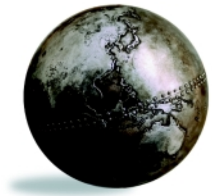


Sri Lanka

Civil conflict in the northeast region of the country contributed to a slowdown of economic growth. Policy reforms are necessary to revive the economy, including fiscal consolidation, public administration and financial sector reform, and private sector development. To sustain growth in the medium term, government policy should also focus on human resource development.

RECENT TRENDS AND PROSPECTS

After achieving real GDP growth of 4.7 percent in 1998, Sri Lanka recorded a lower rate of 4.2 percent in 1999, mainly because of declining industrial output growth. The industry sector's performance improved in the second half of the year, reflecting a gradual improvement in exports. The agriculture sector also performed well, resulting from a higher output of plantation crops.

The national savings-investment gap increased in 1999 compared with the previous year. Domestic investment increased to 27.5 percent of GDP compared with 25.4 percent in 1998, mainly due to aircraft purchases and telecommunications services expansion. Infrastructure development projects, together with housing and small-scale construction projects in rural areas, dominated investment expenditure in 1999. Preliminary data indicate that the ratio of national savings to GDP edged up from 24 percent in 1998 to 25 percent in 1999 because of higher private savings and lower fiscal deficit.

The unemployment rate declined in 1999 due to the increased employment in the tourism sector, strong small business growth, and increased public sector recruitment. The population grew at 1.2 percent annually and reached approximately 19 million at the end of 1999, with about 21 percent below the poverty threshold.

Government revenue increased 12 percent during 1999. A sharp increase in the national security levy and excise tax collections, plus moderate increases in revenues from income taxes and import duty, contributed to the improvement in tax revenue. Total revenue was an estimated 17.6 percent of GDP compared with 17.3 percent in 1998, but it was lower than originally targeted in the 1999 budget. Because of the relatively lower goods and services tax rate and the higher level of exemptions, collections of this tax were lower than the previous year.

Government expenditure increased by 6.3 percent in 1999. Current expenditure is expected to be higher than originally budgeted, largely because of increased salaries and wages and interest payments on domestic debt. However, overall expenditure was 25.6 percent of GDP in 1999, compared with 26.4 percent in 1998. Nonpriority expenditures in the public sector were curtailed and specific borrowing limits imposed on government spending units. Accordingly, the 1999 budget deficit was estimated at 8 percent of GDP, an improvement over 9.2 percent the previous year. Monetary policy in 1999 aimed at maintaining financial market stability, while helping strengthen the declining trend in inflation. The consolidated broad money supply (M2), which includes the operations of the foreign currency banking units, increased by 13.3 percent in 1999. Inflation declined, averaging about 4.7 percent compared with 9.4 percent in 1998, because of improved domestic supply of food items and lower prices of imports.

External sector developments in 1999 reflected the effects of depressed global demand and the decline in commodity prices (see figure 2.17). Exports fell 4.1 percent in 1999 because of weak prices of tea, rubber, textiles, and garments. Imports increased 0.1 percent as import prices—with the exception of oil—went down across the board. Consequently, the trade deficit was $1.3 billion in 1999 compared with $1.1 billion in 1998. Owing to rapid recovery in the tourism sector, the services account significantly improved, registering a surplus of $203 million in 1999 compared with $143 million in 1998. During 1999, tourist arrivals reached 436,400, a 14.5 percent increase from the previous year.

The current account deficit widened to about 2.6 percent of GDP in 1999 and the overall balance of payments registered a deficit of $263 million, down from a surplus of $37 million the previous year. As a result, gross official reserves declined to $1.7 billion at the end of 1999 (3.5 months of import equivalent) from $2 billion at the end of 1998 (4.1 months of imports). External debt was 57 percent of GDP in 1998 and remained at the same level in 1999, but the debt-service ratio increased from 11 percent to 12.7 percent. The Sri Lanka rupee depreciated by 5 percent against the dollar in 1999, trading at SLRe71.5 per dollar at the end of the year.

Real GDP growth is projected at 5 percent and 6 percent in 2000 and 2001, respectively. This higher growth should result from a modest recovery in industrial production, supported by an overall recovery of world trade. Annual average inflation is expected to be around 6.5 percent. However, imported inflation could occur in 2000 following higher oil

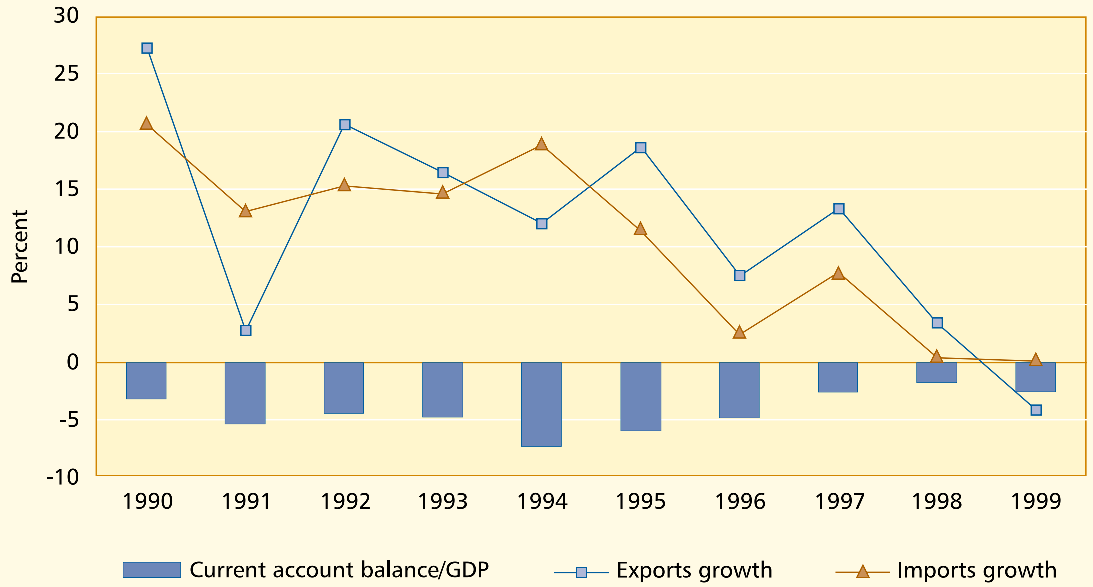
Table 2.18 Major Economic Indicators, Sri Lanka, 1997-2001
(percent)

Item	1997	1998	1999	2000	2001
GDP growth	6.3	4.7	4.2	5.0	6.0
Gross domestic investment/GDP	24.4	25.4	27.5	29.0	29.5
Gross national savings/GDP	21.5	24.0	25.0	25.0	26.0
Inflation rate (consumer price index)	9.6	9.4	4.7	6.5	6.5
Money supply (M2) growth	13.8	9.7	13.3	12.5	12.0
Fiscal balance/GDP[a]	-7.9	-9.2	-8.0	-7.6	-5.7
Merchandise exports growth	13.3	3.4	-4.1	10.0	15.0
Merchandise imports growth	7.8	0.4	0.1	14.0	16.0
Current account balance/GDP	-2.6	-1.8	-2.6	-6.8	-3.8
Debt service/exports	13.3	11.0	12.7	12.0	12.0

a. Excludes grants and privatization proceeds.

Sources: Central Bank of Sri Lanka (2000); Ministry of Finance and Planning; IMF; staff estimates.

Figure 2.17 Exports, Imports, and Current Account Balance, Sri Lanka, 1990-1999



Sources: Central Bank of Sri Lanka (1999, 2000).

prices. The ratio of current account deficit to GDP is expected to be 6.8 percent in 2000 and 3.8 percent in 2001. Because of continuing fiscal consolidation efforts, the budget deficit for 2000 should be lower than in 1999. The money supply is expected to grow at 12-13 percent in 2000, providing adequate liquidity to the economy while avoiding inflationary pressure.

ISSUES IN ECONOMIC MANAGEMENT

The government has achieved considerable progress in structural reforms, which include tax reforms and private sector participation in key areas such as gas, telecommunications, and plantations. To sustain higher economic growth, the government should continue structural reform efforts, including fiscal consolidation and reform in public administration and in the financial sector.

The medium-term strategy for fiscal consolidation should include eliminating distortionary taxes, improving tax administration, restructuring public debt, expanding public enterprise reforms, and reducing defense and security-related expenditures. Public administration reform is also critical to better economic management. The reform agenda should include streamlining government organizations, progressively retrenching or redeploying employees in public institutions and agencies, and ensuring that provincial councils and local governments benefit from a clear delegation of authority. Public administration reform is expected not only to promote private sector development, but also reduce the fiscal deficit.

Although the government has been actively pursuing financial sector reforms to mobilize capital, the role of the domestic capital market remains modest and the development finance institutions are still the major sources of long-term finance. To foster private sector growth in the economy, the government must develop market-based financial institutions and instruments through financial sector reforms.

POLICY AND DEVELOPMENT ISSUES

Traditional agricultural products such as tea and rubber, along with labor-intensive manufacturers, continue to dominate Sri Lankan exports. In the face of modest prospects for these exports and increased competition from regional producers, the government must reorient the existing production structure toward higher-value-added activities. To achieve this objective, human resource development is critical.

Sri Lanka has attained remarkable social progress during the past decades. It ranks highest among South Asian countries in human development indicators, and in the middle in socioeconomic indicators. However, human resource development requires strengthening to provide the necessary skills for the current needs of the economy. Major policy initiatives need to focus on building closer links between education and training and the labor markets, improving health care to meet the requirements of a growing aging population, and developing a social security system to help vulnerable and poor groups.

Speedy reforms in the education sector are needed to improve the quality of higher education, especially in technical skills. Policy initiatives should be taken to further involve the private sector in technical education and for raising standards to international levels. Health sector policy needs to address issues relating to the efficiency and effectiveness of the current health service system, especially its financial sustainability and allocation of resources. The quality of private sector services in health care needs appropriate regulatory legislation to equalize standards for the government and private sector health institutions.

Despite sustained commitment to social welfare through various poverty reduction programs such as direct income transfers and subsidies, approximately 21 percent of the country's population are poor. In the short term, the government must ensure that the poor gain access to social services and continue to receive income support through a transfer scheme. In the medium term, the aim is to improve the earnings of the poor through productivity enhancement. In the long term, economic growth will likely be sufficient to absorb an expanded labor force and provide gainful employment for all segments of the society.

Estimates on the country's poverty level do not include the conflict-centered Northeast Province, which has about 2.8 million people, 15 percent of the total population. A considerable portion of them are poor. The government's policy on relief, rehabilitation, and reconstruction in the region aims at providing basic amenities—including education, health, water, and sanitation—to help those affected by the conflict create a physically, economically, and socially sustainable environment for reintegration into productive life. Concerted efforts of the government and donor agencies will be needed to achieve this objective.