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## QER - Fourth Quarter 2006

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The civil conflict in Sri Lanka has resumed in earnest during 2006. Over two hundred thousand people were internally displaced in the conflict region, around fifteen thousand fled to India, and around four thousand people died in conflict during 2006. The politico military situation further deteriorated during the final quarter of 2006, the east bearing the brunt of the conflict. Although the Norwegian peace facilitators arranged a meeting between the warring parties in Geneva in early October, predictably it failed to produce any results.

The government presented the Budget 2007 in November, which was an expansionary one. Huge public expenditure rise, including for defence, is likely to fuel inflation, increase public debt, and likely to create macroeconomic instability during 2007. In the first two months of 2007 the government has been finding difficult to finance the expanded fiscal outlays.

GDP growth has been decelerating throughout 2006 and is likely to continue into the fourth quarter as well, though data is still not available. During the first three quarters the GDP grew by around 7.5%. The annual growth of GDP in 2006 is likely to be around 7%, which would be about 1% higher than the growth rate in 2005.

Agriculture growth has been decelerating throughout 2006, which continued in the final quarter as well. Paddy, tea, and coconut outputs decreased marginally, but rubber production increased marginally during the quarter under review compared to the preceding quarter. However, paddy, rubber, and coconut outputs were marginally higher than in the corresponding quarter in 2005. Tea auction price continued to surge.

While the private sector industrial production increased considerably, public sector industrial production decreased significantly during the fourth quarter in comparison to the previous quarter as well as the corresponding quarter in 2005. Nevertheless, industrial exports (in value) continued to increase during the quarter under review, recording the highest quarterly export value in the past two years.

Interest rates continued to rise during the quarter under review. The government attempted to arrest inflation by increasing the interest rates and thereby contain borrowings. However, interest rate hike has not been sufficient to reduce inflation, because the government wanted to keep the borrowing cost low for its fiscal expansionism.

Inflation both in terms of the Sri Lanka Consumer Price Index and Colombo Consumer Price Index were on the rise. The point-to-point rate of inflation in terms of CCPI almost topped 20% in December. Annual average rate of inflation was almost 14% by the end of the year. Inflation during the fourth quarter was considerably higher than in the corresponding quarter in 2005.

Public debt increased by 16% at the end of November compared to the same time in 2005. During the first three quarters of 2006 domestic debt was significantly higher than the external debt. However, in the last quarter (data for December is still not available) external debt accounted for nearly two-thirds of the total public debt incurred, primarily due to borrowing in the international capital market and from Sri Lankans living abroad.

Exports increased marginally in the quarter under review while imports declined, which reduced the trade deficit. However, trade deficit during the fourth quarter 2006 was significantly higher (20%) than that in the same quarter in 2005, because although exports increased, imports increased greater during the quarter under review compared to the corresponding period in 2005.

Although the gross official reserves increased considerably during the fourth quarter the overall balance-of-payments was in a precarious position. Besides, the gross official reserve at the end of December was considerably lower than at the same time in 2005. The rise in gross official reserve during the fourth quarter 2006 (in comparison to the previous quarter) was not due to increase in official development assistance, but due to private borrowings.

Tourist arrivals dropped by 21% in the fourth quarter (compared to the preceding quarter) despite being peak tourist season due to suicide attacks in two prime tourist spots (Habarana and Galle) in October. Tourist arrivals in the quarter under review were also lower than in the corresponding quarter in 2005. However, earning from tourism was considerably higher than in the previous quarter as well as the same quarter in 2005.

Stock market continued to be upbeat despite deteriorating politico military situation because of negative real interest rates in the financial market. Nonetheless, with very little companies participating in the stock market and very low market capitalisation stock market could not be barometer of the economy in Sri Lanka.

Economy of the conflict region continued to deteriorate with mass displacement, loss of livelihoods, and escalating cost of living. The cost of living in Jaffna surged during the quarter under review with the depletion of stock of goods in the market after the closure of the A9 highway on August 11th. Scarcity, black markets, and rent seeking have become to

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characterise the economy of the north.

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