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Contents

Policy Perspectives and Performance

Agriculture Reforms: Irrigation Water Charges and Land Policy

Leading Issues in the Development Process

Policy Briefs

Prospects

Appendices

LIST OF FIGURES

LIST OF TABLES

LIST OF BOXES

Policy Perspectives
and
Performance

1. Policy Perspectives

Under normal circumstances, Sri Lanka would have joined the ranks of many countries across the world gripped by economic uncertainty in the wake of the worst global economic crisis in 60 years to be forecast for 2009. For Sri Lanka, however, 2009 will represent a remarkable turnaround in the political arena and possibly in the economic sphere as well. The military victory over an armed separatist conflict spanning three decades has brought the prospect of long term peace and stability a step closer. In the economic sphere, despite the near term economic gloom, it has brightened the prospects significantly for sustained socio-economic development of the country in the longer run.

The renewed sense of economic optimism - captured most visibly by an immediate upturn in the Colombo Stock Exchange following the formal announcement of the defeat of the Liberation Tigers of Tamil Eelam (LTTE) on 18 May, 2009 - is not misplaced. The economic benefits of peace will be manifold, ranging from a halt to the destruction of the country's human and social capital, its infrastructure, and confidence in its economy. It will also help in opening markets and reintegrating economic activities. The end of armed conflict will also allow the rehabilitation and reconstruction of the Northern and Eastern Provinces of the country to commence, with spill-over effects to invigorate economic growth across the country.

While peace and stability hold out the promise of creating the conditions for long term sustained development, there are near term challenges to be overcome, not least the adverse impacts of the global economic crisis as it coalesces with domestic policy constraints. Even before the full magnitude of the global economic crisis began to emerge, it was clear that the Sri Lankan economy was already set to face a number of challenges. What was also clear was that the economy was not on the soundest of platforms to face a global economic crisis of the magnitude that was sweeping across both developed and developing economies.

To a great extent, initial domestic economic conditions determine the possible policy responses to mitigate the downside effects of the global economic recession. Sri Lanka's initial conditions were poor: relatively weak public finances, a ballooning deficit on the external current account, significant inflationary pressure, and a misaligned exchange rate. Domestic macroeconomic policy miscalculations added to bring home the sharp reality of the global economic crisis to the forefront by end 2008 that, in the end, compelled the country to seek assistance from the International Monetary Fund (IMF).

For Sri Lanka, policy concerns for much of 2008 was not so much about a possible slowdown in GDP growth, but concerns over regaining macroeconomic stability and maintaining a lid on a growing external resource gap. GDP growth for the first three quarters of 2008 had continued at a relatively healthy 6.5 per cent. However, the inflationary spiral of recent years increased unabated to peak at 28.2 per cent on a point-to-point basis in June 2008, before reversing in response to the tight monetary policy measures adopted in early 2007. At the same time, the annualized rate of inflation peaked at 23.4 per cent in October 2008. Price instability was accompanied by a significant widening of the external current account deficit - of a magnitude last experienced by the country in 1982. The deficit for the period January-September 2008 had deteriorated sharply to US$ 2990 million from US$ 980 million in the comparable period in 2007.

A sustained deterioration in the external current account suggests, in principle, the need for a depreciation of the exchange rate. Indeed, Sri Lanka has been experiencing a sustained weakening of its current account from 2006 as a result of the external supply-side shock of rising international oil prices. The policy flexibility to allow the exchange rate to mirror developments in the underlying fundamentals, however, was severely constrained. Rapidly spiralling inflation, growing external debt servicing obligations and a need to attract foreign investors into the government debt securities market, all combined to make a stable exchange rate regime an attractive option. In that climate, a devaluing currency would further raise inflation, endanger fiscal consolidation, and generate expectations of further devaluations to add to investor risks. The Sri Lankan rupee in effect saw a nominal depreciation of only 0.9 per cent against the US dollar in 2007. From December 2007 to September 2008, the rupee for all intents and purposes was 'pegged' unofficially at Rs. 108 to the US dollar. This was despite mounting evidence of a sharp appreciation of the real exchange rate. The real effective exchange rate (REER) estimated by the Central Bank of Sri Lanka (CBSL) indicates a real appreciation of the currency by 25 per cent in the twelve months leading up to September 2008.

Thus, well before the global financial crisis was to manifest, the Sri Lankan economy was set to face severe challenges of its own. GDP growth was showing signs of a slowdown, inevitable in view of the tight monetary policy stance that had pushed up interest rates to near 20 per cent. GDP growth of 6.3 per cent in the third quarter of 2008 was well below the 7 per cent achieved in the comparable period in 2007 (or even the 7 per cent growth achieved in the second quarter of 2008). Notably, growth in both industry and services sectors had slowed in the first three quarters of 2008. Industry and services grew at 6.2 and 6.3 per cent, respectively, as compared to rates of 7.3 and 7.0 per cent achieved in the comparable period in 2007. It was the sharply improved contribution from agriculture - recording a growth of 8.6 per cent in the first three quarters of 2008 compared to a rate of 2.7 per cent in the comparable period in 2007 - that kept overall economic growth fairly buoyant.

Export earnings growth during January-September 2008 had already slowed to 9.9 per cent compared to a growth rate of 12.6 per cent over the same period in 2007. Tellingly, much of the export earnings growth in the first nine months of 2008 was driven by agricultural products. Industrial exports were performing extremely poorly. Export earnings growth from textiles and garments, for instance, was down to 2.8 per cent during January-September 2008 compared to a growth rate of 10.4 per cent achieved in 2007 over the same period. Other industrial products fared no better; during the first nine months of 2008, they grew by only 2.6 per cent, relative to a growth rate of 16.5 per cent achieved in 2007 over the same period. A misaligned currency that reports a sharp real appreciation against trading partner currencies obviously would not have helped Sri Lanka's exporters to compete effectively in international markets.

The knock-on policy distortions were not confined to the real sector of the economy. A very modest monetary policy response to evidence of high domestic inflationary pressures not only failed to curb rising inflationary expectations, but instead fuelled a credit boom during 2005-07. At its peak in mid-2007, credit growth to the private sector was at 26 per cent. The outcome inevitably was that the CBSL was required to tighten monetary policy much more sharply from 2007 onwards, abandoning adjustments to policy rates and adopting explicit quantitative targeting. Reserve money growth, for instance, dropped from a high of 21.2 per cent in 2006 to a mere 1.5 per cent by end 2008.

Monetary tightening measures saw interest rates on average spike to over 20 per cent - the high cost of borrowing deterred not only private investment, but imposed a liquidity crunch on financial institutions, and costly loan repayment obligations on borrowers. It is an acknowledged pattern that credit booms create an environment of riskier behaviour on the part of both borrowers and lenders alike. This has been a truism in the current global banking crises and subsequent financial meltdown. Sri Lanka's experience is no exception. The domestic financial system has been coming increasingly under stress in 2008 - an increase in the ratio of non-performing loans of the commercial banking sector, financial collapses, and the exposure of financial frauds run along "Ponsi" schemes have been on the rise. Risks to Sri Lanka's financial system stability, however, have little or nothing to do with the global financial crisis.

The true impact of the global economic crisis on Sri Lanka began to emerge only in the fourth quarter of 2008. The impact came from the most vulnerable point of exposure of the economy - i.e., on the external account position. Export earnings began to be dealt a double blow. In addition to the gradual loss in competitiveness as a result of domestic policy distortions, viz., a sharp appreciation of the real exchange rate, the export sector also began to face a rapidly shrinking export market. The overwhelming dominance of developed country markets - particularly the US and EU - as destinations for Sri Lanka's industrial exports has been a key source of concern with regard to the contours of the global economic crisis. Another has been the sharp decline in commodity prices that have impacted heavily on Sri Lanka's key plantation exports. Total export earnings growth in the fourth quarter of 2008 contracted by 5 per cent as compared to a growth of 12 per cent recorded over the same period in 2007. A positive impact of the decline in commodity prices has been the rapid fall in oil prices. Growth in import expenditure in the fourth quarter of 2008 remained unchanged, assisting somewhat in containing the overall trade balance.

However, access to all forms of foreign capital became scarce with the onset of the global financial crisis. A government invitation for proposals to raise a syndicated loan of US$ 300 million issued in October 2008 had to be abandoned. At the same time, Sri Lanka also began to see outflows from the capital account as a direct result of the global credit crunch. Having partially opened up the capital account from 2007 - permitting foreigners to invest up to 10 per cent of the government debt securities market - the global credit crunch saw foreign investors cashing in their investments from September 2008. Sri Lanka experienced a rapid outflow of an estimated US$ 400 million of foreign investments in Treasury bills and bond holdings from a total inflow at the time of US$ 650 million.

The policy response to these developments on the external front - vis-à-vis the exchange rate - was ill advised. In effect, the policy thrust was to 'lean against the wind' and defend the currency through a run-down of official reserves. As Sri Lanka's gross official reserves dipped alarmingly as a result - from

US$ 3.4 billion in August 2008 (sufficient for 3 months of imports) to US$ 1.7 billion by December 2008 (sufficient for 1.5 months of imports) - the focus shifted to ensuring an adequate re-building of reserves. Notwithstanding attempts to do so through the issuance of 'diaspora' bonds and arranging currency swaps through other central banks, Sri Lanka was compelled to approach the IMF for a Stand-By Arrangement of US$ 1.9 billion for balance of payments (BOP) support in February 2009.

Developing countries are generally perceived to approach the IMF when they have run out of all other options owing to the demanding conditions that it attaches to loans. Despite an announcement in March 2009 that the IMF is overhauling its lending framework, along with the conditions attached to its loans, not much appears to have changed. However, the imposition of conditions is also more likely if weak policy responses are perceived to have led the country to seek assistance. While the Letter of Intent between the Government of Sri Lanka (GOSL) and the IMF is providing an enhanced facility of US$ 2.6 billion under the Stand-By Arrangement - equivalent to 400 per cent of Sri Lanka's quota - it will also place the country on a tight macroeconomic stabilization path.

The IMF facility alone will not solve Sri Lanka's efforts to bridge its foreign resource gap. The country still has to meet its foreign currency denominated debt service obligations and repayments in 2009. These include funds raised via Sri Lanka Development Bonds (SLDB), bilateral lines of credit, payments associated with oil price hedging, etc. By end 2008, the external current account deficit as a percentage of GDP had risen to 9.3 per cent of GDP - just short of the previous high of 11.9 per cent of GDP recorded in 1982. However, the circumstances are vastly different. In the early 1980s, Sri Lanka was in the midst of a capital import-intensive hydro-energy development programme that was almost entirely donor funded. In the current context, Sri Lanka's access to external resources is more difficult to come by. Bridging the external resource gap requires more fundamental reforms, the root of which lies in the country's weak public finances.

The constraints that weak public finances impose on the ability of governments to respond with appropriate policy flexibility to external shocks - such as the current global economic downturn - is clear from Sri Lanka's experience. The potential impact of the global recessionary conditions on Sri Lanka's own growth performance became clear from the fourth quarter of 2008. GDP growth dropped sharply to 4.3 per cent for the fourth quarter of 2008 and further to 1.5 per cent in the first quarter of 2009. The emerging evidence of the downside risks to GDP growth prompted the CBSL to revise the forecast for 2009 to an 'optimistic' assessment of 4.5-5.0 per cent and a 'pessimistic' assessment of 2.5-3.5 per cent in April 2009.

Many countries across the world - both developed and developing - have responded with substantive fiscal stimulus packages to mitigate the downside effects of falling aggregate demand. Sri Lanka's weak public finances allow little leeway for a similar course of action if macroeconomic stability is not to be further weakened. In January 2009, the government was able to offer only a Rs. 16 billion 'stimulus' package - amounting to around 0.3 per cent of GDP, or a 2 percentage point increase in budgeted current spending for the year. Some of that is to be raised from cuts in other areas of spending which to a degree will dilute the expected stimulus to aggregate demand.

The reversal in the build-up of inflationary pressures from mid-2008 has allowed the government some breathing space to offer a monetary policy stimulus. These include efforts to inject liquidity into the market as well as effecting reductions to interest rates. However, the pass-through effects have been slow to trickle down to lenders and borrowers despite repeated calls from the CBSL to pass on interest rate reductions to clients. The ability of monetary authorities to sustain moves to lower interest rates will once again depend critically on developments on the fiscal front.

A positive feature of fiscal performance in 2008 was that the deficit was contained to 7.7 per cent of GDP. However, domestic borrowing to bridge the deficit increased sharply to 7 per cent in 2008 from the budgeted estimate of 3.7 per cent. A similar outcome for 2009 appears likely as Sri Lanka's ability to raise foreign financing to bridge the deficit - despite a budgeted estimate of 2.9 per cent of GDP - faces rising constraints in the current global economic environment. Indeed, the fiscal deficit had already crept up to 4 per cent of GDP in the first four months of 2009, relative to the 2.1 per cent achieved in the comparable period of 2008. The entirety of the deficit has been financed through domestic sources during January-April 2009.

The extent to which monetary authorities can accommodate domestic public borrowing without putting upward pressure on interest rates - or alternatively fuelling inflationary pressures - will depend on aggregate demand conditions in the economy, and by association, private sector appetite to undertake investment. If domestic consumption declines and/or demand for Sri Lanka's exports drop sharply, domestic borrowing to bridge the deficit can be accommodated without necessarily leading to macroeconomic instability. The danger, however, is that the fiscal deficit appears set to increase, as spending pressures mount and government revenues decline. In this context, achieving the revised fiscal deficit target of 7 per cent of GDP for 2009, set under the Letter of Intent with the IMF, will be difficult.

A decline in revenues in times of an economic downturn is to be expected. However, Sri Lanka's expenditure needs are mounting rapidly; rehabilitation and reconstruction needs related to the Northern and Eastern Provinces of the country cannot be ignored, job lay-offs and threats to livelihoods are on the increase, critical industries such as tea - which absorbs a bulk of the most vulnerable sections of the population - are in need of urgent assistance.

Unemployment is on the rise globally. Indeed, recent figures of job market losses spanning the globe suggest that the world economy is set to undergo one of the biggest increases in unemployment for decades. The full magnitude of jobless rates is yet to emerge given that the changes in unemployment come with a lag as output contracts. The channels through which the current global economic crisis is impacting on employment prospects are varied. One of the key channels is faltering demand that is exacerbated by tight credit conditions in most markets. Cash-strapped firms are thus compelled to cut costs, including job-layoffs through voluntary schemes and/or termination of employment.

Precise estimates of job losses in Sri Lanka are not available. Reliable data is difficult to obtain, for instance, owing to the greater share of employment in the informal sector. Nonetheless, reports of job losses are on the rise, with the rate of unemployment estimated to have increased marginally to 5.3 per cent in the first quarter of 2009 from a year end rate of 5.2 per cent in 2008. The government may be compelled to step in with assistance - providing some form of safety-nets, etc., that can in turn sustain demand. In the more medium term, however, the focus has to fall squarely on making Sri Lanka's labour market more flexible through appropriate regulatory reforms.

The current global economic environment also threatens the progress towards poverty alleviation efforts, particularly amongst some of the most vulnerable segments of the population. For developing countries such as Sri Lanka, the adverse impacts on particular channels with linkages to poverty reduction - remittances, foreign investment, trade, etc. - can have direct impacts on pushing people back into poverty. As an agricultural exporter, changes in world demand and prices affect the country's plantation sector. Such heavy export dependent sectors such tea - as well as garments in the industrial export sector - employ large numbers of the economically disadvantaged. Similarly, the majority of Sri Lanka's estimated stock of 1.8 million migrants comes from poor socio-economic backgrounds.

The expected declines in official development assistance (ODA) as developed economies go into recession will impact on aid to developing countries for key socio-economic sectors such as health. Domestic fiscal constraints - particularly as government revenues decrease - may compel budget cuts that impacts adversely on health and social programmes targeting the poor. Impacts on the nutrition and health of young children in poor families are of special concern in this context.

Access to credit for the poor in support of livelihoods may also be affected by the credit crisis. While some may consider microfinance, for instance, to be insulated from the current financial compulsions - in view of the relatively small sums of money involved - many microfinance institutions (MFIs) today are funded internationally, through aid budgets and private organizations. Moreover, there may be instances where microfinance loans actually finance consumption and where borrowers access more than one MFI to pay off loans of another. A credit squeeze can indeed impact adversely on loan repayments rates if such practices are common.

The global financial crisis has also brought the role of regulation in financial systems back to the centre stage. Indeed, the root cause of the financial crises is itself subject to some debate. There are those who advocate the 'global imbalances' argument - large current account surpluses/deficits run by countries like China and the US, respectively - and those that identify inadequate regulation as the more direct contributory factor. The former is argued to have infused liquidity into the US, allowing a credit-fuelled boom to work its way to asset prices such as real estate. However, it could well be argued that it was ultimately a highly deregulated environment that permitted new and riskier financial instruments to flourish, and which in the end unravelled the highly interconnected network of investment banks, mortgage entities, hedge funds, etc. Sri Lanka too has been grappling with mounting risks to the stability of the financial system. Current regulatory oversight of the CBSL provides loopholes for unregistered front companies that rake in deposits. The exposure of scams and the collapse of such front companies call for changes to the enforcement of prudential requirements and the regulatory regime.

The fall-out from the global economic crisis on all of the above mentioned issues are of direct policy relevance to Sri Lanka, and are examined in some detail in the rest of the report. Sri Lanka has to grapple with the problems of responding to not only the current economic downturn, but also the needs of a sustained post-conflict recovery programme. While the fall in oil prices has eased the build up of foreign exchange pressures, there are worrying signs that prices could creep up once more as the global economic contraction bottoms out. The immediate task is to restore macroeconomic stability, and thus provide a sound platform from which a reconstruction programme for the Northern and Eastern Provinces can be launched. However, such expenditure driven programmes hold the potential for destabilizing macroeconomic consequences as well, whether they are funded through government borrowing or donor assistance. They can induce inflationary pressures, impact on the exchange rate through a form of 'Dutch desease' effect, etc.

Thus, a coordinated and prudent approach to macroeconomic policy management in the coming months will be essential. Public institutions need to be strengthened by reducing corruption and wastage to ensure that the greater part of the reconstruction effort is mobilized through domestic resources. Sri Lanka has learnt first hand over the last few years that its traditional sources of donor assistance increasingly comes tied to conditions that go beyond the scope of economic assessments. The questionable attempts to delay the granting of the IMF facility, for instance, is a reminder that the country should resolve to manage its economy without falling into a financial trap of being forced to seek external assistance.

In the first instance, it requires that policymakers exercise prudent and appropriate policy responses to mitigate macroeconomic instability. In the second instance, Sri Lanka should now pay greater attention to the many reforms that are needed - restructuring of public sector/public enterprises to allow fiscal consolidation, labour market reforms to improve flexibility to respond to market needs, reforms to education policy to improve marketable skills, etc. - to sustain higher growth over the longer term. A reconstruction related economic boom can lift Sri Lanka's economic growth in the medium term. But, if it is not accompanied by efforts to improve overall efficiency in the economy - that retains the confidence of investors - the boom can be relatively short-lived, and leave behind macroeconomic instability in its wake. What is required is to ensure that a reconstruction related economic impetus is allowed to transform into a sustained long term growth path through an appropriate economic reform process.

2. Economic Performance

2.1 Introduction

In spite of some adverse domestic circumstances, the Sri Lankan economy was able to sustain a relatively healthy growth performance of 6 per cent in 2005. All major sectors recorded positive growth - with agriculture growing by 1.5 per cent, industry by 8.3 per cent, and services by 6.4 per cent. In agriculture, all crops, except coconut, posted a healthy output growth. In industry, aided by a benign international environment, performance remained robust, despite competitive pressures confronting the sector. The services sector continued to display the dynamism observed in recent years.

With the assistance primarily of lower dissaving by the government, both domestic savings and national savings recorded marginal improvements, pushing the investment rate up by 1.5 percentage points of GDP to 26.5 per cent. The available data also indicates a marginal drop in the unemployment rate, suggesting a slight easing of the unemployment problem. In the fiscal arena, a drop in the current account deficit, though marginal, is a step in the right direction in promoting much desired fiscal consolidation. A 1.5 percentage point of GDP rise in public investment is also an encouraging development, even though some part of the increase may have been on account of tsunami reconstruction. These apart, no significant improvements in fiscal performance are observed.

The public debt/GDP ratio recorded a marked decline of 11.6 percentage points of GDP, falling from 105.5 per cent in 2004 to 93.9 per cent in 2005, giving rise to an initial impression that the country's debt burden is easing. However, it needs to be viewed with some caution; the reduction in the debt/GDP ratio has been brought about by fortuitous circumstances, owing to an unwarranted appreciation of the rupee against major international currencies and a high rate of inflation which pushed up nominal GDP. On the other hand, the decrease in the debt/GDP ratio has not been associated with a fundamental and commensurate improvement in fiscal management. In fact, the fiscal deficit widened further in 2005 and the total government debt increased by 3.9 per cent.

Despite relief provided by an appreciating currency and a favourable domestic supply situation, inflationary pressures persisted throughout 2005. The financing requirements of tsunami rehabilitation and reconstruction and the associated foreign inflows no doubt added some complexity to monetary management during the year. Nevertheless, the response to rein in excess liquidity adequately to ease demand pressure was slow. Although monetary policy was tightened, it was too mild in coping with the excess liquidity problem. Consequently, no noticeable moderation in the rate of monetary expansion took place and the average annual inflation rate continued to remain high throughout the year.

Despite escalating fuel prices, Sri Lanka's external sector performance remained favourable in 2005 with the overall balance of payments (BOP) recording a surplus of US$ 501 million, thereby causing the foreign exchange reserves position to be strengthened. A strong performance in industrial exports, importation of fuel on deferred payment terms, a substantial increase in the inflow of worker remittances, and the international support to cope with the setbacks associated with the tsunami were the main contributory factors for the improvement in the BOP position.

The chapter is organized as follows: Section 2.2 looks at the country's output growth; Section 2.3 traces the trends in employment; Section 2.4 examines performance in investment and savings; Section 2.5 examines government finances and public debt; Section 2.6 looks at price, monetary and capital market developments; Section 2.7 is devoted to an examination of the external sector performance; Section 2.7 looks in brief at a comparison of Sri Lanka's economic performance with that of comparable neighbouring economies; and Section 2.8 concludes.

2.2 Output Growth

Despite the setbacks caused by the tsunami that adversely affected the fisheries and tourism sectors, a sharp escalation of oil prices, political uncertainties connected with the Presidential elections, and competitive pressures arising from the abolition of the Multi-Fibre Arrangement (MFA), Sri Lanka's economy has been able to post a satisfactory GDP growth rate of 6 per cent in 2005. The industrial sector spearheaded this robust performance posting a growth of 8.3 per cent, followed by the services sector recording a growth rate of 6.4 per cent. These compared with growth rates of 5.2 per cent and 7.6 per cent, respectively, in the previous year. Thus, between these two years, the growth performance of these two important sectors has been virtually reversed. The slowing down of growth in the services sector has been largely attributed to lower growth in wholesale and retail trade, and hotels and restaurants. The overall agricultural sector, which includes forestry and fishing, which recorded a negative growth of 0.7 per cent in the previous year, has recovered - due in large part to favourable weather conditions - to post a positive growth rate of 1.5 per cent in 2005. With satisfactory economic growth and aided by an appreciation of the Sri Lankan rupee against the US dollar (2.4 per cent) and a moderation in the rate of population growth (1.1 per cent), Sri Lanka's per capita GDP reached US$ 1,197 in 2005. The 6 per cent growth achieved in 2005 has also enabled the growth momentum in the economy observed in the recent past to be sustained. Accordingly, the economy's average rate of growth over the 3-year period 2003-2005 stood at 5.8 per cent.

In the industrial sector, which was the most dynamic sector, all sub-sectors - manufacturing, electricity, gas and water, and construction - have recorded a relative good performance in 2005. Within the industrial sector, the performance of the manufacturing sector, which posted a growth rate of 6.0 per cent, is most noteworthy considering the competitive challenges that it faced due to the termination of the MFA. The main impetus to this growth came from factory industries, which grew by 6.2 per cent, accounting for over 80 per cent of manufacturing output. The mining and mineral sector also recorded satisfactory growth during the year. In the services sectors, the main contributors were transport, storage, communication, and financial services. The tourism sector (hotels and restaurants) recorded a substantial negative growth (29 per cent), causing the trade, hotels and restaurants sub-sector to post only a moderate growth of 2.8 per cent and dampening the performance of the overall services sector.

With all the agricultural crops, except coconut, showing buoyant output growth, the agricultural sector posted an admirable 8.0 per cent growth in 2005 in contrast to a 0.9 per cent negative growth in 2004. However, a 42.2 per cent drop in fish output caused

Table 2.1
Growth Indicators, 2003-2005

Items	Growth Rate				Average Growth Rate %	Contri-bution %	Share of GDP %
	2003	2004	2005	2006q1	2003-2005	2003-2005	2003-2005
Agriculture, forestry and fishing sector	1.6	-0.3	1.5	7.3	0.9	2.9	18.0
Agriculture	3.2	-0.9	8.8	1.2	3.7	8.6	14.3
Fishing	-6.9	1.6	-42.2	249.5	-15.8	-6.2	2.0
Industrial sector	5.5	5.2	8.3	5.9	6.3	28.7	26.6
Manufacturing	4.2	5.1	6.0	4.7	5.1	14.4	16.3
Electricity, gas and water	21.6	-2.5	23.3	15.3	14.1	3.3	1.6
Construction	5.5	6.6	8.9	6.8	7.0	8.3	7.0
Services sector	7.9	7.6	6.4	9.5	7.3	68.5	55.3
Trade, hotels and restaurants	7.8	6.1	2.6	7.8	5.5	20.9	22.0
Transport, storage & communication	10.6	13.7	12.7	15.3	12.3	29.1	14.5
Financial services	10.6	6.6	7.5	9.5	8.2	12.8	9.3
GDP	6.0	5.4	6.0	8.1	5.8	100.0	100.0
Growth of mid-year population	1.3	1.1	1.1	-	1.2	-	-
Per capita GDP at current market prices (US$)	948	1,030	1,197	-	-	-	-

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

the overall agricultural sector's growth to be moderated to 1.5 per cent. The fishing sector's contribution to GDP growth in 2005 has been negative to the tune of 16.3 per cent. Between 2004 and 2005, the sector's share in GDP has declined by one full percentage point, from 2.3 per cent to 1.3 per cent.

The pattern of economic growth observed in the recent past seems to underscore some basic realities facing Sri Lanka in its quest for speedy economic advancement. First, the most dynamic sector in the economy has emerged to be the services sector, which has posted an average growth rate of 7.4 per cent over the 3-year period 2003-2005. The sector's contribution to GDP growth during this period had been 68.5 per cent and its share in GDP constituted 55.3 per cent. Among the services that have shown dynamism are export trade, hotels and restaurants (barring 2005), cargo handling, storage and warehousing, and financial services. It is very unlikely that the beneficial effects of the prosperity in these service sectors would have been widely disbursed among the populace, with implications for the country's income distribution. In fact, evidence of widening income distribution is borne out by the findings of the recent Consumer Finances and Socio Economic Surveys of the Central Bank of Sri Lanka, the Gini coefficient rising from 0.48 in 1996/97 to 0.50 in 2003/04. So, it would appear that Sri Lanka in its quest for a faster rate of economic growth has to face the unpalatable reality of having to tolerate a more skewed income distribution in favour of higher income classes in the short-to-medium term. Any attempt to deviate from this growth path would result in having to compromise on growth itself, as resources will have to be diverted from more productive to less productive sectors.

Second, the next most dynamic sector having posted an average growth rate of 6.3 per cent over the 3-year period 2003-2005 has been the industrial sector. Its average contribution to GDP growth during this period has been 28.7 per cent and its share in overall GDP has averaged 26.6 per cent. All sub-sectors in the industrial sector - manufacturing, electricity, gas and water, and construction - have contributed to this favourable outcome. The performance of the manufacturing sub-sector is particularly commendable, considering the competitive pressures that it faces from the global trading environment. The sector's average growth over the 3-year period 2003-2005 has been 5.1 per cent, while its contribution to GDP growth and its share in total GDP have averaged 14.4 per cent and 16.3 per cent, respectively. These facts demonstrate the vital necessity for sustaining the level of activity in this sector, for which purpose not only a substantial injection of funds would be required to maintain basic infrastructure facilities, but the pursuit of a conducive policy stance that would sustain private sector initiative would be equally important.

Third, the least dynamic sector in the economy had been the agricultural sector (excluding forestry and fishing), which has posted an average growth of only 3.7 per cent over the 3-year period 2003-2005, most of it coming from a resurgence in performance in 2005. The sector's contribution to GDP growth during this period had been a low of 8.6 per cent and its share in overall GDP has declined to just over 17 per cent, whilst employing around 30 per cent of the workforce. This performance should be viewed in the context of numerous producer and output subsidies, and institutional support made available to the sector, and seems to indicate the limited role that the sector is likely to play in taking the economy to a higher growth path in the coming years. It also underscores the need for a complete overhauling of the sector for it to function in an economically viable manner.

It is well recognized that Sri Lanka needs to graduate itself to a high growth path of 8-10 per cent on a sustainable basis in order to come to terms with its social and economic challenges such as widespread poverty and high unemployment. The question that surfaces is whether an economic strategy centred on agriculture and rural development giving emphasis to equity and social justice will facilitate a speedy movement to such a growth path and generate adequate domestic savings to sustain the process. To put it differently, should Sri Lanka go for a growth strategy based on market economics choosing the problem of poverty and income distribution to be tackled through well targeted social programmes or should it interfere with the growth process itself to induce better income distribution and reduce poverty? This indeed appears to be a dilemma faced by Sri Lanka at the current juncture in its quest for a speedy breakthrough in development with equity and social justice.

Table 2.2
Selected Indicators of Production in Agriculture and Industry, 2000-2005

Sector/Sub-sector	2000	2001	2002	2003	2004	2005
Tea (mn kg)	306	295	310	303.2	309.5	317.2
Rubber (mn kg)	88	86	91	92.0	94.7	104.4
Coconut (mn nuts)	3,096	2,769	2,392	2,562	2,591	2,515
Paddy (metric tons)	2,860	2,695	2,860	3,071	2,628	3,246
Value of industrial production[a]	213.0	204.6	210.5	220.0	233.4	248.0

Note: a. Rupees billion at 1990 constant prices.

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

2.3 Trends in Employment

No consistent data are available to trace the developments in the changes in the labour force, employment and unemployment. The reason for this is that the geographical coverage of the Labour Force Surveys conducted by the Department of Census and Statistics (DCS) has undergone much change over the recent years. Furthermore, the DCS has changed over from quarterly surveys to a one-off survey in 2005. The available data show that the rate of growth of the labour force has declined from 2.8 per cent in 2004 to 1 per cent in 2005. The rate of growth of employment too has decreased from 2.5 per cent in 2004 to 1.7 per cent in 2005. The rate of growth of employment in the agricultural sector has been negative to the extent of 6.8 per cent in 2005, as compared with a growth of 7.5 per cent in the previous year, even though the sector performed well during the year. On the other hand, the growth of employment in the industrial and services sectors has recorded marked increases of 9.1 per cent and 4.3 per cent, respectively. The unemployment rate has declined from 8.3 per cent of the labour force in 2004 to 7.7 per cent, suggesting an easing of the unemployment problem.

2.4 Investment and Savings

2005 witnessed marginal improvements in investment, domestic savings and national savings. The investment ratio or the rate of Gross Domestic Fixed Capital Formation (GDFCF) has risen by 1.5 percentage points to 26.5 per cent. However, this ratio is still lower than the ratio of 28.0 per cent achieved in the year 2000 and the average ratio reached during the latter half of the 1990s. Furthermore, it is still a far cry from the desired investment ratios of 35 to 40 per cent necessary to push the economy to a high growth path of 8-10 per cent. The increase in investment in 2005 has come wholly from the government, which recorded a full 2-percentage point growth in investment to 4.2 per cent of GDP. This is indeed a very welcome development following three years (2002 - 2004) of a very mundane investment effort on the part of the government, although some part of the increase should be attributed to tsunami reconstruction. In contrast to the investment effort on the part of the government, investment by the private sector (inclusive of public corporations) has suffered a setback, falling from 22.7 per cent of GDP in 2004 to 22.3 per cent in 2005. This indicates that the momentum of private sector investment activity has barely been main-

Table 2.3
Trends in the Labour Force, Employment and Unemployment, 2003-2005[a]

	Persons (Thousands)			Growth Rate		Percentage Share		
	2003	2004	2005	2004	2005	2003	2004	2005
Labour Force	7,654	8,061	8,141	5.3	1.0	100	100	100
Employment by main sector	7,013	7,394	7,518	5.4	1.7	91.6	91.7	92.3
Agriculture	2,384	2,475	2,306	3.8	-6.8	31.1	30.7	28.3
Industry	1,529	1,689	1,843	10.5	9.1	20.0	21.0	22.6
Services	3,099	3,230	3,369	4.2	4.3	40.5	40.1	41.4
Unemployment	641	667	623	4.0	-6.6	8.4	8.3	7.6

Note: a. The annual data in this table are not strictly comparable. Up to 2002Q4, QLFS coverage excluded both the Northern and Eastern Provinces. Commencing 2003Q1, the Eastern Province has been included. From 2004Q1, QLFS coverage included both the Northern and Eastern Provinces excluding Vavuniya, Kilinochchi and Mullativu. In 2005, QLFS was conducted on a one off basis in August 2005.

Source: Estimated from DCS data.

Table 2.4
Selected Indicators of Investment and Savings, 2000-2005

	2000	2001	2002	2003	2004	2005
As % GDP						
GDFCF[a]	28.0	22.0	21.2	22.1	25.0	26.5
Private investment	21.5	16.2	16.5	16.8	19.8	19.6
Public corporations	3.3	2.8	2.6	3.0	2.9	2.7
Government	3.3	3.0	2.0	2.3	2.2	4.2
FDI	1.0	0.5	1.1	0.9	1.1	1.0
Domestic savings	17.4	15.8	14.4	15.9	15.9	17.2
National savings	21.5	20.3	19.5	21.6	21.6	23.3
Inflation rate (%)[b]	6.2	14.2	9.6	6.3	7.6	11.6
Average deposit interest rate (%)[c]	9.9	10.8	7.5	5.3	5.3	6.2

Notes: a. Gross Domestic Fixed Capital Formation.
b. Annual Average Change in the Colombo Consumers' Price Index.
c. Average Weighted Deposit Rate of Commercial Banks (AWDR).

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

tained in 2005, probably reflecting the political uncertainties connected with the Presidential elections that prevailed during the year, as well as the lack of a clear cut policy stance that favoured private sector economic activity. Foreign Direct Investment (FDI) has once again played a very marginal role in supporting domestic investment, accounting for only one percentage point of the GDFCF.

There was a slight improvement in the performance of both domestic savings and national savings in 2005. The domestic savings ratio increased by 1.3 percentage points to 17.2 per cent of GDP, while the national savings ratio rose by 1.7 percentage points to 23.3 per cent. The ability of the economy to sustain the savings momentum is encouraging, particularly in the context of negative real rates of return on financial assets for much of the year. Perhaps the potential for higher domestic savings should improve as the country's per capita income increases and its distribution gets skewed more in favour of high-income classes. The higher domestic savings effort, though modest, can be considered a very welcome development in a country striving to achieve a higher rate of investment in the face of not very encouraging prospects for attracting foreign investment. A reduction in the current account deficit (i.e., dis-saving by the government) from 3.9 per cent of GDP to 2.7 per cent no doubt contributed very considerably toward the more favourable domestic savings outcome. It also underscores the vital role that the government can play in sustaining the domestic savings effort through a more restrained fiscal policy in pushing the economy to a more durable growth path. Such a fiscal policy can also help sustain the private savings effort as well by promoting positive real rates of return on financial assets.

2.5 Government Finances and Public Debt

2.5.1 Government Finances

In the midst of severe pressures for additional expenditure commitments, the fiscal outturn in 2005 has shown some improvements, though marginal. Government revenue as a ratio of GDP rose by 0.7 percentage points to 16.1 per cent, while current expenditure has declined by 0.5 percentage points to 18.7 per cent of GDP. The net outcome of these two favourable developments has been a 1.2 percentage point reduction in the current account deficit, requiring a lesser amount of resources be borrowed in fiscal 2005 for meeting current commitments such as the payment of salaries and pensions, and interest on the public debt. The decline in the current account deficit needs to be viewed in a background when it remained stubbornly high at an average of 4.1 per cent of GDP over the 4-year period 2001-2004, underscoring relentless pressures for additional expenditure commitments on the government. In this context, the reduction in the current account deficit in 2005 should be considered a welcome development, although some part of it is attributed to a saving on interest payments under the tsunami debt moratorium programme. The debt moratorium granted by foreign donors resulted in the deferment of debt service payments of US$ 260 million in 2005. This will need to be paid within four years commencing from December 2006, after the grace period of one year.

Although the current account deficit has recorded a noticeable improvement, the same cannot be said of the overall fiscal deficit, which has risen from 8.2 per cent of GDP in 2004 to 8.7 per cent in 2005 - a rise of 0.5 percentage points. The rise in the overall fiscal deficit - over shooting the targeted deficit of 8.2 per cent - has been wholly due to an increase in capital expenditure, from 4.3 per cent of GDP in 2004 to 6.0 per cent in 2005 - a rise of 1.7 percentage points. Alongside a further increase in the overall fiscal deficit, a noticeable change in financing the deficit is also observed as between domestic financing and foreign financing. While the share of domestic borrowing for budgetary purposes has declined to 5.2 per cent of GDP in 2005, from 5.8 per cent in 2004, the share of foreign financing has risen by 1.2 percentage points of GDP to 3.4 per cent. The change in the composition of financing in favour of foreign financing has been made possible due to an increased flow of foreign grants in connection with tsunami rehabilitation and reconstruction. In fact, such grant assistance has risen by 1 full percentage point of GDP to 1.4 per cent, as compared with 0.4 per cent in approved estimates and in the previous year. On the other hand, the utilization of foreign loans for financing the deficit amounted to 2.0 per cent of GDP as compared with 1.8 per cent in the previous year. Thus, leaving out increased availability of foreign financing and debt service relief on account of the tsunami, no significant difference is observed in the fiscal outturn between 2004 and 2005.

Meanwhile, the budgetary estimates for 2006 depict some significant improvements in fiscal management. The revenue/GDP ratio is to rise by 1.7 percentage points of GDP to 17.8 per cent, while the current expenditure/ GDP ratio is to remain unchanged at 18.7 per cent. The resultant current account outturn is a sharp reduction in the deficit, from 2.7 per cent of GDP in 2005 to 0.9 per cent in 2006. This would mean that there would be very little borrowing in 2006 for meeting current commitments. However, total expenditure is to rise by 2.2 percentage points of GDP to 26.9 per cent, owing to a 2.2 percentage point rise of GDP in capital expenditure. While the enhanced allocation of resources for capital expenditure is a welcome development, the resulting increase in the overall fiscal deficit to an estimated 9.1 per cent of GDP is a worrying factor considering the extreme demands for fiscal consolidation in order to create adequate fiscal space for a progressive reduction in the public debt burden and to divert resources for much needed infrastructure development. Once again, there is a further change in the method of financing in favour of foreign financing, with a little over 50 per cent of the deficit (4.6 per cent of GDP) being covered by foreign financing. Although the budgetary estimates anticipate a reduction in the public debt/GDP ratio to 89.5 per cent, it is doubtful whether this would be realizable unless through a further appreciation of the exchange rate and continuing high inflationary pressures.

Table 2.5
Selected Indicators of Public Finance, 2002-2006

	2001	2002	2003	2004	2005	2006[a]
As % GDP						
Revenue	16.7	16.5	15.7	15.4	16.1	17.8
Current expenditure	21.6	20.9	19.0	19.2	18.7	18.7
Capital expenditure	5.9	4.6	4.7	4.3	6.0	8.2
Total expenditure	27.5	25.4	23.7	23.5	24.7	26.9
Current a/c balance	-4.9	-4.4	-3.3	-3.9	-2.7	-0.9
Overall balance	-10.8	-8.9	-8.0	-8.2	-8.7	-9.1
Domestic borrowing	8.8	8.0	4.5	5.8	5.2	4.5
Foreign financing:						
Grants	0.4	0.4	0.5	0.4	1.4	1.6
Loans	1.0	0.1	2.4	1.8	2.0	3.0
Total public debt	103.2	105.4	105.8	105.5	93.9	89.5

Notes: a. Budget 2006 estimates.

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

2.5.2 Public Debt and Service Payments

The net outcome of an accumulation of budget deficits over the years has been a progressive growth in the public debt accounting for 105.4 per cent of the year's GDP at end 2004. In fact, the debt/GDP ratio has remained at this level since 2002, causing serious concerns about the country's fiscal management. A further expansion of total government debt by 3.9 per cent was witnessed in 2005. Nonetheless, in an apparent significant improvement in the fiscal outlook, the debt/GDP ratio has declined to 93.9 per cent in 2005. However, a closer examination of the data seems to suggest that this has been somewhat of a spurious development not supported by a fundamental improvement in fiscal management, and thus needs to be viewed with caution. With the overall deficit rising further to 8.7 per cent of GDP in 2005, there has been little or no contribution from the fiscal management side towards a reduction in the debt/GDP ratio. To put it differently, there has been little macroeconomic strengthening from the fiscal side to facilitate a reduction in the debt/GDP ratio. Rather the decline in the debt weight has been the outcome of two extraneous developments. First, nominal GDP rose by 16.6 per cent, as against a real GDP growth of 6.0 per cent, because of the high level of inflation prevailing throughout the year. The GDP deflator in 2005 was 9.9 per cent. Second, the Sri Lankan rupee has appreciated considerably against international currencies during the year, thus artificially depressing the level of foreign debt in domestic currency. The rupee appreciated against the SDR, which is a composite currency unit, by 11.3 per cent. While it is somewhat puzzling that the rupee appreciated at a time when the rate of domestic inflation remained considerably higher than world inflation, a partial explanation is the significantly higher inflow of tsunami related foreign capital. These capital inflows unlike FDI or portfolio investment inflows are unrelated to the underlying macroeconomic fundamentals of the country. Once these unusual developments get corrected, the reduction in the debt/GDP ratio is likely to get reversed, once again requiring a fundamental improvement in fiscal management in order to cope with it.

The progressively rising public debt meant an inordinate increase in commitments to service it, thus complicating the country's fiscal management. In 2005, total debt service payments amounted to Rs.344.9 billion, absorbing 90.8 per cent of government revenue and accounting for 14.6 per cent of

Table 2.6
Public Debt Indicators, 2002-2005

	2002	2003	2004	2005
Domestic debt (Rs. bn.)	948.4	1,020.0	1,143.4	1,265.7
Foreign debt (Rs. bn.)	722.0	843.9	996.1	956.6
Total debt (Rs. bn.)	1,670.3	1,863.8	2,139.5	2,222.3
Amortization payments (Rs. bn.)	167.8	219.5	180.8	224.7
Interest payments (Rs. bn.)	116.5	125.1	119.8	120.2
Total debt service (Rs. bn.)	284.4	344.6	300.6	344.9
Debt/GDP (%)	105.4	105.8	105.5	93.9
Debt service/govt. revenue (%)	108.6	124.6	96.5	90.8
Debt service/GDP (%)	17.9	19.6	14.8	14.6

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

GDP. The debt service payments in 2005 would have appeared in a much worse light if not for a saving of Rs.26.3 billion under the moratorium on service payments extended to Sri Lanka in 2005 as a tsunami relief measure. So, the burden of public debt continues to be a major macroeconomic concern, underscoring the need for concerted efforts at fiscal consolidation for promoting medium-term fiscal sustainability.

2.6 Price, Monetary and Capital Market Developments

2.6.1 Price Developments

The economy witnessed continued price pressure in 2005 constituting one of the most adverse macroeconomic developments during the year. At the end of 2005, the inflation rate as reflected in the annual average change of the Colombo Consumers' Price Index, which is the official measure of inflation in Sri Lanka, stood at 11.6 per cent. The major part of the increase has been reflected in food prices. The comparative rate at the end of 2004 was 7.6 per cent. The annual change in the index rose progressively to a peak of 12.8 per cent in August 2005 before progressively declining to 11.6 per cent by December 2005 indicating a slight softening of price pressure. A somewhat similar picture is observed in the changes in the Sri Lanka Consumers' Price Index (SLCPI) and in the GDP deflator. Factors such as higher costs of production, increased fuel prices, adverse impact of the tsunami, public sector wage increases, high rate of monetary expansion, and higher international prices for some imported food items have been cited as factors contributing to high price pressure prevailing during the year. On the other hand, the appreciation of the Sri Lankan rupee against all international currencies and a mild tightening of monetary policy, together with a less than full pass through of high fuel prices to domestic consumers, are considered to have exerted a moderating influence on prices.

Table 2.7
Price Developments, 2004 - 2005

Index	Average Index		Point to Point % Change		Annual Average % Change	
	2004	2005	2004	2005	2004	2005
CCPI[a]	3,632.8	4,055.5	13.8	8.0	7.6	11.6
SLCPI[b]	170.9	189.1	16.8	3.6	7.9	10.6
WPI[c]	1,889.0	2,105.9	23.9	1.7	12.5	11.5
GDP deflator	183.6	201.8	-	-	9.3	9.9

Notes: a. Colombo Consumers' Price Index.
b. Sri Lanka Consumers' Price Index.
c. Wholesale Price Index.

Source: Central Bank of Sri Lanka, *Annual Report* 2005.

2.6.2 Monetary Developments

There were some mixed developments on the monetary front in 2005. The rate of expansion of reserve money was moderated during the year, the annual increase declining to 15.8 per cent, from 20.9 per cent in 2004. The deceleration has been mainly due to a very sharp reduction in the net domestic assets of the Central Bank by 94.8 per cent, as against a very sharp increase of 183.3 per cent in the previous year. The growth of reserve money in 2005 has been brought about entirely by an increase in the net foreign assets of the Central Bank by 29.8 per cent. This is in contrast to a decline of 7.8 per cent in such assets in 2004. In the case of domestic assets, a decline in the Central Bank's holdings of Treasury bills by Rs.38 billion is noteworthy from the viewpoint of macroeconomic management. However, an adverse development has been the sharp increase of Rs.60 billion in commercial bank credit to the government, of which Rs.43 billion constituted foreign currency loans. It would appear that the government has resorted to increased foreign currency borrowing for budgetary purposes from domestic banks in order to ease pressure on interest rates, despite the risks that such borrowings carry owing to excessive foreign exposure.

The rate of expansion of narrow money supply accelerated to 22.4 per cent in 2005 from 16.6 per cent in the previous year, while the rate of expansion of broad money remained virtually unchanged at 19.1 per cent - the corresponding increase in 2004 being 19.6 per cent. As was reflected in reserve money growth, an increase in net foreign assets of the banking system has been the major contributory factor for maintaining the momentum of monetary pressure in 2005. The increase in these assets in 2005 was 20.3 per cent, as compared with 1.9 per cent in 2004 and has been mainly attributed to tsunami related inflows and higher private remittances. In comparison, the contribution from domestic assets has decelerated, the rate of increase in such assets declining from 25.0 per cent in 2004 to 18.7 per cent in 2005. This has been brought about by a very considerable moderation in the growth of net bank credit to the government, the rate of increase declining from 25.1 per cent in 2004 to 11.9 per cent in 2005. The slowing down in the use of net bank credit by the government has been wholly due to a sharp decline in such credit from the Central Bank.

A noteworthy feature in the credit scene in 2005 had been a sharp reduction of Rs.24.5 billion or 59.5 per cent in bank credit to public corporations. This has been facilitated mainly by a long-term credit facility made available to the Ceylon Petroleum Corporation (CPC) to purchase oil from

Table 2.8
Monetary and Credit Developments, 2002-2005

Item	Annual Percentage Change			
	2002	2003	2004	2005
1. Reserve money	12.3	11.9	20.9	15.8
i. Net foreign assets	39.2	40.2	-7.8	29.8
ii. Net domestic assets	n.a.	-356.7	183.3	-94.8
2. Narrow money supply (M1)	14.0	15.9	16.6	22.4
3. Broad money supply (M2)	13.2	13.8	19.6	19.1
i. Net foreign assets	49.3	50.9	1.9	20.3
ii. Net domestic assets	7.8	7.6	25.0	18.7
iii. Net credit to government	-4.1	-8.7	25.1	11.9
iv. Credit to private sector	12.0	16.9	22.1	21.5
v. Credit to public corps.	5.4	-15.8	13.8	-59.5

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

Table 2.9
Interest Rate Movements,[a] 2002-2006

	2002	2003	2004	2005	2006[b]
91 day treasury bill rate	9.92	7.35	7.25	10.10	10.16
Overnight Repo rate	9.75	7.00	7.50	8.75	9.00
Overnight reverse Repo rate	11.75	8.50	9.00	10.25	10.50
Average weighted deposit rate (AWRD)	7.47	5.27	5.31	6.24	6.61
Average weighted prime lending rate (AWPLR)	12.24	9.26	10.23	12.24	12.63
Overnight SLIBOR	10.67	7.73	9.66	10.93	11.10

Notes: a. End-of-period rates.
b. Week ending June 2006.

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

India. In comparison, the utilization of bank credit by the private sector has remained high, the rate of increase dropping only marginally to 21.5 per cent in 2005, from 22.1 per cent in 2004, accounting for 84 per cent of the overall growth in broad money. It would appear that monetary policy action during the year has not been sufficiently effective in moderating the private sector credit growth to cope with continuing inflationary pressures in the economy.

Meanwhile, a general but moderate upward movement in interest rates was observed in 2005, which has been more marked at the short end of the market. The 3-months Treasury bill rate has risen from 7.25 per cent at the end of 2004 to 10.10 per cent at the end of 2005. Similar increases, though somewhat of a lower magnitude, are observed in the Repo rate and the Reverse Repo rate, both rates rising by 125 basis points to 8.75 per cent and 10.25 per cent, respectively. The rise in the Average Weighted Deposit Rate has been of a much lower order at 93 basis points, while the Average Prime Lending Rate has risen by 2.01 basis points to 12.24 per cent. A most worrisome feature in the interest rate scenario has been the fact that most of the short-term interest rates have either remained below or very close to the inflation rate with implications on real rates of return in financial investments, a factor which does not augur well in maintaining the savings momentum in the economy.

Against the backdrop of continuing high inflationary pressures in the economy, the Central Bank had little room to pursue an accommodative monetary policy in 2005, despite the challenges coming from escalating oil prices, the phasing out of the MFA, and the financing requirements connected with tsunami related rehabilitation and reconstruction activities. Accordingly, the Bank raised its policy interest rate (Repo rate) by an aggregate of 125 basis points in four stages (25 basis points in May, 50 in June, 25 in September and 25 in December) in order to make the credit market tighter. At the same time, open market operations (OMO) were resumed after a temporary abandonment in the early part of the year following the tsunami to mop up excess liquidity in the economy. In response, market interest rates gradually increased. However, no noticeable deceleration in the growth of money and private sector credit was observed in 2005. Suggesting a somewhat cautious approach to monetary and inflation control, the Central Bank maintained two other key rates of monetary policy - the Statutory Reserve Ratio (SRR) and the Bank Rate - unchanged at 10 per cent and 15 per cent per annum during the year. The net outcome was limited success in restraining inflation during the year.

2.6.3 Capital Market Developments

Despite continuing political and economic uncertainties and the unresolved ethnic cri-

Table 2.10
Share Market Performance, 2002-2006

Items	End Year Values				
	2002	2003	2004	2005	2006[a]
1. All share price index	815.1	1,062.1	1,506.9	1,922.2	2114.4
Year-on-year change (%)	31.2	30.3	41.9	27.6	
2. Milanka price index	1,374.6	1,897.8	2,073.7	2,451.1	2729.0
Year-on-year change (%)	33.3	38.1	9.3	18.2	
3. Market capitalization (Rs. bn.)	163	263	382	584	645.3
As % of GDP	10.3	14.9	18.8	24.7	
4. Value of shares traded (Rs. mn.)	30,183	73,837	59,052	114,599	
5. Number of shares traded (mn.)	1,220	2,255	2,752	5,218	
6. Number of companies listed	238	244	242	239	
7. Number of initial public offers/offers for sale	5	4	2	3	

Note: a. As of end June 2006.

Source: Colombo Stock Exchange and Central Bank of Sri Lanka, *Monthly Economic Indicators* (June 2006).

sis, the Colombo share market has displayed strong bullish sentiments in 2005. This is partly due to the fact that unlike in the late 1990s when foreign investors dominated share market activity, it is increasingly being driven by domestic investors who have factored in the uncertain economic conditions in Sri Lanka. The All Share Price Index (ASPI) increased by 27.6 per cent while the Milanka Price Index (MPI) rose by 18.2 per cent. The corresponding increases in the previous year were 41.9 per cent and 9.3 per cent. Market capitalization rose to Rs.564 billion in 2005 accounting for 24.7 per cent of the year's GDP, compared to a market capitalization of Rs.382 billion or 18.8 per cent of GDP in 2004. The trading value has very nearly doubled to Rs.114.6 billion, from Rs.59.1 billion in 2004. The number of shares traded rose by 88.9 per cent to 5,218 million showing intensified trading activity. Two questionable developments however are the reduction in the number of listed companies by 3 to 239 and a meagre three Initial Public Offerings (IPOs) during the year. These probably reflect the uncertain economic climate as perceived by the private sector.

2.7 The External Sector

Despite a sharp escalation in oil prices making heavy demands on the import bill, Sri Lanka's BOP remained resilient in 2005 owing to a substantial increase in worker remittances and foreign inflows and debt relief received in connection with tsunami reconstruction and rehabilitation, pushing the overall BOP into surplus and strengthening the country's foreign exchange reserves position. The resultant significant real appreciation of the Sri Lankan rupee had implications for the external competitiveness of the country's exports.

2.7.1 Trade and Current Accounts

In 2005, both exports and imports recorded somewhat similar increases - exports by 10.2 per cent and imports by 10.8 per cent. However, because of the higher base of imports, the trade deficit widened by US$ 274 million to US$ 2,516 million, the highest ever on record. This was an increase of 12.2 per cent over the previous year's deficit. The larger share of the export growth has been reflected in industrial exports accounting for 75 per cent. On the import side, a 36.9 per cent increase in the outlay on petroleum imports accounted for 51.6 per cent of import growth. Meanwhile, the net services receipts declined by 19.3 per cent to US$ 338 million and were not able to provide much relief to soften the adverse impact of the widened trade deficit. A major factor contributing to the poor performance of the services account was a 20.3 per cent drop in gross earnings from tourism to US$ 329 million during the year.

Table 2.11
Balance of Payments: Selected Flows, 2003-2006

Item	2003		2004		2005		US$ Million[a]	
	US$ Million	% Change	US$ Million	% Change	US$ Million	% Change	2005	2006
Exports	5,133	9.2	5,757	12.2	6,347	10.2	2392	2530
Imports	6,672	9.3	8,000	19.9	8,863	10.8	3303	4016
Trade balance	-1,539	-9.4	-2,243	-45.7	-2,516	-12.2	-911	-1486
Service receipts (net)	399	35.2	419	5.0	338	-19.3		
Private transfers (gross)	1,414	9.9	1,564	10.6	1,968	25.8		
As % of trade deficit	91.9		69.7		78.2			
Current a/c balance	-71	69.9	-648	-812.7	-650	-0.3		
Capital & financial account	722	62.6	631	-12.6	1,224	94.0		
FDI (net)	171	-5.5	217	26.9	234	7.8		
Overall balance	502	48.5	-205	-140.8	501	344.4		
As % of GDP								
Trade deficit	8.4		11.2		10.7			
Current a/c deficit	0.4		3.2		2.8			
FDI	0.9		1.1		1.0			

Note: a. Based on first five months data.

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

However, tourist arrivals declined by only 3 per cent suggesting that tsunami related aid workers accounted for a significant number of the so called 'tourist' arrivals and that the sector is yet to fully recover from the aftermath of the tsunami devastation and attract genuine travellers. On the other hand, current transfers turned out to be a major source of financing the widened trade deficit, with net inflows rising by 28.6 per cent to US$ 1,736 million. In fact, private transfers have become the most dynamic item of BOP support in recent years in offsetting the adverse impact of expanding trade deficits. In 2005, total private remittances (gross), inclusive of US$ 50 million in tsunami related inflows, amounted to US$ 1,968 million registering a 25.8 per cent growth. This was sufficient to finance 78.2 per cent of the 2005 trade deficit. Meanwhile, official transfers increased rather sharply from US$ 30 million in 2004 to US$ 90 million in 2005, mostly for the provision of relief to tsunami affected areas. After adjusting for receipts on account of services, income and transfers, Sri Lanka's BOP recorded a current account deficit of US$ 650 million in 2005, virtually the same level of deficit recorded in 2004. However, as a percentage of GDP, the deficit dropped to 2.8 per cent, from 3.2 per cent in 2004.

2.7.2 Capital and Financial Account

There was no significant increase in FDI in 2005 to finance the current account deficit, the (net) inflow amounting to only US$ 234 million or 1 per cent of GDP. Net portfolio inflows, though indicating a sharp increase from the previous year's level, amounted to only US$ 60 million. Accordingly, alternative sources of funding had to be utilized for financing the deficit. The net long-term inflows to the government (inclusive of moratorium facilities on debt repayments from Paris Club members and some multilateral institutions) amounting to US$ 553 million, an increase in short-term liabilities totalling US$ 176 million and a surplus of US$ 250 million in capital transfers (mostly representing tsunami related donor assistance), enabled the capital and financial account to register a surplus of US$ 1,224 million, thus more than offsetting the current account deficit. The BOP recorded an overall surplus of US$ 501 million in 2005, enabling the country's foreign exchange reserves position to be enhanced. Sri Lanka's total official reserves in-

Box 2.1
Migrant Remittances

Over the past fifteen years, international migrant remittances have become increasingly prominent - exceeding US$ 232 billion in 2005, with US$ 167 billion flowing to developing countries. This amount, however, reflects only transfers recorded in the BOP. Unrecorded flows through informal channels are believed to be at least 50 per cent higher than recorded flows. In 2004, recorded remittances were the second largest source of external financing in developing countries, after FDI, and amounted to more than twice the size of official aid. Remittances are less volatile than most other sources of foreign exchange earning for developing countries.

While capital flows tend to rise during upswings of economic cycles and decline in bad times, remittances tend to be countercyclical relative to recipient countries' economies. They tend to rise when the recipient country suffers an economic downturn following a financial crisis, natural disaster, or political conflict, as migrants transfer more funds during hard times to help their families and friends.

The top three recipients of remittances in 2004 were India, China, and Mexico. But it is smaller countries, such as Tonga, Moldova and Lesotho that top the list when controlling for the size of the economy - for example, as a share of GDP. On average, the share of remittances in GDP is twice as large in low-income countries than in middle-income countries.

Rich countries are the main source of remittances. The US is by far the largest source, with US$ 39 billion in outward flows. Saudi Arabia (classified as a high-income country in 2005) is the second largest, followed by Switzerland and Germany. But when expressed as a share of GDP, outward remittances were the largest in the upper middle-income countries (0.7 per cent of GDP compared to 0.2-0.4 per cent of GDP in other countries). Although it is conventionally believed that migration flows South-North and remittance flows North-South, South-South migration is estimated to be at least as large as South-North migration, and South-South remittances constitute 30-45 per cent of the remittances received by the South.

Household survey data show that remittances have reduced the poverty headcount ratio significantly in several low-income countries - by 11 percentage points in Uganda, 6 percentage points in Bangladesh, and 5 in Ghana. For the very poor, remittances may not provide more income than could have been earned locally. For the very rich, remittances may even be smaller than the loss of income due to migration. But for the middle-income groups, they enable recipients to move up to a higher income group. In Sri Lanka, for example, households from the third to the eighth income decile moved up the income ladder thanks to remittances.

Remittances can improve a country's creditworthiness and enhance its access to international capital markets. The ratio of debt to exports, a key indebtedness indicator, decreases significantly when remittances are included.

Source: IMF, 2005, *Finance and Development*, Volume 42, Number 4.

creased to US$ 2,735 million and the total foreign exchange reserves to US$ 4,201 million at the end of 2005. The latter provided 5.7 months of import cover. Reflecting the improved foreign exchange position - together with substantial foreign aid pledges made by bilateral and multilateral sources in the aftermath of the tsunami having a positive impact on market confidence - the Sri Lankan rupee saw a considerable appreciation in 2005. Thus, the rupee appreciated against the US dollar by 2.4 per cent, the euro by 17.7 per cent, the pound sterling by 14.5 per cent, the Indian rupee by 5.7 per cent, the

Japanese yen by 17.5 per cent, and the SDR by 11.3 per cent. The rupee appreciated by 8.5 per cent against a basket of five currencies (the US dollar, the Japanese yen, the pound sterling, the euro, and the Indian rupee) in nominal effective terms (NEER) and by as much as 13.1 per cent in real effective terms (REER).

2.7.3 External Debt and Debt Service

Despite resorting to increased foreign funding for BOP financing, Sri Lanka's debt in rupee terms declined marginally in 2005 to Rs.1,160.8 billion, from Rs.1,186.8 billion in 2004. This was wholly reflected in the external debt owned by the government, which fell from Rs.996.1 billion to Rs.956.6 billion between the two years. As a percentage of GDP, total external debt decreased to 49.1 per cent from 58.5 per cent in 2004, largely owing to a 16.6 per cent growth in nominal GDP. The major contributory factor for the decline in external debt in 2005 has been the appreciation of the Sri Lankan rupee against major international currencies. In addition, the debt write-off by Italy, China and the UK amounting to US$ 8.2 million and US$4.4 million respectively, as a tsunami relief measure also made a marginal contribution. Alongside the decline in the debt volume, a significant reduction in the service burden is also observed. Total debt service payments decreased from Rs.84.8 billion in 2004 to Rs.62.6 billion in 2005. The major part of the reduction was reflected in the amortization payments, which decreased by Rs.17.5 billion to Rs.42.1 billion. A moratorium on service payments on selected government loans by members of the Paris Club and multilateral institutions as a tsunami relief measure made a contribution towards this reduction. Consequent to the easing of the debt service burden, the debt service ratio - i.e., service payments as a ratio of exports of goods and services - dropped sharply from 11.5 per cent in 2004 to 7.9 per cent in 2005.

Table 2.12
External Debt, Debt Servicing and Exchange Rates, 2002-2005

	2002	2003	2004	2005
Medium & long term debt (Rs. bn)	844.7	978.6	1,119.2	1,093.0
External debt of the govt. (Rs. bn.)	722.0	852.4	996.2	956.6
Short-term debt (Rs. bn.)	58.1	59.9	67.7	67.8
Banking sector external liabilities (Rs.bn.)	96.8	101.1	149.5	170.2
Total external debt (Rs. bn.)[a]	902.8	1,038.5	1,186.9	1,160.8
External debt/GDP (%)	57.0	59.0	58.5	49.1
Debt service payments (Rs. bn.)	74.7	73.1	85.3	62.6
Amortization	54.0	50.5	60.0	42.1
Interest	20.7	22.6	25.3	20.5
Debt service ratio[b] (%)	13.1	11.6	11.5	7.9
Exchange rate[c]				
US dollar	96.73	96.74	104.60	102.12
Euro	101.38	121.60	142.32	120.96
Yen	0.82	0.90	1.02	0.87

Notes: a. Sum of medium and long term debt plus short term debt.
b. Covers all debts 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.

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

Sri Lanka obtained a sovereign rating for the first time in December 2005 - with sovereign ratings of BB- and B+ from Fitch Ratings and Standard and Poor's Ratings, respectively - prior to the budget presentation with proposals to issue foreign currency bonds. In June 2006, the government raised an initial US$ 300 million through dollar denominated Sri Lanka Development Bonds (SLDBs) with a 2-3 year term of maturity. Faced with rising international oil prices that has seen the country's trade balance widening significantly, resorting to foreign borrowing has been viewed as a means of easing pressure on domestic borrowing. Nevertheless, the relative short maturity of SLDBs - with a floating rate - require that they be re-issued every 2-3 years which can increase Sri Lanka's foreign denominated debt if the volume of such debt builds up over time.

2.8 Sri Lanka's Relative Economic Performance

The data in Table 2.13 compares Sri Lanka's current economic performance with other South Asian neighbours - India, Pakistan and Bangladesh - and some ASEAN economies such as Indonesia, Thailand, Philippines and Malaysia. On economic growth, Sri Lanka's performance has fallen slightly below the average of the three South Asian neighbours. The growth performance of India is seen to be much stronger, followed closely by Pakistan. On the other hand, the growth performance of Bangladesh is very much akin to that of Sri Lanka. Meanwhile, Sri Lanka has done slightly better than the average of four South East Asian countries on the growth front. None in this grouping has shown exceptionally high growth during the reference period.

With respect to inflation control, Sri Lanka is seen in a very poor light both in relation to other South Asian neighbours and the South East Asian countries - Sri Lanka's closest equals on this score being Pakistan and Indonesia. It is noteworthy that India, which has performed well in the growth front, has also faired exceptionally well in inflation control, the annual rate being close to 4.0 per cent. Meanwhile, it is observed that the average inflation performance of South Asia (India, Pakistan and Bangladesh) has been better than that of the selected ASEAN countries. The data seem to suggest that Sri Lanka needs to take much more concerted action to control domestic inflation, which no doubt involves very wide ramifications on overall economic performance.

Table 2.13
Relative Economic Performance - Sri Lanka and Selected Asian Economies, 2004-2006

	Real GDP			Consumer Prices[a]			Current Account Balance[b]		
	2004	2005	2006	2004	2005	2006	2004	2005	2006
Sri Lanka	5.4	6.0	6.9	7.6	11.6	8.0	-3.9	-2.7	-3.3
South Asia	7.7	7.9	7.1	4.3	5.0	5.3	0.1	-2.3	-3.0
India	8.1	8.3	7.3	3.8	4.2	4.8	0.2	-2.5	-3.1
Pakistan	7.1	7.0	6.4	7.4	9.1	8.4	0.2	-2.4	-3.2
Bangladesh	5.9	5.8	6.0	6.1	7.0	6.1	-0.3	-0.9	-1.0
ASEAN	5.8	5.2	5.1	4.6	7.5	8.8	4.4	3.3	2.8
Indonesia	5.1	5.6	5.0	6.1	10.5	14.2	1.2	1.1	0.4
Thailand	6.2	4.4	5.0	2.8	4.5	3.6	4.2	-2.3	-2.0
Philippines	6.0	5.1	5.0	6.0	7.6	7.4	2.7	3.0	2.1
Malaysia	7.1	5.3	5.5	1.4	3.0	3.1	12.6	15.6	14.9

Notes: a: Annual averages.
b: Per cent of GDP.

Source: IMF, *World Economic Outlook* (April 2006) and Central Bank of Sri Lanka, *Annual Report* 2005.

On the external front, Sri Lanka's performance is decidedly less favourable than both the South Asian neighbouring countries and the South East Asian countries. However, this is also an indication that Sri Lanka is absorbing much more foreign capital as a percentage of GDP than either of the two groups. The average current account performance of the ASEAN 4 is very resilient, Malaysia in particular recording exceptionally large current account surpluses during the reference period.

2.9 Conclusions

In spite of having to face some adverse domestic circumstances, Sri Lanka was able to post satisfactory economic growth in 2005. Leaving out high domestic inflation, the country's economic position too appeared to be in reasonable shape, the external sector in particular showing considerable resilience. However, beneath this seemingly satisfactory outlook has been a tendency to conceal the country's real economic problems. The financial flows and debt service relief associated with the tsunami buttressed both government finances and the BOP, thus blurring to a very considerable extent the macroeconomic pressures under which the economy is operating. This could lull the authorities to a false sense of optimism with respect to the country's economic prospects and induce them to postpone much needed reforms and remedial action. Sri Lanka's major macroeconomic problems revolve round high fiscal deficits and the associated high public debt burden. The country needs to reduce its public debt and make sufficient fiscal space for public investment in priority areas of social and physical infrastructure. Failure to do so would mean unnecessarily high interest rates and the country continuing to live in a fiscal straight jacket, straying further and further away from the framework required to push the economy on to a higher growth path. It also makes the country more vulnerable to any adverse developments in the world economy.

3. International Environment

3.1 Introduction

Despite persistent increases in oil prices, the world economy continued to exceed expectations in 2005, helped by positive financial market conditions and supportive macroeconomic policies. The forecast for global GDP was revised upwards due to stronger growth in the second half of 2005 with year-end estimates suggesting an overall growth rate of 4.8 per cent in 2005 compared to an earlier estimate of 4.3 per cent. This was the fourth year in a row when world GDP recorded a rate above 4 per cent. The growth moment is forecast to continue into 2006 with an anticipated growth rate of 4.9 per cent in 2006 with a moderate slow down in 2007 to 4.7 per cent. Despite the positive outlook, a number of risks to the global economy remain, including high and volatile oil prices, a housing-related slump in American consumer demand or a sharp slide in the dollar precipitated by global economic imbalances. The world currently displays an alarming number of large economic and financial imbalances. The US current account deficit widened to US$ 800 billion in 2005, while Germany, Japan and China are running record surpluses.

This chapter will deal with developments in the global economy in 2005 and their implications for Sri Lanka. Section 3.2 will focus on developments in the global economy with a particular focus on economic performance in the US, EU and Japan and emerging countries as well as developments in international trade and financial markets. Section 3.3 will examine progress in multilateral trade negotiations under the Doha Round trade talks with the conclusion of the Sixth Ministerial Meeting in Hong Kong. Section 3.4 examines bilateral and regional trade initiatives undertaken by Sri Lanka and Section 3.5 concludes.

3.2 Trends in the Global Economy

3.2.1 Advanced Economies

Growth in industrial countries averaged 2.7 per cent in 2005 (down from 3.2 recorded in 2004). The US continued to be the engine of growth among the industrial countries in 2005 recording a growth rate of 3.5 per cent in 2005 (down from 4.2 per cent in 2004) despite a temporary dip in the fourth quarter due to a number of factors including Hurricane Katrina. Inflationary pressures in the US remained restrained despite high and volatile oil prices; interest rates were raised 8 times over the course of 2005 and twice in the first quarter of 2006 to keep inflation in check. Consumer spending has been the driving force behind US growth, which is set to slow in 2006 with the increase in interest rates.

The US economy continued to suffer from twin (fiscal and current account) deficits. While the fiscal deficit fell to 4 per cent of GDP in 2005, with revenues exceeding spending, the external current account deficit widened to 5.8 per cent of GDP in 2005. The latter is expected to further widen, contributing to increasing global current account imbalances. This poses a major risk to the near-term global outlook. With household savings rate falling to zero and the emergence of a significant fiscal deficit, large inflows of foreign savings have been financing the current account deficit, a situation which is highly unsustainable over the medium to long term. GDP growth in the US is expected to moderate to 3.4 per cent in 2006 and 3.3 per cent in 2007, reflecting a slowing down of consumer spending and effects of increases in oil prices and interest rate taking a toll.

Growth in the EU in 2005 was disappointing recording a growth rate of only 1.3 per cent (down from 2.1 per cent in 2004) due to slow recovery of domestic demand and low consumer/investors confidence. Growth in the EU was driven primarily by higher exports aided by a moderate depreciation of the euro. Within the region, there were wide divergences across countries in their performances. While Spain preformed strongly, France, Germany and Italy all experienced significant fluctuations during the year, with France and Germany experiencing a slowdown in the last quarter of 2005 as consumer and external demand fell.

All the major economies in the EU face significant fiscal problems, with France, Germany and Italy consistently exceeding the 3 per cent of GDP target set by the EU's Stability and Growth Pact. Monetary policy was tightened in 2005 with the European Central Bank (ECB) raising interest rates but inflation still continued to exceed its target of 2 per cent into the sixth consecutive year. The region continues to suffer from persistent high unemployment - together with high inflation and disappointing growth - underlining existing structural problems in the region that continue to undermine prospects for a turnaround. Growth in the EU is forecast to grow by 2.1 per cent in 2006 reflecting expectation of stronger performances by the larger countries, particularly Germany, and a modest recovery in investment. However, domestic demand which is a key source of recovery remains weak. Outside the Euro area, growth in the UK slowed down sharply in 2005 to 1.8 per cent from 3.1 per cent in the previous year.

Japan's long awaited recovery took hold in 2005. The economy grew by 2.7 per cent (up from 2.3 per cent in 2004) in 2005 with a rebound in investment, a decline in unemployment, rising wages, a recovery in consumer demand, and a reversal in deflationary conditions that has been besetting the economy for the longest period of time. In January 2006, inflation turned positive and grew at a rate of 0.5 per cent. The decline in the fiscal deficit from 4.8 per cent in 2004 to 4.5 per cent in 2005 with an anticipated further decline is seen as a positive development in view of Japan's large public debt. With the end of deflation, monetary policy is likely to be tightened from the previous stance of holding down interest rates close to zero to support the recovery of the economy. The Japanese economy is set to grow by 2.9 per cent in 2006 with the further strengthening of the recovery process, a pick up in domestic and external demand, including consumer spending. It is projected to moderate to 2.4 per cent in 2007, closer to its long run potential growth rate of 2 per cent. With the Japanese economy having recovered and performing well and the EU on a slow road to recovery, the global economy is expected to be in a better position now than in the past to deal with a possible slowdown of the US economy.

3.2.2 Emerging Economies

China's integration into the world economy today is having a bigger global impact than other emerging economies. Most analysis of China's growing importance focuses on its rising share of global output and exports. Its contribution to global GDP growth since 2000 has been almost twice as large as that of the next three biggest emerging economies, India, Brazil and Russia, combined. Driven by better than expected growth in China, India and Russia, growth in emerging economies remained strong in 2005. GDP growth in both China and India continued to be driven by strong domestic demand. With global conditions expected to remain positive, helped by the recovery in the Japanese economy, growth in emerging Asia is expected to continue in 2006 and is projected to grow by 7.9 per cent. Recovery in information technology (IT) related sectors have also helped to accelerate economic activity in countries in the region.

A significant risk to the outlook of the region is the Avian influenza – also known as bird flu - becoming a pandemic. While it primarily affects birds and infections are caused by migratory birds and contaminated cages/clothing, there have been a number of reported human cases of avian influenza in the region. The viral outbreak began in early 2004 and has already resulted in significant human and economic losses to the region. There have also been outbreaks of this virus reported in Europe, the Middle East and Africa. The virus has already killed more than 120 people worldwide. While both the probability and potential risks of a threat of a pandemic are impossible to assess with any certainty, a worse-case scenario could have extremely high human and economic costs - human losses in the range of 5-150 million and loss in global GDP of about US$ 200 million in just one quarter to a worst-case scenario of a global economic recession.

Robust economic expansion continued in Latin America in 2005 with an overall growth rate of 4.3 per cent, despite slower growth in the larger countries of the region. Most Latin American countries benefited from strong global demand and higher prices for commodities. Growth in the region is projected at 4.3 per cent in 2006. In the transitional economies of Europe, regional GDP growth moderated to 5.4 per cent from an exceptional level in 2004 and is projected to remain close to this level, underpinned by strong domestic demand and solid export growth. However, there was a significant slowdown in growth in the CIS during 2005 to 6.5 per cent from 8.4 per cent recorded in 2004. Output growth in sub-Saharan Africa was estimated to have grown at 5.5 per cent in 2005 and is expected to rise to 5.8 in 2006 - the highest ever in three decades - and if sustained over time, is expected to contribute towards poverty alleviation efforts in the region.

3.2.3 World Trade and Commodity Prices

World trade volumes grew by 6.2 per cent in 2005 (down from 10 per cent recorded in 2004) largely due to the slower growth in the US and the EU. Global growth in trade is expected to pick up in 2006-07 at around 7 per cent in line with projected rate of global economic growth.

The Commodities and Energy Price Index prepared by the International Monetary Fund (IMF) rose by over 29 per cent in dollar terms in 2005 due to surging fuel and base metal prices. Energy prices rose by 39 per cent in 2005 owing to significant increases in oil and natural gas prices. Oil prices have been on an upward trend since 2003 and reached a high of US$ 66 a barrel in the wake of Hurricane Katrina and thereafter declining for the rest of 2005. However, oil prices have been on the rise since the beginning of 2006 and touched US$ 77 a barrel in August 2006. It is expected to remain high for the rest of the year due to limited excess capacity in the oil sector (likely to persist beyond 2006), and problems facing most of the oil producing areas - Nigeria, Venezuela, Russia, the Middle East and the Gulf of Mexico. Thus, oil prices in general are likely to remain high in the foreseeable future.

Non-fuel prices rose significantly in 2005 by 10 per cent, reaching record levels due to surging metal prices. This was in complete contrast to the general downward trend observed in non-fuel commodities prices over many years. Non-fuel prices are projected to moderate in 2006/07 as supply responds to higher prices.

Despite higher commodity prices, inflationary pressures remained subdued as monetary authorities across the world tightened monetary policy to pre-empt inflationary pressures. While global headline inflation has picked up in response to higher oil and commodity prices, core inflation has been affected only marginally. Global inflation is projected to average at around 2 per cent in 2006.

3.2.4 Financial Markets and Aid Flows

Financial market conditions in 2005 were favourable, characterized by low risk premiums due to strengthening of economic fundamentals across most of the major markets and other factors such as relatively low interest rates and search for better yields in an environment of easy liquidity. However, over the coming two years, short term interest rates are expected to rise further significantly across countries. Long run interest rates which have been low in 2005 are likely to rise, and as such volatility and risk premiums are expected to pick up. The inversion of the yield curve for the US - as long term interest rates fell below short term interest rates in 2005 - which in the past predicted slower future output growth raised concerns about the future strength of the US economy and the possibility of a slowdown. Though the relationship seems to have weakened as other indicators do not suggest a slowdown, it has reinforced doubts about the future strength of the US economy.

The US stock market remained flat during 2005 while those from other developed country markets showed considerable buoyancy, with the Japanese stock market recording a high of 5 years. Despite the large and growing global current account imbalances, financial markets and financial flows remained stable during the year. Foreign exchange markets have also remained relatively stable; the dollar experienced some depreciation while the euro and Japanese yen bore most of the adjustment costs.

Net capital flows to emerging countries fell sharply in 2005 following a huge rise in 2004. The decline was due to both portfolio and private capital dropping despite strong growth in the emerging economies. On the other hand, net FDI flows rose in 2005 and reached their highest level since 1994, with China continuing to attract a large share in proportion to the size of the country and its growth.

Official Development Assistance (ODA) has grown markedly in the past few years due to various relief efforts, but funding to meet international development goals such as the Millennium Development Goals (MDGs) falls far short of the estimated $150 billion that is required. During the early 1990s, the ODA share of donor countries' gross national income shrank to a low of 0.21 per cent, but the pledges made by donors to increase such aid at the International Conference on Financing for Development in Monterrey, Mexico in 2000 has reversed the trend. By 2005, ODA had recovered to reach a high of US$106.5 billion, with the share of ODA to gross national income equal to 0.33 per cent. However, the recent recovery in aid flows has been mainly the result of debt relief for Iraq and Nigeria and emergency aid to the tsunami-affected countries in the Indian Ocean. In an important development , the G8 meeting in July 2005 at Gleneagles pledged US$ 50 billion (some of it previously announced) in aid to developing countries by 2010, of which US$ 25 billion will go to Africa (with EU members committing a collective aid target of 0.56 per cent of GDP by 2010, and 0.7 per cent by 2015) in addition to promises on debt relief, trade, security and climate change.

Table 3.1
Selected Indicators of Global Economic Conditions

		Current Projections		
	2003	**2004**	**2005**	**2006**
World Output	5.3	4.8	4.9	4.7
Advanced economies	3.3	2.7	3.0	2.58
United States	4.2	3.5	3.4	3.3
Euro Area	2.1	1.3	2.0	1.9
Germany	1.6	0.9	1.3	1.0
France	2.1	1.4	2.0	1.4
Japan	2.3	2.7	2.8	2.1
United Kingdom	3.1	1.8	2.5	2.7
Other advanced economies	4.6	3.7	4.1	3.7
Newly industrialised Asian economies	5.8	4.6	5.2	4.5
Other emerging market and developing countries	7.6	7.2	6.9	6.6
Africa	5.5	5.2	5.7	5.5
Sub-Sahara	5.6	5.5	5.8	5.7
Central and eastern Europe	6.5	5.3	5.2	4.8
Commonwealth of Independent States	8.4	6.5	6	6.1
Russia	7.2	6.4	6	5.8
Developing Asia	8.8	8.6	8.2	8.0
China	10.1	9.9	9.5	9.0
India	8.1	8.3	7.3	7.0
ASEAN-4[a]	5.8	5.2	5.1	5.7
Middle East	5.4	5.9	5.7	5.4
Western Hemisphere	5.6	4.3	4.3	3.6
World trade volume (goods and services)	10.4	7.3	8.0	7.5
Imports				
Advanced economies	8.9	5.8	6.2	5.6
Other emerging market and developing countries	15.8	12.4	12.9	11.9
Exports				
Advanced economies	8.5	5.3	6.6	6.1
Other emerging market and developing countries	14.6	11.5	10.9	10.3
Commodity prices (US dollars)				
Oil	30.7	41.3	14.8	2.9
Non fuel (average based on world commodity export weights)	18.5	10.3	10.2	-5.5
Consumer prices				
Advanced economies	2	2.3	2.3	2.1
Other emerging market and developing countries	5.7	5.4	5.4	4.8
London interbank offered rate (per cent)[b]				
On US dollar deposits	1.8	3.8	5	5.1
On euro depostis	2.1	2.2	3	3.4
On Japanese yen deposits	0.1	0.1	0.3	0.9

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

Source: IMF *World Economic Outlook*, May 2006.

3.3 WTO and Doha Development Round

The Sixth Ministerial Meeting of the WTO in Hong Kong on December 13-18 avoided the fate of Seattle in 1999 and Cancun in 2003, which was an achievement in itself but there was hardly any progress made on substantive issues outlined in the July 2004 Package. It was an imbalanced outcome from the perspective of developing countries, as they gave in to demands of developed countries in services and NAMA but obtained little in turn in agriculture and package on issues of 'development'.

In the key contested area of agriculture, the Hong Kong Ministerial Declaration had only three concrete decisions: (i) to end the EU export subsidy by 2013; (ii) developing countries being allowed to self-designate some products as Special Products; and (iii) developing countries being allowed to keep a *de minimis* level of domestic support.

The most publicized claim of benefit from Hong Kong was the long promised elimination of agricultural export subsidies by developed countries. While agreement had been reached that such subsidies need to be eliminated, the point of disagreement was on finalizing a date. The year 2010 was agreeable to all but the EU - which accounts for the bulk of global export subsidies - but agreement was finally reached to end agricultural export subsidies by 2013 to match the reforms undertaken in the Common Agricultural Policy (CAP) of the EU. However, the ending of export subsidies does not mean the end of such support as a large portion of domestic subsidies enter into export products. Unless domestic subsidies are reduced in parallel, export subsidization will continue even after the elimination of export subsidies in 2013. The Hong Kong Ministerial would have been more meaningful if there was a decision to cut domestic subsidies, which is the main distortion besetting the agricultural sector, and apply greater discipline on the use of Blue and Green Box subsidies by both the EU and US. No progress was made on these, but there was agreement to reduce domestic agricultural support in line with three bands, with higher cuts in the higher bands. The extent of reductions is still left open for negotiations.

At Hong Kong it was also agreed to adopt a banding approach in reducing agricultural tariffs. According to this approach, agricultural tariffs would be categorized into four bands, with tariffs in the higher band subjected to deeper cuts. The extent of cuts in each band is yet to be agreed upon. This would bring down significantly the agricultural tariffs of developed countries as well as that of developing countries which were bound at a very high level as part of Uruguay Round (UR) commitments.

Developing countries, however, have been given the flexibility to self-designate an appropriate number of tariffs as Special Products (SPs), which are to be based on the criteria of food security, livelihoods, and rural development. Self declaration of SPs is a small step forward but there is uncertainty about the number of products allowed to be so designated and the nature of treatment. Developing countries were also given the right to a Special Safeguard Mechanism (SSM) based on import quantities and price triggers. The precise arrangements for the SSM are yet to be negotiated. These will come into operation when other elements of the modalities for agricultural negotiations are put in place.

Retention of the *de minimis* subsidy of developing countries is also a step in the right direction. In Hong Kong, it was agreed that developing countries whose domestic support is below 10 per cent of the total production will be exempted from reductions in *de minimis* as well as in the overall trade distorting domestic support. All that has been secured is to maintain the status quo.

On cotton, the Ministerial Declaration offered to eliminate export subsidies by 2006. But export subsidies constitute a small proportion of the total subsidies that the US gives to its cotton producers. There was no concrete action on reducing trade-distorting domestic subsidies, which are estimated to account for 80-90 per cent of total US support for cotton. Domestic subsidies also make up almost all of the European cotton subsidies.

With regard to non-agricultural market access (NAMA), two specific decisions taken in Hong Kong were: (i) the reduction of industrial tariff according to the Swiss formula with coefficients for developing and developed countries; and (ii) binding unbound tariffs by marking up of applied tariffs rather than applied rates as proposed by developing countries and then reducing them by applying the formula. What this means is that tariffs would be reduced and bound on all industrial products, which have important implications for developing countries.

Under the Swiss formula adopted, higher tariffs will be subjected to deeper cuts on a line-by-line basis. How deep the cuts are will depend on the coefficients which are to be agreed on. But it will mean that developing countries would be offering higher tariff cuts as the tariffs maintained on industrial goods are much higher than those of developed countries. Moreover, reducing tariffs on industrial products was merely an obligation before but now developing countries have undertaken a commitment to reduce tariffs on all products. By agreeing to bind all industrial products, they have given up their rights to maintain unbound tariffs.

Applied rates would be used as the basis for treating unbound tariffs, whereby applied rates would be marked up, which would then be subjected to reductions according to the formula and bound, which would result in low bound tariffs. This could have severe de-industrialization effects for developing countries. In return, developed countries have not made any specific commitment to reduce tariff rate quotas (TRQs), tariff peaks but there is a vague reference that these would be addressed through a suitable formula to be worked out in future.

There was no progress on non-tariff barriers (NTBs) in Hong Kong and no deadline was set for their elimination. The Declaration only took note of the work done on identifying, categorizing and examining notified NTBs and recognized the need for specific negotiating proposals, for which there is no deadline.

The importance of special and differential (S&D) treatment and less than full reciprocity for developing countries was reaffirmed but there is no agreement on how to put them into effect. Also, preference erosion which was one of the major concerns of LDCs in undertaking multilateral trade liberalization was given recognition in the text of the Declaration but there is no consensus as to how this would be addressed.

'Aid for Trade' which received wide publicity, has been suggested as a possible means of addressing preference erosion by providing support for adjustment costs and to build supply side capacity and trade related infrastructure. In showing their support for the idea, the EU, Japan and the US announced increases in resources for 'aid for trade' prior to and at Hong Kong. Japan announced US$10 billion over three years. The EU will increase its annual spending on 'aid for trade' to 2 billion euros by 2010 up from a current level of 400 million euros. The US announced a doubling of annual 'aid for trade' to US$ 2.7 billion by 2010 from US$ 1.3 billion in 2005, pending a successful conclusion of a new trade round. While major developed countries have pledged to increase amounts of assistance, there is no clear indication whether this will be new money or what it will be used for.

Like in NAMA, developing countries made a substantial concession in services without any commensurate concessions from developed countries. Despite strong objection from developing countries, the Hong Kong meeting will lead to an intensification of service negotiations with the adoption of Annex C. The plurilateral approach which was adopted incorporates sectoral and modal approaches which will complement the bilateral 'request-offer' approach. It is feared that this would accelerate the liberalization of services and compromise the flexibility of the General Agreement on Trade in Services (GATS) which allows developing countries to liberalize only in sectors they choose. Annex C may oblige a developing country that is requested by a group of other countries to participate in plurilateral, sectoral or modal negotiations. However, it is not clear whether the participation would be voluntary or mandatory.

An important outcome of the Hong Kong Ministerial in addressing development issues was the agreement to provide duty and quota free access for LDC products. But market access was limited to 97 per cent of products, which allows developed countries to continue to protect sensitive products of export interests to the LDCs such as textiles and clothing, rice, sugar, leather products, fishery products, etc. The US has indicated, for example, that it cannot include textiles and clothing from Bangladesh and Cambodia. There was no movement on many other S&D treatment proposals or on outstanding implementation issues.

After 5 years of hard negotiations the Doha round of trade talks which were supposed to boost world trade and help developing countries were indefinitely suspended following the G6 meeting of 23-24 July 2006 in Geneva between the US, EU, Japan, Australia, Brazil, and India failed to produce agreement on the contentious issue of market access and domestic support in agriculture. At best it looks likely to be some time before the talks could be restarted - there was no indication as to how long the talks will be suspended. The suspension will apply to all negotiating groups. For the moment, the US is being blamed by the EU and others for being inflexible and producing no new proposals for cutting farm subsidies prompting the suspension, while the US accused the EU and advanced developing countries for failing to provide greater market access by introducing loopholes such as sensitive and special products.

With the collapse, there is not enough time to get the details of an agreement resolved before the US President's fast-track trade authority expires in July 2007. The fast-track Trade Promotion Authority (TPA) - which forces Congress to accept or reject a trade agreement without introducing amendments - is important in terms of allowing easier passage for any agreement arrived at the WTO in the US; in effect, it gives other countries confidence that agreements negotiated by the US will not be subject to subsequent renegotiation. The current term of the TPA is due to expire in July 2007 and few expect it to be renewed. As such outstanding issues need to be resolved early enough to get it through the Congress with minimal delays.

Without further progress at the WTO, there will be increased focus on regional and bilateral agreements, which have already proliferated, with just about every member of WTO being a party to bilateral/regional trade agreement of some sort. In fact following the suspension of global trade talks, India announced that it was looking for trade deals with the EU and Japan while EU was planning to discuss more open trade with China and other developing countries later in the year. It could also trigger an increase in protectionism on both sides of the Atlantic and the number of cases brought before the WTO dispute settlement system, especially in agriculture which remains highly protected in the US and the EU. And the suspension could possibly jeopardize the pledges and progress made over the five years of global trade negotiations.

3.4 Sri Lanka and Global Economic Developments

Sri Lanka as a small trade dependent country continued to strengthen its external relations in 2005 through multilateral, regional and bilateral trade agreements. Sri Lanka participated in the WTO Hong Kong Ministerial and was successful in securing proposals submitted to safeguard its trade interests. In agriculture, Sri Lanka will benefit from the designation of Special Products (SPs), and the Special Safeguard Mechanism (SSM). In the area of manufactures, NAMA provides for Sri Lanka not to undertake tariff reductions through the formula given that its bound coverage is less than 35 per cent. Instead, Sri Lanka will be required to bind 100 per cent of its non-agricultural tariff lines at the average of bound tariff rates for all developing countries (estimated to be around 28.5 per cent). The exclusion of 3 per cent of tariff lines under duty and quota free access for LDC products will also be of strategic benefit to Sri Lanka given that the country competes with LDCs in developed markets in the key sector of garments.

Whilst being committed to the multilateral process, Sri Lanka continued to actively participate in bilateral and regional trade initiatives in order to gain better access to markets abroad.

The existing EU Generalized System of Preferences (GSP) scheme was reformed to make it both simpler and fairer and replaced by a three-tired structure consisting of the GSP Plus Scheme (GSP+), the General Scheme and the Everything But Arms Scheme (EBA) for LDC countries. While the GSP Plus entered into effect on 1 July 2005, the other two schemes came into force on 1 January 2006.

The GSP+ is targeted at vulnerable countries that have ratified and effectively implemented key international conventions on sustainable development, labour rights and good governance. The EU granted duty free concession to Sri Lanka under (GSP+) which came into effect on 1 July 2005 and will remain in place until the end of 2008. This will benefit the country's garment sector - which accounts for about 50 per cent of the country's total exports - and would provide some relief in the face of stiff competition following the elimination of the Multi Fibre Arrangement (MFA). Under GSP+ Sri Lanka will receive preferences on around 7200 products where products are eligible to enter the EU duty free.

However, the utilization rates of such schemes have been mixed, with an overall level of utilization of about 51 per cent globally. The utilization rate for textile and apparel, agricultural and industrial exports is estimated at around 39, 50 and 70 per cent, respectively. Given the constraints imposed by obligations to meet stringent rules of origin criteria, etc. to make use of the preference, Sri Lanka is now lobbying the EU for changes. As the apparel industry, for example, is unable to make good use of GSP+ due to restrictive rules of origin criteria (both bilateral and regional cumulation offered under the scheme), Sri Lanka wants the value addition criteria brought down further as the country lacks a domestic fabric base to meet the required criteria as well as seeking an extention of regional cumulation beyond the

SAARC region to include ASEAN so that SAARC and ASEAN would be considered as one regional group and inputs from the other region could be used and still qualify for the GSP preferences.

The US remains Sri Lanka's other main export destination. Attempts to push for a bilateral FTA with the US have more or less petered out. Sri Lanka was the first South Asian country to formalize efforts to strengthen economic links with the US under a Trade and Investment Framework Agreement (TIFA) in 2002. The initial push for an FTA with the US was conceived with the idea of obtaining some tariff concessions for Sri Lanka's garments exports to the US before the phasing out of the MFA by the end of 2004. The US is the country's main export market, accounting for about 50 per cent of the industry's total exports. However, interest in pursuing an FTA stalled after political and administrative changes in 2004/05 and it was found that the reverse preferences associated with the FTA was restricting the 'policy space' to pursue development strategy.

The key rationale for Sri Lanka's pursuit of preferential trade initiatives with the EU and the US has been driven by concerns regarding prospects for the domestic garments industry with the ending of the MFA. The concern was that the end of quotas -, which until then protected the local industry to some extent from competition from larger and low cost players such as China and India - would bring down world wide prices of garments and drive out smaller countries like Sri Lanka from the market. While it appears that initial fears of loss of markets is yet to materialize - and Sri Lanka has done well in certain segments in lingerie, night wear, blouses, cotton trousers, and cotton underwear -- the industry has, nevertheless, lost ground in the US in key areas like baby garments, cotton knit blouses, men's knit shirts, women's coats, pillowcases, jackets and cotton bed sheets.

The imposition of restraints on Chinese exports of textiles and clothing by the US has helped countries like Sri Lanka. The rules of the agreement surrounding China's accession to the WTO specifically allows 'safeguards' against Chinese products whereas normally WTO rules forbid the variation of tariffs or other restrictions against one country alone. Until December 2013, safeguards can be applied on any product if importing countries can show that the Chinese goods are causing 'material injury' to domestic producers. Special measures, with less strict criteria, apply to textiles and clothing. Safeguards can be imposed almost automatically whenever imports create or threaten to create 'market disruption'. There are limits: Chinese exports must be allowed to rise by 7.5 per cent a year; the controls must last only one year, although they can be renewed; and the safeguards must go by the end of 2008. The US has already slapped safeguard quotas, which limits the rise in imports to 7.5 per cent, on seven categories of Chinese textiles and clothing. Similar plans by the EU were averted by imposition of voluntary export restraints on the part of China.

Within the South Asian region, Sri Lanka is trying to expand trade with two of its largest trading partners and economies. Following the significant increase in bilateral trade with the signing of the India-Sri Lanka FTA (ISFTA), both countries have agreed to extend the cooperation to a Comprehensive Economic Partnership Agreement (CEPA) by extending economic cooperation to trade in services and investment. Sri Lanka and India held several rounds of technical level negotiations in 2005 to draw up a framework agreement.

However, the implementation of the ISFTA has not been without problems. Sri Lanka's shipments of vanaspati (a hydrogenated vegetable oil similar to ghee) under the FTA have been a cause of contention in bilateral trade relations. Similar problems have emerged in the case of copper, pepper and bakery shortenings. It has been argued that exports of vanaspati from Sri Lanka is flooding the Indian market and destabilizing the domestic Indian industry. During trade negotiations in 2003, both countries had agreed to cap vanaspati shipments from Sri Lanka to 250,000 metric tons but subsequently India has demanded that such imports should be capped at 100,000 metric tons which Sri Lanka was not keen to carry out. Consequently, India unilaterally decided to restrict imports of vanaspati oil from Sri Lanka, appointing the National Agricultural Cooperative Marketing Federation of India Ltd. (NAFED) as the sole agency for such imports. This is canalization policy likely to adversely affect local vanaspai factories where some are likely to be shut down as a result of the regulations imposed by India.

The Pakistan-Sri Lanka FTA (PSFTA) was signed in July 2002 and came into operation in June 2005. As in the case of the ISFTA, the PSFTA takes into account differences between the two countries and grants Sri Lanka a longer tariff phase out period and a larger negative list. Pakistan has offered 206 items duty free immediately with coming into force of the agreement compared to 102 duty free items on the part of Sri Lanka; Sri Lanka has been given a 5 year period to phase out tariffs compared to 3 years given to Pakistan; and Sri Lanka's negative list contains 697 items while there are 540 items on Pakistan's list. Although bilateral trade between the two countries has been insignificant, Pakistan is an important market for some exports such as tea, copra, rubber, betel leaves and tamarind. In fact Pakistan is the third largest tea importing nation in the world. Similarly for Pakistan, Sri Lanka is an export market for its textiles, pharmaceuticals, machinery and agricultural items. Under the agreement, major items of export interest to Sri Lanka have been given preferential treatment - such as tea, betel leaves, apparel products, ceramics, copra, and rubber. Most importantly, the FTAs with both Pakistan and India will allow Sri Lanka to position itself as transit point for trade between the two major markets in the region which currently takes place through Singapore and Dubai. Sri Lanka is thus well placed to emerge as a hub in the region if it manages to promote Indo-Pakistan trade and also promote Pakistani investors to start up operations in Sri Lanka to export to India using the ISFTA and vice versa.

With the signing of the framework agreement for the South Asian Free Trade Agreement (SAFTA) in January 2004 several rounds of meetings of the Committee of Experts were held to finalize negotiations on outstanding and contentious issues such as rules of origin, revenue compensation mechanism, sensitive lists, etc. Amidst fears that negotiations may not be completed to meet the deadline for entry into force of the agreement on 1 January 2006, outstanding issues were ironed out at the last moment. The implementation of SAFTA was pushed back by 6 months to 1 July 2006 to allow ratification by all member countries.

The objective of SAFTA, which will become fully operational by 2016, is to reduce existing tariffs to less than 5 per cent within the stipulated time frame among the member countries. While intra-regional trade remains low at around 5 per cent of total trade of member countries with the rest of the world, the SAFTA agreement may provide a boost given the potential of the region's large market of 1.4 billion consumers. However, gains are unlikely to be distributed evenly across the member countries with India already having trade surpluses with most of its South Asian neighbours and expected to gain disproportionately from the implementation of the agreement. The agreement has taken this into account to some extent by offering more generous treatment to the smaller and LDC members by instituting a compensation mechanism, extending a longer time frame to liberalize tariffs, and relaxing rules of origin requirements. Nevertheless, the existence of fairly large 'sensitive lists' of items approximating 20 per cent of tariff lines at the HS 6-digit level which are excluded from any tariff reduction is a cause for some concern. For Sri Lanka, SAFTA is unlikely to provide a boost given that it has already obtained more liberal market access to both India and Pakistan under bilateral FTAs.

Sri Lanka is also a member of the Bay of Bengal Initiative for Multi-sectoral Technical and Economic Cooperation (BIMSTEC) where negotiations on outstanding issues following the signing of the framework agreement for an FTA are proceeding. A crucial meeting of the Trade Negotiation Committee (TNC) scheduled for April 2006 to finalize the agreement to allow implementation to begin on 1 July 2006, however, was postponed due to the unsettled political situation in the member country of Thailand. The meeting was to have finalized such outstanding issues as rules of origin, negative list for tariff reductions and list of items to be opened under the fast track trade liberalization. A subsequent meeting in July 2006 failed to resolve the issues and it was agreed at the 9th BIMSTEC Ministerial Meeting in August 2006 that negotiations to finalize a BIMSTEC free trade agreement should be concluded before the second BIMSTEC summit scheduled to be held in early 2007 in India. However, the meeting failed to announce the date for implementing the already agreed upon free trade agreement. Unlike in the SAFTA agreement, BIMSTEC has left provision in its framework agreement to commence negotiations on liberalizing trade in services and investment from 2007 but this would depend on how successful the BIMSTEC would be implementing the FTA without further delays.

3.5 Conclusion

The external environment is likely to remain favourable to Sri Lanka in 2006 but it will depend on sustained global economic growth, especially in major export markets, and on the performance of international oil prices. While global GDP is projected to grow at 4.9 per cent, there are immediate downside risks such as high and volatile oil prices and rising global imbalances. The suspension of multilateral trade negotiations following the Hong Kong Ministerial does not help prospects of growth in international trade and services in the coming years.

The US, which is Sri Lanka's major export market, is expected to grow moderately in 2006, while Japan's growth is expected to pick up and the EU is also expected to perform better in 2006 than it did in 2005. Growth in emerging and developing markets, especially in China and India are likely to remain strong and contribute to global growth quite significantly. These trends are likely to be of benefit to Sri Lanka's export sector.

However, continuing high international oil prices and rising global interest rates will place a significant burden on the country's external position. Sri Lanka which is highly dependent on oil imports remains vulnerable to any significant increase in oil prices. Net oil-importing countries in the Asian region have recognized that the continuation of oil subsidies is not fiscally viable and many countries have brought down subsidies during 2005-06, and as a consequence pushed up inflation, necessitating tightening of monetary policy. Subsidies need to be streamlined as they do not always reach the intended group; targeting the poor by restricting subsidies on fuel types widely used by them is more justifiable. In Indonesia for example, payments are to be made in cash to 15 million of the poorest and those affected most by rising kerosene prices only.

While Sri Lanka's garments sector weathered the MFA phase-out in 2005, the industry is likely to face a tougher international trading environment in 2006 as global prices for clothing are expected to be on a downward trend. It will necessitate measures to upgrade the industry from a mere manufacture of garments to provide a fully integrated service to stay ahead of the competition. Supporting policies adopted by the government included initiatives to push for better access to markets abroad through bilateral and regional trade arrangements and actively pursuing to safeguard Sri Lanka's interests at the multilateral level.

Agriculture Reforms: Irrigation Water Charges and Land Policy

4. Agriculture Reforms: Irrigation Water Charges and Land Policy

4.1 Introduction

Agricultural growth in Sri Lanka at less than 2 per cent per annum on average has seen its share in GDP decline to just over 17 per cent from over 30 per cent in the early 1980s, while agriculture's share in total employment has fallen from 45 per cent to around 30 per cent. The slow growth of agriculture has been a key factor in the persistence of high levels of rural poverty and substantial variations across the country. Rural poverty remains pervasive in Sri Lanka, where an estimated 24.7 per cent of the rural population is considered to be below the poverty line compared with 7.9 per cent in urban areas. Agriculture incomes are constrained by the lack of credit, oligopolistic marketing, and poorly developed and maintained infrastructure.

The relative slow pace of reforms in agriculture compared to the market oriented reforms such as liberalizing trade, deregulating industry and promoting private investment are argued to have directly benefited industry and services sector expansion. By contrast, the agriculture sector, it has been long argued suffers from restrictive land policies, restrictive seed and quarantine regulations, poorly functioning water delivery systems, lack of technological development, unpredictable trade policies, etc., that has constrained productivity improvements in the sector. While it is recognized that the problems facing the agriculture sector are a combined effect of many complex factors, this chapter focuses on two key areas of agricultural reform that is currently under discussion: the imposition of an irrigation charge to improve efficiency of water use for agriculture, and reforming the smallholder land tenure systems to improve efficiency and productivity of land in the country.

The irrigated agriculture sector of Sri Lanka currently faces two major problems. The first is the inefficiency of irrigation water utilization while the second is the rising budgetary burden of providing irrigation water. Both these factors point to the need for some form of charging, or pricing, of irrigation water. The World Bank in 1996 suggested that Sri Lanka should stop subsidizing irrigation water and introduce a water charging scheme in order to minimize inefficiency of water use and recover the budgetary expenditure on irrigation. This proposal met with vehement opposition from many quarters and implementation was never attempted. However, given that the possibility of imposing an irrigation charge is still being debated, at least at an academic level, an analysis of the pros and cons of such a proposal still holds considerable merit.

In the case of land reform, it has long been argued that aspects of rural poverty can be addressed by altering the main smallholder tenure systems of the Land Development Ordinance and the Land Grants (Special Provisions) [LG(SP)], which restricts and controls many actions by permit-holders and grantees. The arguments put forward are that current restrictions on LDO lands negatively affect poor rural households by limiting their ability to inherit, subdivide, mortgage and sell land without prior approval from government officials. It is assumed that these restrictions negatively affect LDO households by reducing the productivity of land and constraining movement into off-farm employment.[1] Thus, the linkages between rural poverty and government involvement in smallholder land tenure remains unclear. Typically, much of the existing literature is contradictory often arguing from pre-conceived assumptions about rural factor markets.

The chapter is organized as follows: Section 4.2 examines issues of inefficiency in irrigation water use and cost of irrigation in Sri Lanka. Section 4.3 discusses the rationale for irrigation water charging and pricing and the principles and methods of water pricing and current water charges in Sri Lanka while Section 4.4 looks participatory irrigation management as an alternative policy option. Section 4.5 turns to issues related to land reform with particular emphasis on the LDO. Section 4.6 examines the current situation with regard to LDO and LG(SP) land with respect to credit and mortgage links, linkages between productivity, land size and tenure, etc. Section 4.7 examines issues related to reform scenarios permitting sale of LDO and LG(SP) lands. Section 4.8 summarizes and concludes with some policy recommendations.

4.2 Inefficiency of Irrigation Water Use in Sri Lanka

Sri Lanka being a predominantly rice based agricultural economy has historically been heavily dependent on irrigation and as a result, the country has been endowed with a sophisticated irrigation infrastructure. Irrigated agriculture is an important sector in the economy of Sri Lanka covering 0.65 million hectares and constituting 11 per cent of its annual GDP. Sri Lanka's economy remains dependent on irrigation for much of its agricultural output, particularly rice, the main staple, and irrigation based agricultural growth has been the primary development strategy in the 20th Century.

At present, 580,887 ha. (or 34 per cent of the total cultivated extent) per year are irrigated where rice is the major crop grown under irrigation (Table 4.1). The most productive of all are the 'major irrigation schemes', each of which comprises at least 650 ha of irrigated land fed by a relatively large reservoir and a network of canals. While 439,341 ha of land belong to this category the 'minor irrigation schemes' consisting of smaller tanks and small stream diversion projects account for the remaining 141,546 ha of irrigated land. Both types of schemes consist of main storage - which is a reservoir in most cases - and an anicut or a barrage across a stream in a fewer cases, one or two main canals that take water out of the storage and a network of secondary and tertiary canals that deliver water to the farmers' fields.

All these schemes are of canal or gravity irrigation mode. Both the storage and canal network structures are owned, controlled and financed by the state with little or no contribution from the farmers. Both the irrigation infrastructure and the water stored and delivered by it are being treated as 'public goods' supplied jointly to the masses without any exclusion from the use. The common ownership finally boils down to no ownership and consequently no one takes the responsibility for management and maintenance except in a minority of cases where the government has sought the participation of the farmers in this connection.

'Inefficiency' in relation to irrigation water use implies that a unit of irrigated land uses more water than the requirement for the crop. Consequently, the extent cultivated with the

[1] However it should be noted that in Sri Lanka, even the private land market is subject to many laws (e.g., Temple Act, Paddy Lands Act, Partition Act, etc.), customary practices (*thesawalmai* and differing inheritance customs) and widespread disputes over the ownership of land.

Table 4.1
Gross Asweddumised[a] and Sown Extents (Hectares)

Year	Total Extent Cultivated	Maha Extent Sown ('000 ha)	Maha Irrigated ('000 ha)	Yala Extent Sown ('000 ha)	Yala Irrigated ('000 ha)	Total Extent Sown ('000 ha)	Total Irrigated ('000 ha)
1990	N/A	531	355	326	165	857	520
1991	N/A	501	298	316	198	817	496
1992	N/A	548	340	255	180	803	520
1993	N/A	546	378	289	208	835	586
1994	N/A	581	412	349	271	930	683
1995	N/A	567	401	348	273	915	674
1996	N/A	499	345	250	191	749	536
1997	N/A	473	323	257	191	730	514
1998	N/A	574	414	274	237	848	651
1999	N/A	547	396	344	270	891	666
2000	N/A	549	394	329	270	878	664
2001	N/A	479	334	319	262	798	596
2002	1,920,324	510	366	342	272	852	638
2003	N/A	602	433	381	310	983	743

Notes: a: Levelled and bunded for submerged rice cultivation.

Source: Department of Census and Statistics.

total volume of water available would be less than the maximum cultivable extent. This results from: (a) a lack of technical know-how on water management and\or (b) a lack of an incentive to use water sparingly. Rice production which uses the bulk of Sri Lanka's irrigation water has been the main farm enterprise of local farmers for millennia. Therefore, the traditional knowledge of Sri Lankan farmers on rice crop-water management is satisfactory and (a) above therefore, is not relevant. (b) on the other hand, is the main cause of inefficient and wasteful water use in Sri Lanka due to its free provision by the state. At zero price of irrigation water there is no incentive for the farmers to limit their water use or to adopt water saving technologies.

Globally, demand for water for agricultural and non-agricultural purposes is increasing steadily and Sri Lanka is no exception to this general trend. Research shows that in Sri Lanka, the irrigation ratio, viz., the ratio of irrigated extent to the total extent cultivated for rice has increased from 62 per cent in 1950 to only 69 per cent in 1985. Over the same period, the cropping intensity, viz., the ratio of the extent cultivated to the total extent available for cultivation, has improved from 107 per cent to 123 per cent. These marginal improvements in spite of near doubling of the irrigable extent during the same period implies that bringing water to rice lands with massive investment in irrigation has not resulted in a comparable utilization of the facility by farmers. This could clearly be attributed to the inefficient use and wastage of irrigation water. Inefficiency in water use has been identified as a major cause of under performance of irrigation systems by a number of researchers. For instance, it has been observed that the standard of irrigation efficiency on large scale irrigation schemes in Sri Lanka was very low while equity in the provision of irrigation was no better.[2] It was also found that head-end farmers were often receiving and draining off water after fulfill-

[2] Moore, M.P. (1989), "The Ideological History of the Sri Lankan Peasantry", *Modern Asian Studies*, Vol. 32.

Table 4.2
Irrigation Investment (Rs. billion in 1995 prices)

Year	New Construction	Rehabilitation	Operation and Maintenance	Total	Percentage of Govt. Expenditure
1950- 1970	2.102	-	0.176	2.278	3.76
1971- 1990	4.865	0.567	0.337	5.77	3.4
1995	0.69	0.61	0.28	1.58	0.8
1997	0.62	0.92	0.26	1.8	1.0
2000	-	-	-	0.831	N/A
2001	-	-	-	0.364	N/A
2002	-	-	-	0.698	N/A
2003	-	-	-	1.001	N/A
2004	-	-	-	0.526	N/A
2005	-	-	-	0.636	N/A

Notes: Deflated into 1995 prices by GDP deflator.
Source: International Water Management Institute, Research Report No.62, 2002; and Central Bank of Sri Lanka, *Annual Report*, various issues.

ing their requirement, while tail-enders lack adequate supply. Others have judged the standard of irrigation management in Sri Lanka in general, to be amongst the worst in the world.[3]

4.2.1 Cost of Irrigation

Since independence, investment in the development or rehabilitation of new or existing water resources and irrigation infrastructure has taken a major share of the development budget. Investment on irrigation development from 1950 to 1985 on average accounted for 19 per cent of the total public investment budget per year. Ninety per cent of the irrigation investment has been for new construction. In addition, the irrigation subsector claimed a disproportionately large share of the public recurrent budget, arguably hindering the development of rain-fed agriculture and other sectors.

Further, Sri Lanka has reached a plateau in expanding large irrigation projects - such as renovation of abandoned ancient tank systems - to more difficult undertakings, including major water resource development, resulting in a sharp increase in the construction cost per hectare of irrigated land that renders new irrigation construction economically non-viable.

Even in the absence of new constructions, provision of irrigation water is still a serious burden to the state in Sri Lanka, currently exceeding Rs. 0.5 billion per year (Table 4.2). Part of this expenditure goes as salaries and other transfers, and estimates suggest that the net irrigation subsidy amounts to 3 per cent of the total value added in the rice sector. Both sub-optimal management of water in existing irrigation schemes and increasing cost of construction of new irrigation infrastructure point to the need for increasing water use efficiency and minimizing the wastage of irrigation.

4.3 Rationale for Irrigation Water Charging and Pricing

In developing countries, irrigation water is frequently being considered as a free gift of nature. This leads to strong social, and there-

[3] Chambers, R. (1988), "Monitoring and Evaluation of Participatory System Management Policy", International Irrigation Management Institute and Hector Kobbekaduwa Agrarian Research and Training Institute, Colombo.

fore political, aversion to any attempt to charge for irrigation water and consequently free supply or under pricing has become a common practice. However, both practices have resulted in a serious misuse of water in many parts of the world. Supply of irrigation water often requires large initial capital investments in infrastructure development. Consequently, governments are often required to administratively allocate water among the users and recover the capital cost. Policymakers use various mechanisms to allocate water, some more efficient and some easier to implement than others, yet they generally involve water pricing of one sort or another. Both under pricing of water and lack of cost recovery mechanisms in many government-managed irrigation systems have resulted in poor operation and maintenance in many of the developing countries. The growing scarcity of water calls for a new approach that recognizes water as a scarce economic resource, where the need for proper pricing of irrigation water is increasing.

The pricing of irrigation water can also be considered as a pre-requisite for sustainable use of water resources in developing countries. The underlying principle of natural resource pricing in relation to sustainability concerns is that natural resource prices should reflect: (i) the cost of extraction; (ii) any environmental cost involved; and (iii) the benefits forgone in the future from using a unit of the resource today. The first category of prices is related to the marginal costs of extraction, viz., the cost of making one additional unit of water available, and the third is the opportunity cost of water, as defined in (iii) above. The economic sustainability criteria or the socially optimal rule for water use can then be established by comparing farmers' willingness to pay and the opportunity cost of water. For example, if the farmer's ability to pay is well below the opportunity cost of water, the water use system shows unsustainable patterns of water usage.

The obvious need for irrigation water pricing today has resulted in a broad discussion of the many related aspects, viz., the theory behind, alternative methods and the basis of, pricing water.

4.3.1 Principles and Methods of Water Pricing

A free market for irrigation water exists only rarely as a result of irrigation infrastructure and water sources showing characteristics of public goods - i.e., goods for which no one holds an exclusive right. Thus, pricing needed for efficient water allocation are not determined naturally by demand-supply interplay and this status quo provides the ideal background for institutional determination of water prices.

Economic theory elucidates that the efficiency of water allocation is achieved by the equalization of the benefits derived by the use of an additional unit of water (marginal benefit) to the additional cost incurred in supplying it (marginal cost). At this point, the scarce water resource generates the maximum net benefit to the society. In addition to efficiency, another aspect receiving considerable attention is equity of water distribution. This aspect is concerned with the 'fairness' of allocating water across economically disparate groups in a society and based on often vague normative assertions. Nevertheless, it is important to notice that efficiency and equity objectives are often incompatible with each other, and consequently, departures from efficient prices are common place in the practice of water pricing.

As mentioned before, efficiency in allocating irrigation water is accomplished by equating the marginal benefits of a unit of water to the marginal cost of supplying that unit. In practice, this proves difficult due to many market distortions associated with irrigation water such as its public good nature, transactions (implementation) cost, incompleteness and scarcity of information, externalities, increasing and decreasing returns to scale and natural monopolies. As such, it is important to note that in spite of practical difficulties of administrative pricing of irrigation water, it ideally needs both supply and demand side optimal price estimates and methods of reconciling them to achieve maximum efficiency of allocation. Failure to do so can result in unsustainable water use patterns.

There are numerous practical considerations which lead to deviations of pricing from the ideal marginal cost pricing. Common methods of pricing can be categorized into volumetric, non-volumetric and market based pricing. A fourth category of quotas has recently been added to this list.

Volumetric Pricing: Volumetric pricing mechanisms charge for irrigation water based on the quantities of water consumed. A special case of volumetric pricing is marginal cost pricing where the price of a unit of water is set equal to the marginal cost of supplying the last unit of water. In the absence of implementation costs and scarcity, the marginal cost of supply includes only delivery costs. In this case, the resulting allocation is economical. However, in practice other costs - such as environmental costs - are unavoidable and consequently the pricing procedure becomes more complicated. One difficulty in marginal cost pricing is determining all the marginal costs and benefits when setting the correct price per unit. Costs include the collection of fees and the provision of maintenance; costs may vary over months and over years; costs also include environmental externalities and may need to account for future supply scarcity. In addition, marginal cost pricing ignores equity concerns.

Non Volumetric Pricing: Non-Volumetric methods charge for irrigation water based on a per output basis, a per input basis, a per area basis, or based on land values. Per unit area is the most common and this method is easy to implement and administer and is best suited to continuous flow of irrigation, which may explain its wide prevalence. Due to the high costs of implementing a meter system, it is often more efficient to use per unit area pricing than volumetric pricing when allocating water.

Water Markets: It has long been recognized that markets provide a means to allocate water according to its opportunity cost, resulting in efficiency gains. For formal water markets to work, there first needs to be well-defined, tradable water rights and the appropriate infrastructure and institutions for distributing water. Informal water markets often develop when water is scarce or when governments fail to respond to rapidly changing water demands. However, given the institutional structure necessary for market-based policy, external effects across users, temporal interdependencies, large fixed investments costs, and uncertain supplies, the prospect of attaining efficient allocation via markets alone are deemed unlikely.

Quotas: Prices based on marginal costs could often be too high for low farm incomes and this is especially true when the scarcity value is such that marginal cost pricing would drive smaller, less productive farms out of production. Quota allotments are often used in these situations to mitigate inequity that arises with a water market or marginal cost pricing.

Economic Valuation Demand Side Pricing: Demand side prices or values of irrigation water is also composed of several components - the use values of water in irrigated agriculture, bathing and washing, reservoirs as fisheries, indirect benefits from raised water table, aesthetic value, etc. - as from the standpoint of economic efficiency, water prices should relate to the marginal value product or the opportunity cost. From the government's viewpoint, water price should at least cover capital costs as well as operation and maintenance expenses. From the farmers' viewpoint, prices should not exceed maximum ability to pay; and from the standpoint of feasible revenue collection, water charges depend highly on farmer's willingness to pay. In addition, the increasing environmental degradation costs of water resources deve1opment - such as upper watershed degradation, water logging, potential ground water and surface water pollution due to excessive use of agrochemicals - impose additional costs to society. From a societal viewpoint, these external costs have also to be considered while determining the economic value of water. Thus, setting prices for irrigation water in a way that addresses all the efficiency and equity issues is a daunting task and coming to a compromise between the ideal and what is practically feasible is an inevitable reality.

In Sri Lanka, charging for irrigation water is not a new practice. In spite of the remarkable growth in the rice sector, economic returns of specific investments were found unsatisfactory and this was attributed to inefficient main systems management and neglected maintenance. As a result, attempts were made in 1981 to implement a previously legislated land tax for irrigated areas. However, collections were minimal. In 1984, a fee for system operation and maintenance to be paid by water users was introduced, but the collection rate achieved fell rapidly from 85 per cent of the amount due in 1984 to less than 10 per cent in 1985. Factors contributing to this failure include revenue collection by a centralized agency not linked to irrigation service improvement, a uniform fee regardless of water availability and scheme conditions, and civil unrest combined with legal challenges to the fee by some farmers. Further, farmers had equal right of access to land and water irrespective of the payment of the fee. What is not recognized here, though, is the fact that the charge were set only on cost considerations but without paying any attention to the productivity of water and farmers' willingness to pay for it.

Past experience on water charges has resulted in two economic losses, viz., losses due to inefficient water allocation and losses due to the inability of recovering (at least a part) of initial capital outlay and operations and maintenance (O&M) costs. In fact, irrigation water charges attempted in Sri Lanka were concentrating on the latter and there is no evidence of water prices being aimed at improving efficiency of water allocation. However, the need for a irrigation water pricing policy that minimize both the above losses has been recognized in the past, but implementation of such a scheme was thwarted by strong social and political resistance.

4.4 An Alternative: Participatory Irrigation Management (PIM)

Inherent difficulties in designing and implementing irrigation water charging programmes, the social and political resistance towards them and past experience of failure in charging for water, collectively prompted the need for a similar alternative. Participatory Irrigation Management (PIM) has been proposed and adopted in Sri Lanka for this purpose.

The main purpose of PIM is to make the farmers work together, with government irrigation agencies taking the responsibility of irrigation system management with a view to improving the productivity of irrigated agriculture, making the system performance efficient and reducing government expenditure. Participatory irrigation system management includes three basic elements, namely; Farmer Organizations, Joint Management Committees and Handing Over.

1) *Farmer Organization:* Farmer Organizations (FOs) whose basic function is to deal with irrigation matters are made up of informal Field Channel Groups (FCGs). Each FCG selects a Farmer Representative (FR) to lead the group and represent the group in the committee that governs the Distributory Channel Organization (DCO). In some schemes, higher level organizations such as System Level Farmer Organizations (SLFOs) have been created by amalgamating DCOs.

2) *Joint Management Committees:* FRs and officers from government agencies form Joint Management Committees (JMCs) such as Project Management Committee (PMC) and Sub-Project Committees (SPC) in each irrigation system. The PMC is responsible for preparation of seasonal plan of water allocation to different parts of the system according to different cropping patterns and for solving irrigation-related problems. In addition, the PMC coordinate efforts among different agencies and attempts to improve communication among each other. SPCs are found only in large schemes and they deal with problems related to agriculture and irrigation in sub-areas.

3) *Handing Over:* Once the FOs and JMCs are established and become capable of handling the responsibilities, the responsibilities for Operation and Maintenance (O&M) of distributory channels and field channels are handed over to DCOs while the relevant agency (Irrigation Department) retains the responsibility for O&M of head works, main channels and branch channels.

Prior to 1978, all medium and major irrigation schemes in Sri Lanka were managed by the government with minimum involvement of farmers. But since then, the government moved towards PIM and a Participatory Management Policy was approved in 1988. The major programmes adopted by the government include the Integrated Management of Major Irrigation Schemes (INMAS), Management of Irrigation Schemes (MANIS) and Mahaweli Participatory Management Programme.

1) The Integrated Management of Major Irrigation Schemes (INMAS): The INMAS programme which was limited to 35 major irrigation schemes began in 1984. It covers 197,000 ha of command area.

2) The Management of Irrigation Scheme Programme (MANIS): In 1986, MANIS programme was initiated to bring benefits of INMAS to the schemes not falling under INMAS. There are 160 schemes which cover 59,000 ha of command area under MANIS.

3) Mahaweli Participatory Management Programme: Mahaweli programme is based on irrigation systems that receive some or all of their water requirements from the Mahaweli River. It contains 4 schemes which cover 121,000 ha.

Major short term objectives of these programmes included increasing agricultural production, adequate, timely and equitable water distribution, O&M cost recovery and optimum O&M of irrigation systems. Crop diversification, integrated development of the farms into commercial holdings, improved marketing and value addition, handing over of some management and operational functions to FOs and socio-economic development of the farming community are the major long term objectives.

Since the initial adoption, many FOs have now taken responsibility for the distributory channel O&M. There has been good progress in establishing farmer organizations. FOs can be seen in about 85 per cent of all major schemes. However, JMCs have been created in about 49 per cent of all major schemes only. The O&M responsibilities have been informally transferred to a large share of FOs and formally transferred to about 20 per cent of the FOs.

Participatory management has improved relations with agency officials and water distribution in most schemes. Head-tail disparities, inadequacy, unreliability and poor timeliness have reduced due to improved seasonal planning, efficient performance of FOs and increased farmer participation in decision making. These have resulted in risk reduction of cultivation. At the same time, farmers contributed their labour for O&M activities. But no significant increases in irrigation cost to farmers resulted due to increased labour contribution replacing cash or kind contribution.

There has been a substantial decline in government expenditure on O&M over time in real terms. Even though the reduction in O&M expenditure was partly compensated by an increase in farmers' contribution in cash or in labour, it was mainly due to government curtailment of funds for irrigation facilities.

On the other hand, management transfer alone did not result in significant changes in the quality of irrigation services. Problems with the understanding of responsibilities and reduction of government allocations have affected the rate of deterioration of channels. In spite of the management transfer, FOs and JMCs are financially still dependent on the government. The O&M work is still financed by the Treasury allocation of funds for irrigation that are distributed among the FOs and JMCs. The impact of participatory management on crop production seems to be marginal and sometimes non-existent. Further, there has been no noticeable increase in either yield or area cultivated.

Institutional problems such as poor agency support (for example, in training) for participatory management to FOs and JMCs, inadequate linkages and coordination between FOs and irrigation agencies, poor performance of JMCs in problem solving and poor communication between farmer representatives and their constituents are also observed as significant problems. Overall, the proponents of PIM believe that the participatory management policy is moving in the right direction. Despite the failures in achieving some desired objectives, the benefits accrued and potentials realizable by revising certain aspects of the programme are argued to be justifying the continuation of the PIM policy.

4.5 Land Development Ordinance and Land Grant (Special Provisions)

With a growing rural population, limited land availability and few off-farm opportunities, many second and third generation settler families in irrigation schemes are now encroachers or technically 'landless', living on their parents or other relatives' properties. Much of the country's land, especially in the major irrigation areas comes under the Land Development Ordinance (LDO). The LDO as passed in 1935 during the British Colonial period following the First Land Commission of 1927 sought to make recommendations to establish a scheme whereby land may be settled by villagers and to prevent such land from passing into the hands of persons from other villagers or small holders. In so doing, the Commission aimed to "create a prosperous, self-respecting and self-supporting multitude of peasant proprietors." The LDO was the proposed mechanism for these aims with a limited area of lowland (or irrigable paddy land) and highland (i.e., non-irrigable land) provided as a lease given in perpetuity - amended in 1969 to allow the lease to be converted to a grant.

Seventy years later, the LDO still forms the dominant land tenure in Sri Lanka. While data is limited, it is estimated that over 70 per cent of smallholder farmers fall under the LDO and over 65 per cent of the land cultivated by smallholders is covered by the LDO. Initially permits were issued under the LDO, but in 80 per cent of the cases these have now been converted to grants.

Since 1935, when the Land Development Ordinance (LDO) was introduced, 1.2 million LDO permits have been issued (including over 70,000 permits by the Mahaweli Authority) - of which about 80 per cent have been converted to grants. The largest number of permits (just over 500,000) has been for village expansion. Regularization of encroachment is the second largest category and the only permit category for which permits are still being issued. Since the 13th Amendment to the Constitution in 1987 and its subsequent implementation, only the Mahaweli Authority and Provincial Land Commissioners (except for a few inter-provincial schemes, which remain the purview of the Land Commissioner in Colombo) issue permits to regularize. Of the 1.2 million LDO permits, about 1 million have been converted to LDO grants, leaving 200,000 still as permits. In addition about 80,000 grants have been issued under the LG(SP) since 1979 but this has now ceased.

A further complication is that Divisional Secretaries can award permits under the State Lands Ordinance (SLO) and often use this to provide some security for encroachers. Unlike for the LDO, where approval is required by the Provincial Land Commissioner, under the SLO, the Divisional Secretary can issue permits without prior approval from any government body. There is, therefore, no data available on the number of permits issued.
Under the LDO, and subsequent amendments and circulars, several activities related to the land are restricted by the LDO permit. These include;

- Cancellation of LDO permits for eligible persons if certain conditions are not adhered to;
- Under inheritance restrictions, after the death of a permit holder, if the spouse is the first nominee then she 'succeeds'. On the death of the spouse, the eldest son succeeds, unless an alternative blood relative has been nominated. If the spouse is not nominated then she has the life interest to the land. Multiple nominees are only allowed if they conform to limits on minimum subdivisions;
- Credit for LDO permits can be accessed only from specific organizations;
- Mortgaging and leasing out LDO permit land is restricted and requires government permission; and
- LDO permit land cannot be transferred.

Most of these restrictions also apply to the LDO and LG(SP) grants. The main difference is that an LDO grant cannot be cancelled administratively and can be 'transferred' for payment in limited circumstances. Transfers must be approved by the government and be to a person in the same 'class'.[4] The Land Grant (Special Provisions) was introduced with similar objectives as the LDO in 1979 to provide land to the 'landless'. The land was taken from the Land Reform Commission and vested in the Land Commissioner's Department for distribution. Many of the LDO grant restrictions apply to LG(SP) grantees.

LDO permits and grants have been issued both for irrigated agricultural land (also known as paddy land) and in the provision of land for settlement (known as highland).[5] Typically, in addition to the house and de-

[4] Class is defined in the regulations as peasant, middle class, etc.

[5] The term 'highland' is somewhat confusing as it simply means 'un-irrigated land' and refers to land primarily for settlement.

Box 4.1
Number of LDO Permit Holders and Grantees

- There are an estimated 3.264 million smallholdings in Sri Lanka. A holding is defined as an area less than 20 acres and one holding may consist of more than one land parcel. These holdings include both home-gardens and land used for other purposes and cover 3.78 million acres - including both cultivated and uncultivated land. These smallholdings are operated by an estimated 1.78 million.
- As of 2001, approximately 1.2 million land operators had been given over 2.5 million acres of land under LDO permits. This suggests that over 70 per cent of Sri Lanka's smallholder farmers operate under the LDO system and over 65 per cent of the land cultivated by smallholders is covered within the LDO.
- The main types of permits that have been issued are towards the regularisation of encroachers and for village expansion.
- Despite provisions in the LDO, the conversion of permit to grants started only in 1982. By 1994 the number of conversions was also very small. In 1995 an amendment was passed (Amendment Act No.9 of 1995), which permitted grants to be issued without the provision of a plan. By 1999, just under 1 million grants had been issued.

pending on the type of soil, climate, etc., the highland will have some rainfed agriculture or tree crops (often known as home-gardens). Originally the permits were given for a combination of a larger area of irrigated land and a smaller area of highland. However, over time some people possess only highland plots, partly because these can be legally divided into smaller plots and provide dwelling space. At the same time, income can be generated as a sharecropper or labourer by working the land of others. However, a segment of the rural population lacks a permit even for a highland plot for residential purposes, and these are typically the poorest and most vulnerable families. The diverse issues that arise in relation to irrigation land and incomes, versus highland for settlement mean that it is difficult to treat these two issues together. Some of the confusion and debate within the discussion of LDO reforms arises from a lack of clarity between these two types of LDO land use - irrigated agriculture and settlement.

4.6 Current Situation with LDO and LG(SP) Land[6]

As a result of LDO restrictions, the choices of permit holders and grantees regarding land usage (i.e., mortgage, lease, sale, subdivide, pass on to children, etc.) are constrained and subject to long delays with much time spent visiting relevant officers with bribes occasionally expected. This leads to much higher transaction costs for LDO land and leads to lowering its value - in some cases, for example, LDO land value is 15-25 per cent below comparable private lands.

Delays and transaction costs of approvals for various LDO land actions are worsened by lack of understanding by responsible government officers including Divisional Secretar-

[6] The results here take an empirical approach based on qualitative field surveys of ten representative locations, which exhibit different agro-ecological zones, livelihood patterns and types of irrigation settlement in Sri Lanka.

ies, clerks, Grama Niladharis and others charged with administering the system and handling disputes. While the Land Commission had published a manual with relevant laws, regulations and circulars about 10 years ago, this has not been updated or reprinted. Many officers make mistakes in administering the LDO that cannot be rectified administratively and may require a long legal process. In addition, only a few permit holders/grantees are aware of their rights or responsibilities under the LDO and the complexities of the system. This makes them dependent on public officials, who may themselves be unaware, overworked, disinterested or unscrupulous. Hence, permit holders/grantees do not receive the most appropriate advice or assistance to swiftly gain the required permission under the Ordinance.

As a result of ignorance or indifference, land operators and government officers ignore some of the provisions of the LDO. Therefore, lifting some LDO restrictions would simply be legalizing what often already happens informally and illegally. Mortgages and even some sales are generally done illegally without government permission. But while this does not seem to matter for mortgages, it can create insecurity and complications for illegal 'buyers' of the LDO permit/grant.

Currently, the LDO is haphazardly enforced and implemented at the local level. Encroachments are equally randomly regularized with no systematic or forward-looking approach to identify lands for the landless. Moreover, conversion of permits to grants is subject to long delays in the complex and bureaucratic process. Land maps are important to reduce disputes over LDO boundaries. While most permits were issued with a plan, in converting these to deeds, however, speed was considered vital and the bulk of the grantees have been given deeds without a plan. This has inevitably increased boundary disputes, and meant that the government has no idea of the extent of the country covered by grants.

4.6.1 LDO Land Inheritance, Price and Sale

Inheritance rules cause much distress, since restrictions ensure that in most cases inheritance is by the eldest son, if the permit holder/grantee dies before nominating a successor. Typically only one person will inherit due to minimal subdivision limits. Thus, the established succession rights adversely affect women in particular. This is different to customary law, which applies to most privately owned lands, where if an owner dies without a will, her/his land is shared equally amongst her/his children. Unlike many other restrictive aspects of the LDO (such as requiring government notification) which are circumvented by being ignored, these restrictions are harder to ignore as the legal successor, typically the eldest son, can ensure that the grant/permit goes to him. In nine out of ten village sites, the permit holders/grantees expressed a strong preference to be allowed to divide their land equally among their children where restrictions were identified as causing family disputes and conflict. In the majority of villages, removal of the inheritance and subdivision rules were identified as the key reform needed in the LDO.

Land prices are often considerable lower for LDO land than for private land. In the study villages where comparable data was available, LDC land prices were found to be lower by approximately 15-25 per cent. However, according to farmers other factors, such as soil fertility, access to infrastructure facilities, water, electricity, roads, etc., are more important than tenure in determining land prices in general. In addition, the reason given for the lower price of LDO land is not because they cannot be easily sold, but because of the restrictions on inheritance and subdivision.

There were limited illegal sales of LDO land in all ten sites, but even private land sales were not very high. However, significant variations between villages were to be found. These illegal LDO sales are typically conducted through a notary public often with a promissory note, sometimes witnessed by a Justice of the Peace. They are typically 'legalized' by the Grama Niladhari or appropriate officer assisting the new owner to register the permit/grant in their name. However, there are some cases of the original owners returning to reclaim their sold land. In general, people prefer not to sell their land, and there is anecdotal evidence for a decline over the last three decades in areas of high illegal LDO land sales. Initially in three of the village sites, a number of new settlers sold their land as they found life difficult in the often incomplete settlements. Now, as facilities have improved people are more reluctant to move. There is also pressure from the next generation to prevent parents selling land. A few illegal LDO sales are linked to poverty, debt and alcoholism. However, in general these were not stated as the major reason for land sales.

4.6.2 Credit and Mortgages Link to LDO Tenure

There is a relationship between credit and tenure in cases where bank loans are harder to get for LDO permits holders than for grantees and often require government approval. Both permit holders and grantees may occasionally find access to formal credit more difficult than private landowners. It is important to ensure that this is not due to other factors such as better access to irrigation of private lands leading to higher output and lower crop failure. In addition, the poor track record of defaults means that commercial banks are often reluctant to lend to most smallholder land operators - regardless of their tenure status. This leads LDO smallholders and private landholders to seek informal credit sources.

Due to lack of access to formal credit, credit is often provided within the village through informal mortgaging or leasing.[7] The main difference between these is that in a mortgage, the permit holder/grantee keeps working the land to pay off the loan, while in 'leasing out' the permit holder/grantee loses access to the land until the loan is repaid. Government regulations requiring approval for the loan by the Divisional Secretary are largely ignored. In seven of the ten villages, land mortgages and leasing out were found to be extremely high. For the three villages where approximate data was collected 40-80 per cent of smallholders had mortgaged or leased their land. This applies both to permit holders/grantees and private smallholders. The implicit interest rates under these informal mortgages are very high. In the other villages, other informal credit sources are used.

Where land is used for collateral for credit (e.g., by mortgaging land), the credit is typically used for consumption, such as family events (weddings or funerals), during crop failure, to invest in the construction of housing, or for migration related costs. Typically, credit for agriculture is provided already by those who provide agriculture inputs (e.g., shops selling fertilizers/pesticides) or by those who purchase outputs. Here again, while the credit is accessible, it locks people into purchasing and selling arrangements from the

[7] In the case of leased land, the permit holder/grantee of the land 'leases' it to someone wealthier and who provides a loan with the land as collateral. The permit holder/grantee loses access to the land until the loan is repaid – although the debtor may be hired as a labourer on his own land. Interest may or may not be charged. The land may be lost if the loan is not repaid.

person who provides the loan, which may have high implicit interest rates (even though the stated interest rate may be low).[8]

In some crops, particularly vegetables, the costs of inputs are extremely high, so in some cases, permit holders/grantees lease out the land to others, as they cannot afford the cost of the inputs. While informal mortgaging and credit through suppliers and purchasers provide accessible credit for smallholders, it comes at very high implicit interest rates. However, in a situation of high risk and hence high transaction costs for lenders, there may be no other way to provide loans to the poorest.

4.6.3 LDO Land Size: Consolidation, Productivity and Poverty

The land plot size tends to be declining, with only a few cases of consolidation. As settlement schemes have proceeded, the land provided has become smaller, from over five acres of irrigated land and two acres of highland in some schemes in the 1950s to three acres of irrigated land and one and a half acres of highland in the 1980s. Through legal and illegal subdivision and sale, the existing plots have become smaller. In addition, subsequent schemes provide only smaller plots to begin with. The Green Revolution also stimulated agricultural intensification, which helped make smaller plots generate higher yields. There are a few cases, where a single family or families have bought up several plots and so increased their holdings, but this is limited. Rarely does any family own more than ten acres. This suggests that fears over LDO reforms leading to inequitable land consolidation would appear to be misplaced as they would go against a historic trend, where people prefer to subdivide land as their family size increases.

The link between land plot size and productivity is not clear. Land operators do not see fragmentation as a major issue in terms of productivity. Often, the high costs of inputs and scarcity of labour means that even where LDO permit holders and grantees still have larger holdings, they lease them out or give them out to sharecroppers. This, for example, seems to occur in the vegetable producing areas where the costs of inputs are very high.

Links between land area owned and poverty are important. While the link between land plot size and productivity is not clear, it is generally the case that larger land area brings in more income; provided that farmers can afford the inputs. In technical terms, the marginal rate of return to plot size may be fixed (or even declining) but still in absolute terms more land brings in more income as a larger land area generates a larger harvest. This is one possible way out of the rural poverty trap, but it assumes that there is sufficient land to be distributed, which is not the case. This is demonstrated by the fact that in almost all the study villages, the wealthier families owned the most land.

4.6.4 Land Productivity and LDO Tenure

Contrary to claims by others, fieldwork carried out suggests that productivity and LDO land tenure are not clearly linked; any link is generally not clear and depends on several factors. This is not to say that tenure security is not important - it is rather that generally people with permits/grants feel secure, as eviction is rare. Field surveys identified very few cases of people having their permit cancelled. It is, therefore, not clear if people would feel a lot more secure with a private deed. It was clear however, that encroachers who lacked permits generally felt less secure than those who had been regularized and received permits.

[8] For wealthier private farmers, land does sometimes act as collateral for credit for agricultural investments such as farm equipment. However, this does not seem to be the case for smaller LDO farmers.

Many of the lands are farmed by sharecroppers (both those without agriculture land and those whose land is mortgaged) or those who lease the land. Productivity in terms of land, investments, etc. depends more on the incentives faced by the sharecropper or person who has leased the land (i.e., length of lease, size share crop, etc.) than tenure status of the permit holder or grantee. Generally, mortgages and leases are for short duration for fear of loss of ownership if the land is mortgaged to a single party for over a year or two. While the land may be mortgaged for longer periods (i.e., 5-8 years), the annual mortgage is 'rolled' from one lender to the next.

Credit obtained using land as collateral is rarely used for improving land productivity or to invest in the land. In most villages, farmers said there was no direct link between tenure and investment. Typically, people have put up permanent houses on LDO land. However, encroachers without a permit worry about putting up a permanent house. Other factors are considered more important for productivity than tenure, such as soil fertility, irrigation facilities and inputs provided.

4.6.5 Encroachers and the Landless

Encroachers are generally the poorest and least secure households, and encroaching does offer a temporary solution to their lack of a place to live. Typically, they tend to be descendents of the original settlers of an area or they come from other areas where land for housing is scarce. Second and third generation descendants of original settlers are often technically 'landless' without any legal land of their own to live on. They often live on the land of their parents or siblings, or encroach into highland areas or other 'reserved' areas to put up their house. For example, in the Mahaweli region the areas 'reserved' for specific use such as cemeteries, schools, temples, tank watersheds and lands for agricultural expansion are often encroached. Until they have a permit issued, these encroacher households are the most insecure and in some cases are reluctant to put up houses made of permanent materials, as they fear they might have to leave the land. However, despite this insecurity, encroached land is illegally bought and sold. For example, encroachers may illegally sell off a small patch of land to a landless family. As the land does not have a permit and the sale is thus illegal, the price tends to be lower and so more affordable. There are a few cases, primarily in the Wet Zone, where encroachers may be better off and politically connected and they encroach not for housing, but as a way of increasing their agricultural land.

Regularization of encroachment seems to be quite haphazard and no data is being collected. The decision to regularize or 'legalize' encroachments by issuing LDO permits varies widely from one area to the next with no clear criteria. Within the Mahaweli, the decision to regularize lies with the Mahaweli Authority and is approved by the Director General. Outside the Mahaweli irrigation areas, the decision to provide LDO land to encroachers used to lie with the Land Commissioner, but with the 13th Amendment to the Constitution, it lies with the Provincial Land Commissioner's Department (except for inter-provincial scheme). No systematic data is collected on how and where these encroachments are being regularized. The field surveys suggest that in some areas government officials are quite sympathetic to the plight of the poorer encroachers; in other areas encroachers have to wait many years for permits, while in others they are turned down year after year. However, there seems to be little evidence of encroachers being forced to move by the state. Indeed, the attempts to prevent encroachments seem to come more from within the village by existing house-

Table 4.3
Issues and Linkages to LDO Tenure: Winners and Losers

Key Issue	Link to Current Situation of LDO and LG (SP)	Winners/Losers
Government processes	Slow and bureaucratic with land officials and LDO permits holders/ grantees ignoring some provisions of the Act	Permits holders/grantees face long delays and restrictions Unscrupulous officials can gain from lack of transparency, dis-cretion etc.
Land inheritance	Constrained by nomination and subdivision restriction, otherwise succession to eldest son	Eldest son benefits Other family members lose out, especially women
Land price	LDO land price 15-25% lower than private land price (where data available)	LDO permit holders and grantees lose out
Land sales, including distress sales	Approx. 5% of LDO land currently sold illegally since permit/grant issued	LDO sellers find it hard to find buyer LDO buyers face insecure ownership
Credit, mortgages and leasing out	Some constraints on bank loans, but other credit sources operate particularly mortgages	Permit holders/grantees have less access to credit Those who gain from inter-linked credit markets benefit from lack of alternative credit to LDO permit holders/grantees
Land plot size, consolidation	Plot size seems to be declining, with few examples of consolidation	More recent permit holders/ grantees generally have received smaller land holdings from the state Some who have consolidated land have become wealthy
Productivity	Permit/grant holders generally secure and so do invest in the land. Encroachers without any permits insecure and hence low investment	No clear winner/loser
Land use and crop choice	Preference for paddy where water is available (e.g., in maha) and other crops where water is limited	No clear winners/losers
Encroachers and landless	Generally poorest families	Encroachers lose out until permits issued
Off farm employment	If people work off farm they often prefer to keep land, and where necessary give land for share cropping, lease it or leave with a relative	Off farm workers can become better off

holds forcing away people who try to settle in areas such as the cemetery or temple reservations.

4.6.6 LDO Land Tenure and Off-farm Employment

Off-farm employment and land tenure do not appear to be clearly linked. Due to declining agricultural incomes, agricultural income may be less than 30 per cent of a household's income. For 'poor' women, remittances from international migration and jobs in garment factories are considerable. For 'poor' men, the majority of off-farm jobs are in the armed forces and in the construction industry. For less poor families, off-farm incomes include hiring vehicles or owning some form of business. For both poor and non-poor households, the links between these off-farm incomes and tenure is not apparent. Generally, at least some family members will remain on the land even if the LDO permit holders or grantees move away to earn incomes outside the village. In some cases, the land will be left with another relative, or leased out, or given for sharecropping. Thus, there is little evidence that LDO and LG(SP) limits on sales 'tie' people unwillingly to the land. Nor is it clear that the lack of access to LDO land 'forces' people off the land - although the restrictions on LDO land inheritance and subdivision may create problems for some. Field interviews suggest that those moving to off-farm employment tend to be the younger generation who see little future in smallholder farming. Those who do not want to or cannot find off-farm employment will work as labourers or sharecroppers on others' land and live with relatives or on encroached land.

Discussions with farmers in the ten villages suggest that the binding constraint to addressing agricultural poverty is not tenure, but lack of competition in rural markets. In many cases, more important issues than tenure are marketing, credit, inputs and infrastructure (social, irrigation and roads) etc. Rural factor markets - land, labour and credit - are heavily inter-linked to create a 'poverty trap'.

The source of many of these inter-linked poverty traps is the lack of competition in rural markets. A few individuals control access to credit, marketing, inputs (e.g., fertilizer and pesticides), technology (e.g., tractors and threshers) and processing (e.g., rice mills). These individuals often act as a cartel to set prices, limit competition and prevent new entrants, to generate maximum profits. They are often located within the village (e.g., owners of local shops or providers of agricultural inputs) or from nearby towns. Introducing competition into these markets is vital to address rural poverty. However, for the reasons highlighted above, changes in land tenure will not have a significant impact on their ability to control rural factor markets. Even in areas of private lands, such arrangements exist.

Discussions also underlined the need to be acutely conscious of the social, cultural and political aspects of land as well as the economic aspects. In particular, concerns about sharing land among children for family harmony and equity, widespread alcoholism and gender inequality, a sense of injustice that LDO permit holders and grantees are 'second class' citizens compared to private landowners, the social stigma of living on encroached land and the linkages to the ethnic conflict. Some argue that some settlement schemes have been designed and implemented to alter the ethnic composition of the country. The ongoing conflict has led to significant displacement of different ethnic groups and there are perceptions (although this were not always borne out by field visits) that certain ethnic groups are 'buying up land' and this would be speeded up by removing restrictions on land sales.

4.7 Reform Scenarios Permitting Sale of LDO and LG(SP) Lands

The pro-poor benefits of allowing sale are not clear-cut and there are potentially negative impacts on the poor as follows:

- Land market is unlikely to take off: sales of private lands are quite low.
- Land prices could move either way: if LDO sales are liberalized, and more land enters the market, land prices as a whole may fall. It is not clear which effect will dominate and what would happen to land prices of formerly LDO land as a result.
- Output from highland plots could increase or decrease depending on the extent of conversion of agriculture land to housing as opposed to increased agricultural intensification in the home-garden around the house.
- Productivity impacts not clear.

It is recommended that reform scenarios for outright sales of permits and grants are only considered after an estimation of the minimum scenario is undertaken, and even then it should be approached cautiously: The benefits of the minimum scenario can then be assessed to determine the extent to which these address the main issues of rural poverty. Even then any introduction of outright sales should be done only following a pilot phase which is evaluated.

A full sale scenario is likely to be less pro-poor than the minimum reform scenario where all restrictions are lifted except for sales. In particular, removing restrictions except for sales will almost certainly lead to a rise in the price of LDO land. It was stated that the reason for the low price of LDO land is the restriction on inheritance and subdivision, which leads to family conflict (and not because LDO land cannot be sold). By contrast, permitting the outright sale of LDO land may cause an influx of land into the market where land prices could fall. Secondly, removing government approvals for mortgages will increase access to credit, but restricting sales will guard against forfeiture of land for non-payment. Allowing outright sale will remove this safeguard. The advantages of keeping restriction on sales were corroborated in field surveys where concerns were raised regarding allowing land sales of LDO without restrictions. Interestingly some members of the control group of private landowners also expressed the advantages of restricting sales.

The scenario of allowing the sale of village expansion land, which is not used for agriculture, has already been approved by the Cabinet, although legislation and implementation could take some time.

Sales allowed on all LDO and LGSP lands is a reform scenario that was begun by the government of 2002-04, but was delayed by a Supreme Court ruling based on a technicality that the appropriate process for the new legislation had not been followed. The impacts of reform depend on how quickly and effectively they were implemented, including the extent to which they were publicized and promoted. The sections below try to determine the impacts of allowing sales - but generally they are likely to be less dramatic than both the detractors and the supporters claim.

Land sales in the study villages are comparatively low even for private land. Land sales conducted at present both illegally and informally are estimated at less than 5 per cent. There are push factors that contribute to land sales as well as pull factors, which influence people to retain their property. It is the general perception of the people interviewed that perhaps 10 per cent of lands could be sold if the LDO is completely liberalized. But the high extent of mortgages does not indicate a desire to sell land outright.

The most vulnerable group to sell land are poor families who are largely dependent on

Box 4.2
Unutilized Paddy Lands in the Wet Zone

In the wet zone, large tracts of paddy land are left idle and the owners or operators find them unprofitable to cultivate due to climatic (high wind during rainy season), physical (high salinity, fragmented land) and economic (unavailability of labour) limitations to rice farming. However, conversion of paddy lands to other uses is prohibited by the law (Paddy Lands Acts of 1956 and 1958, Agrarian Services Act of 1979, Agrarian Development Act of 2000) and hence large areas of land that can be used productively in economic development of the country remains unutilized. This has limited the mobility of land resource not only across the sectors but even within the agriculture sector. Nonetheless, the demand for land in the wet zone from other uses, including urbanization and infrastructure development is quite high. Moreover, comparative advantage in paddy farming in the wet zone is low and the only valid reason for keeping these low lands is their important drainage function. In the face of rapid urban development taking place in the wet zone of the country, leaving a large area of land underutilized is a clear sign of inefficient allocation.

These lands can be used productively for agriculture as well as non-agricultural purposes. However, it is crucial to identify the ecologically sensitive areas and leave them as low lands. Suitable cash crops (leafy vegetables) or fish farming can be profitably undertaken in these lowlands. These lands can also be reclaimed to grow highland crops; however, the cost effectiveness of such measures needs to be evaluated. The prime lands for urban development, especially along the roadsides, can be allowed for allocation on rational basis among other competing uses. Facilitating formal land transactions will also prevent further informal transactions which are already taking place at a cost to the disadvantaged groups. However, in the reallocation process, the economic concerns should essentially be harmonized with the environmental and social concerns to make optimal use of the land while limiting possible social and political conflicts.

casual labour or other non-farm economic activities, incomes from which are seasonal and irregular, do not have the sufficient capital to invest in cultivation and are deprived of accessing improved infrastructure facilities. Potential distress sales could be addressed by focusing on reducing poverty among these vulnerable groups through improved livelihoods and infrastructure facilities.

While LDO prices are currently lower than private land prices, if LDO sales are liberalized, and more land enters the market, land prices as a whole may fall. It is not clear which effect will dominate and the resulting impact on land prices of formerly LDO land even in the short term. Prior to reform, the price impacts are very difficult to predict. Clearly in the medium to long run land prices will appreciate and the price difference between LDO and private lands would no longer exist. It is not clear how long this appreciation would take, although given the high demand for land it is unlikely to take a very long time.

At present, the LDO makes it very difficult for land to be forfeited if credit is not repaid. In the few cases where this has happened, it has often been due to fraudulent practices by the lessors/mortgagers to get the lands transferred to their name. By allowing outright sales, forfeiture of lands may increase. While some land may be lost if land is subdivided and more houses are built, there may be an intensification of home-garden and highland cultivation around houses leading to a net gain in total agricultural output. In addition, despite increasing fragmentation of irrigated land plots, accessing water irrigation infrastructure was not highlighted as an issue by land operators. There are also other laws and regulations such as the Agrarian Services Act and the Paddy Lands Act which limit farmers' ability to undermine existing irrigation management systems.

Productivity benefits of land sales are not clear and could even be counter-productive. Productivity impacts depend on the buyers or sellers being more productive. There are examples of private land being left fallow or kept as land speculation in some other areas. Consolidation, assuming it were to happen, may not be such a contribution to productivity. There is a low perception among the farmers that fragmentation is a problem that has led to reduced productivity.[9] There are also counter-factual arguments such as attempts to promote larger farms in some Mahaweli areas, although these have largely failed. And as mentioned previously, land tenure is not key for accessing credit, particularly agricultural credit.

4.8 Recommendations and Conclusion

The preceding discussion highlighted the complexities involved in both reform of irrigation water pricing as well as reform of smallholder land tenure policy. In the case of the former, it showed that charging for irrigation water, in spite of its theoretical appeal, has many inherent problems, especially in the case of gravity flow irrigation systems. It even fails in ensuring water use efficiency - which is the principal argument for the introduction of pricing - due to the very high implementation costs, particularly in relation to water metering. In addition, the lack of information on marginal costs, marginal productivity and willingness to pay in relation to irrigation water, poses a huge problem in any attempt to fix marginal cost prices or any other volumetric price. Without volumetric pricing, efficiency of water use would not be ensured and waste would not be minimized.

On the other hand, pricing and charging usually does not address the problem of inequity in irrigation water distribution. Variable charges dependent on the quality of irrigation services and the productivity of water should be introduced to mitigate this problem - but at the cost of some efficiency. The relative merits of the alternative to charging - PIM - looks particularly attractive at this juncture and the past experiences of Sri Lanka in this respect, though not striking, are at least encouraging.

The future of both market and administrative price systems in constituting efficiency or equity could often be taken as a justification for refraining from charging. Nevertheless, the second problem relating to irrigation service provision - cost recovery - cannot be solved without some form of a charge. Although there are claims that O&M expenditure reduced due to the introduction of PIM, the remaining burden on the Treasury is still large. Although a decision to curtail the irrigation subsidy is politically risky, the ever increasing O&M expenditure and budget deficit is certain to force the government to at least partially trim down its expenditure on irrigation services provision. This necessitates a mechanism to recover at least a part of O&M expenditure and the obvious choice is an irrigation water charge.

It is evident from the discussion on different water charging mechanisms that what is practically feasible for Sri Lanka is a land based irrigation tax. To reduce the inequity resulting from non-uniform quality of irrigation services and productivity of water, this should be a variable charge which is high for 'good' areas such as the heads of irrigation channels. Even though the farmers in PIM schemes were exempt from any cash or kind payments in the past, it does not appear to be a suitable practice as not all farmers participate equally in management activities. Further, the obvious need for cost recovery is not ful-

[9] The same is shown to be true in the Puttalam District (see Dunaham D., and C. Edwards (1997), "Rural Poverty and an Agrarian Crisis in Sri Lanka, 1985/95: Making Sense of the Picture", IPS.

filled in such instances, although PIM tends to reduce O&M expenditure to some extent. However, the funds collected under an irrigation scheme should be used to cover the expenses in the same scheme and the local PIM bodies should be in control of it. This way the tax payers are assured of the total benefits from the money they pay and transparency of the financial management is also enhanced.

The final question that remains is why not PIM alone with no irrigation charges? Obviously, this would not solve the problem of excessive expenditure by the government on irrigation. The other reason is that PIM is still far from perfect despite scattered success stories. They can be seriously affected by 'traditional ills' such as social non-cohesiveness resulting from segmentation due to education, economic background, caste, political affiliations, etc. Moreover, cooperation and mutual respect between the farmer representatives and government officials serving in PIM bodies are also serious concerns. The technical and managerial capabilities of farmer representatives could often be inadequate and this in combination with differences in personalities can lead to the local bodies being dominated or even 'monopolized' by a few individuals. Experiences with many farm or village level voluntary or elected organizations are not always encouraging in Sri Lanka. Hence, the long run solution to the problems of irrigation water use efficiency, equity and cost recovery seems to lie with a suitable combination of participatory management and land based irrigation charges.

In attempting to explore the linkages between rural poverty and government involvement in smallholder land tenure to assess whether some of the LDO restrictions can be reformed to increase benefits for poor households, the following set of recommendations are suggested towards the implementation of a minimum reform scenario:

- Address agriculture challenges facing LDO permit holders/grantees (i.e., in relation to marketing, infrastructure, credit, etc.).
- Create a more systemic approach to assisting landless and encroachers.
- Facilitate off-farm employment.
- Remove inheritance and subdivision rules for agricultural lands.
- Permit joint ownership of permit/grant.
- Remove the need for permission for credit, mortgages, leasing, etc.
- Improve awareness of land rights amongst land operators, LDO permit holders, and grantees.
- Strengthen strategic administration of land management.

This minimum reform scenario includes the most important issues for poverty reduction. Allowing the sale of LDO land is not a key to rural poverty reduction and, indeed, could in some situations exacerbate several aspects of rural poverty. Most importantly, the debate over LDO sales may use up scarce political capital on issues that are not the highest priority tenure reforms for rural poverty reduction. In particular, given that the poorest households are typically those who have no legal land title - i.e., they are living on land owned by their parents or relatives or have encroached - they should be the target group for pro-poor tenure reforms rather than those who already have LDO permits/grants.

For rural poverty reduction addressing other constraints to viable agriculture may often be more important than tenure reforms - for example, fair and stable prices for agricultural output through improved access to markets and credit at lower interest rates. This emerged in many field sites where land operators indicated that other issues were of higher priority than tenure. Marketing is a major problem and government attempts to offer higher prices to the farmers through guaranteed price schemes, are often circumvented by the sellers who then benefit from the guaranteed price. Many rural households, especially the poor mortgage and lease out their land at prohibitive interest rates. Although other credit institutions exist, such as rural banks, Sanasa, Samurdhi and women's societies, etc., many people are not aware of the availability of these or that the loan amounts are relatively small. Attempts by the state banks to introduce larger loans have sometimes led to defaults.

Land for encroachers and landless can be managed systematically with new areas identified by updating plans in Mahaweli and other areas. There is clearly a shortage of land, but the current approach is largely reactive crisis management with ad hoc regularization of encroachments. There is need to systematically identify potential areas for new lands and allocate them more transparently with clear criteria. Some of the reservations set out in the original Mahaweli areas are quite outdated and need to be revised.

Off-farm employment is vital to reduce dependence on low agriculture incomes, particularly for the landless and encroachers: With growing populations and limited land availability, there will never be enough land for all the encroachers and landless. Many people are already moving into off-farm employment, but they face many challenges. Removing inheritance and subdivision rules for agricultural lands was expressed as a strong preference of almost all people interviewed. There was little evidence from the field that the increase in fragmentation will lead to a decline in productivity. Introducing joint ownership for permit holders/grantees will overcome the lack of land rights for women while their husbands are alive.

Remove the need for permission for credit, mortgages, leasing, etc., would reduce many of the delays and bureaucratic approvals occurring under the current system. It would also free up time of the Divisional Secretaries and other officials from spending time with routine land approvals. Improved awareness of land rights by LDO permit holders/ grantees and land operators would allow land operators to demand better services from the government officers, to know when they were being misled and to demand redress for wrong decisions. In the short run it might lead to additional work for the government as the land operators would be better informed, but in the long run it could lead to a smooth functioning and simpler system. Administration of land management also needs to be strengthened with a more strategic approach to include more capacity to set national standards by the Land Commissioner General's Department and more transparent implementation by the Provincial Land Commissioners. Implementation needs to balance the need for regional flexibility with national guidance. Flexibility could allow local variation to be reflected - for example, Wet Zone versus Dry Zone, crop type, cultural practices (e.g., different inheritance customs) etc.

By removing many of the time consuming routine approvals, land officers will have more time to address the higher priority more strategic land management issues such as proactively identifying land for the landless, addressing the backlog of plots without maps and approving sales swiftly and transparently. Speedy introduction of some of these minimum reforms can be made with limited controversy. Some of these are already included in the amendments approved by the Cabinet, but they are packaged with more controversial reforms allowing sales of village expansion land. Such controversial issues may be subject to delay and their pro-poor impact is less certain. Therefore, the recommendation is to introduce a minimum reform package which would not include outright sale of LDO or LG(SP) lands.

Leading Issues in the Development Process

5. Extending Social Security to Informal Sector Workers

5.1 Introduction

In the recent past, from a social security stance, the informal sector has received renewed interest - largely fuelled by concerns of an ageing population and a growing informal economy – due to the fact that most workers in the informal sector are not safeguarded by protection available to workers in the formal sector. Insecurity faced by workers in all countries arises mainly from income inadequacy and income variability, although discernible through various forms such as - illness, poverty, susceptibility to natural disasters, etc. Earlier schemes that intended to provide social protection to the informal sector operated to *protect* the workers from falling into poverty through inadequacy and variability of incomes. These most often took the form of health insurance schemes, microfinance schemes, old age pensions schemes, etc. One main shortcoming of these schemes was that, although they *protected* workers who were adversely affected by various risks, they did not *prevent* workers from being affected by these risks. The new thinking on social protection aims to treat social security in a more comprehensive manner, where emphasis is given to risk management through *risk prevention*, *risk mitigation and risk coping strategies*.

Under this thinking, both risk prevention and risk mitigation are actions to be taken before the occurrence of an adverse event (i.e., ex-ante), where risk prevention deals with minimizing the risk from an event while risk mitigation deals with minimizing the impact - such as loss of income, damages to assets - of an adverse event. An example of risk prevention may include construction of irrigation schemes to minimize the risk of floods, proper nutrition to prevent the risk of adverse health events, etc. An example of risk mitigation may include insurance for assets that are vulnerable to risks, diversification of income sources, etc. Lastly, coping strategies deals with actions taken after the event to minimize the impact of adverse events. These include income transfers from the government and other sources, borrowing, public works programmes, etc.

Risks and opportunities faced by informal sector workers differ by employment status, by type of industry or trade as well as by the wider social, economic and political context within which the informal sector workers live and work. In this context, this chapter attempts to characterize the informal sector in Sri Lanka, with a view to identifying main risks and vulnerabilities faced by different types of informal sector workers in the country as discussed in Sections 5.2 and 5.3. Section 5.3 then discusses the different types of interventions possible to manage the risks faced by these different sub-groups. Section 5.4 provides a summary of the discussion and conclusions.

5.2 Characteristics of the Informal Sector Workers

The informal sector is a heterogeneous sector consisting of economic activities in agriculture, fishing, and livestock rearing, small and medium scale enterprises, petty traders, and other small commerce, industry and service occupations. As opposed to the 'formal sector' - which is characterized by employment which has better income security, and better legislative protection that provide other

Table 5.1
Formal and Informal Sector Employment Status (%)

Employment status	1992		1997		2004	
	Formal	Informal	Formal	Informal	Formal	Informal
Employee at public sector	930,631 (19)		849,482 (16)		944,990 (13)	
Employee at private sector		2,061,784[a] (43)	1,125,094 (21)	1,279,670 (24)	1,700,987 (24)	1,697,586 (24)
Own account worker		1,334,344 (28)		1,622,530 (30)		2,090,418 (30)
Unpaid family worker		504,260 (10)		517,917 (10)		642,601 (9)
Total		**4,831,019**	**1,974,576**	**3,420,117**	**2,645,977**	**4,430,605**

Notes: The labour force data does not allow a clear distinction between formal and informal private sector workers. This analysis considered daily paid private sector employees to be informal sector workers. Percentage distribution of total employed population is given within brackets.

a. For 1992 private sector employees cannot be distinguished between formal and informal, as their salary payment basis (daily paid or not) is not available.

Source: Author's calculations based on Department of Census and Statistics, *Labour Force Survey* data.

non-income benefits such as pensions, paid holidays, and job security - the 'informal sector' is the remaining sector with relatively less income security and informal terms and conditions of work that are not protected by law.

Although often lumped together, informal sector workers differ widely according to their employment status. At a broad level, the informal sector in Sri Lanka comprises the following:

a) informal employees - these typically include workers in informal enterprises,[1] and casual and contractual workers
b) own account workers - these are workers who are self employed, and
c) unpaid family workers - these are unpaid workers in family enterprises.

It is important to differentiate these three types of workers, as the risks and opportunities attached to their work are quite varied. Various studies on the informal sector in Sri Lanka have found that typically between 60 to 70 per cent of workers of the total employed population are in the informal sector (Table 5.1). In 2004, the majority of informal sector workers were own account workers (30 per cent of employed), followed by informal private sector employees (24 per cent of employed) and unpaid family workers (Table 5.1). And these proportions have remained more or less constant since early 1990s.

5.2.1 Own Account Workers

Own account workers - also often referred to as self-employed - are individuals who work for themselves. Nearly 80 per cent of the own account workers are males. Compared to other types of informal sector workers, own account workers tend to be older, with more than 50 per cent of them falling between ages 30 and 50. Close to 90 per cent of own account workers are located in rural areas. Own account workers as a percentage of total informal sector workers has declined in the rural sector, while it has increased both in the urban and estate sectors.

[1] In this chapter enterprises not adhering to labour regulations of Sri Lanka are referred to as informal enterprises.

Table 5.2
Employment Status by Socio Demographic Characteristics of the Informal Sector

Characteristic	1997 Informal Employees	1997 Own Account Workers	1997 Unpaid Family Workers	2004 Informal Employees	2004 Own Account Workers	2004 Unpaid Family Workers
Employed people	1,276,901	1,619,427	512,916	1,697,125	2,090,418	642,601
Sex						
Male	61.5	79.4	40.5	62.7	79.3	32.7
Female	38.5	20.6	59.5	37.3	20.7	67.3
Age group						
Less than 15	0.2	0.2	0.9	0.2	0.1	2.3
15-19	8.4	1.7	12.5	6.4	1.4	10.7
20-29	36.1	15.0	32.6	38.2	14.2	26.5
30-39	25.0	25.7	25.1	24.6	24.4	21.5
40-49	19.1	27.9	17.3	16.9	26.6	20.1
50-59	8.1	15.5	8.0	10.6	21.3	13.8
Over 60	3.0	14.0	3.7	3.1	12.0	5.1
Sector						
Urban	19.9	9.7	5.0	17.7	11.7	6.5
Rural	73.6	89.2	94.4	66.0	86.0	91.4
Estate	6.6	1.1	0.6	16.3	2.3	2.1
Province						
Western	47.1	22.6	9.2	45.2	23.1	12.2
Central	16.5	14.0	13.9	14.8	9.5	12.5
Southern	7.2	14.4	12.1	11.4	13.4	14.4
Northern	-	-	-	1.5	3.2	1.9
Eastern	-	-	-	2.4	7.4	8.1
North Western	11.4	16.2	17.1	10.6	13.5	12.4
North Central	2.7	10.1	15.1	2.4	10.5	13.7
Uva	6.4	9.1	20.9	3.3	8.8	16.2
Sabaragamuwa	8.7	13.6	11.5	8.4	10.6	8.7

Source: Department of Census and Statistics, Labour Force Survey data, various years.

The majority of own account workers in 2004 were in the agriculture/forestry sector (46 per cent), the wholesale sector (23 per cent), the manufacturing sector (13 per cent) and the transport sector (6 per cent). The proportion of own account workers in the agriculture/forestry sector has declined from 1997 to 2004, while that of wholesale, manufacturing and transport sectors have increased over the same period.[2]

By occupation category, in 2004 own account workers were mainly skilled agricultural workers (44 per cent), senior officials[3] (14 per cent), craft workers (14 per cent), service workers (12 per cent), machine operators (6 per cent) and workers in elementary occupations (6 per cent). From 1997 to 2004, the proportion of senior officials and machine operators has increased, while that of agriculture workers, service workers, and workers in elementary occupations has decreased.

5.2.2 Informal Sector Employees

As with own account workers, a higher per cent of informal sector employees are males, although the male-female disparity is less marked than for own account workers (Table 5.2). The majority of informal sector employees are in the rural sector, but compared to

[2] The percentage of workers in the forestry sector also appears to have increased from 1997 to 2004. But, this is mainly due to a definitional change that took place in 2001.

[3] Informal sector workers are not necessarily poor. Some high income earning individuals such as consultants and freelance professionals also fall under the category of informal sector workers.

the other two types of informal sector workers, a higher proportion of them are in the urban sector; and close to half of them are in the Western Province. However, the proportion of informal sector workers, both in the rural and urban sectors, has declined while those in the estate sector have increased substantially. Greater mobility due to better education and possession of identity cards and the increased demand for unskilled labour due to the expansion of the manufacturing sector - especially the textiles and garments sector - may have resulted in the increase in informal sector employees in the estate sector.

In 2004, a majority of the informal sector employees were in manufacturing, agriculture/forestry or wholesale sectors. Other than for a marginal increase in the number of workers in the wholesale sector, the proportion of informal employees in different industries has remained consistent from 1997 to 2004.

By occupation category, a majority (31 per cent) of informal sector workers are in elementary occupations - i.e., occupations such as street vendors, domestic helpers and cleaners, building caretakers, messengers, garbage collectors, etc. or craft workers (22 per cent). A fair proportion of them were also service workers (9 per cent), machine operators (9 per cent), clerks (9 per cent), and technicians (9 per cent). The composition of informal sector workers in the upper end of the occupation ladder has increased from 1997 to 2004, with the proportion of senior officials,

Table 5.3
Employment Status by Industry and Occupation: 2004

	Public Employees	Formal Employees	Informal Employees	Own Account Workers	Unpaid Family Workers	Total
Industry						
Agriculture	0.5	7.2	0.9	33.7	50.5	16.7
Forestry	3.4	27.0	15.9	12.5	22.4	16.5
Fishing	0.0	3.7	0.8	2.1	0.3	1.8
Mining and quarrying	0.0	1.6	1.1	0.9	0.2	0.9
Manufacturing	2.0	12.7	37.7	13.1	8.7	16.9
Electricity	0.8	0.0	0.2	0.0	0.0	0.2
Construction	0.8	15.4	2.8	2.3	0.4	5.2
Transport	3.6	5.8	5.5	6.3	0.4	5.1
Post & telecommunication	1.7	0.1	1.1	0.2	0.6	0.7
Wholesale	1.8	5.0	12.7	22.5	14.1	12.4
Banking	3.0	0.0	1.8	0.0	0.0	0.8
Insurance	0.8	0.6	4.3	0.9	0.2	1.6
Public administration	51.7	0.1	2.2	0.1	0.0	7.5
Hotels	0.2	1.0	2.8	1.2	1.3	1.4
Other	29.6	19.6	10.0	4.0	0.9	12.3
Occupation						
Senior officials	8.9	0.2	4.0	13.7	2.0	6.4
Professionals	26.5	0.2	5.0	2.3	0.4	5.5
Technicians	17.8	0.5	8.9	1.8	0.4	5.2
Clerks	12.8	1.2	9.1	0.2	0.7	4.3
Service	8.8	3.1	9.4	12.0	13.4	8.9
Skilled agriculture	0.5	4.2	1.8	43.9	67.5	20.6
Craft workers	3.8	18.1	22.0	13.7	6.7	14.8
Machine operators	4.5	6.4	9.2	6.3	1.2	6.3
Elementary occupations	16.4	66.1	30.6	6.1	7.7	28.0

Source: Department of Census and Statistics, Labour Force Survey data.

professionals, technicians, and clerks increasing between these years (Table 5.3).

5.2.3 Unpaid Family Workers

Unlike with other informal sector categories, a larger proportion of unpaid family workers are female. Further, the share of unpaid female family workers has increased from 60 to 67 from 1997 to 2004 (see Table 5.2). As with informal sector employees, unpaid family workers tend to be young, with the highest proportion falling between the ages of 20 and 29. More than 90 per cent of unpaid family workers are in rural areas outside the Western Province.

In 2004, more than 50 per cent of unpaid family workers were in the agriculture sector. The percentage of unpaid family members in agriculture/forestry, wholesale and manufacturing sectors were also high. By occupation category, in 2004 a majority of unpaid family workers were skilled agriculture workers (69 per cent), service workers (13 per cent), craft workers (7 per cent) and workers in elementary occupations (8 per cent).

5. 3 Topology of Risks

All individuals, including workers in the informal sector are faced with a variety of risks. These differ: a) by the type of risk; b) by the level of exposure; and, c) by the frequency of occurrence (see Box 5.1). The level of exposure is usefully distinguished into micro, meso and macro levels, although for some types of risks the level of exposure is not clearly distinguished. In this division, risks affecting individuals or households are referred to as micro level risks, risks affecting communities or regions are referred to as meso level risks, and risks affecting the whole economy are referred to as macro level risks. Some risks happen rarely - at low probability - such as the recently experienced tsunami, or the occurrence of serious illnesses. Other risks are more probable, such as chronic illnesses, occupational health hazards. There are also some risks that are repeated - such as floods, droughts, etc.

5.4 Effective Risk Management

The susceptibility to risks by informal sector workers differ widely according to their employment status, the sector of the economy that they operate in and by the wider natu-

Box 5.1
Examples of Different Types of Risks by their Degree of Covariance

	Level of exposure			
Type of risk	**Micro**		**Meso**	**Macro**
Natural			Rainfall, landslides	Floods, droughts
Health	Illness, injury, disability		Epidemic	
Life-cycle	Birth, old age, death			
Social	Crime, domestic violence		Terrorism	War, social upheaval
Economic	Unemployment, business failure	Harvest failure	Resettlement	Economic downturns, financial or currency crisis, BOP fluctuations
Political	Ethnic/social discrimination		Riots Pollution,	Policy framework
Environmental	Wild animal attacks		deforestation	

Source: Holzmann, R., and S. Jorgensen (2000), “Social Risk Management: A New Conceptual Framework for Social Protection and Beyond” Social Protection Unit, Human Development Network, World Bank.

ral, social, economic and political context within which they live and work. The extent of damage for a given risk depends mainly on two factors. First, it depends on the resilience - of the individuals, household, community or country - to withstand such shocks, and second, it depends on the severity of such shocks. Individuals do not have much control over the severity of a shock; however, by taking preventive action, individuals can control the probability of the risk and they can take action to minimize the loss from different types of risks.

5.4.1 Favourable Macro Environment and Business Climate

All workers, particularly own account workers, have been affected by uncertainty in the policy environment, and adverse macro economic shocks, such as terms of trade shocks and technology shocks. The recent Sri Lanka: Improving the Rural and Urban Investment Climate report by the World Bank and ADB, points to several macro economic and business climate factors limiting returns to investments in the country. These include access to quality sources of energy and transport, access and cost of finance, labour market constraints, access to markets, and macro economic and policy uncertainties.

A steady positive macro environment is a key for risk prevention. It provides the backdrop for planned income generating activities yielding high returns. At the same time, better access to infrastructure and easily affordable access to credit reduces the costs of production, and thereby increases incomes and competitiveness of businesses. Some examples of risk prevention through macro level policies include: proper labour market policies that promote employment opportunities, proper working conditions and adequate earnings, public health, education and skills training policies, etc.

5.4.2 Human Resources Development

Recent research by the IPS on sick industries finds that, among others, "reduction in innovation and competitiveness due to lack of access to information and new technologies" and "insufficient managerial and technical training that reduces the ability of SMEs to deal with change" as key reasons for enterprise closures. These findings highlight the need for better access to information, training and credit as tools for withstanding risks of economic and market shocks.

In this regard, at the macro level, the government can pay special attention to improve the relevance and quality of formal education as well as skills development programmes in the country. The above characterization of the informal sector points to the fact that the majority of informal sector workers are young individuals. Special policies and strategies for youth employment and for upgrading skills and employability of youth can also improve the income security of individuals.[4]

5.4.3 Social Insurance

To a large extent own account workers and unpaid family workers in the agriculture/ forestry sector are constantly affected by sources of natural and environmental risks. Natural risks include floods, droughts, earthquakes, etc. while environmental risks include pollution, wild animal attacks, etc. Workers in other economic sectors - for example, manufacturing, wholesale and transport - are also affected by these risks to a lesser extent.

Although, many large businesses have insurance schemes safeguarding them from income and asset losses due to natural disasters and environmental factors, effective and affordable insurance schemes available for workers in the informal sector in Sri Lanka are limited. The need for developing insurance schemes to safeguard physical assets of

[4] The Action Plan for Youth Employment currently being drafted provides recommendations on policy reforms needed in this area.

Table 5.4
Damages to Micro Enterprises Due to the Tsunami, by District[a]

District	Enterprises Not Functioning After the Tsunami: Number	As a Per cent of Total Micro Enterprises	Number of Enterprises with Losses More than Rs.100,000	Number of Workers Affected
Ampara	2926	37	1,248	498
Hambantota	937	38	497	819
Kalutara	731	51	415	176
Galle	2299	38	1,182	1,762
Gampaha	115	7	28	380
Jaffna	2485	62	1,593	74
Matara	1698	40	857	927
Mulativu	8	75	6	-
Trincomalee	1208	11	441	279

Notes: a. Micro enterprises are defined to be enterprises operating within housing units.

Source: Compiled using Department of Census and Statistics, *Tsunami Census* data.

informal sector workers came to the forefront during the 2004 tsunami, which affected a large number of micro enterprises (Table 5.4). Depending on the type of risk and their level of exposure, the government should promote formal/informal insurance schemes or risk-pooling strategies to help people withstand economic losses due to natural and environmental risks.

5.4.4 Social Protection

Most informal sector workers are not covered by social protection available to workers in the formal sector, such as pension schemes, paid sick leave, holiday pay and unemployment compensation. Although, pension schemes for agricultural workers, fishermen and the self-employed were recently introduced, these schemes have not been successful for various reasons. In almost all the schemes coverage is low due to strict eligibility criteria, and high defaults arising from variability of incomes associated with most self-employment. Also, unlike with contributory schemes for individuals in the formal sector - where the employer and the employee share costs associated with social protection - the self-employed in the informal sector have to bear the cost of contribution to these schemes on their own. Also, there are issues concerning the adequacy of these pensions to sustain life styles. None of these pension schemes are open to informal sector employees (the earlier mentioned informal sector pensions schemes are for self employed informal sector workers not for workers who work for pay) as they do not have formal employers and as they operate outside the organized institutional environment. These schemes are also not open to migrant workers and unpaid family workers, who are mainly females.

Other than for pension schemes, workers in the formal sector also have other measures that secure their income streams. These include compensation against termination of work, paid sick and maternity leave and paid holidays. Most casual workers who are paid on a daily basis do not receive payment when they do not work, regardless of the reason. They also do not have compensation during periods of unemployment due to various reasons such as seasonality. As such, these individuals are compelled to rely on their own resources or they have to resort to informal means of coping such as dis-saving, borrowing - often from informal sources at high interest rates - selling assets, moving children out of schools and sometimes sending them for work. Some of these survival strategies could have irreversible consequences - such as child labour - that can perpetuate poverty from generation to generation.

5.4.5 Institutional Reforms

Often informal sector workers are prevented from benefiting from the same safeguards afforded to formal sector workers due to a variety of reasons including: discrimination, ineffective, inadequate and obsolete institutions, asymmetric information, and ambiguities regarding legal status. Most institutions are formulated keeping the formal economy in mind. As such, they bypass the informal economy. Labour market institutions are a good example that has failed to address the needs of the informal sector workers.

Most safeguards - even when intended for poor informal sector workers - are formulated without taking into account the special circumstances in which these individuals operate. As such, most of these schemes have had low enrolment rates and are inadequate in meeting social protection needs of the poor. Pensions scheme for the farmers, fishermen and self-employed, the *Susahana* lending scheme intended for providing credit for tsunami affected micro enterprises are some examples of schemes that have had limited success due to inappropriate planning.

5.4.6 Pro-poor Regulation

Regulation, especially ad hoc changes, can often affect livelihoods of all types of informal sector workers. For example, changes to regulations on the right to vend on the pavements, parks, and tourist sites can affect the livelihoods of street vendors by taking away their markets and thereby reducing their incomes. Individuals who continue to be vendors, despite restrictions face harassment by law enforcement officials and are constantly subjected to damages to their physical assets, etc.

5.4.7 Informal Social Networks and Informal Sector Organizations

Macro level risk management instruments often fail to reach out to individuals and communities due to lack of information on their needs, and the social, economic and political environment within which they operate. In such instances, informal social net workers can play a major role in identifying risk management needs of informal employees and coming up with strategies for meeting these requirements. These can also provide avenues for information sharing between micro and macro levels for developing better risk management instruments.

Self Employed Women's Association (SEWA) in India is a good example where informal sector organizations have been effective in providing social risk management strategies for the poor. Some of the recent achievements by SEWA include: acceptance of "Paaki Bheeth" by the Gujarat government, which is a proposal for monsoon and disaster proofing housing in rural Gujarat; establishment of two community based tuberculosis diagnosis and treatment centres; organizing an event in Paris for exhibiting and selling textiles products by artisans in Banaskantha and Kutch.[5]

However, most informal sector workers have low levels of education and do not possess organizational and managerial skills. As such, without outside help the tendency for informal sector workers to form into organizations is low. Some third parties who encourage the organization of informal sector workers, do so to further their political clout. In

[5] http://www.sewa.org.

such cases, the political goals of such organizers could undermine the real needs of the informal sector workers.

5.4.8 Social and Gender Aspects

Some informal sector workers are deprived of access to markets and other infrastructure due to discriminatory practices in terms of class, caste, ethnicity and gender. Such discriminations could take place at the household or community level due to social norms and practices, or at the institutional level due to historical practices or lack of 'social capital'.[6] At the household level, females often do not have the same authority enjoyed by males in making financial and other decisions. As such, females are given a secondary role in household decision-making. This is probably why there are a higher proportion of female unpaid family workers, while the proportion of female own account workers and informal sector employees are less. Empowering women and the marginalized will ensure that their contribution to economic activities are enhanced and they are safeguarded from falling into poverty due to various types of shocks - such as natural disasters and illnesses - as described above.

5.5 Conclusions and Policy Recommendations

The above analysis showed that Sri Lanka's informal sector is a heterogeneous sector consisting of different types of workers, working in different industries and occupation groups. Given their socio-demographic backgrounds and their economic activities they are subjected to various types of risks and opportunities. In order to ensure that these informal sector workers are able to maintain adequate and steady income streams they should be provided with similar opportunities available to others in the economy and safeguards against asset and income losses due to different types of risks and vulnerabilities.

Given efficient markets, individuals and households can themselves to a large extent manage risks through savings, accumulation of assets, purchase of insurances, etc. However, when markets do not function well, individuals have only informal means of managing risks. These are often not reliable and nor adequate, especially when the severity of the risks are high and when their exposure is not localized. In the absence of market instruments, especially in developing countries, communities also engage in risk management. Instruments for risk management are most effective when communities are cohesive, and when the severity of adverse events is low and their extent is localized.

Governments can play a major role in social risk management of a country through a variety of ways. First, they can manage the social, political and economic environments of the country to avoid risks. Second, they can promote risk management through facilitating market interventions. Third, in areas where there are market failures, governments themselves can provide risk management instruments to keep people out of poverty. Governments can play a major role in providing interventions for the provision of social protection for those not already covered.

In the areas of managing social risks of informal sector workers, policymakers should be aware of the following key issues. First, policymakers should take into account the interests of informal sector workers when making any policy reform. For example, the no-build buffer zones introduced after the December 2004 tsunami disallowed the occupation and rebuilding of houses that were damaged or destroyed, but allowed the rebuilding of hotels and occupation of houses that were not destroyed. As a result, large numbers of individuals who operated micro

[6] Social capital refers to a person's connections to different social networks. A person is deemed to have a high level of social capital if the social networks s/he is affliated to are influential.

enterprises within housing units were not able to re-start their micro enterprises quickly.

Second, attempts should be made to streamline the informal sector interests into the existing policy framework. Existing labour legislation, for example, not only provide protection only to the formal sector workers, it limits informal sector workers from entering the formal sector by reducing incentives for job creating.

Third, any policies intended for managing risks of informal sector workers should be properly targeted, taking into account the special circumstances under which they work and live. For instance, the needs and risks faced by the urban street vendors are different from that of skilled agriculture workers in rural areas. These differences should be taken into account when designing policies for social risk prevention for informal sector workers.

6. State-Owned Enterprises and Pro-Poor Growth: Policy Perspectives and Options

6.1 Introduction

The academic and policy debate on the role of the state in development, and more specifically in pro-poor growth, is not new. The trajectory of economic development around the world points to the waves and cycles - of state-led growth and nationalization, of privatization and liberalization, and of public-private partnerships (PPPs) - that have shaped national economic management over the decades. As with most socio and political economic phenomena, the empirical evidence on the success of each of these modalities is mixed. However, the debate goes on and remains relevant as new evidence accrues and countries explore strategies that would meet their particular development needs.

As development theoreticians and practitioners have moved up the learning curve, the once widespread notion that the market and the state are diametrically opposed systems of social organization that warrant stark political choices has waned.[1] Instead, what has become increasingly apparent is that both forms of organization encompass a vast range of complex social processes that are inextricably linked and embedded in a particular social and political economic milieu. From a policy perspective therefore, creating an artificial barrier between states and markets is often counter-productive in terms of development and growth.

As in several other developing countries, the policy cycle in Sri Lanka has also been interspersed with experiments in nationalization, liberalization, privatization, PPPs, regulation and deregulation. The forces that have influenced these policy choices have largely been a combination of politics, ideology and economic realities, with the latter being somewhat muted in recent years. The principal motivation for this chapter is to provide some thoughts on the roles of the state and of the market in Sri Lanka, specifically as regards pro-poor growth, and in view of the recent decision spelt out in the policy statement of the current government:

"Government ownership in the strategically important enterprises of banking, power and energy and transport and ports as well as national assets will be continued. Such assets or such public enterprises will not be privatized. Legislation will be enacted clearly spelling out the responsibility of the government in acting as a custodian in the management of institutions and resources in order to protect the people's ownership of national assets. Management of national assets and public institutions in a more professionalized and independent manner without being politicized will also be ensured by this legislation." (http://www.presidentsl.org/data/html)

The main policy issue that this chapter grapples with is to identify viable options for state-owned enterprise (SOE) reform aimed at improving the performance of these entities, in a context of 'constrained optimization' where a political decision rules out

[1] As in for instance, the attempt to suppress the market under Soviet Communism, attempt to totally suppress the State under Thatcherism in Britain, Reaganism in the US, and the somewhat misleading interpretations of the Washington Consensus.

ownership change *per se*. Given the focus on pro-poor growth, the examples identified for discussion in this chapter will draw mostly from service sectors such as infrastructure and banking. Section 6.2 sets out empirical evidence from Sri Lanka as well as from around the world on the outcome of different reform options. Section 6.3 discusses a menu of policy options based on international and local experience, in an attempt to come up with a workable set of strategies for Sri Lanka. Section 6.4 concludes by outlining some necessary and sufficient conditions for successful reforms in the context of inclusive and sustainable development.

6.2 Empirical Evidence on SOE Reforms

Empirical analyses of SOE reforms - encompassing modalities of public ownership, privatization and PPPs -- provide richer and more meaningful policy insights when the evidence is contextualized within a framework that takes into account stakeholder expectations of these reforms and the realization of these expectations. Table 6.1 illustrates a basic conceptual framework, identifying stakeholders and the expectations associated with these players in the reform process.

The rest of this section focuses on providing a snapshot of some of the empirical evidence on SOEs reforms, within the conceptual framework set out in Table 6.1. This framework hinges on the varied perceptions and expectations that players in the SOE reform process have with regard to the outcome of reforms. For example, as pointed out in Table 6.1, the government may focus on fiscal gains and increased investments as its primary objectives of the reform process, while factors such as access, prices, and quality are more important to a consumer, and employment opportunities are important to workers.

Overall, observations on both public and private ownership indicate mixed results. A survey of transition and developing economies[2] shows efficiency gains from private ownership; conversely, other analyses[3] show

Table 6.1
Stakeholder Expectations of SOE Reforms

Expectations	Stakeholder/s						
	Govt.	Private Sector	Owners	(Public Managers & Private)	Workers	Consu-- mers	Donors
Fiscal stabilization	X						X
Increased investments	X	X					X
Efficiency gains/ profitability			X				
Distributional outcomes (access, affordability, quality)						X	
Distributional outcomes (employment)					X		
Distributional outcomes (wage hikes/other positive pecuniary/non-pecuniary incentives)				X	X		

[2] Megginson, W.L. and J.M Netter (2001),'From State to Market: a Survey of Empirical Studies on Privatization' in *Journal of Economic Literature*, vol. XXXIX, no.2.

[3] Millward, R., (1988), 'Measuring Sources of Inefficiency in the Performance of Private and Public Enterprises in LDCs' in Cook, P., and C. Kirkpatrick (eds.) *Privatisation In Less Developed Countries*, Brighton: Wheatsheaf; Parker, D. and H.L. Wu (1998), 'Privatization and Performance: A Study of the British Steel Industry under Public and Private Ownership', *Economic Issues*, vol. 3, part 2.

results favourable to public ownership; and again, studies of privatized firms in Central and Eastern Europe[4] present ambiguous findings on the impact of ownership on enterprise performance.

Comprehensive case studies on the performance of SOEs in infrastructure sectors such as energy, water and transportation in developing countries - which include Sri Lanka - point to low labour productivity, poor and declining service quality, chronic revenue shortages and inadequate investment, serious problems of theft and non-payment, and lack of access.[5] Yet, examples such as South Africa's state-owned vertically integrated entity Eskom that generates 96 per cent of the country's electricity requirements, with household access increasing from 40 per cent in 1993 to 70 per cent in 2003, relatively low prices, sound technical and financial performance, and the ability to attract low-cost funds in local and international capital markets, suggest that the link between ownership and performance maybe rather tenuous.

The bottom line is that there is no conclusive evidence that a change of ownership is a necessary remedy for under-performing entities; instead, what is apparent is that structuring of incentives in line with the specific principal-agent dynamics that govern a particular sector/entity has a greater impact on reform outcomes.

As in the case of public ownership, the jury is still out on the effects of privatization. Studies have shown that privatization in Latin America, Russia, the Ukraine, China and Sri Lanka has had a positive impact on profitability, efficiency and returns to shareholders while simultaneously producing disappointing results in terms of asset distribution (for example, the voucher schemes in transition economies)[6] and access (for example, the availability of telecommunications services to marginalized consumers in Sri Lanka). The findings also indicates that prices in utility sectors such as electricity and water have on average increased following privatization, largely due to the removal of

Box 6.1
Perceptions Matter

Public perceptions of privatization in Sri Lanka:

- Over 50 per cent of respondents felt that social life and economic stability deteriorated with privatization.
- Over 80 per cent felt that future privatization would have a negative impact on poverty and living standards.
- Confusion about actual privatization: 50 per cent thought that electricity was already privatized.
- Viewed privatization as a desperate fix/escape route for the government.
- Strong perception that privatization is driven by external interests.

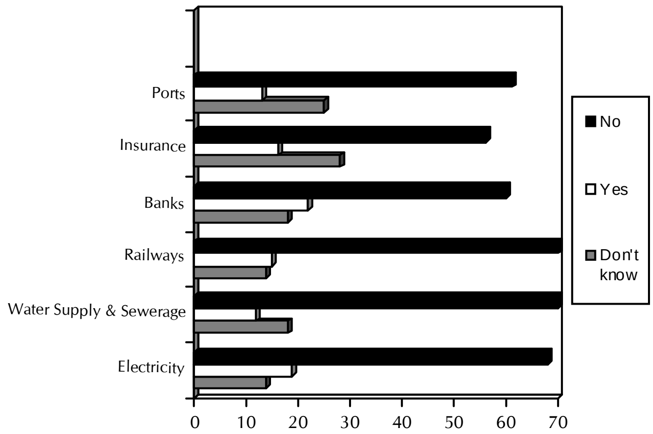
4 Pistor, K, and A. Spicer (1996), "Investment Funds in Mass Privatization and Beyond: Evidence from the Czech Republic and Russia" in *Private Sector*, December, pp. 33-36; Claessens, S., S. Djankov, S. and O. Pohl (1997), *Ownership and Corporate Governance: Evidence from the Czech Republic,* Washington, D.C: World Bank.

5 Nellis, J. and N. Birdsall (2005), *Reality Check: The Distributional Impact of Privatization in Developing Countries,* Washington D.C: Center for Global Development.

6 Russia's mass privatization schemes via vouchers are a classic example of this modality. In this case, privatization began with the conversion of large enterprises into joint-stock companies with tradable shares and boards of directors. Fifty to sixty per cent of the shares were allocated in voucher auctions open to all citizens, each of whom received a Rb10,000 privatization voucher to use at an auction, to invest in an investment fund or to sell off depending on their preferences.

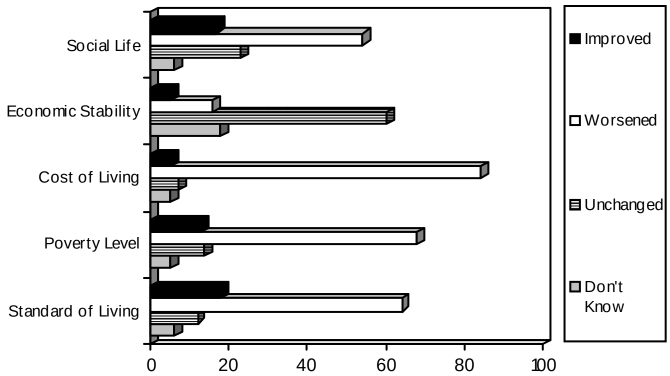
illegal connections and the absence of effective regulatory structures; that quality of service has improved (for instance, Sri Lanka's telecommunications sector); and that short-term job losses co-exist with improvements in wages and other employment benefits.

Figure 6.1
Should the Sector be Privatized?



An interesting -- and yet not surprising - finding on privatization in the literature is that perceptions with regard to the reform process have a greater influence on political decisions regarding reforms as well as on the implementation of reforms when compared to the more 'objective'/ factual evidence. In Russia for instance, the popular dissatisfaction with privatization stemmed largely from allegations of political nepotism and corruption in the reform process. The outcome of a perceptions survey carried out in Sri Lanka by the World Bank (2001)[7] is set out in Box 6.1 and in Figures 6.1 and 6.2.

Figure 6.2
Attitudes towards Privatization



Moving on to modalities of PPPs, the literature indicates more clear-cut, positive outcomes - again cementing the argument set out in the introductory section of this chapter that the state and market naturally complement one another. Studies have pointed out for instance, that while reforms have failed many of the poorest, the situation could be remedied using strategies such as redistribution via fiscal transfers and targeted cross-subsidies. Similarly, tariff re-balancing and improved cost recovery rates can help to mitigate the trade-off between access rates, quality improvements and affordability. Alternatively, a different take on state involvement in the reform process is found in studies where empirical evidence is found to support the argument that establishing a regulatory agency and competition policy prior to embarking on SOE reforms has a higher pay-off. In the final instance, what remains clear is that the state will continue to be a major actor in the reform process, and particularly in terms of pro-poor growth in

[7] World Bank (2001), "Communications for Privatization in Sri Lanka: Audit Report and Draft Strategy" (mimeo).

developing countries, with its involvement ranging from provider, financier, and joint investor to regulator in different sectors and countries.

6.3 Analyzing Policy Options

As is evident from the preceding discussion, a key factor in a successful reform process is the strategic balance established between state and market actors and institutions; any attempt to impose constraints on the natural interplay between these two organizational forms would only be counterproductive in terms of development and balanced growth. However, given the current policy context in Sri Lanka where the transfer of assets is not an option, this section will focus on strategies that exclude ownership change but retain elements of market principles. These options are scrutinized through the lens of principal-agent dynamics; how do you get an agent (enterprise managers) to act in the best interest of the principals (diffused public ownership versus concentrated private ownership) in the face of informational asymmetries.

6.3.1 Corporatization without Privatization

The key features in a standard corporatization strategy include: retaining state ownership; restructuring internal governance and incentive systems along the lines of a modern corporation; and, enacting legislation that sets out guidelines with respect to the board of directors, shareholders, independent financing mechanisms, and the mediation of labour disputes. In a number of countries -- including Sri Lanka in previous years -- corporatization has been used to infuse commercial principles into public-owned entities as an interim measure towards the sale of assets; this strategy is viewed as a means of increasing the net worth -- and the final sales price -- of the public entity.

A widely cited example of corporatization without a view to privatization is the Chinese approach. Elements of this strategy include the transfer of decision making powers from the Communist Party to internal boards of directors and management incentive contracts linking payments to performance. According to some studies,[8] the entities that adopted this approach showed increased performance in terms of profitability and efficiency. However, the positive impacts of these reforms were countered by the incidence of soft budget constraints with these enterprises continuing to rely on state banks for finance.

Corporatization without privatization is also argued to have had a better outcome in the case of South Africa's power sector reforms.[9] However, the principal factors that drive electricity sector reform in most of the developing world - poor utility performance and short-term financial needs - were not evident in the case of Eskom, which provides reliable and quality power at affordable prices, is financially viable with the ability to raise private capital from local and international investors, and has no capacity shortfalls. Moreover, a closer look at the reform approach used in South Africa's power sector reveals a strategic and dynamic combination of corporatization, performance contracting and independent regulation.

A central problem in the governance of SOEs is the prevalence of a dual layer of 'agents' (politicians and bureaucrats) and diffused 'principals' (the public). The fact that each set of agents have different utility maximiza-

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[8] Aivazian, Varouj A., Ying Ge, Jiaping Qiu (forthcoming) "Can Corporatization Improve the Performance of State-owned Enterprises Even Without Privatization?", *Journal of Corporate Finance.*

[9] Eberhard, A. (2005), "From State to Market and Back Again: South Africa's Power Sector Reforms", *Economic and Political Weekly,* December 10, 2005.

tion functions adds an extra layer of complexity to the problems of collective action encountered with diffused ownership. Looking back at Sri Lanka's experience with SOE reforms and given the reality of governance in Sri Lanka - specifically soft budget constraints, political interference in commercial decision-making, over-staffing and the absence of political will to rationalize cadre to increase efficiency and productivity, and the failure to establish 'independent' regulators - it is highly questionable that corporatization alone will bring about better enterprise performance.

6.3.2 Performance Contracts

Performance contracts are defined in as a "negotiated agreement between the management of an SOE and its owners (the government)";[10] the variables contained in such a contract include future goals, performance measurement of each goal, performance targets, management incentives, financing of activities, autonomy of management, information systems to enforce accountability (accounting, reporting, auditing) and dispute settlement. The following steps characterize a generic performance contract:

Step 1: selection of performance indicators (for instance, profitability, customer satisfaction);

Step 2: selection of weights for each criterion to facilitate calculation of a composite score;

Step 3: setting targets for performance criteria (for example, pre-tax profit of x, reduction in telephone waiting lists of x per cent, etc.);

Step 4: calculating composite score to facilitate comparing of SOEs in different sectors;

Step 5: reward or penalty.

Empirical evidence tend to suggest that the success of performance contracts (as well as management contracts) depends on how effectively they address issues of informational asymmetry (for instance, between the government and public or private managers); on the appropriate structuring of incentives to induce contracting parties to comply with the contract (for instance, targeted performance bonuses, hire and fire policies); and on policy makers level of commitment to the reform process (for instance, establishing neutral mechanisms for conflict resolution, checks and balances on the government's discretionary powers, etc.).

Unfortunately, Sri Lanka's brief experimentation with this strategy in 1990 - in the Ceylon Leather Products Corporation and the Sri Lanka Tyre Corporation - was far from being a success story. The main reasons for the failure of this approach in Sri Lanka were the unrealistic incentive structure - bonus payments were not targeted and were paid across the board to every single employee - and a climate of weak political commitment. The disappointing experience with performance contracting in 1990 does not rule out this approach as an instrument for SOE reform; instead, the lessons learnt from the previous experiment, if taken on board by policy makers, could well contribute towards a more effective model of performance contracting. Indeed, early indications of the performance/ cum management contracting approach adopted by some of the state banks are positive. For instance, according to statistics on the financial performance of the People's Bank released by the Treasury for the years 2001-2005, both gross and net profits have increased substantially and the entity has been able to convert negative equity into positive equity over this five year period.

[10] United Nations (1995), *Public Enterprise Reform and Performance Contracting: The State of the Art*. New York: United Nations.

6.3.3 Management Contracts

A basic management contract involves an agreement between the government and a private party to operate an enterprise for a fee. In a generic management contract, the government does not get a fixed rent as in the case of a lease; the government is responsible for fixed investments unlike in the case of a concession; and, the government retains majority ownership as distinct from a joint venture.

A study of 20 management contracts in 11 developing countries revealed that profitability and productivity improved in two-thirds of the cases and only 2 contracts were rated as outright failures.[11] As per the lessons learnt from Sri Lanka's episode in management contracting in the plantations sector, the factors for success included longer contract periods to increase commitment; limiting fixed fees and linking contractor fees to enterprise performance; and, an environment characterized by competition and contestability. As such, what remains clear is that whilst ownership change per se is not a necessary condition for improved enterprise performance, the prevalence of competition and contestability is.

6.3.4 Liberalization and Private Participation

In a policy environment such as that currently prevailing in Sri Lanka, and given the argument propounded in this chapter that states and markets cannot and should not be isolated and that ownership change is less important than competition - or the threat of potential competition - for improved enterprise performance, a reform strategy that allows state entities to compete with private entities is perhaps the way forward. Sri Lanka's experience with liberalization and competition suggests that this approach could work in most sectors other than those that have characteristics of a natural monopoly (as in for instance, electricity transmission). As is evident from international and local trends however, the cases of genuine natural monopolies have declined as technology supersedes government-imposed barriers (for instance, the local loop segment in the telecommunications sector). What is also clear from the Sri Lankan as well as international experience is that the role of the state as an effective regulator is particularly vital for the success of this approach.

Drawing from Sri Lanka's telecommunications sector, the sequencing of sector reforms with the introduction of competition in the fixed sector preceding privatization of the incumbent, resulted in the incumbent recording an average connectivity increase from 12.88 to 31.97 in the pre and post-competition periods, respectively. In addition, the compound annual growth rate for the period 1995-1998 was 48.6 per cent in the competitive mobile segment as against 36.5 per cent in the fixed-access market that retained barriers to competition in international telephony.

Introducing competition in a sector in the absence of effective regulation could however have disastrous consequences as is evident from Sri Lanka's bus transport liberalization and to some extent in the case of the country's LPG sector. In both these cases, performance fell far short of consumer expectations of affordability, quality and access; and common to both these examples is the failure to grasp the principle of regulation for competition. Currently, a prime candidate that stands to gain from the introduction of competition and the infusion of commercial principles is the Ceylon Electricity Board (CEB). Official statistics indicate that

[11] Shirley, M. (1996), "Enterprise Contracts: A Route to Reform?", *Finance and Development,* pp. 6-10, September 1996.

this entity is in a severe financial crisis; reasons for this predicament have been hotly debated in the press with arguments ranging from excessive government interference and political decision-making to internal planning failures, delays in implementing low cost power plants and the inability to increase tariffs to market rates, to the non-implementation of essential reforms such as unbundling and the setting up of effective regulation. Whatever the case may be, the reality is that average tariff rates are amongst the highest in the region, that the CEB is facing high system losses and that the financial position of this entity is precarious.

Access to affordable and reliable power is essential for industrial sector development, for consumer welfare and for growth in general. As such, sector reforms need to be prioritized by policy makers; pressures from various interest groups need to be weighed against the welfare of the country as a whole. Given that the current policy decision on SOEs rules out privatization but not competition, plans drawn up and set on the back burner to unbundle the utility, introduce limited competition in the generation and distribution segments and set up an independent regulator need to be implemented as an immediate priority. It is evident that policy makers understand, and are aware of, the ramifications of delayed power sector reforms. The impediment to reforms, however, has more to do with the state of governance in the country - where the coincidence of politicians' and powerful interest group pressures override concerns of efficiency as well as equity - where the term 'pro-poor' growth lends itself only to political rhetoric.

6.4. Conclusions: Necessary and Sufficient Conditions for Successful Reforms

A vital ingredient for a successful reform process is strong institutional capacity with a clear legal framework, sound regulatory governance and elements of accountability, transparency and credibility. In addition, any reform strategy needs to be tailored to suit the unique governance features of a particular country. The latest blue-print for SOE reform identified by the current regime is that of Singapore's Temasek Holdings model - through which the government holds significant stakes in almost all sectors of the economy; and, has extended investment into blue-chip companies with several companies listed on the Singapore Stock Exchange. The entities that come under Temasek are subject to the same requirements as those for private companies under the Companies Act.

The attempt to introduce this blue-print in Sri Lanka has resulted in the establishment of a Strategic Enterprise Management Agency (SEMA) which has under its purview around 20 enterprises from sectors such as power and energy, transportation, banking and agriculture, defined as 'strategic' by the government. The rationale behind bringing these entities under one umbrella was to facilitate efficient coordination amongst these SOEs given the inter-linkages between them. An example of the underlying logic is as follows: if Sri Lanka Railways is not permitted to increase fares to commercial levels, its ability to make timely payments to the Ceylon Petroleum Corporation (CPC) would be constrained; this would in turn have a knock-on effect on CPC's loan repayments to the state banks.

Whilst the rationale behind the establishment of SEMA can to some degree be justified from an organizational and management point of view, the actual implementation of this scheme is flawed for at least three reasons. First, any attempt at blind policy transfer is bound to fail; Temasek's success has a strong correlation with Singapore's robust state, corporate and regulatory governance institutions; given that Sri Lanka's institutional and governance structures are fast deteriorating, it is doubtful that this model can deliver the expected results.

Second, SEMA has evolved to be more a tool of populist rhetoric - a means of assuaging public apprehensions of privatization - than a carefully thought-out strategy to improve SOE performance. For instance, in almost half a year since the conceptualization of this 'new approach' there has been little progress with respect to drawing up of the core legislation for SEMA. Instead, it appears that policy makers have reversed what is considered a natural sequence of actions in establishing a board of directors prior to enacting legislation. These actions - or non-actions - raise questions about the commitment of policy makers to the reform process.

Third, the division of responsibilities between the Public Enterprise Reform Commission (PERC)[12] still remains hazy on the ground. Given issues of less than optimal governance practices,[13] bureaucratic red-tape, insufficient inter-organizational coordination, and the dearth of technocratic capacity in the country - and given the fact that SEMA is yet to show signs of progress in real terms - a practical option maybe to merge the two entities.[14]

Fourth, as revealed in the academic literature as well as from empirical exercises, a participatory approach to decision-making is now considered vital for inclusive development. Transparency, public consultations and stakeholder buy-in have proven to be essential for sustainable reforms all around the world. Yet, apart from a few nondescript articles in the press, there has been little public debate on the reform strategy embraced by the current regime; more accurately, a lack of accurate official information on the reform process has prevented a useful discussion on a strategy involving enterprises that have a considerable impact on inclusive development.

The bottom line therefore, is that reforms can be successful even with externally imposed constraints such as the ban on asset transfer, if there is commitment at the highest levels of government. In addition, the careful structuring of incentives in line with principal-agent dynamics that lie at the heart of any transaction is vital for a sustainable reform process. It follows therefore, that any policy transfer has to be contextualized and grounded in the local environment if it is to yield beneficial results.

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[12] PERC's functions as defined in the legislation that governs this entity are as follows: a) fostering and accelerating the economic development of the country; b) improving the efficiency and competitiveness of the economy; c) upgrading production and services with access to international markets on a competitive basis by the acquisition of new technology and expertise; d) developing and broad-basing the capital market and mobilizing long term private savings; e) motivating the private sector; and f) augmenting the revenues of the Government so as to enable it to better address the social agenda.

[13] A glaring example of this is the current state of the Public Utilities Commission of Sri Lanka (PUCSL). According to the governing legislation, PUCSL gets its operational powers from the "Industry Acts" that come under its umbrella legislation; and, these Industry Acts are either not in place or still being drafted. As such, the entity is totally hamstrung and functions as a mere "shell", with only seven technical and two support staff.

[14] From a political economy perspective however, this could be an extremely challenging task given the "turf" mentality that is a prominent factor in Sri Lanka's institutional culture.

7. Samurdhi Poverty Alleviation Programme: Recent Developments and Issues

7.1 Introduction

Sri Lanka has long been recognized as a country that despite having a relatively low per capita income has fared well in terms of health, education[1] and other basic needs. Furthermore, the level of human development achieved is at par with many developed countries. This is largely a result of various efforts of successive governments over the decades in the areas of health and education. Furthermore, a number of food subsidy programmes were carried out by governments since the World War II. Despite these efforts and the significant progress shown in human development indicators, the incidence of poverty in the country has continued to remain high.

In this context, the focus of the government in the 1980s shifted from a universal provision of basic needs to more targeted programmes specific to poverty reduction. The inception of the Janasaviya programme in 1989 with the dual objective of short-term income supplementation and long-term employment of low income households was one of such effort. This led to a shift in emphasis from general subsidies to targeted income transfer programmes on one hand, and the adoption of participatory methodologies and bottom-up development approaches to help the poor to help themselves, on the other. With the change in governments, another poverty alleviation programme called Samurdhi replaced the Janasaviya programme in 1995. The new Samurdhi programme was based on a similar concept to the Janasaviya programme but with many additional components, and aimed to take a more holistic approach towards poverty alleviation.

Taking into account the multidimensional aspects of poverty, the Samurdhi programme was designed in such a way that it addresses not only the issue of income insecurity, but also other social problems faced by the poor. In ensuring income security, not only does it provide direct transfers to the poor, but also attempts to look into long-term income security through the provision of income earning opportunities and access to finance, development of infrastructure and other steps enabling the poor to help themselves. In turn, three major components of the Samurdhi programme can be identified. The first and the main component of the programme is the welfare component. This includes consumption support (Samurdhi subsidy) and social insurance for families whose monthly income is below a certain defined level (Rs. 1500 a month). The second component is the Samurdhi microfinance scheme which aims at providing financial services (e.g., savings and credit services) to the poor through a series of Samurdhi Banks that have been set-up throughout the country. The third component is community development through investment in economic and social infrastructure, agriculture, nutrition, etc.

In recent years, various changes have been made to these three key components of the Samurdhi programme while a number of new

[1] Life expectancy at birth is 74, infant mortality rate (per 1,000 live births) is 13, adult literacy rate of 90.4 per cent with an overall score in the Human Development Index of 0.751 (UNDP, *Human Development Report* 2005).

components/programmes have also been introduced. The objective of this chapter is to examine the recent developments that have taken place in the Samurdhi programme and to analyze their effectiveness in alleviating poverty in Sri Lanka. Section 7.2 will provide a brief description of the administrative structure and the various components under the Samurdhi programme. Section 7.3 will analyse the recent developments and changes in various components of the programme while Section 7.4 will provide some concluding remarks.

7.2. Structure of the Samurdhi Programme

The Samurdhi programme has been the single largest welfare programme for the poor in Sri Lanka since its inception in 1995. The administrative and regulatory body of the Samurdhi programme is the Ministry of Samurdhi and Poverty Alleviation, while the implementation arms are the Samurdhi Authority of Sri Lanka and the Department of the Commissioner General of Samurdhi (DCGS).

It is the sole responsibility of the DCGS to carry out the Samurdhi subsidy programme and Samurdhi social security (insurance) programme. In addition, they carry out several rural development programmes as well as nutrition and scholarship programmes. The following are the main programmes that come under the purview of the DCGS.

1. Samurdhi subsidy programme
2. Nutrition allowance programme
3. Labour intensive peoples project programme
4. Samurdhi social security programme
5. Samurdhi *Kantha Pilisarana* programme
6. Samurdhi first aid programme
7. Early childhood development programme
8. Samurdhi "*Nena Nuwana*" scholarship programme

The Samurdhi Authority acts as the main implementer of the Samurdhi microfinance scheme and many rural development programmes including infrastructure development and sanitation projects.

Empirical evidence has shown a number of shortcomings in the Samurdhi programme during the past decade. These include poor targeting, political interference, non-indexing of income transfers to the cost of living index, etc. Thus, in recent years, various amendments have been made to the programme with the aim of improving its effectiveness in reducing poverty in the country. Some of these major developments/changes in the Samurdhi programme during the last few years are discussed in detail in the next section.

7.3. Recent Developments and Changes

7.3.1 Samurdhi Subsidy Programme

As mentioned previously, the Samurdhi welfare component which comprises of the Samurdhi subsidy programme and the social security programme (insurance) is the most important component of the overall Samurdhi programme. Currently, around 2 million households in the country are benefiting from the Samurdhi subsidy programme. In 2006, a number of important changes were made to this subsidy programme. As pledged in the election manifesto of the President, Samurdhi subsidy/benefit is being increased by 50 per cent from 2006 for all the beneficiary groups except for the earlier Jansaviya group (who now receive an additional Rs. 15 for the increase of insurance deduction). The amounts of benefits before and after this change in 2006 for various beneficiary groups are presented in Table 7.1. As shown, a household that received benefits worth of Rs. 1000 a month before the changes would receive Rs.1,500 a month with the changes introduced in 2006.

Table 7.1
Changes to Samurdhi Benefits Before and After 2006

	Total Monthly Benefit (Rs.)	Breakdown of Monthly Benefit Commodity Stamp (Rs.)	Money Stamp (Rs.)	Compulsory Savings (Rs.)	Social Insurance (Rs.)	Housing Fund (Rs.)
Before 2006	1000	400	360	200	30	10
After 2006	1500	605	540	300	45	10
Before 2006	600	250	210	100	30	10
After 2006	900	380	315	150	45	10
Before 2006	350	340	-	-	-	10
After 2006	525	515	-	-	-	10
Before 2006	250	240	-	-	-	10
After 2006	375	365	-	-	-	10
Before 2006	400	360[a]	-	-	30	10
After 2006	415	360[a]	-	-	45	10
Before 2006	140	100[a]	-	-	30	10
After 2006	210	155[a]	-	-	45	10

Notes: a: For commodity purchase or to be converted into money.

Source: Department of the Commissioner General of Samurdhi.

The increase of benefits is planned to be carried out in three stages. The first stage has covered 113 Divisional Secretariat Divisions (D.S. Divisions), giving priority to the poorest D.S. Divisions identified by the Department of Census and Statistics (DCS) of Sri Lanka. The second stage that is expected to commence in July 2006 will cover 105 D.S. Divisions while the third stage will start from January 2007, covering 98 D.S. Divisions. The 2006 budget has allocated Rs. 3000 million to cover the 50 per cent increase in the Samurdhi benefits.

In addition to increase in the amount of benefit, another amendment was made to the Samurdhi subsidy component in 2006. In the past, the subsidy programme allowed the beneficiaries to obtain any commodity that was available at the cooperatives (using their Samurdhi stamps), while encouraging them to buy food commodities. However, from 2006, the beneficiaries are provided only with rice for the value of their food stamps. The amount of rice provided to each group of Samurdhi beneficiary is given in Table 7.2. Whilst this change in the Samurdhi subsidy programme is expected to find a solution to marketing rice (which arises due to the excess harvest of the *Maha* rice production), it contradicts the very objectives of the Samurdhi subsidy programme to help the poor

Table 7.2
Amount of Rice Provided by Type of Samurdhi Beneficiary Group in 2006

Type	Rice Kg. (per month)
Rs. 1,000	15
Rs 600	10
Rs. 400	10
Rs. 350	10
Rs. 250	5

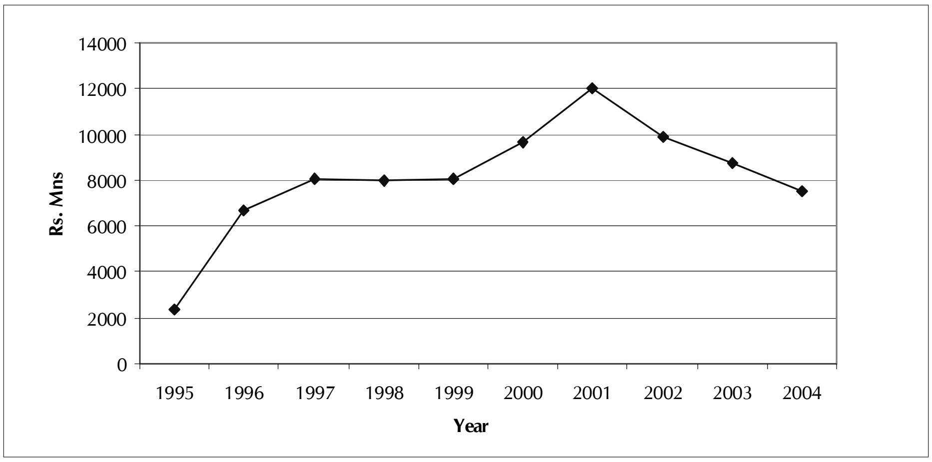
Source: Department of the Commissioner General of Samurdhi.

families improve their nutritional level through the purchase of food commodities and maintain a good standard of living. A similar amendment was made to the Samurdhi subsidy programme in September 2003, but only for a period of two months.

Figure 7.1 shows how the expenditure on the Samurdhi subsidy has changed over the period 1995-2004. As shown, the total expenditure on the Samurdhi subsidy had been rising until 2001, and then has gradually reduced. Moreover, expenditure on the Samurdhi subsidy as a percentage of GDP and total government expenditure also show a similar trend (Figure 7.2). Nevertheless, total expenditure on the Samurdhi subsidy is expected to rise in 2006 due to the increase in the benefit amount. The total amount estimated for 2006 is Rs. 9350 million, in addition to the amount allocated to cover the increase in the amount of benefit.

Given the high cost of the Samurdhi subsidy component, improvement in targeting is critical to ensure the sustainability of the programme. Currently, approximately 41 per cent of households in the country are benefiting from the Samurdhi subsidy programme as compared to about 19 per cent of households in poverty.[2] As can be seen in Figure 7.3, in almost all of the provinces, the percentage of beneficiaries is much higher than the percentage of poor households indicating that a considerable proportion of non-poor are being benefited by Samurdhi income subsidies. Particularly, in provinces like the Western, North Central, North Western and Southern, the proportion of Samurdhi beneficiaries is almost twice the share of the poor. This prevailing situation stresses the need to improve targeting of the Samurdhi subsidy programme. As a first step towards improving targeting, the government requested that all the Samurdhi beneficiaries whose monthly income is above Rs. 1500 voluntarily exit from this programme by end December 2005. Furthermore, as a mechanism to improve transparency and targeting of the Samurdhi subsidy programme, the distribution of the Samurdhi cards to the beneficiaries was made at a public ceremony

Figure 7.1
Expenditure on Samurdhi Subsidy (Rs. mn.)

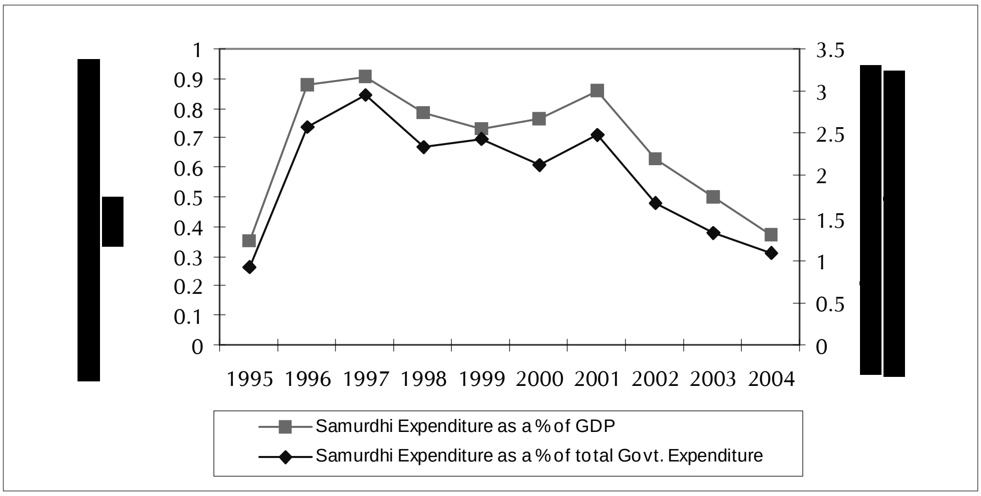


Notes: Data for 2004 is a projection for the year, calculated using the actual expenditure available up to September 2004.

Source: Ministry of Samurdhi and Poverty Alleviation, *Progress 2004 and Programmes 2005.*

[2] Based on the official poverty line of the DCS.

Figure 7.2
Expenditure on Samurdhi Subsidy
(as percentage of GDP and government expenditure)



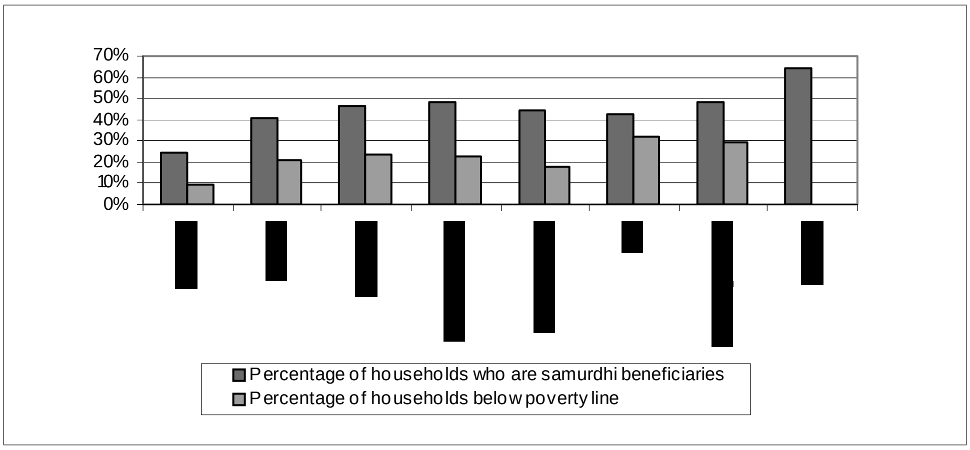
Source: Ministry of Samurdhi and Poverty Alleviation, *Progress 2004 and Programmes 2005* and Central Bank, *Annual Report*, various issues.

from 2006. As a result of these measures, by mid 2006, around 40,000 beneficiaries had self-exited the Samurdhi programme by returning their cards.

7.3.2. Samurdhi Social Security Programme

The Samurdhi social security programme (or the insurance programme) was launched with the aim of helping poor households at times of various life cycle events and protecting

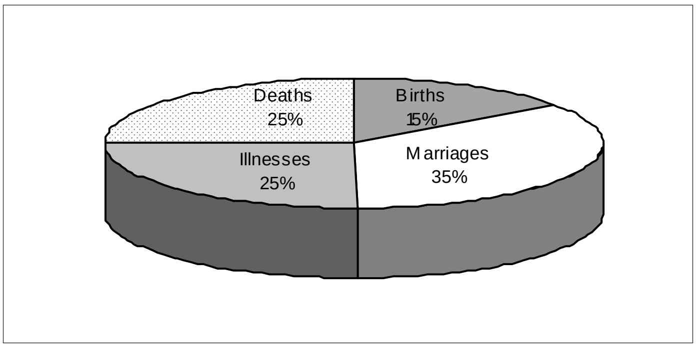
Figure 7.3
Percentage of Beneficiary Households versus Percentage of Households Below the Poverty Line (by province)



Notes: The percentage of poor households is based on the estimates of the DCS using the Official Poverty Line (real per capita monthly total consumption expenditure of Rs. 1423 in 2002) whereas the Samurdhi beneficiary households are those with a total (household) income of less than Rs. 1500 a month (based on the estimates of the DCGS for 2005).

Source: Based on poverty and demographic statistics from DCS and DCGS.

Figure 7.4
Share of Total Insurance Claims in 2005

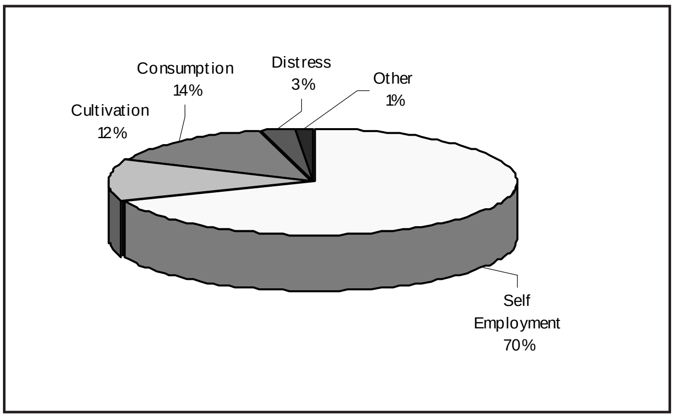


Source: Department of Commissioner General of Samurdhi.

them from falling into severe poverty due to such unexpected events within the household. This programme covers four types of events, i.e., child birth, marriage, illnesses and death. Figure 7.4 shows the shares of total claims made by Samurdhi beneficiaries for each of the four types of events during the year 2005. As indicated, marriages have accounted for the highest share of claims during 2005 (35 per cent).

Some significant changes were made to the Samurdhi social security programme in 2006. With effect from 2006, the death assistance was increased from Rs. 5000 to Rs. 10000 while the child birth allowance was increased from Rs. 2000 to Rs. 5000 for the first child and from Rs. 1000 to Rs. 2500 for the second child. Accordingly, the monthly insurance premium was also increased from Rs. 30 per household to Rs. 45 per household. Though this is a positive step, there are other important issues that should also be addressed simultaneously. For instance, this programme covers only a limited number of risks related to life cycle events of the households. Risks such as natural disasters (e.g., floods and droughts) and employment related risks (e.g., crop failures) are not being covered by this insurance scheme. Another shortcoming is

Figure 7.5
Share of Loans According to the Type/Purpose - 2005



that the insurance scheme does not cover the hospitalization costs of the children of households.

7.3.3. Nutrition Allowance Programme

The nutrition programme of Samurdhi has also been changed following the budget proposals of 2006. The initial programme was designed to provide a monthly allowance of Rs. 200 for mothers of new born babies (from the Samurdhi beneficiary families) for a period of 12 months from the birth of the child. In 2005, this programme covered more than 100,000 mothers in all the 25 districts.[3] The new programme called Poshana Malla (nutrition bag) was started as a pilot project in 5 districts, i.e., in Hambantota, Monaragala, Badulla, Puttalam and Nuwara Eliya. This new *Poshana Malla* programme initiated in 2006 covers all the mothers from low-income families who are unable to maintain proper nutrition levels, irrespective of whether they are Samurdhi beneficiaries or not. Under this new programme, the mothers are provided with Rs. 500 per month for a period of 8 months before child birth and 12 months after the birth of the child. The cash grant can be used to buy only specified categories of food commodities. This is considered a timely requirement, since despite the country's achievements in human development, nutrition levels among the poor have remained low. In Sri Lanka, 22 per cent of married women in the reproductive age group are malnourished and 17 per cent of children under five are under-weight.[4]

7.3.4. Other Social Welfare Programmes

In 2001, the DCGS introduced the Kantha Pilisarana (women's support) programme for 'deserted women',[5] with the objectives of providing them with vocational training according to their skills and abilities, and other necessary facilities for this purpose so as to enable self development and reduce vulnerability among these women and their families. Initially, this programme was conducted in two steps, i.e., a one day legislation awareness programme, and a three day self employment training programme. In 2004, an additional component was added to this programme to identify families that are interested in carrying out self employment activities and provide them with assistance worth of Rs. 2500 which was increased to Rs. 3000 in 2006. Moreover, an early childhood development programme was initiated in 2004 for beneficiary families as well as for non-beneficiary low income families. Under this programme, DCGS selects one DS division (which is considered the poorest and where there is no kindergartens) from each district and sets up an early childhood development centre. At present, 43 such centres have been developed in the country. From 2006 onwards, the DCGS will also carry out a national disaster preparedness programme with the aim of establishing a disaster management force - a volunteer task force consisting of about 50 Samurdhi beneficiaries and non-beneficiaries - at the district level. The programme has already started 13 pilot projects in some of the high risk districts.

7.3.5. Samurdhi Banking Sector Programmes

The Samurdhi banking sector programmes provide loans for a diverse range of activities. As shown in Figure 7.5, out of the total number of loans issued in 2005, 70 per cent have been for self-employment activities, while 12 per cent have been for cultivation purposes. In addition, 14 per cent of loans have been provided for consumption purposes and 3 per cent as distress loans.

[3] DCGS and Ministry of Samurdhi and Poverty Alleviation, *Progress Report 2005*.

[4] DCS, Demographic and Health Survey 2000.

[5] Includes poor women who have been separated/divorced/abandoned by their husbands.

The *Janapubuduwa* programme is one of the two programmes of the *Suwahas Janapubuduwa* programme introduced in 2004. The key objective of the programme is to develop personal capabilities of low income earners through the provision of investment loans for income generating activities. The programme is managed by the banking division of the Samurdhi Authority. Initially, the Janapubuduwa programme aimed at economically strengthening 30,000 low income families by encouraging them to engage in self employment activities through their own projects. For the 30,000 projects, the required fixed and working capital was around Rs. 1163 million. The projects are expected to help the beneficiaries to have a permanent source of income and reduce vulnerability of low income earners. In 2005, the programme expected to expand its activities to cover 100,000 projects. The projects initiated under this programme cover a variety of fields such as agriculture, industries, animal husbandry, fisheries, marketing and services.

The selection of families for the programme is based on the 'zones' which are the areas of jurisdiction of *Samurdhi Banku Sangam* or Samurdhi Bank Societies (SBS). Initially, it was planned to select 30 families from each zone. The necessary basic facilities are provided through the SBS. The eligibility of the families is decided through their proven capabilities in SBS. The amount of loans provided varies from a minimum of Rs. 10,000 to a maximum of Rs. 100,000. The average value of an investment is about Rs. 30,000. The bank provides two-thirds of the value of the project as a loan, subject to an interest rate of 14 per cent while the beneficiary has to provide the balance one-third. This one-third contribution of the beneficiary should not necessarily be in terms of money; instead it can be in capital, land, machinery and equipment or even as technical knowledge.

7.3.6. Samurdhi Rural Development Programmes

Rural infrastructure development has been recognized from the inception of the Samurdhi programme as an important step towards creating sustainable income generation activities among low-income families. Consequently, several community development programmes have been implemented under the Samurdhi programme. The *Gampubudu* programme (the second component of the *Suwahas Janapubuduwa* programme) introduced in 2004 is one of such programmes initiated with the objective of improving rural infrastructure facilities in order to create a favourable environment for income generation.

The *Gampubudu* programme completed around 12,000 development projects worth Rs. 239.7 million in 2004. In 2005, the programme completed a further 10,800 projects. The Samurdhi Societies are responsible for identifying projects suitable for a village. The total value of the completed projects in general is much more than the inputs provided by the government due to the addition of labour by the beneficiaries. For example, the value of completed projects in 2004 was about Rs. 442.5 million. Another programme called the *Sawbhagya* village programme was started in 2004. Under this programme, 10-11 remote villages with limited facilities were selected from several districts for development. In 2004, a total amount of Rs. 10 million was allocated for this programme and 86 agricultural and animal husbandry projects - including the development of infrastructure facilities of these village areas - were implemented. Nevertheless, this programme was discontinued in 2005.[6]

[6] This was mainly due to political interference, particularly in the selection of remote villages for development.

In addition, a sanitation programme, a drinking water programme and a Rs.2800 million community based self employment and infrastructure development programme was implemented at the beginning of 2006. These three programmes started as separate projects for 2006 and are being operated in three stages. The first stage concentrates on the poorest 119 D.S. Divisions selected according to the Department of Census and Statistics categorization. The second stage will cover the next 99 D.S. Divisions that are poor, while the third stage will cover another 98 D.S. Divisions. The objective of the community based self employment and infrastructure development programme is to increase the monthly income level of the beneficiaries to over Rs. 5000. Under this programme, Rs. 10 million is allocated to each selected D.S. Division. The Divisional Secretary has the authority to use the money for any project that would achieve the objective of the programme. Under the sanitation project, Rs. 200 million is provided for each selected D.S. Division. The D.S. Divisions will select the beneficiaries who will need assistance in building toilet facilities and provide material worth of Rs. 6000 each. In addition, under the water supply project, an amount of Rs. 10,000 is provided for drinking water projects - either for the individuals or for the groups. This project is expected to build about 50,000 units per year. However, the *Gampubudu* programme also has

Box 7.1
Summary of Recent Developments in the Samurdhi Programme

2004 - Introduction of *'Janapubudu'* programme
- to support income generation activities among selected Samurdhi beneficiaries

2004 - Introduction of *'Gampubudu'* programme
- to develop infrastructure facilities in the rural sector in order to create a favourable environment for income generation

2004 - Introduction of early childhood development programme

2004 - Introduction of the *'Sawbhagya'* programme
- to improve infrastructure facilities in selected remote villages with minimal facilities (this programme was discontinued in 2005)

2005 - Introduction of *'Diriya Piyasa'* for housing development

2006 - Amendments to subsidy programme
- 50 per cent increase in the Samurdhi monthly subsidy
- Provision of rice for the value of food stamps

2006 - Amendments to the social security programme
- increase in the amount of death assistance and child birth allowance

2006 - Transformation of the nutrition allowance programme
- new '*Poshana Malla* (nutrition bag) programme with increased amount of monthly allowance, extended period of assistance and includes mothers from non-Samurdhi beneficiary families

2006 - Implementation of sanitation programme
- to improve sanitation facilities in selected DS Divisions

2006 - Implementation of community based self-employment and infrastructure provision programme
- to develop necessary infrastructure to facilitate self-employment activities in selected DS Divisions

components on drinking water projects and other infrastructure development projects.

7.3.7. Samurdhi Housing Development Programmes

The Samurdhi Authority also launched a new programme called *Diriya Piyasa* for housing development in 2005. This programme is expected to supply a grant of Rs. 50,000 per household for 5001 households in 22 districts. The beneficiaries are selected by a committee and given the grant in three steps to build their houses. Earlier, the Samurdhi Lottery Fund was used for this programme, but as of 2006, the government allocations and the fund of the Anti-Smoking Flag Day Collection will be used for this purpose. In addition, there is a separate lottery programme that was started in 2005 which uses the Samurdhi Housing Development Fund that is built up through the deduction of Rs. 10 per beneficiary household. It is drawn twice a year and provides Rs. 150,000 per household drawn for a total of 120 household per year for the purpose of building houses.

7.4. Conclusions

The Samurdhi programme has been the single largest poverty alleviation programme in Sri Lanka since 1995. As discussed in this chapter, a number of initiatives have been taken by the government in recent years to improve this programme, either through the development of existing schemes/programmes or the introduction of new schemes. The revision of the Samurdhi subsidy amounts based on the cost of living index has long been recognized as an important step towards improving the effectiveness of the programme. Finally, in 2006 initiatives were taken to increase the subsidy amount by 50 per cent for all the beneficiary groups. Despite such efforts, there exist a number of other important issues that need to be addressed along with the increase in subsidy amount, in order to improve the effectiveness of the Samurdhi programme in alleviating poverty in the country.

As pointed out, the cost of the Samurdhi subsidy programme alone has been around Rs. 8-10 billion per annum in recent years (1-3 per cent of the total government expenditure and 0.4-0.7 per cent of GDP). The cost of this programme is expected to become even larger along with the increase in the subsidy amount from 2006. Therefore, it is important to bring down the cost of the programme in order to minimise the strain on the government budget and to ensure the sustainability of the programme. One way of reducing the cost is through improvement of targeting by including only 'poor' households who deserve to receive Samurdhi subsidies while excluding the 'undeserved'. As highlighted earlier, currently over 40 per cent of the households (or nearly 2 million in number) receive Samudhi subsidies, as against the 19 per cent of poor households in the country. The government has already taken some measures to improve targeting of this programme. Accordingly, by mid-2006 around 40,000 beneficiaries have voluntarily exited the Samurdhi programme by returning their 'Samurdhi cards'. Such efforts are expected to help reduce the cost of the Samurdhi programme while allowing the funds to be used more effectively to the benefit of the poor.

Lack of coordination among various institutions under the Ministry of Samurdhi and Poverty Alleviation involved in handling various components of the Samurdhi Programme is another problem that needs to be addressed in order to ensure the efficient functioning of this programme. Strengthening the coordination between the DCGS and the Samurdhi Authority is important, particularly to prevent any duplication of programmes/ schemes. Moreover, linking the Samurdhi programme with other programmes such as the Gemidiriya Community Development and Livelihood Improvement Project that operates under the Ministry of Samurdhi and Poverty Alleviation (rather than treating the Samurdhi programme as a separate programme) is important. Furthermore, its is vital that various programmes under Samurdhi such as the nutrition and sanitation programmes be linked to other government programmes that have been implemented to achieve the Millennium Development Goals (MDGs) in Sri Lanka. In addition, minimizing the administration costs and political interference are some other measures that need to be taken to improve the efficiency of the Samurdhi programme.

The rigid nature of the Samurdhi programme has been a major obstacle in absorbing households or individuals that have fallen into poverty due to various external shocks such as tsunami, floods, and droughts. For instance, despite the large number of families that were displaced and affected by the tsunami disaster in December 2004, the number of Samurdhi beneficiaries have not shown any significant changes (particularly in those affected districts) in the aftermath of tsunami. Nevertheless, it is vital that the Samurdhi programme - as the main poverty alleviation programme of the country - be able to absorb/integrate such vulnerable groups or 'new poor' to the programme at times of need.

Furthermore, some systematic monitoring and evaluation mechanism is essential and should be in place to evaluate the impact of various programmes/schemes under the Samurdhi programme - to monitor at regular intervals the beneficiaries who have been moved out of poverty (and hence would no longer require the Samurdhi subsidy) and to identify 'new entrants' to the programme. A comprehensive database on Samurdhi beneficiary households and the benefits received by them from various programmes/schemes under the Samurdhi programme is necessary in this regard.

8. Effective Governance as a Pre-condition for Development

8.1 Introduction

The direct co-relation between the level of effectiveness of a country's governance in different periods of time and the pace and quality of development that is achieved during the same periods is amply illustrated by the development experience of Sri Lanka. This is also a clear indication of the multi-faceted roles that the government - at its different levels - has to play in furthering and sustaining the country's development process. A thorough understanding of these roles and their acceptance by the different stakeholders in governance is critical. It is an essential pre-requisite to ensuring the availability of effective levels of governance that would support acceptable levels of economic and social development. Where such understanding and acceptance is absent, the country's development process slides into decline.

The several roles of governance in Sri Lanka in relation to the development process need to be understood at all its three levels - the local community, the province and the centre. At all these three levels, governance has a clear responsibility as a facilitator and of a regulator. At the macro level, governance carries the additional roles of developing macro policies and plans that would lead towards pre-set goals and objectives as well as of ensuring their effective implementation.

The effectiveness of governance in the discharge of these varied roles depends directly on two factors. The first is the unambiguous assignment of specific roles to each of the levels as well as to the individual governance institutions at each level.[1] The second is the continuous availability of effective capacity at each level for the assigned roles. The latter would clearly be an outcome of appropriate structures and processes that are set for the different roles as well as the levels of competence of the personnel. It is critical to recognize that the structures, processes and personnel that are required for the roles and tasks at the different levels of the polity would vary and should, therefore, be specifically planned for. This, regrettably, has been an aspect of governance that has not received appropriate attention in Sri Lanka - contributing to ineffective governance.

At all three levels of the polity are a multiplicity of institutional entities expected to sub-serve a common focus in terms of development objectives. Whilst it is obvious that effective networking between them is a basic precondition for effective governance, Sri Lanka has witnessed the growth of a contrary trend. Each institutional entity - at each level - sees itself as being autonomous with unique loyalties to specific political structures and personages. Attempts at network management have invariably been resisted - overtly and covertly - by the political and administrative bureaucracies of the concerned institutions. This has contributed to governance becoming progressively ineffective in terms of development management.

A further factor that has contributed to ineffective governance in Sri Lanka has been the limited attention paid to the fact that the roles and functions of government are not

[1] It is important to recognize that the contents of the specific roles at each level should be kept continuously under review and modified as the economic, social and political context of the country that triggers a demand for such roles continues to evolve over time.

static. The reality of change over time has several implications; it requires new structures to be purpose-designed and institutionalized to discharge the changed tasks and functions which in turn require prior detailed and comprehensive assessments. It also implies that the historical accumulation of governance structures be kept continuously under review and abolished when found to be irrelevant to the new tasks and functions. Equally critical is the development of new competencies to match the demands of the new and changed tasks and functions. New cadres of personnel with the required competencies would need to be inducted. Any existing cadres that would be retained would need to be retrained. Existing cadres who are no longer required or are not suited for the emergent tasks and functions would require to be retrenched.

The reality as set out in the preceding discussion has two major implications. The first is that no governance structure - whether ministries, departments or para-statal organizations - should be deemed to be permanent. Nor should public sector employment be regarded as permanent. Equally important is to recognize that the historical and current assumption prevalent in Sri Lanka that public sector employees are equipped to discharge their responsibilities with the rudimentary induction training received as they are recruited is no longer valid.

Both imperatives set out above underscore the need for a dedicated institutional arrangement at the apex of the governance structure that would address these interlinked issues continuously. It is clear from Sri Lanka's experience that the ministries that carry responsibility for sectoral policy management are principally pre-occupied with the details and nuances of such policies and tend to take issues of effective governance as being marginal to their responsibilities. Therefore, in order to be effective, the institutional arrangement to address the interlinked issue of governance should both be correctly located, and be vested with the required authority and also be appropriately staffed. It is perhaps appropriate in the Sri Lankan context for such an institutional arrangement to be constituted as the responsibility of the Prime Minister. The Office of the Prime Minister should be empowered to exercise direct responsibility and accountability for all matters connected with the structures, processes and the human resources that relate to governance. It would require that unlike the current practice, the Office of the Prime Minister would then be relieved of all sectoral responsibilities.

This chapter reviews some selected critical areas in Sri Lanka's development management to highlight the manner and the extent to which inadequacies in governance affect their achievement. In this context, Section 8.2 looks at efforts at poverty reduction and the search for growth with equity; Section 8.3 examines the policy reforms of public enterprises; Section 8.4 examines the public sector capacity to respond to the demands of natural disaster management; Section 8.5 examines overall aims of public policy management while Section 8.6 examines issues of corruption in governance. Section 8.7 concludes with a discussion of the tasks ahead for improving governance.

8.2 Efforts at Poverty Reduction and Search for Growth with Equity

Early efforts to address poverty reduction in Sri Lanka focused on programmes of land settlement - utilizing the large extents of state land for the opening up of irrigated settlements. With the exhaustion of land and irrigation resources, poverty reduction took a less direct focus in public policy management - on the assumption that the normal growth of the economy, combined with traditional social welfare interventions, would contribute to the alleviation of poverty. It was as recently as the end of the 1980s that the negative side effects of the lack of a dedicated focus on poverty reduction came to be recognized, leading to the institution of the Janasaviya programme in 1989 which was followed by the Samurdhi programme from 1995. However, it is obvious that the attempts to address the issue of poverty reduction through such stand-alone interventions - without supporting inputs from other sectors in governance - have led to sub-optimal outcomes.

The lesson that emerges from this experience is the importance of ensuring that poverty reduction figures centrally in public policy management. Another aspect of public policy management that needs to be reversed is its current top down culture - with it being replaced by a bottom up approach that would ensure the availability of structures and processes for the participation of the poor. Such a bottom up approach would also enable the differences in poverty reduction across local areas to be specifically recognized, so that the interventions that are planned and implemented would be location specific. Hence, there is a need for participatory institutions at the local level to be involved in the process.

The structures and processes for policy management for poverty reduction at the centre need to be such that the final responsibility for the task should be placed at a point - in the political executive - that would vest the individual with authority over different entities that are sector specific. Given the political culture that has evolved over recent decades, it needs to be recognized that this would be a reform of governance that would generate a high level of political resistance and would, therefore, require dedicated efforts at implementation.

The policy and strategy agendas that are developed and implemented in order to effect poverty reduction would affect the daily lives of the citizens and impact on the economic and social relationships within local communities. Hence, their effective implementation will require a high degree of public acceptance that would depend on levels of transparency and accountability in the formulation and implementation of policies, particularly in each local community. Such accountability and transparency would, therefore, have to be built into the structures and processes that underpin the processes of management of poverty reduction.

The nature of institutional structures that underpin the process of governance at all levels of the polity have direct implications for the effectiveness with which the objective of poverty reduction is achieved. At the centre, it would require that the team of ministries be small in size - with each constituent ministry being made transparently responsible for a set of clearly defined outcomes. Institutional reform would also require a Deputy Head of the Cabinet being vested with specific responsibility and accountability for policy co-ordination in regard to all aspects of poverty reduction. Poverty reduction would also need to figure as a focal responsibility of the Provincial Councils - with similar institutional arrangements as at the centre being replicated, designed to suit the needs of each of the Provincial Councils. There should also be a clearly spelt out focal role for poverty reduction for the different Local Government Institutions (LGIs).[2] As strategies required for poverty reduction would vary within local areas, it is essential to empower each such LGI to develop its own policy package to serve the specific conditions in each of their areas.[3]

[2] These would be the Municipal Councils, the Urban Councils and the Pradeshiya Sabhas.

[3] The implications of such an approach is that whilst the centre would spell out the macro framework for a poverty reduction agenda, it would refrain from imposing agendas on the country as a whole - as was the approach adopted in the post-Janasaviya period.

In Sri Lanka, measures for the provision of production and consumption subsidies figure continuously as strategies for poverty reduction. Effective governance requires that such measures be designed in detail in terms of targeting, duration and management of delivery. It calls for continuous multi-level consultation of all governance directly and indirectly involved in the delivery of such subsidy programmes. Periodic monitoring of the impact and outcome of subsidy programmes would also be required in terms of effective governance. Where such detailed planning and monitoring is absent, subsidy programmes fail to serve as effective tools for poverty reduction and end up as a drain on public financial resources.

Effective governance requires continuous monitoring that would point to gaps and lags in the achievement of equity related goals, underscoring the need for adjustments in policy and implementation in terms of institutional arrangements and management. It is realistic to expect that problems would be encountered in the effecting of changes to policies that have, over time, acquired their own vested interests - political and bureaucratic - in the implementation context. Those occupying the lead rungs of development management have to remain consistently firm in their resolve to overcome resistance from such vested interests.

8.3 State Owned Enterprises

State owned enterprises (SOEs) have continued to be a significant feature of the governance scene in Sri Lanka. Several of them have been the carry over of enterprise type of activities that were run as departments of the government during the colonial period.[4] Others had their origins on the assumption that, given the low level of development of the private sector in the early post-Independence years, investment in what were regarded as key economic areas would not occur unless the state stepped in with such investments.[5] Still others were the result of the take-over by the government of economic activities that were being conducted by the private sector.[6] Once they came into being, SOEs acquired their own vested interests - in the arena of political cadres, bureaucracy and trade unions - that sought to ensure their continuance - regardless of the developments in the economy.

Effective governance requires that all governance structures and processes be subjected to continuous review and modification in the context of economic and social changes that occur in the country. SOEs cannot, logically, be an exception to this requirement. Given the emphasis that is currently placed on pro-poor growth as a key objective of development, it is important that the appraisal and modification of the role of SOEs be within this objective.

SOEs should remain a critical contributor to the Sri Lankan economy in several ways; providing production infrastructure, employment generation, adding to the stock of public financial resources through surpluses on investment made in them, increasing national output through effective performance, etc. However, in the case of SOEs in Sri Lanka, this has not been the case. Several governance issues arise as a consequence of the poor performance of the current array of SOEs.

One such issue is the lack of clarity in public policy management as to the duration of

[4] The Ceylon Electricity Board that had its origins in the Department of Government Electrical Undertakings and the Road Development Authority and the State Engineering Corporation that grew out if the Public Works Department are some examples.

[5] The erstwhile Oils and Fats Corporation, the Textile Mills, the Cement Factories, the Paper Corporation provide examples.

[6] The Ceylon Transport Board, the Co-operative Wholesale Establishment, the Peoples' Bank, the Plantation Companies are some examples of this initiative which, in the main, was driven by ideological considerations.

specific SOEs - which of them should be permanent, which should be of long duration and which should be transitory. It has been assumed that all SOEs, once established, should be permanent even when the specific objective which each was expected to serve has ceased to be relevant. The relationship between the evolution of the capacity of the non-state sector of the economy and the duration of the state's involvement in specific SOEs tends to be ignored.

A second is the importance of a cohesive policy approach to SOEs. The adoption of an *ad hoc* approach to the setting up and continuation of SOEs is counter productive. The importance of public participation in the process of such decision making - through the allocation of adequate time for public discussion and provision of inputs, the availability of a permanent body for the analysis of proposals and of public inputs, etc. - is lacking in the current system of governance regarding SOEs.

Another critical governance issue is that of the entity within the government structure that should, on behalf of the state, shoulder the responsibility for the oversight as well as the enforcement of accountability over SOEs.[7] The practice that has emerged of ministries that carry responsibility for different economic and social sectors attempting to oversee the functioning of SOEs has led to sub-optimal outcomes in terms of ensuring effective financial and operational performance. Effective governance requires that there be an institutional arrangement to ensure public accountability. Such an arrangement should, whilst being serviced by the Ministry of Finance, be accountable to the Parliament where each report is subject to discussion in the Parliament - with special focus on aspects such as management outcomes, rates of return on investment, etc.

Governance concerns also relate to issues of enterprise management. In this regard, the constitution of the Boards of Directors and their role and accountability becomes critical. The *ad hoc* approaches to the appointment and removal of Directors that have been the norm have not been effective. Effective governance requires that the institutional arrangement set up for the oversight of SOEs should have the primary responsibility for the selection of members of the Boards of Directors and that the Parliament should have the final role in the approval of their appointments.

Governance concerns would also include issues related to investment management. The optimal approach would be to set up a State Owned Enterprise Investment Fund (SOEIF) that is controlled by the Treasury. Such a fund should receive inputs from each annual budget whilst the individual disbursements in the form of investments in each enterprise are presented to the Parliament for prior approval.[8] The SOEIF should act as the counterpart of the shareholder of the private corporate sector with the annual reports of each SOE being subjected to scrutiny and questioning through specific panels that are set up for the purpose before such performance accounts are presented to Parliament.

A related governance issue is that of the pay and incentive systems that are applied by each SOE. It is axiomatic that such systems should be both enterprise-specific as well as be within the parameters of market practices in the relevant areas of the economy. They should not be pegged to the salary systems that are used for different segments of

[7] Experience has demonstrated the ineffectiveness of several institutional arrangements such as COPE, PERC and SEMA in ensuring financial and performance accountability in the case of SOEs (see Chapter 6).

[8] It is important that proposals that are presented to the Parliament by the Treasury should clearly set out the quantified returns that are expected as a result of each investment.

the public service. Above all, they should be developed in the context of performance-based incentive systems.

8.4 Natural Disaster Management

The majority of natural disasters that Sri Lanka has faced have tended to be ones that have affected limited areas of the country and relatively small sections of the population. The attention of the government as a result was focussed primarily on post-disaster recovery and a response that could be mounted with minimal preparation by the respective agencies of the government. The tsunami of December 2004 - due to its unprecedented nature and the spatial and human spread of its impact - has underscored the need for rethinking the hitherto reactive approach to natural disaster management. A pro-active approach to disaster management that emphasises the essentiality of anticipatory planning has now come to be accepted as public policy. This change in approach flowing from the change in public policy has several implications in terms of effective governance.

The first such implication is that the effectiveness of a pro-active approach would depend on the degree to which it is based on analysed data in its planning. Hence, the continuous collection and analysis of relevant data becomes a key task of governance. A second implication is that there is a need for designing institutional structures for data collection and analysis, for anticipatory planning and designing of interventions and for their implementation as well as for the monitoring implementation. Such institutional structures have not only to be purpose-designed but also be periodically reviewed in terms of their continuing relevance and effectiveness.

Institutional structures should be designed as networks that extend from the macro policy level at the centre to the implementation level on the ground. The individual structures within the network should be so designed and instituted that they link - at all levels - with other governance structures and with civil society organizations. An equally important implication for effective governance is to ensure the availability of purpose-trained multi-disciplinary staff for the manning of institutional structures that are set up. It is critical that such staff be specifically trained for their tasks and that there be continuity of staff. These requirements mean that such staff not be seconded for temporary periods from what are referred to as 'combined services' in the traditional bureaucracy.

Within the institutional network, the lead policy and management role in regard to the management of natural disasters should be located within the political executive at the centre - with the role and responsibility being entrusted to a member of the political executive who stands as a *primus inter pares* within it.

8.5 Public Policy Management

The foregoing overview in regard to the governance implications of the main thrusts of the country's development effort points to the improvement of public policy management as the most critical issue to be addressed in seeking to enhance the effectiveness of governance. This issue has to be addressed at two levels - at the level of sector related policies and at the level of macro policies.

8.5.1 Sector Related Policies

The pace and quality of the achievement of development objectives in each sector would be directly related to the relevance and quality of the analysis, formulation and implementation of public policies that provide the framework for development within each such sector. Effective governance, hence, requires that there are necessary institutional capacities within each sector that would support the task of effective public policy management. Given the structure of the Sri Lankan polity, it is necessary to project the required institutional structures for sector-related policy management in terms of the three levels of polity - the centre, the province and the local community.

The policy management institutions at each level will need, obviously, to be purpose-designed. This has not been the experience of governance in Sri Lanka. The approach, instead, has been to utilize ongoing structures - and their processes - for sector-specific policy management that have become imperative as a consequence of new policies being adopted. This approach has not been a success - more so as, over the decades, development policies need to be managed in a rapidly changing context. Neither the structures nor their personnel have been appropriate and adequate for the new challenges. The outcome has been weak policy management.

Public policies of today that focus on specific development goals are, inevitably, multi-facetted and are dependent, for their effective implementation, on the co-ordination and collaboration of multiple policy management agencies. This applies to all three levels of the polity. However, Sri Lanka's experience points to several negative factors that have prevented the effective co-ordination of public policy management directed towards the achievement of development objectives.

At the centre, there has been a proliferation of ministries that has resulted in the truncation of the responsibilities for sectors and even sub-sectors. The rapidity with which the proliferation has occurred has been such that it has led to a lack of clarity as to the actual responsibility for specific areas of development policy.[9] Sri Lanka's political culture has encouraged a reluctance on the part of the holders of executive office to collaborate across the political responsibilities that are, individually, allotted to them. Individual performance, rather than collaborative performance, is perceived as the steps in the ladder of success and advancement. The reluctance to collaborate is seen even at the level of provincial governance - even though the political executive at this level is limited by the Constitution to five members. The same elements in political culture have been the contributory factors. The bureaucracy has been ready to support the aversion to collaboration and co-ordination that has characterized the political culture. As a result, a mutually supportive relationship between political and bureaucratic cadres has developed to the detriment of good governance.

At the level of the institutions of local governance, the inability of the concerned institutions to move from their traditional concerns of sanitation and minor infrastructure, to the level of development management has resulted in these institutions not contributing to development objectives such as poverty reduction. The outcome of this situation has been the non-involvement of local communities in development management.

8.5.2 Macro Policies

Effective macro policy management is hinged on the recognition that there is a continuous nexus between the formulation and implementation of policies at all levels - whether at the macro level, the micro level as well as the levels in between. The macro

[9] The sectors of agricultural development and of industrial development provide examples where there is a proliferation of different ministries with very narrow areas of focus and without any clear indications of institutional structures and processes for intra-sector policy co-ordination. The stakeholders are at a loss to understand the institutional focuses of the different intra-sector activities and responsibilities. Equally confused would appear to be the public officials who are expected to provide the public goods and services in the different sectors.

economic, social and international policies of the country would, thus, need to draw their direction from the thrust of the domestic development objectives that are envisaged - whilst they relate and respond to the changes that continuously occur in the international environment.

The preceding discussion on sector-related policy management outlined the institutional structures that should be available at the local and provincial levels for policy management. This chain should be continued to the macro level if the area of policy management in governance in Sri Lanka is to be effective. Such a continuum, however, has not been a feature of Sri Lanka's experience with governance except in brief periods during which specific development objectives have received priority attention.[10] A major governance reform, therefore, has become the review of the continuum of policy management structures and their rationalization, from the community to the macro level.

Such a continuum of policy management structures and processes should -- at each level – provide for obtaining feedback from sources outside the institutional system.[11] This is particularly relevant at the stages of the analysis of policy options and of the monitoring and evaluation of the implementation and impact of such options. An equally important factor is the need for effective networking amongst institutions that focus on macro policy issues. Given the Sri Lankan political and administrative culture, this would be a reform that would face considerable resistance and one that would be most difficult to achieve. Nevertheless, given its essentiality for effective policy management, it is a priority reform that would need to be driven at the highest level of the polity.

Throughout the post-Independence decades, the Parliament has played an insignificant role in policy management - a situation that has worsened with the growth of its size. This is a situation that needs to be reversed as a matter of priority. One reform approach that could be considered is to establish a Permanent Select Committee of the Parliament that would interact with the institutions of policy management at all three levels of the polity as well as with the organizations of civil society, the associations and chambers of the private sector as well as the organizations of the country's workforce. Such a Select Committee should issue a periodic report (half-yearly report would be the most appropriate) that would both be tabled in Parliament for discussion as well as be freely accessible to the public. The free discussion of such reports at different levels of the citizenry and in the media as well as in the academia would make a significant contribution to strengthening and enriching the country's policy management process.

8.6 Corruption in Governance

The effectiveness of governance as a provider of support for the country's sustained development is directly dependent on the level of confidence that the different stakeholders show towards the political and administrative institutions that are set up to ensure the effective functioning of governance structures and processes that support development. These stakeholders - comprising the investors, the workforce, as well as the citizens in their communities - continuously assess the effectiveness of the country's governance

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[10] One such priority was the emphasis laid on food crop production in the second half of the 1960 decade.

[11] These would include the academia, the organisations of the civil society, the private sector and the market as well as the organisations of the workforce.

and use such assessments to decide their response to the government's different initiatives in furthering development.

In this assessment, the stakeholders in Sri Lanka have increasingly started to pay special attention to the level and degree of corruption that prevails in the country's governance. Their perceptions play a key role in shaping the responses of different groups of stakeholders as seen in their respective behaviours:

- In the case of investors - both international and national - the responses relate to their approach to participation in new investments as well as continuing their current investments;
- In the case of the citizenry at large who have continuous interface with public agencies and their staff in regard to the delivery of public goods and services as well issues of law and order, the responses influence their co-operation with institutions of governance; and
- In the case of the workforce, the responses influence their approach to productivity as well as the maintenance of peace and order in the workplaces.

What is critical in all these situations is the credibility of governance in terms of both its political as well as its administrative structures and processes.

All evidence points to an increase in the level and degree of corruption in Sri Lanka over the post-Independence decades - be it in the routine delivery of public goods and services or in the conduct of regulatory tasks relating to the maintenance of law and order, economic management, or in the administrative processes that impinge on the day to day lives of citizens.

Corruption in governance in Sri Lanka takes several forms. The most common of these include:

- seeking of cash rewards or other economic benefits for carrying out or speeding up administrative tasks that arise in the bureaucracy-stakeholder interface in day-to-day governance or the non-observance of mandated procedures in the conduct of government functions;
- seeking similar benefits for the discharge of tasks related to enforcement of law and order;
- soliciting and receiving rewards for making decisions in regard to the award of government contracts and tenders; and
- accepting financial and other material benefits for making appointments to and promotions in posts in the public sector.

Whilst the search for cash rewards and similar economic benefits constitute one aspect of corruption, an equally significant aspect is the use of political influence and connections in decision making in regard to appointments, to the award of contracts and tenders as well as to decisions concerning economic assets.[12] It is the perception of stakeholders that the levels and degrees of corruption have seen a progressive escalation. This trend has been the consequence of several factors, including the following:

- successive expansions in the role of the state and its structures;
- expansion of the size of political institutions at different levels of governance and their failure to attract persons of appropriate quality to participate in them; and

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[12] The disposal of state-owned land, the acquisition of private land by the state, the divestment of other state-owned economic assets provide examples.

- decline in the quality of personnel holding office in the public services and the almost total control that political cadres exercise over them as an outcome of the post-1972 changes to the Constitution.

The level of real effort that is invested in combating corruption remains low. This becomes evident from several examples. One such example is the protracted delay in enhancing the effectiveness of the Office of the Auditor General (OAG). The mandate of the OAG is inadequate to cope with the nature, level and spread of corruption as it is today. The mandate thus requires strengthening the provisions in the Constitution that relate to the OAG and its powers require revision to bring them in line with the changed context. The personnel and financial resources that are available to the OAG are clearly inadequate for the quantum and spread of the tasks that it is faced with.[13]

Equally counter-productive have been the delays in enhancing the effectiveness of the Commission to Investigate Allegations of Bribery or Corruption through a programme of reforms similar to the one that relates to that for the OAG. The tardiness in the conduct of judicial proceedings that relate to matters concerning corruption has also been a factor that has had a negative impact in combating corruption in governance. Not only do such delays impede the systematic and speedy disposal of punishment, they also lead to citizens and other stakeholders losing interest. Equally negative has been the impact of the delays in the conduct of disciplinary proceedings concerning public officers that relate to issues of corruption. The secrecy that envelops such disciplinary proceedings has also meant that the citizens and other stakeholders remain unaware of the steps that are taken to combat corruption. The conclusions that are drawn by the stakeholders in governance from the current situation are that there is apathy in governance in facing issues related to corruption.

8.7 Conclusion: The Task Ahead

The recounting of the situation as regards the reality of governance support for the development initiatives that are articulated from time to time points clearly to several inadequacies as well as dysfunctional trends that have taken root in governance in Sri Lanka. The preceding discussion has identified them as falling within several categories. These include:

- failure to clearly identify the responsibilities, functions and tasks of governance at each of the three levels of the polity leading to intra-polity conflicts as well as to irrational expenditure of public financial resources;
- failure to set up purpose designed institutional structures and processes to deliver the specific development programmes and projects that are announced from time to time;
- failure to attract and place in position appropriately skilled human resources that are demanded by the specific nature of different development initiatives; and
- inadequacy of the quality of policy management related to different development initiatives at each level of the polity.

This iteration serves to underscore the magnitude of the task that Sri Lanka faces in enhancing the effectiveness of its governance to a level that would provide the necessary support to achieving its development objectives. If this challenge were not met, the

[13] It is, however, a significant development that despite the constraints within which it operates, the OAG has in the immediate past placed before the citizens some objective reports that focus on governance issues that have made the stakeholders aware of serious shortcomings in governance.

development goals that are articulated from time to time would remain unfulfilled leading to escalating public dissatisfaction.

Any attempt to enhance the effectiveness of governance in support of development must recognize that the task calls for dedicated attention and a clear understanding of the magnitude of resistance to the attendant reforms that would be encountered. Hence, a specific understanding of the nature of likely resistance as well as designing strategies to counter such resistance would be prerequisites to the process of enhancing the effectiveness of governance in support of development. Such an eventuality would be possible only if the management of the reform process is placed at the highest levels of the polity.

Policy Briefs

9. Liberalization of Services Sector under the India-Sri Lanka CEPA

9.1 Introduction

Services encompass a wide range of activities, dominating economic activities at virtually every stage of development. The adequate provision of services is increasingly recognized as one of the preconditions for - rather than a result of - development. For instance, inadequate infrastructure services, such as poor telecommunications and transport networks or a weak financial system, are perceived as critical bottlenecks on sustainable development. Distribution, trade finance, insurance, marketing and other business services are complementary to a healthy growth of industrial activities. Benefits to be derived from liberalization and competition in the services sector may materialize in terms of increased trade in both goods and services, higher inward investment in the service sectors and, above all, better access to services by consumers at low prices.

The services sector has been the most dynamic growth sector of the Sri Lankan economy in the recent past. The bulk of the contribution to GDP growth and employment comes from the services sector and its potential to contribute further towards improving the welfare of the population is quite significant. For example, wider access to affordable and better quality in health, education, water, sanitation, etc. has a strong bearing on improving welfare, particularly of the poor.

While trade initiatives undertaken by Sri Lanka in the past have focused on liberalization of trade in goods, the liberalization of services is one of the new areas to be included in the proposed Comprehensive Economic Partnership Agreement (CEPA) being negotiated between Sri Lanka and India. The CEPA is a sequel to the 1998 India-Sri Lanka Free Trade Agreement (ISFTA), which has been in operation since March 2000. In June 2002, Sri Lanka and India agreed to expand the ISFTA to bring about greater integration of the two economies - i.e., to deepen and broaden the scope of existing arrangements. This was followed by the appointment of the Joint Study Group in April 2003, which recommended the entering into of a CEPA to further liberalize trade in goods, and also extend its scope to services, investment and economic cooperation. While it may still be the case that the Sri Lankan business sector is yet to get used to the idea that India may be as much an opportunity as a threat, the decision to proceed on the CEPA is a recognition that there is still untapped potential in bilateral trade, investment and services between the two countries. Thus, discussions on the CEPA were launched in 2004 with the Commerce Secretary level meetings, which have been followed by seven rounds of technical level negotiations as of July 2006. The policy brief examines briefly the scope for liberalization of trade in services under the on-going CEPA negotiations.

9.2 Why Services Liberalization?

Liberalizing the services sector refers in this context to the lowering or elimination of barriers to providing services by non-national service suppliers. To understand the nature of these barriers, it is useful to refer to the WTO General Agreement on Trade in Services (GATS), which classifies services into four 'modes of supply' (Box 9.2). Barriers to trade in services basically refer to restrictions affecting any of the four modes of supply.

Box 9.1
Making Services Work for the Poor

Services are very important to the poor. For example, services like education and health underpin human capital, which plays a major role in breaking the cycle of poverty. Similarly, services like transport, energy, financial and ICT all open profitable opportunities to the poor, from being able to bring their produce to the market in less time at lower cost (transport services), to being able to be put in touch with remote buyers and to obtain up-to-date price information (ICT).

Yet, too often the poor have no access to such services, or have access to services of poor quality, while better quality services remain unaffordable. Service sector liberalization is one component of a series of complementary policies that can help to overcome this problem. By liberalizing services, the resultant increase in the level of competition between service providers leads to downward pressure on service prices, making services more affordable to the poor.

However, liberalizing services has to be accompanied by complementary policies if it is to 'work' for the poor. First, the government will have to adopt pro-poor policies such as 'universal service' - requiring new entrants to serve (or contribute to the service of) rural areas in addition to profitable urban areas. Second, there should be an effective regulatory framework to monitor the implementation of policy. Finally, the government may need to adopt innovative funding mechanisms to bridge the gap between service providers and the poor, such as output-based aid and vouchers. Across-the-board subsidies, which have been favoured so far, disproportionately benefit the non-poor and are in fact anti-poor.

Typical examples include, exchange control restrictions on remitting foreign currency for a service obtained abroad, restrictions on foreign ownership in banks, hospitals, schools etc., immigration restrictions on entering the country for work purposes relating to the supply of a service, and non-recognition of qualifications of foreign services suppliers for the purpose of providing a service locally.

Reducing or eliminating barriers to trade in services through liberalization leads to an increase in the volume of internationally traded services, as service consumers have access to

Box 9.2
WTO GATS Modes of Supply

Mode 1 ('cross-border'): services that are transmitted by the service supplier to the service consumer without either having to leave their respective countries (e.g., e-commerce, international telephone calls).

Mode 2 ('consumption abroad'): services provided through the service consumer moving to the service supplier's country (e.g., travel abroad for education, health and tourism).

Mode 3 ('commercial presence'): services provided by a foreign services supplier through ownership of a company, branch or other legal entity in the service consumer's country (e.g., services provided by foreign banks operating locally).

Mode 4 ('movement of natural persons'): the temporary movement of persons to the service consumer's country to provide a service (e.g., foreign doctors working in local hospitals, IT professionals coming to repair a computer system).

the most efficient foreign suppliers. This increase in trade benefits both the service exporting and the service importing economies. The service exporting economy is able to increase its export earnings, and possibly employment in the particular sector. The service importing economy benefits from lower cost and higher quality as a result of the increased competition. This in turn has important knock-on effects throughout the economy, as services (such as transport, electricity, telecommunications and banking and finance) are important inputs in the production of other goods and services. Thus, export industries can become more competitive, while domestic prices can be reduced, resulting in a lower cost of living. In addition, the supply of a service though commercial presence (mode 3) brings in needed investment and foreign exchange.

However, the liberalizing country may have to face certain adjustment costs as a result of opening itself to competition from foreign services suppliers. In particular, less efficient domestic service suppliers may be forced out of business. In theory, based on assumptions of full employment and perfect factor markets, resources will be reallocated to the most efficient use, and the economy will be better off. However, given the realities in developing countries, it is more possible that, as a result of competition from more efficient foreign suppliers, workers would simply be moved from inefficient local sectors into unemployment. Therefore, adjustment costs may be significant and long-term. As a result, liberalization should be approached cautiously. In addition, liberalization has to be accompanied by an effective regulatory framework, to ensure that the services of foreign services suppliers meet the requisite standards of quality, skill and care. For example, there should be licensing and registration requirements for foreign professionals like doctors and engineers wishing to start up a practice in the territory. The regulatory framework should also include provisions to minimize the emergence of 'two-tier' services, such as high quality, expensive services for the rich and low quality, cheap services for the poor.

9.3 Services Profiles of Sri Lanka and India

The services sector is the dominant sector in both India and Sri Lanka, and the driving force of recent economic growth in both economies. In addition, both economies also are heavily reliant on trade in services. In Sri Lanka, the services share of GDP was 55.8 per cent in 2004.[1] The services sector grew at 7.6 per cent, exceeding the year's GDP growth rate of 5.4 per cent. Growth in the sector was driven by sustained strong growth in telecommunications (31 per cent), followed by cargo handling at the port, hotels and restaurants, and import and export trade.

In India, the services sector composition of GDP in 2004-05 was 57.6 per cent, and the sector's growth rate was 8.6 per cent, compared to the average GDP growth rate of 7.5 per cent over the last five years. The main drivers of services sector growth in India were the trade, hotels, transport and communication sectors, which together contributed almost 60 per cent of the sector's growth in 2004-5. The software sector has grown exponentially, with total revenues (domestic revenues and exports) growing by 32 per cent to reach US$ 22 billion in 2004-05, amounting to 3 per cent of GDP.

Both India and Sri Lanka rely heavily on services exports and imports as defined in Box 9.2. Sri Lanka's main services exports are the services of migrant workers (mode 4 in the

[1] 2005 figures have not been used for the comparison because they have been skewed by the effects of the 26 December 2004 tsunami.

GATS classification), tourism (mode 2 of the GATS), transportation services (passenger fares, freight charges and port related earnings) (encompassing modes 1 and 2 of the GATS), telecommunication services and IT (mode 1 of the GATS). Sri Lanka's main services imports are transportation services, other business services and travel.

India's main service exports are software services (including IT-enabled services (ITES) and business process outsourcing (BPO)) (GATS mode 1), transportation, tourism and remittances of migrant Indians. India's main service imports are business and professional services (including construction, financial, communication and managerial services), reflecting the ongoing technological transformation and modernisation of the economy, and travel, of which business travel accounted for about 60 per cent.

Both countries are overall net exporters of services (Table 9.1). The surplus in the services and transfers accounts of the balance of payments (BOP) account has helped to offset the widening deficits in the trade account in both countries in recent years.

9.4 The Liberalization of Services under CEPA

The liberalization of services under CEPA takes place against the backdrop of the two countries' existing level of service sector liberalization, and commitments given to the WTO. Beginning with the existing level of services liberalization, Sri Lanka has unilaterally liberalized modes 1 and 2 under the Exchange Control Act. Sri Lanka maintains a very liberal regime for mode 3, and foreign ownership up to 100 per cent of equity is automatically allowed in most services sectors, including key sectors like banking and insurance, as a result of progressive liberalization since the early 1990s. However, mode 4 is not open yet. Movement under this mode requires case-by-case approval by the relevant line ministry or authority (for example, the Ministry of Health has to give its recommendation before a foreign doctor may be issued with a work permit).

India has also made substantial achievements in unilaterally liberalizing its services sector since embarking on economic reforms in 1991/92. Yet, India has not progressed as far as Sri Lanka. Modes 1 and 2 have been

Table 9.1
Selected Services Exports and Imports of India and Sri Lanka (US$ mn.)

Item	India	Sri Lanka
Travel, net	-497	217
Exports	5,029	513
Imports	5,526	296
Transportation, net	509	209
Exports	5,048	624
Imports	4,539	415
Computer and information services, net	17,200	72
Total non-factor services, net (1)	14,630	419
Worker remittances, net (2)	20,459	1,350
Total of (1) + (2)	35,089	1,769
Trade account balance	-38,130	-2,243

Notes: Figures for India are for 2004-05 and for Sri Lanka for 2004.

Source: Central Bank of Sri Lanka, *Annual Report 2004;* and, Reserve Bank of India, *Annual Report 2004-05.*

liberalized, but are subject to limits prescribed by the Reserve Bank of India. Similarly, while foreign direct investment is allowed up to 100 per cent, without prior approval, in many service sectors (mode 3), key area like banking and insurance are still restricted. As in the case of Sri Lanka, India has not liberalised mode 4.

Second, as WTO members, India and Sri Lanka have given undertakings (called commitments) under the GATS as to minimum levels of openness in certain sectors. These commitments extend to all WTO members. Although India has committed more service sectors in the WTO than Sri Lanka,[2] Sri Lanka is more open based on the extensive unilateral liberalization referred to above. Therefore, under the CEPA, Sri Lanka can gain in the nature of market access to India. However, domestic capabilities may need to be further developed before being able to take advantage of market access to India. In addition, Sri Lankan service suppliers should be interested in accessing the Indian market. Hitherto, most Sri Lankan professionals, for example, have focused mainly on providing services in relation to developed country markets.

The liberalization of services under CEPA is predicated on the recognition of three principles, as in the case of the ISFTA - the asymmetry of the economies, progressive liberalization and sequencing of liberalization. This means that, while both countries will take a gradualist approach to liberalization, Sri Lanka will be entitled to open up less than India at the beginning. In addition, CEPA follows the GATS approach of request-offer negotiations and positive listing of services sectors. This means only those sectors specifically listed by a country will be liberalized. In addition, a country may specify further restrictions, or limitations, on liberalization in the sectors it has listed.[3] Such limitations can effectively address concerns that the CEPA would result in the "floodgates being opened".

Under CEPA, for those sectors that have already been liberalized unilaterally, Sri Lanka may bind itself to preserve the existing level of liberalization to India - compared to the present option of reversing unilateral liberalization at any time. Alternatively, Sri Lanka may bind itself to a lower level of openness than that presently applied. Either way, giving an undertaking under CEPA provides an assurance of a *minimum* level of market opening, which provides a measure of certainty to would-be service suppliers. However, for those sectors already bound in the WTO, liberalization under CEPA will have to offer something beyond what is offered to all other WTO members. This could be undertaking commitments in new sectors, or increasing the level of commitments in sectors opened in the WTO. The same would apply, in return, to India.

Indian requests to Sri Lanka relate, among others, to liberalisation of financial services, professional services, computer services, construction services, other business services, tourism and travel related services and maritime transport services. In most of these sectors, Sri Lanka has already fully liberalized unilaterally, with the notable exception of mode 4. Sri Lanka's main re-

[2] India has taken commitments in ten service sectors, while Sri Lanka has in three – tourism, telecommunications and financial services.

[3] In the GATS methodology, this is by listing specific limitations on 'market access' and 'national treatment' in the country's schedule. Market access denotes the terms on which trade in services under any of the four modes of supply is permitted to take place, while national treatment denotes treating foreign service suppliers not less favourably than their national counterparts.

quests to India relate to liberalization of air services,[4] financial services, maritime transport services, retail services and tourism. In many of these sectors, Sri Lankan service suppliers have faced barriers to access the Indian market.

9.5 Conclusion

What does liberalization of services under CEPA bode for the Sri Lankan economy, service consumers and service suppliers? For Sri Lankan service consumers, there is an outright benefit - better service, better value for money and increased choice as a result of more competition. For Sri Lanka's service suppliers, liberalization represents both challenges and opportunities. The pressure of competition in hitherto protected sectors would force domestic service suppliers to become more efficient, and more responsive to consumer needs. Furthermore, by following the approach of progressive and sequential liberalization (which, as mentioned previously is recognised by CEPA), the costs of dislocation can be minimized.

On the other hand, apart from the pressures of competition, the infusion of Indian talent and investment can be the basis of technology transfer, which will in turn help to invigorate the local services sector. Finally, with Sri Lanka's longer experience with competition from foreign services suppliers as a result of unilateral liberalization, Sri Lanka has a potential competitive advantage vis-a-vis India in a number of sectors. By removing existing restrictions in the way of Sri Lankan service suppliers, CEPA offers the opportunity to gain preferential market access to the huge and rapidly growing Indian services market. As a result of the above effects, CEPA would have a positive impact on the domestic economy as a whole. However, a proper domestic regulatory framework is an important prerequisite for realizing many of these benefits.

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[4] In the WTO, except for the limited areas of aircraft repair and maintenance services, selling and marketing of air transport services and computer reservation system services, air services were excluded from the scope of the GATS. However, Sri Lanka prefers to bring air services under the CEPA, as India and Singapore had done in their 2005 Comprehensive Economic Cooperation Agreement (CECA).

10. Fertilizer Subsidy Programme in Sri Lanka

10.1 Introduction

As in many countries of South and South East Asia, Sri Lanka has pursued self sufficiency in rice as a politically attractive national policy goal. But in addition, it has long been concerned with issues of equity as well. These twin objectives have led agriculture, particularly paddy production, to occupy a special place in the policy formulation process. Besides massive investments in improving irrigation and agricultural research and extension activities to achieve food self sufficiency in the long run, a number of short term policy tools were also adopted in Sri Lanka, including tariff policies, price policies and input subsidy policies such as enactment of a fertilizer subsidy scheme.

Fertilizer subsidies have been widely used in Sri Lanka since 1962 with the intention of encouraging the use of fertilizers and offsetting the adverse effects of low crop prices and high cost of production. It initially covered only paddy but later was extended to all other crops in 1985. The government withdrew the fertilizer subsidy in 1989, but re-started the scheme in 1994. Originally it applied to urea, sulphate of ammonia, muriate of potash and triple super phosphate (TSP) but, a revision made in 1997 restricted the fertilizer subsidy only to urea since it is the most widely used fertilizer in Sri Lanka. The method of deciding on the subsidy varied from time to time to be either a fixed sum per unit amount of fertilizer or a variable sum to maintain a fixed price in the market.[1] This policy brief examines the efficacy of fertilizer subsidies as a policy tool, examining the costs and benefits of such schemes in the pursuit of the country's broader development goals.

10.2 Fertilizer Subsidy as a Policy Tool

A fertilizer subsidy can be considered as a useful policy tool for promoting fertilizer use and decreasing the cost of production of small farmers. Sri Lanka's agriculture sector has shown little dynamism in terms of its contribution to the country's overall growth performance. Nevertheless, the sector plays a key role as a source of employment to the vast majority of the rural population. Subsidies to the farming community are, therefore, viewed as a means of sustaining and ensuring livelihoods and income opportunities in the rural agricultural economy.

While the cost of production of crops continues to rise as a result of increasing input prices, the increase in crop prices has remained relatively low. One way of remaining profitable, economical and competitive is to attempt to lower the unit cost of production by making greater use of inputs such as fertilizer. Nevertheless, the rapid increase of fertilizer prices in the world market has continued to adversely impact the poor small holder farmers, and increased the demand for fertilizer subsidy. Fertilizer subsidies, therefore, are expected to provide fertilizers to farmers at affordable prices while ensuring adequate returns on investment to the producing units. However, the resulting yield increase has to more than compensate for

[1] In 2005, the fixed rate of subsidy was Rs. 23,000 per metric ton of urea. It was revised in late 2005, fixing the price at Rs. 350 per 50 kg bag of urea regardless of world market price.

the increase in cultivation cost, i.e., increased revenue generated by the subsidy has to be higher than the increased cost from the subsidy.

There are numerous reasons for governments to subsidize fertilizer as a policy. The two main reasons, however, can be viewed as political and economic. From a political perspective, the key reason has to do with exchanging political favours which is said to create political benefits. From an economic perspective, the main purpose of the fertilizer subsidy is to reallocate resources with the intention of altering economic activity and behaviour to achieve a desired outcome. Economic arguments for using fertilizer subsidy includes off-setting various market imperfections, exploiting economies of scale and more specifically, meeting social policy objectives such as protecting the poor, changing the income distribution and retaining people in farm business.

10.3 Empirical Implications

Fertilizer costs account for a significant proportion of the cost of cultivation of rice, accounting for over one-fifth of the total cash cost of cultivation and more than a half of the material cost. One of the major constraints facing agricultural activities of farmers has been the increasing world market price of fertilizer. This has had both adverse economic and political implications on individual farm families as well as on the overall economy as a whole. The latter is reflected in the amount spent on fertilizer subsidy which has increased substantially; more than 10 times from Rs. 0.6 billion in 1994 to Rs. 6.8 billion in 2005, equivalent to 0.3 per cent of total GDP.

There are many arguments in favour of and against a fertilizer subsidy scheme - attributed to farmers, consumers, government, environmentalists, etc., - with both economic and non-economic implications.

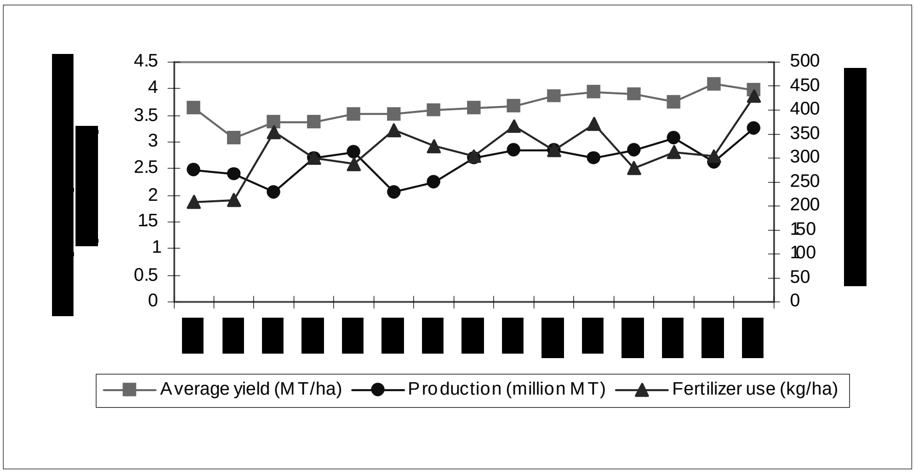
The benefits of a fertilizer subsidy are argued to include the following:

- fertilizer subsidy will stimulate fertilizer demand and enable the marketing of inputs to obtain benefits from economies of scale and thereby reduced prices of other inputs;
- increased use of fertilizer may in turn lead to higher agricultural output or incomes of farmers and traders. This will assist in ensuring greater degree of food self sufficiency in poorer countries;
- an incremental change in yield can have a significant impact on trade flows increasing agricultural exports and decreasing imports. It saves foreign exchange and at the same time it earns foreign exchange; and
- it will also generate several non-economic benefits whose economic impacts are difficult to measure. It may provide social protection by improving food security and alleviating poverty as a result of economic benefits - i.e., yield and income increase.

On the other hand, the arguments against a fertilizer subsidy include the following:

- even though a popular belief with regard to fertilizer subsidy is that it encourages fertilizer application resulting in a greater yield increase, it is rather doubtful that this is the case. For example, while fertilizer application rates more than doubled among rice farmers over the period 1983-2005, average yield increased by only about 9 per cent (Figure 10.1);
- one of the key disadvantages of a fertilizer subsidy is that it entails a high budgetary cost to the government. The fertilizer subsidy for crops accounted for Rs. 6.8 billion at a subsidy rate of Rs. 23,000 per metric ton in 2005 and is likely to exceed 0.4 per cent of GDP in 2006 when a 50 kg urea bag is provided at Rs. 350

Figure 10.1
Yearly Fluctuation of Rice Production, Yield and Fertilizer Use

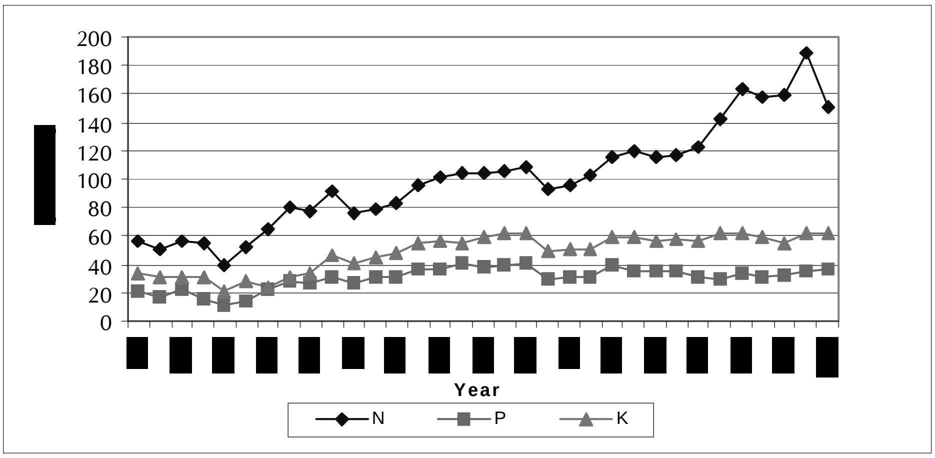


Source: Department of Census and Statistics and National Fertilizer Secretariat.

with a fertilizer cost of Rs. 32,200 per metric ton in the present context;

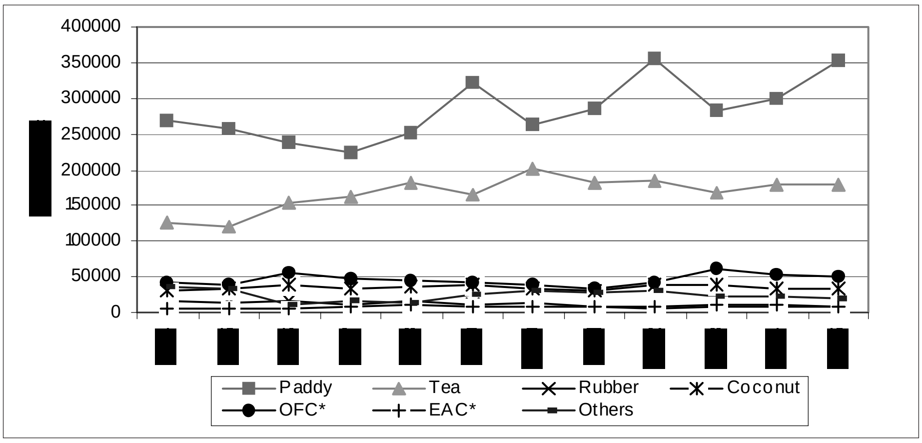
- fertilizer subsidy also encourages wasteful use of urea. Over application of urea relative to Potash (K2O) and Phosphate (P2O5) fertilizers will yield nutrient imbalances in the soil resulting in long term adverse effects on soil fertility. (Figure 10.2);
- improper and excessive fertilizer application, especially nitrates and phosphates cause serious harmful impacts on human health and on the environment as a whole. Fertilizer tends to leach away into down stream water bodies causing human ill health. Deposition of nitrates and phosphates in water bodies or *Eutrophication* causes excessive algae growth resulting in oxygen depletion, water contamination and fish mortality;
- fertilizer use in paddy has increased sharply as a result of the subsidy while it has shown a slight increase in the tea sector, although it was stagnant since the

Figure 10.2
Annual Nutrient Consumption



Source: National Fertilizer Secretariat of Sri Lanka Statistics.

Figure 10.3
Fluctuation of Fertilizer Use



Notes: OFC refers to Other Field Crops and EAC refers to Export Agricultural Crops.

Source: National Fertilizer Secretariat of Sri Lanka Statistics.

1990s (Figure 10.3). Fertilizer use has been almost stagnant in all other crops for the last decade or so. Further, stimulation of fertilizer use for unprofitable and uneconomical ventures - i.e., diversion of scarce resources from other productive investments by the fertilizer subsidy - has adverse impacts for the long term sustainability of the economy; and

- ineffective targeting has become a serious concern in the present context since a larger proportion of the subsidy is captured by wealthier rice farmers regardless of the objective of benefits accruing to resource poor small farmers.[2] A larger share of farmers does not obtain the subsidized fertilizer at the subsidized price and a substantial amount is sold on the black market due to poor targeting, combined with some amount of corruption of government officers.

10.4 Conclusion

While it may be argued that the fertilizer subsidy scheme moves the economy towards equity and security from an economic development perspective, there still remains some ambiguity on whether it can be justified. It is, however, clearer that the fertilizer subsidy scheme cannot be justified on grounds of economic efficiency.

The yield increase achieved has been lower compared to the fertilizer usage since the enactment of the fertilizer subsidy scheme. It provides evidence that suggests the need for the following: (i) to correct problems related to the fertilizer subsidy and (ii) to move towards long-term policy goals. Nevertheless, a withdrawal of the subsidy may create serious problems to small scale farmers, particularly to those engaged in the paddy sector. A withdrawal of the subsidy and the likely increase in cost of production may cause a shift away from paddy. It may lead to an outflow of foreign exchange due to higher rice imports; and to greater poverty and landlessness in the rural sector and increasing malnutrition in the rural economy. Thus, what needs to be done is to manage the fertilizer subsidy effectively and efficiently targeting

[2] About 51 per cent of the total rice area is cultivated by households in the top 40 per cent of the rural expenditure quintiles while only 25 per cent is cultivated by the households in the lowest two quintiles (World Bank, 2003, "Sri Lanka Promoting Agricultural and Rural Non-farm Sector Growth", Report No. 25387-CE).

only the farmers who are in need of the subsidy. The government's role in this regard is to support resource poor farmers who are in poverty and who do not have enough purchasing power to buy fertilizer at market prices or acquire credit to do so. The key issues of concern in this regard are as follows:

- proper identification of the proportion of farmers who are truly in need of the subsidy and proper distribution of subsidized fertilizer by a system such as a voucher scheme[3] are of great importance. Farmers should be permitted to purchase fertilizer from any dealer who will be able to redeem the voucher with possibly a commission;
- fertilizer subsidy should not be confined to urea. However necessary steps could be taken to adjust prices of all fertilizers for minimizing nutrient imbalance and adverse environmental effects;
- steps should be taken to improve knowledge of farmers on scientific fertilizer application including accurate diagnosis of soil nutrient deficiencies, determination of fertilizer types and quantity;
- farmer attitudes should be corrected with a view to shifting the emphasis from increased use of fertilizers to use of organic, inorganic and biological fertilizers optimally;
- infrastructure facilities such as transportation and storage of fertilizer should be developed in order to prevent unnecessary delays in distributing fertilizers;
- there should be a better regulatory framework to prevent inefficiencies and failures such as selling vouchers to other farmers, selling poor quality fertilizers, etc.; and
- there should be a better monitoring mechanism to ensure the farmer uses the subsidy correctly. Efficient and appropriate and well equipped and staffed institutions should be established to ensure that subsidized fertilizer reach only the target farmers, and on time, in adequate amounts and at a minimal cost.

Since fertilizer subsidy is merely a short term policy goal, the government has a greater role to play in developing infrastructure, providing adequate agricultural research and extension, improving rural education and farmer capacity building as long term investments. These have to be coupled with improving the rural credit market in order to increase the availability of credit for farmers to purchase fertilizer. Greater attention should be paid to institutional development, including improving legal systems, introducing proper grading and standardization mechanism, infrastructure and market information. An improved economic environment for the agriculture sector will allow the government more leeway to phase out the fertilizer subsidy over time. Any attempt in this direction should be concurrent with the development of a competitive market. Private sector participation in fertilizer production and import should be encouraged while the government should play a regulatory role to ensure timely delivery of fertilizer of good quality and fair price to farmers.

[3] Voucher is a coupon carrying the name, predetermined quantity of fertilizer and cash value given to target farmers.

11. Equity and Millenium Development Goals for Sri Lanka

11.1 Introduction

The millennium development goals (MDGs) represent a global partnership to respond to development challenges to promote poverty reduction, education, maternal health, gender equality, and aim at combating child mortality, AIDS and other diseases. While developing countries have undertaken to aim for specific targets by 2015 to improve on these indicators, developed countries have pledged to support such efforts through aid, debt relief and fairer trade.

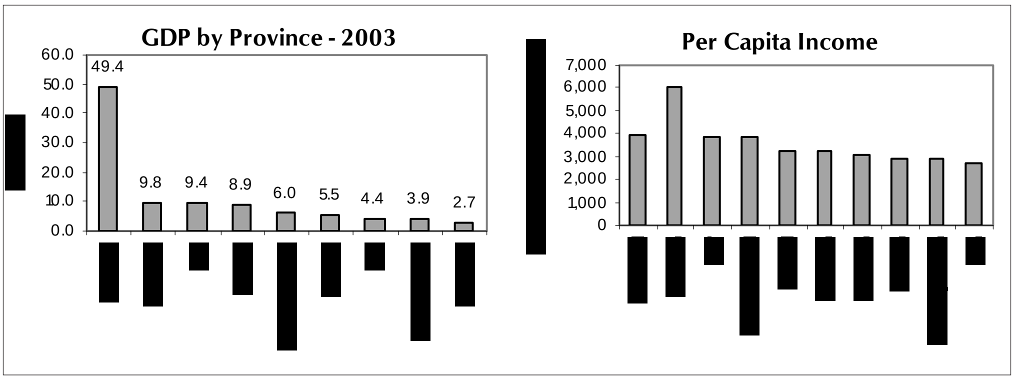
Sri Lanka, based on the current trends, appears to be on track to achieve its MDGs by 2015 at the national level. However, widespread inequity among provinces suggests that achievement at the aggregate may mask significant disparities across regions in the country. This policy brief examines issues of equity in the context of meeting overall MDG goals. The key issues are whether existing patterns of inequity constrain a country from achieving its targets at the macro level; and alternatively, whether a country can truly qualify as having been 'successful' in meeting its targets if there is evidence of persistent inequities within the country.

11.2 Present Status of MDGs in Sri Lanka

Sri Lanka has often been cited as a model lower middle income country - one that has achieved extraordinary success in attaining high levels of male and female literacy rates, educational and health outcomes. Despite overall success in human development indicators, vast regional disparities exist (Figure 11.1). There is also significant diversity of outcomes to be found among social indicators - for example, despite low levels of infant and maternal mortality rates, child malnutrition in Sri Lanka still remains high.

It is estimated that 22.7 per cent of the population live below the official poverty line. The incidence of poverty is the highest in the Northern and Eastern Provinces, the estate sector (30 per cent) and the rural sector

Figure 11.1
Sri Lanka: GDP and Per Capita Income by Province



Source: Central Bank of Sri Lanka.

Table 11.1
Selected MDG Indicators

District	Percentage of Poor Household Based on the Official Poverty Line-2002 (%)	Prevalence of Under-weight Children (under 5 yrs) - 2000 (%)	Net Enrolment Ratios - 2000 (%)	Literacy Rate - 2001 (%)	Infant Mortality Rate - 2002 (per 1,000 live births)	Maternal Mortality Ratio - 2002 (per 100,000 population)	Proportion of Households with Access to Safe drinking Water - 2001 (%)
Sri Lanka	19.2	29.4	98.35	95.6	23.1	27.5	82.0
Colombo	5.0	16.9	98.6	95.3	32.6	11.9	95.5
Gampaha	9.2	20.8	98.7	97.3	15.3	7.9	91.4
Kalutara	17.7	29.0	97.7	96.0	9.0	0	84.0
Kandy	20.9	35.1	99.9	96.4	31.0	10.3	82.8
Matale	24.5	34.7	95.7	95.1	15.9	0	80.5
Nuwara-Eliya	18.2	41.8	97.6	91.8	31.8	51.6	68.7
Galle	21.7	27.2	97.6	96.2	18.9	10.4	81.2
Matara	23.2	28.7	97.3	95.4	15.5	20.8	77.4
Hambantota	27.8	40.2	100	96.6	9.3	14.1	83.4
Kurunegala	21.2	29.3	95.8	96.7	24.3	8.2	86.2
Puttalam	24.5	37.6	96.5	94.2	13.8	13.8	91.6
Anuradhapura	17.2	33.8	100	96.1	34.8	19.1	83.1
Polonnaruwa	20.1	28.0	100	95.2	33.7	0	75.3
Badulla	31.5	40.7	97.5	93.9	33.1	33.8	70.2
Monaragala	32.4	38.0	96.9	94.5	4.2	15.1	63.4
Ratnapura	30.1	32.9	99.2	94.1	26.6	25.5	58.7
Kegalle	27.5	23.5	100	95.8	19.1	0	70.2
Jaffna	n.a	n.a	99.7	n.a	11.3	23.0	n.a
Kilinochchi	n.a	n.a	n.a.	n.a	7.5	28.7	n.a
Mannar	n.a	n.a	95.9	n.a	10	0	n.a
Vavuniya	n.a	n.a	97.7	n.a	24.4	0	n.a
Mullaitivu	n.a	n.a	n.a.	n.a	17.7	0	n.a
Batticalo	n.a	n.a	100	n.a	31.8	32.9	n.a
Ampara	n.a	n.a	97.5	93.5	13.3	8.5	85.3
Trincomalee	n.a	n.a	100	n.a	6.1	13.3	n.a
SECTOR							
Urban	6.2	n.a	n.a	95.5	30	25.8	95.9
Rural	20.8	n.a	n.a	96.3	9.8	25.1	81.2
Estate	24.3	n.a	n.a	85.5	32.1	176.1	61.0

Source: Department of Census and Statistics.

(25 per cent). Large district variations exist as evident from Table 11.1, where the incidence of poverty ranges from 37 per cent in the Monaragala and Badulla Districts to 6 per cent in the Colombo District. Income inequality, low per capita consumption expenditure levels, large household sizes, gender related issues (female headed households) low educational attainment and the lack of access to basic infrastructure are some of the main factors that have resulted in such large regional disparities.

One in three children between the age of 3-59 months is underweight, 13.5 per cent of children below the age of 5 years are stunted, 14 per cent are wasted and 29.5 per cent are underweight. Child malnutrition is the highest in the estate sector, where Nuwara Eliya District had the highest of 41.8 per cent. The main causes for child malnutrition are the mother's age at birth, maternal schooling, infant feeding practices, living standards and access to clean drinking water and sanitation.

In terms of the MDGs, Sri Lanka has already attained the numerical goals relating to universal primary enrolment and completion, and gender parity in primary and secondary school enrolments. Regional variations in net primary school attendance and completion rates are almost negligible. These favourable results are due to strong household demand for schooling and progressive government policies. Educational facilities among children in the plantation sector are poor in comparison to other regions. Many of the plantation schools are underdeveloped and also lack qualified teachers. For example out of 833 plantation schools 270 schools are still without facilities for children. Further attention is needed to develop infrastructure in the estate sector and to improve the quality of national education.

Access to health services has improved over the years. With the exception of the Northern and Eastern Provinces, health care services are available within 1.4 kilometres of most homes and on average, state provided free allopathic health care is available within 4.8 kilometres. At present, medical officers are available at the lowest level of the hierarchy and services of specialist pediatricians are available at the level of base hospitals and above. In addition, preventive care systems are well organized and effective in most districts. Infant and under five-year mortality rates are low and declining. However, large regional disparities still exist. The highest infant mortality rate in 2002 was in the North Central Province, which was nearly four times higher than the rate in the Eastern Province. Regional variations in infant mortality rates are a reflection of variations in living standards, health infrastructure (hospitals, trained health professionals, birth attendants, etc.) age of the mother and the mother's immunization against rubella, and standards of community hygiene.

A steady decline has also been witnessed in the maternal mortality ratio, but regional disparities are once again evident. The declining trend in maternal mortality is associated with access to a wide network of free health services throughout the country in maternal services, which include antenatal care, care at delivery and postnatal care. The maternal mortality rate is above the national average in the estate sector and conflict affected areas due to poverty associated maternal malnutrition and poor access to emergency obstetric care. Post partum care is still weak and access to good emergency obstetric care varies widely - and is inadequate in several districts where one facility covers around 1,000 to 2,000 square kilometres.

In terms of gender equality, women in Sri Lanka have comparatively better status than women in other developing countries and the country is on target to achieve its gender related goals. With regard to literacy rates, gender differences are marginal. Literacy rates are lowest in the Nuwara Eliya and Badulla Districts. However, gender inequality still exists in terms of intra-household discrimination against girls in the allocation of nutritional inputs, health services and in terms of child malnutrition. The labour market also shows significant gender inequalities.

Sri Lanka is a country of low level HIV epidemic but there is potential for spread of the disease. A cumulative total of 614 HIV infections were reported by 2004. Since 1992, HIV infections among women have shown an upward trend. The predominant mode of transmission is sexual. One of the most vulnerable groups for HIV infection is the Internally Displaced Persons (IDPs) of the Northern and Eastern Provinces. Others include women employed in factories in the free trade zones, foreign migrant workers, and those in the estate and fishing communities.

Communicable diseases such as malaria, tuberculosis and other vector borne diseases such as dengue haemorrhagic fever are still prevalent. Containment of such diseases have been difficult due to population increases, large scale human settlement in disease endemic areas, rapid agro-ecological change and altered patterns of population mobility. Once again large regional disparities exist and are a reflection of living conditions, the lack of resources and support in preventive health services and weak infrastructure and lab capacities.

Overall, the country has advanced towards achieving several of its MDG goals. However, success is overshadowed by large regional disparities in social indicators of the poorer districts that face fewer economic opportunities. It is, therefore, evident that the main stumbling block in achieving MDGs by 2015 is the enduring problem of inequity across regions in the country.

11.3 Policy Environment towards Equitable Growth in Achieving MDGs

The new policy framework under the 'Mahinda Chinthana' has recognized poverty reduction as a key objective to build a new economy with social justice. The aim of the government seems to be to increase the income of the poor across the poorer regions at a far more rapid pace than that achieved in the last several decades. The broad investment objective appears to be to increase the investment level to an average of 30-35 per cent of GDP to accelerate economic growth towards 8 per cent over the medium term. Towards this, promotion of modern infrastructure - at both national and rural levels, improvement of productivity and creation of marketable skills for employment in both Sri Lanka and overseas is envisaged. The government plans to mobilize the private sector, foreign investor community, co-operative sector, peoples' sector and the non-governmental sector to achieve this economic transformation.

Building on these objectives, the new policy framework encompasses five themes at the core of its strategies: a community based integrated rural development initiative (*Gama Naguma*), development of rural infrastructure (*Maga Neguma*), strengthening district administration and the public service delivery mechanisms, a national infrastructure development initiative (*Mahinda Randora*), and a macroeconomic strategy to provide a stable economic environment.

Re-balancing the allocation of resources towards the development of less developed provinces in the country including the districts affected by man-made and natural disasters appears to be the other priority. In this context, the National Action Plan for Children, development of the plantation community, reconstruction of the conflict affected areas and the tsunami affected coastal belt, and the development of less advantaged districts in the rest of the country are given special recognition.

Within this broad policy framework specific programme initiatives are expected to assist Sri Lanka in achieving its MDG goals in different sub-sectors.[1] These include specific projects in the provision of social protection, infrastructure development, initiatives adopted to improve standards of health and education in the country, and providing re-

[1] GOSL (2006), Report on MDGs.

lief and reconstruction measures to the conflict affected Northern and Eastern Provinces of the country.

With the emphasis on reducing the sharp regional disparities in poverty special poverty reduction projects are being implemented in rural areas focusing on creating income opportunities. The focus of these programmes is to identify the poorest of the poor by proper targeting together with the creation of productive jobs in the rural areas. Some of these programmes include efforts to raise levels of nutrition, promotion of small and medium handloom industries, provision of concessionary financial assistance, etc. Similarly, in the area of infrastructure development, the policy priority is to invest in large infrastructure initiatives in neglected areas. Community participation in rural infrastructure development is encouraged in order to augment the income earning capacity of the rural poor. Regional initiatives - proposing an international airport, bunkering services and two coal power plants in Puttalam and Trincomalee Districts - construction of several expressways are some of the main programmes. Initiatives are also underway to provide housing to those affected by the tsunami, North and East conflict, plantation workers, and for low income earners.

Public expenditure on primary and secondary education is distributed among different economic classes with a high degree of equity and is shared fairly evenly between affluent, middle class, working class and poor households. Nevertheless, significant regional disparities, particularly in terms of access and quality persist. The key policy priorities to address this consist of progressive central government financing, with favourable treatment for poor provinces and regions and special policy measures to promote equity of education access, quality and opportunity. In the area of health, four priority areas for development have been identified; improving one hospital in each district, expanding services to areas of special need, promotion of public health, preventive and wellness concepts, and improving efficiency and effectiveness of the health care delivery systems. An accelerated programme of relief and rehabilitation has been formulated for implementation.

In the broadest policy terms, an overall strategy of infrastructure development linked to rural areas and poverty reduction targeted at less well off provinces appear to be in place. However, while the governments good intentions and desire to achieve Sri Lanka's MDG goals need to be commended, whether the required resources could be mobilized given the fiscal constraints under which the country is functioning remains questionable.

11.4 Conclusion

Equity, defined primarily as equality of opportunities among people is an integral part of a successful poverty reduction strategy. Sri Lanka may well be on target to achieve its MDG goals by 2015, but that achievement may come at the risk of ignoring existing disparities - across income, gender, location, race, etc. - that have the potential to further undermine socio-economic and political cohesion. While the government has placed the notion of 'growth with equity' as its centrepiece in the policy formulation framework, and has initiated numerous programmes aimed primarily at bridging the development gap across regions, the efficacy of such programmes can be contested. Many of the programmes tend to be ad hoc with significant overlaps in implementation responsibility. Programme implementation continues to be slow and there is lack of effective monitoring and accountability, especially at the regional level. This can be attributed to a lack of interest by respective officers, inadequate facilities and qualified staff, as well as the result of an environment where accountability is not enforced.

To create an enabling environment in which to achieve MDG goals, the government needs to ensure good governance. Political parties follow partisan policies, while bureaucracies tend to fall in line with the existing status quo. Maintaining policy consistency is therefore of paramount importance. Further, strengthening of local governance is essential. It has been argued that wherever local governments are strong - i.e., wherever the 4 "Fs" (functions, functionaries, funds and freedom) have been devolved - poverty has declined and there has been significant development. Therefore, unless fiscal constraints, implementation failures, inappropriate targeting and the lack of consistency in policies is addressed, the achievement of the overall objective of 'growth with equity' remains doubtful despite the best intentions of policymakers.

12. Towards an Essential Medicinal Drug Policy

12.1 Introduction

Equity in health is the most important concept in delivery of health care system in any country. Although Sri Lanka is well known for its well developed health care system, this cannot be equated to more equal public access for medicine and medical goods. Public access to medicine is linked to the pharmaceutical policy in practice. The existing pharmaceutical policies are varied, and in many countries including Sri Lanka pharmaceutical expenditure continues to rise. The reform of pharmaceutical policy in Sri Lanka remains one of the most important areas in the health sector reforms, as well as one of the most contested.

Pharmaceutical policy represents one of the few areas in the health sector on which both the World Bank and the World Health Organization (WHO) agree that major restructuring is needed. The World Bank has called for improvements in the selection and quantification of drug requirements, the use of an essential national drug list, and competitive pharmaceutical policies. The WHO has also called for similar policy reforms, with a focus of achieving greater equity through improved accessibility and affordability of basic drugs to poor people. The WTO Doha Declaration on TRIPS and Public Health recognizes the huge burden of pharmaceutical patents and subsequent high drug prices for developing countries and outlines ways for countries to set patents aside when needed.

Of the four major international human right treaties ratified by Sri Lanka, Article 25 of the Universal Declaration of Human Right identifies that "everyone has a right to a standard of living adequate for the health and well-being of himself and his family including food, clothing, housing, medical care". Article 12 of the International Covenant on Economic, Social and Cultural Rights of 1976 to which Sri Lanka is a signatory outlined treaty obligation to member states for full realization of the right to health for every citizen. Given the wide understanding that health is a fundamental human right, this policy brief examines pharmaceutical policy in the context of essential drugs as a critical component in delivering health care in Sri Lanka.

12.2 The Global Pharmaceutical Industry and Drug Marketing

12.2.1 Harmful and Unnecessary Drugs for the Developing Countries

For most people in the world there is insufficient provision of medical care. Access to medicine does not always correspond to their needs with millions of people in Africa, Asia and Latin America suffering from serious diseases. An estimated 170 million people in the world are suffering from malnutrition while infectious diseases like malaria, tuberculosis and dengue fever are known as neglected diseases that mainly affect people in developing countries. They are diseases which do not represent a commercially viable market for pharmaceutical companies because those affected do not have the purchasing power to afford treatment. Companies therefore keep away from investing in risky and expensive research and development allowing them to fall outside the scope of the drug industry.

The global sales volume of drugs in 2004 was US$ 550 billion recording a 7 per cent

Table 12.1
Top Ten Global Pharmaceutical Companies
(2004 sales revenue)

Rank	Company	Revenue (US$ bn.)	Expenditure on R&D (US$ bn.)
1	PFizer	50.9	7.5
2	GlaxoSmithKline	32.7	5.2
3	Sanofi-Aventis	27.1	9.3
4	Johnson & Johnson	24.6	5.2
5	Merck	23.9	4.0
6	Novartis	22.7	3.5
7	AstraZeneca	21.6	3.8
8	Hoffman-La Roche	17.7	5.1
9	Bristol-Myers Sqibb	15.5	2.5
10	Wyeth	14.2	2.5

Source: Diller, W., and H. Saftlas (2005), "Healthcare: Pharmaceuticals", Standard & Poor's Industry Surveys.

increase over 2003. The global pharmaceutical industry consists of companies that act in accordance with the principles of the market economy. Therefore, in order to increase the shareholder value, the pharmaceutical industry actively intervenes in the health policy of a country. Its influence can be found at all levels -- from trying to raise the drug turnover made by research companies through to medical practitioners and end consumers.

Of the total global pharmaceutical market, nearly 87 per cent is made in North America, the European Union and Japan. German pharmaceutical companies are among the biggest suppliers of drugs to developing countries. Of these, almost 1000 (39 per cent) out of more than 2500 tested drugs have been regarded as irrational according to pharmacological and clinical criteria. Many of these remedies are even dangerous and some of them are forbidden in the country of origin. The therapeutic use of many of these drugs is not sufficiently proven. Irrational drugs do not only harm single patients, they waste scarce resources and cause unnecessary costs. This has considerable consequences, in particular for a country like Sri Lanka where less than US$ 5 can be spent for drugs per person per annum.

Developing countries are more prone to tropical infectious diseases such as malaria, tuberculosis, diarrhoea, etc. but these have largely been neglected by the pharmaceutical industry over the decades. While it is estimated that over the last 25 years nearly 1400 new drugs have been developed, only 16 of them refer to these diseases.

12.2.2 Patents and Generic Drugs

Drugs are patentable and a typical patent lasts for 20 years. However, it often takes as long as 12 years to approve a drug for patient use. Patent protection allows the owner of the patent to charge high margins for the branded drugs. When the patent for the drug runs out, a generic drug is usually created by a competing company and released, causing the price to drop markedly. Often the owner of the branded drug will introduce a generic version before the patent runs out in order to get a head start in the generic market. Today it has become popular for large pharmaceutical companies to protect their patents by producing their own generic product or license their own product to be branded by generic companies.

A generic drug is a drug which is bio-equivalent to a brand name drug with respect to the response process and effect of actions, and is normally sold for a lower price. Generic medicines contain the same active ingredients at the same strengths as the innovator brand, and are required to meet the same guideline requirement for the preparation. Therefore, generics are identical in dose, strength, route of administration, safety, efficacy, and intended use.

The principal reason for the reduced cost of generic medicines is that these are manufactured by smaller pharmaceutical companies which do not invest in research and development (R&D) into new drugs. The R&D costs incurred by large pharmaceutical companies in bringing a new drug to the market are often cited as the reason for the high cost in their attempts to recover costs before the patent expires.

12.3 Improving Access to Affordable Essential Drugs in Sri Lanka

With a comparatively low per capita income of just over US$ 1000, Sri Lanka is able to maintain a reasonably good health status at present with an infant mortality rate of 11.9 per 1000 live births, and maternal mortality rate of 2.9 per 10,000 live births, a life expectancy at birth for males at 71 years and for females at 75 years.

The health care system in Sri Lanka consists of public and private health care services; facilities are provided by the public and private sector with an equal share of funding by each sector. Public health services comprise of preventive, curative, and rehabilitative care while the private sector concentrates exclusively on curative care. Total expenditure on health is around 3.8 per cent of GDP. Out of the total expenditure on health, total government expenditure accounted for 43 per cent of total financing while the rest was financed by private sources. Out of all spending categories, services of curative care and medical goods dispensed to out-patients were the two largest areas of spending by function. Services of curative care accounted for 49 per cent of total spending followed by retail sales and medical goods dispensed to out-patients which accounted for 29 per cent. This expenditure is borne entirely by the out-of-pocket expenditure at household level which amounts to 50 per cent of the total non-government health expenditure.

There is a wide variation in health care needs amongst different income groups in Sri Lanka. Public sector hospitals are expected to provide drugs free of charge for patients, but the reality is that most patients tend to purchase the more expensive drugs from private pharmacies which are generally unavailable in State hospitals faced with intermittent shortages in drug supply. This constraint has forced households to seek out patient treatment from private hospitals and practitioners.

Private practitioners are paid on a fee for service basis and almost all dispense medicines, and in most cases their fees are often charged only for the medicine. Doctors or the physicians are the most important players in pharmaceutical sales. In Sri Lanka, there is typically a three-tiered structure of demand where the physician prescribes, the pharmacist dispenses, and the patient consumes and pays (in some instances the payment is by a third party). Influencing doctors is critical to pharmaceutical sales, and due to industry pressure some doctors are in the habit of prescribing drugs of selected manufacturers or importers when the patient does not require those or alternative cheap varieties are available.

In 2003, the Drug Regulatory Authority estimated that there are around 6000-8000 types of drugs available in the country. According to industry sources, around 80 per cent of imports consist of generic products of innovative brands. For example, the branded drug *Erythromycin* is available in Sri Lanka under 30 generic varieties in the market at different prices while the most demanded drug Amoxicillin has 80 varieties of generics in the market. Table 12.2 gives the prices of some generics available in the market. At present, pharmaceutical imports are regulated by the Cosmetic, Devices and Drug Authority for safety standards and no state entity is involved in the setting of prices. The government decided to permit parallel imports of branded drugs with the aim of bringing down prices, and an earlier cost-plus formula of the Fair Trade Commission (FTC) for imports was done away within 2003.

Table 12.2
Retail Prices of Drugs in Demand (as of March 2006)

Generic Brand	Packs	Price/Cap Rs.	Manufacturer	L/Agent
Amoxicillin 250 mg				
Amoxil	100's	10.80	Gsk	Gsk[a]
Ranoxil	100's	4.75	Ranbaxy	Hemas
Imox	100's	4.60	Ipca	Emarpharma
Moxarin	100's	4.75	Codal Synto	Lm[b]
Decamox	100's	4.25	Hemas	Hemas
Pulmoxil	100's	4.75	Brown & Berk	Halcyon
Ostemox	100's	5.80	Icn	Baurs
Erythromycin 250mg				
Ero tab	100's	6.00	Hovid	Thron group
Erythrocin	100's	10.00	Abbot	Lm
Decamycin	100's	6.40	Hemas	Hemas
Porphyrocin	100's	3.40	Medocheime	Associated Labs
SPMC	1000's	0.40	SPMC	SPC
Erythromycin Syrup		**Price/Bot Rs**		
Erythrocin	100ml	96.00	Abbot	Lm
Decamycin	100ml	178.00	Hemas	Heams
Spc	100ml	95.00	SPMC	SPC
Ranitidine 150mg		**Price/Cap Rs.**		
Zantac	100's	6.61	Gsk	Gsk
Pepticure	100's	4.75	Nabiquasim ind	George Steuarts
Aciloc	100's	5.81	Cadila	Lm
Diclofence Sodium 50 mg				
Voltaran	100's	27.12	Novartis	Bearos
Almiral	100's	7.11	Medochemie	Associated Labs
Biclopan	100's	5.70	Pharmacheme	Emarchemie
Delbitol	100's	4.54	Cetadel	Harcoats
Divolta	100's	7.50	Kalbe	Hemas
Divon	100's	0.70	Eros Pharma	Eros
Inflanac	100's	9.40	Biolab	George Steuarts
Adiflam	100's	4.00	Lyca	Nawakrama

Notes: a. Gsk = Glaxo Smithkline; b.Lm = Lanka Medical.
Source: Pharmaceutical Association.

12.3.1 TRIPS, Parallel Imports and Licensing

In 1995 when the Trade Related Aspects of Intellectual Property Rights (TRIPS) came into force, the provision of the TRIPS agreement obliged all member states to provide a minimum of 20 years patent protection to pharmaceutical products and processes. This gave patent owners monopoly of the market.

At the fourth WTO Ministerial Meeting of 2001 held in Doha, WTO members took the unprecedented step of adopting a special declaration on issues related to the TRIPS agreement and access to medicine for public health. Accordingly, mitigatory features such as parallel imports and compulsory licensing were adopted in Doha to safeguard the interests of developing countries in the provision of the TRIPS agreement.[1] The TRIPS agreement leaves member states to decide whether or not to apply the provisions of parallel imports and parallel compulsory licensing while upholding the rights of WTO members to protect public health, and in particular to promote access to medicine to all.

Sri Lanka enacted legislation in 2003 - the Intellectual Property Bill - to replace existing intellectual property law and to meet its international obligations under various conventions including the WTO agreement on TRIPS. The Bill was challenged in the Supreme Court on account of the absence of provisions as per the Doha declaration related to parallel imports and compulsory licensing.[2] The Supreme Court ruled against the Bill citing its inconsistency with the Constitution, and an amended Bill was passed in Parliament in August 2003 allowing parallel imports but without giving a clear-cut provision for compulsory licensing.

The provision of compulsory licensing in the law on patents will enable Sri Lanka to license a local generic company to manufacture life saving drugs manufactured and/or marketed by a patent holding company in Sri Lanka under the generic name and pay a reasonable royalty to the brand name company on each sale.

12.3.2 Emergence of a National Essential Drug Policy

In 1962, pioneering efforts were undertaken to promote the concept of essential medicine with the formation of the National Formulary Committee established to reform the selection of drugs for government drug supply and to reduce the number of private sector drugs from 4,000 to 2,100 (3,000 dosage forms). In 1970, the government appointed a two-member Committee of Inquiry[3] to prepare a report on measures to rationalize the pharmaceutical sector in Sri Lanka. Eventually, the Ceylon Hospital Formulary (CHF) was prepared by carefully selecting a list of drugs with the total number reduced from 2,100 to 630 drugs under their generic names where the usage of brand name drugs was greatly reduced. A key recommendation of the Committee of Inquiry was to link a state buying agency to a national formulary as a viable option for reducing drug costs while maintaining quality and saving foreign exchange.

As recommended, the State Pharmaceuticals Corporation of Sri Lanka (SPC) was estab-

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1 Parallel imports are importation without the consent of the patent holder of a patented product marketed in another country at lower prices. A patent holder shall not have the right to prevent acts of importation of any products covered by a patent that has been put on the market in any country by the patent holder or by any party authorized to use the invention. Compulsory licensing is the granting by the national authority to a third party the use of a patent without the consent of the patent holder on the ground of public interest problems linked to national emergencies such as epidemics or anti-competitive practices.

2 The said provision for parallel imports was excluded in the Bill to please the US in order to negotiate a bilateral trade agreement by the political regime at that time.

3 Bibile-Wickramasinghe Committee.

lished in 1971 where all pharmaceutical imports, production, calling for worldwide tenders for approved drugs of the CHF was brought under the aegis of SPC. In 1972, the SPC imported 52 drugs at a third of their previous prices and some drug prices dropped by half or two-third. By mid-1973, the SPC had become the sole importer of pharmaceuticals. The pharmaceutical policy reforms introduced in 1971 were further strengthened by the support of the WHO and UN agencies. UNCTAD identified Sri Lanka's pharmaceutical policy as a model for other developing countries as means of formulating, developing and implementing integrated national pharmaceutical policies.

In 1977, the transition to market-oriented policies reversed some crucial elements of the 1971 pharmaceutical reforms. As a result, the SPC lost its monopoly on imports when the private sector was allowed to import and distribute drugs. Brand names became more prominent in the private sector pharmaceutical market. The SPC continued to supply affordable drugs and continued the role of a centralized procuring agency for the State sector drug requirements.

The Cosmetics, Devices and Drugs (CDD) Act was established in 1980 to regulate the pharmaceutical products along with moves to liberalize the economy.[4] With the introduction of the Act, the registration of pharmaceutical products commenced. A Drugs Evaluation Sub-Committee (DESC) plays the key role of approving pharmaceutical products. Implementation of the CDD Act and determinants of Cosmetics, Devices and Drugs Technical Advisory Committee (CDDTAC) and DESC is the responsibility of the Drugs Regulatory Authority (DRA) and the Drug Quality Assurance Laboratory. The role of the Enforcement Division is to ensure quarterly inspection by authorized officers (Food and Drugs Inspectors) of all pharmaceutical organizations, in particular inspections of pharmacies to ensure they are licensed and do not sell prohibited drugs.

The registration process involves issuing licences to all relevant organizations such as drug importers, manufacturers, distributors and pharmacies. The registration of new drugs in Sri Lanka takes almost two years and has led to an increased circulation of unregistered drugs that undermines the objective of quality regulation to ensure the supply of safe drugs to the patients. Ineffectiveness of implementation of the CDD Act has been identified as the main weakness; for example, the DRA has failed to register all premises engaged in drug selling, along with long delays in registering new drugs where lack of transparency in registration, and lack of a systematic post-marketing drug surveillance have been identified as the major drawbacks in implementation.

In 1987, the State Pharmaceutical Manufacturing Corporation (SPMC) was established to import raw materials and manufacture generic drugs. There were attempts to develop a National Drug Policy in 1991 and 1996 which were accepted by the Ministry of Health, but never reached the Cabinet level for approval. The report of the Presidential Task Force on Formulation of a National Health Policy for Sri Lanka which was established in 1992 recognized the need for a national drug policy but it was not fully comprehensive nor was it well defined. In 2005, the government once again initiated efforts to formulate a National Medicinal Drugs Policy (NMDP) as a comprehensive written policy for implementation.

[4] The broad objectives of the Act were "to regulate and control the manufacture, importation, sale and distribution of cosmetics, devices and drugs; to establish a Cosmetics, Devices and Drugs Technical Advisory Committee (CDDTAC); and to provide for matters connected therewith or incidental thereto".

Box 12.1
The Key Elements of the NMDP

- **Selection of essential medicines:** The medicines will be selected according to sound and adequate scientific evidence, the disease pattern in the country and cost effectiveness.
- **Affordability and Equitable Access:** A pricing mechanism to be adopted to ensure affordability.
- **The State to provide sufficient funding for procurement and supply of essential medicine:** Public and private sector health insurance schemes to be encouraged to develop reimbursable lists of medicine.
- **Supply system and donations:** Shared responsibility by public and private sector to ensure continuous availability of essential medicines in the country.
- **Regulation and quality assurance:** An autonomous Drug Regulatory Authority (DRA) to be established to provide a transparent and accountable mechanism.
- **Quality use of medicines:** The State to fund a National Medicines Information Centre to provide unbiased information.
- **Research:** Provide resources and incentives for operational research on issues of access to medicine. Human resources: Special focus on the development of the pharmacy profession.
- **Viable local pharmaceutical industry:** The State to encourage and facilitate a viable local pharmaceutical industry by fiscal and other incentives.
- **Monitoring and evaluation:** An inspection system to be established under DRA for practitioners.

The NMDP under preparation by the Ministry of Health Care and Nutrition cites three key objectives as follows:

- to ensure the availability, affordability of efficacious, safe and good quality medicines relevant to the health care needs of the people in a sustainable and equitable manner;
- to promote the rational use of these medicines by health care professionals and consumers; and
- to promote local manufacture of essential medicines.

12.4 Conclusion

The most important aims in a national drug policy is ensuring that patients get good quality drugs at affordable prices, and that they receive medication appropriate to their clinical needs. The Pharmaceutical Industry is thriving by selling drugs under their trade names, and promoting the branded drugs. Decades ago Sri Lanka demonstrated that national formulary was a viable and powerful instrument for reducing drug cost, to provide quality drugs, and for rationalising drug usage. As there were no written drug policy documents since the Ceylon Hospital Formulary in 1960 and the Bibile-Wickramasinhge Report in 1971, the present effort of National Medicinal Drug Policy (NMDP) is reflecting the previous attempts, and has been based on various WHO documents. The most important new provision in the NMDP is the significant change in the process for the registration of new drugs. Until now the criteria adopted were quality, efficacy and safety but the new policy has included two more clauses - i.e., need for the drug and cost consideration before registration. These are unlikely to be favoured by transnational drug companies. The new clauses are aimed at reducing the number of drugs imported, and to ensure that quality drugs will be available at affordable prices eventually. As the failure of free market principles in the health sector is well known the world over, enactment of legislation to speed implementation of the NMDP will be a step towards reforming the existing health care system as a means of reducing health inequalities and improving the health status of the Sri Lankan population.

Prospects

13. Prospects

In 2005, the Sri Lankan economy once more exhibited its considerable resilience in the aftermath of multiple adverse developments on both the domestic and external fronts. However, despite the brighter growth prospects in the immediate short-term, the economy is likely to face significant challenges in the medium-term. Continued escalation of international oil prices, drying up of concessionary donor finance and above all, an intensification of hostilities related to the unresolved conflict in the North and East are likely to be the most threatening. These developments will test the economy's inherent resilience and its ability to sustain the growth momentum to achieve the much desired national goals of raising standards of living and eliminating poverty in the shortest possible time.

Major external developments such as the escalation of oil prices and its immediate impact on the economy are beyond the control of national governments. The rational policy responses to these often involve decisions on the part of governments to make painful, yet necessary adjustments. While the importance of short term-relief to the masses to support a minimum standard of living among the indigent and for maintaining peace and social stability should not be underestimated, a long-term view of welfare requires that the growth objective is not unduly compromised by diverting scarce resources for consumption and wasteful ventures. However, even given the best of an economic policy environment, an escalation of indiscriminate violence across the country will undermine efforts on the economic front. This is not only because of its potential to drain valuable resources from the government coffers but also because of its negative impact on business confidence in general. Unlike the other 'external' factors, the progress in resolving the conflict in the North and East is at least partly dependent on internal policies and appropriate political strategies.

Sri Lanka's GDP grew by 6 per cent during 2005 with first quarter estimates for 2006 at 8.1 per cent suggesting that the momentum is likely to ensure that GDP growth in 2006 remains at a healthy rate close to 7 per cent. More promisingly, all major sectors are contributing to this satisfactory performance with the agriculture sector in particular witnessing a rebound from the poor performance in 2004.

On the macroeconomic front, however, 2005 saw a significant rise in the general price level - a movement reflected in almost all available price indices. While there was some moderation by the end of the year and continuing into the first quarter of 2006, inflation began to pick up once more from April 2006 as a result of seasonal factors and lagged effects of upward adjustments to fuel prices. Point-to-point inflation increased sharply to 17.7 per cent by end June 2006 with annualized inflation creeping up to 10.1 per cent. The trends so far suggest that inflation will hover in the region of 11-12 per cent in 2006.

Money supply indicators also confirm the increased demand pressures in the economy. In particular, a sharp rise in domestic credit to the private sector during 2005 amounting to about 21 per cent saw growth in broad money to above 19 per cent. With the high growth in monetary aggregates continuing into the first half of 2006 - and inflation running unabated - the authorities effected a gradual tightening of monetary policy. In June

2006, the policy rates were adjusted upwards by 25 basis points for the first time in five months and a more modest increase of 12.5 basis points was effected in July 2006. Given all the evidence so far that fiscal performance will continue to keep inflationary expectations high, monetary authorities are unlikely to have the room to relax monetary policy in the coming months.

Fiscal pressures have continued into 2006 on the back of a budget deficit of 8.7 per cent in 2005. The budget deficit for the four months up to April 2006 rose to 3.2 per cent of GDP to a comparable figure of 2.9 per cent of GDP in 2005. The increase in the fiscal deficit came about with higher spending on capital expenditure, salaries and wages of public sector employers, and subsidy payments. The inability to rein in the deficit in the face of rising inflation will continue to raise questions about the underlying resilience of the recovery and how far the growth momentum can be sustained beyond 2006 without corrective measures being put in place.

It is important to note that inflation, particularly when it rises to double digit levels is not compatible with good growth performance. Firstly, monetary and fiscal measures taken to control the demand pressures may adversely affect investment and capacity utilization, and secondly, domestic savings may decline, thus raising the investment-savings gap. The medium-term macroeconomic framework presented with the Budget 2006 anticipates growth rates of GDP in excess of 7 per cent per annum which may need investment/GDP ratios approaching 30 per cent in the initial years. Given that the average investment/GDP ratio during 2002-2005 was only about 23.7 per cent, it is clear that the present circumstances are not conducive to such a quantum change unless a number of far reaching policy reforms as highlighted in this report are effected as early as possible. The most important among them is the control of the fiscal deficit which in turn requires decisive expenditure control measures. These measures have to be effected without sacrificing government capital expenditure on essential infrastructure and human resource developments on the one hand and relief and other essential social welfare measures on the other. This is underscored by the fact that major supply bottlenecks - as in the power sector - can slow down economic growth in the medium to long term. Achieving fiscal consolidation in the context of competing demands for scarce public resources is perhaps the major challenge that the policy makers face during the next few years. In the past, attempts to achieve fiscal consolidation usually resulted in cut backs in capital expenditure which invariably affected the growth potential of the economy.

Domestic financial constraints are likely to be constrained further by developments in the external sector accounts. Sri Lanka's balance of payments (BOP), despite being vulnerable to changes in prices of petroleum and a number of other major imports benefited from favourable developments in receipts of private transfers and tourism earnings in 2005. During the first four months of 2006, however, the value of petroleum imports increased by nearly 45 per cent compared to the level recorded during the same period in 2005, the increase being mostly the result of sharp price increases in the international markets. Largely as a result, Sri Lanka's import bill for the five months up to May 2006 rose by 21.6 per cent compared to a rate of 8.6 per cent in the same period in 2005.

Exports on the other hand have indicated a slowdown in growth to rate of 5.8 per cent in the first five months to May 2006 as against a comparable growth rate of 9.6 per cent in 2005. Perhaps most worrying, earnings from garments exports increased by only

1.3 per cent during the period January-April 2006 compared to a growth rate of 10 per cent in the same period in 2005. Sri Lanka's trade deficit in the first five months to May 2006 stood at US$ 1485 million as against a comparable deficit of US$ 911 million in 2005.

As in 2005, inward private remittances continued to show strong growth - increasing by 26 per cent to US$ 994 million during the first five months of 2006. Earnings from tourism also recovered to increase by 77 per cent in the first four months of 2006 to contain the current account deficit. Nevertheless, the overall BOP which registered a surplus of US$ 502 at end 2005 had declined to US$ 148 million by May 2006. Gross official reserves stood at US$ 2531 million at end May 2006 indicating a marginal decline from US$ 2735 recorded at end December 2005. Sustaining a healthy external reserves position as foreign capital inflows - associated primarily with tsunami related reconstruction - begin to dry up will be a significant challenge for the government. Leaning towards foreign borrowing - to ease pressure on domestic borrowing - increases the country's exposure to exchange rate related risks. FDI inflows are also unlikely to show a marked change from past trends where Sri Lanka has been able to attract only around US$ 250-300 million per annum.

The most rational strategy will be to ensure that the adverse effects of external factors are minimized by implementing appropriate policies on the domestic front. Implementing reforms in a democracy is complex but if the accomplishments of the past two decades of incremental reforms are not to be dwarfed by what remains to be done, the government has to take the initiative to implement reforms to address the increasing supply-side rigidities in the Sri Lankan economy. A commitment to implement a broad based programme of reforms can also garner support for the country from international financial institutions and allow appropriate financing mechanisms to be negotiated. It could well be argued that Sri Lanka is better placed to negotiate terms more favourable for the country - and ensure that they are in line with a domestic policy programme - at a time when the economy is growing healthily.

Diary of Events

August 2005-August 2006

Fiscal Policy

- The second budget of the UPFA government was presented by the Finance Minister on 08.11.2005. The Budget 2006 estimates forecast a total revenue target of Rs. 477 billion as against a total expenditure of Rs. 671.5 billion. The ensuing budget deficit of Rs.191 billion is to be financed by Rs. 69.8 billion of foreign financing, Rs.10.4 billion of foreign grants, and Rs. 121.5 billion of domestic financing.
- H.E. the President as Finance Minister presented the maiden Budget on 08.12.05 based on the programmes outlines in the 'Mahinda Chintana'. Accordingly, the Budget envisaged a growth rate of 8 per cent in the medium-term. Estimated revenue was revised to Rs. 484 billion and government expenditure to Rs. 681 billion. The non-tsunami related budget deficit for 2006 was estimated at 7.3 per cent of GDP (Rs.197 billion).
- On 21.03.06 the Parliament approved amendments to eight finance related Bills including the Inland Revenue Bill, Value Added Tax (Amendment) Bill, Monetary Law (Amendment) Bill and Betting and Gaming Levy (Amendment) Bill.

Monetary Policy

- The Monetary Board of the Central Bank announced on 12.09.05 that the new companies seeking registration under the Finance Companies Act No.78 of 1988 should have an issued and paid up capital of Rs. 200 million.
- The Monetary Board raised interest rate - i.e., Repurchase (Repo) rate and the Reverse Repurchase (reverse Repo) rate by 25 basis points to 8.50 per cent and 10.00 per cent, respectively effective from 13.09.05.
- The Central Bank sold three-year Treasury bonds at a yield of 11.12 per cent on 12.12.05 at the same yield as the last three-year bond auction held on 29.11.05. Central Bank accepted Rs. 425 million of bids from the market after offering to sell Rs. 1 billion.
- The Monetary Board raised interest rates - i.e., Repurchase (Repo) rate and the Reverse Repurchase (reverse Repo) rate by 25 basis points to 8.75 per cent and 10.25 per cent, respectively effective from 22.12.05.
- The Monetary Board raised interest rates - i.e., Repurchase (Repo) rate and the Reverse Repurchase (reverse Repo) rate by 25 basis points to 9.00 per cent and 10.50 per cent, respectively effective from 15.06.06.
- The Monetary Board raised interest rates - i.e., Repurchase (Repo) rate and the Reverse Repurchase (reverse Repo) rate by 12.5 basis points to 9.125 per cent and 10.625 per cent, respectively effective from 22.07.06.

Capital and Financial Market

- Sri Lanka obtained its first sovereign rating of BB- and BB+ from Fitch Ratings and Standard & Poor's (S&P) Ratings Services on 08.12.05.
- The benchmark All Share Price Index (ASPI) tumbled 30 per cent between November 2005 and January 2006 as violence flared in the North and East raising fears of a resumption in fighting.
- Due to the worsening security situation in the North and East and mounting death toll on government troops coupled with concern over delay in second round of peace talks, the Colombo Stock Exchange lost Rs.30 billion on 17.04.2006. The market capitalization dropped by Rs. 29.8 billion to Rs. 695.3 billion from Rs. 725.1 billion. The ASPI dropped by 4 per cent or nearly 100 points in a single days trading, which was the steepest fall since late December 2005.
- S&P and Fitch Ratings Services downgraded the long-term outlook for Sri Lanka from stable to negative on 27.04.06 and 28.04.06, respectively.
- On 05.06.06, the Bank of Ceylon called quotation for a syndicated credit facility for US$ 250 million from foreign financial institutions to be utilized to meet the heavy oil import bills of the Ceylon Petroleum Corporation.
- On 06.06.06 the Parliament approved new regulations to the Insurance Industry Act, Local Treasury Bills Ordinance, and the Registered Stock and Securities Ordinance.
- The government accepted US$ 250 million of 2 year Sri Lanka Development Bonds (SLDBs) at a rate of 6 month LIBOR + 130.75 basis points (weighted average) and US$ 50 million of 3 year SLDBs at a rate of 6 month LIBOR + 140 basis points on 17.06.06.
- The government accepted US$ 175 million of 3 year SLDBs at a weighted average rate of 138.3 basis points above LIBOR on 11.08.06.

Tariff and Trade Policy

- The government reduced customs duty on importation of selected heavy vehicles from 27.5 per cent to 6 per cent effective from 04.08.05.
- Customs duty on the importation of wheat flour was increased from 2.5 per cent to 15 per cent up to a maximum of Rs. 4.50 per kg from 31.01.06.
- Customs duty on the importation of rice was increased from Rs. 9 per kg to Rs. 20 per kg with effect 17.03.06.
- The Sri Lanka Tea Board (SLTB) announced on 23.03.06 that the cess on exports of tea has been increased by Rs. 1.50 per kilo with effect from April 2006. The move is expected to generate Rs. 470 million more in 2006. In 2005, the SLTB was able to collect Rs. 750 million by way of the cess.
- On the recommendation made by the Export Cluster of the National Council for Economic Development, the government exempted charging of income tax on the profit derived from processing and exports of tea bags effective from 01.04.06.
- Importation of motor cars below 1,500 cc was granted a duty waiver up to 25 per cent of levies with effect from 01.04.2006.
- At the meeting of the SAFTA Committee of Experts on 19.04.05, it was announced that India, Pakistan and Sri Lanka will lower customs duty by

40 per cent in 2006 for the products originating from the LDC of Bangladesh, Bhutan, Nepal, and the Maldives.

Price Adjustments

- Sri Lanka Railways (SLR) increased rail fares by about 50 per cent effective from 01.08.05.
- Ceylon Petroleum Corporation (CPC) increased the retail prices of petrol, diesel and kerosene by Rs. 8.00 each per litre to Rs. 88.00, Rs. 58.00, and Rs. 38.50 per litre, respectively effective from 15.04.06.
- With the increase in fuel prices, bus fares were increased by 16 per cent effective from 24.04.06.

Subsidies

- The government increased the value of the fertiliser subsidy from Rs. 22,000 per metric ton to Rs.23,000 per metric ton effective from 10.08.05.
- The private sector fertilizer importers gave an ultimatum on 26.10.05 to the government that they will completely withdraw from importing fertilizer if the subsidy due to them on the import of urea is not received. The outstanding subsidy was estimated at Rs.3 billion of which 75 per cent was overdue for over 6 months. The Ministry of Agriculture announced on 01.11.05 that the Treasury has released Rs. 820 million for the fertilizer subsidy for 2006.
- The government raised the fertilizer subsidy to Rs. 350 for a 50 kg bag of all varieties of fertilizer for paddy and vegetables effective from 05.12.05.
- Lanka IOC - the Sri Lankan unit of the Indian Oil Corporation - reported a full year net loss of Rs. 7.07 billion (US$ 68.7 million) on 19.05.06 citing an unpaid Rs. 7.44 billion subsidy payments by the government of Sri Lanka.

Labour and Employment

- A Budgetary Relief Allowance of Workers Act (BRAWA 2005) was enacted in Parliament with effect from 1.08.05 to increase private sector employees' salaries by Rs. 1,000 in parallel to the increase in public sector salaries under the Budget 2005 proposals.
- The Department of Census and Statistics announced on 20.06.06 that the unemployment rate at the end of the first quarter had declined to 7.2 per cent, the lowest rate ever recorded with the number of unemployed persons being 546,326. The total number of employed persons was estimated at 7.081,435 in the first quarter excluding the Northern and Eastern Provinces.

Infrastructure Development

- It was announced on 15.03.06 that the People's Republic of China had agreed to fully fund the US$ 4555 million Norochcholai coal fired power plant. The foundation stone for the project was laid on 11.05.06.
- It was announced on 10.05.06 that the Colombo-Katunayake Highway estimated to cost US$ 290 million is to be funded through the Chinese Export and Import Bank on a 20 year soft loan, with a three year grace period.
- Sri Lanka's largest mobile communications operator, and largest infrastructure investor Dialog Telecom Ltd signed an agreement with the Board of Investment of Sri Lanka (BOI) on

19.05.06 to further invest Rs. 15 billion (US$ 15 million) in the country's telecommunication sector over the next 2 years.

Foreign Aid

- On 11.10.05 the Asian Development Bank (ADB) approved a US$ 2 million grant from its Japan Fund for Poverty Reduction (JFPR) financed by the government of Japan, to help restore income-generating opportunities to poor people in Sri Lanka affected by the tsunami disaster.
- On 08.11.05 the World Bank launched a fund of Rs. 900 million to insulate the country from the continued high oil price with the objective of improving the quality of rural life by utilizing off-grid renewable energy technologies to provide electricity to remote communities, and promote private sector power generation from renewable energy resources for the national grid. The amount is funded by an SDR 59.3 million line of credit from the IDA and a US$ 8 million grant from the Global Environment Facility.
- The National Council for Economic Development announced on 17.11.05 that the ADB had agreed to provide Rs. 4 billion to boost the tea industry to increase land and labour productivity to retain the country's comparative and competitive position as a tea exporter.
- The Central Bank announced that a sum of Rs. 22,823 million had been received as at 12.12.05 as part of donations by the government, NGOs and others as private foreign and local donations through banking channels towards tsunami disaster relief.

Governance and Politics

- The Sri Lanka Transport Board (SLTB) Bill was passed by the Parliament on 30.08.05. The Bill is aimed at re-activating the SLTB which was defunct after privatization.
- The Reconstruction and Development Agency (RADA) was established on 15.09.05 to facilitate the government's reconstruction and development efforts in all districts affected by natural disasters.
- The Sri Lanka Transport Board (SLTB) was re-established on 28.09.05.
- With effect from 28.10.05, Sri Lanka temporarily halted all poultry imports after bird flu out-breaks in Eastern Europe and parts of Asia as the island's migratory bird season got underway.
- A National Policy on Bio-safety was approved by the Cabinet on 9.11.05. The policy includes a determination on genetically modified foods and many other areas.
- A new Ministry of Petroleum Resources Development was established on 24.10.05 under Article 44(1) of the Constitution following the discovery of potentially commercially viable oil reserves in the coastal belt from Puttalam to Hambantota.
- On 27.06.06, the Parliament passed the Tobacco and Alcohol Authority Bill presented by the government seeking approval for the establishment of a National Authority on Tobacco and Alcohol specially aimed at discouraging children from smoking and consuming alcohol.
- The Private Medical Institution Registration Bill was passed in Parliament on 24.05.06. The bill is to

provide for the registration, regulation, and monitoring of private medical institutions, provide necessary infrastructure and foster the development of private medical institutions.

- The European Union (EU) formally banned the LTTE as terrorist organization. The 25 nation bloc rubber stamped the ban at a meeting held on 29.05.06.
- The Court of Appeal determined on 05.06.06 that the blanket immunity from lawsuits enjoyed by the President prevents the challenging of appointments to the Independent Commissions made by the President.
- The first round of peace talks between the government and the LTTE was held on 22-23 February, 2006. Expected talks between the government and LTTE in Geneva on 8.06.06 did not materialize as the LTTE refused to sit with the Sri Lankan government delegation.

Appendices

Appendix A: Macroeconomic Indicators (Statistical Base)

Table A1: Socio-Economic Indicators

1. Basic indicators	**Unit**	
Area	Sq. km.	65,610
Mid year population (2005)	('000)	19,668
Population growth rate (2005)	%	1.1
Life expectancy at birth (2003)	Years	74.0
Infant mortality rate (2003)	Per 1000 live births	17
Gross school enrolment ratio (2003)(a)	%	69
Adult literacy rate (2003)	%	90.4
Human development index (HDI) (2003)	Value	0.75
Human poverty index (HPI) (2003)	Value	18.0

		2001	**2002**	**2003**	**2004**	**2005(e)**
2. Output, labour force and employment						
GNP at current market prices	Rs. bn.	1,382.0	1,560.0	1,742.0	2,016.0	2,349.0
GDP at current market prices	Rs. bn.	1,407.0	1,582.0	1,761.0	2,029.0	2,366.0
GDP at current factor cost prices	Rs. bn.	1,245.0	1,403.0	1,562.0	1,800.7	2,098.3
GDP per capita at current market prices	US$	841.08	70.0	948.0	1,030.0	1,197.0
Labour force(b)	mn.	7.0	7.0	7.6	8.1	8.1(c)
Labour force participation (b)	%	49.0	50.0	48.9	48.6	48.3 (c)
Unemployment (b)	%	8.0	9.0	8.4	8.3	7.7 (c)
3. Real output growth						
GDP	%	-1.5	4.0	6.0	5.4	6.0
Agriculture, forestry, and fishing	%	-3.4	2.5	1.6	-0.3	1.5
Mining and quarrying	%	0.7	-1.1	5.7	7.4	12.4
Manufacturing	%	-4.2	2.1	4.2	4.9	5.7
Construction	%	2.5	-0.8	5.5	6.2	8.2
Services	%	-0.5	6.1	7.9	7.0	6.0
4. Prices and wages						
CCPI (annual average)	% change	14.2	9.6	6.3	7.6	11.6
GCCPI (annual average)	% change	11.0	10.6	3.1	-	-
WPI (annual average)	% change	11.7	10.7	3.1	12.5	11.5
Implicit GNP deflator	% change	12.4	8.4	5	9.3	9.9
Real wage rates						
Workers in wages boards trades	% change	-8.2	-2.0	0.7	-4.8	-3.5
Government employees	% change	5.9	6.4	-6.0	2.9	-7.0
5. Consumption, investment, and savings						
Consumption	% of GDP	84.3	85.5	84.1	84.1	82.8
Gross domestic capital formation	% of GDP	22.0	21.3	22.1	25.0	26.5
Gross domestic savings	% of GDP	15.8	14.5	15.9	15.9	17.2
Gross national savings	% of GDP	20.3	19.5	21.6	21.6	23.3
Foreign savings	% of GDP	6.2	6.9	6.2	9.1	9.3
6. Government finance						
Revenue	% of GDP	16.7	16.5	15.7	15.4	16.1
Expenditure and net lending	% of GDP	27.5	25.4	23.7	23.5	24.7
Current expenditure	% of GDP	21.6	20.9	19.0	19.2	18.7
Capital expenditure & net lending	% of GDP	5.9	4.6	5.0	4.8	6.3
Current a/c balance	% of GDP	-4.9	-4.4	-3.3	-3.9	-2.7
Budget deficit						
Primary deficit	% of GDP	-4.1	-1.6	-0.9	-2.2	-3.6
Overall deficit (before grants)	% of GDP	-10.8	-8.9	-8.0	-8.2	-8.7
Public debt						
External	% of GDP	45.3	45.6	47.9	49.1	40.4
Domestic	% of GDP	58.0	59.8	57.9	56.4	53.5

Contd..../-

		Unit	2001	2002	2003	2004	2005(e)
7.	**External trade**						
	Terms of trade	% change	-1.7	4.6	7.4	-5.2	-4.2
	Import price index	% change	-3.6	-8.3	-1.8	9.7	7.8
	Export price index	% change	-5.2	-4.1	5.5	4.0	3.3
	Import volume index	% change	-10.7	11.4	11.2	9.0	2.7
	Export volume index	% change	-8.0	2.2	3.5	7.8	6.7
8.	**External finance**						
	Trade balance	% of GDP	-7.3	-8.5	-8.4	-11.2	-10.7
	Current account balance	% of GDP	-1.6	-1.4	-0.4	-3.2	-2.8
	Capital & financial account balance	% of GDP	3.5	2.7	3.9	3.1	2.8
	Foreign direct investment	% of GDP	1.9	1.4	1.1	1.1	1.0
	Foreign portfolio investment	% of GDP	-0.1	0.2	0.01	0.05	0.03
	Import capacity	months of imports (d)	4.5	4.9	5.8	5.2	5.7
	External debt	% of GDP	61.4	62.4	64.6	63.7	55.4
	Debt-service ratio	% of exports	13.2	13.2	11.6	11.6	7.9
9.	**Exchange rates (year end)**						
	U.S.A.	Rs./US$	93.16	96.73	96.74	104.61	102.1
	U.K.	Rs./UK Pound	135.06	155.12	172.19	201.37	175.9
	Japan	Rs./Yen	0.71	0.82	0.90	1.02	0.9
	European Union	Rs./Euro	82.27	101.38	121.6	142.32	121.0
	India	Rs./Rs. Indian	1.93	2.02	2.12	2.4	2.3
	SDR	Rs./SDR	116.97	130.99	143.75	161.6	146.0
10.	**Money supply**						
	Narrow money supply (M1)	% change	3.2	14.0	16.0	16.6	22.4
	Broad money supply (M2)	% change	13.6	13.4	15.3	19.6	19.1
	Domestic credit	% change	16.2	6.7	7.6	25.0	18.7
	External banking assets	% change	6.6	49.3	51.0	1.9	20.3
11.	**Interest rates**						
	Treasury bills						
	3 month	% per annum	12.9	9.9	7.3	7.2	10.1
	12 month	% per annum	13.7	9.9	7.2	7.6	10.4
	Call money rate	% per annum	18.5	11.4	8.5	9.0	10.3
	Average prime lending rate	% per annum	14.3	12.2	9.3	10.2	12.2
	Commercial banks saving	% per annum	10.9	9.2	7.2	7.7	8.9
	NSB saving	% per annum	10.0	6.9	5.0	5.0	5.0
	Commercial banks fixed deposits	% per annum	16.7	13.2	7.7	9.8	11.5
	NSB fixed deposits	% per annum	14.5	10.9	7.0	8.0	9.0
12.	**Share market indicators**						
	Annual turnover	Rs. bn.	13.9	30.2	73.6	59.0	114.6
	Companies listed	No.	238	238	244	242	239.0
	Market capitalization	Rs. bn.	124.0	162.6	263.0	382.1	584.0
	Net purchases by non-nationals	Rs. mn.	-1,025.0	2,442.0	209.3	1109	6,145.0
	Share price indices						
	CSE share	(Index, 1985 = 100)	621.0	815.1	1,062.1	1506.9	1,922.2
	CSE sensitive (f)	(Index, 1985 = 100)	1,031.0	1,374.1	1,897.8	2073.7	2,451.1

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, 1985-2005

	1996 Prices			Growth Rates		
	GDP Rs. mn.	PGDP Rs.mn.	POP(b) ('000)	GDP	PGDP	POP
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	980,720.0	50,391.5	19,462	5.2	4.2	1.1
2005(a)	1,039,735.0	52,864.3	19,668	5.7	4.7	1.0

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, 1996-2005

	Unit	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005(a)	1996-2005(b)
1. Structure of output												
Agriculture, forestry, and fishing	% of total output	22.4	21.7	21.3	21.3	20.4	20.1	20.5	19.0	17.8	17.2	20.2
Agriculture	% of total output	17.6	17.0	16.6	16.6	15.9	16.0	16.6	14.7	14.3	14.5	16.0
Tea	% of agriculture	8.4	8.8	8.7	8.5	8.9	9.0	7.2	8.6	8.1	7.1	8.2
Rubber	% of agriculture	3.3	3.0	2.7	2.6	2.3	2.4	1.2	2.4	2.5	2.6	2.5
Coconut	% of agriculture	10.5	10.5	10.0	10.4	11.1	10.0	8.4	8.8	7.4	7.8	9.4
Paddy	% of agriculture	16.2	17.5	20.4	20.8	20.4	20.1	18.0	21.6	17.5	17.5	16.6
Mining and quarrying	% of total output	2.0	2.0	1.8	1.8	1.7	-1.8	1.8	1.7	1.9	2.1	1.5
Manufacturing	% of total output	16.2	16.6	16.9	16.8	17.4	-16.9	15.8	16.4	15.3	14.8	12.9
Export processing	% of manufacturing	14.4	13.6	12.7	12.6	12.0	11.7	11.3	11.1	15.2	15.2	13.3
Factory industry	% of manufacturing	77.9	78.7	79.7	79.7	80.6	80.8	77.2	81.3	77.8	77.2	78.8
Small industry	% of manufacturing	7.8	7.6	7.6	7.7	7.4	7.5	7.6	7.6	6.9	7.6	7.5
Construction	% of total output	6.9	6.8	7.6	7.6	7.3	7.6	7.2	7.2	7.9	8.4	7.5
Services	% of total output	59.4	52.8	51.4	52.0	53.3	53.9	54.9	54.7	55.4	55.7	54.3

	Unit	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005(a)	1996-2005(b)
2. Real output growth												
Agriculture, forestry, and fishing	% growth	-4.6	3.0	2.5	4.5	1.8	-3.5	2.5	1.5	-0.3	1.5	1.0
Agriculture	% growth	-5.1	2.9	1.8	4.4	1.7	-4.3	1.9	3.0	-0.9	8.1	1.4
Tea	% growth	5.1	7.1	1.1	1.3	7.8	-3.5	5.1	-2.2	1.5	2.5	2.6
Rubber	% growth	6.3	-5.4	-9.0	1.0	-9.7	-1.5	5.0	1.7	3.1	9.8	0.0
Coconut	% growth	-7.6	3.3	-3.2	9.1	8.0	-13.5	-13.6	7.1	0.1	-2.2	-1.2
Paddy	% growth	-26.7	11.2	18.3	6.6	-0.3	-5.7	5.1	7.4	-17.8	19.6	1.8
Mining and quarrying	% growth	8.9	3.8	-5.4	4.1	4.8	0.7	-1.1	3.6	7.4	12.4	4.1
Manufacturing	% growth	6.5	9.1	6.3	4.4	9.2	-4.2	2.1	4.4	4.9	5.7	4.8
Export processing	% growth	1.0	3.5	-1.2	3.8	4.2	-6.7	-0.9	2.2	1.3	2.6	0.8
Factory industry	% growth	7.3	10.3	7.6	4.5	10.4	-3.9	2.5	4.6	5.7	5.7	5.4
Small industry	% growth	6.3	7.0	6.5	4.8	5.5	-3.5	2.1	6.1	0.0	8.9	4.4
Construction	% growth	3.4	5.4	7.1	4.8	4.8	2.5	-0.8	5.5	6.2	8.2	4.7
Services	% growth	5.5	6.9	3.7	9.8	2.3	-0.5	6.1	7.7	7.0	6.0	5.5
GDP	% growth	5.5	3.8	6.3	4.3	6.0	-1.5	4.0	5.9	5.2	5.7	4.5

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, 1993-2005

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005(a)
1. Value added, current prices (Rs. mn.)													
Food, beverages and tobacco	21,704	24,373	29,507	32,891	35,585	40,452	44,503	49,031	54,282	61,550	69,708	77,850	88,380
Textile, wearing apparel and leather products	18,994	19,916	24,895	31,148	40,581	47,482	55,263	69,451	71,263	77,028	84,623	97,216	101,300
Wood and wood products (including furniture)	831	1,081	1,177	1,250	1,258	1,313	1,390	1,554	1,639	1,736	1,928	2,467	2,790
Paper and paper products	1,912	2,301	2,458	2,580	2,633	2,578	2,664	2,808	3,103	3,124	3,334	3,947	4,530
Chemicals, petroleum, coal, rubber and plastic products	4,723	5,758	6,898	8,957	10,745	14,274	13,832	17,771	19,245	22,653	25,028	32,131	39,800
Nonmetallic mineral products (except petroleum and coal)	7,163	9,272	9,726	10,537	11,600	12,463	13,817	14,240	16,010	17,273	18,477	21,450	25,500
Basic metal products	279	356	347	450	598	710	777	959	1,131	1,306	1,463	1,615	1,895
Fabricated metal products, machinery and transport equipment	3,608	4,344	4,547	4,809	5,924	6,779	7,367	7,714	8,731	9,698	11,198	13,987	15,870
Manufactured products n.e.s.	1,532	1,838	2,319	2,763	3,157	3,426	3,799	3,965	4,154	4,695	5,257	5,909	6,700
Total	60,746	69,239	81,368	95,385	112,011	129,477	143,412	167,493	179,559	199,063	221,016	256,572	286,765
2. Composition of industrial production, %													
Food, beverages and tobacco	35.7	35.2	35.6	34.5	31.7	31.2	31.0	29.3	30.2	30.9	31.5	30.3	30.8
Textile, wearing apparel and leather products	31.3	28.8	30.6	32.7	36.2	36.7	38.5	41.5	39.7	38.7	38.3	37.9	35.3
Wood and wood products (including furniture)	1.4	1.6	1.4	1.3	1.1	1.0	1.0	1.0	0.9	0.9	0.9	0.9	0.9
Paper and paper products	3.1	3.3	3.0	2.7	2.4	2.0	2.0	1.7	1.7	1.6	1.5	1.5	1.6
Chemicals, petroleum, coal, rubber and plastic products	7.8	8.3	8.5	9.4	9.6	11.0	9.6	10.6	10.7	11.4	11.3	12.5	13.9
Nonmetallic mineral products (except petroleum and coal)	11.8	13.4	12.0	11.0	10.4	9.6	9.6	8.5	8.9	8.7	8.3	8.4	8.9
Basic metal products	0.5	0.5	0.4	0.5	0.5	0.5	0.5	0.6	0.6	0.7	0.7	0.6	0.7
Fabricated metal products, machinery and transport equipment	5.9	6.3	5.6	5.0	5.3	5.2	5.1	4.6	4.9	4.9	5.1	5.5	5.5
Manufactured products n.e.s.	2.5	2.7	2.9	2.9	2.8	2.6	2.6	2.4	2.3	2.4	2.4	2.3	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, 1984-2005

	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)
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	310.0	149.30	216.30	90.5	68.80	69.50	2,392	12.10	2,859	-
2003	303.2	149.05	221.01	92.0	102.50	105.25	2,562	9.98	3,071	-
2004(d)	309.5	180.74	248.92	94.7	127.20	128.51	2,591	9.83	2,628	-
2005(e)	317.2	185.84	263.31	104.4	147.41	147.73	2,515	12.46	3,246	-

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, 1996-2005

	Household population (10 yrs. & over)	Labour force	Labour force participation rate (%)	Labour force: Employed		Labour force: Unemployed	
	No. mn.	No. mn.		No. mn.	%	No. mn.	%
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
q4	16.7	8.1	47.8	7.4	91.8	0.7	8.2
2005 (special survey)	16.9	8.1	48.3	7.5	92.3	0.6	7.7

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, 1984-2005

	Private(a) (Rs. mn., current market prices)	Public(b) (Rs. mn., current market prices)	Private(a) (As % of GDP)	Public(b) (As % of GDP)	Private(a) (at 1996 prices(c))	Public(b) (at 1996 prices(c))	Private(a) (Growth in real terms)	Public(b) (Growth in real terms)
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	461,474	45,201	25.7	2.5	251,619.1	26,905.3	18.2	9.9
2005(d)	526,453	99,196	25.1	4.7	268,878.6	49,155.6	12.3	54.4

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, 1992-2005

(As % of GDP)	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005(a)
Gross domestic capital formation	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	26.5
Gross domestic savings	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	17.2
Net imports of goods and non-factor services (b)	9.3	9.5	11.8	10.4	8.9	7.1	6.0	7.8	10.6	6.2	6.8	6.1	9.0	9.3
Net factor income from abroad	-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	-1.3
Net private transfers	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	7.4
Gross national savings	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	23.3
Foreign savings	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	3.2

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, 1994 -2005

(As % of GDP)	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005(b)
Revenue	19.0	20.4	19.0	18.5	17.3	17.7	16.8	16.7	16.5	15.7	15.4	17.1
Grants	1.4	1.4	1.0	0.8	0.7	0.6	0.4	0.4	0.4	0.5	0.4	0.4
Expenditure												
Current expenditure	21.9	23.1	22.8	20.8	19.6	18.7	20.2	21.6	20.8	19.0	19.2	18.4
Capital & net lending	7.5	7.4	5.7	5.7	6.7	6.5	6.5	5.9	4.5	4.7	4.3	6.2
Current account balance	-2.9	-2.7	-3.8	-2.2	-2.4	-1.0	-3.4	-4.9	-4.4	-3.3	-3.9	-1.3
Primary deficit	-3.9	-4.3	-3.1	-1.7	-3.8	-1.9	-4.2	-4.1	-1.6	-0.9	-2.2	-1.9
Overall deficit (before grants)	-10.5	-10.1	-9.4	-7.9	-9.2	-7.5	-9.9	-10.8	-8.9	-8.0	-8.2	-7.5
Financing budget deficit												
Foreign financing	3.5	4.5	2.3	1.9	1.7	0.7	0.4	1.4	0.6	2.9	8.2	7.5
Net borrowings	2.0	3.2	1.3	1.1	1.0	0.1	0	1.0	0.1	2.4	1.8	2.1
Grants	1.4	1.4	1.0	0.8	0.7	0.6	0.4	0.4	0.4	0.5	0.4	0.4
Domestic financing	6.5	5.1	6.5	3.4	7.1	6.8	9.4	8.8	8.0	4.5	5.8	4.6
Market borrowings	6.6	5.0	5.1	4.5	7.1	6.8	9.2	8.7	8.0	4.5	5.5	4.6
Bank	0.2	1.1	1.7	-0.2	1.9	2.5	4.5	3.5	-0.3	-1.2	2.1	-
Non-bank	6.4	3.9	3.4	4.7	5.2	4.4	4.7	5.3	8.3	5.7	3.4	4.6
Other borrowings	-0.1	0.1	1.3	-1.1	-0.1	-0.1	0.3	0.1	-0.1	-	0.2	-
Privatization proceeds(a)	0.5	0.4	0.6	2.5	0.4	_	_	0.6	0.4	0.6	0.1	0.3

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, 1986-2005

	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	2005
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	11.0
Broad money supply	M2/GDP	33.0	35.9	34.6	36.0	36.0	36.0	32.2	37.2	38.3	39.2
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	22.4
Broad money supply	% growth	10.8	13.8	9.7	13.3	13.0	11.4	13.2	15.3	19.6	19.1
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	170,643.0
	% growth	-7.0	44.3	5.0	-10.5	-29.1	39.6	22.6	27.3	-0.3	32.1
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	734,605.0	831,421.0
	% growth	12.7	8.1	14.3	20.1	25.4	9.5	6.8	9.9	21.8	13.2
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	181,111.0	162,633.0
	% growth	37.8	-4.5	26.4	46.6	56.6	20.3	-5.3	-6.3	26.3	-10.2
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	430,575.0	526,236.0	652,929.0
	% growth	11.1	11.8	13.9	16.1	5.1	12.4	16.2	16.2	22.2	24.1
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	-179,132.0
	% growth	-1.3	21.0	20.9	12.1	23.9	17.6	4.0	8.5	15.9	1.9

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, 1992-2005

(%, end of period)	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Bank rate	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	15.0
Treasury bills, yield rates														
3 month	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	10.1
12 month	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	10.4
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	8.8
Call money rate														
Maximum	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	11.1
Minimum	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	10.5
Weighted average prime lending rate	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	12.1
Commercial bank saving														
Maximum	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	10.3
Minimum	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	3.0
NSB saving	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	5.0
Commercial bank fixed deposit (one year)														
Maximum	20.0	17.0	17.0	17.0	17.8	15.3	13.0	12.5	15.0	14.5	11.0	7.7	9.8	11.5
Minimum	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	5.5
NSB fixed deposit (one year, paid on maturity)	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	9.0

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

Table A12: Basic Indicators of the General Price Level, 1986-2005

	CCPI (1952 = 100)	% change	GCCPI (1989 = 100)	% change (Jan-June)	WPI (1974 = 100)	% change	GDPD (1996 = 100)	% change
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	12.5	183.5	9.2
2005	4,055.5(a)	11.6	-	-	2,105.9(a)	11.5	201.8	9.9

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, 1986-2005
(December 1978 = 100)

	Workers in wages boards trades(a)		Government employees(b)	
	Nominal	Real	Nominal	Real
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	1,233.0	81.3	1,872.1	123.3
2005(c)	1,329.7	81.3	2,417.5	142.7

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, 1988-2005

	Unit	1988	1989	1990	1991	1992	1993	1994	1995	1996
1. Exports to selected countries and groupings										
U.S.A	US$ mn.	367.3	400	492.5	559	837.6	1,006.8	1,115.3	1,353.5	1,395.8
U.K.	US$ mn.	80.9	88.4	115.1	126.2	170.2	203.5	285.4	345.3	388.6
Germany	US$ mn.	104.3	95.4	126.7	148.8	211.8	227.5	222.5	254.3	239.3
Japan	US$ mn.	84.9	89	102.4	101.6	128	148	165.3	200.4	256.4
EC	% of total exports	23.7	25.4	25	27	32.8	31.2	31.3	31	29.4
Germany	% of exports to EC	29.8	24.1	25.5	27	26.3	25.5	22.2	21.6	19.8
UK	% of exports to EC	23.1	22.3	23.2	22.9	21.1	22.8	28.4	29.3	32.2
ASEAN	% of total exports	4.7	3.9	3.9	5.5	2.4	2.9	3.9	3.7	2.8
Singapore	% of exports to ASEAN	63.8	59.6	63.7	59.8	56.5	58.6	60.6	52.3	52
Malaysia	% of exports to ASEAN	3.1	2.3	3.3	23.6	7.7	4	4.6	15.7	23.5
SAARC	% of total exports	6.2	5.5	3.6	3	2.3	2.5	2.7	2.7	2.6
India	% of exports to SAARC	20.9	11.5	29.1	20.8	20.3	27.6	27.2	31.3	39.6
NAFTA	% of total exports	27.2	28.4	27.2	30	36.4	37.1	36.8	37.3	35.6
USA	% of exports to NAFTA	91.3	90.3	91.3	91.4	93.5	94.9	94.4	95.4	95.6
Canada	% of exports to NAFTA	5.6	5.8	5.4	5.2	4.3	3.4	4.3	3.5	3.1
APEC	% of total exports	42.5	41.2	39.5	43.7	47.6	48.7	49.6	50.1	48.7
USA	% of exports to APEC	58.5	62.4	62.8	62.7	71.5	72.3	70.1	71	69.8
Japan	% of exports to APEC	13.5	13.9	13.1	11.4	10.9	10.6	10.4	10.5	12.8
Singapore	% of exports to APEC	0.7	0.6	0.5	0.4	0.3	0.2	0.2	0.1	0.1
2. Imports from selected countries and groupings										
Japan	US$ mn.	305.1	295.4	325.4	358.4	415.6	452.6	526.6	498.6	497.3
India	US$ mn.	91	64.2	118.1	220.1	301.9	342.9	404.4	469.2	561.9
Hong Kong	US$ mn.	116.6	109.9	120.4	212.5	241	312.4	316.6	357.4	354.1
U.S.A	US$ mn.	152.7	137	207.7	174.5	159.4	131.3	284.7	172.7	198.3
U.K.	US$ mn.	126.5	125.2	137	166.3	172.8	184.8	247.6	242.6	251.7
Taiwan	US$ mn.	105.3	116.1	1555.8	207.4	214	225.7	250.2	286.4	287.8
EC	% of total imports	17.5	16	14.4	15.2	14.7	15.8	16.3	15.3	15.4
Germany	% of imports from EC	26.2	20	21.7	22	24.7	21.9	21.8	20.5	18.4
UK	% of imports from EC	32.3	35.2	35.5	36	33.5	29.2	31.8	29.8	30.1
ASEAN	% of total imports	10.1	12.7	12.8	13.8	15.1	14.5	13.2	12.8	12.6
Singapore	% of imports from ASEAN	41.1	33.4	29.7	32.3	44.8	35.8	37.2	36.6	37.7
Malaysia	% of imports from ASEAN	27.4	21.5	33.2	33.4	24.1	29.5	28.8	31.1	26.7
SAARC	% of total imports	8.1	5.5	6.9	10.3	11.8	10.7	10.3	10.2	11.9
India	% of imports from SAARC	50.1	52.1	64.1	70.3	72.7	80.1	82.7	86.1	86.9
NAFTA	% of total imports	8.6	6.8	8.5	6.3	5.2	3.7	6.3	3.6	4.3
USA	% of imports from NAFTA	78.8	90.1	91.4	91.3	87	89.4	95	91.3	84.6
Canada	% of imports from NAFTA	21	9.7	8.3	8.3	11.6	10.1	4.6	7.9	10
APEC	% of total imports	53.1	52.9	55.7	58.5	57.1	55.7	55.4	50.2	50.4
USA	% of imports from APEC	12.8	11.6	13.9	9.8	8	5.9	10.8	6.5	7.3
Japan	% of imports from APEC	13.6	11.7	12.1	11.8	11.9	11.3	11	9.4	9.2
Singapore	% of imports from APEC	7.8	8	6.9	7.6	11.9	9.3	8.8	9.3	9.5

Cont../

	Unit	1997	1998	1999	2000	2001	2002	2003	2004	2005(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	1,988.07
U.K.	US$ mn.	525.4	530.4	604.2	736.7	576.4	590.3	640.4	779.2	777.25
Germany	US$ mn.	230	231.9	215.7	230.2	198.5	199.3	232.4	274.1	271.8
Japan	US$ mn.	234.2	196.1	159.1	229.7	185.8	140.3	165.4	157.6	144.6
EC	% of total exports	35	33.6	35.3	33.4	32.3	35.2	35.9	38.3	37.2
Germany	% of exports to EC	17.1	17.9	16.2	15.2	15.8	14.4	15.3	14.9	13.9
UK	% of exports to EC	39	41	45	48.5	45.8	42.8	42.2	42.3	39.9
ASEAN	% of total exports	3.4	3	3.1	3.5	2.9	2.6	2.5	2.6	2.9
Singapore	% of exports to ASEAN	43.7	38.1	37.9	38.7	51.4	63.6	61.8	67.9	52.2
Malaysia	% of exports to ASEAN	16.6	10.1	6	5	5.9	8.4	11.7	7.1	9.5
SAARC	% of total exports	3.1	3	3.8	4.2	4.1	6.5	8.3	10.5	12.5
India	% of exports to SAARC	37	33.2	33.7	30.6	45.6	66.5	70.0	77.3	86.7
NAFTA	% of total exports	45.5	51.5	49.8	50.5	52.0	47.6	44.5	41.2	40.4
USA	% of exports to NAFTA	95.3	95.4	95.1	95.4	95.1	94.6	94.5	94.5	94.1
Canada	% of exports to NAFTA	3.2	3.1	3.1	3.1	3.4	3.3	3.4	3.6	3.7
APEC	% of total exports	58.9	56.3	57.8	59.5	54.6	52.2	52.2	47.8	46.2
USA	% of exports to APEC	72.4	83.4	84.1	83.5	83.1	82.5	80.6	81.4	82.3
Japan	% of exports to APEC	10.2	8.6	7.5	8.7	8.0	6.6	7.4	6.9	5.9
Singapore	% of exports to APEC	0.1	1.9	2.1	2.3	2.5	3.1	3.0	3.8	3.3
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	379.7
India	US$ mn.	559.8	539.4	511.6	600.1	709.3	852.9	1,073.2	1,439.1	1,835.4
Hong Kong	US$ mn.	411.3	411	459.1	515.9	500.3	491.0	559.5	619.4	648.2
U.S.A	US$ mn.	186.6	229.5	216.2	254.9	265.6	218.7	188.3	240.1	204.5
U.K.	US$ mn.	282.4	304.8	251.1	311.4	220.6	262.9	272.9	312.1	276.2
Taiwan	US$ mn.	372.1	378.7	347.1	390.1	322.8	288.0	276.1	290.8	278.7
EC	% of total imports	17.6	23.3	19.4	18.8	18.0	18.0	18.8	18.2	16.7
Germany	% of imports from EC	20.5	20.2	15.8	16.5	16.3	13.5	13.4	15.7	14.3
UK	% of imports from EC	31.6	30.3	29.1	32.8	26.0	29.3	25.5	25.2	22.2
ASEAN	% of total imports	14.7	19.6	21.1	21	19.4	19.1	19.8	20.0	20.5
Singapore	% of imports from ASEAN	38.3	36.8	48.2	46.7	44.8	46.0	46.2	51.2	48.2
Malaysia	% of imports from ASEAN	22.3	22.8	18	20.5	22.7	21.7	25.6	24.1	25.7
SAARC	% of total Imports	13.1	15.1	14.2	14	15.1	19.1	19.9	23.1	26.6
India	% of Imports from SAARC	83.9	83.3	81.4	84.8	84.4	89.4	91.5	91.4	92.6
NAFTA	% of total imports	5.7	7.1	5.5	6	6.2	4.7	4.1	4.1	3.9
USA	% of imports from NAFTA	64.7	75	89	84.1	91.5	93.8	85.4	84.4	71.2
Canada	% of imports from NAFTA	19	13.6	9.3	15.6	8.2	5.8	14.2	15.3	28.0
APEC	% of total imports	61.9	45.9	53.4	54.9	55.6	52.1	49.2	46.4	44.0
USA	% of imports from APEC	5.9	11.6	9.1	9.2	10.1	8.5	7.1	7.6	6.2
Japan	% of imports from APEC	9.4	28.1	23.6	23.2	12.8	13.8	16.0	13	11.6
Singapore	% of imports from APEC	9.1	15.7	19	17.8	15.6	16.8	18.7	20.5	22.4

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, 1986-2005

	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

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	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005(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	1,503.0
Growth	5.2	4.9	4.0	0.3	11.5	-10.7	5.6	11.5	7.1	4.4
% of total imports	19.0	18.5	19.2	18.9	17.3	18.9	19.5	20.1	18.0	16.9
1.1 Food										
Value (US$ mn.)	597.0	642.0	596.0	551.0	566.0	545.0	566.0	564.0	596.0	611.0
Growth	14.3	7.5	-7.2	-7.6	2.7	-3.7	3.8	-0.4	5.7	2.5
% of total imports	11.0	11.0	10.1	9.2	7.8	9.1	9.3	8.5	7.5	6.9
1.2 Other										
Value (US$ mn.)	433.0	442.0	532.0	581.0	696.0	581.0	623.0	780.0	844.0	891.0
Growth	1.8	20.6	9.2	19.8	-16.5	7.2	25.2	25.2	8.2	5.7
% of total imports	8.0	7.5	9.0	9.7	9.5	9.7	10.2	11.7	10.6	10.1
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	5,458.0
Growth	2.6	8.9	-3.9	1.9	23.6	-12.4	-5.6	9.0	22.3	13.0
% of total imports	54.6	55.2	52.8	53.0	53.5	57.4	59.3	59.2	60.4	61.6
2.1 Petroleum										
Value (US$ mn.)	479.9	539.5	345.0	500.0	901.0	731.0	789.0	838.0	1,209.0	1,655.0
Growth	24.1	12.4	-36.1	44.9	80.2	-18.9	7.9	6.2	44.3	36.9
% of total Imports	8.8	9.2	5.9	8.4	12.3	12.2	12.9	13.7	15.1	18.7
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	1,531.0
Growth	0.9	18.7	0.6	-5.5	11.4	-10.3	0.1	3.8	10.3	1.1
% of total imports	21.5	23.7	23.7	22.1	20.1	22.1	21.6	20.6	18.9	17.3
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	1,869.0
Growth	1.5	10.0	11.3	5.9	11.0	-37.8	8.1	12.9	26.5	11.9
% of total imports	22.1	22.6	25.1	26.2	23.6	18.1	19.2	19.8	20.8	21.1
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	8,863.0
Growth	2.6	7.7	0.4	1.5	22.4	-18.4	2.2	9.3	19.9	10.8

Notes:(a): Provisional.

Sources: Central Bank of Sri Lanka, *Annual Report,* various issues; IPS database.

Table A16: Structure of Commodity Exports, 1986-2005

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
1. Agricultural exports										
Value (US$ mn.)	562.7	592.2	632.1	611.7	721.0	641.4	604.7	655.3	702.1	829.0
Growth	-19.7	5.2	6.7	-3.2	17.9	-11.0	-5.7	8.4	7.1	18.1
% of total exports	46.3	42.4	42.8	39.3	36.3	32.3	24.6	22.9	21.9	21.8
1.1 Plantation crops										
Value (US$ mn.)	481.3	509.6	531.3	518.7	617.7	538.5	468.1	514.9	546.8	660.9
Growth	-22.9	5.9	4.3	-2.4	19.1	-12.8	-13.1	10.0	6.2	20.9
% of total exports	39.6	36.5	36.0	33.3	31.1	27.1	19.0	18.0	17.0	17.4
1.1.1 Tea										
Value (US$ mn.)	330.3	361.8	386.7	379.1	494.8	431.9	339.8	412.7	424.2	481.0
Growth	-25.3	9.6	6.9	-2.0	30.5	-12.7	-21.3	21.4	2.8	13.3
% of total exports	27.2	25.9	26.2	24.3	24.9	21.7	13.8	14.4	13.2	12.6
1.1.2 Rubber										
Value (US$ mn.)	93.6	99.5	116.5	86.3	76.9	63.8	67.5	64.0	72.5	111.0
Growth	-0.9	6.3	17.1	-25.9	-10.9	-17.0	5.8	-5.3	13.3	53.8
% of total exports	7.7	7.1	7.9	5.5	3.9	3.2	2.7	2.2	2.3	2.9
1.1.3 Coconut kernel products										
Value (US$ mn.)	57.4	48.3	28.2	53.3	46.0	42.8	60.8	38.3	50.1	69.0
Growth	-34.5	-15.9	-41.7	89.2	-13.7	-7.0	42.2	-37.0	30.9	37.1
% of total exports	4.7	3.5	1.9	3.4	2.3	2.2	2.5	1.3	1.6	1.8
1.2. Minor agricultural crops										
Value (US$ mn.)	53.5	58.2	80.5	66.8	79.9	82.4	113.1	120.7	129.2	134.0
Growth	6.6	8.8	38.3	-17.0	19.5	3.2	37.3	6.7	7.0	3.5
% of total exports	4.4	4.2	5.5	4.3	4.0	4.1	4.6	4.2	4.0	3.5
2. Mineral exports										
Value (US$ mn.)	42.2	61.3	82.2	74.7	87.0	61.9	62.7	75.7	86.9	87.0
Growth	32.6	45.3	34.1	-9.1	16.4	-28.8	1.3	20.7	14.7	-0.1
% of total exports	3.5	4.4	5.6	4.8	4.4	3.1	2.5	2.6	2.7	2.3
3. Industrial exports										
Value (US$ mn.)	566.7	679.4	712.9	789.8	1,036.1	1,237.3	1,763.2	2,102.3	2,398.9	2,870.0
Growth	7.7	19.9	4.9	10.8	31.2	19.4	42.5	19.2	14.1	19.6
% of total exports	46.6	48.6	48.3	50.7	52.2	62.3	71.7	73.4	74.8	75.4
3.1 Textile & garments										
Value (US$ mn.)	343.7	438.0	448.3	489.1	628.1	803.9	1,214.0	1,412.4	1,551.9	1,853.0
Growth	17.3	27.4	2.4	9.1	28.4	28.0	51.0	16.3	9.9	19.4
% of total exports	28.3	31.4	30.4	31.4	31.7	40.5	49.3	49.3	48.4	48.7
3.2 Petroleum products										
Value (US$ mn.)	84.2	88.0	71.2	62.2	99.2	79.5	63.2	78.8	80.1	85.0
Growth	-41.0	4.6	-19.1	-12.7	59.5	-19.9	-20.5	24.6	1.7	5.9
% of total exports	6.9	6.3	4.8	4.0	5.0	4.0	2.6	2.8	2.5	2.2
4. Total commodity exports inc. petroleum										
Value (US$ mn.)	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	3,806.6
Growth	-8.8	14.9	5.6	5.6	27.3	0.2	23.8	16.4	12.0	18.6
5. Total commodity exports excl. petroleum										
Value (US$ mn.)	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	3,721.7
Growth	-4.9	15.6	7.3	6.6	26.0	1.2	25.7	16.2	12.3	19.0

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	1996	1997	1998	1999	2000	2001	2002	2003	2004(a)	2005(b)
1. Agricultural exports										
Value (US$ mn.)	961.0	1060.0	1088.0	947.0	1005.0	932.0	938.0	965.0	1065.2	1,153.8
Growth	16.1	10.3	2.6	-13.0	6.1	-7.3	0.6	2.9	10.4	8.3
% of total exports	23.5	22.9	22.9	20.6	18.2	19.3	20.0	18.8	18.5	18.2
1.1 Plantation crops										
Value (US$ mn.)	801.3	882.1	878.1	738.0	806.0	755.0	728.0	770.0	849.0	905.9
Growth	21.2	10.1	-0.4	4.6	9.2	-6.3	-3.6	5.8	10.3	6.7
% of total exports	19.5	19.0	18.5	16.0	14.6	15.7	15.5	15.0	14.7	14.3
1.1.1 Tea										
Value (US$ mn.)	615.0	719.0	780.0	621.0	700.0	690.0	660.0	683.0	739.0	810.2
Growth	28.2	17.0	8.5	-20.4	12.7	-1.4	-4.4	3.5	8.2	9.6
% of total exports	15.0	15.5	16.4	13.5	12.7	14.3	14.1	13.3	12.8	12.8
1.1.2 Rubber										
Value (US$ mn.)	104.0	79.0	44.0	33.0	29.0	24.0	27.0	39.0	51.0	46.9
Growth	-6.6	-24.4	-44.3	-25.0	-12.1	-17.2	12.5	44.4	30.8	-8.0
% of total exports	2.5	1.7	0.9	0.7	0.5	0.5	0.6	0.8	0.9	0.7
1.1.3 Coconut kernel products										
Value (US$ mn.)81.0	82.0	56.0	84.0	77.0	41.0	41.0		48.0	59.0	48.8
Growth	17.7	2.0	-31.8	50.0	-8.3	-46.8	0.0	17.0	22.9	-17.3
% of total exports2.0	1.8	1.2	1.8	1.4	0.9	0.9		0.9	1.0	0.8
1.2. Minor agricultural crops										
Value (US$ mn.)	132.0	145.0	170.0	165.0	155.0	136.0	168.0	150.0	162.0	183.4
Growth	-1.4	9.9	17.7	-2.9	-6.1	-12.3	23.5	-10.7	8.0	13.2
% of total exports	3.2	3.1	3.6	3.6	2.8	2.8	3.5	2.9	2.8	2.9
2. Mineral exports										
Value (US$ mn.)	96.0	90.0	60.0	64.0	97.0	86.0	90.0	84.0	120.0	143.3
Growth	10.3	-6.7	-33.1	6.7	51.6	-11.3	4.6	-6.6	42.9	19.4
% of total exports	2.3	1.9	1.3	1.4	1.8	1.8	1.9	1.6	2.0	2.3
3. Industrial exports										
Value (US$ mn.)	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	4,948.4
Growth	5.0	14.3	3.2	-1.8	20.6	-13.4	-2.1	9.5	13.3	9.8
% of total exports	73.4	74.1	74.9	77.0	77.6	77.0	77.3	77.5	78.3	78.0
3.1 Textile & garments										
Value (US$ mn.)	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	2,894.6
Growth	2.9	19.6	8.2	-1.4	23.0	-14.7	-4.7	6.2	9.1	3.0
% of total exports	46.4	49.0	52.0	52.7	54.0	52.8	51.6	50.2	48.8	45.6
3.2 Petroleum products										
Value (US$ mn.)	104.0	97.0	73.0	74.0	98.0	68.0	73.0	65.0	100.0	130.9
Growth	22.4	-6.3	-25.9	1.4	32.4	-30.6	7.3	-10.9	53.8	30.9
% of total exports	2.5	2.1	1.5	1.6	1.8	1.4	1.5	1.3	1.7	2.1
4. Total commodity exports inc. petroleum										
Value (US$ mn.)	4,199.0	4,736.0	4,871.0	4,684.0	5,620.0	4,885.0	4,772.0	5,198.0	5,856.7	6,477.6
Growth	10.3	12.8	2.9	-3.8	20.0	-13.1	-2.3	8.9	12.7	10.6
5. Total commodity exports excl. petroleum										
Value (US$ mn.)	3,991.0	4,542.0	4,725.0	4,536.0	5,424.0	4,749.0	4,626.0	5,068.0	5,657.6	6,215.8
Growth	7.2	13.8	4.0	-4.0	19.6	-12.4	-2.6	9.5	11.6	9.9

Note: (a): Revised.
(b): Provisional.

Sources: Central Bank of Sri Lanka, *Annual Report*, various issues; IPS database.

Table A17: Tourism, 1986-2005

	Unit	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
Tourist arrivals	No.	230,106	182,620	182,662	184,732	297,888	317,703	393,669	392,250	407,511	403,101
Excursionist arrivals	No.	6,266	2,417	6,108	4,064	3,954	2,665	5,651	6,093	8,413	10,556
Tourist nights	000	2,513	2,414	2,305	1,970	3,225	3,633	4,055	4,148	4,251	4,024
Earnings	Rs. mn.	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	11,551.6
	US$ mn.	82.1	82.0	76.6	76.0	132.0	156.8	201.4	208.0	230.7	225.4
Receipts per tourist per day	US$	32.7	34.0	33.3	38.6	41.1	42.8	49.7	50.1	54.2	56.1
Average duration	Nights	10.9	13.2	12.6	10.7	10.8	11.4	10.3	10.6	10.4	10.0
Accommodation											
Rooms	No.	9,794	9,921	9,977	9,459	9,556	9,679	10,214	10,365	10,742	11,255
Beds	No.	19,301	19,322	19,432	18,464	18,669	18,947	19,907	20,242	20,929	21,680
Occupancy rate, graded	%	32.9	31.5	32.1	31.0	47.2	48.4	55.3	57.0	56.6	52.6
Sri Lanka nationals											
Arrivals	No.	220,614	217,127	245,065	258,950	306,367	237,424	339,109	375,740	422,367	459,441
Departures	No.	229,386	257,760	298,583	285,510	296,884	310,373	420,749	416,246	448,437	504,420
Employment											
Direct	No.	22,285	20,338	19,960	21,958	24,964	26,878	28,790	30,710	33,956	35,068
Indirect	No.	31,199	28,473	27,944	30,741	34,950	37,629	40,306	42,994	47,538	49,095

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	Unit	1996	1997	1998	1999	2000	2001	2002	2003	2004(a)	2005(b)
Tourist arrivals	No.	302,265	366,165	381,063	436,440	400,414	336,794	393,174	500,642	566,202	549,308
Excursionist arrivals	No.	12,863	18,265	27,629	28,335	44,518	60,008	63,560	82,066	110,000	119,618
Tourist nights	000	2,947	3,680	3,944	4,479	4,056	3,435	3,989	5,093	5,742	4,754
Earnings	Rs. mn.	9,559.1	12,980.0	14,868.0	19,297.3	19,162.2	18,863.3	24,202.0	32,810.0	42,666.3	36,377
	US$ mn.	173.0	216.7	231.5	274.9	252.8	211.1	253.0	340.0	416.8	362
Receipts per tourist per day	US$	57.9	58.6	59.5	61.4	62.3	63.1	63.4	66.8	72.2	74.6
Average duration	Nights	9.8	10.1	10.4	10.3	10.1	9.9	10.1	10.2	10.1	8.7
Accommodation											
Rooms	No.	11,600	12,370	12,772	12,918	13,311	13,626	13,818	14,137	14,322	13,162
Beds	No.	22,040	22,944	23,373	24,216	24,953	25,595	25,956	26,511	26,854	24,740
Occupancy rate, graded	%	40.3	49.1	52.8	57.6	52.3	42.1	43.1	53.2	59.3	45.4
Sri Lanka nationals											
Arrivals	No.	488,055	482,850	481,793	521,073	514,448	487,356	493,947	560,602	646,990	683,169
Departures	No.	494,258	530,712	518,050	496,963	524,212	505,341	533,565	561,126	680,248	727,301
Employment											
Direct	No.	31,963	34,006	34,780	36,560	37,943	33,710	38,821	46,761	53,766	52,085
Indirect	No.	44,748	47,608	48,692	51,184	53,120	47,194	54,349	65,465	75,272	72,919

Notes: (a): Revised.
(b): Provisional.

Source: Ceylon Tourist Board, *Annual Statistical Report,* various issues.

Table A18: Monthly Tourist Arrivals, 1994-2005

	1994		1995		1996		1997		1998		1999	
	No.	Growth	No.	Growth	No.	Growth	No.	Growth	No.	Growth	No.	Growth
January	45,402	6.3	45,987	1.3	30,957	-32.7	32,652	5.5	37,224	14.0	44,379	19.2
February	41,067	2.4	42,591	3.7	29,550	-30.6	35,010	18.5	35,283	0.8	41,526	17.7
March	41,277	8.8	40,074	-2.9	26,442	-34.0	34,098	29.0	32,256	-5.4	41,022	27.2
April	28,080	-5.1	33,756	20.2	20,376	-39.6	26,907	32.1	25,578	-4.9	34,443	34.7
May	21,777	-2.6	24,672	13.3	17,655	-28.4	22,407	26.9	20,394	-9.0	25,212	23.6
June	21,399	4.8	22,416	4.8	19,668	-12.3	23,160	17.8	22,410	-3.2	26,184	16.8
July	35,370	7.5	35,994	1.8	25,380	-29.5	30,867	21.6	29,529	-4.3	33,288	12.7
August	32,817	0.1	35,814	9.1	24,765	-30.9	32,034	29.4	31,446	-1.8	39,081	24.3
September	31,062	13.0	30,828	-0.8	23,211	-24.7	29,793	28.4	31,653	6.2	33,915	7.1
October	33,216	8.5	30,603	-7.9	23,511	-23.2	28,314	20.4	31,767	12.2	35,112	10.5
November	33,306	-5.1	28,365	-14.8	24,921	-12.1	31,995	28.4	38,421	20.1	41,952	9.2
December	42,738	6.4	32,001	-25.1	35,829	12.0	38,928	8.6	45,102	15.9	40,326	-10.6
Total	407,511	3.9	403,101	-1.1	302,265	-25.0	366,165	21.1	381,063	4.1	436,440	14.5

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	2000		2001		2002		2003		2004		2005(a)	
	No.	Growth	No.	Growth	No.	Growth	No.	Growth	No.	Growth	No.	Growth
January	43,311	-2.4	44,187	2.1	28,296	-36.0	40,647	43.6	49,950	22.9	38,187	-23.5
February	43,287	4.2	46,575	7.6	31,683	-32.0	39,081	23.4	43,584	11.5	36,645	-15.9
March	40,110	-2.2	44,290	10.4	33,084	-25.3	40,818	23.4	38,418	-5.9	50,418	31.2
April	33,642	-2.3	36,906	9.7	27,057	-26.7	33,714	24.6	30,672	-9.0	42,261	37.8
May	23,404	-7.2	26,924	-15.0	26,661	-1.0	30,048	12.7	30,162	0.4	40,878	35.5
June	21,825	-16.6	28,323	29.8	26,355	-6.9	31,836	20.8	32,119	0.8	45,699	42.3
July	33,267	-0.1	28,566	-14.1	35,742	25.1	43,743	22.4	50,525	15.5	56,745	12.3
August	34,422	-11.9	15,717	-54.3	35,475	125.7	42,111	18.7	48,675	15.6	51,216	5.2
September	31,035	-8.5	11,758	-62.1	32,982	180.5	36,054	9.3	51,525	42.9	43,536	-15.5
October	26,658	-24.1	12,904	-51.6	36,258	181.0	49,922	37.7	59,442	19.1	44,095	-25.8
November	32,469	-22.6	17,344	-46.6	37,395	115.6	54,946	46.9	64,971	18.2	48,457	-25.4
December	36,984	-8.3	23,300	-36.9	42,183	81.0	57,722	36.8	66,159	14.6	51,171	-22.7
Total	400,414	-8.3	336,794	-15.9	393,171	16.7	500,642	27.3	566,202	13.1	549,308	-2.9

Note: Monthly growth figures reflect percentage changes compared to the same month in the previous year.
(a): Provisional.

Source: Ceylon Tourist Board, *Annual Statistical Report*, various issues.

Table A19: Tourist Arrivals by Country of Residence, 1994-2005

	1994		1995		1996		1997		1998		1999	
	No.	Growth	No.	Growth	No.	Growth	No.	Growth	No.	Growth	No.	Growth
North America	15,612	14.5	14,565	-6.7	12,462	-14.4	15,951	28.0	17,529	10	18,477	5
Canada	4,920	21.1	5,469	11.2	4,689	-14.3	6,477	38.1	7,542	16	7,905	5
U.S.A.	10,692	11.7	9,096	-14.9	7,773	-14.5	9,474	21.9	9,987	5	10,572	6
Western Europe	253,899	0.8	250,152	-1.5	167,343	-33.1	212,052	26.7	238,959	13	275,796	15
Germany	93,528	-2.0	79,698	-14.8	45,075	-43.4	59,814	32.7	74,058	24	77,259	4
United Kingdom	47,766	12.5	63,582	33.1	52,095	-18.1	62,997	20.9	66,432	5	80,919	22
France	30,522	-12.2	30,996	1.6	21,480	-30.7	25,392	18.2	26,874	6	34,458	28
Italy	18,069	-1.1	18,378	1.7	11,988	-34.8	14,424	20.3	15,867	10	19,815	25
Netherlands	12,219	-20.6	14,274	16.8	10,995	-23.0	15,957	45.1	22,977	44	29,670	29
Asia	116,352	9.1	118,323	1.7	102,558	-13.3	113,565	10.7	99,702	-12	114,375	15
Japan	19,497	-4.5	18,180	-6.8	11,724	-35.5	13,374	14.1	13,785	3	16,332	19
India	44,142	36.1	47,448	7.5	42,822	-9.7	47,010	9.8	37,356	-21	42,315	13
Pakistan	10,188	-17.6	11,325	11.2	11,748	3.7	11,439	-2.6	10,782	-6	11,421	6
Australasia	12,033	1.8	10,254	-14.8	8,763	-14.5	11,712	33.7	12,159	4	15,159	25
Australia	9,681	-5.5	9,066	-6.4	7,626	-15.9	10,392	36.3	10,329	-1	13,218	28
Other(a)	9,615	17.4	9,807	2.0	11,139	13.6	12,912	15.9	13,092	1	12,633	-4
Total	407,511	3.9	403,101	-1.1	302,265	-25.0	366,165	21.1	381,063	4	436,440	15

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	2000		2001		2002		2003		2004(b)		2005(c)	
	No.	Growth	No.	Growth	No.	Growth	No.	Growth	No.	Growth	No.	Growth
North America	17,319	-6	15,983	-8	19,866	24	25,110	26	29,759	19	46,457	56
Canada	7,503	-5	7,609	1	8,301	9	11,164	34	14,633	31	21,185	45
U.S.A.	9,816	-7	8,374	-15	11,565	38	13,946	21	15,126	8	25,272	67
Western Europe	260,824	-5	203,984	-22	200,295	-2	255,169	27	284,440	11	227,191	-20
Germany	70,584	-9	60,405	-14	55,170	-9	58,908	7	58,258	-1	46,350	-20
United Kingdom	84,693	5	67,830	-20	67,533	0	93,278	38	106,645	14	92,629	-13
France	25,992	-25	20,949	-19	19,984	-5	28,585	28	29,996	5	26,653	-11
Italy	16,833	-15	12,074	-28	12,177	1	15,654	29	18,862	20	10,192	-46
Netherlands	22,618	-24	12,569	-44	11,748	-7	18,197	55	21,455	18	15,156	-29
Asia	91,521	-20	89,732	-2	143,064	59	177,351	24	198,068	12	223,351	13
Japan	10,226	-37	9,237	-10	13,602	47	17,115	26	19,641	15	17,148	-13
India	31,860	-25	33,924	7	69,960	106	90,603	30	105,151	16	113,323	8
Pakistan	10,005	-12	8,562	-14	6,756	-21	9,704	44	9,638	-1	11,029	14
Australasia	18,228	20	13,105	-28	13,209	1	22,965	74	26,540	16	29,738	12
Australia	16,443	24	11,457	-30	11,217	-2	19,958	78	23,247	16	25,986	12
Other(a)	12,522	-1	13,990	12	16,737	20	20,047	20	27,395	37	22,571	-18
Total	400,414	-8	336,794	-16	393,171	17	500,642	27	566,202	13	549,308	-3

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, 1994-2005

	Unit	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005(a)
1. Trade balance	US$ Mn.	-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	-2,516.0
	% of GDP	-13.3	-11.5	-9.7	-8.1	-6.9	-8.7	-10.8	-7.4	-9.5	-9.5	-12.6	-12.1
2. Services balance	US$ Mn.	179.8	152.1	105.0	159.1	145.0	147.0	38.0	175.0	295.0	399.0	419.0	338.0
	% of GDP	1.5	1.2	0.8	1.1	0.9	0.9	0.2	1.3	2.0	2.4	2.4	1.6
3. Income, net	US$ Mn.	-162.0	-170.0	-197.0	-160.0	-180.0	-254.0	-305.0	-267.0	-253.0	-172.0	-204.0	-299.0
	% of GDP	-1.4	-1.1	-1.5	-1.1	-1.1	-1.6	-1.8	-1.9	-1.7	-1.2	-1.1	-1.4
4. Net private transfers	US$ Mn.	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	1,736.0
	% of GDP	5.3	5.2	5.1	5.2	5.4	5.6	5.9	7.0	7.5	7.4	7.6	8.3
5. Net official transfers	US$ Mn.	58.5	60.8	49.0	44.5	52.0	26.0	24.0	22.0	31.0	36.0	30.0	93.0
	% of GDP	0.5	0.5	0.4	0.3	0.3	0.2	0.1	0.2	0.2	0.2	0.2	0.4
6. Current account balance	US$ Mn.	-867.1	-753.9	-677.0	-393.0	-226.0	-563.0	-1,066.0	-244.0	-237.0	-71.0	-648.0	-650.0
	% of GDP	-7.4	-5.8	-4.9	-2.6	-1.4	-3.6	-6.4	-1.7	-1.6	-0.6	-3.6	-3.1
7. Capital and financial a/c	US$ Mn.	1,077.1	699.0	459.0	602.0	413.0	373.0	443.0	562.0	444.0	722.0	631.0	1,224.0
	% of GDP	9.2	5.7	4.2	4.2	2.6	2.4	2.7	4.0	3.0	4.3	3.5	5.9
Capital account	US$ Mn.	113.1	117.2	95.6	87.1	80.0	80.0	50.0	198.0	65.0	74.0	64.0	250.0
Financial account	US$ Mn.	964.0	581.0	363.0	515.0	334.0	293.0	393.0	364.0	379.0	648.0	567.0	974.0
8. Long-term	US$ Mn.	745.5	502.0	381.0	716.0	398.0	435.0	304.0	164.0	326.0	722.0	680.0	798.0
Foreign direct investment	US$ Mn.	158.2	19.7	86.0	128.6	137.0	177.0	176.0	172.0	185.0	171.0	217.0	234.0
Private long-term (net)	US$ Mn.	316.3	91.0	2.0	47.0	2.0	196.0	82.0	-257.0	-21.0	-33.0	14.0	11.0
Government long-term	US$ Mn.	271.1	358.0	259.0	239.0	203.0	62.0	47.0	249.0	162.0	554.0	439.0	553.0
9. Short-term	US$ Mn.	218.5	79.0	-18.0	-201.0	-64.0	-142.0	88.0	201.0	53.0	-75.0	-112.0	176.0
Foreign portfolio investment	US$ Mn.	27.0	-1.7	6.4	13.0	-24.0	-13.0	-45.0	-11.0	25.0	2.0	11.0	60.0
10 Other (b)	US$ Mn.	67.2	157.4	98.1	27.3	-116.1	-101.0	174.0	71.0	-145.0	-2.0	202.0	323.0
11. Overall balance	US$ Mn.	240.0	52.0	-68.0	163.0	37.0	-263.0	-522.0	220.0	338.0	502.0	-205.0	501.0
	% of GDP	2.0	0.4	-0.5	1.8	1.4	-1.7	-3.1	1.6	2.3	3.1	-1.15	2.4

Notes: (b): Valuation adjustments, errors, and omissions.
(a): Provisional.

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

Table A21: Exchange Rates Behaviour, 1993-2005
(End of period values)

Currency	Unit	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Nominal exchange rates														
U.S.A.	S.L. Rs. per US$	49.56	49.98	54.05	56.71	61.29	67.78	72.12	80.06	93.16	96.72	96.74	104.60	102.12
Japan	S.L. Rs. per Yen	0.44	0.50	0.53	0.49	0.47	0.59	0.71	0.70	0.71	0.82	0.90	1.02	0.87
U. K.	S.L. Rs. per Pound	73.50	78.05	84.25	95.86	101.60	112.62	116.72	119.37	135.06	155.12	172.19	201.37	175.94
European Union	S.L. Rs. per Euro	28.74	32.16	37.76	36.46	34.24	40.36	37.09	38.00	42.07	51.84	121.60	142.32	120.96
India	S.L. Rs. per Ind. Rs.	1.58	1.59	1.54	1.58	1.56	1.59	1.66	1.71	1.93	2.02	2.12	2.40	2.27
Real exchange rates														
U.S.A.	Index, 1990=100	90.19	84.96	88.38	81.82	80.71	79.54	81.56	90.24	98.32	86.10	94.50	100.88	94.69
Japan	Index, 1990=100	102.00	104.31	100.93	79.65	70.58	79.72	89.42	82.47	73.72	88.50	91.77	97.86	76.03
U. K.	Index, 1990=100	77.20	77.45	80.79	81.35	79.39	80.92	81.04	79.98	79.49	80.40	109.87	122.28	98.43
European Union	Index, 1990=100	81.61	84.73	94.00	77.34	67.92	71.95	62.52	62.35	62.28	61.40	127.52	141.61	112.21
India	Index, 1990=100	69.03	71.10	70.01	64.70	60.92	59.77	61.87	63.95	66.28	65.90	106.23	118.68	105.74

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, 2001-2005

	2001	2002	2003	2004	2005(a)
1. Equity market:					
Market capitalization	124,000	162,600	262,800	382,100	584,000
of which central depository	63,166	85,943	136,059	195,032	259,780
2. Debt market:	744,578	943,286	1,035,394	1,165,491	1,266,802*
(i) Private	36,237	43,110	45,751	48,000	29,060*
(ii) Public	708,341	900,176	989,643	1,117,491	1,237,742
(a) Short-term(TBs)	171,000	210,995	219,295	243,886	234,174
(b) Medium & long-term	537,341	689,181	770,384	873,605	1,003,568
3. Total debt and equity (Rs. Mn)	868,578	1,105,886	1,298,194	1,547,591	1,850,802*
as a percentage of GDP(%)	62.03	78.80	83.07	86.07	88.20
of which actually traded through the central depository	69,341	92,118	147,159	209,532	270,680
as a share of Total (%)	8.1	8.3	11.7	13.5	14.6
4. Foreign participation in the central depository as a per cent of market capitalization (%)	21	12	14	14	14

Note: (a): Provisional.
* Debentures listed is no longer available.(Source: CSE Fact Book 2005).

Sources: Colombo Stock Exchange, *Annual Report*; Central Bank of Sri Lanka, *Annual Report*, various issues.

Table B2: Recent Developments in the Share Market, 1997-2005

		1997	1998	1999	2000	2001	2002	2003	2004	2005
1. Number of companies listed		239	240	237	239	238	238	244	242	239
New listings		6	6	4	5	2	9	8	5	6
De-listings		2	5	7	3	3	9	2	7	9
2. Number of companies traded		224	224	226	228	225	231	236	241	242
3. Market capitalization	Rs. bn.	129.4	117	112.8	89	124	162	263	382	584
	US$ bn.	2.1	1.7	1.6	1.2	1.4	1.7	2.7	3.8	5.8
4. Price -earnings ratio times, year end		12.5	9.0	6.6	5.2	7.5	12.1	11.1	10.8	12.4
5. Number of shares traded (mn.)		515	634	486	449	747	1,220	2,255	2,752	5,128
Domestic (mn.)		337	425	357	350	607	1,035	1,932	2,479	4,313
Foreign (mn.)		178	208	129	99	140	185	323	273	815
6. Trades	('000)	206.3	329.0	205.7	160.0	159.7	283.2	481.3	645.1	1100.4
Domestic	('000)	189.8	312.0	193.6	150.0	152.8	273.2	460.9	611.6	1038.5
Foreign	('000)	16.5	17.0	12.1	10.0	6.8	10.0	22.8	33.4	61.9
7. Turnover:	Rs.bn.	18.3	18.2	14.8	11	14.1	30.5	73.8	59.0	114.6
	US$ bn.	0.3	0.3	0.2	0.1	0.2	0.3	0.7	0.6	1.1
Domestic	Rs. bn.	10.5	11.8	9.3	7.9	11.4	24.3	59.9	47.9	89.9
Foreign	Rs. bn.	7.8	6.4	5.5	3.1	2.6	6.2	13.8	11.1	24.6
8. Liquidity- turnover / market										
Capitalization ratio (%)		14.1	15.5	13.1	12.4	11.3	18.7	28.1	15.4	19.6
9. No. of new issues		5	6	4	4	_	5	4	_	_
10. Total no. of shares issued mn.		50	24	29.2	80	_	244	_	_	_
11. Value of shares issued Rs. bn.		0.5	0.3	0.4	0.1	_	3.6	_	_	_
12. Central depository:										
Domestic	(Rs. bn.)	32.1	29.8	33.9	30.9	50.9	66.5	98.2	140.4	179.8
Foreign	(Rs. bn.)	25.2	18.6	17.2	9.5	12.2	19.5	37.8	54.6	79.9
Total	(Rs. bn.)	57.4	48.4	51.1	40.4	63.1	86.0	136.0	195.0	259.8
Percentage of market cap. (%)		44	41	45	45	51	53	52	51	44
13. Non-national activity										
Net purchases	(Rs. mn.)	716.0	-1,560.0	-950.8	-3,364.6	-1,024.8	2,441.5	209.3	1,105.0	6,144.5
Purchases	(Rs. mn.)	8,218.0	5,645.0	5,050.1	1,445.0	2,111.9	7,477.7	13,943.9	11,278.0	27,712.4
Sales	(Rs. mn.)	7,502.0	7,205.0	6,000.9	4,809.9	3,136.7	5,036.2	13,734.6	10,172.0	21,567.9
14. Price indices										
All Share	1985 = 100	702.2	597.3	572.5	447.6	621.0	815.1	1,062.0	1,506.9	1,922.2
Growth	% change	16.5	-14.9	-4.2	-21.8	38.7	31.2	30.2	41.9	27.6
Sensitive	1985 = 100	1,068.0	923.0	937.5	698.5	1,031.0	1,374.6	1,898.0	2,073.7	2,451.1
Growth	% change	19.0	-13.6	-6.2	-25.4	47.6	33.3	38.1	9.3	18.2

Note: 1000 Million = 1 Billion.

Source: Colombo Stock Exchange, *Annual Report,* various issues.

Table B3: Market Concentration
(% of total market capitalization)

	2005(%)
Dialog	20.92
JKH	8.84
SLT	5.10
Commercial Bank	3.08
Lanka IOC	3.01
Carsons	2.31
DFCC	2.17
National Development Bank	2.01
Ceylon Tobacco	1.85
Hatton National Bank	1.82
Total	51.11

Note: As at year 2005 the top ten of the 2234 listed company accounts for 51% of total market capitalization.

Source: Colombo Stock Exchange , *Annual Report*, various issues.

Table B4: New Equity Listings - 2004 & 2005

Company	No. of shares offered	Issue price Rs.	No. of shares subscribed by public	No. of shares devolved to underwriters	Date listed
1. New listings-2004					
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
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				

2. **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
Hotels & travels	9	41,509,831	566,488,000
Investment trusts	4	7,714,730	389,298,340
Manufacturing	1	26,240,529	65,601,323
Total	25	176,619,824	5,321,369,818

3. **New listing-2005**	**No. of shares offered**	**Issue price Rs.**	**No. of shares subscribed by public**	**No. of shares devolved to underwriters**	**Date listed**
Gestetner of Ceylon Ltd.	1,012,500	20.00	1,012,500	–	11-Feb-05
The Fortress Resorts Ltd.	20,737,250	10.00	20,737,250	–	29-Mar-05
Hotel Reefcomber Ltd.	3,932,663	10.00	3,932,663	–	22-Mar-05
Lankem Developments Ltd.	1,800,000	15.00	1,800,000	–	21-Mar-05
Laxapana Battries Ltd.	5,700,000	10.00	3,300,000	–	4-Apr-05
The Ceylon Guardian Investment Trust Ltd.	3,550,896	80.00	3,550,896	–	5-Apr-05
The Ceylon Investment Company Ltd.	4,527,338	50.00	4,527,338	–	5-Apr-05
Tess Agro Ltd.	53,200,000	1.50	30,636,364	–	10-Jun-05
Seylan Merchant Bank Ltd.	11,125,780	11.00	11,125,780	–	22-Jun-05
Nawaloka Hospitals Ltd.	120,000,000	4.00	104,752,798	–	14-Jul-05
Muller & Phipps (Ceylon) Ltd.	54,000,000	2.00	48,000,000	–	15-Jul-05
E-Channeling Ltd.	6,978,938	10.00	6,978,938	–	21-Sep-05

Contd...../-

	No. of shares offered	Issue price Rs.	No. of shares subscribed by public	No. of shares devolved to underwriters	Date listed
Kelsey Development Ltd.	2,582,115	25.00	2,582,115	–	3-Oct-05
Merchant Bank of Sri Lanka	30,000,000	15.00	30,000,000	–	18-Oct-05
Pegasus Hotels of Ceylon Ltd.	15,670,637	18.00	15,670,637	–	6-Dec-05
Equity One Ltd.	34,118,387	30.00	34,118,387	–	9-Nov-05
Equity Two Ltd.	24,800,000	14.00	24,800,000	–	9-Nov-05
Samson International Limited	549,711	46.00	549,711	–	21-Nov-05
Value (Rs)	3,783,189,065				
Issues (No.)	18				

4. Right issues - 2005 By Sector	No.of issues	No. of shares	Value(Rs.)
Banks, finance & insurance	2	41,125,780	572,383,580
Chemicals & pharmaceuticals	1	3,300,000	33,000,000
Construction & engineering	1	1,800,000	27,000,000
Healthcare	1	104,752,798	419,011,192
Hotels & travels	3	40,340,550	528,770,596
Investment trusts	2	8,078,234	510,438,580
Information technology	1	6,978,938	69,789,380
Land & property	3	61,500,502	1,435,304,485
Manufacturing	1	549,711	25,286,706
Stores & supplies	2	49,012,500	116,250,000
Trading	1	30,636,364	45,954,546
Total	18	348,075,377	3,783,189,065

Source: Colombo Stock Exchange, *Annual Report,* various issues.

Table B5: Sri Lanka Structure of Debt Market, 2001-2005

(Rs.bn)	2001	2002	2003	2004	2005(a)
1. Private Debt:					
(a) Commercial paper(year end)	6.18	5.60	11.10	14.50	10.90
(b) Certificates of deposit	22.85	28.71	24.98	21.03	18.16
(I) Commercial banks	21.65	27.21	23.64	19.79	17.06
(ii) Finance companies	1.20	1.50	1.34	1.23	1.10
(c) Debentures (listed)	7.32	10.30	9.67	12.47	**
Total private debt	36.35	44.61	45.75	48.00	29.06*
2. Public debt:					
(a) Short terms					
(i) Treasury bills	170.99	210.99	219.29	243.88	234.17
(ii) Central Bank securities	–	–	–	–	–
(b) Medium & long term					
(i) Treasury bonds	229.17	347.13	483.11	643.35	751.57
(ii) Rupee securities	292.81	287.70	248.41	164.76	140.56
(iii) Certificates of deposit	–	–	–	–	–
Total public debt	692.97	845.82	955.20	1052.00	1126.30
3. Total debt	729.32	890.43	1000.95	1100.00	1155.36*

Note: (a): Provisional.
** All corporate denbentures listed on the Colombo Stock Exchange were transferred to the DEX with effect from August 2005.
* Therefore, debentures listed is no longer available.(Source: CSE Fact Book 2005).

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

Table B6: Listed Debentures, 2003-2005

Issuer	Issued (No.)	Par value (Issue price Rs.)	Interest (p.a.)	No.of debt subscribed	Date listed
1. 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				
2. 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
3. Listings 2005					
Seylan Merchant Leasing Ltd.		100	10.25%	63,000	18.07.05
Seylan Merchant Leasing Ltd.	1,000,000	100	11.00%	399,050	18.07.05
Seylan Merchant Leasing Ltd.		100	11.50%	111,850	18.07.05
Seylan Merchant Leasing Ltd.		100	12.00%	90,000	18.07.05
Seylan Merchant Leasing Ltd.		100	11.75%	23,000	18.07.05
Seylan Merchant Leasing Ltd.		100	12.50%	313,100	18.07.05
Senkadagala Finance Company Ltd.	2,500,000	100	14.00%	2,242,200	10.10.05
Senkadagala Finance Company Ltd.		100	Floating	257,800	10.10.05

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
2006	Agriculture Reforms: Irrigation Water Charges and Land Policy