Ranee Jayamaha: Budget 2007 – a path ahead

Speech by Dr Ranee Jayamaha, Deputy Governor of the Central Bank of Sri Lanka, at a seminar organised by the Society for International Development, Colombo, 21 November 2006.

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Let me first elucidate the key themes underlying the budget and identify the strategies and future directions as announced in the budget. I will then try to outline the macro-economic policy framework highlighted in the budget focusing on the need for closer coordination.

Underlying themes

First, the govt. intends to achieve sustainable development, in particular, a growth around 8-10% in the medium term by focusing on productivity increases through enhancement of infrastructure investments, provision of support facilities, diversion of funds, where possible, from recurrent expenditure to capital expenditure and clearing any administrative impediments.

Second, the 2007 budget attempts to reduce income disparities in different regions and provinces by improving island-wide infrastructure facilities which includes roads, rail roads, port services, airports, telecommunication, etc. and address poverty and unemployment issues.

Third, the budget aims to improve the service economy to promote Sri Lanka as a trading and service hub in South Asia.

Accordingly, sustainable development through investments in infrastructure (Rs 735 bn), the attainment of an equitable growth and improving the service economy are three key themes underlying the 2007 budget.

The strategy and way forward or the path ahead

The year 2007 budget sets out a 10-year horizon within which a medium term plan is presented for the period 2006 - 2009. Therefore, the budget has to be viewed as a forward looking medium to long term strategy.

The sustainable development strategy rests on the following:

Regional and provincial development with focus on rural roads, housing, electricity, water supply and livelihood development; Human resource development programmes; and Other sectoral programmes.

The infrastructure development will expand economic activity, address capacity constraints and bottlenecks. To sustain growth momentum, it is planned to increase investment/GDP ratio to about 30%.

Diversification of exports, relocation of export ventures and provision of support services will address regional disparities and unemployment issues. The budget also plans to improve human resource skills and enable youth to further their career paths. The skills imbalance will be addressed through the university curricula and the universities will be persuaded to improve research skills and talents of undergraduates to cater to the demands made by the business community.

Through infrastructure improvements, such as ports, airports and financial services, it is proposed to make Sri Lanka a service hub in South Asia and a part of the global supply chain. Many firms in East Asia and India have already linked themselves to the global supply chain and there lies an opportunity for Sri Lanka to establish such links now. In this regard, sub-contracting, outsourcing, encouraging business processes, back office functions, strategic partnerships, franchising, promoting off-shore insurance businesses, and the provision of logistical support will be promoted. This move would also help to attract foreign direct investments to the country.

Other strategies include the following:

Improvements to public service

- addresses issues relating to public service and improve the delivery mechanism. About 15% of govt. revenue has been provided for administrative, regulatory and other services and improvements to the public service delivery programme to make it more responsive to public needs. In delivering public services the budget advocates to use e-governance structures which are speedier than the present rule based structures.
- promotes productivity and request public service to eliminate waste and duplication while encouraging to complete activities which have already begun by spending agencies before venturing into new areas. To further facilitate the completion of unfinished work, the budget enables the roll over of all unspent provisions of previous years to the ensuing year.
- addresses the welfare issues of selected community groups and measures to extend the safety nets.

Reopening of closed factories and revival of failed businesses

In the 2007 budget, the fiscal arm has been extended to promote the re-opening of closed factories, abandoned companies and business entrepreneurs which can be revived through provision of debt relief, 3 year tax holidays and an exemption from economic services tax for a period. The budget proposes to grant Rs. 2 bn. to Lankaputhra Development Bank which will provide equity or debt to such factories on the basis of solid restructuring plans. These efforts will also increase employment throughout the country.

Let me now deal with how the budget has linked the key policy areas within a well-coordinated Macro Policy Framework

2007 budget very explicitly articulates a well-coordinated medium term macro policy framework, which includes fiscal policy, monetary policy, reserve management and investment policy.

Through fiscal policy measures, it is intended to:

- promote economic growth beyond 8% and provide impetus to ensure sustainability of growth over the long term
- enhance productivity through value addition with particular focus on industrial and agro-processing ventures.
- Where there is a high content of value addition in local businesses, BOI approval will be granted on the basis that duty free imports of related material will be limited for raw material which are not available locally. Such BOI projects will also be granted a VAT deferment facility for the purchase of material from local industries.
- permit local input supplying companies to open foreign currency accounts to enable them to receive payments in foreign currency from BOI enterprises.

In summary, the 2007 budget through fiscal measures proposes to reduce expenditure, increase revenue, provide incentives for savings and investments, pay attention to potential growth sectors such as SMEs, entreport trade in selected industries and promote effective delivery of public service.

Calls for effective monetary policy and prudent lending by financial institutions

The budget recognizes the impacts of inflation generated through excess liquidity and credit expansion and highlights the need for using monetary policy measures efficiently to contain inflation. While recognizing that a desirable credit growth is necessary to encourage domestic production and diversification of the economic structure, the 2007 budget clearly sets out the need to curb credit expansion towards non-essential items which brings in demand pressures on prices.

Support for financial system stability

By introducing appropriate measures to encourage the financial community to proceed on a prudent lending path, the fiscal policy expects that the relevant authorities will maintain financial system stability.

The 2007 budget also recognized the need to reduce high spreads and margins by banks which enhance transaction cost to the nation. In this regard, the way forward or the path ahead will be to support the potential growth sectors in the economy and reduce transaction cost of financial services. This is also aimed at increasing access to finance by all segments of the population.

Amalgamation of state owned small development banks for greater efficiency

Consolidation of the state owned, small scale banking institutions to ensure that access to finance by SMEs and micro enterprises will strengthen banking institutions. Accordingly, the 6 regional development banks, the SME Bank and the Lankaputhra Development Bank will be amalgamated with a solid capital base of over Rs. 5 bn. It is planned to increase the consolidated capital to Rs.10 bn. in the next 5 years, and rationalize the existing branch network of these banks for a better outreach.

Expeditious disposal of legal cases

As a further measure, the budget promotes expeditious disposal of legal cases to facilitate the long term viability of banks and financial institutions. To ensure expeditious redress to litigation and avoid delays, new provincial high courts will be set up.

Support for capital market and financial sector policies

To promote more investments in the capital market and provide assistance to financial innovations, the budgetary framework plans to raise revenue to around 19%, reduce the budget deficit to 5% of GDP and national debt below 85% of GDP by 2009. These measures are intended to provide more resources to the private sector and deepen the capital market. Already the government has permitted foreign investments in Treasury Bonds.

National Insurance Trust Fund

The budget 2007 also proposes to develop the insurance market in Sri Lanka by setting up a National Insurance Trust Fund which will help to provide risk insurance to affected properties and developing the re-insurance market. While transferring the funds available under the Civil Riots and Commotion Fund, a mandatory cessation of 50% of all re-insurance businesses to the National Insurance Trust Fund is introduced. This too will help save part of the outflow of funds for re-insurance and enhance liquidity in the insurance market.

Support for build up of foreign reserves

The budget has stipulated a minimum salary of Rs 25,000 or USD 250 for employment abroad requiring all employment agencies to comply with it. This proposal will enhance worker remittances into the country and help to finance the widening trade deficit and maintain a positive balance of payment position.

The budget reiterates the need for permitting professionals to earn in foreign currency and retain such funds in foreign currency accounts within the country. The budget also allows expenditure incurred on acquiring international accreditation as a deductible expenditure from taxation. These measures are expected to enhance foreign currency earnings and further facilitate the management of foreign reserves.

The down-side risks

Effective policy coordination is certainly the way forward as set out in the budget 2007 and it is inter-dependent on action by all policy-making authorities. If one or two policy areas lag behind, then the sustainability of achievements over the long term will become an issue. The monetary policy has to play its part to bring down inflationary expectations, while the investment policy has to attract FDIs and other investment flows. The reserve management policy should attempt to enhance foreign reserves through increased worker remittances and other flows. Pushing all these policy fronts to work within the open economic policy framework and keeping pace with each other is critical to the success of the medium term development plan. Very close coordination is essential for it and it is certainly a challenge. At the same time, the fiscal policy should make all attempts to stick to its revenue and expenditure targets. Any deviation would cause problems on the other policy measures, in particular the monetary policy and such a deviation may lead to change the direction and path ahead. If I may reiterate, fiscal support is very critical for monetary policy to be effective.

It is therefore clear that the 2007 budget is a forward looking stage setting document which not only has extended the fiscal policy measures to assist sustainable growth in a number of ways but also provides a way forward through a well focused policy coordination. Although a temporary deviation from the path ahead may not be crucial, it is essential to closely monitor the program, (preferably on a monthly or quarterly basis) to ensure that all actors get back on the track during a shorter period and ensure that all are moving towards the right direction.