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The Economist Intelligence Unit

COUNTRY REPORT

3rd quarter 1998

Sri Lanka

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The Economist Intelligence Unit's country analysis

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The political scene: Military and political initiatives have stalled. Tamil rebels have continued to disrupt the civil administration in the north, despite international pressure to negotiate. There has been no progress on constitutional reform. The government has continued to face mounting criticism.

Economic policy and the economy: GDP at factor cost grew by 6.4% in 1997. The fiscal deficit declined. Aid donors have pledged $780m. Unemployment fell in 1997, partly owing to increased migration. The value of plantation shares has risen sharply. The introduction of the goods and services tax has encountered some problems. Inflation has remained in double digits despite subdued monetary expansion. The rupee has depreciated more rapidly.

Agriculture: Tea and paddy underpinned recovery in 1997. Rice production has surged in 1998, but rubber and coconut output have registered a sharp decline. Tea output has remained buoyant; exports have risen prices have begun to soften. The ADB has extended assistance for small tea plantations.

Industry, transport and tourism, energy and telecommunications: The garment industry drove industrial expansion in 1997. Industrial profitability has improved. Local investments approved by the BOI have risen, while foreign companies are expanding their investments. Another attempt to build the airport highway has been launched. Growing urbanisation has created a shortage of housing. A 51-mw thermal plant, the country's first BOO project, has been commissioned. Bids have been invited for a combined-cycle plant.

Finance and banking: Stocks gained in the first quarter but fell in May-June. Interest rates have remained stable, although repo rates have stayed higher to check currency speculation. Two private banks plan to raise long-term funds in the debt market. Plans to introduce a credit rating agency have moved forward.

Foreign trade and payments: Sri Lanka has updated its balance-of-payments presentation format. Privatisation proceeds boosted the overall balance in 1997. Export and import growth has slackened, leading to a contraction in the trade deficit. Garment exports have expanded but there is a sharp deterioration in exports of other manufactured products. Slackening tourism revenue could reduce the surplus in the services account. Private transfers have grown. Sri Lanka may seek a sovereign rating. Reserves have fallen recently.

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Political structure

Official name	Democratic Socialist Republic of Sri Lanka
Form of state	Strong presidency based on French model
The executive	President is head of state and exercises all executive powers; elected for a period of six years by universal adult suffrage; may dissolve parliament at will
National legislature	Unicameral legislature; 225 members directly elected for six years by a system of modified proportional representation
Local government	Under the 13th amendment to the constitution passed in November 1987, extensive powers devolved to nine directly elected provincial councils, primarily with a view to meeting Tamil demands for greater autonomy. Elections to seven of these councils were held in May 1993; elections to the remaining two councils are being held in 1998
National elections	August 1994 (parliamentary) and November 1994 (presidential); next elections due August 2000 (parliamentary) and November 2000 (presidential)
National government	Chandrika Kumaratunga took office as president in November 1994 after winning a record majority. The People's Alliance formed a minority government in August 1994 with 105 out of the 225 seats in parliament; it is dependent on the support of ethnic minority parties
Main political organisations	Governing coalition—People's Alliance (PA), of which the main components are the Sri Lanka Freedom Party (SLFP), Tamil Democratic People's Liberation Front (PLOTE) and Sri Lanka Muslim Congress (SLMC); main opposition parties—United National Party (UNP), Eelam People's Democratic Party (EPDP), Tamil United Liberation Front (TULF), Nuwara Eliya (UPF); armed opposition—Liberation Tigers of Tamil Eelam (LTTE)

Main members of cabinet	**President, finance, planning, defence, ethnic affairs & national integration**	Chandrika Bandaranaike Kumaratunga
	Prime minister	Sirima Bandaranaike
Key ministers	**Agriculture, lands & forests**	D M Jayaratne
	Cultural & religious affairs	Lakshman Jayakody
	Education & higher education	Richard Pathirana
	Foreign affairs	Lakshman Kadirgamar
	Housing, construction & public utilities	Nimal Siripala de Silva
	Industrial development	C V Gooneratne
	Justice & constitutional affairs, ethnic affairs & national integration	Gamini L Peiris
	Labour	John Seneviratne
	Livestock development & estate infrastructure	S Thondaman
	Ports & shipping	M H M Ashraff
	Post, telecommunications & media	Mangala Samaraweera
	Public administration, home affairs, local government & plantation industry	Ratnasiri Wickramanayake
	Tourism & civil aviation	Dharmasiri Senanayake
Central Bank governor	Amarananda Jayewardena	

Economic structure

Latest available figures

Economic indicators	1993	1994	1995	1996	1997[a]
GDP at market prices (SLRs bn)	499.6	579.1	667.8	768.1	890.5[b]
GDP ($ bn)	10.3	11.7	13.0	13.9	15.1[b]
Real GDP growth (at factor cost; %)	6.9	5.6	5.5	3.8	6.4[b]
Consumer price inflation (av, %)	11.7	8.5	7.7	15.9	9.6[b]
Population (m)	17.6	17.9	18.1	18.3	18.5
Merchandise exports fob[c] ($ m)	2,786	3,208	3,798	4,095	4,639
Merchandise imports fob[c] ($ m)	–3,528	–4,293	–4,783	–4,872	–5,266
Current account[c] ($ m)	–382	–757	–770	–653	–422
Reserves excl gold ($ m)	1,629	2,046	2,088	1,962	2,024
Total external debt ($ bn)	6.9	7.9	8.2	8.0	8.2
Debt-service ratio, paid (%)	9.5	8.2	7.4	7.3	7.1
Exchange rate (av; SLRs:$)	48.32	49.42	51.25	55.27	59.00[b]

July 13th 1998 SLRs65.625:$1

Origins of gross national product 1997	% of total
Agriculture, forestry & fishing	17.8
Mining	2.5
Construction	6.8
Utilities	1.5
Manufacturing	21.5
Services	49.8
GDP at factor cost	**100.0**

Components of gross domestic product 1997	% of total
Private consumption	78.5
Government consumption	10.8
Investment incl stockbuilding	24.3
Exports of goods & services	37.9
Imports of goods & services	–51.3
GDP at market prices	**100.0**

Principal exports 1997	$ m
Textiles & garments	2,279
Tea	721
Diamonds and gems	180
Coconut products	118
Petroleum products	79
Total incl others	**4,642**

Principal imports 1997	$ m
Cotton & textiles	1,386
Machinery & transport equipment	1,020
Petroleum	481
Base metals	317
Sugar	183
Total incl others	**5,888**

Main destinations of exports 1997	% of total
US	36.0
UK	11.3
Japan	5.0
Germany	4.9
Belgium-Luxembourg	9.2

Main origins of imports 1997	% of total
India	9.9
Japan	8.5
Hong Kong	7.3
South Korea	8.1
Taiwan	6.6

[a] EIU estimates. [b] Actual. [c] IMF/World Bank definition.

Outlook for 1998-99

Security problems could delay the provincial elections—

The pressures of military commitments in the war against the rebel Liberation Tigers of Tamil Eelam (LTTE, the Tamil Tigers) and impending provincial elections will adversely affect the government's efforts to implement a political solution to the ethnic crisis and to maintain the pace of economic reform. The government is going ahead with the process of accepting nominations for five provincial councils whose terms of office have lapsed, but it may have to postpone the elections until the ongoing military campaign Operation Jaya Sikuru (Victory Assured) is concluded, to enable it to provide sufficient security for candidates and for the conduct of the polls.

Such a postponement would have to be arranged under emergency regulations, and would be severely criticised by the opposition United National Party (UNP) as well as some members of the People's Alliance (PA) coalition. Ironically, the Buddhist clergy, although at loggerheads with the government over its devolution proposals, will be one of the few groups that will support a postponement.

—and political violence may escalate

Whenever the polls are held—as scheduled in August, or in the first quarter of 1999 as envisaged by the government's security advisers—they are likely to result in an escalation of political violence and unrest. Moreover, newly elected members of the councils, especially those from the UNP, will oppose the government's constitutional reforms, which seek to replace the provincial councils with more autonomous regional councils. Thus, the only benefit of the elections is that they will offer the electorate a chance to deliver a warning to the PA government.

However, a snap presidential election in late 1998 or early 1999 cannot be ruled out. If the president wants to ease some of the pressure on her government, she could opt to delay the provincial council elections and instead hold a presidential election after November, by which time she will have completed four years in office (and therefore it will be within her constitutional right to do so). Her personal credibility could be damaged, given that she pledged on her installation as president to abolish the post. However, if she wins a second term—the most likely outcome—her lacklustre coalition would receive a much-needed boost.

Military offensives will continue—

The need to hold elections soon will compel the government to maintain military pressure on the Tamil Tigers. The intensity of the fighting will increase as the ongoing offensive nears completion towards the end of 1998. Further recruitment into the armed forces will be necessary as more rebel territory falls under government control.

—and more rebel attacks can be expected

The Tamil rebels will in turn retaliate with attacks on civilian targets, especially in the north and east of the island. The newly established civil administration in the Jaffna peninsula will be one of their chief targets, but attacks elsewhere in the island are also likely.

Weak growth in investment will restrict GDP growth—

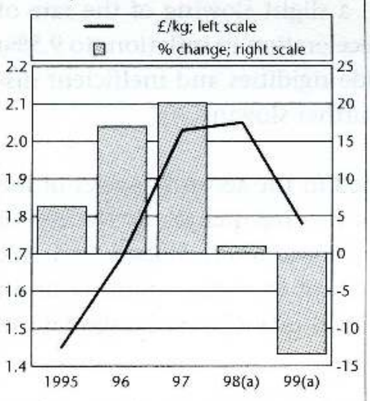
Sri Lanka's recent economic recovery coincided with a economic downturn in Asia, the effects of which are now reverberating throughout the global economy and will limit the country's economic expansion in 1998 and 1999.

Foreign direct investment in new projects will slow, as South Korea, Malaysia, and Japan—leading sources of foreign investment in Sri Lanka—grapple with their own economic problems. Domestically, despite the introduction of new incentives in the 1998 budget, business sentiment will remain weak in the face of the worsening international trading environment. Political uncertainty will also have a significant impact on business confidence; an end to the civil war is still distant, and Sri Lanka is entering an election cycle, which almost invariably leads to a "wait and see" attitude on the part of investors. This will result in a slowdown in real growth in gross fixed investment to 4.5% in 1998. However, the expansion of existing investments will prevent a sharper slowdown. Other sources of domestic demand will remain subdued. Budgetary pressures will check public consumption growth, which is projected to grow by 4.2%, while high inflation will put the brake on private consumption, growth of which is forecast to slow to 4.7%.

—as will a slackening global environment—

Maintaining export growth will be difficult because of more intense competition from other Asian exporters and a weakening in export demand for many of Sri Lanka's products. A continued expansion (albeit at a slower rate) of Sri Lanka's two largest export items, garments and tea exports, can be expected. Demand for tea from the Middle East and the countries of the former Soviet Union will persist, although revenue will be eroded in 1998 by the forecast slump in tea prices resulting from a revival in Kenyan tea production. Exports of "Other industrial products", and of agricultural commodities (such as rubber and coconut) will slow markedly. Consequently, growth of export of goods and services is forecast to slow from 11.6% in 1997 to 5.5% in 1998, rising marginally to 6.6% in 1999 on the back of slight acceleration of world trade growth.

Tea prices



(a) Forecasts.
Source: EIU, *World Commodity Forecast*.

Real growth in imports of goods and services will closely approximate the trend in export and investment growth, slowing from 10.5% growth in 1997 to 4.7% in 1998 and 5.2%. Imports of capital goods will not rise sharply (with the exception of some large "lumpy" imports destined for Air Lanka), reflecting the slow growth in investment, while consumer goods imports will register only a modest growth owing to weak growth in domestic demand.

—although the sectoral performance will be mixed

Record crops for paddy and tea will enable the agricultural sector to achieve 3.7% growth in 1998. However this improvement will be offset by a slowdown in the manufacturing sector, whose growth rate is expected to moderate, albeit to a still reasonable 7.2% in 1998 (but down from 9.3% in 1997). Growth in telecommunications services will remain buoyant, but other services subsectors may lag. The downturn in the stockmarket and slower growth in demand for credit will limit the expansion in financial services, while a slowdown in export and import growth will negatively affect the trade and transport sectors. The sluggishness of the tourism industry will also drag down real growth in the services sector to 5% (from 6.7% in 1997) slowing overall GDP expansion at factor cost to 5.2% in 1998. Growth in the agricultural sector is likely to ease in 1999 as lower prices for tea, rubber and coconut exports in 1998 dampen production in 1999. However, a modest recovery in exports and tourism, on the back of marginally better world trade growth, will boost growth in manufacturing and services, lifting GDP growth at factor cost to 5.4% in 1999.

Double-digit inflation will prevail in 1998—

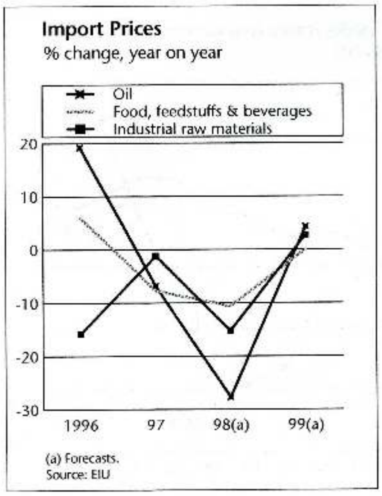
With consumer price inflation—as measured by the Colombo Consumer Price Index (CCPI)—averaging 11.8% year on year in the first five months of 1998, the chances of attaining the government's average annual inflation target of 8.5% in 1998 are remote. While demand-induced pressures on prices will ease with the reduction of the fiscal deficit and the moderate expansion in money supply, the persistence of cost-push pressures will keep inflation in double digits in 1998. Given Sri Lanka's high propensity to import, the rapid depreciation of the rupee that we expect in 1998 will inevitably translate into higher import costs, and thus into higher prices for most goods and services. The increase in paddy production will lead to lower rice prices, but this will be offset by price increases in coconuts and other agricultural commodities, where low productivity and inefficiencies in marketing and distribution remain a problem. Therefore we now expect annual inflation to average 11% in 1998, compared with our previous forecast of 10.4%.

Unless there are major productivity gains in agriculture and a substantial improvement in marketing, storage and distribution channels—which is unlikely in the short term—domestic food prices will remain vulnerable to movements in international prices of essential food items (such as rice, sugar, milk and onions) and in the exchange rate. As a result, a slight slowing of the rate of rupee depreciation will translate into a slight deceleration in inflation (to 9.5%) in 1999, although the persistence of supply-side rigidities and inefficient distribution networks will combine to prevent a further slowing.

—in part because of faster currency depreciation

The pace of depreciation of the rupee accelerated in the second quarter of the year, coinciding with the poor export figures for the first quarter. By the end of the first half of the year the rupee had fallen by about 6% to SLRs65.3:$1. We expect a further depreciation in the second half of the year, resulting in an annual depreciation of just over 11%. This would take the exchange rate to SLRs69.4:$1 by the end of 1998.

Given the economy's high import dependence in key food items, intermediate inputs, such as petroleum, textiles and fertiliser, and almost all investment goods—we do not anticipate a sharper than forecast depreciation, nor a one-off devaluation (as suggested by some exporters), which would further fuel inflation despite softer import prices. In general the depreciation of the rupee will reflect the inflation differential with the US—Sri Lanka's principal export market—and the movement of the dollar in international markets. In 1999, when world trade growth is projected to strengthen, there will be less pressure on the exchange rate as export demand picks up. Nevertheless, in order to maintain export competitiveness a slower, but above average, depreciation rate of 8.4% is projected for 1999.



Export growth will slow as a result of the impact of the Asian crisis on exports of some agricultural and manufactured exports—either through increased competition, reduced prices or lower demand. Moreover, while demand for tea exports (Sri Lanka's second-largest export item) from the Middle East and the countries of the former Soviet Union will persist, revenue will be eroded by the forecast fall in tea prices, resulting from a revival in Kenyan tea production. But Sri Lanka's leading export category—garments—will be less affected, allowing for a marginal increase in the value of merchandise exports.

However, the trade balance will narrow in 1998, as imports contract. Weak growth in consumer demand, a moderation in export expansion and muted investment growth will curb import volumes. Moreover, a contraction in the price of industrial raw materials, manufactures and oil will help to restrain the growth in the value of intermediate imports in 1998, despite a faster depreciation of the rupee. Consequently, the trade deficit (IMF/World Bank definition) will narrow to $425m in 1998. But in 1999, when import prices are forecast to firm, the trade deficit will widen to just below $440m.

—but the current-account deficit will widen

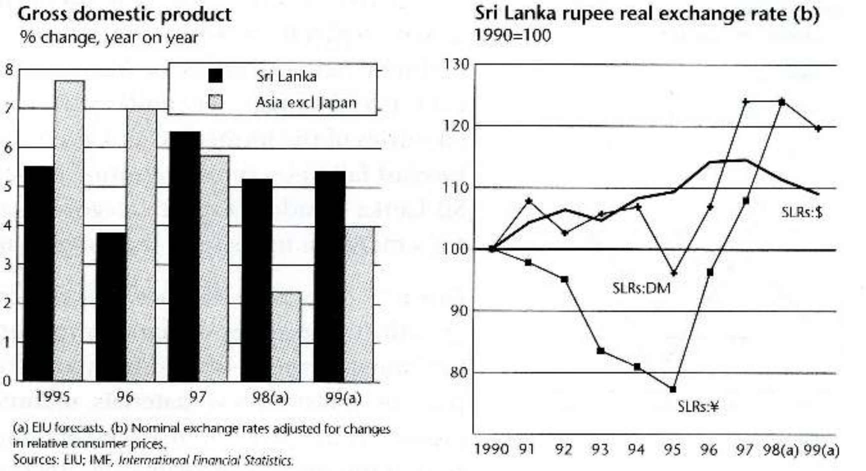
However, a deterioration in the services account in 1998, as net inflows from tourism fall, will prevent a narrowing of the current-account deficit, which is expected to widen to $440m in 1998, from an estimated $422m in 1997. Moreover, net private transfers from migrant workers will shrink slightly. Although Sri Lankans will continue to depart for work abroad in increasing numbers, primarily to the Middle East, inflows from workers in East and Southeast Asia will ebb. The widening of the trade deficit in 1999 will be largely responsible for the further widening of the current-account deficit, to $588m, in 1999.

Forecast summary

(% change year on year unless otherwise indicated)

	1996[a]	1997[a]	1998[b]	1999[b]
Real GDP (at factor cost)	3.8	6.4	5.2	5.4
Agriculture	-4.6	3.1	3.7	2.9
Mining & quarrying	8.9	3.4	4.2	4.9
Manufacturing	6.5	9.3	7.2	7.5
Construction	3.4	5.4	5.0	4.5
Services	6.0	6.7	5.0	5.2
Consumer price inflation (av; %)	15.9	9.6	11.0	9.5
Merchandise exports fob[c] ($ m)	4,095	4,639[d]	4,676	4,959
Merchandise imports fob[c] ($ m)	-4,872	-5,266[d]	-5,101	-5,396
Current-account balance[c] ($ m)	-653	-422[d]	-440	-588
Exchange rate (av; SLRs:$)	55.27	59.00	66.36	72.45

[a] Actual. [b] EIU forecasts. [c] IMF/World Bank definition. [d] EIU estimate.



(a) EIU forecasts. (b) Nominal exchange rates adjusted for changes in relative consumer prices.
Sources: EIU; IMF, *International Financial Statistics*.

Review

The political scene

The prospect of elections sparks momentary excitement—

After months of indifference, interest in Sri Lanka's political and electoral agenda was momentarily rekindled at the end of June, when the president, Chandrika Kumaratunga, announced that she was willing to hold an early presidential election, possibly in late 1998 or early 1999. The announcement was in response to an offer by the the opposition leader, Ranil Wickremasinghe, to lend the support of his United National Party (UNP) for the possible postponement of provincial council elections (which were due to take place in August 1998) in exchange for the president's agreement to hold an early presidential election. Beset with numerous problems, neither the ruling People's Alliance (PA) coalition government nor the UNP was ready to face the provincial council elections. The government was concerned that the security situation would make island-wide campaigning by thousands of candidates very hazardous. It was possibly also concerned that such an election, although having no immediate bearing on the balance of power at parliamentary level, could provide an ideal vehicle for the disenchanted masses to deliver a warning of waning popular support for the government. The UNP, however, was conscious that it had not fully exploited the government's mistakes, and did not have adequate high-calibre candidates in place to defend its dominance at the provincial level.

However, hopes that a mid-term presidential election would kick-start the country's stalled political reform process were short-lived. The defence establishment made it clear to the government that military commitments made it impossible for any elections to be held before the end of 1998. This compelled the government to back-pedal on its acceptance of the UNP demand for a presidential election. Instead, the government announced it would proceed with arrangements for the scheduled provincial council elections. But it is likely that these elections too will be postponed—until next year—under emergency regulations.

—as military and political initiatives stall

The new controversy followed months of stand-off that threatened to swamp the government's political and military initiatives to resolve Sri Lanka's ethnic conflict. Operation Jaya Sikuru (Victory Assured) went into its 14th month of operation as of end-June 1998, and progress remained slow. The offensive, which seeks to open a 70-km land route across the northern mainland, has achieved only two-thirds of its target. But its heavy cost in terms of soldiers and material has negated the tactical and strategic advantages originally envisaged. According to official figures, more than 300 soldiers were killed in June alone; the actual death toll is believed to be much higher.

An amnesty is offered to military deserters—

The pressure on the military resulting from the prolonged Jaya Sikuru offensive was reflected in repeated efforts by the government to re-enlist thousands of deserters from the armed forces. On May 5th it announced a five-day amnesty; this was later extended in the hope that most of the 15,000 deserters would return. The government also warned that any persons employing, harbouring or aiding deserters would face two years in prison. By end-May about 4,500 deserters had accepted the amnesty, but the army still faced difficulty in recruiting the required numbers of soldiers.

—as Tamil rebels sabotage the northern administration—

Meanwhile, the rebels of the Liberation Tigers of Tamil Eelam (LTTE, the Tamil Tigers) continued to sabotage efforts to restore normality in the island's north and east regions. On May 13th one of the group's suicide bombers killed an army major-general in Jaffna, the principal city of the northern peninsula, which is under government control. Four days later, a Tiger assassin shot dead the Mayor of Jaffna, who had been voted into office on January 29th. Her killers subsequently issued warnings to all members of local councils in the north and to judges and lawyers serving courts in the province that the same fate would befall them if they assisted in civil administration. Another Tamil politician, the Jaffna branch vice-president of the Tamil United Liberation Front (TULF), to which the Jaffna mayor belonged, was killed in June; this prompted several resignations from the recently constituted Jaffna Municipal Council.

—despite international pressure to negotiate

The Tamil rebels appear undaunted by the government's military operations against them and mounting international pressure to negotiate a settlement. In April two senior members of the US administration visited Colombo and urged the LTTE to cease their acts of terror. The US permanent representative to the UN, Bill Richardson, and the US assistant secretary of state, Karl Inderfurth, also voiced support for the government's devolution proposals as a basis for a negotiated settlement to the conflict.

Constitutional reforms remain stalled—

However, these proposals appear to be going nowhere. The UNP rejected some of the key aspects of the government's power-sharing package—as enshrined in the government's draft constitution—which aim to devolve substantial powers to regional councils (including a Tamil-administered area), and is drafting its own proposals. The influential Buddhist clergy also denounced the government proposals. The constitutional reform process lost more ground as tensions heightened between the PA and the UNP, which has made alleged government corruption the central theme of its offensive against Mrs Kumaratunga. In June its leader, Ranil Wickremasinghe, accused Mrs Kumaratunga of deliberately seeking to undermine the country's powerful Bribery Commission, after it had received complaints against government ministers. He alleged that the president had violated the legislation under which the commission was formed, by calling for the resignations of the commissioners, who can be removed only by a resolution in parliament.

—and the government faces mounting criticism

Apparent authoritarianism, especially towards the media, did not help the government's case. On June 5th the government imposed blanket censorship on the reporting of military news. The censorship originally covered local and foreign media operating in Sri Lanka, but was later confined to local media. The move drew criticism from many quarters, including some of the government's coalition partners. Less than two weeks later a group of armed men surrounded the residence of a prominent newspaper and sprayed the house with gunfire. The attack was seen as a warning to the editor, who had reported alleged corrupt practices in government.

Economic policy and the economy

The economy grows by 6.4% in 1997—

According to the *Annual Report* of the Central Bank of Sri Lanka, GDP (at factor cost) grew by 6.4% in 1997. GDP growth was led by a 9.3% expansion in the manufacturing sector. The services sector also performed creditably, growing by 6.7%—the fastest rate of growth recorded in recent years. A 7.8% expansion in telecommunications, a 9.8% increase in financial services and 6.5% growth in wholesale and retail trade and commerce underpinned the growth of the services sector. After a 4.6% contraction in 1996, the agricultural sector recovered to post a 3.1% increase in output.

—and the fiscal deficit declines—

The 1997 fiscal deficit (after grants) fell to 4.5% of GDP, 1.6 percentage points below the original target of 6.1% of GDP and 3.3 percentage points less than the 7.8% of GDP recorded in 1996. A surge in privatisation proceeds—to SLRs23.5bn ($400m) and a cut in current and capital outlays helped to cut total spending to 23.8% of GDP, from a budgeted 26.4% of GDP and an actual 27.8% in 1996. However, slower than expected growth in tax revenue reduced revenue collection to 18.5% of GDP from 20% of GDP in 1996.

—but the structure of current expenditure remains unchanged

Interest payments declined to 6.2% of GDP in 1997 from 6.4% in 1996. In cash terms, defence expenditure exceeded its original target of SLRs41.5bn by 8.3%, although as a percentage of GDP it fell to 5.1% from 5.8% a year earlier. Despite these improvements, the structure of current expenditure was little changed, with interest payments, salaries, pensions and defence consuming nearly 80% of current expenditure.

Defence spending and slow revenue growth threaten the budget

The budget deficit is projected to decline further in 1998, to 6.5% of GDP. So far the fiscal performance appears to be on track. In the first quarter of 1998 revenue increased by 9% year on year to SLRs40.9bn, up from SLRs37.5bn a year ago, while expenditure and net lending totalled SLRs57.7bn, compared with SLRs58.1bn in the first quarter of 1997. The deficit therefore fell to SLRs16.8bn, compared with SLRs20.6bn a year earlier. However the projection could be upset if slower than expected economic growth leads to revenue falling below forecast, and this is not matched by a corresponding adjustment to spending. Defence expenditure also remains a potential source of fiscal slippage. The government's ability to hold military spending even at 1997 levels is questionable in the light of the recent intensification in hostilities, while the budget envisages a 1.3% reduction in defence expenditure in cash terms. However, the authorities maintain that since most military capital requirements were purchased in 1996 there is sufficient room for manoeuvre. The government has also warned (in its 1998 budget statement) that overshoots in defence spending would be met by raising the National Security Levy.

Sri Lanka's donors pledge $780m in aid for 1998

At the country's annual aid group meeting (now termed the development forum), held in Paris on May 26th, donors pledged $780m in financial support to Sri Lanka. The award, which was above the government's target of $700m but lower than the $850m committed in 1997, was hailed as a positive development, given the declining trend in overseas development assistance worldwide. Contrary to expectations, aid from Japan—Sri Lanka's largest single donor—was not reduced, despite the falling external value of the yen and Tokyo's previous announcement of a 10% across-the-board cut in international assistance.

Negotiations for another ESAF are continuing—

The government has continued to hold consultations with the IMF regarding a second enhanced structural adjustment facility (ESAF). An IMF mission that visited Sri Lanka in May commended the improvement in the country's macroeconomic management, and in particular the reduction in the fiscal deficit and the management of the exchange rate. The progress in the privatisation of state enterprises and the Central Bank's efforts to strengthen financial regulation also found favour with the Fund. However, the mission emphasised the need to develop a more representative index of inflation than the current Colombo Consumer Price Index (CCPI), which is based on an outdated basket of goods and is susceptible to seasonal fluctuations.

—but the conditions will be stringent

Although Sri Lanka's fairly comfortable level of foreign-exchange reserves and improved external sector performance do not strictly warrant IMF support, the granting of another ESAF will help to underpin business confidence. But the conditions that accompany a second ESAF are likely to be stringent and will require considerable political will to implement. Three main areas were singled out by the IMF for reform—the financial sector, the civil service and the pension system. The mission cautioned that the financial sector suffers from inherent weaknesses, in particular the lack of commercial orientation in the two state banks. Civil service reforms have so far been only peripheral and greater commitment to effecting further cuts in the payroll is needed if the reforms are to yield savings. The mission said that the overhaul of the unfunded public-sector pension system needed to be addressed urgently.

Labour migration helps to reduce unemployment

The rate of unemployment fell to 10.4% in the third quarter of 1997, down from 11.4% in the third quarter of 1996. Growth in the services and informal sector of the economy helped, but labour migration to employment overseas was primarily responsible for the decline. Around 150,000 Sri Lankans are estimated to have secured employment overseas, double the 75,000 additional jobs created domestically. Total public-sector employment declined by 8% to 1.07m in 1997. However, the reduction was cosmetic, being largely the result of the reclassification of privatised public enterprises as private entities. In keeping with established trends, government employment rose by 1% in 1997.

Job seekers prefer white-collar occupations

The deficiencies in Sri Lanka's education system and the changing aspirations among young people have led to a situation where high unemployment co-exists with labour shortages in some economic sectors. Over one-third of job seekers prefer "white-collar" jobs, but are unable to find such employment since they possess neither the qualifications nor the skills demanded by private companies. Agricultural occupations remain lowest on the preference list of job aspirants (only 0.6% opted for such work), and this partly explains the growing shortage of tappers in rubber plantations.

Privatisation proceeds benefited from a rise in plantation share prices—

The sell-off of the government's holdings in plantation companies continued in the second quarter of 1998. A 19% slice of Watawala Plantations was bought by Forbes Group for SLRs232m ($3.5m) in early May. The prospect of improved productivity under private management have boosted the value of plantation shares. The price paid by Forbes was substantially higher than the SLRs60m raised by the initial public offering (IPO) of Watawala Plantations in 1997. IPOs of seven more plantation companies are planned, but given the uncertainty about tea prices and the stockmarket, they are likely to be delayed.

—as evidenced by the record price fetched for shares of the PIMC—

In one of the largest deals recorded in the plantation sector, the Plantation Investment Management Company (PIMC)—a joint-venture company owned by the Employees Trust Fund Board (ETF), the Sri Lankan Insurance Corporation and the Merchant Bank of Sri Lanka—was sold to James Finlay and Company for SLRs1.6bn. The price of SLRs15/share represented a 50% premium over its original value. In June, James Finlay announced that it planned to raise SLRs1.2bn through a rights issue, part of which will be used to finance its investments in the plantation industry. This is the second-largest rights issue on the Sri Lanka stockmarket, behind the SLRs1.4bn Aitken Spence issue launched in 1994.

—and the ETF's share in Maturata plantations

The majority shareholding in Maturata Plantations held by the ETF was acquired by Free Lanka Trading Company Ltd in April (2nd quarter 1998, page 14). At a record price of SLRs72/share (compared with the SLRs45.75/share originally paid by the ETF), the SLRs885m paid for the 51% shareholding in the plantation company was the highest yet among the 20 state companies that have already been divested. The government still holds 39% of the shares in Maturata Plantations, but over half of that SLRs675m holding is likely to be offloaded in the second half of 1998 by way of an IPO.

The privatisation target is on track—

In the first quarter of 1998 the government earned nearly SLRs3.7bn in revenue from privatisation, of which SLRs2.7bn ($45m) was accounted for by the partial divestiture of Air Lanka. Privatisations in the pipeline include the sale of the government's stake in three sugar companies (Hingurana, Pelawatte and Sevenegala). A 9% slice of Sri Lanka Telecom is also likely to be floated in international markets. Revenue from privatisation was budgeted at SLRs8bn in 1998.

—but the GST encounters problems

The introduction of the goods and services tax (GST), which replaced turnover taxes in April 1998, encountered several problems. Many traders used the GST as a pretext to raise prices. Inundated with complaints from consumers, the government set up a special unit to monitor errant traders. The coverage of the GST was also criticised, mainly for drawing in products previously exempt from turnover tax, such as bicycles and some agricultural implements that are used primarily by the poorer rural population. Administrative delays in refunding input credits also created cash-flow problems for producers. The garment industry in particular was badly affected. Garment manufacturers were forced to divert a substantial part of their working capital to pay GST on their fabric imports. According to the industry, the inland revenue department takes a month to process claims and refund input credits, resulting in a severe disruption to cash flow.

Guidelines for public bids are tightened

In June Mrs Kumaratunga announced that bidders for large-scale public projects in ports, power and highways must be represented by listed public companies with a minimum market capitalisation of SLRs500m. The new regulation is aimed at encouraging more companies engaged in infrastructure projects to seek a listing on the stock exchange, while simultaneously tackling the endemic problem of corruption and political patronage associated with the award of large government contracts. Since public companies are bound by disclosure and accountability requirements, it is hoped the move will bring greater transparency to tender procedures. The regulations are also to be extended to tenders in defence and transport, but the minimum required market capitalisation will be lower, at SLRs250m.

Sri Lanka has the fastest-ageing population in the world—

A UN Development Programme study on ageing has warned that Sri Lanka's population is ageing more rapidly than any other country. The percentage of the population aged over 60 is expected to rise from the current 8% to 13% by 2010, and to 20% by 2025, while the median age (presently 25) will double to 50 in the same time period. The workforce is projected to shrink, stabilising at around 14m after 2011. As a consequence, the old-age dependency ratio will jump from the existing 14% to 32% in less than three decades.

—representing a major challenge in the future

According to the study, the challenge facing Sri Lanka is to provide for the 50% or more of the working population currently not covered by pension schemes. The existing civil service pension scheme must also be reformed, to make its fiscal burden more manageable. Government expenditure on pension payments has grown by 15% annually in recent years and could reach 20% of current expenditure if no adjustments are made. Measures advocated by the study include increasing the retirement age (currently 55), and encouraging more women and elderly people to work.

Inflation remains in double digits—

Inflation has remained stubbornly in double digits so far in 1998. In January-May the rate of increase in the CCPI averaged 11.8% year on year. Although the annual rate of inflation fell from 13.2% in January to 10.3% in April, it rose to

12.1% in May. The increase in inflation appeared to be attributable more to seasonal fluctuations than to a pick-up in demand pressures; growth in monetary aggregates and in credit to the public and private sector was relatively subdued. Food prices tend to rise in April-June and October-January. A more rapid depreciation of the rupee also added an upward twist to prices.

—although monetary expansion remains manageable—

The annual rate of monetary expansion averaged 14% in the first four months of 1998, broadly in line with the Central Bank's targets. After growing by 14.3% in February, growth in the broad money supply (M2) subsided to 13.7% by the end of April. Underscoring the deceleration in monetary expansion was a decline in net credit growth to the government, which fell by 2.1% in March and 3% in April. The expansion in private-sector credit growth was also subdued, at around 10% annually since the beginning of 1998.

—and the rupee depreciates more rapidly

After falling by around 1% between January and March 1998, the depreciation of the rupee accelerated in the second quarter, against a background of a weakening export performance. The rupee fell from SLRs62.38:$1 in early April, breaching the SLRs65:$1 barrier in June and subsequently reaching SLRs65.3:$1 by the end of the month. This represented a 5.3% devaluation in the first half of 1998.

Agriculture

Tea and paddy underpin the agricultural recovery

The agricultural sector recovered in 1997, to post modest growth of 3.1% after shrinking by 4.6% in 1996 according to the Central Bank's *Annual Report*. The plantation sector grew by 4.1%, primarily owing to higher tea output, since rubber output declined and coconut production registered only a small increase. Growth in the domestic agricultural sector was slower, at 2.6%. Paddy production recovered only partially, while sugar production, which fell by 9%, was sufficient to meet only 10% of the country's requirements. Competition from cheaper imports discouraged the production of high-value cash crops such as potatoes and chillies, whose output also declined in 1997. The imports of these commodities were liberalised in 1996, and the government has also periodically waived duty on them to reduce their prices.

Rice production surges—

Paddy production was below domestic requirements in 1997, totalling 2.2m tonnes. The shortfall was met by importing over 300,000 tonnes of rice. Production in 1998 promises to be higher. The *maha* (main) harvest yielded 1.77m tonnes—22% more than in 1997 and slightly above the 1995 record of 1.76m tonnes. Based on the area sown, the secondary *(yala)* harvest is also likely to be a bumper crop.

—but a withdrawal of state intervention in the rice trade is needed

In its *Annual Report* the Central Bank highlighted the need for the withdrawal of state involvement in the rice trade. The government intervenes in the market by applying ad hoc revisions to the duty on rice, in a bid to lower or raise prices, depending on domestic availability. This has perpetuated an uncertain policy environment in the rice market and, ironically, has led to significant fluctuations in prices. The Central Bank suggested guaranteeing the paddy sector a minimum degree of protection by fixing tariffs at the maximum rate, which will give a degree of predictability to those engaged in the rice trade.

There is a slump in rubber production—

Rubber production declined by 6% year on year to 106m kg in 1997. The slide in rubber output—the result of a slump in rubber prices and structural deficiencies in the rubber sector, such as a shortage of labour—continued into 1998. In January-April rubber production fell by 23.9% to 32.1m kg, from 42.2m kg in the year-earlier period.

—and in coconut output

After rising by around 3% in 1997, coconut output recorded a decline in the first four months of 1998, falling by 5.8% to 775m nuts from 823m nuts in the year-earlier period. Since coconut production responds to climatic conditions with a one year lag, the prevalence of favourable weather in the second half of 1997 could lead to a recovery in output in the second half of the year.

Agricultural production

	Jan-Apr		
	1997	1998	% change
Tea (m kg)	76.1	81.3	6.8
Rubber (m kg)	42.2	32.1	–23.9
Coconut (m nuts)	823	775	–5.8
Rice (m tonnes)	1,457	1,774	21.8

Source: Central Bank of Sri Lanka, *Selected Economic Indicators*.

Tea output remains buoyant—

Tea production and exports continued to perform well. Total production in the first five months of 1998 was 109.9m kg—a 6.2% increase over the same period in 1997. Low-grown teas, which grew by a robust 16.5% in this period, accounted entirely for the increase in production. The output of medium- and high-grown teas both recorded small annual decreases in output.

—as the world tea supply surges—

The world's three largest tea producing countries are on course to post record crops in 1998. India's production in the first four months of the year rose by 15% compared with that in the same period in 1997, while Kenya's crop rose to 113.3m kg—more than double the output of 55m kg in the year-earlier period when crops were damaged by drought. By April 1998 the world tea market had thus returned to a surplus of nearly 90m kg.

—which is exerting a downward pressure on prices—

Increased supplies of tea from competing countries have begun to exert downward pressure on prices for Sri Lankan teas, and industry analysts believe that the period of booming prices (which began in August 1996) is drawing to a close. Prices of high-grown teas, where Sri Lanka competes in the international markets with Kenya and India, have been affected most. After peaking at SLRs159.26/kg in February, the average auction price fetched for high-grown teas declined to SLRs138.96/kg in May before falling sharply to SLRs108.5/kg in June, just SLRs4.00/kg higher than in June 1997. The start of the "rush crop" season, which usually lasts during May-July, and during which large quantities of teas come to the auction, also contributed to the decline in prices.

—although low-grown teas are firmer

Prices of low-grown teas—predominantly orthodox black teas—were less affected, since Sri Lanka has a niche market in this category in the countries of the former Soviet Union and the Middle East. Prices fluctuated in the range SLRs146-149/kg in the first quarter, fell to SLRs138.5/kg in April, but recovered to SLRs141.4/kg in May and peaked at SLRs152.5/kg in early June.

Tea exports are up—

Total exports of Sri Lankan teas in January-April 1998 were 88.7m kg—a 13% increase from the 78.6m kg exported in the same period of 1997. Of this, orthodox teas accounted for over 80% of total exports. The countries of the former Soviet Union together remained the principal buyer, taking up 21% of total exports, followed by Turkey (10%), the United Arab Emirates (8.9%) and Libya (5.7%). Exports to the US grew to 2.12m kg—more than double the 0.9m kg exported in January-April 1997.

Tea production
(m kg)

	Jan-May		
	1997	1998	% change
High-grown	33.2	32.3	–2.5
Medium-grown	22.1	21.4	–3.1
Low-grown	48.3	56.2	16.5
Total	**103.5**	**109.9**	**6.2**
Orthodox	96.9	101.9	5.2
CTC[a]	6.6	8.0	21.9

[a] Cut, torn and curled.

Source: Sri Lanka Tea Board.

—and small tea plantations receive ADB assistance

The Asian Development Bank is to extend SLRs600m ($9m) to boost productivity in the tea smallholding sector. Apart from aiming to improve production of quality teas, the project will also focus on the improvement of infrastructure facilities in estates, which are an impediment to higher productivity.

Industry, transport and tourism

The clothing sector led industrial growth in 1997

Industrial output expanded in 1997 by 10.3% in real terms (at 1990 constant prices). The most buoyant subsector was the textile, clothing and leather industry, growing by an impressive 18.7%. The food, beverages and tobacco subsector recorded only modest growth of 3.4%, while chemicals, petroleum, rubber and plastic products—the third-largest category—grew by 4.6% in real terms. Private-sector industrial output (which accounted for 93% of total industrial production in 1997) expanded by 12.1%. Public-sector output contracted by 16%, chiefly because of a 12% decline in the output of the Ceylon Petroleum Corporation, which was shut down for routine maintenance in early 1997.

—and industrial profitability improves

A survey conducted by the Central Bank to assess the profitability and cost ratios in firms outside the purview of the Board of Investment (BOI) revealed an increase in the average profit ratio to 15.6% in 1997, from 14.9% in 1996. The clothing sector was the most profitable, with an average profit ratio of 23%. The profitability of food and beverages, chemicals, rubber and petroleum products, and fabricated metal products also improved, but profits in most other industries declined. The wage bill and energy costs of all industries increased in 1997 compared with those in 1996; industries dependent on imported raw materials saw a rise in input costs, while those sourcing domestic raw materials benefited from slightly lower costs. Interest costs fell across the board in line with the downward trend in interest rates in 1997.

The number of locally owned projects approved by the BOI is rising—

According to the BOI, 81 agreements with an investment potential of SLRs12.9bn ($197m) were signed in the first five months of 1998. (However, this figure includes a US-financed project to operate three cargo ships to the Middle East and so the value of the ships—SLRs5.5bn—does not strictly qualify as a foreign investment inflow.) Most of the project agreements were concentrated in the garment manufacturing and services sectors. There are two large agriculture-based projects; one will cultivate sugarcane and manufacture sugar for the domestic market (with an investment of SLRs1.1bn) and the other is a joint venture between the government and the National Dairy Board of India to establish a milk-producing plant, at a cost of SLRs1.2bn. The balancing of incentives between foreign and domestic investors has led to an increase in the number of local projects approved by the BOI. Of the 81 projects signed, 41 were wholly owned local projects, accounting for SLRs3.4bn of investment. In recent years the share of investment approved by the BOI accounted for by locally owned projects has expanded, and cumulatively accounted for 38% of total BOI investment by end-1997.

—and existing foreign companies expand their investment

While the uncertain global economic environment has curtailed the rise in new foreign investment projects, many foreign companies already operating in Sri Lanka are expanding their investments. For example, Angel Australia is investing SLRs600m in expanding its rubber-glove factory. Nortek of Japan will inject SLRs300m into its ceramics operation, while Curative Manchester, a subsidiary of MAST Industries, will spend SLRs720m to set up a textile mill. Other expansion projects include a SLRs60m investment by Australian-based BHP Steel and a SLRs75m injection by Young An at its existing hat factory.

The Air Lanka privatisation is criticised—

The Public Enterprise Reform Commission and the government have come under fire from the opposition UNP for what it terms the "non-transparent" sale of Air Lanka to Emirates. The order by Emirates for six Airbus aeroplanes, which are to replace Air Lanka's ageing fleet of Tri-Stars beginning in 1999, has also attracted strong criticism. The government has sought cover from the Multilateral Investment Guarantee Authority (MIGA) to anchor the deal, but the UNP lodged its objections with the World Bank, stating it would not honour the sale of the airline if it were returned to power. It has also lodged a complaint with the Bribery Commission, alleging substantial commissions were paid on the purchase of the aeroplanes.

—and plans for an airport highway are revisited

The government is to invite bids for the building of the Colombo Katunayake motorway, the construction of which is targeted to commence in April 1999. Although the government has said it will undertake the financing of the project—estimated to cost over SLRs5bn ($76m)—bidders will be given the option of providing a financial package. The development of the motorway has been planned for over five years, but no progress has been made. A memorandum of understanding signed by a Malaysian investor for the project in early 1997 was subsequently withdrawn in the aftermath of the Asian financial crisis.

The tourism industry is flat

Tourist arrivals declined by 5.4% and 4.9% year on year in March and April 1998 respectively. The number of tourists in the first four months of the year was 130,341—just 1.3% above the 128,667 tourists that visited Sri Lanka in the same period in 1997. While visitors from Western Europe, the country's principal source of tourism, increased modestly, there was a pronounced decline in Asian tourists, with arrivals from East Asia and South Asia contracting by 27.8%. The Ceylon Tourist Board has reduced its earlier projection of a 20% annual increase in arrivals to 15%, but industry analysts feel even this is too optimistic. They argue that the lure of cheaper destinations in Asia may reduce the increase in tourist arrivals to about 5-10% in 1998.

Growing urbanisation—

According to a study concluded recently by the Presidential Task-Force on Housing and Urban Development, Sri Lanka needs to build over 500,000 houses by 2005 if it is to avert a serious housing shortage. The task-force was appointed to draw up a plan of action with regard to urban development, environmental infrastructure and housing development, and to recommend policies to develop the domestic local construction industry. The study reveals that the extent of urbanisation has been clearly underestimated in recent years; anecdotal evidence suggests a much higher share for the urban population—estimated at 28% in 1997—than previously thought. This is projected to increase to 30% by 2000, which implies greater pressure on the country's severely stretched infrastructure facilities.

—has led to a severe shortage in urban housing

Sri Lanka's total housing stock in 1996 was estimated at 3.9m houses, of which 3.2m were in rural areas. About 50% of the housing stock is believed to be of substandard quality. There is an acute shortage of urban housing—estimated at 169,110 in 1996—while an additional 322,556 housing units will be required by 2005. The biggest constraints on housing development are: the high cost of land and construction materials; inadequate development of mortgage markets as a result of unclear land titles; high interest rates; and a shortage of trained and skilled construction workers. Among the strategies recommended for overcoming this problem are encouraging greater private-sector participation in housing development and expanding housing finance schemes. Incentives towards this end were announced in the 1998 budget.

Energy and telecommunications

The first BOO project is commissioned—

Sri Lanka's first build-operate-own (BOO) power plant was commissioned on June 23rd. The construction of the 51-mw diesel power plant, which involved an investment of over $60m, was completed two months ahead of schedule. Asia Power, a consortium of British, German and Danish engineering companies, undertook the project. The International Finance Corporation, the Commonwealth Development Corporation and a local conglomerate, John

Keells Holdings Ltd, are other shareholders in the consortium. Asia Power will operate and maintain the power plant for a period of 20 years.

—and bids are invited for a 140-mw combined-cycle plant

The Ceylon Electricity Board has called for bids for the construction of a 140-180-mw combined-cycle plant, to be built in the Kelanitissa power station. Twenty six companies have expressed interest in the project, which is to be funded on a BOO or build-operate-transfer (BOT) basis. The target date for financial closure on the project is June 1999.

Finance and banking

Stocks gain in the first four months of 1998—

Gains in plantation shares helped to buoy activity in the Colombo stockmarket in the first four months of 1998. The All Share Price Index (ASPI) gained 120 points from 662 (1985=100) at the end of January to 782 by April 30th. Foreign activity picked up, and in March—for the first time in 18 months—there was a net inflow of foreign funds.

—before plunging in May and June

In May the nuclear tests conducted in India and Pakistan unsettled the Sri Lankan stockmarket. Selling by foreign institutional investors saw the ASPI plummeting from a peak of 789.4 on May 4th to 682.3 by the end of May, a 14% loss in less than a month. Despite impressive corporate performances, shares in blue chip companies came under heavy selling pressure. The net outflow of foreign funds rose sharply, to SLRs423m ($6.4m), of which SLRs125m flowed out during May 25th-29th. This triggered panic selling by local investors, driving the index down further—to 650 by the mid-June. By mid-July the ASPI had fallen below the 600 mark.

A settlement fund is established

A settlement and guarantee fund was set up in June. The fund will guarantee the settlement of share transactions between stockbrokers and the Central Depository System. The government, which announced the establishment of the fund in the 1998 budget, has also provided the initial capital of SLRs150m. Technical assistance is provided by the US Agency for International Development.

Stockmarket indicators, 1998

	End-Apr	End-May	Mid-Jun
CSE all share price index (1985=100)	782	682	660
CSE sensitive index (1985=100)	1,222	1,063	1,003
Market capitalisation (SLRs bn)	146.3	133.3	125.8

Source: Central Bank of Sri Lanka, *Selected Economic Indicators*.

Interest rates remain stable—

Interest rates remained relatively stable in the first half of 1998, with the average weighted prime lending rate fluctuating within the 14.5-15.5% range. The 12-month Treasury-bill rate edged up from around 10.3% in January 1998 to 11.5% in early April, creeping up to 12% by mid-June, which was still 1 percentage point lower than the rate a year earlier. Interest rates are expected to remain relatively stable, unless there is a significant deterioration in fiscal performance, necessitating increased borrowing from the banking system by the government. With adequate liquidity in the banking system, a slower than anticipated increase in credit demand is expected to keep interest rates soft during the second half of the year.

—but repo rates stay higher to check currency speculation

The repurchase (repo) rate was held at 12%—300 basis points over the 9% that prevailed in the first half of 1997. The rise in the repo rate—the movement of which closely tracks developments in the exchange rate—was aimed at dampening speculation in foreign-exchange (forex) markets, and its. As the depreciation of the rupee stepped up in early May, the repo rate began rising from around 11.9% on May 8th, to 12.1% by mid-June.

Private banks raise funds in the debt market

Two private commercial banks are seeking to raise long-term funds in the debt market to finance their diversification into housing finance. In mid-June Hatton National Bank (HNB) became the first financial institution to float SLRs1bn worth of unsecured subordinated redeemable debentures, through a public offering. This was followed on June 23rd by a similar, though smaller, offering of SLRs250m in subordinated debentures by Commercial Bank. Both debenture issues carry an interest rate of 13.5% per year paid quarterly (equivalent to a 14.2% annual rate), are redeemable after five years and can be traded on the stock exchange. Since subordinated debentures form part of Tier II capital, the issues also contributed to improving capital-adequacy ratios. That of Commercial Bank, which at 15.9% is the highest among private banks, is set to improve to 17.81%, while that of HNB will increase from 8.4% to 10.09%. HNB is the most profitable private bank in Sri Lanka—over the decade its assets have grown by 34% and its profits increased by over 35%.

A credit rating agency will soon be operational

The imminent establishment of a credit rating agency will boost Sri Lanka's fledging capital markets. The US-based Duff and Phelps Credit Rating Agency is expected to commence operations in Sri Lanka in the near future. Initial funding will be provided by the International Finance Corporation, Rating Agency Malaysia, the Central Bank and 15-20 local financial organisations, which will be permitted to take a maximum 2% stake in the agency.

Foreign trade and payments

The balance-of-payments presentation is revised

The presentation of Sri Lanka's balance-of-payments data has been revised to conform to the fifth edition (1993) of the IMF *Balance of Payments Manual*. The salient changes include: a disaggregation of the services account into trade in services and income; the separation of transfers into current and capital transfers which, including project grants and migrants' capital transfers (for example, proceeds from the sale of land), are now shown in the capital account; and the substitution of the previous non-monetary sector by the capital and financial sector account. Commercial banks' assets and liabilities, which were until 1996 shown in the monetary sector, have been transferred to the capital account and are reflected as part of short-term capital. As a consequence, the overall balance in the balance of payments now represents the change in net official reserves only.

Privatisation proceeds boost the overall balance in 1997

Under the new format Sri Lanka's overall balance of payments recorded a surplus of $163m in 1997 compared with a $68m deficit in 1996. A massive increase in foreign capital inflows, primarily as a result of privatisation proceeds, boosted the capital and financial account to a $569.8m surplus—more than sufficient to cover the current-account deficit. At 2.8% of GDP the current-account deficit fell to its lowest level in recent years, well below the 5.3% of GDP recorded in 1996. A shrinking trade balance (with export growth outpacing that of imports), an improvement in the services account balance, and buoyant receipts from migrant workers helped to cut the current-account deficit.

There is a perceptible slackening in export growth in 1998—

Although Sri Lanka remained insulated from the fallout of the Asian economic crisis in 1997, it is now beginning to feel the indirect effects, through reduced demand and more intense competition in international markets. In January-April exports rose to $1.43bn, an increase of less than 5% from the $1.37bn recorded in the year-earlier period. In April exports actually contracted by 5.1% in dollar terms, compared with those in April 1997. The trade balance in the first four months declined by 3.5% year on year, to $573m from $594m in January-April 1997, mainly owing to slower growth of imports; they expanded by just 2.3%, to $2bn in the first four months of the year, from $1.96bn a year earlier.

Trade balance, Jan-Apr

	SLRs m		%	$ m		%
	1997	1998	change	1997	1998	change
Exports fob	78,680	88,996	13.1	1,365	1,431	4.8
Imports cif	–112,899	–124,552	10.3	–1,959	–2,004	2.3
Trade balance	**–34,219**	**–35,557**	**3.9**	**–594**	**–573**	**–3.5**

Source: Central Bank of Sri Lanka, *Selected Economic Indicators*.

—with slower expansion of clothing exports—

The 2.9% overall expansion in industrial exports in January-April was primarily generated by sustained growth in clothing exports and a healthy 29% annual increase in exports of food, beverages and tobacco. Quota restrictions, which provide assured markets, and a shift by some manufacturers into high-quality garments, helped to insulate the industry from the adverse impact of the Asian economic crisis. Nevertheless there was a slowdown in the growth of clothing exports; in the four months to April they expanded by 10% in dollar terms to $723m compared with the year-earlier period, a substantial slowing compared with the near 20% annual growth in 1997.

—but a marked deterioration in some industrial exports

Exports of "Other industrial products" in January-April plummeted by 31.2% year on year, to $106m from $154m in the year-earlier period. Within this category, exports of plastics fell by 28%, while exports of electronic, electrical and mechanical components contracted by 3.7%. The performance of the diamond and jewellery industry, which had already shown signs of wilting under reduced demand from its principal Asian markets, deteriorated further; exports of diamonds fell to SLRs12.06bn, a hefty 73.8% year-on-year decline, while jewellery exports halved—dropping to SLRs2.6bn in January-April 1998 from SLRs5.38bn in the year-earlier period. But exports of leather, rubber, wood and ceramics products—the second-largest export category—recorded only a small decline—to \$140m in the first four months of 1998 from \$141m for the same period in 1997.

Tea exports offset the sharp decreases in rubber and coconut earnings

The growth in agricultural exports was almost entirely the result of expansion in tea exports, since exports of rubber and coconut fell sharply. In the four months to April tea exports rose by 38% to \$272m, with volumes up by 16%. The fallout from the Asian financial crisis was most pronounced in the rubber sector, as prices plunged; coupled with a 46% decline in export volumes, earnings halved to \$17.8m. The value of coconut exports also fell sharply during the same period.

Composition of exports
(\$ m)

	Jan-Apr		
	1997	1998	% change
Agricultural exports	310	362	16.8
of which:			
tea	197	272	37.9
rubber	36	18	-50.8
coconut	25	13	-48.2
Industrial exports	1,010	1,039	2.9
of which:			
textiles & garments	657	723	10.0
leather & rubber products	141	140	-0.7
petroleum products	27	30	11.1
"Other industrial products"	154	106	-31.2

Source: Central Bank of Sri Lanka, *Selected Economic Indicators*.

Import growth also decelerates

Annual import growth, which had already weakened in the last quarter of 1997, decelerated to 2.3% in the first four months of 1998. A 22.5% rise in imports of investment goods drove growth in aggregate imports. A substantial portion of this increase was due to imports of transport equipment such as buses and vans for public transport, probably as a result of the incentives announced in the 1998 budget. Imports of intermediate goods fell by 2.3% to \$1.06bn, while imports of consumer goods stagnated at \$380m.

Composition of imports
(\$ m)

	Jan-Apr		
	1997	1998	% change
Consumer goods	380	380	0.0
Intermediate goods	1,083	1,058	-2.3
Investment goods	422	517	22.5
Total incl others	**1,959**	**2,004**	**2.3**

Source: Central Bank of Sri Lanka, *Selected Economic Indicators*.

Lower revenue from tourism could reduce the services surplus—

The surplus in the services account of the balance of payments (national definitions) improved to \$159m in 1997, a 51% increase in dollar terms on that of 1996. This was the outcome of a healthy recovery in the tourist industry and buoyant growth in port-related services. But this surplus may fall if the current trend in tourism continues. Tourist arrivals rose by only 1.3% year on year in the first four months of 1998 and earnings moved up only slightly, to \$74m in January-April 1998 from \$73m in the year-earlier period.

—and the incomes deficit may widen

The deficit in the income account narrowed in 1997, to $166m from $204m in 1996. A doubling of profits from the trade in securities and foreign exchange held by the Central Bank and a fall in the value of interest outpayments were the chief contributory factors. But there are concerns that increased outflows of profits and dividends by foreign companies, including the growing number of privatised enterprises, will lead to a widening of the incomes deficit in 1998.

Transfers remain a mitigating influence—

Net private transfers remained an important factor in helping to limit the current-account deficit. Private remittances rose by 10% in 1997, partly because of compensation payments paid to workers displaced by the Gulf war. Migrant transfers retained their buoyancy in the first four months of 1998, rising by 12.7% to $62m, compared with $55m in January-April 1997.

—but foreign reserves fall

Although net foreign-exchange reserves are still fairly comfortable, they declined by 3.9% from $2.03bn at the end of December 1997 to $1.95bn by the end of April, mirroring the slowdown in export earnings.

Seeking a sovereign rating is considered

Sri Lanka intends to seek a sovereign rating for the country by 1999. The move is a precursor to the issue of a fixed-rate bond (approximately $100m-200m) in international markets. The government is preparing itself to borrow more in international markets, given the declining trend in aid flows worldwide. Moreover, when the country's income per head exceeds the $925 mark (it currently stands at $814) it will be reclassified by the World bank as a middle-income country, making further aid flows more difficult. In 1997 Sri Lanka successfully raised $50m through a floating-rate note, without having an official rating. The country is believed to have been given an unofficial indication that it would receive a BB+ rating by the rating agencies.

Quarterly indicators and trade data

Quarterly indicators of economic activity

		1995	1996				1997				1998
		4 Qtr	1 Qtr	2 Qtr	3 Qtr	4 Qtr	1 Qtr	2 Qtr	3 Qtr	4 Qtr	1 Qtr
Exports	**Qtrly totals**										
Tea	'000 tonnes	59.8	58.0	55.9	68.8	61.3	59.2	59.9	53.1a	n/a	n/a
Rubber	"	16.1	20.7	18.6	15.6	17.3	22.4	16.1	7.0[a]	n/a	n/a
Wages & prices	**Monthly av**										
Wages: agricultural[b]	Dec 1978=100	834.1	841.6	868.8	956.1	965.5	969.4	968.5	972.9[c]	n/a	n/a
government employees[d]	"	807.9	818.2	818.2	818.2	818.2	900.6	900.6	900.6[c]	n/a	n/a
Consumer prices,											
Colombo:	1990=100	169.1	174.0	188.0	195.1	199.0	201.1	202.3	208.8	216.4	227.5[e]
change year on year	%	13.2	12.2	14.8	18.7	17.7	15.6	7.6	7.0	8.7	n/a
Money	**End-Qtr**										
M1, seasonally adj:	SLRs bn	73.31	78.57	77.11	77.49	76.59	77.72	80.88	83.20	84.09	88.65
change year on year	%	6.7	14.8	10.7	9.0	4.1	–1.1	4.9	7.4	9.8	14.1
	Qtrly totals										
Government cash deficit	% of expenditure	50.8	42.5	24.8	29.3	27.7	35.1	49.8	n/a	n/a	n/a
Foreign trade & payments											
Exports fob	SLRs bn	57.08	49.15	49.73	61.38	66.54	59.84	60.70	76.36	78.84	43.67[f]
Imports cif	"	74.58	67.75	72.18	74.44	85.06	84.36	85.58	83.60	90.99	62.45[f]
Current balance	"	–4.00	–7.25	–11.02	–6.22	–12.15	–13.79	–13.84	n/a	n/a	n/a
Exchange holdings	**End-Qtr**										
Gold[g]	$ m	18.2	18.9	18.4	18.2	17.8	16.6	16.2	15.3	14.5	13.9[h]
Foreign exchange	"	2,057	2,152	1,982	1,933	1,931	1,745	1,716	2,063	1,996	1,873[i]
Exchange rate											
Market rate	SLRs:$	54.05	54.17	55.24	56.38	56.71	58.03	59.05	59.78	61.29	62.70[j]

Note. Annual figures of most of the series shown above will be found in the Country Profile.
[a] Total for July-August. [b] Minimum rates. [c] Average for July-August. [d] Nominal rates. [e] Average for January-February. [f] Total for January-February. [g] End-quarter holdings at quarter's average of London daily price less 25%. [h] End-May 1998, 14.3. [i] End-May, 1,829. [j] End-May, 64.31.

Sources: Central Bank of Sri Lanka, *Bulletin*; IMF, *International Financial Statistics*.

Foreign trade

($ m)

Imports cif	Total		Japan		India		Hong Kong		South Korea	
	Jan-Dec 1994	Jan-Dec 1995	Jan-Dec 1994	Jan-Dec 1995	Jan-Dec 1994	Jan-Dec 1995	Jan-Dec 1994	Jan-Dec 1995	Jan-Dec 1994	Jan-Dec 1995
Food	627.6	318.9	3.6	0.6	49.9	44.1	2.5	0.9	0.2	0.2
of which:										
dairy products	85.1	66.3	0.0	0.0	1.6	0.1	0.9	0.0	0.0	0.0
cereals & products	149.2	11.9	0.0	0.0	2.8	0.6	0.0	0.0	0.0	0.0
sugar & preparations	183.2	91.2	0.0	0.0	0.7	11.7	0.3	0.0	0.0	0.0
Petroleum & products	265.4	214.6	0.7	0.6	0.1	0.1	0.1	0.0	0.4	0.1
Chemicals	388.3	279.7	24.2	17.5	39.8	32.2	6.8	4.2	24.3	12.0
Paper & manufactures	105.7	94.1	3.1	1.5	7.9	12.1	2.9	2.3	4.5	4.1
Textile yarn, cloth & mnfrs	1,024.3	680.7	56.1	29.6	68.3	43.0	229.6	158.8	195.7	131.5
Non-metallic mineral mnfrs	234.3	177.6	3.1	1.6	50.5	22.6	4.7	4.8	1.9	3.6
Iron & steel	126.1	84.4	17.0	7.9	44.4	28.9	0.2	0.1	2.5	1.4
Non-ferrous metals	29.8	27.3	1.2	1.2	2.6	3.7	0.9	0.6	0.9	0.3
Metal manufactures	87.9	56.7	12.0	8.6	7.5	3.6	3.7	2.7	6.4	4.4
Machinery & transport eqpt	1,048.8	561.4	365.4	191.7	99.8	54.8	18.8	8.3	49.8	25.3
of which:										
road vehicles	338.2	170.4	213.3	114.6	63.4	37.9	6.8	0.1	1.9	1.3
other transport	4.3	1.8	0.5	0.1	0.3	0.0	0.0	0.0	0.0	0.0
Scientific instruments etc	59.6	37.3	13.1	10.5	1.9	0.9	1.0	0.5	0.8	0.9
Total incl others	**4,483.6**	**2,833.2**	**526.5**	**288.7**	**404.4**	**263.8**	**316.5**	**215.1**	**326.3**	**207.0**

Exports fob	Total		US		UK		Germany		Belg-Lux	
	Jan-Dec 1994	Jan-Dec 1995	Jan-Dec 1994	Jan-Dec 1995	Jan-Dec 1994	Jan-Dec 1995	Jan-Dec 1994	Jan-Dec 1995	Jan-Dec 1994	Jan-Dec 1995
Food	629.9	425.0	23.5	12.8	35.1	16.3	21.7	15.0	7.1	1.4
of which:										
fish & products	63.6	43.8	5.3	3.8	0.8	0.7	0.9	0.5	0.8	0.2
fruit & vegetables & products	75.5	54.6	3.0	0.9	4.7	3.4	6.0	5.9	4.4	0.8
tea	424.2	282.6	8.1	4.6	27.5	10.7	11.9	7.3	1.8	0.3
Rubber, crude	73.1	52.0	6.6	4.4	10.1	2.3	5.5	3.7	0.3	0.2
Coconut fibre & waste	19.5	15.0	1.2	0.9	3.0	1.9	4.1	2.2	0.4	0.8
Petroleum products	22.4	21.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Chemicals	27.9	19.4	6.8	6.2	2.9	2.1	0.6	0.8	0.2	0.1
Rubber manufactures	53.9	55.3	15.4	16.5	1.7	1.6	7.1	6.7	11.0	9.1
Textile yarn, cloth & mnfrs	131.9	94.4	43.9	30.7	15.7	10.7	10.9	7.8	11.5	8.8
Precious stones etc	225.9	161.6	11.8	6.4	9.7	5.3	2.9	1.1	113.1	91.9
Machinery & transport eqpt	72.8	71.2	3.4	3.4	2.9	1.9	10.9	6.8	0.0	0.0
Clothing	1,474.5	1,130.1	888.7	687.6	170.3	144.2	135.1	97.2	31.5	23.8
Toys etc	57.5	41.9	23.6	17.8	4.6	5.0	2.9	2.6	0.2	0.6
Total incl others	**3,192.5**	**2,378.8**	**1,114.7**	**866.7**	**285.2**	**207.6**	**222.2**	**157.2**	**189.1**	**148.1**

Source: UN, *External Trade Statistics, series D.*

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