SRI LANKA

State of the Economy

2009



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

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Institute of Policy Studies, Sri Lanka

ISBN 978-955-8708-59-0

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

Sri Lanka State of the Economy -- 2009 / Colombo : Institute of Policy Studies of Sri Lanka, 2009 . --- 238 ; 21cm

ISBN 978-955-8708-59-0 Price Rs.

i. 330.95493 DDC 21 ii. Title
1. Economics - Sri Lanka

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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. The Global Economic Crisis: Issues, Impacts and Outlook

2.1 Overview

The year 2009 is projected to see the first global economic contraction since the Second World War. The financial crisis that plagued markets in developed economies through most of 2007 and 2008 cascaded into a full blown global economic crisis in the fourth quarter of 2008. The crisis initially affected major financial institutions in the US and the EU before spreading to the real sector, with construction and the automobile industries being the first to be directly affected. As access to credit was squeezed, consumption declined, reducing demand for imports. The constrained demand for exports and the decline, or indeed reversal, in financial flows in developing markets resulted in the crisis spreading beyond the US and EU to economies where financial markets were largely unexposed to toxic financial instruments.

The impacts of the global economic crisis began to be felt in Sri Lanka in the fourth quarter of 2008. But there remains uncertainty regarding the depth and duration of the global crisis, and thus the eventual true impact on the Sri Lankan economy. The situation is also made particularly complex given the merger of external and internal crises in the Sri Lankan economy. This Chapter will explore the evolution of the global economic crisis, the impacts that have been visible in Sri Lanka, the remedial measures that have been undertaken by the government of Sri Lanka and, finally, the steps that need to be taken to address concerns in the short term and long term in order to overcome the adverse conditions the economy is facing.

2.2 Evolution of the Crisis

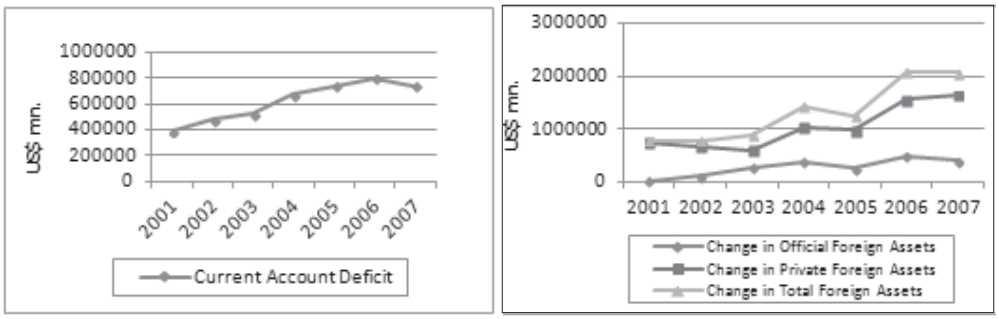
The global economy had grown at above trend rates for five years before the first signs of stress in financial markets began to appear in mid-2007. Several factors combined to contribute to this boom period, and the unwinding of many of these factors resulted in the severe downturn that took hold in September 2008.

i) Global imbalances: A fundamental problem in the global economy that has been visible since the 1990s, and became pronounced at the turn of the century, was the persistence of large current account deficits in the US and equally large current account surpluses in East Asia, and more recently in the Middle East. In the aftermath of the Asian financial crisis of 1997/98, many East Asian economies built up large foreign asset reserves and domestic savings as a buffer against future crises. At the same time, consumption of imports by the US in particular was increasing, resulting in a large and increasing flow of goods from Asia to the US. The result was a widening current account deficit in the US economy which was financed by increasing flows of capital from Asian and Middle Eastern economies to the US. Between 2000 and 2007, US$ 5.7 trillion worth of capital flowed into the US economy, equivalent to 40 per cent of US gross domestic product (GDP) in 2007.[1]

   The constant flow of funds into the US economy resulted in high levels of

[1] US Bureau of Economic Analysis.

Figure 2.1
US External Sector Imbalances (2001-07)



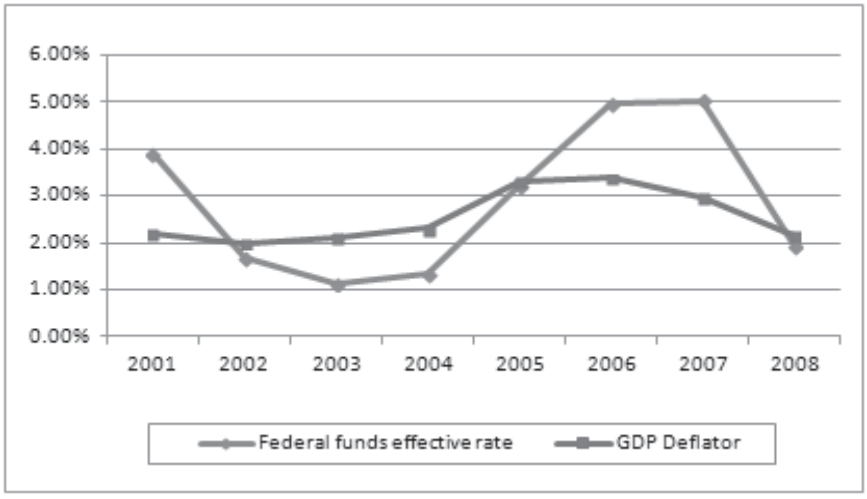
Source: US Bureau of Economic Analysis data.

liquidity, contributing to an abundance of cheap credit that could be invested in various assets. A similar situation was experienced in the UK, Spain, Ireland and some Eastern European countries. The large consumption of foreign imports by the US economy contributed to growth across the global economy.

ii) Loose monetary policy in the US: When the dot.com bubble burst in 2000, the US Federal Reserve reduced interest rates to stimulate economic activity. As is evident from Figure 2.2, between 2002 and 2005, monetary policy was very lax with interest rates being negative or zero. The result of such a monetary policy stance was increased access to cheap credit and substantial incentives for borrowing in the US market. The US economy grew strongly in this period as credit based consumption and investment increased rapidly.

iii) Deregulation and financial innovation: The rapid increase in credit availability at a low price and financial deregulation encouraged financial institutions to create innovative financial products which enabled increased lending to

Figure 2.2
Loose Monetary Policy in the US



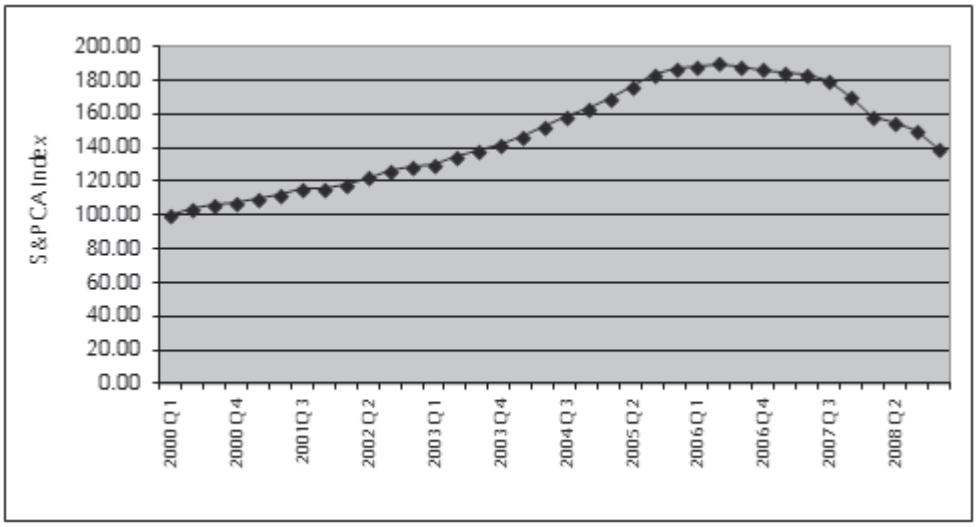
Source: Federal Reserve and US Bureau of Economic Analysis data.

borrowers with limited credit worthiness, particularly in the housing market. Collateralized Debt Obligations (CDOs), for instance, were often sub-prime asset backed securities which were sold to (mainly) investment banks, which then sliced up these assets and re-packaged them into AAA rated investment products which were then sold off to investors across the globe. The initial mortgage seller faced none of the risk and had every incentive to make as many loans as possible, and then sell the resulting assets to investment banks which in turn pass on the risk to an investor at a fee. This detachment between borrower and lender resulted in a substantial under-pricing of risk, and an increasing volume of lending to sub-prime borrowers. The mispricing of risk was exacerbated by the very stable macroeconomic conditions that prevailed until 2007, and the abundance of cheap credit available in the market. Furthermore, the deregulation of financial markets enabled many such investment products to be kept off the balance sheets of the financial institutions that dealt in them.

The confluence of the three major factors mentioned above resulted in massive credit creation in the US, much of which was invested in the housing market, and to a lesser extent in equity markets. House prices in the US increased rapidly between 2002 and 2007, and the resulting positive wealth effects further boosted economic activity.

It was in this context that the downturn began in mid-2007. As inflation pressures gathered pace around 2005, the US Federal Reserve eventually increased interest rates and began to tighten monetary policy. As interest rates increased, it became increasingly difficult for sub-prime borrowers to repay adjustable rate mortgages, and housing defaults began to emerge, forcing a rise in financial market write-downs. Pressure on the US financial sector continued through the second half of 2007 and into the first half of 2008, with institutions such as Bear Stearns, Freddie Mac and Fannie Mae being either

Figure 2.3
US Housing Values (2000-08)



Source: Standards and Poors' data.

taken over by the US government or by other banks. However, on 15th September 2008, the credit squeeze became an economic crisis as Lehman Brother's announced bankruptcy and two days later the US government took a 79.9 per cent stake in the insurance giant AIG. The stability of even the strongest financial institutions came into question as there was a great deal of uncertainty regarding the extent of exposure to toxic assets, particularly CDOs and Credit Default Swaps (CDS) which were not reflected in standard balance sheets. Long standing financial institutions such as Washington Mutual and Wachovia became victims of the crisis. As liquidity declined sharply, the credit driven asset bubble in the US (both housing and equity markets) crashed, driven by increasing defaults in the sub-prime mortgage markets and the flight of capital from equity markets to the relative safety of government assets. The write-downs also spread to European financial institutions which had invested in what became toxic assets. HBOS (the British Building Society) and Fortis (the Benelux bank), were taken over by British bank Lloyds TSB and French bank BNP Parisbas, respectively, and Iceland's three largest banks were nationalized. Investors sought safety, and avoided the slightest perceived risk resulting in the freezing of interbank lending as financial institutions prioritized the consolidation of their own balance sheets over lending between one another.

2.3 Spread to the Real Sector and Emerging Economies

The spread of the emerging crisis to the real sector was heightened in the fourth quarter of 2008 as reduced credit availability resulted in a slowdown in consumption and investment as the ability to borrow declined. Consumption was further dented by falling asset prices through the wealth effect and reduced ability to finance borrowing. As consumption and demand declined, firms cut back on production and investment, resulting in large scale lay-offs and unemployment, further hurting consumption. As a result, US real GDP contracted in the fourth quarter of 2008, with similar results in the EU and Japan as well.

Prior to September 2008, developing countries were largely insulated from the financial turmoil since the kind of sophisticated financial instruments that were affected by the crisis were prevalent primarily in the financial markets of America and Europe. In fact, there was optimism that the domestic consumption of emerging economies such as India, China and Brazil was sufficiently strong for these and other developing economies to have 'de-coupled' from the fortunes of developed markets. However, as the crisis began to spread to the real sector, the chances of developing nations remaining immune diminished sharply. Global trade was adversely affected, as were capital flows between the developed and developing economies. Export oriented countries such as Singapore (3.7 per cent fourth quarter GDP contraction in 2008), South Korea (5.6 per cent fourth quarter contraction from the third quarter 2008), Japan (4.3 per cent contraction in GDP in the fourth quarter, 2008), and ASEAN-5 (2.1 per cent growth in the fourth quarter of 2008) suffered substantial GDP losses due largely to a contraction in export demand.[2]

Developing economies that are reliant on commodity exports have also faced a downturn due to the crash in commodity prices - the Middle East is projected to grow at a substantially slower pace, while Russia is expected to contract by 6.5 per cent in 2009 according to the International Monetary Fund

[2] IMF, *World Economic Outlook*, July 2009 (updates on April Issue).

(IMF) projections (see Table 2.1). Other emerging economies which are heavily reliant on external financing have also suffered due to the freezing up of credit flows. Central and Eastern Europe, for instance, which grew at a respectable 5.4 per cent in 2007, slowed down to 3 per cent in 2008 and is expected to contract by 5 per cent in 2009 according to the IMF.[3] Emerging economies with larger domestic markets are expected to have some degree of cushion to mitigate external demand shortfalls. China and India, for instance, will continue to grow, but at a moderated pace in 2009. Furthermore, economies that entered the crisis with substantial external reserves and strong budgetary and balance of payments (BOP) positions are likely to have more space for supporting their respective economies by stimulating demand.

2.4 Current Global Economic Climate

Given the tumultuous end to 2008, it was clear that 2009 was going to be a very tough year for the global economy. World output is projected to contract by 1.4 per cent in 2009, although a slow recovery is expected from 2010, backed by government monetary and fiscal stimulus measures (see Table 2.1).

Advanced economies are experiencing the deepest recession since World War II with a slowdown of 7.5 per cent in the last quarter of 2008, and GDP expected to contract by 3.8 per cent in 2009. The US - at the centre of the crisis - is expected to contract by 2.6 per cent in 2009, with financial strains and the collapse of the housing market choking the economy. It is, nevertheless, expected to recover from mid-2010 with the support of a fiscal stimulus amounting to 2 per cent of

Table 2.1
Projected World Output (2009-10)

			Projections	
	2007	**2008**	**2009**	**2010**
World Output	**5.1**	**3.1**	**-1.4**	**2.5**
Advanced Economies	**2.7**	**0.8**	**-3.8**	**0.6**
US	2.0	1.1	-2.6	0.8
UK	2.6	0.7	-4.2	0.2
Euro Area	2.7	0.8	-4.8	-0.3
Japan	2.3	-0.7	-6.0	1.7
Canada	2.5	0.4	-2.3	1.6
Emerging & Developing Economies	**8.3**	**6.0**	**1.5**	**4.7**
India	9.4	7.3	5.4	6.5
China	13.0	9.0	7.5	8.5
Russia	8.1	5.6	-6.5	1.5
Brazil	5.7	5.1	-1.3	2.5
Middle East	6.3	5.2	2.0	3.7
ASEAN-5	6.3	4.8	-0.3	3.7
Africa	6.2	5.2	1.8	4.1

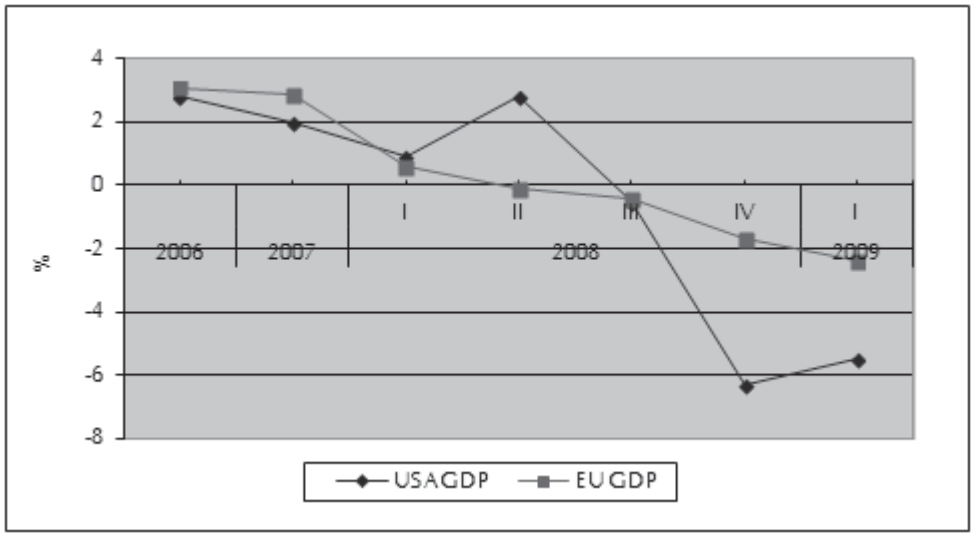
Source: IMF, *World Economic Outlook*, July 2009.

[3] *Ibid.*

its GDP and other counteractive measures to boost economic activity.[4] Western Europe - like advanced Asian countries - has been affected mainly through the trade channel. The UK and the EU, suffering from lower trade and financial constraints are expected to contract by 4.2 per cent and 4.8 per cent, respectively, in 2009, with the EU expected to record a negative growth rate in 2010 as well. As evident from Figure 2.4, the output of the US and the EU has contracted sharply from the third quarter of 2008. East Asian countries such as Japan, which are highly dependent on manufacturing exports, have also been significantly affected. Japan has experienced a 49.4 per cent decline in its exports compared to the previous year, with its exports to the US shrinking by 58 per cent and to the EU by 55 per cent.[5]

Likewise, growth in emerging and developing countries is expected to decline to 1.5 per cent in 2009 (a sharp fall from the 8.3 per cent growth rate in 2007) after suffering a contraction of 4 per cent in the last quarter of 2008. The World Bank estimates that developing economies would be the hardest hit with severe long-term implications: 94 out of 116 developing countries have experienced a slowdown in economic growth.[6] Lower export demand, lower commodity prices and lower capital inflows are expected to drag down the growth rates of economic giants like India and China, although their growth rates are expected to remain positive, buoyed by domestic demand and more importantly government stimulus measures. Whilst China is projected to grow by 7.5 per cent, India is expected to grow by just 5.4 per cent (Table 2.1). It is encouraging to note that China's economic performance remains positive (GDP growth in the second quarter of 2009 was 7.9 per cent) despite a prolonged decline in exports. China's exports have

Figure 2.4
GDP Growth in the US and the EU



Note: Percentage change from previous quarter.

Source: EuroStat and US Bureau of Economic Analysis data.

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[4] IMF (2009), Update on Fiscal Stimulus and Financial Sector Measures, (April 26, 2009).

[5] IMF, *World Economic Outlook*, April 2009.

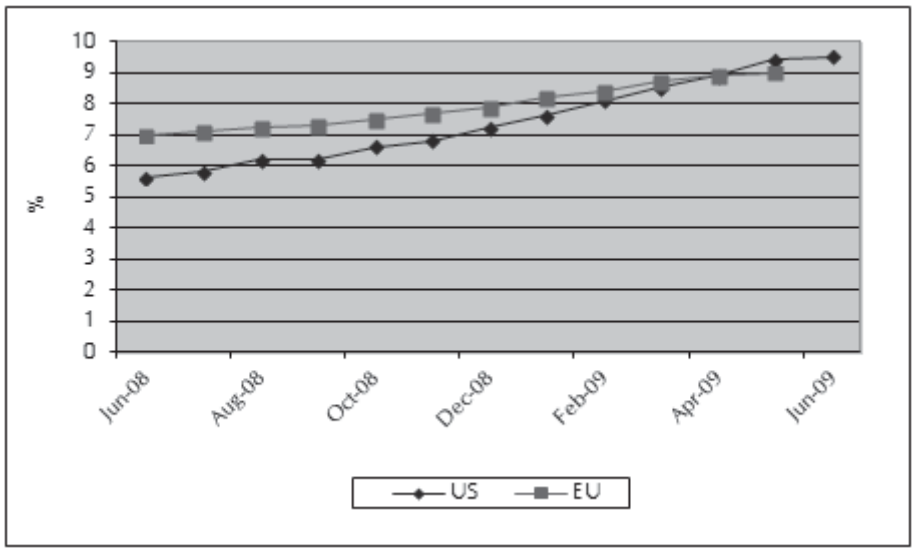
[6] World Bank (2009), "Swimming Against the Tide: How Developing Countries are Coping with the Global Crisis", Background Paper prepared by World Bank Staff for the G20 Finance Ministers and Central Banks. Governors Meeting, Horsham, UK, March 13-14, 2009.

declined for eight successive months with exports down by 19.7 per cent in the first quarter of 2009,[7] and falling by 21.4 per cent in June 2009. Whilst export declines are unlikely to end soon, there has been some moderation in the rate of contraction of exports. The Middle East - which is important to Sri Lanka in terms of worker remittances - is expected to record a slower but positive output growth with the support of their large financial reserves cushioning the extreme impacts of sharply declining oil revenues and the construction sector. Growth in the region in 2009 is expected to reduce to 2 per cent compared to growth of 6.3 per cent and 5.2 per cent in 2007 and 2008, respectively.

The slowdown of the global economy is clearly reflected in global economic activity indicators such as unemployment and consumption levels. The IMF expects global unemployment levels to increase by about 2.5 percentage points which is expected to be larger than in previous recessions.[8] Consumption is also expected to contract by 1.1 per cent, a rate higher than in any previous recession. Given the importance of the US and the EU in terms of Sri Lanka's export destinations, consumption and unemployment provide an indicator of short to medium term prospects for Sri Lankan exports.

Labour markets in the US and the EU have been weakening rapidly as seen from Figure 2.5. Since December 2007, the number of unemployed persons has increased by 7.2 million, with 3.3 million job cuts taking place between November 2008 and April 2009 across many industries in the US. As a result, the total number of unemployed has increased to 14.7 million as of June 2009 with the unemployment rate reaching 9.5 per cent. The situation is similar in the EU with the total

Figure 2.5
Unemployment Rates in the US and the EU

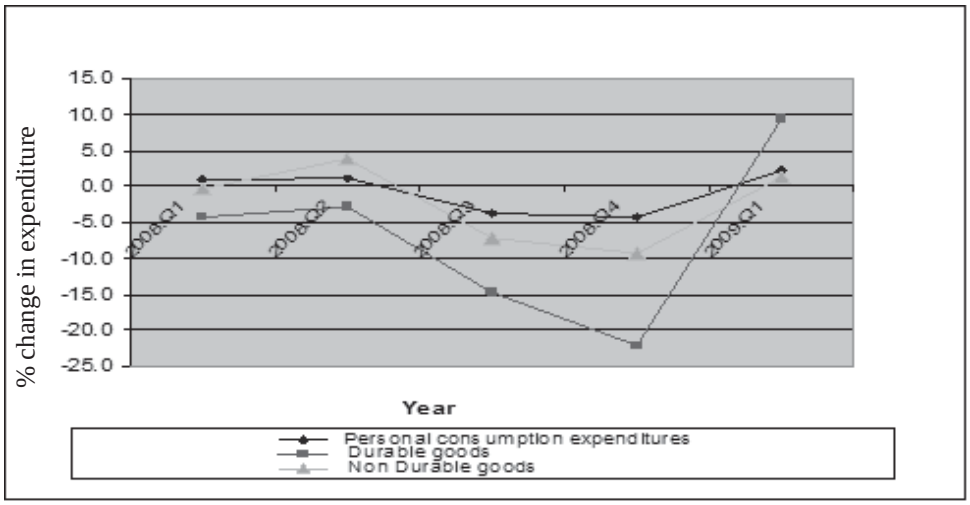


Source: US Bureau of Labour Statistics, and Eurostat data.

[7] National Bureau of Statistics of China.

[8] IMF, *World Economic Outlook*, April 2009.

Figure 2.6
Changing Patterns of Consumption in the US



Note: Percentage change from previous quarter.

Source: US Bureau of Economic Analysis data.

number of unemployed in the region increasing to 21.4 million, with a current unemployment rate of 9 per cent.

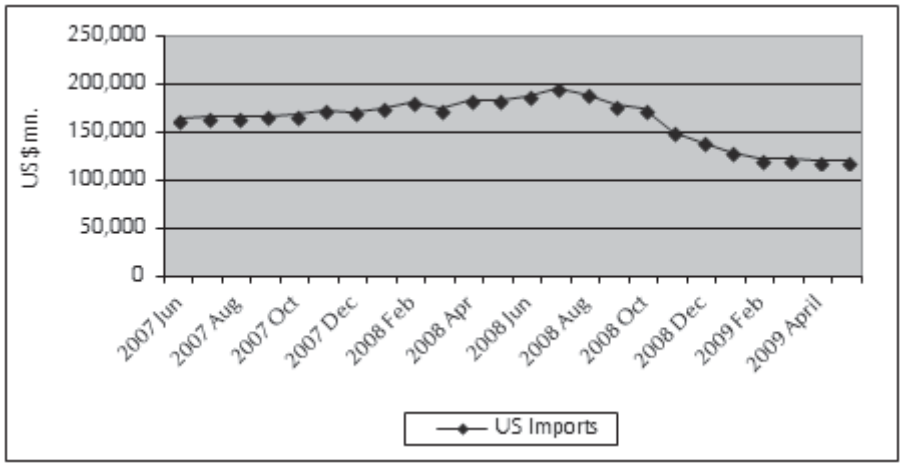
Constrained credit markets and growing unemployment levels have reduced personal income in important export markets for Sri Lanka like the US, dragging down consumption levels with it. The performance in the US market substantially affects economic performance in Sri Lanka's other major export markets as well. As evident from Figure 2.6, US consumption in the fourth quarter contracted by 4.3 per cent, with consumption of non-durables falling by 9.4 per cent from the previous quarter. Encouragingly, consumption levels have increased in the first quarter of 2009, with the consumption of non-durables increasing by 1.3 per cent, compared to consumption in the previous quarter. However, consumption levels in the first quarter of 2009 have fallen substantially compared to consumption in the first quarter of 2008. Consumption contracted by 1.2 per cent and consumption of non-durables contracted by 3 per cent in the first quarter of 2009. The fall in the consumption of non-durables is of particular concern to Sri Lanka given that a majority of Sri Lankan exports to the US are non-durables such as garments. In the Euro area too, final consumption expenditure fell by 1.3 per cent in the final quarter of 2008 compared to the previous quarter.

Along with the declines in consumption and output in the US, imports - which in the past have been a major source of global demand - have also been falling rapidly since July 2008. However, encouragingly, the rate of the slowdown of imports has declined since January 2009, but yet remains at a lower level than in 2007.

2.5 Sri Lanka's Channels of Exposure

Sri Lanka lacks a sophisticated financial market, thus direct exposure to the sophisticated financial instruments which were contaminated by the financial crisis was limited. Capital market liberalization remains at a nascent stage and, therefore, the major transmission channel of the negative impacts of the global economic crisis to Sri Lanka is via trade - both merchandise trade and trade in services.

Figure 2.7
US Monthly Imports (June 2007-May 2009)



Source: US Bureau of Economic Analysis data.

Sri Lanka is a highly trade dependent country with a poorly diversified export basket and export market. An overwhelming majority of 60 per cent of exports from the country go to the US and EU (over 37 per cent to the EU and 23 per cent to the US). This is of particular concern since the global economic crisis has most significantly affected the economies of the US and the EU. With the unfolding of the crisis, Sri Lankan exports like tea, rubber, cinnamon, coconut, garments, gems and a number of other commodities are facing declining demand in international markets, resulting in reduced earnings - a turn of events which can eventually leading to reduced output and employment in the country.

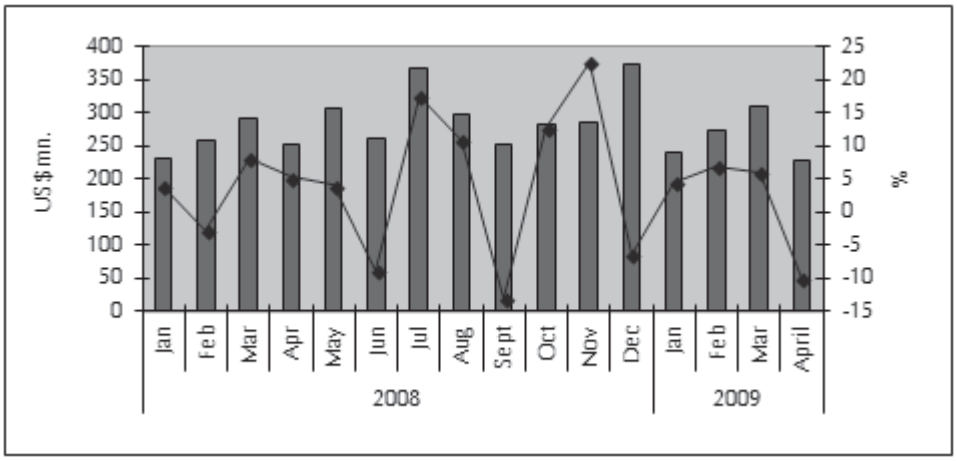
2.5.1 Garment Sector

The impact on the garment sector has been a focal point of discussion as 43 per cent of Sri Lanka's total export earnings are generated through textiles and garment exports. Furthermore, 94 per cent of total garment exports from Sri Lanka go to the EU and the US. After an initial decline in garment exports from Sri Lanka in December 2008, there was a positive growth in exports in the first three months of 2009 (see Figure 2.8). Despite the resilience shown by the garment sector in the first quarter of 2009, the lagged effects of the crisis have resulted in garment exports declining consecutively in April and May by 10.1 per cent and 22.7 per cent, respectively.

The growth in garment exports from Sri Lanka in the first quarter of 2009 was driven by exports to the EU. Industry sources are of the opinion that this can be attributed to the Generalized System of Preferences (GSP-plus) concessions which have helped to keep prices at a competitive level relative to the export prices of other non GSP-plus recipient country garment exporters. Although Sri Lanka initially benefited as an alternative market to China for garment imports by the US,[9] exports to the US declined by 4.5 per

[9] Due to anticipated protection measures against China in the wake of the economic crisis and general trade tensions between China and the US over issues such as currency manipulation, US importers began to search for alternative markets. Sri Lanka is one of the countries that benefited from this although countries such as Bangladesh were able to capture a greater share of the market.

Figure 2.8
Textile and Garment Exports (January 2008-April 2009)



Note: Percentage change in month from previous year.

Source: CBSL, *Selected Monthly Economic Indicators*, various issues.

cent in March 2009. The industry has also attributed the overall growth to the confidence raised by the government's announcement of the Export Development Reward Scheme allowing Sri Lankan companies to offer competitive prices.[10]

There remains some degree of uncertainty with regard to the near term performance of the sector as the ability to secure orders through the rest of 2009 and early 2010 is not guaranteed, and anecdotal evidence suggests downsizing in the sector and closure of some smaller firms due to diminished demand. According to the Joint Apparels Association Forum (JAAF) more than 50 factories have already been shut down, with large companies such as Sinotex closing down due to the shortage of orders from the US. Whilst US clothing retail sales have declined substantially since mid-2008, there has been recent stability as seen in Figure 2.9. This suggests that Sri Lanka's garments exports to the US may stabilize at a lower level towards the end of 2009 if the current retail trends continue.

The medium term sustainability of Sri Lanka's garment exports to the EU remains in doubt given the uncertainty with regard to the continuance of the GSP-plus provision to Sri Lanka. The EU is projected to face a more severe and long lasting downturn than the US, and remedial efforts thus far in the EU have been relatively limited.[11] Furthermore, as unemployment continues to increase, the recovery of demand is likely to be protracted. As the lagged impacts of declining consumption affect Sri Lanka, the sector could face further challenges towards the latter part of 2009. Given that the garment sector provides direct employment to over 270,000 people and is a major source of foreign exchange to the country, declining demand for garments could have substantial macroeconomic implications on the country. However, from a longer term perspective, the global economic crisis may have a silver lining as many of the

[10] More details on the Export Development Reward Scheme are given in Section 2.7.

[11] IMF, *World Economic Outlook*, April 2009.

Figure 2.9
US Clothing Retail Sales (June 2008-June 2009)



Source: US Census Bureau, Advance Monthly Sales for Retail and Food Services.

larger Sri Lankan garment exporters have successfully undertaken substantial production streamlining in order to cut costs. Such measures augur well for the longer term competitiveness of the industry in Sri Lanka.

2.5.2 Tea

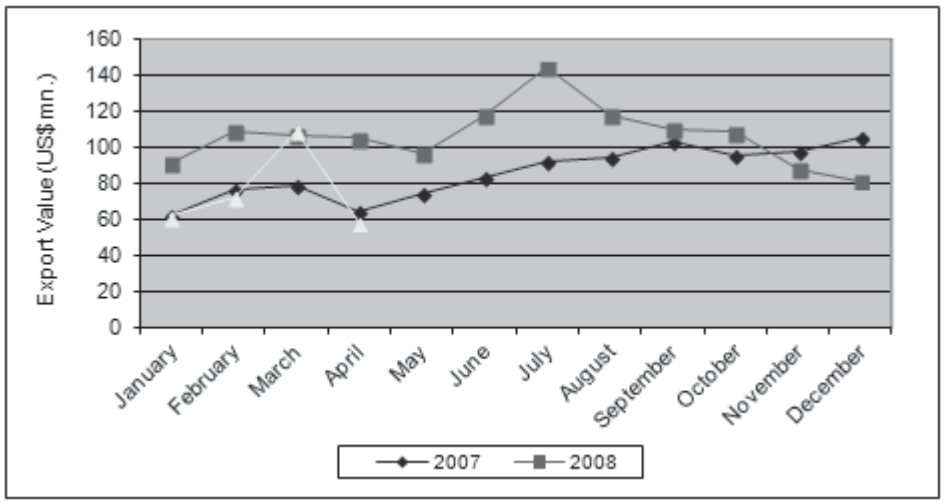
Tea is Sri Lanka's second largest export sector and accounted for 13 per cent of total export earnings in 2008. Sri Lanka's tea sector experienced a substantial boom in the first half of 2008, buoyed by a wide ranging global commodity boom. In July 2008, global tea prices soared and Sri Lankan tea fetched US$ 3.20 per kg. Demand for Sri Lankan tea was largely driven by increases in demand in the Middle East and Russia, which were experiencing an income boom due to the spike in global oil prices. However, with the increased severity of the global downturn, oil prices and general commodity prices began to fall in the second half of 2008. Sri Lanka was particularly affected due to sharp falls in demand in the Middle East and Russia which account for 78 per cent of Sri Lankan tea exports. Furthermore, the Russian ruble depreciated sharply during this time, putting further downward pressure on demand for Sri Lankan tea. As a result of such global developments, prices of Sri Lankan tea collapsed in the fourth quarter of 2008 to an average of US$ 2.12 per kg. compared to US$ 2.88 per kg. in the corresponding period in 2007.

In the first quarter of 2009, the tea sector took a further hit with adverse weather conditions undermining supply, and compounding the impacts of external developments. Sri Lanka's tea prices and export earnings are to an extent influenced by oil prices since this affects demand in the major markets of the Middle East and Russia. Given the expectations of a prolonged depression of global demand, oil prices are expected to remain moderate through 2009 and some part of 2010. Therefore, the prospects for the tea sector will remain muted during this period.

2.5.3 Rubber

The rubber sector is an important export sector for the country. Sri Lanka is the eighth largest rubber exporter in the world. Like tea, rubber prices boomed in 2007 and through

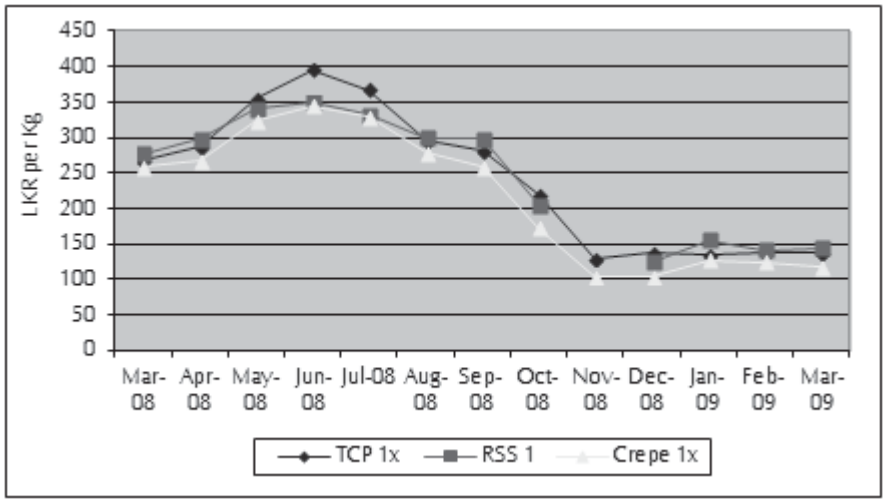
Figure 2.10
Monthly Tea Export Earnings (2007-09)



Source: Sri Lanka Tea Board.

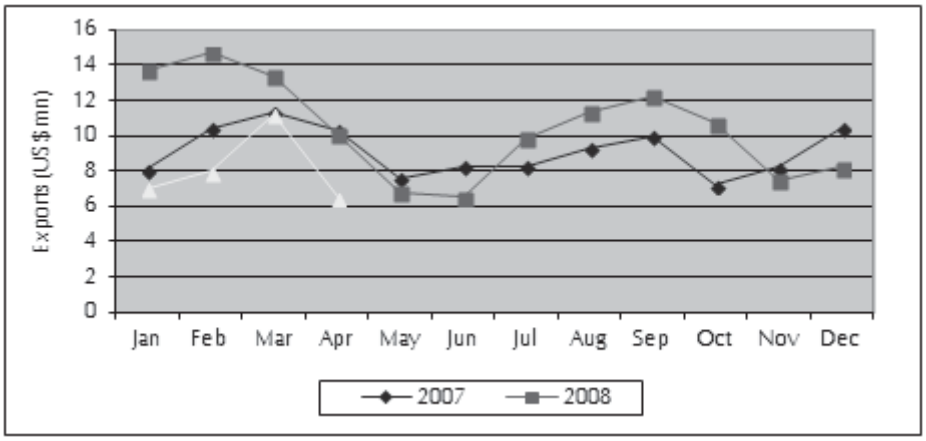
the first half of 2008, driven by increased demand in China and rising demand for natural rubber due to the higher cost of synthetic rubber which requires petroleum as an input. As a result, prices of Sri Lankan rubber exports peaked in mid-2008.

Figure 2.11
Sri Lanka Rubber Export Prices (2008-09)



Source: Rubber Research Institute.

Figure 2.12
Sri Lanka Natural Rubber Export Earnings (2007-09)



Source: Central Bank of Sri Lanka, *Selected Monthly Economic Indicators*, various issues.

However, with the worsening of the global economic crisis, rubber prices and export earnings began to decline in the second half of 2008, particularly in the fourth quarter of 2008.

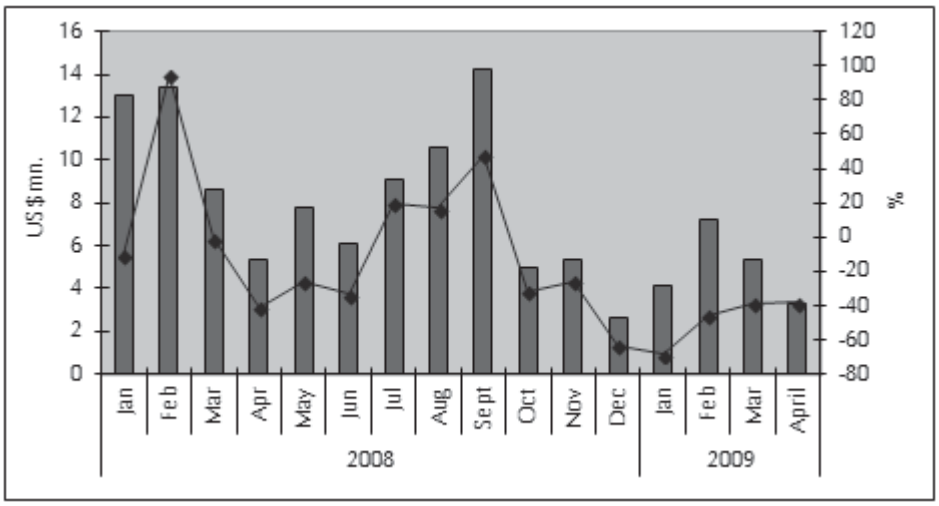
Natural rubber exports from Sri Lanka in 2008 amounted to Rs. 13.5 billion, whilst exports of rubber products amounted to Rs. 58.7 billion, largely composed of rubber tyres and surgical gloves. Growth of exports of both rubber tyres and surgical gloves slowed down in 2008. The bulk (73 per cent) of Sri Lanka's rubber tyre exports are to the EU and the US. The demand for rubber tyres (and natural rubber) is likely to be adversely affected by the collapse of the automobile industry in these countries - particularly in the US, and to a lesser extent in the European automobile sector. Given weak credit availability, increased unemployment and pessimism in consumer markets, the prospects for the automobile sector in these countries remain weak over the next two years. The moderate price of petroleum will also make synthetic rubber and related products relatively competitive and will adversely impact demand for natural rubber and its related products. Therefore, the prospects for rubber and rubber product exports from Sri Lanka are likely to be bleak in 2009 and 2010.

2.5.4 Gems and Jewellery

The export of diamonds and gems has plummeted with the adverse impacts of the crisis on demand for luxury items. Although diamond exports earnings have grown by 20.2 per cent in 2008, driven to an extent by the special incentives provided from the government,[12] the fourth quarter of 2008 saw a decline in exports as demand collapsed (Figure 2.13). Gem exports in the period January-April 2009 have fallen by almost 51 per cent compared to the same period in 2008. This fall in exports has been largely due to the downturn in demand in the US and the EU. The industry is now looking to penetrate new markets such as China, India, Russia, Turkey and the Middle East.

[12] Promotion of value addition in the gem industry by giving tax exemptions, charging a lower income tax, etc.

Figure 2.13
Trends in Gem Exports



Note: Percentage change in month from previous year.

Source: CBSL, *Monthly Economic Indicators*, various issues

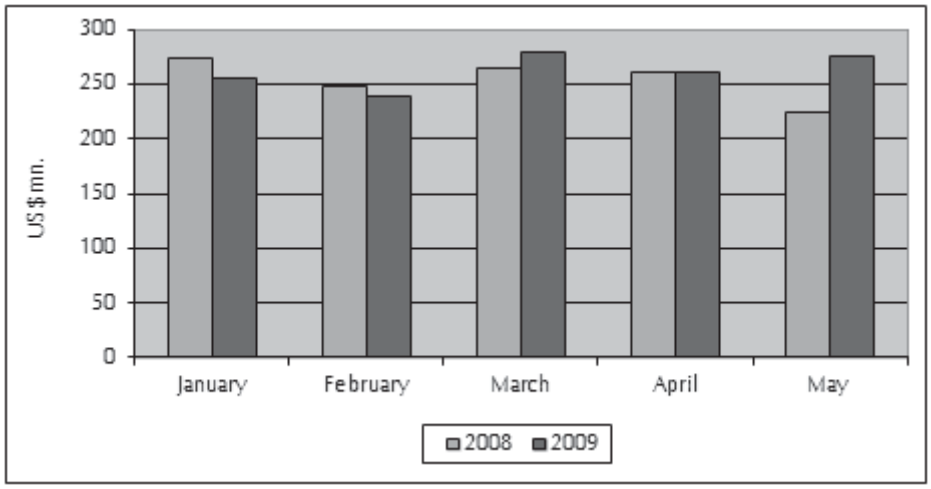
2.5.5 Remittances

Remittances play a major role in the Sri Lankan economy, particularly in terms of bridging the external current account deficit in the country. Worker remittances remained buoyant in 2008 growing from US$ 2.5 billion in 2007 to US$ 2.9 billion in 2008. However, with the onset of the global economic crisis in the fourth quarter of 2008, the sustainability of continued growth in remittance inflows was called into question. Although remittances are usually a stable source of external financing, and are often counter-cyclical in downturns, it may not be so this time due to the widespread nature of the global economic crisis.

The majority of temporary migrants from Sri Lanka work in the Middle East and more than 50 per cent of Sri Lanka's remittances originate from the region. Given the decline in oil prices in 2008 and the likelihood of depressed prices continuing through 2009 and much of 2010, demand in the Middle East is likely to remain deflated. As previously discussed, IMF estimates suggest that growth in the Middle East will drop to 2 per cent in 2009 and remain subdued at 3.7 per cent in 2010. As a result, there will most probably be some slowdown in remittances during 2009-10. A fall in remittances was recorded in Sri Lanka in the first two months of 2009 with remittances in January contracting by 6.6 per cent and by a further 3.8 per cent in February compared to the previous year. As a result, remittances in the first quarter of 2009 contracted by 1.7 per cent in contrast to the 23.5 per cent growth during the same quarter in 2008. However, encouragingly, remittances have grown by 2.9 per cent in the first five months of 2009 compared to the same period in 2008 and recorded a growth of 22.4 per cent in May despite the global economic downturn and stiff competition from other remittance receiving economies.[13] Nevertheless, compared to the 16 per cent growth in private remittances in 2008 where it grew by over 20 per cent right

[13] This increase may be due to the increases in remittances flowing into the country with the ending of the war in May 2009.

Figure 2.14
Monthly Private Remittances (2008-09)



Source: CBSL, *Monthly Economic Indicators*, various issues.

through the first 9 months,[14] the growth of 2.9 per cent in the first five months of the year is considerably low.

2.5.6 Tourism

Another channel through which the Sri Lankan economy is exposed to the global crisis is tourism. In the first five months of 2009, total tourist arrivals fell by almost 20 per cent, compared to the same period in 2008. Heightened security conditions in the country stemming from the final phase of the war, and also the global economic downturn are the most likely reasons for the decline in tourist arrivals into the country (Table 2.2). Nevertheless, in June 2009, a mere one month after the end of the war, there has been an increase in tourist arrivals by 8.1 per cent.[15]

Table 2.2
Percentage Change in Tourist Arrivals (2008/09)

Month	Percentage change
January	-32.4
February	-15.7
March	-10.5
April	-12.4
May	-20.6
June	8.1

Source: Sri Lanka Tourism Development Authority.

The drop in tourist arrivals in the first five months may have been partly due to falling incomes and weakening currencies in key Western European and South Asian markets: the number of tourists from Western Europe fell by 15.4 per cent in the first five months of 2009 compared to the same period in 2008. Arrivals from four of the top five source markets in 2008 - India, UK, Germany and the Maldives - have contracted in the first five months of 2009, with the exception of arrivals from Australia. Tourist arrival figures from a few selected countries are shown in Table 2.3. There have been significant declines in tourist arrivals by key South Asian countries like India (41.2 per cent) and Pakistan (39.6 per cent) in the first quarter of

[14] CBSL, *Annual Report 2008*.

[15] It has been noted that the growth may look exaggerated as June arrivals in 2008 were the lowest since June 2002.

Table 2.3
Tourist Arrivals by Country of Residence

Country of Residence	January to May		% Change
	2008	2009	
India	42,126	24,778	-41.2
UK	34,077	30,265	-11.2
Germany	16,023	11,234	-29.9
USA	5,736	4,813	-16.1
France	4,755	6,707	41.1
Australia	6,402	7,205	12.5

Source: Data from Sri Lanka Tourism Development Authority.

2009. Given the price sensitivity of tourism, another factor that may have contributed to the decline in tourism was the appreciation of the Sri Lankan rupee with respect to currencies of major tourism source markets. The Sri Lankan rupee was soft pegged to the US dollar resulting in appreciations against the sterling pound (23 per cent), the euro (8.7 per cent) and the Indian rupee (15.9 per cent) between March 2008 and March 2009. It is likely that the decline in tourism will continue with arrivals from Western countries reducing significantly as a result of the global economic crisis causing increased unemployment and lower incomes in this sector through 2009 and 2010.[16]

The tourism sector has substantial multiplier impacts on the Sri Lankan economy through foreign exchange earnings (US$ 384 million), direct employment (60,516) and indirect employment (84,723), and derived demand for many goods and services ranging from transport to the supply of agricultural products for consumption. Therefore, the downturn in the tourism sector will have wide ranging impacts on the Sri Lankan economy.

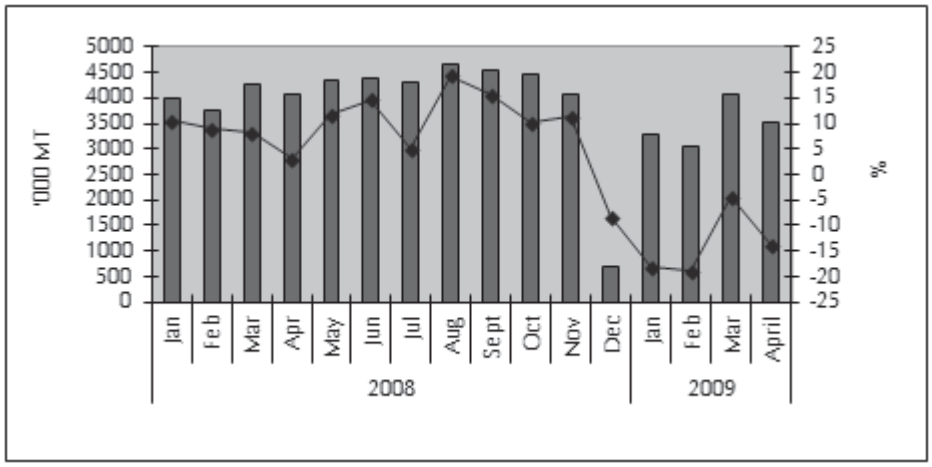
2.5.7 Ports and Aviation

The impact of the crisis as reflected in terms of cargo handling in the port services is illustrated in Figure 2.15. Total cargo handling which saw an increase during October-November 2008 declined significantly in December 2008. Furthermore, in the period January-April 2009, it had reduced by 13.6 per cent compared to the same period the previous year. Given that a majority of cargo handling in Sri Lanka is transshipments to and from India, the numbers to an extent reflect the slowdown in trade in the region as a whole. The general slowdown in business activity is also underlined by cutbacks in flights between India and Sri Lanka.

In terms of air travel, Sri Lankan Airlines flights to India has been slashed by half (from 100 flights per week to 51), with flights to Cochin, Calicut, Coimbatore and Hyderabad being halted as part of a cost-cutting strategy. These routes primarily carried traffic between the Middle East and the Far East, thereby suggesting reduced traffic on these routes. The case of the aviation sector illustrates a dilemma between short term and long term objectives. A long term objective of the Sri Lankan aviation sector is to position itself as a hub for air services to India by maximizing connectivity to the Indian sub-continent. However, short term cost objectives clash with this long term objective. Nonetheless, it is important to

[16] The global economic crisis has also resulted in detrimental impacts on government finances in terms of revenue collection as the import prices of certain commodities have declined, reducing the revenue margin.

Figure 2.15
Cargo Handling



Note: Percentage change in month from previous year.

Source: CBSL, *Monthly Economic Indicators*, various issues.

strike the appropriate balance between these two objectives.

2.6 Impacts on External Finances

Since capital account liberalization in Sri Lanka is at a nascent stage, the main impact of the global economic crisis on external finances is through the government sector. In recent years, the government of Sri Lanka has increased its reliance on foreign commercial borrowing to finance government expenditure. Government current expenditure has consistently exceeded current revenue, and capital expenditure has relied entirely on borrowed financing. Given the pressure that is exerted on domestic interest rates as a result of increased domestic borrowing, foreign borrowing will be required in the near term to finance substantial budget deficits. In the context of the global economic crisis creating investor risk aversion and uncertainty with regard to Sri Lanka's external financial position, access to external commercial finance has been diminishing. The government's ability to roll over debt will be under strain, particularly in the context of the upcoming re-payments due in 2009 and 2010.

Thus far, there has been no major impact on foreign direct investment (FDI) as net FDI in 2008 saw a growth of 26 per cent to US$ 691 million, led largely by the services sector. Portfolio investment, though relatively small, showed signs of decline in 2008, largely due to foreign investors withdrawing investments from relatively risky markets seeking to shore up their balance sheets. Net foreign portfolio investment in 2008 was US$ 60 million, with withdrawals of US$ 488 million.

One area of the capital account that was liberalized was with regards to the government debt securities market, permitting foreign investors to hold up to 10 per cent of the government Treasury bill and bonds market. This market attracted substantial investor interest, and by September 2008 an estimated US$ 650 million had been invested by foreigners. However, in the fourth quarter of 2008, as the global financial crisis took on greater proportions, investors sought safer markets and withdrew money from the Sri Lankan government debt securities. The estimated foreign investment in this sector had declined to just US$ 19 million by April 2009.

A combination of the factors discussed above led to a widening trade deficit and a sharp deterioration of the current account of the balance of payments (BOP). Even as the adverse impacts of withdrawal of capital from government securities on the country's external account was being felt, the Central Bank of Sri Lanka (CBSL) attempted to defend the value of the rupee against the US dollar, undermining export competitiveness and adding to the problems of declining global demand faced by the export sector. The currencies of competing countries have depreciated against the US dollar throughout 2008. Between January 2008 and January 2009, for instance, many countries undertook to depreciate their currencies by significant margins, including Brazil (by 35 per cent), India (21 per cent), Mexico (29 per cent), South Africa (24 per cent), Malaysia (12 per cent), Thailand (11 per cent) and a basket of major currencies calculated by the US Federal Reserve depreciated by 15.2 per cent.[17] During this same period, the Sri Lankan rupee depreciated by only 5.6 per cent.

2.7 Sri Lanka's Response to the Crisis Thus Far

The immediate short term response to the global economic crisis is the need to extend support to exporters who face disruptions due to demand shortfalls in export markets. This is particularly important at a time when credit markets remain tight and there are difficulties in accessing traditional credit channels. Medium term credit lines to tide over the difficulties being faced by exporters will be important.

In January 2009, the government announced a Rs. 16 billion "economic stimulus" package to help exporters adversely affected by the global economic downturn. The package amounts to just 0.3 per cent of GDP, highlighting the limited fiscal space that the government has to provide for an adequate stimulus package. Under this system, incentives for producers in terms of a rebate scheme as well as energy price reductions are offered. A 5 per cent rebate scheme is offered to all industrial exporters subject to certain conditions. Under this system, exporters can either apply for cash outright, or can set off the rebate against their taxes. Exporters who have been trading continuously since January 1, 2006 are eligible to apply for benefits under this Export Development Reward Scheme (EDRS) if they meet the following criteria:

i) An Export Development Reward (EDR) of 5 per cent of export earnings will be given in the 1st quarter of 2009 to those exporters who maintain a minimum of 80 per cent of exports effected in 1st quarter of 2008. For the next 3 quarters of 2009, the exporter should be able to maintain export earnings equal or more to the export earnings recorded in the corresponding quarter of the previous year.

ii) If export proceeds in the first quarter of the current year are equal to 80 per cent or more but less than 90 per cent of export earnings recorded in the corresponding quarter of the previous year, and if export earnings are equal to 90 per cent or more but less than 100 per cent of the export earnings recorded in the corresponding quarter of the previous year in the other quarters, a reward of 3 per cent of the export value will be paid.

iii) Maintenance of employment levels as declared by the Employees' Provident Fund (EPF) and Employees' Trust Fund (ETF) returns as at the third quarter of 2008 must be maintained as well.

[17] US Federal Reserve data.

Furthermore, under the stimulus package, a 15 per cent surcharge on electricity is lifted from tourism, apparel, leather and rubber industries. A cess on manufactured rubber exporters would be lifted, with tea producers supported through state-purchases when the prices are low, through subsidies of fertilizer (at Rs. 1000 per 50 kg. bag until the green leaf prices are Rs. 45) and, by suspending the repayments on loans given to modernize tea factories for one year. One month's working capital is also to be given to tea factories through commercial banks on the recommendations made by the Sri Lanka Tea Board.

According to the government, the stimulus package will not be financed by extra borrowings, but rather through savings on oil price reductions, cutting down on government expenditure, increases in taxes on imported commodities, and also by budgetary allocations to the Export Development Board (EDB) for export promotion. In that sense, the reward scheme is more a redistribution of budgetary expenditure rather than a stimulus of extra funds released to the economy. The practicality of meeting the qualifying criteria set out by the government has been called into question by industrialists. Exporters have emphasized the difficulty in meeting the export values as prices of commodities such as tea and rubber have fallen as a result of lower demand. In response, the government agreed to some flexibility in terms of the revenue criteria, and exporters have begun to apply for the concessions offered for the first quarter of 2009. There has also been some discussion with regards to the possibility of allowing some flexibility in labour market regulations based on negotiations between employers, trade unions and the government, enabling a shorter working week.

2.8 Prospects and Policy Options

The initial global response to the economic crisis was characterized by uncertainty and caution. However, with the serious deterioration of the global economic situation in the fourth quarter of 2008, there was a greater collective effort by key governments to formulate a coordinated response to the crisis. Key areas that have received attention are financial markets, monetary policy and fiscal policy.

Measures to address financial markets remain uncertain. Whilst many measures have been adopted particularly in the US (TARP, PPIP among others),[18] it remains to be seen whether these will be completely effective. One problem is the continued difficulty in assessing the actual extent of losses in the financial markets, and political challenges in financially supporting banks and other financial institutions have forced governments to err on the side of caution.

The priority of global monetary policy has shifted from preventing inflation to preventing deflation. In this context, the importance of communication by Central Banks becomes paramount. Central Banks need to collectively display a commitment to preventing deflation in the short term, but also a commitment to curtailing long term inflation. Conventional monetary policy measures are undermined by the zero interest rate floor and short term imperfections in credit markets which affect monetary transmission. The US Federal Reserve, for instance, has engaged in unconventional quantitative and credit easing, buying US long term government securities, infusing the economy with freshly created money, etc. with the aim of reducing credit costs. Other key economies have slashed interest rates and engaged in expansionary monetary policy. The key challenge is to gauge when to halt the monetary easing

[18] Troubled Asset Relief Programme (TARP) and Public Private Investment Programme (PPIP).

that is currently going on in many countries - an abrupt halt could disrupt recovery, whilst a protracted loose monetary policy stance will be inflationary in the medium term.

Like monetary policy, fiscal policy is faced with a similar dilemma of balancing short term expansion with medium term price and debt stability. Major expansionary fiscal measures amounting to close to 2 per cent of global GDP were announced by G-20 countries such as the US, Europe, Japan and some of the emerging economies in response to falling domestic demand. Current economic indicators suggest that there is a need to continue with expansionary policy during 2010 as well. This indicates substantial medium term pressure on debt positions. The impacts of expansionary fiscal policy will be felt in the real sectors of the economies towards the second half of 2009.

Despite the substantive measures being adopted by governments across the world, it is unlikely that the above-trend global growth rates in the first half of the decade will be replicated any time soon. Nonetheless, there have been some positive developments as the rate of economic contraction appears to be slowing down; there has been some recovery in financial markets, with major financial institutions buoyed by government support. House prices in the US have stabilized somewhat in the first quarter of 2009. Household consumption in the first quarter of 2009 has also improved on the previous quarter, but continues to be weighed down by a weak labour market and low asset prices. The health of the US financial sector remains the major concern as recovery efforts without well functioning credit markets are likely to be of limited efficacy. Whilst second quarter earnings in major financial institutions such as Goldman Sachs, JP Morgan and Bank of America were strong - having taken advantage of federal assistance and the market opportunities that emerged as competitors folded - there remain concerns about overall financial market health. Credit card defaults remain high and mortgage delinquencies are yet to fully stabilize as high unemployment undermines repayments. It also remains to be seen how well the sector will perform when government assistance draws to a close. As such, it is as yet too early to be able to conclude that the financial crisis has completely bottomed out.

For countries such as Sri Lanka, the immediate short term response to the global economic crisis is the need to extend support to exporters who face disruptions due to demand shortfalls in export markets. This is particularly important at a time when local credit markets remain tight and there are difficulties in accessing traditional credit channels. Medium term credit lines to tide over the difficulties being faced by exporters will be important. Some measures have already been extended to exporters in Sri Lanka as detailed in the discussion. However, some of the criteria have been unrealistic, and whilst it is encouraging to note that the government is willing to grant some flexibility in this process, it is more advisable to have a transparent and predictable process rather than an ad hoc, case-by-case criteria for support. At the same time, there will be cases where smaller firms will not be competitive in such circumstances and the government may have a role in acting as an intermediary in takeovers by larger firms to provide the best chance for the resources to be utilized in a productive manner. The export sector downturn is also a prime example of the need for temporary unemployment benefits for retrenched employees.

In the medium term, policy implications are mainly in terms of monetary and fiscal policy. High government expenditure resulting in fiscal deficits has forced the government to rely heavily on short term foreign commercial borrowing, creating vulnerability in ex-

ternal finances, particularly in times of global financial crises. Fiscal rationalization will also provide more policy space to deal with crises of this nature - both in terms of a counter-cyclical stabilizing role of fiscal policy and in terms of providing a direct economic stimulus. Fiscal rationalization will also allow monetary policy to focus on its key role - i.e., the maintenance of price stability in the economy.

Longer term policy measures need to take into account the fundamental changes in the global economy that could result from the current global economic crisis. The above-trend global economic growth since 2002 has largely been driven by credit fuelled consumption in the US (the ratio of liabilities to disposable income in the US reached 138 per cent in 2007 and consumption accounted for 77 per cent of US real GDP growth between 2000 and 2007, which in turn accounted for a third of global private consumption growth).[19] Given likely reforms in the US financial markets, both through formal regulation and through a moderated appetite for risk in terms of lending and financial instruments, the same levels of credit driven consumption are unlikely to materialize in the foreseeable future. In this context, it becomes important for Sri Lankan exporters to seek alternative markets, particularly in Asia, where domestic consumption is likely to be encouraged to a greater extent to offset global imbalances of recent years. Other longer term policy measures include reforms in the labour market to enhance flexibility in responding to external economic crises of this nature, and in energy markets to ensure greater competitiveness of Sri Lankan exporters whose competitiveness is undermined by Sri Lanka having the region's most expensive energy costs. Finally, it is important for policy makers to recognize the fact that Sri Lanka - with a small domestic market of approximately US$ 35 billion - will be reliant on exports to external markets to spur economic growth, taking advantage of economies of scale. In this context, recent global trends in protectionism need to be considered with a great deal of caution. Whilst encouraging domestic production in the country is important, it should not be undertaken through excessive protection, which risks retaliation by trading partners that undermine export market access.

A sharp drop in Sri Lanka's GDP growth in the fourth quarter of 2008 to just 4.3 per cent, followed by a further fall in the first quarter of 2009 to 1.5 per cent, heralded an indication of the likely impact on near term output growth for the country. The most notable downturn was in the services sector - accounting for nearly 60 per cent of GDP - recording a growth rate of just 3.8 per cent in the fourth quarter 2008 and 1 per cent in the first quarter of 2009. The sharp slowdown in services - a sector which is largely unexposed to the channels through which Sri Lanka is most likely to be impacted by the global economic crisis - suggests that there are other factors at work affecting Sri Lanka's recent economic performance. The exposure to the global economic crisis has been discussed, but what is even more pertinent is the impact of domestic policies. The details of Sri Lanka's domestic macroeconomic policy management and response to the emerging global economic crisis will be discussed next in Chapter 3.

[19] McKinsey Global Institute (2009), "Will US Consumer Debt Reduction Cripple the Economy?", March 2009.

3. The Global Economic Crisis and Sri Lanka's Economic Outlook

3.1 Introduction

Amidst the turmoil of an unfolding global economic crisis in 2008, Sri Lanka posted a creditable GDP growth rate of 6 per cent. With world output estimated to contract for the first time since in 60 years - with growth in global export volumes forecast to plummet by 10 per cent after 30 years of uninterrupted growth - the near-term outlook for most economies appear grim. Sri Lanka, too, will not escape unscathed. The sharp drop in GDP growth in the fourth quarter of 2008 to 4.3 per cent, and a further decline to 1.5 per cent in the first quarter of 2009, are indicative of the potential downside effects to the country's economic outlook for 2009.

However, the global downturn cannot be faulted for all of Sri Lanka's economic challenges ahead. Despite maintaining a robust GDP growth of 6.5 per cent in the first nine months of 2008, Sri Lanka was facing mounting pressure on its external accounts position. The rapid increase in international oil prices up to mid-2008 was largely to blame for a ballooning current account deficit - tripling to nearly US$ 3 billion in the nine months to September 2008 from the comparable position in 2007. Despite evidence of a severe deterioration in the current account - on a scale last witnessed by the country in the early 1980s - Sri Lanka had failed to maintain sufficient policy flexibility to respond appropriately.

Policy flexibility was constrained by a series of developments. During 2005-07, high GDP growth - averaging just under 7 per cent per annum - was maintained at the cost of a weakening macroeconomic environment. The economy was prone to overheat as a result of an expansionary fiscal policy thrust that, in turn, was accompanied by an accommodative monetary policy stance. The gradual build-up of inflationary pressures from 2004 took off from mid-2006, with the rate of inflation reaching over 20 per cent on a point-to-point basis in early 2008. As domestic borrowing sources dried up and interest rates began to climb in response to monetary tightening from 2007, Sri Lanka resorted increasingly to short term foreign currency denominated borrowing and allowed a partial opening up of the government debt securities market to foreign investors from 2007.

The build-up of inflationary pressure, greater exposure to short-term foreign borrowing, and attempts to attract foreign investors into the domestic debt market made a stable exchange rate regime an attractive proposition. Thus, despite a worsening external current account position from 2006 onwards, Sri Lanka's currency was held steady for the most part, notwithstanding the means by which the deficit was being financed. The nature of capital flows financing a current account deficit matters to the extent that an economy and its currency may struggle if foreign capital inflows suddenly dry up. In the event, all these developments combined to raise the downside risks of an external shock to the economy such as the current global recessionary conditions.

3.2 Output, Employment and Investment

Sri Lanka's annual average GDP growth slowed to 6 per cent in 2008 from a high of 7.7 per cent achieved in 2006. Despite the slowdown in GDP growth, it was nonethe-

Table 3.1
Output Growth (2003-08)

	2003	2004	2005	2006	2007	2008
GDP	5.9	5.4	6.2	7.7	6.8	6.0
Agriculture	1.7	0	1.8	6.3	3.4	7.5
Industry	4.7	5.4	8.0	8.1	7.6	5.9
Services	7.6	6.7	6.4	7.7	7.1	5.6
Per capita GDP (US$ mn.)	981	1,062	1,241	1,421	1,634	2,014

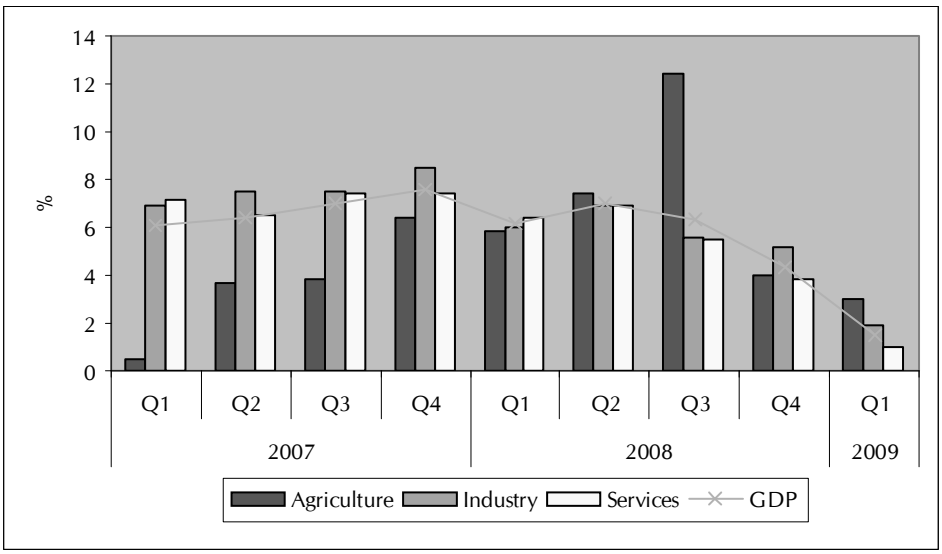
Source: CBSL, *Annual Report*, various issues.

less a creditable achievement in the midst of significant domestic constraints, and a rapidly evolving global economic crisis in the latter part of the year. Sri Lanka also succeeded in crossing the US$ 2000 per capita income threshold in 2008 (Table 3.1).

The Sri Lankan economy was already geared to experience a slowdown of its near 7 per cent average annual growth achieved during 2005-07 on the back of expansionary fiscal and monetary policies. The steady overheating of the economy was evident in the spiralling rates of inflation that the country began to witness over the same period. A tightening of monetary policy from early 2007 was intended to curb demand-pull pressures and rein in aggregate demand in the economy. The most visible impacts of such measures - rising interest rates - was felt most in the industry and services sectors.

Domestic policy measures that would have inevitably decelerated economic activity coincided with the contractionary effects of the global economic crisis in the fourth quarter of 2008. GDP growth slowed sharply to 4.3 per cent (Figure 3.1). The services and indus-

Figure 3.1
Quarterly GDP Growth (2007-09)



Source: CBSL, *Monthly Economic Indicators*, various issues.

try sectors saw output growth decline by 3.6 and 3.3 percentage points, respectively, relative to fourth quarter performance in 2007. Whilst all three sectors are likely to be adversely affected by the global economic crisis - from contracting world demand and depressed commodity prices - Sri Lanka's services and industry sectors have been vulnerable to the added pressures arising from domestic macroeconomic management that has largely spared the agriculture sector.

3.2.1 Sectoral Growth Performance

Much of the growth momentum in 2008 was driven by a resurgent agriculture sector performance. Its contribution to GDP growth increased to over 15 per cent in 2008 relative to just 6 per cent in the previous year, with a share of 12 per cent of GDP. The key factors in the improved performance were the recovery in tea production, along with a significantly higher production of paddy owing to a renewed harvest from the Eastern Province during the Yala season.[1] The Yala season output grew by 51 per cent to yield 1.8 million metric tonnes - a result largely of a 62 per cent increase in the extent of land cultivated when compared to the previous Yala season. The increase in land under cultivation came primarily in the districts of Ampara, Batticaloa and Trincomalee - contributing 23 per cent of the total Yala season paddy production in 2008.

The increase in rice production was also partly a result of the higher prices of cereals, including wheat, in the world market, especially during the first two quarters of 2008. Moreover, with the relaxation of security measures in the Eastern Province, other areas of agricultural activity - e.g., milk and fish production, etc. - benefited. Annual fish production rose by 10 per cent in 2008 - due both to favourable weather conditions and renewal of fishing in the Eastern Province.

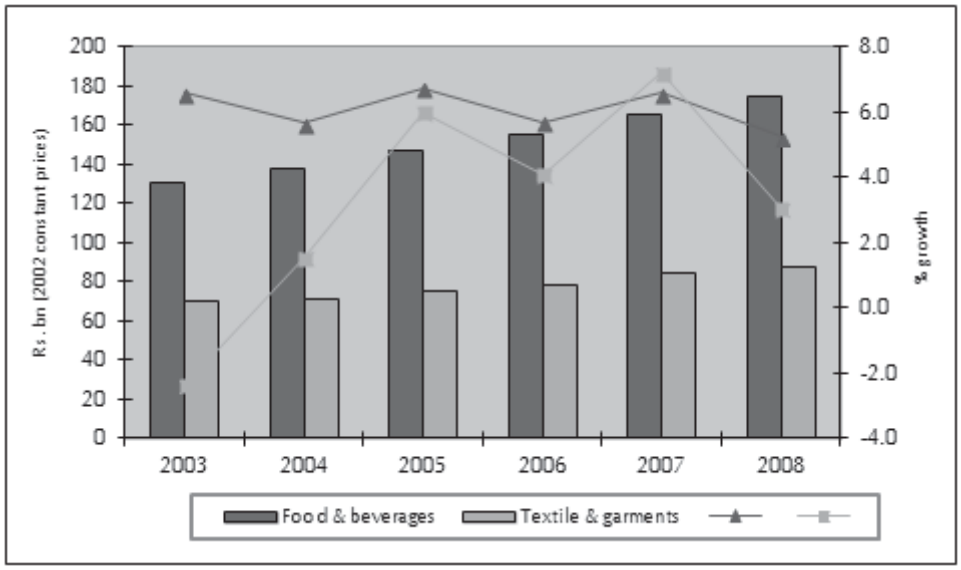
Table 3.2
GDP: Sectoral Performance

	Annual Average (%)		Annual (%)	
	2002-04	**2005-08**	**2007**	**2008**
GDP	5.1	6.6	6.8	6.0
Agriculture	1.3	4.8	3.4	7.5
Tea	1.5	0.8	2.2	4.3
Rubber	2.9	7.5	-2.0	10.3
Coconut	-2.1	3.6	5.1	5.2
Paddy	-0.8	11.0	-6.4	22.9
Industry	3.9	7.5	7.6	5.9
Manufacturing	3.8	5.7	6.4	4.9
Construction	3.8	8.7	9.0	7.8
Services	7.2	6.7	7.1	5.6
Wholesale and retail trade	6.4	5.2	6.1	4.7
Post and telecom	24.8	22.5	21.5	22.3

Source: CBSL, *Annual Report*, various issues.

[1] Rice cultivation in Sri Lanka has two main seasons: Yala season between May-September, and Maha season between December-February.

Figure 3.2
Key Industrial Sector Growth



Source: CBSL, *Annual Report*, various issues.

Tea production increased by 17.5 per cent during the first half of 2008 on account of favourable weather conditions and buoyant external prices. The sector, however, began to feel the adverse impact of the decline in commodity prices in the second half of the year, and contracting demand from key export markets. By year end, tea production had declined to 4.3 per cent relative to a growth rate of 13.3 per cent in 2007. By contrast, rubber production has held steady, growing by 9.9 per cent in 2008 compared to a growth in production of 11.7 per cent in the previous year.

The industry sector grew by 5.9 per cent in 2008, with the largest sub-sector of manufacturing expanding by 4.9 per cent. The key industrial sectors - food and beverages which accounts for nearly 50 per cent of industrial value added, and the textile and garments sector that accounts for a further 25 per cent of value added - saw a decline in 2008. An unfavourable domestic economic environment - high interest rates, rising cost of living, and a misaligned exchange rate - contributed to a less than profitable setting in which to operate. The adverse impacts of declining global demand in the fourth quarter of 2008 only added to the existing challenges facing the industrial sector.

The services sector which has been a key driver of growth in the Sri Lankan economy - accounting for nearly 60 per cent of GDP - has recorded a slowdown in 2008, mainly owing to the decline in export trade, transport, and financial services activities. Again, domestic compulsion weighed heavily against continued expansion of the services related industries before the onset of the global economic meltdown. The latter only served to exacerbate the situation further. The wholesale and retail trade sector, and post and telecommunication sectors - which are the primary contributors to the services sector - have experienced a decline in growth in 2008.

3.2.2 Employment Trends

According to available official statistics, the rate of unemployment in Sri Lanka has been

Table 3.3
Key Statistics of Labour Force

	2000	2002	2004	2006	2008
Labour force ('000 persons)	6,827	7,145	8,061	7,599	7,650
Labour force participation rate (%)	50.3	50.3	48.6	51.2	50.3
Male	67.2	67.9	66.7	68.1	67.6
Female	33.9	33.6	31.5	35.7	35.0
Employment status (%)					
Public sector	13.4	13.4	13.0	13.4	14.9
Private sector	42.9	44.5	46.4	42.1	41.1
Employers	2.3	2.8	2.9	3.1	3.0
Self-employed	28.4	28.6	28.3	30.8	30.2
Unpaid family workers	13.0	10.7	9.4	10.5	10.8
Composition by economic activity					
Agriculture (% of total)	36.0	34.5	33.5	32.2	32.7
Industry (% of total)	23.6	20.9	22.8	26.6	26.3
Services (% of total)	40.3	44.7	43.7	41.2	41.0
Unemployment rate (% of labour force)	7.6	8.8	8.3	6.5	5.2
Male	5.8	6.6	6.0	4.7	3.6
Female	11.1	12.9	12.8	9.7	8.0

Notes: a: Data excludes Northern and Eastern Provinces.
Source: CBSL, *Annual Report*, various issues.

declining steadily in recent years to reach the lowest recorded rate of 5.2 per cent in 2008. Total employment in the country rose by 133,000 in 2008.

During 2000-08, the labour force grew by 12 per cent. However, yearly labour force growth rates show that the labour force is growing at a declining rate. The decrease in the labour force, despite an increase in the working age (15 and over) population is mainly due to the decrease in the labour force participation rates. In addition, the departures for foreign employment have been increasing over the last couple of decades. More than 200,000 persons are estimated to depart for temporary employment abroad each year. According to the Sri Lanka Bureau of Foreign Employment (SLBFE), the stock of overseas contract workers at present is around 1.8 million, which is equivalent to 20 per cent of the workforce in domestic employment.[2]

By employment status, the largest increase during 2008 is seen in the proportion of those employed by the public sector. By sector of employment, there has not been any discernible change: the services sector employed the largest proportion (41 per cent) in 2008, followed by the agriculture (33 per cent) and industry (26 per cent) sectors.

At a first glance, the labour market statistics look promising in view of declining unemployment rates. However, unemployment remains high for females (9 per cent), for youth (22 per cent for 15-19 year olds, and 15 per cent for 20-29 year olds) and for the educated (12 per cent for those qualified in A Levels). In addition, a large proportion of the employment that has been created in the last decade has been in the informal sector, particularly as self-employed. At present, informal sector employment accounts for close to 70 per cent of the total employed.

[2] These figures are not adjusted for arrival of temporary workers after completing their work contracts.

These developments suggest that Sri Lanka's workforce remains vulnerable to socio-economic stress in the event of job lay-offs. In the context of the current global economic downturn that is seeing unemployment estimated to rise sharply across the world, the absence of social security/safety nets for the vast majority of Sri Lanka's working population is a cause of immense concern. An Unemployment Insurance Benefit Scheme has been proposed and discussed, but fiscal constraints have prevented it from being implemented.

3.2.3 Savings and Investment

The improvement in the domestic savings ratio - domestic savings as a percentage of GDP - witnessed over the 2005-07 period reversed sharply in 2008. The domestic savings ratio declined quite markedly to 14.1 per cent in 2008 from 17.6 per cent achieved in the previous year. Sustained cost of living pressures undoubtedly have led to households saving less than earlier. In addition, financial turmoil in the country - the collapse of well recognized organizations and several financial scams that came to light in 2008 - would also have impacted adversely on depositor confidence.

These factors also explain the drop in national savings to 18.2 per cent in 2008. Despite the continued healthy growth in total private remittance inflows to the country, net factor income as a percentage of GDP dropped from 5.8 per cent in 2007 to 4.1 per cent in 2008.

Despite the 5.1 percentage drop in national savings, Sri Lanka was able to maintain a relatively stable rate of investment. Total investment as a percentage of GDP dropped only marginally to 27.5 per cent from a ratio of 28 per cent achieved in 2007. The investment rate was held primarily due to the steady increase in public investment since 2004. Over that period, government investment as a percentage of GDP has grown progressively from 2.7 per cent in 2004 to 6.5 per cent by 2008.

The continued decline in private investment - from a high of 23.9 per cent in 2006 to 21.1 per cent in 2008 - is worrying, although not unexpected. The high interest rate environment has been a key factor. Underlying this has also been a general decline in investor confidence, largely as a result of the weakening of macroeconomic stability that the economy has experienced since 2006.

Some of the government investment activities will lift Sri Lanka's long-term growth potential and is, therefore, to be welcomed.

Table 3.4
Selected Indicators of Investment and Savings

% of GDP	**2002-04**	**2005-2008**	**2007**	**2008**
Investment	22.8	27.5	28.0	27.5
Private	19.5	22.4	22.6	21.1
Government	2.5	5.1	5.4	6.5
Domestic savings	15.6	16.5	17.6	14.1
National savings	21.0	21.8	23.3	18.2
FDI (US$ mn.)	190	481	548	691
FDI (% of GDP)	1.0	1.5	1.7	1.7

Source: CBSL, *Annual Report*, various issues.

These include projects initiated to improve infrastructure facilities such as the port development activities at Colombo and Hambantota, together with the expansion in road development and power generation projects. Other initiatives include programmes directed specifically towards area-based development of the Eastern Province. The Negenahira Navodaya programme under the Board of Investment (BOI) and the Negenahira Udanaya special development programme under the Ministry of Industrial Development are some of the key initiatives.

Despite the weakening of the macroeconomic environment in Sri Lanka, the inflow of foreign direct investment (FDI) has held steady. The total net inflow of FDI in 2008 amounted to US$ 691 million, remaining stable at 1.7 per cent of GDP. Telecommunication, manufacturing, and power generation sectors have continued to be the main areas of attraction for foreign investors. While Sri Lanka is at risk of seeing a reversal of the steady increase in FDI inflows of recent years as a result of the global economic crisis, the ending of the conflict is likely to restore long term investor confidence in the economy.

Clearly, investment by the government by necessity will be a central feature of Sri Lanka's post-conflict rehabilitation and reconstruction process. It holds both advantages and risks in the context of the current global economic downturn. A proactive fiscal policy stance by the government for reconstruction purposes will mitigate the downside effects of a slowdown in private investment and consumption in the economy. However, the risks are many. Sri Lanka's fiscal situation remains fragile. The expected slowdown in output growth will inevitably take its toll on government revenue sources. As the country grapples with the mounting task of raising sufficient financial resources - to continue with ongoing development efforts, and initiate new area-based development programmes in the Northern and Eastern Provinces - fiscal management will be the entry point of ensuring a sustainable economic recovery in the medium term, and one that will eventually translate into a sound long term socio-economic development process.

3.3 Initial Conditions: Fiscal and Monetary Policy Weaknesses

3.3.1 Fiscal Policy

For Sri Lanka, fiscal policy management has long been the bane of underlying weaknesses in the macroeconomic environment. Recent experience has not been very different.

The pressures on budgetary expenditures have been rising on multiple fronts. The post-tsunami reconstruction effort during 2005-06 took a toll on government finances as cost escalations and donor funding gaps between committed and disbursed funds emerged.[3] Military spending aimed at ending the 30 year long conflict that had taken a heavy toll on the economy rose sharply from 2006.[4] Despite these pressures, government capital investment on infrastructure related development too has seen a notable increase - from 4.2 per cent of GDP in 2004 to 6.4 per cent by 2007. Clearly, the government was attempting to ensure that its 'development' drive was not neglected while it pursued its political aim of ending terrorism in the country.

A first glance at Sri Lanka's fiscal policy indicators does provide evidence of some wel-

[3] GOSL (2006), "Post-tsunami Recovery and Reconstruction", Ministry of Finance and Planning and Reconstruction and Development Agency (RADA).

[4] Relevant Appropriation Bills presented to Parliament indicate increases in allocated defence spending from Rs. 96 billion in 2006, Rs. 139 billion in 2007, Rs. 166 billion in 2008, and Rs. 177 billion in 2009.

Table 3.5
Fiscal Policy Indicators

	2005	2006	2007	2008	2009[a]
% of GDP					
Total revenue	15.5	16.3	15.8	14.9	16.4
Tax revenue	13.7	14.6	14.2	13.3	14.9
Total expenditure	23.8	24.3	23.5	22.6	22.8
Current	18.1	18.6	17.4	16.9	15.8
Capital	5.8	5.6	6.1	5.7	7.1
Deficit	-8.4	-8.0	-7.7	-7.7	-6.5
Foreign financing	3.3	2.5	3.7	0.6	2.9
Domestic financing	5.1	5.5	4.0	7.0	3.5
Government debt	90.6	87.9	85.0	81.1	77.1
Foreign	39.0	37.5	37.1	32.8	31.5
Domestic	51.6	50.3	47.9	48.3	45.6

Note: a: Estimate.

Source: CBSL, *Annual Report*, various issues.

come developments. Current expenditure as a percentage of GDP has declined progressively from 2005 to stand at 16.9 per cent in 2008. Capital expenditure has held steady for the most part over the same period. Importantly, the fiscal deficit - although still high at 7.7 per cent of GDP in 2008 - has been contained.

The weaknesses in fiscal policy management that have percolated through other key macroeconomic indicators have arisen largely due to the means through which the deficit has been financed. Domestic financing of the deficit in 2006, for instance, included a heavy reliance on borrowing from the monetary authorities. The significant inflationary pressures that the economy witnessed, particularly from 2006 onwards, was in large part attributable to domestic financing issues. As domestic financing channels began to get exhausted, Sri Lanka turned increasingly to foreign financing, and in particular to foreign currency denominated borrowing on commercial terms. The latter, although costlier, could be accessed fairly speedily, and most critically, came free of 'conditions' tied to disbursement.

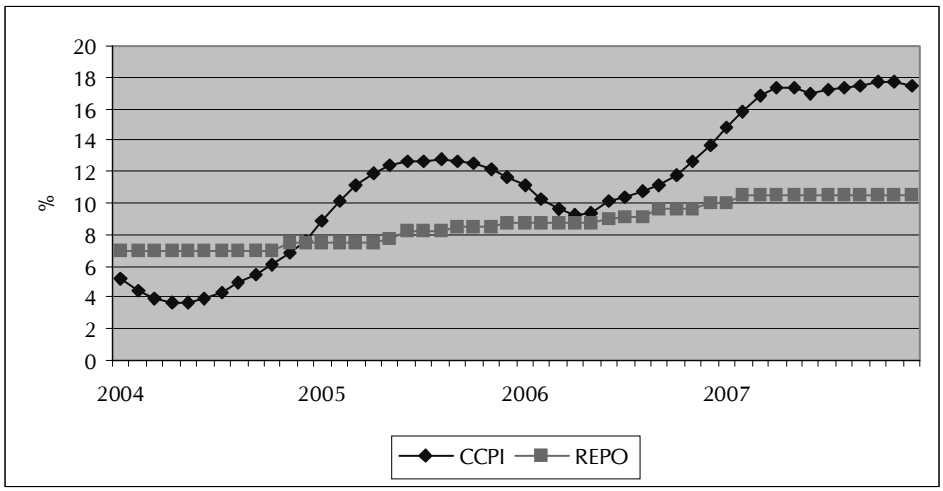
Many of these developments - monetization of the fiscal deficit, recourse to higher volumes of short-term foreign currency borrowing, etc. - held serious implications for monetary policy and exchange rate management if the Sri Lankan economy was to escape a progressive weakening of its macroeconomic environment. The policy responses on many fronts failed to respond adequately to unfolding signs of economic instability.

3.3.2 Monetary Policy

Inflationary pressures in the Sri Lankan economy were present from 2005 - arising primarily from the combined effects of the inflationary impacts of the post-tsunami reconstruction expenditure drive as well as a steady rise in international oil prices. It called for greater vigilance with regard to inflation,[5] including a watch on the external current account developments when setting monetary policy.

[5] See IPS, *Sri Lanka: State of the Economy 2005*.

Figure 3.3
Trends in Policy Interest Rates and Inflation (2004-07)



Source: CBSL, *Monthly Economic Indicators*, various issues.

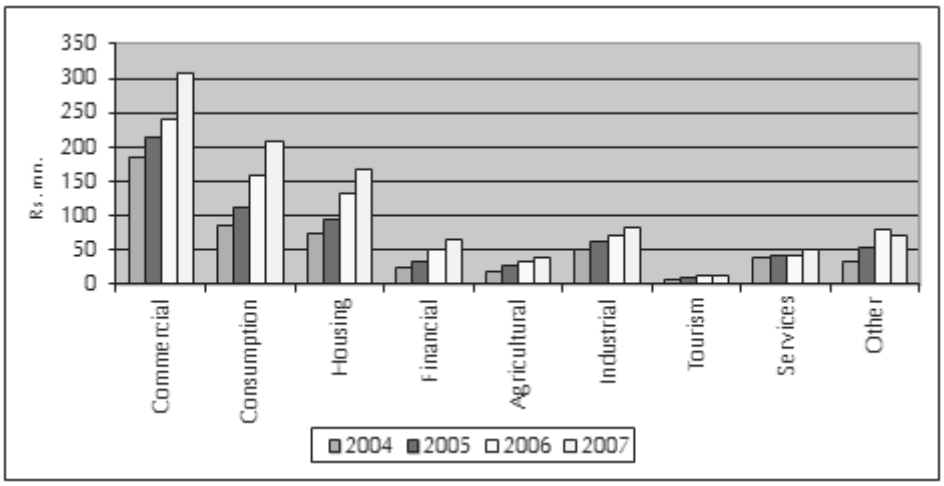
The initial monetary policy response was moderate. Indeed, even as the domestic borrowing requirement to bridge the fiscal deficit peaked in 2006, the accommodative monetary policy stance added to the inflationary pressures that had been building up in the economy from mid-2004. While various measures such as Open Market Operations (OMO) were used, adjustments to policy rates was the main instrument (at least until 2006), but this was used only very sparingly (Figure 3.3). At times, real interest rates were negative as a result during this period.

The culture of 'cheap credit' led to a rapid expansion in credit growth. Credit growth to the private sector, for instance, peaked at about 26 per cent in mid-2007 compared to an annual average of around 17 per cent during 2002-04. Such trends - where prices lose touch with the fundamentals in the midst of a credit boom - in turn can cause other downside risks to emerge in the economy. Access to cheap credit typically lends itself towards risk taking in financial markets on the part of both borrowers and lenders. Not surprisingly, much of the credit boom saw lending rise to riskier areas of activity such as lending for commercial purposes, consumption, and housing/real estate during 2005-07 as evident from Figure 3.4. Despite the absence of comparative data for 2008, available information suggests that the trend was similar. Against a total growth in loans and advances of Licensed Commercial Banks (LCBs) of 6.4 per cent in 2008, credit for consumption grew sharply by 29.5 per cent.[6]

Such developments pose risks to the health of the country's financial system stability. The global financial crisis in part was the result of similar trends - credit driven housing and consumption booms - in developed countries. As credit dries up and interest rates begin to climb, lenders become unable to repay loans. Indeed, the situation exacerbates as the liquidity squeeze begins to hit economic activity in general. Sri Lanka's experience has been that sharply rising interest rates following the credit boom has raised the risks

[6] CBSL, *Annual Report 2008*.

Figure 3.4
Lending by Licensed Commercial Banks (2004-07)



Source: CBSL, *Annual Report,* various issues.

for financial sector stability. The gross non-performing loans (NPL) ratio for the LCBs, for instance, increased from 5 per cent at end 2007 to 6 per cent by 2008 and is expected to rise further in the near term.

The exposure of large financial scams and/or mismanagement - such as Sakvithi finance, Golden Key Credit Card Company, etc. - in the course of 2008/09 have added to draining some confidence in the stability of the financial system in the country. Some of these illegally operated activities were run on the lines of "Ponsi" (pyramid) schemes that invariably run into difficulties during times of a liquidity squeeze. The inability to keep on attracting fresh deposits can quickly lead to an unravelling of such schemes. As the contagion effects spread to banks (e.g., Seylan Bank) and finance companies (e.g., The Finance and Asian Finance) the CBSL was forced to step in, in its role of regulator.

What is clearly important to note is that the stresses facing Sri Lanka's financial sector have not been due to linkages with the unfolding global financial crisis. The country's financial system was to a very great extent shielded from the turmoil of the global financial crisis due to the very limited nature of liberalization in the sector vis-à-vis international capital markets. Sri Lankan banks are allowed only limited exposure to foreign borrowing. Financial institutions in the country were also not permitted to trade in the many sophisticated financial instruments that were at the very heart of the global financial meltdown.

3.4 External Sector Developments and Impact of the Global Crisis

Greater reliance on external sources of financing to bridge Sri Lanka's fiscal deficit opened up another front on which the country's vulnerability to the emerging global economic crisis increased. From 2006, as domestic borrowing peaked and interest rates began to rise as a result, Sri Lanka began to look to short term foreign currency denominated borrowing at commercial rates of interest. These have taken the form of Sri Lanka Development Bonds (SLDBs), sovereign bonds, and syndicated loans. As a further move to attract foreign capital, investment in government securities of up to 10 per cent of the market was opened to foreigners incrementally from 2007.

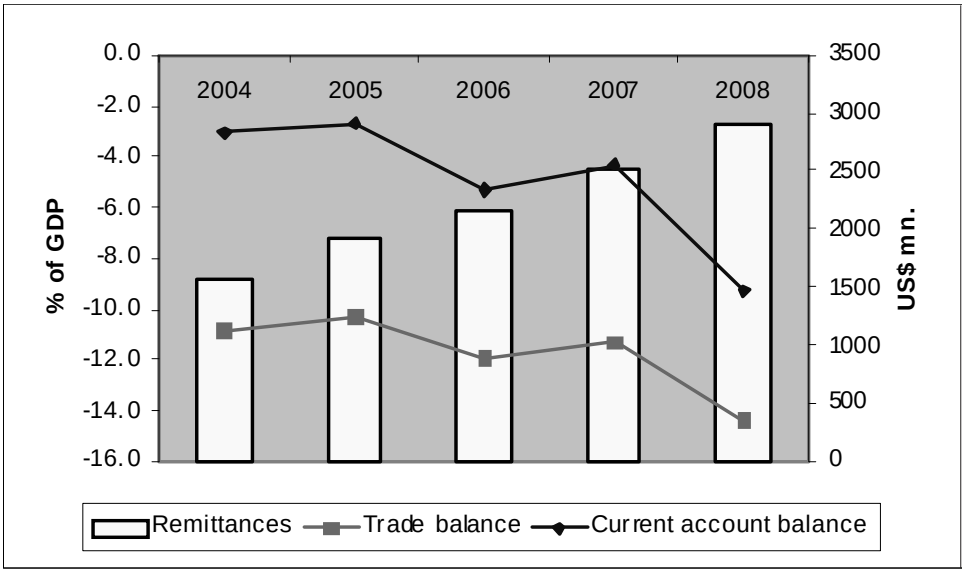
Table 3.6
Exposure to Short-term Foreign Currency Borrowing

Date	Type	Amount ($)	Maturity	Due
2006 June	SLDB	250 mn	2 yr	
2006 June	SLDB	50 mn	3 yr	2009 June
2006 August	SLDB	175 mn	3 yr	2009 August
2006 September	SLDB	70 mn	2 yr	
2006 September	SLDB	35 mn	3 yr	2009 September
2006 December	Syndicated loan	100 mn	3 yr	2009 December
2007 March	SLDB	215 mn	2 yr	2009 March
2007 October	Sovereign bond	500 mn	5 yr	
2008 June	Syndicated loan	150 mn	3 yr	
2008 June	SLDB	230 mn	2 yr	
2008 September	SLDB	60 mn	2 yr	

Source: Compiled from www.cbsl.gov.lk

Short term foreign currency borrowings were used to plug a deteriorating external payments position that the country was facing. Sri Lanka's trade balance weakened sharply as expenditures on oil imports ballooned, and while remittances increased steadily to plug some of that deficit, the external current account position has been weakening progressively (Figure 3.5). During 2006-07, the current account deficit increased to an average of 4.5 per cent of GDP. In 2008, it deteriorated sharply to 9.3 per cent of GDP. The external current account reflects the balance of investment and savings in the economy. A current account deficit is not necessarily bad: an economy may be borrowing from abroad to finance investment that will lift future growth. Nevertheless, a

Figure 3.5
External Current Account



Source: CBSL, *Annual Report*, various issues.

large deficit does mean that an economy and its currency may struggle if foreign capital inflows suddenly dry up. Thus, the nature of capital flows financing the deficit also matters.

For Sri Lanka, the immediate impact of the global economic crisis was felt at its most vulnerable point of exposure - i.e., a weak external payments position. An estimated inflow of US$ 650 million of foreign investment into Sri Lanka's Treasury bills and bond holdings reduced sharply from September 2008 with the onset of the global financial crisis. The general liquidity squeeze in developed markets and investors aversion to risks in emerging economies contributed to this outflow. By end December 2008, capital inflows in the Treasury bill and bonds market in Sri Lanka had shrunk to a mere US$ 212 million.

In addition, export earnings in the fourth quarter of 2008 fell to US$ 1,987 million (from US$ 2,089 over the same period in 2007) while import expenditure remained flat at US$ 3,245 million. Efforts by the CBSL to raise US$ 300 million in October 2008 were abandoned due to the inhospitable global financial environment, and Sri Lanka's balance of payments (BOP) deteriorated accordingly. The overall BOP shrank from a surplus of US$ 516 million in July 2008 to US$ 173 million in September 2008, to end the year with a deficit of US$ 1,225 million (compared to a surplus of US$ 531 million at end 2007).

3.4.1 Policy Response: Exchange Rate Management

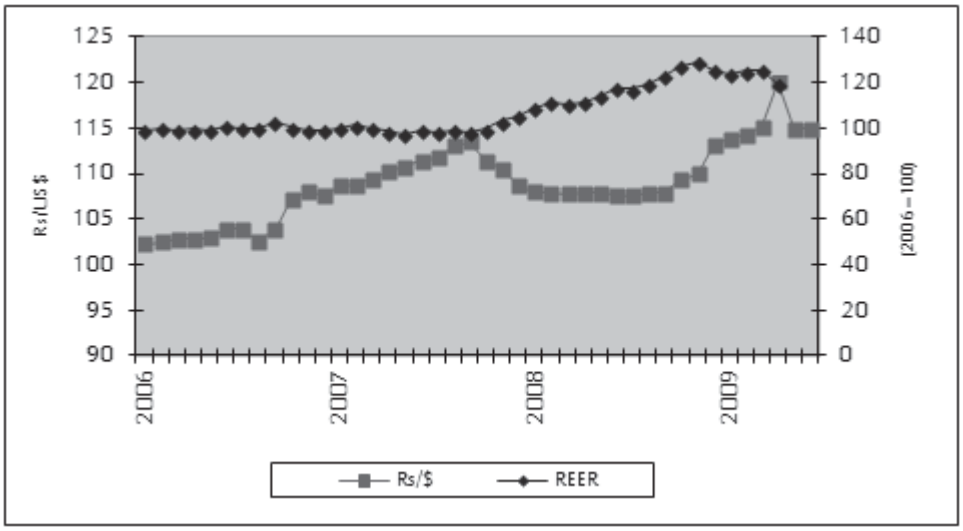
At a fundamental level, a persistent and rising external current account deficit requires appropriate policy adjustments. The deterioration in Sri Lanka's current account was driven largely by an external supply-side shock to the economy in the form of an escalation in international oil prices. Given the duration of the price escalation and the likelihood that oil prices would settle at a higher average level than that prevailing prior to the onset of the price hike, the external supply side shock could hardly be deemed 'temporary'. The persistent weakening of the current account deficit suggests that it required an appropriate adjustment in exchange rate policy management. For instance, a gradual depreciation of the currency in such circumstances would allow the relative prices of Sri Lankan goods and services to be pulled down, making them more attractive in international markets and thus boost exports.

Building pressure on the current account were to an extent offset by foreign capital inflows in the form of short term borrowing, inflows into the Treasury bill and bonds market, etc. Such inflows also have an impact on exchange rate movements: inflows can lead to upward pressure (appreciation) of the exchange rate. Critically, such exchange rate movements do not reflect a change in the aggregate demand for Sri Lanka's goods and services. They will, nonetheless, have the usual effect on relative prices, dampening net exports.

A combination of the above factors was at work to keep Sri Lanka's exchange rate remarkably steady over time (Figure 3.6). The rupee saw a nominal depreciation of just 4 per cent between September 2006 and September 2007, and even that gradual depreciation reversed in October 2007 with the inflows of foreign capital - US$ 500 million sovereign bond and other short term flows. Efforts were made thereafter to keep the exchange rate at an 'unofficial' peg of Rs. 108 to the US dollar.

A steady exchange rate was attractive for three key reasons. In the first instance, the spiralling inflationary pressures in the economy would have worsened in the context of a depreciating currency. A 'suppressed' ex-

Figure 3.6
Nominal and Real Exchange Rate Movements



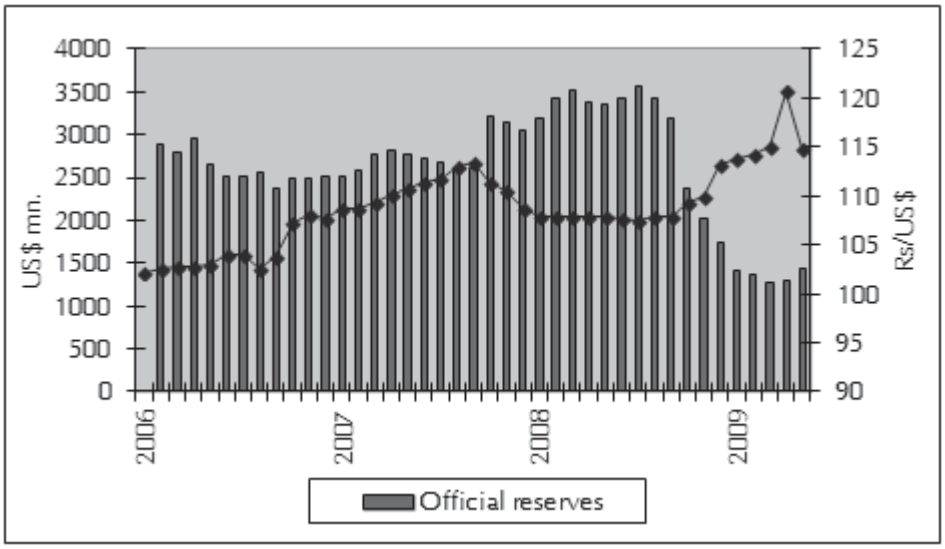
Source: CBSL, *Monthly Economic Indicators*, various issues.

change rate dampens net exports, and thus aggregate demand in the economy. In effect, it has deflationary consequences and supports monetary tightening measures. A second important reason to promote a stable exchange rate was with regard to fiscal consolidation. Sri Lanka's rising exposure to short term foreign borrowing meant that a depreciating currency raises the costs of debt servicing and repayment of the principal. A third factor was the drive to attract foreign investment into the government debt securities market. A depreciating currency, or expectations of future depreciation, raises the risks for investors and could deter such capital inflows from coming into the country.

A misalignment in the exchange rate - at odds with the fundamentals of the economy - has a cost. Clearly, when there is a sharp inflation rate differential between Sri Lanka and her competitor countries, and nominal exchange rate movements do not reflect the fundamental imbalances that exist in the external current account, there will be an appreciation of the real exchange rate that leads to loss of competitiveness of exports in international markets. The real effective exchange rate (REER) of the rupee as measured against a basket of 24 currencies appreciated sharply by nearly 28 per cent during the 12 months of October 2007 to October 2008. Thus, Sri Lanka's export sector found itself attempting to compete in a rapidly shrinking global export market on the back of a weakening in competitiveness as a result of exchange rate policy management.

However, the more costlier policy response to exchange rate management was perhaps the decision to defend the currency using up the country's foreign reserves in the latter part of 2008. As external finance pressures mounted, exacerbated by the outflow of short term foreign capital inflows, the CBSL intervened heavily in the foreign exchange market. Gross official reserves declined from US$ 2.7 billion in July 2008 to US$ 1.7 billion in December 2008, or from 3.2 months of imports to 1.5 months of imports. Prudential rules of thumb suggest that reserves should be sufficient to cover at least three months of imports.

Figure 3.7
Gross Official Reserves



Source: CBSL, *Monthly Economic Indicators*, various issues.

As import coverage declined sharply, the CBSL launched measures to re-build foreign reserves by attempting to encourage Sri Lankan non-residents to subscribe to 'diaspora' bonds and to negotiate with other Central Banks to arrange currency swaps. These measures had very limited success, and Sri Lanka was compelled to approach the International Monetary Fund (IMF) for a Stand-By Arrangement of US$ 1.9 billion for BOP support in February 2009.

3.5 Macroeconomic Response to the Global Economic Crisis

Many economies experiencing, or expected to experience, falling aggregate demand are employing fiscal policy as a key instrument - by raising expenditures or cutting taxes - to stimulate economic activity. For many developed countries, fiscal policy will likely have a more immediate impact given that the margin to reduce already low interest rates and thus provide a monetary policy stimulus is limited.

3.5.1 Is there a Role for Fiscal Policy?

With a relatively high fiscal deficit of 7.7 per cent of GDP in 2008, the options to provide a fiscal stimulus in Sri Lanka is very limited. Nonetheless, in January 2009, the government announced that it would offer a Rs. 16 billion "stimulus package" directed to mitigate the adverse impacts of the global economic downturn on the most severely affected sectors. In reality, the package translates to only around 0.3 per cent of the country's GDP, and in view of a decision to finance the package from cuts in other areas of expenditures, the impact of the fiscal stimulus is likely to be even more limited in raising aggregate demand.

It could well be argued that Sri Lanka does not require any additional fiscal stimulus to mitigate any deflationary trends in the economy. Indeed, the ending of a three decade conflict has brought the needs of rehabilitation and reconstruction of the Northern and Eastern Provinces to the forefront of policy discussion. Even if large scale infra-

structure investment does not get off the ground in 2009, substantial expenditures will have to made to meet the immediate needs of nearly 250,000 internally displaced persons (IDPs) in the Northern Province alone. As the country begins the challenging task of a medium to long term rebuilding effort, the pressures will be on how resource gaps can be filled, and how fiscal policy can be managed without spurring macroeconomic volatility. Thus, Sri Lanka's domestic compulsions override the need to subscribe to standard policy prescriptions followed in other countries in regard to the provision of a fiscal stimulus package to deal with a downturn in the global economy during 2009-10.

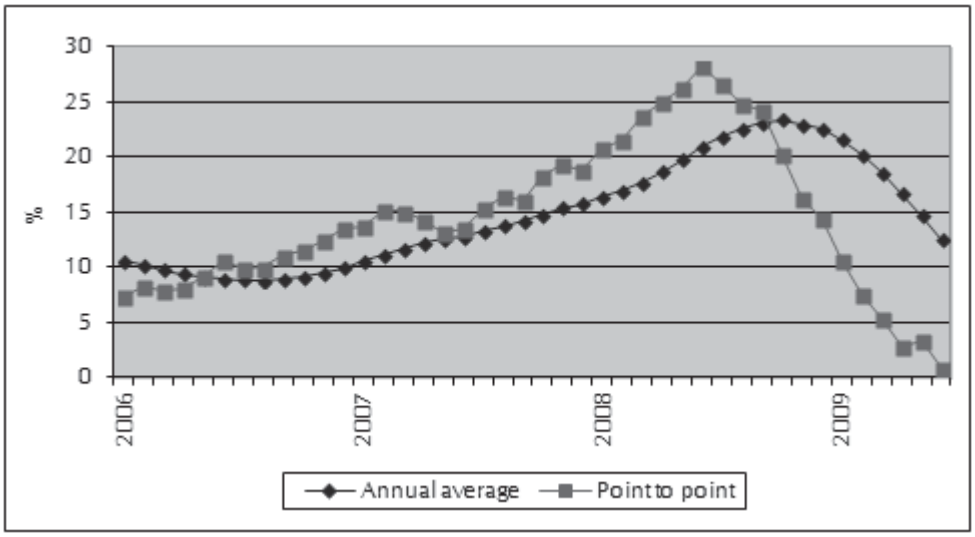
3.5.2 Room for a Monetary Policy Stimulus

The most promising development on the macroeconomic front in 2008 was evidence of a sharp reduction in inflation from the fourth quarter of 2008 (Figure 3.8). The lagged effect of the tighter monetary stance adopted since early 2007 - where reserve money growth which peaked at 21.2 per cent in 2006 had dropped markedly to a mere 1.5 per cent by end 2008 - is the key driver of the current deflationary environment.

The point-to-point rate of inflation dropped steadily from a peak of 28.2 per cent in June 2008 to 0.9 per cent by June 2009. The annualized rate of inflation peaked at 23.4 per cent in October 2008 before beginning a progressive reduction to 12.5 per cent by June 2009.

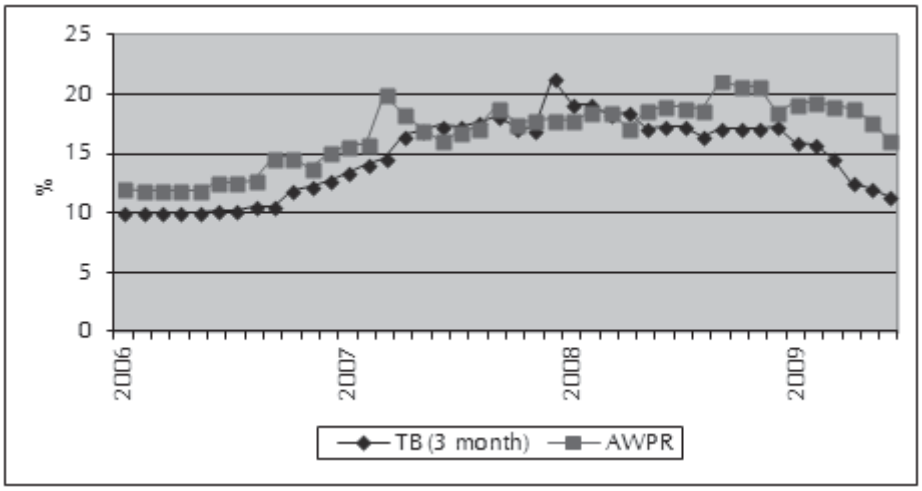
As price inflation dropped, it allowed a gradual easing of interest rates. The 3-month Treasury bill rate which peaked at 21.3 per cent by end 2007 dropped gradually to around 17 per cent by end 2008. In early 2009, the CBSL signalled its intentions to ease monetary tightening measures adopted since early 2007. The Statutory Reserve Requirement (SRR) on commercial banks was relaxed. In February 2009, policy rates were reduced for the first time since abandoning policy rate adjustments in February 2007. Interest rates on 3-month Treasury bills had dropped to 12 per cent by May 2009.

Figure 3.8
Trends in Inflation Ratess



Source: CBSL, *Monthly Economic Indicators*, various issues.

Figure 3.9
Trends in Interest Rates



Source: CBSL, *Monthly Economic Indicators*, various issues.

The impact of a monetary policy stimulus is critically dependent on the effectiveness of the transmission mechanism in the financial system. Lending rates have been slow to respond to easing of liquidity constraints. The Average Weighted Prime Lending Rate (AWPR), for instance, dropped only marginally to begin with (Figure 3.9). The past credit excesses that have led to a mismatch of the asset and liabilities portfolios of banks have hindered a speedier adjustment of interest rates. Indeed, the ability of the CBSL to sustain the easing of monetary policy itself is debatable.

3.6 Constraints on 'Policy Space'

Restoring and sustaining macroeconomic stability while keeping Sri Lanka's growth momentum buoyant will be the key challenge in the medium term. In the immediate short term, fiscal pressures will mount. The slowdown in economic activity will inevitably eat into government revenue collection. The Mid-Year Fiscal Position Report prepared by the Ministry of Finance and Planning suggests that in the period January-May 2009, government revenue had contracted by 8 per cent, with the sharpest falls in key revenue sources such as VAT collections which declined by 24.3 per cent.

Other programmes - such as 'Mathata Thitha',[7] BOI concessions, duty waivers on essential food items, duty free car imports for public servants, etc., - have also eaten into government revenue collection. Efforts to bridge revenue shortfalls has seen the introduction of less welcome ad hoc adjustments such as the scaling up of cess rates, an excise duty on gas, a Nation Building Tax, specific duties on selected imports, etc. Thus, collections from cess rates, import duties and other taxes grew by 11.1 per cent, 7.5 per cent and 39.5 per cent, respectively during the period January-May 2009. However, these taxes account for only around 20 per cent of total revenue to the government and more comprehensive reforms are required to sustain revenue growth in the medium to longer term. Indeed, acknowledging the need, the government has appointed a Presidential Taxation Commission to look at ways and means of raising government revenue to a

[7] The scaling up of tobacco and liquor excise duty as a part of the government's programme to discourage consumption.

Table 3.7
Deficit Financing

% of GDP	**2006**	**2007**	**2008**	**2009**[a]
Total financing	8.4	7.7	7.7	6.5
Foreign financing	2.5	3.7	0.6	2.9
Loans	1.4	2.8	-0.1	2.4
Grants	1.0	0.9	0.7	0.6
Domestic Financing	5.6	4.0	7.0	3.5
Market borrowing	5.6	3.6	7.0	3.5

Notes: a: Estimate.

Source: CBSL, *Annual Report*, various issues.

developing country average of 20 per cent of GDP by 2011.

In the midst of revenue constraints for the government, expenditure is set to mount, not least due to the rehabilitation needs of the IDPs in the Northern Province. According to the Mid-Year Fiscal Position Report, expenditures have already risen by 28 per cent during January-April 2009 from the corresponding period for 2008. Even if the targeted deficit for 2009 is contained to the budgeted 6.5 per cent of GDP, the anticipated means of financing it is questionable (Table 3.7). It appears to rely quite heavily on foreign financing, which in the more recent past, has translated into foreign borrowing rather than loans on concessional terms. Foreign borrowing in the current global economic environment will not be very attractive. On the other hand, even if donor funding for the Northern and Eastern Province reconstruction process is sought, there is typically a one year gap or so between pledges/commitments translating into disbursements. Thus, there is every likelihood that the government will have to resort to a higher level of domestic borrowing than anticipated in the budgetary proposals. In such an event, the policy space to sustain a reduction in interest rates will be limited, particularly in view of the fact that Sri Lanka's annual rate of inflation still remains fairly high at 12.5 per cent by mid-2009.

Developments on the external sector will also have a critical bearing on policy manoeuverability. Sri Lanka can expect to see a narrowing of its trade deficit in 2009 as the drop in import expenditure exceeds any reduction in export earnings. The trade deficit for the first quarter of 2009 had dropped to US$ 645 million as against US$ 1,401 million recorded over the same period in 2008. The growth in remittance inflows has also remained healthy, reaching US$ 774 million in the first quarter of 2009 as against an inflow of US$ 787 million over the same period in 2008. Thus, Sri Lanka will likely see an improvement in its current account deficit in 2009. However, it is still likely to be relatively high given that any improvement is from a severe weakening of 9.3 per cent of GDP in 2008.

A welcome development has been evidence that the exchange rate is being allowed to respond to market signals. The rupee depreciated sharply to Rs. 120.7 to the US dollar in March 2009 in the wake of depleting official reserves. It has since stabilized at Rs. 114-115 per US dollar in the face of weakening import demand, and anticipated build up of foreign capital with the application to the IMF as well as investor confidence on the back of the long awaited end to military operations in the Northern Province. Pledges of foreign loans/grants - e.g., US$ 500 million loan pledged by Libya - have also helped to steady the exchange rate.

However, Sri Lanka is not out of the woods in terms of its vulnerability to external financing constraints. The country's gross official reserves which slipped further to US$ 1,272 million by March 2009 - sufficient for only 1.2 months of imports - improved to US$ 1,436 million by May 2009 (or 1.4 months of imports). This was largely due to the absorption by the CBSL of foreign exchange from the market. Despite the limited build up of reserves, questionable attempts to delay the approval of the Stand-By Arrangement and/or attach 'political' conditions to such a loan have kept a degree of economic uncertainty alive.

Sri Lanka's experience with regard to its request for BOP support in the midst of a global economic crisis underlines the nature of geo-political pressures that developing countries can face. In such a context, it becomes all the more important that prudent policy responses are adopted in managing the country's economy. An inappropriate policy turn weakens the economy to a point that it has no other viable option but to approach the lender of last resort - i.e., the IMF - and accede to 'conditionalities' that can range from exchange policy management to fiscal consolidation. At this particular juncture, Sri Lanka needs to retain some degree of fiscal flexibility to respond appropriately to the overwhelming rehabilitation and reconstruction needs of the Northern and Eastern Provinces.

This calls for domestic responsibility to rationalize public expenditures - to eliminate wasteful expenditures in the delivery of public services. Rationalization will allow the reconstruction needs to be met in part by redirecting existing resources, and without relying unduly on borrowed funds or on donor support. With the end of the three decade long conflict, the country's longer term development potential looks promising. It should not be derailed by imprudent handling of macroeconomic management in the interim. Reconstruction related expenditures will have inflationary consequences, much as they did during the post-tsunami reconstruction effort. A much more appropriate coordinated response - between fiscal and monetary policy - than seen in the more recent past will be needed to address macroeconomic imbalances that are likely to emerge.

The near term outlook for the Sri Lankan economy in the context of the current global downturn and domestic imperatives will be discussed in Chapter 17.

4. How Will the Sri Lankan Labour Market Withstand the Global Economic Crisis?

4.1 Introduction

The global economic crisis has made inroads into the labour markets of countries across the world. A report on *Global Employment Trends* by the International Labour Organization (ILO) in January 2009 predicts that the global economic crisis will result in the number of unemployed increasing from its 2007 level of 18 million to 30 million persons under present conditions. The global unemployment rate is estimated to rise to 6.1 per cent, compared to the 2007 rate of 5.7 per cent. In a worst case scenario, this rate is expected to increase further to 7.1 per cent, resulting in an estimated 50 million unemployed across the globe. The number of working poor in the world - those earning less than US$ 2 a day per person - is estimated to rise up to 1.4 billion, or 45 per cent of the employed population of the world. The report also predicts that the proportion of people in vulnerable employment can rise to 53 per cent of the employed population.[1] Although advanced economies are predicted to be more affected by unemployment, the socio-economic effect of unemployment is likely to be more severe in sub-Saharan Africa and South Asia as these regions have poor labour market conditions - characterized by high unemployment, low employment creation, low levels of social protection, low wages, and the word's largest share of working poor.[2]

How the ongoing crisis will affect the labour market differs from country to country. These differences are only partly explained by the downturn in economic activities in different countries. The structure of the labour market in a country and the policy environment that governs it also play a large role in the explanation. For example, job losses relating to the present crisis are highest in the US, which has one of the most flexible labour markets. The job losses in the US amounted to 4.4 million from December 2007 to March 2009, resulting in an unemployment rate of 8.1 per cent in February 2009, the highest recorded rate in 25 years.[3] By contrast, in Europe, where labour markets are more rigid, the unemployment rates are below that in the US. In Japan, although output is reducing at a faster rate, unemployment is low. This is partly due to a 'dual labour market', where regular workers receive higher benefits and have more secure jobs relative to temporary workers. As a result, job losses in Japan are becoming more apparent amongst temporary workers. Similar outcomes are also apparent in countries with similarly 'dual' labour markets, such as Spain.[4]

The impact of the global economic crisis on the labour markets of the developing countries will also depend on the structure of their labour markets and their exposure to the world markets. Unlike for the developed

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[1] Vulnerable employment comprises workers who are either self-employed or are contributing family workers. They are least likely to be covered by safety nets that guard workers against income loss during economic downturns.

[2] ILO (January 2009), "Global Employment Trends", International Labour Organization. Available at: http://www.ilocarib.org.tt/portal/images/stories/contenido/pdf/LabourMarketInformation/get09.pdf [accessed 13th May 2009].

[3] *The Economist*, March 14th-20th, 2009, Vol. 390, No. 8622.

[4] *The Economist*, March 14th-20th, 2009, Vol. 390, No. 8622.

economies, the consequences of the global economic crisis on the labour markets in the developing world are less known due to lack of information on these markets. Available information suggests that the developing countries have also been severely affected by the crisis, particularly those sectors that are more exposed to the global market.[5] However, with decreasing household incomes and slowing consumer demand, other sectors are also being affected by the crisis. For example, according to a rapid assessment of the impact of the global economic crisis on Indonesia,[6] by December 2008, 17,300 workers were already laid off and there were plans to lay off a further 24,100. According to the same study, the sectors most affected by the crisis in Indonesia were the manufacturing industries such as textiles and garments, wood industry, metal and steel industry, and the pulp and paper industry. Many workers also left plantation companies due to the scaling down of labour forces by companies affected by falling commodity prices. In addition, the food and beverages, electronics and construction industries also experienced job losses due to slow demand. Further, like in many other labour exporting countries, Indonesia's 5.8 million migrant workers were also vulnerable to job losses due to the crisis. Some estimates suggest that 250,000 Indonesian migrant workers have returned home, many from the export agricultural sectors in Malaysia.

The ILO (2009) predicts that as the employment in the formal economy shrinks, workers will move to the informal economy and to rural areas, driving down wages in these sectors and pushing households towards poverty.[7] The crisis will increase poverty in two ways. The first is through the employment effect, as individuals lose jobs, household incomes will reduce. The second is through the income effect, where reduction in wages and profits caused by excess supply of labour and reduced demand for goods will erode family incomes. The World Bank estimates that some 53 million people will fall below the level of extreme poverty due to the crisis.[8]

The exact extent of the crisis on the labour market in Sri Lanka can only be tentatively evaluated due to the lack of timely data availability. As described later, already there is evidence that the more exposed economic sectors - such as the garments, export-oriented agriculture and tourism sectors, as well as the construction sector have been affected by the crisis. This Chapter will examine some of these issues. Section 4.2 will discuss the international policy responses - by both developed and developing countries - to the labour market issues brought on by the current economic crisis and the experience from past responses to similar economic downturns. Section 4.3 will describe the status of the Sri Lankan labour market at the onset of the crisis, and how it has been affected by the crisis thus far. Section 4.4 will describe the social safety nets and their coverage in the country, and their usefulness in providing social support during the present crisis. Section 4.5 will examine the government's response to the crisis and its likely outcomes. Lastly, the Chapter will discuss changes that need to take place to better prepare the labour market to face future such shocks.

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[5] *Ibid.*

[6] Djaja, Komara (2009), "Impact of the Global Financial and Economic Crisis on Indonesia - A Rapid Assessment", ILO.

[7] ILO (January 2009), "Global Employment Trends", International Labour Organization. Available at: http://www.ilocarib.org.tt/portal/images/stories/contenido/pdf/LabourMarketInformation/get09.pdf [accessed 13th May 2009].

[8] *The Economist,* March 14th-20th, 2009, Vol. 390, No. 8622.

4.2 International Policy Responses

4.2.1 Developed Countries

Across the globe, governments have responded to the job losses and declining incomes in a variety of ways. In the US, which has low social safety nets compared to other developed countries, the government is expanding unemployment safety nets by increasing coverage, improving benefits, and lengthening the maximum duration for receiving benefits. In Japan, the government is giving social assistance to non-regular workers, a group that has been sidelined by labour market policies in that country. In other countries, governments are providing financial incentives to companies to keep workers. For example, in Austria, Denmark, France, Germany, Hungary, Italy and Spain, governments are encouraging firms to shorten work weeks, rather than laying off workers. The difference of the shorter work week is paid by the government. Other countries are relaxing the requirement of companies to pay social insurance contributions for affected workers in the short term. The UK has deviated from this general practice by paying firms to hire and train workers who have been unemployed for more than six months, thus allowing the labour market to adjust to the structural changes that are taking place.[9] Japan has tried a combination of policies to assist the jobless. In its earlier less successful attempts, Japan tried to encourage firms to hire temporary workers as regular workers and to send the unemployed to the rural areas to work in farms. These attempts were less successful, as cash strapped firms were unwilling to broaden their shares of the formal sector work force. In more recent times, the government has considered relaxing the requirements for receiving unemployment benefits and providing newly laid-off workers with short term loans for housing and living expenses. It is also subsidizing the pay of workers on mandatory leave, and giving incentives to firms to re-hire laid-off staff. The government is also giving incentives to start up new businesses.

Measures such as subsidizing firms to keep workers and providing incentives for firms to re-hire fired workers cannot be sustained over a long period. In the long run, what is needed is to create productive new jobs and to train workers to match the skill requirements of those jobs. However, until the confidence in the financial markets return and the liquidity situation improves, the scope for new investments will be muted.

4.2.2 Developing Countries

The policy measures adopted by developing countries are somewhat different. Most of these countries do not have unemployment insurance programmes that cover a majority of the workers. As such, governments need to come up with alternative mechanisms to create jobs, and support household income.

The main means adopted by governments of developing economies to support the labour market is by investing in infrastructure projects that create jobs, and by providing direct financial assistance to the poorest. Both China and India are injecting money for infrastructure development projects. Some countries are allowing workers to borrow from their pre-funded retirement schemes as a temporary measure of financial assistance. Countries like Chile and Colombia already have unemployment insurance schemes, where workers pay into individual unemployment accounts from which they can withdraw money during periods of unemployment.[10]

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[9] *The Economist,* March 14th-20th, 2009, Vol. 390, No. 8622.

[10] *The Economist,* March 14th-20th, 2009, Vol. 390, No. 8622.

The effectiveness of these different measures in providing relief to those affected by income and job losses depends largely on the ability of the planners and the implementers. A particular challenge for interventions that seek to assist through provision of jobs or income assistance is targeting. Unless properly targeted, the interventions will do little to improve the living standards of those who are most affected by the crisis. Especially in developing countries, where administrative capacity and governance is weak, ensuring effective coverage is difficult. A concern with regard to the introduction of large scale infrastructure projects is the timing. Developing countries are well known for delays in the commencement of such projects due to procedural bottlenecks such as inefficiencies in awarding tenders and acquiring land needed for such projects. For countries which do not have their own financial resources, raising funds for infrastructure projects will also be a problem. Hence, unless there are already projects in the pipeline, the ability of governments to initiate and start new projects in the short term, when jobs are needed, is unlikely to happen. Governments may have a better chance of implementing simple projects that require less administrative capacity - such as clearing public parks, etc. In this regard, allowing the affected to rely on legislated saving schemes, such as unemployment insurance schemes - such as those in Chile and Colombia - and pre-funded retirement schemes are better in terms of targeting. However, in some countries this would not be a feasible option when these funds have limited liquidity, and when relevant governments are unable to provide credit to these schemes for such relief measures.

4.2.3 Lessons from Past Crises

Lessons from previous economic crises, such as the Asian financial crises of the late 1990s highlight the importance of ensuring that the policy measures taken by governments are targeted, timely and temporary. If not, the interventions will not result in the desired outcomes. Worse, they may result in long term imbalances that are difficult to correct. The experience of public works programmes in Indonesia as a means of increasing labour demand during the time of the Asian financial crises highlights the need for proper targeting. During this crisis, the Indonesian government introduced public works programmes with wages set at the minimum wage levels in Jakarta. However, as the minimum wage levels varied across regions, and as the minimum wages in Jakarta were the highest, the programme attracted a broader band of workers than the targeted.[11]

The need for temporary solutions for solving temporary problems is well illustrated by the consequences of the labour market policy changes by European governments subsequent to the 1970s oil shocks. These governments introduced early retirement schemes to encourage workers to leave the labour market voluntarily as a means of easing the unemployment problem at the time. However, these policies resulted in an increase in the dependency ratio, as people used this as a means of leaving the labour market early, years after the markets recovered from the shock. Once established, these types of policy measures are difficult to reverse due to political pressure.

In the past, during economic crises, governments have intervened in the labour markets

[11] Manning, Chris (2001), "Globalization, Economic Crisis and Labour Market Policy: Lessons from East Asia", No.23, East-West Center Working Papers, East, West Center, Hawaii, USA.

in a variety of ways. These can be broadly categorized into two: active or passive policies. Active labour market programmes (ALMP) include, a) programmes for improving the quality of labour supply, b) programmes for raising labour demand, and c) programmes that aim to facilitate job matching.

The first type of programmes aims to re-train workers to either start their own businesses or to fit into new sectors of the economy. The success of these programmes largely depend on the success of the planners to match the skill training to the skill demand in the market. The second type of programmes aims to increase demand for labour by investing in projects that create employment. The main challenge in these programmes is to ensure proper targeting. For example, if the unemployed are mostly laid-off garment sector female workers, infrastructure projects that provide employment for male construction workers will not result in the desired outcomes. Finally, the third type of programmes helps to match job seekers to employers. However, the success of these programmes depend on the incentives given to job seekers and to employers to register with the prorgamme. In some countries, the unemployed are required to register with job search centres in order to receive benefits. In such instances, a larger pool of job seekers register with these centres, and employers are also attracted by the large skill pool, and willingly register available vacancies.[12]

The passive labour market policies adopted by countries as social safety nets include, a) provident funds covering pensions, disability and worker health, 2) severance payments, 3) minimum wage policies, and 4) unemployment insurance schemes. However, the ability of these to protect workers during times of crisis will depend on their coverage and their effectiveness. In many countries, only the formal sector workers are covered by these policies. When the informal sector is large relative to the formal sector, the ability of these policies to safeguard workers will be less.

The policies are also ineffective when the existing policies are not properly implemented. Proper implementation of policies is especially difficult during times of crisis. For example, during the Asian financial crises, minimum wage regulations were not effective in maintaining wages. The average real wages were lower than the stipulated in many affected countries.[13] Studies have also found that many firms that face financial hardships fail to pay severance payments to displaced workers. Further, as most severance pay amounts are linked to salaries and tenure at work, different workers receive different payments. This has led to management problems.

Unemployment insurance schemes may not be effective in protecting workers during times of crises. First, these schemes may also not cover the whole labour force. In many countries, including some developed countries, part time workers and contractual workers are not covered by unemployment insurance programmes. Also, when the number of unemployed is large, as usually is the case during times of economic downturns, the programme costs can be large, making them unsustainable. Lastly, implementing the programmes can be difficult in countries where institutions are not strong and lack capacity.[14]

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[12] *Ibid.*

[13] *Ibid.*

[14] *Ibid.*

4.3 The Effects of the Crisis on the Sri Lankan Labour Market

4.3.1 Performance and Structure of the Labour Market

According to the *Labour Force Survey of Sri Lanka*, in 2008, 7.6 million individuals were economically active in the country. This represents a labour force participation rate - the proportion of individuals in the employable age who are active in the labour market of 50.2 per cent.[15] Of those in the labour force, roughly 7.2 million were employed, while the rest (0.39 million) were unemployed. In addition to the workers employed domestically, some 1.8 million Sri Lankans are estimated to be working abroad. Of this, around 62 per cent are estimated to be female workers who are mainly working as house maids in the Middle East.[16]

Sri Lanka's unemployment rate has come down steadily since the early 1990s. At present, it is around 5 per cent. However, unemployment remains high for females (9 per cent), for youth (22 per cent for 15-19

Table 4.1
Labour Market Indicators and the Structure of the Labour Force[a]

	2006	2007	2008
Household population[b] ('000)	14,834	15,048	15,079
Labour force ('000)	7,599	7,489	7,569
Employed ('000)	7,105	7,042	7,175
Unemployed ('000)	493	447	394
Labour force participation rate	51.2	49.8	50.2
Unemployment rate	6.5	6.0	5.2
Employment-to-population ratio	47.9	46.8	47.6
Employment by sector (%)	100.0	100.0	100.0
Agriculture	32.2	31.3	32.7
Industry	26.6	26.6	26.3
Manufacturing	19.2	18.9	18.9
Construction[c]	7.4	7.7	7.4
Services	41.2	42.1	41.0
Trade and hotels, etc.	15.3	14.9	14.3
Transport, storage and communication	6.1	6.5	5.9
Finance, insurance and real estate	3.1	3.1	3.3
Personal services and other	16.8	17.7	17.5
Emploment by status (%)	100.0	100.0	100.0
Public	13.4	13.8	14.9
Private	42.1	42.7	41.1
Employers	3.1	2.8	3.0
Self-employed	30.8	30.4	30.2
Unpaid family workers	10.5	10.3	10.8

Notes: a: Data exclude both Northern and Eastern Provinces, b: Aged 10 years and above, c: Mining and quarrying, electricity, gas and water categorized under construction.

Source: CBSL, *Annual Report 2008*.

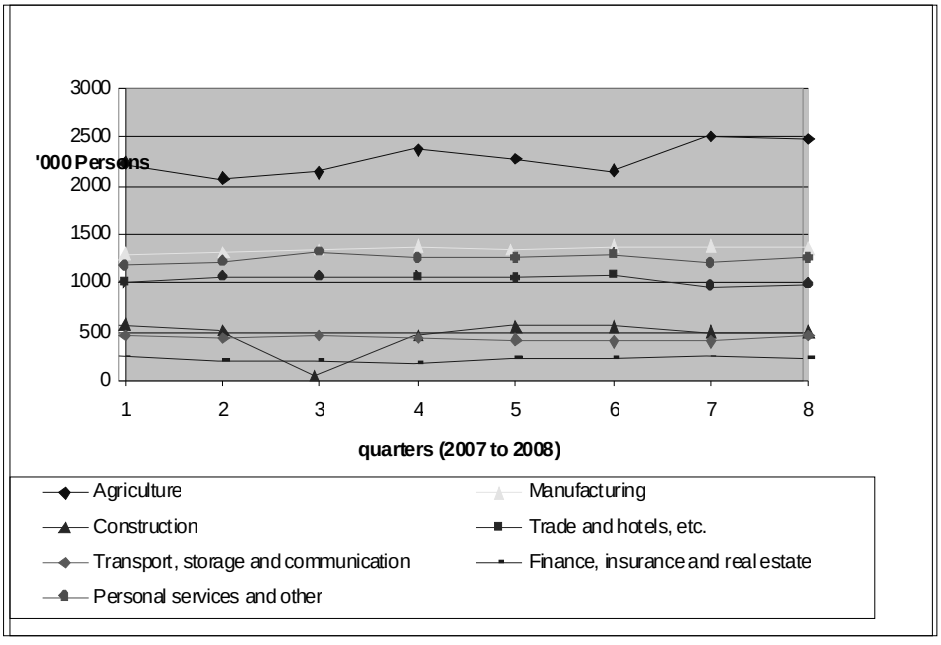
[15] Central Bank of Sri Lanka, *Annual Report 2008*.

[16] *Ibid.*

year olds, and 15 per cent for 20-29 year olds) and for the educated (12 per cent for those qualified in A Levels). Compared to regional averages of unemployment, youth unemployment rates are high in the country. The lowering unemployment rates are mainly explained by a dwindling youth labour force due to demographic changes, labour emigration, and increased participation in higher education.[17]

While the employment-to-population ratio - an indicator largely regarded as a broad measure of the ability of the economy to create employment - has improved over the past decades, it is still low in Sri Lanka compared to regional averages, indicating low job creation in the country.[18] A large proportion of the employment that has been created in the last decade has been in the informal sector, particularly as self-employed. At present, close to 70 per cent of the employed are in the informal sector. In terms of main industrial sectors, the services sector employed the largest proportion (41 per cent) in 2008, followed by the agriculture (32.7 per cent) and industry (26.3 per cent) sectors. These proportions have remained more or less the same in the last three years (see Table 4.1). Of the total employed, the share in agriculture has decreased over time. However, there is no corresponding expansion in wage and salaried employment. Overall, since 1992, most of the gain in employment has been in 'self-employment' at the expense of workers in the public and pri-

Figure 4.1
Employment by Economic Activity



Source: Calculations based on CBSL, *Annual Report*, various issues.

[17] *Arunatilake, N. and P. Jayawardena (2008), 'Labour Market Trends and Outcomes in Sri Lanka', Institute of Policy Studies of Sri Lanka, mimeo.*

[18] For example, around 2005, the youth (15 to 24 year olds) employment-to-population ratio in Sri Lanka was 33.8 per cent, when the corresponding statistics for South Asia and East Asia were, 42.5 per cent and 62.1 per cent, respectively. *Ibid*.

vate sectors.[19] These statistics suggest that a large proportion of workers (around 40 per cent) in the market fall into the category of vulnerable workers - defined to be workers who are either self-employed or are unpaid family workers. The ILO (2009) indicates the need to track the size of these vulnerable workers as they are the least likely to be covered by social safety nets.[20]

4.3.2 Effects of the Crisis on the Labour Market

Since the present crisis started in developed countries around September 2008, the effects of the crisis on the fourth quarter of 2008 labour force data are of interest. Compared to the last quarter of 2007, the employment levels in the last quarter of 2008 shows a sharp decline in the trade and hotels sub-sector coming under services, and in the manufacturing sub-sector under industry. However, employment in agriculture, the construction sub-sector of industry, and all sub-sectors of the services sector (other than the trade and hotels sub- sector) shows an increase in employment levels. According to the latest available data, the overall employment level has increased by 129,000 from the first quarter 2008 to the first quarter 2009. The gain in employment is mainly due to improvements in employment in agriculture (of 203,000) and services (of 21,000) sectors. Employment in the industry sector is estimated to have contracted by 95,000.[21] In the absence of more detailed information, it is difficult to attribute these trends in employment to the present global crisis. However, anecdotal evidence suggests that employment in the trade and hotel sector and in manufacturing is affected by the economic crisis.

Further, there is firm level evidence that confirms that the manufacturing sector has been affected by the global crisis. In the last year, 40,000 garment sector workers were estimated to have been laid off with the closure of several garment factories.[22] According to the Board of Investment (BOI), 11 firms in the Export Processing Zones (EPZs) have closed down during the period September 2008-March 2009 where 3,198 workers lost their jobs. In comparison, only one firm closed between September 2007 to March 2008.[23] According to information from District Labour Offices of the Department of Labour, the majority of the closures were due to lack or reduction of orders and low demand.[24] These developments are likely to continue in 2009 with the predicted deepening of the economic downturn in developed countries. Usually, there is a lag between an economic downturn and the worsening of employment conditions as firms take time to adjust. Given this, the employment conditions can be expected to worsen in the coming months.

4.3.3 Effects of the Crisis on Migrant Trends

As indicated earlier, foreign employment provides a significant source of employment (and foreign financing) to the country. The international literature on migration related issues suggests that over-dependence on foreign employment could make a country more

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[19] *Ibid.*

[20] *ILO (January 2009), "Global Employment Trends", International Labour Organization. Available at: http://www.ilocarib.org.tt/portal/images/stories/contenido/pdf/LabourMarketInformation/get09.pdf [accessed 13th May 2009].*

[21] Department of Census and Statistics (2009), *Bulletin of Labour Force Statistics of Sri Lanka.*

[22] *The Sunday Times,* 'Global Crisis Rips Garment Industry', 1st March, 2009.

[23] Gunatilake, Ramani (2009), "Rapid Assessment of the Impact of the Global Economic Crisis on Employment and Industrial Relations in Sri Lanka", ILO.

[24] Information from District Labour Offices relate to BOI as well as non-BOI firms. *Ibid.*

Table 4.2
Departures for Foreign Employment

				% increase	
	2006	**2007**	**2008**	**2006/07**	**2007/08**
Total placements	201,948	218,459	252,021	8.2	15.4
By manpower category					
Housemaid	99,659	102,349	108,709	2.7	6.2
Other					
Skilled labour	45,063	53,462	65,124	18.6	21.8
Unskilled labour	40,705	52,182	59,427	28.2	13.9
Other	16,521	10,466	18,761	-36.7	79.3

Source: CBSL, *Annual Report 2008*.

vulnerable to external shocks.[25] This is due to the fact that employment protection policies and lay-offs in destination countries could increase labour market pressures in the countries of origin. Table 4.2 provides the latest available figures on departures for foreign employment from Sri Lanka. These indicate that the effect of the global crisis has not affected foreign job placements in 2008. In fact, the trends in foreign job placements show a higher growth rate from 2007 to 2008, compared to the earlier year (see Table 4.2). It is of further interest to note that the total growth in foreign job placements have increased, particularly due to the increase in the placement of skilled and other workers (including professionals). This is the group that is most likely to be affected by the global economic crisis, due to such factors as cut-backs in construction and service sectors in the labour receiving countries. However, as in the domestic market, the effect of the global crisis on foreign job placements could be felt more in 2009. There are already some indications that job orders coming from the Middle Eastern countries - a major destination for migrant workers - are declining.[26]

4.3.4 Effects of the Crisis on Wage Trends

Over the decade 1996-2006, wage trends in Sri Lanka have tended to deteriorate. On average, real earnings grew faster over the 1996 to 2000 period compared to the 2000 to 2006 period. From 1996 to 2000, real earnings grew at 3.8 per cent on average annually, but the corresponding rate for the 2000 to 2006 period was only 0.7 per cent.[27] This decline in real earnings growth is similar for males and females and for private sector workers. However, real earnings in the public sector have grown at a higher rate in the latter period. The above trends are largely explained by the poor performance of the garment and tourist sectors due to the poor external environment and increased competition. At the same time, high inflation and interest rates over the 2000 to 2006 period has crowded out private investments. The ability of the country to attract foreign investment in the post-2000 period has also been low, except in the post-tsunami period, due to the unstable macroeconomic environment in the country. Thus, income levels in the country were already low at the start of the crisis in the country.

[25] World Bank (2006), "Global Economic Prospects: Economic Implications of Remittances and Migration", World Bank.

[26] http://southasia.oneworld.net/todaysheadlines/sri-lanka-uncertain-labour-markets-forecast-bleak-economy. [Accessed: 29th April, 2009].

[27] Arunatilake, N. and P. Jayawardena. (2008). 'Labour Market Trends and Outcomes in Sri Lanka', IPS, mimeo.

In 2007 and 2008, formal private sector wages - measured by the minimum wage rate indices of workers administered by regulations under the Wages Board Trades - shows an increase in real wages (as well as in nominal wages). Although workers in the informal sector also experienced an increase in wages nominally, the real wages have declined for workers in the construction sector and for workers in the tea industry. Although there was a decrease in real wages in 2007, the decline in 2008 is more marked.[28] In contrast, the informal sector workers in rubber and coconut industries, and male paddy workers, have experienced a real wage gain in 2008. The decline in real wages in the tea industry may have been affected by demand shortages in the external market due to the present crisis. Government interventions to stabilize tea and rubber prices may have helped to keep the nominal informal sector wages in the export agriculture sector industries from slipping. However, with the deepening of the economic downturn in developing countries, export markets will further tighten, which will adversely affect wage levels in 2009.

4.4 Social Safety Nets and their Coverage

At present, there are several schemes for providing social security for workers in Sri Lanka. These include various retirement benefit schemes, severance pay schemes, and gratuity payments. This section discusses how these may serve as a safety net to workers affected by the crisis.

4.4.1 Retirement Schemes

There are two main retirement scheme in the country. The Public Service Pension Scheme (PSPS) is provided to former permanent civil servants at retirement. The Employees' Provident Fund (EPF) is available for formal private sector workers.[29] This scheme covers 63 per cent of the formal private sector workers. In addition, there are retirement schemes for farmers (28 per cent coverage), fishermen (78 per cent coverage), self-employed persons (7.7 per cent coverage), and a variety of other workers in the informal sector. Together, all the programmes cover only a little more than a quarter of the working age population in the country.[30]

The retirement schemes are not useful safety nets at a time of crisis such as this given that a person needs to be of a certain age to benefit from these schemes. The earliest a full pension can be obtained is at age 55 for men and age 50 for females, under both the PSPS scheme and the EPF scheme. For workers in the public sector this is not a concern as their jobs are highly protected. Older eligible workers in the private sector who are covered by these programmes can receive some benefit from these schemes in case of retrenchment due to the economic crisis.[31] Some countries are allowing workers to borrow against mandatory retirement schemes - such as the EPF scheme - as a temporary income assistance measure. If Sri Lanka too introduces such a scheme, retrenched workers can get some income support from their retirement savings.

4.4.2 Separation Related Compensation

Sri Lanka does not have a formal unemployment insurance scheme. However, labour legislation in the country has clauses that prevent employers from terminating workers without reason and without compensation. The Termination of Employment of Workmen (Special Provisions) Act of 1971 (TEWA)

[28] CBSL, *Annual Report 2008*.

[29] In addition, some formal private sector workers are covered by approved private provident funds and other private pension funds.

[30] World Bank (2006), "Sri Lanka: Strengthening Social Protection", World Bank.

[31] *Ibid*.

specifies strict procedures for employers to follow before terminating workers. Employers, in firms with more than 14 workers, are required to obtain written permission from the Commissioner of Labour before terminating any workers. The Act also stipulates that a response be given within three months. However, TEWA does not specify the level of compensation to be paid to the workers. This was at the discretion of the Commissioner. A special Act, Industrial Disputes (Hearing and Determination of Proceedings) (Special Provisions) Act, No. 13 of 2003, was passed in 2003 to speed up the legal process involved under TEWA. Since its enactment, workers are compensated according to a formula that is based on the number of years of service, age at the time of termination, and the salary at the time of termination. This formula was revised in March 2005. The revised formula is based on the years of service. Under this, workers with 1-4 year's of service receive 2.5 times their monthly salary per year of service. The total benefits increase with the years of service but are limited to 48 monthly salaries per worker.[32] This formula is very generous according to international standards. For example, workers with 20 years of experience receive the equivalent of 39 months of salary, while the corresponding compensation received by workers in other Asian countries is about 16.3 months of salary.[33]

In addition to this, workers who have served more than five years in a firm are in general eligible to receive a gratuity payment equivalent to half a month's salary for each year of work completed under the Payment of Gratuity Act, No. 12 of 1983 (PGA). This includes workers in firms employing more than 15 workers, and employees hired for work in most agricultural or estate land.

The unemployment benefits under the TEWA cover 37 per cent of the labour force in the formal sector. Most workers who are covered by the TEWA are also covered by the PGA and can expect some relief if terminated due to the crisis. However, past experiences indicate that implementation of the TEWA is weak. The number of applications for TEWA cases received and disposed are low - less than 100 a year - partly because firms prefer to use voluntary retirement schemes to lay-off workers to avoid cumbersome procedures and delays. Further, firms which face financial difficulties and are forced to downsize may not have the liquidity to compensate large numbers of workers in the short term. In these instances, eligible workers may have to wait a long period to be compensated, and may not receive benefits when they need them the most.

4.4.3 Health Insurance

In Sri Lanka, health insurance is not required, as government health services do not charge user fees. However, some treatment procedures are not available in the public sector. Health insurance is available for some in the formal private sector. These provide insurance against treatment that persons may seek from private sector facilities. The coverage of these insurance schemes is estimated to be 25 per cent of the formal private sector.[34] Since many of these benefits are linked to employment, separation from work will make an employee ineligible to participate in the health insurance, thereby increasing their vulnerability to health shocks.

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[32] *Ibid.*

[33] *Ibid.*

[34] Arunatilake, Nisha, *et al.* (2006), "Social Insurance and Social Assistance Post Tsunami", Institute of Policy Studies of Sri Lanka, August 2006, mimeo.

4.4.4 Insurance of Migrant Workers

The Sri Lanka Bureau of Foreign Employment (SLBFE) has introduced the 'Sahana' health insurance scheme maintained by the Sri Lanka Insurance Corporation (SLIC) for migrant workers who are registered with them. In 2007, the 'Sesatha' voluntary retirement benefit scheme was introduced by the SLBFE and the Sri Lanka Social Security Board for migrant workers. However, enrolment in this programme is believed to be small.[35] The afore-mentioned insurance programmes only cover benefits for accidents or harassment-related return to the country, benefits to dependents in case of death, or benefits on retirement.[36] There is no scheme that covers early return to the country due to termination of work contract. As such, the available insurance schemes for migrant workers will not provide relief to workers in case they are forced to return due to termination of contracts. This is particularly of concern for workers who have taken loans to finance the initial costs associated with foreign employment.

4.4.5 Samurdhi and Public Welfare Assistance Allowance

Under the government's Public Welfare Assistance Allowance (PAMA) programme, households selected on the basis of their level of income are provided income support. There has been considerable controversy on the criteria used to select eligible households for PAMA. The Samurdhi Development Offices (Niyamakas) select beneficiaries based on a survey carried out in 1995. These officers are also advised to use their discretion in selecting households based on household characteristics and assets. These selections are subjected to the influence of local politicians as well as the biases of the officers. A further problem with the scheme is that there are no clear entry and exit criteria. As such, households falling into poverty due to an external shock, such as the present economic crisis, cannot expect to benefit from this programme.[37]

4.5 Government Response, Effectiveness and Gaps

4.5.1 The Stimulus Package

In Sri Lanka, the main sectors affected by the global economic crisis are the export- oriented agriculture and manufacturing, and tourism. Exports that enjoyed a 9.6 per cent growth in the first three quarters of 2008, experienced a 2.7 per cent decline in the last quarter of the year. Exports showed a 19 per cent decline from January to May 2009, when compared to the corresponding period in 2009. Increased international competition in the face of lower demand and high production costs reduced the competitiveness of Sri Lanka's exports. Tea, rubber, coconut and cinnamon industries were adversely affected by falling international prices due to low demand. Recessions in Western Europe, the largest regional source of tourism for Sri Lanka, resulted in reducing tourist arrivals to the country.

These effects on the real economy were reflected in the labour market. Several garment factories were closed down and others stopped hiring new workers. As mentioned earlier, workers have been laid off from the apparel industry. Other export-oriented manufacturing industries such as the ceramic industry were also looking to cut jobs in the face of reduced demand. The incomes of the informal rubber and tea sector workers

[35] Help Age (2008), "Tackling Poverty in Old Age: A Universal Pension for Sri Lanka", Health Age International.

[36] Arunatilake, Nisha, et al. (2006), "Social Insurance and Social Assistance Post Tsunami", Institute of Policy Studies of Sri Lanka, August 2006, mimeo.

[37] World Bank (2006),"Sri Lanka: Strengthening Social Protection", World Bank.

dropped due to unavailability of work in tea and rubber plantations, and low profit margins due to low prices on green leaf tea and rubber latex. Another group that is affected by the crisis are the foreign employed workers. High skilled migrant workers and those who are working in the Eastern Pacific Rim, Europe, and the US remain vulnerable to job cuts. The construction and the real estate sectors in the Middle East have been affected by the global economic crisis, where thousands of Sri Lankan workers are employed.[38]

Many of the interventions of the "stimulus package" introduced by the government in January 2009 were to safeguard production rather than to directly safeguard employment and incomes. The limited incentives given to companies to maintain work forces were not sufficient. Many firms in the manufacturing sector were not hopeful of benefiting from the government's stimulus package, as the package was available only to those who could maintain revenue and employment levels. In the face of declining demand, many were unable to afford the costs of present levels of production.[39]

4.5.2 Temporary Active Labour Market Programmes and Assistance to the Self-employed

The workers who are most likely to be affected by the crisis would be temporary and contractual workers, return migrant workers, and workers in the informal sector. These workers have none or very limited social safety nets. The majority of those affected are likely to be females and youth. This is likely to increase the already high unemployment levels amongst these groups. At the same time, the crisis is likely to increase the number of households in poverty. Although the Samurdhi programme provides some assistance to those in poverty, it is unlikely to be beneficial to the newly poor, given poor and inflexible targeting of the poor by the programme. Programmes such as the minimum price for purchasing latex from growers can be beneficial in providing some relief to the informal sector workers. However, such measures are unsustainable unless rubber manufacturers are given financial incentives to buy latex at stipulated minimum prices.[40] This highlights the need for temporary policies to provide employment such as public works programmes aimed at improving demand in the market.

A large proportion of Sri Lankan workers are engaged in self-employment. As described earlier, these workers will be severely affected by lowering demand and reduced liquidity in the market. They are also likely to face higher competition as more and more unemployed workers become self-employed. As urged by the ILO, it is prudent to provide these workers with financial support through emergency assistance programmes to prevent them from falling into poverty.

4.5.3 Extending Social Safety Nets

Although in recent years, the levels of social security awarded to return migrants have improved, their coverage is still low. Further, there are no products to safeguard return migrants from external shocks that affect termination of their work contracts. Given that the government is increasingly seeking to promote foreign employment, it is important to introduce safety nets for these workers. One means of doing this would be

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[38] http://southasia.oneworld.net/todaysheadlines/sri-lanka-uncertain-labour-markets-forecast-bleak-economy. Down loaded on 29th April, 2009.

[39] http://www.lankabusinessonline.com/fullstory.php?nid = 1277882506. Down loaded on 29th April, 2009.

[40] For instance, in the face of declining prices, rubber manufacturers may not be able to pay the stipulated prices for latex.

an insurance scheme to provide workers with some protection during economic downturns such as the present one.

Workers in the public sector have high levels of job and income security and are unlikely to be affected by the crisis. Workers in the formal private sector, especially those covered by TEWA, are also well protected. Even if these workers are to lose their jobs, they will be well compensated in most instances. Workers with more than five years of service and those who are eligible to retire will also benefit from legislated gratuity payments and retirement benefits.[41]

4.5.4 Programmes for Re-training and Labour Market Flexibility

Although existing legislation will protect workers from the adverse effects of the crisis, the inability of firms to adjust to the changing global economy will adversely affect the long term economic growth of the country. The post-crisis economy is likely to be different from the present one. The sectors which experienced high growth may not sustain similar growth patterns, while new sectors will gain momentum. Given this, it is important to allow mobility in the markets, such that workers can learn new skills to cater to the new demands in the market.[42] Thus, it is important to introduce flexibility into the labour markets to re-adjust. It is also important to introduce programmes to re-train workers in order that they can benefit from emerging trends in the new economic landscape.

4.5.5 Improving Domestic Labour Market Conditions

Successive governments in the recent past have relied on foreign markets as a source of employment. Job creation has been severely limited domestically. Even the jobs that were created were in the informal sector. As discussed earlier, over-reliance on foreign employment can increase a country's vulnerability to economic shocks. As such, there is a need to improve the investment climate and promote job creation in the formal private sector. This will help cushion the economy in three ways. First, a larger proportion will benefit from the social safety nets which are currently enjoyed by formal sector workers. Second, the labour market of the country will be less vulnerable to economic downturns and related contractions in the labour markets in labour importing countries. Third, this will help to increase domestic demand for goods and services, lessening the dependence on foreign markets.

4.6 Conclusions and Policy Implications

The global financial crisis that started in the US has now spread to all parts of the globe and made inroads into the real economy. The ILO predicts that these developments will in turn increase the global unemployment rate to 6.1 per cent, and reduce incomes of those who keep their jobs, especially those in the informal sector. The impact of the crisis on the labour markets in developing countries will largely depend on their exposure to the world economy, the structure of the labour markets, and the level of social protection available to workers. In Sri Lanka, for instance, export-oriented agriculture and manufacturing sectors, and the hotel sector in particular, are predicted to be hit hardest by the crisis. Especially in developing countries, where social protection to the unemployed are low, workers laid off from the formal sector and return overseas workers will most likely join the informal economy, thereby reducing incomes in that sector.

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[41] However, it must be mentioned that these are lump sum payments and thus are likely to be beneficial in the short term.

[42] *The Economist*, March 14th-20th, 2009, Vol. 390, No. 8622.

Governments across the world have intervened in labour markets to extend and increase assistance given to the unemployed, to provide assistance to firms to retain workers, and to assist workers to get re-trained for new jobs. In developing countries, governments have resorted to improving the demand for jobs by increasing investments in infrastructure, and providing income assistance through measures such as allowing workers to borrow from their legislated savings schemes.

At the onset of the crisis, Sri Lanka's labour market was in a weak position to face the consequences of the crisis. The structure of the labour market and the design of social safety nets in the country are such that only a limited proportion of workers are covered by social safety nets. The vast majority (close to 70 per cent) of workers in the country are in the informal sector - a sector that is least protected by social safety nets. Of the total employed, a little more than 40 per cent are either unpaid family workers or self-employed - those termed as vulnerable workers by the ILO. The stimulus package introduced by the government mainly seeks to protect production. There are no direct relief interventions to safeguard the living standards of informal sector workers.

The public sector workers and formal private sector workers are in a better position to face the crisis due to the protection provided to them through legislation. However, these protectionist measures in the market also constrains the ability of the firms to re-adjust to the changing economic structure of the world economy. This in turn, will lower productivity of the firms and affect the long term growth of the country. The crisis highlights the need to improve the country's investment climate and to expand formal employment opportunities, and to provide flexibility to the labour market so that Sri Lanka is able to adapt to the changing dynamics in the global economy.

Overseas employment is seen as an easy means of sourcing employment and earning foreign exchange by successive governments. An estimated 20 per cent of the Sri Lankan labour force is working abroad. At least, some percentage of these is likely to be affected by economic stagnation in destination countries, and is likely to return to the country. Over-reliance on foreign markets will increase the vulnerability of the country to global economic shocks. Although overseas employment can be looked on as a temporary solution for low job creation in the economy, in the long term, Sri Lanka will need to improve the investment climate to encourage job growth locally.

5. Global Economic Crisis and Agriculture Sector in Sri Lanka

5.1 Introduction

Sri Lanka's agricultural sector is dualistic in nature, comprising of a well developed export oriented plantation sector and a less developed food crop production sector that is only partially market oriented. The former produces tea, rubber and coconut in medium to large estates, while the latter accounts for paddy, subsidiary food crops, vegetables and fruits in predominantly small holdings.

The importance of the agricultural sector to the economy in generating income and employment is evident from its notable contribution to GDP and the labour force. Although the agricultural sector share in GDP has been declining over time, it still contributes around 12 per cent from both the plantation and non-plantation sectors.[1] Its contribution to employment is more significant. Despite a decline in the employment share - with the expansion of the industrial and services sectors in recent years - agricultural sector employment absorbs nearly 32 per cent of the total labour force, with significant employment generation from paddy and tea - the two dominant players of the non-plantation and plantation sectors, respectively.

Until more recently, the productivity of most agricultural crops had been declining or stagnating over the last few decades. However, recent developments have contributed to improve the volume of production of most domestic agricultural crops, resulting in a decrease in their imports, and a boost to exports of plantation crops. The more recent positive developments have been due largely to technological advances. Productivity improvements can be advantageous in meeting not only domestic shocks, but also global economic shocks to the agricultural sector. The linkages between global economic shocks and impacts on Sri Lanka's agriculture sector differ depending on the sector - i.e., whether it is the export oriented plantation sector or the more domestic oriented food crop production sector. As a net food importer, changes in world supply and prices of food impacts on Sri Lanka's domestic food crop production sector. As an agricultural exporter, changes in world demand and prices affect the country's export oriented plantation sector.

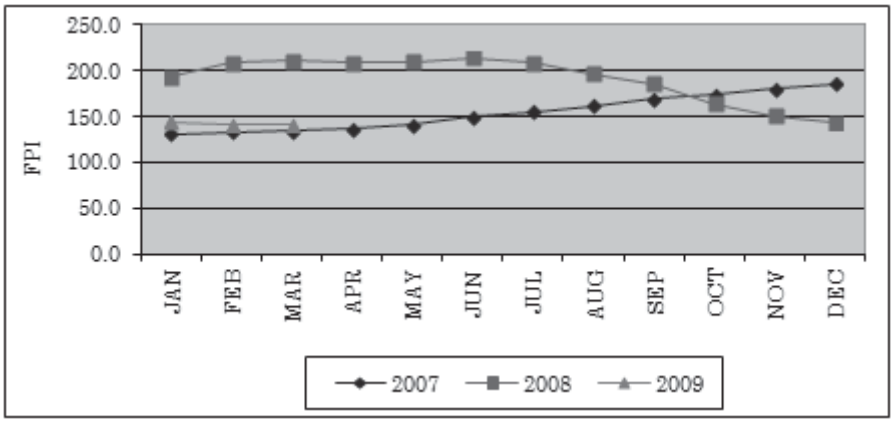
The current global economic crisis follows the food crisis of mid-2007 to mid-2008. The underlying causes of the two crises are fundamentally different in nature and their impacts on Sri Lanka's agricultural sector also differ. The impact from the downturn in the globally economy can be significant, and unevenly distributed amongst different stakeholder groups. Thus, the main aim of this Chapter is to examine the impact of the global economic crisis on both the non-plantation and plantation agricultural sectors, especially on farmer incomes as well as on the overall food security situation for the country.

5.2 Foodflation to Weakening Commodity Prices

Before proceeding directly to examine the impact of the global economic crisis on the

[1] The GDP and labour force share in the agricultural sector has declined from 20 to 12 per cent and from 36 to 32 per cent, respectively, over the period 2000-08.

Figure 5.1
Fluctuations in FAO Food Price Index

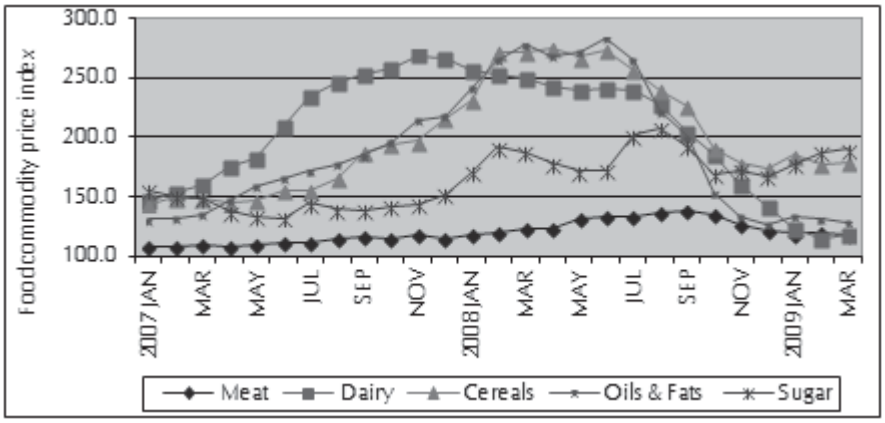


Source: Food and Agriculture Organization (FAO) statistics.

agricultural sector, assessing the transformation from 'foodflation' to weakening commodity prices is in order. The prices of most commodities rose sharply from mid-2007, continuing a multi-year upward trend that began in 2002 (Figure 5.1). The surge in prices was led primarily by dairy and grains, but prices of other commodities - with the exception of sugar - also rose significantly (see Figure 5.3). These price increases were largely driven by financial factors, as well as shifts in the balance between supply and demand. Oil prices also soared by about 50 per cent in the first half of 2007 contributing to the food price hike to some extent.

There was a complete reversal of the so-called foodflation from mid-2008 to date (Figure 5.1). Oil prices plummeted by more than 60 per cent from their peak levels of July-November 2008. The prices of other commodities have also declined significantly. The major contributory factors for the fall in the food price index were once again dairy, cereals and oils and fats, while sugar prices showed an upward trend and meat prices recorded a late decline (Figure 5.2).

Figure 5.2
Food Commodity Price Indices



Source: FAO statistics.

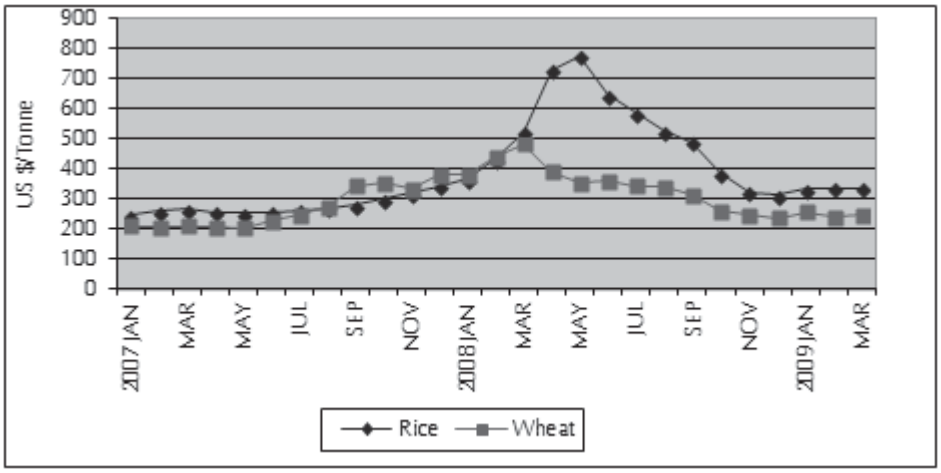
Prices of grains started to decrease from mid-2008 owing to various factors, of which the emerging financial crisis was also one factor. Speculators started to move away from commodity markets to recover asset positions in the financial system. The more recent appreciation of the US dollar and falling oil prices contributed to the drop in international grain prices. An upward shift in grain supply, caused partially by better weather conditions, and a downward shift in demand for grains with the worldwide economic slowdown have also pushed prices downwards. The prices of rice and wheat - the most consumed grains of importance to Sri Lanka - did not continue to fall in early 2009 as expected. Prices have stabilized, or have shown a tendency to increase marginally (Figure 5.3).

The sharp decrease in the price of oil is likely to have weakened incentives to further increase bio-fuel production, which had been an important factor in pushing up the demand for grains in recent time. Most of these prices are expected to stabilize, or decline further, along with the moderation in global demand. However, this will also depend to an extent on oil price trends over times. The observed high price volatility of grains is, however, detrimental to long term investment in the production of grains and could affect food security, unless remedial measures are taken.

A high degree of price uncertainty and weakened international dairy product markets were observed in dairy prices. A decline in dairy product prices since late 2007 was due largely to an increase in milk production - assisted by a return of favourable weather conditions - appreciation of the US dollar, and the global economic downturn. Even though it is not strictly apparent, the health scare related to the melamine contamination of dairy products in China may also have caused a drop in demand to some extent, contributing to the price decline. However, in 2009, some degree of stability in the dairy market appears to have been established (Figure 5.2).

The above discussion shows that even though import demand in most economies was expected to reduce further with the global economic crisis, leading to a decline in prices of food commodities gradually, it had not as

Figure 5.3
World Market Prices of Rice and Wheat



Source: FAO statistics.

yet materialized in the first quarter of 2009. The implications of falling real prices of food in the world vary depending on whether a country is a net importer or a net exporter of food, the composition of the food commodity bundle being traded, and the magnitude of price reductions of different commodities. Similarly, at the micro level, the implications of these depend on whether an individual is a net food consumer or a net food producer. Net food consumers gain at times of falling food prices. Thus, the following section will discuss the food security situation of Sri Lanka in order to assess the implications on the plantation and non-plantation agriculture.

5.3 Status of Food Security of Sri Lanka

In terms of food consumption, the impact of the global economic downturn on Sri Lanka depends basically on the macro and micro level food security situation of the country. Sri Lanka has been a net food importer since the time of British colonial rule, and consequently has been affected by developments in the global food market ever since, both favourably and unfavourably. Efforts to break free of this dependence through increased production, mainly of the major staple food (rice) have been only partially successful chiefly due to population growth. In the meantime, changes in demographic structure, increased urbanization along with the 'demonstration effect' from developed countries have led to increased consumption of some other food items which are largely imported.[2]

It is clear from Table 5.1 that even though Sri Lanka has historically been a net food importer, more than three-fourths (77 per cent) of the food commodities are produced domestically, while slightly less than one-fourth (24 per cent) is imported. The amount of food exports from total domestic food production is very insignificant at just over 1 per cent. Also, food imports into Sri Lanka

Table 5.1
Annual Average Food Availability in Sri Lanka by Major Food Commodity Groups (2000-07)

Commodity Groups	Gross Availability (000 Mt)	Productions		Exports		Imports	
		Qty (000 Mt)	% of Availability	Qty (000 Mt)	% of Availability	Qty (000 Mt)	% of Availability
Rice	3,079.8	2,979.1	96.7	3.9	0.1	104.7	3.4
Wheat flour	703.1	0.0	0.0			703.1	100.0
Other cereals	163.8	42.5	26.0			121.3	74.1
Roots, tubers & other starchy food	404.0	346.7	85.8			57.3	14.2
Sugar	559.4	52.7	9.4			506.7	90.3
Pulses & nuts	144.6	33.4	23.1			111.2	76.9
Vegetables	960.5	841.8	87.6	6.1	0.6	124.8	13.0
Fruits	320.7	282.8	88.2	4.3	1.4	42.3	13.2
Meat	119.8	117.7	98.3	0.1	0.1	2.1	1.8
Eggs	51.4	51.4	100.0				
Fish	356.4	294.9	82.8	15.2	4.3	76.7	21.5
Milk	272.4	215.2	79.0			57.2	21.0
Oil & fats	977.6	1,022.6	104.6	61.9	6.3	16.9	1.7
Total	8,113.4	6,280.7	77.4	91.6	1.1	1,924.2	23.7

Source: Department of Census and Statistics, *Food Balance Sheet*, various years.

[2] Local populations may be influenced by the 'demonstration' of different food habits and modern life styles, especially from developed countries through advertising.

have accounted for only 7-8 per cent of Sri Lanka's total imports in recent years. At individual commodity level, local production of all major food items except wheat flour, other cereals, sugar, and pulses and nuts which are imported in bulk quantities, exceed 75 per cent of total availability. Fish, milk, fruits, onions, and potato are the other major items that are imported in significant quantities, while coconut and fish are the two major food commodities exported, but in small proportions - i.e., 6 per cent and 4 per cent of gross availability, respectively. Hence, the impact of the global economic crisis on domestic producers is minimal except for a few individual commodities that Sri Lanka imports in larger quantities as the country is not heavily dependent on the world food market at the macro level.

At the micro level, the importance of food in the consumers' consumption basket is the key determinant in deciding the impact of price changes on individuals. Food accounts for a significant share of total consumer expenditure, having a share of 48 per cent at the aggregate level while it exceeds 60 per cent in the lower two income deciles. Therefore, the global economic downturn, and the resulting changes in supply and prices of major food commodities of importance to Sri Lanka, has some impact on domestic consumers at the micro level.

The following section will evaluate the losses and gains of changing food prices to the country as a whole, and to the individual producer and consumer. More importantly, it will assess how far the Sri Lankan food market follows changes in the world market.

5.4 Impacts on the Non-plantation Sector

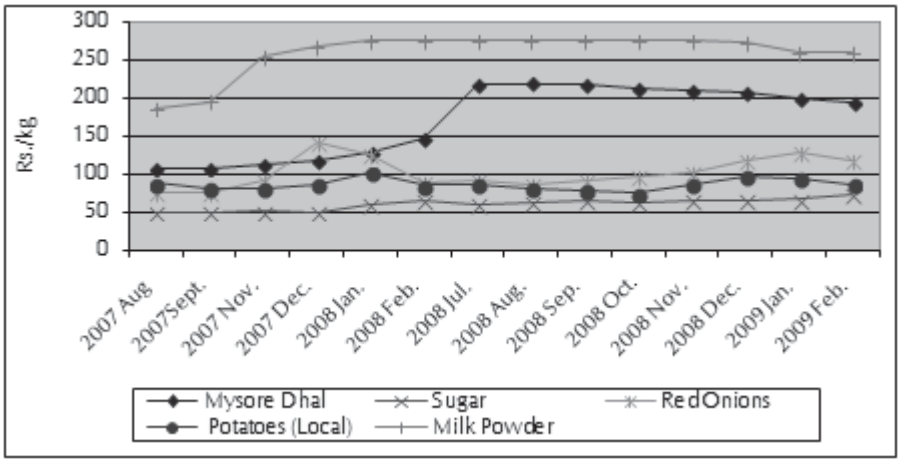
Rising prices of world food commodities such as wheat, milk powder, dhal, etc., exerted significant pressure on Sri Lanka's import bill and added to cost-of-living pressures until mid-2008. Food price increases - some of it contributed through higher import prices - are likely to have eroded the already constrained purchasing power of consumers, especially the urban and the estate poor. A constraint on household food consumption can have other downside adverse effects. It can encourage a shift in consumption to even less balanced diets, worsening the dietary habits of the poor.

On the other hand, food price increases are likely to have contributed positively to lift the income of agricultural sector employees, particularly the rural poor, whose livelihoods are predominantly in agriculture. Further, price increases of imported food items may also have encouraged more competitive behaviour amongst local producers. To some extent, it created opportunities for local producers to popularize domestic substitutes such as fresh milk for milk powder. However, short run measures taken by the government to bring down escalating food prices - such as imposing price ceilings on rice and milk powder, and reducing the import duty on edible oils - were effective in stabilizing price levels to some extent.

Commodity price declines in the international market during the latter part of 2008 caused by the contraction in world demand for most commodities, including crude oil, resulted in a decline in the international prices of food items like milk powder, sugar, dhal, etc., which are of import interest to Sri Lanka.

As Figure 5.4 shows, Sri Lanka's food prices followed world price declines for the most part, not only in major imported food commodities but also items which are imported in lesser quantities. A slight reduction, or near stability, in the prices of most of the commodities is seen since early 2009 following the trend in world price declines. Price reductions would have thus benefited domestic consumers to a certain extent. How-

Figure 5.4
Retail Price Fluctuations of Select Commodities



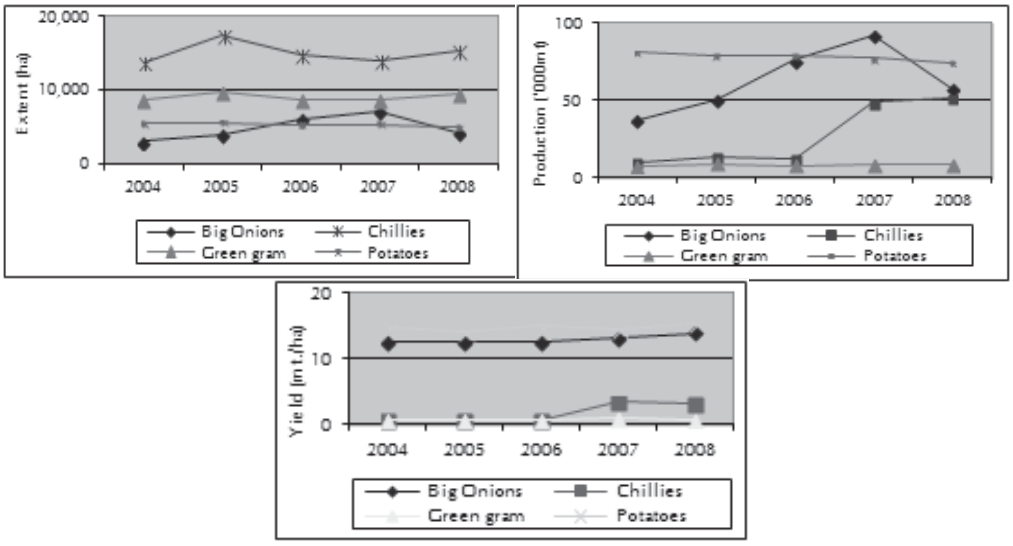
Source: CBSL and HARTI.

ever, since the drop is not comparable to the levels that existed in the same period prior to the price increases in 2007, the benefit to consumers would depend largely on increases to their real income.

Domestic farmers too are unlikely to have been adversely affected by the world price declines, as the bulk of the volume of most food commodities are domestically produced as explained in the preceding section on the status of food security in Sri Lanka. Even in commodities having a bulk import share, the negative impacts on farmers are minimal since the price drop started from the peaks reached in early 2008, and the magnitude of the decline is less.

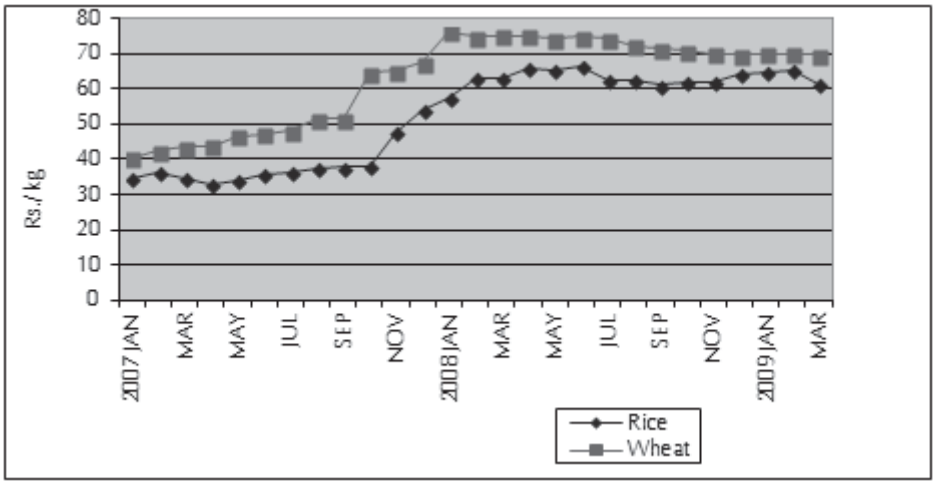
In terms of the production of non-plantation crops, there is no significant change in the

Figure 5.5
Cultivated Extent, Production and Average Yield of Select Food Crops



Source: CBSL and Department of Census and Statistics.

Figure 5.6
Price of Rice and Wheat Flour in the Colombo Market



Source: CBSL and HARTI.

extent of production, volume, and yield in recent years, except for a few isolated cases such as big onions (Figures 5.5). Since most of these crops are used only for domestic consumption, or are exported in minor quantities, and the import content is also very low, the impact of the global economic downturn on the production of these commodities is negligible.

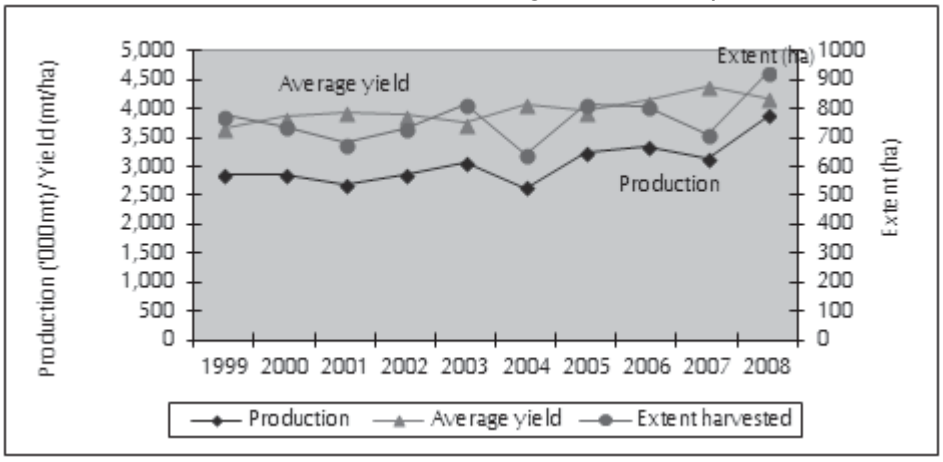
5.4.1: Rice: The Staple Food

Speculative behaviour of oligopolist rice traders/millers resulting from the international price hike caused a sharp increase of prices of all varieties of rice during mid-2007 to mid-2008 (Figure 5.6). Unfavourable weather conditions that damaged a part of the 2007 Maha harvest, and the substitution effect due to increased price of wheat flour also contributed to this price shift. Since this exceeded the seasonal price fluctuation in the rice market during the same period, the government intervened in the rice market by relaxing the specific duty on rice imports and setting a maximum retail price. Even though this stabilized the retail price of rice at a certain level, it also prevented the normal behaviour of the rice market.

As a result, though a sharp increase of the 2008 Yala harvest - resulting largely from the increased cultivated extent - would have otherwise exerted downward pressure on prices, the price of rice did not decline below 60 Rs./kg (Figures 5.6 and 5.7). This was well above the prices that prevailed during the same period in 2007 (Figure 5.6). Increased production can be attributed to more favorable weather, and increased extent of land brought under cultivation in the Eastern Province and other areas under the government's "Api Wawamu-Rata Nagamu" campaign. Nonetheless, the yield decline from 2007 to 2008 indicates that the level of production has not increased in proportion to the extent of cultivation.

Even though the world price hike in rice was reflected in prices charged by local traders, the recent world price decline due to the contraction in world demand has not been transmitted to domestic consumers on account of government intervention. If Figures 5.3 and 5.6 are compared, it is evident that the world rice price decline in early 2008 is much sharper than that seen in Sri Lanka. This is the case in wheat flour too. Even if

Figure 5.7
Extent, Production and Average Yield of Paddy



Source: CBSL and Department of Census and Statistics.

no government intervention was in place, it is questionable whether the present oligopolistic market structure operating in Sri Lanka would allow for any such price decline. The impact of the world price decline on paddy farmers is, therefore, minimal as the private millers buy paddy above the state guaranteed price which is adequate to cover the costs of milling, transport, storage, or retailing margins at the existing retail price.

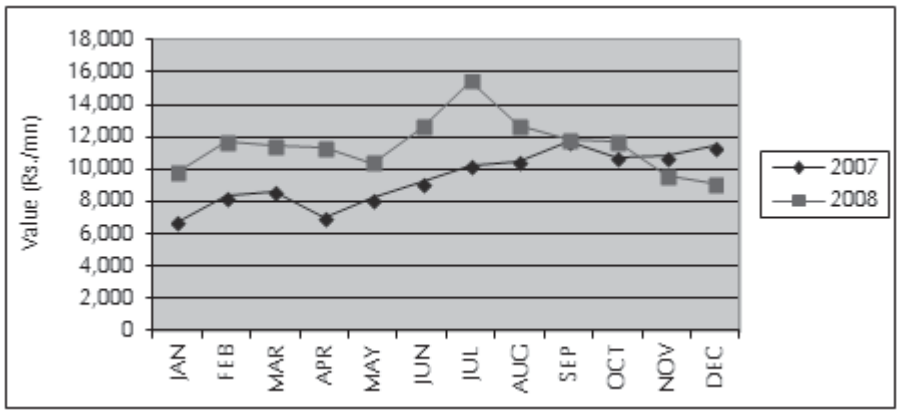
5.5 Impact on the Plantation Sector

Although falling prices have a beneficial effect on reducing inflationary pressure in the economy, the loss of export revenues will have a negative impact on the income of businesses and the government (especially through taxes and state exports). This comes primarily through the plantation sector - dominated by tea, rubber, coconut, and minor export crops (MECs) - which is an important sector in terms of the contribution to GDP, export revenue, and employment generation.

5.5.1 Tea Sub-sector

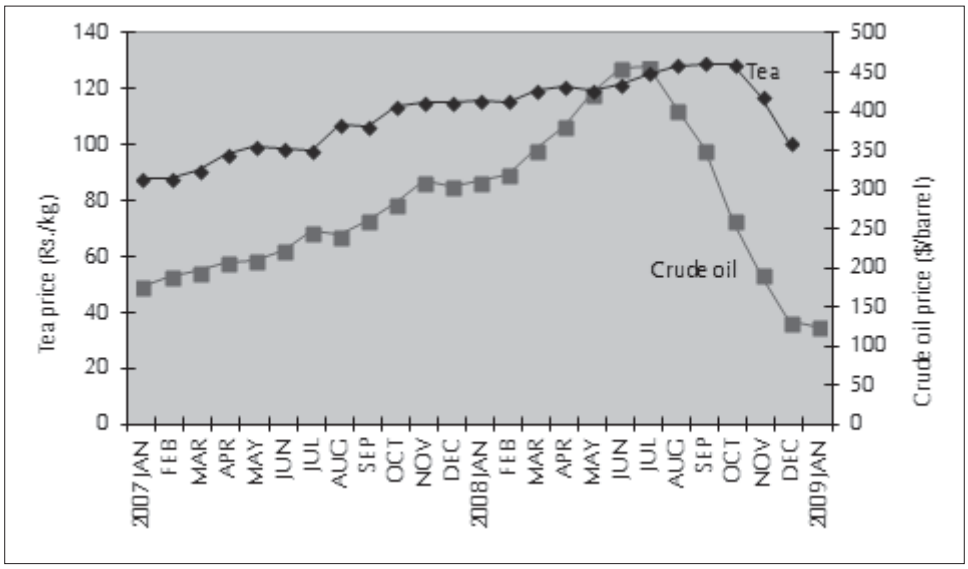
Tea is comparatively price inelastic due to the habit forming property of caffeine con-

Figure 5.8
Value of Tea Exports (2007-08)



Source: CBSL, *Annual Report 2008*.

Figure 5.9
Trends in Crude Oil and Tea Prices



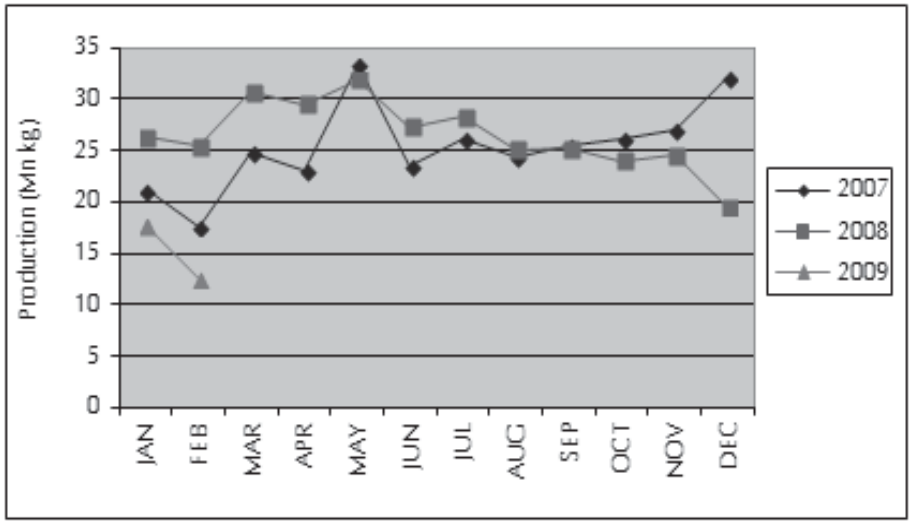
Source: Sri Lanka Tea Board, CBSL, and US Energy Information Administration.

taining beverages. Further, tea has gained popularity in recent times due to its health related benefits. Along with the food price hike, tea exports from Sri Lanka increased substantially from April 2007 to a peak level in July 2008 (Figure 5.8).

The export increase is attributed at the domestic level to increases in production due to favourable weather conditions, undisturbed factory operations, etc. The rise in global tea prices along with the general commodity price boom acted as an external factor in encouraging higher production. The demand for tea was strong in economies that benefited from the international oil price boom, and are of particular export interest to Sri Lanka. As evident from Figure 5.9, tea prices follow the same pattern as oil prices for the most part. Since oil exporting nations from the Middle East, North Africa, Russia and some CIS countries together absorb more than 75 per cent of Sri Lankan tea exports, Sri Lanka's tea sector was in a much better position to gain from the global economic conditions than many other countries.

However, with the onset of the global economic downturn, commodity prices began to ease from mid-2008. For instance, global oil prices began to decline from July 2008. Tea prices too began to decline from September 2008 as demand for tea began to contract, spurred by both depressed demand as well as the emerging global liquidity constraints impacting major trading companies. The price decline effect was reflected in Sri Lanka's export revenue from tea in the fourth quarter of 2008. Although total exports of tea in 2008 surpassed that of 2007, the performance in the fourth quarter of 2008 is indicative of the consequences of global market conditions. A domestic supply shock resulting from unfavourable weather conditions, in combination with the decline in auction prices, caused a further fall in tea supply in the first quarter of 2009 (Figure 5.10).

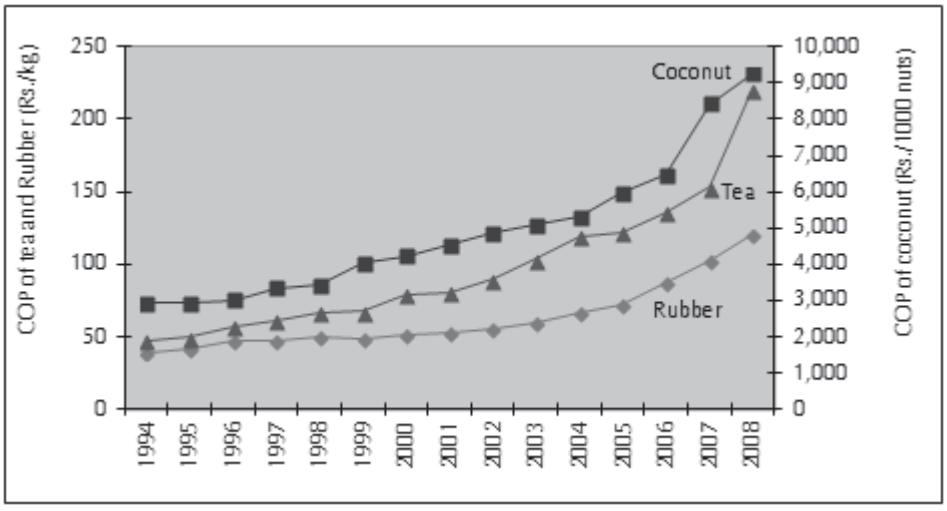
Figure 5.10
Tea Production (2007-09)



Source: Sri Lanka Tea Board and CBSL.

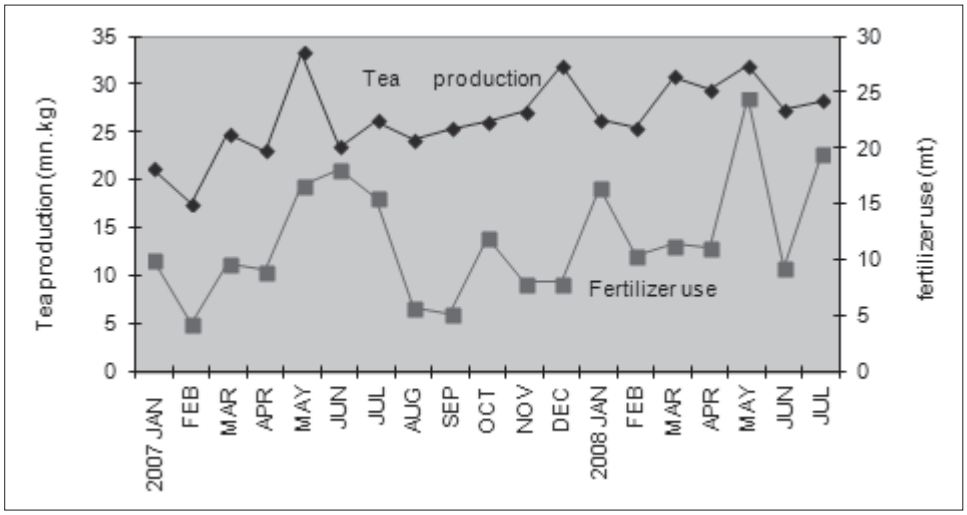
The current developments have serious implications for the future of the tea industry, particularly in the context of rising costs of production. Production costs have been increasing, especially in the last few years, due to higher labour costs - constituting about 60 per cent of total costs - and higher input prices such as on fertilizer (Figure 5.11). Nitrogen fertilizer, such as urea application, is very important for tea production as it is based on the harvesting of young leaves which requires nitrogen for its growth (Figure 5.12). Thus, the increase in urea prices has a major impact on tea production.

Figure 5.11
Cost of Production of Tea, Rubber and Coconut (1994-2008)



Source: Department of Census and Statistics.

Figure 5.12
Monthly Fertilizer Use and Tea Production (2007-08)



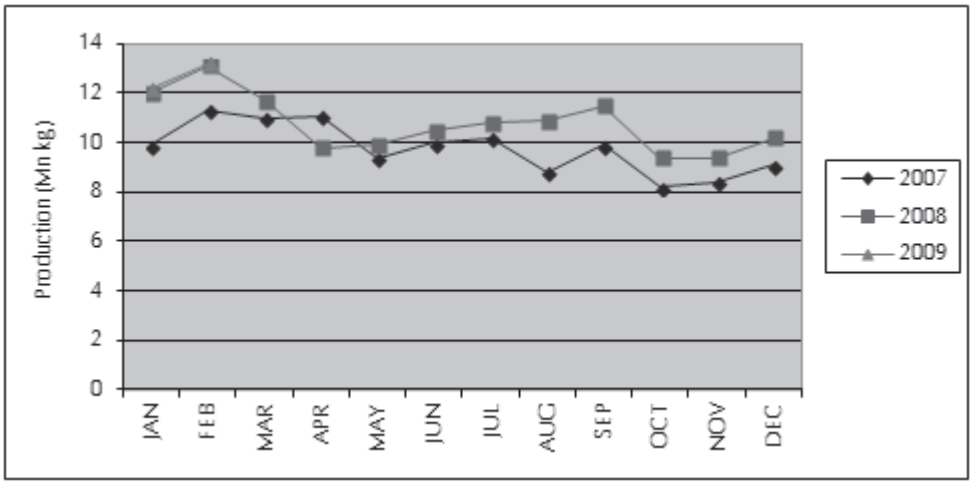
Source: CBSL.

5.5.2 Rubber Sub-sector

Despite an escalation in the cost of production of rubber as evident from Figure 5.11, rubber production recorded a substantial increase in 2008 - though production was initially subject to the adverse affects of high rainfall in the first half the year (Figure 5.13).

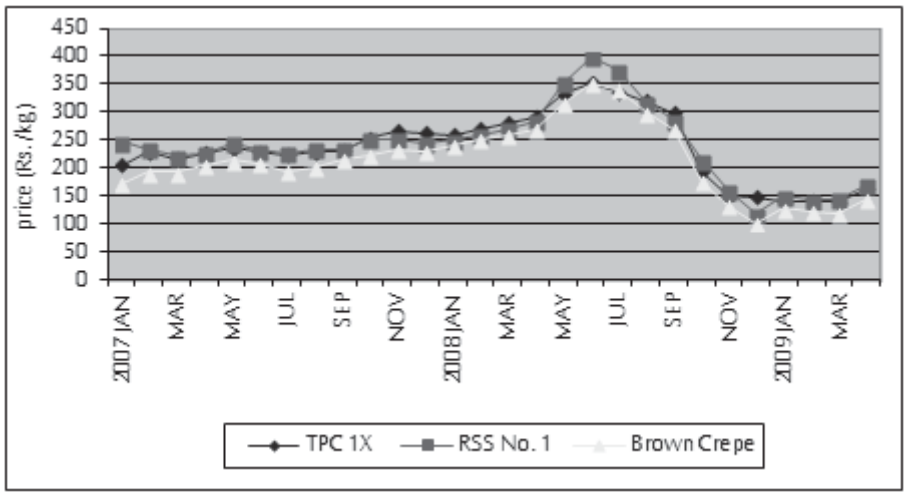
The increase in rubber production was driven mainly by higher international oil prices which has a bearing on the demand for synthetic rubber. The price of synthetic rubber escalates with oil price hikes, increasing the demand for natural rubber. Rubber production continued to show positive trends even into the first half of 2009.

Figure 5.13
Rubber Production



Source: CBSL.

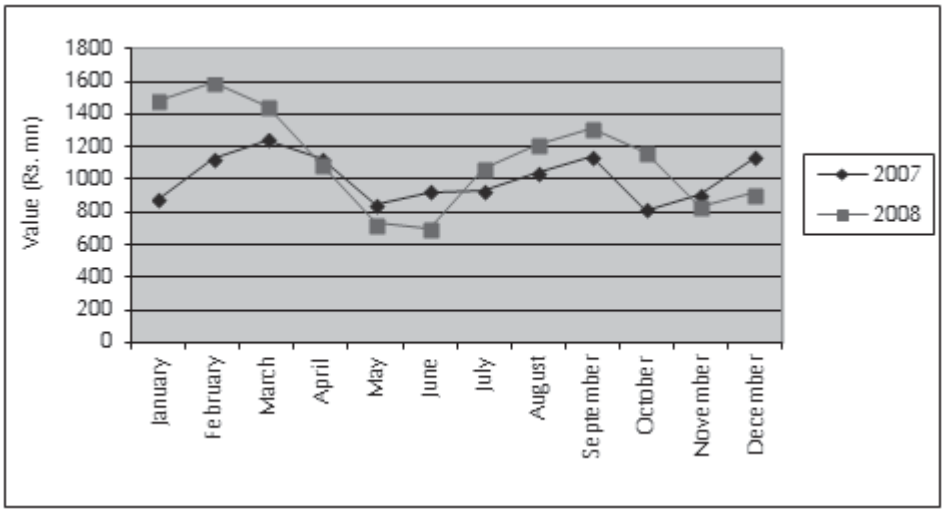
Figure 5.14
Price of Rubber (2007-09)



Source: Colombo Rubber Traders Association.

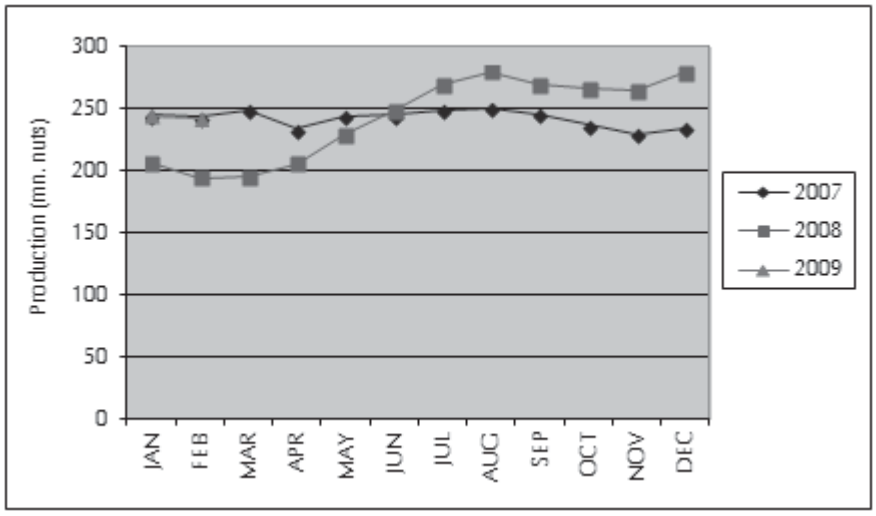
The prices of thick pale crepe (TPC), ribbed smoked sheets (RSS), and brown crepe increased continuously to peak in June 2008 - the highest ever price recorded at the Colombo Rubber Auctions in RSS (Figure 5.14). However, the global economic melt-down has caused rubber prices to decline since. The major causal factor for this was the shift in demand from natural rubber towards synthetic rubber with the decline in oil prices. The most recent data suggests that prices have stabilized, and even picked up marginally.

Figure 5.15
Export Values of Rubber (2007-08)



Source: CBSL, *Annual Report 2008*.

Figure 5.16
Coconut Production (2007-09)



Source: CBSL, *Annual Report 2008*.

Despite the drop in rubber prices, production levels have not been affected thus far as previously discussed. Nonetheless, the price decline has resulted in a drop in export value in the fourth quarter of 2008 (Figure 5.15). More recently, rubber prices have shown some signs of a reversal in prices in mid-2009, raising the possibility of increasing export revenues. Much will depend on the behavior of oil prices in the near future.

5.5.3 Coconut Sub-sector

Coconut production recorded a marginal growth in 2008, mainly due to the improved performance in the second half of the year as a result of improved weather conditions. The first half of 2008 saw the coconut sector suffering from the adverse effects of a drought in the previous year, and production losses due to diseases. However, production levels in late 2008 and early 2009 were quite satisfactory (Figure 5.16).

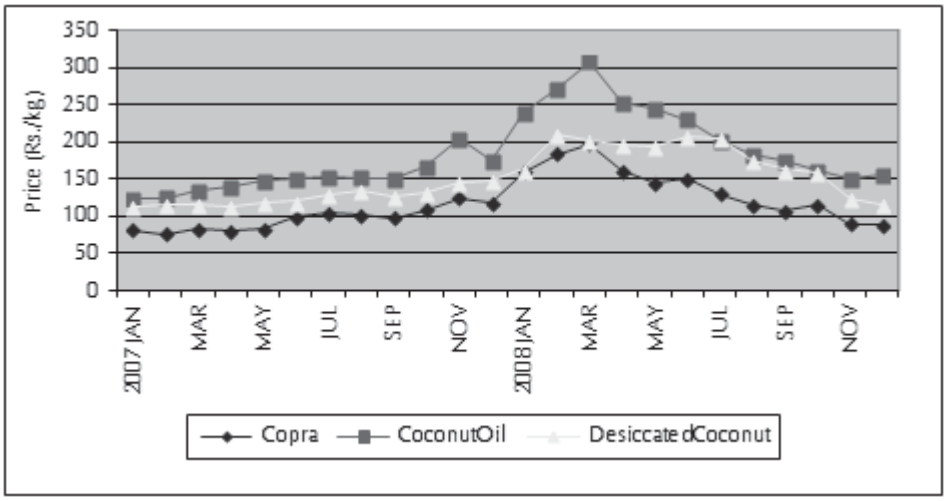
The prices of coconut and coconut-based products, including coconut oil and desiccated coconuts (DC) at the Colombo Auction, increased substantially during the first half of 2008 - continuing from price increases experienced from 2007. However, prices began to decline in the second half of 2008 (Figure 5.17). The higher price for coconut and coconut-based products in the first half of 2008 can be attributed to high domestic and international demand along with supply shortages, and the increase in world demand for coconut oil for bio-fuel production.

However, higher production of coconuts in the latter part of 2008, together with the decline of petroleum prices - that reduced demand for bio-fuel - and changes introduced to the duty structure of imported edible oils, contributed to pull down the price of coconuts and coconut-based products towards the end of 2008.

5.5.4 Minor Export Crops

The production and exports of minor export crops have shown mixed performances in 2008. The production and exports of cloves and cocoa increased in 2008 compared to the previous year. On the other hand, cardamom, pepper, and cinnamon saw a decline in production (Figure 5.18). However, production and exports of these products in the

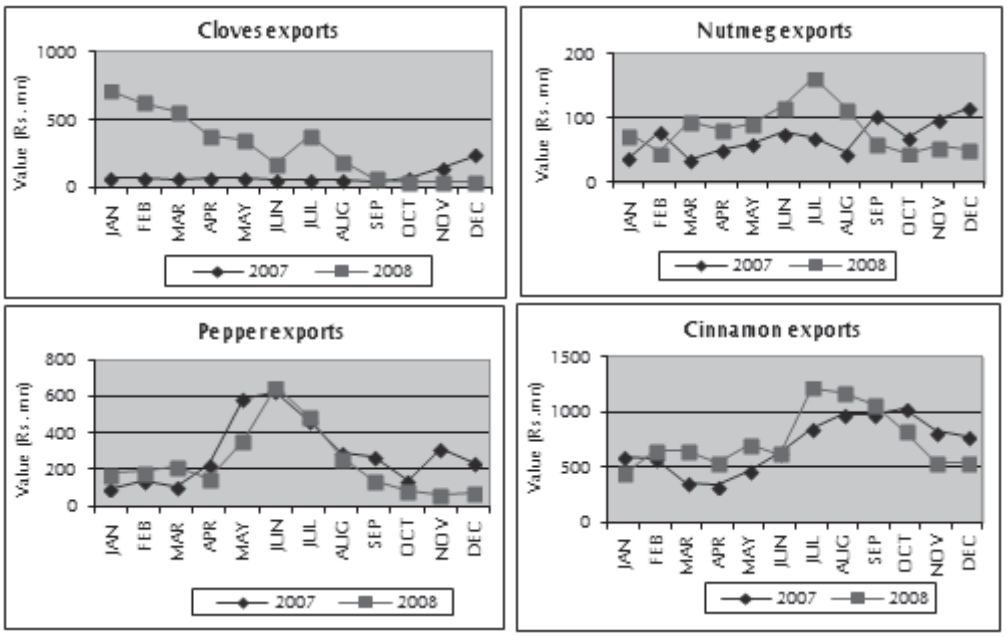
Figure 5.17
Prices of Coconut Products (2007-08)



Source: CBSL, *Annual Report 2008*.

fourth quarter of 2008 were badly affected by the decline of world demand due to the global economic crisis. Accordingly, prices of these products also dropped, especially the price of cinnamon. Apart from reduced export demand, the production of certain crops like pepper has been affected by heavy and continuous rainfall in major pepper grow-

Figure 5.18
Export Volumes of Select Minor Export Crops



Source: CBSL, *Annual Report 2008*.

ing areas, and the imposition of certain trade restrictions under the India-Sri Lanka Bilateral Free Trade Agreement (ISBFTA) that has curtailed growing pepper exports to India.

5.6 Policy Responses Adopted

Sri Lanka dealt with the problem of high food prices in different ways - i.e., with direct controls and indirect support for the development of the agriculture sector. For example, in the first half of 2008, a single composite levy was introduced - instead of customs duty and other applicable taxes - on eleven essential food items. Moreover, duties applicable on some items such as potatoes, big onions, green gram, etc. were reduced to provide relief to consumers. With the aim of controlling the rapid increase of rice prices in the local market, the government specified maximum retail prices for different grades of rice in April 2008, and also raised the customs duty on rice imports in August 2008. In addition, the government continued to provide a fertilizer subsidy for paddy farmers amounting to Rs. 26 billion in 2008, even in the midst of soaring international fertilizer prices.

Without limiting initiatives to direct price controls alone, the government has taken several measures to improve the productivity of the domestic agricultural sector to mitigate the impacts of price fluctuations. These measures include the implementation of the "Api Wawamu-Rata Nagamu" programme to improve domestic agriculture production, revitalizing co-operatives, 'Lak Sathosa' outlets, etc. to distribute essential commodities to consumers at concessionary prices, and the introduction of new cess rates on the importation of some food items which can be grown domestically such as grains and fruits.

Making the domestic dairy industry competitive in the face of increasing world milk prices has also received policy attention. To harness opportunities for dairy development, a special credit package, namely the Agro-Livestock Development Loan (ALDL) scheme was introduced for the dairy sector in 2008. Under this scheme, Rs. 5000 million is to be disbursed for small dairy projects and for milk and crop processing industries at concessionary interest rates.

Relevant authorities have also taken action to control the supply of tea in order to mitigate the impacts of a demand drop and resultant price decline. These include minimizing the tea supply at the Colombo Tea Auction (CTA), restricting plucking only to top quality leaves, and the introduction of pruning in order to induce the vegetative growth of the plant as a future investment during the period of low prices. Further, decisions have been taken to provide loans of one month's working capital to tea factories, suspend the reform of loans extended for tea factory modernization under a plantation development programme for a period of one year, establish a tea trading institution to intervene in tea auctions, maintain a cess on tea imports, and provide a fertilizer subsidy for tea small holders.

A fiscal stimulus package was introduced to revitalize the rubber industry and mitigate the downside risks arising from the global economic crisis. The measures include the implementation of a support price scheme for the purchase of rubber latex, and an increase in the cess to enhance demand for domestic rubber latex.[3] Further, measures were taken to reduce the cost of production by suspending the export cess collected from the domestic rubber manufacturing industries

[3] Rs. 150 per kg support price was introduced for rubber latex, while a cess on imported natural rubber latex and imported synthetic rubber was increased to Rs. 25 and Rs. 35 per kg., respectively.

for a period of one year, suspend the duty surcharge on electricity, and reduce the price of furnace oil. A scheme for providing financial assistance to encourage local manufacturing of tyres which are imported was also introduced by the government. Productivity improvement programmes such as training latex harvesters and bud grafters, cost cutting programmes such as introducing new cover crops to reduce nitrogen fertilizer requirement, and the application of paddy straw to reduce potassium fertilizer cost have also been introduced at the producer level.

The government has taken several short term and long term measures to improve the performance of the coconut industry. A duty waiver granted on the importation of palm oil and coconut oil was reduced in mid-2008, and was later removed.[4] The Coconut Research Institute (CRI) has been encouraged to continue its research activities to improve the productivity, crop conservation, and the introduction of new coconut-based value added products.

The government announced several measures to address the problems faced by cinnamon producers. These include measures such as granting of loans to fulfill working capital requirements of growers at competitive rates, and the introduction of a special incentive scheme under the Export Development Board (EDB) for cinnamon exporters who purchase cinnamon at guaranteed prices from cinnamon cultivators.

5.7 Conclusion and Policy Recommendations

The impact of the global economic crisis on the domestic non-plantation crops and plantation sector are different both in terms of the magnitude and the stage of the value chain. In terms of the magnitude, the plantation sector has been more severely affected than the domestic oriented agriculture sector. In spite of falling international commodity prices in recent months, in the domestic sector, the food price crisis still continues to an extent. Food price levels remain high, and may do so at least in the short term. This is primarily due to the fact that even as prices have declined, the fact that they started from a peak level means that the rate of decline has been lower compared to the increase.

Even though Sri Lanka benefits from reduced import costs as a result, the price impact on overall food consumption to vulnerable groups of the population is still high. The present food crisis which started in early 2008 was triggered by rapidly rising international prices of certain food items, and was driven by a series of short term factors. Addressing only short term causal factors - that have reduced food prices to some extent in recent times - is not sufficient. Long term causal factors too need to be addressed. Short term solutions like price controls should be viewed only as temporary measures to provide relief to consumers. Price controls are unattractive options in the long term as there is a tendency for them to become a permanent feature as has happened in the rice retail market. However, many underlying longer term factors have been looming in the market for some time. These include the long standing problem of stagnating productivity in domestic crops, a decline in real investment in the sector, low value addition, and inadequate technological development.

The latterly seen reversal of commodity price increases has not affected domestic produc-

[4] With effect from July 2008, the duty waiver granted on importation of palm oil and coconut oil was reduced from 23 per cent to 13 per cent. With effect from December 2008, the duty waiver on palm oil and coconut oil was removed, thereby applying a 28 per cent duty on importation of palm oil and coconut oil (CBSL, *Annual Report 2008*).

ers to any great extent. However, since the cost of production has been rising continuously in the absence of significant improvements in productivity, price controls will absorb profit margins of farmers, making them vulnerable to future shocks. Hence, it is of the utmost importance that the governments reviews the current price controls in order to ensure the development of a sustainable agricultural sector in the country. In view of adverse impacts arising from the current global economic crisis, state support may be considered favourably in the short and medium term only.

Thus, while implementing short term measures to safeguard the livelihoods of vulnerable people from the adverse effects of price bubbles, it is important to adopt long term measures. Productivity and quality improvements through technological progress, which is more or less absent at present, appears to be the most viable solution for the agriculture sector to cope with future shocks. Further, without limiting measures to only increase production, more attention is also needed on marketing, extension, and research and development aspects as well. Such measures will improve competitiveness and mitigate future downside risks.

The plantation sub-sector consisting of tea, rubber, and coconut all face a common set of problems. Inadequate productivity growth is the major factor of which the primary source is the slow progress made in technology development. The flow of cess funds to be utilized for the development of the industry is critical. Supply of improved planting materials, increased inter-cropping practices, and more usage of trained skilled labour are important factors for plantation management. The government should seriously study the key recommendations of the D.E.W. Gunasekara and Piyadigama Reports on the plantation sector and consider implementing some of these which are crucial for improving productivity of the sector.

On the production side, the major problem is the adherence to bulk primary product exports. Bulk black tea, smoked sheet rubber, and desiccated coconut are the major exports of the three industries, despite growing opportunities to diversify the product base by adding value, and thereby increasing revenues as well. Securing the participation of the private sector can be one way of circumventing this problem. Further, market diversification by seeking untapped foreign markets should also be pursued vigorously.

6. Economic Crises and Poverty: Special Focus on Sri Lanka's Estate Sector

6.1 Introduction

The current world economic crisis threatens to hamper global poverty alleviation efforts, and indeed reverse some of the gains that have been made in recent years. Most developing countries are experiencing reductions in export earnings and GDP growth, which inevitably will have adverse effects on employment and earnings, and thus on poverty and social welfare. The World Bank, for instance, estimates that 90 million more people across the world can be trapped in poverty as global economic growth slows down in 2009 - on top of an estimated 130-155 million people already pushed into poverty in 2008 due to soaring food and fuel prices.[1] It further projects that more than 1 billion people could go chronically hungry in 2009. The past experiences of crises shows that it may harm human development in four ways: by increasing poverty, worsening nutrition, reducing the quality and supply of education and health services, and wiping out the meagre savings and wages of poor people. This scenario would set back the fight against poverty. Indeed, the World Bank estimates that a one percentage point reduction in GDP growth could trap 20 million more people into poverty.[2]

Sri Lanka too is likely to face significant adverse effects in its drive to alleviate poverty across the country. The negative impacts of the economic downturn on poverty can often get overlooked as the impacts are felt indirectly. However, the consequences can be quite severe, particularly for sections of the population that are already vulnerable and marginalized in terms of their socio-economic development.

Declining demand in industrialized countries for key exports such as garments and tea will affect a large number of workers in these sectors and their families. Remittances from migrant workers may also decline due to the crisis, which will affect not only the families of the migrant workers in Sri Lanka, but also hold wider economy-wide implications. Impacts on employment are on the rise. While employment losses may be felt mostly in the urban sector, the consequent effect on the rural economy and income levels of the rural households cannot be underestimated.

In this regard, the estate sector of the country is likely to be hit far harder than many other sectors, with declining incomes from tea exports being a key channel of transmission. Disaggregated poverty statistics for Sri Lanka indicate an increasing trend in estate sector poverty, while poverty levels for the rest of the country and other sectors have been on the decline. Thus, examining the extent and the ways in which the current global economic crisis and general slowdown in economic activity in Sri Lanka will affect poverty and welfare of estate sector workers is timely.

The Chapter initially provides an overall picture of the state of poverty in Sri Lanka and then goes on to focus on the present poverty

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[1] http://www.worldbank.org/html/extdr/financialcrisis/bankinitiatives.htm

[2] http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTPOVERTY.

Table 6.1
Poverty Trends in Sri Lanka (1990-2006/07)

Sector	1990/91	1995/96	2002	2006/07
PHC				
Sri Lanka	26.1	28.8	22.7	15.2
Urban	16.3	14.0	7.9	6.7
Rural	29.4	30.9	24.7	15.7
Estate	20.5	38.4	30.0	32.0
PGI				
Sri Lanka	5.6	6.6	5.1	3.1
Urban	3.7	2.9	1.7	1.3
Rural	6.3	7.2	5.6	3.2
Estate	3.3	7.9	6.0	6.2
SPGI				
Sri Lanka	1.8	2.2	1.6	0.9
Urban	1.3	0.9	0.5	0.4
Rural	2.0	2.5	1.8	1.0
Estate	0.9	2.5	1.8	1.8

Notes: PHC = Poverty Head Count; PGI = Poverty Gap Index; SPGI = Squared Poverty Gap Index.
Source: Department of Census and Statistics, *Household Income and Expenditure Survey* (HIES) for 1990/91, 1995/06, 2000, and 2006/07.

situation that exists in the country's plantation estate sector. Thereafter, the discussion analyses the role played by the estate sector in the economy and how the economic performance of the sector is being affected by the current economic downturn. Finally, the channels of transmission of the economic shock to the estate workers are explored to assess the degree to which the welfare of estate sector workers is likely to be impacted.

6.2 Poverty in Sri Lanka

Although Sri Lanka is a developing country, most of the human development indicators for health and education in Sri Lanka are now almost on par with the developed world. Sri Lanka has already achieved - or is well on track to achieve - the Millennium Development Goals (MDGs) of most of the health and education indicators. However, improvements in the MDG indicators related to equity in education and health do not show similar improvements. Thus, a key concern remains the continued existence of significant variations between sectors and regions.

The national poverty headcount - the percentage of the population below the poverty line - computed by the Department of Census and Statistics (DCS) for Sri Lanka declined from 26.2 per cent in 1990/91 to 15.2 per cent in 2006/07.[3] During the period from 1990/91 to 1995/96, the poverty headcount increased by 2.7 percentage points, while during the period from 1995/06 to 2000, the headcount actually decreased by 6.1 percentage points. The period from 2000 to 2006/07 shows a decline of 7.2 percentage points, which is remarkable.[4]

Other measures of poverty show similar trends,[5] resulting in a decline in the Poverty Gap Index (PGI) from 5.6 in 1990/91 to 3.1 in 2006/07 at the national level. In the

[3] It should be noted that the *Household Income and Expenditure Survey* (HIES) conducted by the Department of Census and Statistics (DCS) did not cover the Northern and Eastern Provinces in 1990/91, 1995/96 and 2000, while the 2006/07 survey covered the Eastern Province.

[4] However, the more recent price increases of most consumer items may have increased the poverty headcount which may get reflected in the next HIES, expected to be conducted in 2012 after the next Census of Population in 2011.

[5] The Poverty Gap Index ((PGI) is a measure indicating the depth of poverty. This is simply the sum of all the poverty gaps in the population, which can be used as an indicator of the minimum cost of eliminating poverty using perfectly targeted transfers. The Squared Poverty Gap Index ((SPGI) indicates the severity or inequality of poverty and gives more weight to the poorest of the poor.

Table 6.2
Inequality: Gini Co-efficient of Per Capita Expenditure

Sector	1990/01	1995/96	2000	2006/07
Sri Lanka	0.32	0.35	0.40	0.41
Urban	0.37	0.38	0.42	0.46
Rural	0.29	0.33	0.39	0.39
Estate	0.22	0.20	0.26	0.23

Source: DCS, HIES for 1990/91, 1995/96, 2000 and 2006/07.

urban sector,[6] the PGI has declined by nearly two-thirds (from 3.7 in 1990/91 to 1.3 in 2006/07). In the rural sector,[7] the PGI has declined from 6.3 in 1990/91 to 3.2 in 2006/07. In the estate sector,[8] it has increased from 3.3 to 6.2 during the same period. The Squared Poverty Gap Index (SPGI) has also increased from 0.9 to 1.8 in the estate sector during the same period, indicating that the severity of poverty also has increased in this sector between 1990/91 and 2006/07.

The urban sector reported the lowest SPGI and the highest Gini co-efficient among the sectors.[9] The SPGI measures inequality among the poor, while the Gini co-efficient measures overall inequality, when both poor and non-poor are considered together. This shows that inequality among the poor is low in the urban sector, although overall inequality is high. The situation in the estate sector is exactly the opposite, except in 1990/91 when both the SPGI and the Gini co-efficient were lowest in the estate sector.

The SPGI for the estate sector shows that inequality among poor who stay below the poverty line is highest in the estate sector compared to the other two sectors. On the other hand, a low Gini co-efficient for the estate sector shows that even the non-poor are also not much far above the poverty line. Most of them could be clustered just above the poverty line. As such, they could slip easily into poverty due to any economic shock. These could take the form of price increases, low demand for plantation exports, adverse weather conditions, etc. Even in the other two sectors, people clustered just above the poverty line are vulnerable to economic shocks.

The urban sector shows a continuous reduction in poverty from 16.3 per cent in 1990/91 to 6.7 per cent in 2006/07, already passing the expected MDG target of 8.1 per cent to have been achieved by 2015. The rural sector, accounting for nearly 80 per cent of the population, is the main contributor to the reduction of poverty at the national level. The poverty headcount for this sector has fallen from 29.4 per cent in 1990/91 to 15.7 per cent in 2006/07, nearing the expected MDG target of 14.7 per cent to be reached in 2015. If the present trend continues, the target could be achieved before 2015. This remarkable improvement can be attributed to various rural development programmes that are being implemented to improve urban-rural connectivity, access to basic

[6] Areas under Municipal Councils (MCs) and Urban Councils (UCs).

[7] Comprises all areas other than the MC areas, UC areas and the estate sector.

[8] Consists of all plantations which are 20 acres or more in extent, and with 10 or more resident labourers.

[9] The Gini co-efficient which ranges from zero to one explains the total inequality of a distribution. The higher the Gini co-efficient, the greater the income or expenditure inequality.

needs such as health, education, marketing, banking, etc.

The incidence of poverty in the estate sector, accounting for around 5.5 per cent of the total population has increased from 20.5 per cent in 1990/91 to 38.4 per cent in 1995/96. Despite an improvement thereafter - with a decline in the headcount to 30 per cent in 2002 - poverty levels in the estate sector continue to remain high compared to the other sectors. The poverty headcount in this sector increased further in 2006/07 to 32 per cent, while the other two sectors experienced a decline (Table 6.1).

6.2.1 Explaining Poverty in the Estate Sector

Despite the fact that the estate sector accounts for only 11.3 per cent of total poverty in Sri Lanka in 2006/07, the incidence of intra-sector poverty is highest in this sector (32 per cent) as previously discussed. All poverty indicators - PHC, PGI, SPGI, Gini-coefficient, etc. - show that the majority of the poor in the estate sector are clustered around the poverty line and, therefore, are highly vulnerable to economic shocks. A number of other indicators also show that inadequate infrastructure facilities, poor service delivery mechanisms, etc., are still affecting the quality of life of the people living in the estate sector. There are some gradual improvements. For instance, some plantation companies provide better welfare facilities relative to some others owned by private individuals.

Table 6.3 clearly indicates that key indicators - mean household income, per capita income, income receiver's mean income, mean household expenditure, etc. - do poorly in the estate sector compared to the other two sectors. While all previous surveys also showed a similar pattern, the differences between the mean household incomes of rural and estate sectors were not high in earlier periods (Table 6.4).

The food ratio - proportion of expenditure on food and drink to total expenditure - is an indirect indicator of development and living conditions. It is presumed that the lower the food ratio, the better are living conditions. In the estate sector, the food ratio in 2006/07 was 52.7 per cent which is much higher than

Table 6.3
Household Income and Expenditure Patterns by Sector (2006/07)

	Sri Lanka	Urban	Rural	Estate
Income				
Mean HH income per month (Rs.)	25,414	42,878	22,979	15,724
Per capita income per month (Rs.)	6,235	9,989	5,713	3,637
Income receiver's mean income per month (Rs.)	13,705	21,842	12,686	7,290
Average HH size	4.1	4.3	4.0	4.3
No. of income receivers	1.8	1.9	1.8	2.1
Expenditure				
Mean HH expenditure per month (Rs.)	22,671	37,978	20,620	12,879
Food ratio[a]	35.8	27.9	37.6	52.7
Gini co-efficient of HH expenditure	0.42	0.45	0.40	0.25

Note: a: The proportion of expenditure on food and drink to the total expenditure.
Source: DCS, HIES of 2006/07.

Table 6.4
Average Monthly Household Real Income by Sectors[a]

Survey Year	All Sectors	Urban	Rural	Estate
1980/81	881	1,274	795	753
1990/91	1,125	2,151	864	761
1995/96	1,177	2,044	1,064	738
2002	1,362	2,386	1,246	777
2006/07	1,838	3,101	1,662	1,137

Note: a: At 1980/81 constant prices.
Source: HIES, 1980/81 to 2006/07.

the other two sectors. A low Gini co-efficient of household expenditure (0.25) in the estate sector indicates a homogeneous household expenditure pattern.

The Wealth Index is a socio-economic indicator that is used as a proxy for long term living standard of a household. It is based on data relating to ownership of consumer goods, dwelling characteristics, drinking water sources, toilet facilities, and other characteristics related to the socio-economic status of a household. Table 6.5 gives the distribution of household population into five wealth quintiles by sector. The data illustrate that almost half the population in the urban sector (49.2 per cent) is in the highest wealth quintile. In the estate sector, nearly two-thirds (64 per cent) is in the lowest quintile and only 1.3 per cent in the highest quintile. Moreover, 90.4 per cent is in the lowest and second quintiles combined. This further confirms that living conditions in the estate sector are still very poor, although there is a gradual improvement. In the rural sector, the population is found to be more evenly distributed.

The data in Table 6.6 on early childhood mortality rates show that most indicators are much higher in the estate sector compared to the other two sectors. As such, all indicators related to nutritional status of children and early childhood mortality rates (especially infant mortality and under-five mortality) are significantly higher in the case of the estate sector. It has been observed that the mother's education is highly correlated to the nutritional status of their children, as well as early childhood mortality. According to the *Demographic and Health Survey* (DHS) of 2006/07, 19.9 per cent of women in the estate sector have had no education, and another 29 per cent have not completed their primary education. Thus, nearly 50 per cent of women in this sector have a very poor level of education.

Table 6.5
Wealth Quintiles by Sector

Wealth Quintile	Total	Urban	Rural	Estate
Lowest	20.0	8.3	19.2	64.0
Second	20.0	9.9	21.3	26.4
Middle	20.0	12.4	22.0	5.8
Fourth	20.0	20.1	21.0	2.5
Highest	20.0	49.2	16.5	1.3
Total	100.0	100.0	100.0	100.0

Source: DCS, *Demographic and Health Survey of 2006/07*.

Table 6.6
Early Childhood Mortality Rates (2006/07)[a]

Type of Mortality	All Sectors[b]	Urban	Rural	Estate
Neonatal mortality	11	6	15	18
Post- neonatal mortality	5	3	4	11
Infant mortality	15	10	19	29
Child mortality	5	9	3	5
Under-five mortality	21	19	23	33

Note: a: For the ten year period preceding the survey; b: For the year preceding the survey year of 2006/07.

Source: DCS, DHS of 2006/07.

A mother's health and nutrition are directly linked to the health and nutritional status of their children. But, accessing health care is another major problem that women in the estate sector face. Various factors can prevent women from getting medical advice or treatment as indicated in Table 6.7. Accordingly, nearly 77.4 per cent of the women in the estate sector have at least one major problem in accessing health care. Out of the different type of problems, 'distance to health facility' is the main problem for more than 50 per cent of them. Two other reasons for not seeking medical advice or treatment are 'getting money for treatment' (49.2 per cent) and 'having to take transport' (47.4 per cent). This clearly shows that the lack of suitable health care facilities in close proximity is one of the major problems that prevent many women from seeking medical care.

Nutrition is one of the most vital requirements for child survival and early childhood development.[10] Damage in early childhood can have serious long term effects on an individual's well-being and that of the next generation. When children's cognitive development is impaired, particularly before two years of age, the effects may be irreversible. Under-nourished girls face higher risk of maternal and child mortality. They also have a greater probability of low birth weight and

Table 6.7
Problems in Accessing Health Care (2006/07)

Type of Problem	All Sectors	Urban	Rural	Estate
Getting permission to go for treatment	3.0	3.8	2.3	14.4
Getting money for treatment	22.3	19.2	21.2	49.2
Distance to health facility	19.5	9.9	19.2	50.6
Having to take transport	19.3	10.1	19.1	47.4
Not wanting to go alone	21.6	24.9	20.5	30.8
Concern no female provider available	7.5	9.9	6.4	20.2
Concern no provider available	8.2	9.4	6.8	29.0
Concern no drugs available	9.4	10.4	8.1	28.5
At least one of the problems of accessing health care	47.3	44.5	45.9	77.4

Source: DCS, DHS of 2006/07.

[10] See discussion on "Crises and Vulnerability: Improving the Nutritional Levels of Children" in Policy Brief 10 of this report.

Table 6.8
Housing and Related Characteristics (2006/07)

Percentage of Households (HHs)	Sri Lanka	Urban	Rural	Estate
Without exclusive bedrooms	2.6	3.9	2.1	6.1
With only one bedroom	23.2	26.8	21.1	44.4
With safe drinking water	85.7	97.2	85.9	50.6
With semi-permanent wall	11.6	7.8	12.1	14.3
Floor	13.1	3.2	14.4	19.5
Roof	17.7	12.9	14.9	72.9
With floor area less than 100 sq.ft.	4.9	2.1	4.9	11.9
With toilet (for exclusive use of HH)	90.0	87.2	91.5	73.0
Using electricity for lighting	80.4	94.2	78.8	67.0
Using firewood as cooking fuel	80.0	38.3	86.2	98.1
Using gas as cooking fuel	16.2	48.5	11.6	0.5

Source: DCS, HIES of 2006/07.

stunting of their own children - problems that are often compounded by an early start to childbearing among poor women. According to the DHS of 2006/07, 9.6 per cent of women aged 15-19 years in the estate sector have begun childbearing, compared to 6.4 per cent and 6.2 per cent in the urban and rural sectors, respectively.

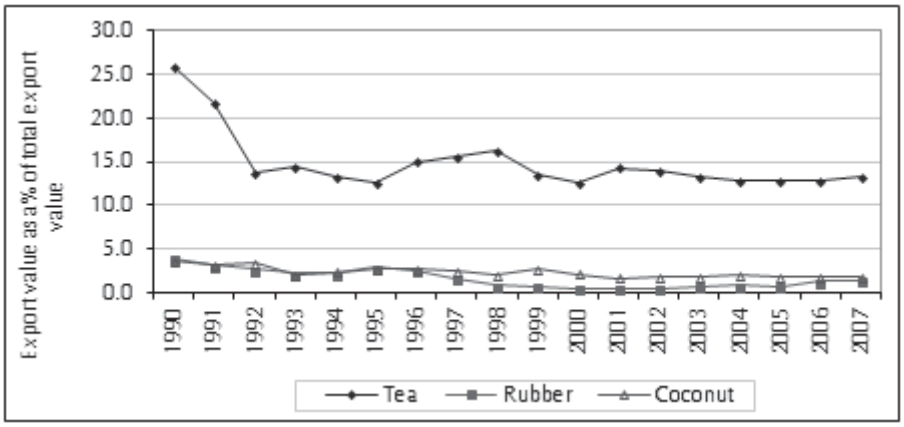
Table 6.8 gives some of the housing characteristics that can be used to compare the living conditions of people in the three sectors. All the characteristics appear to indicate that the living conditions of the people in the estate sector are still at a lower level than those in the other two sectors.

6.3 The Estate Sector in the Sri Lankan Economy

As discussed previously, all indicators on poverty, nutrition, health, housing, etc. indicate that the socio-economic conditions in the estate sector are still relatively weak. Indeed, the estate sector related poverty figures show a worrisome picture, showing no signs of improvement while the other sectors of the economy show positive trends. In addition to some of the factors underlying these developments, some part of the problem lies in the roots of the formation of the estate sector, the significant role it has played in the economy in the past, and the changing role of the estates in the economy at present.

The Sri Lankan economy had a long history of heavy dependence on a few primary commodities, primarily tea, rubber and coconut. Despite emerging evidence of unfavourable terms of trade for primary commodities, Sri Lanka failed to diversify away from a plantation agricultural export base until the opening up of the economy in the late 1970s. Nationalization of the plantation sector in the 1970s - with management vested in the Janatha Estate Development Board (JEDB) and State Plantation Corporation (SPC) - was accompanied for the most part by poor performance. The privatization of plantations began actively in the early 1990s. In 1992, out of a total of 502 estates, 449 estates were formed into 23 Regional Plantation Companies (RPCs) and their management handed over to 23 private sector companies, initially

Table 6.1
Value of Exports of Tea, Rubber and Coconut



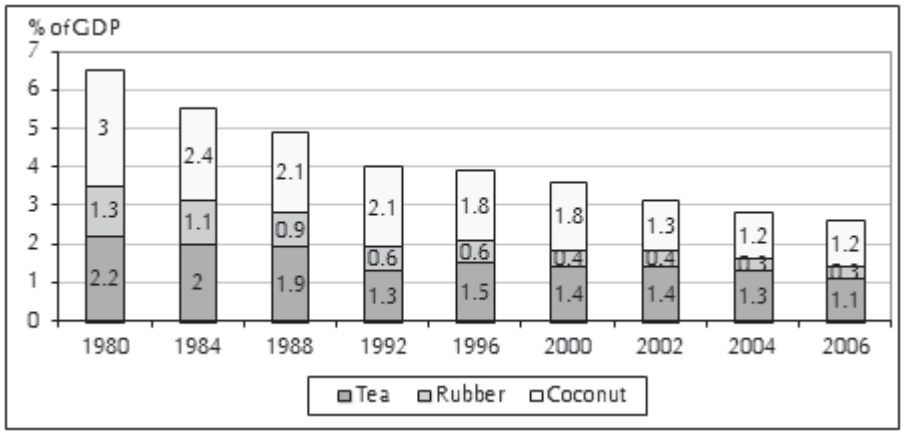
Note: As a percentage of total exports.
Source: CBSL, *Annual Report*, various issues.

for five years. In 1995, the management was leased and vested in 21 RPCs for 99 years initially, which was later reduced to 53 years.

6.3.1 Role of Plantation Crops in the Economy

With the liberalization of the economy and manufactured export thrust, the role of the plantation crops in the economy also changed. Plantation crops which accounted for about 95 per cent of total exports in the 1950s saw its share decline to about 75 per cent in the 1970s. Tea exports played a key role, accounting for close to half of total exports by the late 1970s. By the 1990s, industrial products had come to dominate exports, although agriculture continued to account for about 35 per cent of exports,

Table 6.2
GDP Contribution of the Plantation Crops



Source: CBSL, *Annual Report*, various issues.

while the contribution of the tea sector had reduced by half to 25 per cent.[11] In more recent years, the shares have fallen further - with agriculture accounting for less than 20 per cent of total exports and the share of tea exports declining to around 12 per cent (Figure 6.1).

As mentioned already, the plantation sector has undergone various stages of transformation, including its role in the economy. Although it has been well over a decade since restructuring of the sector began under private management, significant improvements in the corporate plantation sector as a whole cannot be witnessed. Currently, the sector is faced with problems of low productivity, high cost of production, lack of quality improvement and marketing practices, low profitability and an inability to generate sufficient surpluses to maintain its long-term sustainability. Inconsistencies in policy formulation towards the sector and external demand factors have also been a burden at times.

Another key area of concern is the continued existence of deep rooted problems on the labour front. This applies mainly to tea, but also to rubber to an extent, where workers reside in an enclosed structure of estates, separated from the rest of the economy to a great extent. The roots of plantation labour go back to the colonial regime, whereby the transfer of labour from South India to work in the plantations commenced around 1867. Though the labour supply was initially on a contract basis, over time, the workers began to migrate with families to specific estates. After Sri Lanka achieved independence, they were classified as temporary immigrants. Discussions between India and Sri Lanka with regard to future citizenship of such workers saw the enactment of the Sirima-Shastri Pact in 1964, under which an agreement was reached to repatriate 600,000 plantation workers of Indian Tamil origin back to India. A further 375,000 was to be accepted as franchised citizens of Sri Lanka. The present estate population is derived from the latter group who are now wage employees of the estates.

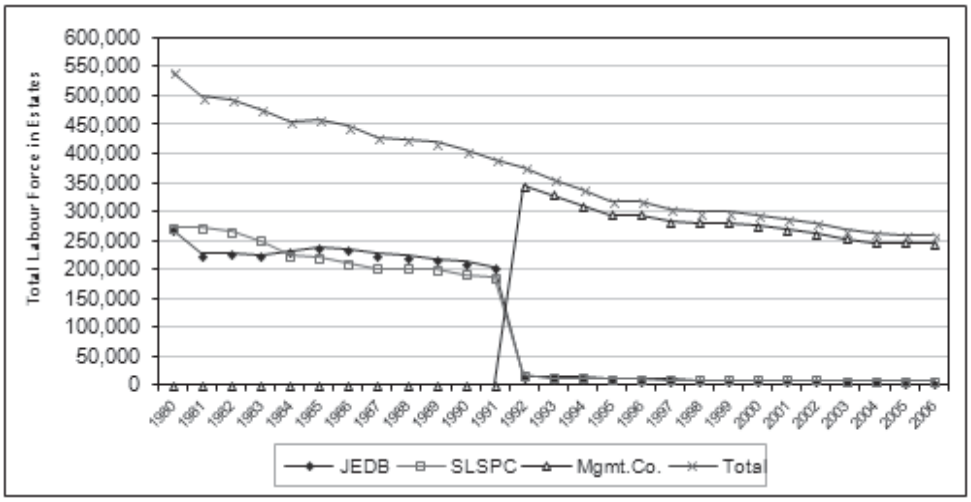
The total labour force of the plantation estate sector was about 550,000 in the 1980s (with State Plantation Companies). With privatization in 1992 and the formation of 23 RPCs, the management of the labour force did change inevitably, without an option for the employees of the estates. Over the years, the labour force has contracted gradually, declining to about a half of the total labour force numbers that prevailed 25 years ago. In total, the 23 RPCs and the state plantations (JEDB and the SLSPC) had 13,645 as staff and 244,681 as labourers by 2006 (Figure 6.3).[12]

The long term commercial viability of the plantation sector is threatened by reduced availability and low productivity of the estate labour force. Skilled labour migration has become a challenge for plantation estates, as skilled operations in harvesting technology plays a key role in determining production, productivity and quality standards in tea. One of the prominent causes for the reduction in the workforce, which was abundant in the early years, is worker out-migration. It is estimated that a 2 per cent out-migration of labour would be a major constraint for the management companies in

[11] See CBSL, *Annual Report*, various issues.

[12] Out of the total land extent of tea, rubber and coconut (146,469 Ha), 93 per cent of the land is with RPCs. For all three types of plantation crops, over 90 per cent representation is with RPCs.

Table 6.3
Total Labour Force in the Estate Sector



Notes: Total labour force in all estates under 23 management companies and state management companies. The total labour includes, staff, regular employees and casual employees.

Source: Ministry of Plantation Industries, *Plantation Sector Statistical Pocket Book 2007*.

estate development unless innovative partial mechanization measures are introduced.[13] Migrating overseas or to other localities for different types of occupations are considered as less strenuous, better paying and more prestigious, and is indicative of the changing long term aspirations of the younger generation towards upward social mobility. In addition to the lack of social acceptance, low standards of living and poor infrastructure at the estates are some of the other main factors which cause labour out-migration.[14]

6.4 Impact of the Economic Downturn on the Estate Sector

In examining the potential impact paths of the current global economic crisis on the estate sector, the discussion will be confined to the tea and rubber sectors as only these two sectors have a majority of its labour force as resident workers. As already discussed in Chapter 2, the global economic downturn has a direct impact on the demand and prices of export crops. Both tea and rubber export sectors have been impacted. Tea production and exports have been on the decline since mid-2008. In the case of the rubber sector, the impact of the global downturn has been more muted.

While the present discussion does not extend to the level of small holdings, limiting the discussion only to the plantations estates, the likelihood of very differing impacts cannot be ignored. The small holders often lack technical know-how, accumulated savings, collateral for alternative financing to diversify, and are also less organized. The impact on the labour force operating in the plantation companies and small holdings will also be different.

In the case of the tea sector, for instance, the impact of the downturn will be more severe

[13] Ministry of Plantation Industries (2008), The Report of the Committee to make recommendations on Development and Management of Estates Leased out to RPCs.

[14] *Ibid.*

on the small holders than the corporate estate sector. The tea small holders occupy about 65-75 per cent of the tea extent in the country and contribute about 65 per cent of tea output. In contrast to the estate sector, the small holders perform better. The yield of tea small holdings is much higher than that of the estates. Much of the growth in tea demand in recent years can be attributed to the attraction consumers of countries like Middle-East had to inherent qualities in low grown tea. This explains the vulnerability of tea small holders, as often the small holders are concentrated in the low-country and produce low-grown tea. As large quantities of tea remain unsold at auctions, the small holders find it difficult to carry out their daily operations, unlike the plantation estates. The adverse impact on the tea sector will not only affect the private estates (small holdings), but also the small holders and employees of both types too, as it provides livelihood for over 1 million family members and over 100,000 workers. In the last quarter of 2008, it was estimated that about 400,000 tea small holders would be affected by the downturn in the global economy.

6.4.1 Impact of the Economic Downturn on Estate Worker Welfare

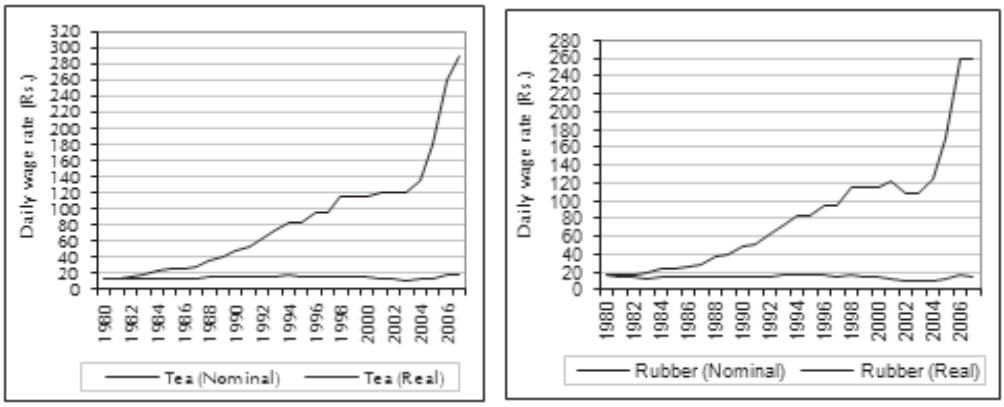
As previously discussed, the importance of the estate sector in the economy cannot be ignored, particularly in terms of foreign exchange income earnings and employment provision. These factors in themselves make the estate sector vulnerable to the global economic crisis. The estate sector accounts for a sizable percentage of the population - one million in absolute terms or 5.4 per cent of the total population. Even more critically, it is the already poor welfare status of the estate sector relative to the rest of the country that makes it vulnerability to the adverse effects of the current economic downturn more serious.

The economic crisis can affect estate worker welfare in direct and indirect ways. Theoretically, the indirect impact would arise if the contraction of world demand results in a reduction of export earnings that in turn would require rationalization/restructuring measures to be adopted by the companies. In such circumstances, it would not be surprising if strategic management decisions involved measures to cut down on production as a means of surviving the financial stresses. Such measures, however, will have a bearing on the earnings of the estate labour. Reduced earnings can fuel poverty, and the welfare of the estate population may deteriorate even further. However, whether the adverse impacts of the global economic meltdown will trickle down in the same extent to the worker level - to result in a sharp drop in welfare - is debatable when the context in which the labour force operates in the estates is considered.

The indirect impacts of the economic crisis can affect the wage rates of the workers. Figure 6.4 illustrates how the total daily wage rates of tea and rubber estate workers have fluctuated over the years since 1980.[15] In nominal terms, wage rates have been increasing and the earning potential of workers have increased with a wage hike after 2005, for both tea and rubber. This is mainly because, in addition to the increasing daily wage rate, they can earn a price share and an incentive which together decides the total daily wage earned. Accordingly, by 2007, the total daily wage of a worker was Rs.290 for tea and Rs.260 for rubber. However, even with the price share and incentive, the real wage rates have remained relatively constant, with only slight fluctuations.

[15] On top of the daily wage, workers were provided with a price share and an incentive. The total daily wage includes all these three components. This provision started from 2005 for both tea and rubber.

Table 6.4
Total Daily Wage Rates for Males and Females in Tea and Rubber



Note: The real wage rates are calculated by using CCPI (1952 = 100) at 1980 constant prices.
Source: Ministry of Plantation Industries, *Plantation Sector Statistical Pocket Book*, various issues, and CBSL, *Annual Report*, various issues.

However, what is interesting to note is the method of wage determination. The wages of estate workers are decided through a collective agreement with the labour unions, which is reviewed every two years. Due to various political-economy reasons, the bargaining power of the labour unions are so high that labour wages are not tied to productivity or output. In recent years, political pressure has even led to the violation of a collective agreement between the Plantation Unions and the Employers' Federation of Ceylon.[16] The RPCs are hoping to come to an agreement on wages, which will tie up the wages with productivity/output in order to ensure economic efficiency. As a statutory requirement mandated by legislation, the estate management is bound to provide not only the wage rates determined through a collective agreement, but also the number of fixed pre-determined days of work to the workers.

In a situation where tea stocks were accumulating due to the drop in prices, managers of estates were left with the only rational strategic option of cutting down production so as not to let the stocks accumulate. As by legislation, the estate management is obliged to provide 300 days of work per year - without deviation - most of the estate management have taken steps to advance pruning. Even the advice of the Sri Lanka Tea Board to growers and producers during the last quarter of 2008 was to 'go slow'. The Tea Research Institute (TRI) has recommended 'selective plucking' of tea leaves and advancing the pruning of tea plants, lowering fertilizer usage to ensure low production of tea leaves, and making use of this interim period for the development of tea estates. Such measures are expected to allow growers and producers to provide the obliged number of days of work, and at the same time to reduce production levels.

This reinforces the arguments that worker welfare may not be adversely affected in indirect ways as a result of the current eco-

[16] Ministry of Plantations Industries (2008), Report of the Committee to make recommendations on Development and Management of Estates Leased out to RPCs.

nomic crisis, unless other factors impinge in the longer run. In the long run, if the estates are able to negotiate a wage rate determination that is tied to productivity, or the estate companies make substantive losses and become incapable of paying wages, or start laying off labour, etc., the impacts on worker welfare will be different. As it stands at present, companies have to absorb the shocks of an external economic crisis with limited trickle down effects on the welfare of workers through wages effects.

Nonetheless, there could be an indirect impact on income if workers are unable to earn through price shares and incentives. These depend on the extra volumes of plucking and the number of days worked. Though such earnings are relatively marginal, it could have an impact on worker welfare, particularly in the longer term. Cumulatively, a drop in earnings will pull down non-poor estate households into poverty. The possibilities exist given the fact that non-poor estate households are often just above the poverty line.

The second effect of the global economic crisis on worker welfare is quite direct. A special characteristic of the estate sector lies in the structure of its formation in the colonial era. As workers were brought down from South India, they were absorbed into an enclave structure of the estates and sidelined from the rest of the economy. As a consequence, the estate population became completely dependent on the management, not only for their work but also for the services of their day-to-day life. The estates perform a quasi government role. Within the enclave structure, the estates provide almost all the welfare services to the workers. There is a high possibility that with the reduction of profits of the estates, the management may divert attention from provision/improvement of welfare services. However, a counter argument is also possible as most of the welfare services provided are fixed, or cannot be reduced. Welfare benefits such as gratuity would continue to exist unharmed by the economic downturn. However, there is already pressure to amend the Payment of Gratuity Act, No. 12 of 1983 which ties up the entitlement to gratuity with a prescribed minimum number of days of working.

It is as yet not possible to arrive at any firm conclusions, particularly due to the lack of information. Nevertheless, it is possible that the initial steps taken to meet financial constraints might be related to gradual reductions in welfare service provision during the downturn. Though this would not be visible initially as fixed welfare services cannot be reduced, it may manifest in the provision of minor services (e.g., whitewashing of houses, cleaning of environment, etc.). In the short run, though the welfare of workers will not be affected to the same extent as the magnitude of the global crisis on the profits of estate companies, it will still have a negative impact.

In addition to the welfare services provided by the estates directly, an independent organization has been formed to overlook the welfare services of the estates called the Plantation Human Development Trust (PHDT). The organization started its operations following the change of estate management in 1992. It is a tripartite organization which fosters close inter-dependent relationships between the employers of the estates, the workers and the government.

The PHDT comes under the mandate of the Ministry of Youth Empowerment and Socio-Economic Development. The line ministries are the Ministry of Plantation Industries, Ministry of Nation Building and Estate Infrastructure Development, and the Ministry of Healthcare and Nutrition. The recurring costs of the PHDT are borne by the RPCs. The PHDT also has several international and local non-government organizations (NGOs)

as partners. The PHDT exists to ensure and integrate the social responsibility of the partners towards the plantation community, channelling the work of several entities often in partnership with the community, estate management, trade unions and other organizations.[17]

Accordingly, most of the welfare services of the estates are streamlined through the PHDT, which acts as the central body for receiving funds from the government, local or international NGOs. In turn, it allocates funds for the welfare services of the estates of RPCs, JEDB and SLPC, based on needs. The key areas are sanitation, housing, health and early childhood care and development. As the recurrent costs of the PHDT are borne by the RPCs - which they cannot waive off - the welfare services provided by the PHDT can be assumed to be fixed. However, the extent to which they can extend services depends on the amount of funding the PHDT receives through channels of government or local/international NGOs. In the long run, with the global economic meltdown and constraints on donor funding, it is likely that worker welfare can get affected in the future.

6.5 Conclusion

The plantation sector remains a vital sector of the Sri Lankan economy. It is likely to continue to play an important role in view of its still significant contribution to overall growth, employment, foreign exchange earnings, etc. Globalization has offered unlimited opportunities as well as challenges for the plantation sector. As detailed in the discussion above, though the impact of the global economic crisis could impair the role that the estates play in the economy, the trickle down adverse effects on the workers are likely to be somewhat muted as it cascades, particularly in the short run. However, it must be noted that should the global recession turn out to be of a longer duration than anticipated at present, it could have more serious repercussions. Companies operating in the sector might be compelled to trim welfare service provisions, as they are not allowed to reduce wages or cut the number of working days under current mandated provisions. Companies have to adopt innovative practices for long term sustainability and attempt to mitigate the impact by diversifying and developing the estates in other ways during the downturn. These kinds of activities may have to be encouraged by the government by way of loans and subsidies.

Even a subtle change in welfare provisions could have a sizable impact in view of the relatively poor socio-economic standing of the estate sector population - in particular, the existing high levels of poverty and the fact that many households are aggregated around the poverty line. In this context, the attention of policy makers should remain focused on developments that could impinge on the welfare status of the estate workers to ensure that overall efforts to address poverty reduction in the country are not undermined.

[17] PHDT, *Annual Report 2007*.

7. Global Economic Crisis and Energy Dependence of Sri Lanka

7.1 Introduction

One of the key sectors that link the Sri Lankan economy to the global economy is the energy sector. Even before the emergence of the current economic crisis, the vulnerability of the Sri Lankan economy to volatile changes in global energy markets has been fairly obvious. The shock waves of oil price changes have had ripple effects throughout the economy. This has been a familiar experience during the last few decades, and most recently during 2004-08. It seems that such trends could easily outlast the current global economic crisis or any of its short-term repercussions.

This Chapter attempts to examine the nature of global energy market issues with a view to identifying major policy implications to mitigate downside impacts on Sri Lanka. In essence, the identified problem is one of growing dependence of Sri Lanka's economy on global energy markets to fulfill its energy needs. Such dependence on global energy markets is on the rise, mainly due to high demand for petroleum-based energy from certain sectors of the economy. A common perception on this issue is that if Sri Lanka can find its own petroleum resources, the problem can be easily overcome. However, in the discussion to follow, it is argued that the situation is somewhat more complex and, therefore, a more broad-based solution is necessary for the country.

7.2 Overview of the Energy Sector in Sri Lanka

In discussing the energy sector issues in Sri Lanka, energy dependence is defined as the external dependence of Sri Lanka in fulfilling its energy needs. Modern economies rely heavily on energy resources to ensure sustainable development. However, the available energy resources are not evenly distributed across the globe geographically, and certain regions are more richly endowed than others. Among others, fossil-based energy sources such as petroleum and coal have become the major sources of energy for modern industrialized economies. Therefore, the uneven distribution of these resources is a major cause of concern for countries which lack such resources. Sri Lanka, being a country which is yet to confirm possession of any type of petroleum or coal resources, therefore has to face the reality of rising dependence on global markets to fulfill its energy needs in the foreseeable future.

The first step towards understanding the problem of energy dependence is to examine the supply and demand for energy in Sri Lanka. The demand for various energy sources are derived from five major sectors of the economy, namely: residential, commercial, industry, transport, and agriculture. As evident from Table 7.1 and Figure 7.1, the residential sector is the largest energy user, where bio-mass plays a prominent role. The transport sector is the second largest user of energy in the economy, followed closely by the industrial sector. Compared with these major sectors, commercial and agriculture sectors consume relatively low amounts of energy. An important point to be noted here is that the composition of the energy mix used by different sectors varies substantially amongst each other. For instance, energy consumption of the household sector is domi-

Table 7.1
Supply and Demand Structure of the Energy Sector in Sri Lanka

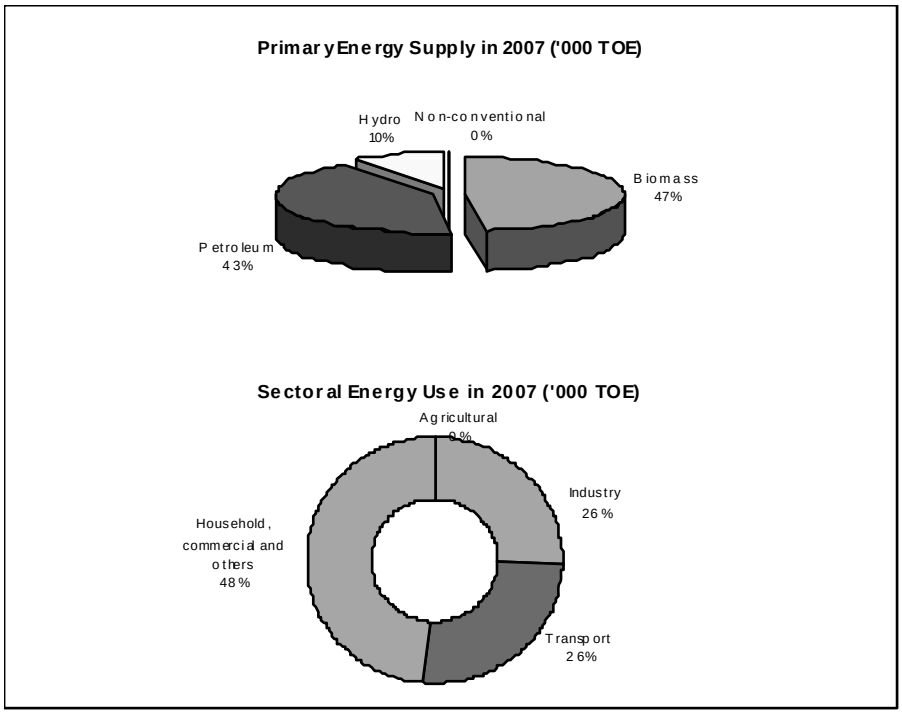
End Users Category	Demand Types of Major Uses/Applications/Scales	Supply ('000 TOE) Types of Energy Sources (Major)	Petroleum Products	Bio-mass	Electricity	Remarks
Households	Cooking	Firewood (rural) LPG, Kerosene (urban)	122	3803	225	92 per cent of energy needs are met by bio-mass products, where petroleum usage is very minimal.
	Lighting	Electricity (all urban & rural) Kerosene (un-electrified areas & rural poor)				
	Domestic appliances	Electricity (urban & rural upper)				
	Other home energy needs	Miscellaneous (solar, etc.)				
Commercial	Power and energy needs of day-to-day running of the commercial establishments	Electricity	58	154	217	Electricity fulfills half of the energy requirement. Petroleum contribution is around 15 per cent.
Industry	Large industries(boilers, furnaces, kilns, driers, etc.)	Electricity Petroleum-based fuels (diesel, heavy fuel oil, kerosene, etc.)	343	1169	225	Major contribution by bio-mass. Petroleum dependence is very low.
	Small & medium industries (boilers, furnaces, kilns, driers, etc.)	Electricity Bio-mass (firewood)				
Transport	All types of public & private vehicles	Petroleum-based fuels (diesel & petrol)	1931	0	0	100 per cent petroleum dependent.
Agriculture	Water pumping	Petroleum-based fuels (diesel & kerosene) Electricity	8	0	0	Energy requirement is comparatively very minimum, yet purely petroleum dependent.

Source: Estimated based on information from "Sri Lanka Energy Balance 2007" and International Energy Agency.

nated by bio-mass, whereas nearly all the energy needs of the transport sector are met through petroleum (Table 7.1).

Figure 7.1 helps to understand certain aspects relating to the supply of energy in Sri Lanka. From the supply side, a major share of Sri Lanka's energy continues to come from renewable, indigenous sources, namely, bio-mass and hydro. Accordingly, 47 per cent of primary supply comes from bio-mass sources, whereas petroleum and hydro account for 43 per cent and 9.5 per cent, respectively. The contribution of non-conventional sources such as wind and solar power is still at an insignificant level. Fuel wood is the major type of bio-mass widely used in households, especially in rural areas, for domestic cooking, heating of water, etc. Besides, a large number of small to medium rural industries also use bio-mass for thermal energy in boilers, driers and kilns, etc. In addition to fuel wood, coconut shells, baggase, and paddy husk, etc. also act as bio-mass energy sources on a limited scale. The hydro option is mainly used for generation of electricity (a type of secondary energy). Electricity fulfills the energy needs of households, commercial establishments, as well as industrial establishments to a certain extent. Electricity provides energy for lighting and various appliances used in households and commercial establishments. Industrial establishments also use electricity for operating various machinery.

Figure 7.1
Overview of Energy Supply in Sri Lanka



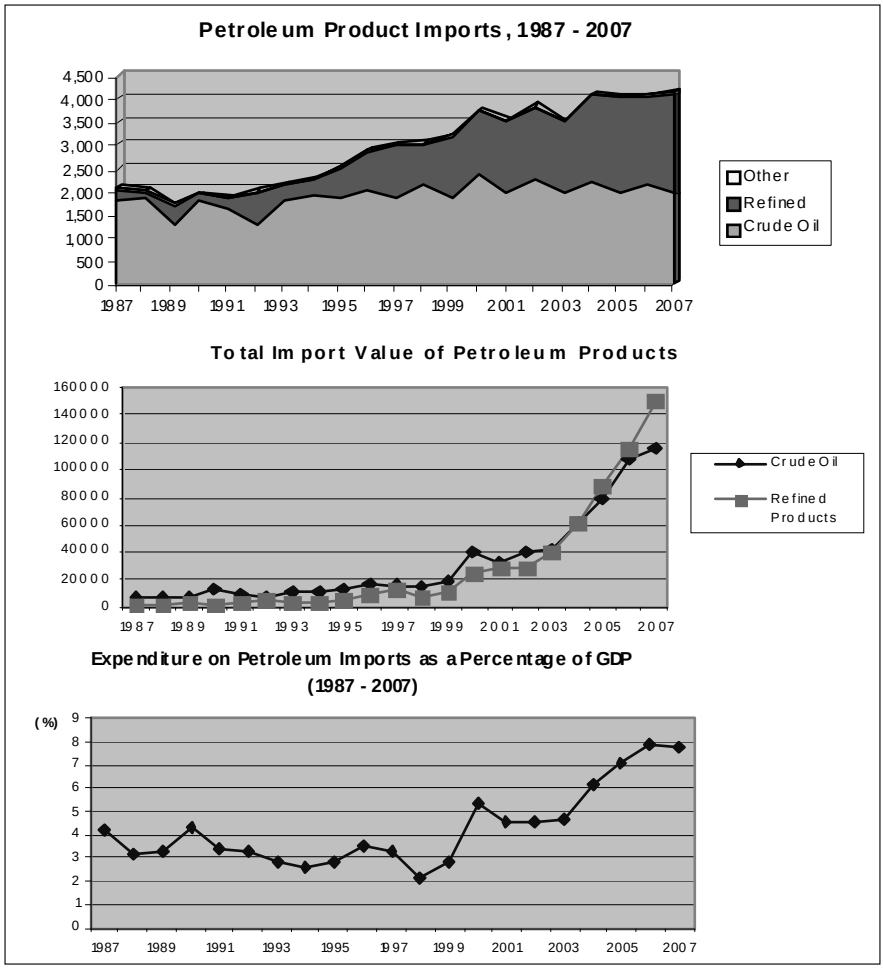
Source: Sri Lanka Energy Balance 2007.

Petroleum fulfills almost all the energy needs of the transport sector. In addition, different fuel oils provide thermal energy for furnaces, boilers, generators, etc., usually in large industrial establishments. From the mid-1990s onwards, thermal electricity generation based on petroleum fuels has become the main source of electricity generation, surpassing hydro-electricity generation.

7.3 Energy Dependence of Sri Lanka

Dependence on the energy sector is mainly determined by the origin of different sources of energy in the energy mix. Accordingly, of the three major sources of primary energy, bio-mass and hydro are totally indigenous sources. Therefore, they do not contribute towards dependence on global energy markets. The key link that determines global dependence of the energy sector is petroleum. Over the course of the last century, petroleum has become the major source of energy for modern economies. This has created a global scale dependence of non-oil producing countries on oil-producing countries. As Sri Lanka is yet to find its own petroleum resources, with gradual modernization and development of the economy, the country has become more and more dependent on global petroleum markets.

Figure 7.2
Sri Lanka's Dependence on Petroleum Products (1987-2007)



Source: Sri Lanka Energy Balance 2007; and CBSL, *Annual Report*, various issues.

Sri Lanka's growing dependence on petroleum markets has two major dimensions, namely; growth of volume of imports (quantity), and rising prices (value). Quantity implies the total amount of petroleum imported by the country annually. A non-oil producing country such as Sri Lanka can import petroleum in two major forms - i.e., either as crude oil or refined products. Petroleum imported as crude oil has to be refined locally. A country should have crude oil storage facilities, refineries, refined oil storage, and distribution facilities to achieve this.

Sri Lanka imports petroleum in both these forms. Figure 7.2 gives the trends in petroleum imports during the period 1987-2007. As far as import volume is concerned, it has nearly doubled during the last two decades, indicating growing demand for petroleum. In terms of the composition of imports, it appears that the locally refined quantity of petroleum has remained more or less stable over the years. It is the share of refined products that has increased steadily over the years to double the total volume of imports by 2007. This indicates that refinery capacity has remained the same over the last two decades without significant improvement. At present, the government is trying to enhance this by increasing the capacity of the existing refinery at Sapugaskanda with the financial support of Iran. Plans are also underway to establish a new refinery in Hambantota along with the new harbour project. In terms of the value of imports, expenditure on refined products has exceeded the expenditure on crude oil from around 2004.

Overall, the expenditure on petroleum imports has increased in absolute as well as relative terms, increasing from Rs. 0.8 billion in 1980 to Rs. 27.6 billion by 2007 in absolute value (Table 7.2). What is more indicative is the relative increase in terms of GDP. While undergoing frequent fluctuations, the share of petroleum expenditure has gradually risen from 3-4 per cent of GDP during 1985-2000 to 7-8 per cent in 2007. This can be considered to be a relatively sharp increase as far as the overall economy is concerned. The government's immediate response to such price instability has been primarily by way of short term measures such as removal of the duty waiver on petrol to cross subsidize the use of diesel, and entering into a hedging deal to mitigate the effects of adverse price fluctuations. However, such measures cannot be expected to provide a solution to deal with the rising burden of energy dependence over the long run.

Table 7.2
Total Value of Petroleum Imports (1980 -2007)

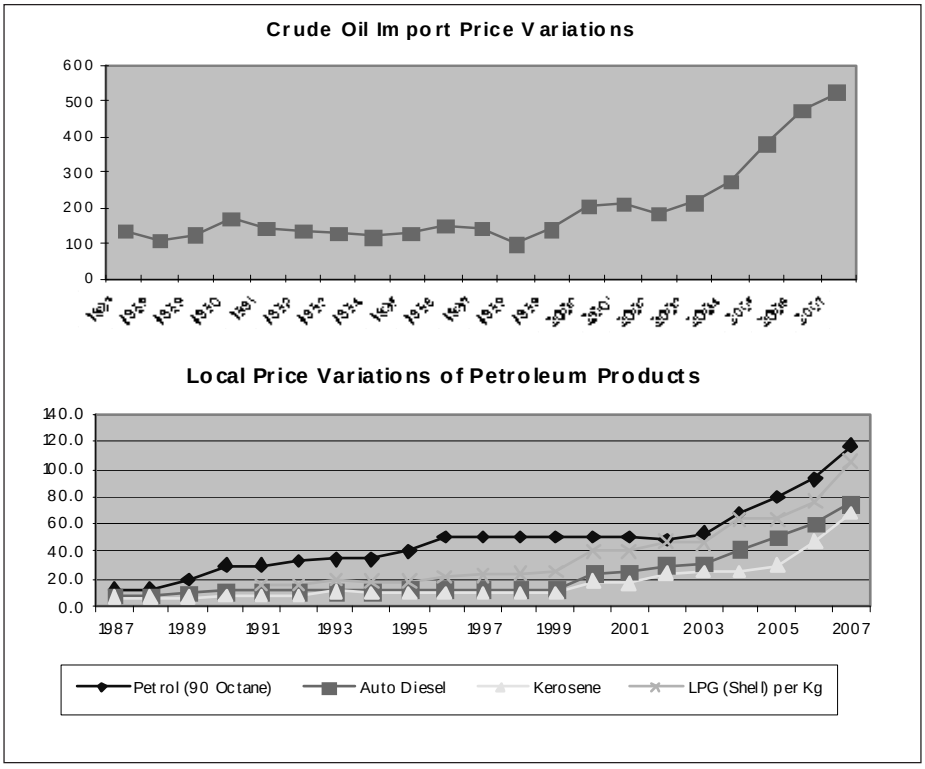
Petroleum Imports (Rs. mn.)	1980	1990	1995	2000	2005	2006	2007
Crude Oil	7,309	12,425	12,360	39,343	77,686	107,160	114,150
Refined products	932	1,150	4,812	24,452	88,767	114,822	151,141
LPG	-	210	1,121	4,172	7,573	9,426	11,462
Total	8,241	13,785	18,293	67,967	174,026	231,408	276,753
GDP	66,527	321,784	667,772	1,257,636	2,452,782	2,938,656	3,578,386

Source: CBSL, *Annual Report*, various issues.

As already mentioned, the overall burden of petroleum imports is a result of both increases in volume as well as price hikes. Figure 7.3 shows that during the last two decades, crude oil prices have increased nearly four times. Although the price level had remained relatively stable from mid-1980 to around 2000, it started to rise steadily from 2003 onwards. The current global downturn in demand appears to have stabilized prices to a certain degree, although this could well be a temporary phenomenon. Figure 7.3 also indicates that the local price of petroleum products mirrors the variations in crude oil prices in the international markets.

As the energy mix of key sectors is different, sectoral dependence on global energy markets also vary. The transport sector remains the most dependent, given that the entire sector depends totally on petroleum while the vehicle fleet in the country has been expanding rapidly. As a result, the transport sector is also the most vulnerable to fluctuations in oil prices. As seen from Table 7.3, the vehicle fleet has increased nearly four-fold over the period 1990-2007, recording an average rate of 9 per cent growth per annum. A majority of new additions to the fleet are petrol vehicles, whereas diesel vehicles account for around one-fourth of the growth. Given the important role of the transport sector in the economy - moving people as well as cargo - its dependence and vulnerability has the potential to adversely affect all products and service sectors.

Figure 7.3
Volatility of Global and Local Petroleum Product Prices



Source: Sri Lanka Energy Balance 2007; and CBSL, *Annual Report*, various issues.

Table 7.3
Growth of Vehicle Fleet in Sri Lanka

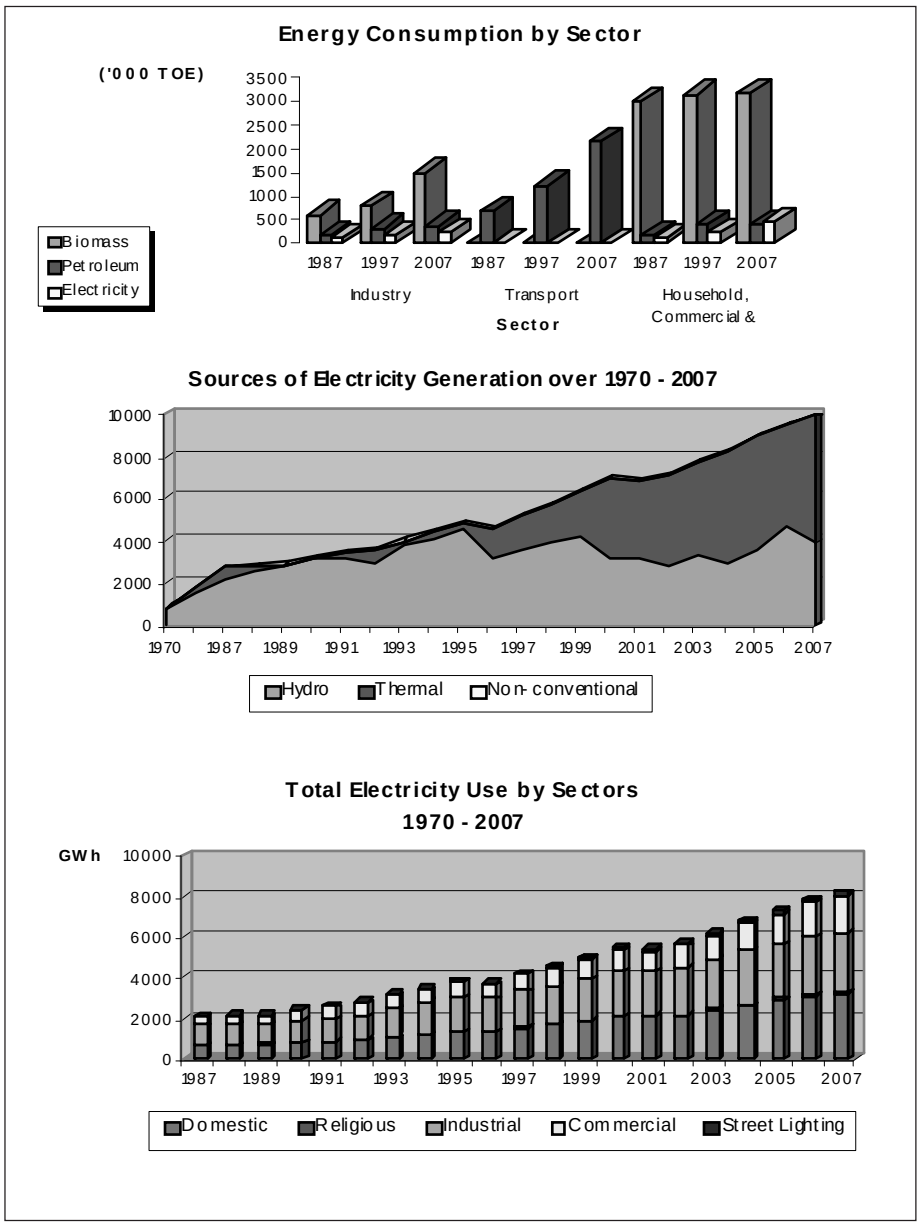
Year	No. of Registered Vehicles	Growth (%)		
		Total	Petrol	Diesel
1990	819,943	14.9	13.1	1.7
1991	904,373	10.3	7.8	2.5
1992	1,003,047	10.9	8.0	2.9
1993	1,086,821	8.4	5.9	2.4
1994	1,162,313	6.9	4.3	2.5
1995	1,244,653	7.1	4.4	2.5
1996	1,325,384	6.4	3.9	2.3
1997	1,407,437	6.2	3.7	2.4
1998	1,511,197	7.4	4.4	2.9
1999	1,614,050	6.8	4.2	2.5
2000	1,706,077	5.7	3.7	2.0
2001	1,778,711	4.3	3.0	1.2
2002	1,892,367	6.4	4.9	1.4
2003	2,073,869	9.6	7.8	1.7
2004	2,297,711	10.8	9.3	1.4
2005	2,527,380	10.0	8.4	1.5
2006	2,827,902	11.9	10.1	1.8
2007	3,125,794	10.5	8.9	1.6

Source: Department of Census and Statistics, *Statistical Abstracts*, various issues.

In addition to the transport sector, the next most dependent sector on global energy is the power generation sector. Prior to the 1990s, Sri Lanka had made reasonable progress in utilizing the country's significant potential for hydro electricity generation. Until then, except during some short periods under severe drought conditions, nearly all power generation was derived from a network of hydro-electric power plants located mainly along two major rivers, Mahaweli and Kelani. However, the country gradually reached the limits of hydro potential in the mid-1990s.

As shown in Figure 7.4, consumption and demand for electricity has been increasing steadily over the years. Owing to uncertainty over other options (a prolonged debate over coal power plants), energy planners opted to rely on thermal power plants that are driven on petroleum-based fuels. As a result, during the last decade, the share of thermal generation has increased to over 60 per cent of total annual generation and continues to grow even further (Figure 7.4). According to the power supply projections by the Ceylon Electricity Board (CEB) in 2006, petroleum-based thermal generation capacity is to rise in the near future until the anticipated increase in the share of power generation from coal takes over gradually. However, from the perspective of energy dependence, the policy of shifting towards coal will not free the country from the burden of energy dependence as Sri Lanka will also have to import coal from foreign markets.

Figure 7.4
Energy Dependence by Sector



Source: Sri Lanka Energy Balance 2007.

Sri Lanka is still unable to find significant alternatives to fulfill the rising demand for power generation from indigenous sources. Therefore, it seems that there is a high likelihood that rising demand for electricity will become a major factor that increases the country's energy dependence in the future.

Overall, Sri Lanka's situation of energy dependence can be summarized as follows:

- Dependence on global energy markets is rising steadily, both in terms of volume of imports as well as expenditure on petroleum. Dependence measured

in terms of the share of expenditure on petroleum to GDP has nearly doubled.

- Level of dependence varies among different economic sectors. Among others, the transport sector is the most dependent sector on petroleum. Rapid demand for transport services from an expanding economy and the resultant increase in the vehicle fleet are the major causes. The vulnerability of the transport sector to global oil price hikes creates economy-wide repercussions.
- Gradual exhaustion of hydro power options for electricity generation has further complicated the situation by increasing the dependence on fossil fuel power generation as well.
- As a result, the Sri Lankan economy overall has become more and more vulnerable to shocks in global petroleum prices.
- Given the fundamental importance of transport and power generation sectors for the growth of the economy, the rising dependence of these sectors on global energy markets can impede the entire process of economic growth.
- Sri Lanka seems to be less prepared to face the repercussions of this problem. This can be observed by the fact that the country has not taken timely measures to expand refinery capacity and explore sustainable alternatives for power generation. The option of coal power generation cannot be expected to reduce energy dependence as coal itself has to be imported.

7.4 The Global Economic Crisis and Energy Markets

To assess the possible impacts of the current global economic crisis on Sri Lanka's growing energy dependence, an understanding of the linkages between energy markets and the global economy is needed. Sudden hikes in petroleum prices can result in economic uncertainty at the global level. Net oil importers quite often find themselves facing balance of payments (BOP) difficulties, inflationary pressures, etc. At the aggregate, global economic output can falter as evidenced during previous oil price hikes in 1973-74, 1979-80, 1990-91 and 2008. In the same vein, economic crises on a global or regional scale are not necessarily linked to oil price hikes, as evidenced by the current global downturn.

The observed movement of oil prices during the course of events leading up to the present economic crisis offers some insights. Oil prices were on a rising trend from 2003 onwards. However, the most severe oil price increase was from early 2007 to the second quarter of 2008 when the acute signs of the global economic crisis began to appear. In fact, the sharp escalation in prices during this period caused the most distress to net oil importers such as Sri Lanka. Thereafter, with the global downturn, decreasing demand had led to a relatively sharp drop in oil prices by late 2008. Falling oil prices provided some relief to economies like Sri Lanka, easing the burden of import expenditures. Indeed, this helped the economy to absorb the adverse impact of a decline in export earnings with the onset of the economic downturn in key developed country markets.

Thus, focusing on the current global economic crisis alone cannot provide useful policy insights on how best to face problems created by rising energy dependence. Instead, it may be necessary to focus more on certain characteristics of global energy markets that affect short to long term horizons. There are certain long term factors that can transform the global energy markets. These should be taken into consideration when domestic policy is adjusted to face

identified challenges. Amongst the more important forces that influence these changes are:

- Supply uncertainty of global energy resources
- Growing demand from emerging economic powers
- Technological changes in the energy sector
- Growing concerns over global warming and climate change
- Emerging structural changes in energy markets and institutions

7.4.1 Supply Uncertainty in Global Energy Resources

All fossil-based energy resources are exhaustible over the long run. Current estimates indicate that proven reserves of petroleum will last for another 40 years only.[1] However, significant uncertainties prevail over such estimates. Even though the price of petroleum has been rising gradually over the years, this cannot be considered as a reliable indicator of growing scarcity due to a number of reasons. Petroleum is geographically concentrated in certain areas of the world, and the industry is controlled by a few major national and multinational companies that enjoy strong market power. Hence, an oligopoly market structure, rather than a competitive market structure, prevails in the oil industry. In addition, the functioning of oil markets is significantly influenced by the governments of major oil producing countries. This situation is further complicated by the behaviour of speculators. Besides, global geo-politics play a major role in energy markets. Therefore, the existing market structure can hardly be expected to yield reliable and un-distorted price signals of growing scarcity.

7.4.2 Growing Demand from Emerging Economic Powers

A rapid rise in demand for petroleum has been reported from fast growing developing economies such as China, India, and Brazil during the recent past. Pressure on global energy resources from these economic growth centres are identified as a major reason for the recent escalation of world energy prices. This has led to a situation where less powerful players, such as non energy-rich developing nations, are being increasingly marginalized. These countries will have to bear a heavy burden of rising oil import costs in the future.

7.4.3 Concerns over Global Warming and Climate Change

In recent years, the threat posed by global warming and climate change has gradually assumed the status of a major world issue. The growing concentration of green house gasses (GHG) in the atmosphere due to burning of fossil-fuel is considered to be the major cause for this global problem. It has been predicted that the entire world community will have to face serious repercussions, unless immediate actions are taken to reduce the rate of GHG emissions. Scientists have expressed the necessity of changing the established pattern of energy use by reducing the global dependence on fossil-based fuels such as petroleum and coal. Overall, it can be expected that pressure to switch to a low-carbon economy will lead to major changes in the global energy scene.

7.4.4 Technological Advancements in the Energy Front

Increasing fuel prices and concern over climate change have provided incentives to search for alternative sources of energy and technologies. This has already triggered sig-

[1] British Petroleum (BP) *Statistical Review of World Energy 2008* estimates the reserves-to-production ratio (R/P) to be 41 - an indicator of the length of time that the remaining reserves will last if production were to continue at that level.

nificant investments on alternative energy applications such as solar, wind, bio-fuel, geo-thermal, wave energy, etc. There are also efforts to improve the energy efficiency of existing systems by reducing wastage of energy. However, to date many such investments have been confined to developed countries. Developing countries need carefully designed strategies to absorb the benefits of such technological improvements in the power and energy sectors.

7.4.5 Emerging Structural Changes in Energy Markets

Traditionally, energy markets have been dominated the world over by large oligopolies or state monopolies. Technologies normally involved in petroleum and related industries, and associated economies of scale, justified these market arrangements to a certain extent. New energy technologies have opened the way for more competitive and flexible market structures that can respond to changing realities more speedily. For instance, alternative energy industries such as solar, wind, and bio-fuel appear to be dominated by relatively small, dynamic, tech-savvy firms which are highly competitive. As a result, they have become the fastest growing businesses, amply supported by venture capital funds.

The above discussed issues are the more long term factors that govern changes in the global energy sector. They determine long term realities that have to be dealt with when facing problems of growing energy dependence. In addition, the petroleum market is frequently affected by short term fluctuations that are caused by the following:

- Uncertainties due to speculative behaviour of certain agents, and
- Disturbances caused by various political issues in major supply regions.

The behaviour of petroleum prices can usually be considered to be an overall outcome of the interaction between these long term and short term factors. For instance, while there is a long term trend of rising oil prices that can be considered as indicative of rising scarcity due to gradual depletion of exhaustible resources, short term factors such as regional political upheavals, behaviour of speculators, etc. also cause significant fluctuations. Understanding the reality of Sri Lanka's vulnerability to such long term as well short term upheavals in the global petroleum market is an essential step in facing the problems of energy dependence.

7.5 Future Energy Security

7.5.1 Oil Exploration in the Mannar Basin

Against the backdrop of energy dependence, it appears that there are many optimists who predict a successful exploration of petroleum resources in the Mannar Basin, offshore of the western and north-western coast of Sri Lanka. However, according to available information, this can at best be considered to be an uncertain prospect. The government is slowly but steadily taking the necessary steps to explore this option. According to the opinion of experts engaged in this sector of activity,[2] the data acquired so far can be interpreted to indicate about a 60 per cent probability of successful oil exploration in the Mannar Basin. Depending on the acquisition of new data as exploration progresses, the probability of success could change. Therefore, it is not possible to draw any firm policy implications at this juncture.

[2] Information cited in this section is based on discussions with the Director General, Petroleum Resources Development Secretariat (PRDS).

However, it is worthwhile to examine some key implications of current developments. The government has taken steps to create the necessary institutional setting by establishing the Petroleum Resources Development Secretariat (PRDS) under the Petroleum Resources Development Act of 2003. So far, it has acquired 6000 km of 2D data in the Mannar Basin with the technical support of TGS-NOPEC, a Norwegian geo-physical company (Figure 7.5). The government called for worldwide bids from technically qualified firms to undertake further exploration of oil prospects in three selected blocks in 2008. Based on the bids, the government decided to enter into a Petroleum Resources Agreement (PRA) for only one block. The successful bidder was Cairn India Ltd., a subsidiary of a British oil firm known as Cairn. In July 2008, the government entered into a PRA with Cairn Lanka (Pvt.) Ltd., a subsidiary of Cairn India. Cairn Lanka has already started petroleum operations in the Mannar Basin. Based on even the most optimistic time frame, it would take five more years (by 2014) to produce the first barrel of crude oil for sale.

Expert opinion suggests that current data availability does not justify the provision of any reliable estimate on the quantity of economic oil deposits lying underneath the Mannar Basin. However, similar offshore basins that have been successfully explored elsewhere seem to have several billion barrels. This can, therefore, be considered as a reasonable guess with regard to Sri Lanka's situation at this juncture too. According to currently available information, it is expected that deposits could contain both oil and gas.

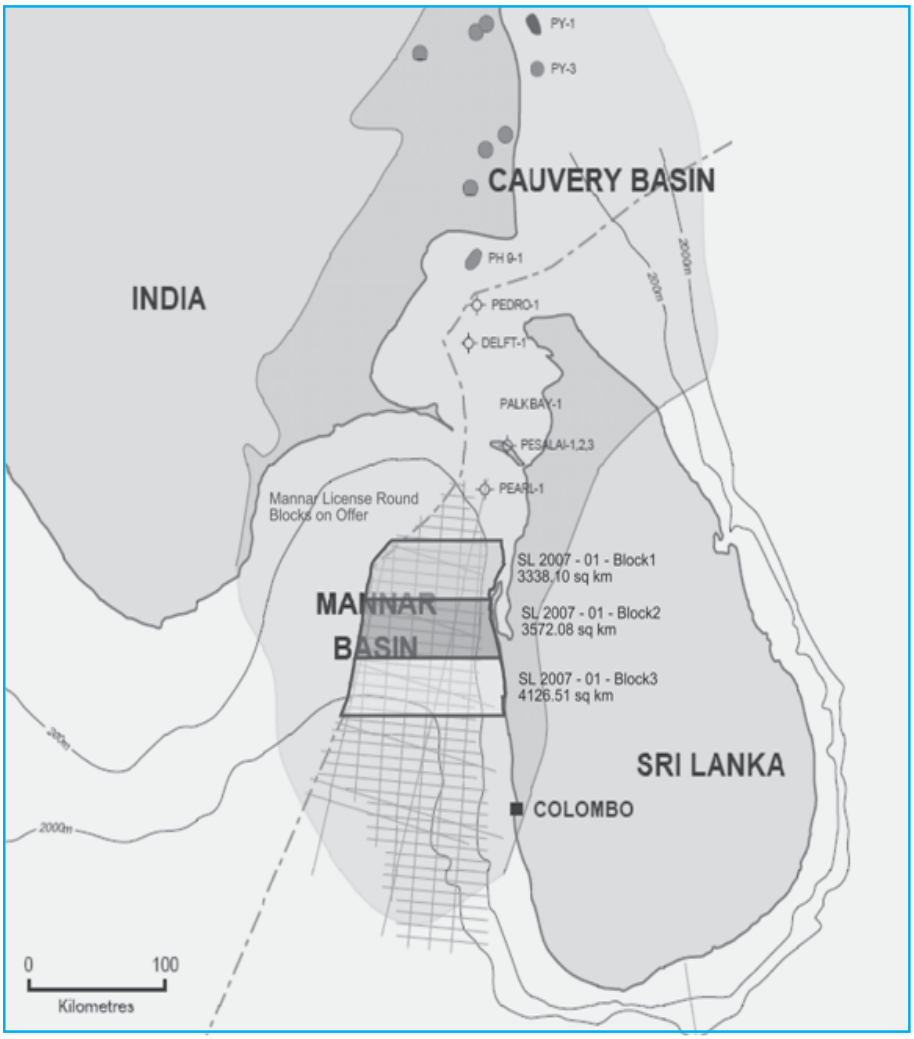
From the perspective of overcoming the problem of rising energy dependence, the significance of a successful exploration of petroleum in the Mannar Basin cannot be overemphasized. It would provide a significant boost to the Sri Lankan economy. Firstly, it will help to reduce the burden of rising oil import bills, thereby lessening budgetary and inflationary pressures on the economy. Secondly, it can provide significant opportunities for earning foreign exchange by exporting surplus production. Essentially, it has the potential to provide substantive benefits to the Sri Lankan economy on the assumption that the potential wealth from the oil is managed and invested in an effective manner to uphold the long term goals and national interests of the country.

7.5.2 Other Alternatives

Despite the potential relief that can be provided by successful exploration of oil prospects, policy makers cannot consider it as the single most important pillar of a long term energy security strategy due to the following reasons. Firstly, petroleum is an exhaustible resource and the country cannot be expected to rely on the deposits over an indefinite period. Secondly, rising concerns over global climate change due to fossil-fuel emissions have seriously undermined the position of petroleum as an energy source of the future. Many scientists are advocating the necessity of a low carbon energy future - a proposition that cannot be overlooked by policy makers. As a result, it may be that a successful oil industry in Sri Lanka has a more important role to play in the short and medium term horizons than in the long run. Given these facts, it is imperative for the country to maximize the potential gains from prospective oil wealth, which also requires speedy action from policy makers.

There is thus much room for other alternatives to play important roles in a national energy security strategy to help overcome the problem of energy dependence. A few essential strategies for national energy security are diversifying energy mix and supply sources, introducing efficiency improvements

Figure 7.5
Oil Exploration Blocks on Offer



Source: Petroleum Resources Development Secretariat.

to the existing system, and reaping the benefits of global carbon trade by improving the environmental outcome of the energy system.

a) Diversifying Energy Mix and Supply Sources

It is necessary to explore the opportunities available in upcoming sustainable energy alternatives such as solar, wind, and biomass energy. Rising concerns over climate change and volatile petroleum prices have recently boosted the prospects of such green energy alternatives, attracting significant investment for research and development. Both the rising price of oil and technological innovations seem to be gradually decreasing the economic gap between petroleum and green energy alternatives. As a result, certain energy sources that were non-economic in the past compared to petroleum are gradually becoming economically viable options. Sri Lanka has already made a preliminary as-

sessment of its wind and solar energy potential, and some efforts to promote bio-mass energy are already underway. A few essential steps needed to achieve this objective are:

- Enhancement of national research and development capacity on indigenous alternative energy resources;
- Selective introduction of suitable technological improvements from success stories in other countries, while undertaking adaptive research to make them locally successful, and;
- Creating an enabling environment for successful adoption of new technologies through appropriate policy and institutional changes.

The government has initiated action in this direction by enacting the Sustainable Energy Act of 2007, and establishing the Sustainable Energy Authority (SEA) under this piece of legislation. It is too early to assess the effectiveness of this measure as all activities initiated by the SEA are still at the initial stage of implementation.

b) Efficiency Improvements in the Existing System

It has generally been accepted that Sri Lanka's present strategy of energy use is not the most efficient, and various improvements are necessary. This includes minimizing the waste of energy by consumers through improved practices, improving the energy efficiency in current industrial processes, and cutting down losses in transmission and distribution systems, etc. Besides, given that the transport sector is the key contributory sector to growing energy dependence, strategic decisions to improve energy usage in this sector is quite imperative. For instance, enhancing the role of the rail network and other public transport to handle passenger and cargo transportation can be expected to improve the efficiency of energy use in the transport sector significantly than at present. Another important aspect of efficiency improvements is institutional reforms. This is an area where strong political sensitivities are involved, as has been particularly evident in the power sector. Recently, the Sri Lanka Electricity Act of 2009 was introduced under the regulatory framework enabled through the Public Utilities Commissions of Sri Lanka (PUCSL) to regulate economic, safety, and technical aspects of the generation, transmission, distribution, supply, and use of electricity.

c) Reaping the Benefits of Global Carbon Trade

International efforts on climate change mitigation have led to the establishment of a reward system for sustainable energy strategies through a Clean Development Mechanism (CDM). Accordingly, developing countries can contribute to climate change mitigation by adopting sustainable energy sources while being rewarded through CDM by earning carbon credits. There are also opportunities to attract green investments to help local economies too. Sri Lanka has scarcely made any progress on this front. It is essential to link any activity relating to the country's quest for sustainable energy to carbon markets so that maximum benefits will be reaped for the economy as well as the environment.

7.6 Conclusions and Policy Implications

Sri Lanka's energy dependence is mainly a matter of the growing share of petroleum energy in the overall energy mix, thereby subjecting the economy to the impacts of volatile fluctuations in global petroleum markets. Given that Sri Lanka has not fully explored any fossil-based energy resources so far, this outcome of dependence is inevitable to a certain degree. The outcome is further aggravated by deep structural weaknesses in the

energy sector caused by lack of preparedness to face such problems. Volatile price hikes in the petroleum market is a result of long term structural factors as well as short term operational factors related to global petroleum markets, which has indirect rather than direct linkages to the major causes of the current global economic crisis. As a result of the downturn, petroleum prices have stabilized to a certain degree during recent months, providing some relief for economies severely affected by the global economic/financial crises. However, as experienced during several years before the current economic crisis, the structural long term factors and short term operational factors that govern the petroleum market have the potential to precipitate hardships once the demand for petroleum begins to rise again. Therefore, policy preparedness to face the consequences of growing energy dependence is a matter linked to a long term energy security strategy, rather than any short term survival strategy for weathering the global economic crisis.

Key options to face the above mentioned challenges include the diversification of the energy mix by promoting indigenous alternatives, increasing the energy efficiency of current systems, and reaping the benefits offered by carbon trade. Harnessing as yet uncertain oil prospects in the Mannar Basin could be a positive factor that could help to transform the energy sector over the short to medium term if managed effectively. However, the future status of petroleum is gradually being undermined by global concerns over climate change. Over the long run, Sri Lanka should take this as an opportunity - while extracting the benefits of potential oil wealth if explorations are successful - to extend its long term national energy interests. To achieve this, the country should be on the alert to absorb suitable technical and market opportunities that emerge in indigenous green energy alternatives such as solar, wind, and bio-mass which are being rapidly identified as dominant options in a low carbon economy in the future.

8. Global Financial Crisis: Regulatory and Policy Challenges for Sri Lanka

8.1 Background

The immediate causes of the current global financial meltdown have been discussed already in this report. These factors combined with an overly accommodative financial regulatory environment in the US that allowed for practices such as speculative borrowing in residential real estate, high-risk mortgage loans, securitization of sub-prime loans that fostered problems of moral hazard, complex and non-transparent financial instruments, and inaccurate credit ratings resulted in a global economic and financial crisis that is widely perceived as being the most pernicious since the Great Depression of 1929. To cite from the "Declaration of the Summit on Financial Markets and the World Economy", by the leaders of the G-20 on November 15 2008:[1]

> *"During a period of strong global growth, growing capital flows, and prolonged stability earlier this decade, market participants sought higher yields without an adequate appreciation of the risks and failed to exercise proper due diligence. At the same time, weak underwriting standards, unsound risk management practices, increasingly complex and opaque financial products, and consequent excessive leverage combined to create vulnerabilities in the system. Policy makers, regulators, supervisors, in some advanced countries, did not adequately appreciate and address the risks building up in financial markets, keep pace with financial innovation, or take into account the systemic ramifications of domestic regulatory action."*

The rapid spread of the crisis that began in the US - particularly with the loss of confidence in financial institutions following the collapse of Lehman Brothers in September 2008 - renders theories of de-coupling of economies a myth, exposes the fragility and volatility of financial markets driven by perceptions, and emphasizes the imminent need for prudent financial regulatory systems both at the domestic and at the international level.

Analyses of international macroeconomic imbalances, and of the consequences of loose monetary policies with respect to the global financial turmoil, have been the subject of discussion earlier in this report. As such, the objective of this Chapter is to address the regulatory and policy lessons gained, and challenges posed by the crisis for Sri Lanka. This is important, particularly in view of two factors: a) that robust regulation and policy credibility are essential for investor confidence in a climate where international and domestic economic and financial markets are in turmoil; and b) that tightening of credit by financial institutions in response to the crisis - a typical problem of informational asymmetry and moral hazard - could have significant impacts on vulnerable sectors such as small and medium enterprises (SMEs) and microfinance, which would in turn have

[1] See http://www.g20.utoronto.ca/2008-leaders-declaration-081115.html for the full text of the Declaration.

a negative spill over effects on employment, livelihoods, and poverty levels. The fact that the Sri Lankan economy has now entered a post-conflict phase further compounds the need for sustainable financial flows for development.

Section 8.2 of this Chapter sets out a brief sequential snapshot of the current global financial crisis together with some examples of international policy responses. This section also provides some background on the global financial regulatory structure, and the nature of financial instruments used in the advanced economies and selected emerging and developing economies, in order to get a better comparative picture of the financial sector in Sri Lanka. The discussion also analyzes policy questions and debates arising from the crisis - such as re-drawing lines between markets and government, global cooperation and the benefits and limits of policy transfer relating to financial sector reform, etc. Section 8.3 looks at the impacts of the global financial crisis on Sri Lanka's financial sector. The key question that underpins the analysis is the 'home-grown' vis-à-vis 'imported' nature of the crisis - i.e., to what extent is Sri Lanka immune to or exposed to the 'contagion' effects of the crisis, and what are the fundamental factors that create instability in Sri Lanka's financial markets and institutions. The concluding section of this Chapter focuses on key regulatory and policy challenges relating to Sri Lanka's financial sector, such as the speed of financial deregulation and arriving at an appropriate balance between over and under-regulation, regulatory governance - in particular regulatory independence - and corporate governance - including issues of trust, corruption, and self-regulation.

8.2 Contextualizing the Global Financial Crisis

Databases developed to track trends in the structure and development of financial institutions and markets across countries indicate that the financial sector has deepened over time, particularly in advanced economies.[2] While the deepening has been less significant in the case of financial institutions such as banks, the globalization of financial services and the interconnectedness of financial markets are becoming more pronounced. Studies also point to the fact that financial sector development has a greater impact on growth in low and middle-income economies relative to high-income economies.[3] Such findings, which underscore the vulnerability of developing countries to volatility and imbalances in global financial markets, reiterate the need to unpack the nature and scope of the current global financial meltdown in order to get to sustainable policy solutions, both at the international and at the domestic country level. Box 8.1 sets out key episodes - including declarations of bankruptcies, country-level bail out schemes and policy responses by international entities and groups such as the IMF and the G-20 - that marked the global financial crisis from March 2007 to April 2009.

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[2] See Beck, T., A. Demirguc-Kunt and R. Levine (2009), "Financial Institutions and Markets Across Countries and over Time", Policy Research Working Paper No. 4943, May, World Bank.

[3] See A., Philippe, P. Howitt and D. Mayer-Foulkes (2005), "The Effect of Financial Development on Convergence: Theory and Evidence", *Quarterly Journal of Economics*, 120, 177-222.

Box 8.1
Evolution of and Responses to the Global Financial Crisis: 2007-2009

- **March/April 2007:** IMF warns of risk to global financial markets due to weakened US home mortgage market
- **February 17, 2008:** UK government temporarily nationalizes housing lender Northern Rock
- **March 2008:** US Federal Reserve prevents Bear Stearns bankruptcy by taking on US$ 30 billion in liabilities and selling off the entity to JPMorgan Chase for a sum considered less than the value of Bear's Manhattan office building
- **May 4, 2008:** Finance Ministers of 13 Asian countries agree to set up a foreign exchange pool of about US$ 80 billion in the event of a regional financial crisis; China, Japan and South Korea pledge to provide 80 per cent of the monies with the balance to come from members of the ASEAN
- **September 7, 2008:** US Treasury announces the take-over of Fannie Mae and Freddie Mac, government-sponsored entities that bought securitized mortgage debt
- **September 15, 2008:** Lehman Brothers declares bankruptcy at US$ 639 billion – the largest in the history of the US
- **September 16, 2008:** US Federal Reserve bails out American International Group (AIG), the international insurance giant – in a US$ 85 billion deal, which was later increased to US$ 150 billion in November 2008 – given its exposure to credit default swaps
- **September 17, 2008:** US Treasury announces a US$ 700 billion economic stabilization package to enable the government to buy toxic assets from the country's biggest banks – a policy move aimed at restoring confidence in the financial system
- **October 8, 2008:** US Federal Reserve, European Central Bank, Bank of England and the Central Banks of Canada and Sweden reduce primary lending rates by a half percentage point in a coordinated effort
- **October 12-13, 2008:** Germany, France, Italy, Austria, Netherlands, Portugal, Spain and Norway announce domestic rescue plans worth around US$ 2.7 trillion; the plans followed the British model of recapitalization, state ownership, government debt guarantees, and better regulations
- **October 13, 2008:** UK government takes over a stake of 60 per cent and 40 per cent, respectively, in Royal Bank of Scotland and Lloyds TSB and HBOS for US$ 60 billion
- **October 14, 2008:** US Treasury, Federal Reserve, and Federal Deposit Insurance Corporation, in coordination with European monetary authorities, announce a plan to invest up to US$ 250 billion in preferred securities of nine U.S. banks – including Citigroup, Bank of America, Wells Fargo, Goldman Sachs, and JP Morgan Chase
- **October 18, 2008:** President Bush, French President Nicholas Sarkozy and the President of the European Union (EU) issue a joint statement proposing an international summit to be held after the US Presidential elections; whilst the Europeans had been pushing for a meeting of the G-8, President Bush called for a broader global meeting that would include countries such as China and India
- **October 19, 2008:** South Korea announces a) foreign debt guarantees of up to US$ 100 billion to its banks; b) pumping in funds of US$ 30 billion into the banking sector
- **October 22, 2008:** Pakistan seeks help from the IMF to meet balance of payments difficulties and to stave off a possible economic crisis given decreasing foreign investment and high fuel prices; November 24, 2008 - IMF approves a 23 month Stand-By Arrangement of US$ 7.6 billion to Pakistan
- **October 19, 2008:** IMF approves the creation of a Short-Term Liquidity Facility to support countries with strong policies that face temporary liquidity problems
- **November 2, 2008:** India's Central Bank cuts its short-term lending rate by 50 basis points to 7.5 per cent, and reduces its cash reserve ratio by 100 basis points to 5.5 per cent

Contd.....Box 8.1

- **November 9, 2008:** China announces a US$ 587 billion stimulus package aimed primarily at infrastructure, housing, agriculture, health care, and social welfare spending
- **November 11, 2008:** IMF defers decision to approve a US$ 2.1 billion loan to Iceland - the third time that the IMF scheduled and then failed to discuss the Iceland proposal. The tentative Iceland package requires the country to implement economic stabilization; November 19, 2008 - IMF finally approves the loan to Iceland, following which Denmark, Finland, Norway and Sweden agree to pump in an additional US$ 2.5 billion in loans to Iceland
- **November 15, 2008:** Japan announces a contribution of US$ 100 billion from its reserves to the IMF to help emerging economies
- **November 24, 2008:** UK announces a fiscal stimulus package of US$ 20.2 billion to deal with the looming recession in the country
- **December 11, 2008:** EU leaders approve a US$ 269 billion economic stimulus package
- **December 23, 2008:** Central People's Bank of China lowers interest rates for the fifth time in four months
- **January, 2009:** Sri Lanka announces a Rs.16 billion bail out package (0.3 per cent of GDP)
- **January 22, 2009:** Singapore announces a US$ 13.7 billion stimulus package
- **January 28, 2009:** US House of Representatives pass the American Recovery and Reinvestment Act of 2009 (with the cost of the bill estimated at US$ 819 billion)
- **January 29, 2009:** Thailand's Parliament announces a US$ 3.5 billion stimulus package
- **February 5, 2009:** Bank of England reduces its key interest rate by 50 basis points from 1.50 to 1.00 per cent - the lowest level since the founding of the Bank in 1694
- **February 14, 2009:** G-7 pledges to prevent a resurgence of protectionism, urging all members to fight recession without distorting free trade
- **February 17, 2009:** General Motors and Chrysler submit recovery plans to the US government requesting US$ 21.6 billion more in loans; December 19, 2008 - President Bush announced a US$ 13.4 billion three year rescue plan for the two companies with several attached conditionalities
- **February 17, 2009:** President Obama signs a US$ 787 billion economic stimulus bill - which includes US$ 575 billion in government spending and US$ 212 billion in tax cuts
- **March 10, 2009:** Malaysia's Finance Minister announces a fiscal stimulus package of US$ 16.3 billion
- **March 14, 2009:** G-20 Finance Ministers and Central Bank Governors agree to take steps to help emerging and developing economies cope with capital flow reversals, and also on the need to boost the resources of the IMF
- **March 24, 2009:** IMF approves a major re-haul of its lending framework in an attempt to increase the flexibility of its lending policies and to streamline conditionality; measures include the creation of a new Flexible Credit Line, enhancing the flexibility of its traditional Stand-By Arrangement, and simplifying cost and maturity structures
- **April 2, 2009:** G-2O London Summit sees the leaders of the world's largest economies agreeing to deal with the global financial crisis with measures amounting to about US$ 1.1 trillion - including US$ 750 billion for the IMF, US$ 250 billion to boost international trade, and US$ 100 billion for multilateral development banks. The Summit also saw pledges to establish a new Financial Stability Board that would work closely with the IMF to ensure cross-border cooperation; tighter regulation of banks, hedge funds and credit rating agencies; and, a crackdown on tax havens. Commitments to resist protectionism were reiterated by the leaders at the Summit

The extent and depth of the global financial crisis are clearly reflected in the domino type failures, widespread rescue operations, and crisis management strategies set out in Box 8.1. A comprehensive understanding of the nature and scope of the global meltdown, however, also requires some knowledge of the much disputed financial tool set used in the US - the epicentre of the crisis - and initial/pre-crisis conditions in the financial sectors of advanced economies such as the UK and selected emerging and developing economies. Unpacking the initial conditions that underpinned the recent crisis also requires an understanding of the institutional architecture that governs international finance, in order to address policy issues on the re-shaping of global financial regulation.

The evolution of the securitized credit model from its simpler formulations - for example, corporate bonds - to more complex incarnations in the form of derivatives such as Credit Default Swaps (CDSs) and Collateralized Debt Obligations (CDOs) is widely perceived to be one of the principal causes of the financial crisis. The structure of these instruments enabled investors and traders to hedge underlying credit exposures, use securitized credit taken off a particular bank's balance sheet as collateral to raise short term liquidity, and engage in highly complex and opaque re-securitization practices. The complex design of the transformed securitized credit model permits issuers to re-package these instruments into varied slices of risk and maturity. The danger with this model is that it can, if not used properly, create principal-agent problems between investors and managers of these funds - a phenomenon illustrated in the case studies on Lehman Brothers and AIG (Box 8.2). The pre-crisis years also saw a rapid growth in highly leveraged, off-balance sheet tools such as Structured Investment Vehicles (SIVs), a form of 'shadow banking' - not on the books of regulated banks - that manage maturity transformation. These financial innovations grew to meet investors' demand for high yielding instruments in a climate of low risk aversion, with the demand for yield uplifts in turn being driven by global macroeconomic imbalances.

Whilst the financial sectors of some emerging and developing economies have been affected by the global crisis, studies indicate that these countries have, for the most part, been shielded from the credit crisis due to negligible exposure to the 'toxic assets' that have devastated financial institutions and markets in the more advanced economies - in particular, the US and the UK.[4]

Research on the history of financial crises indicates that such episodes occur often enough so as to be considered a part of the system of finance capitalism.[5] As such, financial crises can be considered within the broader genre of market failures - which in turn, links to public policy questions on the nature and scope of regulation. The apogee of international financial regulation, as at the time of the current global meltdown, is the Basel process - enshrined in the Basel Accord I created in 1988 and in the Basel Accord II published in 2004. The Basel initiative was a response to a spate of interna-

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[4] See Mohan, Rakesh (2009), "Global Financial Crisis - Causes, Impact, Policy Responses and Lessons", speech delivered at the 7th Annual India Business Forum Conference, London Business School, London, 23 April 2009 - for an analysis of the impact of the crisis on India.

See Gruenwald, Paul and Ivy Tan (2009), "Lessons from the Crisis for Asian Banks", *Asian Journal of Public Affairs*, Vol. 2, No. 2, Lee Kuan Yew School of Public Policy, National University of Singapore - for an analysis of the impact of crisis on Asian banks.

See "Economic Focus: Domino Theory", *The Economist*, February 28, 2009 - for a general analysis of the impact of the crisis on emerging markets.

[5] See for instance, Fratianni, Michele (2008), "Financial Crises, Safety Nets and Regulation". Available at: http://ssrn.com/abstract=1286903.

Box 8.2
The Tale of Lehman Brothers and AIG

Why did Lehman Brothers collapse?

Lehman Brothers filed for bankruptcy on September 15, 2008 – the largest bankruptcy filing in US history – with the entity's assets of US$ 639 billion far surpassing those of bankrupt giants such as Enron and Worldcom. Lehman Brothers, which was founded in 1850, survived the railroad bankruptcies of the 1800s, the Great Depression of the 1930s, and two World Wars; and yet, the sub-prime crisis proved to be too much for this entity. What was different this time around?

- In 2003-04, in the years of the housing bubble in the US, Lehman bought over five mortgage lenders. As the credit crisis heightened in 2007, the company continued to underwrite huge amounts of mortgage-backed securities amounting to a portfolio of US$ 85 billion. Lehman's stocks fell by 48 per cent in March 2008, as hedge fund managers began to question the valuation of the company's mortgage portfolio in the midst of a sub-prime crisis, and following the near collapse of Bear Stearns – the second largest underwriter of mortgage-backed securities in the US. The value of the entity's shares continued to drop despite overtures made by Lehman to several potential partners, and on September 15 2008, the company declared bankruptcy with the value of its stock plunging by 93 per cent from its previous close on September 11, 2008.

- The collapse of Lehman is also perceived as an episode that posed an enormous liability to players in the CDSs market. The declaration of bankruptcy by Lehman led to a transfer of large sums of credit in the CDSs market in order to insure buyers of Lehman credit default risk protection. The sellers of CDSs were obligated to pay the full investment in these bonds back to the insured parties/buyers. The mathematics worked out to the sellers of Lehman CDSs having to pay the insured counterparties 91.375 per cent of the face value of the bonds – which was extremely worrisome given Lehman's legacy of hundreds of billions of dollars in outstanding debt.

Why did the government step in to bail out AIG?

AIG is a financial conglomerate which engages in activities including insurance and investment. The difficulties encountered by this entity are a prime example of contagion, not from core business activities, but from an unregulated part of the group taking on risk via non-regulated products – in this instance, CDSs.

Why would a robust and large company such as AIG take on the gamble of entering into new and risky financial product markets? The lure of money – given that the CDSs market averages around US$ 70 trillion annually – may well have been a factor. Moreover, the traditional insurance and investment lines of AIG's business remained strong, perhaps creating a sense of over-confidence amongst AIG's management. However, on September 16 2008, the US government intervened to bail out AIG, primarily because of the fact that its size and exposure to the CDSs market would have had a devastating domino effect in the global insurance industry, given the extensive presence of AIG's insurance banks in several countries.

tional bank failures in the 1980s, and was a result of a meeting of the central banks and supervisory authorities of ten countries - the Basel Committee on Banking Supervision - in Switzerland in 1987. The objective of the Basel I Accord was to: a) strengthen the stability of the international banking system; and, b) to set up a fair and consistent international banking system to reduce competitive inequality among international banks. However, this first agreement is seen as flawed for the following reasons: a) limited differentiation of credit risk; b) static measure of default risk; c) no recognition of term-structure of credit risk; d) simplified calculation of potential future counterparty risk; and, e) lack of recognition of portfolio diversification effects.

Given these criticisms, it is clear that Basel I would not have been sufficient in the face of the current financial crises. In response to the criticisms of Basel I, the Basel Committee on Banking Supervision set out a second

accord which aims at: a) ensuring that capital allocation is more risk sensitive; b) separating operational risk from credit risk, and quantifying both; and, c) attempting to align economic and regulatory capital more closely to reduce the scope for regulatory arbitrage. In order to achieve these objectives, Basel II uses a 'three pillars' approach: 1) minimum capital requirements, addressing risk; 2) supervisory review; and 3) market discipline to bring about stability in the financial system.

However, the question still remains as to whether the Basel process is sufficient to address serious regulatory lapses in the international financial system. Discussions on this issue take the position that the Basel process is an inadequate and ineffective regulatory instrument,[6] where empirical evidence indicates that Basel I encouraged high-risk, short term borrowing. The emphasis of Basel II on credit ratings, and its dependence on banks to produce risk weights for capital requirements, would also be rather futile in a situation such as the current financial market imbroglio.

Discussions and statements in the international policy arena in relation to the global fiscal crisis, the need to re-haul global financial regulation and to 'fix' global finance in fora such as the G-20 and by key policy makers have one thing in common: a call for a global system of financial regulation of some sort. Clearly, such policy solutions are not rooted in reality. Real politick and issues of national sovereignty render the notion of a global super regulator unfeasible and a non-starter. More important in this debate are the questions of policy transfer, and the inapplicability of generalized, homogenous financial regulation to a diverse spectrum of economies with vastly different domestic financial markets and institutions. A more pragmatic solution would be to create a new financial order with a minimal set of international best practices - together with the restructuring of Bretton Woods institutions such as the International Monetary Fund (IMF) to ensure a more democratic process of country representation and enhanced resources.

Another key policy concern coming out of the global financial crisis is the recurring debate over states versus markets; in this instance, more specifically, nationalization of financial institutions versus maintaining the status quo in terms of private financial entities; and of the extent of re-regulation of the financial sector.

As indicated in Box 8.1, the policy responses to the financial crisis in some countries included the take-over of private banks by the state, in what is best described as measures of crisis management. The more relevant question, however, is what lies beyond the phase of crisis management. It is unlikely that nationalization strategies would rectify the core issues of bad financial institutional practices, which triggered the global crisis. The vast literature on the benefits of state-ownership vis-à-vis privatization suggests that state entities are not immune to the principal-agent problems faced by the private sector.[7] Moreover, in countries that have a poor record of governance in general,

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[6] See Dani Rodrik's argument for national, as opposed to global regulation, in "Economic Focus: A Plan B for Global Finance" in *The Economist*, March 14, 2009.

[7] See Kelegama, S. (1997), 'Privatization: An Overview of the Process and Issues' in W.D.Lakshman (ed), *Dilemmas of Development: Fifty Years of Economic Change in Sri Lanka*, Colombo: Sri Lanka Association of Economists.
Megginson, W. and J.M. Netter (2001), "From State to Market: A Survey of Empirical Studies on Privatization." *Journal of Economic Literature*, 39, 321-389
Willner, J. and D. Parker (2002), *Relative Performance of Public and Private Enterprise under Conditions of Active and Passive Ownership,* Manchester: Centre on Regulation and Competition, University of Manchester.
Knight-John, M. and P.P.A.W. Athukorala (2005), "Rethinking Privatization in Sri Lanka: Distribution and Governance" in J. Nellis, and, N. Birdsall (eds.), *Reality Check: The Distributional Impact of Privatization in Developing Countries*, Washington D.C: Center for Global Development.

nepotism and political capture tend to undermine any positive efficiency impacts of state-ownership. The question of re-regulation will be addressed in detail in the concluding section of this Chapter. However, at this juncture, it is useful to point out the fact that the main causes of the global meltdown were the flawed regulatory practices in place in the US. Clearly, a more targeted regulatory structure that has the capacity to address problems of informational asymmetry - moral hazard and adverse selection - that are rampant in financial markets is essential. It is highly debatable, however, if this translates into more regulation or re-regulation. What it implies rather is a more simplified scheme of regulation that would encourage, rather than deter, competitive market forces.

8.3 Impacts of the Global Financial Crisis on Sri Lanka's Financial Sector

As previously mentioned, Sri Lanka's financial sector does not face the same degree of vulnerability as those other countries listed in Box 8.1. As in the case of countries such as India and other Asian economies - with the exception of South Korea - Sri Lanka has not been exposed to the 'toxic assets' that created havoc in the balance sheets of banks and other financial institutions in advanced economies and some emerging and developing economies in Central and Eastern Europe and in Latin America. The level of capital market liberalization - with Sri Lanka maintaining a partially closed capital account - has also contributed to staving off contagion effects of the global crisis.

This does not imply, however, that Sri Lankan policy makers can be entirely complacent. Whilst the country's financial sector has been shielded from the short term direct impacts of the global financial meltdown, the inevitable tightening of credit flows on the part of the advanced economies that have taken the biggest hit will have medium term impacts on Sri Lanka in terms of access and cost of international finance. According to the IMF, countries such as Sri Lanka and Ghana that have begun to access international capital markets are at medium term risk from the global credit crunch.[8] This is reiterated by Sri Lanka's experience in the latter months of 2008, which indicates that the government securities market that was recently opened out to foreign investors, subject to limits, recorded a significant reversal of capital flows. Moreover, as will be detailed later on, Sri Lanka's financial sector has faced serious 'home-grown' regulatory issues in the past years. As such, regulatory governance issues remain a significant challenge for Sri Lanka - although this is not a phenomenon that is exclusive to the financial sector, but rather one that is relevant for regulation per se in the country.

Sensible and workable regulatory and policy solutions necessitate a thorough understanding of the initial conditions - defined for this purpose as the structure of Sri Lanka's financial market, and the regulatory and legal framework governing the sector. Boxes 8.3. and 8.4 provide a brief overview of key features of Sri Lanka's financial market, and of the existing legislation pertaining to the financial industry, relevant for the purpose of the analysis set out in this Chapter.

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[8] IMF (2009). "The Implications of the Global Financial Crisis for Low-Income Countries", March 2009. Available at: http://imf.org/external/pubs/ft/books/2009/globalfin/globalfin.pdf.

Box 8.3
Sri Lanka's Financial Sector: Structural Features (as at 2007)

- The banking sector dominates the financial system – the CBSL holds approximately 13 per cent of the total assets of major financial institutions, while the rest of the banking sector accounts for 58.1 per cent.
- Sri Lanka's banking sector is highly concentrated, and as at 2006, had the highest market concentration level in the region.
- Contractual savings institutions (including insurance companies and employees' provident and trust funds) account for around 20.6 per cent of total financial sector assets.
- Credit rating agencies, venture capital companies, and unit trusts are negligible in terms of financial sector assets.
- The bond market is dominated by government debt securities; the corporate bond market is relatively underdeveloped, with the corporate sector relying on bank credit.
- The Colombo Stock Exchange (CSE) has modern infrastructure and a main and second board for listing; however, the linkages between market fundamentals and activities on the CSE are very weak.
- Securitization remains at an extremely early stage of development in Sri Lanka

Box 8.4
Financial Sector Regulation: Key Legislation

A. Banking Sector

Banking Act No. 30 of 1988 (and Amendments to this Act, specifically Banking [Amendment] Act No. 2 of 2005

The Act of 1988 provides for the introduction and operation of a procedure to license persons carrying out banking business, and the business of accepting deposits and investing such money. The law sets out guidelines for the regulation of the banking sector and gives wide supervisory powers to the Monetary Board of the Central Bank of Sri Lanka (CBSL).

The 2005 Amendment further expands and strengthens the regulatory powers of the Monetary Board of the CBSL; for instance, Section 83 C (1) of this piece refers to 'pyramid schemes' –

"No person shall directly or indirectly initiate, offer, promote, advertise, conduct, finance, manage or direct a Scheme where a participant is required to contribute or pay money or monetary value and the benefits earned by the participant are largely dependent on:
(a) increase in the number of participants in the Scheme; or
(b) increase in the contributions made by the participants in the Scheme"

B. Non-banking Sector

(1) Securities Market
Securities Council Act No. 36 of 1987 (and Amendments No. 26 of 1991; No. 18 of 2003)

These Acts provide regulatory powers to the Securities and Exchange Commission of Sri Lanka (SEC) over all aspects of the listed securities market outside of government debt; the 1991 Amendment provides for the licensing of unit trusts; the 2003 Amendment extends the jurisdiction of the SEC to market intermediaries such as underwriters, clearing houses, margin providers, investment managers, and credit rating agencies – and also gives the SEC the powers to summon and investigate.

(2) Insurance Market

Insurance Act No. 43 of 2000

This legislation which facilitated the setting up of an insurance regulator – the Insurance Board of Sri Lanka (IBSL) – ensures that the insurance business is carried out with integrity in

order to safeguard the interests of policy holders and potential policy holders; and, registers persons carrying on insurance business in the country.

(3) Auditors

Accounting and Auditing Standards Act No. 15 of 1995

The Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB) was established under this legislation to regulate the accounting and auditing practices of "specified business enterprises" (e.g. companies with a turnover in excess of Rs. 500 million, staff in excess of 100 employees, etc.) The regulatory ambit of the SLAASMB is broader than that of the SEC (with jurisdiction limited to quoted companies) extending to financial institutions, banks, and family-owned entities.

(4) Finance Companies

The Finance Companies Act No. 78 of 1988 (and its subsequent Amendments)
The Act sets out the Monetary Board of the CBSL as the regulator of "finance companies" - entities defined in the Companies Act No. 17 of 1982 as registered to carry out "finance business". The Finance Companies Act No. 78 of 1988 defines "finance business" as the "business of acceptance of money by way of deposit the payment of interest thereon and a) the lending of money on interest; or, b) the investment of money in any manner whatsoever; or, c) the lending of money on interest and the investment of money in any manner whatsoever.

Citing relevant text from Section 10 of the Finance Companies Act of 1978:
Section 10 (1):

"where the Board on a report made by the Director is of the opinion that a finance company-

(i) is following unsound or improper financial practices, detrimental to the interests of its depositors;
(ii) is likely to be carrying on its business in a manner detrimental to the interests of its depositors;
(iii) has contravened or failed to comply with any provisions of this Act, or any direction issued thereunder,

the Board may direct such Company-

(a) to cease following any such practice or desist from any such contravention; or
(b) to comply with the provisions of this Act; or,
(c) to take necessary action to correct the conditions resulting from such practice or contravention; or
(d) secure the reduction of the number of shares held in the company by any person.

Sections 11 and 12 of the Act provide the CBSL with the necessary powers to examine the records and books of finance companies.

(5) Finance Leasing Business

The Finance Leasing Act No. 56 of 2000

The Act provides the Head of the Department of the CBSL to which the subject of financial leasing is assigned by the Monetary Board with regulatory powers over this area. The Act sets out strict criteria for registration as a finance leasing business in Section 3:

"A person shall not be eligible to be registered under this Act unless such person-

(a) is a licensed commercial bank or a licensed specialized bank within the meaning of the Banking Act No. 30 of 1988;
(b) a finance company within the meaning of the Finance Companies Act No. 78 of 1988; or
(c) a public company incorporated under the Companies Act No. 17 of 1982 having such minimum issued and paid up capital as may be prescribed.

Sri Lanka's financial industry is governed by several pieces of legislation,[9] with clear cut regulatory jurisdiction with respect to the various financial markets as indicated in Box 8.4. In general, with a few exceptions (such as the fact that unlisted companies that publicly offer debt securities do not come under the jurisdiction of the SEC), the legislation governing Sri Lanka's financial sector is sound – at least on paper. However, the regulatory challenges lie in the implementation of the law largely due to political-economy factors stemming from weak governance practices. For instance, relevant questions that need to be raised are: to what extent and how effectively did the regulator utilize the provisions granted under Section 10(1) and Sections 11 and 12 of the Finance Companies Act to deal with the problems that emerged with regard to finance companies. Similarly, what were the obstacles faced by the regulator with respect to using Section 83 C(1) of the Banking Act of 1988 to effectively deal with the proliferation of pyramid schemes in the country.

Another area which has not received adequate attention in Sri Lanka, and which is now of increased concern due to the global financial crisis as well as the 'home-grown' problems that afflict the country's financial markets - as will be discussed below - is that of corporate governance and of risk management. The SEC together with the Institute of Chartered Accountants of Sri Lanka (ICASL) put out a voluntary code of corporate governance in 2002. In addition, the Colombo Stock Exchange (CSE) introduced corporate governance standards for listed companies in 2007. These codes of conduct include the minimum number of non-executive and independent directors, criteria for determining independence, disclosure requirements, remuneration, and audit committees. However, only a few companies have adopted these standards given that they are voluntary.

As mentioned earlier on, the recent turmoil in Sri Lanka's domestic financial market does not bear the hallmark of events in the global financial arena. Instead, the crises relating to 'pyramid schemes', and the problems at financial institutions, such as The Finance Company and stresses on banks such as Pramuka and Seylan Bank, point to country-specific factors. As per the Banking Act of1988, the core objective of the Central Bank of Sri Lanka (CBSL) is to maintain financial system stability - i.e., to regulate the entire financial system. It is, therefore, pertinent to question what went wrong. The CBSL did step in post-crisis, to rescue financial entities that were affected by the failure of unregulated and illegal financial firms, and to restore public confidence and systemic stability. For instance, in December 2008, the state-owned Bank of Ceylon was appointed as managing agent to Seylan Bank, and liquidity in the form of collateralized borrowings was pumped into Seylan Bank. In addition, in February 2009, the government announced a special support package to help finance and leasing companies that face liquidity problems due to a crisis of confidence on the part of depositors; and, the CBSL has continuously engaged in public awareness campaigns - ranging from issuing newspaper notices in all three languages to programmes for school children at the regional level - aimed at educating the public on high risk, unregulated financial investments.

The crisis in Sri Lanka's financial sector raises a crucial question as to the role of the regulator - which in accordance with

[9] In addition to these legislative enactments, the industry has a Financial Ombudman to deal with issses relating to dispute settlement .

international best practice is to a) address informational asymmetries - in this instance, make information on high risk investments available to the public; which the CBSL did and continues to do effectively; b) have credible powers of prosecution. In line with this argument, the regulator cannot be held responsible for the risk-taking behaviour (call it "greed") on the part of the thousands of investors that were attracted by the unduly high interest rates offered by unregulated financial entities.

A recent statement by the chairman of the SEC suggests that there are still over 2,000 unauthorized finance companies in Sri Lanka.[10] Currently, the CBSL is in the process of implementing new measures to increase transparency, provide for better coordination amongst the various entities that regulate the financial industry, and to enhance the powers of prosecution. All finance companies are now mandated to list on the CSE in the next two years in order to broad base ownership, and to enhance accountability via disclosure requirements. A consolidated supervision framework is in the process of being institutionalized with the SEC, Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB), the ICASL, and the CSE working together. The Finance Companies Act of 1988 is to be replaced by new legislation that aims to place more restrictions on unauthorized financial institutions and enhance prosecutory powers (including penalties and duration of imprisonment).

Looking to the future - and to the possibility of further capital market liberalization - and the adoption of innovative financial instruments by financial institutions in Sri Lanka, the challenge to address regulatory loopholes and enhance domestic financial regulatory capacity becomes greater.

8.4. Financial Sector Regulation: Policy Challenges

This concluding section of the Chapter addresses three key policy challenges that have been the subject of debate in financial policy circles following the global meltdown. The aim of the discussion in this section is not to arrive at conclusive policy measures for Sri Lanka, but rather to raise the antenna on these issues so as to stimulate more debate amongst local stakeholders in the financial policy space - with the final objective of getting to consensus-based policy solutions.

8.4.1 Speed of Financial Deregulation

The speed and sequencing of financial market liberalization has been at the centre of much controversy, in contrast to trade liberalization for instance, in academic and policy circles internationally and locally. Given the informational asymmetries that characterize financial market products and flows, the possibility of miscalculations, speculative bubbles, and capital outflows/capital reversals are greater in the financial sector, as opposed to the real sector. Empirical evidence on financial liberalization also suggests that the relationship between capital account openness and growth is weaker than that between current account openness and growth.[11]

In emerging and developing economies, the problems of informational asymmetries are compounded by the lack of supporting infrastructure - such as for example, strong financial regulatory institutions and robust macroeconomic frameworks. As such, speedy

[10] "Sri Lankans Still at Risk from Unregulated Financial Firms", Lanka Business Online, June 16 2009. Available at: http://www.lbo.lk/print.php?nid=86402222.

[11] Soebbeke, Eva (2008), "Do Financial Regulation and Deregulation Work Symmetrically?". Available at http://ssrn.com/abstract=1343825.

and ad hoc deregulation of capital accounts can easily destabilize these economies and send them into a downward spiral. The ideal policy prescription, therefore, would be to maintain some degree of capital controls until domestic financial regulatory structures have evolved to a stage where they can handle the complexity and inter-connectedness of global financial flows.

Capital market liberalization has been the topic of much debate and discussion in Sri Lanka over the last two decades. As mentioned earlier on, however, Sri Lanka's policy on capital account openness - maintaining partial controls - was significant in lowering the level of exposure to the global financial crisis. In what may be perceived as a rather surprising and yet bold move, two of the highest ranking officials of the CBSL called for capital account convertibility on the grounds that this would enhance the prospects of capital inflows, and increased investment into the country. Whilst this is by no means an invalid argument, what is relevant in this context is the timing of such a move. Capital account liberalization yields its best results when strong macroeconomic and regulatory fundamentals are in place. As portrayed in the events described in the preceding sections, financial regulation is still at a rudimentary stage in Sri Lanka - certainly not a very conducive environment for unplugging capital controls.

8.4.2 Paradox of Under and Over-regulation

The regulation of financial markets tends to draw two starkly contrasting views, particularly in policy and academic circles: extreme libertarians that oppose any type of regulation, and interventionists that focus on widespread market failures and call for heavy-handed regulation. There is, however, a more balanced and pragmatic middle-ground that is less bent on ideology and more focused on strategic regulatory actions - based on the principle of regulation for competition. That is, regulation not as an end in itself, but as a means to enhance competition and contestability, and to improve consumer and producer welfare. What this also means is that every instance of market failure does not necessitate regulatory action. Instead, sensible and well-informed regulators need to weigh the costs and benefits of any regulatory action prior to instituting it.

Linked to this debate on balanced regulation is a conundrum faced by policy makers in the event of financial crises: labelled the 'paradox of under-and over-regulation'.[12] The main thesis here is that the success of a prudential regulator, or a sustained period of economic stability, may well lead to complacency, reducing the demand for the regulator's services and bringing about under-regulation - which in turn could result in a financial crisis. At the other end of the spectrum lies the phenomenon of over-regulation, where a crisis that imposes costs greater than anticipated, prompts a pendulum shift from under to over-regulation.

At the centre of this paradox is the problem of asymmetric information between stakeholders affected by the regulations and the regulator, with the following policy measures being recommended to address this issue: a) improve information disclosure - the regulator must be kept aware of any exposure by financial institutions to systemic risks; b) increase the independence of the regulator vis-à-vis the political process and lobby groups - given principal-agent

[12] See analysis by Aizenman, Joshua (2009), "Financial Crisis and the Paradox of Under-and Over-Regulation", Working Paper 15018, National Bureau of Economic Research.

problems, regulator independence is essential to institute information disclosure requirements; and, c) centralize the regulatory process - fractured regulation makes the process less transparent, and also provides space for arbitrage between diverse financial regulatory agencies.

8.4.3 Corporate Governance: Issues of Trust, Corruption and Self-regulation

The current global financial crisis negates perceptions that corruption is a phenomenon unique to developing countries. Concrete examples of capture in the course of the global financial crisis are set out in Box 8.5. Corruption and capture are also intrinsically linked to the notion of trust,[13] defined as:

> *"…epiphenomenal to the more basic concept of social capital….social capital consists of norms or values, instantiated in an actual relationship among two or more people that promotes cooperation between them….a group of people embedding such norms will tend to trust one another more than those who do not, or will at least have better grounds for coming to a decision on whether to trust. To understand where trust comes from, one has to understand how the shared norms arise and how they become embedded in actual social groups."*

It could be argued that corruption and capture are less pervasive in high-trust societies, or smaller social or professional groups, that are governed by similar norms and values. These concepts also have a strong bearing on practices of self-regulation, the bed-rock of corporate governance.

The need for sound corporate governance practices has been underscored by the episodes that contributed to the global

Box 8.5
Corruption and the Global Financial Crisis: A Few Documented Examples

- Freddie Mac and Fannie Mae spent millions of dollars lobbying influential members of Congress in exchange for lax capital reserve requirements
- AIG's "small" derivatives unit in London, obscured its accounts, was governed by lax regulatory oversight, and took extraordinary risks
- Countrywide Financial, a giant mortgage lender, switched regulators in order to come under the lax oversight of the Office of Thrift Supervision, funded by fees paid by regulated banks, and which also co-incidentally supervised AIG's derivatives unit
- In April 2004, the largest investment banks in the US persuaded the Securities and Exchange Commission (SEC), at a 55 minute-long meeting, to relax its regulatory stance and enable them to take on larger amounts of debt
- Madoff's giant Ponzi scheme, through system-wide irregularities, points to subtle forms of corruption and capture; although the SEC was aware of Madoff's multiple violations when he served on the Commission's Advisory Committee, the SEC failed to unmask the Ponzi scheme

Source: Kaufmann, Daniel (2009), "Corruption and the Global Financial Crisis", January 27, 2009. Available at: http://www.forbes.com/2009/01/27/corruption-financial - crisis-business.html

[13] Fukuyama, Francis (2001), "Differing Disciplinary Perspectives on the Origins of Trust", *Boston University Law Review*, 81, 479-494.

financial meltdown. Closer to home, the spate of financial institution failures in Sri Lanka further emphasize the need for a workable code of corporate governance, which would create incentives to promote robust self-regulation. Much like the nexus between trust and shared norms, self-regulation functions best when the following factors are in place: a) proximity – self-regulators need to be close to the industry being regulated in order to have hands-on knowledge of the industry, and to identify and respond to potential problems in a timely manner. Ironically, however, proximity can also be a disadvantage due to conflicts of interest; b) collective interests of industry – this can also increase the self-regulator's powers to ensure compliance.

Finally, policy makers have to come to terms with broader and pervasive issues of regulatory governance, including the need for accountability, transparency, and operational and financial independence of the regulator. Whilst financial markets have particular characteristics that distinguish them from other product markets – such as the volatility of capital flows, for instance – the core features of sound regulatory governance remain the same. Sri Lanka's financial sector has, at least up to now, been shielded from the domino impact of the global turmoil. However, issues of governance in general and of regulatory governance in particular remain a challenge.

9. The Global Economic Crisis and Possible Impact on Sri Lanka's Health Sector

9.1 Introduction

An important characteristic of the global economic crisis has been the speed with which it evolved, and the consequent uncertainty facing policy makers across the world. In this regard, the developing world is likely to be handed a particularly raw deal in a crisis that is not of its own making. A key challenge facing the world at large - and developing countries in particular - is to prevent the economic crisis from becoming a social and a health crisis.

An examination of past recessions and their effect on health care provides some indications of the likely impact on socio-economic conditions arising from the current global economic downturn. Given that the duration and magnitude of the downturn is as yet unclear, as is the likely medium term outlook for low-income and emerging economies, conclusions can only be tentative at this stage. Nonetheless, there are significant risks arising from the prospect of cuts in social spending such as on health, education, and social protection. Poorer populations are likely to be the first and hardest hit by any downturn. Over the last three decades, most poor households in developing economies have benefited from the growth of export oriented industries and inward remittances from abroad. As demand declines in developed economies, job losses, and lower remittances from migrant workers are likely to add to the adverse consequences for family income, and the ability to pay for health care.

The objective of this policy brief is to discuss the probable channels through which an economic crisis of this nature can affect Sri Lanka's health sector. In particular, it attempts to make the case for sustaining investments in health, and to identify actions that can help to mitigate the negative impact of the economic crisis. The discussion will examine the overall impact of the economic downturn on key health sector areas such as health financing, donor funding, household out-of-pocket expenditure, cost of medicines, primary health care, and private health care. The concluding section will address some policy options to mitigate the adverse impacts on the country's health sector.

9.2 Sri Lanka's Health Sector

Sri Lanka has continued the practice of providing health care services free of charge at all government health institutions, together with the provision of services in close proximity to households. Over the years, this has led to the establishment of a network of 954 government health institutions in 276 Medical Officers of Health (MOH) areas, with a health workforce of nearly 50,000 spread widely throughout the country. This has ensured that at present, Sri Lanka has on average a total of 49 medical officers, 87 nurses, and 25 public health midwives per 100,000 population.

Government hospitals and dispensaries spread throughout the island are able to treat around 43 million out-patient visits and around 4.5 million in-patients annually.[1] The provision of high standard health care facilities has become a challenging task over the

[1] Ministry of HealthCare and Nutrition, *Annual Health Bulletin 2004/2005*, Medical Statistics Unit.

years due to budgetary constraints. Private sector provision of alternative sources of allopathic and indigenous treatment has helped reduce the public health care burden to some extent. Despite the many challenges, Sri Lanka is on track to achieve its Millennium Development Goals (MDG) targets in terms of the relevant health indicators. The under-five year mortality rate has declined by half over the period from 1990 to 2005, and is on track to be reduced by two-thirds by 2015. The infant mortality rate has declined from 19.3 per 1000 live births in 1990 to 12.0 in 2005, and is on its way to achieve the target of 5.9 per 1000 live births in 2015. The proportion of one year old children immunized against measles has reached 98 per cent. Maternal mortality has declined by two-thirds since 1990, and is on its way to achieve a three-quarter reduction by 2015. The proportion of births attended to by skilled health personnel has reached 98.7 per cent.

Over the years, a steady growth in private healthcare services has been a significant development in Sri Lanka's health sector. Nonetheless, the state health services have continued to focus on pro-poor delivery of own health facilities. This has been important in the context of other socio-economic trends in the country. Although the proportion of people living in extreme poverty - or on less than US$ 1 a day - has fallen since 2000 to stand at 15 per cent of the total population, the gap between the rich and poor appears to have grown since. For example, the share of national consumption of the poorest quintile of Sri Lanka's population is estimated to have fallen from 46 per cent to 39 per cent between 1990 and 2004.[2] Even more worryingly, wealth remains a key determinant of access to health care.

9.3 Impact on the Health Sector

9.3.1 Health Financing

Sri Lanka's two tier health system - comprised of a heavily subsidized public sector and a user charged private sector - has produced a progressive health financing system. The conventional categorizations of finance sources for Sri Lanka's health care are taxation, private health insurance, out-of-pocket payments, and donor assistance. Government finances for health care flows from general taxation, and from donor assistance at a lesser rate.

General government expenditure on health reached Rs. 71 billion in 2007 from Rs. 11 billion in 1995. Total health expenditure in Sri Lanka which accounted for 3.4 per cent of GDP in 1990 increased at a slow pace to 4.1 per cent of GDP in 2007. The government health expenditure to GDP ratio has been fluctuating between 1.7 per cent and 1.9 per cent over the period 1990- 2004, and has remained at a little over 2 per cent since 2005 -reflecting the constraints of financial provisions in budgetary allocation involved in normal years, even in the absence of a sharp economic downturn.

Evidence from past economic crises, especially in the South Asian region, gives a reasonable prediction about what is likely to happen over the next year or so. In a worst case scenario, if the flow of income to state coffers are subject to contraction, government expenditures - inclusive of expenses on health - will be squeezed and is likely fall, contributing to poorer health outcomes.

In Sri Lanka, governments have tended to protect health spending, even to the extent of increasing it over the years. But an eco-

[2] Central Bank of Sri Lanka, *Consumer Finance Survey 2004*.

nomic recession makes the task of defending health budgets more difficult. Financial uncertainty may set one health programme against another in a frantic competition for funds. Likewise, reductions in total expenditure will have an impact on the composition of health spending.

Sri Lanka's health care system has been improving over the years, and as such, a higher standard of health status has been achieved with the relatively limited resources available to the health sector. Historically, health authorities have made significant efforts towards identifying what factors are associated with better performance, and how public delivery can be strengthened. This has been important due to the fact that the state health sector has not always been capable of providing more and better services to low income populations, and to reach the poor in urban slums, remote rural areas, and geographically marginalized areas such as the estate sector. These efforts have been hampered due to lack of adequate funds. If there is a further contraction of budgetary provisions, efforts to address such critical issues will not receive the same level of attention, widening the existing disparities in service delivery beyond acceptable levels.

At provincial level, the devolved system of provincial governance has failed to promote the expected service delivery of health to people of the province. They continue to be heavily dependent on funds from the central government. The financial stresses on the latter are likely to tighten further as a result of the current economic downturn. In the face of an economic crisis, the underlying system of distribution of financial resources from the centre to provincial government could become fractious, paralyzing the existing health care delivery system at the provincial level.

The shortage of allocated financing will have a major impact on infrastructure spending in the secondary and peripheral level health facilities which is critical for sustainable service delivery in the health sector. Maintaining, constructing, or rehabilitating the much needed infrastructure in public health facilities - together with access to roads, water supply, sewerage systems, drainage systems, etc. - could be seriously affected.

Investments in private sector health care facility infrastructure projects could be postponed or put on hold, since private sector investment depends largely on bank borrowing. Delaying capital spending is a common short term response of the private health care industry when faced with budget cuts. While it may be a logical response in the short term, it can, however, lead to longer term problems if the downturn is sustained. Reductions in maintenance, medicines, or other operating costs related to surveillance or supervision are likely to have a more damaging and immediate effect on service delivery.

9.3.2 Donor Funding

A country like Sri Lanka requires financial inflows from the rest of the world to facilitate and accelerate economic growth, trade, and development. These flows which include official development assistance (ODA) are very likely to be negatively affected during the current crisis. The volume of ODA inflows also indicates the strength and value of donor financing to the health sector. In 1995, Sri Lanka's government health sector utilized Rs. 180 million in ODA assistance. In 2007, it had reached Rs 2,533 million.[3]

In the face of a global recession, fiscal pressures in affluent countries may prompt cuts in their ODA budgets. When analyzing the behaviour of donors during previous reces-

[3] Ministry of Finance, *Government Budget Estimates*, various issues.

sions, it is clear that ODA for the health sector too can decline. For example, this was evident during three previous episodes of global economic distress in 1990-93, 1997-99, and 2000-01. During the 1990-93 crisis, total ODA commitments fell, but commitments towards health continued to rise. However, during the 1997-99 and 2000-01 crises, both total ODA and ODA commitments to health declined.[4]

The present scenario with regards to ODA is that OECD and EU countries have given an undertaking not to cut aid, but some donors have indicated possible reductions in aid spending. Even before the present financial crisis, in 2005, ODA spending by the G-8 countries forecasted a shortfall of US$ 34,000 million in 2010. In the last round of budgeting, in December 2008, ODA was reduced by 10 per cent, from US$ 3.1 billion to US$ 2.8 billion, although all programme requests were approved. Recipients were asked to achieve the same goals with reduced funding through changes like cuts in overhead costs or finding lower cost options for pharmaceuticals.[5]

Foreign aid plays a key role in providing a boost to the health sector that a country could not manage on its finances alone. The mobilization of foreign aid in Sri Lanka was channelled to island-wide national services such as prevention of HIV/Aids, controlling tuberculosis (TB), eradication of malaria, improving existing primary care facilities, and constructing new health institutions.

To some extent, aid ensured that spending is genuinely pro-poor where possible, since ODA for health is earmarked along such lines. Moreover, infrastructure investments and opportunities for safeguarding lives could be identified as important advantages reaped from the utilization of ODA funds. In this context, greater predictability of external financing is vital, especially to facilitate planning, and to obtain better value for money. This has been particularly so in cases where ODA has been earmarked for health programmes such as those aimed at fighting HIV/Aids, TB, and malaria. In general, Sri Lanka has generated good results from ODA funds in these areas in the past, and thereby made significant progress towards achieving its health related MDG goals. The danger is that ODA cuts will stall the process, and leave these programmes unprotected when they most need it.

If donors do not cut back on expenditure for medicines or on technical assistance, but yet reduce the overall volume of funds needed for service delivery, medicines may not get to those who need them. Such a situation risks exacerbating the tensions between HIV/Aids treatment and other forms of health spending.[6]

9.3.3 Household Out-of-pocket Expenditure

One component of household health expenditure is that of direct out-of-pocket (OOP) health spending by households on medical goods and services. These OOP health expenditures in Sri Lanka include user fees paid for utilizing i) private medical and dental services, ii) private hospital services and treatment, and over-the-counter (OTC) payments to purchases, iii) medical and pharmaceutical products, or iv) therapeutic appliances and equipment. Private facilities influence the user fees paid by households. Additionally, the pharmaceutical market offers a wide

[4] Parry, J. and G. Humphreys (2009), "Health Amid a Financial Crisis: A Complex Diagnosis", *Bulletin of the World Health Organization*, Vol. 87, No. 1.

[5] BBC, "Health News Hour", 30 January, 2009.

[6] WHO (2009), "High Level Consultation on the Financial and Economic Crisis and Global Health", 19 January 2009. http://www.who.int/mediacentre/events/meetings/financial_crisis_20090113/en/index.html.

range of medical goods which determine the OTC payments. These variations in household health expenditure, in turn, are somewhat reflected by households' Ability to Pay (ATP). When the household ATP falls, patients will switch from the private sector to the public sector, often putting an unbearable burden on government funded free health services.

In contrast to public spending, private OOP expenditure usually tends to decline in a recession, particularly if the service delivery is characterized by equity or fairness, and provided at free of cost in the public sector.

In general, poor households are likely to be the first and hardest hit by any downturn. With possible job losses, decreasing remittances from abroad, etc., there could be a serious drop in household income to pay for health. Although free health services are provided by government health institutions, an average of 46 per cent of total health expenditure is incurred as OOP payments by individual households.[7]

In many countries, social safety nets provided by the state prevent individuals from falling into poverty beyond a certain level. In Sri Lanka, successive governments implemented various income support programmes aimed at reducing poverty - such as food subsidy schemes, food stamp schemes, Janasaviya programme, Samurdhi programme, etc. - in addition to uninterrupted free health care services. This approach to poverty reduction means unconditional cash transfers from the state to the households, placing a heavy burden on the government budget. Once the budgetary provisions for these services are subjected to contraction, there can be significant stress on socio-economic conditions at the household level. This situation is likely to cause increased mental health problems, and can even lead to higher rates of suicide as people struggle to cope with poverty and unemployment. In addition to mental problems such as depression and bipolar disorders, the current economic downturn could exacerbate feelings of despair among people vulnerable to such illnesses. About 75 per cent of suicides in Sri Lanka are in rural households,[8] especially among farmer communities, mainly due to the fact that these communities have high levels of stress because they live at subsistence level, many without even the barest necessities of life.

9.3.4 Cost of Medicines

The rising cost of medicines has been of major concern to consumers and health groups worldwide in recent years. The high and rising prices have made medicines much less accessible to patients, thus hindering the treatment for the needy.

In Sri Lanka, dispensing medicine in the public sector has become more rational, especially in primary and secondary level facilities. Public sector hospitals are expected to provide drugs free of charge to patients. However, the reality is also that most patients tend to purchase more expensive drugs from private pharmacies which are generally unavailable in state hospitals faced with intermittent shortages in drugs supply. This constraint has forced households to spend from out-of-pocket to seek patient treatment from private hospitals and practitioners.

In the current economic downturn, the cost of medicines will probably increase for a country such as Sri Lanka. The economic downturn is likely to be accompanied by a

[7] IPS (2004), *Sri Lanka National Health Accounts 2004*.

[8] *Daily Mirror*, "Suicides in Sri Lanka: Still a Cause for Concern", September 12, 2007.

depreciating currency where the prices of imported medicines, raw materials, and medical equipment will increase. In 2005, Sri Lanka paid out-of pocket a staggering Rs. 24 billion to purchase medicine for out-patient care in the private sector. The expenditure for medicine in the public sector for out-patients was Rs. 590 million.[9] If cost increases are not absorbed, the impact will be reflected in shortages or increased costs of care. If the government cuts back on expenditure for medicines, or reduces the overall volume of funds needed for service delivery, medicines may not get to those who need them. On the other hand, the government is also accountable for shortages of any essential drugs in the country.

At present, there is no price control or regulation of prices of pharmaceuticals in the private sector. The results of a study carried out on the prices of the innovator and generic equivalent of 28 drugs showed that the price of generic drugs in Sri Lanka was lower than that of international prices. However, for the innovator products, there had been an increase in prices of up to 400 per cent more than international reference prices.[10]

In an economic downturn, prices of imported medicinal drugs can be increased to unethical levels as there are no price controls in place. It has been observed that the prices of pharmaceuticals are increased at times without obvious reasons. The pharmaceutical companies often quote the fluctuation in the US dollar as the reason for increasing prices. Adding to the crisis is the reality that thousands of pharmacies in Sri Lanka are being run illegally, without a qualified pharmacist to dispense drugs.

9.3.5 Primary Health Care

It is to be noted that during the Asian financial crises of 1997/98, the Indonesian government paid a heavy price for disproportionately cutting health spending over other sectors of the economy. A 25 per cent budget cut for primary health care resulted in a similar decline in childhood immunization coverage, a drop in the use of clinics, and a reversal of previous falls in infant mortality.[11]

Primary health care needs a high priority approach in policy at a time of financial crisis. The World Bank, for instance, is advising countries to focus spending on specific programmes, such as nutrition for pregnant women or child immunization, as fears are that women and children will bear the brunt of downside effects - rising infant mortality, and worsening nutrition in a worst case scenario.

Although Sri Lanka has made significant improvements in its primary health care during the recent past, there has been little change in maternal and newborn mortality, especially in the plantation sector and in a few other poverty stricken areas where nutrition has been relatively neglected, and problems of low birth weight babies and low nutritional status of children and mothers exist. In these areas, about 50 per cent of pregnant women suffer from anaemia. Children are not much better off. About 32 per cent are malnourished, and one in three is under weight. In most of these geographical areas, around 20 per cent of babies born are of low weight (< 2.5 kg).[12] The economic consequences of the global financial crisis put them at greater risk, and without

[9] IPS/HPP, National Health Account data base.

[10] See Prof. G. Fernando, "The Ills of too Many Pills", *Daily Mirror,* 28 March, 2007 and "Quality Drugs at Affordable Prices", *Daily Mirror*, 8 February, 2008.

[11] WHO (2009), "The Financial Crisis and Global Health", WHO: Geneva.

[12] DCS, *Annual Health Bulletin 2004/2005*, *Demographic and Health Survey 2006/07*, and *Special MDG Survey 2007*.

an adequate social safety net this would likely lead to a serious deterioration in their socio-economic status.

9.3.6 Private Health Care

Experiences in other Asian countries have shown that spending by the private sector tends to decline in an economic downturn, as patients either defer care completely or turn from the private to the public sector, if care is available at free cost. Unless public sector services are ensured adequate financial support in these circumstances, the quality of care is likely to deteriorate.

According to available data,[13] health services in the private sector are 15 times more expensive compared to the public sector health services. On average, the public sector incurs a cost of Rs. 850 for an average in-patient per day, while the private sector treats a patient at a cost of Rs. 12,500. If cost increases are not arrested, the impact will be reflected in shortages, or in increased cost of care. With possible job losses in the private health care sector, especially among paramedic personnel, a contraction of the private sector as a service provider due to lower demand for private health care could be expected. Also infusing capital for infrastructure development and introduction of hi-tech medical care will be put on hold, mainly due to possible low demand. After the Asian financial crises of 1997/98, in Thailand, the private sector health services suffered due to significant demand reductions, and a number of private sector doctors applied to return to the government sector.[14]

From the delivery side, the growing burden of non-communicable diseases, the demand for insulin, cardiovascular medicines and asthma inhalers, for example, is increasing rapidly. Although people can borrow to pay for private care treatment of acute illness episodes, those dependent on long term treatment risk progressive impoverishment.

9.4 Conclusions and Policy Recommendations

The most critical factor affecting Sri Lanka's health care provision has been the inadequacy of resources in general, and that of financial resources in particular.

Many of the key campaigns to combat diseases and to keep global public health objectives on track to achieve the MDG targets are heavily dependent on international co-operation and support. Cutting back on funding would jeopardize ongoing treatment of people affected by diseases such as HIV/Aids, tuberculosis, and malaria. Though societies in wealthier countries have been hard hit by the current global financial crisis, the world cannot afford a reduction in commitments to social expenditure.

For a tropical country like Sri Lanka, mosquito borne diseases are a common occurrence. Diseases such as dengue fever have become endemic in the country. The most recent outbreak is estimated to have led to more than 200 known deaths and over 10,000 clinically/laboratory confirmed cases. There is no specific drug treatment for dengue unlike for malaria, but early management/ treatment of the condition could reduce mortality. A core issue related to dengue is the reduction of vector densities. At present, most of the activities are concentrated on eliminating temporary mosquito breeding places connected to garbage and waste disposal. The major responsibility for such ac-

[13] Data from the IPS Health Policy Programme (IPS/HPP) Data base.

[14] Parry, J. and G. Humphreys (2009), "Health Amid a Financial Crisis: A Complex Diagnosis", *Bulletin of the World Health Organization*, Vol. 87, No. 1.

tivities lies with local government bodies, with limited financial resources at their disposal.

Financial crises can and do act as contributory factors in slowing down progress to eradicate such diseases. A workable programme put forward by the Epidemiology Unit of the Ministry of Healthcare and Nutrition called the *National Plan of Action for Prevention and Control of Dengue Fever: 2005-09* pruned down its activities due to budgetary constraints experienced in the latter stages of the programme. The absence of earmarked global funding for the eradication of dengue, as compared to programmes dealing with HIV/Aids and malaria prevention has also not helped.

As far as the prices of medicinal drugs and pharmaceuticals are concerned, there is evidence that the rise in the cost of care to patients can be controlled, particularly through generic substitution. According to the Drug Regulatory Authority (DRA) there are around 7,000 varieties of drugs that have been registered, including non-essential and highly expensive drugs under a confusing multiplicity of brand names. For instance, some 130 varieties of the generic paracetamol have been registered, while the antibiotic amoxicillin is registered under more than 70 brand names. In addition to government expenditure on essential medicine for government hospitals and dispensaries, private out-of-pocket expenditure on pharmaceuticals in 2006 has been a staggering Rs. 23 billion.[15] In 2006, an 18 member National Standing Committee appointed to work out legislation of the National Medicinal Drugs Policy was expected to slash the 7,000 varieties of drugs to less than 1,000, taking into consideration five factors for the registration of drugs - i.e., quality, efficacy, safety, cost, and need - through an independent Drug Regulatory Authority.

If the proposed National Medicinal Drug Policy is implemented, Sri Lanka would need to import only around 1,000 essential drugs, with significant savings on foreign exchange. It is also necessary to promote the rational use of drugs that requires patients to receive medications appropriate to their clinical needs, in correct doses, for an adequate period of time, and at the lowest cost to them.

With regard to household out-of-pocket expenditure, it may be argued that it is an opportune time for policy makers to implement a comprehensive social safety net programme which should include both unconditional and conditional cash transfers to poor households.

During an economic downturn, it may also be appropriate for medical experts to launch alternative strategies such as initiatives to promote preventive care, healthy habits, and alternative medicine - combining prevention, treatment, rehabilitation, and recovery efforts, while also promoting wellness of alternative medicine such as meditation, massage, acupuncture, and herbal treatments. Many chronic illnesses such as heart disease, diabetes, and some types of cancer can be prevented through such simple steps as a better diet and more physical activity. Heart disease and cancer are the top two killers in the country.

Those providing health care services - government and private stakeholders - must ensure that efforts to safeguard and sustain the performance of the health system are maintained. The Ministry of Healthcare and Nutrition, for instance, can focus on financing specific essential services for vulnerable

[15] IPS, *Sri Lanka National Health Account Estimates 2006*.

populations in times of economic crisis. The emphasis should be on access to defined services, rather than on an overall figure for government health expenditure. This requires that the Ministry identifies key services, those targeted, necessary strategies, etc. It also means having access to better data and monitoring mechanisms. Although short term measures to mitigate the negative consequences of the economic downturn are urgent, there is a need to take a longer term perspective that will have the effect of making the health sector more resilient in the future.

10. Crises and Vulnerability: Improving the Nutritional Levels of Children

10.1 Introduction

Sri Lanka's overall health indicators are on track to achieve the 2015 Millennium Development Goals (MDGs). Compared to other developing countries, infant and maternal mortality rates are markedly low in Sri Lanka. Almost all are vaccinated at the right time. However, malnutrition in children continues to be a serious health concern in Sri Lanka. Recently published government statistics show that malnutrition affects hundreds of thousands of children, despite countless initiatives to alleviate malnutrition over the years. In particular, such conditions are entrenched in traditionally poor and conflict-hit regions. Of children under five years of age, almost one out of five are reported to be underweight, rising as high as one-third of pre-school children in some deprived districts.[1] The impacts on the nutrition and health of young children in poor families are of special concern during times of economic crises. Reductions in government expenditures, cut-backs in donor assistance, etc., can disproportionately raise the risks to already vulnerable groups in society.

Childhood health and nutritional status have significant implications in terms of educational achievements. Good health and nutrition are vital during the process of rapid mental and physical growth that occurs from birth through adolescence.[2] For instance, improved nutrition leads to better developmental levels in infancy, readiness for school, better enrolment rates, learning capacity, and educational attainment.[3] Further, malnutrition during childhood has serious and long lasting consequences. Malnutrition raises the life time risk of poor physical health, constrains intellectual growth, and leads to more chronic illnesses and disability in adulthood. It is also a multifaceted problem. Girls who are born with low birth weight grow into women of short stature, who themselves are more likely to have low birth weight babies, especially if they have their babies whilst they themselves are too young. Unless the vicious cycle of malnutrition is broken at some stage, this situation will continue over many generations resulting in an inter-generational cycle of malnutrition.

Apart from such problems, the impacts of malnutrition can have adverse implications on the economy, through their effects on education, productivity, growth, and health care expenditure. Therefore, in the long run, poor nutrition and health can result in a poorly educated and unhealthy population which will act as a drag on economic growth and development. Nutrition indices need to improve considerably for Sri Lanka to achieve the nutrition MDG of halving the proportion of people who suffer from malnutrition by 2015. This policy brief discusses current conditions and possible policies to move forward.

10.2 Nutritional Status of Sri Lanka

According to the findings of the recent *Demographic and Health Survey 2006/2007*,

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[1] Department of Census and Statistics and Ministry of Healthcare and Nutrition (2008), *Demographic and Health Survey 2006/2007*- Preliminary Report. Available from http://www.statistics.gov.lk .

[2] http://www.neahin.org/programs/physical/schoolchildren.htm (Accessed on 07/04/2009).

[3] World Health Organization (1996), *The Status of School Health*, Geneva: WHO.

among pre-school children, 22 per cent of children are underweight, 18 per cent are too short (stunted), and 15 per cent are too thin (wasted) as measured by weight-for-height.[4] Further, the data reveal that the prevalence of malnutrition varies by socio-economic as well as geographical groups of the country. For example, districts in the western and north-western parts of the island show fewer cases of under-nutrition, while children in conflict-affected and estate areas suffer from alarming levels of malnutrition. At the top of the categories, 41 per cent of children in Nuwara-Eliya district were stunted, while 32

Table10.1
Child Malnutrition[a]

	Height-for-Age		Weight-for-Age	
	2000	2006	2000	2006
Age in months				
<6	5.2	9.7	10.0	12.1
6-8	6.0	9.5	12.4	12.0
9-11	10.9	15.6	18.4	15.6
12-17	19.4	18.6	18.7	18.5
18-23	24.2	22.7	19.8	22.9
24-35	21.7	21.9	25.7	23.4
36-47	17.4	19.8	25.2	24.9
48-59	22.7	15.7	30.2	25.3
Sex				
Male	17.0	18.7	22.1	22.3
Female	20.1	17.2	23.9	20.8
Residence				
Urban	10.2	13.7	15.8	16.6
Rural	18.2	16.7	23.9	21.7
Estate	43.7	42.2	34.7	29.7
Mother's education				
No education	47.4	42.0	41.2	34.9
Primary	31.7	29.8	34.8	33.7
Secondary	19.2	18.8	24.9	22.7
Passed G.C.E (O/L)	13.7	13.8	19.9	17.6
Higher	7.6	10.0	8.9	13.8
Total	18.5	18.0	23.0	21.6

Notes: a: Percentage of children under five years are classified as malnourished according to anthropometric indices. The indices are expressed as standardized scores (z-scores) or standard deviation units from the median for an international reference population that was recently developed by the WHO (2006). These indices are not comparable to indices based on the previously used CHS/CDC/WHO Child Growth standards. Children who fall more than two standard deviations below the reference median are regarded as undernourished.

Sources: Data for 2006 from DCS, *Demographic and Health Survey 2006/2007* preliminary report; and data for 2000 calculated from *Demographic and Health Survey 2000*, WHO Global Database on Child Growth and Malnutrition, 2006.

[4] In children, the three most commonly used anthropometric indices to assess their growth status are weight-for-height, height-for-age and weight-for-age. (https://www.who.int/nutgrowthdb/about/introduction/en/)

These anthropometric indices are defined as follows:
weight-for-age: underweight reflects low body mass relative to chronological age;
weight-for-height: wasting or thinness indicates in most cases a recent and severe process of weight loss;
height-for-age: stunted growth reflects a process of failure to reach linear growth.

per cent of children were found to be underweight in the Badulla district.[5] Moreover, the percentage of underweight children increases steadily with the child's age, while it decreases as the level of education of the mother rises.

The condition of being underweight is found to be far higher for estate children than for children in urban and rural areas. As of 2006 estimates, almost 30 per cent of estate sector children are underweight, while rural and urban sector estimates are 22 per cent and 17 per cent, respectively. Similarly, more than 42 per cent of children are found to be stunted in the estate sector. Stunting levels in estate sector children are three times higher than that of urban sector children (Table 10.1). When compared with estimates of underweight children in 2000, the more recent estimates suggest a marginal improvement in the estate sector. By comparison, in urban areas, the percentage of children who are underweight has been increasing since 2000.

Alternatively, micronutrient deficiencies (most common deficiencies are iodine, iron and vitamin A) which affect healthy child growth and development are less obvious forms of under-nutrition, but constitute major public health problems in Sri Lanka. One-third of pre-school aged children are affected by Vitamin A deficiency and a half of children of 5-10 years of age are affected by iron deficiency. Although iodine deficiency is the most common preventable causes of physical and mental retardation, one out of every five children suffers from iodine deficiency disorders.[6]

10.3 Main Factors Contributing to Malnutrition

Malnutrition in children is the consequence of a range of factors that are often related to inadequate dietary intake and poor health status. These factors themselves are interdependent and closely linked to overall standards of living - i.e., whether a population can meet its basic needs such as access to food, housing, health care, etc. Moreover, malnutrition is frequently a part of a vicious cycle that includes poverty and disease. Socio-economic changes that improve health, nutritional, and overall standards of living can break this cycle.[7] On the other hand, in many developing countries, especially in urban populations, there has been a trend in affluent classes towards increased consumption of energy-dense nutrient poor foods - i.e., high in fats and sugars, and not enough nutrients. Even for low-income families, these foods may be more affordable and accessible than more nutritious foods such as fruits and vegetables.[8]

The immediate determinants and underlying causes of childhood malnutrition in Sri Lanka range from inadequate dietary intake and severe and infectious diseases to socio-economic, knowledge, and cultural factors that influence the utilization of health services and available food. Poverty plays a key role here. It affects malnutrition through household food security, inadequate basic infrastructure, and health services. Although poverty is an important basic determinant of child malnutrition - where 15.2 per cent of Sri Lanka's population is considered to be poor - it does not solely explain the high rates of child malnutrition prevailing in the country. Inappropriate feeding practices, poor sanitation and

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5 Department of Census and Statistics and Ministry of Healthcare and Nutrition (2008), *Demographic and Health Survey 2006/2007*- Preliminary Report. Available from http://www.statistics.gov.lk

6 http://www.unicef.org/srilanka/activities_1667.htm (Accessed on 07/04/2009).

7 https://www.who.int/nutgrowthdb/about/introduction/en/ (Accessed on 15/02/2009).

8 http://www.who.int/childgrowth/4_double_burden.pdf (Accessed on 07/04/2009).

drinking water, and diseases (diarrhoea and acute respiratory infection) are the other major determinants of malnutrition.

Appropriate food must be offered to the child with correct timing and frequency. When children move into complementary feeding, the growth of children might be hampered by wrong kinds of food or a shortage of food. On the other hand, one of the reasons for diseases such as diarrhoea is poor access to safe drinking water and sanitation. In Sri Lanka's estate sector, for instance, around a half of all households have no access to safe drinking water.[9]

10.4 Experiences from Other Countries

Schools are ideal settings for nutrition programmes and services. This is so given close links between nutrition and education - dietary, hygienic, and exercise habits that affect nutritional status are formed during the school-age years. The World Health Organization (WHO) and the Food and Agriculture Organization (FAO) are collaborating in promoting school-based nutrition interventions in developing countries. The WHO, for instance, launched its Global School Health initiative to promote the development of Health Promoting Schools (HPSs) in 1995.[10]

In 1999, the WHO and the FAO assisted in the development of HPS in China with the focus on nutrition. Selected pilot schools supplemented their nutrition education activities (healthy nutrition and the importance of a balanced diet, nutritional deficiencies and their effects, and good hygienic practices) with improvements in health-related school policies and the overall environment, including renovations to school facilities (clean water supplies, hygienic practices in cafeteria) and grounds. The results achieved by the project were quite impressive.[11]

School lunch programmes can also be an important initiative in alleviating child malnutrition. There is evidence to suggest that school lunch programmes can lead to better school attendance and academic achievement in developing countries - i.e., children receiving lunches have more energy to focus on their education. One such initiative was community programmes connecting nutrition to schools that was started in Panama. Selected Panamanian communities focused on improving food security of children, and teaching them how to grow and eat nutritious foods. The students studied nutrition education, food processing, and forestry and worked on maintaining school gardens. Eventually, the project spread into the wider community (involving teachers, farmers, and parents) and accomplished significant changes - underweight children dropped by almost 50 per cent.[12] Similarly, adequate safe drinking water and sanitary facilities are considered as essential elements of a health-promoting school. In China, for instance, a de-worming project was implemented through schools in 1996 with the support of the WHO to ensure a reduction in helminth infection.[13]

10.5 Measures Adopted in Sri Lanka

Successive governments have implemented various programmes to improve the nutritional status in the country. Child growth monitoring, antenatal care, and nutrition education have been established strategies

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[9] *Ibid.*

[10] World Health Organization (1996), *The Status of School Health*, Geneva: WHO.

[11] ftp://ftp.fao.org/docrep/fao/006/j0243m/j0243m04.pdf (Accessed on 07/04/2009).

[12] FAO (2003), *The State of Food Insecurity in the World*, Rome: FAO.

[13] http://heapro.oxfordjournals.org/cgi/content/short/15/3/197 (Accessed on 07/04/2009).

encompassing the whole country for the last several decades. Several new strategies are also being planned as interventions with better targeting. These include supplementary feeding programmes such as a glass of milk for school children, a food basket for pregnant and lactating mothers, etc. Some of the programmes to address problems of malnutrition in Sri Lanka include:

- Care for pregnant mothers: promoting prenatal nutrition services, including iron and folate supplementation, de-worming, monitoring the nutritional status of expecting mothers, and nutrition counselling.
- Promotion of appropriate infant and young child feeding (e.g., breastfeeding, weaning practices, and introducing supplementary food).
- Growth monitoring and promotion: empowering caregivers to understand the growth patterns of their children and to take appropriate action, including funding for child development records.
- Control of micronutrient deficiencies: an island-wide vitamin A supplementation programme, and universal salt iodization.

With the end of the war in May 2009, around 300,000 Internally Displaced Persons (IDPs) fled from the conflict zone and are now accommodated in camps in the Vavuniya, Mannar, Trincomalee, and Jaffna districts. The enormous IDP influx has become a new challenge and has placed an enormous burden on already stretched resources. Nutrition is a critical issue for IDPs, especially for children under five years of age, and lactating mothers who are at risk after months of limited access to food of high nutritional value. The government is attempting to ensure the best possible health care services to the IDPs with the assistance of many national and international agencies (see Box 10.1).
In 2003, as the world's largest provider of

Box 10.1
Nutritional Interventions for IDPs

Nutritional interventions have been employed to provide additional fortified food to all children under the age of five years, and for pregnant and lactating women. Acutely malnourished children, pregnant and lactating women suffering from underweight are further assisted with the provision of multiple micronutrient supplements (sprinkles and vitamin A mega doses) through therapeutic feeding and supplementary feeding. Improved infant and young child feeding practices and breastfeeding are being promoted among the IDP population. Moreover, to control parasites, the distribution of de-worming tablets for all children under five years, and pregnant and lactating women have been initiated. Many national and international agencies (UNICEF, WFP, World Vision, etc.) have provided assistance for these programmes.

Further, the government has made efforts to ensure that several other hygiene related issues – especially water and sanitation – which directly affect the health and nutritional status of IDPs are addressed. Timely provision of safe water, sanitary facilities, garbage disposal, fly control, and drainage of surface water, etc., are essential to prevent any outbreak of diseases. The provision of such services within the domain of government agencies are being addressed with short term, medium term and long term plans.

nutritious meals to poor school children, the World Food Programme (WFP) launched a meals-in-school programme in Sri Lanka for 33,000 children in the conflict-affected zones. The programme targets children who have been most affected as a result of displacement, poverty, and food deficits. The WFP school meals programme is aimed at motivating daily attendance of school children, and thus enhancing their ability to learn. The WFP is working with parent groups to manage the cooking and provision of meals. Such partnerships are expected to further foster social cohesion and community integration among people.[14] In addition, the WFP has been giving school meals for children of some Catch-up Education (CUE) programmes in conflict-affected areas when they attend "catch-up classes".[15] Furthermore, in order to meet the needs of recently displaced IDPs, the WFP has boosted food stocks and supply of nutritionally-rich food for women and children.

In recognition of the need to strengthen coverage and quality of nutrition intervention programmes, the Ministry of Healthcare and Nutrition has recently developed a National Nutrition Policy. As the causes of malnutrition are multi-factorial, the focus is on integrating nutrition with other sectoral activities, including health, agriculture, education, economic reform, and rural development. Another strategy that has been adopted to improve the information base is the establishment and implementation of a National Nutrition Surveillance System. This is expected to help better targeting of interventions by giving timely data on a regular basis on nutritional status and its determinants at divisional, district, provincial, and central levels. Such data availability can enhance the planning and management of interventions, and thus their overall effectiveness.

10.6 Conclusions and Policy Recommendations

Sri Lanka has many decades of experience with programmes to improve nutrition. However, malnutrition continues to remain a challenging problem. Wide disparities that prevail across regions and districts add to the complexities in dealing with malnutrition. Lack of proper targeting of food subsidies and nutritional interventions has resulted in ineffective programmes. Sustainable nutritional interventions should be aimed at enhancing food security, dietary quality, and access to safe water and sanitation at the household and community levels as well as at school levels. Some policy recommendations in this regard are discussed below.

A successful fight against hunger must involve a community-centred approach to malnutrition. To promote long term changes, the individual causes of malnutrition within the community (especially among the poor in the estate sector and in rural areas) must be recognized and removed. It is important to identify food shortages, inadequate feeding practices, and diversities in diet that exist. A community approach to nutrition demands that the community answers these questions with the help of trained individuals, and develops long term solutions to their malnutrition problems.

A safe living environment needs to be encouraged by providing basic facilities, including safe drinking water, sanitary facilities, drainage, and waste management. To provide safe drinking water and proper sanitation, the most appropriate type of water sup-

[14] http://one.wfp.org/english/?ModuleID=137&Key=711 (Accessed on 07/04/2009).

[15] Arunatilake, N. *et al*. (forthcoming), "Catch-up Education in Sri Lanka", IPS: Colombo.

ply and sanitation technology should be chosen. Some identified needs include:

- Pipe borne water to be provided to urban and rapidly expanding areas.
- Safe drinking water and sanitation to estate and rural districts to be provided through community based water and sanitation systems.
- Proper drainage and waste management systems to be provided in urban areas.

In many other countries, linking health programme delivery into the school system through a multi-sectoral approach (education, health and nutrition) has proven to be cost effective. Some options for school health programmes include:

- Target areas identified as being food insecure, with poor school attendance and/or with identified malnutrition problems in school aged children.
- Provision of safe water and sanitation in schools - latrine/toilet, hand washing and drinking water facilities.
- Develop community participation in school feeding programmes to assure their sustainability and possible influence on home feeding.
- Supplement the school feeding programme with nutritional and health education, micronutrient enhancement, and de-worming.

11. Impact of the Global Economic Crisis on Migration and Remittances

11.1 Background

According to the *World Migration Report 2008* published by the International Organization for Migration (IOM),[1] human mobility makes economies more dynamic and more efficient. It argues further that migration has positive features in alleviating various developmental implications of economic downturns, and in particular, an ability to cushion some of the adverse shocks of economic crises. Despite such observations, many destination countries have imposed restrictive laws on migrant labour in response to depressed economic conditions in their own countries. Such developments can arguably result in economic and social instability in poorer countries that depend on remittances. This policy brief will look at possible implications of the global economic crisis on migration and remittances. More specifically, it will look at global shifts in migration, rising unemployment among migrants, the impact on migrant remittances, and the implications of a possible rise in returning migrants. The discussion will attempt to draw relevant lessons and policy implications for Sri Lanka.

11.2 Role of Migration and Remittances in the Sri Lankan Economy

Migration has become an important element in socio-economic life of many developing countries, including Sri Lanka. The Sri Lanka Bureau of Foreign Employment (SLBFE) estimates the current total stock of out migrants from Sri Lanka on employment abroad to be 1.8 million. However, given the dearth of information with regard to those who seek employment through unregistered job agencies or find employment directly, and data on return migrants, the numbers have to be interpreted with some caution. Out-migration for temporary contract work for low skilled jobs by Sri Lankans targeting the Middle Eastern countries began in the mid-1970s. Prior to this, professional and technical personnel migrating to developed countries dominated the foreign employment market. After employment channels to the oil rich Gulf countries emerged, temporary labour migration has been increasing rapidly over the last three decades with an estimated 250,000 persons migrating annually in search of employment.

In 2008, foreign employment placements reported a 15.4 per cent increase against the previous year's growth of about 8.2 per cent. According to the SLBFE, the total number of departures for foreign employment in 2008 was 252,021 compared to 218,459 during 2007. This increase was reflected in all categories of manpower such as housemaids, skilled, unskilled, and professional migrants.

Remittance inflows - the most tangible benefit of migration - contributed US$ 2.9 billion to the Sri Lankan economy in 2008, an increase of 16.6 per cent against the previous year. Despite this healthy growth in 2008, there are concerns that the overall growth in remittances will not be as buoyant in 2009 due to the slowdown in the global economy. Indeed, private remittance inflows decreased by 1.7 per cent to US$

[1] IOM (2008), "World Migration 2008: Managing Labour Mobility in the Evolving Global Economy", Volume 4, IOM World Migration Report Series.

774 million during January-March 2009 as compared to the corresponding period of 2008. However, by May 2009, the cumulative inflow of private remittances had increased by 2.9 per cent to US$ 1,308 million during the first five months of the year.[2]

The impact of the global downturn on remittance flows is of concern given its important role in the Sri Lankan economy. Inflows accounted for 35.6 per cent of total export earnings and were sufficient to finance over 75 per cent of Sri Lanka's trade deficit in 2008. The remittance contribution from the Middle East constituted 57 per cent of the total inflows to the country.[3] In the recent past, remittances have played a multi-dimensional role in the Sri Lankan economy. Accounting for nearly 7 per cent of GDP, remittances have not only helped to support the country's savings and investment rates, but they have also been an important source of income to migrant households. It is in this backdrop that the rest of the discussion focuses on the impact of the current global economic crisis on migrant workers and remittance flows in the medium term.

Table 11.1
Outlook for Remittance Flows to Developing Countries (2009-10)

		Base Case Forecast			Low Case Forecast		
	2008e	2009f	2010f	2011f	2009f	2010f	2011f
US$ billion							
Developing countries	305	290	299	317	280	280	289
(as share of GDP, %)	(1.9)	(1.8)	(1.7)	(1.6)	(1.8)	(1.6)	(1.4)
East Asia and Pacific	70	67	68	72	64	64	65
Europe and Central Asia	53	48	50	53	46	47	50
Latin America and Caribbean	63	60	62	65	58	58	59
Middle-East and North Africa	34	33	34	36	32	32	32
South Asia	66	63	65	70	61	62	64
Sub-Saharan Africa	20	19	20	21	18	18	19
Low-income countries	45	43	45	48	41	42	44
Middle-income countries	260	247	254	269	239	238	245
Growth rate (%)							
Developing countries	8.8	- 5.0	2.9	6.3	- 8.2	- 0.2	3.2
East Asia and Pacific	6.6	- 4.2	1.9	5.6	- 7.5	- 1.3	2.1
Europe and Central Asia	5.4	-10.1	4.2	7.5	-12.7	-1.6	5.1
Latin America and Caribbean	0.2	- 4.4	2.3	5.6	- 7.7	- 1.0	2.5
Middle-East and North Africa	7.6	- 1.4	2.9	5.6	- 5.2	- 0.9	2.1
South Asia	26.7	- 4.2	3.4	6.8	- 7.3	0.5	4.2
Sub-Saharan Africa	6.3	- 4.4	3.5	6.7	- 7.9	0.0	3.5
Low-income countries	13.0	-5.4	4.4	7.5	- 8.2	1.6	4.9
Middle-income countries	8.1	- 4.9	2.7	6.0	- 8.1	- 0.5	2.9

Notes: e = estimate; f = forecast.
Source: World Bank (2009), Migration and Development Brief 09.

[2] Central Bank of Sri Lanka, "External Sector Performance - May 2009", Press Release.

[3] The Middle Eastern region continued to dominate the foreign employment market with over 90 per cent of the total migrants from Sri Lanka being concentrated in the region, with a majority consisting of housemaids.

11.3 Impact of the Crisis on Remittances

Alongside the many revised forecasts for the global economy in 2009, remittance flows to developing countries are expected to show a sharper decline of 5-8 per cent in 2009 (Table 11.1). Having witnessed a buoyant growth in remittance flows globally - recording double digit annual growth in the past few years - the expected downturn in 2009 will have many social and economic implications for poorer countries.

The downturn in economic activity across the world will impact migrant labour through different channels. The impact will also differ depending on the skills profile of the migrant. For instance, the sharp drop in demand for exports being experienced by many advanced and emerging economies - and related inflows of foreign direct investment (FDI) - is one obvious channel. Most of these industrial centres and commercial production sites tend to employ more migrant labour. These trends can create significant shifts in the structure of the global labour market, in turn affecting labour exporting countries like Sri Lanka.

As unemployment in advanced economies rises, there will be a decline in the demand for migrant labour from many countries. Recent trends suggest that many low and semi-skilled workers who already reside in advanced economies are at risk of losing their jobs, while new entrants may be unable to secure employment. Thus, advanced economies can be expected to reduce the numbers of migrant workers permitted to seek work in their countries. In the UK, for instance, immigration from Poland for workers seeking summer employment in 2008 was at its lowest level since 2004, down by 36 per cent from 2007.[4]

Developing countries are also being affected by the global economic crisis. Many are experiencing a decline in demand for their exports, while all forms of capital flows are also expected to be constrained. Declines in FDI, official development assistance (ODA) and a possible downturn in private transfers are some of the key features. For many of these countries, the impacts are more significant on internal migrant patterns. For instance, as China's export sector has been hit hard, with an estimated 10 million workers losing their jobs in the final months of 2008, there are rising implications for its internal migrant population. Export processing zones in India have also been affected by the significant drop in demand for their products where large job losses were experienced.[5]

Inevitably, as employment opportunities for migrant workers shrink, they and their dependents will be called on to bear the adverse impacts. A study conducted by the Pew Hispanic Center in the US,[6] for instance, has found that 70 per cent of migrants surveyed had sent less money home in 2008 compared to 2007 - a trend which could have significant consequences for families back home who are dependent on these funds.

As seen from Table 11.2, many governments - in both developed and developing economies - have adopted more restrictive immigration policies in order to protect the local labour market and to reduce the intake of foreign labour. It could be envisaged that the numbers with regard to regular migration

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[4] Development Research Centre on Migration, "Globalization and Poverty", Briefing, February 2009.

[5] IOM (2009), "The Impact of the Global Economic Crisis on Migrants and Migration" IOM Policy Brief, March 2009.

[6] Lopez, M.H., G. Livingston and R. Kochhar (2009), "Hispanics and the Economic Downturn: Housing Woes and Remittance Cuts", Pew Hispanic Center Report, January 2009. Available online: http://pewhispanic.org/files/reports/100.pdf.

Table 11.2
Rising Immigration Controls Worldwide

Country	Immigration Control during 2008/09
UK	• Has introduced a point-based system that favours high-skilled migrants over unskilled migrants
	• It has most recently raised the minimum educational and financial qualifications for high-skilled migrants
Australia	• Will reduce the intake of skilled migrants by 14 per cent
US	• A provision of the stimulus package makes it more difficult for beneficiary firms to hire high-skilled foreign workers
Spain	• Has introduced a "voluntary return" programme for migrants
Italy	• Plans to introduce tougher requirements for residency permits, requiring doctors to report undocumented patients and authorizing citizens' patrols to pick up illegal immigrants
Malaysia	• Has instituted a freeze on the issue of work permits to foreign workers in the manufacturing and services sectors (attempting to restrict the entry of new and returning workers)
	• Cancelled work visas for 55,000 Bangladeshi workers in early March 2009
Russia	• Announced in December 2008 that it would reduce work permits by half in 2009 from 4 million to 2 million
Thailand	• Announced that it would not issue new work permits or renew the work permits of about half a million foreign workers
	• The planned 2009 registration of irregular migrants in Thailand has been postponed
Kazakhstan	• Has imposed a moratorium on the admission of less-skilled workers from April 2009

Source: Compiled using World Bank (2009), Migration and Development Brief 09.

flows have also declined as potential migrants choose to stay back in the home country, adopting a 'wait-and-see' approach to the evolving situation.

11.4 Impact on Sri Lanka

As previously mentioned, Sri Lanka has significant numbers of its labour force engaged in temporary employment abroad. The Sri Lankan economy too has been shedding some jobs in sectors such as garments as the impact of the global economic downturn is felt in key export industries. However, the depth and scope of the effect on remittances and migration is yet to be seen in full. The growth of remittance flows has slowed in the period January-May 2009 to 2.9 per cent as noted earlier, against a robust growth in the last few years. The immediate implications of a slowdown in remittance flows will be on the balance of payments (BOP) at the macro level, on household income at the micro level, etc. However, another worrying feature that could emerge is that of returning migrants, adding to the stresses on employment generation.

Evidence of past economic downturns show that migrant workers are often the most vulnerable category of workers, in terms of job losses and treatment in the host country. This is mainly due to the common perception that the presence of migrant workers tend to reduce employment opportunities for the

locals. However, migration has also to be viewed as contributing to productive economic activity in the host countries, particularly when efforts are under way to stimulate an economic recovery.

The bulk of Sri Lanka's migrant workers - comprising of housemaids that account for 47 per cent of Sri Lanka's temporary workers - is less likely to be immediately affected by the global economic downturn. This is particularly so due to the type of occupation where locals are reluctant to engage in similar work. Such jobs are not taken up by many locals for both social and economic reasons. In addition, the housemaid category tends to remit about 85 per cent of their income to his/her dependents back at home.[7] To some extent, this will also safeguard the volume of remittances that Sri Lanka receives in any given year.

The unskilled category of workers - comprising 24 per cent of total migrants from Sri Lanka - is the most vulnerable to suffer job losses in the near term. There have been reports that migrants in Dubai, for instance, are being affected due to the slowdown in the construction and services sectors. Unskilled migrant workers engaged in the construction industry, therefore, may see job lay-offs which can also impact some proportion of workers from Sri Lanka in this area of activity.

However, the situation in Dubai, for instance, cannot be generalized to all migrant workers in the Middle East. Dubai is more dependent on trade and financial services, and real estate than many of the other Gulf countries which depend primarily on oil revenues. The recent decline in oil prices may also not have a major impact on remittance flows. There is evidence to suggest that in recent years, remittance outflows from Saudi Arabia, for example, have been uncorrelated with oil prices.[8] Many Gulf Cooperation Council (GCC) countries (especially Saudi Arabia) are following longer term strategies for infrastructure development for which funding has been planned on a long term basis. Therefore, it is unlikely that migrant workers engaged in these sectors will lose jobs on a large scale as there may not be a significant drop in the level of investment for existing projects. In addition, in certain labour market sectors in destination countries, there is likely to be a continued need for migrant workers. Recent studies suggest that in certain sectors - such as health care, household/domestic employment, and care work (as well as in certain agricultural work) - where demand for workers is structural, loss of employment opportunities will be minimal.[9]

In terms of skilled and professional migrant workers, the impact of the global economic downturn on Sri Lanka will be muted. Although most developed countries have imposed restrictive migrant policies that are mainly applicable to professional categories of migrant workers, such developments will likely hold only minimum implications for Sri Lanka. Sri Lanka's professional category of migrants makes up only about 1 per cent of total migrants from the country. Of course, new entrants to this category can drop significantly in 2009 due to host country restrictions.

Overall, Sri Lanka's migrant population is unlikely to be significantly affected in terms of loss of employment. However, there is

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[7] De Silva, A., W.D.Lakshman and N.D. Samarawickrama (1995), "Employment and Investment Opportunities for Women Migrants in Sri Lanka", (ILO-ARTEP).

[8] Ratha, D. and S. Mohapatra (2009), "Revised Outlook for Remittance Flows 2009-2001: Remittances Expected to Fall by 5-8 per cent in 2009", Migration and Development Brief, No. 09, World Bank.

[9] IOM (2009), "The Impact of Global Economic Crisis on Migrants and Migration", IOM Policy Brief, March 2009.

also emerging evidence of reduction in wages or non-payment of wages, reduction in the number of working days, and limited opportunities for overtime work, poor work conditions, etc. in some destination countries. Typically, migrants have weak bargaining powers, especially irregular and temporary contractual workers. According to the International Organization for Migration (IOM), some countries have implemented policies to speed up the deportation of irregular migrants. The common tendency of migrants that lose jobs is to seek opportunities in the informal economy, thus increasing the stock of irregular migrant workers. Such developments pose risks to the well-being of Sri Lanka's migrant population as well, and needs to be watched carefully.

In anticipation of a possible reduction in remittance flows, Sri Lanka launched a programme to attract inflows via "Diaspora" bonds. In February 2009, Sri Lanka announced an initiative to sell US$ 500 million of government securities to the Sri Lankan diaspora community with road shows and promotional campaigns in 11 countries.[10] Although the government was optimistic of raising the targeted amount, the expectations were not met. The economic slowdown in developed countries, currency risks etc., may have acted as deterrents. Moreover, the financial ability of the Sri Lankan diaspora community to subscribe large sums is also questionable. The bulk of the migrant community are housemaids and low skilled workers as previously mentioned.

In addition to the above measures, in June 2009, the government also decided to pay a 20 per cent bonus interest on Resident Foreign Currency (RFC) and Non Resident Foreign Currency (NRFC) accounts. A supplementary estimate of Rs. 1.5 billion was approved by the Parliament to meet the expenditure for the payment of this bonus interest. The CBSL has further proposed to pay a 50-100 per cent premium for those who invest funds in the newly introduced Economic Resurgence Certificates which also targets Sri Lankans living abroad.[11]

11.5 Conclusion

Despite the emerging evidence that there will be a sharp decline in global remittance flows, Sri Lanka appears not be at significant risk of experiencing a sharp downturn in inflows in the near term. The bulk of migrant workers from Sri Lanka are in the GCC region, engaged in low skilled jobs and as housemaids. This category of workers typically tends to save less in the host country which ensures that a high proportion of their income is remitted back home to support their dependents. This scenario can be expected to continue in the current environment of an economic slowdown, as most migrant workers are supporting the basic needs of their dependents back home. In addition, it has to be noted that remittances are sent by accumulated flows of migrants over the years, and not only by new migrants of the last year or so. This can make remittances more stable over time.

Sri Lanka may also not face the additional stress of significant numbers of returning migrants due to job lay-offs. Job losses to date are seen mainly in employment sectors that are more sensitive to economic cycles such as private construction work, manufacturing, financial services, retail and trade/ tourism related services, and thus affecting migrants in these particular sectors. The numbers of Sri Lankan migrants in these sectors are not particularly significant.

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[10] "Sri Lanka Targets US$ 500 from Diaspora: CB Governor", Lanka Business Online, 2 February 2009, available at http://www.lankabusinessonline.com/fullstory.php?nid=435672348.

[11] "Sri Lanka to Pay Bonus for NRFC and RFC", Colombo Page, Wed, Jun 24, 2009. Available at http://www.colombopage.com/archive_091/Jun1245849648RA.html.

12. Global Financial Crisis and Microfinance in Sri Lanka

12.1 Introduction

During the currency crises in East Asia and the banking crises in Latin America in the 1990s, institutions serving poor customers generally performed better financially than mainstream banks.[1] However, the current global financial crisis is more complex, deeper, and difficult to predict, particularly since it has since evolved into a global economic recession. What is clear, however, is that the current economic turmoil will have a number of potential implications for financial service providers across many countries. One such potential sector is microfinance institutions (MFIs). As in the case of other financial services providers, MFIs will also face the challenges of a fall in capital availability as a direct consequence of the global financial turmoil. In addition, it can have a significant impact on microfinance clients' spending habits which change the savings and debt profiles of MFIs. MicroRate,[2] for instance, expects that microfinance will be more affected by economic cycles than it has been in the past.[3] This is due to two main reasons; MFIs are more strongly integrated into financial sectors compared to the past, and secondly, the definition of 'microcredit' has taken many forms of loan schemes than before.

Although it is still too early to fully evaluate the effects of the global financial crisis on the microfinance sector in Sri Lanka, potential channels of impact need to be kept in mind. The MFIs serve a particularly vulnerable segment of the population - the poor and informal sector workers - that stand more exposed to the downside risks of economic and financial instability. In examining the channels of exposure, it must also be noted, however, that Sri Lanka's financial system stability is under stress at present due largely to domestic policy imperatives. There has hardly been any contagion effect from the global financial crisis, although the country will be impacted by the world economic recession as explained in previous chapters.

The discussion will set out an initial exploration of issues related to the linkages between the economic downturn and implications for the microfinance sector. It will also attempt to provide some tentative recommendations for MFIs to deal with the current adverse environment, based on information derived from a sample of eight selected MFIs in Sri Lanka.

12.2 Impact of a Financial Crisis on MFIs

MFIs in Sri Lanka can be categorized into three broad groups. They are formal institutions, semi-formal institutions, and informal institutions. State owned banks, private commercial banks, and development banks are included in the formal group. The semi-formal group consists of non-governmental organizations (NGOs), community based organizations (CBOs), cooperative societies,

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[1] Littlefield, E. and C. Kneiding (2009). 'The Global Financial Crisis and Its Impact on Microfinance', Focus Note, 52, CGAP.

[2] It is the rating agency for microfinance which provides microfinance information services.

[3] MicroRate, (2009), "The Impact of the Global Financial Crisis on Latin American and Caribbean Microfinance Institutions", MicroRate, Inc. Arlington.

and banking societies. Rotating Savings and Credit Associations (ROSCAS) and money lenders are included in the third microfinance group. Nevertheless, MFIs are defined to include only the institutional sources, i.e., formal and semi-formal institutions providing microfinance services as the major (or an important) part of their business.[4]

The regulation of MFIs is important as it ensures their financial soundness and helps to build the confidence of donors, funders, members, and depositors. The regulation and supervision structure of MFIs in Sri Lanka is complicated. For example, the regulatory structure with regard to the non-bank MFIs is different from the regulatory framework of government sponsored MFIs and banks that provide microfinance. NGOs are not permitted to accept savings, while cooperative societies are permitted to mobilize savings and to lend only to members. All the banks which are dealing with microfinance activities are supervised by the Central Bank of Sri Lanka (CBSL).[4]

As most of the empirical evidence suggests, MFIs in developing countries remain stable during a financial crisis because microfinance focuses on micro-entrepreneurs. Most of these microfinance clients are living in relatively less affected environments where there is less of an impact arising from international trade, capital flows, and exchange rate exposure. Moreover, mainstream financial institutions are likely to follow rigid credit rules during a crisis which pre-empts the poor from borrowing from these commercial institutions, and MFIs will, therefore, continue to be more attractive. However, due to the likelihood of high inflation during a financial crisis - prompting people to allocate more on consumption and less on savings - clients may be unable to repay their loans on time. This phenomenon can directly affect the portfolio quality of MFIs. Therefore, the impacts of a global financial crisis can be broadly divided into four groups: availability of resources, outreach and loan portfolio, operations and sustainability, and interest rates.

12.2.1 Availability of Resources

Microfinance Investment Vehicles (MIVs) - comprising of two main players, international financial institutions (IFIs) and private investment funds - are the most recent source of funds for MFIs. Thus, the global financial/economic crisis can directly impact on the microfinance sector through a slowdown in portfolio growth. MFIs will be affected by the sharply curtailed funding from domestic and international lenders, investors, and depositors. Therefore, money will become scarcer, and refinancing risk is likely to become a serious concern for some institutions.

It is important to look at the main sources of funds of selected MFIs in Sri Lanka before analyzing the extent to which the availability of resources has been affected by the current financial crisis. Table 12.1 shows the income source of selected MFIs.

As can be seen from Table 12.1, almost all the selected MFIs are partially dependent on donor funds, where most of such donor funds are foreign funds. Therefore, the global financial crisis has an effect on the availability of resources for MFIs. Every institution expressed the opinion that donor funding is becoming more limited, or that they are conditional. As a result, the cost of funding has been increasing during the financial crisis.

[4] A Draft MFI Act was prepared in 2005, but is yet to be approved. Microfinance business is defined by this Act as "acceptance of deposits or receiving and/or obtaining external funds and providing financial accommodation in any form and other financial services, particularly to low income persons and to small and micro-enterprises". The MFI Act will prevent carrying out microfinance activities without a licence. The minimum capital requirement for operating at a national level is Rs. 50 million. Responsibility of supervision of licensed MFIs is assigned to the Department of Supervision of Non-Bank Financial Institutions of the CBSL.

Table 12.1
Income Sources of Selected MFIs

MFI	Sources of Funds	Change during 2007-08
Agro Microfinance	Portfolio interest and donor funds	Decreased
Arthancharya Foundation	Portfolio interest, credits and grants	Decreased
Hatton National Bank	Portfolio interest and donor funds	Cost of funding has increased
Samurdhi	Portfolio interest and government funds	Decreased
Sanasa Development Bank	Portfolio interest and donor funds	No change
SEEDS	Portfolio interest, donor funds, Business Development Services (BDS) earnings, capacity building development earning, investments such as treasury bills and bonds.	Limited
Sewa Finance	Portfolio interest and donor funds	Decreased. Donors ask for 20 per cent of money in the bank as a guarantee which was necessary at the initial stage.
Women's Bank	Portfolio interest and no donor funds	Decreased

Source: Based on primary information.

Savings are increasingly becoming a more attractive funding source as capital markets tighten. However, it is not always a feasible or better option due to two reasons. The first is due to changes in savings habits - i.e., lack of savings and high withdrawals. These changes are again due to two main reasons. The first is that fewer savings are raised on account of higher cost of living and uncertainty in the midst of an economic downturn. The second reason is due to Sri Lanka's domestic financial situation. For example, there have been many recent financial scams (e.g., 'Danduwam finance,' 'Sakvithi finance', Golden Key, etc.) that have drained some amount of confidence in the financial system. These scams are also likely to discourage the poor from saving at MFIs. Not unexpectedly, most of the selected MFIs have experienced a decrease in savings during the current downturn. In addition, some of the MFIs operating in Sri Lanka are not permitted to mobilize savings deposits as mentioned previously.

Thus, capital flows that were flowing into the MFIs have begun to shrink in the current financial and economic climate. The reduction in available resources currently being experienced by MFIs in Sri Lanka can be argued to be a result of the combined impacts of both global and domestic financial sector developments, and holds implications for the microfinance sector.

In particular, limited and more expensive funds have an adverse effect on the expansion targets of MFIs, meeting clients' demands, and covering operational costs.[5] Expansion or growth of the microfinance

[5] A few MFIs also show large increases in commercial borrowing which leads to higher lending rates at MFIs.

sector is set by demand and institutional capacity. Demand for microfinance services in Sri Lanka remains high. This is in part due to the fact that mainstream financial institutions are credit constrained and are charging high interest rates which are not affordable for poor micro entrepreneurs. Many microfinance providers further contend that clients continue to turn to MFIs as many are affiliated to reputed CBOs. For example, SEEDS is affiliated to the 'Sarvodaya Movement' and Sewa Finance is affiliated to 'Sewa Lanka Foundation'. Thus, select institutions are handling microfinance activities while their mother organizations are dealing with other social activities. These social activities provided by their mother organizations are able to tie their members to MFIs.

Some of the MFIs are already beginning to indicate signs of their inability to meet client demand with a shrinking portfolio. Most of the MFIs which are at initial stages of development do not have loan reserves. The inability to meet demand has created some frustration in the microfinance sector. The management of MFIs interviewed identified the inability to meet demand as a black mark against their reputation amongst clients. In fact, one of the newly established MFIs, for instance, is finding it difficult to even cover its maintenance costs. While cost cutting strategies such as moving to smaller premises are being followed up, the survey of MFIs in Sri Lanka suggests that most of the institutions are trying to increase their savings as a preferred option.

12.2.2 Outreach and Loan Portfolio

According to the management of select MFIs in Sri Lanka, continued high demand for microfinance services despite the current economic downturn is an important feature. Strong demand is one of the determining factors of the growth of the microfinance sector in a country, as mentioned previously. The expansion targets of MFIs and their revenues are likely to be adversely affected by the glo-

Table 12.2
Expansion of Operational Areas by MFIs (2007-08)

MFI	New Operational Areas	Problems Faced during the Expansion
Agro Microfinance	New branches were opened within existing districts	None
Arthancharya Foundation	Expansion of operations to Puttlam district	Lack of funds
Hatton National Bank	Two new branches	None
Samurdhi	By 2006, Samurdhi Banks were well established in each village in the country with no necessity of further expansion.	None
Sanasa Development Bank	16 new Development Centres in Northern and Eastern Provinces	None
SEEDS	38 sub-branches (after March 2008)	Lack of capacity of existing staff
Sewa Finance	Plans to open branches in another three districts: Kurunegala, Anuradhapura and Ampara.	Not enough capital
Women's Bank	One branch in Matale was opened in 2008.	Competition from other MFIs

Source: Based on primary information.

bal financial crisis and the domestic financial situation. The expansion targets are twofold: expansion of the operational areas, and expansion of the products. Table 12.2 shows the new areas where MFIs expanded their operations during 2007-08.

It would appear that the expansion targets of most of the selected, well established MFIs in Sri Lanka are unaffected. They do not appear to have faced any problem during the expansion process. However, newly established MFIs in Sri Lanka have faced financial difficulties during expansion over the last two years. For example, Sewa Finance - one of the newly established MFIs - had planned to expand their operations into three other districts - namely, Kurunegala, Anuradhapura and Ampara. According to the management of Sewa Finance, they have not been able to achieve this target due to the lack of funds.

The second expansion target is the introduction or development of new microfinance products into the market. In the case of the Sri Lankan microfinance sector, the financial stress and economic downturn does not appear to hold major adverse impacts on the expansion of microfinance products. There is also no difference between well established institutions and newer organizations. Table 12.3 shows the new products introduced, and the development of existing products done by selected MFIs during 2007-08.

As can be seen from Table 12.3, almost every selected MFI has introduced at least one new microfinance product into the market

Figure 12.3
New Products Introduced by Selected MFIs (2007-08)

MFI	New Products
Agro Microfinance	Three loan products were introduced – Shakthi, Unnathi, and Pragathi – for income generation activities Compulsory loan scheme (2008) Loan Security Fund (2007)
Arthancharya Foundation	No new products
Hatton National Bank	Joined the poverty alleviation microfinance programme funded by the Japan Bank for International Cooperation (JEBIC) conducted by CBSL
Samurdhi	Introduced three loan schemes: cultivation loan scheme, Mihi Jaya loan scheme to start businesses, and a housing loan scheme for Samurdhi beneficiaries Introduced two savings schemes: Diriya Matha women's saving scheme and Sisurata children's savings scheme.
Sanasa Development Bank	Introduced small scale loan scheme for low income earners 'Pilisaru' savings scheme for school children was introduced
SEEDS	New lottery system Investment certificate Children's saving scheme
Sewa Finance	No new products were introduced
Women's Bank	New welfare scheme named 'Subani III' and new insurance scheme named 'Sarani' was introduced.[a]

Notes: a: Sarani is a micro-insurance scheme. The annual premium is Rs. 360 and the scheme was formed to secure children's education after member's death.

Source: Based on primary information.

during the reference period. Therefore, it can be concluded that the global financial crisis and domestic financial sector developments to date have had no effect on service expansion of the microfinance sector in Sri Lanka.

12.2.3 Operations and Sustainability

Due to the higher cost of living experienced in Sri Lanka recently, the ability to save has declined, affecting the ability to repay loans as well. Simultaneously, purchasing power has also declined, whereby micro entrepreneurs find it more difficult to sell their products in the market. As a result, they earn a lesser income which is not sufficient to repay their loans on time. The borrowers - largely the relatively poor - have been finding it difficult to meet loan obligation due to rising costs of borrowing from MFIs, in part related to the high interest rate regime in the domestic financial sector.

Default in loan repayment is the major concern of selected MFIs in Sri Lanka at present. Most of the selected MFIs are facing a problem of lower repayment rates. Those not currently facing such problems are nonetheless anticipating future lower repayment rates. In addition, most of the MFIs facing problems of lower repayment are of the opinion that it is very significant in sectors where clients are dependent on plantation and tourism activities. These are two areas that have been adversely affected by the global economic crisis. However, the MFI arm of the government's poverty alleviation programme (Samurdhi) appears not to be facing a problem of low loan repayment. An effective monitoring system is viewed by the management team as the basis for its relative success.[6] Samurdhi has been successful in maintaining a repayment ratio of more than 95 per cent.[7]

Defaults in loan repayments can lead to many other problems in the microfinance sector such as lower quality of portfolio, an increase in non-performing loans, lower capital stock, and reduction in total assets. Except for the government microfinance programme, almost all the selected MFIs have faced a deterioration in their portfolio quality. There is no difference in respect to whether the institution started recently or has been in operation over a long period. Some of the officers in the selected MFIs declared that their Portfolio-at-Risk (PAR) increased up to 20 per cent, and as a result, they could not receive donor funds. This may be one of the reasons for the reduction in available resources to the MFIs. As a result, some of the selected MFIs have had to turn to commercial borrowing at a higher cost.

12.2.4 Interest Rates

Increased financing costs lead to higher lending rates during a financial crisis. It seems that this phenomenon is common to the Sri Lankan microfinance sector as well. When MFIs seek their funds through commercial borrowing, the cost of finance is higher, which in turn leads to higher lending rates. Both domestic and global developments have had a bearing on interest costs incurred by MFIs. The global financial crisis reduced the volume of foreign funds available to MFIs through MIVs, forcing MFIs to turn to the domestic market. The generally high interest rate regime in Sri Lanka's financial markets - the result of domestic policy scenarios - has

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[6] This is the only microfinance programme in Sri Lanka in which there is a field officer (Samurdhi animators) in each and every village across the country.

[7] People may repay Samurdhi loans, though they do not repay the loans from other institutions as a result of a good monitoring system and being a government programme. On the other hand, the Samurdhi programme has the highest outreach and, therefore, the percentage of members from plantation and tourism sectors may be smaller compared to the other select MFIs which operate within a few districts. As a result, the loan default of members from these two sectors might be a small segment out of the total loan default.

Table 12.4
Changes in Interest Rates on Loans and Savings

MFI	Interest Rate on Loans	Interest Rate on Savings
Agro Microfinance	No change	Savings are not mobilized by this MFI[a]
Arthancharya Foundation	No change	Reduced
Hatton National Bank	Increased	No change
Samurdhi	Reduced	No change
Sanasa Development Bank	Increased	No changes in the normal savings accounts. But interest rate on fixed deposits was increased
SEEDS	Increased	Increased
Sewa Finance	No change	Savings are not mobilized by this MFI
Women's Bank	No change	No change

Note: a: Existing regulations do not permit NGOs to mobilize savings.

Source: Based on primary information.

meant that MFIs have had to pay higher financing costs as a result. Table 12.4 shows the interest rates on loans and savings charged by MFIs during 2007-08.

As can be seen from Table 12.4, the government microfinance programme (Samurdhi) from the selected MFIs appears to be the least affected by the crisis. It has decreased its interest rate for loans, while three other institutions increased their interest rate for their micro credits. However, some of the MFIs have not changed their interest rates for loans during the reference period.

During a financial crisis, people save less as described earlier. The global financial crisis, together with the domestic financial stresses described earlier, has meant lower savings at most of the MFIs in Sri Lanka. In addition, some of the MFIs pointed out that they record higher amounts of savings withdrawals. It is especially valid for MFIs which are based on portfolio interest. Higher interest rates on savings are a motivating factor to encourage savings and, therefore, it is important to motivate people to save more as a stable source of funds. However, despite the generally high interest rate regime that prevailed in Sri Lanka during the reference period, only two institutions have increased their interest rate on savings (Table 12.4). It seems that other institutions have still not taken the necessary steps to encourage people to increase their savings. However, as was seen in the Table 12.3, most of the selected MFIs have introduced new savings schemes as a savings stimulating strategy.

12.3 Strategies Utilized by MFIs to Adapt to the Current Environment

It is difficult to separate out the effects directly related to the global financial crisis from those caused by the food crisis, and domestic financial stresses. Most of the MFIs interviewed do not consider the current downturn in the microfinance sector to be a result of the global financial crisis. However, some of the institutions have taken steps to adapt to the current situation in Sri Lanka. These include savings mobilization, interest rate adjustment, and tightening of collateral policies and monitoring systems. It seems that liquidity risk is one of the major problems that the Sri Lankan MFIs are experiencing as a result of both the global financial crisis and domestic financial sector developments. Savings mobilization may be an al-

ternative to this problem. Therefore, almost all the MFIs which are permitted to mobilize savings have introduced new savings schemes to the market. In addition, some of the MFIs have adjusted their interest rate for savings so that it can attract more savings.

On the other hand, credit risk and default in repayment are major concerns faced by MFIs at present, where collateral is viewed as the means of mitigating risks. Prior to the crisis, most of the MFIs issued loans without physical collateral, or social collateral like group guarantees. Most of the MFIs mentioned that they have since tightened the collateral requirements by way of a personal guarantee of government officers or bank statements. In addition, Sewa Finance is following another strategy to reduce the defaults in loan repayments. The management team of this institution makes field visits to investigate the reasons for lower repayments in an attempt to decrease outstanding loan balances. The Women's Bank is also in the process of computerizing their systems in order to improve the monitoring of borrowers.

12.4 Conclusions and Policy Implications

MFIs operating in a developing country like Sri Lanka are bound to face some impact as a result of the current global financial crisis, although it is still too early to evaluate the full impact on the Sri Lankan microfinance sector. In addition, separating the impacts resulting from the global financial crisis and impacts resulting from domestic financial developments is difficult. For the most part, they are inter-linked.

Nonetheless, according to the experience of select MFIs, there are different types of risks in regard to the microfinance sector in Sri Lanka at present. These are liquidity risk, interest rate risk, reputation risk, credit risk, and guarantee risk.

Liquidity risk is one of the key negative impacts of the global financial crisis on the Sri Lankan microfinance sector. Most of the external funding agencies have trimmed the amounts of funds, and are requesting guarantees. Prior to the onset of the crisis, most of the loans obtained by the MFIs were acquired at subsidized rates of interest. More recently, however, these subsidies have been cut, and most funds increasingly tied to various conditions. One of the major reasons for the decrease in funding is also related to higher Portfolio-at-Risk (PAR), resulting from domestic financial stresses as mentioned earlier.

Some institutions have turned to local commercial loans at higher interest rates. Changes in interest rates can affect the operations of MFIs. Interest rate increases - due largely to domestic financial developments - raise the cost of financing from local lending points or external funds. This high cost is non transmittable to the loans as borrowers are unable to repay loans at high interest rates. However, some MFIs have transferred the higher cost of financing to borrowers. Such developments run the risk of harming the reputation of MFIs, and can lead to a sense of frustration amongst the clients. In addition, due to inadequacy of capital, some MFIs are also unable to fulfill their clients' needs - adding to loss of reputation of the affected MFIs.

The Sri Lankan microfinance sector has also faced the problem of credit risk as a result of recent developments. Delays or non-payment of loan obligations is a significant feature, and is due to two major reasons: the higher cost of loans, and the higher cost of living which leads to lower savings. This is an issue of great concern to MFIs as it leads to the risk of portfolio losses. However, compared to the mainstream financial institutions, credit risk might be lower for MFIs as loan amounts tend to be smaller. Lack of collat-

eral may undermine the willingness to repay loans. Most MFIs, therefore, have decided to tighten collateral requirements. However, in this regard as well, MFIs are better off compared to the mainstream financial institutions as most of the collateral required by mainstream financial institutions are based on listed securities or real estate that tend to lose value during economic downturns.

Capital inadequacy is one of the most important adverse impacts of the global financial crisis experienced by the Sri Lankan microfinance sector. The results of the negative impact can be masked by diversification of funding sources of MFIs. Donor diversification is important among funding source diversification strategies. MFIs should explore more funding agencies rather than depending on a few agencies. In addition, MFIs can minimize dependence on foreign funds and increase more local money through local funding agencies and savings promotions. Savings promotions can be done by offering attractive interest rates and by the introduction of new savings schemes. Locally raised funds will also mitigate currency risk. In addition, MFIs can maintain revolving funds.[8] For example, Etimos Lanka Private Limited has provided loans to Arthacharya Foundation, whereby the latter is able to maintain a revolving fund using that money. Such arrangements can assist in overcoming tighter government rules during a crisis that may lead to a shrinking of external funds for MFIs.

Credit risk is another potential adverse impact of the global financial crisis on Sri Lanka's microfinance sector. This impact can be reduced with a transparent monitoring system. In addition, loan risk funds might be a partial solution to mitigate lower repayment rates. A loan risk fund is a form of credit insurance. An insurance premium can be deducted from the loan at the time the loan is issued, and it can be deposited in a loan risk fund. During a crisis, MFIs should decrease loan sizes. Small sized loans might reduce credit risk. Monthly or weekly instalments are lower and, therefore, borrowers are in a better position to repay the smaller amounts. On the other hand, risk to the MFIs is also less as the amounts are small and can be covered partially through a loan risk fund. In addition, institutions can also consider tightening up the collateral conditions for loans so that clients are motivated to repay their loans and discharge the collateral.

Microfinance clients should be motivated to diversify their income sources. Income diversification will help them to cope better during a financial crisis, and they can aim to earn sufficient money to repay loan instalments. In addition, they can also save some amount of money from diversified income sources. On the other hand, clients should be informed about potential changes to consumption patterns during recessionary conditions. Savings withdrawals due to misconceptions can be reduced if clients are better informed.

Domestic financial sector stresses can create mistrust of MFIs as well. Government intervention may be necessary in this context. Regulation and supervision of MFIs by the government or a relevant authority is important. Such regulation will help to build confidence between MFIs and their client base. In addition, during times of crisis, governments may need to consider subsidizing the most severely affected entrepreneurs and income generating activities so that poor clients can continue their microfinance activities unhindered.

[8] A revolving fund is a fund whose income remains available to finance its continuing cycle of operations. This can be established for a specific purpose such as making loans, with the stipulation that repayments to the fund may be used anew for the same purpose.

13. Impact of the Global Economic Crisis on Sri Lanka's Fishery Industry

13.1 Introduction

The fishery sector plays an important role in the Sri Lankan economy in terms of providing employment for many people, ensuring food security, and earning foreign exchange through exports. The sector is a direct source of livelihood for about 150,000 fishermen, and provides indirect employment for another 100,000 persons.[1] Its contribution to food security is also valuable as 60-70 per cent of the country's animal protein requirement is supplied by local fish production.[2] Over the last decade, the sector has emerged as an important source of foreign exchange through the export of fish and fishery products such as fresh, chilled or frozen fish (tuna, sword fish, sear, shark, etc.), crustaceans (shrimp, prawns, lobster, crabs, etc.), sea cucumber, and shark fins. Apart from food fish exports which are dominant, a steady growth in ornamental fish exports is a notable feature due to its high potential for further exploitation. The total fish exports represent around 2 per cent of the country's total exports.[3]

The total national fish production consists of three main sub-sectors, namely: offshore/deep sea fishing (35 per cent), coastal (52 per cent), and inland fisheries (13 per cent).[4] Different sub-sectors employ different methods of fishing, have varying potential, and face diverse challenges. How these sub-sectors face the current global economic crisis will also differ. Apart from differences in each sub-sector, the work force engaged in the fishery sector cannot be differentiated into particular sub-sectors. Resource mobilization in the fishery sector by fishermen is notable. For example, during off seasons, most of the young coastal fishermen work as crew/labourers in multi-day boats which are used for offshore fishing. The Fibreglass Reinforced Plastic (FRP) boats/one-day boats owned by these coastal fishers are hired by small boat owners. Therefore, the direct impact on one sub-sector due to any external factor has indirect implication on other sectors, and on the overall fishery sector.

The following sections examine briefly the context of the three main sub-sectors of the fishery industry, and the impact of the current global economic downturn in terms of changes in fishery exports, credit and insurance facilities, and new investments in each sector. The final section presents some conclusions and suggestions on how best to face critical challenges, and remain as a competitive industry.

13.2 Offshore/Deep Sea Fishing

Offshore/deep sea fishing using multi-day boats which takes place outside the continental shelf and beyond, extending to the edge of the Exclusive Economic Zone (EEZ) has been the fastest growing sector with high potential. Currently, there are about 2,600 registered multi-day boats operating in Sri

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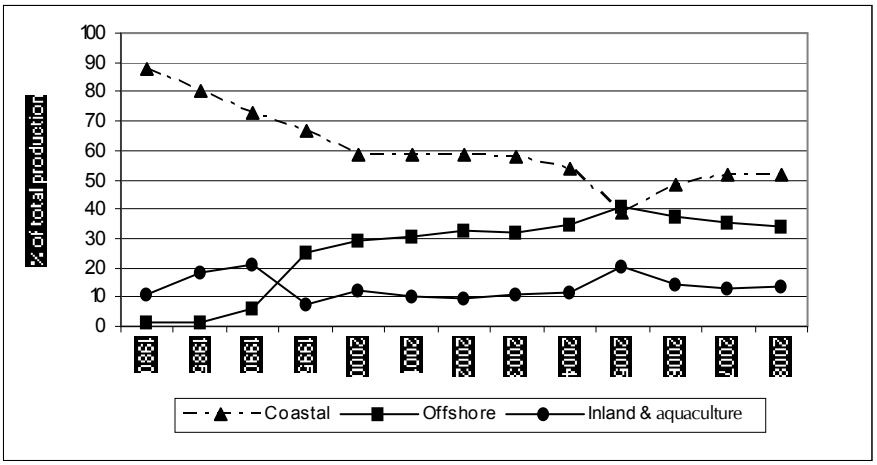
[1] Nevil N. B. (2005), "Trash Fish Production and National Fish Feed Requirement in Sri Lanka", a paper presented at the Regional Workshop on Low Value and Trash Fish in the Asia-Pacific Region, Vietnam.

[2] Department of Census and Statistics, Food Balance Sheet.

[3] MFAR (2007), *Ten Year Development Policy Framework of the Fisheries and Aquatic Resources Sector: 2007-2016*, Ministry of Fisheries and Aquatic Resources.

[4] Figure 13.1 shows the contribution of each sub-sector to the total national fish production since 1990.

Figure 13.1
Fish Production by Sub-sector (1980-2008)[a]



Notes: a. As a percentage of total national fish production.

Source: Ministry of Fisheries and Aquatic Resources.

Lankan waters. Offshore fishing is largely for the export market, with about 25-30 fish exporters currently registered with the Board of Investment (BOI). Most of these companies are Sri Lankan, and one-third of them are either joint ventures or foreign companies. Around one-third of such exporters engage in deep sea fishing, and another one-third engage in processing and exporting prawns.[5] There has been strong demand for tuna fish caught by offshore fishing as many buyers prefer tuna from the Indian ocean due to low levels of heavy metals. Sri Lankan fish exports have benefited from the EU Generalized System of Preferences (GSP-plus) scheme in further expanding trade as a result of free access to European markets.

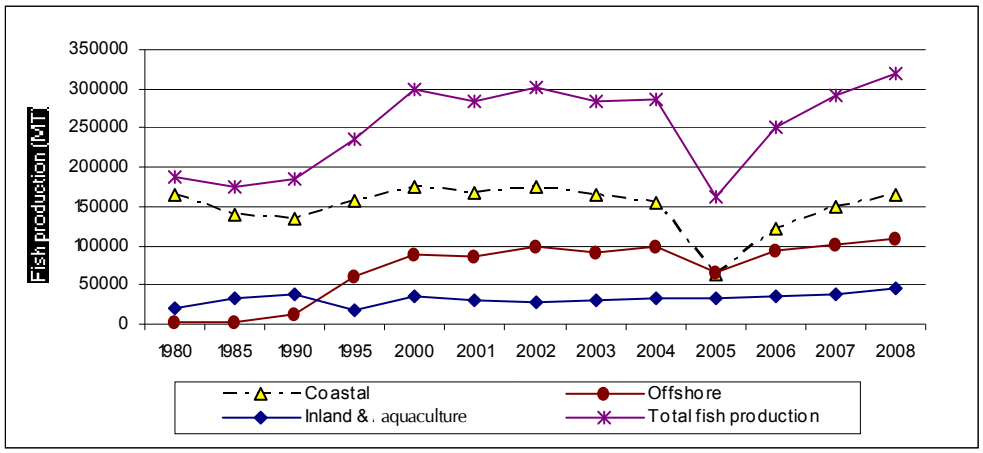
In 2008, the sub-sector's contribution to the total national fish production was 34 per cent (Figure 13.1). Fish production in this sub-sector has been growing since 1990 despite a sharp drop in 2005 due to the December 2004 tsunami and has continued to grow thereafter (Figure 13.2).

There have been various efforts to expand offshore fishing given substantive potential for improvement. Recently, the Ministry of Fisheries and Aquatic Resources (MFAR) provided Rs. 100,000 worth of subsidy for 55 people to buy new boats with advance technology.

Although there is significant potential to improve trade, expanding this sector is somewhat challenging in view of heavy initial investment required, which is not affordable to the average fisher folk. Not only is the capital investment required to buy a multi-day boat very high, but the operating cost (fuel, labour, food, ice, and other costs) of such boats at sea for one or more weeks is also comparatively high. In addition, a majority of existing multi-day boats are not equipped with advanced technology to ensure high quality of fish captured, as well as efficient use of fuel. On-board systems such as navigation, lighting, toiletry, etc., in many multi-day boats are not well developed to facilitate offshore fishing efficiently. Mod-

[5] National Aquatic Resources and Research and Development Agency (NARA), *Fisheries Yearbook 2007*.

Figure 13.2
National Fish Production by Sub-sector (1980-2008)



Source: Ministry of Fisheries and Aquatic Resources.

ernizing the available boats with high technology - for example, fixing cold rooms (onboard cold storage systems instead of bringing tonnes of ice cubes) - needs more investment, while at times improvements are not possible with existing boats.

In the past, it was the case that most of the boats were not insured, although the risk in offshore fishing is very high. In 2007/08, the MFAR made insurance compulsory for multiday boats. Thereafter, most boat owners insured their boats when licensing or at the time of renewing licences. The Sri Lanka Insurance Corporation (SLIC) and another two private companies have been engaged in insuring such boats. However, the situation is such that most of the fishermen are reluctant to pay insurance as they claim that insurance companies are reluctant to pay damages for the insured boats, follow cumbersome procedures that waste time, charge additional costs for boat owners (harbour fees and loss of revenue), and that they demand proof of damage for boats in the deep sea which is sometimes difficult to provide.

13.2.1 Impact of the Economic Downturn on the Offshore Fishery Sector

The impact of the current global economic crisis on the offshore fishery sector is discussed under the following themes: export demand, export related costs, access to credit, new investments, and insurance facilities.

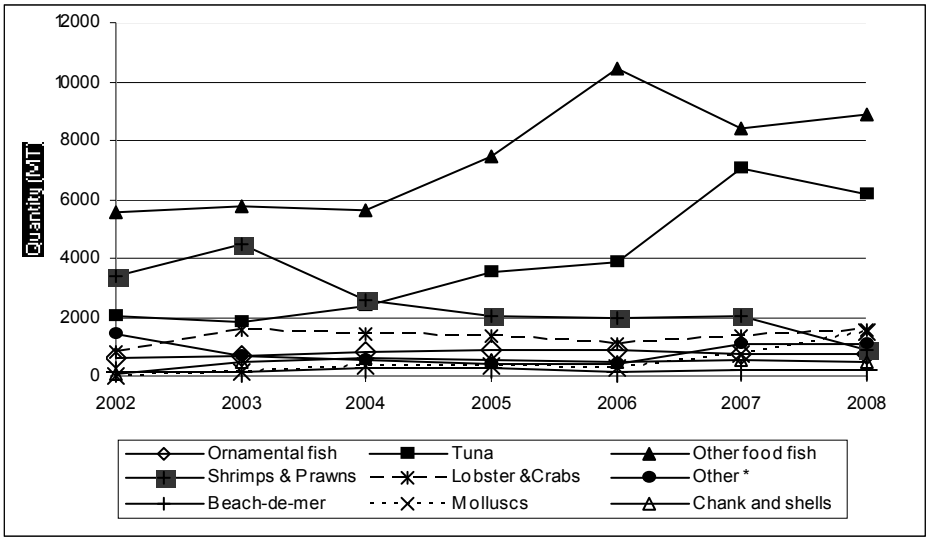
a) Reduction of Export Demand

Sri Lanka's total fish exports have been on the rise over the years. For instance, during the period 2000-07, exports have risen by 10-15 per cent per annum (apart from 2004). However, a slight reduction of 3.7 per cent of the total quantity of exports is observed in 2008 compared to 2007. Nonetheless, it is interesting to note that export earnings in the same period have reduced by only 0.2 per cent (see Figure 13.5).

Despite the reduction of tuna exports, the export performance varies with different types of fish.[6] Tuna exports have been dominant in Sri Lankan fish exports over the last

[6] For example, chank and shell fish exports also reduced in 2008, but earnings have increased by 33 per cent compared to the previous year. It is interesting to note that exports of other food fish have been increasing rapidly. This category includes frozen and fresh fish (herrings, swordfish, pacific salmon, trout, mackerel) excluding livers and roes, fresh or chilled fish fillets and other fish meat. The majority of these items are imported and re-exported to different countries. Crabs and lobsters and molluscs exports have been increasing over the last years and shown positive growth (see Figures 13.3 and 13.5).

Figure 13.3
Quantity of Fish and Fishery Product Exports (2002-08)



Note: a: 'Other' category includes fish maws, canned fish, shark fins, dried fish, Maldive fish, and sprats.

Source: Ministry of Fisheries and Aquatic Resources.

decade. There has been a steady increase of tuna exports from 2003 to 2007, before a decline was experienced in 2008 (Figure 13.3). For instance, tuna exports increased by 82 per cent in 2007, but fell by 13 per cent in 2008, while earnings also fell by 4 per cent (Figure 13.4). The major destinations for tuna exports from Sri Lanka are EU members such as the UK (41 per cent), France (17 per cent), the Netherlands (9 per cent), Italy (9 per cent), and Germany (6 per cent). It is likely that the reduction in fishery exports is due to the reduction of demand by EU countries due to the global economic downturn.

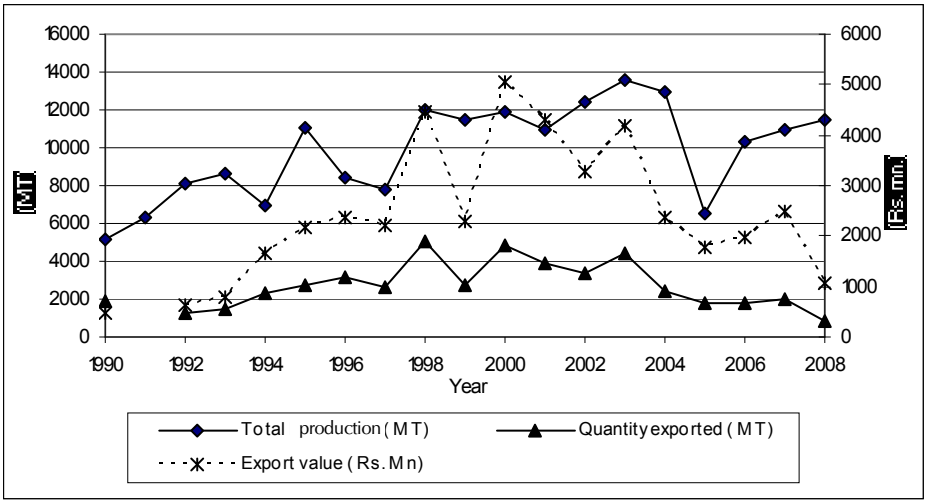
According to the major exporters, competition in the world fish market is increasing, and there has been a slight reduction in prices. This has resulted in exporters receiving lower profit margins. However, most of the big exporters have been able to secure their regular shipments.

b) Access to Credit and Impact on Investment

Inadequate formal credit facilities and use of informal credit is very common in the Sri Lankan fishery sector. Fish exporters and processors make use of formal credit from state and private banks. In addition to the slight reduction of demand for particular exports, many exporters face the problem of delays in payments by foreign buyers. This has resulted in exporters borrowing money from banks to meet their financial needs until payments are realized. Sharp increases in interest rates on credit, and unwillingness of banks to lend more in the current economic environment has resulted in liquidity constraints.

Boat owners and other fishermen also face difficulties in obtaining loans. Even to buy multi-day boats, it is difficult to obtain loans from banks unless the borrower owns a property to mortgage. In addition, no bank credit is provided to cover the operational cost.

Figure 13.4
Prawn Production and Exports (1990-2008)



Source: Ministry of Fisheries and Aquatic Resources.

Most of these financial needs are fulfilled by merchants and businessmen in the fishery sector. Some of them are multi-day boat owners, wholesale fish traders, or commission agents. In addition, some fishery cooperatives are also helping fishermen to buy boats and nets.

Quality improvement and increasing productivity are critical for the fishery sector to remain as a competitive exporting industry. As mentioned above, offshore fishing requires investment in advanced technology in order to get high quality fish and fishery products, reduce wastage, etc. in order to enable a reduction in the overall cost of fishing and be competitive in the export market in the future. The prevailing high interest rates and lack of innovative credit facilities to enhance investment in this sector will have negative impacts in the long term.

c) New Investments

In areas such as Negombo and Chilaw, remittances from foreign employment by locals have been a source of investment for new multi-day boats. Some of the migrants, particularly those in the construction sector, have been adversely affected by the global economic downturn. A decline in remittance flows can have negative implications on new investments in newly advanced multi-day boats.

d) Boat Insurance

Although a majority of multi-day and some one-day boats have already been insured, apart from the SLIC, the other two private insurance companies offering services to the fishery sector have been reluctant to provide such services as they are also facing financial constraints. Even the SLIC finds that the premiums paid by the boat owners are not sufficient to compensate the damage claims.

13.3 Coastal Fishery Sector

The coastal fishery sub-sector has been the major contributor to national fish production. It is still dominant, although its contribution has reduced gradually from 90 per cent in 1980 to 52 per cent in 2008. The fish catch received from coastal fishing goes mainly towards local consumption. It is largely a small scale industry, characterized by multi-species and multi-gear fishing, taking place within the continental shelf with

the use of fishing craft (small canoes, beach seine, traditional motorized, traditional non-motorized, FRP boats, and one-day boats) which are suited for one day or few hours of fishing. The coastal fishery sector has been facing several challenges such as increased competition among fishermen due to an increase in the number of craft, increases in operational costs due to the rise in fuel prices (fuel prices are comparatively lower at present), poor access to credit facilities, inability to fish during the off season, lack of alternative livelihood opportunities, poor access to infrastructure facilities (e.g., lack of anchoring places/harbours), poor supplies of inputs (e.g., ice and fuel), etc.

13.3.1 Impact of the Economic Downturn on the Coastal Fishery Sector

Fish production that comes from coastal fishing goes mainly towards local consumption. Therefore, it is difficult to find direct impacts of the global economic downturn on this sector in terms of reduction in demand. Except in the Northern and Eastern Provinces, coastal fishermen are facing problems with the increase in the number of fishing craft, with hardly any room to expand the sector by increasing fishing effort. Due to the conflict situation that prevailed in many areas of the Northern and Eastern Provinces, coastal fishing was limited, due both to the number of fishermen who were operating as well as owing to security restrictions on fishing times. Efforts to reduce restrictions on fishing time have already been announced. Expanding the coastal fishing industry in these areas can lead to an increase in total fish production. Providing the necessary infrastructure facilities will be critical, including facilities such as harbours, storage, transport, etc.

In addition, there is substantive room for the sector to improve its productivity by improving the quality of fish. Quality improvement has to be achieved by increasing training on fish handling techniques, as well as providing required infrastructure facilities. Although there have been some government investment in infrastructure, further investment in such facilities (storage, ice plants, etc.) is critical to improve productivity. The sector will face negative impacts in the long run if investments by the government have to be reduced due to the economic downturn.

There will be an indirect impact due to reduction of export demand for Sri Lankan fish in terms of reduction of fish prices in the local market, and less availability of work for young fishermen during off seasons.

13.4 Inland Fisheries and Aquaculture

Inland fishery has been identified as a sub-sector with a potential for expansion in view of the availability of inland water bodies in the country. During 1980-1990, its contribution to total fish production had increased from 10 per cent to 20 per cent. However, from 1995 there was a significant drop in inland fisheries production which reversed in 2001 with the sub-sector showing a steady incremental growth. This has largely been in response to several attempts to promote and enhance aquaculture production. In 2008, its contribution to total fish production was 14 per cent (see Figure 13.1).

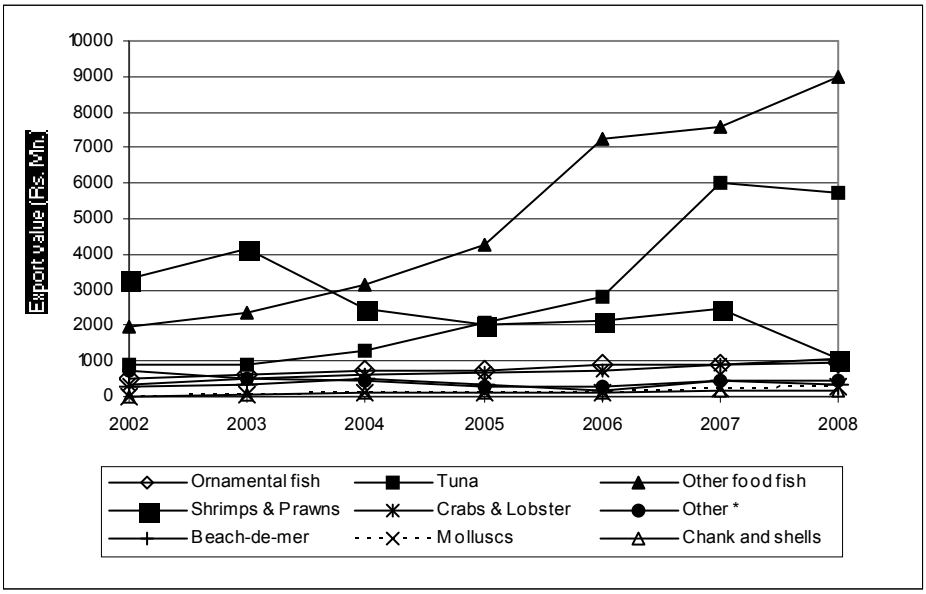
In the late 1990s, fish exports from Sri Lanka were dominated by prawns and shrimps. In 1998, for instance, prawn exports contributed 1.4 per cent of total exports. However, from the late 1990s, prawn production and exports reduced drastically as Sri Lanka experienced several disease outbreaks. Three major disease outbreaks were experienced in 1988-1990, 1996, and 2003. The first outbreak was due to White Spot Disease and resulted in a loss of production of 35-70 per cent of the stocks. In the second outbreak, caused by White Spot Disease and Yellow Head Virus, 85 per cent of the total farm

area became non-functional.[7] The third major outbreak of disease (White Spot) also impacted adversely on the production capacity and export earnings of the industry. In addition to these major disease outbreaks, there have also been frequent localized outbreaks in prawn farms due to bacterial infections.

After the third outbreak of disease in prawn farms, the National Aquaculture Development Authority (NAQDA) instituted measures to regulate prawn farming. The NAQDA with the Ministry of Fisheries of the North Western Provincial Council launched a comprehensive programme to control the situation and to rehabilitate the collapsed industry in 2003.[8] The NAQDA took a further step to introduce a zoning plan and a crop calendar for farmers to reduce the risk of the disease spreading. New prawn farms were not allowed to be set up in the North Western Province. Due to these control measures, the number of farms in operation dropped for 1-2 years. However, from 2006, prawn production has been showing a slow, but steady growth (see Figure 13.4). There have been efforts by NAQDA to introduce new prawn farms in Batticaloa which can also result in further increases in production.

Despite the steady increase in prawn production over the last few years, it is interesting to note that prawn exports are on a de-

Figure 13.5
Export Value of Fish and Fishery Products (2002-08)



Note: a: 'Other' category includes fish maws, canned fish, shark fins, dried fish, Maldive fish, and sprats.

Source: Ministry of Fisheries and Aquatic Resources.

[7] Jayasinghe J.M.P.K. (1998), "Shrimp Culture in Sri Lanka: Key Issues in Sustainability and Research", National Aquatic Resources Research and Development Agency, Sri Lanka.

[8] Among several measures taken to eliminate the further spreading of such diseases, regularizing hatcheries which were producing high quality post larvae, screening existing brooder stock, training prawn farmers to use best management practices, and cleaning of Dutch canal which has been the main source of water for prawn farms were dominant.

clining trend. This is basically due to the preferences by prawn farms to sell their products in the local market to obtain higher profits within a comparatively shorter period of time. Input costs to grow prawns to export standard size are comparatively high. Therefore, prawn farmers find catering to the local market to be a lucrative business where standard prawn sizes are not demanded.

Ornamental fish exports have been growing steadily up to 2007. There has been a slight reduction in export quantity of 1 per cent in 2008. Although the exported amount has reduced, there was an increase in export earnings of 7.3 per cent compared to the export value of 2007. Therefore, there is no significant evidence that the current global downturn has had any impact on ornamental fish exports so far. However, as most of the ornamental fish exporters are small and medium scale, they face problems in terms of access to credit as interest rates climb. This has had a negative impact on the profit margins of these exporters.

13.5 Conclusions and Policy Implications

In recent years, Sri Lanka's fishery industry has been facing several changes as a result of the tsunami impact, post-tsunami fishery livelihood donations (boats and fishing equipment), and changes in fuel prices. Therefore, it is difficult to attribute changes in the fishery industry to effects brought on by the global economic crisis.

However, according to available information, it is clear that a segment of fishery exports (tuna) has been impacted negatively due to the global downturn as a result of reduced export demand by European buyers. According to exporters, competition among exporters in the world market has been increasing as buyers are looking for cheaper markets.

Therefore, fish exporters and processors cum exporters have to make certain efforts to remain competitive in the export market. Among a few measures that can be taken to mitigate downside risks include, reduction of operating costs by optimum use of available resources, reduction of wastage, implementing measures to maintain high quality of fish (backward integration, improved fish handling techniques, packing techniques, etc.), and developing a committed workforce as an essential short term measure. However, reducing costs alone will not be sufficient to maintain long term competitiveness of such industries. Therefore, export companies will need to take a more proactive approach by offering better value for existing customers, finding new buyers for existing markets, and finding new markets or niche markets.

In addition, offshore fishing needs new investment in advanced technologies to remain competitive in export markets, to provide good quality fish, and reduce wastage. However, inadequate innovative credit and insurance facilities carry the threat of low investments that can ultimately result in poor growth and competitiveness of the fish export industry in the long run. Therefore, innovative credit and insurance facilities are vital for the fishery sector to deal with financial barriers that hinder new investments, particularly at a time when the industry is facing a challenging export environment. In addition, the BOI should encourage technology intensive investments through joint ventures to exploit the EEZ to obtain high quality fish. This can ensure the continuous supply of quality products to help Sri Lanka remain competitive in the world market.

14. Economic Crises and Sustainable Resource Management: Community Forestry in Sri Lanka

14.1 Introduction

As the unfolding impacts of the global economic crisis capture the immediate attention of policy makers, other evolving global concerns - such as climate change - are in danger of being sidelined, at least for the time being. However, the impacts of such developments could have more serious and longer lasting consequences for the global economy than the relatively more short-lived economic cycles of busts and booms. A key concern in this regard relates to sustainable management of natural resources. Deforestation - like the heavy consumption of fossil fuels that is primarily responsible for increased green house gas (GHG) emissions - also acts as a factor that accelerates the process of GHG emissions. Moreover, there are numerous forest goods and services that make a positive contribution to the economy and environment. Therefore, reducing deforestation is important to face the threat of climate change, as well as to secure the overall sustainability of economies around the world. In this context, community forestry (CF) is viewed as an alternative strategy to reduce deforestation and support sustainable development.

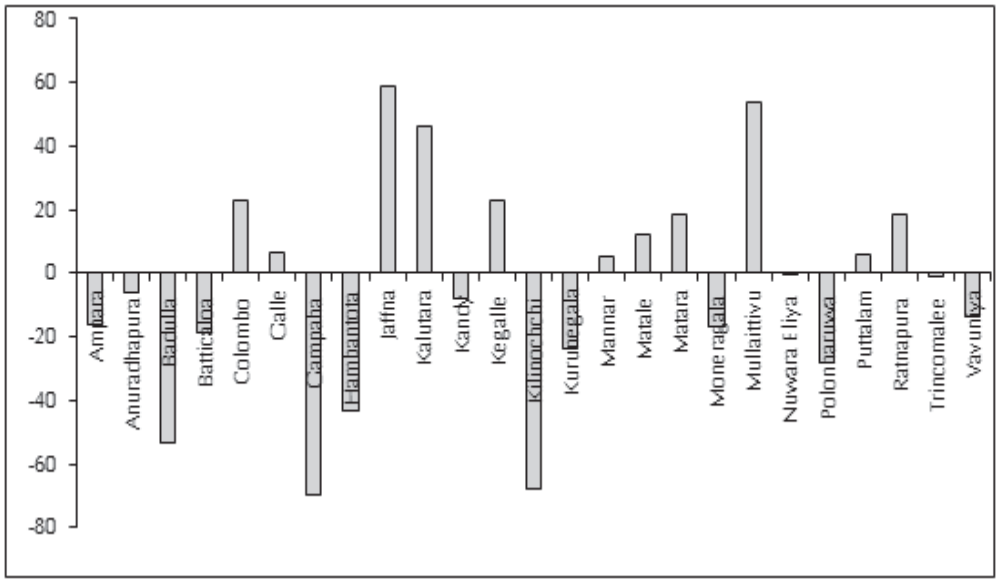
14.2 Issues of Deforestation in Sri Lanka

Although deforestation in Sri Lanka is often viewed as a consequence of locally driven factors, historically, it has had clear associations with the global economy. The issue of deforestation first came up in Sri Lanka in the latter part of the 19th century, due to large scale conversions of virgin wet zone forests for export oriented plantation agriculture. For instance, establishment of tea, rubber, and coconut plantations in the low country wet zone has resulted in significant reduction in natural forest cover. Also, the establishment of cardamom crop in the Knuckles forest has caused severe deforestation and degradation. Secondly, as currently experienced, due to increased population pressure, and consequent issues of land fragmentation, farmers tend to cultivate commercial food crops by clearing the surrounding natural forests in the dry and intermediate zones. For example, rapid expansion of highland commercial agricultural crops has become a main cause for deforestation in the dry zone of the country today.

Figure 14.1 shows the decline of natural forest cover between 1983 and 1992, where a majority of districts located in the dry and intermediate zones recorded a negative change in their forest coverage. Agricultural expansion in the dry zone is primarily driven by the motive of import substitution of locally consumed food crops, and thus has clear implications for deforestation. While the implications of the global economic crisis on natural forests may not be clearly visible at present, it might have indirect implications on natural resources, including forests. The implications primarily come in the form of conversion of forest lands to agriculture, and not through trading of forest products as in the case of many other forest-owning countries.

Due to the fact that a majority of agricultural development and colonization programmes from the mid-20th century were concentrated in dry zone areas, forests in the

Figure 14.1
Percentage Change in Natural Forest Cover by District (1983-1992)



Source: Illustrated using data from Legg, C.,N. Jewell (1995), "A 1:50,000-scale Forest Map for Sri Lanka: The Basis for a National Forest Geographic Information System", *The Sri Lanka Forester*, Vol.10, Nos. 3 & 4.

dry zone have become more fragmented recently. As a result, the management of fragmented and isolated patches of dry zone forest has become a challenge for the forest managing agencies. The Forest Department (FD) with its command and control oriented approach to forest management, seems to be less effective in protecting such isolated patches of dry and intermediate zones due to a number of reasons. The situation calls for adopting a participatory approach to forest management, where local communities have an important role to play as key stakeholders in forest management than at present. As per the international experience, CF is viewed as an alternative strategy to reduce deforestation and, thereby, to foster sustainable forest management through meaningful community involvement (Box 14.1).

14.3 Importance of CF in Sri Lanka

Managing fragmented forest patches with the available limited human and financial resources poses a considerable challenge to the FD. On the other hand, the root cause of deforestation in fragmented forest sites is upland cultivation and associated farming activities. Thus, direct and active community involvement is crucial to manage fragmented forests effectively. Lessons from a recent pilot project on CF, Sri Lanka- Australia Natural Resource Management Project (SLANRMP) - implemented by the FD with the support of the Australian government - shows that active community involvement in forest management can generate favourable results to control deforestation in certain local forests in the dry and intermediate zone. The experience of the project also provides successful examples for aforestation and reforestation initiatives, undertaken with active community involvement in degraded forest areas.

In addition, CF may induce attitudinal changes among communities towards conservation. The introduction of CF is often associated with awareness creation among the communities on the importance of forest resources, and the role of communities

Box 14.1
International Experience of CF

CF is increasingly being recognized as an alternative approach for managing natural forest resources. Based on the experience from CF implementing countries all over the world, Malla (2007) finds that community management of forest areas – including forests with high bio-diversity value – have generated favourable impacts. A significant amount of degraded forest lands in the world have been converted into improved watersheds and landscapes through which local communities are also benefited. Based on present evidence, it is found that CF has led to improved forest governance with community involvement in an inclusive, transparent, and accountable manner.

Communal management of forests is also seen as an important source of investment, particularly in developing countries where overall government spending on forest conservation is comparably low. However, governments have to respond positively to new and changing demands of forest management, rather than continue to rely on the top-down, highly bureaucratic approaches in place. It requires a range of knowledge and skills in planning and implementing CF. As per the international experience, most of the successful CF programmes have been developed by government agencies in close collaboration with ground level government officers, community level leaders, NGO representatives, researchers, and donor agencies, where every stakeholder has an important role to play. Also, outside donor funding is found to have been more effective where donors have encouraged collaboration amongst relevant stakeholders. A few examples of such effective and long term donor commitments are the Nepal Swiss CF Project, the Nepal-Australia CF Project, and the Livelihood and Forestry Programme. Such projects have enabled local people to earn a significant amount of cash income, and have enhanced rural development in turn. In spite of the positive impacts of CF, it involves key challenges such as scaling up of CF programmes beyond pilot projects, equitable distribution of benefits, etc. which should be considered in the planning and implementation process.

Source: Malla, Y. (2007), "Community-Based Forest (Natural) Resource Management: A Path to Sustainable Environment and Development, Lessons from Three Decades of Experience and Future Challenges", in RECOFTC 1987–2007: The First Twenty Years, RECOFTC.

to protect them. Favourable attitudes generated by such programmes could lead to significant impacts in terms of wise use of forest products and services by the communities.

CF can result in a number of favourable direct and indirect environmental outcomes. The protection of catchments which contains tributaries of major rivers in Sri Lanka is an important outcome in this regard. This is particularly important because agriculture in Sri Lanka is largely dependent on irrigation tanks which are supported by such catchments. The protection of catchments is again important in the face of increasing water scarcity due to the ongoing climate change processes.

Available evidence shows that CF has a number of subsidiary impacts on communities, in addition to its direct positive impacts in reducing deforestation and protection of catchments. The experience of the CF pilot projects implemented in several districts of Sri Lanka shows that the formation of com-

Table 14.1
Community Forestry Pilot Activities Undertaken through SLANRMP

Category	Activities undertaken	Remarks
Forest-based activities	Establishment of nurseries Establishment of plantations Maintenance of plantations Establishment of fire line Maintenance of fire line Collection of non-timber forest products	Undertaken to restore degraded forest lands, to afforest selected lands, and to minimize the impacts on forest fires.
Micro-enterprise activities	Home gardens development Dress making Handicrafts Paddy farming Lime drying Soap making Dairy Other livestock Food processing Shoe making Bee keeping	Aimed at providing alternative income sources for households, and thereby to upgrade well-being of poor communities, which would act as an incentive to participate in CF activities.
Community-based activities	Tank rehabilitation Village infrastructure Community halls/facilities Community-based aquaculture Eco tourism	Undertaken to improve infrastructural and livelihood opportunities at the community level.

Source: Sri Lanka-Australia Natural Resource Management Project, Annual Plan 2007-2008.

munity-based organizations (CBOs) and their active role in CF has not only led to the success of the initiative, but also resulted in certain positive spill-over impacts on the community. For instance, through various training and capacity-building programmes and hands-on experience, the communities have been better able to link with outside organizations to mobilize their support for community development.

Table 14.1 provides a summary of pilot activities adopted by the SLANRMP in different local areas with community participation.

14.4 Challenges for CF in Sri Lanka

The relationship between forests and people is somewhat distinct in Sri Lanka when compared with other developing countries. The forest peripheral communities in Sri Lanka are comparatively less dependent on forest products as a source of income. Instead, they are dependent on forest land for their upland agricultural activities which forms a major part of household income. This is somewhat distinct from the observations from other countries such as India, Nepal, and certain African countries where there is high dependence on forest products. The nature of the forest-people relationship in Sri Lanka creates a challenge for sustainability of the forest resource. This is because being dependent on forest lands (rather than on forest products) has direct implications on deforestation, and thereby on the sustainability of the resource. Thus, the common notion that 'high dependence on forest products could act as a powerful economic incentive for communities to protect natural forests' may not be applicable to the Sri Lankan context.

Thus, the introduction of CF in the current setting may lead to negative impacts on livelihoods of the households who are dependent on forest lands for their farming activities. Therefore, the creation of a proper incentive mechanism for households for those farming income to be forgone, is of prime importance. This is critical in terms of safeguarding the livelihoods of people, as well as in ensuring the sustainability of CF initiatives.

Since the dependence on forest products is low in Sri Lanka, there is only limited space for promoting forest-based small industries as a means of compensating forgone economic benefits. In this backdrop, it is important to introduce alternative ways of compensating forgone benefits for communities. However, livelihood related activities are beyond the scope and mandate of the FD. Therefore, at the ground level, it is a challenge to get the relevant agencies involved in the process, and to properly coordinate them to achieve the goals of CF. Given current capacities and availability of resources, it remains a challenging task for the FD.

14.5 Institutional and Policy Issues

The present system of forest management is based on the provisions made by the Forest Ordinance. Accordingly, there is a command and control approach to management, where community participation is not considered a key stakeholder involvement in forest management activities. As such, the Ordinance does not have provisions for creating legal partnerships with the communities and the private sector. Hence, there is limited room for active community involvement in forest management in Sri Lanka. However, having identified the importance of partnering with the communities and the private sector, the FD is in the process of introducing new forms of legal partnership agreements with communities.

The introduction of CF has to be necessarily coupled with capacity building programmes at all levels of implementation. On the other hand, physical and financial facilities required for implementation of CF has also to be provided. In the present set-up, the FD alone, with the limited amount of financial resources it receives from the Treasury, is not capable of financing such programmes. Whereas such resource needs have been covered to some extent with donor support in the pilot project, it is necessary for the FD to explore innovative mechanisms of resource mobilization for CF in the future. The international experience suggests that while donor funds are important in the initiation and expansion of CF programmes, in the long run, alternative funding sources - for instance, community-private partnerships - will have to be looked into.

14.6 Policy Implications and Recommendations

Recent pilot experiences have established CF as an alternative approach to forest management with the potential to generate numerous social, economic, and environmental benefits. In particular, it can be seen as a useful way of managing isolated patches of forest resources in the dry and intermediate zones of the country which are surrounded by agricultural communities. However, the present regulatory system of forest management does not create a conducive environment for necessary cooperation between local communities and the FD for successful CF. It is a positive sign that the FD is in the process of bringing necessary modifications to allow for legal partnerships with local communities in forest management.

In order to perform facilitation and coordination of CF activities, dedicated staff members of the FD are required. Essentially, capacity building of dedicated staff has to be done in order to enable them to interact and collaborate with the communities effec-

tively. Maintaining favourable relationships by ground level FD officers is a significant factor that determines the success of CF. Thus, training has to be given to staff at all levels of the implementation process. On the other hand, training and capacity building programmes should also aim at creating a right attitude towards active community involvement in forest management.

Above all, in order to raise necessary resources for implementation of CF, the FD has to mobilize additional resources than at present. This could partly be achieved by coordinating with other relevant agencies that have direct and indirect interests in CF. Such organizations include government organizations, private organizations, non-governmental organizations (NGOs), microfinance institutions and CBOs. Development of funding facilities at the local, regional, and national levels with such relevant organizations is also very important to compensate community members who are engaged in supportive CF activities.

Due to the comparatively low dependence on forest resources of the local communities, future CF initiatives should necessarily look into avenues for creating incentives for community participation. Past experience suggests that incentives can be brought about at household as well as at community level through livelihood support activities and community development activities. In this regard, the FD should be the facilitator and the coordinator of support extended by various agencies.

15. SAARC Food Bank: Dealing with Food Insecurity during Crises

15.1 Introduction

South Asian countries currently face three types of crises: namely; financial, food and fuel crises. While the region accounts for 23 per cent of the world's population, it generates only 2 per cent of global income. The region also has the highest concentration of poverty and hunger - accounting for 40 per cent of the world's poor, and 35 per cent of the undernourished.[1] While agriculture is the main income source for the vast majority, agricultural productivity remains very low. It is frequently argued that a South Asian household on average suffers from food insecurity.[2] Indeed, on a wider scale, it is estimated that the most recent food crisis pushed nearly 41 million people in Asia and the Pacific back into hunger and poverty during 2007-08.[3]

The Food and Agricultural Organization (FAO) in its report *Regional Strategies and Programme for Food Security in the SAARC Member State*s has identified four dimensions of food insecurity:

- Availability - measures the availability of resources for food production and their productivity,
- Access - the level of income determines access to food, especially where the family income reflects household food security,
- Utilization - whether the food is cooked or processed in a way that it could be easily absorbed into the body, and
- Vulnerability - explained as the risks due to environmental, market and entitlement, nutrition and health factors.

The above four dimensions suggest that South Asian countries are at risk in terms of food insecurity at different levels - i.e., availability measures food insecurity at national levels, whereas access to food measures it at regional and household levels, and utilization and vulnerability measures food insecurity at household levels. While Individual countries have adopted several strategies to mitigate the risks, it could be argued that it is also important to have collective strategies on a regional scale. One such approach proposed for the South Asian region is the establishment of a SAARC Food Bank.

15.2 What is a Food Bank?

The poor we will always have among us, but why the hunger?"
John van Hengel (founder of the food bank)

A food bank is a non-profit organization which distributes non-perishable goods and perishable food items to non-profit agencies involved in local emergency food programmes. Emergency food programmes provide immediate hunger relief to individuals and families who are unable to afford food, and receive inadequate government

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[1] It is estimated that 35 per cent of the people in Bangladesh, 25 per cent in Sri Lanka, 20 per cent in India and 20 per cent in Nepal are undernourished according to the "State of Food and Agriculture in Asia and Pacific Regions 2008". Available at : ftp://ftp.fao.org/docrep/fao/010/ai411e/ai411e00.pdf

[2] Adhikari. K. (2008), SAARC Seed Bank, *Trade Insight*,Vol.4, No.3.

[3] "Hunger on the Rise" available at: www.fao.org/newsroom/EN/news/2008/1000923/index.html

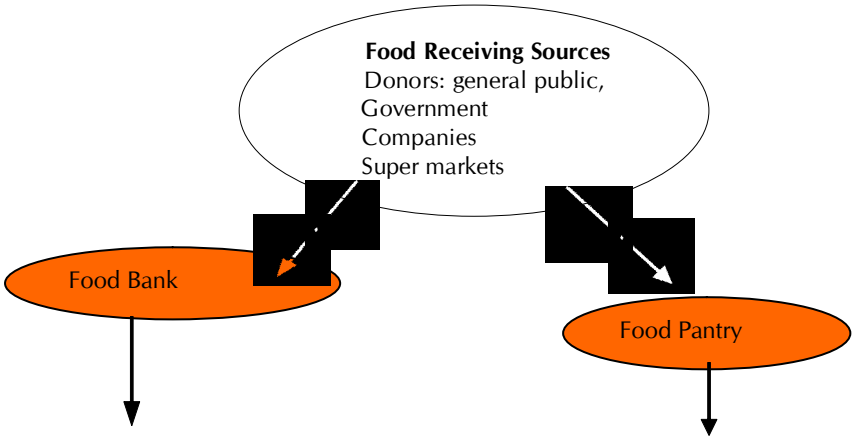
financial assistance from initiatives such as a food stamp programme.[4]

The world's first food bank was the St. Mary's Food Bank, started in 1967 in Arizona, US. Unwanted food items from hotels, cafeterias, grocery stores, and farms were collected for distribution among the poor. From this experience, the concept of food banking was started. Based on the idea of a 'bank', individuals and companies who had the resources could make a 'deposit' of food and funds through donations, and agencies could make 'withdrawals'.

At present, many countries have food banks, most of which are non-profit organizations or civil society organizations. For example, the US has the biggest food bank network; the Second Harvest Bank represents more than 200 food banks. Canada, Europe, and Australia are some of the other countries which successfully operate food banks. These food banks distribute food and grocery industry donations to welfare agencies that in turn identify the poor, and utilize those funds to feed the hungry. Some of the countries have opened food pantries in schools with the aim of eradicating hunger in school children.

However, there are some differences between food banks and food pantries. A food bank is similar to the wholesale arm of the food distribution system for people living in poverty, while a food pantry is similar to the retail arm that serves people directly with emergency food. Some food pantries serve only a few families each month, but there

Figure 15.1
Features of a Food Bank and a Food Pantry



[4] Food stamps is typically a government programme, whereby households below a certain income threshold are provided monthly food spending credits that can be redeemed at local food stores.

are many that provide emergency food support to hundreds of families every month.

15.3 The SAARC Food Bank

The SAARC Food Bank is the world's first regional food bank to be established in order to address issues of regional food insecurity.[5] The main purpose of the SAARC Food Bank is similar to other food banks - i.e., to operate as a regional hunger relief agency. However, it has several unique characteristics, such as limiting itself to only two main grains - rice and wheat - to be used only during food emergency or food shortage periods. It could be argued that it is similar to a 'buffer stock' or a 'safety stock' which is organized to stabilize prices, and counter uncertainties in supply and demand.

15.3.1 Evolution

The SAARC Food Bank is an improved version of the SAARC Food Security Reserve system that was first conceptualized at the 3rd SAARC Summit in Kathmandu in 1987 (see Box 15.1). The initial proposal to set up the SAARC Food Bank was adopted at the Islamabad Ministerial Conference of the SAARC in January 2004. In the same year, the Technical Committee of the Agriculture and Rural Development (SAARC-TCARD) discussed in detail a Concept Paper on the SAARC Food Bank. Most importantly, at the 15th SAARC Summit held in Colombo in 2008, the Heads of State of all governments in South Asia adopted the "Colombo Declaration of Food Security". This declaration (Colombo Statement) states that "we, the Heads of State or Governments, affirm our resolve to ensure region-wide food security and make South Asia, once again, the granary of the world". It has proposed several strategies to ensure food security within the region. One such strategy is to establish the SAARC Food Bank. The declarations also states, "we direct that the SAARC Food Bank be urgently operationalized".

15.3.2 Objectives and Operation

In terms of the agreement signed to establish the food bank, the objectives of the food bank can be identified as follows:

- Act as a regional food security reserve for SAARC member countries during normal time food shortages and emergencies
- Provide regional support to national food security efforts
- Foster inter-country partnerships and regional integration
- Solve regional food shortages through collective action

The SAARC Food Bank reserve covers only two main grains in the region - i.e., rice and wheat, or a combination thereof. This acts as a reserve in addition to the already existing national reserves, and will remain as the property of the respective member country. Member countries are responsible for assessing their share of the reserves, and informing the SAARC Food Board on the quantity of its reserves and its location (see Box 15.2). At the time of signing the SAARC Food Bank agreement, the SAARC Food Board assessed the share of individual member countries, considering their production capacity, per capita consumption, food availability in the country, etc. The shares of member countries are set out in Table 15.1.

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[5] The Common Market for Eastern and Southern Africa (COMESA) perhaps provides the closest example. A key objective of COMESA was to expand regional trade in key food staples, and to improve national marketing systems. Agricultural programmes under COMESA have two objectives; sustainable regional food security and enhanced regional integration. To obtain food security, a strategy proposed in 2005 was to establish a regional food security reserve. However, more up dated information on its progress is not readily available.

Table 15.1
Assessed Share of Food Grains for the Reserve (in MT)

Country	MT
Afghanistan	1,420[a]
Bangladesh	40,000
Bhutan	180
India	153,200
Maldives	200
Nepal	4,000
Pakistan	40,000
Sri Lanka	4,000

Note: a: This was decided at the first meeting of the SAARC Food Board.
Source: Agreement on Establishing the SAARC Food Bank.

The SAARC Food Bank agreement refers also to the quality of the reserves. It is compulsory for member countries to provide adequate storage facilities for the food grains, to inspect the food grains periodically, to apply appropriate quality control measures, to include turnover of the food grains, and to immediately replace any food grains that do not satisfy the said standards. In addition, each member country agrees to undertake every effort to comply with any guidelines on storage methods or quality control measures adopted by the SAARC Food Board.

Member countries can withdraw food grain in the event of a food emergency,[6] and/or food shortage.[7] When there is a food emergency or a food shortage, the food requiring country needs to inform the other member countries about its need. If the said country needs other members' help, it has also to inform the SAARC Food Board. During an emergency, a member country is allowed to withdraw food grains from its assessed reserve (within the own country) and/or from its voluntary reserve (in other member countries) with immediate effect. During a period of food shortage, a member country needs to provide three months advance notice to the other member countries and the SAARC Food Board if withdrawals are from its accessed reserve, or one month prior notice if the withdrawals are from voluntary reserves.

The SAARC Food Board will decide the prices, terms and conditions of payments. There are three broad principles in the determination of prices:

- Prices quoted shall be lower than prices generally charged or quoted for countries beyond the region
- Prices shall be representative of the market, both domestic and international, and may be adjusted suitably to reflect seasonal variations and price movements in the recent past
- A responding member country shall endeavour to accord, as far as possible, national treatment in respect of calculating the cost components such as the

[6] A situation where the member country suffers a severe and unexpected natural or man-made calamity, or is unable to cope with a state of condition by using its national reserves.

[7] A situation where the member country suffers from a production shortfall or storage shortfall, and where it is difficult to cope by using available national reserves.

costs related to storage, internal freight, interest, insurance and overhead charges, margin of losses, etc., while maintaining its reserve and making releases.

A member country can decide on a suitable place for a food bank in their country, and if needed, can appoint a member (may be private or government sector) to carry out food bank transactions. The expenditure relating to the functioning of the food bank will be borne by the member countries proportionately, as part of the SAARC Secretariat budget. The first meeting of the SAARC Food Bank Board was held in November 2008 in New Delhi.

15.4 Opportunities and Challenges of the SAARC Food Bank

The collective attempt to establish a SAARC Food Bank is commendable as it is the first ever regional food bank, and demonstrates the collective cooperation of the member countries in addressing issues such as the global food crisis. Nonetheless, there are

Box 15.1
SAARC Food Security Reserve and Reasons for its Failure

The establishment of a SAARC Food Security Reserve was proposed during the third SAARC Summit in Kathmandu in 1987, and came into effect on 12th August 1988. The reserve comprised of rice and wheat to meet 'emergencies' (i.e., a state or condition resulting from having suffered a severe and unexpected natural or man-made calamity) in member countries. This reserve was maintained in addition to the national reserves of the respective member countries. It was administered by the SAARC Food Security Reserve Board which comprises representatives from each member country. The main functions of the Board were to undertake a periodic review and assessment of the food situation and prospects in the region, including factors such as production, consumption, trade, prices, quality, and stocks of food grains. The main condition to utilize the food from the reserve was to declare a national emergency by the member-state. However, no government of member countries was found to be willing to declare emergencies to utilize it, even though there were food demands in the region, (e.g., wheat crisis in Pakistan, floods and cyclone in Bangladesh, tsunami in Sri Lanka, etc.). Member countries were also reluctant to utilize the reserves due to the complicated procedures involved in obtaining access, as the whereabouts of its location was not clear. Further, due to the non-existence of a price advantage in drawing from reserves, member countries preferred to import rather than draw from the reserves. The availability of food aid as grants from other sources, inability of the SAARC Food Reserve to compete with food aid given as grants, and political tensions between member states discouraged member countries from using the food reserve.

Due to the inactivity of the Food Security Reserve and having identified the importance of regional collective efforts to address food insecurity, a second attempt was made by initiating the establishment of the SAARC Food Bank. It is an improved version of the SAARC Food Security Reserve, where member countries can use the reserve during normal food shortages and emergencies, price preferences are explained in both quantitative and qualitative terms, procedures are more transparent through the SAARC Food Bank Board, etc.

several opportunities as well as challenges ahead in operationalizing the concept.

First of all, it offers several benefits to member countries. The agreement specifically focuses on the determination of prices of the food grains in an attempt to be fair by all member countries. In particular, it provides for exceptional situations, determining for instance that "*in the case of emergency, the humanitarian aspects would be given due importance while determining prices*". Maintaining a food bank will be an added advantage to member countries, providing an additional source of reserves to their national reserves. Given that the food bank consists of the two stable grains produced in the region, it will also enable member countries to easily consume these grains as they are well accustomed to them. Costs relating to transport and distribution may also be lower when borrowing from the region as opposed to borrowing from outside.

However, there are several challenges for member countries in making the food bank a success. The success of operating a food bank will depend on how people are able to access the reserve and its distribution system, including the cost of distribution. In general, governments will select a nodal point to establish the food bank. This location is likely to be close to the capital city with ease of access to necessary infrastructural facilities. However, in most cases of food shortages at the household level, it is questionable whether the people who are in remote areas and who do not have access to the reserve will actually benefit from it. Further, most of the people in the South Asian region have low purchasing power, and are already facing a food deficit. Therefore, some doubts

Box 15.2
The SAARC Food Bank

The SAARC Food Bank Board comprises all member countries, and its functions are to undertake periodic reviews and assessments of the food situation, examine immediate short term and long term policy actions, review implementation of the provisions of the agreement, assess the demands for food grains, identify institutions and organizations in member countries, and determine prices, etc.

The SAARC Food Bank is identified as a short term solution for food security. Thus, debates are ongoing on whether to establish a SAARC Seed Bank. The operationalization of a seed bank will create an effective long term mechanism of production, exchange, and use of community and environmental friendly improved seeds that are in the domain of private and public sectors as well as farmers. Different strategies have been identified to ensure and expand farmers' access to high yielding seeds through a seed bank. These include the implementation of policy and institutional support measures, establishment and cooperation with regional private seed companies and public sector agricultural research institutions, assistance from international seed banks and companies, etc. The SAARC Agricultural Ministerial Board is in the process of preparing an action plan to establish the SAARC Seed Bank. Currently, the Board deals with several issues relating to its implementation. These include identifying a clear mechanism to facilitate the process of access to seeds that deals with mutually agreed terms, Prior Informed Consent (PIC) procedures, seed development process, Intellectual Property Rights (IPR) rules relating to seeds, bio-safety and bio-technology policies, etc.

remain as to whether the neediest will actually benefit from the food bank. As explained before, in order to overcome this situation, world-wide food banks have identified the needy people and areas with food shortages before they establish these banks, thus making it possible to directly serve the needy people. They have also established several branches in different areas where it provides easy access to people.

It is also not clear as to how the SAARC Food Bank will react in an event of a regional disaster where several countries get affected. In such a crisis, the food bank has to prioritize the recipient countries according to their needs and requirements. How such a system can be operationalized is not spelt out.

In addition, there may be some concern that the agreement provided for consumer preferences when selecting the types of grains. For example, there are varieties of rice (raw rice, parboiled rice, etc.,) and preferences in this regard vary from country to country, as well as within different regions of the same country. Therefore, it is important to identify whether the selected varieties are compatible with the preference of consumers of the member countries. At least, it should substitute for consumer preference.

The SAARC Food Bank is an improved version of the SAARC Food Security Reserve. The latter, however, did not operate as planned due to non-effective use of the reserve by member countries as its location was not known to many member countries. As such, justifiable concerns remain as to whether the SAARC Food Bank would also face a similar plight.

The SAARC Food Bank is a short term solution to face a food crisis. It is, therefore, important that long term solutions are also identified, with the overall objective of increasing food production across the South Asian region. The SAARC Seed Bank is one such initiative aimed at providing facilities to exchange high yield seeds, exchange new technologies, provide know-how within the region, etc. Similar initiatives should also be adopted to complement the concept of a regional food bank.

Individual SAARC member countries may also have their own specific challenges to be overcome. In the case of Sri Lanka, for instance, there are several issues that can affect the implementation of the food bank. Sri Lanka's monthly rice consumption is 60,000 MT, whereas the SAARC Food Bank would reserve only 4,000 MT, sufficient for only two days of consumption. Before liberalizing rice imports in 1996, Sri Lanka reserved three months of rice requirement in its buffer stocks. Therefore, it may be important to reconsider the food bank's assessed share of reserves.

Prior to 1996, when Sri Lanka had buffer stocks, the storage costs were very high, the stocks were in danger of getting spoilt, and monitoring facilities were not adequate, etc. Therefore, the government tried to stabilize the rice market through imports by adjusting tariff rates from 1996. When considering costs, importing rice is cheaper than having a reserve, due largely to the high storage costs involved in maintaining a reserve. However, there is an element of uncertainty when a country depends on imports. Hence, it is necessary to reassess the opportunity cost of having a 4,000 MT reserve as against importation of rice.

According to the SAARC Food Bank agreement, Sri Lanka has to stock rice in its own reserves. However, it is a proven fact that storing paddy is less costly and less likely to get spoilt when compared to storage of rice which needs an extra formulation cost.

It is also not clear as to how the reserve would operate in different countries. In the Sri Lankan context, the question is whether it is the government or the private sector that will operate it. If it is a government body (e,g., the Paddy Marketing Board) it would incur a cost which the Treasury would have to bear. At present, there are well established private rice producers in Sri Lanka (Nipuna, Araliya, etc.) who have the capacity to handle the reserve. For example, if ten rice producers are selected, they only have to provide 40 MT each for the reserve. In such a situation, the government could act as the monitoring body, and if needed, it could provide them with storing facilities, subsidies, etc. As such, it is important to study available options, and select the best feasible operational method.

15.5 Conclusion

In light of the above discussion, it is clear that having a regional food bank is a short term solution in the event of a regional or a global food crisis. However, there are specific individual factors which are to be considered by each of the member countries in this regard. The success of the SAARC Food Bank in the region will depend on the operation of the individual banks in member countries, and its sensitiveness to catering to the needs in the region. Simultaneously, as a region, it is important to identify long term solutions to tackle food crises in the future.

16. The Global Economic Crisis and ICT

16.1 Introduction

Information and Communication Technologies (ICT) are key pervasive technologies that can increase productivity and efficiency, and drive economic growth. Indeed, the tech industry was regarded as a long term growth industry that could withstand difficult economic times such as the dot.com burst of 2001-03. To a degree, this is based on the supposition that demand for basic services is income-inelastic. However, more recent evidence suggests that the ICT sector is unlikely to remain unaffected by the current global economic crisis. A recent report prepared by the International Telecommunication Union (ITU) argues that demand for ICT can be adversely affected as consumer incomes are squeezed, and employment prospects come under threat as the global economy contracts on a scale not witnessed for well over 60 years.[1] However, such studies also note that the current economic downturn may present opportunities for disruptive technologies,[2] and new business models to emerge. Such developments can occur where prices are falling and where technology is changing - for example, in markets facilitated by the availability of lower-priced, higher performance consumer broadband. In the longer term, therefore, there is optimism that the ICT industry may emerge relatively unscathed from the current global economic crisis.

However, there are downside risks to the ICT sector which may be regional or country specific. Funding in the current financial climate is likely to be a key issue for many. Private sector operators that invest in the national backbone infrastructure, including next-generation-networks, can be expected to be facing financial constraints. In turn, such developments will require governments to step in to meet shortfalls in financing where possible. In the case of Sri Lanka, the general consensus appears to be that the direct impact of the global downturn might not affect the ICT industry immediately, but that its spin-off effects can create issues as regards to opportunities for expansion and employment in the sector. This policy brief is an exploratory attempt to investigate some of the possible impacts on Sri Lanka's ICT sector, based largely on discussions held with relevant stakeholders.

16.2 Global Economic Downturn and the ICT Sector

The ICT sector at present is an important sector in its own right, typically accounting for up to 7.5 per cent of GDP worldwide (depending on which sectors and services are included), in addition to its important facilitating role in many other sectors.

Of the many areas of ICT activity, telecom services are vital for consumers and businesses alike. Studies project that the telecom services market will be affected significantly in 2009, generating US$ 1.4 trillion, at a growth rate of only 1 per cent (compared to the 10-11 per cent annual growth rates over recent years).[3] This is largely owing to the

[1] Information and Communication Technologies (2009), "Confronting the Crisis: Its impact on the ICT Industry", February 2009.

[2] Aimed at improving a product or service in ways that the market does not expect, typically by being lower priced or designed for a different set of consumers.

[3] Pyramid Research Report (2008), "Global Telecom Services Revenue Forecast 2008-2013: Emerging Market Opportunities", December 2008.

grim economic outlook and substantial currency fluctuations resulting from the global economic and financial crises. Moreover, voice services are expected to be the hardest hit in 2009, contracting by 3 per cent compared with a 6 per cent expansion in 2008. Meanwhile, business growth in non-voice mobile applications and broadband Internet access are expected to remain strong with the data market (both fixed and mobile) reaching US$ 411 billion in 2009, up 12 per cent from 2008. Many analysts also appear to agree that the true impact of the economic downturn is yet to materialize across the ICT sector.[4]

Despite general concerns over the overall impact of the downturn on the ICT sector, it is also likely that there will be variations in impact across regions and countries. Studies examining the income elasticity of ICT services suggest different patterns of response in consumer demand for developing and developed countries. In developing countries, mobile phones were considered a luxury good for the most part. On this basis, mobile phone usage might be expected to fall with a reduction in real income,[5] as in the case where consumers' disposable incomes were hit recently by rises in food prices. However, as mobile networks have continued to grow in developing countries beyond all expectations, the argument that they are a 'luxury good' is hard to defend and is being increasingly rejected. Thus, demand may still continue to grow in developing economies despite falling incomes, as telecom networks are in the early stages and business use is high.[6] By contrast, in the case of developed countries, most research suggests that broadband Internet access is inelastic,[7] implying that a fall in income would lead consumers to give up their broadband subscriptions or defer connection upgrades.

In respect of mobile communications, it could, therefore, be argued that the global economic crisis is unlikely to have a major adverse impact on developing countries. There has been a remarkable growth in the penetration of mobile phones in developing countries, with every two persons estimated to have a mobile phone by end 2008. In most developing countries with a mobile penetration of less than ten, restrictive government telecommunication policies are likely to have caused more harm to the growth of the ICT sector than any economic crisis could. Therefore, a key challenge during the current economic crisis will be not only about providing high quality services to current subscribers, but also ensuring that infrastructure rollout continues to pick up new subscribers.

The economic crisis could affect mobile subscribers in developing countries if consumers lose their jobs or see their incomes being cut. However, once a user gets a mobile phone, it is difficult to give up, and in many countries, mobiles have become a necessity.[8] Mobiles have largely replaced fixed lines for voice communications in many developing nations.[9] Therefore, other ICT services are likely to be dropped, with mobile only being discontinued as a last resort.

Thus, by the end 2008, the economic crisis had yet to impact growth in mobile services

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4 http://www.analysysmason.com/About-Us/News/Insight/Will-telecoms-escape-the-economic-downturn/7/11/08

5 Income elasticity of demand for mobiles is estimated roughly at + 1.5 for an average developing country with 8 per cent penetration.

6 http://www.lse.ac.uk/collections/media@lse/pdf/Wheatley%20paper%2003.02.2006.PDF

7 For example, long-run income elasticity of demand for broadband in OECD countries is estimated at + 0.78. See: www.itu.int/osg/spu/ni/voice/meeting.phtml

8 Frost and Sullivan (2006), "Social Impact of Mobile Telephony in Latin America", available at: http://www.gsmlaa.org/files/content/0/94/Social%20Impact%20of%20Mobile%20Telephony%20in%20Latin%20America.pdf

9 ITU (2008), "Asia-Pacific Telecommunication/ICT Indicators 2008", available from: http://www.itu.int/ITU-D/ict/

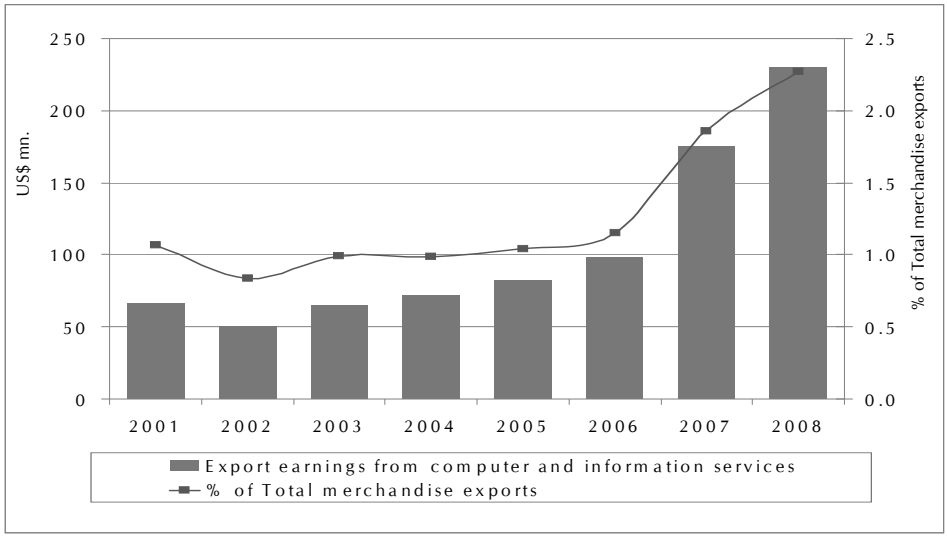
in the largest developing country markets. The tightening of credit has threatened capex and investment in telecom networks, but this impact has so far been mainly confined to developed countries. It might spread to developing countries, especially those reliant on foreign direct investment (FDI) from developed countries for financing network roll-out. This will be particularly so where mobile operators are controlled by European or North American carriers. However, as previously mentioned, the impact so far has been limited, and demand for mobile services in developing countries is expected to be strong.

The rest of the discussion will examine the emerging issues of concern as a result of global developments with regard to the ICT industry in Sri Lanka.

16.3 IT-BPO Sector

Information technology enabled services (ITES) include business process outsourcing (BPO), knowledge process outsourcing (KPO), and other information technology (IT) related services. The IT-BPO sector holds an important position in Sri Lanka's ICT sector. The *Export Value Survey of 2007/08* by Price Waterhouse Cooper (PWC) and the Export Development Board (EDB) suggests that the IT-BPO sector was the fifth largest exporter with the potential to even surpass earnings from the tea export sector. Furthermore, it is clear that the momentum in export earnings growth in computer and information services in recent years has been relatively high (Figure 16.1). While net export earnings have grown steadily from US$ 50 million in 2002 to US$ 230 million in 2008, its contribution as a share of total merchandise exports and services has also increased from 0.8 per cent to 2.3 per cent over the same period. The ITES sector recorded strong growth in excess of 31 per cent in 2008. However, it is likely to experience a slowdown in the coming years due to the economic downturn in the top export markets, namely, the US and the EU.

Figure 16.1
Export Earnings from Computer and Information Services (2001-08)



Source: CBSL, *Annual Report*, various issues.

Given that most of the key clients for Sri Lanka's IT-BPO sector are based in developed countries, there are some emerging concerns for the local industry. Many developed countries, hit hard by the global downturn, are taking measures - such as cost cutting - to mitigate the impacts. The general downturn in outsourcing as well as on embarking on new projects has affected the IT-BPO business organizations in Sri Lanka, with the immediate impact being a drop in revenue according to industrialists operating in the sector.

Accordingly, in response to the slowdown in incoming businesses, various measures have been adopted by the local IT-BPO sector. Some leading organizations have taken aggressive measures, especially since the fourth quarter of 2008 to reduce costs, adhere to best practices, as well as attempts to increase market penetration. In this regard, many of the interviewed IT-BPO organizations have also been investing in improving sales and marketing, and looking at entirely new market segments such as Asian and Middle Eastern regions.

Recruitment has also been more tightly controlled. Indeed, in some instances, recruitment has been put on hold and there has been a certain amount of job cuts in the local IT-BPO sector. As the IT-BPO sector provides a large number of job opportunities, especially for new graduates in IT and related fields, this is likely to have some effects on the employment opportunities in the ICT sector.

However, it was also noted that though there has been a slowdown in outsourcing and new projects coming in with the onset of the global economic crisis with clients taking measures to reduce costs, the outlook in the future may nonetheless change. Beyond the initial period of the crisis, it may prove beneficial for clients to outsource more towards cheaper outsourcing destinations in the longer run. Thus, a more optimistic scenario also exists that business will gradually begin to pick up towards the end of 2009. If this were to materialize, the global economic crisis could indeed result in positive developments for the local IT-BPO sector in the long run.

Despite such optimism, many of those interviewed in the ICT industry have voiced concerns over possible protectionist measures which may be taken by developed countries that could adversely affect the local ICT industry, and especially the IT-BPO sector.

16.4 ICT Employment and Education

According to leading academics in the ICT sector, there are a growing number of graduates in IT and related fields annually. Currently, there seems to be a reduction of employment opportunities in the ICT sector. This is expected to effect the newly passing out graduates the most, as this group lacks industrial experience. With lesser number of employment opportunities, the industry is also becoming quite selective about the candidates to whom it will offer the limited amount of placements available. However, most individuals interviewed were of the opinion that this situation may be a temporary one, which could change in about a year. It was also noted that the experience was similar during the 2001-03 dot.com collapse.

Some are also of the opinion that as state sector e-government projects and similar IT related initiatives are ongoing without any hindrance or slowdown, it may present ICT employment opportunities for at least a portion of the new and recent ICT graduates. This situation may also provide an opportunity for the government to attract some of the best passing out graduates, who usually prefer to seek private sector employment under normal circumstances.

In order to ensure some degree of flexibility in staff strength based on performance, revenue, and the general economic climate, some business organizations in the ICT sector appear to be exploring the possibility of having workforce flexibility in terms of recruitment of staff members through man power consultancy companies rather than resorting to direct employment.

In the meantime, the number of ICT personnel who are enrolling on postgraduate ICT courses has shown an increase, which may indicate that the established individuals in the ICT sector are taking the environment created by the current downturn to enhance and improve their qualifications. It is perhaps also a timely opportunity to further expand education/training facilities in the ICT sector, particularly by encouraging private sector participation.

Additionally, while job losses in the ICT sector have been reported in many developed countries, Sri Lanka could also experience the phenomenon of return migrant workers in the sector. However, the dearth of information in this regard makes any observation difficult at present.

16.5 Remedial Measures

16.5.1 ICT as an Enabler

It is noted that with the impact of the global economic crisis on core businesses, the impacts have also affected their respective IT operations. As IT plays a key role in maintenance and uplifting the productivity of organizations, IT divisions may be required to take precautionary and proactive measures to mitigate the downside effects. Many of the players in the local ICT sector that were interviewed were of the opinion that recruitment has been halted, unless it is extremely necessary, and role stretching and other practices have been introduced. As such, efforts to incorporate and adhere to best practices and industry standards, and to focus on absolute requirements and concentrate on tighter integration with the core business have been observed.

Careful cost reductions have taken place. However, according to those engaged in local multinationals and conglomerates, the cost reduction measures due to the global economic crisis have not impacted the long term strategies so far. The impacts have also not gone down to the level of entering a vicious cycle of cost reduction on IT services, affecting the quality of services provided, which in turn impacts the core business. Industrialists were of the view that the global economic crisis has actually provided them a positive opportunity to improve and uplift cost effectiveness, efficiency, and standards of the services provided.

16.5.2 Mobile and Telecommunication

As previously mentioned, mobile operators are better placed than fixed line operators to weather the current economic crisis.[10] Nonetheless, telecom services are expected to come under further price pressure, requiring operators to take a more rigorous approach to control costs and improve internal efficiency.

Despite the global upheaval, it was noted that the local mobile and telecommunication sector has not been impacted much. It was also noted that there has not been any demand decrease, and the customer surplus is increasing. Moreover, the local scenario seems to be driven more by internal competition - i.e., competition between local telecommunication providers, rather than external forces, including the current global outlook.

[10] Many analysts highlight differences in cost structure between fixed and mobile operators, with mobile operators enjoying greater flexibility in terms of capex commitments (as capex represents only 20-30 per cent of total costs for mobile operators). See discussion on "Mobile Operators Capex Analysis 2008"at: http://www.abiresearch.com/research/1001072Mobile_Operator_Capital_Expenditures_Analysis.

National telecommunication infrastructure plays a prominent and vital role in driving business. As was previously noted, in the international scenario, there may be instances where governments have to intervene and invest in the Next Generation Networks, in the event that telecommunication investors pull out due to financial constraints. However, according to leading telecommunication providers in Sri Lanka, this has not been the case so far, where almost all plans and investments on expansions of network, bandwidth and coverage, and introduction of new technologies in the mobile and telecommunication sector are going ahead despite the economic downturn.

This is primarily because there is an expectation that the mobile and telecommunication industry will continue to grow during the crisis times as well. In addition, with the end of the 30 year long separatist conflict in the country, operators believe that the Northern and the Eastern Provinces will provide opportunities to improve market penetration and revenue growth.

However, one of the areas where revenue has dropped - which may be attributed to the global economic crisis - is income generated from roaming communication. As observed, the drop may be due to reduced activity in the tourism sector, as well as other factors.

Box 16.1
Government ICT Initiatives

ICT is an enabler and a tool that can help people increase their income levels in whatever fields of employment they are involved in. The government of Sri Lanka has initiated several programmes with the objective of promoting information technology literacy of the people in the country. As a major step towards this, 2009 has been declared as the "Year of ICT and English".

One of the goals identified under the government's "e-Sri Lanka" initiative is to facilitate access to ICT amongst the most vulnerable groups, and to ensure that the benefits of ICT development flow to these groups. In view of the declaration of 2009 as the year of ICT, the Information and Communication Technology Agency of Sri Lanka (ICTA) has taken steps to implement an extensive national programme to disseminate and create awareness about ICT.

The “Nenasala” of the e-Sri Lanka project is intended to empower rural communities all across the country with affordable access to computers and the Internet. It is intended to provide a catalytic effect for the rural communities in poverty reduction, social and economic development, and peace building while aiming at providing services in a long term sustainable manner. The Nenasala project aims to establish 1,000 centers throughout the country by end 2009. Out of this proposed total, 500 Nenasala have already been established.

The e-government initiatives implemented by the ICTA have been progressing successfully in meeting their objectives. One example is the Government Information Center project which was recently declared as one of the winners of the World Summit Award 2009, a contest which has been launched as a part of the United Nations Summit on Information Society. This implemented project, which provides general information such as how to obtain a passport or a national identity card, getting a loan facility from a government bank, and other related information to the general public over an easily accessible telephone number "1919" has been declared as a winner with best practices in high quality e-Content, and has been quoted as a worldwide example of outstanding e-Content.

The decline is not considered to be significant with respect to the overall revenue generated.

16.5.3 Role of FOSS

Free or Open Source Software (FOSS) are programmes or applications that have licences which allow users to run, modify, distribute copies of it, as well as to distribute their own modified version of the programme or application, free of charge. However, though the software is free it does not mean the quality is poor. There are many FOSS applications powering up business-critical services worldwide. With the economic crisis and resultant trend towards cost cutting, where many industries worldwide are going into more cost effective alternatives, FOSS based applications may present such an alternative.

Several ICT sector players in Sri Lanka have already moved into, or are moving into using FOSS applications where applicable as a cost cutting measure due to the current economic downturn. Developing reputed FOSS based applications (which will be available for the customers free) and offering the service at a cost is a business model followed by some software companies. One local company operating on the above business model informed that their revenue has already doubled to date as a result. The above business model may present opportunities to attract more business even during turbulent times, as well as enabling companies to compete directly with the big players in the industry.

16.6 Conclusion

The global economic crisis has had an impact on the Sri Lankan ICT industry, especially in the IT-BPO/software development sectors. However, the current outlook seems to be positive, based on the feedback received from discussion with relevant industrialists. Most expect the local ICT industry to pick up in around a year's time, assuming that there will not be any protectionist measures adopted by developed countries. However, it also should be noted that under the current uncertain circumstances, it is quite difficult to make definitive predictions.

Employment opportunities, especially for new graduates, seem to be declining somewhat. However, most industrialists expressed the view that so far, the global economic crisis has also been an opportunity for businesses to grow, to be more focused and cost efficient with new and efficient business practices and technologies coming up. Thus, there is some expectation that the local ICT industry may emerge more resilient and geared towards the future through this crisis, as it did through the dot.com collapse.

It was noted that almost all government e-governance ICT initiatives have been going on successfully, and have not been affected by the current economic environment. According to officials, there has not been any indication so far about the impacts of the economic crisis on the local ICT sector which necessitates action by the government.[11]

Nonetheless, many players in the ICT sector are of the opinion that the government could explore the possibility of providing tax incentives to locally built/developed software, which might be particularly helpful during the current tough times the industry is facing. In addition, it was also noted that the cost of Internet bandwidth is high in Sri Lanka compared to other countries, and exploring possibilities for the government to bring costs down might be a timely intervention.

[11] Thought it may not be directly related, it was also noted that there has not been any decrease in the number of websites being registered under the LK domain registry (i.e., websites ending with the .lk prefix, the country's top level domain).

17. Prospects

Despite the general gloom pervading the outlook for the global economy, Sri Lanka has reasons for some optimism. The military victory ending a 30 year long separatist conflict in the country in May 2009 has revived expectations of long term political stability that can create a conducive environment for sustained growth and development. Indeed, the near term economic outlook has also brightened. In early July 2009, the Central Bank of Sri Lanka (CBSL) revised the GDP growth forecast for the year to a more optimistic 4.5 per cent. Assurances that the first tranche of the long awaited IMF Stand-By Arrangement - enhanced from an initial US$ 1.9 billion to US$ 2.6 billion - would be disbursed from July 2009 further boosted expectations of a better-than- expected economic recovery.

The anticipated economic dividends from the conclusion of the war effort are many. In the immediate short term, the mere revival of economic activity - in agriculture, fisheries, etc. - in the previous conflict-affected regions can stimulate output. In the more medium term, reconstruction of damaged and destroyed infrastructure - road/rail networks, housing, schools, hospitals, etc. - will provide an additional stimulus. It is quite likely that active economic participation of the private sector in the Northern and Eastern Provinces will inevitably be linked to progress in restoring large scale infrastructural needs in energy, transportation, communication, etc. Private sector investors may be averse to finance specific investments - in tourism related facilities, for instance - until such infrastructure materializes, or there is a credible commitment to improve facilities. Nonetheless, the emerging evidence points to strong private sector interest in entering markets in previously conflict-affected areas. By mid-June 2009, the CBSL had already granted approval for 67 new banking service outlets to be opened in the Northern Province - the largest number of approvals given during a comparable period.

The economic resurgence of the Northern and Eastern Provinces are inextricably linked to ensuring socio-political stability in the country. Thus, reconstruction needs cannot be delayed on account of financial constraints of the government, exacerbated by the global economic downturn. Not only is Sri Lanka facing a revenue crunch as economic activity slows, but bilateral donors are also distracted by their own domestic economic concerns. In this context, the enhanced loan facility of US$ 2.6 billion from the IMF is a mixed blessing. It will undoubtedly ease Sri Lanka's external resource constraints, but it could well impose fiscal restraints on a speedy reconstruction process. Indeed, the IMF noted that it supported the government's goals of "reducing the fiscal deficit to a sustainable level" with the initial announcement under the Staff Level Agreement.[1]

Conditionalities - attaching demanding conditions that have become shorthand for austerity - lie at the root of arguments in favour of and against IMF programmes. In some instances, such conditionalities are viewed positively, as imposing external discipline to macroeconomic management in the face of lax domestic macroeconomic

[1] http://www.imf.org/external/np/sec/pr/2009/pr09265.htm.

Table17.1
Key Fiscal Developments (January-April)

	% Change		% of GDP	
	2008	**2009**	**2008**	**2009**
Revenue	23.5	-9.6	4.8	3.9
Expenditure	24.2	28.0	6.9	8.0
Current	23.5	34.5	5.2	6.2
Public investment	11.4	9.1	1.8	1.7
Overall budget deficit	25.8	113.7	2.1	4.0
Domestic financing	98.8	165.3	1.7	4.0

Source: Ministry of Finance and Planning, *Mid Year Fiscal Position Report*, various issues.

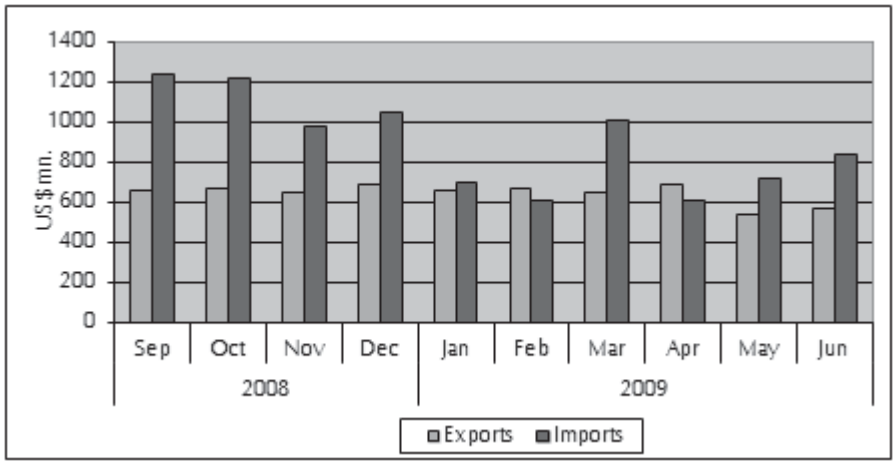
prudence. Alternatively, the very standard, "one-size-fits-all" approach can also prove to be counter-productive in dealing with specific country situations. This partly explains why countries prefer to avoid the IMF until they have run out of options. But it also underlines why it is critical to practise prudent macroeconomic management, and avoid the necessity of being subject to lending conditionalities - and thus, surrender some degree of policy flexibility.

For instance, Sri Lanka at present needs to retain a degree of fiscal flexibility to respond effectively to the reconstruction needs of the previously conflict-affected areas, not least on political-economy considerations. Fiscal developments so far in 2009 have been unfavourable. Revenue growth has contracted sharply by 9.6 per cent during January-April 2009 compared to a growth of 24 per cent in the corresponding period in 2008, while expenditure has grown at 28 per cent - slightly above the 24 per cent growth recorded in the corresponding period in 2008 (Table 17.1). As a result, the overall budget deficit estimate for the period has doubled to 4 per cent of GDP relative to the 2.1 per cent recorded in the same period of 2008. These developments suggest that Sri Lanka's fiscal situation is set to weaken considerably, contrary to the optimistic fiscal deficit target of 6.5 per cent of GDP announced in November 2008 in the government budgetary estimates for 2009. Indeed, the revised fiscal target of 7 per cent of GDP announced following the Letter of Intent with the IMF also looks to be similarly optimistic.

The deficit financing pressures will be significant, with more immediate implications for monetary policy management as well. The entirety of the deficit bridging needs during January-April 2009 has been met through domestic financing (Table 17.1). While the government has rightly appointed a Presidential Taxation Commission with a view to strengthening revenue generation in the medium term, there is limited room to raise additional revenues in the near term. Businesses are struggling in the current economic environment, while consumers have seen an erosion of their real incomes in view of the high inflationary environment of recent years. The Nation Building Tax (NBT) introduced through the 2009 budget proposals, for instance, has been raised already from 1 to 3 per cent as of May 2009. Thus, the immediate response calls for rationalization of expenditures - cutting back on any profligate expenditure - so that priority areas are not unduly affected.

The rapid decline in inflationary pressures seen in recent months - initially as a response to the tighter monetary policy stance that subsequently coalesced with the impacts of the global economic crisis - should not be re-

Figure17.1
Trends in Trade Flows (September 2008-June 2009)



Source: CBSL, *Monthly Economic Indicators*, various issues.

ignited. The annualized rate of inflation still stands high at 10.4 per cent in July 2009.The risks for continued price stability are two-fold: domestic borrowing pressures from the fiscal side, and the potential for oil prices to recover as the global economic recession bottoms out.

These factors - the global economic downturn and the accompanying commodity price glut - have been a mixed blessing for Sri Lanka. While the global downturn undoubtedly impacted negatively by hurting the country's export sector, the sharp drop in oil prices allowed the country to avert a looming foreign exchange crisis. During January-June 2009, Sri Lanka's trade deficit contracted by 60 per cent to US$ 1,249 million - primarily on the back of a sharp drop in the import expenditure bill. While export earnings dropped by 18 per cent, the reduction in imports was much more pronounced at 37.7 per cent over the period (Figure 17.1).

The much reduced import expenditure bill and general slowdown in economic activity eased mounting pressure for an adjustment in the exchange rate. Sri Lanka's depleted foreign exchange reserves hit a low of US$ 1,272 million in March 2009 on the back of an ill advised attempt to prop up the currency in spite of a rapidly worsening foreign exchange gap. Having approached the IMF for a Stand-By Arrangement of US$ 1.9 billion in February 2009, the CBSL eased its involvement in the foreign exchange market. The rupee depreciated to a high of Rs. 120 to the US dollar in March 2009, before beginning to recover, as the demand for dollars dropped sharply with the fall in import demand.

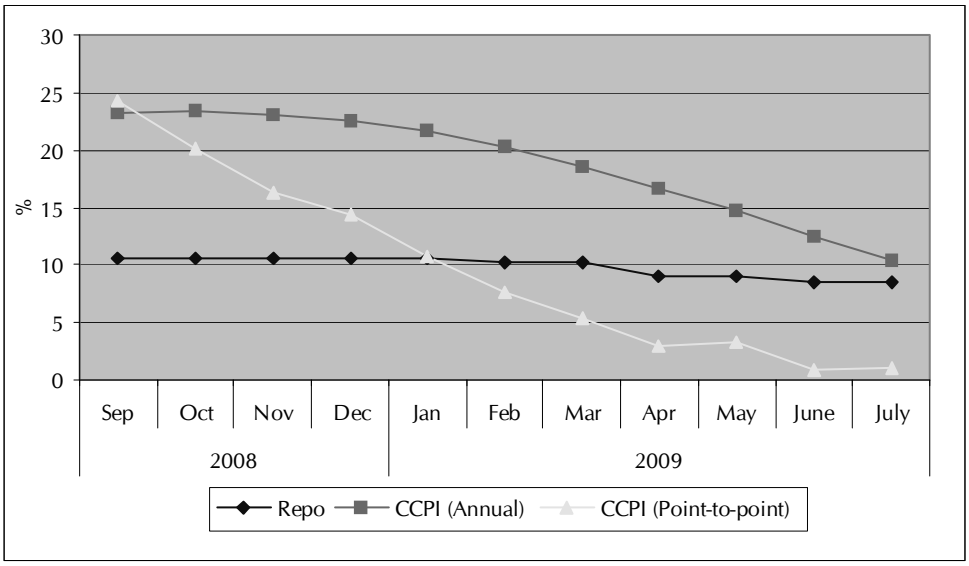
In addition, Sri Lanka continued to see a relatively healthy inflow of remittance inflows. After an initial drop in the first quarter of 2009, private remittances remained steady at US$ 1,505 million in the period January-June 2009 (up 5.4 per cent over the corresponding period in 2008). As anticipated, remittance inflows are unlikely to see an immediate reversal on account of the global economic crisis. At the same time, Sri Lanka will also not have the benefit of the robust growth in remittance inflows of approximately 15 per cent per annum seen in recent years.

The resulting liquidity in the domestic foreign exchange market allowed the CBSL to mop up dollars. This not only prevented an

undue appreciation of the rupee in view of the already uncompetitive real exchange appreciation of recent times, but also helped the CBSL to re-build the country's foreign reserves position. By June 2009, official reserves stood at US$ 1,618 million, equivalent to 1.7 months of imports. By mid-August 2009, net foreign exchange purchased by the CBSL in the domestic market is estimated to have exceeded US$ 600 million. Excluding the first tranche of the IMF disbursement, official reserves had thus crept up to US$ 2.3 billion. A steady increase in net foreign inflows to the Treasury bills and bonds market of US$ 270 million by mid-August 2009, received a further boost with an inflow of US$ 850 million from an estimated US$ 1.2 billion commitment from an international hedge fund in the US. Additionally, a new allocation of the reserves of the IMF saw Sri Lanka receive an equivalent of US$ 475 million to push the country's official reserves to an estimated US$ 4 billon by end August 2009.

Despite the significant improvement in net inflows of foreign capital, Sri Lanka's external payments position will need to be watched carefully in the near term. There are inherent risks of capital flight related to portfolio investment flows - such as those in government debt securities - as experienced in the fourth quarter of 2008. The country still has to meet outstanding settlements on bilateral lines of credit, oil price hedging, foreign borrowing, etc., in the course of 2009-10. It is in that context that the long delayed agreement between the IMF and the GOSL for the disbursement of a Stand-By Arrangement saw Sri Lanka's stock market rallying immediately. The proposed disbursement of a US$ 2.6 billion facility (amounting to 400 per cent of the country's quota) - in eight tranches over 20 months, and at an interest rate of approximately 1.5 per cent - is a boost to medium-term investor confidence in the economy.

Figure17.2
Changes in Inflation and Policy Rates (September 2008-July 2009)



Source: CBSL, *Monthly Economic Indicators*, various issues.

The 'mopping' up of liquidity from the foreign exchange market has ensured that inflationary pressures remain under control, and the easing of interest rates could continue. The CBSL which began to use policy rate adjustments in February 2009 once more, after a lapse of one year, had successively cut the repurchase rate (Repo) by 200 basis points by June 2009 (Figure 17.2). By end 2009, it is quite likely that Sri Lanka's annual rate of inflation will fall to single digit levels for the first time since 2004.

However, medium term inflationary pressures will need to be watched closely. Inflation is expected to pick up in the second half of 2009, despite the anticipated decline of annual inflation to single digits by year end. The latter will materialize as the lagged effects of the sharp decline on a point-to-point basis seen in the first half of 2009 (reaching 0.9 per cent in June 2009) gets reflected in the more gradual decline in the annualized rate by end 2009. As previously mentioned, the outlook on inflation for the more medium term will depend on fiscal developments, and external conditions related to international oil price trends.

As evident from the discussion earlier, Sri Lanka's developing fiscal situation in 2009 looks fragile. The IMF funding will go a long way to easing external resource constraints, and thus help towards fiscal consolidation by easing the need to resort to costly short term commercial borrowing. Nonetheless, the magnitude of funding needed for the reconstruction process will be quite significant. For instance, the re-building of roads alone in the Northern and Eastern Provinces is estimated to cost US$ 750 million. In addition, the country is also likely to experience the general tendency towards some degree of fiscal slippage associated with electoral cycles. Presidential and General Elections are widely expected to be held by end-2009 or early 2010. Past experience in this regard highlights the risks; the 14-month Stand-By Arrangement entered into with the IMF in April 2001 fell apart before the General Elections of end 2001, before it was rescued once more by the incoming new government.

Sri Lanka will undoubtedly hope to tap bilateral donors and international development agencies for reconstruction related finance. But, there is always a considerable time gap - of at least 12 months or more - between the issuance of pledges/commitments and their translation to the actual disbursement of funds. In the interim, the government will have to take the lead in financing reconstruction and rehabilitation related needs. These developments can hold inflationary implications.

Other risks to macroeconomic stability have also to be considered. A significant inflow of foreign capital can cause destabilizing effects on exchange rate policy management. Apart from bilateral/international development agency support for the reconstruction, capital inflows can also come by way of many other channels. With the re-bounding of the Colombo Stock Exchange - with stocks up by 60 per cent so far in mid-2009 - "hot money" can flow in to take advantage of investor opportunities. With the improvement to Sri Lanka's sovereign credit rating following the IMF agreement, the government may resort once more to foreign currency denominated borrowing to ease pressure on domestic sources of funding.

A heavy inflow of foreign capital - some of it of a likely volatile nature - will complicate attempts to sustain macroeconomic stability in the longer term. If policy is geared to exchange rate stabilization, central banks intervene in the foreign exchange market and increase their holding of reserves - as done by the CBSL in recent months. However, rising net foreign assets become a major source of money supply growth. To ensure price sta-

bility, governments can resort to sterilization of domestic monetary expansion. Sri Lanka does not maintain a fully liberalized capital account, and thus, there is still some leeway to implement both monetary and exchange rate stabilization policies. For instance, even if open market operations result in higher interest rates, domestic borrowers are constrained from accessing funds from abroad. Nonetheless, whilst such a policy thrust may help stabilize short run macroeconomic equilibrium, it can also raise the long run risks of instability.

Over the 20 month period of disbursement agreed with the IMF, the loan conditionalities will be aimed at keeping Sri Lanka on a fairly tight fiscal and monetary policy path - to achieve the targeted fiscal deficit of 5 per cent of GDP by 2011. In that constricted policy space, addressing weaknesses in fiscal management - raising revenue and cutting down on unnecessary expenditures - to support the reconstruction drive in the Northern and Eastern Provinces will be critical. It is only from a platform of sound macroeconomic fundamentals that the country will be able to reap the full economic dividends of the end to the 30 year separatist conflict.

Appendix A: Macroeconomic Indicators (Statistical Base)

Table A1: Socio-Economic Indicators

1.	**Basic indicator**	**Unit**					
	Area:	Sq. km.	65,610				
	Mid year population (2008)	('000)	20,217				
	Population growth rate (2008)	%	1.0				
	Life expectancy at birth (2005)	years	71.6				
	Infant mortality rate (2005)	per 1000 live births	12.0				
	Gross school enrolment ratio (2005)(a)	%	62.7				
	Adult literacy rate (2005)	%	90.7				
	Human development index (HDI) (2005)	Value	0.7				
	Human poverty index (HPI) (2005)	Value	17.8				
			2004(g)	**2005**	**2006**	**2007**	**2008(e)**
2.	**Output, Labour force and Employment**						
	GNP at current market prices	Rs. bn.	2,070.0	2,423.0	2,898.0	3,540.0	4,311.0
	GDP at current market prices	Rs. bn.	2,091.0	2,453.0	2,939.0	3,579.0	4,411.0
	GDP at current factor cost prices	Rs. bn.	1,800.7	2,098.0	2,484.2	2,233.0	2,365.0
	GDP per capita at current market prices	US$	1,062.0	1,241.0	1,421.0	1,634.0	2,014.0
	Labour force(b)	mn.	8.1	7.3	7.6	7.5	7.6(c)
	Labour force participation(b)	%	48.6	48.3	51.2	49.8	50.2(c)
	Unemployment (b)	%	8.3	7.7	6.5	6.0	5.2(c)
3.	**Real output growth**						
	GDP	%	5.4	6.2	7.7	6.8	6.0
	Agriculture, forestry, and fishing	%	0.0	1.8	6.3	3.4	7.5
	Mining and quarrying	%	7.9	14.1	24.2	19.2	12.8
	Manufacturing	%	5.1	6.0	5.5	6.4	4.9
	Construction	%	6.6	8.9	9.2	9.0	7.8
	Services	%	6.7	6.4	7.7	7.1	5.6
4.	**Prices & wages**						
	CCPI (annual average)	% change	7.6	11.6	13.7	17.5	22.6
	New CCPI (2002 = 100)	% change	9.0	11.0	10.0	15.8	22.6
	WPI (annual average)	% change	12.5	11.5	11.7	24.4	24.9
	Implicit GNP deflator	% change	8.8	10.4	11.2	14.0	16.3
	Real wage rates						
	Workers in wages boards trades	% change	-4.8	-3.5	-9.9	4.4	2.6
	Government employees	% change	2.9	-7.0	-11.8	5.0	-12.4
5.	**Consumption, investment, and savings**						
	Consumption	% of GDP	83.6	82.1	83.0	82.4	85.9
	Gross domestic capital formation	% of GDP	25.3	26.8	28.0	28.0	27.5
	Gross domestic savings	% of GDP	16.4	17.9	17.0	17.6	14.1
	Gross national savings	% of GDP	22.0	23.8	22.3	23.3	18.2
	Net Imports of goods and services	% of GDP	-8.8	-8.9	-11.0	-10.4	-13.4
6.	**Government finance**						
	Revenue	% of GDP	14.9	15.5	16.3	15.8	14.9
	Expenditure & net lending	% of GDP	22.8	23.8	24.3	23.5	22.6
	Current expenditure	% of GDP	18.6	18.1	18.6	17.4	16.9
	Capital expenditure & net lending	% of GDP	4.2	5.8	5.6	6.1	5.7
	Current a/c balance	% of GDP	-3.7	-2.6	-2.4	-1.6	-2.0
	Budget deficit						
	Primary deficit	% of GDP	-2.2	-3.6	-2.9	-2.6	-2.9
	Overall deficit (before grants)	% of GDP	-7.9	-8.4	-8.0	-7.7	-7.7
	Public debt						
	External	% of GDP	47.6	39.0	38.4	37.1	32.8
	Domestic	% of GDP	54.7	51.6	50.3	47.9	48.3

Contd..../-

	Unit	2004(g)	2005	2006	2007	2008(e)
7. External trade						
Terms of trade	% change	-5.2	-4.2	-3.5	-1.0	-10.6
Import price index	% change	9.7	7.8	8.0	5.9	18.7
Export price index	% change	4.0	3.3	4.2	4.8	6.1
Import volume index	% change	9.0	2.7	7.1	4.1	4.4
Export volume index	% change	7.8	6.6	4.1	7.3	0.3
8. External finance						
Trade balance	% of GDP	-11.2	-10.7	-11.5	-11.3	-14.4
Current account balance	% of GDP	-3.2	-2.8	-5.3	-4.3	-9.3
Capital & financial account balance	% of GDP	3.1	2.8	6.7	6.5	4.4
Foreign direct investments	% of GDP	1.1	1.0	1.7	1.7	1.7
Foreign portfolio investments	% of GDP	0.05	0.03	0.19	0.31	0.2
Import capacity	months of imports (d)	5.2	5.7	4.7	5.3	3.3
External debt	% of GDP	61.8	53.3	50.3	51.0	43.7
Debt-service ratio	% of exports	11.6	7.9	12.7	13.1	15.0
9. Exchange rates (year end)						
U.S.A.	Rs./US$	104.61	102.1	107.7	108.7	113.1
U.K.	Rs./UK Pound	201.37	175.9	211.3	217.1	163.3
Japan	Rs./Yen	1.02	0.86	0.90	0.97	1.25
European Union	Rs./Eoro	142.32	120.96	141.58	160.27	159.5
India	Rs./Rs. Indian	2.40	2.27	2.40	2.76	2.35
SDR	Rs./SDR	161.60	145.90	162.00	171.60	174.27
10. Money supply						
Narrow money supply (M1)	% change	16.6	22.4	12.6	2.7	4.0
Broad money supply (M2)	% change	19.6	19.1	17.8	16.6	8.5
Domestic credit	% change	25.0	18.7	25.9	16.3	18.0
External banking assets	% change	1.9	20.3	-15.0	33.2	-57.3
11. Interest rates						
Treasury bills						
3 month	% per annum	7.2	10.1	12.8	21.3	17.3
12 months	% per annum	7.6	10.4	12.9	19.9	18.6
Call money rates	% per annum	9.0	10.3	11.5	12.0	11.0
Average prime lending rate	% per annum	10.2	12.2	15.2	17.9	18.5
Commercial banks saving	% per annum	7.7	10.2	10.5	16.5	16.5
NSB saving	% per annum	5.0	5.0	5.0	5.0	5.0
Commercial banks fixed deposits	% per annum	9.8	11.5	14.0	20.0	20.25
NSB fixed deposits	% per annum	8.0	9.0	11.0	15.0	15.0
12. Share market indicators						
Annual turnover	Rs. bn.	59.0	114.6	105.1	104.9	110.4
Companies listed	No.	242	239	237	235	235
Market capitalisation	Rs. bn.	382.1	584.0	835.0	821.0	489.0
Net purchases by non-nationals	Rs. mn.	1109	6,143.0	5,377.0	11,254.0	13,950.5
Share price indices						
CSE share	(Index, 1985 = 100)	1506.9	1,922.2	2,722.4	2,541.0	1,503.0
CSE sensitive(f)	(Index, 1985 = 100)	2073.7	2,451.1	3,711.8	3,291.9	1,631.3

Notes: (a): Combined first, second, and third level gross enrolment ratio.
(b): Excluding Northern and Eastern Provinces.
(c): Average of four 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.
(g): From 2003, data are based on GDP estimates compiled by the Dept. of Census and Statistics.

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, 1986-2008

	Constant Prices (c)			Growth Rates		
	GDP	PGDP	POP(b)	GDP	PGDP	POP
	Rs. mn.	Rs.mn.	('000)			
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(d)	1,733,222.0	90,028.2	19,252	5.9	4.6	1.3
2004	1,827,597.0	93,905.9	19,462	5.4	4.3	1.1
2005	1,947,671.0	99,027.4	19,668	6.2	5.5	1.0
2006	2,090,548.0	105,126.6	19,886	7.7	6.2	1.1
2007	2,232,656.0	111,563.6	20,010	6.8	6.1	0.6
2008(a)	2,365,500.0	117,005.5	20,217	6.0	4.9	1.0

Notes: (a): Provisional.
(b): From 2001 the figures are based on Census of Population and Housing-2001.
(c): Up to 2002 data are based on 1996 prices and 2003 onwards data are based on 2002 prices
(d): From 2003, data are based on GDP estimates compiled by the Department of Census and Statistics.

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

Table A3: Structure and Growth of Output, 2000-2008

	Unit	2000	2001	2002	2003(c)	2004	2005	2006	2007	2008(a)	1998-2007	1999-2008(b)
1. Structure of output												
Agriculture, forestry, and fishing	% of total output	20.4	20.1	20.5	13.2	12.5	11.8	11.3	11.9	12.1	12.2	13.4
Agriculture	% of total output	15.9	16.0	16.6	14.7	14.3	14.3	13.4	10.8	10.9	11.6	12.7
Tea	% of agriculture	8.9	9.0	7.2	10.9	11.6	11.4	10.5	13.6	11.0	8.3	9.4
Rubber	% of agriculture	2.3	2.4	1.2	2.6	3.2	3.8	6.1	5.9	5.4	2.8	3.3
Coconut	% of agriculture	11.1	10.0	8.4	13.4	11.9	11.3	10.1	11.2	12.5	8.7	10.0
Paddy	% of agriculture	20.4	20.1	18.0	14.8	13.7	14.8	13.1	12.3	19.1	12.7	14.6
Mining and quarrying	% of total output	1.7	-1.8	1.8	1.4	1.4	1.5	1.6	1.6	1.6	0.9	1.1
Manufacturing	% of total output	17.4	-16.9	15.8	18.6	18.7	19.5	19.2	18.5	18.0	11.1	12.9
Export processing	% of manufacturing	12.0	11.7	11.3	4.2	4.0	3.4	3.1	3.3	4.1	5.3	5.7
Factory industry	% of manufacturing	80.6	80.8	77.2	89.6	89.8	90.9	91.4	91.5	91.0	69.2	78.3
Small industry	% of manufacturing	7.4	7.5	7.6	6.3	6.2	5.7	5.5	5.3	4.9	5.1	5.6
Construction	% of total output	7.3	7.6	7.2	6.0	6.1	6.8	7.4	7.4	7.4	5.6	6.3
Services	% of total output	53.3	53.9	54.9	58.3	58.8	58.0	58.0	58.4	57.3	45.4	51.1

	Unit	2000	2001	2002	2003	2004	2005	2006	2007	2008(a)	1998-2007	1999-2008(b)
2. Real output growth												
Agriculture, forestry, and fishing	% growth	1.8	-3.5	2.5	-54.9	-5.5	-6.1	-4.3	3.4	7.5	-6.7	-5.9
Agriculture	% growth	1.7	-4.3	1.9	-12.9	-2.8	0.0	-6.7	2.3	7.3	-2.1	-1.4
Tea	% growth	7.8	-3.5	5.1	33.9	6.4	-2.3	-8.7	-1.8	4.3	3.7	4.1
Rubber	% growth	-9.7	-1.5	5.0	53.2	20.5	15.8	37.7	4.2	10.3	12.5	13.6
Coconut	% growth	8.0	-13.5	-13.6	37.3	-12.4	-5.2	-12.1	5.1	5.2	-0.6	-0.1
Paddy	% growth	-0.3	-5.7	5.1	-21.9	-7.6	7.4	-13.2	-6.2	22.9	-4.2	-1.9
Mining and quarrying	% growth	4.8	0.7	-1.1	-28.5	2.8	1.6	6.8	19.2	12.8	0.6	1.9
Manufacturing	% growth	9.2	-4.2	2.1	15.0	0.7	4.1	-1.5	6.4	4.9	3.2	3.7
Export processing	% growth	4.2	-6.7	-0.9	-170.6	-3.4	-19.3	-7.9	2.4	5.3	-20.2	-19.7
Factory industry	% growth	10.4	-3.9	2.5	13.8	0.3	1.2	0.6	6.7	5.0	3.2	3.7
Small industry	% growth	5.5	-3.5	2.1	-21.3	-1.8	-7.4	-4.8	4.5	5.6	-2.7	-2.1
Construction	% growth	4.8	2.5	-0.8	-19.2	1.1	10.8	7.2	9.0	7.8	1.5	2.3
Services	% growth	2.3	-0.5	6.1	5.9	0.8	-1.5	0.1	7.1	5.6	2.0	2.6
GDP	% growth	6.0	-1.5	4.0	5.9	6.9	7.9	8.9	6.8	6.0	4.6	5.2

Notes: (a): Provisional.
(b): Average annual growth rate.
(c): From 2003, data are based on GDP estimates compiled by the Department of Census and Statistics.

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

Table A4: Value Added in Industry and Industrial Production, 1996-2008

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008(a)
1. Value added, current prices (Rs. mn.)													
Food, beverages and tobacco	32,891	35,585	40,452	44,503	49,031	54,282	61,550	136,058	158,229	202,785	241,854	282,843	348,358
Textile, wearing apparel and leather products	31,148	40,581	47,482	55,263	69,451	71,263	77,028	76,511	85,179	103,198	113,956	131,522	147,822
Wood and wood products (including furniture)	1,250	1,258	1,313	1,390	1,554	1,639	1,736	1,085	1,121	1,143	1,245	1,353	1,447
Paper and paper products	2,580	2,633	2,578	2,664	2,808	3,103	3,124	1,669	2,079	2,963	3,998	4,857	5,789
Chemicals, petroleum, coal, rubber and plastic products	8,957	10,745	14,274	13,832	17,771	19,245	22,653	46,133	58,912	72,089	95,346	112,915	135,447
Nonmetallic mineral products (except petroleum and coal)	10,537	11,600	12,463	13,817	14,240	16,010	17,273	11,388	13,432	15,805	17,930	20,352	22,776
Basic metal products	450	598	710	777	959	1,131	1,306	970	998	1,061	1,292	1,521	1,638
Fabricated metal products, machinery and transport equipment	4,809	5,924	6,779	7,367	7,714	8,731	9,698	28,339	30,217	34,480	38,872	47,947	55,185
Manufactured products n.e.s.	2,763	3,157	3,426	3,799	3,965	4,154	4,695	1,307	1,350	1,446	1,879	2,208	2,508
Total	95,385	112,011	129,477	143,412	167,493	179,559	199,063	303,460	351,517	434,970	516,372	605,544	720,979
2. Composition of industrial production, %													
Food, beverages and tobacco	34.5	31.7	31.2	31.0	29.3	30.2	30.9	44.8	45.0	46.6	46.8	46.7	48.3
Textile, wearing apparel and leather products	32.7	36.2	36.7	38.5	41.5	39.7	38.7	25.2	24.2	23.7	22.1	21.7	20.5
Wood and wood products (including furniture)	1.3	1.1	1.0	1.0	1.0	0.9	0.9	0.4	0.3	0.3	0.2	0.2	0.2
Paper and paper products	2.7	2.4	2.0	2.0	1.7	1.7	1.6	0.5	0.6	0.7	0.8	0.8	0.8
Chemicals, petroleum, coal, rubber and plastic products	9.4	9.6	11.0	9.6	10.6	10.7	11.4	15.2	16.8	16.6	18.5	18.6	18.8
Nonmetallic mineral products (except petroleum and coal)	11.0	10.4	9.6	9.6	8.5	8.9	8.7	3.8	3.8	3.6	3.5	3.4	3.2
Basic metal products	0.5	0.5	0.5	0.5	0.6	0.6	0.7	0.3	0.3	0.2	0.3	0.3	0.2
Fabricated metal products, machinery and transport equipment	5.0	5.3	5.2	5.1	4.6	4.9	4.9	9.3	8.6	7.9	7.5	7.9	7.7
Manufactured products n.e.s.	2.9	2.8	2.6	2.6	2.4	2.3	2.4	0.4	0.4	0.3	0.4	0.4	0.3
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.
(b): From 2003, data are based on GDP estimates compiled by the Department of Census and Statistics.

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

Table A5: Major Agricultural Crops, Production and Prices, 1986-2008

	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.nut	Rs./nut	'000 Mt	Rs./bushel(c)
1986	211.0	30.28	44.52	137.8	16.62	23.83	3,039	1.46	2,588	70.00
1987	213.0	38.06	52.97	121.8	19.87	27.63	2,291	2.64	2,128	70.00
1988	227.0	41.59	55.95	122.4	24.40	37.33	1,936	4.00	2,477	80.00
1989	207.0	52.16	66.91	110.7	22.63	36.18	2,484	3.36	2,063	80.00
1990	233.0	65.72	91.78	113.1	22.93	35.50	2,532	3.63	2,538	110.00
1991	241.0	57.13	84.12	103.9	23.59	34.55	2,184	4.82	2,389	136.00
1992	179.0	60.51	81.98	106.1	29.28	37.65	2,296	6.47	2,340	136.00
1993	231.9	68.88	91.16	104.2	35.48	44.34	2,164	6.31	2,570	155.00
1994	242.2	65.12	91.32	105.3	50.36	51.81	2,622	5.67	2,684	155.00
1995	245.9	72.21	102.31	105.7	72.04	83.69	2,755	6.08	2,810	155.00
1996	258.4	103.88	139.56	112.5	67.85	79.78	2,561	9.42	2,061	155.00
1997	276.9	119.40	158.40	105.8	56.70	75.40	2,631	9.60	2,239	155.00
1998	280.1	134.30	184.90	95.7	49.70	67.70	2,552	8.30	2,692	155.00
1999	283.7	115.30	162.40	96.6	45.30	54.00	2,828	9.90	2,857	155.00
2000	305.8	135.50	184.40	87.6	55.00	66.90	3,096	7.40	2,860	155.00
2001	295.1	143.90	208.90	86.2	55.00	66.40	2,796	7.10	2,695	-
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	309.5	180.74	248.92	94.7	127.20	128.51	2,591	11.00	2,628	-
2005(d)	317.2	185.84	263.31	104.4	147.41	147.73	2,515	13.00	3,246	-
2006	310.8	198.87	279.97	109.2	202.50	189.90	2,785	24.30	3,342	-
2007	305.2	279.10	364.28	117.6	234.22	234.50	2,869	16.87	3,131	-
2008(e)	317.7	301.63	430.40	129.2	269.51	278.20	2,909	22.71	3,875	-

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, 1998-2008

		Household population (10 yrs. & over)	Labour force	Labour force participation	Labour force			
					Employed		Unemployed	
		No. mn.	No. mn.	rate (%)	No. mn.	Rate	No. mn.	Rate
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 (a)								
	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 (b)		16.9	8.1	48.3	7.5	92.3	0.6	7.7
2006								
	q1	14.8	7.6	51.7	7.1	92.8	0.5	7.2
	q2	14.8	7.6	51.1	7.1	93.7	0.5	6.3
	q3	15.0	7.6	50.7	7.1	93.5	0.5	6.5
	q4	15.0	7.6	51.0	7.1	93.7	0.5	6.3
2007								
	q1	15.0	7.5	49.8	7.0	93.3	0.5	7.1
	q2	15.0	7.4	49.0	7.0	94.6	0.5	7.1
	q3	15.0	7.5	50.2	7.1	94.7	0.4	5.6
	q4	15.1	7.6	50.1	7.2	94.7	0.4	5.6
2008								
	q1	15.1	7.5	49.8	7.1	94.7	0.4	5.1
	q2	15.1	7.5	49.6	7.1	94.7	0.4	5.3
	q3	14.8	7.6	51.1	7.2	94.7	0.4	5.2
	q4	15.2	7.6	50.3	7.2	94.7	0.4	5.2

Notes: (a) 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.
(b) Quarterly labour force survey was conducted as a one-off survey in August 2005.

Source: Department of Census and Statistics, *Quarterly Report of the Sri Lanka Labour Force.*

Table A7: Gross Domestic Fixed Capital Formation, 1986-2008

	Private(a)	Public(b)	Private(a)	Public(b)	Private(a)	Public(b)	Private(a)	Public(b)
	(Rs. mn., current market prices)		(As % of GDP)		(at constant prices(c)(e))		(Growth in real terms)	
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	298,731	31,812	19.1	2.0	188,863.2	19,913.6	4.1	-44.1
2003(f)	318,909	46,285	17.5	2.5	325,998.0	47,784.0	42.1	58.3
2004	422,060	51,262	20.2	2.5	387,917.5	47,115.2	19.0	-1.4
2005	478,917	94,347	19.5	3.8	398,641.6	78,532.7	2.8	66.7
2006	624,972	105,938	21.3	3.6	467,495.5	79,244.4	17.3	0.9
2007	807,400	192,900	22.6	5.4	468,438.9	111,916.2	0.2	41.2
2008(d)	928,800	286,000	21.1	6.5	480,877.6	148,092.2	2.7	32.3

Notes: (a): Private sector and public corporations.
(b): Government and public enterprises.
(c): Current series deflated by GDP deflator.
(d): Provisional.
(e): Up to 2002 data are based on 1996 prices and 2003 onwards data are based on 2002 prices.
(f): From 2003, data are based on GDP estimates compiled by the Department of Census and Statistics.

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

Table A8: Saving and Investment, 1994-2008

(As % of GDP)	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003(c)	2004	2005	2006	2007	2008(a)
Gross domestic capital formation	27.0	25.7	24.2	24.4	25.1	27.3	28.0	22.0	21.3	20.0	22.6	23.4	24.9	27.9	27.5
Gross domestic savings	15.2	15.2	15.3	17.3	19.1	19.5	17.4	15.8	14.5	16.0	16.4	17.9	17.0	17.6	14.1
Net imports of goods and non-factor services (b)	11.8	10.4	8.9	7.1	6.0	7.8	10.6	6.2	6.8	6.4	6.6	7.1	6.7	10.4	13.4
Net factor income from abroad	-1.4	-1.0	-1.5	-1.1	-1.1	-1.6	-2.1	-1.7	-1.6	-0.9	-1.0	-1.2	-1.4	-1.1	-2.2
Net private transfers	5.4	5.2	5.1	5.2	5.4	5.6	5.9	6.2	6.6	6.4	6.5	7.1	6.7	6.8	6.3
Gross national savings	19.1	19.5	19.0	21.5	23.4	23.5	21.5	20.3	19.5	21.5	22.0	23.8	22.3	23.3	18.2
Foreign savings	7.9	6.2	5.2	5.2	1.7	3.8	6.5	1.7	1.8	-1.5	0.6	-0.4	2.6	1.1	2.2

Notes: (a): Provisional.
(b): Also referred to as external inflow or the resources gap.
(c): From 2003, data are based on GDP estimates compiled by the Department of Census and Statistics.

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

Table A9: Summary of Government Fiscal Operations, 1996-2008

(As % of GDP)	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Revenue	19.0	18.5	17.3	17.7	16.8	16.7	16.5	15.7	15.4	16.1	16.3	15.8	14.9
Grants	1.0	0.8	0.7	0.6	0.4	0.4	0.4	0.5	0.4	1.5	1.7	1.6	1.6
Expenditure													
Current expenditure	22.8	20.8	19.6	18.7	20.2	21.6	20.8	19.0	19.2	18.7	18.6	17.4	16.9
Capital & net lending	5.7	5.7	6.7	6.5	6.5	5.9	4.5	4.7	4.3	6.0	5.6	6.1	5.7
Current account balance	-3.8	-2.2	-2.4	-1.0	-3.4	-4.9	-4.4	-3.3	-3.9	-2.7	-2.4	-1.6	-2.0
Primary deficit	-3.1	-1.7	-3.8	-1.9	-4.2	-4.1	-1.6	-0.9	-2.2	-3.6	-2.9	-2.6	-2.2
Overall deficit (before grants)	-9.4	-7.9	-9.2	-7.5	-9.9	-10.8	-8.9	-8.0	-8.2	-8.7	-8.0	-7.7	-7.7
Financing budget deficit													
Foreign financing	2.3	1.9	1.7	0.7	0.4	1.4	0.6	2.9	8.2	3.4	2.5	3.7	0.6
Net borrowings	1.3	1.1	1.0	0.1	0	1.0	0.1	2.4	1.8	2.0	1.4	2.8	-0.1
Grants	1.0	0.8	0.7	0.6	0.4	0.4	0.4	0.5	0.4	1.4	1.0	0.9	0.7
Domestic financing	6.5	3.4	7.1	6.8	9.4	8.8	8.0	4.5	5.8	5.2	5.6	3.6	7.0
Market borrowings	5.1	4.5	7.1	6.8	9.2	8.7	8.0	4.5	5.5	5.0	5.6	3.6	7.0
Bank	1.7	-0.2	1.9	2.5	4.5	3.5	-0.3	-1.2	2.1	1.1	2.7	0.4	4.4
Non-bank	3.4	4.7	5.2	4.4	4.7	5.3	8.3	5.7	3.4	3.9	2.9	3.1	2.6
Other borrowings	1.3	-1.1	-0.1	-0.1	0.3	0.1	-0.1	-	0.2	0.2	-	-	-
Privatisation proceeds(a)	0.6	2.5	0.4	-	-	0.6	0.4	0.6	0.1	-	-	-	-

Notes: (a): Since 1994, privatization proceeds have been shifted from the capital expenditure and net lending category to the financing section.
(b): Provisional.
(c): From 2003, data are based on GDP estimates compiled by the Department of Census and Statistics.

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

Table A10: Money Supply and Underlying Factors, 1989-2008

	Unit	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
1. Financial depth											
Narrow money supply	M1/GDP	14.0	12.3	12.5	11.8	11.9	12.2	11.3	10.2	10.7	10.5
Broad money supply	M2/GDP	30.3	28.1	29.7	30.5	32.1	33.1	34.2	33.0	35.9	34.6
2. Monetary expansion/contraction											
Narrow money supply	% growth	9.1	12.1	17.7	7.4	18.6	18.7	6.7	4.0	9.8	12.1
Broad money supply	% growth	12.5	18.5	22.1	17.4	23.4	19.7	19.2	10.8	13.8	9.7
3. Causal factors											
3.1 External banking assets	Rs.mn.	4,732.0	3,419.0	12,258.0	20,940.0	48,119.0	64,467.0	66,532.0	61,861.0	89,292.0	93,724.0
	% growth	-33.0	-27.7	258.5	70.8	129.8	34.0	3.2	-7.0	44.3	5.0
3.2 Domestic credit	Rs.mn.	102,321.2	115,964.3	127,751.2	144,003.0	150,696.9	173,795.6	223,798.3	252,317.0	272,733.0	311,626.0
	% growth	5.6	13.3	10.2	12.7	4.6	15.3	28.8	12.7	8.1	14.3
3.2.1 Government	Rs.mn.	36,118.0	35,358.0	35,392.0	33,065.0	26,993.0	28,148.0	35,214.0	48,537.0	46,365.0	58,591.0
	% growth	0.1	-2.1	0.1	-6.6	-18.4	4.3	25.1	37.8	-4.5	26.4
3.2.2 Private sector	Rs.mn.	66,203.2	80,606.3	92,359.2	110,938.0	123,703.9	145,647.6	188,352.0	203,780.0	226,368.0	253,035.0
	% growth	8.9	21.8	14.6	20.1	11.5	17.7	29.3	8.2	11.1	11.8
3.3 Other liabilities	Rs.mn.	-30,619.8	-28,838.0	-29,435.0	-35,150.0	-38,679.0	-46,590.0	-61,794.0	-60,978.0	-73,768.0	-89,176.0
	% growth	-14.9	-5.8	2.1	19.4	10.0	20.5	32.6	-1.3	21.0	20.9

Contd…

	Unit	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
1. Financial depth											
Narrow money supply	M1/GDP	10.9	10.5	9.8	8.8	8.9	9.0	9.4	8.8	7.4	6.3
Broad money supply	M2/GDP	36.0	36.0	36.0	32.2	31.9	32.9	33.6	33.8	32.1	29.1
2. Monetary expansion/contraction											
Narrow money supply	% growth	12.8	9.1	3.2	14.0	16.0	14.2	18.3	11.2	2.7	4.0
Broad money supply	% growth	13.3	13.0	11.4	13.2	15.3	15.6	16.4	17.1	15.6	11.7
3. Causal factors											
3.1 External banking assets	Rs.mn.	83,892.0	59,448.0	82,966.0	101,717.0	129,487.0	129,152.0	167,147.0	185,005.0	273,000.0	354,700.0
	% growth	-10.5	-29.1	39.6	22.6	27.3	-0.3	22.7	9.6	7.6	8.0
3.2 Domestic credit	Rs.mn.	374,120.0	469,084.0	513,457.0	548,578.0	602,898.0	734,605.0	864,392.0	1,138,805.0	1,607,800.0	1,897,500.0
	% growth	20.1	25.4	9.5	6.8	9.9	21.8	11.6	24.1	44.9	43.0
3.2.1 Government	Rs.mn.	85,881.0	134,484.0	161,735.0	153,171.0	143,444.0	181,111.0	249,565.0	357,289.0	374,100.0	572,000.0
	% growth	46.6	56.6	20.3	-5.3	-6.3	26.3	11.6	30.1	10.5	13.0
3.2.2 Private sector	Rs.mn.	288,239.0	334,599.0	351,722.0	395,407.0	430,575.0	526,236.0	680,693.0	856,842.0	1,184,500.0	1,278,500.0
	% growth	13.9	16.1	5.1	12.4	16.2	22.2	22.7	20.0	33.1	29.0
3.3 Other liabilities	Rs.mn.	-99,936.0	-123,863.0	-145,696.0	-139,899.0	-151,638.0	-175,793.0	-208,608.0	-330,545.0	-431,800.0	-472,000.0
	% growth	12.1	23.9	17.6	4.0	8.5	15.9	15.7	36.8	12.1	10.7

Notes: Data have been reclassified starting from 1990. For more information, see Central Bank of Sri Lanka, 1995, *Annual Report*.
From 2003, data are based on GDP estimates compiled by the Department of Census and Statistics.

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

Table A11: Interest Rates, 1995-2008

(%, end of period)	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Bank rate	17.0	17.0	17.0	17.0	16.0	25.0	18.0	18.0	15.0	15.0	15.0	15.0	15.0	15.0
Treasury bills, yield rates														
3 Month	19.3	17.5	10.0	12.0	12.1	17.8	12.9	9.9	7.3	7.2	10.1	12.8	21.3	17.3
12 Month	19.0	17.4	10.2	12.6	12.8	18.2	13.7	9.9	7.2	7.6	10.4	13.0	20.0	19.1
Repurchase rate	16.5	12.8	11.0	11.3	9.3	17.0	12.0	9.9	7.0	7.5	8.8	10.0	10.5	10.5
Call money rate														
Maximum	102.0	31.0	20.0	16.5	14.3	32.0	13.0	10.9	8.2	10.6	11.1	15.1	40.0	19.0
Minimum	16.0	13.0	9.0	11.3	9.8	20.3	12.5	10.2	7.4	9.5	10.5	12.7	16.0	13.0
Weighted average prime lending rate	20.0	18.4	14.2	15.1	15.2	21.5	14.2	12.2	8.9	10.2	12.1	14.7	18.0	18.5
Commercial bank saving														
Maximum	13.0	13.0	11.0	10.0	10.0	10.0	12.0	11.0	7.2	7.7	10.3	10.5	16.5	16.5
Minimum	5.0	4.5	3.0	2.0	2.0	2.0	4.0	3.5	2.1	3.0	3.0	3.0	3.0	3.0
NSB saving	12.0	12.0	10.8	10.5	9.2	8.4	8.4	6.0	5.0	5.0	5.0	5.0	5.0	5.0
Commercial bank fixed deposit (one year)														
Maximum	17.0	17.8	15.3	13.0	12.5	15.0	14.5	11.0	7.8	9.8	11.5	14.0	20.0	20.3
Minimum	10.0	12.0	8.5	9.0	9.0	9.0	9.5	7.5	5.0	5.0	5.5	5.5	8.5	8.5
NSB fixed deposit (one year, paid on maturity)	16.0	15.0	11.0	11.5	11.5	15.0	13.0	10.0	7.0	8.0	9.0	11.0	15.0	15.0

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

Table A12: Basic Indicators of the General Price Level, 1988-2008

	CCPI (1952 = 100)	% change	CCPI (2002 = 100)	% change	WPI (1974 = 100)	% change	GDPD (1996 = 100)	% change
1988	744.1	14.0			488.7	17.8	42.8	11.5
1989	830.2	11.6			532.9	9.0	46.9	9.6
1990	1,008.6	21.5			651.1	22.2	56.3	20.0
1991	1,131.5	12.2			710.8	9.2	62.5	11.0
1992	1,260.4	11.4			773.0	8.8	68.7	10.0
1993	1,408.4	11.7			831.8	7.6	75.2	9.5
1994	1,527.4	8.4			873.4	5.0	82.3	9.3
1995	1,644.6	7.7			950.7	8.9	89.2	8.4
1996	1,906.7	15.9			1,145.1	20.4	100.0	12.1
1997	2,089.1	9.6			1,224.3	6.9	108.6	8.6
1998	2,284.9	9.4			1,298.7	6.1	117.8	8.4
1999	2,392.1	4.7			1,295.3	0.3	123.1	4.4
2000	2,539.8	6.2			1,317.2	1.7	131.3	6.7
2001	2,899.4	14.2			1,471.2	11.7	147.6	12.3
2002	3,176.4	9.6			1,629.0	10.7	159.9	8.4
2003	3,377.0	6.3			1,679.1	3.1	168.2	5.1
2004	3,632.8	7.6	115.3	9.0	1,889.0	12.5	183.0	8.8
2005	4,055.5	11.6	128.0	11.0	2,105.9	11.5	202.1	10.4
2006	4,610.8	13.7	140.8	10.0	2,351.6	11.7	224.9	11.3
2007	5,416.1	17.5	163.1	15.8	2,924.4	24.4	256.4	14.0
2008			199.9	22.6	3,653.6	24.9	298.3	16.3

Notes: CCPI : Colombo Consumers' Price Index.
GCCPI : Greater Colombo Consumers' Price Index.
WPI : Wholesale Price Index.
GDPD : GDP deflator.

Sources: Department of Census and Statistics.
Central Bank of Sri Lanka, *Annual Report*, various issues.

Table A13: Wage Rate Indices, 1988-2008 (December 1978 = 100)

	Workers in wages boards trades(a)		Government employees(b)	
	Nominal	Real	Nominal	Real
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	1,329.7	81.3	2,417.5	142.7
2006	1,358.2	70.7	3,150.8	164.0
2007	1,648.8	73.6	3,828.4	171.6
2008(c)	2070.4	75.5	4,116.1	150.4

Notes: The wage rates used in the calculation of index numbers are minimum wages.
(a): Combined index for workers in agriculture, industry and commerce, and services.
(b): Combined index for non-executive officers and minor employees.
(c): Provisional.

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

Table A14: Sri Lanka's Direction of Foreign Trade, 1991-2008

	Unit	1991	1992	1993	1994	1995	1996	1997	1998	1999
1.Exports to selected countries and groupings										
U.S.A	US$ mn.	559.0	837.6	1,006.8	1,115.3	1,353.5	1,395.8	1,666.4	1,890.2	1,791.8
U.K.	US$ mn.	126.2	170.2	203.5	285.4	345.3	388.6	525.4	530.4	604.2
Germany	US$ mn.	148.8	211.8	227.5	222.5	254.3	239.3	230.0	231.9	215.7
Japan	US$ mn.	101.6	128.0	148.0	165.3	200.4	256.4	234.2	196.1	159.1
EC	% of total exports	27.0	32.8	31.2	31.3	31.0	29.4	35.0	33.6	35.3
Germany	% of exports to EC	27.0	26.3	25.5	22.2	21.6	19.8	17.1	17.9	16.2
UK	% of exports to EC	22.9	21.1	22.8	28.4	29.3	32.2	39.0	41.0	45.0
ASEAN	% of total exports	5.5	2.4	2.9	3.9	3.7	2.8	3.4	3.0	3.1
Singapore	% of exports to ASEAN	59.8	56.5	58.6	60.6	52.3	52.0	43.7	38.1	37.9
Malaysia	% of exports to ASEAN	23.6	7.7	4.0	4.6	15.7	23.5	16.6	10.1	6.0
SAARC	% of total exports	3.0	2.3	2.5	2.7	2.7	2.6	3.1	3.0	3.8
India	% of exports to SAARC	20.8	20.3	27.6	27.2	31.3	39.6	37.0	33.2	33.7
NAFTA	% of total exports	30.0	36.4	37.1	36.8	37.3	35.6	45.5	51.5	49.8
USA	% of exports to NAFTA	91.4	93.5	94.9	94.4	95.4	95.6	95.3	95.4	95.1
Canada	% of exports to NAFTA	5.2	4.3	3.4	4.3	3.5	3.1	3.2	3.1	3.1
APEC	% of total exports	43.7	47.6	48.7	49.6	50.1	48.7	59.8	58.9	56.3
USA	% of exports to APEC	62.7	71.5	72.3	70.1	71.0	69.8	72.4	83.4	84.1
Japan	% of exports to APEC	11.4	10.9	10.6	10.4	10.5	12.8	10.2	8.6	7.5
Singapore	% of exports to APEC	0.4	0.3	0.2	0.2	0.1	0.1	0.1	1.9	2.1
2. Imports from selected countries and groupings										
Japan	US$ mn.	358.4	415.6	452.6	526.6	498.6	497.3	479.3	555.9	560.9
India	US$ mn.	220.1	301.9	342.9	404.4	469.2	561.9	559.8	539.4	511.6
Hong Kong	US$ mn.	212.5	241.0	312.4	316.6	357.4	354.1	411.3	411.0	459.1
U.S.A	US$ mn.	174.5	159.4	131.3	284.7	172.7	198.3	186.6	229.5	216.2
U.K.	US$ mn.	166.3	172.8	184.8	247.6	242.6	251.7	282.4	304.8	251.1
Taiwan	US$ mn.	207.4	214.0	225.7	250.2	286.4	287.8	372.1	378.7	347.1
EC	% of total imports	15.2	14.7	15.8	16.3	15.3	15.4	17.6	23.3	19.4
Germany	% of imports from EC	22.0	24.7	21.9	21.8	20.5	18.4	20.5	20.2	15.8
UK	% of imports from EC	36.0	33.5	29.2	31.8	29.8	30.1	31.6	30.3	29.1
ASEAN	% of total imports	13.8	15.1	14.5	13.2	12.8	12.6	14.7	19.6	21.1
Singapore	% of imports from ASEAN	32.3	44.8	35.8	37.2	36.6	37.7	38.3	36.8	48.2
Malaysia	% of imports from ASEAN	33.4	24.1	29.5	28.8	31.1	26.7	22.3	22.8	18.0
SAARC	% of total imports	10.3	11.8	10.7	10.3	10.2	11.9	13.1	15.1	14.2
India	% of imports from SAARC	70.3	72.7	80.1	82.7	86.1	86.9	83.9	83.3	81.4
NAFTA	% of total imports	6.3	5.2	3.7	6.3	3.6	4.3	5.7	7.1	5.5
USA	% of imports from NAFTA	91.3	87.0	89.4	95.0	91.3	84.6	64.7	75.0	89.0
Canada	% of imports from NAFTA	8.3	11.6	10.1	4.6	7.9	10.0	19.0	13.6	9.3
APEC	% of total Imports	58.5	57.1	55.7	55.4	50.2	50.4	61.9	45.9	53.4
USA	% of imports from APEC	9.8	8.0	5.9	10.8	6.5	7.3	5.9	11.6	9.1
Japan	% of imports from APEC	11.8	11.9	11.3	11.0	9.4	9.2	9.4	28.1	23.6
Singapore	% of imports from APEC	7.6	11.9	9.3	8.8	9.3	9.5	9.1	15.7	19.0

Cont../

	Unit	2000	2001	2002	2003	2004	2005	2006	2007	2008(a)
1. Exports to selected countries and groupings										
U.S.A	US$ mn.	2,192.5	1,925.9	1,764.0	1,777.4	1,869.3	1988.1	2,005.5	1,970.0	1,869.3
U.K.	US$ mn.	736.7	576.4	590.3	640.4	779.2	777.3	880.1	1,018.0	1,090.4
Germany	US$ mn.	230.2	198.5	199.3	232.4	274.1	271.8	328.8	437.9	405.3
Japan	US$ mn.	229.7	185.8	140.3	165.4	157.6	144.6	163.6	159.6	159.0
EC	% of total exports	33.4	32.3	35.2	35.9	38.3	37.2	40.7	37.6	37.3
Germany	% of exports to EC	15.2	15.8	14.4	15.3	14.9	13.9	14.5	15.2	13.4
UK	% of exports to EC	48.5	45.8	42.8	42.2	42.3	39.9	38.7	35.4	35.9
ASEAN	% of total exports	3.5	2.9	2.6	2.5	2.6	2.9	3.4	2.8	2.9
Singapore	% of exports to ASEAN	38.7	51.4	63.6	61.8	67.9	52.2	39.0	37.6	31.8
Malaysia	% of exports to ASEAN	5.0	5.9	8.4	11.7	7.1	9.5	12.9	16.7	18.6
SAARC	% of total exports	4.2	4.1	6.5	8.3	10.5	12.5	10.7	8.5	6.9
India	% of exports to SAARC	30.6	45.6	66.5	70.0	77.3	86.7	81.6	79.8	74.6
NAFTA	% of total exports	50.5	52.0	47.6	44.5	41.2	40.4	38.1	27.6	24.9
USA	% of exports to NAFTA	95.4	95.1	94.6	94.5	94.5	94.1	94.2	93.3	92.4
Canada	% of exports to NAFTA	3.1	3.4	3.3	3.4	3.6	3.7	3.6	3.7	4.4
APEC	% of total exports	57.8	59.5	54.6	52.2	47.8	46.2	44.0	37.1	35.0
USA	% of exports to APEC	83.5	83.1	82.5	80.6	81.4	82.3	81.5	69.4	65.6
Japan	% of exports to APEC	8.7	8.0	6.6	7.4	6.9	5.9	6.6	5.6	5.6
Singapore	% of exports to APEC	2.3	2.5	3.1	3.0	3.8	3.3	3.0	2.8	2.7
2. Imports from selected countries and groupings										
Japan	US$ mn.	646.0	336.9	355.3	448.1	411.7	379.7	449.6	413.2	424.5
India	US$ mn.	600.1	709.3	852.9	1,073.2	1,439.1	1,835.4	2,172.9	2,610.1	3,443.0
Hong Kong	US$ mn.	515.9	500.3	491.0	559.5	619.4	648.2	659.1	724.8	694.6
U.S.A	US$ mn.	254.9	265.6	218.7	188.3	240.1	204.5	200.6	412.1	272.6
U.K.	US$ mn.	311.4	220.6	262.9	272.9	312.1	276.2	303.4	229.8	243.2
Taiwan	US$ mn.	390.1	322.8	288.0	276.1	290.8	278.7	274.8	263.6	251.2
EC	% of total imports	18.8	18.0	18.0	18.8	18.2	16.7	15.9	12.4	12.4
Germany	% of imports from EC	16.5	16.3	13.5	13.4	15.7	14.3	16.2	16.4	16.2
UK	% of imports from EC	32.8	26.0	29.3	25.5	25.2	22.2	22.1	16.5	14.0
ASEAN	% of total imports	21.0	19.4	19.1	19.8	20.0	20.5	21.7	16.7	15.7
Singapore	% of imports from ASEAN	46.7	44.8	46.0	46.2	51.2	48.2	52.9	59.3	56.7
Malaysia	% of imports from ASEAN	20.5	22.7	21.7	25.6	24.1	25.7	23.7	15.0	16.3
SAARC	% of total imports	14.0	15.1	19.1	19.9	23.1	26.6	27.2	24.9	26.1
India	% of imports from SAARC	84.8	84.4	89.4	91.5	91.4	92.6	92.4	92.7	94.1
NAFTA	% of total imports	6.0	6.2	4.7	4.1	4.1	3.9	4.8	4.4	4.7
USA	% of imports from NAFTA	84.1	91.5	93.8	85.4	84.4	71.2	48.0	83.5	41.6
Canada	% of imports from NAFTA	15.6	8.2	5.8	14.2	15.3	28.0	51.4	16.1	57.9
APEC	% of total imports	54.9	55.6	52.1	49.2	46.4	44.0	43.8	42.5	39.4
USA	% of imports from APEC	9.2	10.1	8.5	7.1	7.6	6.2	5.3	8.6	4.9
Japan	% of imports from APEC	23.2	12.8	13.8	16.0	13	11.6	11.9	8.6	7.7
Singapore	% of imports from APEC	17.8	15.6	16.8	18.7	20.5	22.4	26.2	23.3	22.5

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, 1989-2008

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
1. Consumer goods										
Value (US$ mn.)	581.5	709.4	782.1	734.6	774.5	930.6	982.0	1,030.0	1,084.0	1,128.0
Growth	6.1	22.0	10.3	-6.1	5.4	20.1	5.6	5.2	4.9	4.0
% of total imports	26.1	26.4	25.5	21.0	19.3	19.5	18.5	19.0	18.5	19.2
1.1 Food										
Value (US$ mn.)	364.4	390.0	404.9	419.7	415.9	483.9	522.0	597.0	642.0	596.0
Growth	13.5	7.0	3.8	3.7	-0.9	16.4	7.8	14.3	7.5	-7.2
% of total imports	16.4	14.5	13.2	12.0	10.4	10.2	9.8	11.0	11.0	10.1
1.2 Other										
Value (US$ mn.)	217.1	319.4	377.2	314.9	358.7	446.6	461.0	433.0	442.0	532.0
Growth	-4.4	47.1	18.1	-16.5	13.9	24.5	3.1	-5.8	1.8	20.6
% of total imports	9.8	11.9	12.3	9.0	8.9	9.4	8.7	8.0	7.5	9.0
2. Intermediate goods										
Value (US$ mn.)	1,255.4	1,391.7	1,553.3	1,884.4	2,154.4	2,425.0	2,900.0	2,971.0	3,235.7	3,108.0
Growth	-1.0	10.9	11.6	21.3	14.3	12.6	19.6	2.6	8.9	-3.9
% of total imports	56.4	51.8	50.7	53.8	53.7	50.9	54.6	54.6	55.2	52.8
2.1 Petroleum										
Value (US$ mn.)	232.4	358.7	311.5	318.0	309.2	296.3	386.9	479.9	539.5	345.0
Growth	-5.7	54.4	-13.2	2.1	-2.8	-4.2	30.6	24.1	12.4	-36.1
% of total imports	10.4	13.3	10.2	9.1	7.7	6.2	7.3	8.8	9.2	5.9
2.2 Textiles										
Value (US$ mn.)	276.9	335.8	498.2	765.5	865.1	1,038.1	1,158.5	1,168.8	1,386.9	1,397.0
Growth	0.1	21.3	48.3	53.7	13.0	20.0	11.6	0.9	18.7	0.6
% of total imports	12.4	12.5	16.3	21.9	21.6	21.8	21.8	21.5	23.7	23.7
3. Investment goods										
Value (US$ mn.)	333.4	584.4	720.1	850.9	1,046.8	1,366.5	1,189.0	1,203.0	1,324.0	1,477.0
Growth	-12.2	75.3	23.2	18.2	23.0	30.5	-13.0	1.5	10.0	11.3
% of total imports	15.0	21.7	23.5	24.3	26.1	28.7	22.4	22.1	22.6	25.1
4. Total imports										
Value (US$ mn.)	2,225.6	2,689.0	3,061.1	3,503.4	4,011.3	4,767.3	5,311.1	5,439.0	5,864.0	5,889.0
Growth	-0.3	20.8	13.8	14.5	14.5	18.8	11.4	2.6	7.7	0.4

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	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008(a)
1. Consumer goods										
Value (US$ mn.)	1,131.0	1,261.0	1,126.0	1,189.0	1,344.0	1,440.0	1,503.0	1,782.0	1,768.0	2,174.0
Growth	0.3	11.5	-10.7	5.6	13.0	7.1	4.4	18.6	-0.8	23.0
% of total imports	18.9	17.3	18.9	19.5	20.1	18.0	16.9	17.4	15.6	15.5
1.1 Food										
Value (US$ mn.)	551.0	566.0	545.0	566.0	564.0	596.0	611.0	757.0	831.0	1,130.0
Growth	-7.6	2.7	-3.7	3.9	-0.4	5.7	2.5	23.9	9.8	36.0
% of total imports	9.2	7.8	9.1	9.3	8.5	7.5	6.9	7.4	7.3	8.1
1.2 Other										
Value (US$ mn.)	581.0	696.0	581.0	623.0	780.0	844.0	891.0	1,024.0	937.0	1,044.0
Growth	9.2	19.8	-16.5	7.2	25.2	8.2	5.6	14.9	-8.5	11.4
% of total imports	9.7	9.5	9.7	10.2	11.7	10.6	10.1	10.0	8.3	7.5
2. Intermediate goods										
Value (US$ mn.)	3,168.0	3,916.0	3,430.0	3,622.0	3,948.0	4,828.0	5,458.0	6,161.0	6,751.0	8,716.0
Growth	1.9	23.6	-12.4	5.6	9.0	22.3	13.0	12.9	9.6	29.1
% of total imports	53.0	53.5	57.4	59.3	59.2	60.4	61.6	60.1	59.8	62.2
2.1 Petroleum										
Value (US$ mn.)	500.0	901.0	731.0	789.0	838.0	1209.0	1,655.0	2,070.0	2,501.0	3,368.0
Growth	44.9	80.2	-18.9	7.9	6.2	44.3	36.9	25.1	20.8	34.7
% of total imports	8.4	12.3	12.2	12.9	13.7	15.1	18.7	20.2	22.1	24.0
2.2 Textiles										
Value (US$ mn.)	1,320.0	1,471.0	1,320.0	1,321.0	1,372.0	1,514.0	1,531.0	1,546.0	1,632.0	1,702.0
Growth	-5.5	11.4	-10.3	0.1	3.9	10.3	1.1	1.0	5.6	4.3
% of total imports	22.1	20.1	22.1	21.6	20.6	18.9	17.3	15.1	14.5	12.2
3. Investment goods										
Value (US$ mn.)	1,565.0	1,737.0	1,081.0	1,169.0	1,320.0	1,670.0	1,869.0	2,246.0	2,685.0	2,979.0
Growth	6.0	11.0	-37.8	8.1	12.9	26.5	11.9	20.2	19.5	10.9
% of total imports	26.2	23.6	18.1	19.2	19.8	20.8	21.1	21.9	23.8	21.3
4. Total imports										
Value (US$ mn.)	5,979.0	7,320.0	5,974.0	6,105.0	6,672.0	8,000.0	8,863.0	10,254.0	11,296.0	14,008.0
Growth	1.5	22.4	-18.4	2.2	9.3	19.9	10.8	15.7	10.2	24.0

Notes: (a): Provisional.

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

Table A16: Structure of Commodity Exports, 1989-2008

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
1. Agricultural exports										
Value (US$ mn.)	611.7	721.0	641.4	604.7	655.3	702.1	829.0	961.0	1060.0	1088.0
Growth	-3.2	17.9	-11.0	-5.7	8.4	7.1	18.1	16.1	10.3	2.6
% of total exports	39.3	36.3	32.3	24.6	22.9	21.9	21.8	23.5	22.9	22.9
1.1 Plantation crops										
Value (US$ mn.)	518.7	617.7	538.5	468.1	514.9	546.8	660.9	801.3	882.1	878.1
Growth	-2.4	19.1	-12.8	-13.1	10.0	6.2	20.9	21.2	10.1	-0.4
% of total exports	33.3	31.1	27.1	19.0	18.0	17.0	17.4	19.5	19.0	18.0
1.1.1 Tea										
Value (US$ mn.)	379.1	494.8	431.9	339.8	412.7	424.2	481.0	615.0	719.0	780.0
Growth	-2.0	30.5	-12.7	-21.3	21.4	2.8	13.3	28.2	17.0	8.5
% of total exports	24.3	24.9	21.7	13.8	14.4	13.2	12.6	15.0	15.5	16.4
1.1.2 Rubber										
Value (US$ mn.)	86.3	76.9	63.8	67.5	64.0	72.5	111.0	104.0	79.0	44.0
Growth	-25.9	-10.9	-17.0	5.8	-5.3	13.3	53.8	-6.6	-24.4	-44.3
% of total exports	5.5	3.9	3.2	2.7	2.2	2.3	2.9	2.5	1.7	0.9
1.1.3 Coconut kernel products										
Value (US$ mn.)	53.3	46.0	42.8	60.8	38.3	50.1	69.0	81.0	82.0	56.0
Growth	89.2	-13.7	-7.0	42.2	-37.0	30.9	37.1	17.7	2.0	-31.8
% of total exports	3.4	2.3	2.2	2.5	1.3	1.6	1.8	2.0	1.8	1.2
1.2. Minor agricultural crops										
Value (US$ mn.)	66.8	79.9	82.4	113.1	120.7	129.2	134.0	132.0	145.0	170.0
Growth	-17.0	19.5	3.2	37.3	6.7	7.0	3.5	-1.4	9.9	17.7
% of total exports	4.3	4.0	4.1	4.6	4.2	4.0	3.5	3.2	3.1	3.6
2. Mineral exports										
Value (US$ mn.)	74.7	87.0	61.9	62.7	75.7	86.9	87.0	96.0	90.0	60.0
Growth	-9.1	16.4	-28.8	1.3	20.7	14.7	-0.1	10.3	-6.7	-33.1
% of total exports	4.8	4.4	3.1	2.5	2.6	2.7	2.3	2.3	1.9	1.3
3. Industrial exports										
Value (US$ mn.)	789.8	1,036.1	1,237.3	1,763.2	2,102.3	2,398.9	2,870.0	3,006.0	3,436.0	3,607.0
Growth	10.8	31.2	19.4	42.5	19.2	14.1	19.6	5.0	14.3	3.2
% of total exports	50.7	52.2	62.3	71.7	73.4	74.8	75.4	73.4	74.1	74.9
3.1 Textile & garments										
Value (US$ mn.)	489.1	628.1	803.9	1,214.0	1,412.4	1,551.9	1,853.0	1,902.0	2,274.0	2,460.0
Growth	9.1	28.4	28.0	51.0	16.3	9.9	19.4	2.9	19.6	8.2
% of total exports	31.4	31.7	40.5	49.3	49.3	48.4	48.7	46.4	49.0	52.0
3.2 Petroleum products										
Value (US$ mn.)	62.2	99.2	79.5	63.2	78.8	80.1	85.0	104.0	97.0	73.0
Growth	-12.7	59.5	-19.9	-20.5	24.6	1.7	5.9	22.4	-6.3	-25.9
% of total exports	4.0	5.0	4.0	2.6	2.8	2.5	2.2	2.5	2.1	1.5
4. Total commodity exports inc. petroleum										
Value (US$ mn.)	1,558.4	1,983.9	1,987.5	2,460.8	2,863.7	3,208.6	3,806.6	4,199.0	4,736.0	4,871.0
Growth	5.6	27.3	0.2	23.8	16.4	12.0	18.6	10.3	12.8	2.9
5. Total commodity exports excl. petroleum										
Value (US$ mn.)	1,496.2	1,884.7	1,908.0	2,397.5	2,784.9	3,128.5	3,721.7	3,991.0	4,542.0	4,725.0
Growth	6.6	26.0	1.2	25.7	16.2	12.3	19.0	7.2	13.8	4.0

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	1999	2000	2001	2002	2003	2004	2005	2006	2007(a)	2008(b)
1. Agricultural exports										
Value (US$ mn.)	947.0	1005.0	932.0	938.0	965.0	1065.2	1,153.8	1,292.7	1,507.2	1,854.8
Growth	-13.0	6.1	-7.3	0.6	2.9	10.4	8.3	12.0	16.6	23.1
% of total exports	20.6	18.2	19.3	20.0	18.8	18.5	18.2	18.8	19.7	22.8
1.1 Plantation crops										
Value (US$ mn.)	738.0	806.0	755.0	728.0	770.0	849.0	905.9	1,027.1	1,194.9	1,479.0
Growth	-16.0	9.2	-6.3	-3.6	5.8	10.3	6.7	13.4	16.3	23.8
% of total exports	15.8	14.3	15.5	15.3	14.8	14.5	14.0	14.4	15.6	18.2
1.1.1 Tea										
Value (US$ mn.)	621.0	700.0	690.0	660.0	683.0	739.0	810.2	881.2	1,025.2	1,271.5
Growth	-20.4	12.7	-1.4	-4.3	3.5	8.2	9.6	8.8	16.3	24.0
% of total exports	13.5	12.7	14.3	14.1	13.3	12.8	12.8	12.8	13.4	15.6
1.1.2 Rubber										
Value (US$ mn.)	33.0	29.0	24.0	27.0	39.0	51.0	46.9	93.1	109.4	125.1
Growth	-25.0	-12.1	-17.2	12.5	44.4	30.8	-8.0	98.5	17.5	14.4
% of total exports	0.7	0.5	0.5	0.6	0.8	0.9	0.7	1.4	1.4	1.5
1.1.3 Coconut kernel products										
Value (US$ mn.)	84.0	77.0	41.0	41.0	48.0	59.0	48.8	52.8	60.3	82.4
Growth	50.0	-8.3	-46.8	0.0	17.1	22.9	-17.3	8.2	14.2	36.7
% of total exports	1.8	1.4	0.9	0.9	0.9	1.0	0.8	0.8	0.8	1.0
1.2 Minor agricultural crops										
Value (US$ mn.)	165.0	155.0	136.0	168.0	150.0	162.0	183.4	194.6	231.5	287.3
Growth	-2.9	-6.1	-12.3	23.5	-10.7	8.0	13.2	6.1	19.0	24.1
% of total exports	3.6	2.8	2.8	3.5	2.9	2.8	2.9	2.8	3.0	3.5
2. Mineral exports										
Value (US$ mn.)	64.0	97.0	86.0	90.0	84.0	120.0	143.3	119.9	127.8	122.4
Growth	6.7	51.6	-11.3	4.7	-6.7	42.9	19.4	-16.3	6.6	-4.2
% of total exports	1.4	1.8	1.8	1.9	1.6	2.0	2.3	1.7	1.7	1.5
3. Industrial exports										
Value (US$ mn.)	3,551.0	4,283.0	3,710.0	3,631.0	3,977.0	4,506.0	4,948.4	5,401.1	5,967.3	6,159.5
Growth	-1.6	20.6	-13.4	-2.1	9.5	13.3	9.8	9.1	10.5	3.2
% of total exports	77.0	77.6	77.0	77.3	77.5	78.3	78.0	78.5	78.1	75.7
3.1 Textile & garments										
Value (US$ mn.)	2,425.0	2,982.0	2,543.0	2,424.0	2,575.0	2,809.0	2,894.6	3,080.4	3,339.6	3,468.7
Growth	-1.4	23.0	-14.7	-4.7	6.2	9.1	3.0	6.4	8.4	3.9
% of total exports	52.7	54.0	52.8	51.6	50.2	48.8	45.6	44.8	43.7	42.6
3.2 Petroleum products										
Value (US$ mn.)	74.0	98.0	68.0	73.0	65.0	100.0	130.9	188.4	168.9	254.8
Growth	1.4	32.4	-30.6	7.4	-11.0	53.8	30.9	43.9	-10.4	50.9
% of total exports	1.6	1.8	1.4	1.5	1.3	1.7	2.1	2.7	2.2	3.1
4. Total commodity exports inc. petroleum										
Value (US$ mn.)	4,684.0	5,620.0	4,885.0	4,772.0	5,198.0	5,856.7	6,477.6	7,140.3	7,640.0	8,136.7
Growth	-3.8	20.0	-13.1	-2.3	8.9	12.7	10.6	10.2	7.0	6.5
5. Total commodity exports excl. petroleum										
Value (US$ mn.)	4,536.0	5,424.0	4,749.0	4,626.0	5,068.0	5,657.6	6,215.8	6,882.7	7,740.5	7,881.9
Growth	-4.0	19.6	-12.4	-2.6	9.6	11.6	9.9	10.7	12.5	1.8

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

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

Table A17: Tourism, 1989-2008

	Unit	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
Tourist arrivals	No.	184,732	297,888	317,703	393,669	392,250	407,511	403,101	302,265	366,165	381,063
Excursionist arrivals	No.	4,064	3,954	2,665	5,651	6,093	8,413	10,556	12,863	18,265	27,629
Tourist nights	000	1,970	3,225	3,633	4,055	4,148	4,251	4,024	2,947	3,680	3,944
Earnings	Rs. mn.	2,739.7	5,303.3	6,485.8	8,825.6	10,036.8	11,401.6	11,551.6	9,559.1	12,980.0	14,868.0
	US$ mn.	76.0	132.0	156.8	201.4	208.0	230.7	225.4	173.0	216.7	231.5
Receipts per tourist per day	US$	38.6	41.1	42.8	49.7	50.1	54.2	56.1	57.9	58.6	59.5
Average duration	Nights	10.7	10.8	11.4	10.3	10.6	10.4	10.0	9.8	10.1	10.4
Accommodation											
Rooms	No.	9,459	9,556	9,679	10,214	10,365	10,742	11,255	11,600	12,370	12,772
Beds	No.	18,464	18,669	18,947	19,907	20,242	20,929	21,680	22,040	22,944	23,373
Occupancy rate, graded	%	31.0	47.2	48.4	55.3	57.0	56.6	52.6	40.3	49.1	52.8
Sri Lanka nationals											
Arrivals	No.	258,950	306,367	237,424	339,109	375,740	422,367	459,441	488,055	482,850	481,793
Departures	No.	285,510	296,884	310,373	420,749	416,246	448,437	504,420	494,258	530,712	518,050
Employment											
Direct	No.	21,958	24,964	26,878	28,790	30,710	33,956	35,068	31,963	34,006	34,780
Indirect	No.	30,741	34,950	37,629	40,306	42,994	47,538	49,095	44,748	47,608	48,692

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	Unit	1999	2000	2001	2002	2003	2004	2005	2006	2007(a)	2008(b)
Tourist arrivals	No.	436,440	400,414	336,794	393,174	500,642	566,202	549,308	559,603	494,008	438,475
Excursionist arrivals	No.	28,335	44,518	60,008	63,560	82,066	110,000	119,618	128,719	98,432	87,695
Tourist nights	000	4,479	4,056	3,435	3,989	5,093	5,742	4,754	5,793	4,940	4,165
Earnings	Rs. mn.	19,297.3	19,162.2	18,863.3	24,202.0	32,810.0	42,666.3	36,377	42,586	42,519	37,094
	US$ mn.	274.9	252.8	211.1	253.0	340.0	416.8	362	410	384	319
Receipts per tourist per day	US$	61.4	62.3	63.1	63.4	66.8	72.2	74.6	83.4	79.1	76.7
Average duration	Nights	10.3	10.1	9.9	10.1	10.2	10.1	8.7	10.3	10.0	9.5
Accommodation											
Rooms	No.	12,918	13,311	13,626	13,818	14,137	14,322	13,162	14,218	14,604	14,793
Beds	No.	24,216	24,953	25,595	25,956	26,511	26,854	24,740	27,117	27,500	28,698
Occupancy rate, graded	%	57.6	52.3	42.1	43.1	53.2	59.3	43.6	39.8	46.2	43.9
Sri Lanka nationals											
Arrivals	No.	521,073	514,448	487,356	493,947	560,602	646,990	683,169	734,421	817,524	900,815
Departures	No.	496,963	524,212	505,341	533,565	561,126	680,248	727,301	756,735	862,011	966,337
Employment											
Direct	No.	36,560	37,943	33,710	38,821	46,761	53,766	52,085	55,649	60,516	51,857
Indirect	No.	51,184	53,120	47,194	54,349	65,465	75,272	72,919	77,909	84,723	72,599

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

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

Table A18: Monthly Tourist Arrivals, 1997-2008

	1997		1998		1999		2000		2001		2002	
	No.	Growth	No.	Growth	No.	Growth	No.	Growth	No.	Growth	No.	Growth
January	32,652	5.5	37,224	14.0	44,379	19.2	43,311	-2.4	44,187	2.1	28,296	-36.0
February	35,010	18.5	35,283	0.8	41,526	17.7	43,287	4.2	46,575	7.6	31,683	-32.0
March	34,098	29.0	32,256	-5.4	41,022	27.2	40,110	-2.2	44,290	10.4	33,084	-25.3
April	26,907	32.1	25,578	-4.9	34,443	34.7	33,642	-2.3	36,906	9.7	27,057	-26.7
May	22,407	26.9	20,394	-9.0	25,212	23.6	23,404	-7.2	26,924	-15.0	26,661	-1.0
June	23,160	17.8	22,410	-3.2	26,184	16.8	21,825	-16.6	28,323	29.8	26,355	-6.9
July	30,867	21.6	29,529	-4.3	33,288	12.7	33,267	-0.1	28,566	-14.1	35,742	25.1
August	32,034	29.4	31,446	-1.8	39,081	24.3	34,422	-11.9	15,717	-54.3	35,475	125.7
September	29,793	28.4	31,653	6.2	33,915	7.1	31,035	-8.5	11,758	-62.1	32,982	180.5
October	28,314	20.4	31,767	12.2	35,112	10.5	26,658	-24.1	12,904	-51.6	36,258	181.0
November	31,995	28.4	38,421	20.1	41,952	9.2	32,469	-22.6	17,344	-46.6	37,395	115.6
December	38,928	8.6	45,102	15.9	40,326	-10.6	36,984	-8.3	23,300	-36.9	42,183	81.0
Total	366,165	21.1	381,063	4.1	436,440	14.5	400,414	-8.3	336,794	-15.9	393,171	16.7

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	2003		2004		2005		2006		2007		2008(a)	
	No.	Growth	No.	Growth	No.	Growth	No.	Growth	No.	Growth	No.	Growth
January	40,647	43.6	49,950	22.9	38,187	-23.5	52,103	36.4	56,553	8.5	56,916	0.6
February	39,081	23.4	43,584	11.5	36,645	-15.9	52,687	43.8	43,051	-18.3	40,551	-5.8
March	40,818	23.4	38,418	-5.9	50,418	31.2	54,746	8.6	35,031	-36.0	38,049	8.6
April	33,714	24.6	30,672	-9.0	42,261	37.8	49,776	17.8	33,039	-33.6	29,747	-10.0
May	30,048	12.7	30,162	0.4	40,878	35.5	43,825	7.2	26,307	-40.0	31,140	18.4
June	31,836	20.8	32,119	0.8	45,699	42.3	44,066	-3.6	30,810	-30.1	27,960	-9.3
July	43,743	22.4	50,525	15.5	56,745	12.3	55,354	-2.5	44,142	-20.3	32,982	-25.3
August	42,111	18.7	48,675	15.6	51,216	5.2	52,931	3.3	44,742	-15.5	30,672	-31.4
September	36,054	9.3	51,525	42.9	43,536	-15.5	38,485	-11.6	37,104	-3.6	29,529	-20.4
October	49,922	37.7	59,442	19.1	44,095	-25.8	38,815	-12.0	37,011	-4.6	35,103	-5.2
November	54,946	46.9	64,971	18.2	48,457	-25.4	37,591	-22.4	45,102	20.0	36,901	-18.2
December	57,722	36.8	66,159	14.6	51,171	-22.7	39,224	-23.3	61,116	55.8	48,925	-19.9
Total	500,642	27.3	566,202	13.1	549,308	-2.9	559,603	1.9	494,008	-11.7	438,475	-11.2

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, 1997-2008

	1997		1998		1999		2000		2001		2002	
	No.	Growth	No.	Growth	No.	Growth	No.	Growth	No.	Growth	No.	Growth
North America	15,951	28.0	17,529	10	18,477	5	17,319	-6	15,983	-8	19,866	24
Canada	6,477	38.1	7,542	16	7,905	5	7,503	-5	7,609	1	8,304	9
U.S.A.	9,474	21.9	9,987	5	10,572	6	9,816	-7	8,374	-15	11,565	38
Western Europe	212,052	26.7	238,959	13	275,796	15	260,824	-5	203,984	-22	200,295	-2
Germany	59,814	32.7	74,058	24	77,259	4	70,584	-9	60,405	-14	55,170	-9
United Kingdom	62,997	20.9	66,432	5	80,919	22	84,693	5	67,830	-20	67,533	0
France	25,392	18.2	26,874	6	34,458	28	25,992	-25	20,949	-19	19,989	-5
Italy	14,424	20.3	15,867	10	19,815	25	16,833	-15	12,074	-28	12,177	1
Netherlands	15,957	45.1	22,977	44	29,670	29	22,618	-24	12,569	-44	11,748	-7
Asia	113,565	10.7	99,702	-12	114,375	15	91,521	-20	89,732	-2	143,064	59
Japan	13,374	14.1	13,785	3	16,332	19	10,226	-37	9,237	-10	13,602	47
India	47,010	9.8	37,356	-21	42,315	13	31,860	-25	33,924	7	69,960	106
Pakistan	11,439	-2.6	10,782	-6	11,421	6	10,005	-12	8,562	-14	6,756	-21
Australasia	11,712	33.7	12,159	4	15,159	25	18,228	20	13,105	-28	13,209	1
Australia	10,392	36.3	10,329	-1	13,218	28	16,443	24	11,457	-30	11,217	-2
Other(a)	12,912	15.9	13,092	1	12,633	-4	12,522	-1	13,990	12	16,737	20
Total	366,165	21.1	381,063	4	436,440	15	400,414	-8	336,794	-16	393,171	17

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	2003		2004		2005		2006(b)		2007		2008(c)	
	No.	Growth	No.	Growth	No.	Growth	No.	Growth	No.	Growth	No.	Growth
North America	25,110	26	29,759	19	46,457	56	35,323	-24	28,355	-20	24,311	-14
Canada	11,164	34	14,633	31	21,185	45	14,623	-31	11,869	-19	10,258	-14
U.S.A.	13,946	21	15,126	8	25,272	67	20,700	-18	16,486	-20	14,053	-15
Western Europe	255,169	27	284,440	11	227,191	-20	228,447	1	194,448	-15	167,187	-14
Germany	58,908	7	58,258	-1	46,350	-20	47,402	2	35,042	-26	30,625	-13
United Kingdom	93,278	38	106,645	14	92,629	-13	88,306	-5	94,060	7	81,331	-14
France	28,585	28	29,996	5	26,653	-11	22,693	-15	8,091	-64	10,594	31
Italy	15,654	29	18,862	20	10,192	-46	12,424	22	11,451	-8	13,030	14
Netherlands	18,197	55	21,455	18	15,156	-29	19,360	28	17,526	-9	9,116	-48
Asia	177,351	24	198,068	12	223,351	13	242,132	8	202,480	-16	173,039	-15
Japan	17,115	26	19,641	15	17,148	-13	16,189	-6	14,274	-12	10,075	-29
India	90,603	30	105,151	16	113,323	8	128,370	13	106,067	-17	85,238	-20
Pakistan	9,704	44	9,638	-1	11,029	14	11,145	1	10,204	-8	7,885	-23
Australasia	22,965	74	26,540	16	29,738	12	25,127	-16	22,924	-9	21,839	-5
Australia	19,958	78	23,247	16	25,986	12	21,849	-16	20,241	-7	19,536	-3
Other(a)	20,047	20	27,395	37	22,571	-18	28,576	27	45,801	60	52,099	14
Total	500,642	27	566,202	13	549,308	-3	559,603	2	494,008	-12	438,475	-11

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, 1997-2008

	Unit	1997	1998	1999	2000	2001	2002	2003(c)	2004	2005	2006	2007	2008(a)
1. Trade balance	US$ mn.	-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	-3,370.0	-3,656.0	-5,871.0
	% of GDP	-8.1	-6.9	-8.7	-10.8	-7.4	-9.5	-8.1	-10.9	-10.3	-11.9	-11.3	-14.4
2. Services balance	US$ mn.	159.1	145.0	147.0	38.0	175.0	295.0	399.0	419.0	338.0	257.0	302.0	402.0
	% of GDP	1.1	0.9	0.9	0.2	1.3	2.0	2.1	2.0	1.4	0.9	0.7	1.0
3. . Income, net	US$ mn.	-160.0	-180.0	-254.0	-305.0	-267.0	-253.0	-172.0	-204.0	-299.0	-389.0	-358.0	-972.0
	% of GDP	-1.1	-1.1	-1.6	-1.8	-1.9	-1.7	-0.9	-1.0	-1.2	-1.4	-1.1	-2.4
4. Net private transfers	US$ mn.	788.1	849.0	887.0	974.0	984.0	1,097.0	1,205.0	1,350.0	1,736.0	1,904.0	2,214.0	2,565.0
	% of GDP	5.2	5.4	5.6	5.9	7.0	7.5	6.3	6.5	7.1	6.7	6.8	6.3
5. Net official transfers	US$ mn.	44.5	52.0	26.0	24.0	22.0	31.0	36.0	30.0	93.0	101.0	97.0	101.0
	% of GDP	0.3	0.3	0.2	0.1	0.2	0.2	0.2	0.1	0.4	0.4	0.3	0.2
6. Current account balance	US$ mn.	-393.0	-226.0	-563.0	-1,066.0	-244.0	-237.0	-71.0	-648.0	-650.0	-1,499.0	-1,401.0	-3,775.0
	% of GDP	-2.6	-1.4	-3.6	-6.4	-1.7	-1.6	-0.4	-3.1	-2.7	-5.3	-4.3	-9.3
7. Capital and financial a/c	US$ mn.	602.0	413.0	373.0	443.0	562.0	444.0	722.0	631.0	1,224.0	1,808.0	2,097.0	1,773.0
	% of GDP	4.2	2.6	2.4	2.7	4.0	3.0	3.8	3.1	5.0	6.4	6.5	4.4
Capital account	US$ mn.	87.1	80.0	80.0	50.0	198.0	65.0	74.0	64.0	250.0	291.0	269.0	291.0
Financial account	US$ mn.	515.0	334.0	293.0	393.0	364.0	379.0	648.0	567.0	974.0	1517.0	1828.0	1483.0
8. Long-term	US$ mn.	716.0	398.0	435.0	304.0	164.0	326.0	722.0	680.0	798.0	907.0	1251.0	1016.0
Foreign direct investment	US$ mn.	128.6	137.0	177.0	173.0	82.0	181.0	171.0	217.0	234.0	451.0	548.0	691.0
Private long-term (net)	US$ mn.	47.0	2.0	196.0	82.0	-257.0	-21.0	-33.0	14.0	11.0	-35.0	31.0	74.0
Government long-term	US$ mn.	239.0	203.0	62.0	47.0	249.0	162.0	554.0	439.0	553.0	491.0	672.0	252.0
9. Short-term	US$ mn.	-201.0	-64.0	-142.0	88.0	201.0	53.0	-75.0	-112.0	176.0	610.0	577.0	466.0
Foreign portfolio investment	US$ mn.	13.0	-24.0	-13.0	-45.0	-11.0	25.0	2.0	11.0	60.0	51.0	101.0	60.0
10. Other (b)	US$ mn.	27.3	-116.1	-101.0	174.0	71.0	-145.0	-2.0	202.0	323.0	293.0	364.0	-185.0
11. Overall balance	US$ mn.	163.0	37.0	-263.0	-522.0	220.0	338.0	502.0	-205.0	501.0	204.0	531.0	-1225
	% of GDP	1.8	1.4	-1.7	-3.1	1.6	2.3	2.6	-1.0	2.1	0.7	1.6	-2.9

Notes: (a): Provisional.
(b): Valuation adjustments, errors, and omissions.
(c): From 2003, data are based on GDP estimates compiled by the Department of Census and Statistics.

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

Table A21: Exchange Rate Behaviour, 1997-2008

Currency	Unit	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Nominal exchange rates													
U.S.A.	S.L. Rs. per US$	61.29	67.78	72.12	80.06	93.16	96.72	96.74	104.60	102.12	107.71	108.72	113.14
Japan	S.L. Rs. per Yen	0.47	0.59	0.71	0.70	0.71	0.82	0.90	1.02	0.87	0.90	0.97	1.25
U. K.	S.L. Rs. per Pound	101.60	112.62	116.72	119.37	135.06	155.12	172.19	201.37	175.94	211.29	217.15	163.28
Europeon Union	S.L. Rs. per Euro	-	-	72.53	74.32	82.27	101.38	121.60	142.32	120.96	141.58	160.27	159.45
India	S.L. Rs. per Ind. Rs.	1.56	1.59	1.66	1.71	1.93	2.02	2.12	2.40	2.27	2.44	2.77	2.36
24 currency													
Nominal effective exchange rates (NEER)	NEER 2006 = 100	-	-	-	-	-	-	110.31	97.57	104.77	94.35	87.79	93.71
Real effective exchange rate (REER)	REER 2006 = 100	-	-	-	-	-	-	92.01	89.64	100.15	99.26	105.64	125.47

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

Appendix B: Capital Market

Table B1: Sri Lanka's Capital Market Structure, 2004-2008

	2004	2005	2006	2007	2008(a)
1. Equity market:					
Market capitalization	382,100	584,000	834,800	820,700	488,812
of which central depository	195,032	259,780	370,076	418,088	488,813
2. Debt market:	1,165,491	1,266,802*	1,460,644*	1,507,693*	1,026,400
(i) Private	48,000	29,060*	42,260*	50,320*	
(ii) Public	1,117,491	1,237,742	1,418,384	1,457,373	
(a) Short-term(TBs)	243,886	234,174	257,732	307,012	402,600
(b) Medium & long-term	873,605	1,003,568	1,160,652	1,351,999	1,623,863
3. Total debt and equity (Rs. mn)	1,547,591	1,850,802*	2,295,444	2,328,393	1,515,212
as a percentage of GDP(%)	86.07	88.20	78.11	65.09	34.35
of which actually traded through the central depository	209,532	270,680	393,576	449,288	
As a share of total (%)	13.5	14.6	17.1	19.3	
4. Foreign participation in the central depository as a per cent of market capitalization (%)	14	14	14	19	

Notes: (a): Provisional.
* Debentures listed is no longer available. (Source: CSE Fact Book 2005, 2006 & 2007).

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

Table B2: Recent Developments in the Share Market, 2000-2008

	2000	2001	2002	2003	2004	2005	2006	2007	2008
1. Number of companies listed	**239**	**238**	**238**	**244**	**242**	**239**	**237**	**235**	**235**
New listings	5	2	9	8	5	6	2	-	3
De-listings	3	3	9	2	7	9	4	2	2
2. Number of companies traded	228	225	231	236	241	242	232	231	232
3. Market capitalization Rs. bn.	89	124	162	263	382	584	835	821	489
US$ bn.	1.2	1.4	1.7	2.7	3.8	5.8	8.0	8.0	4.3
4. Price -earnings ratio times, year end	5.2	7.5	12.1	11.1	10.8	12.4	14.0	11.6	11.3
5. Number of shares traded No. mn.	449	747	1,220	2,255	2,752	5,128	3,912	2,952	3,155
Domestic No. mn.	350	607	1,035	1,932	2,479	4,313	3,178	2,049	1,935
Foreign No. mn.	99	140	185	323	273	815	734	902	1,220
6. Trades ('000)	160.0	159.7	283.2	481.3	645.1	1100.4	952.4	876.9	776.2
Domestic ('000)	150.0	152.8	273.2	460.9	611.6	1038.5	908.2	831.7	730.4
Foreign ('000)	10.0	6.8	10.0	22.0	33.4	61.9	44.2	45.3	45.8
7. Turnover: Rs. bn.	11	14.1	30.5	73.8	59.0	114.6	105.1	105.0	110.5
US$ bn.	0.1	0.2	0.3	0.7	0.6	1.1	1.0	1.0	1.0
Domestic Rs. bn.	7.9	11.4	24.3	59.9	48.3	89.9	70.7	63.8	50.8
Foreign Rs. bn.	3.1	2.6	6.2	13.8	9.8	24.6	34.5	41.2	59.7
8. Liquidity- turnover / market									
Capitalization ratio (%)	12.4	11.4	18.8	28.1	15.4	19.6	12.6	12.8	22.6
9. No. of new issues	4	_	5	4	_	_	_	_	_
10. Total no. of shares issued (mn.)	80	_	244	_	_	_	_	_	_
11. Value of shares issued (Rs. bn.)	0.1	_	3.6	_	_	_	_	_	_
12. Central depository:									
Domestic (Rs. bn.)	30.9	50.9	66.5	98.2	140.4	179.8	248.7	260.4	162.3
Foreign (Rs. bn.)	9.5	12.2	19.5	37.8	54.6	79.9	121.4	157.6	108.0
Total (Rs. bn.)	40.4	63.1	86.0	136.0	195.0	259.7	370.1	418.0	270.3
Percentage of market cap.	45.4	50.9	53.1	51.7	51.0	44.5	44.3	50.9	55.3
13. Non-national activity									
Net purchases (Rs. mn.)	-3,364.6	-1,024.8	2,441.5	209.3	1,106.3	6,144.5	5,377.0	11,254.3	13,950.5
Purchases (Rs. mn.)	1,445.0	2,111.9	7,477.7	13,943.9	11,278.0	27,712.4	37,167.0	46,796.8	66,632.2
Sales (Rs. mn.)	4,809.9	3,136.7	5,036.2	13,734.6	10,172.0	21,567.9	31,790.0	35,542.5	52,681.7
14. Price indices									
All Share 1985 = 100	447.6	621.0	815.1	1,062.0	1,506.9	1,922.2	2,722.4	2,541.0	1,503.0
Growth % change	-21.8	38.7	31.2	30.2	41.9	27.6	41.6	6.7	40.9
Sensitive 1985 = 100	698.5	1,031.0	1,374.6	1,898.0	2,073.7	2,451.1	3,711.8	3,291.9	1,631.3
Growth % change	-25.4	47.6	33.3	38.1	9.3	18.2	51.4	11.3	-11.3

Note: 1000 Million = 1 Billion.

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

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

Company	2008 (%)
SLT	39.75
AMW	8.79
JKH	5.98
Distilleries	2.78
Dialog	2.58
Hayleys	2.23
Hotel services	2.02
Ceylinco Insurance	1.09
CDIC	1.05
Commercial leasing	1.01
Total	67.28

Note: As at 2007, the top ten of the 232 listed companies account ed for 55.1% of total market capitalization.
As at 2008, the top ten of the 232 listed companies accounted for 67.3% of total market capitalization.

Source: Colombo Stock Exchange, *Fact Book*, various issues.

Table B4: New Equity Listings, 2006, 2007 & 2008

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-2006					
Blue Diamonds Jewellery Worldwide Ltd.	65,589,385	2.50	30,057,291	–	6-Jan-06
Cargo Boat Development Co. Ltd	3,400,012	15.00	3,400,012	–	4-Jan-06
Commercial Leasing Co. Ltd	2,016,667	60.00	2,016,667	–	30-Jan-06
Regnis (Lanka) Ltd	1,207,271	50.00	1,207,271	–	20-Jan-06
Chemical Industries (Colombo) Ltd	8,100,000	62.00	8,100,000	–	29-Mar-06
Chemical Industries (Colombo) Ltd	2,430,000	35.00	2,430,000	–	29-Mar-06
Dankotuwa Porcelain Ltd	18,094,296	10.00	12,791,509	5,302,787	25-Apr-06
Seylan Merchant Leasing Ltd	5,047,475	18.00	5,047,475	–	20-Apr-06
The Fortrees Resorts Ltd	38,882,344	10.00	38,882,344	–	23-May-06
Seylan Bank Ltd	83,560,000	12.50	83,560,000	–	2-May-06
Vidullanka Ltd	2,981,250	20.00	2,981,250	–	3-May-06
Overseas Reality (Ceylon) Ltd	69,057,200	15.00	10,133,921	58,923,279	23-Aug-06
Pan Asia Banking Corporation Ltd	55,571,883	10.00	55,068,524	–	26-Oct-06
Seylan Merchant Leasing Ltd	3,028,485	20.00	3,028,485	–	30-Oct-06
Diesel & Motor Engineering Co. Ltd	1,100,000	50.00	1,100,000	–	20-Nov-06
People's Merchant Bank Ltd	12,500,000	20.00	12,500,000	–	14-Nov-06
Value (Rs)	4,705,479,692				
Issues (No.)	15				

2. Right issues - 2006 by sector	**No.of issues**	**No. of shares**	**Value (Rs.)**
Banks, Finance & Insurance	6	161,724,510	2,122,643,100
Chemicals & Pharmaceuticals	1	10,530,000	587,250,000
Hotels & Travels	1	38,882,344	388,823,440
Land & Property	2	72,457,212	1,086,858,180
Motors	1	1,100,000	55,000,000
Manufacturing	3	84,890,952	405,279,972
Power & Energy	1	2,981,250	59,625,000
Total	15	372,566,268	4,705,479,692

3. New listing-2007	**No. of shares offered**	**Issue price Rs.**	**No. of shares subscribed by public**	**No. of shares devolved to underwriters**	**Date listed**
Kshatriya Holdings PLC	19,679,528	10.00	19,679,528	–	12-Feb-07
Kelsey Development Ltd	5,809,758	20.00	5,809,758	–	12-Feb-07
The Fortress Resorts Ltd	20,161,215	10.00	17,242,725	2,918,490	27-Feb-07
Lanka Tiles Ltd	5,052,420	35.00	5,052,420	–	1-Mar-07
John Keells Holdings PLC	92,103,534	140.00	92,103,534	–	6-Feb-07
Amana Takaful PLC	12,500,099	30.00	12,500,099	–	22-Mar-07
Commercial Bank of Ceylon Ltd	40,288,996	138.00	40,288,996	(Voting)	4-Apr-07
Commercial Bank of Ceylon Ltd	2,790,138	65.00	2,790,138	(Non-voting)	4-Apr-07
ACME Printing & Packing Ltd	4,472,160	14.00	3,510,191	961,969	24-Apr-07
DFCC Bank	21,639,134	140.00	21,639,134	–	27-Apr-07
Kshatriya Holdings PLC	73,798,230	10.00	73,798,230	–	21-Jun-07
Dialog Telecom PLC	740,343,492	21.00	740,343,492	–	21-May-07
John Keells Hotels PLC	496,413,675	5.75	496,413,675	–	28-Jun-07
Marawila Resorts Ltd	14,000,000	4.00	14,000,000	–	7-Aug-07
Muller and Phipps (Ceylon) Limited	216,000,000	1.00	87,571,714	–	31-Dec-07
First Capital Holdings PLC	18,750,000	10.00	18,750,000	–	17-Aug-07
Parquet (Ceylon) Ltd	1,324,800	10.00	1,324,800	–	23-Oct-07
LB Finance Ltd	10,100,000	17.00	10,100,000	–	27-Nov-07
Coco Lanka Ltd	6,300,000	18.00	6,300,000	–	7-Nov-07
Ceylon Glass Company PLC	395,869,200	1.90	395,869,200	–	5-Nov-07
The Lanka Hospitals Corporation Ltd	67,119,651	15.00	67,119,651	–	20-Dec-07
Ceylon Hotels Corporation PLC	150,000,000	2.00	150,000,000	–	31-Dec-07
Value (Rs)	44,622,201,960				
Issues (No.)	21				

Contd...../-

Company	No.of issues	No. of shares	Value (Rs.)
4. Right issues - 2007 by sector			
Banks, Finance & Insurance	5	106,068,277	9,504,919,448
Beverage Food & Tobacoo	1	6,300,000	113,400,000
Hotels & Travels	4	680,574,890	3,411,990,781
Healthcare	1	67,119,651	1,006,794,765
Manufacturing	4	406,718,580	1,004,844,420
Diversified Holdings	3	185,581,292	13,829,272,340
Land & Property	1	5,809,758	116,195,160
Stores & Supplies	1	216,000,000	87,571,714
Telecommunication	1	740,343,492	15,547,213,332
Total	21	2,414,515,940	44,622,201,960

5. New listings - 2008	**No. of shares offered**	**Issue price Rs.**	**No. of shares subscribed by public**	**No. of shares devolved to underwriters**	**Date listed**
Janashakthi Insurance Company Ltd.	33,000,000	12.00	33,000,000		21-Jul-08
Ceylinco Insurance PLC	8,500,000	175.00	6,414,480		14-Aug-08

6. Right issues - 2008 by sector	**No.of issues**	**No. of shares**	**Value (Rs.)**
Banks Finance & Insurance	3	46,519,739	1,136,239,907
Chemicals & Pharmacuticals	2	21,000,000	1,335,856,107
Healthcare	2	76,502,766	165,000,000
Manufacturing	1	1,464,044	14,640,440
Investment Trust	1	1,366,667	27,333,340
Total	9	146,853,216	2,679,069,794

Source: Colombo Stock Exchange, *Fact Book*, various issues.

Table B5: Structure of Debt Market, 2004-2008

(Rs. bn.)	2004	2005	2006	2007	2008(a)
1. Private debt:					
(a) Commercial paper(year end)	14.50	10.90	23.50	30.00	24.00
(b) Certificates of deposit	21.03	18.16	18.76	19.10	19.10
(I) Commercial banks	19.79	17.06	17.70	17.76	17.76
(ii) Finance companies	1.23	1.10	1.06	0.86	0.91
(c) Debentures (listed)	12.47	**	**	**	**
Total private debt	48.00	29.06*	42.26	50.30	43.10
2. Public debt:					
(a) Short terms					
(i) Treasury bills	243.88	234.17	257.73	307.01	402.60
(ii) Central Bank securities	–	–	–	–	–
(b) Medium & long term					
(i) Treasury bonds	643.35	751.57	885.97	1018.85	1281.97
(ii) Rupee securities	164.76	140.56	116.71	131.51	130.01
(iii) Certificates of deposit	–	–	–	–	–
Total public debt	1,052.00	1,126.30	1,260.41	1,456.37	1,814.58
3. Total debt	1,100.00	1,155.36*	1,302.67*	1,507.67*	1,857.68*

Notes: (a): Provisional.
** All corporate denbentures listed on the Colombo Stock Exchange were transferred to the DEX with effect from August 2005.
* Debentures listed is no longer available. (Source: CSE Fact Book 2005, 2006 and 2007).

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

Table B6: Listed Debentures, 2006-2008

Issuer	Issued (No.)	Par value (Issue price Rs.)	Interest (p.a.)	No.of debt subscribed	Date listed
1. Listings 2006					
Seylan Merchant Leasing Ltd.	10,000,000 with an option	100	13.00%	7,646,400	25.07.06
	to issue up toa further	100	13.50%	4,620,800	25.07.06
	5,000,000 if oversubscribed	100	Floating	305,950	25.07.06
DFCC Bank		1,000	13.75%	200,000	17.11.06
	Unsecured subordinated		Floating	170,000	17.11.06
	redeemable debenture		Floating	40,000	17.11.06
			14.00%	590,000	17.11.06
2. Listings 2007					
Commercial Bank of Ceylon Ltd	Issue of 1,000,000 with an	1,000	13.50%	527,800	23.01.07
	option to issue up to a further	1,000	Floating	131,020	23.01.07
	500,000	1,000	13.75%	250	23.01.07
		1,000	Floating	300	23.01.07
		1,000	14.00%	467,260	23.01.07
		1,000	Floating	400	23.01.07
Seylan Merchant Bank PLC	950,000	100	16.00%	321,390	08.01.07
		100	17.00%	628,260	08.01.07
		100	Floating	350	08.01.07
	Issue of 1,000,000 with	100	16.00%	588,080	01.01.07
	an option to issue	100	16.50%	352,300	01.01.07
	upto a further 950,000	100	16.25%	9,000	01.01.07
		100	16.75%	6,300	01.01.07
		100	16.50%	11,120	01.01.07
		100	17.00%	8,500	01.01.07
		100	17.00%	8,600	01.01.07
		100	17.50%	16,100	01.01.07
Seylan Bank PLC	Issue of 5,000,000 with	100	15.75%	2,916,200	18.01.07
	an option to issue	100	16.75%	4,275,450	18.01.07
	upto a further	100	Floating	302,350	18.01.07
	5,000,000				
Sampath Bank Ltd	Issue of 10,000,000	100	15.50%	222,650	04.10.07
	with an option to	100	17.50%	5,206,725	04.10.07
	issue up to a	100	Floating	9,570,625	04.10.07
	further 5,000,000				
Nation Trust Bank PLC			14.10%	1,650,000	25.05.07
			Floating	1,650,000	25.05.07
			Floating	1,700,000	25.05.07
Hatton National Bank PLC			Floating	2,625,000	13.01.07
			Floating	2,500,000	13.01.07
			Floating	3,000,000	13.01.07
			Zero coupon	5,143,445	13.01.07
			Zero coupon	13,628,000	13.01.07
			16.00%	5,000,000	28.11.07
			16.75%	7,000,000	28.11.07
Nationla Development Bank PLC			17.50%	250,000	24.12.07

Issuer	Issued (No.)	Par value (Issue price Rs.)	Interest (p.a.)	No.of debt subscribed	Date listed
3. Listings 2008					
Seylan Bank PLC	Up to 10,000,000	100	17.00%	2,089,550	14.01.08
	Unsecured subordinated	100	Floating	107,550	14.01.08
	redeemable debentures	100	Floating	433,350	14.01.08
	559,285,000	100	18.00%	2,962,400	14.01.08
LB Finance PLC	Up to 450,000	1000	21.00%	149,480	21.10.08
	Unsecured subordinated	1000	14.00%	296,570	21.10.08
	redeemable debentures				
	450,000,000	1000	Floating	2,500	21.10.08
		1000	Floating	1,450	21.10.08
Singer (Sri Lanka)	Up to 6,000,000	100	Floating	280,000	28.10.08
PLC	Unsecured redeemable				
	listed rated A +				
	300,000,000	100	19.75%	2,720,000	28.10.08
Bank of Ceylon	Up to 50,000,000	100	19.00%	3,451,000	19.12.08
	Unsecured subordinated				
	redeemable debentures				
	4,272,370,000	100	Floating	36,993,900	19.12.08
		225	Zero	2,277,900	19.12.08
	10,000,000				
Nations Trust	Unsecured subordinated		21.00%		06.11.08
Bank PLC	redeemable debentures				

Source: Colombo Stock Exchange.