Quarterly review of Sri Lanka's economy

08/10/02 Island.

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Executive Summary *

The political environment remained conducive for the economy despite hitches in the implementation of the MoU and the continuing power struggle between the government and the executive President. The reopening of the A9 highway after a lapse of 15 years was a landmark politico-economic event of the second quarter of this year.

There were early signs of the economy recovering this year from the dismal performance last year, the worst since independence. The economic growth rate during the first quarter crept back into the positive territory with a marginal positive growth of 0.3%. The agricultural and services sectors contributed to this resurgence, but the industrial sector once again posted a negative growth.

In the agricultural sector, tea production increased markedly, rubber production did not experience much change, but coconut production continued to decline during the quarter under review compared to the previous quarter. However, disturbingly, the price of tea (in terms of US dollars) has been declining every month of the quarter.

Industrial production (both private and public sector) picked up during the last two months of the quarter. Likewise, industrial exports also picked up during the latter two months after a dramatic drop in the first month of the quarter. However, industrial exports during the first half of this year was 20% less than during the corresponding period last year.

Major Agricultural Production – 2nd Quarter 2002

	April	May	June	1st Quarter	2nd Quarter
Tea (million kgs)	27.3	33.6	26.1	72.2	87.0
Rubber (million kgs)	7.6	7.8	7.5	23.8	22.9
Coconuts (million nuts)	177	190	210	661	577

Source: CENTRAL BANK

April-June 2002

Interest rates continued its downward trend during the quarter. Likewise, the annual average rate of inflation also continued its downward trend during the quarter. These two indicators are positive developments for the economy. The total public debt of Sri Lanka rose by 5% at the end of the second quarter in comparison to the end of the first quarter. The external debt in US dollar terms increased by 6% between the same periods.

The performance of the international trade sector during the quarter was very disappointing. That is, exports declined whilst imports soared. Hence, the trade deficit doubled during the quarter under review in comparison to the first quarter. This was primarily due to the external economic environment depressing the demand for exports from Sri Lanka. Despite the doubling of trade deficit the balance-of-payments situation remained relatively upbeat as the gross official reserves increased by 20% at the end of the second quarter compared to the end of the previous quarter. The gross official reserves at the end of the quarter were adequate to five months' imports. This accumulation of reserves was possible due to increased donor assistance during the quarter.

The remittances from abroad remained more or less at the same level as was in the preceding five quarters. Thus, there was no change in the contribution of remittances to the balance-of-payments and the overall economy. The contribution of the tourism sector to the balance-of-payments and the overall economy dropped during the second quarter, because it was off-season for tourism. More disturbing is the fact that there was a 24% drop in tourist arrivals and income from tourism during the first six months of the year compared to the corresponding period last year.

The capital market behaviour during the quarter under review was not stable. It recorded ups and downs during each month of the quarter. The economy of the North and East experienced positive and negative impacts of the lifting of the economic sanctions. There was not much economic development taking place in the province, because of donor scepticism and financial squeeze experienced by the government.

Industrial Production and Exports – 2nd Quarter 2002

IPI = Industrial Production Index	Jan	Feb	Mar	April	May	June
Private Sector IPI (1997=100)	126.7	129.1	120.1	116.9	120.8	125.3
Public Sector IPI (1997=100)	216.6	687.6	103.1	87.3	124.5	127.1
Industrial Exports (USD million)	254.2	278.3	269.3	179.0	254.3	255.1

Source: CENTRAL BANK

Politico Economy Milieu

The political situation remained buoyant during the second quarter of the year as well despite irritants in the implementation of the Memorandum of Understanding (MoU) between the Government of Sri Lanka and the Liberation Tigers of Tamil Eelam (LTTE). Yet another milestone in the peace process was achieved when the A9 highway linking the Jaffna peninsula and the rest of the island was reopened in April after 15 years.

The closure of the A9 for vehicular traffic about 15 years ago cut off the Northern Province from the rest of the island. This was the origin of the economic blockade of the Northern Province. This coupled with the economic sanctions imposed in 1990 made the Northern economy insular. Agriculture (including fishing) became subsistence and small and medium scale industries were virtually wiped out of the regional economy. Besides, the high transportation cost due to the shipment of consumer goods by sea resulted in untold hardships to the population in the North. Therefore, the reopening of the A9 was expected to rejuvenate the dormant economy and enhance the livelihoods of the people in the North.

However, the LTTE's refusal to allow state-owned buses to ply the A9 highway is an inconvenience to travellers to/from Jaffna. Likewise, the delay in the vacation of public buildings (such as schools and temples) by the state security forces was also a major hindrance to the restoration of normally in the North & East province. In spite of such teething problems in the implementation of the MoU and the continuing riff between the President and the government on a variety of issues the feel good factor was by and large in tact during the quarter under review.

Economic Growth

The first quarter real Gross Domestic Product (GDP) grew at a marginal positive rate of 0.3% which was a marked improvement from the (-) 3.4% recorded in the final quarter of 2001. But, the first quarter economic growth rate at almost zero percent was dismal compared to the almost 2% posted during the first quarter of 2001.

The agricultural sector contributed positively to the overall growth in the economy during the 1st quarter, but the industrial output contracted considerably by about 4%. The agricultural production experienced a turnaround with 2.4% growth (compared to (-) 5.2% during the 4th quarter of 2001) primarily due to partial easing of the prolonged drought. The recession in the industrial sector was mainly due to the continued sluggishness in industrial exports as a result of prolonged recession in the US and European economies (the two largest markets for Sri Lankan exports). The services sector posted a minor growth during the 1st quarter from the negative growth experienced in the 4th quarter last year. The services sector largely depends on agricultural and industrial sectors for its value-added, and therefore susceptible to the growth of those sectors.

The growth prospect for the 2nd quarter was not encouraging, because of poor external economic environment and the slow implementation of the MoU, which had resulted in the postponement of direct negotiations between the government and the LTTE. The Asian Development Bank predicted that the Sri Lankan economy would rebound during the second half of this year, and the government still predicts a 3% growth rate for the current year. The IMF (in August 2002) predicted a growth rate of about 4%. These seem to be wishful thinking, because the domestic and international politico-economic environment is not favourable to attain the growth rate expected by the government and the multilateral organisations. It has to be remembered that the IMF predicted a 3% growth rate for 2001 even as late as August 2001, but in reality the growth rate recorded (-) 1.4. Especially if the war against Iraq begins in earnest then international fuel price would soar, which would be fatal to the growth prospects of Sri Lanka as it is entirely dependent on imports for fuel.

Agricultural Production

The major agricultural produce of Sri Lanka are paddy (food crop), tea, rubber, and coconut (cash crops). Paddy production figures are not regularly published. Tea production improved considerably by 20%, rubber production declined marginally, and coconut production dropped by 13% during the 2nd quarter compared to the previous quarter. Both tea and rubber production during the first six months of this year were before than the corresponding period last year, but coconut production declined by 10%. The continuous decline in coconut production is due to the impact of the prolonged drought.

Tea output increased from 27 million kgs in April to 34 million kgs in May, but declined to 34 million kgs in June. Rubber output remained at almost the same level during each of the three months under consideration, i.e. around 7.6 million kgs. However, the coconut output showed a consistently upward trend from 177 million nuts in April to 190 million nuts in May to 210 million nuts in June, yet it was lower than that recorded in the first three months of this year.

Interest Rate Movement – January - June 2002

	Jan	Feb	Mar	April	May	June
Prime Lending Rate (%)	13.84	13.42	13.55	13.47	13.65	14.04
Treasury Bill Rate (%)	13.70	13.54	13.61	15.31	15.56	13.72
Repo Rate (%)	12.0	12.0	11.50	11.50	11.50	11.50
Reverse Repo Rate (%)	14.0	14.0	13.65	13.85	13.85	13.75

Source: CENTRAL BANK

The Colombo tea auction price (in USD) dropped month after month during the quarter under review, i.e. from USD 1.70 in March, to USD 1.58 in April, to USD 1.48 in May, and to USD 1.43 in June 2002. The price of tea, which has been consistently increasing in the last quarter of 2001 and the first quarter of 2002, has consistently declined during the three-month period under consideration.

Industrial Production

Both the private sector industrial production index and the public sector industrial production index dropped in April compared to the previous month. However, they recovered considerably in May and June. April is a traditional holiday period in Sri Lanka coinciding with the Sinhala and Tamil New Year during the middle of the month. This may have accounted for the considerable drop in industrial output, particularly in the public sector. Besides, the lifting of the long drawn out power shedding in May also would have helped revive industrial production.

Industrial exports dipped by 34% in April from USD 269 million in March to USD 179 million in April. It later recovered to nearly USD 225 million during May and June, a 42% rise. Nevertheless, industrial exports of Sri Lanka showed a 20% drop during the first six months of this year in comparison to the corresponding period last year. This is partly due to the recession in the economies that are the major markets for Sri Lanka's industrial exports (USA and Europe), and partly due to the war risk surcharge on shipping.

Interest Rates

Interest rates generally showed a declining trend, barring the prime lending rate. The prime lending rate declined marginally in April compared to March, but later increased to 13.65% in May and 14.04% in June. The interest rate on 12-month treasury bills increased considerably in April compared to March by 1.70%, and increased marginally in May, but later decreased by 1.84% in June. The Repurchase (Repo) rate remained at 11.50% throughout the period under consideration, and the Reverse Repo rate increased marginally in April but declined in June [1]. The foregoing interest rates are significantly lower than that prevailed last year during the same time.

Inflation

One of the positive developments in the second quarter was the gradual decline in the annual average rate of inflation as measured by the Colombo Consumers' Price Index (CCPI). The point-to-point inflation2 dropped to 8.3% in April from 11.4% in March, but increased to 10% and 10.7% in May and June respectively.

Inflation Rate – January – June 2002

	January	February	March	April	May	June
Point-to-point rate	8.9	8.5	11.4	8.3	10.0	10.7
Annual average rate	13.5	12.8	12.7	12.2	11.7	11.4

Source: CENTRAL BANK

On the other hand the annual average rate of inflation declined consistently from 12.7% in March to 12.2% in April, to 11.7% in May, and to 11.4% in June. It is worth not in that the annual average rate has declined month after month since the beginning of the year.

In spite of the utility (electricity and water) price hikes during the quarter under review the inflation rate has marginally declined due to improved agricultural production.

Public Debt

Sri Lanka's total public debt has exceeded the annual GDP during 2001. The government revenue through direct and indirect taxes is not even adequate to make the annual repayments (capital plus interest) on public debt. The total outstanding public debt of Sri Lanka soared to LKR 1,580 billion by the end of second quarter, which was a rise of nearly 19% in comparison to the corresponding time last year. The total outstanding public debt by end-June 2002 was split into LKR 883 billion domestic debt (56%) and LKR 697 billion external debt (44%).

The total public debt at the end of second quarter (LKR 1,580 billion) was a 5% rise from the level at the end of first quarter 2002 (LKR 1,500 billion). The total outstanding external debt at the end of the quarter under review was USD 7.3 billion out of which USD 7 billion was concessional loans. This is a 6% rise from the level at the end of the previous quarter (USD 6.9 billion). Since December 2001, the outstanding defence loans are included in the total public debt data.

(To be Continued)