Chapter 1

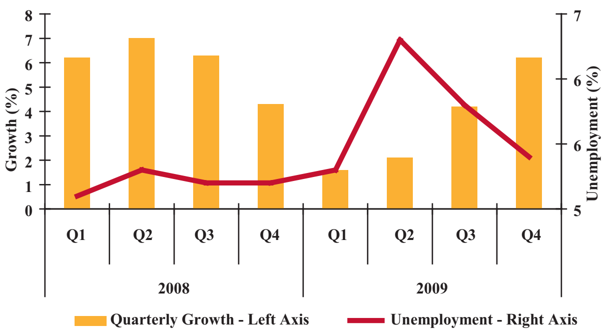
ECONOMIC, PRICE AND FINANCIAL SYSTEM STABILITY, OUTLOOK AND POLICIES

1.1 Overview

The economy of Sri Lanka demonstrated its resilience by growing at 3.5 per cent in 2009 amidst most challenging domestic and external conditions. This remarkable performance was largely due to the steady recovery in the economy since the second quarter of the year, resulting in a notable growth of 6.2 per cent in the final quarter. On the external front, Sri Lanka continued to be impacted by the spill-over effects of the global financial and economic crises, while domestically, the internal conflict, which had ravaged the country for almost three decades reached a critical juncture during the early part of the year. The sudden withdrawal of capital by foreign investors resulting from adverse global conditions placed an enormous strain on the country's foreign reserves and the management of liquidity. The slump in global demand and the consequent contraction in external trade as well as the slowdown in domestic economic activity had a negative impact on government revenue. In addition, higher government expenditure on defence, interest payments, salaries and wages as well as the continuation of urgent resettlement, rehabilitation and reconstruction (RRR) activities exerted a heavy burden on government finances. Despite these unprecedented challenges, the country made an extraordinary recovery in the second half of the year. The end to the prolonged conflict and the coordinated and timely policy actions of the Central Bank of Sri Lanka (CBSL) and the government, including the securing of the Stand-by Arrangement (SBA) from the International Monetary Fund (IMF) and measures taken to preserve financial system stability, were instrumental in turning around the domestic economy. Enhanced investor confidence in the economy saw a sharp reversal in foreign financial flows helping the country to record an unprecedented surplus in the balance of payments (BOP) of US dollars 2.7 billion by end 2009 and raising foreign exchange reserves from a low level of US dollars 1.1 billion in March 2009 to a historic high of US dollars 5.1 billion by end 2009.

A notable achievement in 2009 was the sharp deceleration in inflation, a result of the prudent monetary policy measures adopted by CBSL over the last few years and the significant decline in global commodity prices. Inflation, as measured by the year-on-year change in the Colombo Consumers' Price Index (CCPI), which reached 28.2 per cent in June 2008, declined sharply to 4.8 per cent by end of 2009, recording an overall average rate of

Chart 1.1 Quarterly Growth and Unemployment

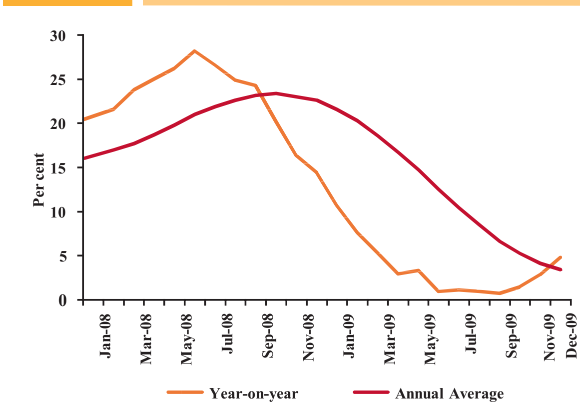


3.4 per cent in 2009, the lowest since 1985. This enabled CBSL to relax its monetary policy stance to support the domestic economy, which was affected by the global economic downturn. The Penal rate of interest applicable on reverse repurchase (reverse repo) transactions with CBSL when participating institutions exceeded their monthly quota and served as an effective ceiling for interbank interest rates was reduced gradually from 19 per cent in January 2009 and was harmonised with the reverse repo rate in May 2009. Further, Repo and Reverse Repo rates were brought down in several steps to 7.5 per cent and 9.75 per cent, respectively. In response to the significant reduction in policy interest rates, there was a substantial downward adjustment of market interest rates across the term structure, albeit with a time lag. However, the demand for credit from the private sector remained subdued largely due to the sluggish recovery in the domestic and the global economies as well as the cautious approach to lending by banks. However, monetary growth, which remained subdued during the first half of the year, began to increase during the second half with the unprecedented expansion in net foreign assets (NFA).

The policy action of CBSL, supported by the government, successfully mitigated the contagion of the global financial and economic crises and the failure of a few entities connected to certain domestic financial institutions. The strong regulatory and supervisory framework and enhanced risk management systems that have been put in place over time enabled the financial system to withstand the shocks from the external and domestic fronts and maintain confidence in the financial system. However, the spill-over effects of the global economic downturn on the domestic economy posed a challenge for banks and other financial institutions. In this challenging environment, financial institutions remained profitable and reasonably well capitalised, although credit risk increased due to tight market conditions.

The impact of the challenging domestic and global environment resulted in an overall set-back in fiscal operations in 2009. Despite several revenue measures introduced during the year, there was a significant shortfall in revenue due to the slowdown in economic activities and the contraction in imports. In addition, government expenditure increased due to higher security related spending during the decisive phase of the conflict and continued urgent RRR activities in the second half of the year, as well as increased salaries and wages, interest payments and expenditure on continuing public investment projects. Accordingly, the budget deficit widened to 9.8 per cent of GDP in 2009 compared to the revised target of 7.0 per cent leading to an increase in the borrowing requirement. In financing the deficit, greater reliance was placed on domestic sources during the early part of 2009. However, the availability of foreign financing during the latter part of the year enabled the settlement of some high cost domestic debt. The higher financing requirement together with lower growth in nominal GDP led to an increase in the debt to GDP ratio, reversing the declining trend observed in the recent past.

Chart 1.2 Movements in Inflation



The end to the prolonged internal conflict and the restoration of peace provide a greater optimism on economic prosperity providing a strong basis for long-term sustainable development, supported by appropriate policies. The opportunities created by the restoration of peace, will be complemented by the ongoing global economic recovery. The current low inflation and interest rate regime also provides a conducive environment to fuel economic activities. To harness these opportunities, the existing bottlenecks that hinder a faster growth need to be addressed urgently. Infrastructure projects, already commenced and planned, need to be accelerated to expand the productive capacity of the economy and to improve the efficiency and productivity of economic activities. At the same time, special attention needs to be paid to implement much needed structural and institutional improvements, including the enhancement of the profitability and productivity of public enterprises that are a significant drain on public finances. The fiscal consolidation process also needs to be strengthened. The contribution of the private sector to overall economic development needs to be encouraged. The regulatory framework has to be further strengthened. Establishment of a strong development planning and monitoring process would be helpful to prioritise projects, avoid delays and ensure optimal distribution of resources. In the short to medium-term, moving to a high growth trajectory while maintaining price stability remains a key policy challenge. In this respect, it is very important to recognise the need for a gradual and cautious unwinding of accommodative fiscal and monetary policies as the recovery gathers momentum in order to prevent inflationary pressures forming in the economy.

1.2 Macroeconomic Developments, Stability and Policy Responses in 2009

Real Sector Developments

The Sri Lankan economy grew by 3.5 per cent, in real terms, in 2009, a commendable achievement in spite of a number of external and domestic shocks. The economy recovered strongly to record a notable 6.2 per cent growth in the fourth quarter from a mere 1.6 per cent in the first quarter. The impact of adverse global developments that affected almost all sectors of the economy at varying levels, and unfavourable domestic weather conditions that lowered agricultural output were the main causes for the lower growth rates in the first quarter. However, since the second quarter, growth has rebounded driven by the end to the conflict and the gradual recovery of the global economy.

In 2009, all major sectors of the economy contributed positively to economic growth. The Agriculture sector recorded a low growth of 3.2 per cent compared to a high growth of 7.5 per cent in 2008, mainly owing to the contraction in the output of tea and paddy. However, within the Agriculture sector, the fisheries sub-sector performed well recording a 6.9 per cent growth driven by increased coastal fishing with the relaxation of security restrictions. The Industry sector slowed down registering a growth rate of 4.2 per cent compared to a growth of 5.9 per cent in 2008. All sub-sectors of the Industry sector, except for electricity, gas and water, recorded low growth rates compared to the previous year, largely as a result of the drop in demand in both international and domestic markets. The Services sector grew by 3.3 per cent in 2009 contributing 55 per cent to the overall economic growth. The wholesale and retail trade sub-sector, which is the largest contributor to the Services sector, registered a sluggish performance, mainly reflecting the contraction in import and export trade. The transport and communication sub-sector also slowed down considerably due to the low growth in telecommunication services and cargo handling. The slowdown in domestic economic activity resulted in a marginal increase in the unemployment rate (excluding the Northern Province), to 5.8 per cent in 2009 from 5.4 per cent in 2008.

The lower growth in the Agriculture sector in 2009 was due to several factors. While the tea production was adversely affected by the drought in the major tea planting districts in the early part of the year, paddy production in the Yala season was severely affected as a result of the delay in the monsoon. Coconut production in 2009 declined

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 (%)	
	2008(a)	2009(b)	2008(a)	2009(b)	2008(a)	2009(b)	2008(a)	2009(b)
Agriculture	**285,897**	**294,921**	**12.1**	**12.0**	**7.5**	**3.2**	**15.1**	**10.8**
Agriculture, Livestock and Forestry	258,881	266,033	10.9	10.9	7.3	2.8	13.2	8.5
Fishing	27,016	28,888	1.1	1.2	9.9	6.9	1.8	2.2
Industry	**672,791**	**701,129**	**28.4**	**28.6**	**5.9**	**4.2**	**28.3**	**33.8**
Mining and Quarrying	48,090	52,030	2.0	2.1	12.8	8.2	4.1	4.7
Manufacturing	413,681	427,334	17.5	17.4	4.9	3.3	14.6	16.3
Electricity, Gas and Water	56,847	58,974	2.4	2.4	2.7	3.7	1.1	2.5
Construction	154,173	162,790	6.5	6.6	7.8	5.6	8.4	10.3
Services	**1,406,813**	**1,453,254**	**59.5**	**59.3**	**5.6**	**3.3**	**56.6**	**55.4**
Wholesale and Retail Trade	571,911	570,152	24.2	23.3	4.7	-0.3	19.4	-2.1
Hotels and Restaurants	8,741	9,901	0.4	0.4	-5.0	13.3	-0.3	1.4
Transport and Communication	310,029	330,390	13.1	13.5	8.1	6.6	17.5	24.3
Banking, Insurance and Real Estate etc.	206,048	217,819	8.7	8.9	6.6	5.7	9.5	14.0
Ownership of Dwellings	73,137	74,051	3.1	3.0	1.1	1.3	0.6	1.1
Government Services	181,051	191,778	7.7	7.8	5.7	5.9	7.4	12.8
Private Services	55,896	59,164	2.4	2.4	6.5	5.8	2.6	3.9
Gross Domestic Product	**2,365,501**	**2,449,304**	**100.0**	**100.0**	**6.0**	**3.5**	**100.0**	**100.0**
Net Factor Income from Abroad	-56,330	-28,332			-131.2	49.7		
Gross National Product	**2,309,172**	**2,420,972**			**4.6**	**4.8**		

(a) Revised
(b) Provisional

Source : Department of Census and Statistics

largely owing to the lagged effect of the unfavourable weather conditions that prevailed during the previous year. Sugar production also declined during the year due to the decline in sugar cane supply on account of adverse weather conditions. Nevertheless, the healthy performances of several sub-sectors, such as rubber, other field crops mainly maize and big onions, fish and livestock, helped maintain a moderate growth in the Agriculture sector in 2009.

The Agriculture sector benefited from better prices. The buoyancy in tea prices in 2009 helped producers to mitigate the impact of lower production. Paddy prices continued to remain high due to the shortage of paddy as the Yala harvest declined. Maize and coconut oil fetched high prices due to limitation of imports by the protection provided through customs duties. The price of liquid milk remained high owing to the price support mechanism continued by the government to encourage local milk production. The farmgate price of broiler chicken and eggs recorded very high prices in the second half of the year as demand grew towards the end of the year and the price of animal feed increased.

The government took several measures to support the Agriculture sector during the year. An interest subsidy was granted for loans obtained by tea factory owners and a guaranteed price scheme was introduced for rubber growers affected by low international prices due to the global financial crisis. Import duties on palm oil were increased to support the local coconut oil industry. The fertilizer subsidy scheme was continued for the paddy sector and the tea small holder sector. The government has given special attention to promote fisheries and dairy sectors in the former conflict affected areas. Meanwhile, action was initiated to re-commence operations in the sugar factories at Hingurana and Kantale with a view to increasing local sugar production.

The output of the Industrial sector grew by 4.2 per cent in 2009 compared to 5.9 per cent in 2008. The deceleration of the growth was mainly due to the slowdown of factory industry, which contributed more than 55 per cent to the industrial sector output in 2009. The output of textile, wearing apparel and leather products, rubber based products and other export market based products recorded a low growth

Table 1.2 **Aggregate Demand and Savings Investment Gap**

Item	Rs. billion		Growth %		As per cent of GDP	
	2008(a)	2009(b)	2008(a)	2009(b)	2008(a)	2009(b)
1. Domestic Demand	5,014.3	5,139.0	26.9	2.5	113.7	106.5
1.1 Consumption	3,799.1	3,955.4	28.8	4.1	86.1	82.0
Private	3,085.3	3,103.8	28.4	0.6	70.0	64.3
Public	713.8	851.5	30.6	19.3	16.2	17.6
1.2 Investment (Gross Domestic Capital Formation)	1,215.2	1,183.7	21.5	-2.6	27.6	24.5
Private	929.1	865.1	15.1	-6.9	21.1	17.9
Public	286.1	318.6	48.3	11.3	6.5	6.6
2. Net External Demand	-603.6	-313.9	-62.6	48.0	-13.7	-6.5
Exports of Goods and Services	1,095.7	1,030.9	5.2	-5.9	24.8	21.4
Imports of Goods and Services	1,699.3	1,344.8	20.2	-20.9	38.5	27.9
3. Total Demand (GDP) (1) + (2)	4,410.7	4,825.1	23.2	9.4	100.0	100.0
4. Domestic Savings (3) - (1.1)	611.6	869.7	-2.8	42.2	13.9	18.0
Private	700.0	1,046.7	1.9	49.5	15.9	21.7
Public	-88.5	-176.9	-53.3	-100.0	-2.0	-3.7
5. Net Factor Income from Abroad	-105.0	-55.8	-168.9	46.9	-2.4	-1.2
6. Net Private Current Transfers	277.7	336.6	13.3	21.2	6.3	7.0
7. Natinal Savings (4) + (5) + (6)	784.3	1,150.5	-6.1	46.7	17.8	23.9
8. Savings Investment Gap						
Domestic Savings - Investment (4) - (1.2)	-603.6	-313.9			-13.7	-6.5
National Savings - Investment (7) - (1.2)	-431.0	-33.2			-9.8	-0.7
9. External Current Account Deficit without						
Official Grants (2) + (5) + (6)	-431.0	-33.2			-9.8	-0.7

(a) Revised
(b) Provisional

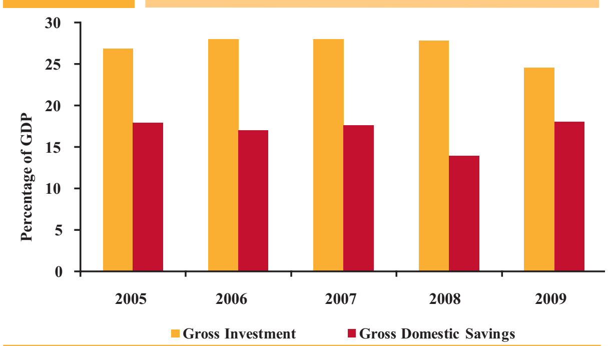
Sources : Department of Census and Statistics
Central Bank of Sri Lanka

in 2009. However, major players in the textile, wearing apparel and leather products category continued to maintain their competitiveness by supplying high quality and high valued products. Small and medium scale manufacturers were affected by the low demand in both export and the domestic markets and the increase in the cost of production. Lower growth in disposable income and subdued performance in the construction sub-sector contributed towards the low demand for domestic market oriented industries. However, the food, beverages and tobacco products category was able to maintain its growth momentum in 2009 as a result of the access to new markets in the Northern and the Eastern provinces and the revival of tourism, including domestic tourism, during the second half of the year.

The output of the factory industry recovered gradually with the revival of the demand in both export and domestic markets and with institutional support. The gradual recovery of the global economy, low inflation and interest rates, a stable exchange rate, ongoing infrastructure and housing development projects in the Northern and the Eastern provinces, and recovery of commercial and housing construction activities supported the growth of the factory industry during the latter part of 2009. Meanwhile, the government with the support of other relevant authorities took several initiatives to address the challenges faced by industries through providing fiscal stimulus, regionalising the industrial base, conducting productivity improvement programmes, encouraging Public Private Partnerships (PPPs), enhancing the use of technology and supporting Small and Medium Enterprises (SMEs) by providing financial assistance and advisory services.

The growth in the Services sector decelerated to 3.3 per cent in 2009 from 5.6 per cent in 2008, mainly due to the poor performance in the wholesale and retail trade sub-sector.

Chart 1.3 **Savings and Investment**



Other sectors excluding hotels and restaurants, government services and ownership of dwellings also recorded slower growth compared to the previous year. The set-back in both the export and import sub-sectors stemming from the global economic downturn, resulted in a contraction in wholesale and retail trading activities. However, the domestic trade sub-sector performed well due to robust demand for domestically produced goods along with the increase in economic activities in the Northern and the Eastern provinces. The hotels and restaurants sub-sector showed a strong recovery compared to the set-back in 2008, due to the end of conflict and expansion in both local and foreign tourist activities. The transport and communication services grew, though at a slower pace, compared to the previous year. Meanwhile, the banking, insurance and real estate sub-sector grew moderately due to the slowdown in domestic economic activity.

In 2009, total investments of the country declined, while the savings and investment gap narrowed. Private investment declined significantly to 17.9 per cent of GDP from 21.1 per cent in the previous year, while public investment increased marginally to 6.6 per cent. As a result, total investment as a percentage of GDP declined to 24.5 in 2009 from 27.6 in 2008. Meanwhile, national savings increased to 23.9 per cent of GDP from 17.8 per cent in the previous year. The decline in investments coupled with the significant increase in national savings narrowed the savings-investment gap to 0.7 per cent of GDP in 2009 from 9.8 per cent in 2008 as reflected in the significant contraction in the current account deficit of the BOP.

External Sector Developments

The external sector recovered strongly during 2009 amidst a challenging global economic environment. The external sector experienced a downturn since the latter part of 2008, until the end of the first quarter of 2009. The sharp outflow of foreign investments, the non-rollover of short-term debt, drying up of new commercial financing and servicing of higher petroleum bills were the main reasons for this downturn. Amidst the challenging domestic and external environment, the gross official reserves declined to a low level by end March 2009. However, with the dawn of peace and improved investor confidence, the external sector rebounded strongly, recording the highest ever level of reserves by the end of the year.

Chart 1.4 Value of Petroleum Imports and Average Price of Crude Oil Imports

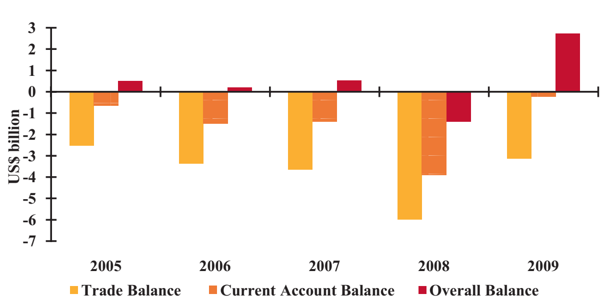
External trade, which contracted in 2009 due to the impact of the global economic crisis, improved towards the latter part of the year. Earnings from exports declined by 12.7 per cent, led by lower demand for industrial exports, while expenditure on imports declined by 27.6 per cent, mainly due to the substantially lower expenditure on petroleum and fertilizer imports. Accordingly, the trade deficit contracted by 47.8 per cent to US dollars 3,122 million in 2009 compared to the 63.6 per cent expansion in 2008 to US dollars 5,981 million, reflecting a significantly larger reduction in import expenditure in 2009 relative to the decline in export earnings. However, external trade improved towards the latter part of the year, as the global economy showed signs of recovery. Growth in export earnings was led by the sharp improvement in agricultural and industrial exports during the fourth quarter. Similarly, the expenditure on imports also increased during the fourth quarter, led by higher expenditure on imports of consumer and intermediate goods.

The services account of the BOP, which experienced a set-back in the first half of 2009, showed a noteworthy improvement during the second half of the year. This improvement was mainly due to the gradual recovery in the global economy and improvement in the market confidence brought about by the end to the conflict. Albeit at lower levels, transportation, telecommunications, computer and information, construction and insurance services recorded surpluses during the year. Despite a sharp drop in tourist arrivals during the first few months of the year, a notable increase in arrivals was seen subsequent to the end of the conflict and removal of travel advisories by some key tourist generating countries, leading to an increase in earnings from tourism by 2.2 per cent. Accordingly, the services account recorded a surplus of US dollars 391 million in 2009.

The deficit in the income account contracted significantly to US dollars 488 million during 2009 from US dollars 972 million recorded in 2008. This was mainly due to the increase in interest income on the highest ever foreign exchange reserves accumulated during the year coupled with higher valuation and exchange gains resulting from the mark-to-market valuation of trading securities in US dollar terms.

The current account of the BOP improved remarkably due to the lower trade deficit and increase in migrant workers' remittances. In spite of the sluggish growth in the first quarter of the year, workers' remittances grew by 14.1 per cent to US dollars 3,330 million in 2009. The current account, which recorded a surplus of US dollars 339 million for the first nine months of the year, turned around to record a deficit of US dollars 214 million due to the increase in the trade deficit during the last quarter of 2009. The current account deficit was US dollars 3,886 million in 2008. As a percentage of GDP, the

Chart 1.5 Balance of Payments (BOP)



current account deficit narrowed substantially from 9.5 per cent in 2008 to a marginal level of 0.5 per cent in 2009.

The inflows to the capital and financial account increased substantially during the second half of the year. Foreign financial inflows to the government that declined considerably during the first half of the year reversed increasing considerably during the second half of the year with the ending of the conflict and the receipt of the SBA facility from the IMF. Sri Lanka successfully floated the second international sovereign bond of US dollars 500 million in October 2009, which was oversubscribed by more than thirteen times. Accordingly, during the year, total long and medium term loan inflows to the government, excluding the proceeds of the international sovereign bond, amounted to US dollars 1,280 million compared to US dollars 1,059 million in 2008. Of these loan receipts, US dollars 673 million (53 per cent) was received on concessional terms, while US dollars 607 million (47 per cent) was on non-concessional terms. Foreign direct investments (FDI) including loans, decreased to US dollars 601 million during 2009 after reaching a record high of US dollars 889 million in 2008.

Foreign inflows to the government securities market increased during the second half of the year reversing the trend observed during the early part of 2009. Renewed investor confidence, stable exchange rate and comparatively low international interest rates encouraged these inflows. Government securities attracted US dollars 1,369 million of net foreign inflows in 2009 against net outflows of US dollars 213 million in 2008. All inflows were absorbed by CBSL to facilitate and cushion the impact of any sudden withdrawals by foreign investors, without exerting any undue pressure on the domestic foreign exchange market.

Long-term foreign loan inflows to the private sector increased by 47 per cent to US dollars 390 million during the year. Telecommunication, power and energy, and aviation industries were the main areas of private sector investments financed by foreign loans. In spite of the high level of foreign

Table 1.3 **External Sector Developments**

Item	US$ million 2008(a)	US$ million 2009(b)	% Change
Exports	**8,111**	**7,085**	**-12.6**
Agricultural Products	1,855	1,690	-8.9
Industrial Products	6,158	5,305	-13.8
Mineral Exports	98	88	-9.3
Other Exports	-	-	-
Imports	**14,091**	**10,207**	**-27.6**
Consumer Goods	2,560	1,972	-23.0
Intermediate Goods	8,344	5,669	-32.1
Investment Goods	3,048	2,451	-20.0
Other	139	115	-17.6
Trade Balance	***-5,981***	***-3,122***	***-47.8***
Services (net)	**401**	**391**	**-2.5**
Receipts	2,004	1,892	-5.6
Payments	1,603	1,501	-6.4
Income (net)	**-972**	**-488**	**-49.8**
Receipts	-32	116	-462.5
Payments	940	603	-35.9
Current Transfers (net)	**2,666**	**3,005**	**12.7**
Private Transfers (net)	2,565	2,927	14.1
Receipts	2,918	3,330	14.1
Payments	353	403	14.2
Official Transfers (net)	101	77	-23.8
Current Account Balance	***-3,886***	***-214***	***-94.5***
Capital Account	***291***	***233***	***-19.9***
Financial Account	***1,483***	***2,361***	***59.2***
Direct Investment (net)	691	384	-44.4
Inflows	752	404	-46.3
Outflows	62	20	-67.6
Private Long-term (net)	74	79	6.8
Inflows	265	390	47.2
Outflows	191	311	62.8
Government, Long-term (net)	252	840	233.3
Inflows	1,059	1,780	68.1
Outflows	807	940	16.5
Government, Short-term (net)	-213	1,369	-742.7
Private Short-term (net)	679	-311	-145.8
of which:Portfolio Investment (net)	60	-6	-110.0
Errors and Omissions	728	346	
Overall Balance	***-1,385***	***2,725***	
Gross Official Reserves (without ACU)	1,594	5,097	
Months of Imports	1.4	6.0	
Total External Reserves (without ACU)	2,832	6,770	
Months of Imports	2.4	8.0	
Export Price Index	113.0	112.5	
Import Price Index	136.3	109.5	
Terms of Trade	82.9	102.8	
Exchange Rates (Average)			**App(+)/Dep(-)**
Rs./US dollar	108.33	114.94	-5.8
Rs./Japanese yen	1.05	1.23	-14.6
Rs./Euro	159.32	160.21	-0.6
Rs./Sterling pound	200.73	179.87	11.6

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

inflows to the Colombo Stock Exchange (CSE) in the second half of 2009, gross portfolio investments recorded a substantial decline during the year compared to that of 2008.

The overall BOP recorded an unprecedented surplus of US dollars 2,725 million in 2009 compared to a deficit of US dollars 1,385 million in 2008. The BOP recorded a deficit of US dollars 688 million by end of the first quarter of 2009. However, it improved to record a surplus since the second quarter of the year in response to measures taken by CBSL including the arrangement of foreign currency swap facility of US dollars 200 million, promotional campaign on investment in Treasury bills and Treasury bonds among the Sri Lankan diaspora and migrant workers, payment of a bonus interest of 20 per cent in rupee terms on interest earned on Non-Resident Foreign Currency (NRFC) and Resident Foreign Currency (RFC) deposits, which was further reinforced by the improvement of investor confidence with the ending of prolonged conflict and the approval of the IMF-SBA facility of Special Drawing Rights (SDR) 1.65 billion (US dollars 2.6 billion) by IMF as BOP support. The first two tranches of the SBA facility amounting to US dollars 652 million and the SDR allocations by IMF of US dollars 508 million were received during the second half of the year. Accordingly, the total external official reserves, excluding Asian Clearing Union (ACU) receipts, rose to its highest ever level of US dollars 5,097 million by end 2009 compared to US dollars 1,594 million at end 2008. This was sufficient to cover 6 months of imports compared to 1.4 months of imports recorded in 2008.

The total external debt of the country increased to 44.5 per cent of GDP in 2009, from 37.1 per cent in 2008. This increase was mainly driven by the increase in foreign investments in government securities, issuance of the international sovereign bond, and disbursements under the IMF-SBA facility as well as low growth in nominal GDP. Of the total medium and long-term external debt outstanding, government debt accounted for 88.5 per cent, while the balance represented borrowings of the private sector and public corporations, and debt obligations to IMF. Amortisation and interest payments as a percentage of exports of goods and services increased to 19.0 per cent in 2009 from 15.1 per cent in 2008. The increase in debt service payments was mainly due to the repayment of the syndicated loan of US dollars 225 million, while the effect of the reduction in earnings from export of merchandise goods and services during the year caused the debt service ratios to increase substantially.

The exchange rate policy in 2009 focused mainly on maintaining stability in the domestic foreign exchange market. During the first four months, the increased foreign exchange outflows exerted pressure on the exchange rate to depreciate, and CBSL supplied foreign exchange on a net basis to mitigate excessive volatility in the market. However, increased inflows of foreign exchange into the country since May 2009 exerted pressure on the exchange rate to appreciate. CBSL intervention in the foreign exchange market by way of net absorption of foreign exchange therefore, prevented the rupee from further appreciating against the US dollar while building up official reserves. The intervention strategy adopted by CBSL helped to maintain a stable exchange rate to a great extent in 2009.

Fiscal Sector Developments

The fiscal sector came under severe stress in 2009 as in many other countries, resulting in a notable deviation from the original fiscal targets. The Budget 2009 expected to reduce the overall budget deficit to 5.9 per cent of GDP after grants. However, with the subsequent developments in the domestic as well as external fronts, the budgetary estimates were revised, targeting an overall deficit of 7.0 per cent of GDP. During the first half of 2009, there was a severe pressure on fiscal operations mainly due to the lower growth in government revenue as a result of the slowdown in domestic economic activity and, particularly the shrinking of imports reflecting the adverse impact of the global economic crisis. Meanwhile, the intensified security situation, urgent RRR activities in the Northern and the Eastern provinces and increased interest payments, while continuing expenditure on the public investment programme, raised government expenditure. During the second half of the year, the positive impact of the ending of the conflict in May 2009 and the rebound in domestic economic activity in line with the gradual recovery in the global economy eased fiscal operations to some extent, to record an overall budget deficit of 9.8 per cent of GDP in 2009.

Chart 1.6 Government Revenue, Expenditure and Budget Deficit (As a per cent of GDP)

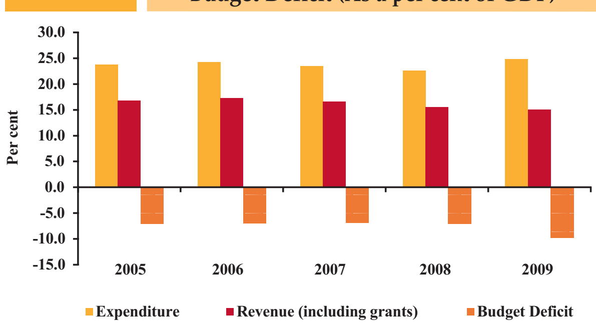
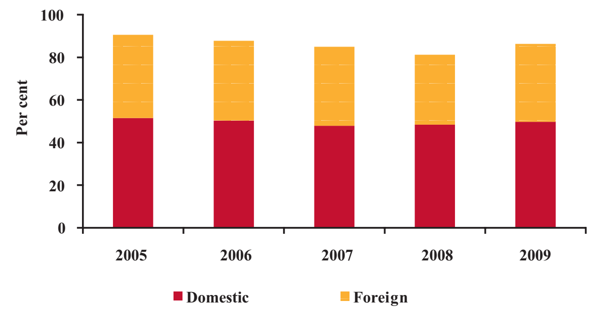


Chart 1.7 Government Debt (As a per cent of GDP)



The high deficit was a combined outcome of the revenue shortfall, overrun in the recurrent expenditure and increased expenditure on infrastructure projects. The government revenue was significantly below the targeted level. The total revenue as a per cent of GDP declined to 14.6 per cent in 2009 compared to 14.9 per cent in 2008 and 16.3 per cent in 2006. Meanwhile, total expenditure and net lending increased to 24.9 per cent of GDP, compared to that of 22.6 per cent in 2008 and 24.3 per cent in 2006. Recurrent expenditure increased significantly, as a per cent of GDP to 18.2 per cent from 16.9 per cent in 2008. Public investment increased to an encouraging level of 6.8 per cent of GDP in 2009 compared with 6.0 per cent in the previous year.

In financing the deficit, the government raised more funds from domestic sources during the early part of 2009 and from foreign sources during the latter part of the year. The increased borrowing requirement and the tight liquidity conditions in the international capital markets led the government to depend heavily on domestic borrowings during the first half of the year. However, the significant increase in foreign investments in government securities and the receipt of proceeds from the international sovereign bond issue during the second half of the year enabled the government to retire a large amount of Treasury bills held by CBSL. As a result, total borrowing from the banking sector declined to Rs. 49 billion by end 2009 compared to Rs. 189.6 billion at end July 2009. Total net domestic financing in 2009 amounted to 5 per cent of GDP while net foreign financing was 4.8 per cent of GDP, which consisted of foreign loans (1.8 per cent of GDP) and foreign investments in government securities (3.0 per cent of GDP). Meanwhile, the outstanding government debt to GDP ratio increased slightly to 86.2 per cent in 2009 mainly reflecting the higher budget deficit and the lower growth in nominal GDP.

Monetary Sector Developments

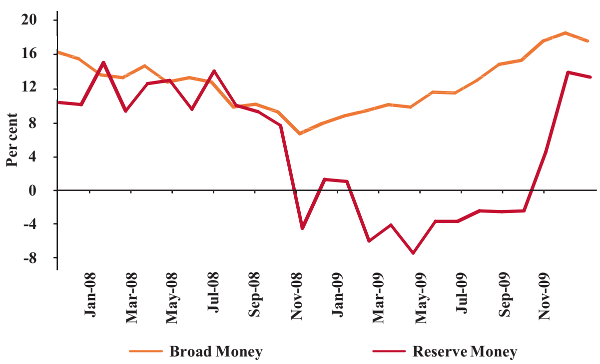
CBSL relaxed its monetary policy stance in 2009 to support domestic economic activity. The rapid deceleration in inflation during 2009 due to the stringent monetary policy measures implemented during the last few years and the decline in global commodity prices enabled CBSL to relax its monetary policy. The Penal interest rate applicable on reverse repo transactions when participating institutions exeeded the maximun number of times they could access the reverse repo window, which was introduced in November 2007, was reduced gradually and harmonised with the Reverse Repo rate in May 2009. At the same time, restrictions on access to CBSL's repo and the reverse repo facilities were also removed, thus re-establishing the interest rate corridor. The Central Bank's policy rates were also gradually reduced during the year: the repo rate was reduced by 300 basis points to 7.50 per cent and the reverse repo rate was reduced by 225 basis points to 9.75 per cent. In addition, margin deposit requirements that were imposed to restrict the demand for credit for certain categories of vehicle and non-essential imports, were removed during the first half of the year, to ease credit conditions.

CBSL took timely and appropriate measures to manage rupee liquidity in the market. The continued capital outflows during the first quarter of the year necessitated CBSL to supply foreign currency to the market resulting in a drain in rupee liquidity from the market. CBSL lowered the Statutory Reserve Ratio (SRR) by a further 75 basis points to 7 per cent in February 2009, releasing about Rs.9 billion to the market, following the reduction in the SRR imposed on all rupee deposits of commercial banks by 225 basis points in the last quarter of 2008. In addition, CBSL purchased Treasury bills from the primary market, while also engaging in reverse repo transactions to enhance rupee liquidity. CBSL also removed the restriction on access to reverse repo standing facility by market participants in 2009.

However, since June 2009, there has been a turnaround in liquidity, posing a challenge to managing the surplus. Renewed investor confidence with the end to the conflict and the securing of the SBA facility from IMF substantially increased foreign investments in government securities from May 2009 onwards. The proceeds of these inflows were purchased by CBSL to stabilise the foreign exchange market and to build official reserves. The resulting increase in rupee liquidity in the market was absorbed through CBSL's open market operations (OMO), thus leading to a significant reduction in the Central Bank's holdings of government securities necessitating the use of alternative instruments to conduct OMO. Accordingly, Central Bank Securities were issued to absorb liquidity on overnight basis and term basis from October 2009. In addition, CBSL commenced foreign exchange swap transactions as an additional instrument for absorbing liquidity.

The targets for monetary aggregates, which were initially set out in the Monetary Programme for 2009 and announced in the 'Road Map: Monetary and Financial Sector Policies for 2009 and beyond' (Road Map) were subsequently revised downward. The reduction in the SRR, the rapid decline in inflation and the slowdown in the domestic economy were the main factors that warranted this downward revision. Accordingly, the target for the growth in reserve money was brought down from 5 per cent to 2.8 per cent, while that of broad money was revised downward from 14 per

Chart 1.8 Growth in Reserve Money and Broad Money



cent to 13 per cent. Although the growth in reserve money contracted during the first three quarters of 2009 largely due to the lowering of SRR in the last quarter of 2008 and the first quarter of 2009, it began to increase in the last quarter of 2009, due to the increase in net credit to government (NCG) from CBSL and the dissipation of the impact of the changes in SRR in the last quarter of 2008, on reserve money. Accordingly, the annual average growth in reserve money contracted by 0.7 per cent, which was within the target set in the revised Monetary Programme for 2009. The growth in broad money, which moderated during the first half of the year, gathered pace thereafter, with annual average broad money growing by 13.6 per cent, which was marginally above the target set in the revised Monetary Programme for 2009.

The source of expansion in monetary aggregates was the increase in NFA as net domestic assets (NDA) of the banking system declined during the year. During the first quarter of 2009, there was a considerable decline in NFA of CBSL, as CBSL intervened to ease the pressure on the foreign exchange market resulting from the withdrawal of foreign investments in government securities. The decline in NFA was however, partly off-set by an increase in NDA as a result of higher credit to the government from CBSL. However, this position reversed from April 2009, with NFA of CBSL increasing significantly, while NDA declined. Foreign exchange purchases by CBSL to build its reserves from the significant foreign inflows after the end to the conflict and the approval of the SBA facility by IMF contributed to the improvement in NFA of CBSL. Meanwhile, NFA of commercial banks increased during the year due to the repayment of foreign currency borrowings by some public corporations and the settlement of some outstanding foreign currency liabilities of the government using the proceeds of the international sovereign bond. The decline in NDA of the banking sector during the year was due to several factors. The retirement by the government of a large stock of government securities held by CBSL with proceeds from foreign investments in government securities, the sterilised intervention by CBSL to stabilise the foreign exchange market and the issue of Central Bank Securities were the main reasons for the decline in NDA of CBSL. The slowdown in domestic economic activity partly due to the spin-off effect of the global financial crisis, the tight monetary policy stance adopted until 2008 and conservative lending practices of banks, which led to the decline in credit to the private sector by commercial banks was the main reason for the decline in NDA of commercial banks.

Interest rates across the term structure shifted downwards in line with the changes in the policy rates and the improvements in market liquidity. The average weighted call money rate (AWCMR) was brought within the policy interest rate corridor, improving the effectiveness of the Central Bank's monetary policy operations. Other market interest rates also declined in line with these changes, although lending rates of commercial banks declined at a slower pace. Yield rates on government securities across all maturities responded more swiftly to changes in the Central Bank's policy rates

Chart 1.9 Central Bank Policy Rates and Average Weighted Call Money Rate

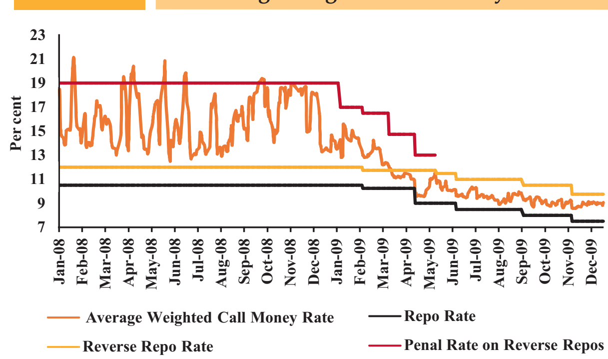
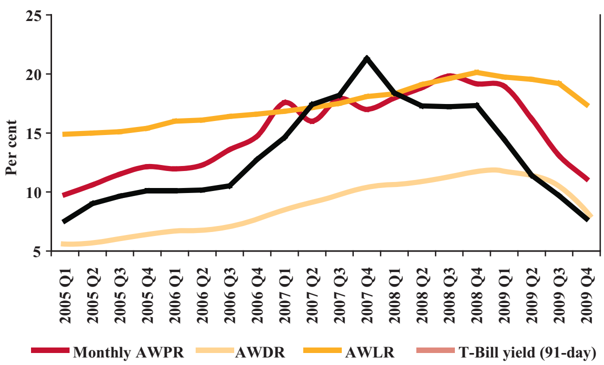


Chart 1.10 Movements in Market Interest Rates



and improvements in the investment climate. This was also reflected in the yield curve for government securities in the secondary market, which shifted downward and extended outward to longer maturities during the year.

The effective communication of the monetary policy stance of CBSL was successful in aligning market expectations with those of the Bank to a large extent. CBSL continued to release its 'Road Map: Monetary and Financial Sector Policies for 2010 and beyond' at the beginning of the year and announce its policy decisions, explaining the rationale that underlies these actions, in its monthly monetary policy press releases, in order to enhance the effectiveness of its policy actions. As a part of the commitment to engage with various stakeholders, CBSL continued to obtain the views of the Monetary Policy Consultative Committee (MPCC), which comprises representatives from the private sector and academia, as an input into its monetary policy discussions.

Financial System Stability

During 2009, the financial sector remained resilient and financial system stability was maintained despite challenging market conditions. Financial sector institutions were confronted with the stresses caused by spill-over effects of the global financial crisis and the consequent decline in demand in the domestic economy which had an adverse impact on their business operations. As the global financial turmoil deepened and the global economy contracted, there was an outflow of foreign investments in government securities creating a liquidity shortage in money markets, although this situation turned around with the money market becoming liquid and the equity market rebounding after the end of the conflict in May 2009. The loss of investor confidence and liquidity constraints faced by several entities connected to banks and finance companies in the Ceylinco Group had an adverse impact on the finance and leasing sectors.

However, swift and decisive measures taken by CBSL and the government contributed towards ensuring public confidence and continued stability in the financial system. CBSL successfully resolved the liquidity problems encountered by Seylan Bank, a systemically important licensed commercial bank (LCBs), which was a part of the Ceylinco Group. Seylan Bank was recapitalised by issuing new shares and is currently carrying on normal business operations. With a view to resolving the liquidity constraints faced by distressed registered finance companies (RFCs) and specialised leasing companies (SLCs) in the Ceylinco Group, CBSL appointed managing agents and obtained the services of a panel of experts to advise and guide the recovery process. Further, CBSL in conjunction with the Ministry of Finance and Planning introduced a special stimulus package to assist troubled RFCs that were facing liquidity problems. In addition, CBSL introduced a credit guarantee scheme for bank loan facilities granted to RFCs and SLCs, including the securitisation of lease rental receivables. These measures were successful in facilitating the commencement of business operations and bringing stability to the sector.

CBSL took several initiatives to further strengthen the regulatory and supervisory framework of the financial sector in 2009 to improve the soundness and resilience of the financial system. The proposed Finance Business Regulation Act will address several weaknesses in the present law with respect to regulation and supervision of institutions engaged in finance business and deposit taking. The present Banking Act will also be amended to enable the consolidated supervision of banking groups, facilitate the mergers and acquisitions of banks and strengthen the regulatory framework. In addition, amendments have been proposed to the Regulation of Insurance Industry Act to expand and strengthen the supervision of the insurance industry. Several regulations were issued permitting primary dealers to diversify their business, initially to include fee based activities and investment in shares and debentures of its own group companies, and expanding thereafter to include investment in quoted shares, debentures, bonds and commercial paper. A law to regulate and supervise micro-finance institutions (MFIs) has been formulated to strengthen and realign the role of MFIs and to enable them to better serve the economy.

Overall, financial institutions performed well despite the challenges faced by the slowdown in domestic demand. The profitability of the banking system was maintained despite the decline in demand for credit on account of the slowdown in economic activity and the cautious approach taken by banks towards lending on account of an increase in non-performing loans. The performance of RFCs and SLCs were more adversely affected by the severe liquidity problems faced by RFCs due to the loss of investor confidence and liquidity constraints faced by finance and leasing companies connected to the Ceylinco Group. However, a special stimulus package and a guarantee scheme put forward by CBSL with the support of the government to assist RFCs and SLCs that were experiencing liquidity problems were instrumental in rebuilding public confidence and recommencing business operations in the sector.

CBSL facilitated the expansion of institutional infrastructure and building of capacity to enhance access to finance. A notable development was the large number of bank branches opened outside the Western province, especially in the Northern and the Eastern provinces after the end to the conflict and the renewed investor confidence. Out of the 49 new bank branches opened by LCBs, 17 branches were opened in the Eastern Province, while 10 branches were opened in the Northern Province. CBSL implemented a special loan scheme to boost livelihood development and the resumption of economic activities in the Northern Province, while continuing with several loan schemes that were in operation aimed at regional development through coordinating and facilitating credit delivery to agriculture, livestock, micro and small and medium enterprise sectors.

CBSL continued to strengthen the oversight framework by adopting necessary measures to minimise the risks involved in the payment system, thereby ensuring the stability, safety and efficiency of the payment system. CBSL issued the Service Providers of Payment Cards Regulations No. 01 of 2009 with effect from 31 July 2009. The purpose of the regulation is to enhance the safety of the payment card industry by ensuring that all service providers of payment cards observe international standards and best practices, and thereby reduce the risks of credit card fraud and increase public confidence in card based electronic payments. All service providers of payment cards were required to obtain a license from CBSL to carry on activities relating to credit cards, debit cards, charge cards and stored value cards, including devices that contain a code or any other means of access to an account.

1.3 Global Economic Environment and Outlook[1]

In 2009, most of the economies around the world continued to be affected by the global financial and economic crises. In response to the sharp economic downturn, advanced as well as emerging economies adopted diverse policies, such as relaxed monetary policy, historically low interest rates, unprecedented expansion of central bank balance sheets and expansionary fiscal policy, to boost demand and stabilise financial markets. Despite wide-ranging policy actions, the financial system remained strained during a greater part of 2009, negatively affecting the real economy. According to IMF projections, the world economy is estimated to have contracted by 0.8 per cent in 2009 compared to a growth of 3.0 per cent in 2008.

1 The analysis in this section is based on the World Economic Outlook of the IMF, October 2009 and January 2010 (update), and World Bank and Asian Development Bank publications.

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

Item	Actual 2007	Actual 2008	Projections 2009	Projections 2010
World Output	**5.2**	**3.0**	**-0.8**	**3.9**
Advanced Economies	2.7	0.5	-3.2	2.1
United States	2.1	0.4	-2.5	2.7
Euro Area	2.7	0.6	-3.9	1.0
United Kingdom	2.6	0.5	-4.8	1.3
Japan	2.3	-1.2	-5.3	1.7
Emerging and Developing Economies	8.3	6.1	2.1	6.0
Developing Asia	10.6	7.9	6.5	8.4
China	13.0	9.6	8.7	10.0
India	9.4	7.3	5.6	7.7
World Trade Volume (Goods and Services)	**7.3**	**2.8**	**-12.3**	**5.8**
Imports				
Advanced Economies	4.7	0.5	-12.2	5.5
Emerging and Developing Economies	13.8	8.9	-13.5	6.5
Exports				
Advanced Economies	6.3	1.8	-12.1	5.9
Emerging and Developing Economies	9.8	4.4	-11.7	5.4
Price Movements				
Consumer Prices				
Advanced Economies	2.2	3.4	0.1	1.3
Emerging and Developing Economies	6.4	9.2	5.2	6.2
Commodity Prices (US dollars)				
Oil	10.7	36.4	-36.1	22.6
Non-fuel	14.1	7.5	-18.9	5.8
Six-month London Interbank Offered Rate on US dollar Deposits (per cent)	**5.3**	**3.0**	**1.1**	**0.7**

(a) Annual percentage change unless otherwise indicated.

Source: World Economic Outlook (January 2010 & October 2009), IMF

This economic downturn was led by the advanced economies, which were estimated to have contracted by 3.2 per cent. The largest economic contractions were observed in Japan, the UK and the Euro area. The downturn of the advanced economies has greatly affected the growth of emerging and developing economies that are dependent on export based industries and services. Although the emerging and developing economies grew by an estimated 2.1 per cent in 2009, this growth was not sufficient to off-set the economic contraction in the advanced economies. Meanwhile, low consumer demand, weak corporate revenues, large excess capacity, and tight credit conditions increased unemployment rates across the world to high levels with the unemployment rate in advanced economies rising to around 10 per cent.

In its latest forecasts, IMF has projected that global economic growth would be around 3.9 per cent in 2010, largely driven by the growth in emerging and developing economies. Consumer demand is gradually on the rise due to monetary policy and fiscal stimulus measures adopted to boost spending. As a result, international trade is expected to increase and IMF has projected the global trade volume in both goods and services to increase by 5.8 per cent in 2010. Further, given the capital flows into developing and emerging economies, the imports into such economies are also expected to increase substantially. Advanced economies are projected to grow at around 2.1 per cent in 2010 and increase further to 2.5 per cent by end 2011. This growth is expected to be led by a rebound in manufacturing, which is also expected to gradually stabilise retail sales, thus restoring consumer confidence and improving housing markets. Signs of an economic recovery are apparent in some advanced economies although others continue to lag behind. The recovery in advanced economies is still expected to be weak by historical standards, with real output projected to remain below its pre-crisis levels until late 2011. Meanwhile, unemployment in the USA and the Euro area is projected to rise to around 10 per cent and 12 per cent, respectively in 2010. The growth in emerging economies would continue to drive the global economic recovery in the short to medium-term. Emerging and developing economies are expected to grow by around 6 per cent in 2010, and accelerate to 6.3 per cent in 2011. Wide-ranging public intervention and the rapid economic recovery in the Asian region are expected to augment demand, and lower uncertainty and systemic risk in financial markets.

The sharp decline in international commodity prices in 2009 and the unprecedented slowdown in global demand led to a dramatic fall in headline inflation in both advanced and emerging economies in 2009. Inflation in advanced economies fell to 0.1 per cent during 2009 from 3.4 per cent in 2008, while inflation in emerging and developing economies declined to 5.2 per cent in 2009 from 9.2 per cent in 2008. Notwithstanding the decline in headline inflation, core inflation has remained relatively stable in advanced economies. However, Japan experienced a drop in core inflation below zero. The economic recovery and the gradual increase in global demand are expected to exert upward pressure on commodity prices in 2010. However, large levels of inventories and excess capacity are expected to moderate the increase in prices. IMF has projected that headline inflation in advanced economies would rise from 0.1 per cent in 2009 to 1.3 per cent in 2010 due to the expected increase in prices. Meanwhile, inflation in emerging and developing economies is expected to increase in 2010, as some of these economies are likely to face upward pressure in demand arising from increased capital flows.

Global financial markets have recovered faster than expected due to the strengthening of financial institutions although the financial conditions are likely to remain more difficult than before the crisis. With the easing of tight bank lending practices, banks have become less dependent on emergency financing facilities provided by the central banks and government guarantees. As banks need to recapitalise after large write-downs of bad debts incurred during the acute phase of the crisis and for the possible future credit write-downs, bank lending is not expected to increase significantly in the coming months. The corporate bond markets' surge in new bond issues, given the prevailing low interest rates and the return of investors' risk appetite, is still smaller than the reduction in bank credit growth to the private sector. The equity markets too have soared amid a reopening of most high-yield markets. However, small and medium enterprises that have limited access to capital markets are likely to face credit constraints in the coming year. Accordingly, public credit guarantee schemes will ensure that credit flows do not dry-up for these sectors of the economy. Meanwhile, the expansionary fiscal policies adopted by many governments and the ensuing large fiscal deficits have put sovereign debt under pressure, especially for some small countries. Given the rebound in many emerging economies and future prospects of such economies, the portfolio inflows into these economies have picked up almost to pre-crisis levels.

In response to the monetary policy relaxation in many advanced and developing economies, short-term interest rates declined considerably. Monetary policy easing has brought policy interest rates close to zero in many advanced economies. Excluding the USA where the policy rates were already close to zero, the rate cuts among advanced economies averaged 1.5 per cent in 2009. As room for further rate cuts have already been exhausted in advanced economies, markets do not foresee significant rate reduction over the coming year. The U.S. Federal Reserve Bank (The Federal Reserve), the Bank of Canada, and the Swedish Riksbank have explicitly committed to maintaining low policy rates until there are clear signs of recovery, in an effort to transmit the lowering of short-term rates to longer maturities. In contrast, rate reductions were generally smaller in emerging economies. This was primarily due to a combination of the higher inflation that prevailed and the pressure for exchange rates to depreciate in response to capital outflows. However, as emerging economies have managed much better than expected, it is anticipated that some emerging economies may start increasing interest rates to curb monetary expansion.

Central banks in most advanced economies and some emerging economies resorted to a range of unconventional measures to further ease financial conditions during 2009 (See Box No. 1). There have been a variety of different approaches, mainly reflecting different financial system structures. All central banks deployed extensive liquidity support measures for banks, given their importance in each financial system. Many central banks also provided liquidity in US dollars, arranged via swap lines with the Federal Reserve. The Federal Reserve and the Bank of England, among others, intervened with outright purchases of government bonds in an effort to lower long-term yields. Given the much greater importance of securities markets for the US economy, the Fed also intervened heavily in markets for the debt of government-sponsored enterprises, for mortgage-backed securities, and for commercial papers and provided funding and some protection to investors in asset-backed securities. Together with policy interest rate cuts and fiscal stimulus measures,

Box 01

The Response of Central Banks to the Global Financial Crisis

Central banks in both advanced and emerging economies initiated unprecedented policy responses to the global financial crisis. These policy responses, some within the traditional operational framework of central banks and others, unconventional to traditional central banking, were instrumental in averting a systemic collapse of the global financial system. The overall policy responses of central banks to the financial crisis can be broadly categorised into a number of stages on the basis of different phases through which the crisis evolved. Accordingly, the first definable set of policies, implemented during the initial stages of the crisis was aimed at relieving the stresses in short-term money markets through the provision of ample liquidity. During the second stage, when the stresses in short-term markets spilled over to the broader financial markets, central banks eased funding pressures in broader financial markets through expanding both the collateral and counterparties and increasing the maturity period over which funding was released to market participants. Thereafter, when the continued stresses in financial markets dented confidence in the real economy, central banks coordinated policy action to provide long-term funding and enhanced communication measures to allay fears and risk perceptions.

Central bank intervention in the early phase of the financial crisis that emerged in August 2007 was mainly a response to the drying up of interbank lending in many advanced economies. Lending in interbank money markets was curtailed due to perceived liquidity and credit risks associated with uncertainty over valuations of a broad array of complex securities. In this backdrop, central banks began injecting liquidity into interbank money markets. Firstly, central banks resorted to more traditional monetary policy measures, such as lowering policy interest rates. However, it was becoming apparent that traditional monetary policy measures alone were ineffective in improving the conditions in interbank lending markets. This was because changes in policy rates had a marginal impact on the interbank money markets.

Thus central banks looked into more unorthodox measures to address the liquidity crisis in interbank markets. Apart from their regular operations to provide liquidity, central banks conducted open market operations, providing liquidity larger than the regular provision of liquidity. Central banks also resorted to emergency liquidity assistance during the early stages of the crisis.

As the global financial crisis entered its second year, central banks undertook a number of unprecedented policy actions aimed at stabilising the financial system. The notable policy action was the decision to provide emergency liquidity assistance to banks and other financial institutions which were systemically important to the stability of the financial system, such as the assistance by the US Federal Reserve Bank (Federal Reserve) to the insurance company, AIG and to the Citigroup banking conglomerate.

The coordinated policy action of major central banks was another notable feature in the central banks' response to the global financial crisis during 2008. The first of these joint actions was executed by end 2007, when the Federal Reserve, the European Central Bank (ECB), the Bank of England (BOE), the Bank of Japan (BOJ), the Bank of Canada (BOC), the Swiss National Bank (SNB), and the Swedish Riksbank announced measures to release liquidity directly to a large number of financial institutions and against a broader set of collateral. This was followed by another round of coordinated policy action on 8 October 2008, when six major central banks, Federal Reserve, ECB, BOE, BOC, SNB and the Swedish Riksbank simultaneously announced a reduction in their policy interest rates.

The third category of policy responses, which were executed by central banks was to ease credit conditions in the non-bank sector. Under these measures, funds were directed to non- banks to improve liquidity. Specific markets such as commercial paper, asset back securities and corporate bonds were also targeted to alleviate tight credit conditions and to dispel excessive risk perceptions. Central banks also expanded the earlier measures to augment liquidity in the interbank market by widening the counterparties, extending the maturity period and extending the range of securities eligible as

Central banks in emerging economies too relied on a mix of conventional and unconventional monetary policy measures, to alleviate stresses in foreign exchange and domestic financial markets. The foreign exchange reserve balances of many emerging countries were adversely affected by the financial crisis. In response, the central banks of emerging economies undertook measures primarily to strengthen their foreign exchange reserves, by entering into swap arrangements with other central banks for the provision of dollar liquidity. In addition, the IMF assisted a number of emerging economies to strengthen their reserves by a special allocation of SDR and by th e provision of loan facilities. Several central banks relaxed the domestic reserve requirement including reductions in reserve requirement ratios, while many central banks eased the terms of existing standard liquidity providing facilities to alleviate domestic liquidity shortages.

Central banks around the world have implemented a wide range of policy measures to counteract the effects of the financial crisis on their respective economies. Emerging markets too were not immune to the adverse repercussions of the global financial crises. Exchange rates came under pressure and reserves were drawn down with the withdrawal of foreign currency. At the same time, exports and remittances declined and financial intermediaries with large exposure to foreign currency denominated loans came under strain. The provision of foreign currency to the foreign exchange markets led to a commensurate decline in domestic currency liquidity as well. The response of the emerging economies, particularly those of small open economies, was particularly important as they were thought to be more vulnerable to external shocks. Hence, there are several lessons that can be learnt from the financial crisis and the response of central banks to the crisis, particularly to small open economies:

- Global problems need global solutions. Due to the systemic nature of the financial crises, there is a need for coordinated policy actions between central banks and governments across the world. In the case of the recent crisis, the global response increased confidence in financial markets at a time of heightened uncertainty.

- In crisis situations, policy actions need to be taken quickly and decisively. In the case of the recent financial crisis, delays in implementing policies to mitigate the impact of the crisis on the financial system in particular and the economy as a whole, proved costly. On the other hand, early action taken by the IMF to provide financing to emerging market and developing countries adversely affected by the crisis enabled these countries to weather the crisis and turn around their economies more rapidly.

- Policies should be based on a long - term view so as to prevent the build-up of risks. The lack of long - term vision could otherwise result in policy makers having to resort to short-term stimulus measures in the face of a crisis.

- Central banks and governments need to be proactive in communicating with markets in order to minimise the fallout from crises, as the lack of predictability and clarity of policy actions can increase the level of uncertainty in the market.

- The resilience of countries depends on the macroeconomic policies that are put in place long before a crisis takes place. For instance, measures taken by some countries to build foreign reserves enabled those countries to meet the demand for foreign currency during the crises.

- The crises also highlighted the need to anticipate risks and prepare responses during good times so that countries are in a state of readiness to act decisively during bad times. Countries that build up counter cyclical capital buffers for banks, during good times were able to run down these capital buffers during the time of the crisis without risking the solvency of banks.

- Having a sound financial system is vital to reducing the risk in a constantly evolving financial market. Consequently, central banks across the world are looking at strengthening the regulation and supervision of the financial sector and identifying "early warning" signs. The recent financial crisis has also highlighted the importance of taking a macro-prudential view to regulation, thus focusing on the entire financial system as opposed to micro-prudential regulation, which is more concerned with the stability of individual institutions.

these operations helped to improve confidence and liquidity conditions in financial market.

The premature withdrawal of accommodative monetary and fiscal policies is a particular concern as the global demand could contract as a result of tightening policy measures. The key requirement remains to restore financial sector health, while maintaining supportive macroeconomic policies until the recovery is on a firm footing. The global response to the aftermath of the financial crisis will be mainly focused around the gradual withdrawal of fiscal support. Accommodative monetary policy strategies would be required to moderate the impact of these exit strategies. Various economies have already started to employ various exit strategies and in fact, some interventions are already being unwound with the improvements in financial conditions. The Federal Reserve has already taken measures to reverse the asset buy-back scheme through which they purchased toxic assets of financial institutions in 2008. Further, banks have been requested to payback the emergency credit facilities obtained from the US government. Many central banks have unwound the emergency swap facilities with the Federal Reserve that were entered into during the acute phase of the crisis. Countries such as Japan and the UK have stopped the corporate bond purchase schemes. Australia has already begun to increase its policy rates with a view to managing excess market liquidity. Emerging economies have relaxed exchange control regulations to promote inward remittances in order to help local organisations seeking foreign borrowing at a reduced interest rate. As 2010 progresses, central banks' policies would focus greatly on liquidity management and thus ensuring that the markets do not once again spiral into another asset bubble led economic expansion.

1.4 Medium Term Macroeconomic Outlook, Challenges and Policies

The economy of Sri Lanka is expected to recover steadily and grow above the pre-crisis level in the medium term facilitated largely by the positive outlook brought about by the end to the conflict. The improved macroeconomic environment, increased investor confidence, new investment opportunities created with the end to the conflict, together with the commitment shown by policymakers to implement appropriate strategies, speedy implementation of several major infrastructure projects and rehabilitation and reconstruction activities in the newly liberated areas as well as the expected recovery of the global economy would provide the required impetus for such a high growth.

A higher growth of 7-8 per cent is expected in the medium term. The required investment of around 30 per cent of GDP to achieve such a growth target is expected mainly from domestic savings though there will be considerable inflows of foreign resources as well. The increase in domestic savings to enhance investments in the medium term is expected from both the government and the private sector. This would require a generation of a surplus in the current account of the budget and maintaining a conducive macroeconomic environment with low inflation to encourage private savings. Hence, it is expected that the fiscal policy in 2010 and beyond will be directed towards strengthening the fiscal consolidation process through enhancing government revenue and rationalising recurrent expenditure. Monetary expansion will be maintained at an appropriate level to provide the necessary liquidity required to facilitate the smooth functioning of markets, while containing demand pressures. Inflation in the medium term is expected to be maintained at a single digit level. The external sector is expected to improve further in the medium term, maintaining reserves equivalent to over five months of imports. In addtion, credible implementation of identified structural and institutional changes, including those in the power and energy sectors, introduction of necessary measures to improve the investment climate further, effective utilisation of the post-conflict opportunities, addressing infrastructure bottlenecks by timely completion of ongoing and planned infrastructure projects, and further strengthening of the financial system are envisaged. The expected favourable global economic conditions, benign security situation and contribution from former conflict areas would

Table 1.5 **Medium Term Macroeconomic Framework (a)**

Indicator	Unit	2008(b)	2009(c)	Projections 2010	2011	2012	2013
Real Sector							
GDP at Market Prices	Rs. bn	4,411	4,825	5,445	6,202	7,064	8,009
Real GDP Growth	%	6.0	3.5	6.5	7.5	8.0	8.0
Inflation-GDP Deflator	%	16.3	5.7	6.0	6.0	5.5	5.0
Total Investment	% of GDP	27.6	24.5	27.8	29.5	32.0	33.0
Domestic Savings	% of GDP	13.9	18.0	18.6	20.4	23.0	24.2
National Savings	% of GDP	17.8	23.9	24.2	26.3	29.2	30.4
External Sector							
Trade Gap	US$ mn	-5,981	-3,122	-4,874	-5,588	-6,307	-7,042
Exports	US$ mn	8,111	7,085	8,094	9,067	10,197	11,528
Imports	US$ mn	14,091	10,207	12,968	14,655	16,504	18,571
Services (net)	US$ mn	401	391	517	695	837	996
Current Account Balance	US$ mn	-3,886	-214	-1,642	-1,638	-1,642	-1,766
Current Account Balance	% of GDP	-9.5	-0.5	-3.5	-3.1	-2.7	-2.6
Overall Balance (d)	US$ mn	-1,385	2,725	700	967	902	970
External Official Reserves (Months of Imports) (d)(e)(f)	Months	1.4	6.0	5.3	5.5	5.5	5.0
Debt Service Ratio (g)	%	15.1	19.0	14.5	15.3	19.8	18.5
Fiscal Sector							
Revenue and Grants	% of GDP	15.6	15.1	15.4	16.6	17.5	17.6
Expenditure and Net Lending	% of GDP	22.6	24.9	23.0	23.1	22.5	22.4
Current Account Balance	% of GDP	-2.0	-3.6	-1.9	0.4	1.0	1.2
Overall Budget Deficit	% of GDP	-7.0	-9.8	-7.5	-6.5	-5.0	-4.8
Domestic Financing	% of GDP	7.1	5.0	5.1	3.5	3.4	3.5
Financial Sector (h)							
Reserve Money Growth	%	1.5	13.1	13.5	14.0	13.9	13.4
Broad Money Growth (M_{2b})	%	8.5	18.6	13.5	14.1	14.0	13.5
Narrow Money Growth (M_1)	%	4.0	21.4	7.5	8.1	8.0	8.0
Growth in Credit to Private Sector	%	7.0	-5.7	13.2	15.1	17.3	17.2
Growth in Credit to Public Sector	%	48.8	13.1	7.4	5.1	0.6	-1.5

(a) Based on the information available by mid March 2010.
(b) Revised
(c) Provisional
(d) Values for 2008 were revised due to a change in the classification of external assets.
(e) Excluding receipts of Asian Clearing Union.
(f) External official reserves from 2010 onwards include the expected proceeds from the IMF Stand-by Arrangement facility 2009.
(g) Total debt service payments as a percentage of earnings from export of goods and services.
(h) Year-on-year growth in end year values.

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

help boost external trade and tourism as well as foreign investments. Even though the trade deficit is expected to widen in the medium term, the anticipated increase in migrant workers' remittances is expected to ease the deficit in the external current account. Further, with the expected higher level of foreign inflows to the government and the private sector, the surplus generated in the capital and financial account is expected to more than offset the current account deficit, thereby resulting in a BOP surplus. However, a slower than expected recovery of the global economy and delays in the implementation of much needed structural changes, unexpected increase in commodity prices, particularly the oil prices, and weather related shocks, could adversely affect the achievement of the medium term targets.

Positive investor sentiment following the ending of the internal conflict, coupled with the recovery of global financial markets are expected to make available more foreign financial flows to the government and the private sector, including FDI, in 2010 and beyond. Further, with the easing of global liquidity constraints, both the government and the private sector would be able to raise funds at competitive rates in the international capital market. By end 2009, the government had a cumulative financial commitment of around US dollars 6.4 billion from Sri Lanka's development partners in the pipeline for development activities as compared to US dollars 5.9 billion at end 2008. The project implementation duration for these commitments is in the range of 2-5 years and is mostly for infrastructure projects that would further expand the production capacity of the country. In addition, a higher level of FDI is expected especially in the tourism, agriculture, construction and manufacturing sectors.

Effective planning and co-ordination and strong commitment for implementation of projects are essential to maximise the benefits of the new opportunities created by integration of the Northern and the Eastern provinces with the rest of the country. Timely implementation of various rehabilitation, reconstruction and development projects identified under the "Neganahira Navodaya" (Eastern Resurgence) and "Wadakkil Wasantham" (Uthuru Wasanthaya/Northern Spring) programmes will pave the way for enhancing economic activities in conflict affected areas as well as the rest of the country. New investment opportunities will also be available in the areas of infrastructure, agriculture, tourism, transport, health, education, industry, commerce, fisheries and the services sectors. A number of projects have already been approved by the Board of Investment (BOI) for the Northern and the Eastern provinces. The commitment shown so far needs to be continued to fast track development activities in the two provinces to realise the maximum benefits to the entire country in the long run.

Fluctuation in prices of domestically produced agricultural commodities leads to high volatility in inflation. The key to controlling inflation in the long run is the management of aggregate demand through appropriate monetary and fiscal policies. However, supply side constraints, such as the lack of storage facilities, deficiencies in transportation, shortage of labour in certain areas, and seasonal issues need to be addressed to reduce short-term fluctuations in commodity prices. Policies focused on improving facilities, such as irrigation, transport in remote areas, extension services, availability of high yielding varieties of seeds and research and development, would help to improve productivity while reducing cost of production. At the same time, measures are required to increase storage facilities for key food items at national and regional levels to maintain buffer stocks to address seasonal price fluctuations. In addition, the promotion of forward sales contracts and commodity exchanges will be helpful to address price volatility and stabilise the income of farmers.

The contagion of the global financial crisis as well as problems encountered due to the failure of a few entities connected to domestic financial institutions have highlighted the importance of strengthening the regulatory and supervisory framework to ensure the stability of the financial system. A stable financial system not only ensures customer protection and development in the financial sector, but also helps effective transmission of macroeconomic policy measures. It is in that context that many measures were taken by CBSL to further improve the regulatory and supervisory framework in order to strengthen the soundness and safety of the financial system through strengthening the legal framework. As a further measure of strengthening public confidence in the financial system, it has been proposed to introduce a deposit insurance scheme. The recent international financial turmoil has highlighted the need for effective mechanisms for a depositor compensation scheme. Hence, the establishment of a mandatory deposit insurance scheme (MDIS) would assist in improving and maintaining public confidence in the financial system. Deposit insurance, a key component of a financial safety net, limits the scope for discretionary decisions, helps contain the cost of resolving failed banks and provides an effective mechanism for dealing with bank failures. An explicit deposit insurance scheme also complements the prudential regulation and lender of last resort facility, which are other components of a financial safety net. Further improvements are also necessary in the financial system, to reduce high intermediation cost and enhance the resilience of the financial system.

The fiscal consolidation process needs to be strengthened further to facilitate demand management policies and to enhance public investment to support higher and sustainable economic growth. The relatively lower level of the government revenue underscores the need for strengthening the tax system in the country. In this context, introducing necessary steps to simplify the tax system, such as introducing appropriate rates, broadening the tax base, rationalising tax concessions and exemptions, reducing the complexity of the import duty structure, and improving tax administration, while introducing new technology to improve tax collection, will be helpful. An efficient tax regime will encourage private sector economic activity and capital formation. Possible gains from expenditure rationalisation can be expected only in the medium term as the scope for reducing recurrent expenditure in the short-term is limited. As the continued high growth of recurrent expenditure is un-sustainable, effective measures to rationalise transfers, subsidies, pensions, and interest payments need to be introduced by addressing the root causes of such expenditure sources. At the same time, vulnerable sections of the society have to be protected by appropriate safety nets.

In order to improve overall economic efficiency and productivity and promote long-term economic growth, structural and institutional changes already identified need to be implemented. In this respect, special attention is needed to implement appropriate changes in the areas of state owned enterprises (SOEs), health and education sectors to improve efficiency and productivity along with sound regulatory systems. SOEs, which provide important infrastructure services, such as electricity, petroleum, water supply and passenger transportation, are operating below their optimum level although the majority of them function as state owned monopolies. The services rendered by most of these institutions are below the desired level and depend heavily on public funds rather than operating as commercially viable entities. Therefore, it is important that these institutions operate at least on cost recovery basis, while improving efficiency to reduce their dependence on the budget. The proposal to increase workplace efficiency and productivity by 50 per cent during the next six years as stated in the government's policy agenda also needs to be credibly implemented.

Deficiencies in financial operations of the power sector continue to pose serious challenges to the country's financial management. Over the years, the financial position of the Ceylon Electricity Board (CEB) has remained significantly weak, exerting pressure on fiscal and monetary management. Hence, necessary changes, as provided under the Sri Lanka Electricity Act (SLEA), need to be introduced to make CEB a financially viable institution in the long run, thereby reducing its reliance on the government budget and on bank credit to meet its financial needs. Introduction of distinctive profit and management centres for key areas of operations, such as generation of hydropower and thermal power, transmission and distribution etc., need to be considered. If necessary, these profit and management centres could also be listed on CSE in order to improve transparency and accountability of their operations. The sustainability of the power sector largely depends on shifting towards low cost power generation in the medium term. The ongoing and planned low cost power plants are expected to be added to the national grid in the coming years reducing the exposure of the power sector to adverse weather conditions and oil price shocks. Hence, timely completion of planned low cost power projects is imperative as any delay in the implementation of these will lead to high expenditure on petroleum imports for electricity generation as well as the maintenance of a high electricity tariff. The pricing and regulatory aspect of the power sector also needs to be strengthened under the Public Utilities Commission of Sri Lanka (PUCSL).

Although the financial operations of the Ceylon Petroleum Corporation (CPC) showed some improvement in 2009, the long-term financial viability of CPC remains exposed to risk. The provision of furnace oil at a highly subsidised price to CEB, the non-adjustment of retail prices to reflect the cost, and the non-settlement of a significant amount of outstanding credit by several institutions, including CEB, have placed a heavy burden on CPC's financial position. Hence, appropriate changes need to be introduced to make CPC a financially viable institution in the medium to long-term. These could include the introduction of a realistic and flexible pricing mechanism to price petroleum products in the local market and the implementation of a profit centre concept, covering various key activities of CPC, such as the refinery, supply of agro chemicals and supply of aviation fuel. At the same time, while continuing with the ongoing oil exploration activities, it would be important to commence licensing for the next round of oil exploration in the remaining blocks in the Mannar Basin as well as some blocks in the Cauvery Basin, which have better prospects.

Reorientation of the higher education system to explore new frontiers of knowledge and change the present 'supply driven' education system to a 'demand driven' one to meet the labour market requirements in the economy is required. Though the government has already taken progressive steps towards improving general education, additional measures need to be taken to further strengthen the initiatives to address the disparity between schools in the centre and periphery, while taking measures to improve accessibility and relevance of tertiary education. Given the fiscal constraints, the scope for expanding accessibility to university education in state universities is limited and far below the demand. Hence, a large number of students are seeking placements in foreign universities, including universities in the South Asian region, in addition to universities in the United States, Europe and Australia. The outflow of foreign exchange on account of such education is estimated to be substantial. Hence, it is now time to allow non-state sector higher education institutions to participate in the higher education sector with appropriate regulations and accreditation policies so as to cater to the significantly increasing demand for higher education in the country.

Public-Private Partnerships (PPP) have been identified as an alternative mode of attracting capital and entrepreneurship. The promotion of PPP model has been particularly emphasised in implementing various infrastructure projects as against the continuation of the existing practice of financing them through the government budget, which tends to widen the fiscal deficit and increase the outstanding government debt. Despite the recognition of the importance of PPP, the progress that Sri Lanka has made over the years in this area appears to be insufficient due to many reasons, including the lack of awareness and unavailability of a well prepared plan to attract private sector investors towards such projects. Hence, it is essential to identify specific projects, in which the private sector can participate under PPP, while creating a conducive environment for the private sector to actively engage in PPP.

Sri Lanka's export strategy in the medium-term would need to focus on diversifying products as well as markets. Exporters should be encouraged to differentiate the range of their products and services, through branding, value addition and product diversification, to cater to different segments of the market, in order to capture new markets. The promotion of knowledge based exports, such as Information and Communication Technology (ICT) related Business Process Outsourcing (BPO) and Knowledge Process Outsourcing (KPO), would also be needed to increase the earnings from the export of services. In diversifying markets, adequate attention would need to be paid to opportunities available in the South Asian region. This is already reflected in the increasing share of Sri Lanka's exports to countries in this region. India has become the sixth largest export destination for Sri Lanka after the implementation of the bilateral free trade agreement (FTA) with India. Other regional countries are also becoming important trading partners and Sri Lanka has already entered into an FTA with Pakistan as well. Deeper regional economic integration would help access the relatively large consumer base in this region, which would be an important catalyst to promote external trade. Meanwhile, given the highly competitive nature of port services and considering the development of several major port projects around the country, it is very important to strategically develop the port sector operations within a new business model. In this respect, PPP have already been proven successful as reflected in the performance of the South Asia Gateway Terminals

(SAGT) Ltd. Further, it would generate more value to society if the ownership of such entities were further broad-based by inviting the general public to contribute towards its capital. This would also enhance the governance and accountability of such enterprises.

Several additional measures are to be taken by CBSL to broaden and strengthen the institutional and market infrastructure in the financial system to realise the full potential of the financial sector for economic growth and to improve the resilience of the financial sector. It has been proposed to set up an Export and Import Bank (Exim Bank) with a view to integrating the Sri Lankan economy with the global economy by promoting financing and facilitating international trade and investment. This bank will be involved in providing financial assistance to exporters and importers to promote the country's international trade in goods, services and capital. With regard to market development, a multi-asset class trading mechanism is to be set up consisting of commodity futures and warehousing/collateral management. In many developing countries, including Sri Lanka, the main source of corporate financing is the banking sector as the corporate debt market is not sufficiently developed. Accordingly, several new initiatives will be undertaken aimed at promoting further growth in the corporate bond market and enabling it to play a significant role in providing the financing needs of the economy.

Further liberalisation of exchange control restrictions relating to capital account transactions are to be undertaken, as announced in Road Map, to deepen the domestic financial system and promote greater integration of the Sri Lankan economy with global markets. In liberalising the financial sector, CBSL has always adopted a gradual and phased approach to ensure that the overall stability of the financial system is safeguarded whilst reaping the resultant benefits to the economy. Accordingly, considering the developments in the foreign exchange market, in March 2010, the exchange restrictions on opening and maintaining of accounts with banks abroad for Sri Lankans were removed and a greater flexibility was accorded for foreign investors to invest in different assets. Several further measures have also been announced in the Road Map, which will provide alternative investment and borrowing opportunities for private sector individuals, while foreigners will also be given greater flexibility to invest in financial assets. It is expected that these new measures will contribute to further improving investor confidence and developing financial markets.

The resilience of the export sector to various external and internal shocks would need to be strengthened further. Sri Lanka's export sector has successfully overcome a range of shocks in the recent past, including the abolition of the Multi-Fibre Arrangement (MFA), the unprecedentedly high price of oil and other commodity prices, the imposition of the war risk premium etc. The European Union (EU) indicated that Sri Lanka would continue to receive preferential access to the European market under GSP+ scheme until August 2010. The government of Sri Lanka continued to engage in a dialogue with EU on some of the concerns raised by them. EU has expressed its willingness to extend GSP+ facility until end 2011, provided a mutual agreement is reached on certain key areas. The benefits availed by GSP+ facility helped Sri Lankan producers to compete with producers of other countries in the European market, particularly during difficult times. However, the future of the country's external trade would depend on the comparative advantage of its goods and services and not on preferential tariff concessions, and this factor must be clearly recognised. Thus, domestic industries must aim for higher levels of value addition and improve technology to raise their productivity, in order to compete with producers of similar products from other countries. Sri Lankan exporters have proven their resilience amidst difficult times before and are expected to continue to find innovative ways of improving their competitive advantage (See Box No. 7).

The dawn of peace has brought about a positive outlook for the country's tourism industry and is bound to offer a multitude of benefits to the economy. The impact of peace is already manifested in increased tourist arrivals and the revival of the tourism sector. The number of tourist arrivals is expected to grow significantly in 2010 and this growth momentum is expected to continue in the coming years. Necessary measures would need to be taken to expand the facilities at major tourist destinations to cater to the requirements of the increased number of arrivals. It is expected that, with an effective marketing strategy, tourist arrivals would exceed the one million mark within a few years. Sri Lanka's prospects for tourism were dampened over the years due to adverse travel advisories, insufficient planning, inadequate infrastructure, poor products and ineffective marketing strategies. Hence, it is important that a long-term tourism development plan is prepared and implemented to fast track the growth in the country's tourism industry. Sri Lanka should capitalise on its diverse array of attractions which can be traversed within a short period of time and a capacity to cater to tourists with varied interests. Tourism can be promoted to draw attention to the various natural and cultural features that are unique to Sri Lanka, through ecological, recreational, adventurous, religious, cultural and heritage tourism. Investments in these sectors can range from hotels, restaurants, recreational and entertainment facilities, transportation facilities, medical, sports, shopping and other auxiliary services related to the hospitality industry. Further liberalisation of domestic air transport services would also help the growth of the tourism industry.

The SME sector needs special attention. The SME sector makes a significant contribution to the economy by catering to domestic and foreign demand and supplying to larger industries thereby generating employment opportunities in all parts of the country and contributing to the reduction of regional disparities. A number of measures, including refinance schemes, have been introduced to assist SMEs considering the adverse impact of the global economic recession and decreased domestic demand on this sector. Given the fiscal constraints, direct assistance that can be expected from the government is limited. Hence, with a view to easing the financing constraints faced by SMEs, it has been proposed to establish a credit guarantee scheme for SMEs. Under this scheme, SMEs will have increased access to bank financing at competitive interest rates thus enabling them to expand their productive capacities. Further, a pragmatic approach is needed to assist the affected enterprises on a priority basis. In line with these efforts, it is also essential that SMEs re-align their operations and improve productivity to face emerging challenges.

The optimism created by the restoration of peace, the conducive macroeconomic environment, complemented by the global economic recovery has placed the economy in a position to grow at a faster rate. A vast potential exists in all key sectors of the economy to grow at higher rates. Implementation of a large number of infrastructure projects in the areas of ports, airports, power, roads, railways, irrigation and water supply will increase the productive capacity of the economy facilitating such higher economic growth. However, faster economic growth could have some challenging environmental implications and therefore, higher economic growth and environmental safeguards should reinforce each other. Hence, environment protection and promotion have to be given due recognition in the development process.

Box 2

Post-Conflict Development Programmes and Investment Potential in the Northern and the Eastern Provinces

The liberation of the Northern and the Eastern provinces has provided an unprecedented opportunity to revive economic activities in these regions, the benefits of which are bound to spill over into the entire country. Nearly three decades of conflict hindered the development of the two provinces due to destruction of infrastructure, under-utilisation of production capacity, weak investor confidence and severe human suffering. These two provinces account for over two thirds of the country's coastal and maritime resources and about one third of the country's fertile land area. Unrestricted access to these areas, which were centres of military conflict until very recently, has offered a tremendous potential for the development of the agricultural and fisheries activities and related industries in these areas. Since regaining control over these two provinces, the government has initiated two province specific programmes; *Neganahira Navodaya (Eastern Revival)* in the Eastern Province (EP) and *Wadakkil Wasantham (Uthuru Wasanthaya/ Northern Spring)* in the Northern Province (NP) to revive abandoned industries, which these provinces were well known for, and to facilitate the development of new industries, in order to accelerate development and enhance the livelihoods of the people in these regions. Both programmes comprise two components; a resettlement and rehabilitation component to enable people to get on with their livelihoods, and an infrastructure development component to enhance long-term development and facilitate connectivity within the two provinces as well as with the rest of the island.

Neganahira Navodaya (Eastern Revival)[1]

The *Neganahira Navodaya* development plan was launched in 2007 to improve the long neglected economic and social infrastructure in the EP. All Internally Displaced Persons (IDPs) in EP have been resettled by the end of 2009, in keeping with international standards. Construction work under the North East Housing Reconstruction Programme (NEHRP), which commenced in 2005, was expedited to provide housing to a larger number of beneficiary families. The plan included the restoration of agriculture and irrigation, livelihood support, fisheries and livestock development, roads, power and energy, education, civil administration and health and sanitation. In addition, mega infrastructure projects, in line with the Randora, the National Infrastructure Development Plan, were also included in this programme. More than 3,000 kilometres of roads and 30 bridges have already been constructed with the aim of linking major cities and towns in the EP with the other regions of the country, providing more efficient transportation facilities, enabling the lateral movement of people and promoting private sector investments. The investment in power sector has enabled an increasing number of households to access electricity. The developments undertaken in the area of water supply and irrigation systems have helped to increase the capacity of water treatment plants, to extend water supply in major towns in the province and to increase the agricultural productivity. Access to both financial and non-financial resources, has helped the agriculture sector thrive, as evident by the substantial increase in land used for cultivation of paddy and other field crops and the improved quality of agricultural products. The construction work of the Oluvil Port has commenced. Steps have also been taken to complete the construction of new police stations, judiciary courts, school buildings, playgrounds, health clinics, dispensaries, hotels and office buildings to improve the quality of life of those residing in EP.

Wadakkil Wasantham (Uthuru Wasanthaya/ Northern Spring)

With the end of the conflict in May 2009, a Presidential Task Force was appointed to formulate a medium term strategic framework for resettlement, rehabilitation and reconstruction activities and to strengthen security in the NP. The Task Force moved quickly to introduce the *Wadakkil Wasantham* programme, in mid-2009 which included a 180-day accelerated programme to expedite the resettlement and rehabilitation process, and a concurrent two-year programme for the rehabilitation and development activities in the province. A total investment of Rs. 295 billion has been allocated for the planned investment programme for the period 2010-2012.

1 For details see Central Bank of Sri Lanka Annual Report – 2007, Box 2, pp. 16-18.

Table B 2.1 Total Investment Programme under Wadakkil Wasantham for 2010 – 2012

Sector	Amount (Rs. mn)
Social Protection and Livelihood Development	15,091
Improving Economic Infrastructure	176,247
Strengthening Social Infrastructure and Fostering Social Services	29,313
Revitalisation of Productive Sectors	28,477
Human Settlements Development	45,739
Total	**294,867**

Source: Department of National Planning

Of the total IDPs in the NP, 182,025 persons have been resettled by mid-March, 2010. Infrastructure projects in the areas of electricity, water supply and sanitation, transportation, irrigation, livestock development, inland fisheries, health, education, sports and cultural affairs have already commenced. Special projects, such as the reconstruction of the A-9 highway, Vavuniya-Horowpathana, Madawachchiya - Mannar, Mannar - Pooneryn, Mannar - Karaitivu - Nawakkuli and Paranthan - Mullaitivue roads, Northern railway line, Mannar bridge, Kokavil transmission tower and Kankesanthurai port development project, are also in progress. Furthermore, several vocational training centres have been set up in the Vavunya and Mannar districts to help prepare people to embark on new careers. Renovation of schools and temples were carried out to promote religious and cultural activities.

Investment Potential in the Post-Conflict Era

The ongoing infrastructure development programmes in the post-conflict era provides a diverse array of investment opportunities ranging from infrastructure, agriculture, tourism, transport, health, education, industry to the commerce and the services sectors. Several projects have been approved by the Board of Investment (BOI) of Sri Lanka in the areas of manufacturing (textile, garments, furniture and concrete tiles) and agriculture (rice, maize, fruits and vegetables, livestock and deep sea fishing) for both domestic and foreign markets.

The long, scenic, unpolluted beaches, the ecological conservation areas and the numerous important cultural and historical sites are bound to support a vibrant tourism industry in these two provinces. Potential areas of investment includes holiday homes, guest houses, hotels, villas and restaurants in Trincomalee, Jaffna, Nilaweli, Arugambay and Pasikudda and other localities as well as in transportation, entertainment, travel agencies, tourist information centres, human resource development and other support services for the hospitality industry.

Supported by fertile lands, irrigation and other infrastructure facilities, and the ample availability of labour, there is tremendous scope for investment in large scale commercial agriculture and livestock development pursuits as well as in the development of value added agricultural products. There is also a high potential for investments in the coastal and deep sea fisheries sectors. The average width of the coastal waters bordering these two provinces is about 25 kms throughout most of its length of 1,180 kms, with shallow fish banks in the Gulf of Mannar, Pedro Bank and Palk Bay, which are known to have a high density of high valued fish, prawns and lobsters.

Avenues for investments in the industrial sector range from the development of existing industries, such as salt, cement, chemical, sugar and paper to the establishment of new industries such as textiles, light manufacturing, agricultural food processing, dairy products, canned fish, gas, etc. Commencement of housing development projects will make a significant contribution to the housing needs in the two provinces. Nearly 235,000 houses in the NP have been damaged which would need to be rebuilt. Investments are also needed in the areas of transportation, education and healthcare sectors as well as in Information and Communication Technology (ICT) and Business Process Outsourcing (BPO). Furthermore, the prospective Cauvery basin is now open for oil exploration.

Having identified the viable investment potential, which could unleash new sources of growth, the government has already made several efforts to implement and support them in various ways. In addition to the restoration of basic infrastructure needs, the Government has also taken steps to strengthen the legal, administrative and institutional framework to encourage investors. A variety of tax concessions have been offered to attract investments into these regions (Box 16). The first post-war investor forum, "the Business for Peace Action Programme (or BizPAct) Investment Forum – Jaffna" was launched in June, 2009. The Central Bank's approval has been granted to establish 137 bank outlets in the Northern and the Eastern provinces to support the private sector.

Even though the Northern and the Eastern provinces together account for about 29 per cent of the country's land area and 14.5 per cent of the total population, their contribution to GDP[2] remained abysmally low at 8.4 per cent as these two provinces continued to be poverty ridden, lagging regions due to the prolonged conflict. However, the cumulative effects of *Neganahira Navodaya* and *Wadakkil Wasantham* development programmes and the exploitation of viable investment potentials is bound to enhance the productivity, leading to higher GDP growth, increased employment and enhanced internal and external trade. This would, in turn, reduce the level of poverty by improving the living conditions of people in these provinces and the entire country, while contributing to growth, reducing the distributional inequality and fast tracking the development of the country.

2 As per provincial GDP in 2008.