

**ECONOMIC AND
MARKET ANALYSIS:
SRI LANKA**

Economics

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Sri Lanka

2007: Resilience Despite the Odds

- **Despite the ongoing civil strife, political issues and a devastating tsunami in 2004, Sri Lanka's economy remains resilient. Its economic growth is likely to remain around 6% in 2007**
- **Sri Lanka is the first South Asian economy with a per-capita income of over US\$1000; moreover, we think it has achieved a lot on the human development front**
- **Although Sri Lanka has the highest inflation and fiscal deficit in the sub-continent...,**
- **...policy-makers are compelled to maintain a tight balance between raising rates and leaving room for fiscal flexibility, given that expenditure on debt-servicing is high**
- **Investment policies appear to be market friendly, with the most recent initiative being the opening of the G-Sec bond market to foreign investors**

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Despite the ongoing civil conflict, volatile political conditions and a devastating tsunami in 2004, the Sri Lankan economy remains resilient, with growth likely to stay around 6%.

Politics and Governance

Sri Lankan politics since independence has been dominated by two major political parties — the United National Party (UNP) and the Sri Lanka Freedom Party (SLFP) — which in general have enjoyed alternating rule. For the past four decades, Sri Lanka has been plagued by civil conflicts between the ruling governments and the Liberation Tigers of Tamil Ealam (LTTE) for a separate state. Conflict and strife between the groups has led to numerous outbreaks and breach of security. In February 2002, with facilitation by the Norwegian Government, the two sides agreed to a joint ceasefire accord. However, despite the ceasefire, both sides — the Government and the LTTE — continue to engage in violent conflict, with the most recent incident being the air raids by the LTTE. Such events disrupt economic activity, with reports indicating that the conflict has lowered Sri Lanka's economic growth by 2-3 percentage points a year.

Growth: Resilience Despite Setbacks

Despite decades of civil unrest, volatile political conditions, a devastating tsunami in 2004 and tense domestic security situations, the Sri Lankan economy has exhibited resilience, with growth averaging 5% in the 1990s and touching 7% in 2006. While a milestone achieved in 2004 was its per-capita income crossing US\$1000, a key feature of the economy is the growing regional disparity, with the World Bank saying that Sri Lanka is a text-book example of how market-oriented reforms positively impact growth while the lack of policies leads to stagnation and persistent poverty. The Western province has benefited the most from the market-oriented reforms of the 1970s — liberalization of trade and investment regimes — and due to its proximity to ports, it has been able to integrate with global markets.

Inflation, Interest Rates and the Fiscal Situation

Inflation has been a worry since the tsunami disaster, which set back agriculture and created supply shortages. This, along with higher oil prices, a depreciating rupee and increased government spending on wages all resulted in inflation touching a 10-year high of 20%. High inflation resulted in the Central Bank raising rates 7 times over the last 2 years by a cumulative 337.5bps, thus taking the repo rate to 10.5% and the reverse repo rate to 12%. But going forward, with the fiscal deficit hovering at 8%, the bank will be forced to maintain a tight balance between raising rates and allowing for fiscal flexibility, given that debt-servicing comprises a significant chunk of expenditure.

Trade and the External account

On the external front, while Sri Lanka's trade deficit remains high at around 10%, similar to the other South Asian economies, remittances and tourism have resulted in its current-account deficit being within manageable limits.

Statistical Snapshot

Figure 1. Sri Lanka Macroeconomic Summary (Fiscal Year runs from Jan through Dec)

	1998	1999	2000	2001	2002	2003	2004	2005	2006*	2007E	2008E
National Income Indicators											
Nominal GDP (US\$ bn)	15.8	15.7	16.6	15.7	16.5	18.3	20.1	23.5	27.1	30.9	34.5
Nominal GDP (Rs bn)	1,018	1,106	1,258	1,407	1,582	1,761	2,029	2,365	2,802	3,306	3,802
Per Capita GDP (US\$)	839	825	857	840	870	948	1,030	1,197	1,355	1,536	1,696
Real GDP Growth	4.7	4.3	5.9	-1.5	4.1	6.0	5.4	6.0	7.4	6.3	6.6
Agriculture Growth	2.5	4.5	1.8	-3.4	2.5	1.6	-0.3	1.9	4.7	3.0	3.0
Industry Growth	5.9	4.8	7.5	-2.1	1.0	5.5	5.2	8.3	7.2	7.0	7.0
Services growth	NA	NA	NA	-0.5	6.3	7.9	7.6	6.2	8.3	7.0	7.5
Consumption & Invest (% GDP)											
Total Investments	25.1	27.3	28.0	22.0	21.2	22.1	25.0	26.5	28.7	29.6	30.4
Private Investments	21.8	24.1	24.8	19.0	19.1	19.8	22.8	22.3	24.8	25.7	26.8
Public Investments	3.3	3.2	3.3	3.0	2.0	2.3	2.2	4.2	3.8	3.7	3.8
Total Consumption	80.9	80.5	82.6	84.2	85.6	84.1	84.1	82.8	82.9	81.1	81.5
Private Consumption	71.1	71.5	72.1	74.0	76.8	76.2	76.0	74.5	73.8	72.0	72.0
Public Consumption	9.8	9.0	10.5	10.3	8.8	7.9	8.1	8.2	9.0	9.2	9.6
Monetary Indicators											
Repo Rate- year end	11.25	9.25	17.00	12.00	9.75	7.00	7.50	8.75	10.00	10.50	9.00
Rev Repo Rate – year end	NA	NA	NA	NA	11.75	8.50	9.00	10.25	11.50	12.00	11.00
Inflation – CPI		0.6	8.1	13.4	6.6	1.0	16.8	3.6	17.9	13.0	10.0
Bank credit growth	14.4	17.1	27.0	16.2	6.5	7.6	22.4	15.5	28.5	-	-
Fiscal Indicators (% to GDP)											
Total Revenue	17.2	17.7	16.8	16.6	16.6	15.7	15.3	16.1	17.3	17.9	19.3
Total Expenditure	26.3	25.2	26.7	27.5	25.5	23.7	23.5	24.7	26.1	26.8	27.9
Fiscal Deficit	9.2	7.5	9.9	10.8	8.9	8.0	8.2	8.7	8.8	8.9	8.7
External Sector (US\$bn)											
Exports	4.8	4.6	5.5	4.8	4.7	5.1	5.7	6.3	6.9	7.6	8.6
% yoy	3.4	-3.9	19.8	-12.8	-2.4	9.2	12.2	10.2	8.4	11.0	12.0
Imports	5.9	6.0	7.3	6.0	6.1	6.7	8.0	8.9	10.3	11.5	12.7
% yoy	0.4	1.5	22.4	-18.4	2.2	9.3	19.9	10.8	15.7	12.0	11.0
Trade deficit	-1.1	-1.4	-1.8	-1.2	-1.4	-1.5	-2.2	-2.5	-3.4	-3.8	-4.2
Invisibles	0.9	0.8	0.7	0.9	1.2	1.5	1.6	1.9	2.0	2.7	3.2
Current A/c Def	-0.2	-0.6	-1.1	-0.2	-0.2	-0.1	-0.7	-0.6	-1.3	-1.2	-1.0
% to GDP	-1.4	-3.6	-6.4	-1.4	-1.4	-0.4	-3.3	-2.8	-4.9	-3.9	-3.0
Forex Reserves (excl gold)	2.0	1.6	1.0	1.3	1.7	2.3	2.2	2.5	2.5	2.7	2.8
Months of imports	4.0	3.3	1.7	2.7	3.3	4.2	3.3	3.3	2.9	3.2	3.3
Exchange Rates											
Rs/US\$ – annual avg	64.59	70.4	75.8	89.4	95.7	96.5	101.2	100.5	104.0	110.0	115.0
% depreciation	9.5	9.0	7.7	17.9	7.0	0.8	4.9	-0.7	3.5	5.8	4.5
Rs/US\$ – year end	67.78	72.1	80.0	93.1	96.7	96.7	104.6	102.1	107.7	113.0	118.0
% depreciation	10.6	6.4	11.0	16.4	3.9	0.0	8.1	-2.4	5.5	4.9	4.4

* Estimates by CBSL. Source: Central Bank of Sri Lanka, CEIC Data Company, Citi estimates.

South Asia in Pictures

Figure 2. Nominal GDP (US\$bn)

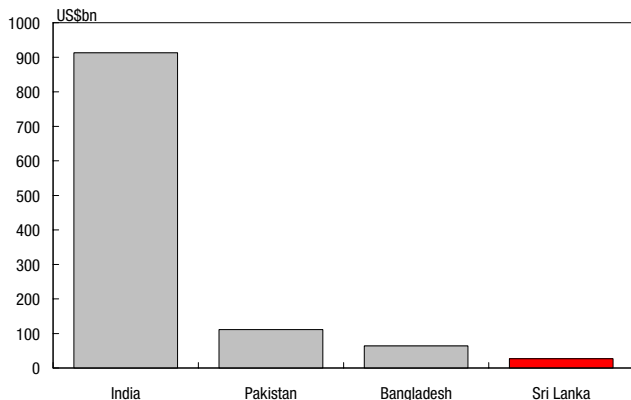


Figure 3. Per Capita Income (US\$)

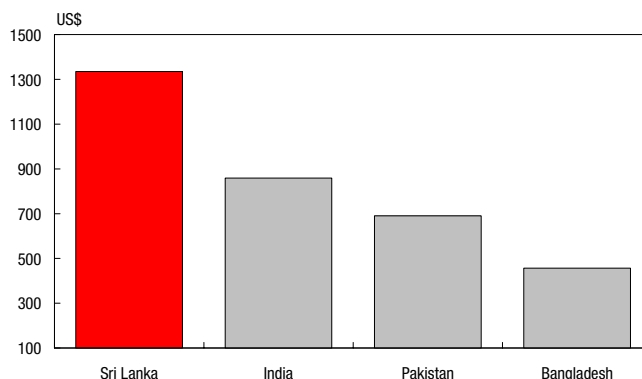


Figure 4. Real GDP Growth (% yoy)

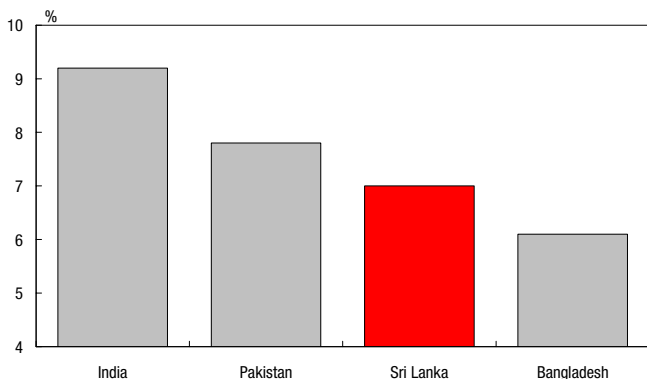


Figure 5. Average Inflation (% yoy)

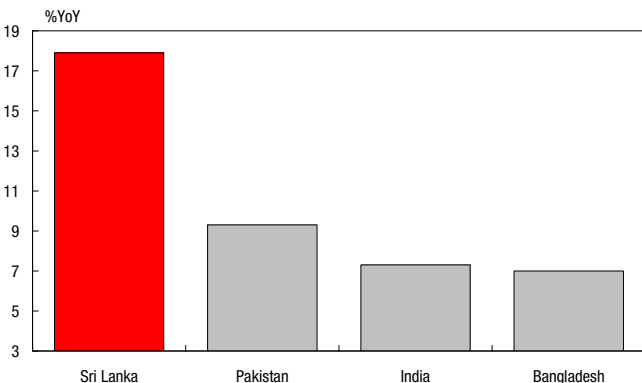


Figure 6. Foreign Exchange Reserves (US\$bn)

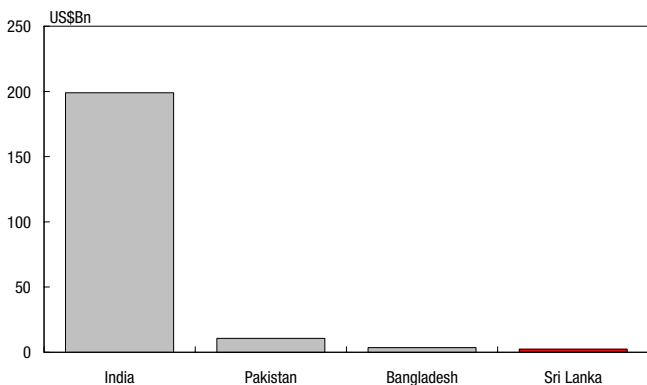
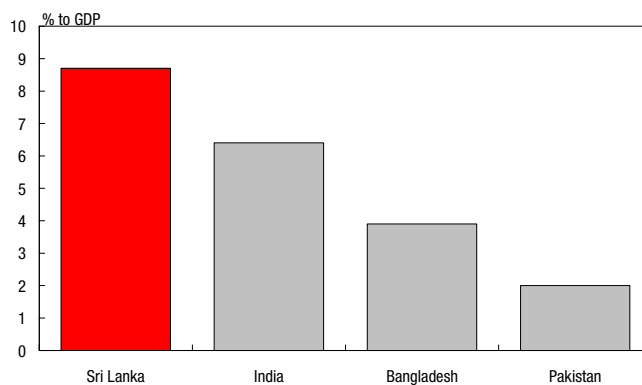


Figure 7. Budget Deficit (% to GDP)



Source: CIA Fact Book; ADB, World Bank

Politics and Governance in Sri Lanka

- Sri Lankan politics since Independence has been dominated by two political parties — the United National Party (UNP) and the Sri Lanka Freedom Party (SLFP) — which have had alternating rule. While the UNP is an anti-communist party, the SLFP is left-wing in nature
- For the past four decades, Sri Lanka has been plagued by conflict between successive governments and the LTTE (which has been classified as a Terrorist Group by most countries)
- Conflict has led to numerous security-related issues, hindering growth

Background: Occupied by the Portuguese in the sixteenth century and by the Dutch in the 17th century, the island was ceded to the British in the late 18th century, and finally gained independence as Ceylon in 1948.

Figure 8. Sri Lankan Political Scenario: Chronology of Events

Events and Time Scale	Details
1948-56: The UNP comes to power	<ul style="list-style-type: none"> • Soon after independence in 1948, D.S Senanayake of the UNP became the first prime minister. • After his death in 1952, his son Dudley Senanayake became the Prime Minister, and was followed by Sir John Kotelawala
1956-65: SLFP	<ul style="list-style-type: none"> • In 1956, the SLFP gained premiership-first under SWRD Bandaranaike, and after his assassination in 1960 under Sirimavo Bandaranayake
1965-70: UNP	<ul style="list-style-type: none"> • From 1965-70, Dudley Senanayake and the UNP once again returned to power
1970-77: Emergency under the SLFP - A new constitution; country renamed - The LTTE is established	<ul style="list-style-type: none"> • The SLFP under Mrs. Bandaranaike once again assumed premiership in 1970. A year later, a revolt by the People's Liberation Front broke out. To suppress this, a state of emergency was declared that lasted 7 years. • At this time, a new constitution was introduced that changed the country's name from Ceylon to the Republic of Sri Lanka. Policies adopted were socialist • In 1972, the Liberation Tigers of Tamil Eelam (LTTE) was formed. Its chief demand since then has been the creation of an independent state in northern and eastern Sri Lanka
1977-1994: The UNP returns - Another new constitution, based on the French model	<ul style="list-style-type: none"> • The SLFP's authoritarian rule ended with the 1977 elections, and the UNP came to force under J R Jayewardene. • Reform processes to liberalize the economy were initiated, and, in 1978, the country was renamed the Democratic Socialist Republic of Sri Lanka. A new constitution was promulgated based on the French model. • In 1988, UNP's Ranasinghe Premadasa defeated the SLFP in the presidential elections. Mr Premadasa was assassinated by the LTTE in 1993, and replaced by D B Wijetunga
1994-2000: The SLFP resumes power	<ul style="list-style-type: none"> • The SLFP returned to power after 17 years as the main party in the People's Alliance (PA) coalition, with Chandrika Bandaranaike Kumaratunga as PM. • Mrs Kumaratunga won the 1994 elections, but appointed her mother (Sirimavo Bandaranaike) as the Prime Minister.
2001 - Present: Cohabitation Crisis; the UNPFA rules	<ul style="list-style-type: none"> • General Elections in 2001 resulted in a co-habitation of both parties, with Ranil Wickremasinghe of the UNP as PM; while Chandrika Kumaratunga (SLFP) remained President • But in 2003, President Kumaratunga took control of three key ministries, triggering a cohabitation crisis • In Jan 2004, the SLFP and the JVP (People's Liberation Front) formed the United People's Freedom Alliance (UPFA). In Feb, President Kumaratunga dissolved Parliament and called for fresh elections where the UPFA formed a govt and appointed Mahinda Rajapakse as PM • In presidential elections held in 2005, Mahinda Rajapakse became President, and Ratnasiri Wickramanayake; the PM

Source: Citigroup, Government Documents, World Bank, ADB

Conflict and Efforts Toward Peace

Sri Lanka has been plagued by the persistence of civil conflict between ruling governments and the LTTE over the past four decades. The LTTE has been uncomfortable with the country's unitary form of government¹ and since the country's independence has been apprehensive that its rights would be comprised by the majority Sinhalese. These fears were reinforced following the appointment of the SLFP in elections in 1956 which saw Sinhala being declared as the official language coupled with new education and agriculture policies that encouraged the Sinhalese farmers from the south to move to the newly irrigated areas of the east.

The divide between the Sinhalese majority and Tamil separatists finally erupted in violence in 1983 when 13 Sinhalese soldiers were killed by the LTTE. This unleashed the largest outburst of communal violence in the country, where tens of thousands died in an ethnic war and a large number were left homeless.

Indian Intervention

In mid-1987, India intervened in the conflict by initially air dropping food to people in the Jaffna Peninsula. Following this Rajiv Gandhi and President Jayewardene signed the Indo-Lanka Accord. With this, the Sri Lankan government agreed to a number of concessions to the Tamil population, which included devolution of power to the provinces, while India promised to establish order in the north and the east with an Indian Peace-Keeping Force (IPKF) and cease assisting Tamil insurgents. However, the LTTE refused to disarm and the IPKF became increasingly entangled in the struggle between the two groups. Fighting between the LTTE and the IPKF continued to escalate and eventually, India withdrew troops from Sri Lanka in 1990.

Norwegian Peace Negotiations and the Current Scenario

Following the IPKF withdrawal in 1990, fighting continued between the government and the LTTE as various government-initiated peace plans failed to materialize. However, with the election of a new UNP government in December 2001, the LTTE and government declared unilateral cease-fires. In February 2002, with Norwegian Government facilitation, the two sides agreed to a joint cease-fire accord. After holding six rounds of talks, the LTTE withdrew from the negotiation process in April 2003 on grounds of being marginalized.

In February 2006 – four years after the ceasefire agreement was signed, the government and the LTTE renewed their commitments to the agreement in Geneva. Currently, the Scandinavian-led Sri Lanka Monitoring Mission (SLMM) is in charge of monitoring a ceasefire. But, it has been accused of bias and violence by both sides. The recent demise of Anton Balasingham, the LTTE's chief negotiator, has further stalled peace talks.

At this time, the informal peace process continues on the ground and both sides in theory continue to observe the February 2002 ceasefire. However, despite ceasefire, both sides — the Government and the LTTE — continue to engage in violent conflict, often resulting in disruptions to economic activity. More recently, the LTTE launched a series of air raids near Colombo, which resulted in disruptions at the country's international airport (resulting in a current suspension of night flights).

¹ The President has an expansive role in the political framework, given that he is Head of State, Head of Government, and Commander in Chief of the Armed Forces. He thus has control over most functions, and can also call for dissolution of parliament.

The Cost of Conflict and the Dividends of Peace

Economic costs of the conflict

Although it is difficult to quantify the impact of peace, the Central Bank of Sri Lanka, in an Annual Report, estimated that the conflict has reduced Sri Lanka's economic growth by about 2-3 percentage points a year. One study indicates the significant difference in growth prior to the ceasefire agreement in 2002 and after (*see table below*).

While the ceasefire has since then all but broken down, the comparison only serves to confirm the benefits that a stable political environment will bring. Apart from its impact on investment flows and overall growth, the deteriorating security situation is also posing a tremendous strain on fiscal health through growing military expenditure. Spending on defense now totals 3.4% of GDP from 1.3% in 1980. Although this is lower than the 5.6% levels seen in 2000, it remains significant. Moreover, a continued dependence on foreign aid has distorted growth. In addition, as one World Bank study² points out, there are many invisible costs, including the crowding out of public investment due to the large defense outlays, foregone tourist arrivals, labor market rigidities, high risk premia on international trade, and disruptions in economic activity,

While conflict between both sides continues and attempts to bring peace in the country seem fragile, the onset of peace is becoming imperative for economic growth in Sri Lanka. Clearly, the dividends from peace will be wide-ranging.

Figure 9. Quantifying the Benefits of Peace (avg annual GDP growth by province)

	1997-2001 (Pre Cease fire)	2002-2003(Post Cease fire)
Northern	3.4%	12.6%
Eastern	4.6%	10.1%
North Central	-0.2%	8.2%
Western	6.0%	6.2%
Overall Sri Lanka	3.9%	5.0%

Source: World Bank Country Assistance Strategy Progress Report, Jan 2006

² Sri Lanka- Recapturing Missed Opportunities, World Bank, June 2000

Economic Overview

- Despite decades of civil conflict, volatile political conditions, a devastating tsunami in 2004, and tense domestic security situations, the Sri Lankan economy has exhibited resilience with growth averaging 5% in the 1990s and touching 7% in 2006
- While a milestone achieved in 2004 was its per-capita income crossing US\$1000, a peculiarity of the economy is growing regional disparities
- Inflation has been a worry since the tsunami disaster and the resultant setback to agriculture, which in turn created supply shortages. This, along with higher oil prices, a depreciating rupee and higher government spending on wages, all resulted in inflation touching a 10-year high of 20%
- High inflation resulted in the Central Bank raising rates 7 times over the last 2 years by a cumulative 337.5bps; thus taking the repo rate to 10.5% and the reverse repo rate to 12%.
- But going forward, with the fiscal deficit hovering at 8%, the bank will be forced to maintain a tight balance between raising rates and allowing for fiscal flexibility, given that debt-servicing comprises a significant chunk of expenditures.
- On the external front, while Sri Lanka's trade deficit remains high in the 10% range, similar to the other South Asian economies, remittances and tourism have resulted in its current account deficit being under manageable limits

Growth: Structure and Trends

Structure of the Economy

Services drive growth, with mobile telephony one of the fastest growing segments

As with many other developing countries, Sri Lanka has seen the agricultural sector's share in GDP decline drastically from nearly 30% in the 1980s to its current level of 17%. Industry comprises close to 27% of GDP, while services contributes over 55% of the total.

Despite the declining share of agriculture in GDP, its importance cannot be undermined, as its development is crucial for Sri Lanka in boosting incomes and consumer demand in rural areas where 80% of Sri Lanka's population continues to live. Rubber, coconut, tea, and paddy³ comprise Sri Lanka's key agricultural produce. While Sri Lanka is the world's largest exporters of tea, one of the key

³ Rice is the principal food crop in Sri Lanka. Its production has been increasing over the past century but is still below the island-wide demand. Rice is cultivated during two seasons principally in the Northern and Eastern plains of the country. The principal cultivation season, October to March, is known as "Maha". The second cultivation season, known as "Yala", is from April to September.

factors that have resulted in low productivity of other products is the fragmentation of land holdings – a result of the Land Development Ordinance, farmers cannot use land as collateral to access credit. Since the country's transition from socialism in the late 1970s⁴, a number of services, such as telecommunications, port services, and financial services have gained prominence with services now the key driver of growth. Tourism, a sector which has been badly hit by the tsunami in 2004 and mounting security concerns, comprises just 1% of GDP. Industrial production in the recent past has been led by strong growth in the textile industry as well as higher expenditure on construction and real estate in the wake of the tsunami.

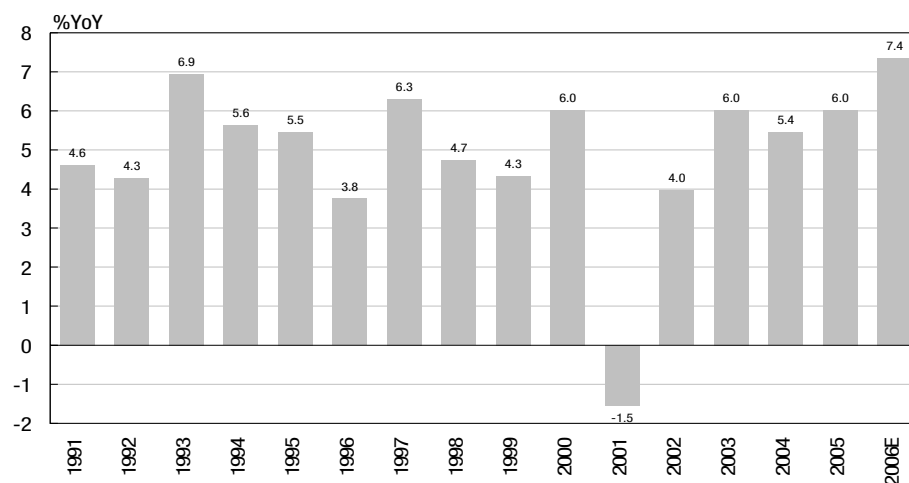
Growth has been Consumption-Driven

Sharing another similarity with India is the fact that growth in Sri Lanka has been consumption-driven, with total consumption comprising more than 82% of GDP. With rising living standards reflected in a higher per capita income, the uptrend in consumption has originated largely from the private sector (75% of GDP). But, interest from private sector investors has resulted in an up tick in private sector investor investment (25% of GDP). Looking ahead, investments could see a further pick up in sectors such as construction, manufacturing, telecom and transportation.

Trends in Growth

Despite decades of civil conflict, volatile political conditions, a devastating tsunami in 2004, and a tense domestic security situation, the Sri Lankan economy has exhibited resilience. GDP growth which averaged 5%+ growth during the 1990s, saw a contraction in 2001 due to a combination of power shortages, budgetary problems, continuing civil strife, and the global slowdown. To its credit, the economy has been quick to rebound – with growth coming in at 6% in 2005 and 7% in 2006. A milestone achieved in 2004 was its per-capita income crossing US\$1000. Going forward we expect growth to decelerate to 6.3% levels in 2007 due to tightening in 2006 coupled with a marginal deceleration in investments and services led by tourism.

Figure 10. Trends in GDP Growth (%YoY)



Source: CBSL, CEIC Data Company

⁴ During this time, and with a second liberalization movement in the early 1990s, tariff structures were revised, restrictions on foreign investment were removed, and an ambitious privatization program was embarked upon

*The western provinces
are far more developed
than the rest of the
country*

Regional Disparities are an Issue...

One peculiarity of the economy is the growing regional disparity. While growth in the Western Provinces has been strong (at 18% compared with the national average of about 13%), and also accompanied by a reduction in poverty, the other regions particularly the North and East have lagged behind. A World Bank study⁵ says that Sri Lanka is a text book example of how market-oriented reforms positively impact growth, while lack of policies lead to stagnation and persistent poverty. The Western provinces have benefited most from the market-oriented reforms of the 1970s — liberalization of trade and investment regimes — and thanks to its proximity to ports have been able to integrate with global markets. This in turn helped unleash a private sector boom in the Western provinces — both manufacturing (with over 70% of the garment factories being located here) as well as services. In contrast, other regions, particularly those in the north and east, remain severely impacted by political strife. But government steps, such as the ‘300 factories program’⁶ could be positive if implemented.

...But Human Development Indicators Suggest Major Achievements

On a positive note, Sri Lanka’s achievements on the human development front have been lauded. As the World Bank points out, with a per capita income of over US\$1000, Sri Lanka has achieved human development outcomes comparable to those of high income countries and already surpassed some of the Millennium Development Goals. These are evident particularly in education and literacy. Moreover, with the revamping of its welfare program – *Samrudhi* – we believe Sri Lanka will make faster gains in poverty reduction.

Figure 11. Key Social Indicators — A Comparative View

	Sri Lanka	India	Bangladesh	Pakistan
Poverty (% of popn below national poverty line)	23	26	50	33
Urban population (% of total population)	15	29	25	35
Life expectancy at birth (years)	74	63	63	64
Infant mortality (per 1,000 live births)	12	62	46	74
Child malnutrition (% of children under 5)	30	47	48	35
Access to an improved water source (% of popn)	79	86	74	90
Literacy (% of population age 15+)	91	61	41	47
Gross primary enrollment (% of school-age popn)	98	116	109	68
Male	NA	120	107	80
Female	NA	112	111	57

Source: World Bank

⁵ Sri Lanka Development Forum - World Bank, January 12, 2007.

⁶ **300 factories:** This is the BoI’s incentive program to promote regional development with the aim of establishing new factories or service companies (such as hotels, hospitals, or training institutes) in 300 districts outside the capital. Incentives include 5-10 year tax holidays depending on the location and number of employees, exempting imports of machinery and equipment would be exempted from both customs duty and the value-added tax. A minimum investment of approximately SLR30mn and employment of 200 persons is required.

Monetary Indicators: Inflation, Interest Rates and Policy

Measurement of Inflation

The Colombo Consumer Price Index (CCPI) is the official index and it uses expenditure data for the lowest 40% of households (with 1952 as the base year) to derive weights. The other price indices include the Greater Colombo Consumer Price Index (GCPI) which has a wider coverage with its weights updated with data for 1985-86; while the Sri Lanka Consumer Price Index (SLCPI) uses weights for the lowest 80% of households, obtained over the period from Nov95-Oct96; thus capturing seasonal variations.

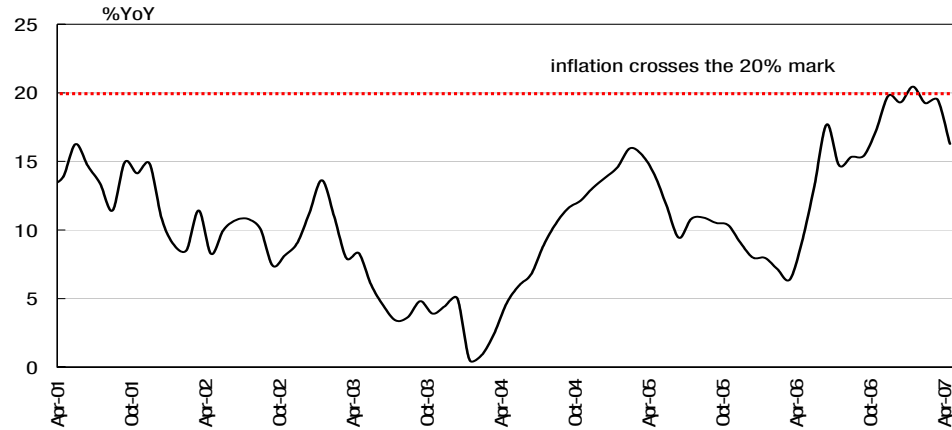
Figure 11. SLCPI- Weights for the base period: 1995-97

Major Group	Weights
Food, Beverages, Tobacco	71.2
Clothing and Footwear	4.1
Housing, Water, Electricity, Gas	13.1
Furnishing, Household Equipment	2.1
Health	2.4
Transport	2.9
Leisure, Entertainment, Culture	0.8
Education	1.3
Miscellaneous	2.1
Total	100

Source: Department of Census and Statistics

Current Trends in Inflation: Price Pressures Mount Again

Following the period of high inflation in Sept-96, when both the GCPI and the CCPI touched all-time highs of 21% and 21.5% respectively, inflation had been under control till 2005 — except for a spike in 2001. However, inflation has been a worry since the tsunami disaster, and the resultant setback to agriculture in turn has created supply shortages. In addition, higher oil prices compelled the government to raise administered gasoline and diesel pump prices. Inflation has also been demand-driven, with higher government spending on public sector wages. Finally, a depreciating rupee has also increased the cost of imports. All this has resulted in the average inflation touching 13.6% in 2006 as compared to 7.6% in 2004. More recently, the CCPI crossed 20% in Jan 07 — the highest in a decade while the SLCPI touched 18%. Looking ahead, the central bank expects to see inflation moderating to 10% in 2007 on the back of continued monetary tightening and a recovery in agriculture. However, politics and oil prices remain a threat, and we expect inflation to trend closer to 13%.

Figure 12. Monthly Trends in Inflation (%YoY)

Source: CBSL

Monetary Management and Interest Rates

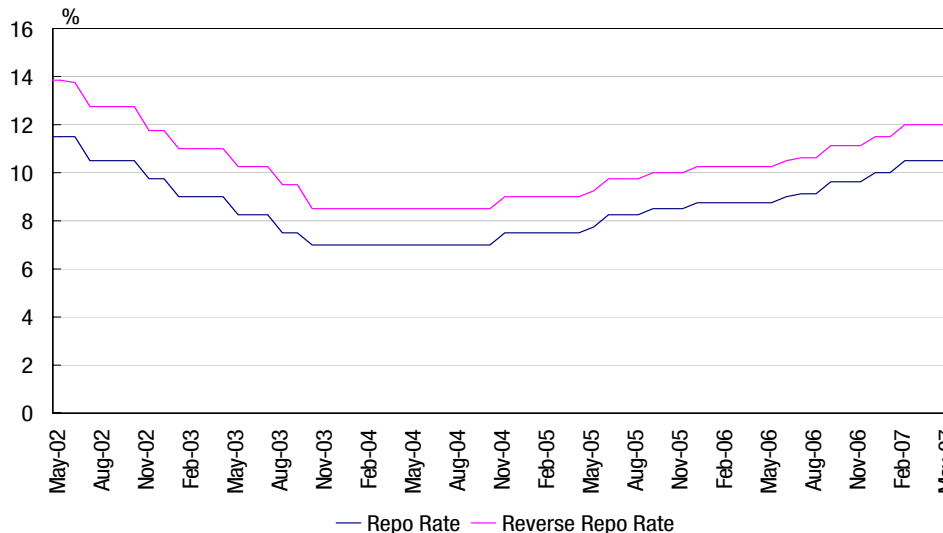
The Central Bank of Sri Lanka (CBSL) is the chief authority responsible for the formulation and implementation of monetary policy in the country. The Bank has at its disposal a wide range of instruments — both direct and indirect — for the conduct of monetary policy. These include the Statutory Reserve Ratio on commercial bank deposits, the Bank Rate, Open Market Operations (OMO), the imposition of credit ceilings, and directed lending. While in the 1980s, emphasis was placed on developmental objectives and exchange rate stability, the CBSL is now increasingly focusing on price stability. To this end, open market operations have been the most intensively used market-based instrument in recent past.

Interest Rates: Tightening Continues as Prices Mount

The CBSL follows a monetary targeting framework using *reserve money as the operational target and broad money (M2) as an intermediate target* to achieve a favorable growth-inflation path. In a bid to curb runaway growth in money supply (up over 19% in 2006) on account of rapid credit growth (+20%), the Central Bank has resorted to raising interest rates 7 times over the last 2 years by a cumulative 337.5bps, thus taking the repo rate to 10.5% and the reverse repo rate to 12%.

Looking ahead, with real interest rates still negative and price pressures remaining high due to strong domestic demand, there could be room for another hike. However, the Central Bank will be forced to maintain a tight balance between raising rates and allowing for fiscal flexibility, given that debt-servicing comprises a significant chunk of expenditures.

The Central Bank has been raising rates to control growth in money supply, inflation

Figure 13. Trends in the Repo and Reverse Repo Rate (%)

Source: CBSL, CEIC Data Company

Fiscal Policy: Reforms would be positive, if implemented

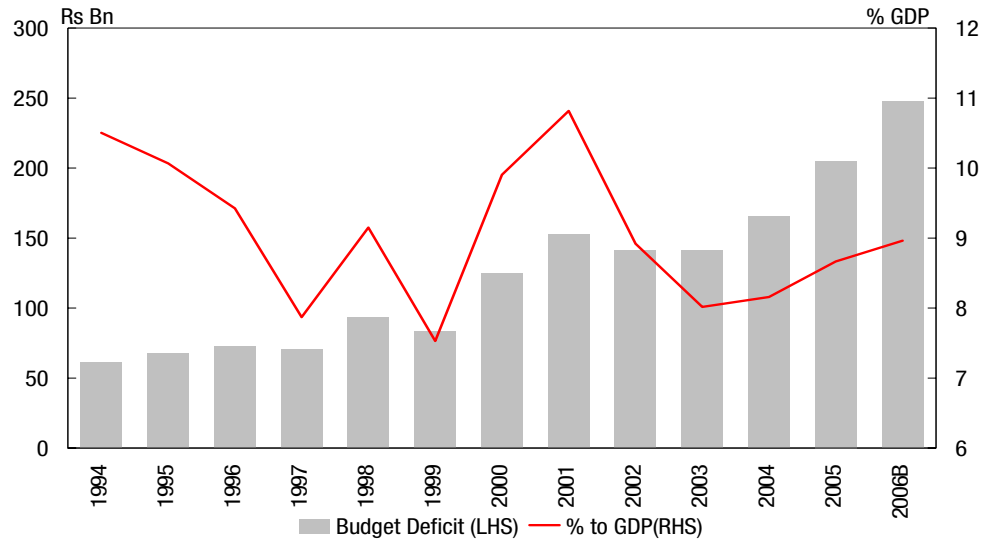
Fiscal Deficit: Reduction a Key Goal

Sri Lanka's fiscal deficit is among the highest in South Asia and has been averaging over 8% for the last ten years due to both revenue and expenditure constraints. The deficit has come down from 10.8% levels seen in 2001 to 8.7% of GDP in 2006 with the government targeting it to decline to 7.5% in 2007E and ultimately 5% of GDP by 2009E as laid out by the Fiscal Management Responsibility Act. However, given the intractable military expenditure coupled with small tax base we expect the deficit to remain in the 8% range. Reduction of the budget deficit remains a key concern for Sri Lanka, particularly since high budgetary expenditures are doing little to promote economic growth.

On the **revenue** front, total revenues accounted for a little over 16% of GDP, with the tax-GDP ratio at 14%. Collections have been low due to the small tax base — a result of various tax holidays to attract investment, difficulties in collecting tax from the North East region as well as the civil servants being out of the tax base until recently. The introduction of a Goods and Services Tax in April 1998 has been a positive development; with VAT contributing to over 40% of total tax revenues.

On the **expenditure** front, revenue expenditures comprise a bulk of the total (76% currently), of which the on-going civilian strife has resulted in high defense expenditure (close to 5% of GDP). Other items include subsidies, wages and transfer payments. As regards capital expenditure, a bulk of the amount is dedicated toward post-tsunami reconstruction efforts.

Figure 14. Trends in Budget Deficit (SLR Bn, % GDP)

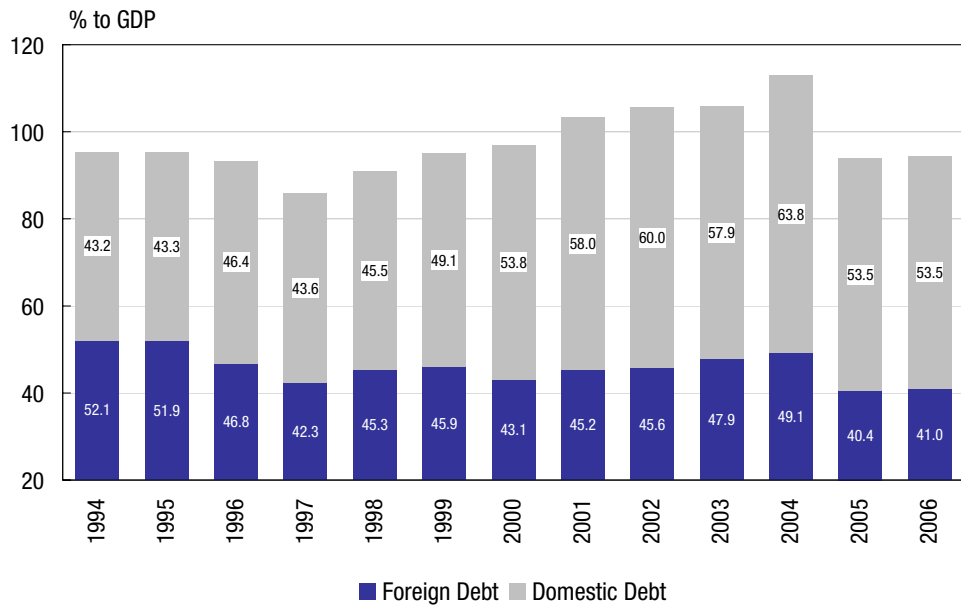


Source: Ministry of Finance

Public Debt: Highest in the Region

Although Sri Lanka is a major recipient of foreign aid, much of this is concessional in nature. However, public debt levels remain alarmingly high, at 94% of GDP in 2005, higher than in India (86% of GDP), the Philippines (65% of GDP) and Pakistan (53% of GDP). Moreover, as the first installments of foreign amortization have to be paid, debt-servicing is becoming a huge fiscal strain. Currently, 20% of expenditure is still spent on interest payments, which is crowding out much-needed public investment.

Figure 15. Trends in Public Debt — Domestic + Foreign (% to GDP)



Source: CBSL, CEIC Data Company

Policy Reforms are Encouraging

Improvement on the fiscal front is a priority for the government as large deficits have taken its toll on government investment as well as led to an expansionary monetary policy, thus resulting in higher inflation.

In response to the revenue shortfall, authorities have initiated a number of policy reforms to strengthen the tax regime, including streamlining VAT, increasing levies, and strengthening tax administration. The Fiscal Management Responsibility Act (FMRA), enacted in December 2002, is also a step in the right direction. The Act, which initially required the overall fiscal deficit to be reduced to 5% of GDP by 2006 and the debt to GDP ratio to less than 85% by 2006, has been revised. New targets aim at reducing the deficit to 7.5% in 2007 and 5% by 2010. In general, fiscal policy has been consistent with the government's overall policy vision, stressed in the *Mahinda Chintana*; and the Medium Term Budgetary Framework⁷.

Sovereign Ratings

In 2005, the country was assigned its first sovereign ratings from S&P, at B+ with a stable outlook, while Fitch assigned it a rating of BB-. However S&P later revised its outlook to negative in April 2006 on the back of the deteriorating security situation. Fitch also has a negative outlook on the country. More recently, in an affirmation of its negative outlook, Fitch said that "*a further deterioration in the security situation to the point where it adversely affects Sri Lanka's credit fundamentals would lead to a downgrade of the sovereign ratings...conversely, the Outlook could revert to Stable given clear signs of fiscal consolidation, a reduction in inflation and, in Fitch's judgment, a material diminution in the risk to sovereign creditworthiness from the conflict*"⁸

Financial Sector: Banking and Capital Markets

The banking system in Sri Lanka comprises Licensed Commercial Banks (LCBs- they include state banks, foreign banks, and domestic private banks) and Licensed Specialized Banks (LSBs comprise development finance institutions, regional development banks, and the National Savings Bank). Currently, there are 23 LCBs and 14 LSBs. More recently, 6 regional development banks, as well as the Small and Medium Enterprise Bank (SME Bank) are to be merged with a newly-created LSB- the Lanka Puthra Development Bank. Reforms in the banking sector have showed slow progress, and continue to suffer from NPLs (in the range of 5-7%) largely due to political uncertainties.

On the capital markets front, the principal stock exchange is the Colombo Stock Exchange (CSE) — among the most technologically sophisticated in the region. It has 242 listed companies and is one of the best performing markets in the region, gaining 28% in 2005 and 42% in 2006. Although it remains vulnerable to political developments, strong corporate performance and negative real interest rates encourage stock purchases⁹. Market capitalization has increased to Rs814bn, although remains low at about 30% of GDP. The CSC has also launched a Debt Exchange (DEX) that will deal in corporate debt securities. Other key reforms have included the setting up of a Real Time Gross Settlement (RTGS) system in 2003 and the proposed introduction of a SWIFT Service Bureau in Sri Lanka that will help reduce transaction costs.

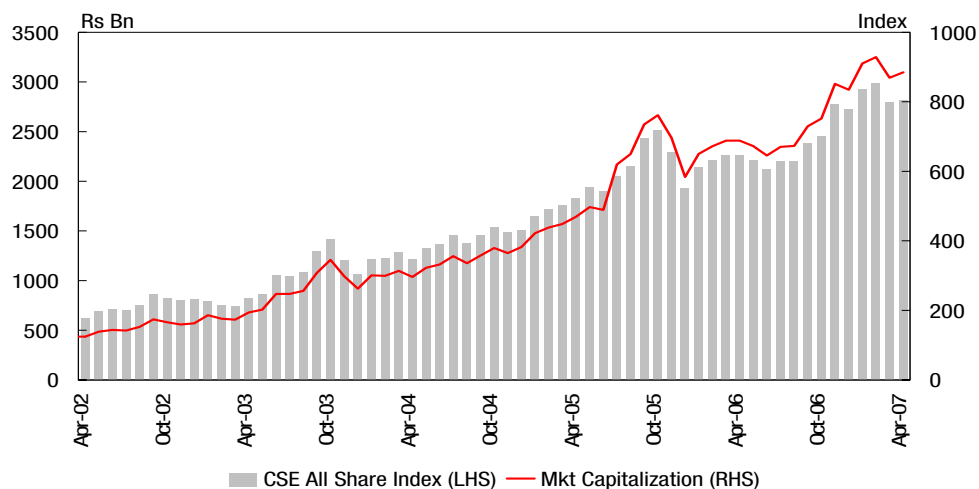
⁷ In brief, the MTBF expects a turn in the revenue deficit from deficit to surplus, higher public investment, lower domestic financing, and a continuation of tsunami-related construction. See Annexure for more details on the Mahinda Chintana

⁸ Fitch Ratings, 23 April 2007

⁹ US Department of State- Country Summary, Investment Climate. For details see <http://www.state.gov/e/eeb/ifd/2007/80746.htm>

On the debt side, the Central Bank of Sri Lanka opened the Gsec bond market to foreigners in November 2006, allowing the purchase 5.00% of the total outstanding Treasury Bonds (or US\$400mn), which was fully subscribed by foreigners.

Figure 16. Trends in the CSE All-Share (Index Value, Mkt Capitalization)



Source: CSE, CEIC Data Company

Figure 17. Colombo Stock Exchange: Top 25 Companies (based on Mkt Capitalization as on 14 May 07)

Company ID	Company Name	12 Month Range		Market Capitalization (Rs Mn)	Market Cap. as % of Total Mkt. Cap.
		High	Low		
DIAL	Dialog Telekom Limited	30	19	192,489	23.4
JKH	John Keells Holding Limited	223	118	93,235	11.3
SLTL	Sri Lanka Telecom Limited	43	17	68,133	8.3
DIST	Distilleries Company of Sri Lanka Limited	135	41	30,000	3.6
COMB	Commercial Bank of Ceylon Limited	250	145	23,368	2.8
CARS	Carson Cumberbatch & Company Limited	5,000	1,830	18,948	2.3
HNB	Hatton National Bank	225	97	18,933	2.3
LIOC	LANKA IOC LIMITED	37	23	14,378	1.8
DFCC	DFCC Bank	275	148	14,282	1.7
NDB	National Development Bank	228	144	13,997	1.7
NEST	Nestle Lanka Limited	310	160	13,431	1.6
HHL	Hemas Holdings Limited	128	99	11,144	1.4
HAYL	Hayleys Limited	165	85	10,500	1.3
CTC	Ceylon Tobacco Company Limited	80	55	10,303	1.3
SPEN	Aitken Spence & Company Limited	400	270	10,015	1.2
BUKI	The Bukit Darah Company Limited	1,600	975	10,010	1.2
AHPL	Asian Hotels and Properties Limited	55	38	8,468	1.0
AMW	Associated Motorways Limited	1,100	141	7,860	1.0
RICH	Richard Pieris & Company Limited	90	60	7,103	0.9
SAMP	Sampath Bank Limited	134	78	7,095	0.9
SHAL	The Shalimar (Malay) Estate Co. Limited	900	601	6,246	0.8
OSEA	Overseas Realty (Ceylon) Limited	25	11	6,186	0.8
DIPD	Dipped Products Limited	130	73	5,941	0.7
CDIC	Capital Development and Investment Co. Ltd	185	112	5,701	0.7
LLUB	Caltex Lubricants Lanka Ltd.	98	66	5,025	0.6

Source: CSE

The External Sector and Exchange Rates

Trade Liberalization over the Years

Trade policy reforms with a focus on export expansion were a key element of Sri Lanka's liberalization program in 1977. This was in contrast to the inward-looking policies that were in place since Sri Lanka got its Independence. However, its trade regime is still moderately restrictive and frequent changes make it uncertain. While the average overall tariff rate at 12%, agricultural imports are subject to specific tariffs which are frequently adjusted according to domestic supply¹⁰.

Trends in Trade

Principal exports comprise textiles and garments, tea, gems and jewellery. Despite strong export growth (+8.4%yoy in 2006), higher imports led by oil, investment goods, such as machinery and equipment, building materials, in the wake of post-tsunami reconstruction as well as consumer goods (specifically motor vehicles) have been on an uptrend. This has resulted in the trade deficit widening from 7.3% of GDP in 2001 to 12.5% currently. Going forward, the trade deficit may widen further if exports weaken on the back of growing security concerns. But, what is positive is that the government is taking several initiatives to enhance trade. These include a comprehensive treaty with India, free-trade agreements with India and Pakistan, as well as initiatives with the EU that have resulted in lower tariffs for Sri Lanka's exports.

Figure 18. Composition of Trade (US\$m, %, 2005)

Exports	US\$m	% to total	Imports	US\$m	% to total
Agricultural	1,154	18.2	Consumer Goods	1,644	18.5
<i>Tea</i>	810	12.8	<i>Food and beverages</i>	753	8.5
Industrial Products	4,948	78.0	Intermediate Goods	5,317	60.0
<i>Textiles and garments</i>	2,895	45.6	<i>Textiles and Clothing</i>	1,531	17.3
Minerals	143	2.3	<i>Petroleum</i>	1,655	18.7
Other	101	1.6	Investment Goods	1,870	21.1
			<i>Machinery and Equip</i>	860	9.7
			Other	33	0.4
Total	6,345	100.0	Total	8,863	100.0

Source: CBSL

Sri Lanka's RMG Industry

In the two decades since the liberalization of the Sri Lankan economy, the garment industry has emerged as the mainstay of the country's industrial sector. Currently, textile and apparel exports comprise over 45% of Sri Lanka's total exports, and 39% of industrial production. However, Sri Lanka has enjoyed quota-free and reduced-duty access to the EU and the US, which means that since the phasing out of quotas in January 2005¹¹, it has had to compete with low-cost imports to these markets and may be faced with the difficult task of retaining its market share that has been protected thus far.

¹⁰ International Monetary Fund, Staff Report- Article IV Consultation; Feb 2004.

¹¹ **The Multi-Fibre Agreement** (MFA) is an arrangement on textile quotas that came into force in 1974. It was followed by an Agreement on Textiles and Clothing where it was decided that quotas would be phased out completely post-January 2005, whereby all products would be integrated into normal GATT rules.

Sri Lanka's competitive strength has rested on its large pool of literate and cheap labor, strategic shipping lines, investment-friendly policy, and an expanding resource basis. So far, Sri Lanka has faced quota-phase out with moderate growth in the RMG industry, largely because it continues to enjoy GSP benefits to the EU and US. However, looking ahead, it faces several challenges: it remains dependent on imported inputs (value-added is estimated at just about 30%), weak infrastructure results in poor backward linkages and higher lead times, and worker productivity remains low. As the BoI itself admits, lead times in Sri Lanka are 90-150 days, against the internationally acceptable standard of 60 days.

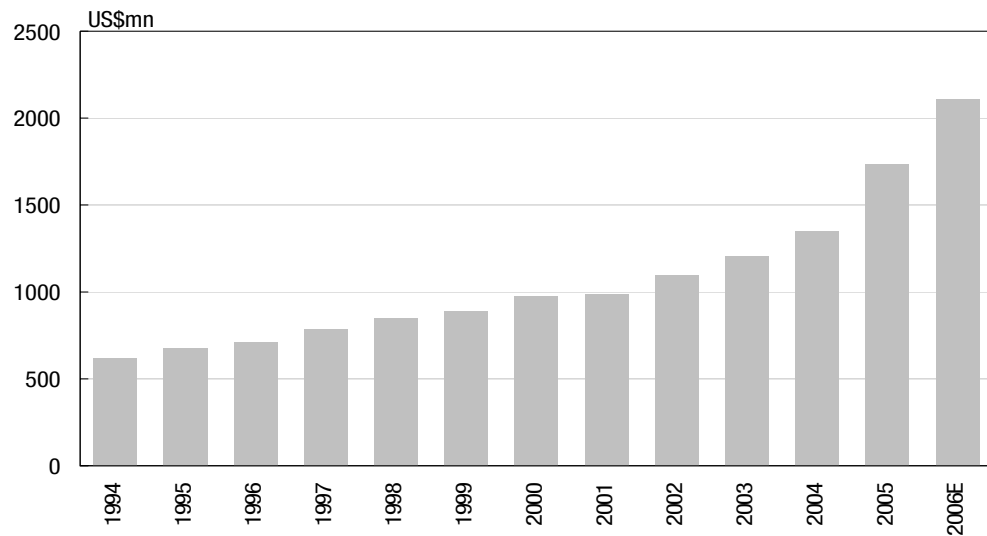
Figure 19. Comparisons of labor costs and productivity in the RMG industry

	Labor Cost- US\$/hr	Mins per woven shirt dress	Implied Labor Cost – US\$/shirt	Mins per pair of jeans	Implied Labor Cost – US\$/jeans
Bangladesh	0.23	61	0.23	62	0.24
India	0.41	63	0.43	65	0.44
Pakistan	0.37	65	0.40	70	0.43
Sri Lanka	0.35	50	0.29	55	0.32
China	0.77	60	0.77	60	0.77
Indonesia	0.41	n.a.	n.a.	70	0.48
Vietnam	0.30	65	0.33	65	0.33
Italy	14.71	35	8.59	35	8.59

Source: Bangladesh- End of MFA Quotas; World Bank, Jan 2006

Remittances: Partially Offset Trade Deficit

Similar to the other South Asian economies, workers' remittances play an important role in the Sri Lankan economy. Inflows have averaged nearly 6% of GDP per annum over the past decade, and currently comprise nearly 7.5% of GDP at US\$2bn. A significant share comes from Sri Lankan immigrants in the Middle East. Since most immigrants work on 2-3 year contracts, their propensity to remit is higher — thus ensuring a steady flow of remittances. Regulatory and policy changes have also aided inflows, with transfers through the banking system becoming less expensive and the Board of Foreign Employment providing migrants with extensive consulate and training services. Tourism is also an important source of invisible earnings, although tourist arrivals have waned in the aftermath of the tsunami, and in the face of mounting security concerns.

Figure 20. Trends in Remittances

Source: CBSL, CEIC Data Company

Current Account

While Sri Lanka's trade deficit remains high (12.5% of GDP currently), similar to the other South Asian economies, remittances and tourism have resulted in its current account deficit being under manageable limits. The current account balance has improved significantly, from a deficit that comprised over 6.4% of GDP in 2000 to 4.9% currently. Looking ahead, we are likely to see a further narrowing in the current-account deficit on the back of greater remittance flows.

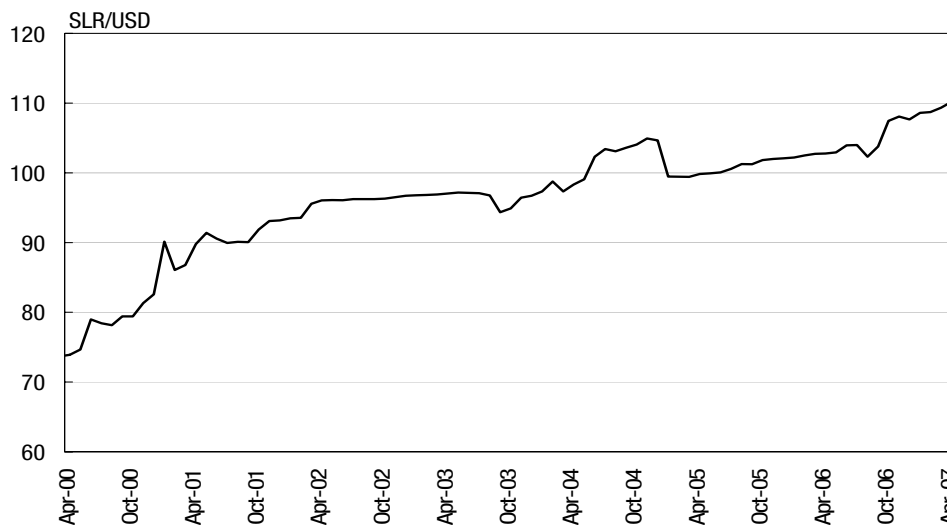
The Capital Account

Promotion of foreign investment has been a pivotal element of Sri Lanka's market-oriented policy reforms since 1977. As one of the most liberalized economies in South Asia, Sri Lanka has plenty of unexploited potential to attract further FDI. A productive human capital base, good port facilities, ease of business immigration, transparent and investor-friendly laws and a Free Trade Agreement with India are some of the major factors that could help the country gain on this front.

Progress on the peace process and lesser political uncertainty will also be an added positive. In 2005, the Board of Investment approved 223 investment projects, which led to realizations worth Rs233bn. Sectors such as telecom and infrastructure development have attracted the largest share of FDI.

Exchange Rates

The Sri Lankan Rupee was allowed to float since early 2001, following the removal of administrative controls. Under the present exchange rate regime, forces of demand and supply in the market determine the rate. Central Bank intervention is mainly to prevent excessive volatility and maintain a comfortable level of reserves. A Monetary Policy Committee reviews economic developments on a monthly basis, while a Market Operations Committee monitors daily activity relating to the management of foreign exchange rates.

Figure 21. Trends in the Sri Lankan Rupee (SLR/USD)

Source: CBSL, CEIC Data Company

Challenges to Growth

Although Sri Lanka has demonstrated immense resilience to external setbacks and natural disasters in recent years and continued to achieve sustained trends in growth; there remain a number of challenges to be addressed:

- 1 **Weak governance and a deteriorating political situation** are the single largest threat to growth. An unstable government has stalled reforms and hindered growth to a significant extent. Some reports suggest that Sri Lanka's mounting security concerns could also impact international relations, with foreign governments halting aid in order to push forward the peace process.
- 2 **Inclusive Growth:** As noted earlier, the distribution of growth in the country has been skewed, such that the western province has enjoyed much higher growth than other areas. In order to bridge this gap, improvements in agriculture, infrastructure, and efforts toward poverty eradication are essential.
- 3 **Labor rigidities:** Restrictive labor laws have undermined Sri Lanka's attractiveness as an investment destination. The labor market remains relatively rigid — a result of the pro-employee legislation along with trade unionism implemented by the left leaning parties in the 1980s. High severance costs result in low staffing across firms, and are also a hindrance to productivity. Moreover, a majority of workers are employed in the informal sector, and not protected by health or security benefits. Government intervention is constant and industrial unrest is a regular feature.
- 4 **Poor Infrastructure:** This is yet another constraint to investment and overall growth. High electricity costs coupled with relatively poor road quality and port congestion have undermined competitiveness and raised costs of doing business in Sri Lanka. However, what is encouraging is that progress on post-tsunami reconstruction is well underway and is likely to lead to improvements in the overall infrastructure scenario.

- 5 **Agriculture Growth:** Stagnation in the agri sector is a key issue halting overall growth, given that 80% of the population and 90% of the poor live in rural areas. As one World Bank report¹² explains, Sri Lanka's agricultural policies have been inclined towards socialist traditions, and thus discourage private sector investments in commercial agriculture/food processing. For instance, policy has aimed at achieving self-sufficiency in rice production; they do not allow farmers to diversify towards more lucrative crops. Other hurdles include unpredictable changes in agricultural tariffs, and subsidies that benefit richer classes.

¹² *Sri Lanka Development Forum: The Economy, Regional Disparities, and Global Opportunities*; Jan 2007

Infrastructure Overview

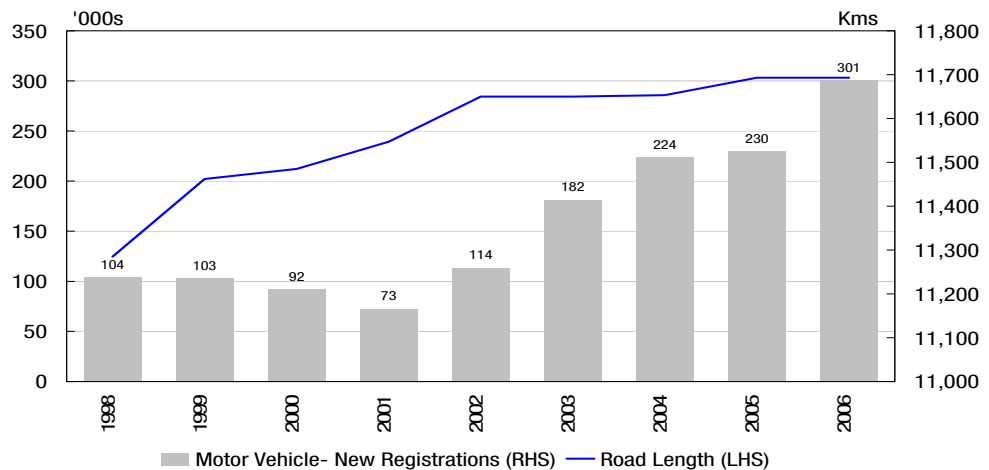
- **The infrastructure industry has potential across sectors. On ports, Sri Lanka’s proximity to major trading routes, given its strategic location, has resulted in its growth as a regional trading hub and in the transport sector contributing close to 10% of GDP**
- **Telecom is the fastest growing sector in the economy with growth fuelled largely by efforts toward privatization**
- **However, power tariffs are regulated and lower than average costs result in a weak financial position for the electricity board**

Roads and Highways

Roads form the backbone of Sri Lanka’s transport sector, accounting for about 93% of land transport in the country. The road network covers about 93,000km, comprising 12,000km of national highways, and 16,000kms of provincial roads and 65,000kms of local authority roads. With a road density of 1.6km/km² of area, much higher than in India, Pakistan and Bangladesh; the network plays an important role in the movement of people and goods- about 95% of the passengers and 98% of freight traffic are carried over roads.

However, a lack of reform has resulted in poor road quality and congestion. While highways cannot handle the strain of mixed traffic, the quality of provincial and local roads has deteriorated. In order to provide for growing motor traffic, improve port connectivity, the government has undertaken a number of projects, particularly in the Southern Provinces. Plans for other expressways, such as the Colombo-Katunayake and Colombo-Kandy expressways, are also underway. In November last year, the ADB extended funds to the tune of US\$90mn toward the construction of a highway linking Colombo to Matara, in the Southern Province. Moreover, under the Ten-Year Vision, several major road projects have been implemented including the construction of express ways, upgradation of national highways, and rehabilitation of rural, tsunami-affected, and provincial roads.

Figure 22. Trends in Length of Public Roads and New Motor Vehicle Registrations ('000 Nos, Kms)



Source: CEIC Data Company

Railways

The railway network in Sri Lanka is operated by the government, and comprises 1447km of track, transporting 86mn passengers and 1m tonnes of goods each year. Although railways played a dominant role in Sri Lanka's land transport system, they have dwindled in importance and face continued competition from road transportation. Moreover, railways have been subject to security risks, with only 1200km of the available 1445km in operation. In its annual review of the economy, the Central Bank of Sri Lanka has pointed out that in order to provide satisfactory train services, the railways require 161 locomotives, but currently have just 119.

In a bid to improve the railways infrastructure, the government has undertaken projects upgrading the existing track, and allocated 0.5% of GDP annually for capital investment. Other proposals include the construction of a light rail transit system in Colombo, along the lines of the Delhi Metro Rail Corporation. Another key positive is that Sri Lankan Railways is proposing the development of 10 railway station sites along the coastline with private sector participation.

Figure 23. Railways — Key Statistics

	2000	2001	2002	2003	2004	2005	2006
Operated Kilometers (Mns)	8.6	8.9	8.5	8.3	7.6	7.6	7.8
Passenger Kilometers (Bns)	3.2	4.0	4.1	4.6	4.7	4.4	4.3
Freight Ton Kilometers(Bns)	88	109	131	129	134	135	138
Total Revenue(Rs Bn)	1.0	1.2	1.4	1.3	1.7	2.0	2.5
Current Expenditure (Rs Bn)	2.7	3.0	3.3	3.4	4.3	5.5	6.5
Operating Revenue or Loss (Rs Bn)	1.7	1.8	2.0	2.9	2.7	3.5	4.0

Source: Sri Lanka Railways; CEIC Data Company

Aviation

Sri Lanka has one international airport — the Bandaranaike International Airport (BIA), with SriLankan Airlines being the national carrier. Domestic flights operate from Ratmalana Airport. The Civil Aviation Authority of Sri Lanka is responsible for overseeing all functions related to aviation.

In 2006, passenger and freight handling saw an increase of 12% and 7% respectively, despite the fact that tourist arrivals remained impacted by political uncertainty.

Another key positive has been the conclusion of 59 bilateral air transport agreements and Open Skies agreements with six countries as at the end of 2006.

Figure 24. Civil Aviation: Key Statistics

	2001	2002	2003	2004	2005
Passengers Carried (Mns)					
Departures	1.3	1.4	1.6	2.0	2.1
Arrivals	1.3	1.3	1.6	2.1	2.1
Freight Carried (Mn Kgs)					
Departures	52.6	54.2	33.7	83.2	84.8
Arrivals	35.3	33.1	49.7	50.4	57.5

Source: Civil Aviation Authority of Sri Lanka, CEIC Data Company

Telecommunications

Telecom is the fastest growing sector in the economy, rising 27% yoy in 2005. Growth in the segment has been fuelled largely by efforts toward privatization. Divestiture of the sole fixed line operator in the country, Sri Lanka Telecom (SLT) began in 1997, when the government sold a 35% stake to Japan's Nippon Telegraph and Telephone Corp (NTT). A further 12.5% was sold to the public in 2003.

Sri Lanka was also the first country in the region to introduce second-generation digital communication systems (2G), such as GSM, WAP, and GPRS. Currently, there are three fixed-line operators, four mobile operators, 32 providers of data, and 23 internet service providers. On the back of rapid growth, Sri Lanka's mobile subscriber base expanded to 5m in 2006, up 61% yoy, while fixed-line subscribers, at 2m, are up 52% yoy.

Looking ahead, the mobile subscriber base is expected to continue along its growth trajectory, as Code Division Multiple Access (CDMA) technology expands base. CDMA was introduced in 2005 and the operators which have been allocated CDMA spectrum so far include Suntel Limited, Lanka Bell, SLT and, more recently, Bharti Airtel. Sri Lanka is also on its way to introducing 3G mobile services, as Dialog GSM (owned by Telekom Malaysia) teams up with Ericsson. Moreover, existing players, such as Celltel and Suntel, are in expansion mode.

Figure 25. Telecommunication — Key Statistics

	2000	2001	2002	2003	2004	2005	2006
Fixed Line Subscribers	767	827	883	939	991	1244	1896
Cellular Subscribers	430	668	932	1393	2211	3362	5412
Tele Density (Cellular phones)	NA	NA	9.6	12.1	16.5	23.6	27.1
Internet and Email Services	40	62	70	86	93	115	130

Source: Telecommunications Regulatory Commission of Sri Lanka

Port Services

Sri Lanka's major commercial port is Colombo, while other large ports include Galle, Trincomalee, and Kankasanthura and Point Pedru. The Port of Colombo handles about 3mn TEUs of both cargo as well as container traffic and attracts mainline containers such as SINA, ANWC, CSI and CIX. However, port capacity was significantly impacted by the tsunami in 2004, as well as political conflict. In a bid to further expand port capacity, the Sri Lanka Ports Authority has recently signed an agreement with China Harbour Engineering Company Limited and the Sino Hydro Corporation Limited worth US\$360m for the construction of a new port-Hambantota Port.

An expansion project for the Port of Colombo is also underway. Financed by the ADB, the SLR35bn project aims at the construction of four additional container terminals and is scheduled for completion by 2010. It will expand port capacity from 4mn TEUs to 12mn TEUs.

Currently, a new Colombo South Harbor is being developed on a priority basis, in order to relieve congestion at the Port of Colombo. The new harbor would help accommodate bigger container vessels with a draft of 16meters, and have 3 terminals. The first terminal would be operational by 2010 with a capacity of 2.4mn TEUs.

Figure 26. Port Services- Key Statistics

	2000	2001	2002	2003	2004	2005	2006
Vessels Arrivals ('000s)	4.2	4.0	4.1	4.0	3.9	4.1	4.5
Container Handle ed(Mn MTs)	1.7	1.7	1.8	2.0	2.2	2.5	3.1
Transshipments (Mn TEUs)	1.2	1.2	1.2	1.4	1.5	1.7	2.3
Cargo Handled (Mn TEUs)	27.5	27.1	28.4	30.5	34.0	37.3	42.7

Source: Sri Lanka Port s Authority, CEIC Data

Power and Electricity

The Ceylon Electricity Board is responsible for the generation, transmission and distribution of power, although independent power producers have a share of about 42% in total generation. Development of Sri Lanka's power generation capacity took place in 2002, when, in response to growing demand for electricity, the government secured a loan from the ADB to expand electricity infrastructure. Currently, the total installed capacity of electricity in the country is 2403 MW, with total generation at 8766MW. Tariffs are regulated, and substantially lower than average costs. This has led to a weak financial position of the CEB; operating losses of the CEB are estimated to have risen by 84% to Rs13bn, while its long-term loans amounted to Rs54bn at the end of Dec 06.

A notable feature of Sri Lanka's electricity sector is continued dependence on hydro-electric power, which accounts for a 49% share of total generation (down from a 94% share in 1995). This makes it vulnerable to the vagaries of rainfall.

The CBSL has pointed out that for every 1% increase in growth, electricity supply needs to increase by 1.5-2%. In an effort to diversify its generation base, the government has made initiatives toward attracting foreign investors to build thermal power plants. To this end, the government has recently signed an agreement with the National Thermal Power Company (NTPC) for the construction of a 500MW coal power plant in the eastern region. Construction of several major power projects (for instance, a 300MW coal plant, a 150MW electric power project, and a 300MW combined-cycle power plant) has also been initiated.

Figure 27. Electricity — Key Statistics

	2000	2001	2002	2003	2004	2005	2006
Available Capacity (MW)	1,837	1,999	2,230	2,243	2,378	2,411	2,429
Installed Capacity (MW)	1,779	1,901	1,930	2,223	2,329	2,403	2,429
Emergency Power Capacity (MW)	58	98	300	20	20	NA	NA
Total Power Generation (GwH)	6,844	6,627	6,951	7,612	8,159	8,766	9,388

Source: Ceylon Electricity Board; CEIC Data Company

Investment Environment in Sri Lanka

- **Given its strategic location and proximity to India, Sri Lanka serves as a regional trading hub and offers a host of investment opportunities**
- **With its literacy levels among the highest in South Asia, Sri Lanka has a large pool of cheap and skilled labor**
- **However, its uncertain political environment has been a major deterrent to foreign investment.**
- **In addition, rigid labor laws, coupled with slow efforts toward privatization, have also undermined its competitiveness**

Overview of Regulations

- **The Judiciary:** Sri Lanka's legal framework is a mix of both British as well as Roman-Dutch law. Key legislative acts include the Board of Investment, the Intellectual Property Act, the Securities and Exchange Commission Act, and the Companies Act, among others. Though the judiciary has been reasonably strong, the World Bank points out that lengthy procedures and the limited capacity of the judiciary in commercial law matters compel most firms to resort to out-of-court settlements. What is positive, however, is that bankruptcy laws in Sri Lanka are far more effective than most other countries in South Asia¹³.
- **Labor Laws:** Although employing workers in Sri Lanka is a straight forward task, it remains one of the most difficult countries as far as firing workers is concerned. Labor laws are seen as a major hindrance to productivity. This is because the Termination of Employees Act necessitates large redundancy payments for workers employed for more than 6 months. As a result, firms recruit more staff on a contract basis. Moreover, 62% of jobs are in the informal sector, where workers are not protected by health or security benefits. Government intervention is constant and industrial unrest is a regular feature.
- **Foreign Investment Regime:** The Board of Investment (BOI) is the chief authority for handling foreign direct investment flows. Similar to India, most investments are automatically approved. These include financial services, construction, water supply, telecom, energy, and mass transportation. Other norms regulating foreign investment include the Securities and Exchange Commission Act (for takeovers). Current account transactions are exempt from exchange control. Remittances of business fees are also freely permitted, as well as funds for debt service and capital gains. The Central Bank of Sri Lanka opened the Gsec bond market to foreigners in November 2006, allowing the purchase of 5.00% of the total outstanding Treasury Bonds (or US\$400m), which was fully subscribed by foreigners. Key sectors that have seen investor interest include textiles, telecoms, power, ports, and financial services.

¹³ The World Bank Doing Business Indicators estimate that the average creditor spends about 2 years to recover 36 cents on the dollar, in the event of bankruptcy. Comparative figures for S Asia are 4 years to recover 20 cents.

- **Trade Regime:** Sri Lanka has trade agreements with a number of countries, including India and Pakistan. Tariffs are low in comparison with other economies in the region (the peak tariff rate is 27.5%). While Sri Lanka is fairly competitive in terms of port infrastructure in comparison with others in the region, it still takes 27 days, and 13 documents to import goods. To export goods is almost as cumbersome, and takes 25 days and 8 documents. The World Bank suggests that efforts toward privatization, cutting red-tape, and improving customs administration could enhance port competitiveness to a major extent.

Figure 28. Doing Business in Sri Lanka — A Comparative View, 2006

Parameters	Indicators	Sri Lanka	Bangladesh	China	India	Nepal	Pakistan
Starting a Business	Procedures (number)	8	8	13	11	7	11
	Time (days)	50	37	35	35	31	24
	Cost (% of income per capita)	9	88	9	74	79	21
	Min. capital (% of income per capita)	0	0	213	0	0	0
Dealing with Licenses	Procedures (number)	17	13	29	20	15	12
	Time (days)	167	185	367	270	424	218
	Cost (% of income per capita)	151	272	84	606	324	973
Hiring and Firing Workers	Difficulty of Hiring Index	0	11	11	33	67	78
	Rigidity of Hours Index	20	40	20	20	20	20
	Difficulty of Firing Index	60	40	40	70	70	30
	Rigidity of Employment Index	27	30	24	41	52	43
	Non-wage labor cost (% of salary)	15	0	44	17	10	12
	Firing costs (weeks of wages)	178	51	91	56	90	90
Registering Property	Procedures (number)	8	8	3	6	3	6
	Time (days)	63	425	32	62	5	50
	Cost (% of property value)	5	11	3	8	6	4
Getting Credit	Legal Rights Index	3	7	2	5	4	4
	Credit Information Index	3	2	4	3	2	4
	Public registry coverage (% adults)	0	1	10	0	0	0
	Private bureau coverage (% adults)	3	0	0	6	0	1
Protecting Investors	Disclosure Index	4	6	10	7	6	6
	Director Liability Index	5	7	1	4	1	6
	Shareholder Suits Index	7	7	4	7	9	7
	Investor Protection Index	5	7	5	6	5	6
Paying Taxes	Payments (number)	61	17	48	59	35	47
	Time (hours)	256	400	872	264	408	560
	Total tax payable (% gross profit)	75	40	77	81	33	43
Trading Across Borders	Documents for export (number)	8	7	6	10	7	8
	Time for export (days)	25	35	18	27	44	24
	Cost to export (US\$ per container)	797	902	335	864	1,599	996
	Documents for import (number)	13	16	12	15	10	12
	Time for import (days)	27	57	22	41	37	19
	Cost to import (US\$ per container)	789	1,287	375	1,244	1,800	1,005
Enforcing Contracts	Procedures (number)	20	50	31	56	28	55
	Time (days)	837	1,442	292	1,420	590	880
	Cost (% of debt)	21	46	27	36	24	23
Closing a Business	Time (years)	2	4	2	10	5	3
	Cost (% of estate)	18	8	22	9	9	4
	Recovery rate (cents on the dollar)	36	25	32	13	25	40
Economy Characteristics	Gross National Income per capita (US\$)	1,160	470	1,740	720	270	690
	Population (millions)	20	142	1,305	1,095	27	156

Source: World Bank Doing Business Indicators

Annexure

Impact of the Tsunami

The devastating tsunami that hit Sri Lanka in December 2004 wreaked widespread damage across the country, resulting in 35,000 tsunami-related deaths and the displacement of over a million people. Given that 28% of the population lives within a kilometer of the sea, coastal infrastructure, including houses, was destroyed with overall asset losses estimated at US\$1bn (4.5% of GDP). Reconstruction costs amounted to about 1.4% of GDP in 2005, 0.8% in 2006, and have been budgeted to rise by 0.7% of GDP in 2007¹⁴.

- **On growth**, the tsunami had a relatively small impact, given that fisheries and tourism — the most impacted segments — have a small contribution to overall GDP (approximately 3%). Recovery in these sectors has also been fairly quick. As one World Bank study points out, fishing output recovered to 60% of pre-tsunami levels in 2005, and by Sept 2006, output recovered to 80% of pre-tsunami levels. As regards tourism, the drop in tourist arrivals from European countries was bridged by those from neighboring countries post the tsunami, which minimized the impact.
- **The BoP** saw a surplus to the tune of US\$503m post-tsunami, largely on the back of foreign aid inflows (total donor assistance amounted to US\$2.2bn at the end of May 2005).
- **On the fiscal sector**, the impact of the tsunami has resulted in only a marginal increase in the deficit, since a bulk of the reconstruction has been pledged by donor funds from both bilateral and multilateral sources. A 1-year debt moratorium by the Paris Club provided an additional cushion. But, since repayments resumed this year, there will be an increase in debt-servicing costs.
- **The impact on inflation** was restricted to construction-related commodities. However, an appreciating rupee on the back of large aid inflows resulted in a moderation in prices.

Brief on the 'Mahinda Chintana'

Economic policy in Sri Lanka has focused primarily on poverty alleviation and reducing disparities through investments in agriculture and further development of the SME sector. To this end, policy is guided largely by President Rajapakse's broad economic strategy outlined in his election manifesto '*Mahinda Chintana*' (or Mahinda's Thoughts).

The *Mahinda Chintana* provides a ten-year macroeconomic framework from 2006-2016 that targets 8% GDP growth during the first 6 years and a higher target of 9-10% thereafter. Underpinning higher growth is an uptrend in investment, with the total investment-GDP ratio targeted at 34% in 2010. The largest contribution in investment is anticipated to come from the public sector, as well as FDI.

¹⁴ Estimates from World Bank, "Post Tsunami Recovery and Reconstruction Report", April 2006.

The key thrust of the policy is on agriculture, with non-traditional products remaining a key focus area. Industrial policy aims at improving the macroeconomic environment, facilitating private investment, and improving state-owned enterprises. Within services, tourism, telecommunications and IT are expected to be the fastest-growing areas.

Disclosure Appendix

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