

Sri Lanka Development Forum:
The Economy, the Tsunami and
Poverty Reduction

May 16-17, 2005



Poverty Reduction and
Economic Management Sector Unit
South Asia Region

Abbreviations

ADB	Asian Development Bank	JVP	Janatha Vimukthi Peramuna
BOC	Bank of Ceylon	LTTE	Liberation Tigers of Tamil Eelam
BOI	Board of Investment	MDGs	Millennium Development Goals
CBSL	Central Bank of Sri Lanka	MFA	Multi-Fiber Agreement
CCD	Coast Conservation Department	MTBF	Medium Term Budget Framework
CCPI	Colombo Consumer Price Index	NGOs	Non Governmental Organizations
CEB	Ceylon Electricity Board	PB	People's Bank
CPC	Ceylon Petroleum Corporation	PC	Provincial Council
DFID	UK Department for International Development	PRS	Poverty Reduction Strategy
ETF	Employees Trust Fund	SEMA	Strategic Enterprise Management Agency
EU	European Union	SLFP	Sri Lanka Freedom Party
FAO	Food and Agriculture Organization	SME	Small and Medium Enterprise
FDI	Foreign Direct Investment	SOE	State-Owned Enterprise
FMRA	Fiscal Management Responsibility Act	TAFREN	Task Force for Rebuilding the Nation
FTA	Free Trade Agreement	TEWA	Termination of Employment of Workermens' Act
GDP	Gross Domestic Product	UN	United Nations
GOSL	Government of Sri Lanka	UNDP	United Nations Development Programme
GST	General Sales Tax	UNF	United National Front
ICA	Investment Climate Assessment	UNFPA	United Nations Population Fund
ILO	International Labour Organization	UNICEF	United Nations Children's Fund
IMF	International Monetary Fund	UPFA	United People's Freedom Alliance
IT	Information Technology	US	United States
JBIC	Japan Bank for International Cooperation	USAID	US Agency for International Development
JICA	Japan International Cooperation Agency	VAT	Value Added Tax
		WHO	World Health Organization

GOVERNMENT FISCAL YEAR

January 1 - December 31

CURRENT EQUIVALENTS

(Exchange Rate Effective as of April 22, 2005)

Currency Unit = Sri Lankan Rupee

US\$ 1.00 = Rs. 99.80

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Introduction

This report is intended to inform the discussions of the May 16-17, 2005 Sri Lanka Development Forum, which will focus on the tsunami, the economy, and the broader development agenda. It is also hoped that the report will contribute to the national debate on these issues and serve as an input to the Government's Poverty Reduction Strategy (PRS), a draft of which will be presented at the Forum.

The tsunami disaster that hit Sri Lanka on December 26, 2004 caused enormous losses in terms of lives, infrastructure and economic assets. As the country embarks on recovery from this disaster, it is important to understand the prevailing economic conditions as they will have a bearing on the scope and potential impact of proposed interventions. It is also important that post-tsunami reconstruction does not detract from and is consistent with the poverty reduction agenda for the country as a whole.

Section 1 provides an overview of recent economic outcomes and the status of reforms. Attesting to its resilience, Sri Lanka quickly recovered from the 2001 downturn and restored growth rates averaging 5 percent annually. However, the relative peace enjoyed since the ceasefire in February 2002 has not led to higher growth. Growth has been uneven. The services sector has been the main driver, while industry has recovered more gradually from the 2001 downturn, and agriculture has stagnated. Sri Lanka's below-potential growth performance can be largely attributed to remaining structural constraints, including weaknesses in the macroeconomic framework. More recently, the hike in international oil prices combined with expansionary policies have led to rising inflation and widening macroeconomic imbalances. Meanwhile, Sri Lanka's past growth pattern has not been adequate for significant poverty reduction beyond the urban areas.

Section 2 presents an analysis of the impact of the tsunami, financing needs and implementation issues for the reconstruction phase. Although the human and asset losses from the tsunami were extensive, the impact on output and GDP will be limited because the sectors affected only represent a small part of national production. While large aid flows have already been mobilized, particularly from private donations, implementation remains a challenge due to absorptive capacity constraints. In particular, there is a need to ensure that fiscal and monetary policies underpinning the recovery effort are consistent with the restoration of a sound macroeconomic framework.

Section 3 discusses poverty trends and priority reforms for meeting the Millennium Development Goal (MDG) on poverty reduction. An analysis of past growth and poverty trends shows that much of Sri Lanka's skewed growth record and ensuing income inequality is a reflection of the unfinished reform agenda. Important strides have been made in trade liberalization and private sector development, which explain the country's resilience to adverse shocks, including the prolonged conflict. However, significant challenges remain. These include containing the fiscal deficit and public debt to sustainable levels, increasing export diversification against the backdrop of the abolition of the Multi-Fiber Agreement (MFA), and reviving non-plantation agriculture and the rural economy. Critical for both growth acceleration and poverty reduction is the achievement of permanent peace. It is also essential that policy reversals be avoided so that gains from past reforms can be further strengthened.

In sum, despite strong growth in the wake of adverse shocks, too many Sri Lankans are still poor. The tsunami is a painful reminder of this fact, as a lot of the victims are poor (which is why the impact on GDP is mild). Therefore, reconstruction efforts are needed to address the plight of the poor in the affected areas. There is however a risk that exclusive focus on the tsunami will delay reforms that are vital for up-lifting the poor in the rest of the country. The Development Forum would have succeeded if it helps to bring consensus between the government and the development partners on the range of measures that are critical to accelerating growth and reducing poverty in Sri Lanka.



Overview of Recent Economic Developments

Introduction

1. Sri Lanka's recent history attests to the economy's resilience to adverse shocks. The economy has been growing at around 5 percent for over two decades even during the conflict years. Much of this resilience has to do with the country's relatively well developed human capital and the continuation of market-friendly reforms since the late 1970s. However, it is surprising that the relative peace enjoyed since the ceasefire in February 2002 has not translated into higher growth.¹ Against this backdrop, recent statistics show that this past growth performance has not been adequate for significantly reducing poverty beyond the urban areas. To achieve faster growth and poverty reduction, Sri Lanka will need to address remaining structural constraints, including weaknesses in the macroeconomic environment.

A. Political Context

2. The country's recent political context has been marked by a number of important events which have influenced the decision-making process, including management of the economy. A ceasefire agreement was signed in February 2002 between the Government of Sri Lanka (GOSL) and the Liberation Tigers of Tamil Eelam (LTTE), putting a temporary end to hostilities and opening the way for peace negotiations and hopefully for durable peace. Although peace talks have been stalled since April 2003, the ceasefire has been holding for the third consecutive year, which is the longest period without open hostilities since the outbreak of the conflict in 1983. In addition, Sri Lanka has undergone two general elections in a period of less than three years leading to a change in leadership and a shift in the policy stance in certain areas such as the role of the state. Having won the December 2001 parliamentary elections by a slender majority, the United National Front (UNF) coalition was defeated by the United People's Freedom Alliance (UPFA) in the April 2004 elections held four years ahead of schedule. The UPFA-comprising the Sri Lanka Freedom Party (SLFP) and the Janatha Vimukthi Peramuna (JVP) as main co-partner-is just short of a parliamentary majority and rules through alliances with other minority groups. Finally, the split of the LTTE in 2004, following the break away of the Karuna faction, has introduced additional uncertainty with regard to the prospects for peace in the North and East.

B. Economic Outcomes

3. Sri Lanka recovered from the economic slump of 2001 when a series of adverse shocks (including a prolonged drought, the airport attack by the LTTE and falling export demand in the aftermath of September 11) led to a 1.5 percent contraction in real GDP-the first since Independence. Economic growth resumed in 2002 and has since averaged 5 percent annually, which is close to the growth rates achieved in the 1990s. The cessation of hostilities since the ceasefire agreement no doubt contributed to the recovery. Meanwhile, the rate of unemployment (excluding the North and East)² has fallen only modestly over the period - from 8.8 percent in 2002 to 8.5 percent in the past two years - and stayed above the all-time low achieved in 2000 (7.6 percent).³

1. According to the Central Bank, the conflict reduced real GDP growth by 2 to 3 percentage points a year.

2. The unemployment rate including the North and East averaged 8.8 percent in second and third quarter of 2004, but there are no comparable data for past years.

3. The rapid decline in the rate of unemployment during the 1990s reflected a faster rate of employment relative to the growth in the labor force.



MDGs: Prioritizing the Poverty Reduction Goal

50. Sri Lanka is on track to meet a number of the Millennium Development Goals (MDGs) set out for 2015. In particular, the country is doing well in the areas of universal primary enrollment, gender equality, and infant and maternal mortality. However, despite the substantial reduction in child mortality, malnutrition remains high. Moreover, Sri Lanka is lagging behind in terms of the poverty MDG.

Box 1 : Sri Lanka and the Millennium Development Goals

Selected Millennium Development Goals	Sri Lanka's Position
• Enroll all children in primary school by 2015	• Net primary enrollment currently at 96 percent
• Eliminating gender disparity in primary and secondary schools by 2015	• Gender equality achieved at all levels of education
• Reduce infant and child mortality rates by two thirds between 1990 and 2015	• Between 1975 and 2001, infant mortality fell from 45 to 12 per 1,000 live births; child mortality fell from 100 to 17
• Reduce maternal mortality rates by three quarters between 1990 and 2015	• Maternal mortality (23 per 100,000 live births), on par with middle-income countries
• Reduce poverty incidence by half between 1990 and 2015	• Poverty fell from 26.1 % 1990-91 to 22.7% 2002

Source: World Bank Development Policy Review (2004).

A. Overview of Poverty and Growth Trends

51. In 2002, the national poverty headcount ratio stood at 22.7 percent which is high for a country with a per capita GDP of around US\$900.¹⁹ Furthermore, between 1990-91 and 2002 this ratio fell by only 3 percentage points, which is modest considering that per capita income has grown by around 3.5 percent during the period. This modest decline however underlies sharply unequal poverty trends across sectors and regions. Poverty incidence in urban areas was halved, while rural poverty ratios declined by less than 5 percentage points, and poverty in the estate sector actually increased by 50 percent. Similarly, differences in poverty ratios across provinces have been pronounced: in 2002 the poverty headcount ratio was 11 percent in the Western Province compared to around 35 percent in Sabaragamuwa and Uva.

Table 9: Poverty Trends 1990-91 to 2002 (%)

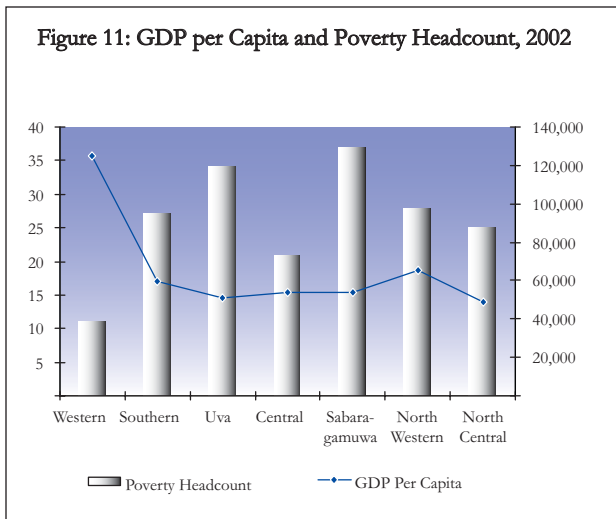
	1990-91	1995-96	2002
Urban	16.3	14.0	7.9
Rural	29.4	30.9	24.7
Estate	20.5	38.4	30.0
National	26.1	28.8	22.7

Table 10: Per Capita Growth by Economic Sector (%)

	1991-96	1996-02	1990-02
Agriculture	0.0	0.4	0.2
Industry	5.7	3.0	4.1
Services	4.4	3.3	3.8
GDP	3.9	2.5	3.2

Source: Department of Census Statistics and Central Bank Annual Reports.

19. Excludes the North and East.



Source: Central Bank of Sri Lanka and Department of National Planning, Ministry of Finance.

Table 11: GDP Shares by Province

Province/Year	1990	1996	2002
Western	40.2	43.7	48.1
N. Western	11.1	11.3	10.1
Central	12.1	10.0	9.4
Southern	9.5	9.0	9.7
Sabaragamuwa	8.1	9.0	6.9
Eastern	4.2	4.8	4.9
Uva	8.1	5.1	4.3
N. Central	4.8	4.6	3.9
Northern	4.4	2.4	2.6
National GDP	100.0	100.0	100.0

52. Sri Lanka's highly unequal poverty record over the period reflects uneven development across sectors and regions (with a heavy bias in favor of Colombo and neighboring districts). Notably, agricultural value added barely increased in real per-capita terms while that in services and industry grew by over 3 percent annually. Moreover, the share of the Western province in nominal GDP increased from 40 to 48 percent between 1990 and 2002.

53. Much of Sri Lanka's skewed growth record and ensuing increased income inequality is a reflection of the unfinished reform agenda. More liberal trade and industrial policies spurred higher growth in industry and services, while pervasive controls and weak infrastructure stifled the dynamism of agriculture. A corollary of this uneven economic management also is that income growth has become heavily skewed in favor of Colombo and neighboring districts while poverty persists in rural areas where 90 percent of the poor live.

54. The disappointing trend in the national poverty incidence also reflects a long-term growth performance significantly below the country's potential. Despite its early lead in social development, Sri Lanka has been left behind the high-performing East Asian countries like Korea, Malaysia, and Thailand. Contributing factors to this outcome include: (i) the pursuit (from the mid-50s to the mid-70s) of inward-oriented policies, while the East Asian comparators followed more open policies; and (ii), the 20-year civil conflict which afflicted the country since 1983. A direct impact of the conflict was to reduce economic growth by an estimated 2-3 percent annually and per capita income by about 40 percent. Furthermore, the conflict diverted public resources and the attention of policy-makers away from economic priorities and reforms contributing to large fiscal deficits and rising interest payments, declining public investment in roads and power infrastructure, falling quality of education, and weakening of administration and governance.

B. Towards Faster and More Equitable Growth

55. Sri Lanka's recent poverty trends underscore the need for faster and more broad-based economic growth. The Government's own MDG report emphasizes the importance of accelerating growth and job creation to reduce income poverty. This will be a challenge in light of the country's structural weaknesses, including: high fiscal deficits and public debt levels that constrain the role of fiscal policy; limited export diversification against the backdrop of the abolition of the MFA since January 2005; and continued stagnation of non-plantation agriculture and the rural economy.

56. Addressing the structural weaknesses will require containing the burgeoning fiscal deficits, diversifying the export base, and realizing the growth potential of non-plantation agriculture. To do all will require putting in place a more conducive public investment program and encouraging foreign and domestic private investment. In addition, critical for both growth acceleration and poverty reduction will be the success in attaining durable peace. It will be also essential that in managing the economy, policy reversals be avoided and that gains from past reform efforts be sustained and further strengthened.

(a) Managing Public Finances

57. A sustainable fiscal stance remains the cornerstone of any viable growth strategy. Despite the enactment of the 2002 FMRA, the fiscal situation remains under considerable stress. In 2004, the fiscal deficit remained high at around 8 percent of GDP and the public debt stood at around 105 percent of GDP, a long way from the FMRA targets for 2006 (of 5 and 85 percent of GDP, respectively). Key priorities include:

58. **Reducing public debt.** Sri Lanka's public debt and debt service burden - absorbing over one half of tax revenue-needs to be brought down to manageable levels within the medium term parameters of the FMRA. This will require eliminating the primary deficit (from 3-4 percent of GDP) and imposing strict limits on non-concessional borrowing.

59. **Raising tax revenue.** The challenge in revenue generation are to reverse the massive decline in the tax-to-GDP ratio in the face of the sharp drop in trade taxes since 1990; the stagnation of income taxes at around 2.5 percent of GDP, which is very weak by international standards; and the difficult transition from a system of turnover taxes and special levies to a VAT, which has been further complicated by the introduction of a three-tier system.²⁰ Key priorities include: (i) strengthening VAT, by expanding its coverage to the retail level; (ii) raising the income tax yield, by gradually phasing out tax holidays and exclusions; and (iii) improving tax administration, through a better integration between customs and the tax department, and separation of the audit and collection functions.

60. **Containing the wage bill.** Sri Lanka has one of the largest bureaucracies in the region, with a ratio of 3.9 civil servants per 100 people. Although the size of Sri Lanka's civilian wage bill is not unmanageable relative to other countries (over 3 percent of GDP until 2004),²¹ the trend is worrisome. After maintaining a cap on public sector recruitment, employment accelerated to 2 percent in 2004 and in 2005 the wage bill is projected to increase to nearly 4 percent of GDP on account of both higher recruitment and wage rates.

(b) Improving Public Service Delivery

61. **Reforming wage and employment policies.** While keeping the wage bill in check, strong political commitment is needed to address well-known constraints to public service delivery. These include overstaffing (particularly at the lower grades); excessive salary compression (8:1) which limits the public sector's ability to attract skilled staff; and administrative fragmentation, duplication, and wastage (partly exacerbated by the ineffective devolution of functions).

62. **Rationalizing public spending and linking it to the poverty reduction strategy.** The scope for expenditure rationalization is significant, not least because of the duplication and overstaffing problems of the public administration. The Ministry of Finance is developing a medium term budget framework (MTBF) which could potentially combine macro (i.e., attaining fiscal sustainability) and micro objectives (such as enhancing the development impact of public spending). Building on the recent introduction of budget ceilings and of a three-year planning horizon, the budget formulation process needs to better align policy priorities with resource allocation within and across sectors. In general, there is a need to reorient expenditures from recurrent to investment to support faster economic growth. Within the recurrent budget, there is an urgent need to improve the targeting of existing welfare programs to better reach the poor, through objective eligibility criteria and making transfers more progressive, which is fully consistent with the Government's MDG report which calls for addressing mistargeting.

63. **Improving the performance of public enterprises:** A program of fiscal consolidation and improved service delivery requires that remaining public enterprise be substantially restructured. Regardless of the restructuring method used, concerned enterprises need to be allowed to operate on a commercial basis (with no political interference) and be subject to a hard budget constraint. The success of current plans to restructure twelve strategic public enterprises under the oversight of SEMA hinges on improving their autonomy and accountability.

20. The VAT introduced in 2002 to replace the General Sales Tax (GST) and the National Levy consisted of two rates (10 and 20 percent). In 2003, the two rates were unified into 15 percent rate, but multiple rates were introduced with the 2005 budget.

21. The civil service salaries are not comparable to other countries since it is not subject to income tax. If income tax is included in the salaries the total wage bill would be higher than 3 percent of GDP.

(c) **Reviving Non-Plantation Agriculture**²²

64. The slow growth of non-plantation agriculture is a primary factor explaining the persistence of poverty in Sri Lanka. The modest decline in rural poverty between 1990 and 2002 is consistent with a barely positive growth trend in per capita agricultural value added over the period. Heavy public sector interventions in agricultural commodity and input/factor markets—primarily geared toward the attainment of self-sufficiency in paddy production—have hampered growth in the sector. Although many of these interventions (e.g., subsidies, land, technology, trade, and irrigation policies) have sought to protect the interest of paddy farmers, their unintended outcome has been to squeeze the returns from agricultural production, limit productivity and income-enhancing investments, hold back diversification to higher value activities, and "pushed" many into low-paying, casual non-agricultural wage labor. More rapid agricultural productivity growth and rural development will require stronger commitment to removing existing policy and regulatory constraints which stand in the way of a more diversified production base.

65. **Allowing full and transferable ownership rights to land.** The transfer of state-owned land to smallholder farmers through grants and permits since the 1930s succeeded in promoting greater equity in land distribution and food security. However, restrictions on the transferability and use of these grants/permits have led to the fragmentation of land into non-economical 'miniature' holdings,²³ with adverse equity and efficiency implications. The conversion of grant/permits into title and the ensuing development of land markets are essential to enhance farmers' ability to expand and consolidate land into economically viable holdings as well as to access credit (using land as collateral) for much needed productivity-enhancing investments. Lack of access to credit (which is linked to the lack of land collateral) is actually a top constraint for the development of rural firms. Concerns that some farmers may become landless if private land ownership is allowed could be addressed by developing appropriate safety nets and impact assessments.

66. **Facilitating access to improved technologies.** Currently farmers are faced with restrictive seed and quarantine regulations and limited extension²⁴ and research services (which have primarily focused on paddy for the domestic market). Farmers' access to improved technologies could be facilitated by adopting more liberal seed and plant regulations, as envisaged under the National Seed Policy and the 1999 Plantation Act, as well as by expanding the scope of research and the supply of extension services through increased private sector participation, including of NGOs.

67. **Phasing out trade distortions.** Selected commodities (i.e., rice, potatoes, chillies and onions) remain subject to high and variable tariffs. These policies lead to price distortions; create considerable uncertainty for farmers, consumers and local firms; and discourage private investment (e.g., in storage). The correction of ensuing inefficiencies in resource allocation will require a more stable trade regime and a gradual reduction in tariffs.

68. **Ensuring the sustainable use of water.** Substantial public resources have been invested in irrigation infrastructure (including the Mahaweli program launched in the early 1980s).²⁵ However, the sustainability of past large investments is threatened by poor maintenance, leading to the rapid deterioration of canal systems and costly rehabilitation requirements as well as poor quality of services. Also, the provision of free water has reduced the incentive for farmers to save and use water more efficiently. Building consensus on a national water policy—which effectively addresses maintenance, rehabilitation, and water management issues to deal with growing competition for water—will be essential for the sustainable development and management of water resources.

69. The removal of policy and regulatory constraints will need to be accompanied by **increased investments in basic rural infrastructure**. According to the ADB/World Bank Investment Climate Assessment (ICA), poor **transport** infrastructure constitutes the single most important constraint to rural firms.²⁶ Although, the country's road network is dense (1.5 km/km² of area) by regional standards, only 10 percent of the paved road network is in good working condition due to lack of maintenance. In general, Sri Lankans living outside the Western Province do not enjoy

22. Issues related to plantation agriculture are beyond the scope of this report. However, in light of the poverty statistics for the plantation sector, a special study of the issues has recently been launched.

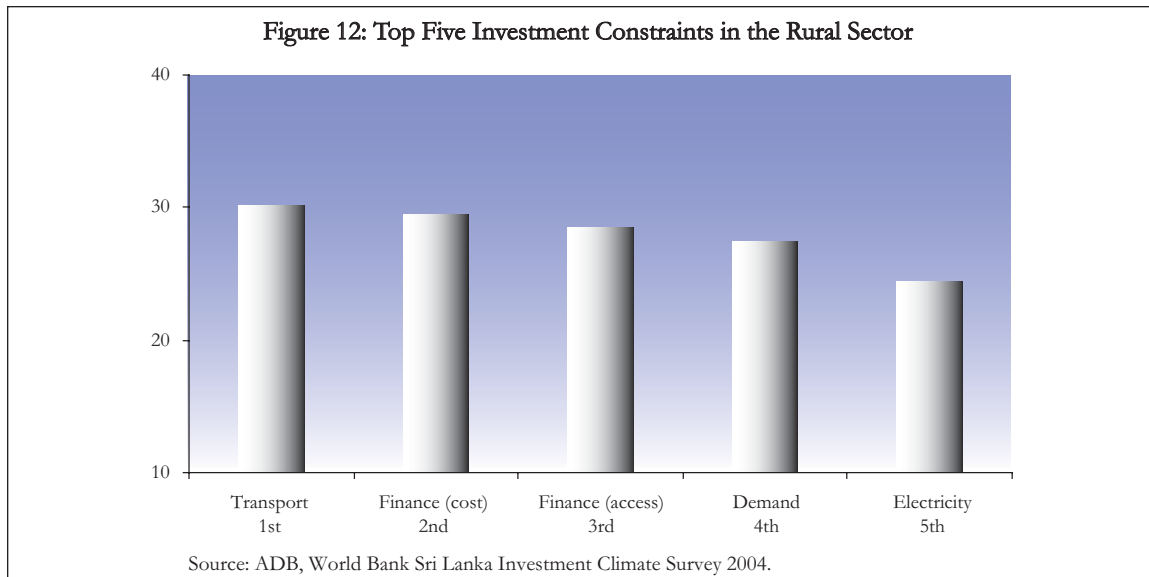
23. Over 40 percent of small holdings have less than one acre and over 60 percent below two acres.

24. According to the Sri Lanka Integrated Survey (SLIS), 1999/2000, only about 13 percent of agricultural households reported receiving technical assistance from a government extension agent (15 percent from all sources).

25. Between 1980 and 1997, about Rs. 215 billion (constant 1996 rupees) in public funds were spent in irrigation.

26. ADB and World Bank (2005).

the connectivity that others have. Given scarce public resources, public spending needs to focus on designing and promoting a regionally equitable strategy for rural infrastructure development and increasing funding for maintenance and rehabilitation.



(d) Promoting Export-led Growth

70. Liberal external sector policies since the late 1970s have underpinned Sri Lanka's export-led strategy and explain the resilience of the economy in the face of prolonged stress and occasional shocks. These policies have contributed to bringing down the unemployment rate to single digits from close to 20 percent in the 1970s. Notably, garment exports have become one of Sri Lanka's major industries, currently accounting for half of all exports and employing 5-6 percent of the labor force while providing indirect employment to about one million workers (15 percent of the labor force). Similarly, liberal emigration policies have contributed enormously to the generation of foreign exchange (about 10 percent of GDP) and of employment opportunities for about one million workers, helping to more than halve the female unemployment from over 30 percent in the 1970s.

71. Although the medium term prospects for Sri Lanka's garment industry in the post-MFA period seem positive—as larger firms have been able to move up to higher value segments of the market—there could be significant disruptions among smaller exporters who account for about two-thirds of all exporters and around 35 percent of employment in the sector.²⁷ There is, therefore, an urgent need to strengthen Sri Lanka's ability to compete in a changing world environment by improving existing external sector policies and addressing remaining "behind the border" constraints that undermine the competitiveness of Sri Lankan firms. Some key priority issues are discussed below:

72. **Avoiding trade policy reversals.** The pursuit of a flexible exchange rate policy, which has been central to Sri Lanka's export-led strategy to date, will need to be continued. In addition, further efforts are needed to meet the medium term goal of a single low, uniform tariff. While the country lowered average tariffs and effective rates of protection during the 1990s, the tariff regime has become more complicated since 2001 due to a new tariff surcharge, reintroduction of specific duties, a minimum duty, ad-hoc duty exemptions, case-by-case duty adjustments and the introduction of preferential tariffs under several trade agreements.

73. **Preferential trade liberalization.** Sri Lanka has concluded the India-Sri Lanka Free Trade Agreement (FTA) and initiated FTA negotiations with the US and several other countries. While there are substantial economic and political benefits to be reaped from FTAs with India and the US, the proliferation of bilateral agreements could distract from Sri Lanka's successful program of unilateral trade liberalization, incur sizable administrative and economic costs of multiple complex rules of origin, and complicate the tariff structure. In the post-MFA era, an FTA with the US

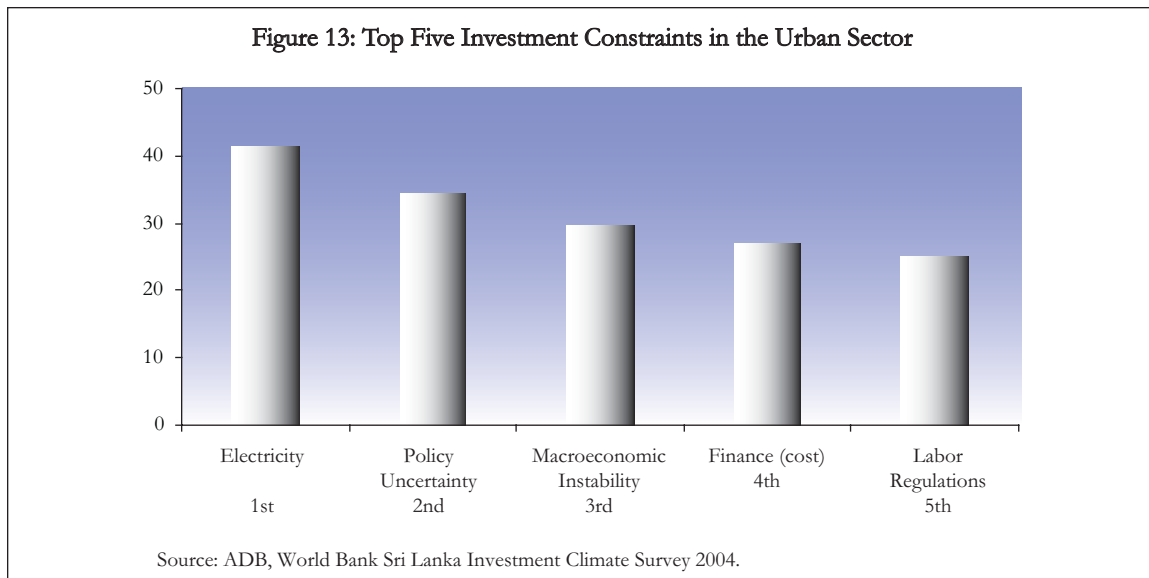
27. While smaller firms account for 5 percent of total export value, it is speculated that about 10 percent of jobs (or about 30,000) might be lost.

would help Sri Lankan garment exports to compete since half of US imports of these products occur under various preferential arrangements. These benefits would have to be balanced against the costs of possible requirements to free the capital account and to source inputs from the US. It is also important to note that preferential access to markets cannot substitute for needed improvements in labor productivity, lead time, and cost effectiveness.

74. **Refocusing investment policy.** A liberal investment regime has been an integral part of Sri Lanka's successful export-led strategy, with FDI driving the growth of the garment sector and other labor-intensive export activities. However, a major policy issue relates to the provision of generous tax holidays (often in perpetuity) to companies operating under the Board of Investment (BOI). These tax holidays have adversely impacted the budget and the 'level playing field' among firms, without bringing significant gains in terms of FDI which by all standards has remained modest. Legislation to bring fiscal incentives in line with Inland Revenue laws and away from the BOI needs to be implemented. In addition, given fiscal considerations, some form of a moratorium on direct tax incentives needs to be seriously considered.

75. Greater focus needs to be placed on **removing behind the border constraints** which adversely impact the competitiveness of firms. According to the ICA, top constraints to doing business for rural and urban firms include: poor electricity and transport infrastructure, policy uncertainty, macroeconomic instability, limited access and high cost of finance, and restrictive labor regulations.²⁸

76. Progress in fiscal consolidation and financial sector reforms will contribute to reducing the **cost of finance** and improve overall macroeconomic stability. In addition to addressing transport constraints discussed earlier, a priority is to improve **electricity** infrastructure. Key measures include: (i) expanding generation capacity, (ii) implementing efficiency-raising restructuring plans for CEB; and (iii) addressing inequities by providing off-grid connections to rural households and subsidizing rates when electrification cannot be provided on a commercial basis.



77. To enable firm to be more competitive, especially in the post-MFA period, policies should encourage enterprise consolidation, facilitate restructuring of credit to small exporters, improve infrastructure and trade facilitation, and bring current costly **labor regulations** in line with international standards. The implementation of labor reforms combined with improving the quality and relevance of **education**, for example by increasing use of English²⁹ and technology, will go a long way in increasing the productivity of labor and will enhance prospects for job creation.

28. ADB and World Bank (2005).

29. This would entail permitting schools to offer English medium education from grade 1.

Table 12: Regulations for Labor Redundancy for Selected Asian Countries

Country	Administrative Authorization Required	Statutory Redundancy Payment Per Year of Service
Sri Lanka	Yes, if over 15 employees	42-75 days
India	Yes, if over 100 employees. Not applicable to managerial and administrative employees.	15 days
Pakistan	Yes, if closing down or retrenching more than half of workers	20 days
Malaysia	No	10-20 days
Thailand	No	Approximately 30 days; capped at 180 days total
Vietnam	No	2 weeks

Source: ADB and World Bank (2005)

78. In sum, the Government has taken positive steps towards boosting growth, protecting those affected by the tsunami, and maintaining relative peace. As it embarks on finalizing its poverty reduction strategy, it is hoped that equal emphasis is placed on raising investments in infrastructure and on addressing remaining policy constraints. Efforts need to be stepped up to strengthen the macroeconomic environment, address behind the border barriers including road and power infrastructure and labor regulations, and revamp the rural economy towards faster growth and more rapid poverty reduction.

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The Tsunami: Impact, Responses, and Issues¹⁴

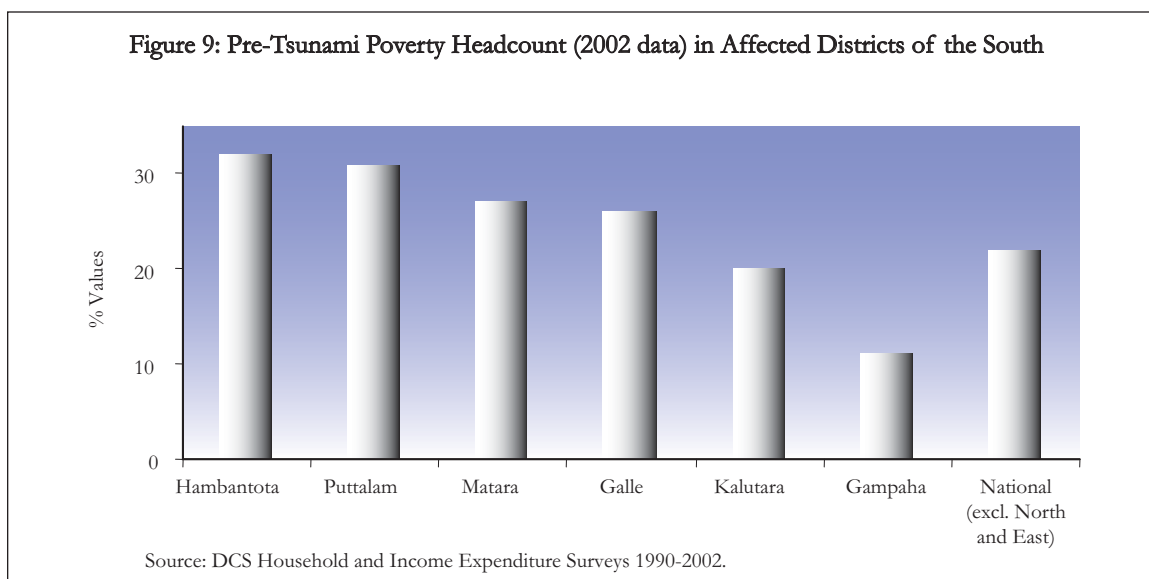
Introduction

25. The tsunami that hit Sri Lanka on December 26, 2004 caused the worst devastation from a natural disaster in the country's history. While the human and asset losses from the tsunami were extensive, the impact on output and GDP will be limited because the sectors affected only represent a small part of national production. The international community has come to Sri Lanka's aid with unprecedented levels of financial assistance, particularly from private donors. While substantial financial resources have been committed, implementation will be a major challenge. Capacity constraints will limit the speed in which assistance can be delivered. Better and more durable coordinating mechanisms will need to be developed to ensure that aid is effectively channeled to the affected areas. Furthermore, aid flows need to be managed in a way that is consistent with overall macroeconomic stability.

A. Social Impact

26. The tsunami struck a relatively thin but long (1,000 km) stretch of Sri Lanka's coastline from Jaffna in the north, the entirety of the eastern and southern coasts, and part of the west coast. The worst affected districts were Ampara, Batticaloa and Trincomalee in the East, Galle, Hambantota and Matara in the South, Jaffna, Mullaitivu and Kilinochchi in the North, and the Western district of Kalutara.

27. Sri Lanka has been hard-hit in terms of loss of life, infrastructure, and economic assets. Official estimates are that more than 31,000 people in Sri Lanka were killed and approximately 6,300 are missing. Displaced person estimates stand at 443,000, while the affected population is estimated at 1 million, out of a total population of approximately



14. This section draws on the preliminary findings of the first and second phase of the Joint Needs Assessment conducted by the ADB, JBIC and World Bank, given that the GOSL's Needs Assessment has not yet been released.

19 million people (5 percent).¹⁵ Around 100,000 people are still living in relief camps while the rest of the displaced have moved in with friends or relatives. The number of damaged houses is estimated at more than 110,000, of which more than 70,000 have been completely destroyed.

28. The tsunami affected a broad range of income and ethnic groups. More women and children died as many men were away from their homes at the time of impact. Before the tsunami, poverty in the worst affected districts was above the national average, and the catastrophe has likely increased their vulnerability. Among the affected districts in the South for which poverty estimates are available, poverty headcounts for the Galle, Hambantota and Matara districts are much higher than the national average (excluding the North and East for which estimates are not available). These three districts are also among the worst affected in the South in terms of job losses, accounting for about 60 percent of job losses in this region. For the affected districts in the North and East, other economic and social indicators suggest that the poverty rates would have likely been higher than the national average as well, due to the social and economic deprivations brought about by a long history of conflict. This situation would be exacerbated by the fact that two of these districts (Ampara and Batticaloa) are among the worst affected in the country.

Table 3: Preliminary Estimates of Losses and Financing Needs (\$ Millions)

Sector	Losses		Financing Needs		
	Asset Loss	Output Loss***	Short Term	Medium Term	Total Needs
Housing	306-341	-	50	387-437	437-487
Roads	60	-	25	175	200
Water and Sanitation	42	-	64	53	117
Railways	15	-	40	90	130
Education	26	-	13	32	45
Health	60	-	17	67	84
Agriculture*	3	-	2	2	4
Fisheries*	97	200	69	49	118
Tourism*	250	130	130	-	130
Power	10	-	27	40-50	67-77
Environment	10	-	6	12	18
Social Welfare**	-	-	30	-	30
Excluded Items	90		30	120	150
Total (\$ Millions, rounded)	970-1,000	330	500	1,000-1,100	1,500-1,600
Percent of GDP	4.4-4.6	1.5			7.0-7.3

* Includes estimates from **livelihoods damage** assessment of fishermen, small farmers, and small businesses in tourism totaling \$140 million.

** Targeted assistance to vulnerable groups.

*** Refers to 2005 and 2006.

Source: ADB, JBIC, World Bank (2005)

15. Department of Census and Statistics Census of Tsunami Affected Areas January 25, 2005.

B. Economic Impact

29. **Asset Losses.** Overall direct asset damage is estimated at around US\$1 billion (4.5 percent of GDP). Destruction of private assets in the affected districts is substantial, with losses estimated at around US\$700 million. This figure includes losses in fishing (US\$100 million), tourism (US\$250 million), and housing (around US\$300-350 million). In terms of the damages sustained by the private sector, preliminary estimates report around 110,000 houses have been partly or fully damaged, over 19,000 private fishing vessels sustained damages, and about a quarter of hotels were affected (58 of the total 242 registered hotels have been fully or partly damaged). In the public sector, about 97 healthcare institutions, and 190 schools, universities and vocational training institutes were damaged.

30. **GDP and output.** The impact of the tsunami on the nation's output and GDP is not as considerable as the extent of asset and human losses. Output losses resulting from the damage of assets and the disruption in economic activity in the affected sectors are estimated at US\$330 million during 2005 and 2006 (around 1.5 percent of GDP). In terms of employment, an estimated 200,000 people (or about 3 percent of the labor force) might have lost their jobs, including 100,000 in fisheries, 27,000 in tourism and tourism-related activities, and the rest in other informal sector activities.

31. The tsunami is expected to slow down GDP growth in 2005 by up to 1 percentage point from an original government estimate of 6 percent. The relatively limited impact is due to the fact that the most affected sectors of the economy - fishing, hotels and restaurants - together contribute only 3 percent to GDP. Other sectors that will also be negatively affected (but to a much lesser extent) include telecommunications and transport. The construction sector, on the other hand, is likely to partly mitigate losses in output and is expected to grow from an average of 5.5 percent in the recent past to 8 to 10 percent in the next three years.

Table 4: Selected Economic Indicators

	Actual 2003	Estimate 2004	Pre-Tsunami 2005	Post-Tsunami 2005
Real GDP Growth (%)	6.0	5.4	6.0	5.0
Nominal GDP (Bn. Rs.)	1,760	2,029	2,354	2,374
Fish production (tons)	284,960	300,000	300,000	200,000
Tourist arrivals	500,642	565,000	600,000	425,000
Construction sector growth (%)	5.5	6.6	6.0	9.0
Average Inflation Rate (%)	6.3	7.6	10.0-11.0	12.0
Monetary Growth	15.3	19.6	15.0	15.0

Source: Central Bank of Sri Lanka and staff estimates

32. **Inflationary pressures.** The tsunami is likely to push prices up further in 2005 due to supply shortages of certain food items in the immediate aftermath of the disaster (e.g., fish and seafood). In addition, increased demand for construction materials (sand, cement) and high price of steel will add to inflation. Wages may also go up reflecting labor shortages. In order to contain the inflationary impact of these factors and of further oil price increases, money supply growth will need to be brought down to 15 by the end of the year as currently programmed by the Central Bank. The average rate of inflation, as measured by the Colombo Consumer Price Index (CCPI), is projected to average 12 percent for 2005 compared to the pre-tsunami estimate of 10-11 percent.

33. **Balance of payments.** Rebuilding activities and rising oil prices will lead to a substantial increase in merchandise imports in 2005. Since merchandise exports are expected to grow at pre-tsunami levels, the trade deficit will widen accordingly. Increased private transfers will finance part of the trade deficit, but tourism receipts will decline

Table 5: Selected Balance of Payments Indicators (\$ million), 2003-2005

	2003	Estimate 2004	Pre-Tsunami 2005	Post-Tsunami 2005
Exports	5,133	5,757	6,305	6,354
Imports	6,673	8,000	8,824	9,725
Current account balance	-76	-648	-824	-1,575
Capital account:				
Direct investment	201	227	261	295
Private long term	-33	18	90	63
Government long term	554	439	470	348
Disbursements	913	771	873	751
Amortization	359	331	403	403
Financing gap	-	-	-	710
Overall balance	502	-205	97	101
C/A balance (% GDP)	-0.4	-3.3	-3.8	-6.9
Gross official reserves	2,147	1,825	1,948	2,133
In months of imports	2.8	2.2	2.2	2.3
Oil price (\$ per barrel)	28.9	37.7	40.5	48.0

Source: Central Bank of Sri Lanka and staff estimates.

reflecting a drop in tourist arrivals (in the order of 175,000 relative to original 2005 projection of 600,000). The financing gap relative to the pre-tsunami scenario is estimated at US\$710 million in 2005,¹⁶ which is expected to be met through new concessional loans, grants, and a temporary debt moratorium. The receipt of large foreign inflows is expected to help mitigate the impact of the tsunami disaster on the external sector.

34. **Fiscal impact.** According to the Ministry of Finance, the impact of the tsunami on revenues is expected to be marginal (0.3 percent of GDP). Revenues from value added tax (VAT) and customs duty from increased imports in 2005 are expected to compensate for most of the revenue shortfalls from tourism and fisheries. Incremental tsunami-related expenditures are estimated at Rs. 50 billion (over 2.2 percent of GDP) to be financed through extraordinary external assistance, including debt moratorium. Of this amount, Rs. 10 billion will be additional recurrent cost and the rest will go to capital expenditures. This will result in the widening of the fiscal deficit from the budgeted 7.6 percent of GDP to 9.6 percent of GDP in 2005.¹⁷ However, additional measures will be needed to achieve the pre-tsunami fiscal targets. The revenue and interest expenditure of the original budget were somewhat optimistic and may result in a gap equivalent to 1.2 percent of GDP. In addition, the budget was based on declining international oil prices, while oil prices have actually increased over 2004 levels. Therefore, the fiscal framework would need to be revised in light of these developments.

16. The gap includes the impact of the hike in oil prices.

17. This assumes the government's intention to utilize the savings from the debt moratorium to lower the net domestic financing of the deficit. However, since the agreement with the Paris Club is that "proceeds of the debt moratorium would be used for tsunami relief", net domestic financing is unlikely to be reduced based on the moratorium.

Table 6: Post-Tsunami Central Government Fiscal Operations (As a Percentage of GDP)

	Estimate 2004	Budget 2005	Post-Tsunami 2005*
Total expenditures and net lending	23.7	24.8	26.5
Current expenditures	19.2	18.5	18.5
Subsidies and transfers	4.9	4.0	4.5
Civil service wages and salaries	5.4	5.6	6.2
Interest payments	6.0	5.6	5.2
Capital expenditures and net lending	4.3	6.4	8.0
Total revenues	15.4	17.2	16.9
Tax	13.9	15.5	15.2
Non-tax	1.5	1.7	1.7
Current account balance	-3.9	-1.3	-1.6
Budget deficit (w/o grants)	-8.2	-7.6	-9.6
External financing (w/grants)	1.8	2.5	5.7
Domestic financing	5.8	4.6	3.6
Public debt	105.5	-	-

* Assumes debt moratorium.

Source: Ministry of Finance estimates.

C. Financing Requirements and Availability

35. The overall incremental financing needs for tsunami reconstruction are estimated to be around US\$1.5 to 1.6 billion. This is equivalent to around 7 percent of GDP or 1.5 times the island-wide capital budget.¹⁸ It excludes the US\$200-300 million that the GOSL estimates that it has already spent as well as further relief expenditures. The recovery needs run parallel to the level of damage sustained by each sector, but are generally higher given that the reconstruction strategy will not be based only on the replacement value of damaged assets but also on the required infrastructure which will often involve upgrades to specifically agreed standards. The majority of resources are required for housing, transportation infrastructure, and livelihood restoration for fishermen, small farmers, and small and micro enterprises. In terms of geographical allocation, the North and the East together will represent about 60 percent of total financing needs.

36. In response to the unprecedented destruction caused by the tsunami, the international community has mobilized equally unprecedented sums of financial resources to assist in the humanitarian and reconstruction effort. It is estimated that over US\$ 2 billion has been committed, excluding debt relief, of which about one half consist of private donations. Although, the levels of commitments are substantial, there remains some uncertainty regarding the timing and magnitude of actual assistance. The unusually large size of private donations, which are typically channeled for humanitarian relief, means that a large part of these funds will available for reconstruction.

18. See ADB, JBIC and World Bank (2005).

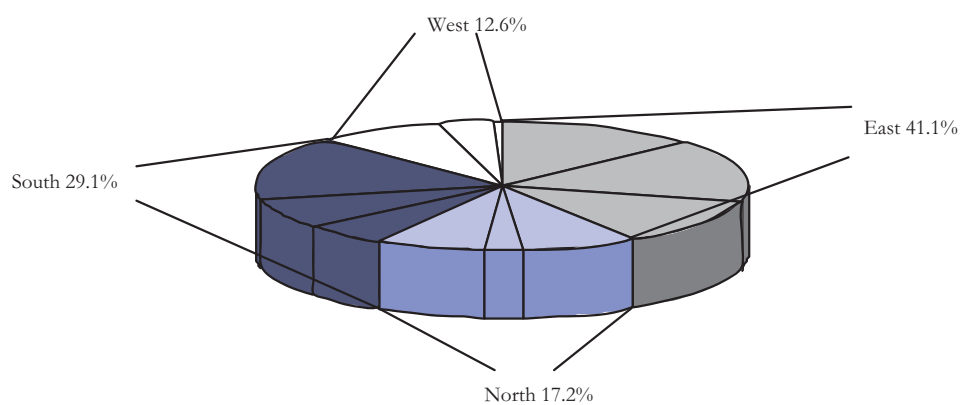
Table 7: Donor Assistance for Tsunami Recovery (Mn US\$)

Donor Countries & Agencies	Total commitment	Additional expected	Debt relief 2005	Total
Bilateral Donors	784	199	339	1,322
France	109		9	118
Germany	81		36	117
India	22	30	5	57
Italy	11	149	10	170
Japan	180		209	389
USA	62		40	102
Multilateral Agencies	646	57	0	703
ADB	150			150
World Bank	150			150
UN agencies	69	2		71
EU	75	55		130
NGOs/Private Sector	720			720
Total	2,150	256	339	2,745

Note: Excludes IMF.

Source: External Resources Department, Ministry of Finance as of April 27, 2005.

Figure 10: SRI LANKA: Tsunami Financing Needs by Province (Sectors include health, education, housing, power, water & sanitation, fisheries, tourism, roads and railways)



Source: ADB, JBIC, and World Bank Joint Tsunami Needs Assessment 2005.

D. Implementation Issues

37. Ultimately, the speed and effectiveness of the reconstruction effort hinges on the establishment of adequate implementation mechanisms. The task will be challenging given the government's weak implementation capacity at the central and local levels; the large financial flows that need to be channeled to the affected areas; and the large number of entities involved in reconstruction activities which include around 30 bilateral and multilateral donor agencies, and about 200 local and international NGOs and private donors.

38. In order to oversee and facilitate the overall reconstruction effort the GOSL has appointed the Task Force for Rebuilding the Nation (TAFREN) as a 3-5 year national secretariat responsible for setting priorities, policies and guidelines. At the district level, Disaster Management Authorities have been appointed to coordinate local relief and reconstruction efforts.

39. **Guiding Principles.** It has been recognized among GOSL and a number of stakeholders, including development partners, that the reconstruction strategy should build on a set of guiding principles, drawing from international experience in previous disasters, and bearing in mind the special political circumstances of Sri Lanka. Such guiding principles, to be considered for adoption by all key stakeholders, include:

- Allocation of resources by identified needs and local priorities, supporting the ceasefire and peace
- Subsidiarity to the lowest level of government
- Consultations with affected communities
- Transparency and communication
- Reduce future vulnerabilities
- Analysis of interventions on peace, gender, environment, resettlement, and human rights
- Coordination
- Role of debt relief

40. The second phase of the GOSL's needs assessment, which will focus on implementation issues, will address potential stumbling blocks to speedy reconstruction, including: (i) the 100 and 200 meter buffer zone; (ii) decentralization arrangements; and; (iii) coordination of official and private funds.

41. **The 100 and 200 meter buffer zone.** The Government has adopted a "no development" 100 meter buffer zone policy for the districts of Kilinochchi, Mannar, Puttalam, Gampaha, Colombo, Kalutara, Galle, Matata and Hambantota; and a 200 meter zone for the districts of Jaffna, Mullaitivu, Trincomalee, Batticaloa and Ampara. The policy prohibits any new construction of buildings (permanent or temporary), reconstruction of completely or partially damaged buildings, and additions and alterations to existing undamaged buildings within the buffer zone. An exception has been made for partially damaged buildings belonging to the hospitality industry and if the partial damage is below 40 percent of the replacement cost of the building.

42. The proposed policy would result in over 60 percent of the damaged housing units (about 70,000) in the coastal belt requiring relocation outside the buffer zone. Since the coastal area is densely populated, particularly in the South, identifying suitable land for relocation in close proximity to the sea has caused delays in starting housing reconstruction. In Jaffna and Ampara, the narrow width of these districts may require reallocation at a considerable distance from the coast which may have adverse social consequences. Some lands identified will be very expensive to develop since no infrastructure and services are available. Furthermore, the social and environmental impacts of massive relocation programs have yet to be addressed by GOSL.

43. While there is wide consensus that a buffer zone may be necessary to reduce potential coastal risks, there is no scientific and consultative basis for the proposed zones. In 1997, the Coast Conservation Department (CCD) developed a Coastal Zone Management Plan through a consultative process, taking into account multiple coastal risks and proposed setbacks depending on local conditions. The setbacks proposed by the CCD range from 25 meters to 125 meters depending on the risks. This plan was approved by the Cabinet of Ministers in 1997 and is GOSL policy, but implementation has been weak. An approach for dealing with risk issues linked to the tsunami and avoiding

unwarranted disruption of people's lives could be to implement the Coastal Zone Management Plan, while specifying better construction standards for reconstruction within the coastal zone.

44. **Decentralization arrangements.** The Government's weak implementation capacity, particularly at the local level, will be substantially over-stretched by additional emergency and reconstruction activities. Early feedback on implementation issues arising from visits to the affected districts, including those reported by the Second Phase of the Needs Assessment carried jointly with TAFREN and several donor organizations and civil society representatives, suggest there is an urgent need for (i) clear national policy direction from the top; (ii) systematic coordination of all efforts affecting the district; (iii) a sound, uniform, and consolidated information base of needs; (iv) an effective dialogue and feedback mechanism with affected communities; (v) adequate recurrent budget allocation to the district to implement programs; and (vi) decentralizing implementation as far as possible.

45. Coordination between the national and district levels need to improve, including a better allocation of responsibilities between the various levels of Government. For example, rebuilding of schools and hospitals can be devolved to the Provincial Councils (PCs), the repair of minor roads and provision of water and sanitary facilities in camps to Pradheshia Sabhas so the District Secretaries can concentrate on housing and water and sanitation plans for relocating families, and selecting beneficiaries for livelihood programs. The central government-with the assistance of TAFREN-should focus on setting clear national policies, standards and guidelines for adoption by implementing entities, including NGOs. These are consistent with the devolution of powers to the Provincial Councils and local authorities under the Thirteenth Amendment to the Constitution. National policies, standards, and guidelines need to be actively communicated to the relevant parties. It is reported however that local authorities themselves are often unclear about the national policies concerning key issues such as the housing allowance for destroyed and partially destroyed units, the eligibility criteria for cash payments to affected persons, etc.

46. The shortage of managerial and technical skills at the district level could be addressed more systematically. A stock taking of available skills and needs should precede any capacity building program. Once the skills shortage is established, critical staff could be redeployed from relevant government departments, such as the PCs where staff seem to be underutilized. Finally, remaining staff and skill shortages can then be filled by fresh recruitment and suitable capacity building programs.

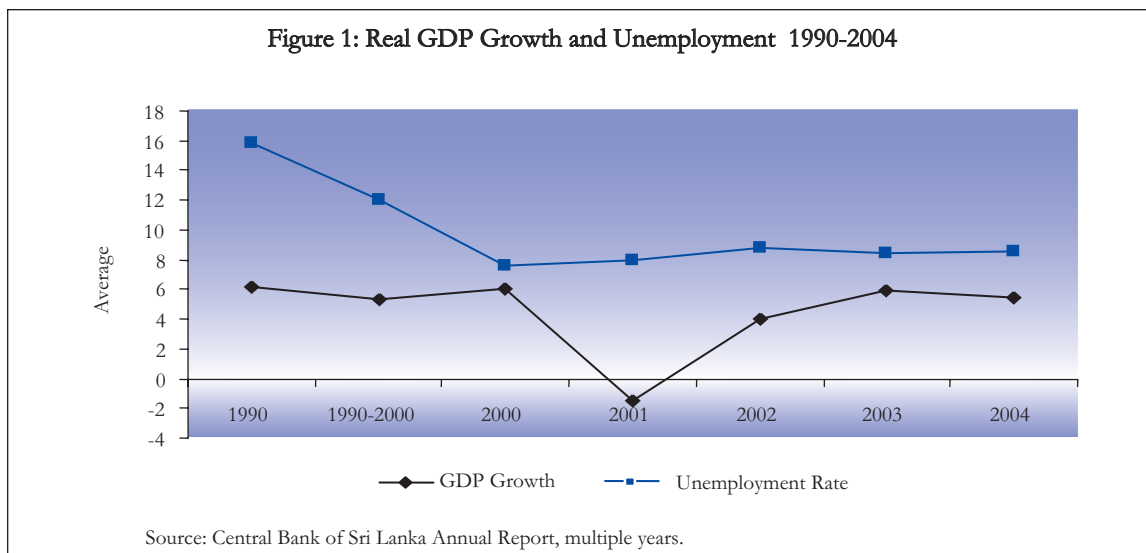
47. An effective information exchange strategy is needed that both informs and also gets feedback from the public in general and the affected people in particular about the different initiatives being carried out by government and the various development partners. This strategy should include regular briefing of communities on progress in recovery plans as well as consultations on ways to improve their implementation.

48. **Coordination of official and private funds.** The effective coordination of official and private funds for reconstruction will be challenging particularly given the amount of private donations. Some progress is being made in establishing basic coordinating mechanisms for information sharing and implementation. First, international donor agencies and NGOs have established customized websites aimed at tracking data on commitments and disbursements broken down by sector and district. The intention is that these data be updated on a regular basis by each donor agency. TAFREN would be responsible for consolidating this information and making it available in the government's website. Second, representatives of TAFREN, the international donor agencies, the NGOs and other private sector organizations hold bi-weekly coordination meetings to exchange information on reconstruction plans and to raise issues for follow-up by the relevant parties.

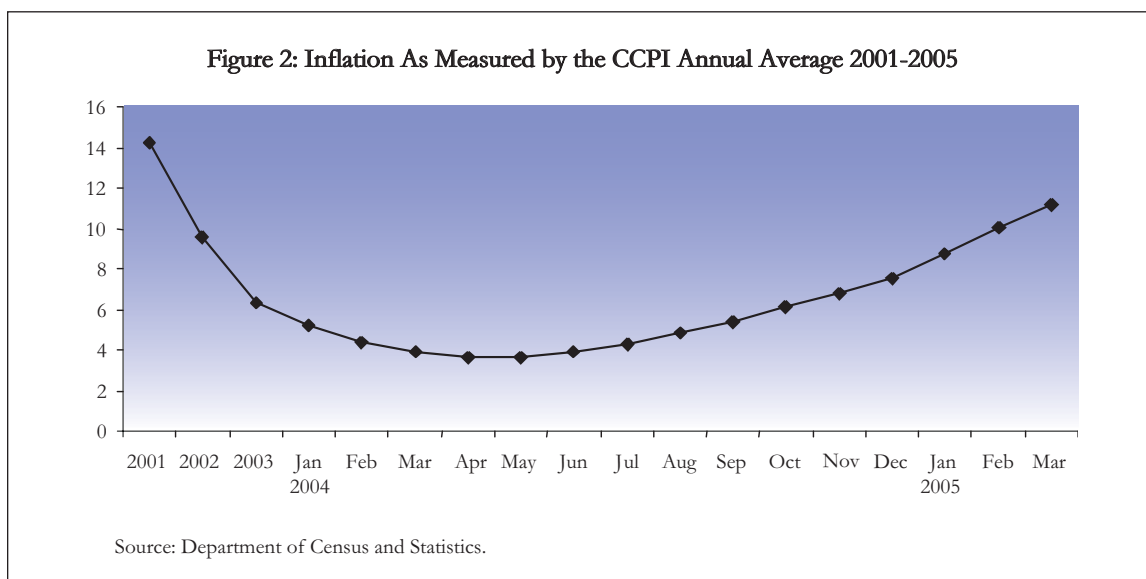
49. To improve coordination among development partners and Government, sector Working Groups have been established. On the donor side, partners have been identified to take a coordinating responsibility for individual sectors. Coordinating donors in each sector would be expected to establish working contacts with TAFREN and key line Ministry counterparts in that sector, and from time to time bring together those interested in particular sectors. The coordinating donor would keep other partners informed about developments and status through this Working Group. Similarly, coordinating NGOs, domestic and international, would be expected to perform a similar function on behalf of their colleagues. This will be important as many NGOs and private foundations are currently operating in an uncoordinated manner in providing livelihood support and housing resulting in inappropriate targeting of beneficiaries.

Table 8: Coordination Responsibilities by Partner and by Sector

Sector	Coordinating Donor(s)
Capacity Building/Governance	UNDP/DFID
Disaster Response	UNDP
Economic (macro) impact	IMF
Education	UNICEF
Environment/GIS	Netherlands
Fisheries	FAO/Norway
Health	WHO/JICA
Housing	World Bank
Livelihoods (cash and cash-for-work)	ILO/World Bank
Microfinance/SMEs	Germany/ADB
Power	ADB/JBIC
Protection/Psycho-Social	UNICEF/USAID/UNFPA
Railways	India (to be requested)
Roads and Ports	ADB
Tourism	USAID
Water and Sanitation	JBIC



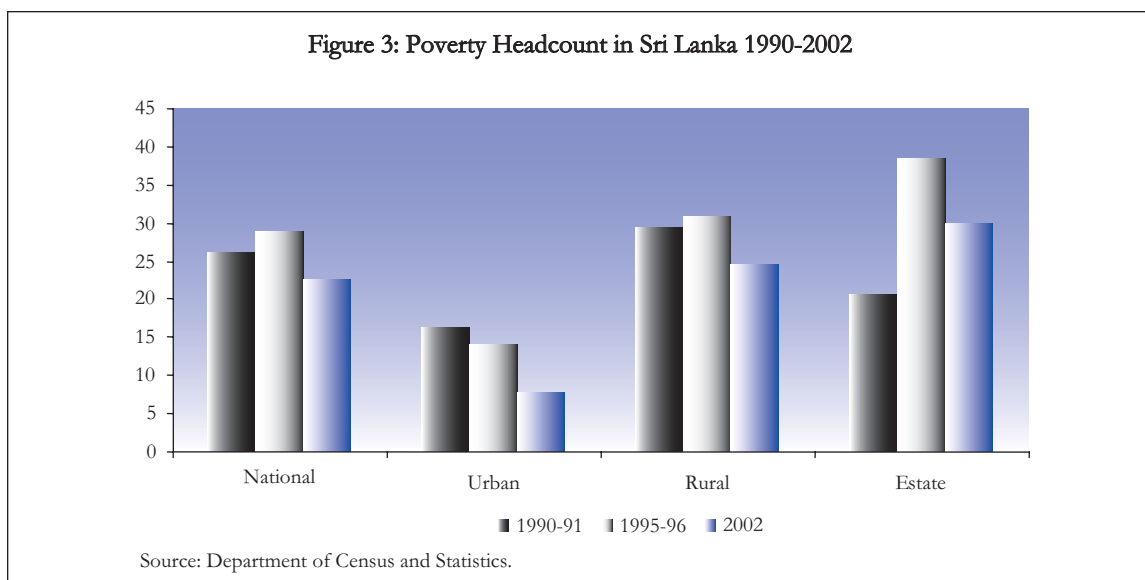
4. Inflation moderated from an annual average of 14.2 percent in 2001 to 7.6 percent in 2004. However, after bottoming out during the second quarter of 2004 (around 3.5-4 percent), inflation has been rising reaching 11.1 percent in March 2005.⁴ Despite a substantial decline in gross official reserves of over US\$300 million (from 2.9 to about 2 months of imports), the rupee depreciated by 8 percent against the US dollar in 2004. While these outcomes reflect the impact of exogenous shocks such as higher world oil prices and a drought, expansionary fiscal and monetary policies also played a role. The budget deficit remained at around 8 percent of GDP and money supply growth accelerated to about 20 percent. Moreover, the pass-through of increased oil prices to consumers was delayed leading to substantial losses by the state-run Ceylon Petroleum Corporation (CPC) and the Ceylon Electricity Board (CEB), which were financed through the budget and bank credit.



5. Sri Lanka's national poverty headcount ratio fell by only 3 percentage points to 22.7 percent between 1990 and 2002, despite a 3.5 percent annual growth in per-capita income over the period.⁵ This modest decline underlies sharply unequal poverty trends across sectors and regions. Poverty incidence in urban areas was halved (to 7.9 percent) while rural poverty declined by less than 5 percentage points (to 24.7 percent) and poverty in the estate sector actually increased (to 30 percent). Similarly, differences in poverty ratios across provinces have been pronounced: in 2002 the poverty headcount ratio was 11 percent in the Western Province and around 35 percent in Sabaragamuwa and Uva.

4. As measured by the 12-month moving average.

5. Excludes the North and East because data for these provinces are not yet available.



C. Sectoral GDP Growth, Investment, and Savings

6. In contrast with the 1990s, real GDP growth since 2002 has been driven by the services sector (mainly transport and telecommunications), while industry has taken second place due to a considerable slowdown in manufacturing growth. Meanwhile, agriculture has continued to lag and virtually stagnated over the recent period.

7. **Slowdown in industry.** The industrial sector, which contributes about 26 percent of GDP, has recovered slowly with growth averaging 3.6 percent in 2002-04. This growth record is well below the rates achieved in the 1990s (6.8 percent on average) which in turn reflected strong manufacturing growth (8.1 percent on average). A primary reason is that the global economic slowdown during 2001/02 has limited the demand for Sri Lanka's manufactured exports, especially for textiles and garments, which are the country's largest export category. By 2004, textile and garment exports at about US\$2.8 billion were below the levels attained in 2000 (US\$3 billion).

8. **Thriving services.** The services sector, which accounts for about 55 percent of GDP, has been on the upswing in the course of the past three years growing by over 7 percent in 2002-04 compared to the average annual growth of 5.6 percent recorded in the 1990s. The telecommunications subsector has been at the forefront of this growth performance, reflecting the participation of the private sector in expanding the telecommunications network and provision for higher value added services growing on average by 25 percent the last three years. Healthy growth in transport, trade, and banking and real estate have also contributed to the expansion of the sector.

9. **Stagnating agriculture.** Agriculture (including forestry and fisheries) has continued to lag behind other sectors and virtually stagnated during 2002-2004, compared to an average growth of 2.5 percent during the 1990s. A drought in 2004 contributed to a 0.7 contraction in value added. The poor performance of the sector reflects its concentration on a few crops: paddy, tea, rubber, coconut, and a small number of other field crops. This concentration entails high risks and makes the sector highly vulnerable to weather conditions. Infrastructure bottlenecks continue to hamper the distribution of agriculture produce, and unpredictable tariff adjustments create uncertainty and discourage long-term investments in the sector.

10. **Investments picking up and savings stable.** Gross domestic investment remained somewhat subdued at around 22 percent of GDP in the immediate years after the ceasefire, but gained momentum in 2004 reaching an estimated 25 percent of GDP. Much of the rebound reflected increased demand for technology upgrades from the apparel industry in preparation for the abolition of the MFA, and new investments in tourism and telecommunications. Foreign Direct Investment (FDI) also rebounded to US\$230 million in the last two years.⁶ Nevertheless, its contribution to total investment is still fairly modest (1 percent of GDP or 5 percent to total investment). Meanwhile, national savings

6. If privatization receipts are excluded, FDI has almost tripled over the 2001 level (from US\$82 to US\$217 million).

Table 1: Sectoral GDP Growth Rates 1990-2004

	1990-2000 Average	2001	2002	2003	2004
Agriculture Sector	2.5	-3.4	2.5	1.6	-0.7
Industrial Sector	6.8	-2.1	1.0	5.5	5.2
Manufacturing	8.1	-4.2	2.1	4.2	5.1
Construction	5.2	2.5	0.8	5.5	6.6
Services Sector	5.6	-0.5	6.1	7.9	7.6
Transport, Storage, and Communications	6.4	3.8	7.6	10.2	13.7
Wholesale and Retail Trade	5.5	-6.7	5.6	7.3	5.7
Banking, Insurance, and Real Estate	7.7	7.9	11.1	10.6	6.6
Public Administration and Defense	3.5	1.0	0.0	0.6	2.0
GDP	5.3	-1.5	4.0	6.0	5.4
National Savings	19.8	20.3	19.5	21.3	--
Total Investment	25.2	22.0	21.3	22.3	25.0
Foreign Direct Investment (\$ Mn)	164	172	197	229	227
Of which privatization proceeds:	39	90	5.0	30	10

Source: Central Bank of Sri Lanka.

rates have remained relatively uniform since the 1990s at around 20 percent of GDP. Stability in national savings reflect the combined effects of even corporate sector savings, downward trend in Government dis-savings, and increased net inflows from abroad.

D. Status of Policy and Institutional Reforms

11. Sri Lanka has been ahead of other countries in the South Asian region in implementing first generation reforms such as trade liberalization. To a large extent these reforms explain the economy's resilience to adverse shocks, including the prolonged conflict. There have been recent efforts at fiscal consolidation, but the macroeconomic framework still remains fragile. In addition, while the role of the private sector has been growing, the state still dominates important economic and financial services (e.g., power, transport, and banking), key commodity inputs (paddy and agricultural inputs), and factor markets (land and labor). The state also remains in many ways the employer of first resort, absorbing about one half of formal sector employment.⁷

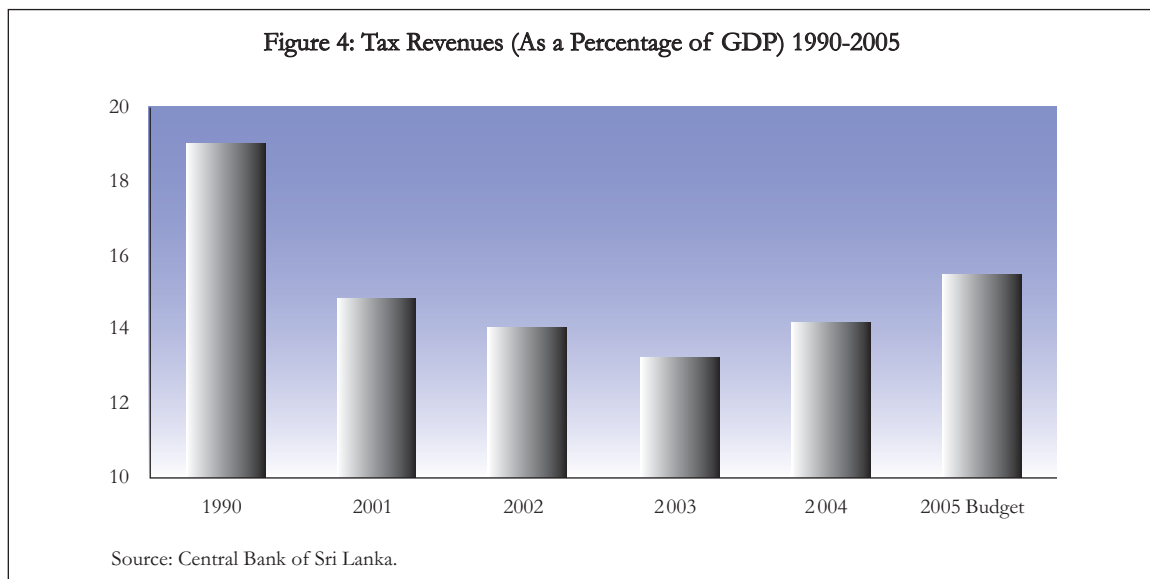
12. The UPFA coalition government elected in April 2004 has outlined its economic policy framework in the recently released *"Creating our Future, Building our Nation"*.⁸ This document departs from the previous Government's policy framework in certain areas such as the role of the state. It also lays out the Government's broad areas of focus for reducing poverty-e.g., developing the rural economy, promoting Small and Medium Enterprises (SMEs), restructuring of strategic state-owned enterprises, reinvigorating the civil service and cutting the budget deficit. While the Government places a welcome focus on poverty reduction, it still needs to translate this broad framework into specific programs and actions in the form of a revised Poverty Reduction Strategy (PRS).

7. See Central Bank Annual Report, 2003.

8. GOSL (2004).

Macroeconomic Management

13. **Fiscal policies.** Large fiscal deficits led to mounting public debt during the 1990s. Several factors contributed to this situation, namely: (i) a downward trend in tax revenues (from 19 percent of GDP in 1990 to about 14 percent) reflecting reduced reliance on trade taxes as liberalization progressed; (ii) rising conflict-related defense expenditures; (iii) rapid increase in public sector employment, averaging 3.5 percent annually in the 1990s; and (iv) greater recourse to market-based domestic debt to finance the budget, resulting in a rising ratio of interest payments to GDP. These underlying pressures heightened by the 2001 economic downturn took the public debt to GDP ratio to over 105 percent, raising concern about the country's fiscal/debt sustainability.



14. In order to put the fiscal accounts on a sustainable path a Fiscal Management Responsibility Act (FMRA) was passed in December 2002. The Act set medium term ceilings on the fiscal deficit (to below 5 percent of GDP by 2006) and public debt (less than 85 percent of GDP by 2006 and 60 percent by 2013) as well as on government guarantees (to a maximum of 4.5 percent of GDP).

15. Despite some efforts at fiscal consolidation, the past two years have seen a slippage from the FMRA targets. The fiscal deficit was brought down from 10.8 percent of GDP in 2001 to 8 percent in 2003. However, the fiscal adjustment during the period was short of original targets and relied entirely on reduced expenditures (mostly in defense and capital) while tax revenues continued to fall, partly reflecting the complex transition from a sales tax to a two-tier Value Added Tax (VAT) system. Although the decline in tax revenues was reversed in 2004, additional election-related expenditures and petrol and food subsidies kept the deficit high at around 8 percent of GDP. This was above the original target of 6.8 percent of GDP which was later revised to 7.3 percent under the March 2004 Pre-Election Budgetary Position Report. Furthermore, the deficit does not reflect arrears payments due to public enterprises on account of petroleum and food subsidies (estimated at around 0.4 percent of GDP). Net domestic financing increased from 4.5 percent of GDP in 2003 to 6 percent in 2004, including a US\$250 million dollar-denominated bond issue. Public debt stood at around 106 percent of GDP at the end of the year (of which 56 percent was domestic debt).

16. Recognizing the importance of attaining fiscal sustainability, the GOSL has announced its intention to adhere to the FMRA targets, albeit on a delayed timetable.⁹ Accordingly, the 2005 budget contains positive measures to reduce the fiscal deficit to 7.6 percent of GDP, by substantially raising revenue (1.6 percent of GDP) and containing expenditure increases to 0.6 percent of GDP. Revenue projections however may be on the high side as administration has been made more complicated by the introduction of a three-tier VAT system¹⁰ and numerous exemptions and cesses. Substantial expenditure increases were directed to wages¹¹ and domestically financed investment-of 1.2 and 1

9. See Ministry of Finance (2004).

10. The system includes a 15 percent VAT for most products, 5 percent for essential food items and 18 percent for luxury goods.

11. Reflecting a 40 percent wage hike to be spread over two years and hiring of 30,000 new graduates.

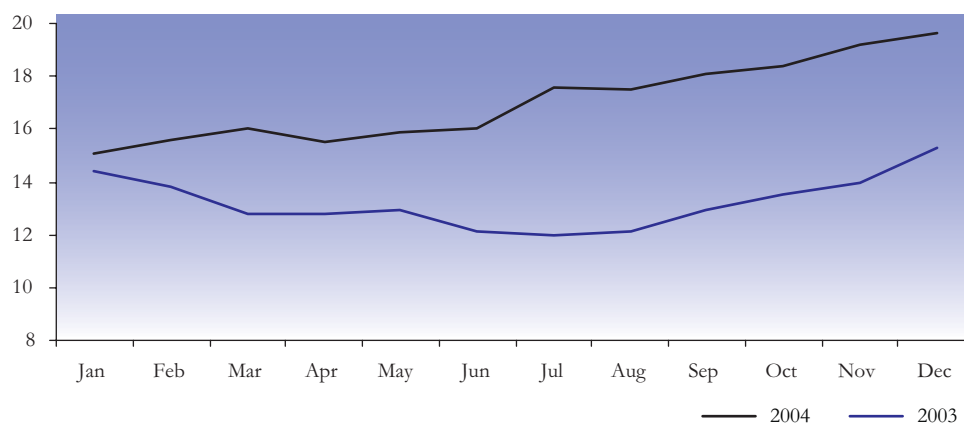
Table 2: Summary of Central Government Fiscal Operations (As a % of GDP) 2001-2005

	Actual			Estimate	Budget
	2001	2002	2003	2004	2005
Total expenditures and net lending	27.5	25.4	23.7	23.5	24.8
Current expenditures	21.6	20.9	19.0	19.2	18.5
Subsidies and transfers	4.6	4.7	4.0	4.9	4.0
Wages and salaries	5.5	5.6	5.2	5.4	5.6
Interest payments	6.7	7.4	7.1	6.0	5.6
Capital expenditures and net lending	5.9	4.6	4.7	4.3	6.4
Total revenues	16.7	16.5	15.7	15.4	17.2
Tax	14.6	14.0	13.2	13.9	15.5
Non-tax	2.0	2.5	2.5	1.5	1.7
Current account balance	-4.9	-4.4	-3.3	-3.9	-1.3
Budget deficit w/o grants	-10.8	-8.9	-8.0	-8.2	-7.6
External financing	1.4	0.6	2.9	1.8	2.5
Domestic financing	8.8	8.0	4.5	5.8	4.6
Public debt	103.2	105.4	105.9	105.5	-

Source: Ministry of Finance estimates.

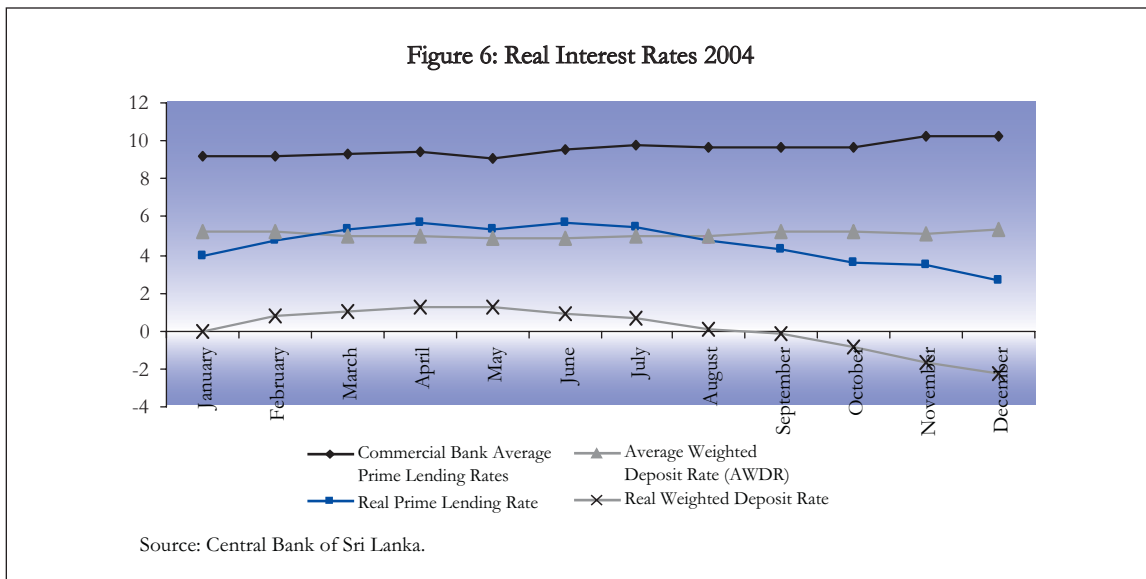
percent of GDP, respectively - but were to be partially offset by a 1 percent of GDP cut in subsidies and lower interest payments. The bulk of the capital budget increase was allocated to the creation of an SME bank and the remainder consisted of several smaller projects for rural development.

Figure 5: Annual Changes in Money Supply (M2) 2003-04



Source: Central Bank of Sri Lanka.

17. **Monetary policies.** Money supply growth accelerated in 2004 led by a rapid expansion of domestic credit. Broad money expanded by about 20 percent, compared to a target of 15 percent. Net credit to government increased by 25 percent and private sector credit expanded by 22 percent. The rapid credit expansion reflects increased financing of the government budget and higher private demand for credit in the context of declining real interest rates. The acceleration in money supply growth fueled inflationary pressures with the point-to-point inflation rate reaching 13.8 percent in December 2004 while the moving annual average reached 7.6 percent in the same month. Despite rising inflation, the Central Bank raised the overnight (repo and reverse repo) rates only by 50 basis points in November 2004 to 7.5 and 9 percent, respectively, but instead is relying on open market operations to mop up excess liquidity. It is hoped that these measures would be adequate to reverse the negative real deposit rates which are affecting the returns on savings; otherwise the Central Bank may need to consider further adjustments of policy rates.



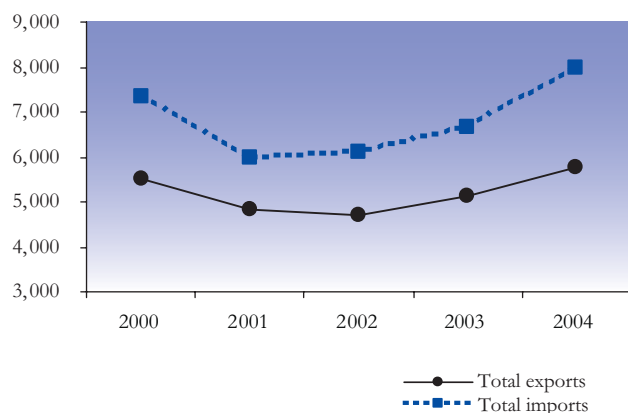
18. **External sector policies.** Sri Lanka's external position weakened in 2004 and the overall balance of payments recorded a deficit after being in surplus since 2001. Notably, the current account deficit (after grants) widened from 0.4 percent of GDP in 2003 to an estimated 3.3 percent of GDP in 2004, reflecting a significant increase in the trade deficit. Merchandise imports rose by 20 percent to about US\$8 billion, as a result of substantial increases in both non-oil and oil imports (16.7 and 37 percent, respectively). A 30 percent hike in international oil prices and buoyant domestic demand account for the rise in imports. In addition to the expansive fiscal and monetary stance, lagged adjustments in domestic oil prices and the exchange rate kept up import demand (particularly for capital goods). Although merchandise exports performed well growing by 12 percent to US\$5.7 billion, this level was just above the US\$5.5 billion attained in 2000. At US\$2.8 billion, garments exports were still slightly below the 2000 level, but higher export receipts from tea and rubber more than compensated for the shortfall. Positive net capital flows in the order of US\$500 million were insufficient to prevent a deficit in the overall balance of payments and gross official reserves fell from US\$2.1 to US\$1.8 billion (from 2.9 to 2.1 months of import cover). Nevertheless, the rupee depreciated by 8 percent against the US dollar.

Status of Selected Reforms

19. **Public administration.** The past two decades have witnessed a substantial erosion of the institutional capacity and economic governance of the nation's administrative system. Despite the growing role of the private sector in the economy, the proportion of public sector employees both in absolute numbers and as a proportion of the labor force remains quite high. Around 13 percent of the labor force is employed in the public sector, which results in Sri Lanka having one of the largest bureaucracies in the developing world (3.9 civil servants per 100 people compared to an average of 2.6 per 100 people in Asia).¹² In the 1990s, public sector employment grew by 3.5 percent annually, outpacing population and labor force growth. Public sector workers at the lower ranks are paid higher than their comparators in

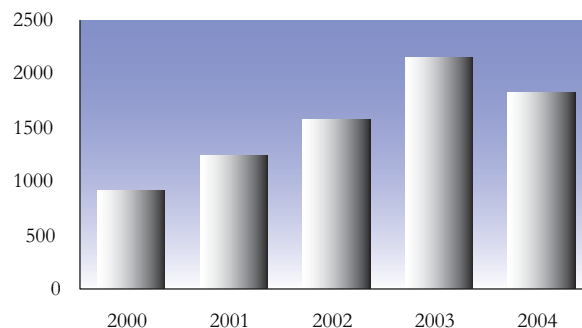
12. Includes only civilian public sector employees.

Figure 7: Exports and Imports (\$ Mns) 2000-2004



Source: Central Bank of Sri Lanka.

Figure 8: Gross Official Reserves (\$ Mn) 2000-2004



the private sector, while top policy-makers and professionals are insufficiently compensated. As a result, Sri Lanka's public sector compression ratio (about 8:1) is the lowest in South Asia. The inappropriate incentive system and administrative duplication/overlap combined with overstaffing contribute to inefficiencies and ineffectiveness in service delivery.

20. **Public enterprises.** A number of successful privatizations since the early 1990s have boosted growth in key sectors such as telecommunications, airline and ports. However, state-owned enterprises (SOEs) still continue to play a significant role in the energy, transport, water, and banking sectors, posing a heavy fiscal burden and delivering poor services. Most are overstaffed, incur operating losses, have large debts (mostly with the state-owned banks), and require large investments to provide adequate services. Total direct transfers alone represent 3 percent of GDP, which is above the entire education budget. This calls for urgency in improving the performance of SOEs by implementing restructuring plans and adjusting tariffs to reflect full cost recovery. Of particular concern is the situation of the Ceylon Electricity Board (CEB) which has accumulated a debt of over US\$80million (0.4 percent of GDP) and is running substantial operating losses. While recognizing the need to improve the performance of SOEs, the government has ruled out privatization as an option and intends to restructure twelve strategic enterprises within a more autonomous corporate structure under the oversight of the recently established Strategic Enterprise Management Agency (SEMA). Business plans for all twelve have been completed and are being considered by Cabinet.

21. **Financial sector.** Sri Lanka's financial system has developed over the past decade reflecting a strengthened regulatory framework and greater private sector participation. The two state banks -the People's Bank (PB) and Bank of Ceylon (BC)-account for 46 percent of banking assets. After two recapitalizations in the 1990s, PB remains insolvent and both banks continue to have high non-performing loans. High intermediation costs (associated with overstaffing and loss-making branches) have contributed to the high cost of funds and large spreads. Earlier plans to commercialize the PB (and thus strengthen its governance structure) through privatization have now been ruled out and the government intends to restructure the bank under SEMA with the assistance of the Asian Development Bank (ADB). Although the financial performance of the banks improved in 2004, the financial position of the banks is at risk owing to increased lending exposure to CPC and CEB. The recent establishment of a State SME bank further raises the need for appropriate oversight in this sector.

22. **Social welfare.** Sri Lanka has a long legacy of social welfare ranging from free education and health to subsidies and cash transfers. However, Sri Lanka's largest cash transfer program, Samurdhi, while making up a significant proportion of public expenditures (0.6 percent of GDP) remains ineffective in providing a safety net to the poor. Samurdhi transfers minimal amounts of cash to almost half of the population and still significantly misses a large

proportion of the poor (40 percent of households in the two poorest quintiles). Early measures to address the mis-targeting in welfare programs involved setting up the Welfare Benefit Board under the Social Welfare Act of 2002 and developing objective criteria for selecting beneficiaries. However, it is still not clear yet whether the government will adopt and implement these newly developed criteria.

23. **Labor regulations.** Sri Lanka's complex and costly labor regulations constrain labor market flexibility and undermine the competitiveness of firms. Labor disputes can take over one year and retrenchment costs are high. Under the 1971 Termination of Employment of Workmen's Act (TEWA), firms with more than 15 workers are required to obtain the written consent of the employee and/or the permission of the labor commissioner for the termination of the employee on non-disciplinary grounds. Employers have responded by limiting job creation, suppressing base wages, and resorting to outsourcing and subcontracting. In 2003, TEWA was amended to require the application of a compensation formula for termination cases and thus improve predictability. The Industrial Disputes Act was also amended, setting timelines for tribunal cases, arbitration cases and termination applications. However, the compensation formula-revised last in March 2005-implies the payment at termination of 1.5-2.5 months wages for each year of service, which is high by regional and world standards.¹³ Meanwhile, the system remains unpredictable as the Labor Commissioner's approval continues to be required. An unemployment benefit scheme is also planned (involving the payment of up to twelve month wages) to be funded by increased employer's contributions to the Employees Trust Fund (ETF). Employers have voiced concerns that these measures will undermine the competitiveness of Sri Lankan firms.

24. **Agricultural policies.** Reforms in agriculture and rural development have been limited, with the exception of the privatization of plantations in the early 1990s. A number of longstanding policy constraints have reduced the capacity of farmers to diversify production, enhance their productivity, and respond to market opportunities. These include unpredictable trade policies, highly restrictive seed and quarantine regulations, discretionary commodity price interventions, complex and restrictive land policies, and poorly functioning water delivery systems. Although several initiatives to address some of these constraints have been put forward since the late 1990s, much is still left to be done. The Government is in the process of revising land and water policies, and is reviewing regulations pertaining to access to technologies, but the content and timetable for implementation is still being developed.

13. The average for South Asia is 0.8 wages for each year of service.