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## Sri Lanka: Economic, Political and Security Update

Asian Development Bank

## I. RECENT ECONOMIC DEVELOPMENTS

1. Sri Lanka's economy recovered remarkably quickly from the tsunami. Growth rates were 8.1% in the first quarter of 2006 and 7.1% in the second, year on year (y-o-y). Although much of this growth was demand driven, the country's export performance was also quite strong, despite a slight weakening in the traditional bulwark of exports earnings, the garment sector. Agricultural processing and related exports, including tea, combined with a flourishing service sector (primarily telecommunication and financial services), contributed to this impressive performance. The outbreak of large-scale fighting in the north and east that started on 11 August 2006 has not yet dented the country's economic performance. The directly affected provinces account for little more than 10% of GDP. For the immediate and medium-term outlook, much depends on (i) tourist bookings in the traditional high season during the European winter, (ii) global oil price trends, and (iii) whether the textile sector can continue to compete with exports from the People's Republic of China (PRC) and India. The 14% drop y-o-y in garment exports in July 2006 might be the precursor to a decisive structural shift in the industry.

2. The fiscal costs of the escalating conflict are not yet known as there is a substantial time lag in the publication of expenditure data. The Government's approved defense budget in November 2005 was approximately SLRs96 billion (\$960 million), or about 3.6% of GDP.<sup>1</sup> The appropriation bill for 2007, passed by parliament in early October, increases the defense budget to about 4.4% of GDP. The Government is increasingly financing its fiscal deficit through the domestic banking system: the stock of bank credit to the government increased by 2% of GDP in the period July 2005 to July 2006. The Government's net exposure to commercial, foreign currency denominated short-term debt alone grew by SLRs60 billion (\$588 million) from January 2005 to July 2006. This strategy adds to the country's exposure to foreign exchange risk, but lowers immediate interest rate repayments (and thereby the budget deficit) as long as these interest rates remain low and manageable.

3. Inflation remains high, and picked up again in August 2006 to 15.3% (year on year). Inflation is driven by a mix of increasing demand and cost push factors. A relatively loose monetary and fiscal policy has increased aggregate demand and the increase in administered fuel prices by a weighted 50% in 2006 could add about 5% to inflation.<sup>2</sup> The Central Bank has gradually tightened monetary policy, and, in a rather dramatic and unannounced move, increased policy rates overnight by 50 basis points to 11.125% on 28 September 2006, to reduce commercial bank borrowing from the Central Bank.

4. Sri Lanka's oil import bill will increase from \$1.6 billion in 2005, to \$2 billion in 2006, significantly increasing the current account deficit. So far, the inflow of private remittances (which increased by 24% in the first 7 months of the year alone compared to the same period the year before) have helped the balance of payments. The increase in the cost of oil imports is being financed through a mix of loans from the banking sector, and intergovernmental loans. The dramatic drop in textile exports in July 2006 may have been affected by the strike at Colombo port's Jaya container terminal in that month, but it may also reflect longer-term production shifts to the PRC and India. Gross official international reserves have gradually fallen by 10% since the beginning of the year to \$2.6 billion in August 2006. While the Sri Lanka rupee was stable against the dollar for the first half of the year, the Central Bank acted swiftly to prevent increased currency speculation and imposed a deposit requirement of 50% for letters of credit for non-essential imports on 20 October 2006. The International Monetary Fund (IMF) has determined, at its Board meeting for the Sri Lanka Article IV consultation, held on 25 October 2006, that this represents a currency restriction as specified in Article VIII of the IMF's Articles of

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<sup>1</sup> Defense expenditure in 2004 was 3.7% of GDP, and in 2005 3.2%.

<sup>2</sup> According to Central Bank calculations, a 10% increase in fuel prices raises inflation by up to 1.2 percentage points.

Agreement, and is therefore subject to approval by the IMF. Discussions between the Government and the IMF on this matter are ongoing. The currency fell on 17 October 2006 by SLRs5 to \$1 compared with the previous month (to almost SLRs 107.4).

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

5. Large-scale fighting broke out in the north and east of Sri Lanka on 11 August 2006. Claymore mine attacks, the murder of 17 Sri Lankan aid workers working for an international NGO, a large battle on the Jaffna peninsula that left 130 soldiers dead, suicide bombings, and an attack on Galle naval harbor in the south of the country on 17 October, have all significantly worsened the security situation. The precise number of civilian deaths since August is not known but it estimated to be in the high hundreds. About 120 soldiers and civilians died in the two most recent suicide attacks since 16 October 2006. However, the Government has, for the first time since the signing of the ceasefire in 2002, made territorial gains. It also moved forward on the so-called “forward defense line”, the informal border separating Government and Liberation Tigers of Tamil Eelam (LTTE) controlled areas, by over 1 km and advanced toward the administrative stronghold of the LTTE, Kilinochchi. The Karuna faction (a 5,000 strong LTTE splinter group based in the east of the country) split off from the LTTE in March 2004, and has since then allegedly established links with the army. The fact that the European Union designated the LTTE a terrorist organization in May 2006 thereby making fund raising in the EU illegal, and a crack-down on illegal funding mechanisms and blackmailing of the Tamil diaspora, have had some impact on the military strength of the LTTE. However, as the most recent attacks have shown, the LTTE remains a potent force.

6. About 40,000 soldiers are based in the Jaffna peninsula, and they can only be supplied by air and sea, as the only road access to Jaffna, leading through LTTE-controlled territory, remains closed. As a result, fuel supplies have been unable to reach Jaffna, and electricity has now been rationed to about 1 hour a day. Prices of essentials have increased dramatically, medicines are short in supply, and humanitarian agencies report that many people have to barter, as banks have run out of cash.

7. On 23 October 2006, a memorandum of understanding (MOU) between the two main political parties, the Sri Lanka Freedom Party (SLFP) and United National Party (UNP) was signed. The MOU, though vague, promises collaboration on key issues of conflict in the north and east, electoral reforms, good governance, and social development. If implemented swiftly and without inter-party wrangling for cabinet positions, this MOU could signal a breakthrough in forging a southern consensus on how to resolve the ethnic conflict. The absence of such a consensus has stalled peace talks in the past. However, the MOU is silent on the proposed structure for collaboration, which will hinder the achievement of a final agreement between the two political parties.

8. The worsening security situation has hampered both post-conflict and tsunami reconstruction in the north and east. Most aid agencies face shortages of material because of transport restrictions and report that their reconstruction activities have been severely curtailed. To some extent, this also applies to activities supported by Sri Lanka’s key development partners. While no ADB-financed infrastructure (except for one ADB-financed ambulance) has been damaged, ADB has postponed implementing large infrastructure projects until the security situation and the availability of construction material improves. However, offices of projects supported by ADB and World Bank in the north and east, staffed by government officials, largely continue to function. As projects use the government’s system and the provincial councils (structures that continued to function at the height of the civil war, even in LTTE-controlled

areas) ADB has been able to award \$50,000 community-based contracts even up to September 2006. The World Bank is reporting similar progress in the projects it is supporting. Suppliers use existing material in the area to implement these small-scale projects, such as building schools. Disbursements for reconstruction projects to date are \$12 million, or 57% of projections, while \$19.6 million has been disbursed for post-tsunami reconstruction, compared with \$11 million for the whole of 2005. Major tsunami road rehabilitation contract awards worth \$52 million for the north and east have been delayed. One project financed by Japan Bank for International Cooperation (JBIC) has extended the tender period in the north and east, and some consultants could not be mobilized. While JBIC has only a few large infrastructure projects ongoing or planned in the conflict-affected areas, it has not so far postponed or deferred any of them. The proposed Jaffna Water Supply and Sanitation Project to be supported by ADB has been postponed to 2007 but preparations continue as far as possible. Neither the Government nor ADB has plans to reallocate these crucially important funds to the south.

9. However, these “holding” options are viable for only a limited amount of time, and ADB, through its resident mission in Colombo, continues to monitor the situation carefully. As part of the preparations for the new 5-year country partnership strategy due to be presented to the ADB Board of Directors in the second half of 2007, the country team is in the process of developing possible peace and conflict scenarios and linking them to different commitment levels. The escalation of the conflict has had some impact on ADB operations, but so far that impact is manageable and has been felt mainly through a slow down in disbursements and contract awards.

### III. PROSPECTS

10. So far, the economic impact of the deteriorating security situation has been small. The private sector remains vibrant, and is mostly based in Colombo and the western provinces. In these parts of the country, apart from increased military presence and the increased frequency of bomb attacks, life has changed little since 11 August 2006. Sri Lankans have lived under similar conditions for over 20 years during which economic growth was in the region of 4-5% per year. If key economic infrastructure is not attacked, and defense expenditure can be contained, the outlook for economic growth is stable. However, the slump in garment exports and risks to tourism earnings (especially after the attack on Galle, a traditional tourist hub); the combined impact of these two developments on the balance of payments; and the fiscal impact of fuel and electricity subsidies are more immediate economic concerns. However, the economy faces significant and growing risks. A larger defense budget could crowd out the private sector, and make fiscal management more difficult. Such an increase would probably increase public debt above its current level of 96% of GDP, and reduce domestic investment and already small foreign direct investment (FDI) inflows. However, to a certain extent reductions in fuel and electricity subsidies mitigate these economic risks.

11. It seems unlikely that very significant steps will be taken toward a political solution to the conflict, or that a ceasefire will be called during 2006, particularly since talks in Geneva did not succeed at the end of October 2006. It also remains to be seen how the new political consensus between the SLDP and UNP will affect the peace process. Against this background, the most likely scenario is for a continued low intensity war in the north and east.

## KEY ECONOMIC INDICATORS

Item	2001	2002 <sup>a</sup>	2003	2004	2005
<b>Income and Growth</b>					
GNI per Capita (current prices, \$)	830	860	900	980	1130
Growth in Real GDP at Factor Cost (% change)	(1.5)	4.0	5.9	5.5	6.1
Agriculture	(3.4)	2.5	1.5	(0.2)	1.5
Industry	(2.1)	1.0	5.5	5.2	8.3
Services	(0.5)	6.0	7.8	7.7	6.4
<b>Saving and Investment (% of GDP)</b>					
Gross National Saving	20.3	19.7	21.5	21.7	23.7
Gross Domestic Investment	22.0	21.3	22.3	23.2	27.0
Gross Fixed Capital Formation	22.0	21.0	22.1	23.2	27.0
Saving-Investment Gap	(1.7)	(1.6)	(0.7)	(1.5)	(3.3)
<b>Central Government Finance (% of GDP)</b>					
Total Revenue (including grants)	17.0	16.9	16.1	15.9	17.5
Tax Revenues	14.6	14.0	13.1	13.9	14.2
Other Revenues and Grants	2.4	2.9	3.0	2.0	3.2
Total Expenditure (including net lending)	26.9	25.0	23.1	23.5	24.7
Current Expenditures	21.6	20.8	19.0	19.2	18.7
Capital Expenditures and Net Lending	5.3	4.2	4.1	4.3	6.0
Overall Fiscal Surplus (+)/Deficit (-)	(9.8)	(8.1)	(6.9)	(7.6)	(7.2)
Foreign Borrowing	1.0	0.1	2.9	1.8	2.0
Domestic Borrowing	8.8	8.0	4.0	5.8	5.2
Fiscal Surplus less Grants and Privatization Proceeds	(10.8)	(8.9)	(8.0)	(8.2)	(8.9)
<b>Money and Inflation (% change)</b>					
Narrow Money (M1)	3.2	14.0	16.0	0.0	0.0
Broad Money (M2)	13.6	13.4	15.3	19.5	16.6
Consumer Price Index	12.1	10.2	2.6	7.9	11.7
GDP Deflator	12.4	8.3	5.1	9.4	9.8
<b>Balance of Payments</b>					
Merchandise Trade Balance (% of GDP)	(7.4)	(8.5)	(8.4)	(11.2)	(10.7)
Exports (% of GDP)	30.6	28.4	28.1	28.7	27.0
Imports (% of GDP)	37.9	36.9	36.5	39.9	37.7
Current Account Balance (% of GDP)	(1.6)	(1.6)	(0.6)	(3.2)	(2.8)
Export Growth (\$, % change)	(12.8)	(2.4)	9.2	12.2	10.2
Import Growth (\$, % change)	(18.4)	2.2	9.3	19.9	10.8
<b>External Payments Indicators</b>					
Gross Official Reserves (\$ millions)	1,338	1,700	2,329	1,824	2,458
(in months of imports of G&S)	2.1	2.7	3.5	2.4	3.3
External Debt (% of GDP)	56.6	56.7	58.3	50.2	48.8
External Debt Service (% of exports of G&S)	6.7	8.2	7.1	6.6	4.4
<b>Memorandum Items</b>					
GDP (current prices, SLRs billions)	1,407	1,585	1,766	2,029	2,366
Average Exchange Rate (SLRs per \$)	89.4	95.7	96.5	101.2	100.5
Midyear Population (millions) <sup>b</sup>	18.7	19.0	20.0	20.3	20.6

GDP = gross domestic product; GNI = gross national income; G&S = goods and services (factor and nonfactor services).

<sup>a</sup> Preliminary figures.

<sup>b</sup> Provisional estimates based on the Census of Population and Housing 2001.

Sources: Central Bank of Sri Lanka (various issues) *Economic and Social Statistics of Sri Lanka* and (various issues) *Annual Report*.