity. They would be more productive if they also had inputs from members of civil society organizations. At the same time, such organizations could further contribute to the process by providing - through the use of the print and electronic media - analytical information on the positive aspects of devolution.

The second pre-condition is that there should be an integrated approach in planning the road to the future. The different elements involved in such a plan would, necessarily, be inter-related - with each having an effect on the other. Hence, different issues such as the sharing of governance responsibilities, the formulation of an electoral system, the setting of political and administrative structures, developing a system of fiscal devolution and the adoption of practices of human resources management have to be addressed within a common framework.

11.8.1 Sharing of Governance Responsibilities

The foundation for a future reform process has, obviously, to be the redefinition of the allocation of responsibilities, functions and tasks of governance amongst the three levels of the polity - LGIs at the level of the local community; the provincial - or regional councils as a collective of LGIs; and the centre. This is an aspect that received inadequate attention on the part of the designers of the 13th Amendment. This in turn led to a situation where attempts were made to build a superstructure of a devolutionary polity without a well-defined and appropriate base, resulting in an unstable structure.

The redefinition of the allocation of responsibilities should not be based on historical antecedents of the colonial or post-colonial periods. It should, instead, be based on the contextual situation that has evolved and is likely to evolve in Sri Lanka in the short and medium term. In assessing the contextual situation due regard should be paid to aspects such as the growth of political and social awareness amongst citizens; enhancement of management capability at the local community levels; economic levels in the different areas of the country; and the expansion of communication and transport infrastructure.

The convenience that would accrue to the public in the delivery of public goods and services should be a guiding factor in assigning responsibilities to the different levels. The convenience that would result from direct involvement of citizens at the community level in planning and in monitoring such delivery are factors that should figure high in deciding on the reallocation. Equally relevant for consideration would be the contribution made through the reallocation in ensuring and strengthening of the enforcement of public accountability and of transparency.

Another important aspect is the contribution that would accrue in reducing costs of delivery of public goods and services through the removal of the current multiple levels of supervision and oversight through community-based management autonomy of such delivery. Such policies should also be designed to foster the recognition by citizens at the level of the community of their own responsibility for the costs, efficiency, effectiveness and quality of the delivery of public goods and services.

Such a re-examination of the allocation of responsibilities and functions would lead to LGIs assuming responsibility for the delivery of all public goods and services that are specific to their own spatial areas. Examples of such would be found in the delivery of primary and secondary education; of primary curative and preventive health care services; of local road infrastructure; and of local water supply and drainage systems. It would also extend to the regulation of public transport and, as appropriate, the management of such transport services.

The responsibility of LGIs would include the planning of all stages of development and delivery of such goods and services. It would include the autonomous management of financial and human resources. The assignment of this responsibility should be accompanied by providing for personal and group accountability on the part of the members of LGIs (accountability that is based on optimal transparency). It is inevitable that an efficient and effective delivery of public goods and services would necessitate the formation of institutional structures to manage the delivery of goods and services with a multi-community-area spread.[12] These institutions should function as autonomous entities with the relevant LGIs to whom they provide services having a stake on the Management Boards.

As a result of the enhancement of the governance responsibilities of LGIs, the sequential role of the PCs would be radically different from their current role. The new role envisaged for the PCs would be one of providing support to LGIs, of ensuring the overall co-ordination of the governance responsibilities that lie within the province and of providing the necessary interface between LGIs and the government at the centre. The PCs would, thus, lead the task of short and medium term development planning for the province as a whole - an activity that would be based on an integration of the local plans that are prepared by the LGIs and their co-

[12] Examples would include inter-local area roads, highways and water supply and drainage systems; tertiary education facilities other than the autonomous universities; and tertiary health care facilities other than university-managed teaching hospitals.

ordination. This would, necessarily, be a participatory exercise with all LGIs within the province. This would include the planning of financial resources and would particularly focus on the provision of expenditure support to each LGI as well as reaching agreements on the mobilization of financial resources - both from the centre as well as from within the province.

The provincial development and resource management plan that is agreed upon would require to be monitored in terms of its performance. This is a second task that would be the responsibility of the PC. There should be maximum transparency in regard to the outcomes of the monitoring - with such outcomes being subject to public discussion in the meetings of the PC. A major task for PCs would be the conduct of negotiations with the centre - through the Finance Commission - in regard to the sharing of financial resources. This entails that each PC equip itself with the required data and the competences required for the task.

The PCs should also be engaged in the conduct of negotiations with the centre concerning the formulation of macro policies. These negotiations should be an integral element in the analysis of policy options prior to their adoption as macro policies of the country. The objective is to ensure that the macro policies that are formulated for the country reflect the priority needs of different provinces and respond to them. Obviously, institutional structures and processes would require to be evolved to ensure that this becomes an operational reality.

As a result of the changes suggested above, the role of the centre would change radically. It would be restricted to a limited set of critical responsibilities and functions. Though they would be few in number as compared to those exercised by the central institutions of governance of the colonial and immediate post-colonial periods, there would be responsibilities and functions critical to the political, economic and social stability and progress of the country as a whole. One primary responsibility that should be exercised by the centre would be the conduct of external relations - comprising both political as well as economic relations.

A second responsibility would be the formulation of the macro economic and fiscal policies of the country and their management. The monitoring of the progress and impact of the management of the individual policies and strategies as well as of the package of such policies would be an integral element of this responsibility. A third responsibility that flows from the above would be the periodic formulation and re-formulation of strategies that guide the delivery of essential public goods and services. The objective of the centre in this regard would be to ensure that citizens enjoy equity of access. This would require special attention being paid to issues of eligibility of groups of citizens for free or subsidized access to goods and services. This responsibility would also entail the provision of policy guidance to PCs to ensure minimal social security for citizens of the respective provinces.

Disaster management and the provision of relief in the event of disasters would be another responsibility that would vest with the centre. This would also include disaster preparedness - including the anticipatory provision of minimal financial resources that would be required to cope with initial responses to disaster. Whilst the actual mounting of relief, rehabilitation and reconstruction responses to disasters would involve the participation of relevant PCs and LGIs, the overall policy and strategy formulation would inevitably rest with the centre. The defence and security of the country would obviously be a responsibility of the centre. The maintenance of law and order within each province would rest with the different provincial governments, while trans-provincial aspects of the maintenance of law and order would rest with the centre. In the area of administration of justice, the institutions and cadres that relate to the appellate judiciary would rest with the centre.

11.8.2 Setting of Political and Administrative Structures

The conclusions that have emerged from the discussion of the future sharing of governance responsibilities should guide the setting of political and administrative structures. The primary focus of these structures should be to ensure that the responsibilities at each level are effectively discharged. Hence, the political and administrative structures at each of the three levels must be purpose-designed so that they serve the functions and roles at each level.

At the centre, political as well as administrative structures that support them should be designed to be effective as instruments of macro policy management - both in terms of the analysis of policy options, oversight of the implementation and continuous monitoring of impact. In addition to the sector-based structures for this purpose, there would need to be structures that would monitor the inter-sectoral impact of such policies. It is essential that the responsibilities of the sector-based structures should not overlap - as multiplication of institutional structures with overlapping mandates can only lead to confusion and poor governance. Functions of co-ordination should be vested in positions that are placed at hierarchically super-ordinate positions in the political executive.

The task responsibilities at the centre have inevitable implications for the structure of the legislature at that level. The indications of the experience so far are that effective macro policy management would be better served by a legislature of a smaller size. It is preferable that it be bi-cameral - with the second chamber providing for direct participation of sub-national units of governance in the policy management process. The contribution of the legislature to macro policy management would be enhanced if its work were organized around Standing Committees that have membership from both chambers.

The task responsibilities of LGIs would focus on the micro management of the delivery of public goods and services - including the maintenance of law and order - that maximizes transparency and direct accountability to the citizens of the relevant community. Such LGIs should be based on a system of elections that enable citizens to directly elect their representatives to the Council. Such Councils should also organise themselves on the basis of Standing Committees that relate to the different economic and social sectors - with the Chairs of the Committees constituting themselves as an Executive Board led by the Head of the Council. The preceding discussions have underscored that the task responsibilities of the PCs should be the provision of support to LGIs through the supply of technical services and financial resources, as well as being the spokesperson on behalf of the LGIs with the centre.

11.8.3 A Relevant Electoral System

In seeking to enhance the effectiveness of the devolutionary system, a major issue that needs to be addressed is the appropriateness of the current electoral system used to constitute the PCs. It is desirable to design specific electoral systems for the institutions at each level - the Parliament, the PCs and LGIs. The post-1988 period has underlined the inter-institutional conflicts that can arise where institutions at different levels of the polity claim legitimacy from the same electoral base.

As discussed, the real role of these institutional structures at the meso level is to coordinate and support the activities of LGIs at the micro community level; to provide financial, technical and human resources support required by LGIs; and to monitor and evaluate the progress, the effectiveness and the efficiency of delivery of services. Given this role, it would be more effective if the PCs were constituted of representatives elected by LGIs within each province.

The PR-based electoral system - currently used in Sri Lanka for elections to all political institutions - has had an inhibiting influence on the evolution of PCs as autonomous institutions. In effect, the 'list system' of nominations has led to a situation where the 'first rung' of political cadres in each geographical area are nominated to the Parliament at the centre with the 'second rung' being foisted on the PCs. The outcome of this hierarchical approach is that the members of PCs are expected to be 'subservient' to their seniors at the centre - particularly to the members of the Cabinet at the centre. This unwritten culture has become the dominant mindset of the Sri Lankan polity.

11.8.4 Developing a System of Fiscal Devolution

There has been no serious attempt since the enactment of the 13th Amendment to work towards ensuring that the financial resources available to the three levels of governance match the requirements for the discharge of responsibilities expected at each level. Hence, if higher degrees of functional responsibilities are assigned to LGIs and PCs, there needs to be a radical change in the current approaches to the allocation of financial resources. Such a change should be based on a move away from passive dependency of the PCs and LGIs on handouts from the centre to a situation where the process is based on a pre-set and equitable sharing of total revenue resources of the country by the centre, the PCs and LGIs. Thus, there is an urgent need to comprehensively review the ongoing basis of revenue mobilization in the country. The current heavy emphasis on centrally levied customs and excise and on VAT as well as the assumptions on which the taxes on income are based needs re-appraisal.

The changes that are required include the assignment of a greater role of revenue mobilization to LGIs and PCs. This should be explored through a carefully planned reassignment of sources of revenue to them. Taxes that are based on enterprises - whether industrial, agricultural or commercial - would be one such source. Taxes based on consumption would be another such source. Direct charges for services that are provided - particularly by LGIs - should be collectible by such governance institutions. Land and maritime-based taxes provide further examples. It is essential also that the provider institutions of governance recover charges for the delivery of all public goods and services.

11.8.5 Policies and Practices of Human Resources Management

A major constituent of the reform process would relate to policies and practices that relate to human resources management in the public sector. Given the impact that it would have on privileges that are enjoyed by existing cadres, this is an area of reform that would be the hardest to implement. Nevertheless, this is an inevitable and essential set of reforms that are required if devolution of governance is to be effective in Sri Lanka.

The future changes should be based on a set of principles that would ensure the following:

- the positions at each level of governance are specifically identified in terms of the tasks that are involved in each such position;
- the qualifications for each such position is clearly spelt out; and

- the tenure of each such position is clearly pre-determined.

Such an approach would call for several radical changes in the existing public personnel systems. To begin with, the groups of posts that are designated as All-Island Services should be terminated. These are no longer relevant to the task demands at different levels of governance. Future recruitments should be to specific positions - based on medium-term, renewable contracts. In such a context, any jobholder who wishes to change his/her job should be free to do so through applying for vacancies that are announced.

In the transition, current personnel should be allowed to apply for new positions that would be created through reform and to be considered for such jobs. Where they fail to be selected, they should be offered Voluntary Retirement Schemes to seek their careers elsewhere. The future super-annuation schemes for all public sector employees at all levels should be contributory schemes. Where necessary, existing super-annuation schemes would need to be modified to fit into contributory systems.

11.9 Conclusion

It would be unrealistic not to recognise that there would be considerable impediments to the implementation of the road map that has been outlined above. A clear recognition of such impediments, the likely resistance and their sources is essential for the effective planning and implementation of the changes that constitute the road map.

One group from which such resistance should be expected would be the vested interests that exist in the current political cadres that have benefited from the existing centralized polity. A second equally important group would be the vested interests in the bureaucracy that have grown around the existing system. It is to be expected that such groups - in the political cadres and in the bureaucracy - would form coalitions of resistance. Hence, in the planning of reforms, steps should be taken to develop and to implement strategies to counter such resistance.

There would naturally be a measure of reluctance - in the society at large - to change systems, structures and processes of governance that have been historically inherited. Such apathy would arise from a low awareness of citizens of the issues involved and their ramifications. It is important to also recognize the emotive nature of the behaviour of citizenry. Hence, an essential ingredient of a future reform agenda is a well-planned and carefully implemented exercise in creating and sustaining public awareness on the reform agenda. There is, thus, an obvious need for a dedicated group comprising the top rungs of the polity, of the bureaucracy, of the civil society and of the private sector that could be concerned with the planning of the reform agenda, with the creation of public awareness, with the removal of the impediments - as they are anticipated and as they arise - and for the implementation of the changes and for the monitoring and impact assessment of such implementation.

Policy Briefs

12. Pro-poor Growth

12.1 Introduction

Rapid and sustained growth is a necessary condition for poverty alleviation efforts but economic growth alone is not always a sufficient condition. Other factors, such as initial conditions and institutions, by influencing distribution contribute to poverty reduction. Thus, pro-poor growth is a critical element in a poverty reduction strategy as it factors in the distributional dimension. This policy brief assesses what is meant by pro-poor growth, including the conceptual adequacy and practical issues of defining poverty for pro-poor growth; analyses the different approaches adopted to measure pro-poor growth; and discusses the required policies and institutions to achieve pro-poor growth.

12.2 What is Pro-poor Growth?

Pro-poor growth is primarily centred on the interrelation between the three elements of growth, poverty and inequality and has been subject to various definitions. These differences are in part a reflection of the multidimensional nature of poverty itself as well as the complex and interdependent relationships between growth, poverty and inequality. The available literature suggests broadly that a measure of pro-poor growth must take into account both reductions in poverty as well as improvement in inequality.

A number of approaches are available in defining and measuring the pro-poor growth. There are two terms of pro-poor growth, namely, relative and absolute pro-poor growth. Both require that the 'poor' be identified by specifying a poverty line, such as the international US$ 1 a day line or a national poverty line. Those below this income are considered to be the poor. The concept of relative pro-poor growth arises when economic growth benefits the poor proportionally more than the non-poor. This means that growth is pro-poor if the incomes of poor people grow faster than those of the population as a whole. On the other hand, pro-poor growth is said to be absolute if the poor receive the absolute benefits of growth equal to or more than that of the absolute benefits received by the non-poor. Under the relative definition, inequality must fall. The absolute definition, by contrast, looks only at the income growth of poor people, whether inequality changes or not.

There are currently debates on how exactly to define pro-poor growth. However, pro-poor growth has been broadly defined by a number of international organizations as growth that lead to significant reduction in poverty, thereby benefiting the poor and improving their access to opportunities (e.g., UN 2000; World Bank 2000; OECD 2001). But it is not clear how significant a reduction in poverty must be and how progress in achieving pro-poor growth is to be monitored. Critical to the definition of pro-poor growth is the joint consideration of growth and its distribution. The Asian Development Bank (ADB) defines growth to be pro-poor "when it is labour absorbing and accompanied by policies and programmes that mitigate inequalities and facilitate income and employment generation for the poor, particularly women and other traditionally excluded groups". Pro-poor growth is the type of growth that enables the poor to actively participate in economic activity and benefit proportionally more than the non-poor from overall income increase. Furthermore, pro-poor growth is primarily about the distribution of growth between, not within, lower and upper income groups. Pro-poor growth purely requires that the proportional income growth of the poor exceed the overall average income growth.

12.2.1 Definition of Poverty for Pro-poor Growth

Poverty is not just an inadequacy of income to meet basic needs or the inability to spend. The poverty dimensions are rather multifaceted. It is associated with lack of assets, income, landlessness, unemployment or underemployment, illiteracy, pattern of consumption, malnutrition, high infant mortality, large family size, low productivity, low position in the social hierarchy, less access to publicly provided goods and poor infrastructural facilities and extreme vulnerability to natural calamities, disease and social conflicts.

As shown in the triangular (Figure 12.1), the wider the definition of poverty, the richer and more meaningful it is, but the less practical it becomes to operationalize, and the more difficult it is to make quantitative comparisons.

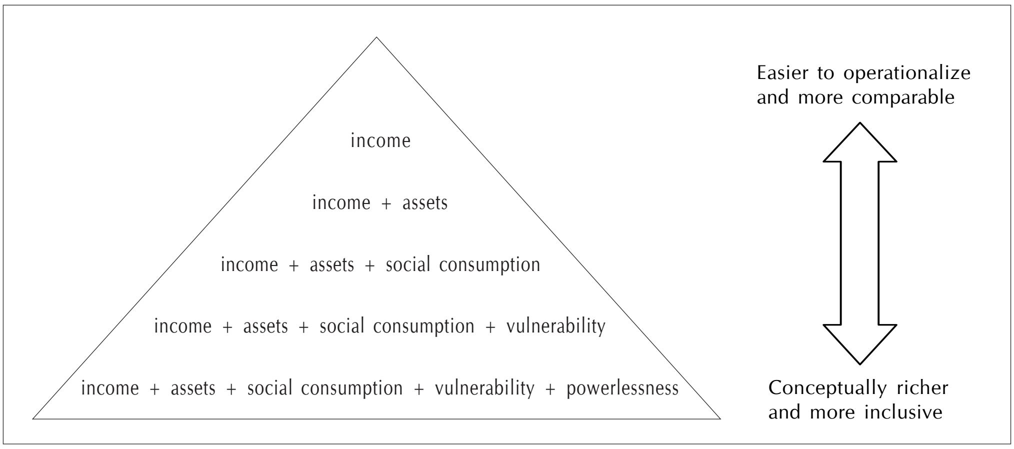
The pyramid of poverty concept provides an important insight into the trade-off between conceptual adequacy and practicality. The focus on pro-poor economic growth suggests that absolute income as the core indicator of poverty. Furthermore, it seems that income is a much more manageable concept to operationalize than the more complex multidimensional definitions of poverty. Income is also the central variable in absolute poverty, affecting most or all of the other factors that go into broader poverty definitions.

12.3 Measuring Pro-poor Growth

The most widely using measures focusing on the different approaches to measure pro-poor growth are shown in Figure 12.2. The aggregate measures analyze the distributional pattern of growth regardless of the definition of pro-poor growth. The pattern of pro-poor growth can be measured using absolute and relative definitions. These measures are directly related to the chosen definition.

However the calculation is done, it has two limitations. First, averaging the income growth rates of the poor conceals income 'turbulence' - some poor people's incomes may go down even if on average the incomes of

Figure 12.1
Pyramid of Poverty Concepts



Source: USAID (2004), "Pro-Poor Growth: A Guide to Policies and Programmes".

the poor are rising. This problem is common to all standard measures of poverty. Second, a comprehensive measure of pro-poor growth would also need to take into account the non-income dimensions of poverty, such as access to education, health, empowerment, malnutrition, child mortality, insecurity, voicelesness, low returns to assets, risk, vulnerability, etc. With any of those measures or definitions, the major consequence is that policies must lead to active policies in favour of the poor. Pro-poor growth is, therefore, is a clear departure from the 'trickle-down' approach that meant a gradual top-down flow from the rich to the poor. However, there are no consensuses on how to define or measure pro-poor growth.

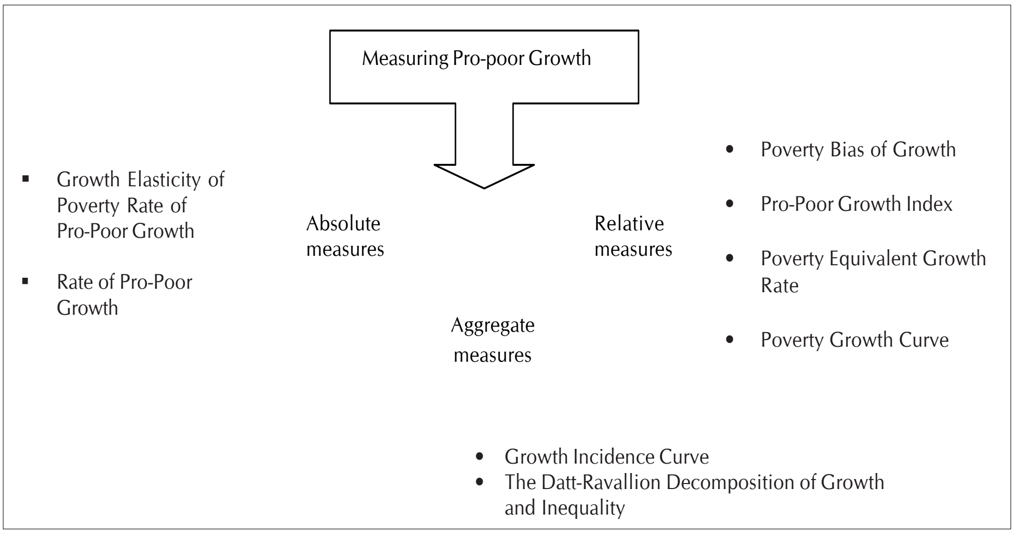
12.4 How Can Pro-poor Growth be Achieved?

The poverty reduction framework is based on three pillars, namely, pro-poor economic growth, social development, and good governance. These pillars should be embedded in the social, economic, and institutional fabric in the country. The heterogeneity impact of growth on poverty holds important clues as to what else needs to be done by governments to promote poverty reduction, on top of promoting economic growth. A combination of growth promoting economic reforms and right social-sector programmes and policies are important to enable the poor to participate fully in the opportunities unleashed by growth. There are several elements that can contribute towards this objective:

- Developing human and physical assets of the poor
- Helping to make markets work better for the poor, especially for credit, labour and land
- Removing biases against the poor in public spending, taxation, trade and regulation
- Promoting agriculture and rural development and investing in local public goods in poor areas
- Providing an effective safety net as a short term palliative or key instrument for long-term poverty reduction.

Growth can effectively reduce poverty when it generates employment and income opportunities for those at the bottom end of the income distribution. Policies that make effi-

Figure 12.2
Different Approaches to Measure Pro-poor Growth



cient use of labour - the principal asset of the poor - are therefore, particularly powerful pro-poor measures. Sound macroeconomic management that emphasizes fiscal prudence and good tax administration leads to sustainable public debt. It facilitates physical and social investment - in education and health - that benefits the poor, besides ensuring long term growth. Both urban and rural poor groups tend to have limited access to pubic infrastructure and services, but the constraints on physical access to job and product markets are bigger concerns for the rural poor. Investment in infrastructure in

Box 12.1
Economic Growth and Poverty in Sri Lanka

Sri Lanka's economy has indicated an improved outcome in terms of GDP growth in the two decades of reforms, sustaining an average per capita GDP growth of over 3 per cent per year. However, poverty reduction over the period has seen only a modest decline while there is evidence more recently to suggest a rise in income inequality and sharply unequal poverty trends across sectors and regions. In fact, perceptions of inequity in access to the benefits of market driven policies is argued to have been a contributory factor in heightening social and political tensions in the country in the latter part of the 1980s that prompted the adoption of targeted poverty alleviation programmes from the 1990s.

Sri Lanka suffers from a lack of comparative statistics to assess change in poverty status accurately over time. Nevertheless, there is evidence to suggest that the incidence of poverty reduced by about 2 percentage points over the period 1985 to 1995. However, population growth meant that the absolute number of poor did not decrease over time. More recent data indicate that the national poverty headcount ratio showed a modest decline from 26.1 per cent in 1990-91 to 22.7 per cent in 2002. However, there are significant inequities in poverty reduction across sectors and provinces of the country. During the decade 1990-91 to 2002, the poverty gap between the urban sector and the rest of the country widened, while there was also a significant increase in poverty in the estate sector.[1]

Sri Lanka is also characterized by significant regional differences in poverty with the Western Province which accounts for nearly 50 per cent of GDP in the economy registering by far the lowest rates of poverty. There is evidence to suggest that over the past decade, Sri Lanka has witnessed an increasing tendency towards wider regional disparity in the incidence of poverty. Although numerous qualitative studies have been undertaken in the conflict-affected areas, there is no official estimate of the extent of poverty in the North and Eastern Provinces as they have been excluded from national consumptions surveys in the past two decades.

Increasing inequality over the decade is also reflected by the Gini coefficients. For the country as a whole, the Gini co-efficient is estimated to have increased from 0.34 to 0.44, while for the urban sector it increased from 0.37 to 0.44 and for the rural sector from 0.30 to 0.39 during the period 1990-91 and 2002. Analysis of the links between poverty reduction, growth and inequality suggest that had inequality not increased during the decade, Sri Lanka would have experienced a significantly greater reduction in poverty.

[1] A decrease in income earners per estate household during the period is likely to explain part of the increase in poverty in this sector.

rural areas can therefore have a significant impact on the poor. The particular needs of vulnerable groups such as the elderly, women, children, ethnic minorities, etc. - including those in conflict affected areas or those displaced by natural disasters - have to be taken account of to ensure they have the same access to social programmes as the rest of the population. Finally, sound governance is an important element given that it affects the ability to target programmes designed specifically to help the poor as they are especially vulnerable to corrupt officials.

12.5 Conclusion

While there appears to be no clear consensus on how to define or measure pro-poor growth, pro-poor growth is implicitly understood to require that the proportional income growth of the poor exceed the overall average income growth. It can be measured, but with several limitations. There is, however, a broader consensus on the types of policies that may be required to be in place to achieve pro-poor growth mainly, sound macroeconomic management, efficient use of labour, appropriate investments in health, education and infrastructure; political and social security, sound institutions, etc. Continuous monitoring of progress and evaluation of specific pro-poor growth policies and programmes will form a crucial input for effective domestic and international efforts against poverty.

13. Decent Work: A National Action Plan for Sri Lanka

13.1 Introduction

The decent work agenda was adopted in 1999 by the International Labour Organization (ILO) tripartite constituents (governments, employers and trade unions) to address the decent work deficit. Decent work involves "opportunities for work that is productive and delivers a fair income, security in the workplace and social protection for families, better prospects for personal development and social integration, freedom for people to express their concerns, organize and participate in the decisions that affect their lives and equality of opportunity and treatment for all women and men".

It is important to understand what is meant by decent work. The ILO defines decent work as that "based on the realities, values and goals of a given society. But it is a dynamic concept, the content of which evolves with social and economic progress of a given country". This definition looks at decent work in terms of work and employment which encompasses universal rights and values and goals of a given society. The ILO is focused towards providing decent and productive work for both men and women under conditions of freedom, equity, security and human dignity. Rights at work extend to all workers, including the self-employed, casual and informal and hidden workers such as women.

13.2 How to Achieve Decent Work

While focusing on promoting decent work along the continuum of the informal to formal economy, the ILO agenda (in dealing with decent work) places much emphasis on gender equality and development issues. In order to achieve the goal of promoting decent work, the ILO considers four strategic objectives, namely; achieving fundamental principles and rights at work; creation of greater employment and income opportunities for women and men; extending social protection; and promoting social dialogue.

At the Thirteenth Asian Regional Meeting of August 2001, it was concluded that member states in the region should define a National Plan of Action for Decent Work through a tripartite process. This process was to aim at integrating fundamental rights at work, more decent work opportunities for men and women, social protection and increased social dialogue. These issues are discussed below.

13.2.1 Achieving Fundamental Principles and Rights at Work

In 1998, the International Labour Conference adopted the Declaration on Fundamental Principles and Rights at Work and its follow up. This declaration is a pledge to respect, promote and realize the freedom to associate and the right to collective bargaining, the prohibition of forced or compulsory labour, abolition of child labour and elimination of discrimination in employment and occupation.

The ILO also plays a role in promoting the Declaration. Promotion of this nature is directed towards raising awareness regarding the Declaration at different levels such as national, regional and international; to provide understanding of its impact on development in various aspects; and to promote the necessary policies which will implement such principles. Media and educational campaigns, research, policy advice, social reviews are among some of the methods to be utilized in achieving awareness. In addition to promoting the Declaration, the ILO will have a role with regard to follow up action on the Declaration.

The ILO believes in rights for everyone at work and has been committed to providing equality[1] of opportunity and treatment between men and women at work. In addition to existing instruments relating to gender equality, the International Labour Conference has adopted three more instruments relevant to women and children:

- The Home Work Convention (No. 177) and Recommendation (No. 184) in 1996;
- The Declaration on Fundamental Principles and Rights at Work in 1998;
- The Worst Forms of Child Labour Convention adopted in June 1999 and which calls for account to be taken of the special situation of girls.

13.2.2 Promoting Employment and Income Opportunities

The ILO has a goal to achieve full, productive and freely chosen employment. The focus here is on the provision of sufficient numbers of jobs for men and women that are of decent quality. Quality of employment depends on a variety of factors including, but not limited to wage, regularity of employment, intensity of work, occupational risk, social status attached to job are among some such factors.

It is also important to help women in the labour market by reducing occupational segregation by sex. This can be achieved through provision of policies for childcare and other services, affirmative action and equal opportunity programmes and increased training and education for women in non traditional subjects.

Another problem faced by women that should be addressed is lack of training opportunities once in employment. This is due to women being considered a risk in terms of investment, more women being in informal sector employment where prospects of training are poor and many other reasons. This could be dealt with by setting quotas for girls in different types of training programmes, making way for persons with family responsibilities to enter the labour market, provision of support services for women to help secure and keep employment and many other such options.

While gender related issues are important in promoting income and employment opportunities, it is also necessary to focus upon income generation in low-income groups. Some ILO policies in this regard include raising the production capabilities in small urban and rural enterprises and methods to increase labour absorption in the rural economy. It is also possible to generate employment through development of infrastructure. This generates employment and utilizes the services of small units comprised of poor workers. Such schemes would be beneficial in terms of employment as well as improved infrastructure facilities for the poor. The government can contribute to employment generation through investment in social services. Such actions would have long term implications for a healthy and educated society, thus making way for increased productivity in the economy.

13.2.3 Extending Social Protection

Social protection encompasses the prevention of work related accidents and other such

[1] Equal Remuneration Convention (No. 100), adopted in 1951, Maternity Protection Convention (revised), 1952 (No.103), Discrimination in Employment and Occupation Convention (No.111), adopted in 1958, Workers with Family Responsibilities Convention (No.156), adopted in 1981 and Part-time Convention (No.175), adopted in 1994.

occupational hindrances. Basic security and protection is very important to ensure decent work but in some countries many workers lack access to minimum levels of social and income security. The ILO plays a role in providing advice and training to relevant authorities in order to ensure long term economic and financially viable social protection networks.

With regards to possible measures that can be taken relating to women in order to attain equality of treatment include health care for pregnant women and mothers, maternity leave, childcare systems and more. Women are more prone to health affects due to their dual reproductive and economic roles. A large number of women world wide are infected with HIV and AIDS. Persons infected with the virus are discriminated against when seeking employment and it is, therefore, important to provide protection and prevent spread of the virus. In situations where there is a lack of a formal system of social security, it might be best to delegate the responsibility to local communities. This would help include the participation of women, the disabled and other such groups which are likely to be left out.

13.2.4 Promoting Social Dialogue

Social dialogue is to provide reconciliation among groups and persons with differing interests in the work place. It is possible to promote decent work for men and women and remove gender based inequities through social dialogue. It is important to have women participate at these dialogues and make their voices heard.

The role of the ILO should also be to advocate social dialogue and thereby help employers and workers understand the value of positive labour-relations, strengthen social partners, provide links with civil society and also highlight the successful use of social dialogue in traditional and new purposes.

13.3 Action Plan for Sri Lanka and its Relevance

The Decent Work Country Programme is a framework in which the government, employers and workers organizations agree to work together towards achieving decent work in Sri Lanka. A broader National Plan of Action for Decent Work is being developed under the Ministry of Labour Relations and Foreign Employment.[2]

Under this programme the main challenges and priority areas of action for Sri Lanka have been identified and discussed. Some of the main challenges in addressing the issue of rights at work include the lack of complete accessibility to core ILO Conventions relating to Freedom of Association and Collective Bargaining, the prevalence of child labour and also the glass ceiling in existence for women. Priority areas of action in dealing with these issues involve conducting studies and supporting the Labour Department in order to enforce freedom of association and collective bargaining rights, supporting employers and workers in having good work place practices, making way for diversity and equal employment principles, improving compliance with international buyers, promoting the ILO "Tripartite Declaration of Principles Concerning Multinational Enterprises & Social Policy" and also providing support to the International Programme on the Elimination of Child Labour (IPEC) to eliminate such abuses.

The main challenges to overcome constraints in employment generation in Sri Lanka include low productivity, challenges of competition faced by the export sector, the exist-

[2] As in "Decent Work Country Programme Sri Lanka 2004-2008" (ILO).

ence of weak labour market institutions, high unemployment, little access to formal sector employment for certain groups, loss of employment as a result of labour reforms, privatization and factory closure and also the social and economic problems faced by the conflict affected north and east of the country. The necessary priority areas of action include reducing youth unemployment through an efficient youth employment network, generation of employment opportunities in the north and east, better quality and more effective training, institutions and programmes, quality job creation in small and medium enterprises, programmes to help vulnerable groups integrate in to the labour market, strategies to deal with job losses (especially in the garments sector), improvement of work condition in the plantation sector and the creation of diversified employment opportunities within the sector.

Challenges under the 'social protection for all' objective includes risk of social exclusion, constraints of existing social security schemes, lack of old age security for a large part of the population, lack of proper working conditions and wages for workers and lack of access to protection for migrant workers. These challenges are to be met by an unemployment insurance scheme for workers affected by labour reforms, provision of support for excluded groups, provision of occupational safety and health programmes and protection for sub contracting work arrangements and migrant workers.

Finally, the need for social dialogue faces problems relating to the inability of the tripartite partners to participate in broader policy making, practices at the workplace (confrontational) and low participation rates of women in tripartite institutions. In dealing with these issues, it is important that the Ministry of Labour Relations and Foreign Employment play a key role with regard to social and economic planning, support the tripartite consultative mechanism to foster labour and social policy issues, promote strengthened trade union action, increased participation of gender in tripartite institutions and increased representation of employers and workers organizations.

Having mentioned the priority areas of action above, it is also important to state that the monitoring of progress of the activities will be carried out by means of quarterly and annual review meetings and other such review mechanisms.

14. Output-based Aid: A Useful Approach in the Development Toolkit

14.1 Introduction

Enhancing the access of the poor to basic infrastructure and social services is a key goal of poverty alleviation and 'pro-poor' growth strategies. It is recognized that universal access to basic health, education, water and sanitation, electricity, transportation, communication and other similar services underpin economic development. Due to many of these services sharing the characteristics of public or merit goods, the market mechanism cannot be relied on for the optimal level of their provision. In others, the market may not be willing to provide the services on terms which are affordable to the poor. In both these cases it has fallen to government or donor-funded subsidies to bridge the gap in order to realize the development-oriented outcome. Yet, despite the government and donor funds that have been spent so far, in many developing countries many of the poor still lack access to such services, or cannot afford the terms on which access is offered.

This result is in part due to several weaknesses inherent in the traditional approaches to funding these services. Namely, subsidy funding has traditionally been directed towards *inputs* - for example, building a hospital or school, or providing training for doctors or schoolbooks to schoolchildren - as opposed to focusing more directly on the desired *outcomes* - such as improved health or education. The resultant attainment of the desired outcomes has been less efficient and effective than could be hoped for. Other shortcomings arise from service delivery having traditionally been channelled through monopoly operators. The absence of any kind of competition has marked a lack of innovation, efficiency and effectiveness in the utilization of aid resources to deliver services. These several shortcomings are heightened in the context of ever mounting demands on limited government resources.

14.2 Output-based Aid (OBA)

'Output-based Aid (OBA) is an approach that seeks to address these shortcomings. By shifting the focus from inputs to outputs and creating incentives for innovation and efficiency and for mobilising private financing, it aims to better target the delivery of basic infrastructure and social services to the poor. It involves service delivery through third-party providers under contracts that link the payment of subsidies to the outputs or results actually delivered to target beneficiaries. Examples of such outputs include, number of new rural households connected to electricity, quantity of water provided to poor families and number of students attending a school.

It may be questioned whether OBA - characterized by its focus on outputs - does indeed represent anything very 'new'. Sound development practice had anyway been converging towards results or outcomes-based approaches. An example would be performance contracting in the public sector, whereby some traditional public services have been contracted out under terms that tie compensation to performance criteria. The innovation that OBA represents perhaps is a strategic approach to the targeting of subsidy payments to achieve output goals, and a sharper focus on leveraging private sector finance.

For example, a development goal may be to increase rural electrification. Under the traditional approach aid may have been targeted at constructing a new hydro-power generation station, extending the transmission grid or building distribution lines. Under an OBA scheme, a contract may be awarded under which the service provider is paid a subsidy for each rural household supplied with electricity. By shifting the focus from inputs, it is left to the service provider's discretion as to how to meet the output target. This provides the incentive for the introduction of efficient and innovative delivery mechanisms, such as off-grid renewable energy. The contract may also be structured so that the service provider will be able to mobilize private finance for the project, thereby easing the burden on government or donor resources.

14.3 Lessons from OBA Practice

Already, several OBA projects have been piloted and implemented in a number of developing and transitional economies with assistance from the World Bank. They encompass expanding rural telephony in Nepal and Peru, extending rural electrification in Argentina, Cape Verde, Chile, Mozambique and Panama, making water affordable in Chile, rehabilitating and maintaining roads in Argentina, and improving primary and preventive health care in Bangladesh, Haiti and Romania. OBA has also been used in developed countries like New Zealand and the UK in the public transport and education sectors.

The lessons from these schemes indicate that when well thought through and implemented, OBA has succeeded in delivering better-targeted and more cost effective services to the intended beneficiaries. On the other hand, the numerous cases where such schemes have failed to live up to their promise highlights the critical importance of the design of the particular contract and the monitoring framework. These two aspects are the key determinants of the costs of the scheme, the incentives and risks faced by the service providers and the prospects of mobilizing private financing to leverage subsidy payments. Some of the key issues that scheme designers have to address are briefly discussed in the following paragraphs.

To begin with, it is necessary to decide the target beneficiaries of the scheme and the parameters of the service to be provided to them. Consulting with the target beneficiaries at this early stage to identify their expectations for the service helps to ensure that the project will generate sufficient demand to make it financially viable. The scheme will then need to specify the form and amount of the subsidy payment and its structure - specifically, how the subsidy is going to be linked to performance. The latter will be influenced by the expectation of private finance being available to the service provider. Where the service provider is expected to undertake significant investment and/or the capital markets are not sufficiently developed, the scheme will often need to provide for some form of up-front payment. A key factor influencing each of the design decisions is the amount and duration during which the scheme is funded by the government or donor agency.

Contract designers will need to carefully specify the performance criteria for the contract and devise measures of performance. In so doing they have to be mindful of the need to provide appropriate incentives for efficiency and innovation, as well the need to ensure sustainability of the service (relevant to the delivery of infrastructure services). The market structure within which the service is to be provided will also need to be decided upon - whether the contract awards an exclusive right to provide the service, or whether competition is allowed for. In the case of an exclusive right, competition between service suppliers for the time-bound concession will provide a form of competitive discipline. Finally, the administrative arrangements for managing funds, monitoring and verifying performance and making disbursements will have to be set out.

14.4 OBA for Sri Lanka?

The foregoing discussion leads to the question whether OBA can also be utilized in Sri Lanka to improve the delivery of infrastructure and social services to the poor. In this respect, a few cautionary points should be made:

- Output-based approaches would not be suitable in every case of infrastructure or social service delivery. An OBA scheme can also involve substantial costs, both in designing the scheme and in subsequent ongoing monitoring of performance, which in some cases may warrant reverting to inputs as the focus of subsidy.
- OBA projects should be justifiable under the same project appraisal processes as any other infrastructure project. Grafting an 'output-based' payment structure cannot in itself be expected to make a project become otherwise sustainable or return value for money.
- OBA requires policymakers to shift their focus away from managing inputs to managing outputs and outcomes, relinquishing the former in favour of a third party service provider. This requires a cultural change in the way that policymakers perceive their role. Otherwise, OBA risks becoming a sterile 'given' that is only paid lip service by policymakers.
- The terms of the contract are a critical determinant of the success or failure of a given scheme. This may necessitate looking abroad to find the requisite expertise, which has implications for the design cost of the scheme.
- The key ongoing role vested in the entity responsible for monitoring performance against outputs would require that funds are expended on building the requisite capacity to fulfil this role. This is particularly important in a context where institutional capacities are low. In the absence of a suitable local agency able to undertake this capacity building task, the training may have to come from abroad.
- A feature of several successful OBA schemes has been the process of consultation with affected local communities in the contract design process, and their involvement in subsequent monitoring of service performance. In effect, this represents a more participatory approach to governance. Policymakers may be little accustomed to such approaches, and again the requisite cultural change could pose a stumbling block to effective implementation.

Bearing these factors in mind, Sri Lankan policymakers could identify a suitable area and initiate a pilot project based on OBA. The country could indeed do well to join the number of other countries that have harnessed the benefits of this approach.

Box 14.1
Extension of Telecommunication Services in Rural Areas Utilizing OBA

One area where the market mechanism is likely to fail is, in extending rural coverage of telecommunication services. This is due to the associated higher costs and low revenues making the extension of service commercially unviable. This has led to the creation of 'universal service funds', funded by levies on telecoms operators to finance the expansion of rural networks. In Sri Lanka, the Telecommunications Regulatory Commission (TRC) has established a Telecommunications Development Fund with such a purpose in mind. This fund is made up of a levy on the public switched telephone networks operators on their income on each international call minute terminated on their networks. It is proposed to utilize this to encourage rural network expansion by offering each operator a refund of two-thirds of the levy paid by it, against investments made in that area. While this has not been made operational yet, the TRC under a separate arrangement already pays a fixed amount of Rs. 75,000 per each payphone installed in (defined) rural areas.

It is submitted that a properly tailored OBA scheme would be more effective, and provide better value for money, in furthering the expansion of rural telecommunications. For instance, with the refund proposal, there would seem to be no incentive for the operator to reduce costs (i.e., become more efficient) beyond the value of the refund. And, with either of the approaches discussed above, there would also conceivably continue to be rural areas where the refund/subsidy would be insufficient to make investment viable, leaving these areas to continue to go unserved. As a result, under both approaches, the refund/subsidy (as the case may be) would either be too much, or not enough.

It is possible to devise an OBA scheme whereby bids are called for the least amount of subsidy required to provide a particular level of service within a specified geographical area(s). As an example, this could be the provision of one public pay phone with domestic and international facility in each Grama Niladhari division in the specified area(s). While the necessary technical standards of quality and availability of service would be also outlined, the choice of technology would as far as possible be left to the service provider. This approach should keep with the hallmarks of OBA discussed already in order to lead to a more efficient and effective result in the pursuit of extending telecommunication services to the rural areas.

15. Sethusamudram Shipping Canal Project: Environmental Hazard?

15.1 Introduction

The Sethusamudram Shipping Canal Project (SSCP) was originally the brain child of British Naval Commander A.D. Taylor in 1860. However, it had been put on hold over several decades as each assessment revealed a higher cost factor. In 1999, however, the SSCP was boosted by an announcement by the then Indian Defence Minister that the government would complete the project within 3 years. The Sethusamudram Canal Project was launched in July 2005 by the Prime Minister of India. While the Indian government has continually stressed that the project is not harmful to Sri Lanka and that its concerns will be addressed, the SSCP on the whole has not been viewed favourably in Sri Lanka.

The motivation for building the canal is the fact that the Palk Bay between northern Sri Lanka and southern India is un-navigable by ships due to its shallowness created in particular by the Adam's Bridge. Therefore, any ship travelling from the east to the west coast of India needs to circumnavigate Sri Lanka. By dredging a canal across the Palk Bay it would be possible for small to medium size ships to avoid this circuit and simply cut across the Palk Bay thereby saving 25 hours per voyage (300 nautical miles at an average speed of 12 knots) and Indian Rs. 5.36 lakhs according to estimates of the Tuticorin Port. It should, however, be noted that the 25 hour time saving may be exaggerated as there will be delays in the crossing process and speed limits will be imposed. Furthermore, the south Indian ports led by Tuticorin are more than likely to capture a greater share of the growing transshipment market in the Indian subcontinent.

It is also likely that economic benefit is not the only incentive driving the SSCP. The canal would also allow Indian naval ships to have better access to the waters between India and Sri Lanka, thus providing a geopolitical incentive for the canal.

The total length of the canal in Palk Bay is 152.2km. This breaks up into 3 legs, the Adam's Bridge leg of 20km, the central leg of 78km and the Palk Strait leg of 54.2km. Of these, the central leg already has the required depth of over 12 m; however, the other two legs require dredging. Dredging a 12m deep canal in the Palk Strait and Adam's Bridge legs would allow ships of draught 9.15m and 10.7m to completely pass through Palk Bay. The width of the canal is estimated at 300m.

The National Environmental Engineering Research Institute (NEERI) of Nagpur, India has submitted an Environmental Impact Assessment Report and a Techno-Economic Feasibility report to the Indian government. In September 2004, the government of Sri Lanka set up an Inter-Ministerial Committee comprising of the Foreign Ministry, Environmental and Natural Resources Ministry, Ports and Aviation Ministry, Fisheries and Aquatic Resources Ministry, Defence Ministry and the Science and Technology Ministry, chaired by the Foreign Secretary. This committee has studied the potential impacts of the SSCP on Sri Lanka and has had a meeting with the Indian government. The Indian authorities have agreed to consider an amended Environmental Impact Assessment based on the concerns raised by Sri Lanka. Prior to this in late 2004, the President of Sri Lanka met the Prime Minister of India in New Delhi and discussed, among other things, the SSCP. The Prime Minister assured the visiting President that "any issue that may have adverse effects for Sri Lanka will be resolved in Sri Lanka's favour."

This policy brief provides some insights into the impacts of the SSCP on Sri Lanka. It concludes that the canal brings about a large international negative externality, with Sri Lanka at the receiving end. If these external costs are taken into account, the overall cost of the project may not be worth the benefits that are anticipated. Sri Lanka should, therefore, ensure that India takes account of such external costs in proceeding with the project. This policy brief will assess some key issues, focusing primarily on the environmental impacts of the SSCP project.

15.2 Implications for Shipping

The Colombo port is a major hub port strategically located in both a global and regional context. As the Palk Bay is currently not navigable (by most modern ships), the transport of goods from the eastern ports (Calcutta, Chittagong, Chennai) of the Indian subcontinent to the western ports (Karachi, Mumbai, Cochin) and vice versa goes via Colombo in the form of a network of feeder lines. Such feeder cargo makes up approximately 70 per cent of Sri Lanka's transshipment volume.[1]

With the Sethusamudram canal being created, ships can travel from east to west directly, saving time and fuel costs. The port of Tuticorin in southern India is likely to attract more new shipping since it is closest to the proposed canal. However, it will face competition from Chennai and Cochin in particular. The SSCP lacks the depth to accommodate the larger vessels that make up the bulk of main line (as opposed to feeder) vessels. The maximum depth that could be dredged across the Palk Bay is estimated at 12m and this is far too shallow for large mainline vessels to pass through. Furthermore, the trend in modern shipping has been towards larger ships with greater carrying capacity, requiring fewer stops. Dredging the canal to accommodate larger ships of draught greater than 10.7m, such as 12.8m draught ships, would call for a 14m deep and 500m wide canal and the dredging and environmental costs of this would not be worth the benefit. The present proposal is for a 12m deep, 300m wide channel to be created which could accommodate ships of 9.15 and 10.7 draught requirements.

It could, therefore, be assumed that in the long run the SSCP will cater almost entirely to sub-continental feeder cargo. It is essential that Colombo tries to shift her comparative advantage from feeder transport to main line shipping. Sri Lanka is strategically located in between the eastern and western worlds. However, the Colombo port is too shallow (14m) to accommodate some of the larger mainline vessels and certainly will not be able to accommodate the new generation of super carriers (Malaccamax carriers). As a result, Southeast Asian ports such as those of Malaysia and Singapore attract the bulk of mainline vessels.

This makes it all the more imperative that the work on the Colombo South Harbour gets moving soon. The new harbour will have an initial depth of 17m but will eventually be of depth 23m. The project is partially funded by the ADB (US$ 100 mn.) and

[1] Transshipment is the shipment of goods to an intermediate destination, and then from there to yet another destination.

initial pre-construction work is complete including a business plan, detailed studies, tender document and a regulatory framework. The balance US$300 million is expected to be raised from donors. However, work is expected to be completed only by the year 2020 at the earliest. In the meantime, the Colombo Ports Authority has stepped up investment in the existing port including extending the JCT (Jaya Container Terminal) quay wall by 100m, deepening JCT 1 and 2 and basin to 15 metres, new super-post Panamax quay cranes for JCT, widening the South Entrance and fast tracking the procurement of a new IT system to enhance productivity. As a result, it has been rewarded with increasing transshipment handlings in the last couple of years, including a record 2 million TEUs in 2004.

The shipping trade in Asia is growing in importance. The booming economies of China and India have generated massive amounts of goods transport across the region. The Malaysian Maritime Institute has predicted that by 2011 Asia is expected to handle 206.7 million TEUs, including 64 million in transshipment requiring 430 new container berths. The Colombo port needs to exploit its natural location (Colombo is closer to the international shipping routes than the Indian ports) and supplement this with speedy improvements to the port including the Colombo South Harbour[2] and thereby capture a portion of this expanding transshipment market. It could then negate any diversions in sub-continental feeder cargo due to the SSCP.

15.3 Environmental Impacts

The existing ocean currents travel from the Bay of Bengal to the Arabian Sea and vice versa depending on the prevailing monsoonal winds. These currents do not cross the Palk Bay since Adam's Bridge acts as a breakwater. However, if dredging occurs across Adam's Bridge it could allow part of the Arabian Ocean-Bay of Bengal current to gush through the Palk Bay. The current could potentially erode Adam's Bridge enabling even more water to pass through and thus result in a cycle. The change in currents will affect temperature, salinity and nutrient levels in Sri Lankan waters.

Ocean temperatures could fall as the colder east and west Indian coastal currents enter the Palk Bay due to the SSCP. This drop in temperature could affect cloud formation and sea breeze. Clouds that form due to oceanic convection require an ocean temperature of around 27 degrees celsius. If the change in currents pushes the temperature below this threshold it will adversely affect cloud formation and thereby affect rain and drought patterns in Sri Lanka. At present, oceans in the region have a temperature close to the 27 degrees celsius mark. Scientific understanding of the relationships between cloud formation, rainfall and sea temperatures is incomplete and poses risks of unforeseen impacts.

The possible environmental effects of the SSCP will have significant economic implications for Sri Lanka. Effects of shifting currents include a possible rise in sea level as currents pass through Adam's Bridge causing sea erosion in the Jaffna peninsula and may even cause part of the peninsula to go underwater. The change in salinity, nutrients and ocean temperature will affect marine life and ecosystems. Similarly, the change in currents will bring with it new deep ocean marine life that will alter food chains. Commercial fish populations and their food sources maybe adversely affected by these changes. Thus, a key impact will

[2] The Asian Development Bank (ADB) hired Australia-based Maunsell McIntyre consultants carried out a feasibility study for the Colombo South Harbour and concluded that the project would be economically viable despite the high initial costs considering ever increasing traffic.

be on fishing in the Jaffna peninsula. There is a possibility of marine life being adversely affected by changing water temperatures, introduction of alien species which would alter the food cycle, pollution, etc. There is a strong chance that this would alter the fish stocks in the Palk Bay. Furthermore, there will be heightened activity in oceans during the SSCP building process which is likely to disrupt traditional fishing. As an estimated 40 per cent of the Northern Province labour force is involved in agriculture and fisheries, this would have a major impact on the population of this conflict affected poverty stricken region.

Another problem is due to the possibility of changing tidal patterns - as more water flows through the Palk Bay as it is exposed to the Arabian Sea and Bay of Bengal currents - which could cause damage to the coastal structures such as jetties that are required for fishing. The changes in ocean patterns in the Palk Bay will also affect constructions in coastal areas of northern Sri Lanka. Coastal structures have been built to withstand present coastal patterns. If tides become stronger there will need to be new measures put in place to combat sea erosion. Jetties and minor port structures will have to be re-engineered. There may be a requirement for relocation of housing if there is significant sea erosion. The cost of altering these structures to adapt to new coastal patterns will fall on Sri Lankan fishermen, another externality created by SSCP.

There is the added potential damage to agriculture in Sri Lanka if the SSCP comes into force. Changing sea temperatures may affect the climate in the form of rainfall and length of droughts. As it is, drought is a serious problem in much of Sri Lanka, particularly in the North Central Province. The drought in 2004 caused much hardship and created supply side shocks in the national economy.

While oil tankers will not be allowed to cross the SSCP and other vessels will not be allowed to discharge bilge, ballast, treated sewage, solid wastes, oily wastes and spillage of cargo, it remains to be seen whether this could be implemented effectively at all times. In addition, the stronger currents in the Palk Bay could result in coastal pollution as pollutants are drawn in from the larger seas and these could be deposited on Sri Lankan coastlines. Furthermore, noise pollution from increased shipping will adversely affect communication of marine mammals such as whales and dolphins which may drive them away. A popular tourist attraction in the eastern coast of Trincomalee in Sri Lanka is dolphin watching which may no longer be tenable if the natural habitats are disrupted.

There has been no systematic survey of the geology of the sea bed to be excavated. However, there is evidence to suggest that much of northern Sri Lanka and southern India lies on a continuous stretch of limestone. The SSCP requires dredging that would damage this bed of limestone. In the future it could break up causing land subsidence both from northern Sri Lanka and southern India. It could be argued that the dredging required is only to create a 12 metre deep canal thus damage will not be significant; however limestone is far softer than normal rock, and is susceptible to the slightest damage. Before the SSCP goes through, a thorough survey of the region's geology is required. Even so it would be difficult to predict what may occur in the distant future.

Palk Bay is also one of the major sedimentation sinks of India, with deposits from rivers in India and Sri Lanka and from currents from the Bay of Bengal and the Gulf of Mannar. The greater the level of sedimentation, the more will be the dredging required in the future. The National Environment Engineering Research Institute (NEERI) of India which carried out an Environmental Impact Assessment calculated annual sediment transport from ocean currents in the Adams Bridge area, but this value falls short of the total annual sediment load of the Palk Bay calculated by others to be over 99 per cent.[3] Furthermore, other studies (Ramasamy, 1998; Ramanickam, 2004) suggest that in certain sections of the Palk Bay that the SSCP passes through, sedimentation rate is up to 75 times higher than that predicted by previous estimates of 99 per cent.[4] It is evident that NEERI may have underestimated the extent of sedimentation and along with it the extent of future dredging required and potential dumping sites. If this excess dredged material is dumped in a haphazard manner there are potentially serious environmental consequences for Sri Lanka and South India.

The SSCP area is prone to cyclonic activity. In fact, the Indian Meteorological Department considers the coastal stretch between Nagapattinam and Pamban as a high risk zone for tropical cyclones. Strong cyclones could displace dredged material (to be dumped in the Bay of Bengal and in Pamban Island) and deposited in Sri Lankan territorial waters creating negative environmental impacts. The threat of future tsunamis is very real and the SSCP would provide a deep sea route for a tsunami, carrying with it dredged material and threatening the SSCP itself. In fact, the tsunami of December 2004 is likely to have affected the depth of the Palk Strait. It is reported that certain stretches of the Malacca Strait have changed slightly after the tsunami.

15.4 Legal Implications

Marine law is determined by the 1982 UN Law of the Sea Convention. The Indian government would need to take the following clauses within this agreement into account if it were to go through with the SSCP.

General Obligation: States have the obligation to protect and preserve the marine environment.

Article 194

2) States shall take all measures necessary to ensure that activities under their jurisdiction or control are so conducted as not to cause damage by pollution to other States and their environment, and that pollution arising from incidents or activities under their jurisdiction or control does not spread beyond the areas where they exercise sovereign rights in accordance with this Convention.

5) The measures taken in accordance with this Part shall include those necessary to protect and preserve rare or fragile ecosystems as well as the habitat of depleted, threatened or endangered species and other forms of marine life.

The potential for environmental damage and pollution has already been highlighted, indicating the real threat that this pollution extends beyond the areas where India exercises her sovereign rights.

Article 196

Use of technologies or introduction of alien or new species

1) States shall take all measures necessary to prevent, reduce and control pollution of the marine environment resulting

---

[3] Chandramohan, P., 2001, "Littoral Drift Sources and Sinks along the Indian Coast", *Current Science*, Vol. 81, No. 3.

[4] Ramasamy, S.M., 1998, "Rapid Land Building Activity along Vedaranniyam Coast and its Implications", *Current Science*, Vol. 75. No. 9; Rajamanickam, V.G., 2004, "Sethasumdram Canal", proceedings of a national seminar on "Ecological Balance: Sethasamudram Canal", Alagappa University, India, 1-3 October, 2004.

> from the use of technologies under their jurisdiction or control, or the intentional or accidental introduction of species, alien or new, to a particular part of the marine environment, which may cause significant and harmful changes thereto.

Changes in ocean currents will bring with it alien species that will alter food chains in the Palk Bay and may wipe out several species of fish and other marine life as large deepwater fish enter the ecosystem.

15.5 Conclusion

The SSCP has been a desire of successive Indian governments over several decades, and the project is now set to become a reality. However, this project has significant and potentially devastating side effects (such as subsidence of the Jaffna peninsula) for Sri Lanka. It may be argued that some of the cited dangers are far fetched, but the reality is that several of the environmental impacts are not understood sufficiently. The meetings between the Indian authorities and Sri Lanka's Inter-ministerial Committee proved to be a step in the right direction but they were not consistently followed up. Despite expectations that India will consider any new environmental concerns put forward by Sri Lanka that in turn would lead to a joint consultation between Sri Lankan environmental experts and the project's designers, the outcome has been otherwise. Now that the project is underway it may not be possible to reverse some of the potential ill effects pointed out earlier. It is important that the Sri Lankan government and civil society continues to highlight Sri Lanka's concerns regarding this issue.

Prospects

16. Prospects

Sri Lanka's near-term economic prospects have to be viewed in the context of the December 26, 2004 tsunami that devastated the coastal areas of the country, adding a new dimension to the country's economic management. On the positive side are the anticipated additions to output arising from widespread reconstruction activities, and the availability of a large volume of external funding which helped to ease some of the macroeconomic imbalances threatening to emerge by the end of 2004. On the negative side are the large scale destruction of infrastructure facilities associated with the fisheries and tourism sectors - two economic sectors having an important bearing on the livelihoods of a large section of the population - and full or partial destruction of around 119,000 dwellings. Certain other developments unrelated to the tsunami such as the sharply rising oil prices in the international market and the crises in the electricity and fuel sectors also appear set to cast a shadow on the country's near-term economic performance. The uncertainties that loom in the horizon consequent to the unresolved conflict in the North and East and the political shocks that await the country both due to the struggle for political power and the vagaries of coalition politics too may impact heavily on the country's economic outlook. There is also the problem of a lack of clear direction in economic policy. It is against this background and the possible developments in the international environment that Sri Lanka's near-term economic prospects have to be assessed.

Driven by growth in exports and domestic consumer demand, the Sri Lankan economy is estimated to have grown by 5.4 per cent in 2004, slightly less than the growth rate of 6 per cent recorded in 2003. Despite a decline in foreign aid, the rate of investment rose marginally by 2.9 percentage points to 25 per cent of GDP. Given stagnant domestic and national savings ratios, the higher level of investment was reflected in a widening of the savings/investment gap, financed by foreign savings and the utilization of foreign exchange reserves. Though exports grew robustly, a much stronger growth in import payments, mainly due to high oil prices, led to sharply expanded trade and current account deficits. The anticipated fiscal consolidation was not realized in spite of commitments under the Fiscal Management Responsibility Act (FMRA), due to both revenue shortfalls and expenditure over-runs. The budget deficit escalated to 8.2 per cent of GDP compared to a projected deficit of 6.8 per cent. This, in the context of lower inflows of foreign aid resulted in heavy recourse to domestic borrowings, rising to a level of 5.8 per cent of GDP as against a target of 3.2 per cent. Under the impact of a higher than anticipated domestic credit expansion, broad money supply increased by an annual rate of 19.6 per cent, as against a projected expansion of 13.5 per cent, exerting pressure on the price level, foreign exchange reserves and the exchange rate. The annual average inflation rate rose to 7.6 per cent from a low of 3.7 per cent in May 2004. The overall balance of payments (BOP) recorded a deficit after three consecutive years of surpluses and official foreign exchange reserves fell by about US$ 133 million to US$ 2196 million, providing only 3.3 months of import cover. The Sri Lankan rupee depreciated against all major currencies during the year, the depreciation against the US dollar being 7.5 per cent. The stock market however performed strongly in 2004 with the All Share Price Index rising by 42 per cent. On the policy front, there was little or no progress in implementing much needed structural reforms and/or restructuring of public sectors utilities in 2004.

It was against this background that the tsunami struck Sri Lanka at the end of 2004 that led to a downward revision of the country's growth forecasts for 2005. Most estimates suggest a shaving 0.7 to 1.0 percentage points off the previously anticipated GDP growth, even though most productive sectors were unaffected.[1] On the basis of improved performance of agricultural and industrial sectors, speedy revival of fisheries and tourism sectors and heightened construction activities in the tsunami affected areas, the Central Bank has projected a growth rate of 5.3 per cent in 2005. Thus, the prospective growth of the Sri Lankan economy in 2005 is expected to be moderate at best.

It must be emphasized that even the modest growth rate anticipated in 2005 would *inter alia* be dependent on developments in the global economy, prevalence of domestic political stability, the maintenance of reasonable macroeconomic stability, and much needed structural reforms. For Sri Lanka, the 2005 international environment offers both positive and negative conditions. Among the positive developments is the reasonably robust world economic performance anticipated in 2005 - albeit a marginal decline from the previous year. The world economy is expected to grow by 4.4 per cent in 2005 while the volume of world trade is projected to grow by 6.5 per cent in 2005. Sri Lankan exports are likely to enjoy strong demand in major world market, save for a lack-lustre demand from the slow growing Euro area. At the same time, inflation and inflationary pressures are expected to remain moderate in the near future with favourable market conditions and low real interest rates. This will enable the world economic expansion to be underpinned by accommodative macroeconomic policies.

Among the negative international developments are the escalating oil prices. As of early April 2005, the spot market price of crude oil had risen to as high as US$ 56 a barrel and has since been hovering in a range of US$ 55 to 60. While futures markets project prices to average about US$ 54 a barrel for the rest of the year, according to some other forecasts the prices could rise as high as US$ 100 per barrel by end 2005. The higher the price of oil, the bigger will be the adverse impact on Sri Lanka in maintaining macroeconomic stability and in protecting the external payments position. Another potential downside risk is the greater exposure to competition of the garment industry consequent to the cessation of the Multi Fibre Arrangement (MFA).

Political instability has become a feature of Sri Lanka's institutional makeup, aggravated even more so than before. It has the unfortunate effect of subjecting the economy to stop-go policies and indifferent economic performance. A change in policy thrust in April 2004 - that gave more weight to the state sector; to self reliance through a 'mixed economy' model, with emphasis on rural sector development, small and medium enterprises and regionally balanced economic growth - signalled a departure in policy continuity to some extent. Tariff policy saw some reversals with the imposition of additional levies and cesses on some items considered to be 'luxury' goods making tariff policy less predictable. The planned scaling down of the country's bloated bureaucracy suffered a setback with the recruitment of approximately

[1] It is also pertinent to mention that almost all growth forecasts referred to above are gross of tsunami destruction of economic assets which has been estimated to be around 4.5 per cent of GDP.

40,000 graduates to the public service. Amendments to the TEWA were enacted to enhance compensation payments to private sector workers upon retrenchment.

The policy environment for instituting structural reforms has been made more difficult with the advent of increasingly fractious coalition politics; coalition governments of political parties with ideologically divergent views on economic policy create conflicts in policy formulation, and hence in articulating a consistent policy thrust. This is perhaps most apparent in the area of public enterprise reform. Privatization has been replaced by 'restructuring' of government owned enterprises with a view to infusing greater commercial and operational autonomy and efficiency. However, in the face of stiff resistance from trade unions and constituent coalition partners in government, restructuring has made little head-way in reality with some of the privatized enterprises to be reinvested in the government; for example, legislation for converting the Railways Department to a Railway Authority has been rescinded. Although the government announced a phased restructuring of the two state banks - the Bank of Ceylon and the People's Bank - progress so far has been very slow. Even more critically, restructuring of loss making enterprises such as the Ceylon Electricity Board (CEB) and the Ceylon Petroleum Corporation (CPC) have stalled. Due to both poor management and imprudent pricing policies, the two corporations have accumulated heavy operational losses, financed with bank credit. According to most recent estimates, the CEBs accumulated debt is in the region of Rs.89 billion. The failure to adjust prices in keeping with escalating international prices and rising domestic costs also meant that the two energy sources - fuel and electricity - were heavily subsidized prompting over-consumption. The total subsidy bill falling on the government in 2004 due to the non-adjustment of domestic fuel prices has been estimated at Rs.18 billion or 0.9 per cent of GDP. Apart from unsustainable pricing policies, all attempts at restructuring the two public utilities have met with stiff resistance from both trade unions and political parties. Although domestic selling prices of fuel were revised upwards recently - in May and June 2005 - it is still insufficient to constitute a full pass-through of the high oil prices. If the government were to continue to absorb the operational losses of the two corporations, with limited capacity in additional tax effort, the burden of financing enlarged deficits will fall on additional government borrowings.

Failure to institute structural reforms has serious knock-on effects on the prospects for the country's long-term macroeconomic stability. Programmed fiscal deficit reductions have not been realized with the overall deficit averaging 9.2 per cent of GDP over the period 2000-2004. As a consequence, the debt/GDP ratio has risen progressively to over 105 per cent in 2004, absorbing a disproportionately large share of public resources as service payments. Sri Lanka has witnessed a rapid increase in the inflation rate, with the average annual growth in the CCPI rising to 12.4 per cent as at end May 2005. Apart from the temporary shortfalls in the supply of domestic food items and the removal of the subsidy on wheat flour, the upward adjustment of fuel prices was a major contributory factor. In addition, the demand pressure created by a substantial public service wage increase and excessive monetary expansion also contributed to pushing up the rate of inflation. Broad money expansion continued to remain high with the annual increase standing at 18.9 per cent as at end March 2005.

One major factor contributing to excessive monetary expansion in recent months has been the heavy demand for bank credit from the private sector, the annual growth rising to 22 per cent by end 2004 in the context of declining real interest rates. Save for a single 50-basis point increase in November 2004, the Central Bank policy interest rates remained intact during the period October 2003 to April 2005. Apart from the inflationary consequences of keeping interest rates at artificially depressed levels, the fact that the real interest rates have turned negative *vis-à-vis* benchmark rates and interest rates on government paper does not augur well for maintaining the savings momentum in the economy. Monetary authorities have moved away from the soft monetary policy stance recently and raised policy interest rates twice (in May and June 2005) by a total of 75 basis points. The problem of excess domestic liquidity can take a turn for the worse with the anticipated influx of donor funds for tsunami relief and reconstruction in the coming months and the outflow of Central Bank refinance to meet the commitments under the *Susahana* loan scheme. It would require firm action on the part of monetary authorities to rein in excessive growth in domestic liquidity and contain inflationary pressures. Such a policy stance would also ensure that post-tsunami recovery efforts are consistent with the restoration of a sound macroeconomic framework.

A 4-year medium term macroeconomic framework (MTMF) embodied in the 2005 Budget aims at sustained high savings and investment, high economic growth, moderate inflation, improvement in fiscal performance to reduce domestic borrowings and improved external payments position. The MTMF however, fails to detail structural reforms to be undertaken to meet the underlying macroeconomic targets. Among the long identified list of reforms are measures to

Box 16.1
Medium-term Macroeconomic Framework

The framework anticipates sustaining a medium term GDP growth of 6-7.5 per cent and a gradual moderation of the inflation rate from 8 per cent in 2005 to 4.5 per cent in 2008. The rate of investment is to increase from 25 per cent of GDP in 2004 to 34 per cent in 2008, mostly supported by rising domestic and national savings. The underlying medium-term fiscal strategy is to achieve a current surplus of 3.6 per cent of GDP by 2008 and correspondingly phasing out domestic borrowings.

The key policy objective in the external sector is to diversify export earnings, facilitate larger inflows from migrant remittances and foreign investments and strengthen the foreign reserves position. Thus, the external current account deficit is to decline from 4.6 per cent of GDP in 2005 to 3.1 per cent in 2008, while the overall BOP is to record surpluses throughout the 4-year period, strengthening the external reserves position.

In order to achieve macroeconomic stability, the rate of monetary growth is to be contained at around 14.5 per cent in 2005 and progressively reduced to 11.8 per cent by 2008.

The MTMF adjusted for post-tsunami relief and reconstruction largely assumes the same targets with only a marginal drop in growth anticipated in 2005. The major deviations are the larger trade and current account deficits due to tsunami related construction imports and larger fiscal deficits financed wholly from external sources - new concessional loans, grants and temporary debt relief.

improve the operational efficiency of public enterprises, more particularly the CEB and the CPC; labour market and land market reforms; financial sector reforms, particularly the problem of high intermediation costs; public service reform; provision of efficient infrastructure facilities; low agricultural productivity; education reforms; and improving the regulatory system.

In the current policy and political vacuum - functioning as a minority government from mid-June 2005 - it seems increasingly unlikely that any major structural reforms can be undertaken. Instead, attention will focus on the tsunami-related reconstruction and rehabilitation. With pledges of assistance to the tune of US$ 3.2 billion being made by the donor community - bilateral donors, multilateral donors, NGOs and INGOs, including temporary debt relief - the government is anticipating an inflow of funds totally approximately US$ 1300 million and disbursements of US$ 950 million in 2005.

Although tsunami related reconstruction efforts will exert pressure on the BOP, such pressures are expected to be eased off very considerably owing to the availability of foreign funds and the moratorium on external debt service payments. In fact, the overall BOP has recorded a surplus of around US$ 179 million in the first quarter of 2005, raising gross official reserves to US$ 2200 million as at end March 2005. Building on this first quarter performance, the annual BOP is expected to record a comfortable surplus. On the fiscal front, although the deficit is expected to expand by about 2 percentage points of GDP over the budget target of 7.5 per cent owing to higher current and capital outlays following the tsunami, the availability of increased foreign funding and the bilateral debt moratorium is expected to bring the fiscal deficit closer to the target set by the budget for 2005, save for the risk of delayed mobilization of donor assistance. An overriding concern, however, should be whether the BOP and budgetary support made available following the tsunami has instilled a sense of complacency regarding the lack of progress in implementing a programme of structural reforms.

Diary of Events

August 2004-July 2005

Fiscal Policy

- The first Appropriation Bill of the UPFA government was presented in Parliament by the Finance Minister on 19.10.04. It estimated an increase in total government expenditure to more than Rs. 438 billion in 2005 from Rs. 378 billion in 2004. A substantial increase in the defence budget from Rs. 43 billion rupees to Rs. 53 billion was announced.
- The first Budget of the UPFA government was presented by the Finance Minister on 18.11.04. According to the budget estimates of 2005, a total revenue target of Rs.389 billion as against a total expenditure of Rs.560 billion was indicated. The ensuing budget deficit of Rs.171 billion to be financed by Rs.58.8 billion of foreign financing, Rs.10.2 billion foreign grants, and Rs.104 billion by domestic financing.
- The maiden Budget of the UPFA government was passed in Parliament on 10.12.04 by a majority of 95 votes.
- Amendments to the Tax Amnesty, Value Added Tax (VAT) and the Tobacco Tax Laws were presented in Parliament on 08.09.04

Monetary Policy

- The exchange rate of the rupee against the US dollar continued to rise to a new high of Rs.104 in the interbank spot market on 03.08.04.
- The Monetary Board increased the Central Bank policy interest rates - i.e., Repurchase (Repo) rate and the Reverse Repurchase (Reverse Repo) rate by 50 basis points to 7.50 per cent and 9.00 per cent, respectively to be effective from the close of business on 10.11.04.
- A Bill to amend the Banking Act was presented in Parliament on 24.09.04. The new Bill is to amend Clause 37 of the Banking Act No.30 of 1998 to enable the CBSL to take necessary action against schemes which affect economic stability of the country.
- The rupee appreciated sharply on 06.01.05 against the US dollar. The spot market exchange rate closed at 98.53.
- The Monetary Board decided to increase the Repurchase (Repo) rate and the Reverse Repurchase (Reverse Repo) rate by 25 basis points to 7.75 per cent and 9.25 per cent from 13.05.05.
- The Monetary Board increased the Repurchase (Repo) rate and the Reverse Repurchase (Reverse Repo) rate by 50 basis points to 8.25 per cent and 9.75 per cent, respectively from 15.06.05.

Capital and Financial Market

- At the Monetary Board Meeting held on 04.08.04 a final decision was taken to cancel the licence and liquidate Pramuka Savings and Development Bank.
- GOSL announced a further US$ 55.25 million two year Sri Lanka Development Bond (SLDBs) issue on 25.08.05.This is was the third tranche of SLDBs with the

first two raising US$ 195 million as part of the government's strategy to opt for competitive dollar borrowing thereby freeing up rupee resources. As in the previous issues interest rate would be 6 month LIBOR +margin through competitive bidding and interest paid semi-annually.

- The Colombo Stock Exchange (CSE) reached a milestone on 03.08.04 recording its highest number of transactions for a given day. The CSE recorded 10,145 transactions surpassing 8,153 trade recorded on 25.03.98.
- The turnover at the CSE plunged to its lowest of Rs. 48 million on 30.08.04 for the year. It was the lowest since 31.12.03 figure of Rs.33 million.
- The All Share Price Index (ASPI) of the CSE recorded its highest level reaching 1530.9 points on 20.10.04.
- Global Investors snapped up Sri Lanka Telecom's US$ 100 million (Rs.10 billion) bond issue. The values of the order book was around US $ 10 billion reflecting an over-subscription of 10 times.
- The CSE dipped sharply on 28.12.04 following the tsunami tragedy. The ASPI and the MPI plunged by 4 and 6 per cent, respectively, while market capitalization dipped by Rs.17 billion to Rs.381.4 billion.
- Trading at the CSE reached new highs on 06.01.05 with the ASPI moving up by 18.41 points and the Milanka Price Index (MPI) moving up by 24.45 points.
- The CSE recorded the highest ever points in the ASPI on 25.01.05. The ASPI closed at 1,619.44 points moving up by 13.7 points against the closing figure of 1605.70 the previous day.

Tariff and Trade Policy

- GOSL decided to remove VAT on rice, sugar and milk foods as of 07.10.04. Accordingly, rice imports were made duty free until 31.12.04.
- GOSL through the CBSL imposed a 100 per cent margin deposit requirement to open Letters of Credit to import vehicles for private use on 23.10.04.
- The Finance Ministry increased the duty on private motor cars and vans with effect from 15.10.04. Accordingly, the GOSL removed a flat 25 per cent excise tax on all cars and replaced it with a three tier structure as follows: vehicles with engine capacity of 1 litre (30 per cent); mid-size cars with engines up to 1.5 litres (40 per cent); and 60 per cent on bigger cars.
- The Ministry of Trade, Commerce and Consumer Affairs obtained special preference for Sri Lankan goods exported under the EU GSP scheme in return for sound labour norms from 01.02.04.
- GOSL imposed a cess under the Sri Lanka Export Development Act on the importation of certain non-essential commodities with effect from 04.11.04. The rate of the cess ranges from 10-20 per cent with a corresponding specific duty per unit.
- An import duty of Rs. 9.00 per kilogram was imposed on imported rice with effect from 18.01.05.
- A preferential trade agreement between Iran and Sri Lanka was signed in Teheran on 25.11.04 during the visit by the President of Sri Lanka to Iran.
- A free trade agreement was entered into with Pakistan on 09.02.05 during the visit by the President of Sri Lanka to Pakistan.

Price Adjustments

- Shell Gas Lanka Ltd. increased the price of a 12.5 kg domestic cylinder by Rs. 70 to Rs. 690 effective from 01.08.04. According to the company, the increase was due to the revoking of the subsidy given by the GOSL.
- The Cabinet Sub-committee appointed to negotiate with representatives of the bus operators and bus passenger societies agreed to an overall fare revision of 9 per cent effective from 01.09.04.
- Shell Gas Lanka Ltd. increased the price of its 12.5 kg domestic cylinder by Rs. 99 with effect 05.09.04. Accordingly, the new price will be Rs. 789 per cylinder.
- The Ceylon Electricity Board (CEB) revised the electricity tariff by 5 per cent effective from 01.11.04. All households who consume up to 90 electricity units were exempted from the proposed tariff revision.
- The retail selling price of diesel was increased by Rs.6 per litre and diesel and petrol sold within Colombo Municipal limits were levied with a premium of Rs. 2 per litre with effect from 14.09.04.
- Amidst the conflict between the Consumer Affairs Ministry and the Prima Company, the Consumer Affairs Authority clamped down price control on wheat flour on 18.01.05. Wheat flour was declared as an essential item and the maximum retail price was fixed at Rs. 27 per kilogram.
- Prima Ltd increased the wholesale price of a kilo of flour by Rs.6.50 to Rs.29.70 on 01.03.05.The price increase followed the removal of the Rs.7.50 subsidy given to Prima Ltd. by the GOSL.
- Shell Gas Lanka Ltd. increased the price of its 12.5 kg domestic cylinder from Rs. 789 per cylinder to Rs. 894 from 01.07.05.

Labour and Employment

- A collective agreement on wage increases for plantation workers was signed in 04.11.04 by the Ceylon Workers Congress and Employers' Federation of Ceylon. The agreement increased a regular take home daily wage of a tea plantation worker to Rs.180 and a rubber plantation worker to Rs.170.
- The Ministry of Labour Relations and Foreign Employment announced that a new compensation formula will be implemented from 15.03.05. Under the new formula the compensation ceiling will be 48 months salary or a maximum of Rs.1.25 million.
- The Finance Ministry announced the recruitment of the second batch of 24,207 graduate to be drafted into the public sector under the government's graduate employment drive on 01.09.04.

Infrastructure Development

- A national project to reconstruct irrigation systems commenced on 19.08.04. The project is to involve the reconstruction of 10,000 tanks island wide.
- Sri Lanka Telecom (SLT) and India's Bharat Sanchar Nigam Limited (BSNL) signed a memorandum of understanding (MOU) on 18.08.04 for the Bharat Lanka Optical Fibre Submarine Cable System between Tiruchchendur and Colombo.
- The government of Japan through JICA undertook to work with the Ceylon Electricity Board (CEB) to prepare a Master Plan Study on Development of the Power Generation and Transmission

System in Sri Lanka on 09.03.04. The objective of the study is to prepare a comprehensive master plan for 20 years for generation and transmission system expansion. The study will cover the whole country including the North and East.

- The World Bank granted US$ 100 million for the Regional Telecommunication Networks (RTN) projects to construct the tele-communication network in the North and East and other provinces.

Foreign Aid

- The government of Japan provided Rs.530 million on 26.08.04 to improve test services of the local food industry which include upgrading of and strengthening of the technological support capabilities of IT with respect to food technology, food analytical services and post harvest management.
- The ADB announced on 07.11.04 that it will lend US$ 570 million to Sri Lanka from 2005 to 2006 as a part of its latest country strategy programme.
- The European Commission on 09.09.04 granted 4 million Euros to the GOSL to support the rehabilitation and resettlement of Internally Displaced People (IDPs) in the North and East.
- The Danish government granted US$ 4.4 million on 16.09.04 for a Repatriation, Reintegration, Rehabilitation, and Reconstruction Programme in the North and East.
- The World Bank approved US$ 53 million credit for the e-Sri Lanka Project on 23.09.04 which is a comprehensive programme of Leveraging Information Communication Technologies (ICT).
- The International Fund for Agricultural Development (IFAD) pledged to grant Rs. 2,750 million to the Agriculture Ministry on 25.09.04 towards its projects formulated to uplift the socio-economic conditions of the farmer community.
- The government of China granted Rs.500 million on 08.10.04 for development projects agreed upon between the two governments.
- On 29.10.04, the Asian Development Bank approved a soft loan of US$ 35 million to improve the quality of secondary education in Sri Lanka.
- The government of Japan provided a grant of Japanese yen 800 million (approximately Rs.780 million) under its Non Project Grant Aid Programme (NPGA) on 18.11.04. The proceeds of this grant will be used to import goods as agreed upon between the two governments.
- The government of Japan agreed on 05.11.04 to provide its 36th ODA Loan to the GOSL amounting to 26,631 million yen (approximately Rs.24,767 million) towards projects aimed at facilitating the country's economic development initiatives.
- The Export and Import Bank of India extended a US$150 million loan to Sri Lanka on 09.11.04 to facilitate Indian Oil Co. to export petroleum to Sri Lanka.
- On 15.11.04 the World Bank approved credit worth US$ 75 million for a housing construction programme for IDPs in the North and East.
- The ADB provided a grant of Rs. 500 million on 06.12.04 to the Samurdhi Authority for a period of four years to develop the Samurdi bank system.

- The World Bank announced on 11.12.04 that the Royal Norwegian Government granted Norwegian Kroner seven million (US$ 1.13 million) to help Sri Lanka service its debt to Bank.
- On 20.12.04 the GOSL signed two loan packages totalling US$ 135 million from the ADB to carry out fiscal management reforms and strengthen the financial sector including funds for re-capitalization of the People's Bank for overall private sector development.
- The International Development Association (IDA) signed an agreement on 15.02.05 to provide credit of US$ 75 million to finance a Housing Reconstruction Programme in the conflict affected areas in the North and East.
- Sri Lanka Development Forum 2005 was held in Kandy on 16.05.05 at which total donor commitments were an estimated US$ 3.2 billion.

Governance and Politics

- On 03.08.04 the Supreme Court issued an interim order suspending the decision of the National Police Commission to promote 143 Inspectors to the rank of Chief Inspectors.
- The President resigned from the post of Leader of the UPFA effective from 04.08.04.
- Twenty three public officials including fifteen police officers were indicted before the Colombo High Court on 05.08.04 on charges of bribery or corruption. The Commission to Investigate Allegation of Bribery or Corruption filed these cases against the public officers.
- On 05.08.04, the government announced that it had decided to cancel all state land transfers carried out by the Land Reforms Commission during the period of the UNF government from January 2001 to March 2004.
- In a bid to enhance good governance the President appointed a ten member National Administration Council on 13.08.04.
- On the recommendation of the Minister of Foreign Affairs the Cabinet approved setting up of an Inter Ministerial Committee to study the implication of the Sethusamudram project on Sri Lanka and its economy and environment on 17.09.04.
- The Supreme Court determined that the Election (Special Provision Bill) is consistent with the Constitution on 18.08.04. The Bill seeks to make it compulsory for a voter to produce a valid identity document in proof of identity at elections.
- The Election Act (Special Provision) Bill aimed at making the production of the National Identity Cards compulsory for voting in future election was passed unopposed in the Parliament on 07.10.04. The Law however will come into effect one year after it was passed in Parliament and after GOSL takes all necessary steps to issue identity cards to all eligible voters in the country.
- On 10.06.05 the Janatha Vimukthi Peramuna (JVP) in the United People's Freedom Alliance (UPFA) government gave the President a five day deadline in which to drop the proposal of a Joint Mechanism with the LTTE for tsunami rehabilitation in the North and East.
- The JVP withdrew from the ruling alliance effective from midnight 15.06.05.

Tsunami

- An unknown number of persons were killed on 26.12.04 by massive tidal waves that devastated the coastal areas of Sri Lanka. The GOSL declared a state of national disaster and called for international assistance. The tsunami tidal waves were caused by an earthquake measuring 9 on the Richter Scale off the coast of Sumatra Island. The tidal waves smashed into the coastal areas from Kankesanthurai in Jaffna peninsula in the north to Hambantota in the south of Sri Lanka.
- The Centre for National Operations (CNO) was set up under the President on 30.12.04 to co-ordinate all operations related to the tsunami disaster.
- The CBSL announced on 05.01.05 that the damages to Sri Lanka from the tsunami disaster to be a provisional US$ 1.3 billion.
- The GOSL decided to declare the land area 100 metres from the coast as a reservation on 03.01.05. Construction of new buildings and effecting existing buildings in the reservation areas were declared prohibited.
- The President appointed three task forces, namely: Task Force for Rescue and Relief, Task Force to Rebuild the Nation, and Task Force for Law and Order on 04.01.05.
- The Government decided to grant a sum of Rs. 5,000 to each family displaced by the tsunami catastrophe as an immediate start-up allowance to commence their daily life in the affected areas on 18.01.05.
- On 17.01.05, the GOSL issued orders to the police for strict implementation of the law banning any construction within the forbidden coastal areas. Police were empowered to remove all new buildings near the sea, up to 100 metres in the southern and western coast and up to 200 metres in the northern and eastern coast.
- On 17.01.05, the President presented a US$ 3.5 billion medium term action plan for Rebuilding the Nation encompassing detailed plans to construct 15 new townships in the tsunami affected southern and eastern coasts of the country.
- On 26.01.05, the Cabinet decided to fully adhere to the 100 metre buffer zone rule in general, agreeing to make a case by case study with regard to special situation concerning hotels.
- The Disaster Management Bill was passed in Parliament on 09.03.05 by a majority of 40 votes.
- The preliminary damage and needs assessment report released on 02.02.05 by the ADB, JBIC, and the World Bank indicated that Sri Lanka will need approximately US$ 1.5 billion to effectively implement recovery and rehabilitation strategy.
- The World Bank provided immediate and medium support worth of US $ 100 million for relief and rehabilitation of tsunami affected areas on 01.01.05.
- The European Commission provided a total package of 8 million Euros as outright grant as tsunami aid on 04.01.05.
- The CBSL announced on 05.01.05 a low interest rate loan scheme with 6 per cent interest worth Rs.5 billion to help tsunami affected small and medium enterprises.
- The Indian High Commission in Sri Lanka announced on 05.01.05 that India

would provide US$ 23 million for relief, rehabilitation, and reconstruction on government to government basis.

- The government of Japan on 06.01.05 announced that it would provide US$ 80 million under it non-project grant aid for the tsunami reconstruction effort.
- The Paris Club of creditor nations on 12.01.06 offered a temporary moratorium on debt repayments for countries hit by the tsunami.
- The IMF granted Sri Lanka deferral of its repayments in 2005 to the tune of US $ 113.5 million on 13.01.05.
- Under the Re-building Programme of the GOSL, the People's Bank initiated housing loans to affected people on 24.02.05. Accordingly, housing grants of Rs.250,000 for totally destroyed houses in 4 instalments, and Rs. 100,000 for partially damaged houses in 2 instalments were offered.
- The World Bank increased its commitment to Sri Lanka by another US$ 75 million on 25.02.05 making a total of US$ 150 million for the tsunami recovery effort.
- The IMF Executive Board on 05.03.05 approved US$ 157.5 million in emergency assistance to deal with the tsunami devastated recovery programme.
- On 01.03.05 the Monetary Board of CBSL decided to increase the loan limit to Rs. 10 million for small hotels affected by the tsunami.
- The US Embassy of Sri Lanka announced on 15.05.05 that the US government agreed to freeze Sri Lanka's loan repayments amounting to US$ 40 million in 2005.
- The GOSL signed a controversial Post-Tsunami Operational Management Structure (P-TOMS) aid sharing deal with the LTTE on 24.06.05.

Appendices

Appendix A: Macroeconomic Indicators (Statistical Base)

Table A1: Socio-Economic Indicators

1. Basic indicators	**Unit**					
Area	Sq. km.	65,606				
Mid year population (2004)	('000)	19,462				
Population growth rate (2004)	%	1.1				
Life expectancy at birth (2002)	Years	72.5				
Infant mortality rate (2002)	Per 1000 live births	17				
Gross school enrolment ratio (2002)(a)	%	65				
Adult literacy rate (2002)	%	92.1				
Human development index (HDI) (2002)	Value	0.74				
Human poverty index (HPI) (2002)	Value	18.2				
		2000	**2001**	**2002**	**2003**	**2004(e)**
2. Output, labour force and employment						
GNP at current market prices	Rs. bn.	1,233.0	1,382.0	1,560.0	1,742.0	2,016.0
GDP at current market prices	Rs. bn.	1,258.0	1,407.0	1,583.0	1,761.0	2,029.0
GDP at current factor cost prices	Rs. bn.	1,125.3	1,245.0	1,403.0	1,562.0	1,797.0
GDP per capita at current market prices	US$	856.0	841.0	870.0	948.0	1,031.0
Labour force(b)	mn.	6.8	7.0	7.0	7.6	7.9(c)
Labour force participation (b)	%	50.3	49.0	50.0	48.9	47.8(c)
Unemployment (b)	%	7.6	8.0	9.0	8.4	8.5(c)
3. Real output growth						
GDP	%	6.0	-1.5	4.0	6.0	5.4
Agriculture, forestry, and fishing	%	1.8	-3.4	2.5	1.6	-0.7
Mining and quarrying	%	4.8	0.7	-1.1	5.7	7.9
Manufacturing	%	9.2	-4.2	2.1	4.2	5.1
Construction	%	4.8	2.5	-0.8	5.5	6.6
Services	%	7.0	-0.5	6.1	7.9	7.6
4. Prices and wages						
CCPI (annual average)	% change	6.2	14.2	9.6	6.3	7.6
GCCPI (annual average)	% change	3.2	11.0	10.6	3.1	–
WPI (annual average)	% change	1.7	11.7	10.7	3.1	12.5
Implicit GNP deflator	% change	6.7	12.4	8.4	5.1	9.2
Real wage rates						
Workers in wages boards trades	% change	-3.6	-8.2	-2.0	0.7	-4.8
Government employees	% change	1.9	5.9	6.4	-6.0	2.9
5. Consumption, investment, and savings						
Consumption	% of GDP	82.6	84.3	85.5	84.1	84.1
Gross domestic capital formation	% of GDP	28.0	22.0	21.3	22.1	25.0
Gross domestic savings	% of GDP	17.4	15.8	14.5	15.9	15.9
Gross national savings	% of GDP	21.5	20.3	19.5	21.6	21.6
Foreign savings	% of GDP	10.6	6.2	6.9	6.2	9.1
6. Government finance						
Revenue	% of GDP	16.8	16.7	16.5	15.7	15.4
Expenditure and net lending	% of GDP	26.7	27.5	25.4	23.7	23.5
Current expenditure	% of GDP	20.2	21.6	20.9	19.0	19.2
Capital expenditure & net lending	% of GDP	6.4	5.9	4.6	5.0	4.8
Current a/c balance	% of GDP	-3.4	-4.9	-4.4	-3.3	-3.9
Budget deficit						
Primary deficit	% of GDP	-4.2	-4.1	-1.6	-0.9	-2.2
Overall deficit (before grants)	% of GDP	-9.9	-10.8	-8.9	-8.0	-8.2
Public debt						
External	% of GDP	43.1	45.3	45.6	47.9	49.1
Domestic	% of GDP	53.8	58.0	59.8	57.9	56.4

Contd..../-

	Unit	2000	2001	2002	2003	2004(e)
7. External trade						
Terms of trade	% change	-6.1	-1.7	4.6	7.4	-5.2
Import price index	% change	8.1	-3.6	-8.3	-1.8	9.7
Export price index	% change	1.5	-5.2	-4.1	5.5	4.0
Import volume index	% change	12.9	-10.7	11.4	11.2	9.0
Export volume index	% change	18.3	-8.0	2.2	3.5	7.8
8. External finance						
Trade balance	% of GDP	-10.8	-7.3	-8.5	-8.4	-11.2
Current account balance	% of GDP	-6.4	-1.6	-1.4	-0.4	-3.3
Capital & financial account balance	% of GDP	3.7	3.5	2.7	3.9	3.1
Foreign direct investment	% of GDP	1.5	1.9	1.4	1.1	1.1
Foreign portfolio investment	% of GDP	-0.4	-0.1	0.2	0.01	0.05
Import capacity	months of imports (d)	3.5	4.5	4.9	5.8	5.2
External debt	% of GDP	61.0	61.4	62.4	64.1	65.0
Debt-service ratio	% of exports	14.7	13.2	13.2	11.6	11.5
9. Exchange rates (year end)						
U.S.A.	Rs./US$	80.06	93.16	96.73	96.74	104.61
U.K.	Rs./UK Pound	119.37	135.06	155.12	172.19	201.37
Japan	Rs./Yen	0.70	0.71	0.82	0.90	1.02
European Union	Rs./Euro	74.32	82.27	101.38	121.6	142.32
India	Rs./Rs. Indian	1.71	1.93	2.02	2.12	2.39
SDR	Rs./SDR	104.31	116.97	130.99	143.75	161.6
10. Money supply						
Narrow money supply (M1)	% change	9.1	3.2	14.0	16.0	16.6
Broad money supply (M2)	% change	12.9	13.6	13.4	15.3	19.6
Domestic credit	% change	26.9	16.2	6.7	7.6	25.0
External banking assets	% change	-31.9	6.6	49.3	51.0	1.9
11. Interest rates						
Treasury bills						
3 month	% per annum	17.8	12.9	9.9	7.3	7.2
12 month	% per annum	18.2	13.7	9.9	7.2	7.6
Call money rate	% per annum	17	18.5	11.4	8.5	9.0
Average prime lending rate	% per annum	20	14.3	12.2	9.3	10.2
Commercial banks saving	% per annum	9.9	10.9	9.2	7.2	7.7
NSB saving	% per annum	8.4	10.0	6.9	5.0	5.0
Commercial banks fixed deposits	% per annum	15	16.7	13.2	7.7	9.7
NSB fixed deposits	% per annum	15	14.5	10.9	7.0	8.0
12. Share market indicators						
Annual turnover	Rs. bn.	11.0	13.9	30.2	73.6	59.0
Companies listed	No.	239	238	238	244	242
Market capitalization	Rs. bn.	88.8	124.0	162.6	263.0	382.0
Net purchases by non-nationals	Rs. mn.	-3,364.0	-1,025.0	2,442.0	209.3	1109.0
Share price indices						
CSE share	(Index, 1985 = 100)	447.6	621.0	815.1	1,062.1	1506.9
CSE sensitive (f)	(Index, 1985 = 100)	698.5	1,031.0	1,374.1	1,897.8	2073.7

Notes: (a): Combined first, second, and third level gross enrolment ratio.
(b): Excluding Northern and Eastern Provinces.
(c): Average of first three quarters.
(d): Months of same year imports.
(e): Provisional.
(f): The Milanka Price Index (MPI) was introduced in January 1999, (1998 December = 1000) to replace the Sensitive Price Index.

Sources: IPS database.
Central Bank of Sri Lanka, *Annual Report*, various issues.
Colombo Stock Exchange, *Annual Report*, various issues.
UNDP, *Human Development Report*, various issues.
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, 1984-2004

	1996 Prices			Growth Rates		
	GDP Rs. mn.	PGDP Rs.mn.	POP(b) ('000)	GDP	PGDP	POP
1984	416,915.0	26,727.0	15,599	5.1	3.8	1.2
1985	437,582.1	27,630.4	15,837	5.0	3.4	1.5
1986	456,316.2	28,312.7	16,117	4.3	2.5	1.8
1987	462,949.6	28,295.9	16,361	1.5	-0.1	1.5
1988	475,441.7	28,665.2	16,586	2.7	1.3	1.4
1989	486,140.6	28,926.6	16,806	2.3	0.9	1.3
1990	516,152.7	30,335.2	17,015	6.2	4.9	1.2
1991	539,954.8	31,270.9	17,267	4.6	3.1	1.5
1992	563,061.9	32,311.6	17,426	4.3	3.3	0.9
1993	602,171.5	34,125.1	17,646	6.9	5.6	1.3
1994	636,061.5	35,571.9	17,891	5.6	4.2	1.3
1995	670,742.2	36,984.0	18,136	5.5	4.0	1.4
1996	695,934.0	37,954.5	18,336	3.8	2.6	1.1
1997	739,763.0	39,875.1	18,552	6.3	5.1	1.2
1998	774,796.0	41,225.7	18,794	4.7	3.4	1.3
1999	808,340.0	42,448.1	19,043	4.3	3.0	1.3
2000	857,035.0	44,270.6	19,359	6.0	4.3	1.7
2001	843,794.0	45,045.6	18,732	-1.5	1.8	1.4
2002	877,284.0	46,155.8	19,007	4.0	2.5	1.5
2003	930,057.0	48,309.6	19,252	6.0	4.6	1.3
2004(a)	979,925.0	50,350.6	19,462	5.4	4.2	1.1

Notes: (a): Provisional.
(b):From 2001 figures are based on Department of Census and Statistics, *Population and Housing*.

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

Table A3: Structure and Growth of Output, 1995-2004

	Unit	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004(a)	1995-2004(b)
1. Structure of output												
Agriculture, forestry, and fishing	% of total output	20.0	22.4	21.7	21.3	21.3	20.4	20.1	20.5	19.0	17.9	20.5
Agriculture	% of total output	17.0	17.6	17.0	16.6	16.6	15.9	16.0	16.6	14.7	13.8	16.2
Tea	% of agriculture	11.1	8.4	8.8	8.7	8.5	8.9	9.0	7.2	8.6	8.0	8.6
Rubber	% of agriculture	2.4	3.3	3.0	2.7	2.6	2.3	2.4	1.2	2.4	2.5	2.5
Coconut	% of agriculture	12.5	10.5	10.5	10.0	10.4	11.1	10.0	8.4	8.8	7.4	9.9
Paddy	% of agriculture	24.8	16.2	17.5	20.4	20.8	20.4	20.1	18.0	21.6	17.5	19.3
Mining and quarrying	% of total output	2.4	2.0	2.0	1.8	1.8	1.7	-1.8	1.8	1.7	1.7	1.5
Manufacturing	% of total output	20.4	16.2	16.6	16.9	16.8	17.4	-16.9	15.8	16.4	16.3	13.6
Export processing	% of manufacturing	10.9	14.4	13.6	12.7	12.6	12.0	11.7	11.3	11.1	15.2	12.9
Factory industry	% of manufacturing	82.1	77.9	78.7	79.7	79.7	80.6	80.8	77.2	81.3	77.8	79.2
Small industry	% of manufacturing	7.0	7.8	7.6	7.6	7.7	7.4	7.5	7.6	7.6	6.9	7.4
Construction	% of total output	6.8	6.9	6.8	7.6	7.6	7.3	7.6	7.2	7.2	7.0	7.2
Services	% of total output	57.1	59.4	52.8	51.4	52.0	53.3	53.9	54.9	54.7	55.7	54.5
	Unit	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004(a)**	**1995-2004(b)**
2. Real output growth												
Agriculture, forestry, and fishing	% growth	3.3	-4.6	3.0	2.5	4.5	1.8	-3.5	2.5	1.5	-0.7	1.0
Agriculture	% growth	3.3	-5.1	2.9	1.8	4.4	1.7	-4.3	1.9	3.0	-1.4	0.8
Tea	% growth	1.6	5.1	7.1	1.1	1.3	7.8	-3.5	5.1	-2.2	1.6	2.5
Rubber	% growth	0.9	6.3	-5.4	-9.0	1.0	-9.7	-1.5	5.0	1.7	3.3	-0.9
Coconut	% growth	5.1	-7.6	3.3	-3.2	9.1	8.0	-13.5	-13.6	7.1	-1.6	-0.6
Paddy	% growth	4.7	-26.7	11.2	18.3	6.6	-0.3	-5.7	5.1	7.4	-15.1	0.6
Mining and quarrying	% growth	3.4	8.9	3.8	-5.4	4.1	4.8	0.7	-1.1	3.6	7.9	3.3
Manufacturing	% growth	9.2	6.5	9.1	6.3	4.4	9.2	-4.2	2.1	4.4	5.1	5.2
Export processing	% growth	4.4	1.0	3.5	-1.2	3.8	4.2	-6.7	-0.9	2.2	1.2	0.9
Factory industry	% growth	10.0	7.3	10.3	7.6	4.5	10.4	-3.9	2.5	4.6	6.1	5.9
Small industry	% growth	4.9	6.3	7.0	6.5	4.8	5.5	-3.5	2.1	6.1	-0.6	3.9
Construction	% growth	4.9	3.4	5.4	7.1	4.8	4.8	2.5	-0.8	5.5	6.6	4.4
Services	% growth	5.1	5.5	6.9	3.7	9.8	2.3	-0.5	6.1	7.7	7.6	5.4
GDP	% growth	5.6	5.5	3.8	6.3	4.3	6.0	-1.5	4.0	5.9	5.4	4.7

Notes: (a): Provisional.
(b): Average annual growth rate.

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

Table A4: Value Added in Industry and Industrial Production, 1992-2004

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004(a)
1. Value added, current prices (Rs. mn.)													
Food, beverages and tobacco	18,668	21,704	24,373	29,507	32,891	35,585	40,452	44,503	49,031	54,282	61,550	69,708	72,636
Textile, wearing apparel and leather products	14,630	18,994	19,916	24,895	31,148	40,581	47,482	55,263	69,451	71,263	77,028	84,623	91,308
Wood and wood products (including furniture)	677	831	1,081	1,177	1,250	1,258	1,313	1,390	1,554	1,639	1,736	1,928	2,007
Paper and paper products	1,397	1,912	2,301	2,458	2,580	2,633	2,578	2,664	2,808	3,103	3,124	3,334	3,374
Chemicals, petroleum, coal, rubber and plastic products	3,989	4,723	5,758	6,898	8,957	10,745	14,274	13,832	17,771	19,245	22,653	25,028	26,179
Nonmetallic mineral products (except petroleum and coal)	5,918	7,163	9,272	9,726	10,537	11,600	12,463	13,817	14,240	16,010	17,273	18,477	19,881
Basic metal products	263	279	356	347	450	598	710	777	959	1,131	1,306	1,463	1,593
Fabricated metal products, machinery and transport equipment	3,629	3,608	4,344	4,547	4,809	5,924	6,779	7,367	7,714	8,731	9,698	11,198	11,679
Manufactured products n.e.s.	1,196	1,532	1,838	2,319	2,763	3,157	3,426	3,799	3,965	4,154	4,695	5,257	5,425
Total	50,367	60,746	69,239	81,368	95,385	112,011	129,477	143,412	167,493	179,559	199,063	221,016	234,082
2. Composition of industrial production, %													
Food, beverages and tobacco	37.1	35.7	35.2	35.6	34.5	31.7	31.2	31.0	29.3	30.2	30.9	31.5	31.0
Textile, wearing apparel and leather products	29.0	31.3	28.8	30.6	32.7	36.2	36.7	38.5	41.5	39.7	38.7	38.3	39.0
Wood and wood products (including furniture)	1.3	1.4	1.6	1.4	1.3	1.1	1.0	1.0	1.0	0.9	0.9	0.9	0.9
Paper and paper products	2.8	3.1	3.3	3.0	2.7	2.4	2.0	2.0	1.7	1.7	1.6	1.5	1.4
Chemicals, petroleum, coal, rubber and plastic products	7.9	7.8	8.3	8.5	9.4	9.6	11.0	9.6	10.6	10.7	11.4	11.3	11.2
Nonmetallic mineral products (except petroleum and coal)	11.7	11.8	13.4	12.0	11.0	10.4	9.6	9.6	8.5	8.9	8.7	8.3	8.5
Basic metal products	0.5	0.5	0.5	0.4	0.5	0.5	0.5	0.5	0.6	0.6	0.7	0.7	0.7
Fabricated metal products, machinery and transport equipment	7.2	5.9	6.3	5.6	5.0	5.3	5.2	5.1	4.6	4.9	4.9	5.1	5.0
Manufactured products n.e.s.	2.4	2.5	2.7	2.9	2.9	2.8	2.6	2.6	2.4	2.3	2.4	2.4	2.3
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Notes: (a) Provisional.

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

Table A5: Major Agricultural Crops, Production and Prices, 1983-2004

	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)
1983	179.0	37.0	52.5	140.0	14.0	22.8	2,312.0	2.4	2,484.0	62.5
1984	208.0	46.5	77.2	142.0	14.4	26.2	1,942.0	4.8	2,420.0	62.5
1985	214.0	35.4	60.6	137.5	15.9	21.3	2,958.0	2.6	2,661.0	70.0
1986	211.0	30.3	44.5	137.8	16.6	23.8	3,039.0	1.5	2,588.0	70.0
1987	213.0	38.1	53.0	121.8	19.9	27.6	2,291.0	2.6	2,128.0	70.0
1988	227.0	41.6	56.0	122.4	24.4	37.3	1,936.0	4.0	2,477.0	80.0
1989	207.0	52.2	66.9	110.7	22.6	36.2	2,484.0	3.4	2,063.0	80.0
1990	233.0	65.7	91.8	113.1	22.9	35.5	2,532.0	3.6	2,538.0	110.0
1991	241.0	57.1	84.1	103.9	23.6	34.6	2,184.0	4.8	2,389.0	136.0
1992	179.0	60.5	82.0	106.1	29.3	37.7	2,296.0	6.5	2,340.0	136.0
1993	231.9	68.9	91.2	104.2	35.5	44.3	2,164.0	6.3	2,570.0	155.0
1994	242.2	65.1	91.3	105.3	50.4	51.8	2,622.0	5.7	2,684.0	155.0
1995	245.9	72.2	102.3	105.7	72.0	83.7	2,755.0	6.1	2,810.0	155.0
1996	258.4	103.9	139.6	112.5	67.9	79.8	2,561.0	9.4	2,061.0	155.0
1997	276.9	119.4	158.4	105.8	56.7	75.4	2,631.0	9.6	2,239.0	155.0
1998	280.1	134.3	184.9	95.7	49.7	67.7	2,552.0	8.3	2,692.0	155.0
1999	283.7	115.3	162.4	96.6	45.3	54.0	2,828.0	10.0	2,857.0	155.0
2000	305.8	135.5	184.4	87.6	55.0	66.9	3,096.0	7.4	2,860.0	155.0
2001	295.1	143.9	208.9	86.2	55.0	66.4	2,796.0	7.1	2,695.0	-
2002 (d)	310.0	149.3	216.3	90.5	68.8	69.5	2,392.0	12.1	2,859.0	-
2003 (d)	303.2	149.05	221.01	92.0	102.50	105.25	2,562	9.98	3,071	-
2004 (e)	308.1	180.74	249.38	94.8	110.75	127.20	2,557	11.03	2,609	-

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, 1995-2004

		Household population (10 yrs. & over)	Labour force	Labour force participation rate (%)	Labour force			
					Employed		Unemployed	
		No. mn.	No. mn.		No. mn.	%	No. mn.	%
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	9.5
	q3	12.9	6.7	51.9	6.1	90.9	0.6	9.1
	q4	12.9	6.6	51.4	6.0	91.2	0.6	8.8
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	13.5	6.7	49.4	6.2	92.0	0.5	8.0
	q4	13.6	6.7	49.2	6.2	92.6	0.5	7.4
2001								
	q1	13.7	6.7	49.2	6.2	92.3	0.5	7.7
	q2	14.0	6.9	49.0	6.3	91.7	0.6	8.3
	q3	13.9	6.7	48.3	6.2	92.2	0.5	7.8
	q4	14.1	6.8	48.9	6.2	91.7	0.5	8.3
2002								
	q1	14.1	7.2	51.7	6.7	91.3	0.6	8.7
	q2	14.2	7.0	49.5	6.3	90.2	0.7	9.8
	q3	14.2	7.1	49.4	6.4	90.9	0.6	9.1
	q4	14.3	7.2	50.6	6.7	92.5	0.5	7.5
2003								
	q1	15.6	7.6	49.1	6.9	90.8	0.7	9.2
	q2	15.6	7.5	48.3	6.9	91.9	0.6	8.0
	q3	15.7	7.6	48.6	7.0	91.6	0.6	8.4
	q4	15.8	7.8	49.6	7.2	92.1	0.6	7.9
2004								
	q1	16.3	7.9	49.0	7.3	91.9	0.6	8.1
	q2	16.5	8.0	48.6	7.3	91.0	0.7	9.0
	q3	16.7	8.0	47.8	7.3	91.5	0.7	8.5

Notes: Up to 4th quarter 2002, data excludes both Northern and Eastern Provinces. Commencing from 1st quarter 2003, Eastern Province is included and only the Northern Province is excluded from the survey.

Source: Department of Census and Statistics, *Quarterly Report of the Sri Lanka Labour Force*.

Table A7: Gross Domestic Fixed Capital Formation, 1983-2004

	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)**	
1983	29,379	5,963	24.2	4.9	102,386.4	20,781.2	0.9	6.9
1984	32,483	7,075	21.1	4.6	96,706.3	21,063.2	-5.5	1.4
1985	30,690	7,767	18.9	4.8	90,542.8	22,914.5	-6.4	8.8
1986	32,692	9,634	18.2	5.4	91,122.2	26,852.8	0.6	17.2
1987	34,536	11,216	17.6	5.7	89,958.6	29,215.2	-1.3	8.8
1988	37,156	12,805	16.7	5.8	86,801.6	29,914.3	-3.5	2.4
1989	39,943	14,306	15.9	5.7	85,114.8	30,484.7	-1.9	1.9
1990	57,910	12,507	18.0	3.9	102,852.2	22,213.3	20.8	-27.1
1991	68,368	15,838	18.4	4.3	109,412.4	25,346.3	6.4	14.1
1992	86,407	13,632	20.3	3.2	125,717.4	19,833.8	13.0	-27.8
1993	105,305	20,570	21.1	4.1	139,953.2	27,338.1	10.2	27.4
1994	136,649	17,611	23.6	3.0	166,094.3	21,405.8	15.7	-27.7
1995	147,280	23,595	22.1	3.5	165,105.2	26,450.7	-0.6	19.1
1996	160,181	23,328	20.9	3.0	160,181.0	23,328.0	-3.1	-13.4
1997	186,950	29,923	21.0	3.4	172,145.0	27,553.4	6.9	15.3
1998	221,754	33,960	21.9	3.3	188,246.2	28,828.5	9.4	4.6
1999	266,518	35,210	24.1	3.2	216,505.3	28,602.7	15.0	-2.6
2000	311,460	41,132	24.8	3.3	237,212.5	31,326.7	9.6	9.5
2001	267,298	42,346	19.0	3.0	181,058.0	28,683.6	-23.7	-8.4
2002	301,709	31,812	19.1	2.0	188,863.2	19,913.6	4.1	-44.1
2003	345,915	40,706	22.1	2.6	205,901.8	24,229.8	8.3	17.8
2004(d)	461,721	45,201	25.7	2.5	251,619.1	26,905.3	18.2	9.9

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, 1991-2004

(As % of GDP)	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004(a)
Gross domestic capital formation	22.8	24.3	25.5	27.0	25.7	24.2	24.4	25.1	27.3	28.0	22.0	21.3	22.0	24.9
Gross domestic savings	12.8	15.0	16.0	15.2	15.2	15.3	17.3	19.1	19.5	17.4	15.8	14.5	15.9	15.9
Net imports of goods and non-factor services (b)	10.1	9.3	9.5	11.8	10.4	8.9	7.1	6.0	7.8	10.6	6.2	6.8	6.1	9
Net factor income from abroad	–2.0	-1.8	-1.2	-1.4	-1.0	-1.5	-1.1	-1.1	-1.6	-2.1	-1.7	-1.6	-0.9	-1.0
Net private transfers	4.5	4.8	5.4	5.4	5.2	5.1	5.2	5.4	5.6	5.9	6.2	6.6	6.6	6.7
Gross national savings	15.2	17.9	20.2	19.1	19.5	19.0	21.5	23.4	23.5	21.5	20.3	19.5	21.6	21.6
Foreign savings	7.6	6.4	5.3	7.9	6.2	5.2	5.2	1.7	3.8	6.5	1.7	1.8	0.4	3.3

Notes: (a): Provisional.
(b): Also referred to as external inflow or the resources gap.

Sources: IPS database; Central Bank of Sri Lanka, *Annual Report*, various issues.

Table A9: Summary of Government Fiscal Operations, 1993 -2004

(As % of GDP)	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004(b)
Revenue	19.7	19.0	20.4	19.0	18.5	17.3	17.7	16.8	16.7	16.5	15.7	16.4
Grants	1.6	1.4	1.4	1.0	0.8	0.7	0.6	0.4	0.4	0.4	0.5	0.5
Expenditure												
Current expenditure	20.5	21.9	23.1	22.8	20.8	19.6	18.7	20.2	21.6	20.8	19.0	17.6
Capital & net lending	7.6	7.5	7.4	5.7	5.7	6.7	6.5	6.5	5.9	4.5	4.7	5.5
Current account balance	-0.8	-2.9	-2.7	-3.8	-2.2	-2.4	-1.0	-3.4	-4.9	-4.4	-3.3	-1.3
Primary deficit	-2.4	-3.9	-4.3	-3.1	-1.7	-3.8	-1.9	-4.2	-4.1	-1.6	-0.9	-0.8
Overall deficit (before grants)	-8.4	-10.5	-10.1	-9.4	-7.9	-9.2	-7.5	-9.9	-10.8	-8.9	-8.0	-6.8
Financing budget deficit												
Foreign financing	3.6	3.5	4.5	2.3	1.9	1.7	0.7	0.4	1.4	0.6	2.9	3.0
Net borrowings	2.0	2.0	3.2	1.3	1.1	1.0	0.1	0	1.0	0.1	2.4	2.5
Grants	1.6	1.4	1.4	1.0	0.8	0.7	0.6	0.4	0.4	0.4	0.5	0.5
Domestic financing	4.9	6.5	5.1	6.5	3.4	7.1	6.8	9.4	8.8	8.0	4.5	3.2
Market borrowings	4.4	6.6	5.0	5.1	4.5	7.1	6.8	9.2	8.7	8.0	4.5	3.2
Bank	-1.2	0.2	1.1	1.7	-0.2	1.9	2.5	4.5	3.5	-0.3	-1.2	-1.3
Non-bank	5.7	6.4	3.9	3.4	4.7	5.2	4.4	4.7	5.3	8.3	5.7	4.5
Other borrowings	0.4	-0.1	0.1	1.3	-1.1	-0.1	-0.1	0.3	0.1	-0.1	-	-
Privatization proceeds(a)	-	0.5	0.4	0.6	2.5	0.4	_	_	0.6	0.4	0.6	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, 1986-2004

	Unit	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
1. Financial depth											
Narrow money supply	M1/GDP	11.8	12.8	14.6	14.0	12.3	12.5	11.8	11.9	12.2	11.3
Broad money supply	M2/GDP	28.3	29.7	30.6	30.3	28.1	29.7	30.5	32.1	33.1	34.2
2. Monetary expansion/contraction											
Narrow money supply	% growth	12.9	18.4	29.1	9.1	12.1	17.7	7.4	18.6	18.7	6.7
Broad money supply	% growth	5.1	14.7	16.5	12.5	18.5	22.1	17.4	23.4	19.7	19.2
3. Causal factors											
3.1 External banking assets	Rs. mn.	9,180.2	9,291.2	7,058.5	4,732.0	3,419.0	12,258.0	20,940.0	48,119.0	64,467.0	66,532.0
	% growth	0.0	1.2	-24.0	-33.0	-27.7	258.5	70.8	129.8	34.0	3.2
3.2 Domestic credit	Rs. mn.	64,108.5	75,565.5	96,867.0	102,321.2	115,964.3	127,751.2	144,003.0	150,696.9	173,795.6	223,798.3
	% growth	8.2	17.9	28.2	5.6	13.3	10.2	12.7	4.6	15.3	28.8
3.2.1 Government	Rs. mn.	22,546.1	27,047.9	36,064.5	36,118.0	35,358.0	35,392.0	33,065.0	26,993.0	28,148.0	35,214.0
	% growth	10.8	20.0	33.3	0.1	-2.1	0.1	-6.6	-18.4	4.3	25.1
3.2.2 Private sector	Rs. mn.	41,562.4	48,517.6	60,802.5	66,203.2	80,606.3	92,359.2	110,938.0	123,703.9	145,647.6	188,352.0
	% growth	6.9	16.7	25.3	8.9	21.8	14.6	20.1	11.5	17.7	29.3
3.3 Other liabilities	Rs. mn.	-22,428.5	-26,521.9	-35,979.6	-30,619.8	-28,838.0	-29,435.0	-35,150.0	-38,679.0	-46,590.0	-61,794.0
	% growth	12.1	18.3	35.7	-14.9	-5.8	2.1	19.4	10.0	20.5	32.6

Contd…

	Unit	1996	1997	1998	1999	2000	2001	2002	2003	2004
1. Financial depth										
Narrow money supply	M1/GDP	10.2	10.7	10.5	10.9	10.5	9.8	8.8	10.3	10.5
Broad money supply	M2/GDP	33.0	35.9	34.6	36.0	36.0	36.0	32.2	37.2	38.3
2. Monetary expansion/contraction										
Narrow money supply	% growth	4.0	9.8	12.1	12.8	9.1	3.2	14.0	16.0	16.6
Broad money supply	% growth	10.8	13.8	9.7	13.3	13.0	11.4	13.2	15.3	19.6
3. Causal factors										
3.1 External banking assets	Rs. mn.	61,861.0	89,292.0	93,724.0	83,892.0	59,448.0	82,966.0	101,717.0	129,487.0	129,152.0
	% growth	-7.0	44.3	5.0	-10.5	-29.1	39.6	22.6	27.3	-0.3
3.2 Domestic credit	Rs. mn.	252,317.0	272,733.0	311,626.0	374,120.0	469,084.0	513,457.0	548,578.0	602,898.0	734,605.00
	% growth	12.7	8.1	14.3	20.1	25.4	9.5	6.8	9.9	21.8
3.2.1 Government	Rs. mn.	48,537.0	46,365.0	58,591.0	85,881.0	134,484.0	161,735.0	153,171.0	143,444.0	181,634.0
	% growth	37.8	-4.5	26.4	46.6	56.6	20.3	-5.3	-6.3	26.6
3.2.2 Private sector	Rs. mn.	203,780.0	226,368.0	253,035.0	288,239.0	334,599.0	351,722.0	395,407.0	459,454.0	552,971.0
	% growth	11.1	11.8	13.9	16.1	5.1	12.4	16.2	16.2	20.3
3.3 Other liabilities	Rs. mn.	-60,978.0	-73,768.0	-89,176.0	-99,936.0	-123,863.0	-145,696.0	-139,899.0	-151,638.0	-175,793.0
	% growth	-1.3	21.0	20.9	12.1	23.9	17.6	4.0	8.5	15.9

Notes: Data have been reclassified starting from 1990. For more information, see Central Bank of Sri Lanka, 1995, *Annual Report*.

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

Table A11: Interest Rates, 1991-2004

(%, end of period)	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Bank rate	17.0	17.0	17.0	17.0	17.0	17.0	17.0	17.0	16.0	25.0	18.0	18.0	15.0	15.0
Treasury bills, yield rates														
3 month	16.3	17.7	18.1	18.7	19.3	17.5	10.0	12.0	12.1	17.8	12.9	9.9	7.3	7.2
12 month	17.4	19.0	19.4	19.4	19.0	17.4	10.2	12.6	12.8	18.2	13.7	9.9	7.2	7.6
Repurchase rate	-	-	16.5	20.0	16.5	12.8	11.0	11.3	9.3	17.0	12.0	9.9	7.0	7.5
Call money rate														
Maximum	19.0	27.0	28.0	28.0	102.0	31.0	20.0	16.5	14.3	32.0	13.0	10.9	8.2	10.6
Minimum	14.0	13.0	16.5	14.0	16.0	13.0	9.0	11.3	9.8	20.3	12.5	10.2	7.4	9.5
Weighted average prime lending rate	19.6	20.2	20.4	17.8	20.0	18.4	14.2	15.1	15.2	21.5	14.2	12.2	8.9	10.2
Commercial bank saving														
Maximum	14.0	14.0	14.0	13.0	13.0	13.0	11.0	10.0	10.0	10.0	12.0	11.0	7.2	7.7
Minimum	6.5	6.5	5.5	5.5	5.0	4.5	3.0	2.0	2.0	2.0	4.0	3.5	2.1	3.0
NSB saving	14.0	14.0	14.0	14.0	12.0	12.0	10.8	10.5	9.2	8.4	8.4	6.0	5.0	5.0
Commercial bank fixed deposit (one year)														
Maximum	20.0	20.0	17.0	17.0	17.0	17.8	15.3	13.0	12.5	15.0	14.5	11.0	7.7	9.7
Minimum	10.0	13.5	13.5	10.0	10.0	12.0	8.5	9.0	9.0	9.0	9.5	7.5	5.0	5.0
NSB fixed deposit (one year, paid on maturity)	17.0	17.0	16.0	14.0	16.0	15.0	11.0	11.5	11.5	15.0	13.0	10.0	7.0	8.0

Sources: 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, 1985-2004

	CCPI (1952 = 100)	% change	GCCPI (1989 = 100)	% change (Jan-June)	WPI (1974 = 100)	% change	GDPD (1996 = 100)	% change
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	1,008.6	21.5	124.6	20.0	651.1	22.2	56.3	20.0
1991	1,131.5	12.2	138.9	11.5	710.8	9.2	62.5	11.0
1992	1,260.4	11.4	152.0	9.4	773.0	8.8	68.7	10.0
1993	1,408.4	11.7	164.8	8.4	831.8	7.6	75.2	9.5
1994	1,527.4	8.4	172.6	4.7	873.4	5.0	82.3	9.3
1995	1,644.6	7.7	179.3	3.9	950.7	8.9	89.2	8.4
1996	1,906.7	15.9	202.5	12.9	1,145.1	20.4	100.0	12.1
1997	2,089.1	9.6	220.1	8.7	1,224.3	6.9	108.6	8.6
1998	2,284.9	9.4	235.2	6.9	1,298.7	6.1	117.8	8.4
1999	2,392.1	4.7	244.1	3.8	1,295.3	-0.3	123.1	4.4
2000	2,539.8	6.2	252.0	3.2	1,317.2	1.7	131.3	6.7
2001	2,899.4	14.2	279.6	11.0	1,471.2	11.7	147.6	12.3
2002	3,176.4	9.6	309.3	10.6	1,629.0	10.7	159.9	8.4
2003	3,377.0	6.3	319.0	3.1	1,679.1	3.1	168.0	5.0
2004	3,632.8	7.6	-	-	1,889.0(a)	12.5	183.5	9.2

Notes: CCPI : Colombo Consumers' Price Index.
GCCPI : Greater Colombo Consumers' Price Index.
WPI : Wholesale Price Index.
GDPD : GDP deflator.
(a) : Provisional.

Sources: Department of Census and Statistics.
Central Bank of Sri Lanka, *Annual Report*, various issues.

Table A13: Wage Rate Indices, 1985-2004
(December 1978 = 100)

	Workers in wages boards trades(a)		Government employees(b)	
	Nominal	Real	Nominal	Real
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	801.7	100.7	818.2	103.5
1997	849.1	97.3	906.5	104.0
1998	953.3	99.9	1,001.4	104.9
1999	977.6	97.8	1,001.4	100.2
2000	1,000.4	94.3	1,084.7	102.1
2001	1,049.3	86.6	1,310.8	108.1
2002	1,126.5	84.9	1,525.3	115.0
2003	1,205.2	85.4	1,525.0	108.1
2004(c)	1,233.0	81.3	1,872.1	123.3

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 A 14: Sri Lanka's Direction of Foreign Trade, 1987-2004

	Unit	1987	1988	1989	1990	1991	1992	1993	1996
1. Exports to selected countries and groupings									
U.S.A	US$ mn.	355.2	367.3	400	492.5	559	837.6	1,006.8	1,395.8
U.K.	US$ mn.	75.2	80.9	88.4	115.1	126.2	170.2	203.5	388.6
Germany	US$ mn.	101.1	104.3	95.4	126.7	148.8	211.8	227.5	239.3
Japan	US$ mn.	67.2	84.9	89	102.4	101.6	128	148	256.4
EC	% of total exports	21.7	23.7	25.4	25	27	32.8	31.2	29.4
Germany	% of exports to EC	33.4	29.8	24.1	25.5	27	26.3	25.5	19.8
UK	% of exports to EC	24.9	23.1	22.3	23.2	22.9	21.1	22.8	32.2
ASEAN	% of total exports	3.2	4.7	3.9	3.9	5.5	2.4	2.9	2.8
Singapore	% of exports to ASEAN	72.2	63.8	59.6	63.7	59.8	56.5	58.6	52
Malaysia	% of exports to ASEAN	2.7	3.1	2.3	3.3	23.6	7.7	4	23.5
SAARC	% of total exports	3.9	6.2	5.5	3.6	3	2.3	2.5	2.6
India	% of exports to SAARC	11.6	20.9	11.5	29.1	20.8	20.3	27.6	39.6
NAFTA	% of total exports	27.8	27.2	28.4	27.2	30	36.4	37.1	35.6
USA	% of exports to NAFTA	91.6	91.3	90.3	91.3	91.4	93.5	94.9	95.6
Canada	% of exports to NAFTA	6.3	5.6	5.8	5.4	5.2	4.3	3.4	3.1
APEC	% of total exports	40.5	42.5	41.2	39.5	43.7	47.6	48.7	48.7
USA	% of exports to APEC	62.8	58.5	62.4	62.8	62.7	71.5	72.3	69.8
Japan	% of exports to APEC	11.9	13.5	13.9	13.1	11.4	10.9	10.6	12.8
Singapore	% of exports to APEC	0.9	0.7	0.6	0.5	0.4	0.3	0.2	0.1
2. Imports from selected countries and groupings									
Japan	US$ mn.	304.2	305.1	295.4	325.4	358.4	415.6	452.6	497.3
India	US$ mn.	83.5	91	64.2	118.1	220.1	301.9	342.9	561.9
Hong Kong	US$ mn.	129.8	116.6	109.9	120.4	212.5	241	312.4	354.1
U.S.A	US$ mn.	114.1	152.7	137	207.7	174.5	159.4	131.3	198.3
U.K.	US$ mn.	140.4	126.5	125.2	137	166.3	172.8	184.8	251.7
Taiwan	US$ mn.	106.1	105.3	116.1	1555.8	207.4	214	225.7	287.8
EC	% of total imports	17.6	17.5	16	14.4	15.2	14.7	15.8	15.4
Germany	% of imports from EC	24.7	26.2	20	21.7	22	24.7	21.9	18.4
UK	% of imports from EC	38.5	32.3	35.2	35.5	36	33.5	29.2	30.1
ASEAN	% of total imports	10.8	10.1	12.7	12.8	13.8	15.1	14.5	12.6
Singapore	% of imports from ASEAN	44.8	41.1	33.4	29.7	32.3	44.8	35.8	37.7
Malaysia	% of imports from ASEAN	26.3	27.4	21.5	33.2	33.4	24.1	29.5	26.7
SAARC	% of total imports	6.7	8.1	5.5	6.9	10.3	11.8	10.7	11.9
India	% of imports from SAARC	60.2	50.1	52.1	64.1	70.3	72.7	80.1	86.9
NAFTA	% of total imports	6.4	8.6	6.8	8.5	6.3	5.2	3.7	4.3
USA	% of imports from NAFTA	86.3	78.8	90.1	91.4	91.3	87	89.4	84.6
Canada	% of imports from NAFTA	13.2	21	9.7	8.3	8.3	11.6	10.1	10
APEC	% of total imports	51.8	53.1	52.9	55.7	58.5	57.1	55.7	50.4
USA	% of imports from APEC	10.6	12.8	11.6	13.9	9.8	8	5.9	7.3
Japan	% of imports from APEC	14.7	13.6	11.7	12.1	11.8	11.9	11.3	9.2
Singapore	% of imports from APEC	9.3	7.8	8	6.9	7.6	11.9	9.3	9.5

Cont../

	Unit	1997	1998	1999	2000	2001	2002	2003	2004(a)
1. Exports to selected countries and groupings									
U.S.A	US$ mn.	1,666.4	1,890.2	1,791.8	2,192.5	1,925.9	1,764.0	1,777.4	1,869.3
U.K.	US$ mn.	525.4	530.4	604.2	736.7	576.4	590.3	640.4	779.2
Germany	US$ mn.	230	231.9	215.7	230.2	198.5	199.3	232.4	274.1
Japan	US$ mn.	234.2	196.1	159.1	229.7	185.8	140.3	165.4	157.6
EC	% of total exports	35	33.6	35.3	33.4	32.3	35.2	35.9	38.3
Germany	% of exports to EC	17.1	17.9	16.2	15.2	15.8	14.4	15.3	14.9
UK	% of exports to EC	39	41	45	48.5	45.8	42.8	42.2	42.3
ASEAN	% of total exports	3.4	3	3.1	3.5	2.9	2.6	2.5	2.6
Singapore	% of exports to ASEAN	43.7	38.1	37.9	38.7	51.4	63.6	61.8	67.9
Malaysia	% of exports to ASEAN	16.6	10.1	6	5	5.9	8.4	11.7	7.1
SAARC	% of total exports	3.1	3	3.8	4.2	4.1	6.5	8.3	10.5
India	% of exports to SAARC	37	33.2	33.7	30.6	45.6	66.5	70.0	77.3
NAFTA	% of total exports	45.5	51.5	49.8	50.5	52.0	47.6	44.5	41.2
USA	% of exports to NAFTA	95.3	95.4	95.1	95.4	95.1	94.6	94.5	94.4
Canada	% of exports to NAFTA	3.2	3.1	3.1	3.1	3.4	3.3	3.4	3.6
APEC	% of total exports	58.9	56.3	57.8	59.5	54.6	52.2	52.2	47.8
USA	% of exports to APEC	72.4	83.4	84.1	83.5	83.1	82.5	80.6	81.4
Japan	% of exports to APEC	10.2	8.6	7.5	8.7	8.0	6.6	7.4	6.9
Singapore	% of exports to APEC	0.1	1.9	2.1	2.3	2.5	3.1	3.0	3.8
2. Imports from selected countries and groupings									
Japan	US$ mn.	479.3	555.9	560.9	646	336.9	355.3	448.1	411.7
India	US$ mn.	559.8	539.4	511.6	600.1	709.3	852.9	1,073.2	1439.1
Hong Kong	US$ mn.	411.3	411	459.1	515.9	500.3	491.0	559.5	619.4
U.S.A	US$ mn.	186.6	229.5	216.2	254.9	265.6	218.7	188.3	240.1
U.K.	US$ mn.	282.4	304.8	251.1	311.4	220.6	262.9	272.9	312.1
Taiwan	US$ mn.	372.1	378.7	347.1	390.1	322.8	288.0	276.1	290.8
EC	% of total imports	17.6	23.3	19.4	18.8	18.0	18.0	18.8	18.6
Germany	% of imports from EC	20.5	20.2	15.8	16.5	16.3	13.5	13.4	15.7
UK	% of imports from EC	31.6	30.3	29.1	32.8	26.0	29.3	25.5	25.2
ASEAN	% of total imports	14.7	19.6	21.1	21	19.4	19.1	19.8	20.4
Singapore	% of imports from ASEAN	38.3	36.8	48.2	46.7	44.8	46.0	46.2	51.2
Malaysia	% of imports from ASEAN	22.3	22.8	18	20.5	22.7	21.7	25.6	24.1
SAARC	% of total Imports	13.1	15.1	14.2	14	15.1	19.1	19.9	23.6
India	% of Imports from SAARC	83.9	83.3	81.4	84.8	84.4	89.4	91.5	91.4
NAFTA	% of total imports	5.7	7.1	5.5	6	6.2	4.7	4.1	4.3
USA	% of imports from NAFTA	64.7	75	89	84.1	91.5	93.8	85.4	84.4
Canada	% of imports from NAFTA	19	13.6	9.3	15.6	8.2	5.8	14.2	15.3
APEC	% of total imports	61.9	45.9	53.4	54.9	55.6	52.1	49.2	46
USA	% of imports from APEC	5.9	11.6	9.1	9.2	10.1	8.5	7.1	7.8
Japan	% of imports from APEC	9.4	28.1	23.6	23.2	12.8	13.8	16.0	13.4
Singapore	% of imports from APEC	9.1	15.7	19	17.8	15.6	16.8	18.7	22.7

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, 1986-2004

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
1. Consumer goods										
Value (US$ mn.)	437.4	469.1	548.2	581.5	709.4	782.1	734.6	774.5	930.6	982.0
Growth	13.6	7.2	16.9	6.1	22.0	10.3	-6.1	5.4	20.1	5.6
% of total imports	22.5	22.8	24.6	26.1	26.4	25.5	21.0	19.3	19.5	18.5
1.1 Food										
Value (US$ mn.)	240.8	253.4	321.1	364.4	390.0	404.9	419.7	415.9	483.9	522.0
Growth	10.7	5.2	26.7	13.5	7.0	3.8	3.7	-0.9	16.4	7.8
% of total imports	12.4	12.3	14.4	16.4	14.5	13.2	12.0	10.4	10.2	9.8
1.2 Other										
Value (US$ mn.)	196.7	215.7	227.1	217.1	319.4	377.2	314.9	358.7	446.6	461.0
Growth	17.3	9.7	5.3	-4.4	47.1	18.1	-16.5	13.9	24.5	3.1
% of total imports	10.1	10.5	10.2	9.8	11.9	12.3	9.0	8.9	9.4	8.7
2. Intermediate goods										
Value (US$ mn.)	1,021.5	1,175.7	1,267.8	1,255.4	1,391.7	1,553.3	1,884.4	2,154.4	2,425.0	2,900.0
Growth	-5.4	15.1	7.8	-1.0	10.9	11.6	21.3	14.3	12.6	19.6
% of total imports	52.5	57.2	56.8	56.4	51.8	50.7	53.8	53.7	50.9	54.6
2.1 Petroleum										
Value (US$ mn.)	224.6	296.0	246.5	232.4	358.7	311.5	318.0	309.2	296.3	386.9
Growth	-44.5	31.8	-16.7	-5.7	54.4	-13.2	2.1	-2.8	-4.2	30.6
% of total imports	11.5	14.4	11.0	10.4	13.3	10.2	9.1	7.7	6.2	7.3
2.2 Textiles										
Value (US$ mn.)	226.8	274.6	276.5	276.9	335.8	498.2	765.5	865.1	1,038.1	1,158.5
Growth	62.1	21.1	0.7	0.1	21.3	48.3	53.7	13.0	20.0	11.6
% of total imports	11.6	13.4	12.4	12.4	12.5	16.3	21.9	21.6	21.8	21.8
3. Investment goods										
Value (US$ mn.)	376.8	384.9	379.8	333.4	584.4	720.1	850.9	1,046.8	1,366.5	1,189.0
Growth	-1.5	2.2	-1.3	-12.2	75.3	23.2	18.2	23.0	30.5	-13.0
% of total imports	19.3	18.7	17.0	15.0	21.7	23.5	24.3	26.1	28.7	22.4
4. Total imports										
Value (US$ mn.)	1,947.4	2,055.6	2,233.2	2,225.6	2,689.0	3,061.1	3,503.4	4,011.3	4,767.3	5,311.1
Growth	-2.1	5.6	8.6	-0.3	20.8	13.8	14.5	14.5	18.8	11.4

Contd…/

	1996	1997	1998	1999	2000	2001	2002	2003	2004(a)
1. Consumer goods									
Value (US$ mn.)	1,030.0	1,084.0	1,128.0	1,131.0	1,261.0	1,126.0	1,189.0	1,344.0	1,440.0
Growth	5.2	4.9	4.0	0.3	11.5	-10.7	5.6	13.0	7.1
% of total imports	19.0	18.5	19.2	18.9	17.3	18.9	19.5	20.1	18.0
1.1 Food									
Value (US$ mn.)	597.0	642.0	596.0	551.0	566.0	545.0	566.0	564.0	596.0
Growth	14.3	7.5	-7.2	-7.6	2.7	-3.7	3.8	-0.4	5.7
% of total imports	11.0	11.0	10.1	9.2	7.8	9.1	9.3	8.5	7.5
1.2 Other									
Value (US$ mn.)	433.0	442.0	532.0	581.0	696.0	581.0	623.0	780.0	844.0
Growth -5.8	1.8	20.6	9.2	19.8	-16.5	7.2	25.2	25.2	8.2
% of total imports	8.0	7.5	9.0	9.7	9.5	9.7	10.2	11.7	10.6
2. Intermediate goods									
Value (US$ mn.)	2,971.0	3,235.7	3,108.0	3,168.0	3,916.0	3,430.0	3,622.0	3,948.0	4,828.0
Growth	2.6	8.9	-3.9	1.9	23.6	-12.4	-5.6	9.0	22.3
% of total imports	54.6	55.2	52.8	53.0	53.5	57.4	59.3	59.2	60.4
2.1 Petroleum									
Value (US$ mn.)	479.9	539.5	345.0	500.0	901.0	731.0	789.0	838.0	1209.0
Growth	24.1	12.4	-36.1	44.9	80.2	-18.9	7.9	6.2	44.3
% of total Imports	8.8	9.2	5.9	8.4	12.3	12.2	12.9	13.7	15.1
2.2 Textiles									
Value (US$ mn.)	1,168.8	1,386.9	1,397.0	1,320.0	1,471.0	1,320.0	1,321.0	1,372.0	1,514.0
Growth	0.9	18.7	0.6	-5.5	11.4	-10.3	0.1	3.4	10.3
% of total imports	21.5	23.7	23.7	22.1	20.1	22.1	21.6	20.6	18.9
3. Investment goods									
Value (US$ mn.)	1,203.0	1,324.0	1,477.0	1,565.0	1,737.0	1,081.0	1,169.0	1,320.0	1,670.0
Growth	1.5	10.0	11.3	5.9	11.0	-37.8	8.1	12.9	26.5
% of total imports	22.1	22.6	25.1	26.2	23.6	18.1	19.2	19.8	20.9
4. Total imports									
Value (US$ mn.)	5,439.0	5,864.0	5,889.0	5,979.0	7,320.0	5,974.0	6,105.0	6,672.0	8,000.0
Growth	2.6	7.7	0.4	1.5	22.4	-18.4	2.2	9.3	19.9

Notes: (a): Provisional.

Sources: Central Bank of Sri Lanka, *Annual Report*, various issues; IPS database.

Table A16: Structure of Commodity Exports, 1985-2004

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
1. Agricultural exports										
Value (US$ mn.)	700.4	562.7	592.2	632.1	611.7	721.0	641.4	604.7	655.3	702.1
Growth	-21.1	-19.7	5.2	6.7	-3.2	17.9	-11.0	-5.7	8.4	7.1
% of total exports	52.5	46.3	42.4	42.8	39.3	36.3	32.3	24.6	22.9	21.9
1.1 Plantation crops										
Value (US$ mn.)	624.1	481.3	509.6	531.3	518.7	617.7	538.5	468.1	514.9	546.8
Growth	-23.0	-22.9	5.9	4.3	-2.4	19.1	-12.8	-13.1	10.0	6.2
% of total exports	46.8	39.6	36.5	36.0	33.3	31.1	27.1	19.0	18.0	17.0
1.1.1 Tea										
Value (US$ mn.)	441.9	330.3	361.8	386.7	379.1	494.8	431.9	339.8	412.7	424.2
Growth	-28.7	-25.3	9.6	6.9	-2.0	30.5	-12.7	-21.3	21.4	2.8
% of total exports	33.2	27.2	25.9	26.2	24.3	24.9	21.7	13.8	14.4	13.2
1.1.2 Rubber										
Value (US$ mn.)	94.5	93.6	99.5	116.5	86.3	76.9	63.8	67.5	64.0	72.5
Growth	-27.2	-0.9	6.3	17.1	-25.9	-10.9	-17.0	5.8	-5.3	13.3
% of total exports	7.1	7.7	7.1	7.9	5.5	3.9	3.2	2.7	2.2	2.3
1.1.3 Coconut kernel products										
Value (US$ mn.)	87.7	57.4	48.3	28.2	53.3	46.0	42.8	60.8	38.3	50.1
Growth	43.7	-34.5	-15.9	-41.7	89.2	-13.7	-7.0	42.2	-37.0	30.9
% of total exports	6.6	4.7	3.5	1.9	3.4	2.3	2.2	2.5	1.3	1.6
1.2. Minor agricultural crops										
Value (US$ mn.)	50.2	53.5	58.2	80.5	66.8	79.9	82.4	113.1	120.7	129.2
Growth	-8.1	6.6	8.8	38.3	-17.0	19.5	3.2	37.3	6.7	7.0
% of total exports	3.8	4.4	4.2	5.5	4.3	4.0	4.1	4.6	4.2	4.0
2. Mineral exports										
Value (US$ mn.)	31.8	42.2	61.3	82.2	74.7	87.0	61.9	62.7	75.7	86.9
Growth	-3.0	32.6	45.3	34.1	-9.1	16.4	-28.8	1.3	20.7	14.7
% of total exports	2.4	3.5	4.4	5.6	4.8	4.4	3.1	2.5	2.6	2.7
3. Industrial exports										
Value (US$ mn.)	526.3	566.7	679.4	712.9	789.8	1,036.1	1,237.3	1,763.2	2,102.3	2,398.9
Growth	3.6	7.7	19.9	4.9	10.8	31.2	19.4	42.5	19.2	14.1
% of total exports	39.5	46.6	48.6	48.3	50.7	52.2	62.3	71.7	73.4	74.8
3.1 Textile & garments										
Value (US$ mn.)	293.0	343.7	438.0	448.3	489.1	628.1	803.9	1,214.0	1,412.4	1,551.9
Growth	-1.5	17.3	27.4	2.4	9.1	28.4	28.0	51.0	16.3	9.9
% of total exports	22.0	28.3	31.4	30.4	31.4	31.7	40.5	49.3	49.3	48.4
3.2 Petroleum products										
Value (US$ mn.)	142.7	84.2	88.0	71.2	62.2	99.2	79.5	63.2	78.8	80.1
Growth	10.4	-41.0	4.6	-19.1	-12.7	59.5	-19.9	-20.5	24.6	1.7
% of total exports	10.7	6.9	6.3	4.8	4.0	5.0	4.0	2.6	2.8	2.5
4. Total commodity exports inc. petroleum										
Value (US$ mn.)	1,333.0	1,216.1	1,396.9	1,475.4	1,558.4	1,983.9	1,987.5	2,460.8	2,863.7	3,208.6
Growth	-9.2	-8.8	14.9	5.6	5.6	27.3	0.2	23.8	16.4	12.0
5. Total commodity exports excl. petroleum										
Value (US$ mn.)	1,190.2	1,132.0	1,308.9	1,404.2	1,496.2	1,884.7	1,908.0	2,397.5	2,784.9	3,128.5
Growth	-11.1	-4.9	15.6	7.3	6.6	26.0	1.2	25.7	16.2	12.3

Contd../

	1995	1996	1997	1998	1999	2000	2001	2002	2003(a)	2004(b)
1. Agricultural exports										
Value (US$ mn.)	829.0	961.0	1060.0	1088.0	947.0	1005.0	932.0	938.0	965.0	1065.0
Growth	18.1	16.1	10.3	2.6	-13.0	6.1	-7.3	0.6	2.9	10.4
% of total exports	21.8	23.5	22.9	22.9	20.6	18.2	19.3	20.0	18.8	18.5
1.1 Plantation crops										
Value (US$ mn.)	660.9	801.3	882.1	878.1	738.0	806.0	755.0	728.0	770.0	849.0
Growth	20.9	21.2	10.1	-0.4	4.6	9.2	-6.3	-3.6	5.8	10.3
% of total exports	17.4	19.5	19.0	18.5	16.0	14.6	15.7	15.5	15.0	14.7
1.1.1 Tea										
Value (US$ mn.)	481.0	615.0	719.0	780.0	621.0	700.0	690.0	660.0	683.0	739.0
Growth	13.3	28.2	17.0	8.5	-20.4	12.7	-1.4	-4.4	3.5	8.2
% of total exports	12.6	15.0	15.5	16.4	13.5	12.7	14.3	14.1	13.3	12.8
1.1.2 Rubber										
Value (US$ mn.)	111.0	104.0	79.0	44.0	33.0	29.0	24.0	27.0	39.0	51.0
Growth	53.8	-6.6	-24.4	-44.3	-25.0	-12.1	-17.2	12.5	44.4	30.8
% of total exports	2.9	2.5	1.7	0.9	0.7	0.5	0.5	0.6	0.8	0.9
1.1.3 Coconut kernel products										
Value (US$ mn.)	69.0	81.0	82.0	56.0	84.0	77.0	41.0	41.0	48.0	59.0
Growth	37.1	17.7	2.0	-31.8	50.0	-8.3	-46.8	0.0	17.0	22.9
% of total exports	1.8	2.0	1.8	1.2	1.8	1.4	0.9	0.9	0.9	1.0
1.2. Minor agricultural crops										
Value (US$ mn.)	134.0	132.0	145.0	170.0	165.0	155.0	136.0	168.0	150.0	162.0
Growth	3.5	-1.4	9.9	17.7	-2.9	-6.1	-12.3	23.5	-10.7	8.0
% of total exports	3.5	3.2	3.1	3.6	3.6	2.8	2.8	3.5	2.9	2.8
2. Mineral exports										
Value (US$ mn.)	87.0	96.0	90.0	60.0	64.0	97.0	86.0	90.0	84.0	120.0
Growth	-0.1	10.3	-6.7	-33.1	6.7	51.6	-11.3	4.6	-6.6	42.8
% of total exports	2.3	2.3	1.9	1.3	1.4	1.8	1.8	1.9	1.6	2.0
3. Industrial exports										
Value (US$ mn.)	2,870.0	3,006.0	3,436.0	3,607.0	3,551.0	4,283.0	3,710.0	3,631.0	3,977.0	4,506.0
Growth	19.6	5.0	14.3	3.2	-1.8	20.6	-13.4	-2.1	9.5	13.3
% of total exports	75.4	73.4	74.1	74.9	77.0	77.6	77.0	77.3	77.5	78.3
3.1 Textile & garments										
Value (US$ mn.)	1,853.0	1,902.0	2,274.0	2,460.0	2,425.0	2,982.0	2,543.0	2,424.0	2,575.0	2,809.0
Growth	19.4	2.9	19.6	8.2	-1.4	23.0	-14.7	-4.7	6.2	9.1
% of total exports	48.7	46.4	49.0	52.0	52.7	54.0	52.8	51.6	50.2	48.8
3.2 Petroleum products										
Value (US$ mn.)	85.0	104.0	97.0	73.0	74.0	98.0	68.0	73.0	65.0	100.0
Growth	5.9	22.4	-6.3	-25.9	1.4	32.4	-30.6	7.3	-10.9	53.8
% of total exports	2.2	2.5	2.1	1.5	1.6	1.8	1.4	1.5	1.3	1.7
4. Total commodity exports inc. petroleum										
Value (US$ mn.)	3,806.6	4,199.0	4,736.0	4,871.0	4,684.0	5,620.0	4,885.0	4,772.0	5,198.0	5,857.0
Growth	18.6	10.3	12.8	2.9	-3.8	20.0	-13.1	-2.3	8.9	12.6
5. Total commodity exports excl. petroleum										
Value (US$ mn.)	3,721.7	3,991.0	4,542.0	4,725.0	4,536.0	5,424.0	4,749.0	4,626.0	5,068.0	5,657.0
Growth	19.0	7.2	13.8	4.0	-4.0	19.6	-12.4	-2.6	9.5	11.6

Note: (a): Revised.
(b): Provisional.

Sources: Central Bank of Sri Lanka, *Annual Report*, various issues; IPS database.

Table A17: Tourism, 1985-2004

	Unit	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
Tourist arrivals	No.	257,456	230,106	182,620	182,662	184,732	297,888	317,703	393,669	392,250	407,511
Excursionist arrivals	No.	9,882	6,266	2,417	6,108	4,064	3,954	2,665	5,651	6,093	8,413
Tourist nights	000	2,365	2,513	2,414	2,305	1,970	3,225	3,633	4,055	4,148	4,251
Earnings	Rs. mn.	2,233.3	2,300.1	2,415.2	2,438.3	2,739.7	5,303.3	6,485.8	8,825.6	10,036.8	11,401.6
	US$ mn.	82.2	82.1	82.0	76.6	76.0	132.0	156.8	201.4	208.0	230.7
Receipts per tourist per day	US$	34.8	32.7	34.0	33.3	38.6	41.1	42.8	49.7	50.1	54.2
Average duration	Nights	9.2	10.9	13.2	12.6	10.7	10.8	11.4	10.3	10.6	10.4
Accommodation											
Rooms	No.	9,826	9,794	9,921	9,977	9,459	9,556	9,679	10,214	10,365	10,742
Beds	No.	19,352	19,301	19,322	19,432	18,464	18,669	18,947	19,907	20,242	20,929
Occupancy rate, graded	%	32.7	32.9	31.5	32.1	31.0	47.2	48.4	55.3	57.0	56.6
Sri Lanka nationals											
Arrivals	No.	220,094	220,614	217,127	245,065	258,950	306,367	237,424	339,109	375,740	422,367
Departures	No.	239,272	229,386	257,760	298,583	285,510	296,884	310,373	420,749	416,246	448,437
Employment											
Direct	No.	22,723	22,285	20,338	19,960	21,958	24,964	26,878	28,790	30,710	33,956
Indirect	No.	31,810	31,199	28,473	27,944	30,741	34,950	37,629	40,306	42,994	47,538

Contd../

	Unit	1995	1996	1997	1998	1999	2000	2001	2002	2003(a)	2004(b)
Tourist arrivals	No.	403,101	302,265	366,165	381,063	436,440	400,414	336,794	393,174	500,642	566,202
Excursionist arrivals	No.	10,556	12,863	18,265	27,629	28,335	44,518	60,008	63,560	82,066	155,095
Tourist nights	000	4,024	2,947	3,680	3,944	4,479	4,056	3,435	3,989	5,093	5,742
Earnings	Rs. mn.	11,551.6	9,559.1	12,980.0	14,868.0	19,297.3	19,162.2	18,863.3	24,202.0	32,810.0	41,790.0
	US$ mn.	225.4	173.0	216.7	231.5	274.9	252.8	211.1	253.0	340.0	413.0
Receipts per tourist per day	US$	56.1	57.9	58.6	59.5	61.4	62.3	63.1	63.4	66.8	72.9
Average duration	Nights	10.0	9.8	10.1	10.4	10.3	10.1	9.9	10.1	10.2	10.1
Accommodation											
Rooms	No.	11,255	11,600	12,370	12,772	12,918	13,311	13,626	13,818	14,137	14,322
Beds	No.	21,680	22,040	22,944	23,373	24,216	24,953	25,595	25,956	26,511	26,818
Occupancy rate, graded	%	52.6	40.3	49.1	52.8	57.6	52.3	42.1	43.1	53.2	59.3
Sri Lanka nationals											
Arrivals	No.	459,441	488,055	482,850	481,793	521,073	514,448	487,356	493,947	560,602	646,990
Departures	No.	504,420	494,258	530,712	518,050	496,963	524,212	505,341	533,565	561,126	680,248
Employment											
Direct	No.	35,068	31,963	34,006	34,780	36,560	37,943	33,710	38,821	46,761	53,766
Indirect	No.	49,095	44,748	47,608	48,692	51,184	53,120	47,194	54,349	65,465	75,286

Notes: (a):Revised.
(b):Provisional.

Source: Ceylon Tourist Board, *Annual Statistical Report*, various issues.

Table A18: Monthly Tourist Arrivals, 1993-2004

	1993		1994		1995		1996		1997		1998	
	No.	Growth	No.	Growth	No.	Growth	No.	Growth	No.	Growth	No.	Growth
January	42,726	19.6	45,402	6.3	45,987	1.3	30,957	-32.7	32,652	5.5	37,224	14.0
February	40,116	3.2	41,067	2.4	42,591	3.7	29,550	-30.6	35,010	18.5	35,283	0.8
March	37,953	13.6	41,277	8.8	40,074	-2.9	26,442	-34.0	34,098	29.0	32,256	-5.4
April	29,589	4.1	28,080	-5.1	33,756	20.2	20,376	-39.6	26,907	32.1	25,578	-4.9
May	22,368	6.4	21,777	-2.6	24,672	13.3	17,655	-28.4	22,407	26.9	20,394	-9.0
June	20,412	-11.9	21,399	4.8	22,416	4.8	19,668	-12.3	23,160	17.8	22,410	-3.2
July	32,904	-2.6	35,370	7.5	35,994	1.8	25,380	-29.5	30,867	21.6	29,529	-4.3
August	32,796	-18.3	32,817	0.1	35,814	9.1	24,765	-30.9	32,034	29.4	31,446	-1.8
September	27,495	-7.9	31,062	13.0	30,828	-0.8	23,211	-24.7	29,793	28.4	31,653	6.2
October	30,621	-4.5	33,216	8.5	30,603	-7.9	23,511	-23.2	28,314	20.4	31,767	12.2
November	35,103	-2.4	33,306	-5.1	28,365	-14.8	24,921	-12.1	31,995	28.4	38,421	20.1
December	40,167	-2.7	42,738	6.4	32,001	-25.1	35,829	12.0	38,928	8.6	45,102	15.9
Total	392,250	-0.4	407,511	3.9	403,101	-1.1	302,265	-25.0	366,165	21.1	381,063	4.1

Cont../

	1999		2000		2001		2002		2003		2004(a)	
	No.	Growth	No.	Growth	No.	Growth	No.	Growth	No.	Growth	No.	Growth
January	44,379	19.2	43,311	-2.4	44,187	2.1	28,296	-36.0	40,647	43.6	49,950	22.9
February	41,526	17.7	43,287	4.2	46,575	7.6	31,683	-32.0	39,081	23.4	43,584	11.5
March	41,022	27.2	40,110	-2.2	44,290	10.4	33,084	-25.3	40,818	23.4	38,418	-5.9
April	34,443	34.7	33,642	-2.3	36,906	9.7	27,057	-26.7	33,714	24.6	30,672	-9.0
May	25,212	23.6	23,404	-7.2	26,924	-15.0	26,661	-1.0	30,048	12.7	30,162	0.4
June	26,184	16.8	21,825	-16.6	28,323	29.8	26,355	-6.9	31,836	20.8	32,119	0.8
July	33,288	12.7	33,267	-0.1	28,566	-14.1	35,742	25.1	43,743	22.4	50,525	15.5
August	39,081	24.3	34,422	-11.9	15,717	-54.3	35,475	125.7	42,111	18.7	48,675	15.6
September	33,915	7.1	31,035	-8.5	11,758	-62.1	32,982	180.5	36,054	9.3	51,525	42.9
October	35,112	10.5	26,658	-24.1	12,904	-51.6	36,258	181.0	49,922	37.7	59,442	19.1
November	41,952	9.2	32,469	-22.6	17,344	-46.6	37,395	115.6	54,946	46.9	64,971	18.2
December	40,326	-10.6	36,984	-8.3	23,300	-36.9	42,183	81.0	57,722	36.8	66,159	14.6
Total	436,440	14.5	400,414	-8.3	336,794	-15.9	393,171	16.7	500,642	27.3	566,202	13.1

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 A19: Tourist Arrivals by Country of Residence, 1993-2004

	1993		1994		1995		1996		1997		1998	
	No.	Growth	No.	Growth	No.	Growth	No.	Growth	No.	Growth	No.	Growth
North America	13,635	8.1	15,612	14.5	14,565	-6.7	12,462	-14.4	15,951	28.0	17,529	10
Canada	4,062	-1.0	4,920	21.1	5,469	11.2	4,689	-14.3	6,477	38.1	7,542	16
U.S.A.	9,573	12.5	10,692	11.7	9,096	-14.9	7,773	-14.5	9,474	21.9	9,987	5
Western Europe	2251,934	2.2	253,899	0.8	250,152	-1.5	167,343	-33.1	212,052	26.7	238,959	13
Germany	95,430	11.7	93,528	-2.0	79,698	-14.8	45,075	-43.4	59,814	32.7	74,058	24
United Kingdom	42,474	22.8	47,766	12.5	63,582	33.1	52,095	-18.1	62,997	20.9	66,432	5
France	34,779	-13.5	30,522	-12.2	30,996	1.6	21,480	-30.7	25,392	18.2	26,874	6
Italy	18,267	-28.6	18,069	-1.1	18,378	1.7	11,988	-34.8	14,424	20.3	15,867	10
Netherlands	15,387	-12.3	12,219	-20.6	14,274	16.8	10,995	-23.0	15,957	45.1	22,977	44
Asia	106,668	-6.6	116,352	9.1	118,323	1.7	102,558	-13.3	113,565	10.7	99,702	-12
Japan	20,421	-29.1	19,497	-4.5	18,180	-6.8	11,724	-35.5	13,374	14.1	13,785	3
India	32,433	25.0	44,142	36.1	47,448	7.5	42,822	-9.7	47,010	9.8	37,356	-21
Pakistan	12,369	7.7	10,188	-17.6	11,325	11.2	11,748	3.7	11,439	-2.6	10,782	-6
Australasia	11,823	-4.4	12,033	1.8	10,254	-14.8	8,763	-14.5	11,712	33.7	12,159	4
Australia	10,242	-6.8	9,681	-5.5	9,066	-6.4	7,626	-15.9	10,392	36.3	10,329	-1
Other(a)	8,190	0.7	9,615	17.4	9,807	2.0	11,139	13.6	12,912	15.9	13,092	1
Total	392,250	-0.4	407,511	3.9	403,101	-1.1	302,265	-25.0	366,165	21.1	381,063	4

Contd.../

	1999		2000		2001		2002		2003(b)		2004(c)	
	No.	Growth	No.	Growth	No.	Growth	No.	Growth	No.	Growth	No.	Growth
North America	18,477	5	17,319	-6	15,983	-8	19,866	24	25,110	26	29,759	19
Canada	7,905	5	7,503	-5	7,609	1	8,301	9	11,164	34	14,633	31
U.S.A.	10,572	6	9,816	-7	8,374	-15	11,565	38	13,946	21	15,126	8
Western Europe	275,796	15	260,824	-5	203,984	-22	200,295	-2	255,169	27	284,440	11
Germany	77,259	4	70,584	-9	60,405	-14	55,170	-9	58,908	7	58,258	-1
United Kingdom	80,919	22	84,693	5	67,830	-20	67,533	0	93,278	38	106,645	14
France	34,458	28	25,992	-25	20,949	-19	19,984	-5	28,585	28	29,996	5
Italy	19,815	25	16,833	-15	12,074	-28	12,177	1	15,654	29	18,862	20
Netherlands	29,670	29	22,618	-24	12,569	-44	11,748	-7	18,197	55	21,455	18
Asia	114,375	15	91,521	-20	89,732	-2	143,064	59	177,351	24	198,068	12
Japan	16,332	19	10,226	-37	9,237	-10	13,602	47	17,115	26	19,641	15
India	42,315	13	31,860	-25	33,924	7	69,960	106	90,603	30	105,151	16
Pakistan	11,421	6	10,005	-12	8,562	-14	6,756	-21	9,704	44	9,638	-1
Australasia	15,159	25	18,228	20	13,105	-28	13,209	1	22,965	74	26,540	16
Australia	13,218	28	16,443	24	11,457	-30	11,217	-2	19,958	78	23,247	16
Other(a)	12,633	-4	12,522	-1	13,990	12	16,737	20	20,047	20	27,395	37
Total	436,440	15	400,414	-8	336,794	-16	393,171	17	500,642	27	566,202	13

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, 1993-2004

	Unit	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004(a)
1. Trade Balance	US$ Mn.	-1,147.6	-1,558.7	-1,504.5	-1,343.8	-1,225.0	-1,092.0	-1,369.0	-1,798.0	-1,157.0	-1,406.0	-1,539.0	-2,243.0
	% of GDP	-11.1	-13.3	-11.5	-9.7	-8.1	-6.9	-8.7	-10.8	-7.4	-9.5	-9.5	-12.6
2. Services Balance	US$ Mn.	162.6	179.8	152.1	105.0	159.1	145.0	147.0	38.0	175.0	295.0	399.0	419.0
	% of GDP	1.6	1.5	1.2	0.8	1.1	0.9	0.9	0.2	1.3	2.0	2.4	2.4
3. Income, net	US$ Mn.	-124.9	-162.0	-170.0	-197.0	-160.0	-180.0	-254.0	-305.0	-267.0	-253.0	-172.0	-204.0
	% of GDP	-1.2	-1.4	-1.1	-1.5	-1.1	-1.1	-1.6	-1.8	-1.9	-1.7	-1.2	-1.1
4. Net private transfers	US$ Mn.	557.3	622.6	675.0	709.8	788.1	849.0	887.0	974.0	984.0	1,097.0	1,205.0	1,350.0
	% of GDP	5.4	5.3	5.2	5.1	5.2	5.4	5.6	5.9	7.0	7.5	7.4	7.6
5. Net official transfers	US$ Mn.	56.2	58.5	60.8	49.0	44.5	52.0	26.0	24.0	22.0	31.0	36.0	30.0
	% of GDP	0.5	0.5	0.5	0.4	0.3	0.3	0.2	0.1	0.2	0.2	0.2	0.2
6. Current Account Balance	US$ Mn.	-496.4	-867.1	-753.9	-677.0	-393.0	-226.0	-563.0	-1,066.0	-244.0	-237.0	-71.0	-648.0
	% of GDP	-4.8	-7.4	-5.8	-4.9	-2.6	-1.4	-3.6	-6.4	-1.7	-1.6	-0.6	-3.6
7. Capital and Financial A/C	US$ Mn.	1,106.2	1,077.1	699.0	459.0	602.0	413.0	373.0	443.0	562.0	444.0	722.0	636.0
	% of GDP	10.7	9.2	5.7	4.2	4.2	2.6	2.4	2.7	4.0	3.0	4.3	3.6
Capital Account	US$ Mn.	108.6	113.1	117.2	95.6	87.1	80.0	80.0	50.0	198.0	65.0	74.0	64.0
Financial Account	US$ Mn.	997.6	964.0	581.0	363.0	515.0	334.0	293.0	393.0	364.0	379.0	648.0	572.0
8. Long-Term	US$ Mn.	635.9	745.5	502.0	381.0	716.0	398.0	435.0	304.0	164.0	326.0	722.0	684.0
Foreign Direct Investment	US$ Mn.	188.8	158.2	19.7	86.0	128.6	137.0	177.0	176.0	172.0	185.0	171.0	217.0
Private Long-Term (net)	US$ Mn.	186.5	316.3	91.0	2.0	47.0	2.0	196.0	82.0	-257.0	-21.0	-33.0	18.0
Government Long-Term	US$ Mn.	260.7	271.1	358.0	259.0	239.0	203.0	62.0	47.0	249.0	162.0	554.0	439.0
9. Short-term	US$ Mn.	361.7	218.5	79.0	-18.0	-201.0	-64.0	-142.0	88.0	201.0	53.0	-75.0	-112.0
Foreign portfolio investment	US$ Mn.	67.8	27.0	-1.7	6.4	13.0	-24.0	-13.0	-45.0	-11.0	25.0	2.0	11.0
10 Other (b)	US$ Mn.	37.2	67.2	157.4	98.1	27.3	-116.1	-101.0	174.0	71.0	-145.0	-2.0	202.0
11. Overall balance	US$ Mn.	661.0	240.0	52.0	-68.0	163.0	37.0	-263.0	-522.0	220.0	338.0	502.0	-205.0
	% of GDP	6.4	2.0	0.4	-0.5	1.8	1.4	-1.7	-3.1	1.6	2.3	3.1	-1.15

Notes: (b): Valuation adjustments, errors, and omissions.
(a): Provisional.

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

Table A21: Exchange Rates Behaviour, 1992-2004
(End of period values)

Currency	Unit	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Nominal exchange rates														
U.S.A.	S.L. Rs. per US$	46.00	49.56	49.98	54.05	56.71	61.29	67.78	72.12	80.06	93.16	96.72	96.74	104.60
Japan	S.L. Rs. per Yen	0.37	0.44	0.50	0.53	0.49	0.47	0.59	0.71	0.70	0.71	0.82	0.90	1.02
U. K.	S.L. Rs. per Pound	69.43	73.50	78.05	84.25	95.86	101.60	112.62	116.72	119.37	135.06	155.12	172.19	201.37
European Union	S.L. Rs. per Euro	28.57	28.74	32.16	37.76	36.46	34.24	40.36	37.09	38.00	42.07	51.84	121.60	142.32
India	S.L. Rs. per Ind. Rs.	1.75	1.58	1.59	1.54	1.58	1.56	1.59	1.66	1.71	1.93	2.02	2.12	2.39
Real exchange rates														
U.S.A.	Index, 1990 = 100	92.16	90.19	84.96	88.38	81.82	80.71	79.54	81.56	90.24	98.32	86.10	94.50	100.88
Japan	Index, 1990 = 100	96.59	102.00	104.31	100.93	79.65	70.58	79.72	89.42	82.47	73.72	88.50	91.77	97.86
U. K.	Index, 1990 = 100	78.36	77.20	77.45	80.79	81.35	79.39	80.92	81.04	79.98	79.49	80.40	109.87	122.28
European Union	Index, 1990 = 100	90.57	81.61	84.73	94.00	77.34	67.92	71.95	62.52	62.35	62.28	61.40	127.52	141.61
India	Index, 1990 = 100	79.77	69.03	71.10	70.01	64.70	60.92	59.77	61.87	63.95	66.28	65.90	106.23	118.68

Sources: 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, 2000-2004

	2000	2001	2002	2003	2004(a)
1. Equity market:					
Market capitalization	89,000	124,000	162,600	262,800	382,100
of which central depository	40,416	63,166	85,943	136,059	195,032
2. Debt market:	634,497	744,578	943,286	1,035,394	1,165,491
(i) Private	30,854	36,237	43,110	45,751	48,000
(ii) Public	603,643	708,341	900,176	989,643	1,117,491
(a) Short-term(TBs)	135,000	171,000	210,995	219,295	243,886
(b) Medium & long-term	468,643	537,341	689,181	770,384	873,605
3. Total debt and equity (Rs. mn)	723,497	868,578	1,105,886	1,298,194	1,547,591
as a percentage of GDP (%)	57.53	62.03	78.80	83.07	86.07
of which actually traded through the central depository	44,379	69,341	92,118	147,159	209,532
as a share of total (%)	6.1	8.1	8.3	11.7	13.5
4. Foreign participation in the central depository as a per cent of market capitalization (%)	11	21	12	14	14

Note: (a): Provisional.

Sources: Colombo Stock Exchange, *Annual Report*; Central Bank of Sri Lanka, *Annual Report*, various issues.

Table B2: Recent Developments in the Share Market, 1996-2004

		1996	1997	1998	1999	2000	2001	2002	2003	2004
1. Number of companies listed		235	239	240	237	239	238	238	244	242
New listings		9	6	6	4	5	2	9	8	5
De-listings		0	2	5	7	3	3	9	2	7
2. Number of companies traded		214	224	224	226	228	225	231	236	241
3. Market capitalization	Rs. bn.	104.2	129.4	117	112.8	89	124	162	263	382
	US$ bn.	1.8	2.1	1.7	1.6	1.2	1.4	1.7	2.7	3.8
4. Price-earnings ratio times, year end		10.7	12.5	9.0	6.6	5.2	7.5	12.1	11.1	10.8
5. Number of shares traded (mn.)		227	515	634	486	449	747	1,220	2,255	2,752
Domestic (mn.)		133	337	425	357	350	607	1,035	1,932	2,479
Foreign (mn.)		94	178	208	129	99	140	185	323	273
6. Trades	('000)	98.2	206.3	329.0	205.7	160.0	159.7	283.2	481.3	645.1
Domestic	('000)	87.8	189.8	312.0	193.6	150.0	152.8	273.2	460.9	611.6
Foreign	('000)	10.4	16.5	17.0	12.1	10.0	6.8	10.0	22.8	33.4
7. Turnover:	Rs.bn.	7.4	18.3	18.2	14.8	11	14.1	30.5	73.8	59.0
	US$ bn.	0.1	0.3	0.3	0.2	0.1	0.2	0.3	0.7	0.6
Domestic	Rs. bn.	3.4	10.5	11.8	9.3	7.9	11.4	24.3	59.9	47.9
Foreign	Rs. bn.	4.1	7.8	6.4	5.5	3.1	2.6	6.2	13.8	11.1
8. Liquidity- turnover / market										
Capitalization ratio (%)		7.1	14.1	15.5	13.1	12.4	11.3	18.7	28.1	15.4
9. No. of new issues		8	5	6	4	4	_	5	4	_
10. Total no. of shares issued mn.		64	50	24	29.2	80	_	244	_	_
11. Value of shares issued Rs. bn.		2.2	0.5	0.3	0.4	0.1	_	3.6	_	_
12. Central depository:										
Domestic	(Rs. bn.)	25.2	32.1	29.8	33.9	30.9	50.9	66.5	98.2	140.4
Foreign	(Rs. bn.)	16.2	25.2	18.6	17.2	9.5	12.2	19.5	37.8	54.6
Total	(Rs. bn.)	41.4	57.4	48.4	51.1	40.4	63.1	86.0	136.0	195.0
Percentage of market cap. (%)		38	44	41	45	45	51	53	52	51
13. Non-national activity										
Net purchases	(Rs. mn.)	352.0	716.0	-1,560.0	-950.8	-3,364.6	-1,024.8	2,441.5	209.3	1,105.0
Purchases	(Rs. mn.)	4,224.0	8,218.0	5,645.0	5,050.1	1,445.0	2,111.9	7,477.7	13,943.9	11,278.0
Sales	(Rs. mn.)	3,872.0	7,502.0	7,205.0	6,000.9	4,809.9	3,136.7	5,036.2	13,734.6	10,172.0
14. Price indices										
All Share	1985 = 100	603.0	702.2	597.3	572.5	447.6	621.0	815.1	1,062.0	1,506.9
Growth	% change	-9.1	16.5	-14.9	-4.2	-21.8	38.7	31.2	30.2	41.9
Sensitive	1985 = 100	897.7	1,068.0	923.0	937.5	698.5	1,031.0	1,374.6	1,898.0	2,073.7
Growth	% change	-9.4	19.0	-13.6	-6.2	-25.4	47.6	33.3	38.1	9.3

Note: 1000 Million = 1 Billion.

Source: Colombo Stock Exchange, *Annual Report,* various issues.

Table B3: Market Concentration
(% of total market capitalization)

Company	2004 (%)
JKH	9.53
SLT	7.32
Lanka IOC	6.03
Carsons	3.99
DFCC	3.09
Commercial Bank	2.72
Aitken Spence	2.45
National Development Bank	2.25
Distilleries Lanka	2.24
Ceylon Tobacco	2.10
Total	41.72

Note: As at year 2004 the top ten of the 242 listed companies accounted for 42 per cent of total market capitalization.

Source: Colombo Stock Exchange , *Annual Report*, various issues.

Table B4: New Equity Listings, 2003 & 2004

Company	No. of shares offered	Issue price Rs. by public	No. of shares subscribed Underwriters	No. of Shares Devolved to	Date Listed
1. New Listings-2003					
Marawila Resorts Ltd.	34,666,388	5.00	32,666,806	–	21-Jan-03
The Ceylon Investment Company Ltd.	1,293,525	50.00	1,293,525	–	1-Jul-03
The Ceylon Guardian Investment Trust Ltd.	760,906	80.00	760,906	–	1-Jul-03
Hunter & Company Ltd.	42,875,000	3.00	42,875,000	–	9-May-03
Kahawatte Plantations Ltd.	24,958,677	5.00	15,184,902	9,773,775	24-Feb-03
Nations Trust Bank Ltd.	35,000,000	13.00	35,000,000	–	23-Jun-03
Sunshine Holdings Ltd.	7,000,000	20.00	7,000,000	–	10-Mar-03
Connaissance De Ceylan Ltd.	9,648,751	10.00	9,648,751	–	10-Jul-03
Diesel & Motor Engineering Co. Ltd.	3,000,000	20.00	3,000,000	–	6-Aug-03
Hayleys Ltd.	5,000,000	20.00	5,000,000	–	11-Sep-03
Colombo Fort Investments Ltd.	1,016,666	10.00	950,000	–	1-Dec-03
John Keells Holdings Ltd.	37,418,676	75.00	37,418,676	–	21-Nov-03
Parquet (Ceylon) Ltd.	4,968,000	10.00	4,404,363	563,637	17-Sep-03
Tangerine Beach Hotels Ltd.	2,500,000	20.00	2,500,000	–	25-Nov-03
Miramar Beach Hotels Ltd.	550,000	65.00	22,431	527,569	18-Dec-03
Ruhunu Hotels & Travels Ltd.	12,442,350	10.00	11,442,350	1,000,000	18-Dec-03
Tess Agro Ltd.	3,800,000	12.50	3,800,000	–	18-Dec-03
Commercial Bank of Ceylon Ltd. (Voting)	13,000,000	140.00	13,000,000	–	26-Sep-03
Commercial Bank of Ceylon Ltd. (Non-Voting)	930,046	95.00	930,046	–	26-Sep-03
Value (Rs)	6,425,397,225				
Issues (No.)	18				

2. Right Issues - 2003 By Sector		No.of Issues	No. of shares	Value(Rs.)
Banks, Finance & Insurance	2	48,930,046	2,363,354,370	
Diversified Holdings	2	42,418,676	2,906,400,700	
Hotels & Travels	5	57,807,907	469,995,040	
Investment Trust	4	10,071,097	275,048,730	
Manufacturing	1	4,968,000	49,680,000	
Motors	1	3,000,000	60,000,000	
Plantations	1	24,958,677	124,793,385	
Stores	1	42,875,000	128,625,000	
Trading	1	3,800,000	47,500,000	
Total	18	238,829,403	6,425,397,225	

3. New Listings-2004	No. of shares offered	Issue price Rs.	No. of shares subscribed by public	No. of Shares Devolved to Underwriters	Date Listed
Riverina Hotels Ltd.	4,051,914	20.00	4,051,914	–	26-Jan-04
Commercial Leasing Company Ltd.	4,033,335	25.00	4,033,335	–	30-Jan-04
Capital Development and Investment Co. Ltd.	19,355,000	56.00	19,355,000	–	1-Mar-04
Kuruwita Textile Mills Ltd.	5,000,000	22.00	5,000,000	–	31-Mar-04
Eden Hotel Lanka Ltd.	4,800,000	10.00	4,800,000	–	8-Apr-04
The Ceylon Investment Company Ltd.	3,018,225	50.00	3,018,225	–	19-Jul-04
The Ceylon Guardian Investment Trust Ltd.	2,663,172	80.00	2,663,172	–	19-Jul-04
Sigiriya Village Hotels Ltd.	1,159,650	45.00	1,159,650	–	9-Jul-04
Stafford Hotels Ltd.	6,324,295	10.00	6,324,295	–	30-Jul-04
Colombo Investment Trust Ltd.	1,033,333	10.00	1,033,333	–	9-Aug-04
Hayleys Ltd.	5,000,000	20.00	5,000,000	–	18-Aug-04
Associated Hotels Co. Ltd.	3,902,850	18.00	3,902,850	–	17-Sep-04
Chemanex Ltd.	875,000	50.00	875,000	–	14-Sep-04
Hotel Sigiriya Ltd.	1,953,000	30.00	1,953,000	–	23-Sep-04
Elephant Lite Corporation Ltd.	6,480,648	10.00	6,480,648	–	10-Sep-04
Colombo Fort Investments Ltd.	1,000,000	15.00	1,000,000	–	15-Oct-04
Hatton National Bank Ltd.	22,000,000	55.00	22,000,000	–	9-Oct-04
Hatton National Bank Ltd.	6,600,000	33.00	6,600,000	–	9-Oct-04
Marawila Resorts Ltd.	6,000,000	10.00	6,000,000	–	22-Oct-04

Contd...../-

	No. of shares offered	Issue price Rs.	No. of shares subscribed by public	No. of Shares Devolved to Underwriters	Date Listed
The Fortress Resorts Ltd.	10,368,625	10.00	10,368,625	–	26-Oct-04
Blue Diamonds Jewellery Worldwide Ltd.	26,240,529	2.50	26,240,529	–	5-Nov-04
Lankem Developments Ltd.	5,103,372	10.00	5,103,372	–	10-Nov-04
Hotel Reefcomber Ltd.	2,949,497	10.00	2,949,497	–	19-Nov-04
Sampath Bank Ltd	17,221,907	60.00	17,221,907	–	20-Nov-04
Asiri Hospitals Ltd.	9,485,472	30.00	9,485,472	–	29-Nov-04
Value (Rs.)	5,321,369,818				
Issues (No.)	25				

4. Right Issues - 2004 By Sector	No.of Issues	No. of shares	Value(Rs.)
Banks, Finance & Insurance	5	69,210,242	3,645,827,795
Construction & Engineering	1	5,103,372	51,033,720
Chemicals & Pharmaceuticals	2	7,355,648	108,556,480
Diversified	1	5,000,000	100,000,000
Footwear & Textiles	1	5,000,000	110,000,000
Healthcare	1	9,485,472	284,564,160
Manufacturing	1	26,240,529	65,601,323
Total	25	176,619,824	5,321,369,818

Source: Colombo Stock Exchange, *Annual Report,* various issues.

Table B5: Sri Lanka Structure of Debt Market, 2000-2004

(Rs. bn.)	2000	2001	2002	2003	2004(a)
1. Private debt:					
(a) Commercial paper (year end)	3.96	6.18	5.60	11.10	14.50
(b) Certificates of deposit	21.28	22.85	28.71	24.98	21.03
(I) Commercial banks	19.09	21.65	27.21	23.64	19.79
(ii) Finance companies	2.19	1.20	1.50	1.34	1.23
(c) Debentures (listed)	5.80	7.32	10.30	9.67	12.47
Total private debt	31.04	36.35	44.61	45.75	48.00
2. Public debt:					
(a) Short term					
(i) Treasury bills	134.99	170.99	210.99	219.29	243.88
(ii) Central Bank securities	–	–	–	–	–
(b) Medium & long term					
(i) Treasury bonds	204.12	229.17	347.13	483.11	643.35
(ii) Rupee securities	263.89	292.81	287.70	248.41	164.76
(iii) Certificates of deposit	–	–	–	–	–
Total public debt	603.00	692.97	845.82	955.20	1,052.00
3. Total Debt	634.04	729.32	890.43	1,000.95	1,100.00

Note: (a): Provisional.

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

Table B6: Listed Debentures, 2002-2004

Issuer	Issued (No.)	Par Value (Issue price Rs.)	Interest (p.a.)	No.of Debt Subscribed	Date Listed
1. Listings 2002					
Ace Power Generation Matara Ltd.	265,000	100	Floating	265,000	18.04.02
Ace Power Generation Matara Ltd.	540,000	100	Floating	540,000	18.04.02
Ace Power Generation Matara Ltd.	535,000	100	Floating	535,000	18.04.02
Ace Power Generation Matara Ltd.	450,000	100	Floating	450,000	18.04.02
Eagle Insurance Company Ltd.	12,000,000	10	15.35%	Dividend Debenture	01.04.02
The Lanka Hospital Corporation Ltd.	100,000	1,000	Floating	100,000	11.01.02
The Lanka Hospital Corporation Ltd.	100,000	1,000	Floating	100,000	11.01.02
The Lanka Hospital Corporation Ltd.	100,000	1,000	Floating	100,000	11.01.02
The Lanka Hospital Corporation Ltd.	100,000	1,000	Floating	100,000	11.01.02
Aitken Spence & Company Ltd.	2,000,000	100	15.25%	2,000,000	21.05.02
Aitken Spence & Company Ltd.	2,000,000	100	15.75%	1,000,000	21.05.02
Aitken Spence & Company Ltd.		100	16.00%	1,000,000	21.05.02
Hatton National Bank Ltd.		100	13.75%	16,442,037	22.10.02
Hatton National Bank Ltd.		100	Floating	1,149,440	22.10.02
Hatton National Bank Ltd.	20,000,000	100	14.00%	1,271,583	22.10.02
Hatton National Bank Ltd.		100	Floating	4,700	22.10.02
Hatton National Bank Ltd.		100	14.20%	1,125,940	22.10.02
Hatton National Bank Ltd.		100	Floating	6,300	22.10.02
2. Listings 2003					
Commercial Bank of Ceylon Ltd.	2,000,000 with an	1,000	10.00%	115,890	09.07.03
Commercial Bank of Ceylon Ltd.	option of issuing	1,000	Floating	2,128,520	09.07.03
	a further 1,000,000				
3. Listings 2004					
Merchant Bank of Sri Lanka Ltd.	1,000 (with an	100	10.38%	83,000	08.04.04
	option of issusing	100	10.12%	7,280	08.04.04
	a further 1,000)	100	10.00%	33,320	08.04.04
		100	Floating	7,110	08.04.04
		100	Floating	50	08.04.04
		100	Floating	32,590	08.04.04
Sampath Bank Ltd.	10,000 (with an	100	10.00%	226,840	29.06.04
	option of issusing	100	9.75%	45,150	29.06.04
	a further 5,000)	100	Floating	1,228,010	29.06.04

Source: Colombo Stock Exchange.

Themes of the "Sri Lanka: State of the Economy Reports"

1992	Macroeconomy
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
2003	Garment Sector
2004	Land Policy
2005	Post-Tsunami Economic Issues