



March 2009

Sri Lanka: Political and Economic Update

CURRENCY EQUIVALENTS

(as of 19 March 2009)

Currency Unit	–	Sri Lanka rupee/s (SLRe/SLRs)
SLRe1.00	=	\$0.01
\$1.00	=	SLRs 115.05

ABBREVIATIONS

ADB	–	Asian Development Bank
GDP	–	gross domestic product
ICRC	–	International Committee of the Red Cross
IDP	–	internally displaced person
IMF	–	International Monetary Fund
LTTE	–	Liberation Tigers of Tamil Eelam
UN	–	United Nations

NOTES

- (i) The fiscal year (FY) of the Government ends on 31 December. FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY2009 ends on 31 December 2009.
- (ii) In this report, "\$" refers to US dollars.

I. RECENT POLITICAL DEVELOPMENTS

A. Conflict and Humanitarian Situation

1. Since the abrogation of the ceasefire agreement between the Government of Sri Lanka and the Liberation Tigers of Tamil Eelam (LTTE) in January 2008,¹ the Government's military campaign against the LTTE has intensified significantly. This has led to a dramatic change in Sri Lanka's long-running civil conflict, which has been largely confined to the country's Northern Province since the liberation of the Eastern Province in September 2007.

2. After taking full control of Mannar District from the LTTE in August 2008, government forces continued to advance strongly, taking the LTTE strongholds of Kilinochchi (the de facto capital of the LTTE) and Mullativu in January 2009. Puththukuddiruppu, the last remaining urban center under LTTE control, was captured on 3 March 2009. Government and independent sources estimate that the LTTE now controls little more than 30 square kilometers of territory in Mullativu District on the northeast coast.

3. Since the beginning of the present northern offensive, a large civilian population has been displaced. A substantial number of these internally displaced persons (IDPs) have moved, either voluntarily or involuntarily, with the LTTE as they have retreated. Estimates of the number of IDPs in the uncleared (LTTE) areas vary from the Government's 70,000 to the United Nations' (UN's) 120,000–150,000. The plight of these IDPs is a major concern. Most are confined to a government-declared "no-fire zone/safe zone"—a relatively small strip of land on the coast north of Mullativu town to the east of the Nanthi Kadil Lagoon—within the remaining LTTE-controlled area. While the Government has continued to allow food and medicines into the safe zone under the flag of the International Committee of the Red Cross (ICRC), these supplies meet only the very basic needs of the population and medicines are particularly scarce. ICRC and the UN continue to work closely with the Government in negotiating and facilitating the provision and movement of food and medicines into the area.²

4. The LTTE is increasingly using the IDPs as a human shield while continuing to engage in forceful recruitment, including that of children, to fight alongside its dwindling number of hard-core cadres. Some LTTE artillery pieces are placed close to or even in the no-fire zone/safe zone. Shelling by both sides in the conflict zone has continued. As a result, the number of civilian casualties has risen sharply in recent weeks, in addition to reportedly heavy casualties among the security forces and LTTE fighters. The Government has tried to encourage the IDPs to move to government-controlled areas, but such movement is extremely dangerous in the absence of a bilateral agreement to set up a humanitarian corridor—especially given evidence that the LTTE has fired on fleeing civilians. An LTTE suicide bombing in one of the government-controlled IDP transitional camps in February 2009, which killed a number of civilian IDPs as well as members of the security forces, also discouraged IDPs from moving. Nevertheless, the number of IDPs moving to government controlled areas has again started to increase. In the meantime, civilian casualties are being evacuated by sea under the auspices of ICRC.

¹ See ADB. *Sri Lanka: Economic and Political Update, February 2008*.

² ICRC is the only international agency authorized to operate in LTTE-controlled areas since the Government directed the United Nations and nongovernment organizations (including international nongovernment organizations) in early September 2008 to relocate out of LTTE-controlled areas, as it could no longer guarantee the safety of their staff. ICRC staff, including a small number of international staff, work with the assistant government agent and other government officials in the area and are supported by volunteers, often local staff members from the UN and nongovernment organizations who remain in the area.

5. International concern over the plight of the IDPs and the growing number of civilian casualties is intense. This has led to pressure on both sides for a ceasefire or at least a humanitarian pause to allow civilians to leave the combat zone. At the same time, there has been growing pressure from the international community on the LTTE to surrender and lay down its arms, which it has refused to do. While the Government has indicated its willingness to grant an amnesty to all but the most senior LTTE leadership, international involvement and supervision is likely to be an essential part of any such process.

6. International concern has also been expressed over the situation of 45,000–50,000 IDPs in government-controlled areas of the north, held in transitional camps/welfare villages, primarily in Vavuniya and Mannar districts. These concerns center on the process of screening for LTTE cadres, access by humanitarian agencies, freedom of movement of the IDPs, and the permanence of the transitional camps/welfare villages. The Government has sought to show the international community that it is running these facilities to international standards, and is doing its best to win over the hearts and minds of the IDPs, some of whom are suspected of either having direct links with, or being sympathetic to, the LTTE. The Government has recently stated that it is keen to resettle all IDPs in the north as soon as practical following the end of hostilities, once demining and the reestablishment of both police and civilian administration are complete. It has also indicated that it hopes to resettle up to 80% of the IDPs by the end of 2009.

7. The international community has stressed that, even with the military defeat of the LTTE, the Government will need to find a meaningful and acceptable political solution to the country's long-standing ethnic conflict. The Government has reiterated its commitment to achieve this, based initially on full implementation of the 13th Amendment of the Constitution that envisages the devolution of substantial powers to the provinces. The Government is expected to duplicate the approach and sequence of the strategy of "demilitarization, democratization, development and devolution" in the north, which it followed after taking back full control of the Eastern Province in September 2007. Even so, it is likely that remnants of the LTTE will continue to wage a terrorist guerilla war, in an attempt to destabilize the south and threaten the stability of the east. On 10 March 2009, an LTTE suicide bombing at a mosque 160 kilometers south of Colombo targeted a procession attended by a number of government ministers; it killed 14 civilians and injured 46, some seriously. The attack was widely condemned by the international community.

B. Other Political Developments

8. Following its electoral victories in the Eastern Province in May 2008, and North Central, and Sabaragamuwa provincial elections in August 2008, the Government won elections in the Central and North Central provinces in February 2009 with a considerable majority. The election for the Western Provincial Council, which includes the capital Colombo, is scheduled for 25 April 2009. The Government views these electoral successes as popular endorsement of the military drive against the LTTE. The United National Party, the main opposition party, has internal rifts despite considerable support from minority groups that traditionally form its voter base. Given the Government's popularity, there is speculation that it may call an early presidential and general election in mid-2009.

9. At the same time, the Government has come under increased criticism over human rights. Its military success in the north has fueled an environment in which government opposition and criticism of its military actions are circumscribed. There are also concerns over an apparent culture of impunity, particularly with regard to politically motivated crimes and attacks against media personnel considered critical of the Government.

II. RECENT ECONOMIC DEVELOPMENTS

10. Despite the ongoing conflict and deteriorating global economic outlook, Sri Lanka's economy remained resilient in 2008, growing at around 6.0%. This was due mainly to remarkable growth in agriculture, reflecting the Government's drive to encourage cultivation of abandoned paddy lands, including areas of the Eastern Province abandoned for years because of the conflict, and better rainfall and higher prices. This resulted in 50.5% growth in paddy production. However, as an open economy that has relied increasingly on commercial debt, much of it short-term, Sri Lanka is significantly affected as the global recession deepens. Economic growth is forecast to fall to around 4.5% in 2009.

11. Inflation had risen rapidly to 28.2% in June 2008, but has recently declined, with the point-to-point rate falling to 7.6% in February 2009—achieving single-digit levels for the first time since July 2006. This has enabled the central bank to ease its monetary policy in response to the global downturn by cutting its policy rates—a move expected to feed through to lower market rates. On the fiscal front, the economic slowdown has had an adverse impact on revenue mobilization. On the expenditure side, a shortfall in capital expenditure compensated for the higher-than-budgeted current expenditure, but this trend goes against the Government's intention of raising public investment in infrastructure. The fiscal deficit in 2008 is estimated to have been around 7% of gross domestic product (GDP), which is not sustainable in conjunction with a large current account deficit of the balance of payments and low foreign exchange reserves. Despite the limited fiscal space, the Government announced a stimulus package of SLRs16 billion, with cuts in energy prices and incentives for exporters, in December 2008. Such interventions, which the Government considers necessary to maintain growth, will make it harder to meet fiscal targets in 2009, especially with revenue collection likely to be affected because of a decline in industrial growth and slack import demand.

12. Externally, the effects of the global recession were apparent from 2008 trade data (released in February 2009). Exports contracted by 19% in December 2008 compared with December 2007. Garments and tea took the brunt of falling demand. Imports declined for the second consecutive month, by 9.7% in December. The annual trade deficit widened by 61% compared with 2007. Private remittances increased by 16.6% to \$2,918 million in 2008 (7.1% of GDP) and helped contain the current account deficit. In 2009, the decline in exports is likely to be mitigated by a lower import bill caused by slack domestic demand and a sharp fall in commodity prices, including fuel. The current account of the balance of payments will also be affected by the impact of the global recession on remittances. A sharp slowdown of economic activity in the Middle East could adversely affect this year's remittances, and the current account deficit will remain high (around 7.5% of GDP) in 2009.

13. In 2008, the central bank intervened to stem depreciation of the Sri Lanka rupee, leading to a sharp drop in reserves and erosion in the competitiveness of exports. Sri Lanka's foreign reserves dropped to just 1.5 months of imports by December 2008. With growing pressure on the exchange rate in early 2009, the currency has depreciated from SLRs111 per US dollar at the end of December 2008 to SLRs115 by mid-March 2009. Nonetheless, the Sri Lanka rupee remains considerably overvalued compared with 2007. In January 2009, the Government announced measures to rebuild the reserve position, such as currency swaps with other central banks and actively seeking investments by the Sri Lankan diaspora in treasury bills and bonds.

14. With limited options for external financing and foreign exchange reserves of little more than 1 month's cover, the Government is in dialogue with the International Monetary Fund (IMF)

for a standby facility of up to \$1.9 billion. The IMF facility will assist the Government in fiscal consolidation and in building up foreign exchange reserves. The facility is expected to be negotiated in April 2009.

III. IMPACT ON ADB OPERATIONS

15. Through close coordination with the UN and other international agencies (including ICRC), which are taking the lead role in negotiating with the Government and LTTE on the urgent humanitarian situation in the North, the Asian Development Bank (ADB) is well informed of the situation in the conflict zone. ADB has been supporting projects throughout Sri Lanka's conflict-affected areas, including the Northern Province, since 2001. However, it has become increasingly difficult to implement projects following the resurgence of the conflict in mid-2006, particularly in uncleared areas. While project implementation resumed in the Eastern Province, after the Government reestablished control in late 2007, no project activities have been possible in uncleared and recently cleared areas of the Northern Province in the last few months.

16. While some of the infrastructure built or rehabilitated by the Government and development partners since 2001 has been damaged, in most cases the assets remain or can be brought back into operation quickly. For example, Kilinochchi Hospital, built with ADB support,³ is intact although all the equipment and beds were taken and moved with the IDPs as the LTTE retreated. Similarly, the main power supply systems in the north are intact. Along with schools and other community infrastructure and services, these assets will be vital in resettling and providing basic needs to the returning IDPs.

17. The Government has approached a number of development partners, including ADB, for additional support to help reconstruct and develop the north once the conflict is over. Like other development partners, ADB will need to proceed with caution. As experience in the Eastern Province has shown, it will take time for sufficient security and law and order to be assured. Project activities will also need to follow the conflict sensitivity guidelines set out in ADB's country partnership strategy⁴. Discussions have begun among development partners on a set of engagement principles for development work in the north, which would ideally be endorsed by the Government. These are similar to a set of principles adopted for development work in the Eastern Province that are generally considered to have had a positive impact.

18. Once an appropriate operating environment in the north is established, ADB is considering to reallocate loan savings from the ongoing portfolio to the North East Community Development Project II,⁵ since it is designed to assist conflict-affected and post-conflict environments and has proven to be a very effective project modality⁶. ADB will also seek cofinancing support for the proposed Jaffna Water Supply Project, which was almost ready for consideration by ADB's Board of Directors in 2006 prior to the resurgence of fighting in the north.

19. ADB's country partnership strategy also notes that conflict sensitivity requires ADB and other development partners not to neglect development needs in the rest of the country since this will help prevent alienation and assist in creating a greater consensus toward a political

³ ADB. 2001. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Democratic Socialist Republic of Sri Lanka for the North East Community Development Project*. Manila.

⁴ ADB. 2008. *Sri Lanka: Country Partnership Strategy (2009-2011)*. Manila

⁵ ADB. 2005. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Democratic Socialist Republic of Sri Lanka for the North East Community Development Project II*. Manila.

⁶ This will also require an extension of the loan closing date.

solution to the conflict. At the same time, ADB support for infrastructure development will assist Sri Lanka to endure and recover from the impact of the global financial crisis.

Table 1: Economic Indicators

Item	Fiscal Year				
	2004	2005	2006	2007	2008
A. Income and Growth					
1. GDP per Capita (\$, current)	1,062	1,241	1,421	1,617	2,016
2. GDP Growth (% , in constant prices)	5.4	6.2	7.7	6.8	6.0
a. Agriculture	0.0	1.8	6.3	3.3	7.5
b. Industry	5.4	8.0	8.1	7.6	5.9
c. Services	6.7	6.4	7.7	7.1	5.6
B. Saving and Investment (current and market prices, % of GDP)					
1. Gross Domestic Investment	25.3	26.8	28.0	27.9	
2. Gross National Saving	22.0	23.8	22.3	23.3	
C. Money and Inflation (annual change, %)					
1. Consumer Price Index	9.0	11.0	10.0	15.8	22.6
2. Total Liquidity (M2b)	19.6	19.1	17.8	16.6	8.5
D. Government Finance (% of GDP)					
1. Revenue and Grants	15.8	16.8	17.3	16.7	16.5 ^a
2. Expenditure and Onlending	23.5	23.8	24.3	23.5	23.0 ^a
3. Overall Fiscal Surplus (deficit)	(7.8)	(8.4)	(8.0)	(7.7)	(7.0) ^a
E. Balance of Payments					
1. Merchandise Trade Balance (% of GDP)	(10.9)	(10.3)	(11.9)	(11.0)	(14.0)
2. Current Account Balance (% of GDP)	(3.1)	(2.7)	(5.3)	(4.2)	(7.1) ^b
3. Merchandise Export (\$) Growth (annual % change)	12.2	10.2	8.4	12.5	6.5
4. Merchandise Import (\$) Growth (annual % change)	19.9	10.8	15.7	10.2	24.0
F. External Payments Indicators					
1. Gross Official Reserves (including gold, \$ million in weeks of current year's imports of goods) ^c	13.2	14.8	13.2	14.8	6.0
2. Gross Official Reserves (\$ million) ^c	2,196	2,458	2,515	3,063	1,753
3. External Debt Service (% of exports of goods and services)	11.6	7.9	12.7	13.0	14.3 ^d
4. Total External Debt (% of GDP)	63.9	54.2	52.1	50.9	37.0 ^e
G. Memorandum Items					
1. GDP (current prices, SLRs billion)	2,091	2,453	2,939	3,578	4,411
2. Exchange Rate (SLRs-\$, average)	101.19	100.50	103.96	110.62	108.33
3. Population (million)	19.5	19.7	19.9	20.0	20.2

() = negative, GDP = gross domestic product, M2b= broad money, SLRs = Sri Lankan rupees.

^a Central Bank of Sri Lanka. 2008. *Recent Economic Developments, Highlights of 2008 and Prospects for 2009*. Colombo

^b Asian Development Bank Staff estimates

^c As of end December 2008

^d Provisional figure for 2008. Feedback from Central Bank of Sri Lanka (CBSL) received on 13 March 2009.

^e Calculated based on the external debt service as a percentage of exports of goods and services. Figure obtained from the CBSL.

Sources: Central Bank of Sri Lanka. 2007. *Annual Report*. Colombo; Central Bank of Sri Lanka. *Selected Weekly and Monthly Economic Indicators*, www.cbsl.gov.lk; Central Bank of Sri Lanka. 2008. *Recent Economic Developments, Highlights of 2008 and Prospects for 2009*. Colombo; Department of Census and Statistics of Sri Lanka *Press Release 2008 GDP data*. www.statistics.gov.lk