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## QER - Third Quarter 2006

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The politico military situation turned for the worse during third quarter 2006, both in the east and north with the full resumption of hostilities by the third week of July. Trincomalee district in the east and Jaffna district in the north bore the brunt of the sustained offensive operations by both the warring parties. Nonetheless, economic growth was stable and high during the quarter under review. Third quarter GDP growth of 7.5% was mainly due to strong growths in the industrial and services sectors. In spite of the deceleration of GDP growth rates in the first three quarters the annual growth rate is expected to be around 7%

Agricultural growth decelerated because of lower output of paddy, tea, and rubber. However, coconut output increased considerably during the third quarter. During the first three quarters of the year, while quarterly outputs of tea and rubber have been declining coconut output has increased. Colombo tea auction price has been on the rise throughout the quarter under review partly due to lower tea production in Kenya because of drought.

While both the private and public sector industrial production indices dropped in September compared to the last month of the previous quarter, industrial exports in value increased during the third quarter (particularly in August and September). However, in July and August both the private and public sector industrial production indices were on the rise.

Interest rates continued to rise though the real interest rate still remains negative because inflation is higher than the nominal interest rate. The Central Bank is reluctant to raise the real interest rate to positive level because it would negatively impact on economic growth.

Inflation continued to rise during the quarter under review. Cost of living in terms of the Colombo Consumer Price Index was much higher than in terms of the Sri Lanka Consumer Price Index. Increase in public and private borrowings (due to artificially lower interest rates and rise in military and welfare expenditures), lower agricultural output, and rise in world oil price are the causes for the rapidly escalating cost of living.

Though public debt during the third quarter was less than half that of the previous quarter (but almost the same amount as in the corresponding quarter last year), the preponderance of domestic borrowing during the quarter was a major cause for the relentless rise in inflation. Shrinking external borrowing is likely to cause harm to the balance-of-payments as well.

Greater increase in total export value coupled with marginal increase in total import value in the quarter under review has cut the trade deficit significantly in comparison to the preceding quarter. However, trade deficit in the quarter was significantly higher than that of the same quarter last year. Moreover, trade deficit in the first nine months of the year was significantly greater than in the corresponding period in 2005. Growing trade deficit is straining the balance-of-payments.

Gross official foreign exchange reserve continued to decline in the third quarter of 2006. Despite significant drop in trade deficit and marginal increase in tourism earnings the gross official reserve dipped due to drastic reduction in foreign aid flows and considerable drop in private remittances. In spite of foreign capital mobilisation through the sale of US dollar denominated Development Bonds during the course of the year the gross official reserve was slowly but steadily depleting. This trend is a pointer to a potential balance-of-payments crunch during the course of the new year.

Though the total net private remittance dropped in the quarter under review compared to the previous quarter the annual total net private remittance is well on course to hit USD.2,000 million mark by the end of the year, which would be a record. Further, tourist arrivals and earnings increased marginally in comparison to the second quarter. However, prospect for the last quarter of 2006 is bleak.

Capital market performance indices (ASPI & MPI) and average daily turnover were on the rise in the third quarter compared to the first two quarters in spite of deteriorating security situation. However, the ASPI and MPI were lower than in September 2005 and the average daily turnover was lower than the corresponding quarter of 2005.

The economy in the conflict region was on fast track to pre-ceasefire times of scarcity, black markets, long queues, and uncertainty as a result of full-scale hostilities in the east and closure of the sole highway connecting the north and rest of the country. Mass displacements and livelihood losses intensified both in the east and north. Prospects on the peace front are bleak.

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