Ajith Nivard Cabraal: Road map for monetary and financial sector policies in 2007 and beyond

Speech by Mr Ajith Nivard Cabraal, Governor of the Central Bank of Sri Lanka, at the Central Bank International Conference hall, Colombo, 2 January 2007.

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1. Introduction

Your Excellencies, Members of the Monetary Board, Deputy Governors, Ladies and Gentlemen,

At the outset, I wish to extend a warm welcome to all of you and wish you a very happy new year. As we mark the new year 2007, we thought it would be appropriate and timely for the Central Bank to enunciate its policies as well as the rationale therefor, so as to **enhance policy predictability and transparency**. We shall also take this opportunity to indicate our policy targets and share our latest available information in relation to the economy, upon which our analysis and targets have been based.

The Central Bank of Sri Lanka was established in August 1950 under the Monetary Law Act No. 58 of 1949, and the Act sets out two inter-dependent core objectives. These are the attainment of the **economic and price stability** and the maintenance of the **financial system stability**.

Today, the Central Bank follows a monetary targeting policy framework in conducting monetary policy to attain **Economic and Price Stability**, i.e., to achieve a sustainable, low and predictable level of inflation. Such an outcome, among others, is a prerequisite to achieving <u>sustainable</u> economic growth and development. The key policy instrument used in this endeavour is the **establishment of policy interest rates** for borrowing (Repurchase Rate) and for lending (Reverse Repurchase Rate) that operates through the Bank's Open Market Operations. The Central Bank conducts **Open Market Operations** to keep the level of Reserve money in the system at an appropriate level, while it uses the **Statutory Reserve Ratio** (SRR) on commercial bank deposit liabilities to further support the monetary policy.

Financial System Stability, the other core objective of the Central Bank, is achieved through the regulation and supervision of financial institutions, the overseeing of the financial infrastructure which includes critical payment and settlement systems, as well as keeping a close watch on the financial markets as a whole. To achieve this objective, the Central Bank employs a series of prudential and regulatory measures.

In addition to the core objectives, the Central Bank provides **policy advice to the Government** and vital state sector enterprises to strengthen macroeconomic stability and to enhance growth prospects. The Bank also undertakes **several agency and ancillary functions**, which include managing the Foreign Reserves of the country, Public Debt and Employees' Provident Fund (EPF). Further, the Central Bank plays a key role in broadening the financial infrastructure and strengthening the small, medium and microfinance sectors in the country.

2. Outline of today's statement

The policy statement presented today for the year 2007 and beyond focuses on several areas.

First, it sets out an account of the **developments in the economy** and the conduct of monetary policy and financial sector policies in the year 2006. It also presents an evaluation of the key sectoral developments in 2006, the policy measures taken and the expected impact of such measures on the country's macro-economic environment.

Second, it examines the **challenges in meeting monetary policy objectives and financial stability in 2007** and beyond.

Third, the statement provides a detailed account of the Central Bank's **monetary policy strategy in 2007** and beyond, as a major mechanism to drive the economy along a low – inflationary/high - growth path, supported by a series of other policies and strategies.

Fourth, it discloses the **policies for financial system stability in 2007** and beyond.

Fifth, it presents the identified **policies for strengthening the economy**, through the encouragement of high savings and investment.

While we hope you would find our statement of interest, we wish to mention that, in the light of any unexpected external and internal developments, we may sometimes deviate from the strategies or targets as explained today. In such an event, we would, at that time, communicate our reasoning for such deviations for your understanding as well.

3. Developments in the economy

As is already known, the Sri Lankan economy achieved a growth of 8 per cent in the first half of 2006, and a growth of 7.5 per cent in the third quarter of 2006, Overall, it is very likely that the **economy would have grown at over 7 per cent in 2006**.

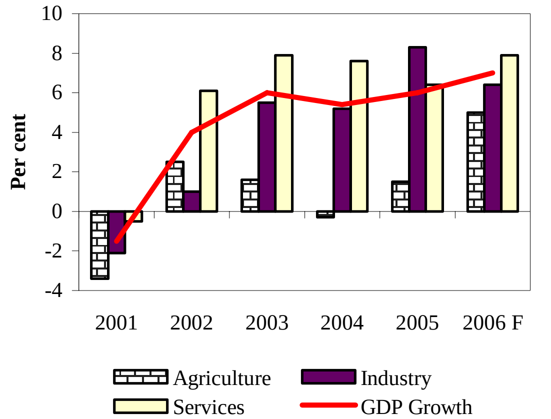
These values are laudable because they have been achieved in the face of several major challenges, particularly high international oil prices and an escalation of security concerns during the year. Notwithstanding such challenges, all major sectors of the economy grew at healthy rates.

The Agriculture sector continued its expansion with growth recorded in all sub sectors, except tea. Remarkable growth in rubber and coconut, fast recovery in the fish production, record harvests of paddy in the Maha season 2005/2006, supported the growth in the agricultural sector.

The Industry sector continued to grow, benefiting from the rapid global economic growth and strong domestic demand. Weather, favourable to hydropower generation, also contributed to the substantial growth in this sector.

The Services sector growth was dominated by the telecommunication services, port services, domestic and international trade, and financial services.

Figure 1: GDP Growth and Sectoral Contribution to Growth



At the same time however, **inflation began to increase since April 2006** due to rising demand pressures in the economy. The point-to-point change in the Colombo Consumers' Price Index (CCPI) which is popularly considered as "inflation", has been increasing since April 2006 and the CCPI increased by around 19 per cent during each of the last two months. Although it was noted that a part of the increase was due to very high prices in vegetables, affected by extreme weather conditions, we noted with concern that core inflation too, which is a measure of inflation directly caused by demand pressures, had also risen to 15 per cent by November 2006. These pressures were somewhat aggravated by supply side developments, such as the upward adjustments in administered prices, increases in prices of some of the imported consumer items, and adjustments in import tariffs applicable to some consumer food items. Such factors, of course, would essentially cause a one-time price increase and would necessarily contribute to long term inflation only if such impact is accommodated by continuing monetary expansion.

In the meantime, we observed with satisfaction that increased economic activities had led to **lower unemployment** during the year. The Labour force grew by approximately 1.0 per cent to 8.1 million by end 2005, and was expected to increase further to 8.2 million by end 2006. As a consequence, the unemployment rate declined to a level of 7.2 per cent in the first quarter 2006 and to its lowest level of 6.3 per cent in the second quarter 2006.

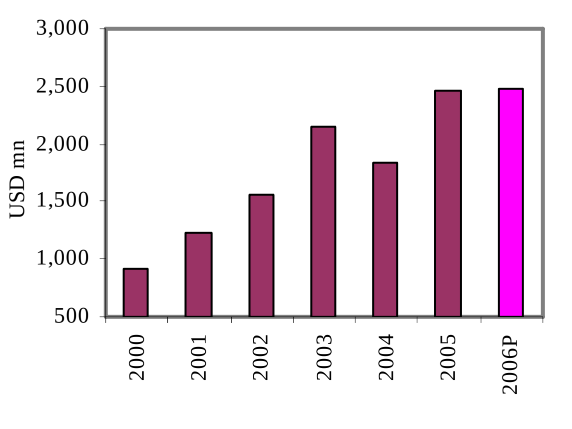
Savings and investment, both recorded upward trends. Domestic private savings in 2006 has now been projected to increase to 19.4 as a percentage of GDP. National savings are also projected to increase, resulting from increased savings by non-resident Sri Lankans as evidenced by the high growth in migrant worker remittances. The Investment to GDP ratio is also expected to improve from 26.5 per cent in 2005 to 29.0 per cent in 2006, and **Private sector investment, which accounts for about 87 per cent of total investment, is estimated to increase by 31.4 per cent**. Public sector investment too is projected to rise by 7.5 per cent as a result of growing construction activity in highways, roads, infrastructure facilities, community development projects, and tsunami related reconstruction and rehabilitation projects.

The performance in the **External sector improved** with the continued expansion in international trade and growing global demand. During the first ten months of 2006, exports grew by 6.5 per cent and Imports by 15.8 per cent with a higher growth in intermediate and investment goods. The outlay for petroleum imports increased by 29.6 per cent during this period due to the soaring oil prices. For the year as a whole, export growth is projected at 7 per cent and import growth at 15.4 per cent.

An aspect of the economy which caused some concern in the year was that the **trade deficit widened** to US dollars 2,955 million. As the result, the Current Account also recorded a deficit of US dollars 1,038 million in the first nine months of 2006. It reflects the imbalance between national savings and investment, which needs to be addressed by encouraging greater savings. Such Trade and Current Account deficits were financed through net inflows to the capital and financial accounts. It was also observed that Sri Lanka could reasonably and comfortably afford a bulk of the additional foreign exchange cost on account of high oil prices in the first nine months of 2006 as a result of the higher migrant worker remittances and foreign currency denominated loans obtained by the government from external and domestic sources. **Worker remittances increased** by US dollars 338 million in the first ten months and **foreign currency denominated debt** rose by US dollars 404 million by end November 2006. The higher quantum of worker remittances was, to some extent, facilitated by the active promotion campaigns launched by the Central Bank with the support of the Sri Lanka Foreign Employment Bureau, overseas job agencies, foreign missions and the state banks and we believe that the impact of such initiatives would be further felt in the next few years as well.

During this year, a remarkable **increase was also seen in foreign direct investments**. All in all, these factors contributed towards the overall **balance of payments (BOP) surplus which is estimated to exceed US dollars 150 million** during 2006.

Figure 2: Gross Official Reserves



It is useful to recollect that since moving to the “Floating exchange rate” regime in 2001, the gross **official reserves have continued to increase** except in 2004 when the country was hit by the sudden increase in oil prices. As of now, the gross official reserves have been sufficient to meet about 3 months of average imports in the recent years despite the rising expenditure on oil imports.

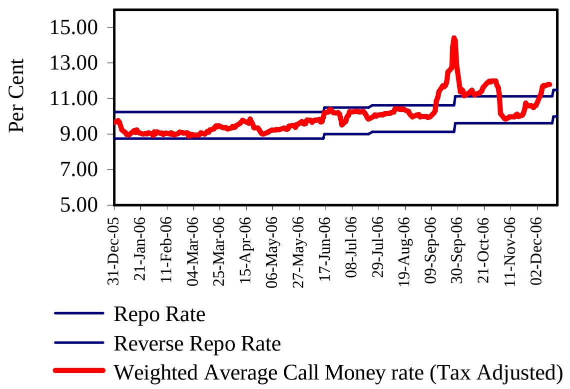
We also note that according to the overall policy vision announced in the “*Mahinda Chintana”*, the Government’s commitment to reduce the budget deficit to a sustainable level in the medium term has been made clear. In that context, the fact that the total revenue during the first nine months of 2006 increased, and thereby led to an **improved Revenue/GDP ratio** is laudable. In addition, it was noted that several measures were introduced by the Government to rationalise recurrent expenditure, especially adjusting domestic fuel prices to reduce the burden on the Government. Nevertheless, the Government has had to resort to borrowings from the banking sector to meet shortfalls in the face of many challenges, and in order to avoid such a situation in the future, it would be highly desirable to further improve the Revenue generation and collection process in 2007 and beyond.

Another key fiscal indicator, namely recurrent expenditure as a ratio of GDP recorded a value of 14.0 per cent during this period. Capital expenditure and net lending also increased by 28.2 per cent during this period. The main contributors to this increase were the acceleration of infrastructure development and tsunami related reconstruction activities. All in all, the overall budget deficit in the first nine months of 2006 reached 6.0 per cent of GDP, while the budget deficit in 2006 is estimated to be 8.7 per cent of GDP.

In relation to the **outstanding debt stock of Government, we note with satisfaction that it is expected to decline to 93.1 per cent** of GDP by end 2006 from 93.9 per cent as at end 2005. The outstanding government debt to GDP ratio is also expected to decline in the medium term in line with the path enunciated in Fiscal Management (Responsibility) Act.

We could also report that the tight monetary policy stance adopted from end 2004 was further firmed in 2006 to curtail high growth in monetary and credit aggregates to contain rising inflationary pressures. Accordingly, the **Central Bank raised its policy interest rates** by 25 basis points in June 2006, 12.5 basis points in July 2006, 50 basis points in September 2006, and a further 37.5 basis points in December 2006: a total of 125 basis points during the year. This is in addition to the increase of policy rates by 175 basis points during 2004 and 2005. At the same time, the Central Bank has also been conducting Open Market Operations aggressively, to manage the liquidity position in the market to be within the reserve money targets.

Figure 3: Repo, Reverse Repo and Call Money Rates



Responding to the tight monetary policy measures adopted thus far, market interest rates have increased, thereby discouraging excessive consumption and borrowing for such purposes. In turn, this has led to a deceleration in the high growth in the money supply. We believe that the tight monetary policy exercised by the Central Bank was instrumental in pulling back the growth in Reserve money from 20 per cent at end 2004 to 17 per cent by end August 2006. This decrease would have naturally led to a corresponding deceleration in broad money growth in the future, although in absolute terms, the growth in broad money remained uncomfortably high, around 19-20 per cent, during January to June 2006, a legacy of the high reserve money growth in the past.

In keeping with its primary objective, the Central Bank has also been very concerned about the **inflationary impact of the regular use of Central Bank's Reverse Repo window** by some commercial banks which appear to use such window as a convenient instrument of regular funding. We wish to clearly discourage this practice in 2007 and therefore, with effect from 1st January 2007, the Reverse Repo facility of the Central Bank will not be made available on days when there is a liquidity surplus in the commercial banking system, according to our estimates. We would also closely monitor the Banks that seek this facility regularly to ascertain whether they are doing so because of any structural deficiencies that they are suffering from.

We also noted that the financial sector grew with increased resilience, possibly benefiting from robust economic growth and a rather favourable external environment. Profitability, capital funds and asset quality of banks improved, leading to strengthening of capacity of the financial sector to absorb shocks. In the meantime, interest rates across markets rose in response to gradual tightening of monetary policy; turnover in the foreign exchange market recorded substantial increases; and market capitalisation and price indices in the equity market continued to improve.

Figure 4: Ratio of Capital Funds to Total Assets of LCBs

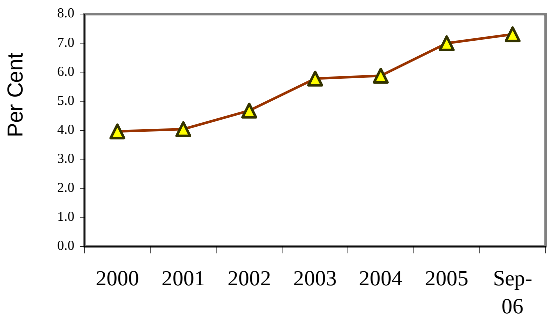
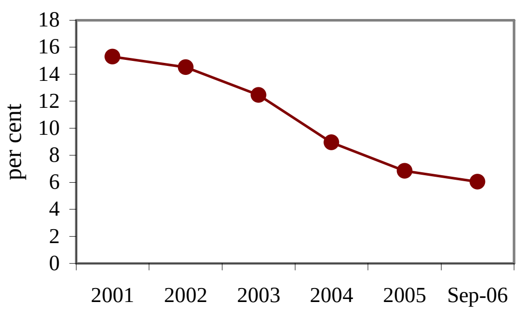


Figure 5: Non Performing Advances to Total Advances of LCBs



It would also be noted in the year 2006, several important measures were taken to strengthen and improve the efficiency of the financial sector, improve risk management, enhance access to finance, strengthen the payment and settlement system as well as supervision and regulation. Banks were required to include market risk in the computation of capital adequacy to ensure that they are adequately capitalised to meet any adverse fluctuations in market prices and are not vulnerable to any unanticipated shocks. Prudential norms for classification and valuation of bank investment portfolios were further strengthened. To improve the safety and efficiency in the payments and settlements systems, the Central Bank also drafted a payment system policy in consultation with the National Payment Council to declare a public policy regarding the regulatory framework.

As is well known, the Central Bank manages the **Employees' Provident Fund** (EPF). It does so by receiving member contributions, maintaining member accounts, investing funds and paying benefits to members. The total assets of the EPF grew by 13 per cent to Rs.439 billion during the 12 months ending June 2006. Total contributions and refunds during this period amounted to Rs.16 billion and Rs.13 billion, respectively. The total investment portfolio consisted mainly of government securities at 98 per cent, while the total income for the first half of 2006 amounted to Rs.25 billion.

The Central Bank also manages the Public Debt to ensure that the Government's financing needs and its payment obligations are met at the lowest possible cost over the medium to long term, consistent with a prudent degree of risk. During 2006, the Central Bank took several measures to strengthen the management of public debt by:

- Increasing the capital requirements, introducing a risk based supervision system and supervision activities to strengthen the Primary Dealer System and financial sector stability
- Introducing on-line data reporting to enhance the transparency in trading government securities
- Facilitating capacity building of market players
- Permitting subscription upto 5 per cent of Treasury bonds by foreign investors
- Assisting the government to raise foreign currency commercial debt through syndicated loans from the international market
- Developing a comprehensive debt consolidation strategy
- Introducing a new debt instrument named Sri Lanka Nation Building Bonds for the Sri Lankan working community living abroad thereby offering them an opportunity to contribute funds towards infrastructure development in the country.

In 2006, in order to create a more conducive external sector environment for both local and foreign investors, the **Exchange Control Department** also initiated the following several measures:

- Facilitating non-resident investments in government securities
- Introducing two new foreign currency accounts to expand incentives available for professionals who earn foreign exchange and for the suppliers of inputs to BOI companies who help to save foreign exchange.
- Authorized dealers have been permitted to open and operate Treasury Bond Investment External Rupee Accounts (TIERA) in commercial banks in Sri Lanka, in order to facilitate the fund transfers in purchasing treasury bonds by non-residents.

4. Challenges in meeting price and economic stability and financial system stability in 2007 and beyond

Sri Lanka, being a small open economy, continues to face external shocks arising from global political and economic developments, domestic disturbances and natural disasters. At the same time, while the emergence of South Asia as a new force in the world economy would provide new opportunities for Sri Lanka to achieve higher economic growth, the geopolitical uncertainties that would impact global economic stability would probably pose a threat to meeting external sector targets in 2007 and beyond, and therefore would need close monitoring.

Two of the more significant challenges that would have to be faced in 2007 would be the impact of possible high and volatile international oil prices, as well as the security concerns in the country.

The impact of high oil prices is manifold. It increases the import bill: widens the current account deficit: adversely impacts on the exchange rate stability; raises domestic fuel prices causing a serious supply side shock; and raises both headline and core inflation since domestic inflation becomes adverse with the demand pressure in the economy and supply side shocks. At a time when the entire world is strengthening its security capabilities to meet the threat against terrorism, Sri Lanka too would need to address the prevailing situation. At the same time, it is important that the business community continues with its investment plans in Sri Lanka because the very concerns regarding security provides a certain “discount” which could be of advantage in a highly competitive global business field.

External and internal shocks and vulnerabilities may also thrust fresh challenges to financial system stability. Hence, it would be useful to consider a few such shocks and risks as well.

The continuing high growth in private sector credit could also pose threats to price as well as financial system stability. First, it could deteriorate the quality of the assets of commercial banks and that situation could increase the risk of high non-performing loans in the future. Second, such expansion of credit could generate inflationary pressures in the economy through increased aggregate demand.

With the rapid and intense integration of the Sri Lankan economy with global financial markets, money laundering, terrorist financing and pyramid schemes could threaten financial stability.

Therefore, continued regulatory vigilance and timely interventions would be necessary to avoid and/or mitigate any harmful effects of all such threats.

It should also be noted that a continuing high budget deficit could also pose a formidable challenge in the conduct of monetary policy, as such deficit requires borrowings by the Government from the banking system, making it difficult to maintain the monetary expansion along a pre-determined, tight path.

As seen from the case studies of many successful countries, rapid infrastructure development is a strong contributory factor towards achieving sustainable high growth. However, the timely mobilisation of necessary resources for infrastructure development while maintaining budget deficits and debt at reasonable levels would be particularly challenging for a developing country like Sri Lanka.

At the same time, maintaining a comfortable and reasonable level of foreign currency reserves in order to be able to mitigate the impacts of external shocks is also a challenging task for any developing country. Needless to say, it is vital to manage the foreign reserves at an appropriate level, while ensuring that the exchange rate fluctuations are within reasonable limits, in order to enhance the confidence in the economy.

These and other challenges would need to be faced by our country and it is clear that our policies and actions would have to be so designed in order to deal with, and respond to, such challenges if we are to be successful.

5. Monetary policy strategy in 2007 and beyond

Monetary policy is the mechanism that is used by central banks all over the world to direct an economy along a non-inflationary, growth path. Such policy would ideally be supported by a series of other policies and strategies as well. The policy framework adopted by the Central Bank of Sri Lanka is a **monetary targeting framework with reserve money as the operational target and broad money (M_{2b}) as the intermediate target**[1].

Such targets are carefully computed and set after taking into consideration, the potential growth and after assessing the liquidity needs of the economy to move along the projected growth path while keeping inflationary pressures in check. The veracity and accuracy of the values derived from the computation of the demand for money and the value of the money multiplier[2] are important prerequisites for effective monetary targeting.

In that context, it is important to note that in Sri Lanka, there is a stable relationship between the operational target, i.e., reserve money, and the intermediate target, i.e., broad money, with the money multiplier consistently remaining around 5 during the recent past. The long-term relationship of monetary aggregates and inflation also indicates that money would be a useful leading indicator for inflation. Hence, we believe that monetary targeting could continue to be an effective framework for Sri Lanka in the short to medium term.

In 2001, Sri Lanka moved to a “Floating exchange rate” regime thereby allowing market forces to largely determine the exchange rate. The floating exchange rate system has served well in the conduct of monetary policy. As in the past, the Central Bank interventions in the foreign exchange market would be limited to building up the international reserve position and to stabilise any undue fluctuations in the foreign exchange market due to excess or shortage of international currencies.

As per available international data, the global economy is projected to grow at around 5 per cent in 2006 and is expected to moderate to around 4.7 per cent in 2007. Sri Lanka’s major export markets such as the United States of America (USA) and the Euro area and other trading partners are also expected to grow at healthy rates. It is therefore likely that the continuation of favourable global economic conditions will generate healthy external demand for Sri Lanka’s goods and services.

Based on the external and internal factors, the Sri Lankan economy is expected to grow by 7.5 per cent in 2007. Growth is also expected to be broad-based, with all three sectors, Agriculture, Industry

[1] Broad Money (M2b) is complied consolidating the operations of the Central Bank and operations of domestic banking units and off shore banking units (OBUs) of commercial banks.

[2] The money multiplier is the amount of money created by an additional unit of reserve money.

and Services, poised to grow at healthy rates. The government's planned infrastructure projects in the areas of road development, port and airport development, power generation and social infrastructure development, would also facilitate sustainable and broad-based growth.

The external sector is expected to perform well in 2007 recording an overall balance of payments surplus of about US dollars 200 million, boosting the level of official reserves to US dollars 2,650 million or about 3 months of imports. Export growth is expected to continue in 2007 at around 10 per cent, benefiting from continuing high growth in the global economy, and opportunities offered by Free Trade Agreements. Imports are projected to grow at a higher rate of 12 per cent, reflecting increased demand for intermediate and investment goods.

The Government's Medium Term Macro Framework (MTMF) enunciated in the Fiscal Management Report 2007, indicates that the overall deficit in 2007 will be contained at around 7.2 per cent of GDP. To meet this target, adjustments have to be introduced in the areas of enhancing revenue through additional measures and improved tax administration, rationalisation of current expenditure and improvements in the government debt management. Public investment will also need to be maintained at a high level to provide complementary capital for private sector investment.

In this background, the growth in Reserve money and Broad money for 2007 will need to be clearly targeted to support the smooth functioning of the economy while preventing the build-up of inflationary pressures and expectations.

Accordingly, the 2007 Monetary Programme has been designed to accommodate the expected economic growth of 7.5 per cent and the BOP surplus of US dollars 200 million while aiming to contain inflation at 8.5 per cent, as measured by the GDP deflator. It is also assumed that the velocity and multiplier would be around 2.52 and 5.2 respectively.

While a significant moderation in inflation as measured by the Colombo Consumers' Price Index (CCPI) is expected during the year, the Central Bank would be closely monitoring the CCPI behaviour in order to respond effectively to any unfavourable developments. While we believe that the tightening of monetary policy during the year should be mainly directed to contain private sector credit growth to a moderate degree, it is hoped that government borrowings from the banking sector too will be limited to the budgeted target of Rs. 16.7 billion. On the supply side, the expansion of production together with improved distribution systems is expected to have a favourable impact on prices. With regard to the key external factors, we anticipate that international prices of major non-fuel consumer imports would decline during the year while the impact of international oil prices on the economy will be contained to some degree through appropriate hedging mechanisms.

Based upon the aforementioned assumptions and trends, the Reserve money target for end 2007 has been computed by allowing the necessary increase from that as targeted at the end 2006 value to accommodate the expected GDP growth of 7.5 per cent, inflation of 8.5 per cent, and an extra 1.6 per cent to cover the change in velocity, a total of 17.6 per cent. The Broad money (M_{2b}) target too, has been computed by applying the properties of the Quantity Equation, the inflation target and expected economic growth[3].

The Reserve money growth will be facilitated by two major developments, the change in the Net Foreign Assets and the change in the Net Domestic Assets of the Central Bank. The Net Foreign Assets of the Central Bank have been determined by the expected BOP surplus of US dollars 200 million.

As already explained, the planned monetary programme requires the Reserve money growth to be maintained at 17.6 per cent from the <u>targeted level</u> of Reserve money as at the end of 2006. At the same time, the expected reserve build up of the Central Bank indicates an increase in Net Foreign Assets of the Central Bank by Rs. 21 billion while the Net Credit to the Government from the Central Bank will increase by Rs 11.5 billion, which includes provisional advances of Rs 12.5 billion, and a decline of Treasury bills by Rs. 1.0 billion.

[3] A crucial factor in developing the monetary programme is the assumptions in velocity of money and money multiplier. In the recent past the velocity has been declining, while multiplier has hovered between 5.0-5.2. In 2007, this trend is expected to continue.

Table 1

Quarterly targets for reserve money

Rs. billion

	Dec. 2006		2007 Targets			
	Target	**Actual**	**Mar**	**Jun**	**Sep**	**Dec**
Reserve Money	**227.6**	**239.8**	**254.6**	**250.4**	**257.8**	**267.6**
Point to Point Change %	*15.0*	*21.2*	*17.3*	*17.9*	*16.1*	*11.6*

Table 2

Indicative targets for broad money (M_{2b})

Rs. billion

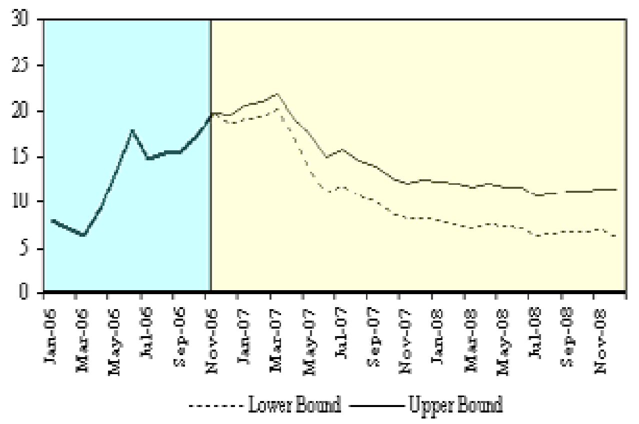
	Dec. 2006		2007 Targets			
	Target	**Estimates**	**Mar**	**Jun**	**Sep**	**Dec**
Broad Money (M_{2b})	**1,175.6**	**1,221.6**	**1,274.9**	**1,291.4**	**1,315.9**	**1,383.2**
Point to Point Change %	*15.0*	*19.5*	*19.2*	*19.0*	*17.9*	*13.2*

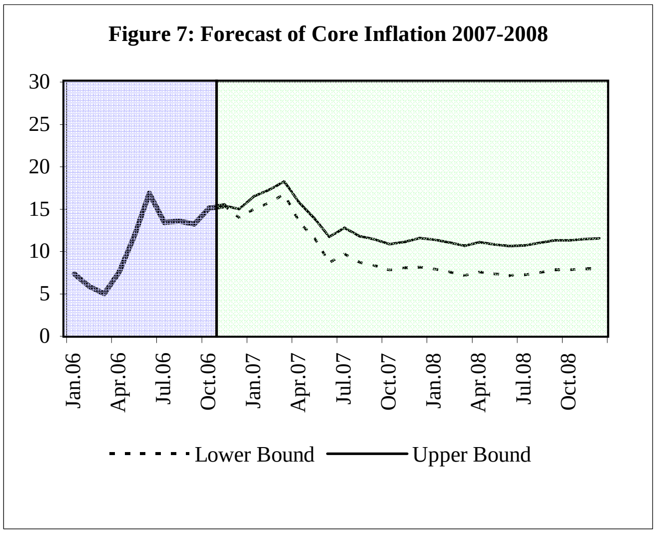
The programme also allows for a Broad money growth of 17.6 per cent from the targeted level of Broad money at end 2006. This will reflect an increase in Net Foreign Assets of the banking system of US dollars 200 million, and increase in private sector credit by Rs 147.3 billion (15.5 per cent) and net credit to Government by Rs 16.7 billion. To maintain the overall increase in net credit to the Government at Rs 16.7 billion, net credit to the Government from commercial banks would need to be maintained at Rs 5.2 billion.

The Central Bank expects to direct economic activities and outcomes within its control to meet the Reserve money and Broad money targets. Such activities would include changes to the policy interest rates if considered necessary, conduct of open market operations, moral suasion, public communications and other available actions. Regular reviews of the general policy stance will also be made and intensive public awareness campaigns would be used to manage inflation expectations.

In response to our policy measures and actions, we believe that both headline inflation and core inflation would moderate. It is also our belief that inflation will respond over the months in the manner as set out in the charts that follow, but nevertheless we shall be watching developments with very keen interest.

Figure 6: Forecast of Headline Inflation 2007-2008





The Monetary Programme for 2008 and beyond will be based on the high growth path targeted by the government in the medium term, and containing money supply to maintain inflation at a low level. In this context, inflation will be targeted to gradually decrease to a level of 4 per cent within a 10 year time period. Such a target would be in line with the Government's 10 year plan. The achievement of such a target will be facilitated by continued economic growth resulting from high public and private investment and savings, improving competitiveness, gradually rationalised expenditure which leaves sufficient funds for development work, and reducing the budget deficit resulting in low demand pressure. Needless to say, the Central Bank will actively support strategies that ensure such outcomes.

In addition, transparency of monetary policy decisions and operations will be maintained to enhance the policy effectiveness and during the year we will also seek the views and advise of experts in the field of economics and on macroeconomic management in order to benefit by their expertise in our monetary policy decision making process. Further, as done in the past, the policy announcements will continue to be made according to an advance announcement calendar, and the Calendar for 2007 is set out below.

Table 3

Monetary policy announcements for 2007

Month	**Date of Monetary Policy Announcement**
January	18 Thursday
February	15 Thursday
March	16 Friday
April	11 Wednesday
May	16 Wednesday
June	15 Friday
July	18 Wednesday
August	16 Thursday
September	14 Friday
October	17 Wednesday
November	16 Friday
December	14 Friday

6. Policies for financial system stability in 2007 and beyond

The Central Bank has just issued the Financial Stability Report for 2006, which clearly indicates that the financial system in Sri Lanka is resilient and that there are no imminent threats that may endanger its stability. The report however contains information regarding certain possible risks and those will of course need to be attended to by the relevant authorities in due course. The resilience of the financial system is underlined by the robustness of the macro-economy, soundness of systemically important financial institutions, healthy developments in financial markets, sound supervision and oversight, and continuation of a safe payment and settlement system.

At the same time, a series of measures will need to be implemented to further enhance the efficiency and strengthen the financial sector, which will contribute to financial system stability. These encompass regulatory and supervisory measures of major financial institutions; forward looking surveillance indicators and tools to predict emerging vulnerabilities; measures to improve efficiency of financial markets including access to finance; initiatives to enhance the safety of payment systems; and introduction of necessary changes to legal enactments governing the wider financial system.

In general, the aim will be to promote an adequate level of competition in the banking industry, while ensuring that the banks are capable of adding value to the economy and expanding in order to serve presently underbanked areas of the country. In keeping with such aim, the overall policy thrust of banking supervision and regulation will be to promote higher standards of risk management among banking institutions. Towards such end, the Central Bank has already implemented several measures to further strengthen the supervision and regulation and these include:

(a) Introduction of enhanced minimum capital requirements,

(b) Introduction of the market risk factor in the computation of capital adequacy,

(c) Introduction of conditions for the quarterly publication of financial performance indicators, and

(d) Introduction of provisioning requirements in the banking sector to cover potential credit risk.

Prudential requirements imposed on banks will also be further strengthened in 2007. This will include the introduction of a general provision on performing advances and increasing the provisioning requirement for non performing loans; increasing the risk weights on residential mortgage loans and ‘other’ loans adopted in the capital adequacy computation; and the revision of the Single Borrower Limit in line with improved risk management by banks.

In addition, the Central Bank intends to implement Basel II, the new international capital framework in 2008, with a standardised approach which will help better align a bank’s capital with its risk profile, enhance risk management and increase market discipline due to the need for greater market disclosure. Through such actions, it is expected to enhance the stability of the banking system and thereby provide greater confidence to all stakeholders and the general public.

It is also our intention to change the supervision of the banking institutions from “compliance based’’ systems to a “risk focused” systems, whereby a corrective action plan is consistently applied across the industry. This will necessitate banks to develop integrated risk management systems and strengthen internal controls and procedures, in line with more advanced prudential requirements. Banks will also be required to set up integrated risk management mechanisms and begin ‘stress testing’ to assess their resilience to internal and external shocks, in order to facilitate the identification of risks and to initiate corrective measures.

The supervision and regulation of non-bank financial institutions will also be strengthened by enhancing the minimum capital requirement of such institutions. This will facilitate the non-bank financial institutions to enhance resilience and expand their business activities. Accordingly, the existing finance companies will have to increase their core capital to Rs. 100 million by 31 January 2007 and to Rs. 200 million by 30 June 2008.

Further, the regulatory framework of registered leasing establishments will also be further strengthened by carrying on comprehensive on-site examinations of selected leasing establishments and spot examinations of the others on a regular basis.

In addition, in order to enhance the orderliness in the business of money changing, the minimum annual turnover required to be considered for the renewal of the money changing permits will be increased from US dollars 120,000 to US dollars 600,000 with effect from 1st January 2007. At the same time, to enhance the scope of operations of money changers, they will be granted approval to encash Travellers' Cheques from 2007 onwards.

As is being done internationally, a close cooperation will also be maintained among all relevant supervisory and regulatory institutions to facilitate the supervision and regulation of financial conglomerates. In this regard, a Working Group of Regulators for Financial Conglomerates comprising the Central Bank, Insurance Board of Sri Lanka, Securities and Exchange Commission of Sri Lanka, Sri Lanka Accounting and Auditing Standards Monitoring Board and the Department of Registrar of Companies has already been established to develop a mechanism of monitoring the systemic risk of conglomerates.

In the meantime, the Payment and Settlement Policy has already been drafted in consultation with the National Payment Council, to mitigate risks and increase efficiency. The proposed policy will be implemented during 2007-2010.

A local SWIFT Service Bureau will be set up in 2007 to provide a common connectivity point for users to communicate with SWIFTNet from the Disaster Recovery Site.

The coverage of the Wide Area Network will be expanded by including the Primary Dealers to resolve the remaining problems relating to registering all investor transactions in the Securities Depository of the Central Bank. This will further enhance the safety of investments in the government securities market. The Central Bank will permit Primary Dealers to diversify their business into certain activities and within limits, with appropriate regulatory and prudential safeguards.

Some of the Primary Dealers who are dealing outside the Scripless Securities Settlement System could have caused potential threats to the system. This may have been particularly due to the fact that using SWIFT was considered to be an expensive method of transferring data. Therefore, the Central Bank has now introduced a low cost method of transferring data using the Wide Area Network connecting them with the Central Bank. Accordingly, all Primary Dealers are now urged to use this method to ensure retail transactions are not proceeded outside the system.

Two new laws, namely the Prevention of Money Laundering Act No. 5 of 2006 and the Financial Transactions Reporting Act No. 6 of 2006 have been enacted last year to prevent money laundering and terrorist financing and to strengthen the reporting mechanism for financial transactions. Arising from such initiative, the Financial Intelligence Unit has already been established to investigate and take action to combat money laundering and terrorist financing. The work of the FIU will be further expanded during the year 2007.

In line with the global trends, we will be taking steps to further promote corporate governance in the financial sector by implementing several measures. Mandatory corporate governance rules covering important areas of corporate governance principles will be introduced in place of the existing voluntary codes.

Measures will also be taken to increase awareness and educate the public on important information such as comprehensive lists of financial institutions authorised to accept deposits by the public and particulars about those that are being regulated by the Central Bank.

Share ownership of banks will be broad-based to promote better corporate governance and to reduce the concentration of ownership and to address conflicts of interest that may arise due to large shareholdings. New policies on share ownership will be issued shortly, where a single entities' material share ownership would be generally limited to 15 per cent of a bank's share capital.

A revised format for publication of banks' financial statements in their annual reports will be introduced so as to improve disclosure requirements and provide more information to market participants. The Central Bank will also facilitate the adoption of the internationally accepted accounting and reporting standards such as IAS 32, IAS 39 and IFRS 7 by banks. A continuous dialogue will be maintained with the external auditors and other relevant institutions with respect to the operations of banks, the publication of accounts and adoption of international accounting standards.

The Central Bank's currency management policies are also being formulated to ensure that Sri Lankan Rupee notes and coins are available to the public in required denominations upon demand. In achieving this, the Bank will forecast the currency demand and maintain a buffer stock of currency to meet the seasonal and any contingent demand. As in the past, the currency management policy of the Central Bank will be focused on maintaining quality standards. In this effort, continuous upgrading of security features mainly in high denomination notes, conducting aggressive public awareness programmes, especially for cash handlers of commercial banks, counterfeiting aspects and clean note policy will be the main tools in achieving the quality standards. Advocating the clean note policy, the Central Bank presently withdraws unserviceable banknotes from circulation regularly and issues new or serviceable notes through the banking system.

Another matter of some concern is the steadily rising outstanding and overdue balances on credit cards. In this regard, the Central Bank intends to introduce prudential guidelines on the issuance and the minimum repayment requirements on credit cards so as to ensure that credit card operations do not threaten financial system stability.

At the same time, the Central Bank has noted with satisfaction that the imposition of the 50 per cent margin on DA term imports is deriving its desired results. If this trend continues and the desired outcome is achieved, this measure will be withdrawn by 31st March 2007.

In addition to the initiatives and programmes as already enunciated we also believe that the appropriate legal and regulatory framework supporting financial system stability needs to be further strengthened if we are to address potential future issues in a timely manner. Accordingly, suitable amendments are to be proposed to the existing legislation pertaining to banking. A summary of such proposed revisions are:

- Debt Recovery Law: to expedite the recovery process and create a creditor friendly environment
- Asset Management Company Law: to enable the speedier resolution of non performing loans of a failed bank
- Credit Information Bureau Act: to widen the scope of the Credit Information Bureau and to provide greater (including positive) credit information
- Computer Crimes Law: to reduce any potential risks that may arise through computer frauds.
- Micro Finance Institutions Act: The proposed Act envisages to bring all micro finance institutions under the regulatory framework. The licensing and supervising authority will be the Monetary Board while arrangements will be made to delegate the supervisory functions to agents.
- Finance Leasing Act: The finance leasing law will be amended to permit strongly capitalised leasing companies to mobilise funds from the public through the issue of debt instruments. This will enable them to broaden their funding sources and to expand their operations prudently.
- Finance Companies Act: The law will be strengthened to bring in more stringent provisions for dealing with unregistered businesses and persons carrying on finance business, in contravention of the laws.
- Business Recovery Law: Law proposed to provide a procedure for the resuscitation of sick industries.

7. Policies for strengthening the economy

Among the fundamental requirements in strengthening the economy are high savings and investment. Savings are encouraged by strengthening the financial system and delivering positive real interest rates through appropriate monetary policy measures. The Central Banks' contribution to promoting investment will be somewhat indirect and will mainly arise from the business confidence that would be generated as a result of maintaining low inflation and minimising the macroeconomic risks.

Currently, the Central Bank managed Employees' Provident Fund (EPF) plays a significant role in supplying both equity and debt capital to the private sector as well as the Government, while generating optimum long term returns for members. The Central Bank will continue to fulfill this role and supply equity and debt capital in 2007 by carefully evaluating investment opportunities and a gradual diversification of investments. In addition, the service provided to the presently active two million members will be enhanced through a comprehensive reengineering programme of the EPF by fully automating its operations, using electronic means to update the member accounts in real time.

The Central Bank will also actively explore the possibility of introducing a unified voluntary contributory social security scheme for over three million informal sector workers. This will provide a social security to these workers, while generating large scale savings and funds for investment as well.

In keeping with the vision of the Central Bank, access to finance by all segments of the population will be improved through continued development of the finance sector. Accordingly, the Central Bank will continue to promote development initiatives through co-ordinating credit delivery activities among the government, financial institutions, foreign donors and beneficiaries. In 2007, the Bank will expand its outreach under existing micro finance programmes, for families in poverty in various parts of the country, with the assistance of lending institutions and other support groups. New and improved poverty focused micro finance programmes will be developed through self-help group mechanisms, while encouraging savings habits and ensuring credit availability for diverse economic opportunities.

The Central Bank has also recognised the vital importance of foreign remittances in supplying funds for investment. Thus, the Central Bank will continue to assist both the Bureau of Foreign Employment and the banking sector to attract remittances to Sri Lanka through the formal banking channels. The ambitious awareness campaign embarked by the Central Bank in 2006 will continue with greater interest in 2007, with the aim of raising the level and quantities of remittances significantly.

We will also continue in our efforts to support financial markets during the year. The public debt management policy of the Central Bank will be reformulated to develop and strengthen the government securities market, enhance the efficiency in the debt market and access to finance, and maintain a proper balance between commercial borrowings from local and external sources. Towards such objective, the Central Bank will continue in its efforts to strengthen the intermediary participants in the government securities market, and continue with the debt consolidation process while expanding the investor base in government securities.

8. Concluding remarks

The Central Bank's vision is to continue being a credible and dynamic institution contributing to the prosperity of Sri Lanka. In that endeavour, we will strive to effectively utilise the productive resources of our country by maintaining economic, price and financial system stability, and offering sound policy advice to the government. Further, in keeping with our values, the Central Bank will also continue to maintain transparency by announcing its policies to the public, which will, in turn, enhance the policy effectiveness.

Your Excellencies, Ladies and Gentleman, we do hope our statement to you today helped to clarify our policies and would assist you in your economic endeavours. May we also assure you that, we, at the Central Bank remain deeply committed to contributing towards the prosperity of our country and appreciate very much your endeavours that are directed towards such goal.

It is our wish and hope that the year 2007 will be a highly successful year for all of us and we offer you our closest co-operation and support. Once again, I wish all of you a Happy, Prosperous and Peaceful New Year.