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September 2007

## Sri Lanka: Economic and Political Update

Asian Development Bank

## **CURRENCY EQUIVALENTS**

(as of 13 September 2007)

Currency Unit	–	Sri Lanka Rupee (SLRe/SLRs)
SLRe1.00	=	\$ 0.01
\$1.00	=	SLRe 113.9

## **ABBREVIATIONS**

ADB	–	Asian Development Bank
ACU	–	Asian currency unit
ADO	–	Asian Development Outlook
APRC	–	All Party Representative Committee
GDP	–	gross domestic product
LTTE	–	Liberation Tigers of Tamil Eelam
UNP	–	United National Party
SLFP	–	Sri Lanka Freedom Party

## **NOTES**

- (i) The fiscal year (FY) of the Government ends on 31 December.
- (ii) In this report, "\$" refers to US dollars.

## I. RECENT ECONOMIC DEVELOPMENTS

1. Despite the resumption of fighting between Sri Lankan Government forces and the Liberation Tigers of Tamil Eelam (LTTE) since August 2006, Sri Lanka's economy continues to do remarkably well. However, economic growth is beginning to slow, from a peak of 7.4% growth in gross domestic product (GDP) in 2006 to 6.2% in the first half of 2007. This is mainly due to a stagnating agricultural sector that has been unable to repeat its impressive post-tsunami recovery performance of 2006, and a shrinking tourism sector because of conflict-related travel warnings issued by governments.

2. The main economic concerns continue to be (i) the impact of the ongoing hostilities on the fiscal deficit and business confidence, (ii) high inflation, and (iii) low foreign exchange reserves. After the central bank reduced its net lending to the Government in the first five months of 2007, the Government returned to central bank borrowing to finance its deficit in June 2007, a move likely to increase inflationary pressures. In addition, frequent adjustments to administered prices have increased the level of the consumer price index. These adjustments have included a one-off increase in previously heavily subsidized kerosene (the price of which increased by SLRs16 per liter in May 2007) as well as frequent changes to diesel and gas prices. Year on year inflation rose again to 16.6% in June 2007, and the Asian Development Outlook (ADO) Update 2007 predicts that annual average inflation for 2007 will be at least 14.5%.<sup>1</sup> The Government is trying to combat the rising cost of living by exempting 15 basic key goods<sup>2</sup> from import duties. The Government has estimated that this resulted in a revenue shortfall of SLRs 9 billion for the first half of 2007. Interest rates on government securities have increased sharply from 12% in January to 17.8% in September 2007.

3. The budget call of July 2007, requesting submissions for the 2008 budget by line ministries and government agencies, included a revised macro-economic framework of the Government. It shows that the Government plans to reorient spending toward recurrent expenditure, rather than capital expenditure. The original budget of November 2006 almost doubled the allocation allotted to capital expenditure, but this has now been scaled back substantially, with capital spending plans revised from 9.2% to 7.4% of GDP. Because of the relatively slow implementation of capital projects, and difficulties in securing financing, the projected budget deficit is still in line with the revised Government forecast of July 2007, despite some shortfalls in revenue collection in the first half of 2007. The implications of the escalation of hostilities on expenditure are not yet clear and will only be published with the budget presentation in November 2007. Available data show that salary costs increased by over 30% from January to May 2007 to SLRs 85 billion, compared with the same period in 2006. This was mainly because of increases in the recruitment of civil servants and military staff. Resettlement of people recently displaced by the conflict and some rehabilitation have cost the government SLRs 288 million so far.

4. Foreign exchange reserves excluding Asian currency units (ACUs) stand at \$2.68 billion, or about 2.5 months of imports.<sup>3</sup> However, in the first half of 2007 Sri Lanka's trade deficit shrank because of a reduction of 7.8% in the oil import bill as the temporary closure of one refinery and high stocks of oil temporarily reduced demand for imports. As a result, Sri Lanka's total imports grew by only 3.9%, while exports did better than projected by ADB in its ADO 2007, growing at 13% for the first 6 months of the year. The key reason for this success was,

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<sup>1</sup> Sri Lanka Consumer Price Index.

<sup>2</sup> This ranges from lentils, to dried fish, wheat and onions.

<sup>3</sup> This figure is lower than the official central bank estimate, as it includes the import of services (rather than just manufactured goods), and uses 2007 as the base year for imports (rather than 2006).

once again, Sri Lanka's resilient and high-end garment export sector, which continued to make substantial inroads into European markets. Exports to Europe increased, while those to the country's other key market, the USA, actually shrank in value terms. As in previous years, the current account was supported by remittances from overseas workers, which grew by 17% in dollar terms to June 2007 (year on year). The balance of payments was in surplus as capital inflows (mostly borrowing by the Government and by state-owned banks) increased sharply. The Government partially liberalized its capital account with the gradual opening of the T-bond market to external investors, a move that attracted \$490 million in the first half of 2007.

## **II. RECENT POLITICAL DEVELOPMENTS AND IMPACT ON ADB PROJECTS**

### **A. New political alignments**

5. Sri Lanka's traditionally complex coalition politics have become even more complicated. The United National Party (UNP) is the main opposition party to the ruling coalition led by the Sri Lanka Freedom Party (SLFP). In January 2007, 18 disaffected UNP members and 6 members of the Muslim Congress, previously aligned with the UNP, joined the Government (although the UNP MPs did not forfeit their UNP membership). In February 2007, a key SLFP minister, Mangala Samaraweera, and his key ally, Sripathi Sooriyarachchi, lost their ministerial posts after they were accused of trying to topple the government. These two formed a new faction, the SLFP (M) party. In July 2007, this faction signed a memorandum of understanding to set up a new alliance to be called National Congress with the main UNP under the leadership of former Prime Minister Ranil Wickremasinghe. The National Congress has announced it will try to introduce votes of no confidence based on the high cost of living, the move to raise a sovereign bond, and corruption in defense procurement. However, in an environment as politically fluid as Sri Lanka's, it is not possible to forecast the likely outcome. At this stage most political observers think the present Government will continue to hold onto power.

### **B. Latest military developments**

6. Colombo itself has been relatively quiet, with only two suicide attacks recorded in 2007 so far, targeting army personnel. However, these attacks also killed civilians. After intense fighting that mostly focused on the last LTTE stronghold, a largely uninhabited jungle area, on 11 July 2007 the Government announced it was in control of the Eastern Province, significant parts of which had been under LTTE control for over 10 years. However, only four days after this announcement, the new chief secretary of the eastern province was assassinated by gunmen in an attack blamed by most observers on the LTTE. While the situation in the east is calmer than a year ago, when a daytime curfew was imposed because of high tensions, overall the security situation remains fragile. On 31 May 2007, the Government announced the establishment of a high security zone (HSZ) in key areas overlooking the strategically important harbor of Trincomalee. However, the size of this zone remains unclear. Civil society groups have voiced fears that it might lead to the displacement of the mostly Tamil population in the area, and are especially concerned that this population may be replaced by Sinhala settlers. The government has announced that it will revise the government gazette that set up the HSZ, drastically reducing its size from the original 90 square kilometers.

7. In parallel, about 130,000 of the 270,000 internally displaced people since the outbreak of hostilities in 2006–2007 have been resettled in their original homes. There are some concerns that not all areas have been fully cleared of mines, but, overall, this resettlement appears to have been implemented successfully. The Government has also set up two major working groups on the rehabilitation and reconstruction of the Eastern Province, and has announced plans to hold local elections soon. Political analysts have voiced concerns that these

elections could be marred by violence, particularly as the role of the Karuna group is not yet clear.<sup>4</sup> This is a splinter group of the LTTE that broke away in late 2003 and has since then fought the LTTE. The Karuna Group is alleged to have close links to the Sri Lankan army. It has already announced that its political wing plans to contest the elections. Reports from early September suggesting that the Karuna group will not allow any other Tamil parties to contest, still have to be verified.

### **C. Moves towards holding talks on resuming peace process**

8. In contrast to the military campaign, the move toward peace talks has all but stalled. The last time the LTTE and the Government met was in February 2006 in Geneva, and the agenda was the implementation of the ceasefire agreement of 2002, rather than peace talks. Talks scheduled for April the same year collapsed when the LTTE refused to meet the Government delegation in Geneva, claiming it was too junior to be fully representative of the Government.<sup>5</sup> An All Party Representative Committee was set up in July 2006 by the President and tasked with formulating a political proposal that could be used as the basis for negotiations with the LTTE. However, after many difficulties and controversies, the committee was adjourned indefinitely on 14 August 2007 and it is unclear when it will present its final proposal. The Government still says it remains interested in a political solution, while fighting what it perceives to be a terrorist threat, and attempting to remove any possibility of the LTTE regrouping and rearming.

### **D. Impact on ADB projects**

9. Despite the resurgent conflict, damage to physical infrastructure has been relatively limited. Based on present assessments, only a few buildings that ADB helped to rehabilitate in Vachcharai were damaged. Disbursements of projects in the north and east slowed down significantly, but, at the July 2007 Provincial Council Coordination Committee Meeting in Trincomalee, the number and amount of subprojects approved for the Eastern Province increased again. This reflects greater Government confidence that these projects can be implemented smoothly, given the reduction in restrictions on the movement of construction materials. However, the renewed conflict has been a major factor behind delays in the implementation of ADB-supported post-tsunami reconstruction.

## **III. PROSPECTS**

10. So far, the economic impact of the deteriorating security situation has been relatively small. The private sector is versatile, and mostly based in Colombo and the Western Province, where, apart from increased military presence and higher frequency of bomb attacks, life has changed little since the escalation of hostilities. Sri Lankans have lived under similar conditions for over 20 years during which economic growth was 4-5% per year. Assuming that key economic infrastructure is not attacked, defense expenditure is contained, and macroeconomic imbalances are addressed, the outlook for economic growth is stable. As foreign governments start to lift blanket travel warnings, the tourism industry expects a moderately good winter season in 2007–2008. However, the downside risks have become more sizable. In addition to the impetus given by post-tsunami reconstruction, economic growth is mostly stimulated by loose monetary and fiscal policies, which, combined with high global oil prices, is leading to high and accelerating levels of inflation, persistently high fiscal and current account deficits, and low levels of international reserves. The Sri Lanka rupee has started to depreciate significantly

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<sup>4</sup> Local elections, while becoming much more peaceful over the years, are still the most violent elections in Sri Lanka.

<sup>5</sup> The LTTE knew the composition of the government delegation before both parties headed to Geneva.

against the US dollar which will raise the costs of external debt servicing and imports. A larger defense budget could crowd out the private sector, and make fiscal management more difficult.

11. The scope for reaching a “southern” consensus for a political solution is limited, and key political analysts think that it is also becoming increasingly unlikely that the LTTE will be willing to return to the negotiation table, even if new proposals are submitted to it. Thus the impasse is expected to continue until well beyond 2007. A scenario of a continued war increasingly waged in the north (but less now in the east as the army is largely in control there) remains the most likely scenario.

**Table 1: Key economic indicators**

<b>Item</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>
GDP Growth (% change per year)	6.0	7.4	6.1	6.0
Gross domestic fixed capital investment (% of GDP)	26.5	28.7	32.1	31.2
CPI (% change per year)	10.6	9.5	14.5	10.0
Fiscal balance (% of GDP)	-8.7	-8.5	-8.0	-7.4
Export growth (% change per year)	10.2	8.4	10.0	8.0
Import growth (% change per year)	10.8	15.7	8.0	9.0
Current account (% of GDP)	-2.8	-4.9	-3.7	-3.5

Source: ADB 2007. *Asian Development Outlook Update*. Manila.