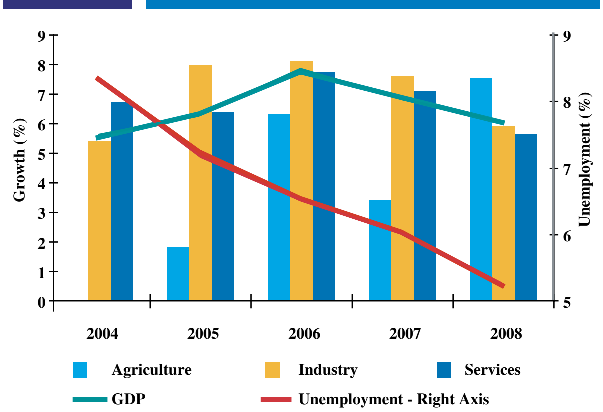
1.1 Overview

surplus of US dollars 515 million by end July 2008 turned into a deficit of US dollars 1.2 billion by the end of 2008.

In the midst of these extraordinary challenges, the Central Bank continued its focus on achieving the two key objectives, namely, economic and price stability, and financial system stability. The Bank's monetary policy strategy, which is mainly based on restricting monetary expansion through quantitative targeting, demonstrated its effectiveness by recording the sharpest ever deceleration of year-on-year inflation from 28.2 per cent in June 2008 to 7.6 per cent by end February 2009. Tumbling global food and energy prices and allowing such price reduction to pass through to domestic prices, together with favourable supply side shocks by way of higher domestic agriculture production, also reinforced the monetary policy efforts in achieving price stability. Despite the tight monetary policy restraining the expansion in domestic demand and the looming global recession decelerating external demand, agricultural production recorded a favourable development, supported mainly by the renewed economic activity in the Eastern Province and attractive prices, particularly during the first half of the year. The continuation of the implementation of major infrastructure development projects also supported the economy to maintain around 6 per cent economic growth for the fourth consecutive year. Benefits of the continuation of high economic growth were reflected both in the lowest ever levels of unemployment and poverty levels recorded recently.

Chart 1.1 Economic Growth and Unemployment



Prudential regulations and timely action by the Central Bank enabled to maintain financial system stability despite looming threats arising from excessive domestic credit expansion in the past, high interest rates resulting from the tight monetary policy, and the collapse of a domestic illegal deposit taking institution linked to a major financial institution. Although the domestic financial sector did not have any adverse impact from the global financial crisis due to the lack of exposure to toxic assets, domestic commercial banks faced the challenges posed by drying up of external credit lines for their operations.

Implementation of fiscal policy in line with targets announced in Budget 2008 was most challenging. Two unprecedented external shocks, namely global food and energy crises in the first half of 2008 and the intensification of the global financial crisis towards the latter part of the year, seriously affected the economy. Further, the government had to bear the cost of continuing the decisive phase of the war against terrorism in order to bring permanent peace to the country. The need for expediting the humanitarian and development work in the newly liberated areas, high domestic interest rates, high international prices of petroleum, fertiliser and essential commodities during the first half of 2008 exerted pressures to overrun recurrent expenditure. The exemptions of taxes and duties on fuel and essential food items, and the slowdown in imports and economic activities towards the latter part of the year, also created a significant revenue shortfall. In relation to financing the higher than expected budget deficit, the virtual drying up of external commercial financing and the sudden withdrawal of foreign investments in government securities forced the government to rely more on domestic bank financing. These challenges affected the fiscal outcome to deviate from the underlying assumptions of Budget 2008.

The Sri Lankan economy has now come to a historically important juncture with the recent domestic and external developments. The ending of the three decades long conflict resulting in a greater integration of the Northern and the Eastern Provinces with the rest of the country on a permanent basis and new opportunities that will be created with the expected recovery in the global economy would place the country on a better platform to move along a higher growth path. Increased access to the enormous amount of untapped resources in the Northern and Eastern provinces will enhance the country's growth potential while the integration with other provinces would provide a significant boost to the economy, mainly through the expanded markets, better utilisation of natural and human resources and proper direction of talent and innovation. At the same time, the new environment would build up the confidence leading to enhanced foreign investments, other private investments and assistance from the development partners. The current recessionary conditions in the global economy will also necessitate the private sector businesses and investment ventures in the country to adjust their positions accordingly to better face the crisis situation. It will also be an important occasion to introduce changes to their business models and management practices while taking measures to improve productivity. The public sector too will have to re-think and re-orient its policies and strategies to cope with the unfolding situation. These new developments will make the entire country ready to exploit new opportunities with the upturn of the next global business cycle. If these emerging opportunities are utilised effectively and strategically with proper policies in place and with better management, the country has an enormous potential to take off towards greater heights.

1.2 Macroeconomic Developments, Stability and Policy Responses in 2008

Real Sector Developments

The economic growth of 6.0 per cent during 2008 was driven by the impressive performance in the first nine months of the year with a growth rate of 6.5 per cent. However, with the adverse external developments impacting on the economy towards the latter part of 2008, the growth decelerated to 4.3 per cent in the last quarter of 2008. In 2008, all sectors contributed positively to the growth. The Industry and Services sectors, which witnessed over 7 per cent growth in the previous year decelerated to 5.9 per cent and 5.6 per cent, respectively mainly due to the slowing down of domestic economic activity amid lower external demand in the fourth quarter of the year. However, the Agriculture sector grew at an impressive rate of 7.5 per cent benefitting from higher commodity prices and the re-awakening of the Eastern Province. The Services sector continued to provide the highest contribution of 57 per cent to overall growth while the Industry and Agriculture sectors contributed to 28 per cent and 15 per cent, respectively. The key performing sectors in the Services sector were Transport and Communication, and Banking, Insurance and Real Estate sub-sectors. The Wholesale and Retail Trade sub-sector, with a share of 24 per cent of GDP, slowed down owing to the external sector developments. In the Industry sector, the low performance of the manufacturing sector due to unfavourable external developments stemming from the global slowdown was the main contributory factor for the deceleration witnessed in the industry sector. The Agriculture sector performed well with an impressive growth with tea production recording its best ever performance in any first half in its history and the paddy sector also recording a bumper harvest in the Yala season. The performance of the fisheries sector was also strong given the continuation of growth on a high base from the previous year. The first nine month's economic growth at 6.5 per cent was instrumental in the decline of the unemployment rate to a record low of 5.2 per cent in 2008 compared to 6.5 per cent and 6.0 per cent in 2006 and 2007, respectively.

In 2008, the Agriculture sector reflected a diverse performance with a positive contribution to economic growth. The sub-sectors, such as paddy, sugar, fish and rubber, showed substantially high growth rates. The remarkable growth of paddy production was attributable to an increase of the extent of lands cultivated due to high farm gate prices for paddy, the liberation of the Eastern Province, and the effect of the government national programme to increase domestic agriculture production. The increased sugar production was largely caused by the strategy followed by sugar factories to increase the production while the increase of fish production was mainly driven by the favourable weather conditions, increase of fishing operations in the

Table 1.1 **Gross National Product by Industrial Origin at Constant (2002) Prices**

Sector	Value (Rs. million)		As a Share of GDP (%)		Rate of Change (%)		Contribution to Change (%)	
	2007(a)	2008(b)	2007(a)	2008(b)	2007(a)	2008(b)	2007(a)	2008(b)
Agriculture	**265,870**	**285,897**	**11.9**	**12.1**	**3.4**	**7.5**	**6.1**	**15.1**
Agriculture, Livestock and Forestry	241,285	258,881	10.8	10.9	2.3	7.3	3.8	13.2
Fishing	24,585	27,016	1.1	1.1	15.6	9.9	2.3	1.8
Industry	**635,199**	**672,790**	**28.5**	**28.4**	**7.6**	**5.9**	**31.6**	**28.3**
Mining and Quarrying	42,631	48,090	1.9	2.0	19.2	12.8	4.8	4.1
Manufacturing	394,233	413,680	17.7	17.5	6.4	4.9	16.8	14.6
Electricity, Gas and Water	55,339	56,847	2.5	2.4	4.6	2.7	1.7	1.1
Construction	142,996	154,173	6.4	6.5	9.0	7.8	8.3	8.4
Services	**1,331,587**	**1,406,814**	**59.6**	**59.5**	**7.1**	**5.6**	**62.3**	**56.6**
Wholesale and Retail Trade	546,145	571,911	24.5	24.2	6.1	4.7	22.3	19.4
Hotels and Restaurants	9,199	8,741	0.4	0.4	-2.3	-5.0	-0.1	-0.3
Transport and Communication	286,764	310,029	12.8	13.1	10.5	8.1	19.2	17.5
Banking, Insurance and Real Estate etc.	193,375	206,048	8.7	8.7	8.7	6.6	10.9	9.5
Ownership of Dwellings	72,345	73,137	3.2	3.1	1.1	1.1	0.6	0.6
Government Services	171,259	181,051	7.7	7.7	6.0	5.7	6.8	7.4
Private Services	52,500	55,896	2.4	2.4	7.8	6.5	2.7	2.6
Gross Domestic Product	**2,232,656**	**2,365,500**	**100.0**	**100.0**	**6.8**	**6.0**	**100.0**	**100.0**
Net Factor Income from Abroad	-24,365	-53,117			**15.3**	**-118.0**		
Gross National Product	**2,208,291**	**2,312,383**			**7.1**	**4.7**		

(a) Revised
(b) Provisional

Source : Department of Census and Statistics

newly liberated Eastern Province as well as the promotion of community participatory programme on management of water bodies and release of large fingerlings free of charge, etc. Rubber production also increased benefiting from the very attractive prices in the first half of the year although the production marginally declined in the second half in the backdrop of declining prices of natural rubber as a result of the global slowdown of demand and falling oil prices.

The sub-sectors of Agriculture, such as tea, coconut, milk and poultry registered a lower than expected growth. The sharp turnaround of tea prices at the Colombo tea auctions in the latter part of the year and the measures adopted to arrest the falling prices caused production to decline to some extent towards the end of the year leading to a slowdown in the buoyant growth momentum in the first half of the year. The decline in coconut production was mainly due to the drought that prevailed in 2007 and the new coconut disease known as "*weligama wilt*". Although the growth of national milk production was marginal, a phenomenal increase of milk production was recorded by the National Livestock Development Board (NLDB) due to better management practices and the upgrading of animals to obtain high milk production in line with the government policy to become self-sufficient in milk production. The growth of poultry meat production was lower than the expected level and such outcome was mainly due to the increased cost of production resulting from increased prices of animal feed ingredients.

The production of other agricultural export crops showed a mixed performance in 2008. The production of cocoa, cloves, arecanuts and coffee showed increases while the production of betel, cardamom, pepper, cinnamon and cashew declined. In particular, the clove harvest showed exceptional performance in 2008 being the fourth year in the production cycle which hits a boom harvest. Meanwhile, the declined world demand and accordingly, drop in prices caused production of cinnamon to decline while pepper production was affected by excess rainfall in major growing areas and the imposition of some restrictions by importing countries.

The favourable prices recorded for agriculture products in the first half of 2008 showed a sharp

reversal with the burst of the commodity bubble starting from the third quarter of the year. In response, the government took several remedial measures through Budget 2009 followed by the Economic Stimulus Package that was announced in December 2008 in order to invigorate the affected agriculture sectors in both plantation and non-plantation sectors. Accordingly, government took measures to change the duty rates, introduce and revise Cess rates and other applicable levies at the Customs and to provide financial assistance in addition to reinforcing the government's national program launched in 2007 under the theme of "Api Wawamu - Rata Nagamu" aiming at increasing the domestic production.

The Industry sector maintained a growth over 6 per cent in the first nine months but recorded a 5.9 per cent growth in 2008 as a result of the deceleration it experienced in the fourth quarter to 5.2 per cent with the global slowdown. The regional industrialisation and small and medium enterprises were encouraged by several measures taken by the line ministries. Special programs such as "Nipayum Sri Lanka", "Gamata Karmantha", and "Negenahira Navodaya" were launched to facilitate regional industrialisation. Several fiscal measures were introduced to help maintain the sustainability of certain industries which were affected by the global economic slowdown. Further, these fiscal measures envisaged the encouragement of the use of locally produced raw materials, such as rubber, maize, etc.

The textile, wearing apparel and leather products category experienced a sharp deceleration due to the slowdown in the external demand. Several measures were taken by the apparel manufacturers to face future challenges of the industry. These measures took into account global benchmarks for low energy consumption, water conservation, solid waste management and low carbon emissions. The manufacturing industries of chemicals, petroleum, coal, rubber and plastic were adversely affected owing to decreased international demand with the poor performance of the automobile industry in key industrial countries. The ceramic industry also suffered mainly due to the high cost of production arising from increased raw material and energy cost, decreased demand for wall

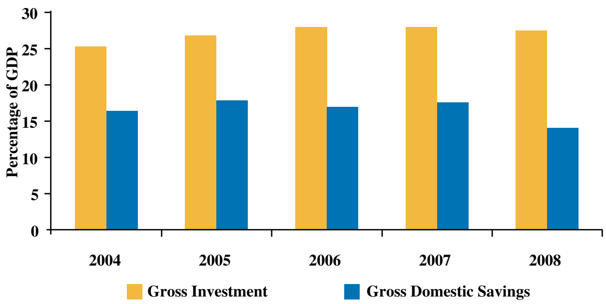
Table 1.2 Aggregate Demand and Savings Investment Gap - 2007 and 2008

Item	Rs. billion		Growth %		As per cent of GDP	
	2007(a)	2008(b)	2007(a)	2008(b)	2007(a)	2008(b)
1. Domestic Demand	3,950.0	5,002.2	21.1	26.6	110.4	113.4
1.1 Consumption	2,949.7	3,787.4	20.9	28.4	82.4	85.9
Private	2,403.2	3,073.7	20.9	27.9	67.2	69.7
Public	546.5	713.8	21.1	30.6	15.3	16.2
1.2 Investment (Gross Domestic Capital Formation)	1,000.3	1,214.8	21.7	21.4	28.0	27.5
Private	807.4	928.8	14.8	15.0	22.6	21.1
Public	192.9	286.0	61.9	48.3	5.4	6.5
2. Net External Demand	-371.3	-591.7	-14.8	-59.3	-10.4	-13.4
Exports of Goods and Services	1,041.9	1,098.4	17.7	5.4	29.1	24.9
Imports of Goods and Services	1,413.3	1,690.1	16.9	19.6	39.5	38.3
3. Total Demand (GDP) (1) + (2)	3,578.7	4,410.6	21.8	23.2	100.0	100.0
4. Domestic Savings (3) - (1.1)	629.0	623.1	26.1	-0.9	17.6	14.1
Private	686.7	711.6	20.7	3.6	19.2	16.1
Public	-57.7	-88.5	17.7	-53.3	-1.6	-2.0
5. Net Factor Income from Abroad	-39.1	-99.0	3.4	-153.6	-1.1	-2.2
6. Net Private Current Transfers	245.0	277.7	23.8	13.3	6.8	6.3
7. National Savings (4) + (5) + (6)	834.9	801.8	27.2	-4.0	23.3	18.2
8. Savings Investment Gap						
Domestic Savings - Investment (4) - (1.2)	-371.3	-591.7			-10.4	-13.4
National Savings - Investment (7) - (1.2)	-165.4	-413.0			-4.6	-9.4
9. External Current Account Deficit without Official Grants (2) + (5) + (6) (c)	-165.4	-413.0			-4.6	-9.4

(a) Revised
(b) Provisional
(c) The difference with the BOP estimates is due to the time lag in compilation.

Sources : Department of Census and Statistics
Central Bank of Sri Lanka

Chart 1.2 Savings and Investment



tiles from the construction sector and low demand for tableware from the European Union (EU) and the United States.

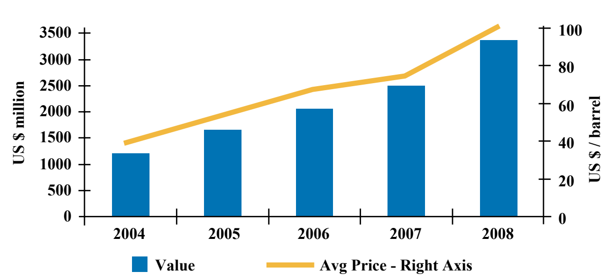
The Services sector decelerated with a contraction in the Hotels and Restaurants sub-sector. All other sub-sectors too recorded slower growth compared to the previous year. The slowdown mainly arose from the deceleration in export trade, transport and financial services activities. However, Import Trade, and Post and Telecommunication, which are components of the Wholesale and Retail Trade sub-sector, and the Transport and Communication sub-sector, respectively recorded expansions at higher rates. The slowdown in the export trade sub-sector stemmed from the global economic slowdown, which contributed heavily to the slowdown in the growth momentum in the services sector. The growth in the telecommunication sector was largely supported by the expansion in the coverage as reflected by the increased telephone density.

External Sector Developments

The external sector performance had been improving steadily until the end of the third quarter of 2008, amidst challenging domestic and external environments but reversed thereafter, in the wake of financial and economic crises that pervaded the world. Most of the external sector indicators: exports, workers' remittances, balance of payments, short-term investments and external reserves, performed well above the original projections before the intensification of the global financial crisis. Exports grew by around 10 per cent during the first nine months of the year, despite many challenges, such as the economic slowdown of major trading partners, the rising oil prices and costs of production, the higher interest rates and the uncertainty about the renewal of concessions under the Generalised System of Preferences Plus (GSP+) scheme. Import expenditure grew sharply by 33.7 per cent on account of the unprecedentedly high petroleum and commodity prices in the international markets and widened the trade deficit by 88.1 per cent by end September 2008. The widened trade deficit was partly offset by the increased private remittances, which grew by well above 20 per cent throughout the first nine months, helping contain the current account deficit. Net foreign short-term inflows to the government and the private sector peaked at US dollars 1,004 million by end September 2008 and helped generate a surplus in the capital and financial account. This was more than sufficient to finance the higher current account deficit, generating a surplus by end September 2008.

As the year progressed, the entire external financial landscape changed rapidly and deteriorated the global economic growth prospects, which weakened the satisfactory external sector performance achieved by the country until the end of September 2008. The financial crisis triggered by the sub-prime mortgage lending in the United States, spilled over to other major markets, which in turn, resulted in a global financial turmoil that gradually seeped into the real sector. The resulting slowdown in global growth, particularly in the advanced economies including the United States, led to a substantial decline in global demand for energy and other commodities. Exports, which suffered from the contraction in global demand towards the end of the year, declined by 2.8

Chart 1.3 Value of Petroleum Imports and Average Price of Crude Oil Imports

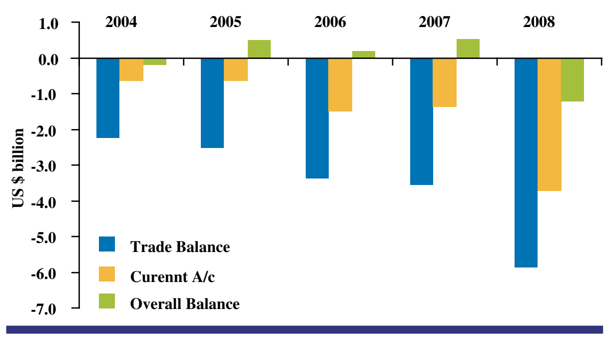


per cent in the last quarter. This set-back led exports to grow only by 6.5 per cent in 2008. Nevertheless, Agricultural exports contributed to nearly 70 per cent of this, which is largely due to the attractive prices fetched in the international markets towards the early part of the year. Industrial products recorded a modest growth partly due to the sluggish demand for apparel in the United States. The sharp depreciation of the Euro and the Sterling pound against the US dollar contributed to erode the competitiveness of Sri Lanka's exports to some extent. Nevertheless, exports to the EU increased, offsetting the set-back in the United States. In terms of destination, the United States remained the most important single market. As a region, the EU continued to increase its importance in recent years.

The global financial crisis led the prices of most commodities, including petroleum, that exhibited a series of historical highs, to plummet during the fourth quarter of 2008. The unexpected decline in prices had a favourable impact on import expenditure in the last quarter. Petroleum imports, which grew by 61.4 per cent during the first three quarters, declined by 25.6 per cent in the fourth quarter. Reduction in expenditure on other imports, along with petroleum, led imports to decelerate very rapidly, to record a flat growth in the last quarter. As a result, imports grew by 24.0 per cent in 2008. All major categories of imports increased reflecting a broad based expansion. The higher growth of expenditure on imports in 2008 relative to the lower growth in exports contributed to the substantial expansion in the trade deficit in 2008. The overall trade deficit widened by 60.6 per cent to US dollars 5.9 billion in 2008 from US dollars 3.7 billion in 2007. As a percentage of GDP, the trade deficit deteriorated to 14.4 per cent in 2008 from 11.3 per cent in 2007.

In the service sector, the strong performance of transportation, telecommunication, computer and information services, construction and insurance services was partially offset by the slowdown in travel and other business services. The tourism industry remained sluggish during 2008. At the beginning of the year, arrivals were mainly affected by the travel advisories issued by some key

Chart 1.4 Balance of Payments (BOP)



tourist generating countries. However, as the year progressed, arrivals declined further with the onset of the global recession.

Net factor income received on investment declined considerably in 2008 due to low interest income from investment of official reserves and valuation losses in the external reserves due to sharp depreciation of major currencies, such as the Euro and Sterling pound against the US dollar. Meanwhile, outflows in the income account increased mainly due to the substantial increase in repatriation of profits and dividends of the foreign direct investment enterprises by foreign investors. However, this outflow had an offsetting inflow in the financial account as those investors re-invested profits and dividends for the expansion of existing operations.

Workers' remittances continued to be a major source of inflows financing around 50 per cent of the trade deficit in 2008. Workers' remittances grew at a higher rate in 2008, and reached US dollars 2,918 million compared to US dollars 2,502 million in 2007. This increase was attributable mainly to an increase in the number of migrant workers leaving for foreign employment, increase in the average wages of migrants in the Middle Eastern region due to the rise in income level of oil producing countries and increased migration to high wage countries. The current account deficit more than doubled to US dollars 3,775 million in 2008 from US dollars 1,401 million in 2007 due to increased trade deficit led by unprecedentedly high import expenditure. In terms of GDP, the current account deficit deteriorated to 9.3 per cent of GDP in 2008 from 4.3 per cent of GDP in 2007.

Inflows to the capital and financial accounts, which were more than sufficient to offset the unprecedentedly high current account deficit during the first nine months of 2008, reversed thereafter, with the intensification of the global financial crisis. Foreign Direct Investments (FDI) inflows reached the highest recorded level in 2008 mainly due to increased reinvestment of retained earnings. Foreign inflows to the government consisting of both loans and grants decreased in 2008, mainly due to the lack of counterpart funds for externally funded projects due to the global financial crisis. Though some commercial loans did not materialise as a result of the intensifying global financial crisis towards the end of the year, the government was able to mobilise US dollars 1.4 billion worth of loans and grants during 2008 as compared to US dollars 1.6 billion in 2007, which included the sovereign bond proceeds of US dollars 500 million. A larger portion of the loan inflows was on concessional terms and mostly directed towards the implementation of infrastructure projects such as expansion of the Colombo Port, construction of the Southern Expressway, the new Hambantota Port, etc.

Short-term inflows were the main driver of the changes in the capital and financial account in 2008. The government permitted foreigners to invest up to a maximum of 10 per cent of the value of outstanding Treasury bills effective from May 2008 as a part of further liberalisation of the capital account. As a result, outstanding Treasury bills and bonds investments by foreigners reached its peak level of US dollars 641 million by September 2008. However, these investments collapsed with the deepening of the global financial crisis and the inflows recorded till the end of September 2008, suddenly reversed and by end 2008, turned into a net outflow of US dollars 213 million. This was due to the withdrawal of US dollars 430 million in the last quarter as investors shifted funds rapidly on concerns of safety and liquidity amidst the global credit crunch. In order to meet the sudden foreign exchange requirement arising from the liquidation of these investments and to create confidence among the investors, the Central Bank created a Sinking Fund, which facilitated the withdrawal of funds by foreign investors without exerting any undue pressure on the domestic foreign exchange market.

Table 1.3 External Sector Developments

Item	US$ mn 2007	US$ mn 2008(a)	% Change
Exports	**7,640**	**8,137**	**6.5**
Agricultural products	1,507	1,855	23.1
Industrial products:	5,967	6,159	3.2
Mineral exports	128	122	-4.2
Other exports	38	-	-100.0
Imports	**11,296**	**14,008**	**24.0**
Consumer goods	2,002	2,549	27.3
Intermediate goods	6,517	8,341	28.0
Investment goods	2,685	2,979	10.9
Other	92	139	51.1
Trade balance	***-3,656***	***-5,871***	***60.6***
Services, net	**302**	**402**	**33.1**
Receipts	1,775	2,003	12.8
Payments	1,472	1,601	8.8
Income, net	**-358**	**-972**	**171.5**
Receipts	449	-32	-107.1
Payments	807	940	16.5
Current transfers, net	**2,311**	**2,666**	**15.4**
Private remittances, net	2,214	2,565	15.9
Receipts	2,502	2,918	16.6
Payments	288	353	22.6
Official Transfers, net	97	101	4.1
Current account balance	***-1,401***	***-3,775***	***169.5***
Capital account	***269***	***291***	***8.2***
Financial account	***1,828***	***1,483***	***-18.9***
Direct investment, net	548	691	26.1
Inflows	603	752	24.7
Outflows	55	62	12.7
Private long-term,net	31	74	138.7
Inflows	199	265	33.2
Outflows	168	191	13.7
Government, long-term,net	672	252	-62.5
Inflows	1,290	1,059	-17.9
Outflows	618	807	30.6
Government, short-term,net	372	-213	-157.3
Short-term:	205	679	231.2
of which:Portfolio investment,net	101	60	-40.6
Errors and Omissions	-165	777	
Overall balance	***531***	***-1,225***	
Gross official reserves (without ACU)	3,063	1,753	
Months of imports	3.3	1.5	
Total external reserves (without ACU)	4,511	2,992	
Months of imports	4.8	2.6	
Export price index	106.8	113.4	
Import price index	113.6	134.9	
Terms of trade	94.0	84.1	
Exchange rates (Average)			**App(+) /Dep(-)**
Rs./US$	110.62	108.33	2.1
Rs./Yen	0.94	1.05	-10.5
Rs./Euro	151.63	159.32	-4.8
Rs./STG	221.46	200.73	10.3

(a) Provisional

Source: Central Bank of Sri Lanka

Foreign capital to the private sector and public corporations increased in 2008. Long-term borrowings by the private sector enterprises, particularly in power and energy, telecommunications and finance sectors, increased as the domestic interest rates were relatively high in 2008. Short-term capital inflows, which consist of portfolio investments, private short-term credits and changes in commercial bank assets and liabilities, also increased substantially largely due to the extension of an Iranian line of credit to the Ceylon Petroleum Corporation (CPC) for petroleum imports. Despite a record level of gross inflows to the Colombo Stock Exchange (CSE), the net portfolio investment inflows declined in 2008.

As a result of these developments, the balance of payments, which recorded a surplus of US dollars 515 million by end July 2008, turned into a deficit of US dollars 1,225 million by end 2008. Consequently, external official reserves, which were maintained at a comfortable level equivalent of well over 3 months of imports during the greater part of the first nine months, declined gradually thereafter as total outflows were higher than inflows with the intensification of the global financial crisis. By end 2008, the gross official reserves, with and without ACU payments, declined to US dollars 2,561 million and US dollars 1,753 million, respectively.

The Central Bank took several measures to rebuild the reserve level of the country in 2009. The Central Bank has been in negotiation with three countries for currency SWAP arrangements. Under such arrangements, the Central Bank has, so far in 2009, received US dollars 200 million. In addition, several other steps have also been taken to boost the reserves. Promotion of investments in Treasury bills and bonds among the Sri Lankan diaspora and the introduction of 20 per cent bonus interest on interest earned on NRFC and RFC accounts to encourage a higher level of inflows into those accounts were some of such initiatives. Further, in response to an offer of the International Monetary Fund (IMF) to support Sri Lanka during the current global financial crisis, the government has sought a Stand-by Arrangement facility from the IMF.

Continuing with the declining trend observed in the past few years, the total external debt consisting of medium and long-term, and short-term debt of the country declined to 37.1 per cent as a percentage of GDP in 2008 from 43.2 per cent in 2007. In US dollar terms, the total external debt increased by around 8.0 per cent to US dollars 15,107 million in 2008 basically driven by large short-term debt of CPC and other trade credits. The total external debt and liabilities, which consist of total external debt and banking sector external liabilities, decreased as a percentage of GDP in 2008 to 43.7 per cent from 51 per cent in 2007. The banking sector external liabilities as a percentage of GDP decreased to 6.6 per cent, though in absolute terms, it increased by 7.1 per cent to US dollars 2,669 million by end 2008, mainly due to the increase in ACU liabilities.

The government debt continued to account for a major share of external debt. From the total medium and long-term debt, the government debt accounted for 92 per cent, while the remaining share represented borrowings of the private sector, public corporations and debt obligations to the IMF. Out of total government external debt, the concessional debt accounted for about 86 per cent. The elevation of the country to the lower middle income status has reduced the availability of concessional loans from multinational financial institutions, compelling the government to seek non-concessional loans to finance its development projects. However, the government maintained its non-concessional debt stock at a low risk level, reducing the government's burden on debt services.

Amortisation and interest payments, which constitute the total foreign debt service payments, increased to 15 per cent as a percentage of earnings from merchandise exports and services, in 2008 compared to 13.1 per cent in 2007, mainly due to the increased debt servicing cost of government's commercial borrowings and the continuation of the re-scheduled debt repayments since 2006 after one-off reduction due to tsunami based debt moratorium in 2005.

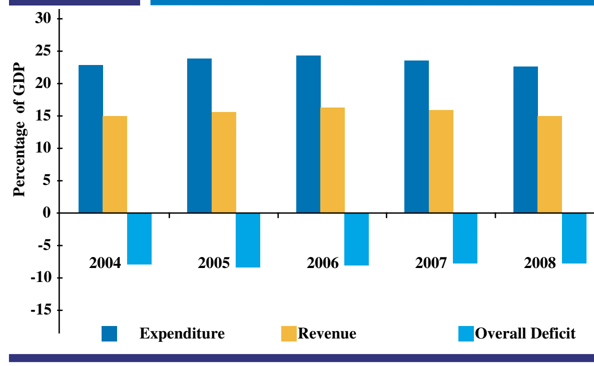
The Central Bank's exchange rate policy in 2008 mainly focused on stability, amidst unprecedentedly high volatility in global currency markets, while allowing gradual depreciation to maintain external competitiveness. To mitigate excessive volatility in the foreign exchange market and to ensure that the competitiveness of the export sector is unaffected by an undue appreciation of the rupee, the Central Bank regularly absorbed foreign exchange from the domestic foreign exchange market, thereby strengthening its reserve position in the early part of 2008. With the intensification of the global financial crisis, heavy outflows of foreign exchange due to the repatriation of short-term investments in Treasury bills and bonds and payments of high valued petroleum bills exerted heavy pressures on the exchange rate to depreciate in the last quarter of 2008. Accordingly, the Central Bank supplied foreign exchange to the market to prevent excessive volatility during the last quarter of 2008. As a result, by end 2008, the depreciation of the rupee against the US dollar was around 3.91 per cent as compared to a depreciation of around 0.93 per cent in 2007.

Fiscal Sector Developments

The fiscal strategy of the government in Budget 2008 focused on achieving the targets stipulated in the "Medium Term Macro Fiscal Framework (MTMF): 2008-2011", presented along with the budget. The MTMF continued to be based on the overall development strategy of the government enunciated in its "Ten Year Horizon Development Framework" (Ten-year Vision), which aims at achieving a higher level of economic and social development. The meeting of fiscal targets in Budget 2008 was a challenging task due to several reasons: First, the need for enhanced allocations for intensified war against terrorism, and for expediting the humanitarian and development work in the newly liberated areas. Second, the relatively high inflation that prevailed until mid-2008 and the relatively high interest rates that prevailed in the domestic market throughout the year. Third, the high international prices of petroleum, fertiliser and essential commodities that prevailed until end July 2008. Fourth, the global financial crisis, which intensified since mid-September 2008 and resulted in a slowdown of domestic economic activities, outflow of foreign investments in government securities and virtual drying up of expected foreign commercial borrowings for budgetary operations. These challenges affected the targeted fiscal outcome, as they led to the deviations in the underlying assumptions of Budget 2008.

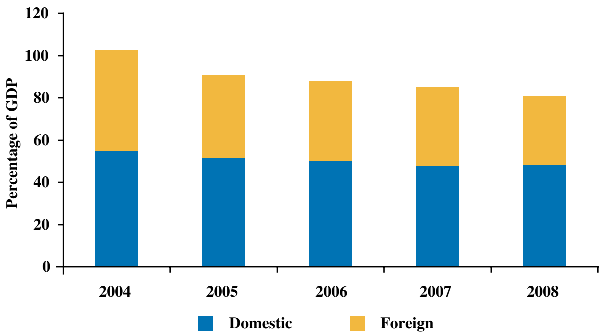
Amidst these adverse developments, the fiscal sector demonstrated a mixed performance in 2008. The relatively better fiscal performance experienced during the first nine months of 2008 changed significantly during the last quarter of the year and resulted in deviations in the annual outcome of some key fiscal aggregates. During the first nine month period of the year, total revenue continued to increase at a relatively high rate of 22 per cent while total expenditure and net lending increased by 20 per cent. The financing mix between domestic and foreign sources was fairly good and the government continued to repay the outstanding debt to the Central Bank until September 2008.

Chart 1.5 Government Revenue, Expenditure and Budget Deficit



These favourable developments changed rapidly during the latter part of the year with the deepened global financial crisis since around mid-September 2008. As a result, total annual revenue, in nominal terms, increased only by 16 per cent. This was mainly attributed to a sharp drop in international trade related taxes, especially due to the lower quantity and value of vehicle imports, and the slowdown in domestic economic activities, which resulted in a drop in the revenue from both direct and indirect taxes. The recurrent expenditure, in nominal terms, exceeded the budgetary target but as a per cent of GDP, continued to decline. The overrun in the recurrent expenditure was mainly due to the higher than expected expenditure on salaries and wages, pension payments, fertiliser subsidy, counter terrorism activities, and intensified humanitarian and development work in the newly liberated areas. Nevertheless, the public investment was maintained at 6.0 per cent of GDP compared to 6.4 per cent recorded in the previous year, which is a commendable achievement under difficult

Chart 1.6 Government Debt as a percentage of GDP



financial conditions. This performance was achieved through the continuation of the mega infrastructure development projects and implementation of a number of provincial and rural infrastructure development activities aiming at empowering the rural masses. However, the performance of the public investment programme was considerably below the expectations mainly due to the lower inflow of foreign commercial financing and the shortfall in the government revenue, which necessitated the prioritisation of the projects and the releasing of funds. As a combined outcome of these developments, the overall budget deficit in 2008 amounted to 7.7 per cent of GDP, same as in the previous year, compared to the original target of 7.0 per cent.

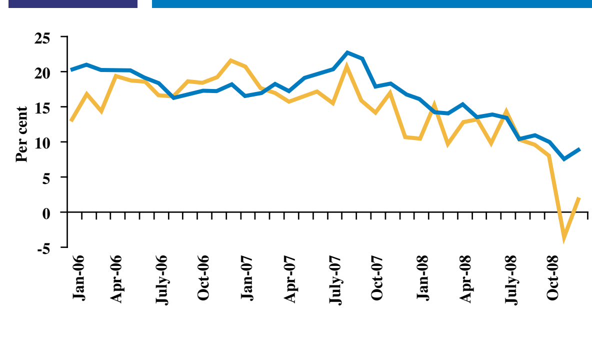
The financing mix of the overall budget deficit in 2008 reflected a significant change compared to the targets in the original Budget. The government opted to rely more on domestic borrowings to finance the budget deficit in the midst of the tight liquidity situation in the international financial markets. Accordingly, net domestic financing increased significantly to 7.1 per cent of GDP and the net financing from foreign sources was considerably below the targets and accounted for 0.6 per cent of GDP. The recourse to bank financing was increased mainly due to the limited availability of resources in the domestic non-bank sector and the relatively high interest rates that prevailed in the government securities market. Of the total borrowings from the banking system in 2008, about three fourth was made during the fourth quarter of the year. Meanwhile, the government's outstanding debt to GDP ratio continued to decline mainly reflecting the higher growth of nominal GDP than the growth in nominal debt.

Monetary Sector Developments

Inflation declined significantly to 14.4 per cent on a year on year basis in 2008 from its peak level of 28.2 per cent in mid-2008, which could be attributed to firstly, the continued tight monetary policy measures adopted by the Central Bank and secondly, the sharp decline in international commodity prices from around mid-2008. The significant deceleration in inflation confirms that the Central Bank's strategy of focusing more on quantitative targets to contain market liquidity and allowing the market interest rates to adjust at a faster pace has been more effective in a high inflationary environment. Inflation further decelerated during the first quarter of 2009, at a faster rate than expected, and reached single digit levels by end February. Since inflation is stabilising at a more manageable level, the Central Bank intends to revert to conducting the monetary policy operations within the interest rate corridor formed by its policy rates in 2009 and maintain interest rates stable around a level consistent with the reserve money targets.

The reserve money targeting approach was further refined in 2008 by setting the quarterly targets for 2008 on the basis of quarterly averages of daily reserve money to ensure a more disciplined and smooth expansion in reserve money. Accordingly, the target for annual average growth in reserve money in 2008 was initially stipulated at 14.7 per cent and was announced in the Road Map for Monetary and Financial Sector Policies for 2008 and beyond. However, the targeted

Chart 1.7 Growth in Reserve Money and Broad Money



1 ECONOMIC, PRICE AND FINANCIAL SYSTEM STABILITY, OUTLOOK AND POLICIES

Box 1

Sri Lanka in the face of the Global Economic Downturn

The current global financial crisis spurred from the collapse of the US subprime mortgage market in 2007, quickly spread throughout the financial markets. It initially spilled over to other advanced economies that were financially closely interlinked with the United States and subsequently, across the globe. The financial crisis was soon followed by the current global economic crisis that has spiralled up to an unprecedented level, one that has not been experienced since the establishment of the current world economic order. The trajectory of the deceleration in global measures of trade, industrial production, financial flows, etc. has been shockingly rapid. The forecasts for the global economic growth in the immediate future are getting progressively gloomy. The International Monetary Fund's (IMF) baseline forecast published in January 2009 and latest forecasts from the United Nations show global GDP to grow closer to zero during 2009 and they do not rule out the possibility of even a negative growth.

The global financial system meltdown has had adverse macroeconomic impacts at varying intensities on developing countries depending on their interaction with the global economy. In the case of Sri Lanka, because of the fact that the capital account has not been fully liberalised and that many local banks did not trade in complex financial instruments, the direct impact of the global financial crisis on the country's financial sector was minimal. However, with the intensification of the crisis that has spilled into the real sector of the economy, the effects of the turmoil are being felt strongly by the country.

Due to the global financial crisis, many foreign investors who have invested in developing markets repatriated their short-term investments back to their countries for meeting rising liquidity requirements. Sri Lanka has not been an exception. With the increased outflow of foreign exchange and coupled with declined inflows due to a lower demand for exports, there was a pressure on the exchange rate to depreciate amidst virtual drying up of credit lines. To ensure adequate US dollar liquidity in the domestic foreign exchange market, the Central Bank, while allowing limited flexibility in the exchange rate, supplied US dollars to the market, to ensure stability in the domestic foreign exchange market. With the supply of US dollars to the domestic market, the rupee liquidity however suffered continuous shortfalls, resulting in rupee borrowing costs remaining at higher levels. To overcome the liquidity shortfalls, the Central Bank released the liquidity absorbed through foreign exchange operations by reducing the Statutory Reserve Ratio in three steps by 3 per centage points to 7.00 per cent and purchasing Treasury bills both in the primary and secondary markets. Any remaining shortfalls were covered through reverse repo transactions on overnight basis. These measures were supplemented by subsequent reductions in policy interest rate which however was prompted by decreasing inflation which warranted a relaxation of monetary policy.

Since the epicentre of the crisis was the largest export destination of Sri Lanka, the economic slowdown followed by the crisis has resulted in a reduction in demand for Sri Lankan exports, particularly for apparel products. The exports, which increased by 9.6 per cent during the first three quarters of 2008, declined by 2.7 per cent in the last quarter of 2008. Due to the highly competitive nature of the export market and relatively high cost of production in Sri Lanka, many exporters operate with comparatively low profit margins. Accordingly, many exporters have found it difficult to sustain growth of apparel exports in the face of reducing demand. The tea industry was also adversely affected due to the reduction of the tea prices in the international markets. With the international prices of other agricultural export crops like rubber and cinnamon also declining, making continued production unviable, the government had to intervene to stabilize the prices. In addition, other export oriented industries such as rubber based products, diamond and jewellery etc., were also affected by the crisis and the government had to unveil an economic stimulus package that aimed at revitalizing these key sectors. In the meantime, some local industries resorted to short-term lay-offs of workers in the hope of staying afloat with the depressed demand.

To date, the severity of the impact of the crisis on Sri Lanka is comparatively modest. However, given the lagged and lingering effects of the slowdown in advanced economies, it is widely believed that the severity is yet to come. Most countries in the G-20 which represents about 90 per cent of global gross national product and 80 per cent of world trade are considered to be in recession. A slowdown in advanced economies will have substantial effects on foreign direct investment inflows, export demand, commodity prices, debt roll-over, short-term foreign financing and finally, on exchange rate movement and reserves. The fairly high trade openness which is measured by the share of trade in income indicates the increased exposure of the country to external vulnerabilities. Although the share of agriculture in the total exports is lower at about 15 per cent, high prices fetched by agricultural commodities led by tea provided the basis of export earnings in 2008. Further, agricultural exports contributed to 70 per cent of export growth, while the depressed performance of the industrial sector was somewhat compensated by apparel exports. However, apparel exports are expected to encounter renewed pressure in view of deteriorating demand in the international markets in the midst of severe competition from other exporters. The low volume of exports together with a decline in commodity prices due to dwindling demand will have an impact on exports in 2009. In recent years, much of the productive resources had been diverted to the export sector. Therefore, the low demand for exports indicates both low investments and low exports in the near term. A decline in imports will have a favourable impact on the trade balance, balance of payments and finally on reserves. However, the low imports of capital goods and raw materials due to lack of financing, which account for more than 82 per cent of total imports impede the production capabilities and the flow of productive resources, thus, spurring a renewed fear over shrinking growth prospects.

Western Europe which constitutes the largest source of tourism for Sri Lanka is heading towards an incessant economic slowdown. Therefore, it is unlikely that tourism would rebound in 2009 due to mounting uncertainty about global economic prospects, volatile exchange rate movements, high job losses and weakening consumer confidence in the tourist generating countries. Further, there exists a high risk of many Sri Lankan migrant workers engaged in high-income employment in the Eastern Pacific Rim, European countries and the United States being laid-off while the migrant workers engaged in low-income jobs would not be much affected by the slowdown. A decline in oil income as well as downturn in economic conditions in the Middle East could lead to economic instability in the region. However, worker remittances during 2009 are expected to be relatively steady in view of the nature of migrant workforce in the Middle East.

The growing fears about protectionism by developed countries amidst the global economic downturn would risk an early revival of the global economy and deter the free flow of trade and investment particularly to the developing countries. This may worsen the impact of global economic slowdown on trade in goods as well as services, particularly, new services such as Business Process Outsourcing and Knowledge Process Outsourcing and other IT related services; areas in which Sri Lanka is emerging as a favourite offshore outsourcing destination.

The persistently high current account deficit reflects the high savings-investment gap of the country. The non availability of adequate national savings for productive long-term investments suggests the need for substantial foreign capital, to achieve a consistently high rate of growth in coming years. In recent years, high interest rates in the domestic financial market encouraged the government and the private sector to obtain foreign loans to finance projects and business expansion. Several private sector enterprises including a few Board of Investment (BOI) enterprises, particularly in power and energy, telecommunications and finance sectors, obtained foreign facilities in recent years. Several foreign funded projects were implemented in 2008 with the help of commercial financing which provided the required counterpart funds. However, the unfolding global crisis would deter the flow of such funds into the domestic financial market affecting business expansion, the continuation of ongoing projects and also exerting pressure on the domestic money market.

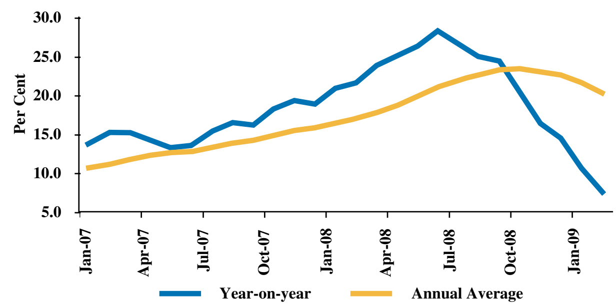
The combined effects of the crises are expected to affect government revenue due to lower imports, profits, economic activities, etc. Limited external and domestic financing also constrain the ability to finance a higher budget deficit. The government has unveiled a stimulus package to boost ailing sectors of the economy requiring additional financing. At the same time the government need to make additional spending particularly with the resettlement, rehabilitation and reconstruction work in the Northern and the Eastern Provinces. The stortage of short-term foreign finacing and challenging task of rolling over of existing foreign debt pose downside risks to the budgetory position of the government. Therefore, the short-fall in government revenue and substantial increases in expenditure would lead to a temporary deviation from the fiscal consolidation process as formulated within the "Ten-Year Horizon Development Framework: 2006-2016".

The financial system of the country has been robust and not been directly affected significantly by the global crisis. However, as a result of the crisis, Sri Lanka has lost external reserves and likely to face balance of payments difficulties unless a substantial inflow of foreign exchange is ensured. In this context, the country has implemented several measures including the promotion of investments in government securities by the Sri Lankan diaspora, arranging swap facilities and providing bonus interest on Non-Resident Foreign Currency (NRFC) and Resident Foreign Currency (RFC) accounts. These will be further strengthened by the pending Stand-by Arrangement with the IMF which will build up confidence internationally on the debt repayment capacity of the country and encourage further capital inflows while ensuring fiscal consolidation as envisaged by the government.

growth was revised on three occasions during the year by bringing it down to 9.7 per cent, in order to further tighten monetary policy to contain inflation expectations, and to maintain the policy stance amidst the changes in the Statutory Reserve Ratio (SRR) introduced towards the end of the year to relieve the liquidity constraint that emerged following the global financial crisis. The Central Bank has mainly relied on aggressive open market operations to maintain market liquidity at a level consistent with the reserve money targets. Therefore, to streamline open market operations, restrictions were imposed on market participants' access to the Central Bank's standing facility at the reverse repurchase rate, to only 3 times per calendar month, and were limited in aggregate only to an amount equivalent to the liquidity shortfall as estimated by the Central Bank. The access beyond these limits was allowed at a penal rate of 19 per cent. To enforce its tight monetary policy stance, the Central Bank also refrained from subscribing to Treasury bills at primary market auctions and special issues, except for replacing liquidity absorbed through operations in the foreign exchange market. In line with the policy measures aimed at managing liquidity to maintain quantity targets, market interest rates continued to remain at relatively high levels.

The Central Bank took several measures particularly during the last quarter of the year to mitigate the adverse impact of the global financial crisis on the domestic financial market. The outflows of foreign investment in government Treasury bills and bonds in the heightened global liquidity shortage and the drying up of foreign credit lines making it difficult to raise foreign commercial borrowings, created a severe shortage of liquidity in the domestic foreign exchange market requiring the Central Bank to supply foreign exchange to meet the excess demand including that for settlement of large oil bills and foreign loans. This created a large rupee liquidity deficit in the market, which had to be addressed through monetary policy measures. Accordingly, the Central Bank reduced the SRR on all rupee deposit liabilities of commercial banks on two occasions in October and November 2008 by a total of 2.25 percentage points to 7.75 per cent and thereby released Rs. 24.5 billion to the banking system. In addition, the Central Bank also purchased Treasury bills, both in the primary and secondary markets, to enhance rupee liquidity, while temporarily relaxing restrictions on the access to the Central Bank's reverse repurchase facility in October 2008.

Chart 1.8 Movements in Inflation

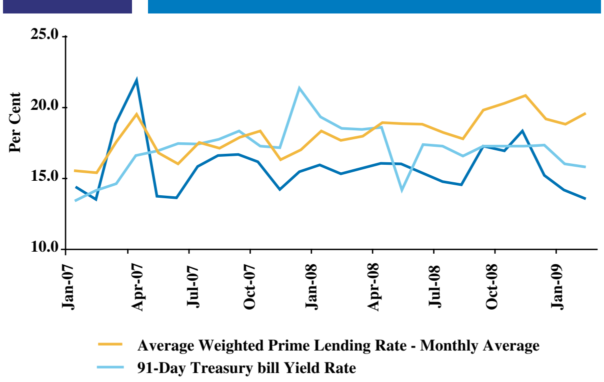


The Central Bank was successful in maintaining the growth in reserve money well within the quarterly targets in 2008. However, the reserve money expansion decelerated at a faster rate during the latter part of the year as the impact of demand management policies were re-imposed by the liquidity constraint resulting from the global financial crisis. As a result, the annual average reserve money growth moderated to around 8.5 per cent as compared to the annual target of 9.7 per cent. In tandem with the trend in reserve money, the rate of expansion in the broad money also declined significantly to 8.5 per cent by end 2008 as compared to an expected growth of 11 per cent. The expansion in the broad money supply was entirely due to the increase in net domestic assets (NDA) as net foreign assets (NFA) of both the Central Bank and the commercial banks had declined considerably by end 2008. The NDA of the banking system picked up significantly during the latter part of the year primarily due to higher growth in net credit to the government (NCG) despite the deceleration in credit to the private sector. NCG, which remained below the end 2007 levels during the first quarter, escalated thereafter particularly as a result of the difficulties in raising envisaged foreign financing by the government due to the global financial crisis. The expansion in NCG was noted in credit by both the Central Bank and the commercial banks. The contribution by the Central

Bank is accounted for by an increase in its holdings of Treasury bills as well as provisional advances extended to the government. The increase in the Treasury bill holdings of the Central Bank reflects largely the efforts made by the Bank to relieve the liquidity constraints in the market, particularly during the third quarter. Meanwhile, credit to the private sector continued to decelerate, reaching single digit levels by the third quarter of the year. The slowdown in credit growth was brought on by several factors such as, high market interest rates, the negative outlook for the global economy and its impact on the prospects of domestic businesses as well as concerns of banks on their asset quality and liquidity.

The communication policy of the Central Bank has succeeded in anchoring inflation expectations and narrowing the gap between market expectations and the Central Bank's projections. The Central Bank announced to the general public its policy decisions and their rationale through the Bank's regular publications, press releases and notices to the general public in a timely manner. This helped to narrow the gap between market expectations and the Central Bank's own views, and increases near-term predictability, from the perspective of markets, resulting in the smooth adjustment of markets to policy initiatives. The effectiveness of the Central Bank's communication strategies is exhibited by the trends in inflation expectations of the public, which show a gradual decline in the expected future inflation as perceived by the public. In carrying out its responsibilities, the

Chart 1.9 Movements in Market Interest Rate



Central Bank also continued its policy of engaging in dialogue with market participants and stakeholders. In this regard, the views of the Monetary Policy Consultative Committee (MPCC) were also taken into consideration by the Central Bank, in formulating its monetary policy.

Financial System Stability

The global financial environment was marked by intensifying turbulence, particularly since mid- September 2008. As the effects of the US sub-prime mortgage market crisis spread to other parts of the world, the result was a worldwide credit crunch. The drying up of liquidity in financial markets the world-over had ripple effects on real variables as well.

Sri Lanka's financial sector faced the spin-off effects of the turbulence in the international financial markets commendably well. While banks operating locally did not have direct exposures to US mortgage linked securities or to the financial institutions that failed elsewhere, the partial closure of Sri Lanka's capital account as well as the sound regulatory framework in place, safeguarded the domestic financial system. In addition, since January 2008, licensed banks, which account for the greater part of financial intermediation in the country, have been migrating to the Basel II Capital Adequacy Framework, which encompasses credit, market, and operational risk aspects, and this has helped further strengthen the domestic financial system. The domestic financial system also came under stress due to liquidity problems faced by one commercial bank and the failure of some unauthorised finance businesses during 2008. However, the Central Bank came to the rescue of the troubled commercial bank in a timely manner and also implemented measures to prevent any systemic risks stemming from the undesirable external or domestic developments taking effect. Hence, Sri Lanka's financial system remains sound and continues to support economic activity.

Banks performed relatively well in 2008 despite the moderation in lending by banks in view of the monetary policy tightening. This trend was re-imposed by the negative effects of the global financial crisis on domestic economic activity, particularly during the last quarter. Nevertheless, banks maintained their profitability. The capital adequacy ratio for the banking sector was also well above the stipulated minimum ratio of ten per cent, while the liquidity position of the banking industry was also maintained at comfortable levels. The non-performing loan ratio however, increased somewhat.

Registered finance companies and leasing companies faced some difficulties during the year. Finance companies recorded a slowdown in their lending activities, which mainly relate to finance leasing and hire purchase. Their profitability declined while their non-performing loan ratio increased. However, as a consequence of the Central Bank increasing the required minimum capital for finance companies, their overall capital position improved, increasing their ability to face shocks. Specialised leasing companies also experienced declining profits. They were permitted by the Central Bank to issue debt securities to raise funds, which will help them to overcome the funding constraints.

The Insurance sector remained healthy with all insurance companies maintaining solvency as per the stipulated regulatory requirements. As insurance companies are required to hold a large percentage of their portfolio in government securities, they have been able to manage credit and market risks in the current turbulent financial conditions. Their profitability has come down, however, along with a slowdown in the growth of their premium income.

The equity market, which remained volatile during most of the first three quarters of the year, recorded sharp declines in both the All Share Price Index and the Milanka Price Index, during the remainder of the year. While the high interest rates and lower company earnings during the year impacted negatively on stock market performance, the slowdown in domestic economic activity as a consequence of the global financial crisis further resulted in downward pressure on share prices at the Colombo Stock Exchange. Foreign fund inflows however, reached record high levels during 2008, due to several large value transactions in relation to a listed company.

Steps were taken to further strengthen the legal framework supporting the financial system. With a view to consolidating and strengthening the regional banks, the Pradeshiya Sanwardhana Bank Act was enacted. The Credit Information Bureau Act was amended, enlarging the scope of its activities and enabling insurance companies, utility companies, state agencies and the Central Bank to avail of its services. Amongst the other laws being prepared or amended, is the Finance Companies Act, which, once amended, will strengthen the laws prohibiting persons and companies from conducting unauthorised finance business and deposit taking. The amended Act will also have a wider definition of "deposits". A new law is also being formulated to supervise micro-finance institutions. Meanwhile, the Securities and Exchange Commission (SEC) has prepared a new law relating to securitisation, with a view to developing the domestic capital market.

1.3 External Economic Environment and Outlook

The global economy, which expanded over 4 per cent since 2004, experienced a set-back in 2008 with the intensification of the financial crisis. The global economy, which slowed markedly in the last quarter of 2007 largely due to turbulence in the financial markets, entered a major downturn in 2008 with advanced economies experiencing the deepest recession since the Great Depression of the 1930s. The downturn in the advanced economies has adversely affected the growth in the emerging and developing countries although this group of countries had in place sound policy frameworks and stronger public sector balance sheets. With the downturn in United States and Europe, countries with strong trade links with those countries experienced a slowdown, while some countries that relied on bank-related or portfolio inflows to finance large current account deficits were hard hit by an abrupt tightening of external financing. According to the World Economic Outlook (WEO, Update - January 2009) of the International Monetary Fund (IMF), the world economy is estimated to have grown by 3.4

Table 1.4 **Global Economic Development and Outlook (a)**

Item	Actual		Projections	
	2006	2007	2008	2009
World output	**5.0**	**5.2**	**3.4**	**0.5**
Advanced economies	3.0	2.7	1.0	-2.0
United States	2.9	2.0	1.1	-1.6
Euro area	2.8	2.6	1.0	-2.0
United Kingdom	2.8	3.0	0.7	-2.8
Japan	2.4	2.4	-0.3	-2.6
Emerging and developing economies	7.7	8.3	6.3	3.3
Developing Asia	9.6	10.6	7.8	5.5
China	11.1	13.0	9.0	6.7
India	9.7	9.3	7.3	5.1
World trade volume (Goods and services)	**9.2**	**7.2**	**4.1**	**-2.8**
Imports				
Advanced economies	7.4	4.5	1.5	-3.1
Emerging and developing economies	14.9	14.5	10.4	-2.2
Exports				
Advanced economies	8.2	5.9	3.1	-3.7
Emerging and developing economies	11.0	9.6	5.6	-0.8
Price Movements				
Consumer prices				
Advanced economies	2.3	2.1	3.5	0.3
Emerging and developing economies	5.1	6.4	9.2	5.8
Commodity prices (US dollars)				
Oil	20.5	10.7	36.4	-48.5
Non-fuel	28.7	14.1	7.4	-29.1
Six-month London Inter-Bank Offered Rate (per cent) on US dollar deposits	**5.4**	**5.3**	**3.0**	**1.3**

(a) Annual percentage change unless otherwise indicated.

Source : World Economic Outlook (January 2009 & October 2008), IMF

per cent in 2008 as compared to a growth of 5.2 per cent in 2007. The United States economy has suffered most from the direct effects of the financial crisis and despite the aggressive policy easing by the US Federal Reserve, and a timely stimulus package, the United States economy grew only by 1.3 per cent on average since the fourth quarter of 2007. Economic activity slowed down substantially in Western Europe as well due to adverse impacts of high oil prices, tightening credit conditions, housing downturn in several economies and the slowdown in the United States. The Japanese economy, which showed more resilience initially, has recently been affected by slowing exports and the impact of deteriorating terms of trade on domestic demand. The growth in emerging and developing countries eased from 8.0 per cent in the first three quarters of 2007 to 7.5 per cent in the subsequent three quarters and is expected to slowdown to 6.3 per cent in 2008 as compared to 8.3 per cent in 2007.

It is widely believed that the global economy is expected to shrink in 2009. IMF has projected that the global growth in 2009 will be between 0.5-1.0 per cent, the lowest since the World War II, before recovering during the course of 2010. Despite a series of both monetary and fiscal policy measures implemented by several advanced economies, the financial crisis continues to pull down the real economy as such policies failed to dispel uncertainty in the markets. Falling asset values across advanced and emerging economies and declining household wealth have exerted downward pressure on consumer demand and thereby sharply declining the international trade. Moreover, uncertainty among households and investors has prompted them to postpone expenditure thereby reducing the demand for consumer, intermediate and investment goods. Against this uncertain backdrop, the growth in advanced economies is now expected to contract by 2.0 per cent in 2009 as compared to a moderate growth of 1.0 per cent in 2008. The United States and Euro region, the major export destinations for Sri Lanka's industrial exports, are projected to contract by 1.6 per cent and 2.0 per cent, respectively, in 2009, compared to an estimated growth of 1.1 per cent and 1.0 per cent, respectively, in 2008. Meanwhile, the growth in emerging and developing economies is expected to continue, albeit at a slower rate of 3.3 per cent in 2009 from 6.3 per cent in 2008, mainly due to the expected decline in exports to advanced economies from these countries. The exports of emerging and developing countries are projected to contract by about 0.8 per cent in 2009 as compared to the growth of 5.6 per cent in 2008. With the continuous efforts to ease credit tightness, and expansionary fiscal and monetary policies pursued by several developed, and emerging and developing countries to stimulate domestic economies, the global economy is projected to recover gradually in 2010 with growth picking up to about 3.0 per cent. However, the growth projections for 2009 and beyond are uncertain and the economic recovery depends critically on the effectiveness of policy measures implemented by various governments in bringing in confidence among households and investors.

The global economic outlook faces several downside risks under the current global financial conditions and uncertainties. The main risk is that unless stronger financial strains and uncertainties are effectively addressed quickly, deteriorating financial market conditions may further depress the real economic activities leading to a prolonged global recession. Further, the risks of deflation are rising in a number of advanced economies, while emerging and developing economies' corporate sectors could be adversely impacted by continued limited access to external financing dampening the economic activities.

Global inflationary pressures eased towards the latter part of 2008 with a sharp deceleration in international commodity prices since July due to the slump in global demand. The global inflation was initially projected to accelerate faster in 2008 with rising international prices of crude oil and essential food items and expansionary fiscal and monetary policies implemented to overcome economic slowdown and liquidity shortages resulting from the sub-prime crisis. However, with the intensification of the global financial crisis since mid September 2008 and the resultant economic downturn in the advanced economies, the commodity prices dropped drastically easing inflationary pressures significantly. World inflation reached the highest rates since the late 1990s pushed up by a surge in fuel and food prices. In advanced economies, inflation reached around 4.3 per cent in August 2008 down from a peak in July with the easing of some commodity prices. Inflation was in double digits in several emerging and developing countries and it reached an average of around 8.3 per cent in August 2008 mainly due to considerably higher weight of food items in the consumption basket of these countries, typically in the range of 30-45 per cent as opposed to 10-15 per cent in the advanced economies. With the sluggish demand and slump in economic activity in the advanced economies, inflation is expected to decline from 3.5 per cent in 2008 to a low of 0.3 per cent in 2009. Some advanced economies may experience very low inflation, while some may even experience deflation if real economic activity contract drastically. In emerging and developing economies, inflation is expected to moderate to around 5.8 per cent in 2009, from 9.2 per cent in 2008.

The short-term interest rates have been declining drastically with substantial easing of monetary policy by way of a series of rate cuts and the provision of additional liquidity by central banks to address liquidity shortages created by the financial crisis. The rate cuts initiated by central banks in advanced countries with the turbulence in the international financial markets since July 2007 continued aggressively in 2008 and prompted central banks in several emerging and developing countries also to cut policy rates to avoid a slide in economic activity. Accordingly, the United States lowered its benchmark federal funds rate from 4.25 per cent by end 2007 to 0.00-0.25 per cent by end 2008. The European Central Bank reduced its benchmark rates from 4.25 per cent in July to 2.50 per cent in December 2008. Japan reduced its benchmark rates for the first time in 7 years by 20 basis points in October and by a further 20 basis points in December 2008. Meanwhile, UK reduced its policy rates by 1.5 percentage points in November, the largest single move in its history. Australia reduced its cash rate to 4.25 per cent in December 2008. Against the backdrop of sustained stress in the money markets, five of the leading central banks, namely, the Federal Reserve, European Central Bank, Bank of England, Bank of Canada and the Central Bank of Switzerland, in a coordinated move announced a series of measures to inject liquidity which was aimed at encouraging lending. The central banks in emerging markets too closely followed the coordinated rate cuts of the advanced countries to manage the global financial crisis and to calm the domestic financial markets. The Bank of Korea lowered its base rate for the first time in nearly 4 years to 4.25 per cent while Taiwan lowered its benchmark rate to 3.25 per cent in October 2008.

Risks to financial stability intensified during 2008, particularly since mid-September, despite coordinated action by major central banks to provide liquidity. The financial crisis that erupted in August 2007 deepened further with the collapse or near collapse of several key institutions since mid-

September 2008 following the bankruptcy of Lehman Brothers Inc., a highly reputed major financial institution in the United States, causing significant losses to creditors and counterparties. Consequently, market pressures increased substantially eroding confidence in counterparties and seizing up the inter-bank market, despite coordinated injections of massive amounts of liquidity by major central banks and agreements on foreign exchange SWAPs of an unprecedented magnitude. Subsequently, the unfolding instability necessitated the closure, nationalisation or merger of a number of other banks in United States and Europe. However, the increasing size and breadth of write-downs borne by financial institutions along with continued high funding pressures have hampered the ability of policy makers to address the crisis effectively. The financial system has been severely weakened by mounting losses, falling asset prices, and deepening economic downturn. The intensifying worries about counterparty risks have seriously affected the smooth operations of the global money markets as banks became very cautious in lending even among themselves as it is hard to assess the counterparty risks under the current global market conditions. In these circumstances, it is necessary to rebuild counterparty confidence and the financial soundness of institutions to ease liquidity tensions, allowing inter-bank markets to function normally again and intermediation to continue. In this regard, provision of sufficient liquidity and term-funding support from central banks, re-capitalisation of banks and effective measures to deal with troubled assets are vital to resolve the ongoing financial crisis and to restore confidence in the global financial system.

The drying up of global liquidity conditions may adversely affect public and private sectors in the emerging and developing countries. The governments of several emerging and developing countries largely rely on external financing to finance their development activities, while the private sector, including banks, relies on external financing to supplement the domestic resources for their operational activities. The lack of access to external financing may hamper the development activities in these countries and in some cases, public sector borrowing may grow at the expense of the private sector. It has been observed that cross border bank lending has declined substantially in recent months thereby affecting emerging and developing countries' reliance on external funds for their own domestic credit expansion or for trade financing. The reduction in investors' risk appetite has resulted in a retrenchment in short-term capital flows to emerging and developing countries, exerting pressure on local markets and sharply raising costs of credit. With the drying up of financial flows to the private sector, it became imperative for the governments to implement fiscal stimulus to support economic activities and ensure financial stability.

The major international currencies experienced higher volatility, especially during the last quarter of 2008, mainly due to the intensification of the financial crisis since mid-September. The US dollar, which has been depreciating since 2002 against other major currencies reversed its trend towards the third quarter of 2008. This reflected the concerns about the growth outlook for the rest of the economies relative to the US economy as tensions in the global credit and funding markets intensified to extreme levels. The US dollar, which depreciated against the euro by 8.2 per cent to its weakest level since the inception of euro, appreciated in the third and fourth quarters of 2008 by 9.0 per cent and 1.9 per cent, respectively. Meanwhile, the Japanese Yen, which weakened against the US dollar in the first quarter, strengthened against the dollar in the third and fourth quarters by 3.5 per cent and 15.3 per cent, respectively. The Indian rupee depreciated against the US dollar at a higher rate due to substantial outflows of portfolio investment with the intensification of the global financial crisis and expected slowdown in the Indian economy. The Sterling pound too depreciated very sharply due to the weakening economic growth and fears of the economy slipping into a recession.

1.4 Medium Term Macroeconomic Outlook, Challenges and Policies

The Sri Lankan economy is projected to grow at a lower rate in 2009 and then recover its growth momentum in 2010 with expected recovery in

the global economy. The economy, which has been growing over 6 per cent continuously for four consecutive years since 2005 thereby strengthening the prospects of the economy achieving the medium-term growth targets of 8 per cent as enunciated in the medium-term macroeconomic policy framework, the Ten -year Vision, is likely to slowdown in 2009 primarily due to the impact of the global financial crisis and subsequent global recession on Sri Lanka. Several advanced and emerging economies have launched extraordinary measures to deal with the global credit crunch, while adopting expansionary fiscal and monetary policies to stimulate domestic economic growth. These measures are expected to help recovery of the global economy and thereby boost demand for Sri Lanka's exports in the medium-term. Meanwhile, stimulus packages announced by the government in respect of industries and exporters in December 2008 and banking and other financial institutions in February 2009, respectively along with the easing of monetary policy by the Central Bank are expected to boost domestic demand and avoid any drastic decline in economic activity. The implementation of the planned infrastructure projects with bilateral and multilateral external funding is expected to continue providing some stimulus to economic growth though there could be some delays in the implementation of some projects, which require considerable amount of domestic funding or external commercial funding. In addition, economic activity in certain areas in the North and East of Sri Lanka, which were liberated by the armed forces recently, is likely to surge in the medium-term with the implementation of several rehabilitation and resettlement projects under the *"Neganahira Navodaya"* (Reawakening of the East) and *'Vadakkin Wasantham'* (Flourishing North) programmes in the immediate future. The expected external and domestic financing for these projects and easing of monetary policy stance are likely to raise total investment as a percentage of GDP to 32 per cent in the medium-term. The private investment as a per cent of GDP is projected to reach around 24 per cent, while the public investment is projected to rise to over 8 per cent in the medium-term.

Financial flows to the government and the private sectors are likely to decline in 2009 and recover gradually thereafter. The foreign financial flows to emerging and developing countries have drastically declined in 2008 due to the ongoing financial crisis and resultant uncertainties in the global financial markets, and this trend is expected to continue in 2009 as well. Though the government continues to receive financial flows from development partners out of funds already committed by them, it has become very challenging to raise loans from international markets at competitive rates of interest. As a result, implementation of some of the projects that require additional foreign financing and substantial domestic financing might have to be postponed or implemented at a slower pace, especially in 2009. However, in the medium-term with the expected recovery of the global economy, the government would be able to mobilise required external commercial financing to supplement the disbursement of committed funds by Sri Lanka's development partners. By end 2008, the government had a cumulative financial commitment of around US dollars 5.9 billion from Sri Lanka's development partners in the pipeline as compared to US dollars 4.7 billion at end 2007 and this amount is likely to increase further in the medium-term with the expected external funding for resettlement and rehabilitation of the liberated Northern and Eastern Provinces of Sri Lanka.

Inflation, which decelerated to a single digit in February 2009, is projected to remain at a single digit level throughout 2009 and stabilise at a low level in the medium-term. The high inflation experienced over a long period of time remains one of the weaknesses in the Sri Lankan economy. This has been fuelled largely by the excessive monetary expansion arising from the increased financing of widening fiscal deficits with bank resources. In order to contain the inflation and inflation expectations, the Central Bank adopted a quantity based stringent monetary policy strategy in 2007 and 2008 that has yielded desired results supported by declining international commodity prices. With the expected global recovery, the international commodity prices might also revert to pre-crisis levels. Hence, in

Box 2

The Development of Northern Province: Potential and Strategies

The Northern Province (NP), one of the biggest provinces in Sri Lanka by land mass, comprises five districts, namely, Jaffna, Kilinochchi, Mannar, Mullaitivu and Vavuniya[1]. It covers a land area of 8,884 square kilometres accounting for 13.6 per cent of the total land area of the country with an estimated population of about 1.3 million, which is about 6.5 per cent of the country's total population. The NP is enriched with a range of natural resources such as fertile agricultural lands, mineral ores, forests, scrublands, wet lands, beautiful beaches, the coastal shallow sea from Trincomalee to Mullaitivu enriched with a very high fish density in seas around the country and coral deposits. However, for more than 25 years, the NP had been adversely affected by the internal conflict situation. As such, the government intervention in economic activities in this area was severely restricted. The prolonged conflict in the NP has brought a significant devastation to the region. It is manifested by the displacement of a large number of families, damages to basic infrastructure facilities, badly affected educational and training facilities, weak banking facilities, destruction of productive assets and properties and a significant disruption to the major economic activities in agriculture, livestock, fisheries, small industry as well as health and education services.

Before the intensification of the conflict in early 1980s, the NP played an important role in the overall economy, particularly in the areas of agriculture, livestock and fisheries, utilizing available resources effectively[2]. In addition, the province was rich in developing productive human resources such as professionals in the civil and business sectors as well. Some small scale industries such as light manufacturing and textiles were also present before the escalation of the terrorist activities. However, with much of the infrastructure facilities in the province being destroyed due to the conflict, the usage of resources in NP has also declined sharply thereby reducing the income earning capacity of the people. The lack of regular connectivity with the Southern part of the country has been one of the major obstacles for uplifting the Northern economy.

With the gradual decline in economic activities, the contribution of the province to the overall Gross Domestic Product (GDP) continued to decline and accounted for only 2.9 per cent in 2007, which is significantly lower than its potential level. According to a survey conducted by the Census and Statistics Department in 2005, the mean household income per month in NP was Rs. 16,725 per month compared to the national average of Rs. 20,048. Other socio-economic indicators, such as child and maternal mortality and malnutrition, also deteriorated in the NP due to the conflict. Hence, the liberation of the entire province from the clutches of terrorism has provided a golden opportunity to revive the prospects of the region. Therefore, it is necessary to implement a comprehensive development programme to bring the lost prosperity back to the province, as in the Eastern province.

Several projects have been already identified in the comprehensive public investment programme of the government "*Randora*" to be implemented in the NP such as the construction of the Mannar Bridge at a cost of Rs. 2,116 million and the Jaffna Water Supply Scheme costing Rs. 11,800 million. In 2009, allocations have been provided for the development activities in the NP through different Ministries. These development activities include *Gama Neguma* (village reawakening) project, construction of the Mannar Bridge, Kankesanthurai Port Development project and *Maga Neguma* project. However, with the significant progress that has been made in the liberation of the NP, the government has decided to accelerate the development programme in the NP.

In line with this, the government, in its Budget 2009, has announced a comprehensive programme called *'Vadakkin Wasantham'* (Florishing North) covering all districts in the province. Accordingly, this programme primarily aims at resettlement of people and rehabilitation and reconstruction of economic infrastructure to restore livelihoods and basic needs such as water supply, sanitation, electricity, health and education facilities etc. and the creation of income

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[1]The NP consists of two distinct geographic areas known as (1) Jaffna peninsula where the majority of the NP population lives, and (2) Vanni, which is made up of the remaining four districts; Kilinochchi, Mannar, Mullaitivu and Vavuniya.

[2]The main products of the NP, particularly in Jaffna, include sea products, red onion, mangoes, grapes and tobacco.

generating activities in the province. The reconstruction of the rail track and highways connecting the North and the South and schools, hospitals, government offices and about 80,000 houses are envisaged in this plan. The rehabilitation of the children, women and youth living in the area, and the rehabilitation of the former LTTE members and making them useful citizens in the society will also be priorities. With these initiatives, additional allocations of Rs. 3,000 million were made available to the Ministry of Nation Building and Estate Infrastructure Development (MNB) for providing welfare facilities, initiating reconstruction and rehabilitation activities, while a sum of Rs. 500 million also has been provided to the Ministry of Resettlement and Disaster Relief Services as an additional allocation to carry out resettlement programmes in NP.

The relevant authorities are now in the process of finalising short-term, medium-term and long-term development priorities under the *'Vadakkin Wasantham'* programme which will be implemented soon after obtaining the necessary security clearances. The main responsibility of implementing this programme has been vested with the MNB. As an initial step, a new division, called 'Northern Regional Development Division', has already been established within the MNB. Accordingly, planning and preparation of progammes, implementation, coordination, monitoring, progress review and follow-up action have been entrusted to this division. A multi-sectoral integrated development process, covering social and economic infrastructure, general services and cultural aspects, will be adopted under this programme to address the total development of the NP. The institutional impediments to commence productive activities in all sectors of the NP will also be addressed gradually. The coordination of the development activities with line Ministries and development partners will also be carried out by MNB. The cost estimation for the entire programme is in progress and development partner assistance is expected to be obtained to finance the identified projects.

Some Internally Displaced Persons (IDPs) have already come to the special camps and as an immediate step, government continues to provide them with basic needs such as food, water, clothes, health and shelter, with the assistance of international organisations and the general public. Education facilities are also being provided in temporary schools initially. Under the development programme, as a short-term measure, building of semi-permanent houses for IDPs have already been started and IDPs in temporary camps will be settled in those houses until permanent settlement arrangements are made by the government.

In order to restore the livelihoods of the people, various incentive schemes are to be implemented covering fishing and agriculture, agriculture processing, palmyrah, coconut and cashew plantations with a major focus on rural based micro-industries in the medium-term. Priority also will be given to empowering the co-operative movement and revitalising the civil administration in the province. The reconstruction of roads and restoration of electricity transmission and distribution network will be implemented. In the longer term, development projects which have already been identified to be implemented soon in these areas such as the Northern highway connecting Kandy and Jaffna, Jaffna water supply and sanitation scheme, Mannar bridge, Vavuniya-Kilinochchi transmission line project and expansion of the Jaffna university are planned to be expedited.

Measures will also be taken to exploit the wide range of natural resources in the NP. Accordingly, the re-establishment of the major factories such as the Cement Factory at Kankesanthurai and Chemical Factory at Paranthan will be expedited. Several projects aiming at promoting self-employment opportunities in palmyrah based industries and processing of other agricultural products such as onions, chillies, potatoes, grapes and mangoes etc. are to be implemented over the years. The opening of the A9 and A32 highways will result in the re-integration of the NP economy with the rest of the country, which will lead to enhanced flow of produce of NP to other provinces and vice versa, thereby creating new opportunities to the people in the NP. In order to complement these efforts, measures will also be taken to attract investment and business interest from the NP diaspora to convert their accumulated financial and human capital into the development process in addition to the funds to be provided by the government, private investors, and development partners. By implementing all these programmes, the government expects to rehabilitate and rebuild the devastated NP and bring the lost prosperity back to the region.

order to maintain inflation at a single digit level in the medium-term, it is imperative to continue with an appropriate tight monetary policy stance, while being accommodative to some extent during the ensuing periods to cushion the adverse impact of financial crisis.

The continuous decline observed in the unemployment rate during recent years may reverse during 2009 due to the impact of global economic recession, but would likely to revert in the medium-term supported by global recovery and the resultant boost for domestic production, and increased new economic activities in the North and East. The unemployment in the country has been continuously declining primarily due to substantial increase in recruitment to the public sector, increased foreign employment opportunities, and sustained expansion in the domestic economy. However, due to the current global conditions, recruitment for foreign employment might suffer as Sri Lanka's major labour hiring countries are experiencing a severe economic downturn, while the declining external demand for

Table 1.5 **Medium Term Macroeconomic Framework: 2008 - 2012 (a)**

Indicator	Units	2007	2008(b)	Projections 2009	2010	2011	2012
Real Sector							
GDP at Market Prices	Rs. bn	3,579	4,411	4,927	5,665	6,485	7,324
Real GDP Growth	%	6.8	6.0	2.5	5.0	6.0	6.5
Inflation-GDP Deflator	%	14.0	16.3	9.0	9.5	8.0	6.0
Total Investment	% of GDP	28.0	27.5	24.0	27.0	29.0	32.0
Domestic Savings	% of GDP	17.6	14.1	16.6	18.7	20.3	22.8
National Savings	% of GDP	23.4	18.0	21.5	24.2	26.2	29.5
External Sector							
Trade Gap	US$ mn	-3,656	-5,871	-3,365	-3,967	-4,476	-5,171
Exports	US$ mn	7,640	8,137	7,394	7,911	8,720	9,620
Imports	US$ mn	11,296	14,008	10,759	11,878	13,196	14,790
Services, net	US$ mn	302	402	300	357	449	581
Current Account Balance	US$ mn	-1,401	-3,775	-931	-1,165	-1,269	-1,208
Current Account Balance	% of GDP	-4.3	-9.3	-2.2	-2.7	-2.7	-2.4
Overall Balance	US$ mn	531	-1,225	-141	592	603	614
External Official Reserves (Months of Imports) (c)	Months	3.3	1.5	3.0	3.2	3.5	3.6
Debt Service Ratio (d)	%	13.1	15.0	17.2	14.8	13.9	16.5
Fiscal Sector							
Revenue	% of GDP	15.8	14.9	15.1	16.0	16.7	16.7
Expenditure and net lending	% of GDP	23.5	22.6	22.1	22.0	21.7	21.6
Current Account Balance	% of GDP	-1.6	-2.0	-1.3	-0.2	1.0	1.1
Overall Budget Deficit	% of GDP	-7.7	-7.7	-7.0	-6.0	-5.0	-4.9
Domestic Financing	% of GDP	4.1	7.0	6.9	4.4	3.5	3.3
Financial Sector (e)							
Reserve Money Growth	%	10.2	1.5	11.9	13.3	14.2	12.6
Broad Money Growth (M_{2b})	%	16.6	8.5	14.0	14.5	14.0	12.7
Narrow Money Growth (M_1)	%	2.7	4.0	8.0	10.0	10.0	8.0
Growth in Credit to Private Sector	%	19.3	7.9	14.1	13.3	12.6	11.0
Growth in Credit to Public Sector	%	8.9	46.2	24.1	-1.4	-0.8	0.3

(a) Based on the information available as at mid-March 2009.
(b) Provisional.
(c) External official reserves from 2009 onwards include the expected inflows from the IMF
(d) Total debt service payments as a percentage of earnings from merchandise exports and services.
(e) Point-to-point growth in end-year values.

Sources: Ministry of Finance and Planning
Central Bank of Sri Lanka
Department of Census and Statistics

1 ECONOMIC, PRICE AND FINANCIAL SYSTEM STABILITY, OUTLOOK AND POLICIES

Sri Lankan products might lead to lower domestic production causing some job losses in 2009. The unemployment rate, which declined to 6.0 per cent in 2007 further declined to around 5.2 per cent in 2008 with a considerable increase in departures for foreign employment and recruitment to the public sector. As there will be more employment opportunities in the near future, both locally and overseas with the expected global recovery, it would be prudent to use the current situation to train and retrain the unemployed in areas where there will be more employment opportunities. Meanwhile, as the public service is already overstaffed and absorbs a substantial part of budgetary allocation, it is imperative that further recruitment be limited by the government assessing the essential cadre requirement in the public sector.

The year 2009 will be a challenging one in terms of fiscal operations, particularly in the midst of the continuing global financial crisis and economic slowdown coupled with the need for accelerating the humanitarian and development activities in the newly liberated areas. Any further deceleration in economic activities during the course of the year would adversely affect the expected revenue collection in 2009. The potential spillover effects of the global financial crisis may necessitate the government to adopt decisive and properly conceived responses through additional fiscal measures to mitigate such negative effects. In such a scenario, given the limited fiscal space, it is vital to ensure that measures so introduced are well targeted, temporary and contribute to stimulate economic activities without having a significant fiscal slippage. In the meantime, the provision of sufficient funds to develop the Northern and Eastern provinces has to be continued considering its utmost importance. Therefore, taking complementary measures to minimise the revenue shortfall and the creation of room in the recurrent budget to offset the additional expenditure to the maximum possible extent, should be given the highest priority in the overall fiscal strategy towards minimising the adverse ramifications emanating from the global financial crisis at this important juncture. Once these issues are addressed effectively, the government will be able to switch into the normal medium term fiscal consolidation path, announced along with Budget 2009.

The continuation of the measures towards fiscal consolidation is essential in order to ensure low fiscal deficit and price stability. To ensure a sustainable higher economic growth and anchor the inflation expectation towards low inflation, it is crucial that the government fast track the fiscal consolidation measures on a priority basis. The medium-term fiscal consolidation efforts need to particularly focus on addressing the still prevailing drawbacks in the country's fiscal system. The shortfall in the revenue collection and expenditure overruns increase the government's borrowing requirement thereby augmenting the outstanding debt and future interest cost. It has been observed that more often, the government borrowing from the banking system has far exceeded its original targets by a substantial amount posing major challenges to the monetary authority in the conduct of monetary policy. In addition, the higher domestic borrowings, especially to meet recurrent expenditures, pre-empts the available resources for public investment thereby seriously affecting the future growth potential of the country, which is a huge opportunity cost compared to the benefits that could accrue to the country from capital investments in the future. The monetary policy measures implemented to contain the excessive monetary expansion in the economy inevitably lead to contraction of credit to the private sector as the government's borrowings are insensitive to market interest rates. This would adversely impact on the private sector, which generally contributes to the largest share of domestic production thereby retarding the future growth prospects of the country. The government's borrowings from the domestic banking system are likely to increase sharply in 2009 as well, since it will be very challenging to raise loans from external sources under the current global conditions. In this context, it will be prudent to postpone the implementation of any new mega projects till the recovery of global financial markets, while carrying out projects that are already in progress at a slower pace to keep the domestic financing requirement in check. Alternatively, government should explore the possibility of obtaining the entire project financing requirement from the development partners. Despite the adjustment of domestic fuel prices to reflect the costs, and the revision of passenger transport fares and electricity prices in the recent past, the performance of some State Owned Enterprises (SOEs) still remains a concern and the financial viability of major State Trading Enterprises (STEs) also remains a strain on the government budget, highlighting the necessity of introducing appropriate measures to rectify these issues.

It has been difficult to bring down the market interest rates and enhance private sector credit due to several constraints. The heavy exposure of state banks to the government and hence their inability to expand credit to the private sector and the high Treasury bill yield rate, which is the benchmark for deposit rates, and high cost of funds are among them. Hence, the monetary policy would not be effective unless fiscal consolidation is achieved with a significant reduction in the exposure of state banks and domestic financing.

The government, after identifying the implications of deviating fiscal aggregates to unsustainable levels, has already announced its commitment to address the above drawbacks in its various policy documents, including the Ten-year Vision. This is particularly manifested in the medium-term plans to reduce the overall budget deficit to a sustainable level to meet the targets in the Fiscal Management (Responsibility) Act (FMRA) through enhancing the revenue by improving tax administration and expanding the tax base, containing recurrent expenditure, and maintaining a relatively high level of public investment. Meanwhile, the debt management policy also has to be directed towards improving domestic debt market activities, facing the challenge of accessing foreign concessional financing in the future being an emerging middle income country, and finding alternative financing sources, such as Public-Private Partnerships (PPPs) to reduce the burden on the government budget. In this context, the timely and dedicated implementation of the planned fiscal consolidation framework is essential to achieve the anticipated targets and thereby to avoid adverse ramifications that high fiscal deficits would have on the country's overall macroeconomic management, including monetary management, and the realisation of anticipated high and sustainable economic growth in the medium term.

Under the current global conditions, SMEs are facing severe difficulties and hence need fiscal and monetary support to ensure their viability under the trying conditions. Certain sectors of the economy, which are either directly or indirectly linked to exports, have been affected by the global economic recessions. In this regard, particularly the SMEs require some respite to continue to be in existence as the lack of demand for their products and high financing cost threatened their operational viability. As current difficulties faced by them are due to global factors, the government should create some fiscal space to assist them as a significant number of people depend on this sector for their sustenance. The Central Bank has also been taking steps to reduce interest rates, while progressively lowering the statutory reserve requirements in order to increase market liquidity and reduce the cost of funds. However, in these trying circumstances, it is essential for SMEs to reorganise themselves to face the current challenges, which are expected to fade away in the period ahead, in order to improve their productivity.

Due to concerns on the counterparty risks, banks appear to have tightened their self imposed inter-bank lending limits while taking even greater caution in extending credit to customers for fear of possible default in the current environment. The confidence on the financial markets has eroded considerably with the intensification of the global financial crisis and the resultant uncertainty in the markets. Consequently, banks and other lending institutions have been exercising greater caution in lending and charge higher premia on lending rates raising the cost of borrowings. As a result of these developments, financial flows among banks, investors, businesses and borrowers have been affected and may even dry up, eventually affecting the expected recovery and future growth prospects of the country. In this context, banks and other financial institutions are encouraged to lend to each other and to other economic agents to avoid a further slide in economic activity as the current global environment is expected to rebound in the immediate future, and banks could gain more business opportunities once the economy recovers. The Central Bank has encouraged and facilitated commercial banks' lending activities by relaxing the monetary policy stance and providing liquidity to meet requirements of market participants.

The collapse of several illegal deposit taking institutions have posed a threat to the financial system stability creating uncertainty among the general public warranting effective action to avoid it spilling over to the regulated financial institutions. Though the domestic banks and other financial institutions were not directly affected by the global financial crisis, primarily due to the existing restrictions on foreign investment by these financial institutions, the collapse of a few illegal deposit taking institutions caused some panic in the domestic financial markets. Consequently, there was a tendency to withdraw deposits even from registered finance companies posing a threat to financial institutions. The Central Bank has been continuously engaged in educating the general public, which includes the publication of a list of registered finance companies in the mass media and warning the general public to be vigilant about illegal deposit mobilisation by various institutions and individuals under a different guise. However, it appears that some members of the public have ignored the high risks associated with depositing their money with the illegal institutions as they were searching for higher returns for their deposits. Considering this situation, the Central Bank is in the process of amending the Finance Companies Act with the view of strengthening the provisions prohibiting illegal financial businesses and deposit-taking. In addition, the definition of "deposits" is also to be widened to cover a broader range of fund mobilisation activities while the acceptance of deposits without authorisation will also be made an offence.

The economic recession in Sri Lanka's major markets have highlighted the benefits of diversifying exports, in terms of types of goods as well as markets. It has become imperative to tap into the vast regional markets through the proper implementation of the range of existing regional and bilateral trade agreements. Given the centrality of the country's location and associated logistics, catering to demand from both, the developed economies and the emerging markets, may not be a difficult task, if properly planned. Apparel products continue to be the single largest industrial export, though the country's export structure has diversified to some extent since the liberalisation of the economy in 1977. In terms of markets, Sri Lanka's exports to the US have continued to decline, while exports to the EU have improved, especially under the increased market access offered under the GSP+ scheme. The EU has extended the GSP+ scheme for Sri Lanka for 3 years from 2009-2011, subject to an investigation. In this context, the government would need to coordinate activities with the apparel exporters to initiate diplomatic actions, jointly, to obtain duty free market access to the US and to continue to have the duty free access to the EU market. Meanwhile, the exporters should make concerted efforts to penetrate into other emerging markets and the government should formulate an effective industrialisation and export strategy to diversify the export structure and the markets. In this respect, it is necessary to formulate strategies jointly with the exporters to penetrate into the giant markets of India and Pakistan where duty free market access under the free trade agreements (FTAs) is available, but has not yet been fully harnessed.

Private sector participation in financing and operation of major infrastructure facilities should be encouraged as financing of these projects entirely by the government would lead to a higher fiscal burden in the future requiring more resources to service higher debt. The continuous budgetary support for infrastructure development, despite fiscal constraints, is laudable, while more efforts to catalyse greater private financing through Public Private Partnerships (PPPs) are needed to supplement government investments and for a sustained development of infrastructure. In fact, PPP is a joint venture between the government and the private sector, where the private sector will contribute to the capital, engage in management and share profits or losses. In this regard, as an initial step, it is necessary to increase awareness on PPPs, among all stakeholders, including politicians and policy makers, while creating necessary regulatory and administrative mechanisms to encourage private investment and to ensure quality of services and fair pricing. It should be noted that consistent policy, good governance and transparency, institutional capacity building, effective regulations and efficient financial markets are prerequisites in promoting private investments in both economic and social infrastructure projects. A proper mechanism to promote PPPs will eventually reduce government commercial borrowings in the backdrop of gradually declining concessional loans from Sri Lanka's development partners as a result of the increasing per capita income of the country and substantially reduce the future fiscal burden of the government. This would enable the government to use the available limited resources to provide public goods in which, the private sector is reluctant to provide, thereby raising the overall economic efficiency.

It is commendable that the government has taken initiatives, through the passing of the Sri Lanka Electricity Bill (SLEB) in the Parliament, aimed at removing the structural bottlenecks at the Ceylon Electricity Board (CEB) to ensure its commercial viability. The CEB is one of the public utilities that has been making persistent operational losses due to numerous structural weaknesses. In this context, the Sri Lanka Electricity Act (SLEA) provides the basic legal framework for separation of specific operational activities an allows the Public Utilities Commission of Sri Lanka (PUCSL) to regulate the electricity sector. Nevertheless, the Act still imposes certain constraints on private sector participation in key areas of operation, such as generation and distribution, whereby either complete or partial involvement of the government in the generation and distribution is compulsory. In addition, the CEB will continue to function as a vertically integrated utility with powers to hold generation, transmission and distribution licences simultaneously. Further, the CEB needs to implement identified low cost new power projects as planned to cater to the future demand, which is likely to increase further with the liberation of the Northern and the Eastern Provinces.

Proper and sound business strategies need to be introduced in all public corporations to ensure their commercial viability. The Ceylon Petroleum Corporation (CPC) faces serious liquidity problems due to non-realisation of outstanding bills from several government institutions including the CEB, which owes a substantial amount, thereby making it difficult to remain as a commercially viable institution. As a result, the CPC has borrowed heavily from commercial banks to settle import bills thereby incurring high financial costs leading to operational losses. This situation highlights the need for proper assessment of commercial viability of the loss making corporations and the introduction of proper business strategies to run them as profitable ventures.

The initiatives launched in 2007 towards oil exploration need to be continued to harness potential petroleum resources in the country. The oil exploration process was initiated in 2007 when the oil prices were rising to historically high levels. Accordingly, the Ministry of Petroleum and Petroleum Resources Development called for bids from international oil companies for petroleum exploration in Blocks 2, 3 and 4 in the Mannar Basin. The Cairn India Ltd., was selected as the successful tenderer and has been offered the licence for exploring oil in the Block 2. Cairns Lanka Ltd., the local subsidiary of Cairn India Ltd. is to commence exploration activities during the first quarter of 2009. The continuation of this process as planned is important despite the sharp dip in international oil prices, as the oil prices are bound to surge sharply once the global economy recovers in the period ahead.