

2003 economic outlook, medium-term prospects

The Central Bank said that future economic prospects of Sri Lanka are favourable, but concerns remain on some downside risks.

The Bank in its 2002 review said that the country's economic prospects will depend mainly on the progress in the ongoing peace process, strengthening macroeconomic management, speed and effectiveness of implementing structural reforms, finalisation and implementation of the long overdue long term concessional financial assistance programmes i.e., PRGF with the IMF, PRSC with the World Bank, enhanced country assistance programme with the ADB and other donors, improvement in the external environment and favourable weather conditions. Except the last two factors, all others are directly under the control of the country, if necessary measures are implemented effectively and in time. Given the severe effects of a ballooning public debt, strengthening macro-economic management has to be centred around a medium-term fiscal sustainability strategy consisting of a faster reduction in the budget deficit and a consequent reduction in public debt. A time-bound comprehensive structural reform programme consisting of reforms in all major areas, i.e., input markets, public enterprises, civil service, financial sector, pensions, utilities, regulatory systems and judicial system, would not only reinforce the macroeconomic management but also improve investor confidence and increase productivity, enabling the achievement of high economic growth with economic stability.

Lasting peace is essential to ensure economic recovery in 2003 and achieve a high, sustainable growth in the medium term. An early political solution to the North and East issue would increase growth prospects significantly, while any reversal in the peace process would have huge economic, political and social costs. Therefore, every effort must be made to accelerate the ongoing peace process and to complete it successfully by finding a lasting political solution through consensus

building as soon as possible. Political stability and national consensus on key political and economic issues among the major political parties, segments of society and institutions are essential, as a national priority, in achieving the twin major objectives of peace and sustainable high economic growth.

The present macroeconomic prospects for 2003 are favourable, if correct measures are implemented, even though some high downside risks remain. The projections under the baseline scenario consist of a continuation of economic recovery, higher investment expansion, greater stability in prices and exchange rate, lower unemployment, improvement in external reserves, greater macroeconomic stability and strengthening resilience of the economy. Nevertheless, the realisation of these desirable results depends on four major factors: (a) forward movement in the on going peace process, (b) strong policy adjustments, particularly containing the public sector deficit and domestic deficit financing as envisaged in Budget 2003 to be compatible with the medium-term sustainable fiscal strategy, (c) continuation of structural reforms without delays and reversals to remove constraints on productivity improvement and investment expansion and (d) mobilisation of adequate external concessional assistance, including financing under the PRGF/PRSC augmenting other external donor support necessary mainly for economic reforms, infrastructure development, rehabilitation and reconstruction.

Real output is expected to grow by about 5.5 per cent in 2003 benefiting from a recovery in all major sectors; Agriculture (2.9 per cent), Industry (5.3 per cent) and Services (6.6 per cent). The Agriculture sector growth will be mainly driven by the expected monsoon rains, expanding economic activity in the North and the East and continuing strong export demand for minor agricultural crops. The Industrial sector growth will be generated by the momentum in manufacturing

industry and construction activity. Expanding activities in trade and transport, recovery in tourism and port services, and the continuation of a high growth momentum in the telecommunications and financial sectors will mainly drive the high growth in the Services sector, which is the largest sector in GDP, accounting for more than half of the total value addition, on the aggregate demand side, both domestic demand driven mainly by the investment expansion and consumer confidence, and increased export demand with the expected expansion in the world trade, would enable the realisation of high growth. Envisaged growth enhancing structural reforms not only raise the growth potential of the economy, but also improve the external competitiveness of the country by increasing productivity and strengthen resilience of the country by diversifying the economy.

Global Economic Prospects for 2003

The pace of the global economic recovery has slowed since late 2002, amid continuation of the adverse effects of the bursting of the equity market bubble, rising geopolitical uncertainties, low market confidence and increased oil prices. Assuming the issue in Iraq is resolved quickly, the revised world economic outlook by the IMF in February 2003 adjusted downward the global growth forecast for 2003 by 0.4 percentage points to 3.3 per cent under the baseline scenario. The advanced economies are projected to grow by 2 per cent, 0.5 percentage points lower than the September 2002 projections. A downward adjustment has been made for all three major economies. The reduction in the US economy was marginal, while larger downward revisions were made for the Euro area and Japan, as policy reforms, in particular labour market reforms, are delayed in the Euro area and financial sector woes in Japan continue unabated. Developing countries are expected to grow at a high rate at 5 per cent even after a downward adjustment of 0.3 percentage

points. This will be mainly driven by high growth centres in developing Asia, mainly China, India and the ASEAN-4.

The projected recovery in world trade has been also adjusted downwards correspondingly. The world trade volume in goods and services is projected to grow by 4.9 per cent in 2003 down from earlier projection of 6.1 per cent, but still higher than the 2.9 per cent in 2002. Growth in imports by advanced countries was adjusted downward to 4.9 per cent in 2003 but is still better than the 2 per cent in 2002 and -1.2 in 2001 indicating prospects for export expansion from developing countries, which is projected to grow by 6.3 per cent. Commodity prices are projected to increase at higher rates in 2003 compared with the moderate recovery in 2002 and declines in 2001. Oil prices, which rose by 2.7 per cent in 2002, are estimated to rise by 12.3 per cent in 2003, aggravating difficulties faced by oil importing developing countries. Non-oil commodity prices are projected to grow by 9.3 per cent.

Reflecting commodity price increases, world inflation is expected to be higher in 2003 but still remain low compared with historical levels. Inflation in industrial countries is projected to be about 1.7 per cent, while it is expected to be 5.7 per cent in developing countries. Given the subdued inflationary pressure and the need for a growth stimulus, interest rates are expected to remain low in 2003.

However, downward risks remain high on these projections given under the baseline scenario. The first and most important one is the intensity and duration of the war in Iraq. Any spread to the Middle East region and/or protraction would have serious implications on the global economy, in particular on developing countries. It would stall the expected recovery in the global economy with a likelihood of reverting to recession, as global trade growth slows down and investment dries up. Disruption to the supply of oil would result in a sharp increase in oil prices from the already

high levels, exerting pressure on the balance of payments of oil importing developing countries and consequently on their exchange rates. The Gulf region being a large source of employment for developing Asian economies, a protracted war in the region would result in a sharp drop in private remittances further worsening BOP problems and increasing unemployment in those countries.

Second, the continuation of growth imbalances in major world economic centres increases the risk of sudden and abrupt corrections disturbing stability in the international financial system. The sluggish conditions in the second largest economy, Japan, and the Euro area, which have made the global economy heavily dependent on the fortunes of the US economy, would result in the continuation of growth imbalances in major economic blocks. Reflecting these imbalances, heavy fluctuations in major currencies, in particular the US dollar, the yen and the euro, could have destabilising effects in exchange markets resulting in difficulties for developing countries in macroeconomic management.

Third, the continuation of restrictions on entering the markets in advanced countries prevents the maximisation of benefits of globalising economic activities for developing countries.

Therefore, an early resolution to the conflict in Iraq is necessary to ensure the recovery in the global economy. Meanwhile, further strengthening of co-ordination in macroeconomic management among advanced countries would minimise growing imbalances among them. Similarly, opening of markets in advanced countries enhances the opportunities for developing countries to expand their exports and to integrate into the world economy successfully. Nevertheless, improving discipline in fiscal and monetary management and advancing in structural reforms are necessary in developing countries to improve their growth potential and strengthen resilience to withstand external shocks.