

## QER - Second Quarter 2007

Thursday, 14 February 2008

Last Updated Wednesday, 27 February 2008

Air strikes by the LTTE, defection of two key ministers, and the pullout of the second largest political party from the coalition government have created political uncertainty during the second quarter of this year. However, continued military successes in the East have boosted the morale of the government.

Economic growth has marginally improved during the quarter under review compared to the previous quarter, but was considerably lagging behind the corresponding quarter last year. During the first half of this year the economy grew by 6.2%, considerably lower than 8% recorded in the corresponding period last year. The agriculture sector continues to under-perform and recorded no growth at all, the services sector growth declined, and the industrial growth remained static.

In the agriculture sector, tea and coconut output increased, but paddy and rubber output declined compared to the previous quarter. While tea production during the quarter under review was lower, rubber and coconut productions were higher in comparison to the corresponding quarter last year. The Colombo tea auction price remained over USD 2 per kg during the first six months of this year, which is a record. The agriculture sector is expected to perform better in the second half of the year because of the stabilisation of the security situation in the Eastern Province that would increase agriculture production, which was severely disrupted during the first half of the year due to intense fighting.

The private sector industrial production index remained more or less the same as in the first quarter, but the public sector industrial production index has increased during the second quarter. The private sector industrial production index during the quarter under review was higher, and the public sector industrial production index was lower than the corresponding quarter last year. Industrial exports, in value terms, increased considerably during the second quarter in comparison to the previous quarter as well as the corresponding quarter last year.

Interest rates were steady during the quarter under review. The weighted average prime-lending rate declined, but the Treasury bill rates increased, and the repo and reverse repo rates remained unchanged during the second quarter. Interest rates were generally much higher than during the same time last year. Higher interest rate has reduced investment and thereby reduced the growth rate.

While the annual average rate of inflation, in terms of both the SLCPI and CCPI, was higher, the point-to-point rate of change in inflation was lower than the preceding quarter. Both these inflation measures were much higher than in the same quarter last year. There is a deceleration in the rise of inflation during the quarter under review. However, inflation is expected to remain double-digit throughout the rest of the year.

Total public debt incurred during the second quarter was significantly lower than the previous quarter as well as the corresponding quarter last year. Public expenditure has been reduced as a result of tight monetary policy of the Central Bank. However, the cuts in public expenditure have been on non-defence expenditure. While the domestic debt incurred was significantly lower than the preceding quarter as well as the same quarter last year, external debt was significantly higher than the preceding quarter as well as the same quarter last year.

The external sector of the economy received a setback due to drop in exports and rise in imports, which has resulted in huge increase in the trade deficit. This was despite the increase in industrial exports and further depreciation of the rupee. Both the exports and imports declined compared to the corresponding quarter last year. Trade deficit was higher than the corresponding quarter last year.

The gross official foreign exchange reserve dropped marginally in comparison to the first quarter, but was higher than the same quarter last year. Despite the huge rise in trade deficit, the drop in gross foreign exchange reserve was limited due to greater foreign aid and net private remittances received during the quarter under review.

Net private remittances increased during the second quarter compared to the first quarter and the corresponding quarter last year. Tourist arrivals and earnings dropped enormously during the quarter under review in comparison to the previous quarter as well as the corresponding quarter last year. The rise in net private remittances is a reflection of the fleeing of people abroad due to the raging conflict. Likewise, the drop in tourist arrivals and earnings is also due to the intensification of the conflict, particularly due to the air raids by the LTTE and closure of the airport at night time.

The capital market activities were also negatively affected by the intensification of the conflict and political instability. Although the ASPI and MPI were lower than the preceding quarter, they were higher than the corresponding quarter last year.

The cost of living continued to rise in the conflict region, particularly in Jaffna, during the quarter under review. Commodity prices were generally higher in the conflict region compared to the previous quarter as well as the corresponding quarter last year. Rising transportation cost and supply constraints have pushed up the prices and thereby the cost of living.

In spite of the problems faced due to multitude of factors, the Sri Lankan economy is quite stable. The annual economic growth is expected to be considerably lower than last year, and the inflation is expected to remain at the double-digit level. However, the security dividend is expected to mitigate the impact of the turbulence in the economy and political instability.

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