Sunil Mendis: Economic performance, prospects and challenges

Speech by Mr Sunil Mendis, Governor of the Central Bank of Sri Lanka, at the Donor Conference, Kandy, 15-17 May 2005.

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Introduction

Honourable Minister of Finance, representatives of the donor community and friends,

Sri Lanka has achieved considerable economic progress in the past few decades. Per capita income has increased, taking Sri Lanka into the category of a low middle income country. Many years of government focus on meeting the social needs of the people have enabled Sri Lanka to achieve human development indicators well beyond countries with comparable levels of income, in fact, similar to those of more developed middle income countries. The structure of the economy has been diversified from its earlier concentration on primary agricultural commodities, making the economy more resilient to internal and external shocks. Overall macroeconomic management has been reasonably sound, although achieving a better balance has sometimes been a challenge due to external and internal shocks.

However, despite these positive developments, many weaknesses remain, posing strong challenges to policy makers. Poverty still remains at significant levels; marked disparities in regional economic activity are clearly evident; unemployment, although declining, is still high, particularly among the youth; agricultural productivity is low, resulting in low farmer income and higher prices for consumers; despite some diversification of the economy, exports are concentrated in a few commodities and a few markets, thereby increasing the vulnerability of the economy; the fiscal deficit has remained high, resulting in inflationary pressures and increasing public debt; and essential economic infrastructure remains inadequate. These concerns have been aggravated by the tragic consequences of the tsunami that resulted in the loss of so many lives and extensive destruction of property.

Today, the challenge is to consider how to achieve a balanced growth with economic and social stability.

Let me now highlight some of the specifics on recent economic developments and policy challenges.

Macroeconomic developments

Sri Lanka was able to maintain an annual average economic growth of around 5 per cent in the post liberalization era. The country's resilience to adverse shocks has improved with a significant diversification of economic activity, particularly in the export structure. This enabled Sri Lanka to achieve a growth of 5.4 per cent in 2004, in spite of several major shocks, such as the surge in international oil prices, a severe drought in the early part of the year and floods later in the year and finally, the tsunami disaster. Per capita income has increased to US dollars 1,030 in 2004. However, overall economic progress has been below the desired level for a sustainable reduction in unemployment and poverty in Sri Lanka.

Sri Lanka's inflation has averaged 11 per cent in the post liberalization era. This has the adverse consequence of eroding the living standards of people, particularly vulnerable groups such as pensioners, other fixed income earners and the poor. Supply side factors, including sharp increases in the price of oil imports, have contributed to cost-push inflation. Sri Lanka's vulnerability to the vagaries of weather, and relatively low agricultural productivity have been causal factors. Monetary management has been able to contain demand-pull inflation to a degree. The increase in inflation in 2004 over 2003 was perhaps typical - caused by a prolonged drought in certain areas of the country, a rise in international prices of key commodities, especially fuel, a somewhat higher growth in money supply and an increased budget deficit.

Investment and savings ratios have been moderate; not sufficient to raise economic growth to the level necessary to improve the standards of living to the desired degree. Investment improved in 2004 to 25 per cent of GDP. However, a level of about 30 – 35 per cent of GDP is required on a sustained basis over the next five to ten years to improve essential infrastructure, to promote a higher and regionally balanced growth.

The external sector has been developing rapidly since 1977 with a significant degree of export diversification. External trade expanded considerably in 2004 with an increase in both exports and imports, benefitting from the fastest global economic growth recorded in the past few decades.

Trade deficits have been mitigated by increased worker remittances, and inflows from services, mainly tourism and port services. The flexibly managed exchange rate regime has helped to maintain Sri Lanka's external competitiveness.

Throughout the post liberalization era, fiscal deficits have been high due to heavy public investment in the early eighties and high defence expenditure from the mid eighties until the signing of the ceasefire in 2002. This has led to the public debt rising to over 100 per cent of GDP, a cause for concern. Recognising this, the government made a commitment to strengthen the fiscal consolidation process with the enactment of the Fiscal Management (Responsibility) Act (FMRA) in 2002, designed to reduce the budget deficit and outstanding debt in the medium term. The Economic Policy Framework of the new government emphasises the need to increase government revenue, in the fiscal consolidation effort, while maintaining an adequate public investment programme to improve the quality of the infrastructure in the country.

The framework of monetary management has continued to be improved since 1977 to increase the effectiveness of monetary policy. Indirect policy instruments are now the primary means of monetary management. In order to make the operations of the Central Bank more focussed, the twin objectives of economic and price stability, and financial system stability, were designated as the primary objectives of the Bank in 2002. Monetary policy operations were made more market based and active, especially after the introduction of the independent float of the exchange rate in 2001. Monetary policy has concentrated on stability, while promoting economic growth. However, monetary expansion was somewhat above the expected path in 2004. The relatively higher monetary expansion during 2004 was mainly driven by the higher expansion in credit to the private sector as well as to the public sector. Responding to these developments, the Central Bank tightened its monetary policy by raising policy rates in the fourth quarter of 2004. The policy focus was on market stability in the immediate aftermath of the tsunami. Subsequently, after ensuring market stability, the Central Bank has conducted open market operations aggressively to mop up excess liquidity. The Central Bank will continue to mop up liquidity in the coming months. Monetary growth is expected to be contained to 15 per cent in 2005. Monetary policy will focus on restraining inflationary pressure.

An area that has experienced rapid growth since liberalisation is the financial sector. This has not only contributed to economic growth in its own right, but has also facilitated growth in other sectors. The Central Bank has actively promoted financial sector stability and development by assisting in the deepening of markets, creation of new instruments and strengthening of the regulatory framework.

Prospects and challenges

The foregoing forms the background for the economic policies of the government. I would now like to highlight several challenges that have to be faced. Perhaps, the greatest challenge is to achieve a lasting peace. Economic growth and peace are interlinked. Therefore, the process to accelerate economic growth and the peace process need to move in tandem. Further, structural reforms have to be continued. In this connection it is necessary to convince all stakeholders of the need for reforms to enhance the efficiency in the economy. Macroeconomic management has to be strengthened further to contain macroeconomic imbalances. In this regard, we have had the benefit of considerable assistance from international financial institutions, in particular, the IMF, World Bank and the ADB. Not only have they provided funds at critical times, but they have also been most helpful in providing technical assistance and advice. Sound macroeconomic management requires that the fiscal consolidation process be continued as required in the Fiscal (Responsibility) Management Act, to enhance public investment, attain a sustainable level of public debt, and reduce inflationary pressures. This has to be accompanied by the continuation of a monetary policy that would maintain price stability and avoid the emergence of inflationary pressures that are highly injurious, particularly to the most vulnerable groups in society. The Central Bank will continue to focus on this area. In addition, reforms in the financial sector need to be pursued vigorously to ensure a vibrant and stable financial environment that would be able to take advantage of the links to the international markets and support growth. The high international price of fuel is a major concern. Competitiveness of the economy has to be improved through productivity and technological improvements, especially in the agriculture sector. The tsunami related relief, rehabilitation and reconstruction have to be accelerated to restore normalcy to economic activities throughout the country. Finally, the economy has to be further diversified so that it is better able to withstand internal and external shocks.

I have highlighted the main economic challenges that face Sri Lanka and the broad policy requirements. I hope that today's discussions would shed further light on how to move forward with a coherent policy package that will have the broadest support in Sri Lanka, as well as from all other stakeholders and well wishers.

Thank you.