

SRI LANKA ECONOMIC QUARTERLY

Highlights

- ☞ **Economic Developments:** Sri Lanka continued to enjoy strong economic growth during first quarter, as its foreign trade finally began to revive. The country should achieve growth in excess of 5% for the year, with inflation below 6.5%. The Government needs to address the slippages on the fiscal side if its ambitious budget targets are to be met.
- ☞ **Policy Issues:** The Government's enactment of the Fiscal Management (Responsibility) Act is an important step toward sustainable management of public finance. To increase the transparency and accountability of fiscal operations, twice a year the Government will formally report to Parliament on the status of budget implementation. Under the Act, the Government has committed itself to reduce the fiscal deficit to 5% of GDP and the public debt to 85% of GDP by 2006.
- ☞ **Development Focus:** Sri Lanka receives foreign assistance from a wide variety of sources, but most of the funds are in the form of loans rather than direct transfers. However, the concessional terms of the loans generate a real transfer of resources in net present value terms that is equivalent to a grant. A loan's "grant element" can be increased by lowering the interest rate, extending the grace period, or postponing the maturity.

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I. Economic Developments

The recovery in 2002 was stronger than anticipated, despite weak performance on the external front. Slack production capacity, a result of the downturn in 2001, has been absorbed to a certain extent such that higher investment rates will be needed to sustain the growth in the future. The Government has made progress in controlling the fiscal deficit and curbing inflation, but more difficult work lies ahead.

The first quarter of 2003 continued the trend begun in the second half of 2002. Trade picked up and tourism remained strong, in spite of the war in Iraq and the Severe Acute Respiratory Syndrome (SARS) outbreak in East Asia. With oil prices stabilizing and signs of recovery appearing in Sri Lanka's main export markets, the short-term growth outlook remains positive. The Liberation Tigers of Tamil Eelam's (LTTE) temporary withdrawal from the peace negotia-

tions has raised an element of uncertainty, which has so far not affected the stability of the macroeconomy. However, the resumption of the peace talks is necessary for sustaining growth. The fiscal situation as well must be managed closely to ensure the ambitious deficit reduction targets for 2003 are achieved.

A. Year 2002 in Review

An acceleration in economic activity during the last half of the year generated growth in 2002 that exceeded expectations. As Table 1.1 shows, the actual growth in real gross domestic product (GDP) of 4% surpassed even the Central Bank's projected rate of 3.7%. Services led the recovery, accounting for 80% of the total increase in output, while agriculture contributed 13% and industry only 7%. Industrial output began to pick up in the latter half of the year, but only managed to increase its real value added by 1% in

The 4% real growth in 2002 exceeded even the Government's projections.

Table 1.1: Comparison of Projected and Actual Indicators, 2002

Indicator (%)	Projections for 2002			Actual Outcomes
	ADB	EIU	CBSL	
GDP Growth	3.5	3.3	3.7	4.0
Fiscal Balance/GDP	-8.5	-	-6.7	-8.1
w/o grants and privatization	-	-8.5	-8.5	-8.9
Money Supply (M2b) Growth	12.0	-	12.5	13.4
Inflation Rate:				
Colombo CPI	-	9.1	9.0	9.6
Sri Lanka CPI	8.5	-	-	10.2
Merchandise Export Growth	7.0	6.0	5.0	-2.4
Merchandise Import Growth	15.0	5.0	5.6	2.2
Current Account Balance/GDP	-6.5	-4.3	-2.4	-1.6

ADB = Asian Development Bank; CBSL = Central Bank of Sri Lanka; EIU = Economist Intelligence Unit.

Sources: ADB. 2002. *Asian Development Outlook*. Manila; EIU. 2002 (January). *Country Forecast: Sri Lanka*. London; CBSL. 2001 and 2002. *Annual Report*. Colombo.

The Government made progress in fiscal consolidation in 2002, although it fell short of its announced target.

2002. While this compares favorably with the 2.1% contraction in the sector in 2001, power cuts during the first half of the year and slow recovery in Sri Lanka's export markets were clearly a drag on the industry sector's performance.

Saving and investment rates remained low in 2002. Gross national saving dropped to 19.7% of GDP, from 20.3% in 2001, as higher private consumption offset the gains from fiscal consolidation. As a comparison, India's saving rate was 23% in 2000, while Thailand and Malaysia had saving rates of 32% and 40% in the same year. The Asian tiger economies of Taiwan, Hong Kong, Korea, and Singapore had saving rates well in excess of 30%, particularly during their periods of rapid development. Fixed capital investment, as well, declined as a share of GDP to 21% from 22% in 2001, which is inadequate to sustain the higher rates of growth envisioned by the Government. Currently, the incremental capital to output ratio (ICOR) is roughly 5, which means 5% of GDP in investment is required to generate a percentage point of growth at the current efficiency levels of investment. As such, the country needs investment levels of roughly 35% of GDP in the near term to sustain growth rates of 7%, until higher rates of productivity bring the ICOR down to a lower level.

The labor market did not respond to the acceleration of economic activity, with unemployment rising from 7.9% in 2001 to 8.8% in 2002. Unemployment figures for the North and East of the country—which have been unavailable for a number of years due to lack of access—are even more stark.¹ Unemploy-

¹ Department of Census and Statistics (DCS) could not include the North and East in its surveys in recent years because of the civil conflict. Following partial enumeration of households in the conflict-

ment rates in 2002 were 13% in the North and 15.9% in the East. Despite the high rates of unemployment, the Government did not attempt to absorb the excess labor into its already overstuffed ranks. Public sector employment, including government and semigovernment institutions, still accounted for 16% of total employment in 2002 even with a civil service hiring freeze in place, voluntary retirement in some state-owned firms, and continued privatization of public commercial enterprises.

The Government achieved some success in its efforts to consolidate the fiscal situation, but actual performance was below expectations. The budget deficit, excluding grants and privatization proceeds, declined to 8.9% of GDP in 2002 from 10.9% in the previous year. This was somewhat below the 8.5% of GDP figure announced at the time the budget was presented to Parliament, as given in Table 1.1. The main culprit for the shortfall was tax revenue. The 2002 budget had projected tax receipts on the order of 15% of GDP, but the actual intake was only 14% of GDP. Part of this shortfall was met through a tightening of recurrent expenditures, and capital spending fell short of its target as well. The bulk of the deficit was financed through domestic nonbank borrowing, as the privatization program only generated about a quarter of its targeted SLRs21 billion in proceeds and foreign borrowings mirrored the shortfall in capital spending.

Despite the reduction in the fiscal deficit, the public debt burden edged

affected districts during the 2001 population census, DCS has begun to include the North and East in the labor force survey since 2002. The coverage in the North is incomplete. DCS. 2003. *Bulletin of Labour Force Statistics of Northern and Eastern Provinces – 2002*. Colombo.

higher to 105% of GDP in 2002, from 103% of GDP in 2001. In the late 1990s, the high fiscal deficits forced the Government to turn to short-term domestic borrowing, a large portion of which reached its maturity last year. This is reflected in the sharp rise in debt service, which exceeded total Government revenue in 2002. The Government has made progress in converting short-term domestic debt to longer-term instruments, by paying off most of its overdraft and issuing Treasury bonds with maturities greater than 3 years. Longer loan maturities, coupled with the general decline in interest rates, should lead to lower government debt service in the near term.

Monetary policy was similar to the previous year, with broad money expanding by 13.4%. However, the higher rate of economic activity meant less pressure on the price level, and the Central Bank reduced interest rates accordingly. The increase in domestic credit to the private sector accounted for roughly 65% of the new money, but increases in net foreign assets—a reflection of the Central Bank's policy to accumulate foreign reserves—also played an important role. Inflation slowed in 2002 regardless of which price indicator is used, but by less than had been projected at the beginning of the year (Table 1.1). The Sri Lanka consumer price index registered an inflation rate of 10.2%, down from 12.1% in 2001, while the narrower Colombo consumer price index showed a more dramatic decline in inflation, from 14.2% in 2001 to 9.6%. After an initial drop in the value of the rupee, exchange rates were relatively stable, particularly in the latter part of the year. The average value of the rupee depreciated by 7% for the year—in contrast to the 10% average annual depreciation experienced in the previous 5 years—ending the year at SLRs96.7 to the dollar.

Merchandise trade suffered for the second consecutive year, due to the lackluster performance of the global economy. The consensus projections at the beginning of the year had been for a revival of trade, especially in the second half of the year, but this did not materialize. As economic recovery eluded the US and EU—the main importers of Sri Lankan textiles and apparel—the dollar value of exports contracted by 2.4% in 2002. This is on top of the 12.8% contraction in the previous year. Imports fared a little better, expanding by 2.2% mainly through the import of intermediate goods, but was insufficient to make up for the 18.4% contraction in 2002. Trade in services was much more promising, as shipping and tourism returned to the levels attained prior to the July 2001 drop caused by the LTTE attack on the international airport. With the net income from services and remittances partly offsetting the widening merchandise trade gap, the current account deficit of 1.6% of GDP was manageable. The overall balance of payments was in surplus, with the Central Bank accumulating official reserves to raise the import coverage to 2.7 months of goods and services, from 2.1 months at the end of 2001.

B. First Quarter 2003

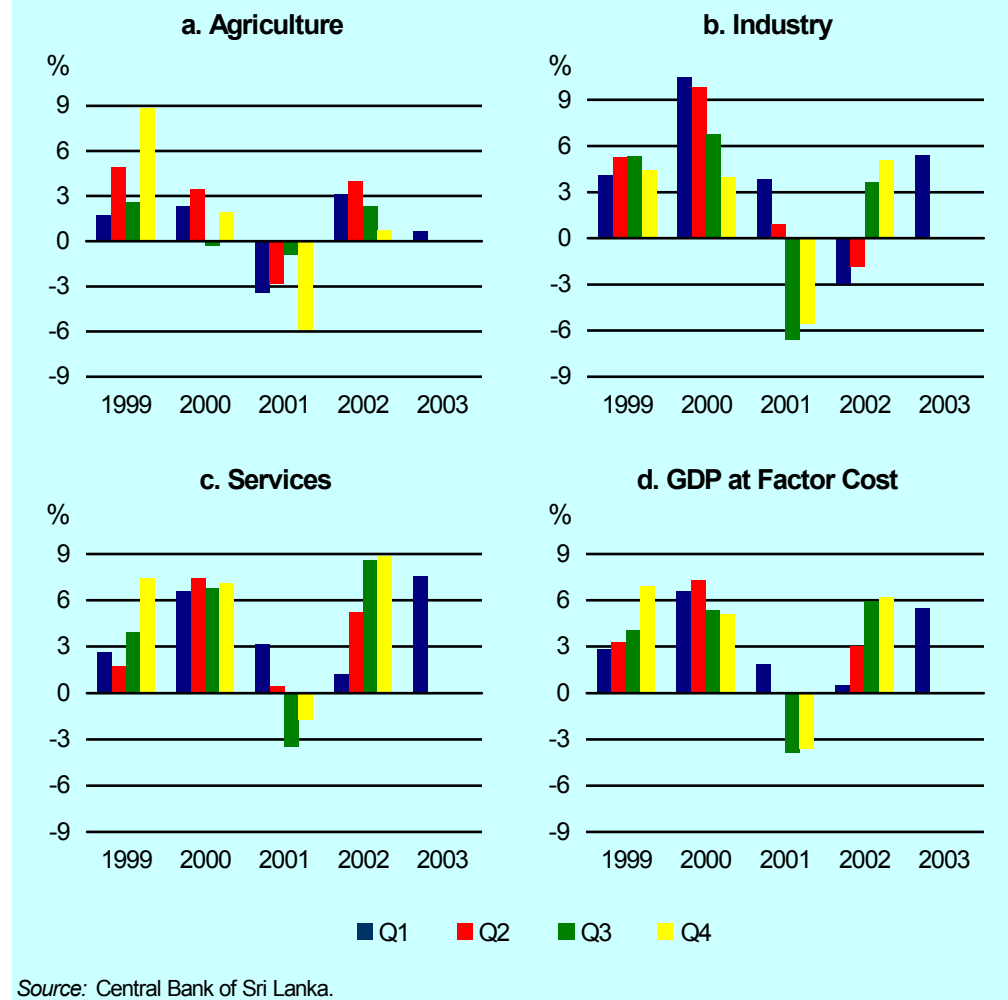
Following on the previous year's recovery, Sri Lanka's economic performance in 2003 is off to a promising start. First quarter growth and inflation rates continued the trends started in mid-2002, and international trade picked up speed. Within this bright scenario, however, fiscal performance remains an area of concern.

Output and Growth:

The 5.5% real GDP growth in the first quarter of 2003—which comes on the heels of the 6.2% and 5.9% expansion in the fourth and third quarters of

Trade fell far short of expectations in 2002, as the recovery in Sri Lanka's main export markets failed to materialize.

Figure 1.1: Quarterly GDP Growth by Sector, 1999-2003



First quarter 2003 continued the previous year's growth trend, with the service sector taking the lead.

2002—demonstrates that Sri Lanka's recovery is well underway. As Figure 1.1 shows, this is the strongest first quarter performance in three years. As in 2002, services provided the bulk of the additional value added, accounting for more than 70% of the growth. A key shift in the sources of growth was the resurgence of industry, which accounted for 26% of first quarter 2003 growth compared to only 7% of total growth in 2002. Agriculture, which had nearly returned to its pre-drought output levels in 2002, maintained its production levels but accounted for less than 3% of the economy's real expansion.

Overall, the agriculture sector grew by less than a percentage point during first quarter 2003, but this masks considerable variance across subsectors. Paddy production, for example, was quite strong. During the Maha season—which runs from September to April and is the larger of the two cropping seasons—Sri Lanka produced 1.9 million metric tons of paddy, a 6.7% increase over the previous year's output. This is particularly noteworthy in light of the fact that the 2001/02 Maha season's production had almost returned to the levels of output achieved before the 2000/01 drought. Improved weather

conditions and increased cultivation in the conflict-affected districts led to the higher output levels. Forestry as well experienced a strong increase in first quarter output. Plantation crops—tea, coconut, and rubber—on the other hand showed poor results. Plantation production declined by 7% compared with the first quarter of 2002, which had already been nearly 5% lower than the first quarter of 2001. The tea industry had been hit particularly hard by the war in Iraq, as orders from the Middle East were delayed or cancelled. The fishing subsector was another poor performer, with its first-quarter output declining by 4.8%.

After growing by 3.6% in the third quarter of 2002 and 5.1% in the fourth quarter, expansion of industrial production accelerated further in the first quarter of this year, expanding by 5.4%. The major industry subsectors all performed well, but the utilities sector was particularly striking. With no load shedding in the first quarter, the electricity sector generated 1,834 gigawatt hours of power, a 20% increase over the same period in 2002. There were concerns at the beginning of the year that the war in Iraq would adversely affect manufacturing production by raising oil prices and hindering trade. However, the effects on trade were less pronounced than expected, and the sharp increase in international oil prices preceding the war was short lived and partly offset by the Government. In the end, manufacturing output increased by 3.2% for the quarter, continuing the trend from the previous two quarters. A positive leading indicator, the construction industry grew by 7.6% in the first quarter, ending 5 consecutive quarters of declining output.

Continuing its leading role from 2002, the service sector was the dominant performer in first quarter 2003 expanding by 7.6%. Further, tourism and

shipping played a critical role in this effort. While tourism levels did not realize the record levels of first quarter 2001, the number of arrivals was beyond the average levels of first quarter arrivals in the late 1990s. Shipping has recovered from the effects of the war risk surcharge imposed after the LTTE bombing of the international airport. However, despite the expanded capacity in Colombo port, the levels were not much higher than what had been achieved before the airport attack. Rising foreign trade also helped to boost the service sector's performance, but the finance and real estate subsector was the real star. After growing by 11.1% in 2002—and despite the fact that the subsector's performance had not faltered during the 2001 economic contraction—finance and real estate expanded by 14.9%, partly a result of the higher interest spreads that manifested in 2002 as average interest rates declined.

Fiscal Policy:

The fiscal performance during the first quarter of the year suggests some slippages vis-à-vis the approved budget. As Table 1.2 shows, revenue performance reached roughly 25% of the budgeted figure—essentially on track to achieve the overall target—but nontax revenues offset lagging tax receipts. The value added tax (VAT)—which replaced the goods and services tax and national security levy and accounts for nearly half of total revenue—has not performed up to expectations. VAT collections in the first quarter were 2% less than the amount generated in the previous year by the taxes it replaced. As of the end of March, VAT receipts were only 20% of the budgeted figure for the year. This is particularly disappointing in light of the increased economic activity and international trade during the period. Excise tax collections, the next largest revenue source, also declined during the first

Agriculture growth slowed in the first quarter, but industry benefited from continuous power supply and improved foreign trade.

Table 1.2: Fiscal Operations
(% of GDP)

Item	3 Months		Budget 2003	Budget Utilized (%)
	2002	2003		
Revenue	4.2	4.2	16.9	24.6
Tax	3.2	3.1	14.7	21.1
Nontax & Capital	0.9	1.0	2.2	48.4
Expenditure	6.4	6.3	24.3	25.7
Current	5.2	5.2	19.2	26.9
Capital & Net Lending	1.2	1.1	5.2	21.5
Deficit	-2.2	-2.1	-7.4	28.3

Note: 2003 ratios are based on staff estimates of GDP at market prices.

Source: Central Bank of Sri Lanka; staff estimates.

Overall, the Government budget was on track in the first quarter, but weaknesses are appearing in tax receipts and current spending.

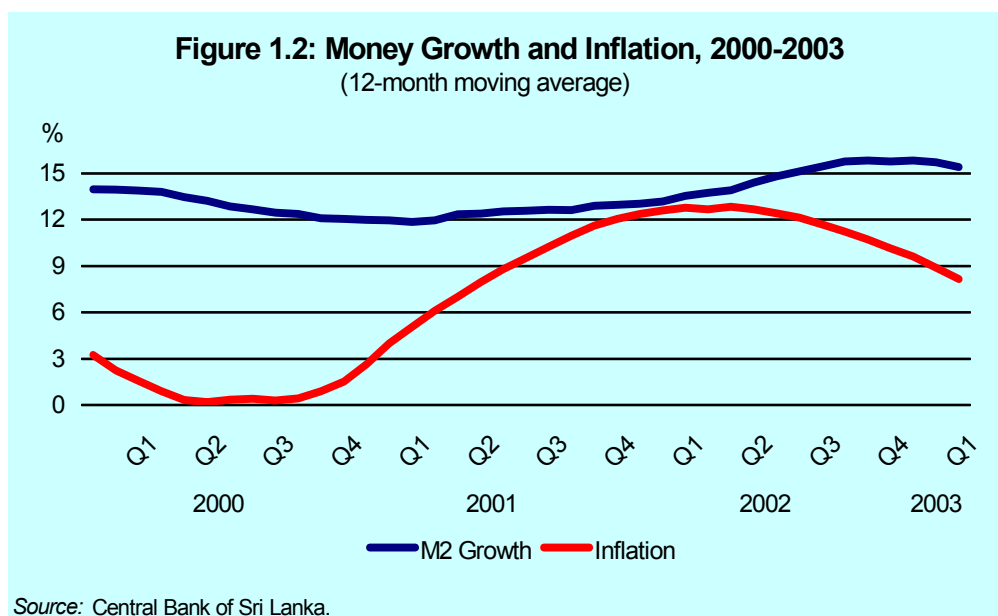
quarter, but they are on track to meet the budgeted target. Income tax receipts, on the other hand, increased by 50%, but were below the level needed to achieve the ambitious target for this tax. Customs duties were also performing as forecast in the budget.

Mirroring the performance on the revenue side, Government expenditures were on track to achieve the overall annual target, but the composition of spending shows signs of weakness. Current spending, at 27% of the annual target at the end of three months, is being offset by underspending on the capital side. While this has kept the deficit under control, the pattern of spending needs to be reversed. Aid utilization was a key point raised by the donor countries at the recent Tokyo conference, and so more rapid implementation of the Government's capital program needs to be addressed urgently. At the same time, current spending needs to be brought under control if the ambitious deficit target for the year is to be achieved, particularly in light of possible revenue shortfalls. The Government's taking advantage of the lower interest rates by paying back its short-term debt will help

relieve some of the pressure on current spending.

Money and Inflation:

With the amendments to the Monetary Act passed by Parliament in December 2002, the Central Bank's primary objective has been shifted to price stability, and current monetary policy is consistent with that objective. Moreover, in a move toward the use of market-based instruments for monetary policy, in March the Central Bank introduced open-market operations (i.e., the purchase and sale of government securities) to regulate money supply. Broad money growth peaked at the end of 2002 and is now on a downward trend. As Figure 1.2 shows, the 12-month moving average of M2 growth was just over 15% at the end of the first quarter of this year. The 3.3% increase in the money supply during the first quarter is on target for an annual expansion of broad money on the order of 13.5%, which is in line with the Central Bank's projections. Domestic credit to the private sector was the source of most of the money supply growth, but net foreign assets also increased in line with the Central Bank's policy to shore



up the country's official reserves. Domestic credit to the public sector, however, declined during the first quarter, a reflection of the Government's continuing efforts to replace its higher-interest, short-term debt (including bank overdrafts) with longer-term instruments.

Inflation in Sri Lanka continued the downward trend from its peak in May 2002 (Figure 1.2). The twelve-month moving average inflation rate, according to the Sri Lanka consumer price index, fell to 8.2% by the end of first quarter 2003. The other consumer price indices followed similar patterns. The slowing change in the price of food items was a driving factor overall. Average annual food price changes were 7.8% at the end of the first quarter, compared to a 9.2% increase in nonfood prices. Some staple goods prices actually declined—the retail price of red rice fell by 35% and local onions by 44% compared to March 2002—while many other food prices were stable. Part of the stability in non-food prices came from the Government's intervention to smooth local oil prices. The Government absorbed the effect of the short-term spike in interna-

tional oil prices, a result of speculative trading before the war in Iraq, rather than passing it on to the local market.

In January, the Central Bank reduced the repurchase rate and the reverse repurchase rate by 75 basis points to 9% and 11% in response to the lower inflation. Other interest rates responded accordingly. The average weighted deposit rate dropped from 7.5% to 6.5% during first quarter 2003, and the average weighted prime-lending rate fell from 14.3% to 11.7% during the same period indicating a decline in the interest rate spread. This is in contrast to the experience in 2002 when deposit rates declined more sharply than lending rates, widening the interest rate spread. The average exchange rate of SLRs96.93 in March was stable against the dollar, depreciating by less than 2.5% since March 2002. This stability helped to keep the price level in check. However, due to the weakness of the dollar, the rupee's depreciation with respect to other currencies has been more pronounced. The rupee lost 13% of its value against the yen, 14% against the pound sterling, and 26% against the euro

Stable food prices helped to restrain inflation, keeping it on a declining trend through the first quarter.

over the twelve months ending in the first quarter of this year.

Balance of Payments:

In the months preceding the war in Iraq, there were concerns that heightened instability in the Middle East would adversely affect Sri Lanka's exports. These concerns were further aggravated by the slow recovery in the US and EU, the main markets for Sri Lanka's nonagriculture manufactured exports. While these fears did materialize in terms of tea exports causing the dollar value of agriculture exports to decline by 10% compared first quarter 2002, industrial exports continued to surge. Overall, the dollar value of merchandise exports grew by 11% in the first quarter of 2002. However, merchandise imports expanded by 13% causing the trade deficit to widen. Much of the increase in imports was due to rising inflows of intermediate goods—many of which are used in the production of export products—but consumption goods were also on the rise. Significantly, imports of investment goods rose by 12% during the first quarter, a positive sign for future growth of the economy.

With the war in the Middle East gearing up and the SARS outbreak in East Asia coming to light toward the end of the first quarter, it appeared that Sri Lanka could become isolated, with tourists avoiding the main transit centers to the country. Fortunately, the worst-case scenario did not materialize and tourist arrivals continued to be strong in the first quarter, in part due to an influx of Indian tourists. The impending war in Iraq did have an effect on remittances, as the country's overseas workers in the Middle East transferred their savings to the relative "safe haven" of Sri Lanka. As a result of the robust trade in services and the spike in remittances, the current account balance for the first quarter was

actually positive. The overall balance of payments was positive, and official reserves increased to \$1,725 million or more than 3 months of import coverage.

C. Macroeconomic Outlook

Based on the first quarter results, the outlook for 2003 is somewhat more optimistic than the projections from ADB's Asian Development Outlook (ADO).² Two key risks identified at the beginning of the year—the war in Iraq and the SARS outbreak in East Asia—have had limited impacts on Sri Lanka's industry and trade. However, the LTTE's pulling out of the peace talks in April has added a new element of uncertainty to the projections, although the ceasefire continues to hold. As such, the short-term growth projections of 5% in 2003 and 5.5% in 2004 are unchanged (Table 1.3). Higher growth rates are certainly within Sri Lanka's reach, and the projections will be reviewed in light of second quarter results and progress in the peace negotiations.

As stipulated in the Fiscal Management (Responsibility) Act, the Government submitted its *Mid-Year Fiscal Position Report* to Parliament in end-June.³ The midyear report discusses the progress in achieving the Government's fiscal objectives for the year, based on the first four months of the budget year. The report shows that the weaknesses discussed previously with respect to revenue collections continued beyond the first quarter. VAT collections were falling far short of expected receipts, in part because of an increase in input credit leading to high refunds. The problem arises when an industry's inputs are taxed at the higher VAT rate but its out-

Exports surged during the first quarter, despite the adverse affects of the Iraq war on the tea trade.

² ADB. 2003. *Asian Development Outlook*. Manila.

³ Section II provides an overview of the salient features of the Fiscal Management (Responsibility) Act.

Table 1.3: Outlook for Key Economic Indicators

Indicator (%)	2000	2001	2002	Projections	
				2003	2004
GDP Growth	6.0	-1.5	4.0	5.0	5.5
Fiscal Balance/GDP ^a	-9.9	-10.8	-8.9	-7.5	-6.5
Money Supply (M2b) Growth	12.9	13.6	13.4	13.5	12.5
Inflation Rate	1.5	12.1	10.2	6.5	6.0
Merchandise Export Growth	19.8	-12.8	-2.4	10.0	11.0
Merchandise Import Growth	22.4	-18.4	2.2	9.0	12.0
Current Account Balance/GDP	-6.5	-1.6	-1.6	-2.5	-3.0

^a Excludes foreign grants and privatization proceeds.

Sources: Central Bank of Sri Lanka; Ministry of Finance; staff estimates.

puts are subject to the lower rate. Postponement of the extension of VAT to the wholesale and retail sectors will further hinder efforts to meet the annual target. Although not discussed in the midyear report, the tax amnesty has negatively affected collections, as enforcement slowed during the first half of the year.

In contrast, expenditures—even recurrent spending—were generally on track to achieve their targeted levels for the year. Overall, the target 2003 deficit of 7.5% of GDP is still within reach. The Government states in the report that it will arrest the revenue shortfalls by (i) extending VAT coverage to all financial services, and (ii) strengthening the tax administration in the VAT and large taxpayers' unit. Moreover, continuing efforts to pay off high-cost debt and take advantage of the current low interest rates will help reduce the single largest expenditure item in the budget. As such, our projections for the fiscal situation for the year have not changed, but will be reviewed in light of the Government's success in mobilizing additional revenue in the next few months.

The Central Bank's conduct of monetary policy to date suggests money supply growth will be within its projected rate of 13.5%, possibly lower.

The current decline in the inflation rate is likely to slow, but the economy should experience lower rates of price changes than the ADO projections. Our revised forecast for inflation, based on the Sri Lanka consumer price index, is 6.5% in 2003 (compared to the projected rate of 8.5% in ADO) with a further reduction to 6.0% in 2004 (compared to 7.5% in the ADO).

In contrast to the experience in 2002, trade performance has outperformed projections in the beginning of the year. The war in Iraq has had a large impact on tea exports, but this was more than offset by the increase in manufactured imports to the US and EU. As there are signs of strengthening in the economies of these key destinations for Sri Lankan products, export performance should be more robust than had been anticipated in the beginning of the year. As such, export growth in 2003 is likely to reach 10%—a significant adjustment from the 6.5% projection in the ADO—with a similarly rapid expansion in the following year. However, decisions on contracting new electricity generation capacity need to be made soon to sustain the growth in manufactured exports in the years beyond 2004. The projections on imports, on the other hand, remain unchanged from the ADO. De-

Sri Lanka is on track for growth in excess of 5% and inflation below 6.5% in 2003, with further improvements in 2004.

pending on the Government's success in accelerating development works, these rates may need to be adjusted upward as well. With the increase in projected export growth, the current account deficit is forecast to reach 2.5% of GDP in 2003 and 3.0% in 2004, whereas the ADO had anticipated a gap of 3.5% in 2003 and 4.5% in the following year.

In general, the economy has moved beyond economic recovery to economic expansion. The first quarter 2003 results point to a number of strengths in the current macroeconomic situation. However, two areas will require concerted efforts on the part of the Government. First, the optimistic medium-term projections are based on an assumption of continued progress on the peace negotia-

tions. Second, emerging fiscal imbalances need to be addressed immediately to stay within the targeted budget envelope. Looking forward, higher rates of investment are required to achieve and sustain the levels of growth outlined in *Regaining Sri Lanka*. Macroeconomic stability is a precondition to attracting private-sector investment, but stability alone is insufficient and continued efforts are needed to overcome the numerous structural rigidities in the economy. Public investment in basic infrastructure is also needed to support private investment and higher growth. In this context, Government procedures need to be reviewed and streamlined to accelerate aid utilization.

II. Policy Issues

The need for comprehensive fiscal reforms in Sri Lanka has been apparent for some time. Unsustainable budget deficits have caused the country to accumulate debt beyond the level of national income. Interest payments have grown to consume a substantial proportion of public resources. Despite attempts at fiscal consolidation in the 1980s, the reforms were overtaken by mounting expenditure on the civil conflict in the north and east of the country. Over the past decade, fiscal deficits were in the range of 9-10% of GDP while the country grew at an average of 5%. The Government's heavy domestic borrowing to finance the gap pushed interest rates up to as high as 20% in the late 1990s—crowding out private investment in the process. Moreover, its increased use of bank financing drained official reserves when the exchange rate was fixed and caused inflationary pressures after the float.

Attempts at fiscal control by recent governments have been at the expense of public investment, as capital expenditures have borne the brunt of spending cuts. In contrast, cuts to recurrent expenditure tend to be politically charged. The situation called for prioritizing of expenditure to contain the deficits and bring down the level of debt now standing at 105% of GDP. While an increase in the volume of public debt in itself may need not be a great cause for concern, the sharp increase in the outstanding debt stock and its associated high debt service burden raises concerns about the sustainability of public debt as well as the fiscal deficit.

Successive governments have recognized that the fiscal deficits are far too large for sustainable development and that these deficits should be brought down to 5-6% of GDP, at least in the

medium term. The task of restoring fiscal sustainability, through the reduction of expenditure and the debt-to-GDP ratio to a more sustainable level was brought to the forefront of the Government's macroeconomic policy agenda and outlined in the policy document *Re-gaining Sri Lanka*. In January 2003, the Government passed the Fiscal Management (Responsibility) Act (the Act), which is an important initiative towards a more sustainable management of public finances. The Act signals the transition to fiscal rectitude, as budgetary discipline has now been built into the country's legislative framework.

Experience in Other Countries

An increasing number of countries—such as New Zealand, United States, United Kingdom, Australia, European Union, Argentina, India and Pakistan—have introduced legislation to improve budget accountability and transparency and ensure long-term macroeconomic stability.

Fiscal responsibility legislation alone will not rid a country of its fiscal problems. However, it does play a crucial role in supporting and reinforcing a government's pursuit of budgetary control. Key features of fiscal responsibility legislation are a clear statement of principles, monitorable performance indicators, regular reporting, and accountability for results. The response of governments to publish their fiscal objectives and to assess them against principles of responsible fiscal management, and to build credibility among the general public on public finance is recognized as a way forward.

The New Zealand Fiscal Responsibility Act was introduced to partly address the country's poor fiscal performance, reduce public debt, and improve

Sri Lanka's Fiscal Management (Responsibility) Act is an important step in institutionalizing fiscal discipline.

Key elements of fiscal management laws are a clear set of budget principles and monitorable indicators of performance.

fiscal management. The New Zealand act sets legal standards for transparency of fiscal policy and reporting. While the New Zealand act does not specify targets for fiscal deficits or public debt, it does require the Government to set short-term fiscal targets with these longer-term fiscal objectives in mind. In the event that the Government does not meet the fiscal targets, an explanation is required from the Government on the deviation from the principles of responsible fiscal management as well as how the targets will be achieved. Australia and the UK have similar legislation where the Government or statistics bureau sets the fiscal targets and are bound to specific fiscal reporting and transparency with the public.

In the case of European Union and India, the legislation binds governments to predetermined fiscal targets over the medium term. The Indian legislation commits the central government to a phased reduction of the fiscal deficit to 2% of GDP by 2005/2006. In the event that the Government fails to meet quarterly and annual targets on revenue and expenditure, automatic cuts in expenditure will take place. In the US, initially a deficit ceiling was legislated, to force the Government to take firm decisions on expenditure reductions. However, the revised US act has done away with the ceilings, but supports the policy measures taken by the US Government to bring in better management of expenditure and prevent increases in discretionary spending.

Fiscal Management Responsibility Act

Sri Lanka's Act sets out the Government's fiscal strategy and targets that need to be achieved over a 10-year period. The Act stipulates a set of policy rules that requires the Government to:

- Reduce the budget deficit to 5% of GDP in 2006 and such levels be maintained thereafter;
- Reduce total Government liabilities to 85% in 2006 and 60% in 2013;
- Limit issuance of Government guarantees for the current and two preceding years to 4.5% of GDP; and
- Adopt policies relating to spending and taxing, which do not increase Government debt to excessive levels.

In addition, the Act calls for the Minister of Finance to submit several reports to Parliament and the general public within a stipulated time frame. The regular reports include (i) the Fiscal Strategy Statement—to be submitted with the second reading of the Budget Speech in Parliament—which will outline the Government's medium-term fiscal policy and strategy within the broad macroeconomic framework; (ii) the Mid-Year Fiscal Position Report (see Box 2.1) containing the Government's fiscal performance for the first four months of the year; and (iii) the Budget Economic and Fiscal Position Report, which is to provide sufficient information to the public on the Government's fiscal performance against its fiscal strategy. Additionally, a pre-election budgetary position report is to be submitted by the Secretary to the Ministry of Finance within 3 weeks of the announcement of a general election, with a particular view to avoid election hand-outs.

The Act gives mandatory targets to be achieved within a specified time-frame, but no sanctions are imposed for any deviation for the targets set out in the Act. The question then arises as to

Box 2.1: Highlights of the Mid-Year Fiscal Position Report

The Mid-Year Fiscal Position Report was submitted to Parliament on 30 June, as required in the Act. The report is an indication of the Government's commitment to increase transparency and accountability of its fiscal operations. It provides an update of the Government's fiscal performance for the first four months of the year as against the Government's fiscal strategy. Since the Act was passed subsequent to the second reading of the budget bill, the Government's fiscal strategy is based on the Budget for 2003.

The main features of the 2003 budget are:

- reduction of the fiscal deficit to 7.5% in 2003;
- reduction of the current account and primary deficits to 2.3% and 0.2% of GDP;
- increased tax revenue from 14.5% to 14.9% of GDP and total revenue to 17.1 % of GDP;
- reduction in current expenditure by 1.8% to 19.3% of GDP; and
- increased public investment by 0.7% to 5.3% of GDP.

The Government has taken several steps to contain recurrent expenditure and has restructured its short-term borrowings with longer-term instruments. Tax revenue has fallen short of the estimates for the first four months, mainly due to low collections of value added tax. Higher expenditure on foreign funded projects relative to the original estimates has resulted in a deficit of Rs1 billion in the primary balance. The budget deficit is therefore likely to exceed the target of 7.5% of GDP for the year, unless the Government adopts stronger measures to strengthen tax administration and increase tax revenue collection. Additional privatization proceeds will also be required to finance the emerging gap.

whether Governments can be made more responsible for the management of public finances by introducing fiscal responsibility legislation. Any deviation could affect macroeconomic stability and this could affect the credibility of the Government. In the case of Sri Lanka, the Act makes the Government more transparent about its spending and taxation decisions both in the short and medium term. It will help Governments

improve consistency of short-term measures without resorting to intentions for political gains, while giving more weight to longer-term consequences of their decisions. The medium term fiscal strategy and reporting will increase predictability and stability of fiscal policy settings, and increase confidence in the public about the services and payments made by the Government.

Although compliance is voluntary, the commitments the Government has spelled out in the Act provide a clear baseline by which to judge its fiscal results.

III. Development Focus

Loans make up the bulk of Sri Lanka's foreign assistance, but the soft lending terms generate a "grant element" from the flow of funds.

Sri Lanka receives foreign assistance from a wide variety of sources, but the bulk of the support takes the form of loans rather than direct transfers. Even the \$4.5 billion pledged during the recently concluded Tokyo Donor Conference has a high proportion of lending rather than grant assistance. However, the loans from multilateral financial institutions and bilateral development agencies are contracted on much more favorable terms than Sri Lanka could receive were the country to approach the international capital market for funds. Lower interest rates, generous grace periods, and longer repayment periods combine to provide a real transfer of resources to the country when compared to commercial loans. So even though loans may carry interest charges and the principal must eventually be repaid, the concessional terms generate a "grant element" from the flow of funds. The payment obligations arising from these loans, however, do highlight the need for better management of development assistance to ensure that the accumulation of debt does not become a burden to the country.

Grant Element Defined:

The grant element measures the extent to which a loan's disbursements and payments generate a real transfer of resources to the country due to the difference in the timing of the cash inflows and outflows. Underlying this concept is the idea that people place a higher value on money received today than they do on the same amount received in the future. Similar to the way that the interest rate shows the compensation needed to induce people to postpone spending their money to a future date, the discount rate shows how much less a person would be willing to pay today for the right to receive a set payment tomor-

row. Essentially, future cash flows must be reduced by the discount rate to make them comparable to cash-in-hand today, where the discount rate represents the opportunity cost of the funds.⁴ To clarify this point, consider the illustrative development assistance flows presented in Table 3.1. The first column shows a \$1,000 lump-sum grant disbursed during the current period. Alternatively, the donor could keep the resources in a trust and transfer only the interest income to the country for a set period. If the trust fund earns an annual rate of return of 10%, the flows would look like the grant flows in the second column. With a 10% discount rate, the recipient country values the installment grant at roughly 60% of the value of the lump-sum grant, despite the fact that the two grants entail the same net resource transfer in the simulation.

Unlike grants, loans must eventually be repaid. The difference between the discounted values of the stream of disbursements and the discounted value of the stream of interest and principal repayments is a loan's net present value. Table 3.1 also includes three illustrative loans, which vary only by their interest rate, with the principal repaid as a lump-sum after 10 years. The first loan has no interest payments, such that the net resource transfer for the funds is zero. The net present value is exactly the same as the grant with equal annual payments, so the country would be indifferent between the two types of assistance in this scenario. Essentially, the zero-interest \$1,000 loan today is equivalent to the

⁴ Mathematically, for a given discount rate d , an amount received next year, A_1 , would be valued at $A_1/(1+d)$ in today's terms. An amount received two years hence would be discounted twice—that is, $A_2/(1+d)^2$ —and so forth.

Table 3.1: Illustrative Development Assistance Flows
(\$, 10% discount rate)

Item	Grants		Loans by Interest Rate		
	Lump-sum	Annual	0%	5%	10%
Year					
0	1,000	0	1,000	1,000	1,000
1	0	100	0	(50)	(100)
2	0	100	0	(50)	(100)
3	0	100	0	(50)	(100)
4	0	100	0	(50)	(100)
5	0	100	0	(50)	(100)
6	0	100	0	(50)	(100)
7	0	100	0	(50)	(100)
8	0	100	0	(50)	(100)
9	0	100	0	(50)	(100)
10	0	100	(1,000)	(1,050)	(1,100)
Net Resource Transfer	1,000	1,000	0	(500)	(1,000)
Net Present Value	1,000	614	614	307	0

Source: Authors' calculations.

\$100 per year grant flows at a 10% discount rate, as the discount rate reflects the opportunity cost of the funds—that is, the next best use of the resources—from the point of view of the borrower. As long as the interest rate on the loan is less than the discount rate, a transfer equivalent to the present value of the loan can be devised. Only at the point where the interest rate equals the discount rate does the net present value become zero.

The Organisation for Economic Co-operation and Development (OECD) defines the grant element as “the difference between the face value of a financial loan commitment and the discounted present value (using a 10% discount rate) of the service payments to be made by the borrower during the lifetime of the loan, expressed as a percentage of the face value.”⁵ OECD considers

a loan to be concessional if the grant element is at least 25%. Following this definition, both the first and second loans in Table 3.1 are concessional with grant elements of 61% and 31%. For a ten-year loan with lump-sum repayment of principal, as in the example, loans with interest rates greater than 5.9% would be nonconcessional. However, the choice of the 10% discount rate in the definition is arbitrary, and may not accurately reflect the borrower's opportunity cost of the funds.

Under perfect capital markets, the equilibrium interest rate reflects the marginal opportunity cost of the funds to both lenders and borrowers. It is for this reason that the International Monetary Fund (IMF) uses a discount rate

As long as a loan's interest rate is less than the discount rate, a grant can be devised that is equivalent to the loan in present value terms.

⁵ OECD. 1978. *Recommendations on Terms*

and *Conditions of Aid*. Reproduced in OECD, *Reporting Directives for the Creditor Reporting System* (2002, Paris), 56-58.

based on the commercial interest rate to calculate grant elements for monitoring nonconcessional borrowing under the Poverty Reduction and Growth Facility.⁶ The discount rate used is the average of the commercial rate (6-month average for loans with maturity less than 15 years and 10-year average otherwise) applicable to the currency of the loan being contracted, plus a margin that increases depending on the loan's maturity. For countries such as Sri Lanka that have limited access to international capital markets, particularly for long-term funds, this rate is a better indicator of the lender's opportunity cost. However, by understating the borrower's opportunity cost, this approach avoids exaggerating the true size of the grant element to the country.

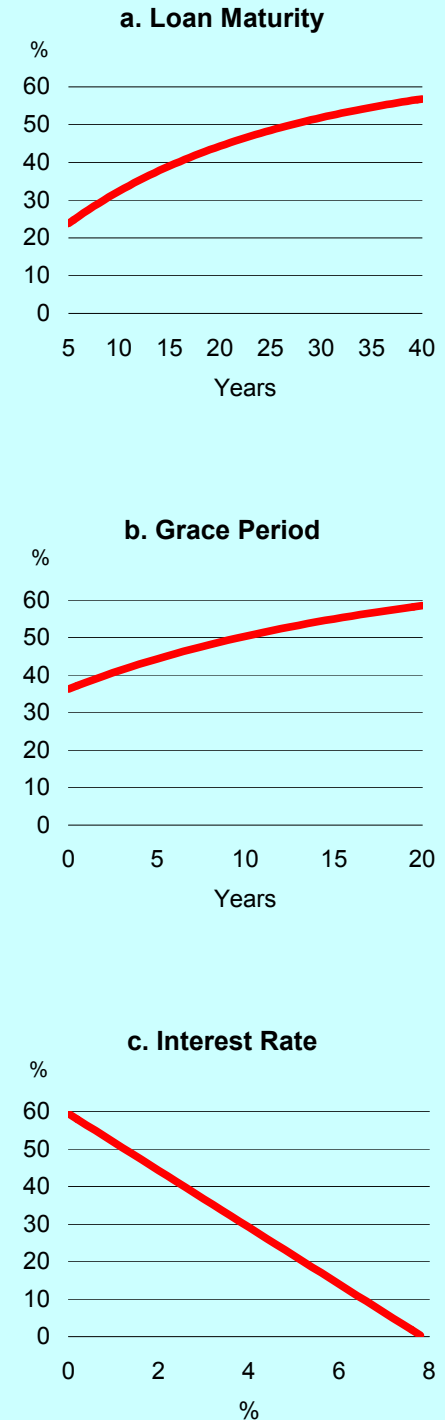
Lending Terms and Grant Elements:

Because the terms of a loan affect the timing and magnitude of the fund flows, they have a direct effect on the level of the grant element. Consider a simple example to illustrate the point. Take a basic loan with the following terms: 20-year maturity, 5-year grace period, 2% interest rate during both the grace and repayment periods, and equal semiannual principal repayments starting immediately after the grace period. Assuming the total principal is disbursed upon approval and an 8% discount rate, the base case loan has a grant element of 44%.

Figure 3.1 shows the effect of altering the three key lending terms of loan maturity, grace period, and interest rate. By extending the grace period from 20 to 40 years, the grant element rises by about 12 percentage points compared to

Extending the grace period or maturity increases the concessionality of loans with below-market interest rates.

Figure 3.1: Grant Elements in Relation to Lending Terms



Source: Authors' calculations.

⁶ IMF. 2003. *Request for a Three-year Arrangement under the Poverty Reduction and Growth Facility, and Use of Fund Resources—Request for an Extended Arrangement*. Washington, DC.

Table 3.2: Approximate Grant Elements for ADB Loans

Loan Type	Terms (Years)		Grant Element (%)			
	Maturity	Grace	SDR	Dollar	Yen	Euro
Asian Development Fund						
Program Loan	24	8	55%	–	–	–
Project Loan	32	8	61%	–	–	–
Ordinary Capital Resources						
Program Loan	15	3	–	17%	18%	15%
Project Loan	20	5	–	22%	25%	19%
Project Loan	30	7	–	28%	35%	25%

SDR = Special Drawing Rights.

Source: ADB, IMF, and Authors' calculations.

the base case. Conversely, when the maturity is reduced to 5 years—essentially, having a lump-sum repayment of principal after the grace period—the grant element drops by 20 percentage points. Changing the grace period has a similar effect. By increasing the grace period to 20 years, the grant element rises by 14 percentage points; while eliminating the grace period altogether causes the grant element to decline 8 percentage points compared to the base case. Note that if the interest rate during the grace period were lower than the rate in the repayment period, this effect would be amplified. As discussed previously, increasing the interest rate reduces the grant element, bringing it to zero at the point where the interest rate equals the discount rate.

ADB lends to Sri Lanka from two different sources of funds: its concessional Asian Development Fund (ADF) and its Ordinary Capital Resources (OCR). Project loans funded under ADF have a 32-year maturity and an 8-year grace period. For quick-disbursing program loans (i.e., loans that finance the adjustment cost of policy reforms rather than the purchase of goods and services), the maturity is 24 years with an

8-year grace period. The interest is fixed at 1% during the grace period and 1.5% during loan repayment. All loans are denominated in SDRs.

The repayment terms of OCR-funded project loans depend on project- and country-specific conditions. However, maturities are generally in the range of 20-30 years with grace periods in the range of 5-7 years. Repayment terms for quick-disbursing program loans, on the other hand, are set at 15-year maturity and 3-year grace period. Interest rates on the disbursed balance are initially floating and are based on 6-month LIBOR plus a fixed spread. The loans also carry a 0.75% commitment fee on the undisbursed balance and are currently subject to a 0.5% up-front fee. Loans can be taken in US dollars, euros, or yen. There are options to convert the disbursed balance from a floating rate to a fixed rate as well as options to convert the currency of the loan.

Table 3.2 shows the approximate grant elements for ADB's lending products. The calculations assume the full amount is disbursed on approval, for simplicity. The discount rate follows the IMF's convention of using commercial

Loans from ADB's

commercial

resources also

carry a grant

element, as ADB

absorbs the risk of

onlending to its

developing

members.

Improving public investment planning and project management can maximize the effective grant element of the Government's borrowings.

interest rates. Both ADF loans are clearly concessional, and the project loan, with its longer maturity, is somewhat more concessional. However, the OCR loans also have a grant component, albeit much smaller. The grant element on OCR loans arises from the fact that the countries benefit from ADB's low risk premium on its borrowings from international capital markets. That is, the interest spread that ADB charges on OCR loans covers only administrative costs and not the risk differential between ADB and its developing country borrowers. Because of this, even the terms of the OCR loans can be "softened" by extending the grace period and maturity.

Implications for Resource Planning:

Sri Lanka's need for foreign capital to support its rehabilitation efforts and public investment program far outstrips the availability of grant funds. While loans on less than market terms provide a real transfer of resources to the country equivalent to a grant, the fact remains that loans must eventually be repaid. This fundamental difference between grant and debt financing has implications for resource planning, and the grant element calculation provides a useful framework for exploring these issues.

The most obvious way for a country to maximize resource transfers from debt transactions is to soften the lending terms to the extent possible. As already noted, a country can maximize the grant element by negotiating lower interest

rates, longer grace periods, and extended maturities. However, the scope for such manipulation is limited, particularly in the context of loans that are already highly concessional.

Considering the nature of the use of the funds rather than their source reveals greater opportunities for increasing the resource transfer of a loan. The discount rate used in the grant element calculation can be thought of as the marginal return on the corresponding investment. Strengthening investment planning can increase the overall economic returns of the Government's capital budget, and ensure that the levels of public debt and debt service remain manageable.

The grant element calculations previously discussed had the simplifying assumption of full disbursement of the loan proceeds upon approval. A more general approach would be to have a profile of disbursements over a number of years. In this case, minimizing the period of disbursements would increase the grant element. In part, this can be achieved by strengthening project management, but new approaches to the public investment program are also required. In particular, the up-front activities—such as environmental clearances, land acquisition, and resettlement—need to be completed before the investment loan is contracted to avoid delays in implementation. Overall, improved investment planning and project management provide the greatest scope for maximizing the resource transfer from concessional loans.

