Ajith Nivard Cabraal: Macroeconomic background and outlook for 2007

Presentation by Mr Ajith Nivard Cabraal, Governor of the Central Bank of Sri Lanka, at the Sri Lanka Development Forum – 2007, Colombo, 29-30 January 2007.

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Your Excellency President Mahinda Rajapaksa, President of Sri Lanka, Hon Chairman, Hon Ministers, Your Excellencies, Development Partners and friends,

In the next few minutes, I will endeavour to give you a quick update of Sri Lanka's macroeconomic achievements in 2006 and also share with you, some thoughts on the outlook for 2007.

As we now know, the Sri Lankan economy recorded a growth of 7.8 per cent in the first three quarters of 2006 and according to current available data, it is very likely that the economic growth in 2006 would be well over 7 per cent. Unemployment recorded its lowest level of 6.3% during the year. Our international reserves increased by nearly 5 per cent. Exports, imports and FDI grew significantly. Many major infrastructure development projects commenced. A large number of village development projects were implemented. Migrant worker remittances reached the highest ever level of over US dollar 2.3 billion.

These achievements by any standards, would have been considered significant. But, in the light of several major challenges faced by the country during 2006, these achievements could very well be even considered quite remarkable. The unprecedented high international oil prices, the unfavourable security situation due to heightened terrorist activity, the unforeseen investment needs in the post tsunami reconstruction, the ending of the debt moratorium that was granted in the wake of the Tsunami and the intense export competition arising from the elimination of textile quotas, all left its mark on the economy in 2006.

While each of these challenges were very serious, let me briefly deal with the special challenge arising from the uncertain security situation as a result of terrorist attacks launched by the LTTE from early January 2006. In face of these attacks, even reluctantly, this threat had to be faced head-on and the terrible attacks <u>had</u> to be repulsed by the Government. Such efforts obviously required the appropriation of a significant amount of resources, a part of which could have been otherwise available for more productive activity. Nevertheless, no responsible government could ignore persistent and delibarate attacks against the country's integrity, defence, economic centers and public, and hence, as has been done in many countries across the world, the key economic centers and the public has to be safeguarded from the terrorist attacks through the implementation of the necessary anti-terrorism initiatives. In that context, the governmental interventions to protect the interests of the country, and its economic infrastructure should be clearly recognised as a basic imperative in the overall defence as well as macroeconomic plan of the nation.

The good news however is that despite this and other serious challenges, the country was able to maintain macroeconomic stability at a reasonable level. The balance of payments recorded a surplus; the exchange rate, which in the years 2001 to 2004 had depreciated by approximately 5.9 per cent per annum, depreciated by only 5.2 per cent during 2006; a comfortable level of reserves was maintained; Government revenue and fiscal deficit targets were achieved as planned; the outstanding Government debt to GDP ratio declined; investor confidence remained high; a remarkable increase was seen in foreign direct investments (FDI) and for the first time, the yearly FDI exceeded US dollars 500 million; foreign portfolio inflows into the Stock Market increased substantially; the share indices recorded its highest ever levels; the government was able to mobilise around US dollars 1.2 billion in loans and grants from bilateral and multilateral donors and commercial sources.

But we have to admit that not everything was rosy. There were a few down-sides and draw-backs too. Inflation began to rise since April due to higher than expected monetary expansion, some revisions to administered prices and escalating vegetable prices. In response, a tight monetary policy stance was adopted to curtail high growth in monetary and credit aggregates and it is likely that such measures would lead to the moderation of the rising inflationary pressures, and reflect a downward trend from April 2007 onwards.

Chairman, Your Excellencies, friends,

Over the next few years, we are also very keen to deal with two key disparities prevailing in our country.

These are: (a) regional disparity in economic development, and (b) significant income disparity between the poor and rich. Creating more opportunities within the regions outside the Western Province and encouraging village development and human resource development at all levels, hopefully the need to reduce poverty significantly, and address income inequality. These efforts therefore would need to be pursued with renewed enthusiasm, as already vowed in the Mahinda Chinthana, the President's development plan for the nation.

We are also deeply conscious that for the country to achieve its macro-economic goals, the monetary policy too should play a key role. Towards that end, the monetary policy framework adopted by the Central Bank has been made consistent with the government's macroeconomic framework. Accordingly, the 2007 targets in the monetary programme of the Central Bank have been set, after taking into consideration the potential growth and liquidity needs of the economy to move along the projected growth path while keeping inflationary pressures in check.

Your Excellency, In November 2006, the Government of your Excellency announced its medium-term macroeconomic framework within a 10-year development framework. This programme targets an 8 per cent growth for the next six years and 9-10 per cent thereafter. These are tough targets. But these are achievable. When striving towards such goals, we must remember that our development focus should always be clear. We must also remember that our external environment may not always and necessarily be ideal. But we would do well to remember that ours has been and is a resilient economy. We have shown that we can grow even in the face of highly adverse circumstances and scenarios. In that context, we would be wise, if we do not develop our economic plans on the overriding assumption of a totally terrorism free environment. Of course, if the peace process is successful and a early political solution is found to the on-going conflict, it would be highly desirable. But at the same time, if we consciously develop our plans and frameworks on less than perfect conditions, we could still find ways and means to succeed and deliver the planned results. We owe that to our people, who cannot and should not have to wait until everything falls in to place. Therefore, our future strategies should be aimed at moving ahead even in the face of threats of terrorism and other adversities without setting out as a pre-condition, the achievement of a permanent peace or ideal conditions to embark on our development projects and programmes.

We are also working today on the basis that all our strategies would be of no avail, if we are not sufficiently committed to achieving those plans. We know we are serious in our efforts. We also have to show we are serious. That is why, at the beginning of 2007, in close consultation with the Secretary to the Ministry of Finance, the Monetary Board developed a comprehensive monitoring mechanism of key macroeconomic variables in the external, fiscal and monetary sectors. These are based on a financial programming framework to ensure that key macroeconomic targets are met as announced, both in the Budget and our Road Map. We will continue to monitor these key macro economic variables and take appropriate policy measures if and when there are any deviations from the pre-determined targets.

We are therefore confident that we will be able to keep our economy and development agenda on track and make rapid progress. It is also our hope that our development partners will understand our strategies and efforts towards achieving macroeconomic stability and growth and we look forward to their close support in our endeavours.

Finally, I would like to leave a simple message with all of you, our Development partners. The outlook for Sri Lanka is bright. We are optimistic about our country. Join us in our endeavours. Now is the time.