Chapter 1

ECONOMIC, PRICE AND FINANCIAL SYSTEM STABILITY, OUTLOOK AND POLICIES

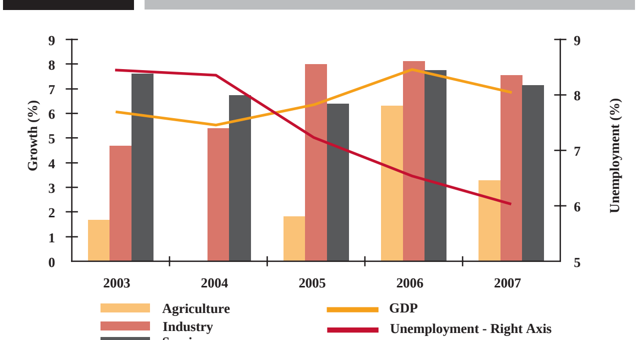
1.1 Overview

In 2007, the Sri Lankan economy recorded a growth of well above 6 per cent for the third consecutive year for the first time since Independence, demonstrating that Sri Lanka has now moved on to a higher growth path of above 6 per cent per annum from the historical average of around 4-5 per cent. The economy grew by 6.8 per cent, the annual average rate of unemployment reached its lowest ever recorded level of 6.0 per cent, while the per capita income rose further to US dollars 1,617 in 2007. This performance is commendable, as it was achieved in a challenging environment of heightened security concerns arising from intensified terrorist activities and rising petroleum and commodity prices in international markets which threatened the achievement of price stability. The tight monetary policy stance of the Central Bank decelerated the growth in monetary aggregates and slowed down the aggregate demand to a certain extent during 2007, reflecting the effectiveness of demand management policies. However, it was disappointing for the monetary authority to observe the negation of the demand management efforts by external price shocks and supply side shocks, despite the tighter and more disciplined monetary policy stance maintained by the Central Bank. These external price movements and supply side shocks resulted in a higher than expected inflation towards the second half of the year. The fiscal consolidation process pursued by the government moved in the right direction; both the fiscal deficit and public debt continued to improve in line with the trend observed in recent years despite the lower than expected revenue collection during the year. This was achieved amidst significant challenges faced by the government such as rising defence expenditure, rising domestic interest rates and the need to grant several tax and duty concessions in order to rein in the escalating cost of goods and services. At the same time, the government continued with its higher public investment programme, aiming at expanding the country's economic and social infrastructure to facilitate future economic growth. The government's ability to reduce the deficit financing from domestic banking sources substantially, despite a deviation from the revised target, was a welcome development as such fiscal policy complemented the tight monetary policy stance of the Central Bank.

The external sector demonstrated its resilience to external shocks, with the balance of payments recording a surplus of US dollars 531 million, which raised the country's external reserves to a higher level, along with a greater stability in the exchange rate. Country received the highest ever foreign direct investment (FDI) inflow of around US dollars 734 million demonstrating the continuous foreign investor confidence. While higher growth in exports and a steady increase in worker remittances mitigated the impact of higher petroleum and commodity prices on imports to some extent, the higher expenditure on import of investment goods required for infrastructure development was financed partly through debt and partly through FDI inflows. However, large inflows of foreign exchange by way of loans may pose challenges to external competitiveness through an appreciation of the rupee and to monetary management through excessive monetary expansion.

The financial sector continued to grow strongly and the financial system remained resilient in the face of unfavourable global financial market conditions and rising domestic interest rates. The systemically important financial institutions maintained their financial soundness through continued high profitability, stronger capitalisation, improved asset quality and enhanced risk management, which consolidated their capacity to deal with the stressful environment. The regulation and supervision of the financial system was further strengthened with the implementation of several new prudential regulations, while the systemically important payment and settlement systems operated with near 100 per cent availability and safety. Hence, any near-term risks to the financial system would be manageable and the outlook for financial system stability is positive, with policies and measures being implemented to mitigate risks and address vulnerabilities.

Chart 1.1 Economic Growth and Unemployment



1.2 Macroeconomic Developments, Stability and Policy Responses in 2007

Real Sector Developments

The economic growth in 2007 was mainly driven by the performance in industry and services sectors which grew by 7.6 per cent and 7.1 per cent, respectively, while the agriculture sector grew moderately by 3.3 per cent. The services sector made the highest contribution of 62 per cent to the overall growth, while the industry and agriculture sectors contributed 32 per cent and 6 per cent, respectively. However, the shares of GDP from the services, industry and agriculture sectors remained almost unchanged at 60 per cent, 28 per cent and 12 per cent, respectively. In the services sector, posts and telecommunications, cargo handling, transport, and financial services were the key performing sectors. Construction, export manufacturing, and mining and quarrying activities performed well in the industrial sector. Most of the agricultural activities achieved relatively high growth rates, but the drop in the production of two major crops, *viz.,* tea and paddy, dampened the overall growth performance of the sector. The expansion of the economy generated more employment opportunities, contributing to a further drop in the annual unemployment rate from 6.5 per cent in 2006 to 6.0 per cent in 2007, the lowest annual unemployment rate ever reported.

In 2007, most of the sub-sectors in the agriculture sector achieved relatively high growth rates except for tea and paddy. Continuous efforts to enhance the quality of Sri Lankan tea, higher global demand and increased value addition led tea prices to rise well above the global average price, offsetting the decline in production in 2007. Rubber production benefitted from attractive prices, combined with the adoption of new technologies. In order to develop the rubber sector, steps were taken to increase the cultivation area, providing more incentives to growers and improved extension services. Coconut production rose by 3.0 per cent during the year benefitting from favourable weather but the prices of coconut and coconut based products increased sharply reflecting

Table 1.1 **Gross National Product by Industrial Origin at Constant (2002) Prices**

Sector	Value (Rs. million)		As a Share of GDP (%)		Rate of Change (%)		Contribution to Change (%)	
	2006	2007(a)	2006	2007(a)	2006	2007(a)	2006	2007(a)
Agriculture	257,131	265,586	12.3	11.9	6.3	3.3	10.3	6.0
Agriculture, Livestock and Forestry	235,872	241,010	11.3	10.8	3.4	2.2	5.3	3.6
Fishing	21,260	24,576	1.0	1.1	53.5	15.6	5.0	2.3
Industry	590,298	635,199	28.2	28.5	8.1	7.6	29.8	31.7
Mining and Quarrying	35,769	42,631	1.7	1.9	24.2	19.2	4.7	4.8
Manufacturing	370,355	394,233	17.7	17.7	5.5	6.4	13.1	16.8
Electricity, Gas and Water	52,926	55,339	2.5	2.5	14.8	4.6	4.6	1.7
Construction	131,248	142,996	6.3	6.4	9.2	9.0	7.4	8.3
Services	1,243,119	1,331,602	59.5	59.6	7.7	7.1	60.0	62.4
Wholesale and Retail Trade	514,511	546,145	24.6	24.5	7.1	6.1	22.9	22.3
Hotels and Restaurants	9,411	9,199	0.5	0.4	2.5	-2.3	0.2	-0.1
Transport and Communication	259,546	286,779	12.4	12.8	12.6	10.5	19.4	19.2
Banking, Insurance and Real Estate etc.	177,817	193,375	8.5	8.7	8.5	8.7	9.4	11.0
Ownership of Dwellings	71,533	72,345	3.4	3.2	1.1	1.1	0.5	0.6
Government Services	161,611	171,259	7.7	7.7	5.0	6.0	5.2	6.8
Private Services	48,689	52,500	2.3	2.4	7.8	7.8	2.4	2.7
Gross Domestic Product	2,090,548	2,232,387	100.0	100.0	7.7	6.8	100.0	100.0
Net Factor Income from Abroad	-28,757	-24,251			-20.9	15.7		
Gross National Product	2,061,791	2,208,137			7.5	7.1		

(a) Provisional

Source : Department of Census and Statistics

the world trend of increasing demand for organic oils to produce bio-fuel as a supplement to expensive fossil fuel.

With the sharply rising milk powder prices in global markets, the local dairy industry has been identified as an emerging key sector. The government has implemented a series of programmes, with the assistance of the private sector to encourage dairy farmers. Budget 2008 proposed to provide credit facilities at concessionary rates for the importation of milch cows, development of animal husbandry and establishment of small and medium milk processing centres. Milk products from locally produced milk were exempted from VAT with effect from January, 2008. Arrangements have been made to develop infrastructure facilities in the dairy sector, while veterinary surgeons were recruited to provide veterinary services in the rural areas. Veterinary clinics were established at regional level, while livestock sector health programmes were conducted and necessary equipment provided. To increase the herd population, a policy decision was taken to obtain high quality heifers for the dairy industry and regulations on the prevention of slaughtering of milch cows were strengthened by increasing the fine on their slaughter.

Fish production fully recovered from the adverse impact of the tsunami, reaching the highest ever level of 291 million kg in 2007, an increase of 16 per cent. Marine, and inland & aquaculture fish production increased by 17 per cent and 9 per cent, respectively. Fish prices remained generally stable during most of the year, mainly due to higher production and intervention through direct purchasing of fish stocks by the Ceylon Fisheries Corporation (CFC) and fish distribution through the CFC's stalls and trucks with freezer facilities. Several steps have been taken to increase fish production further and to optimally use the marine resources (Box 5).

With a view to increasing domestic food production, the government presented the National Policy on Agriculture in 2007. A national campaign was introduced under the theme "*Api Wawamu – Rata Nagamu*" with the objective of increasing domestic agricultural production and containing the rising cost of goods and services. Under this campaign, attempts have been made to transfer new technology to farmers with a view to improving agricultural productivity.

The growth momentum in the industrial sector in 2007 was mainly attributed to the dynamism in factory industry. The government continued to focus on regional industrialisation and small and medium enterprise development with the aim of improving the quality of products to international standards for export markets, and addressing regional income disparity.

Duty and tariff concessions and tax concessions for establishing, relocating or expanding industries through special programmes, establishment of new economic zones and industrial parks, human resource development through vocational training and university courses, facilitation of expanding market access and brand promotion activities were the major initiatives taken by the government to promote the industrial sector during 2007. Meanwhile, industrial sector performance also benefited significantly from the Generalised System of Preferences (GSP+) granted by the EU countries, and from bilateral and regional trade agreements during the year. However, the industrial sector needs to be able to compete without preferential access as non-reciprocal preferential access such as GSP+ could be withdrawn for non-economic reasons (Box 12).

The textile, wearing apparel and leather products category, which is the major export oriented industrial sub-sector of the country, recorded a higher output with the increased utilisation of GSP+ duty concessions. Other export market oriented industries such as rubber based products, diamond processing, fabricated metal, machinery and transport equipment and gem and jewellery also recorded healthy growth rates in 2007. On the domestic front, strong demand boosted the output of food, beverages, cement, building materials, plastic and PVC products. The healthy growth of the construction sector including mega infrastructure development projects by the government such as power generation, ports and highways, irrigation projects, and increased property development by the private sector was clearly reflected in the better performance of non-metallic mineral products including cement, building materials and fabricated metal. Certain areas need to be addressed to improve the industrial sector performance further, including productivity enhancement by increasing the usage of modern technology, increasing competitiveness by promoting the quality of products to international standards, introducing energy efficient production methods to mitigate the rising cost of fuel and energy, promoting backward linkages and maintaining international standards on labour regulations and environment.

The growth in value addition of the services sector decelerated marginally, mainly due to the contraction in the hotels and restaurants sub-sector, which was affected by the unfavourable security situation, and also due to the slowdown in import and domestic trade activities. The service sector growth was driven by export trading services and port related services, reflecting the healthy external demand, while the domestic oriented services, such as, banking and telecommunication services also contributed significantly towards the better performance. The growth momentum in the

Table 1.2 Aggregate Demand and Savings Investment Gap - 2006 and 2007

Item	Rs. billion		Growth %		As per cent of GDP	
	2006	2007(a)	2006	2007(a)	2006	2007(a)
1. Domestic Demand	3,262.0	3,946.4	22.1	21.0	111.0	110.3
1.1 Consumption	2,439.8	2,949.7	21.2	20.9	83.0	82.4
Private	1,988.4	2,403.2	17.5	20.9	67.7	67.2
Public	451.4	546.5	40.6	21.1	15.4	15.3
1.2 Investment (Gross Domestic Capital Formation)	822.2	996.7	25.0	21.2	28.0	27.9
Private	703.0	804.5	27.9	14.4	23.9	22.5
Public	119.2	192.2	10.0	61.3	4.1	5.4
2. Net External Demand	-323.4	-368.0	-47.6	-13.8	-11.0	-10.3
Exports of Goods and Services	885.4	1,046.1	11.6	18.1	30.1	29.2
Imports of Goods and Services	1,208.8	1,414.1	19.4	17.0	41.1	39.5
3. Total Demand (GDP) (1) + (2)	2,938.7	3,578.4	19.8	21.8	100.0	100.0
4. Domestic Savings (3) - (1.1)	498.8	628.7	13.6	26.0	17.0	17.6
Private	569.0	686.4	13.2	20.6	19.4	19.2
Public	-70.1	-57.7	-10.3	17.7	-2.4	-1.6
5. Net Factor Income from Abroad	-40.4	-38.8	-34.5	4.0	-1.4	-1.1
6. Net Private Current Transfers	197.9	245.0	13.4	23.8	6.7	6.8
7. National Savings (4) + (5) + (6)	656.3	834.9	12.5	27.2	22.3	23.3
8. Savings Investment Gap						
Domestic Savings - Investment (4) - (1.2)	-323.4	-368.0			-11.0	-10.3
National Savings - Investment (7) - (1.2)	-165.9	-161.8			-5.6	-4.5
9. External Current Account Deficit without Official Grants (2) + (5) + (6)	-165.9	-161.8			-5.6	-4.5

(a) Provisional

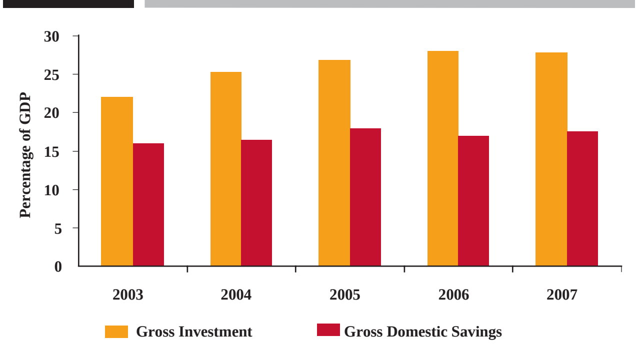
Sources : Department of Census and Statistics
Central Bank of Sri Lanka

telecommunications sector continued in 2007, largely supported by further expansion in the coverage, introduction of advanced technology and value added services, increased competition and affordability, and higher investments. Several new telecommunication projects were implemented during the year to improve the capacity, technology, coverage and efficiency of the service.

A slowdown in real domestic aggregate demand reflects the effectiveness of the tight monetary policy stance maintained by the Central Bank. Both consumption and investment demand in real terms decelerated to 4.9 per cent and 8.7 per cent in 2007 from 7.1 and 13.4 per cent, respectively in 2006. Deceleration in domestic aggregate demand also reflected in the slower growth in the demand for import of goods and services. However, the impact of slowing down in the domestic aggregate demand on overall growth was partly mitigated by the higher external demand. In real terms, export of goods and services increased by 6.8 per cent in 2007 compared to 3.8 per cent growth in 2006.

The savings-investment gap as a per cent of GDP, improved during 2007. The government managed to reduce its dis-savings, thus helping to raise overall domestic savings. However, the still high domestic savings-investment gap of around 10 per cent highlights the important role played by foreign capital and worker remittance inflows in filling the required gap in investment in order to achieve the desired rate of economic growth. The gross domestic investments at 28 per cent of GDP remained at a level almost similar to 2006, while the domestic savings ratio improved to 17.6 per cent in 2007 from 17.0 per cent in 2006. With the lower current account deficit in fiscal accounts, the government was able to reduce the dis-savings ratio to 1.6 per cent of GDP in 2007 from 2.4 per cent in 2006, contributing to the overall increase in the domestic savings ratio. Consequently, the domestic savings-investment gap as a per cent of GDP dropped to 10.3 per cent in 2007 from 11.0 per cent in 2006. Savings by Sri Lankan residents abroad by way of worker remittances helped to reduce the national savings-investment gap to 4.5 per cent, which was reflected in the improvement of the current account deficit of the balance of payments as well. The remaining gap was financed through FDI inflows, loans and grants to the government and portfolio inflows. The savings-investment gap is expected to remain high in the medium-term with the envisaged high investment requirements to achieve sustainable high growth, as domestic savings are not likely to increase at a faster rate than investments.

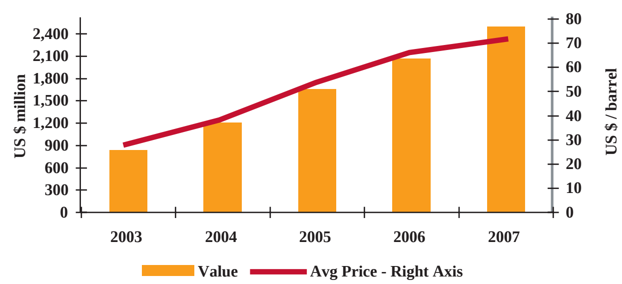
Chart 1.2 Savings and Investment



External Sector Developments

The external demand provided a major impetus to economic growth and stability in 2007, supported by better performance in exports and remittances and supplemented by higher capital inflows. The robust growth of key export destination countries during the major part of 2007, and initiatives taken by local entrepreneurs and the government, enhanced access to key markets with preferential treatment being received by Sri Lankan exporters under various trade agreements. Foreign exchange inflows from the major sources, such as garments and textiles and tea, further increased in 2007 with earnings from tea exceeding the US dollars 1 billion mark. Many of the other key categories of exports such as machinery and equipment; food, beverages and tobacco; rubber products; and diamonds and jewellery, also increased. The higher growth of exports compared to the growth of imports helped contain the expansion of the trade deficit in 2007. The trade deficit expanded by 5.6 per cent in US dollar terms compared with the 34 per cent expansion in 2006 and improved as a percentage of GDP in 2007. Increased expenditure on imports of investment goods needed for development projects undertaken by the government as well as investment activity of the private sector also contributed to the increased expenditure on imports. Earnings from the export of services such as transportation, information technology (IT) and IT enabled services, continued to increase, though there was a decline in the earnings from tourism. Tourist arrivals, which declined sharply during the first half of the year, recovered substantially during the latter part. Gross inflows on account of transportation services continued to perform better, led mainly by a substantial increase in port related activities, resulting from a higher volume of cargo handling, and increased earnings from

Chart 1.3 Value of Petroleum Imports and Average Price of Crude Oil Imports

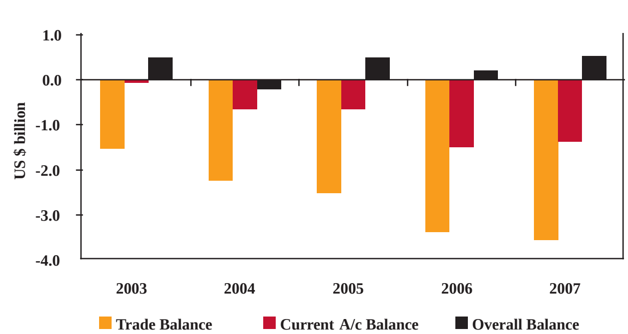


passenger fares due to the expansion of flying destinations, flying hours and flying frequency by SriLankan Airlines.

Worker remittances continued to be a major source of inflows, financing around 70 per cent of the trade deficit in 2007. Worker remittances, which grew at a high rate for the third consecutive year, reached US dollars 2,502 million in 2007**.** The services account surplus, together with the increase in worker remittances, helped to contain the current account deficit, which improved as a percentage of GDP to 4.2 per cent in 2007 from 5.3 per cent in 2006.

The capital and financial account registered an improvement in 2007 with higher inflows. The capital account, which records grants of a capital nature mostly to the government from development partners, received almost the same level of assistance as in 2006. The gross FDI inflows, including the foreign loans obtained by BOI approved companies, reached a record level of US dollars 734 million in 2007 from US dollars 604 million in 2006, mainly due to a sharp increase in reinvestment of retained earnings by existing BOI companies, especially those engaged in the services sector. Total long-term and medium-term loan inflows to the government increased to US dollars 1,290 million compared to US dollars 932 million in 2006. The debut international bond issue and the opening up of 10 per cent of the outstanding Treasury bond stock to non-residents contributed to higher external inflows to the government. Despite turbulence in the worldwide stock markets due to the subprime issue, the Colombo Stock Exchange (CSE) attracted more foreign inflows on both gross and net basis, confirming investor confidence in Sri Lanka. Reflecting these developments, the financial account recorded a surplus of US dollars 1,828 million in 2007 from US dollars 1,517 million in 2006. As a result, the combined surplus in the capital and financial account increased substantially, and was more than sufficient to finance the current account deficit, resulting in a surplus of US dollars 531 million in the overall balance. Consequently, the external official reserves of the country improved significantly to comfortable levels, being sufficient to finance more than 3 months of imports, thereby improving the resilience of the external sector to shocks.

Chart 1.4 Balance of Payments (BOP)



Meanwhile, the total external debt of the country, as a percentage of GDP, increased to 44.1 per cent in 2007 from 43.3 per cent in 2006 mainly due to the government's higher reliance on external sources to finance its deficit in an environment of rising domestic interest rates. This strategy eased pressure on domestic resources and released resources to the private sector and helped to stabilise domestic interest rates towards the end of the year. However, it is important to maintain the recent favourable trends in public external debt in order to improve debt and macroeconomic sustainability.

Under the floating exchange rate regime, the Sri Lankan rupee can no longer be regarded as a steadily depreciating currency. With the maturing domestic foreign exchange market, the exchange rate is now more responsive to, and determined through, market forces of supply and demand, while the intervention by the Central Bank is limited to mitigate excessive volatility in the market and to build up official external reserves. The rupee, which depreciated at a relatively higher rate against the US dollar during the first three quarters of the year, appreciated in the last quarter with the inflow of the proceeds from the debut sovereign bond issue, and recorded a marginal depreciation of 0.93 per cent by end 2007. The recent stabilisation of the Sri Lanka rupee underlines the need for the export and import competing sectors to focus more on productivity improvements and market access in order to maintain external competitiveness.

Sri Lanka successfully completed its debut international bond issue of a benchmark size of US dollars 500 million in October 2007. The

Table 1.3 External Sector Developments

Item	US$ mn 2006	US$ mn 2007 (a)	% Change
Exports	6,883	7,740	12.5
Agricultural products	1,293	1,507	16.6
Industrial products:	5,401	5,920	9.6
Mineral exports	120	129	7.7
Other exports	69	184	166.2
Imports	10,254	11,301	10.2
Consumer goods	1,980	2,002	1.1
Intermediate goods	5,962	6,513	9.2
Investment goods	2,246	2,685	19.6
Other	65	100	53.2
Trade balance	*-3,371*	*-3,560*	*-5.6*
Services, net	257	239	-7.0
Receipts	1,625	1,711	5.3
Payments	1,368	1,473	7.6
Income, net	-389	-358	7.9
Receipts	311	449	44.3
Payments	700	807	15.3
Current transfers, net	2,005	2,311	15.3
Private remittances, net	1,904	2,214	16.3
Receipts	2,161	2,502	15.8
Payments	257	288	11.9
Official Transfers, net	101	97	-4.0
Current account balance	*-1,499*	*-1,369*	*8.7*
Capital account	*291*	*269*	*-7.4*
Financial account	*1,517*	*1,828*	*20.5*
Direct investment, net	451	548	21.6
Inflows	480	603	25.6
Outflows	29	55	87.1
Private long-term,net	-35	31	188.6
Inflows	139	199	43.3
Outflows	174	168	-3.4
Government, long-term,net	491	672	36.9
Inflows	932	1,290	38.4
Outflows	441	618	40.1
Government, short-term,net	0	372	
Short-term:	610	205	-66.4
of which:Portfolio investment,net	51	101	99.2
Errors and Omissions	-105	-198	
Overall balance	204	531	
Gross official reserves (without ACU)	2,526	3,063	
Months of imports	3.0	3.3	
Total external reserves (without ACU)	3,695	4,511	
Months of imports	4.3	4.8	
Export price index	103.3	108.3	
Import price index	107.0	113.3	
Terms of trade	96.6	95.6	
Exchange rates (Average)			App(+) /Dep(-)
Rs./US$	103.96	110.62	-6.0
Rs./Yen	0.89	0.94	-5.0
Rs./Euro	130.63	151.63	-13.8
Rs./STG	191.53	221.46	-13.5

(a) Provisional   Source: Central Bank of Sri Lanka

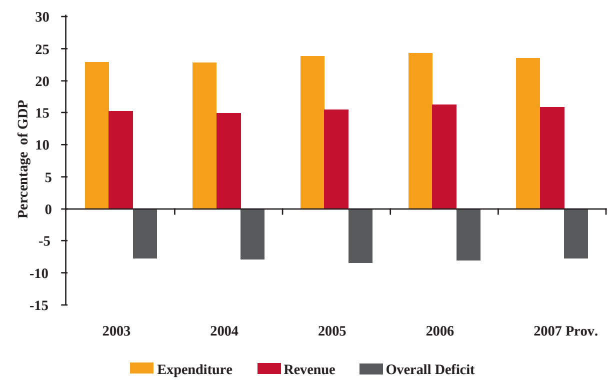
country's sound economic fundamentals, conducive investment climate, future growth potential and the unblemished debt servicing record, played a major role in the success of the bond, which was issued at a time when the global financial markets were in turmoil due to the after effects of the subprime issue. With the bond issue, Sri Lanka has marked its presence in the global financial market and enhanced its access to the market. This is particularly useful in view of the declining access by Sri Lanka to concessional financing from traditional development partners with the achievement of middle income status. The bond issue has also brought about self-imposed macroeconomic discipline, as the wider global investor community and international rating agencies will now be closely monitoring Sri Lanka's macroeconomic developments (Box 15).

Fiscal Sector Developments

The fiscal strategy of the government continued in the direction enunciated in the *"Ten-year Vision"* policy document, which was the basis of the government's fiscal policy framework. The fiscal policy thrust has been designed to achieve a higher and sustainable economic growth while strengthening the fiscal consolidation process further. Strong efforts were made to achieve fiscal targets in the face of several challenges including the need for enhancing counter terrorism measures to strengthen national security, relatively high inflation and inflationary pressures, sharply rising international commodity and oil prices, and sharply rising domestic interest rates. These challenges resulted in deviations in the factors associated with underlying assumptions of Budget 2007, thereby affecting the targeted outcomes. Amidst these adverse trends, the fiscal sector continued its improving trend, albeit at a slower pace than originally envisaged. Notwithstanding the improvements, the sector still suffers from several drawbacks such as shortfalls in revenue collection, overruns in recurrent expenditure, lower than expected performance in the public investment programme and weak financial performance of major state trading enterprises (STEs) and state owned enterprises (SOEs). Therefore, it is necessary to work intensively towards improving the fiscal performance at a faster rate and to strengthen the debt management process further.

In 2007, total revenue in nominal terms increased by 18.3 per cent, compared to 2006. The increase was due to the continuous efforts made by the government in further strengthening tax administration, streamlining tax incentives and exemptions, enhancing tax compliance and strengthening enforcement. However, total revenue was lower than the budgetary target mainly due to the provision of tax concessions on essential imported commodities to counter the rising cost of goods and services, and lower volume and total value of vehicle imports in 2007, as people opted to import lower value motor vehicles due to the high import duty structure maintained on fuel inefficient vehicles as a measure of managing the impact of escalating oil prices. The

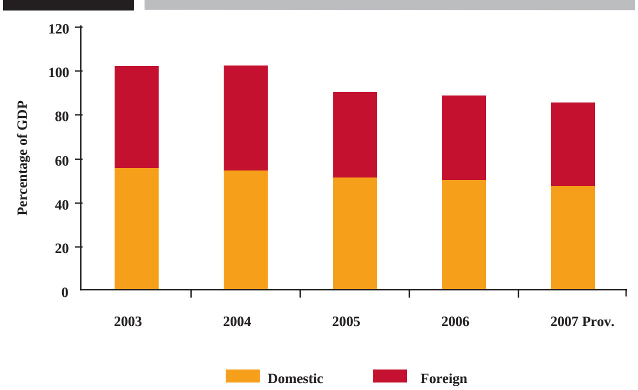
Chart 1.5 Revenue, Expenditure and Budget Deficit



revenue loss due to these two factors alone has been estimated to be Rs. 24 billion (0.7 per cent of GDP). Total revenue amounted to 15.8 per cent of GDP in 2007 compared to 16.3 per cent in the previous year. Public investment continued its rising trend and reached 6.4 per cent of GDP compared to 6.0 per cent in 2006. The implementation of economic and social infrastructure projects with an emphasis on mega infrastructure development projects and rural development initiatives contributed to this improvement. However, the realised public investment ratio was much lower than the original target of 8.6 per cent of GDP. The recurrent expenditure exceeded the target mainly due to higher than planned expenditure on national security, salaries and wages, pension payments and interest payments. As a combined outcome of these developments, the overall deficit in 2007 turned out to be 7.7 per cent of GDP, a decline compared to both the original target of 8.4 per cent and the deficit of 8.0 per cent in 2006.

In 2007, there was a notable change in the financing mix of the budget deficit, in line with the continued efforts towards diversifying deficit financing options. The debut international bond issue in 2007 was the most recent financing instrument introduced by the government in this context. In response to the rising and volatile domestic market interest rates, the government opted to switch to more external borrowings. However, more external borrowings would increase the debt stock's exposure to exchange rate risks, which need to be managed prudently. A higher amount of the budget deficit in 2007 was financed through foreign sources. Consequently, financing from domestic sources fell below the budgeted level. Borrowing from the banking system was marginally below the original target and recorded a significant decline from the previous year. The debut international sovereign bond issue and foreign investments in rupee denominated Treasury bonds were mainly responsible for the relatively lower recourse to bank financing in 2007.

Chart 1.6 Government Debt as a percentage of GDP



The declining trend in the outstanding debt to GDP ratio continued in 2007 and reached 85.8 per cent from 88.7 per cent at end 2006, improving the sustainability of public debt. This was mainly due to the stabilisation of the rupee *vis-a-vis* major foreign currencies towards the end of 2007 and slower growth in outstanding debt relative to nominal economic growth. In nominal terms, the outstanding debt increased by Rs. 462 billion to Rs. 3,070 billion during 2007. Meanwhile, a number of debt service indicators continued to reflect improved performance. However, there is a need to smoothen the maturity profile of the domestic debt to minimise the pressure on government fiscal operations. In order to avoid bunching of the repayment of foreign currency denominated commercial loans, their maturity structures also need to be lengthened.

The fiscal sector still suffers from several weaknesses despite the improvements in 2007, highlighting the need for intensive efforts towards further improvements. Revenue shortfalls and overruns in recurrent expenditure lead the government to borrow to meet the additional fund requirement, resulting in an increase in the debt stock and the future interest cost. The shortfall in the revenue collection in 2007 also poses a risk in achieving the revenue target for 2008, unless appropriate measures are introduced during the course of the year to manage this risk. The incurrence of recurrent expenditure over and above the target acts as an impediment to the long-run growth potential of the country, as it reduces the resources available for public investment. The opportunity cost involved in such expenditures is much higher in terms of the benefits that could accrue to the country from capital investments in the future. In addition, slow progress in the public investment programme leads to cost escalations requiring higher amount of resources to implement the infrastructure projects so delayed. Meanwhile, the financial viability and the performance of some SOEs remains a concern.

The government, in its policy documents, including the *"Ten-year Vision"* and the *"Medium Term Macro Fiscal Framework: 2007-2010"*, has already announced its commitment to address the above weaknesses. It is evident that the government is mindful of the implications of fiscal aggregates moving to unsustainable levels. Accordingly, containing the budget deficit at a sustainable level has been given priority and is considered to be the centerpiece of the entire fiscal process. Timely implementation of planned and additional measures to achieve the anticipated targets is essential since deviations from the targets in the fiscal front will create adverse ramifications on the overall macroeconomic management of the country. In particular, they would make monetary management more difficult, while hindering the realisation of the anticipated high and sustainable economic growth with stability, which aim at reducing poverty and regional economic disparities on a sustainable basis.

Monetary Sector Developments

In 2007, the Central Bank further strengthened its tight monetary policy stance to restrain the rising inflationary pressures. During 2007, the monetary policy implementation strategy was more geared towards not exceeding tight quantitative targets of monetary aggregates, thereby allowing market interest rates to adjust upwards in order to curtail excessive demand. At the beginning of the year, the Central Bank announced its monetary policy objectives, strategy and targets for 2007 in its "*Road Map for Monetary and Financial Sector Policies for 2007 and Beyond*". In setting monetary targets for 2007, in addition to the expected macro-economic developments in 2007, the higher monetary expansion experienced in 2006 was also taken into consideration. Accordingly, tighter monetary policy targets were set for the year, and strong measures were implemented to achieve them. The policy interest rates, *viz.,* Repurchase and Reverse Repurchase rates, were raised by 50 basis points in early 2007. Open Market Operations were conducted aggressively, while imposing certain limits on the banks on their access to the reverse repurchase facility of the Central Bank, thereby directly restricting the credit creating capacity of banks. In addition, moral suasion was used to discourage banks from excessive credit creation, while continuing with the prudential measures introduced in 2006 to safeguard banks against unhealthy credit expansion. The more focused quantitative target approach was adopted to fast track the transmission mechanism as the increase in policy rates by 350 basis points since end 2004 appeared to impact the monetary expansion with a long time lag.

The monetary policy decision making process was further strengthened with the introduction of a new monitoring mechanism to assess macroeconomic developments against the targets. Major macroeconomic variables that have a bearing on monetary policy targets were identified and a comprehensive mechanism for monitoring their developments was introduced at the beginning of 2007. This mechanism helped the Central Bank to ascertain in advance any slippages of policy variables and make recommendations to the government for early corrective action. A Monetary Policy Consultative Committee (MPCC) comprising various stakeholders, including representatives of the private sector and academia, was established in order to use their expertise to strengthen the monetary policy decision making process.

The monetary policy strategy with a focused quantitative target approach was more effective in containing monetary expansion, thereby curtailing demand-pull inflation. The growth in reserve money was contained well within the targets and restricted to 10.2 per cent, the lowest growth in the last five years. This helped to neutralise almost fully, the impact of excessive reserve money expansion experienced in 2006. The reserve money expansion was highly restrictive compared with the nominal GDP growth of 21.8 per cent. As a result, broad money growth also decelerated, though it remained above the level envisaged in the monetary programme. Both the net foreign assets (NFA) and net domestic assets (NDA) increased, contributing to the broad money expansion

Chart 1.7 **Growth in Reserve Money and Broad Money**

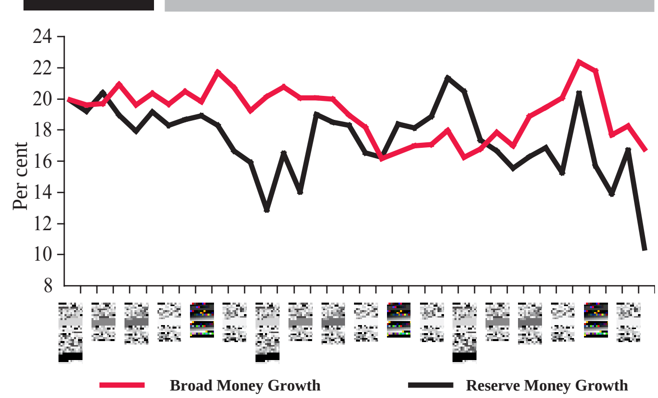
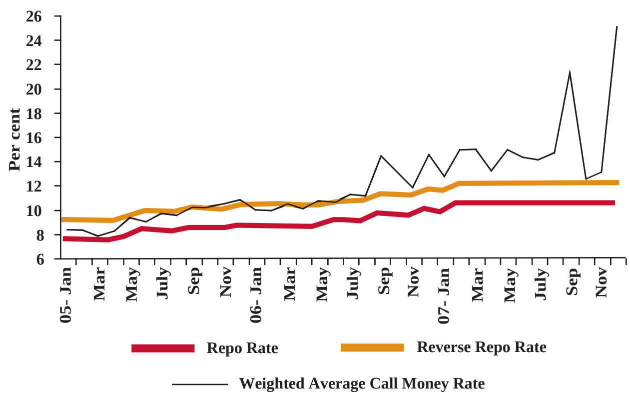


Chart 1.8 Interest Rate Movements



in 2007. Within the NDA, the growth in credit to the private sector decelerated by about 7 percentage points to around 19 per cent, responding to the higher market interest rates, resulting from the tight monetary policy measures. The borrowings by the government from the banking sector, which increased significantly in 2006, were contained at the budgeted level during 2007. However, credit to public corporations increased substantially compared to the expected level entirely due to increased borowings by the Ceylon Petroleum Corporation (CPC).

Despite the tight demand management policies of the Central Bank, inflation exceeded the orginal expectation for the year due to several factors. The tight monetary policy measures of the Central Bank helped to reduce inflation gradually during the first half of 2007. However, the substantial increase in international market prices of oil, the complete removal of fuel subsidies since July 2007 and sharp rises in several other commodity prices in international markets led to an upward adjustment in domestic prices of several goods and services, particularly during the second half of the year (Box 17). The passthrough of international price increases, though it led to a one-off increase in prices, will have a favourable impact on containing future inflation by eliminating the need for subsidising the same through the expansionary borrowings of the government.

Financial System Stability

The Financial sector remained resilient and stable in 2007, despite increased pressures from external and domestic macroeconomic and financial market developments. The key financial institutions maintained their soundness through high profitability, increased capital levels and improved asset quality within an enhanced regulatory and supervisory framework, which has strengthened their resilience and risk absorption capacity. During 2007, the reach of the banking sector in the country improved with the expansion of the branch network of both licensed specialised banks (LSB) and licensed commercial banks (LCB). The US subprime housing mortgage issues, which resulted in tighter credit conditions and higher risk premiums in international financial markets, have not affected Sri Lanka, as local financial institutions did not have exposure to the asset backed securities and derivatives (Box 18). Although the outlook for financial system stability remains positive, the prevailing downside risks require continued vigilance and risk mitigation to prevent the occurrence of events that could have an adverse impact.

The supervisory and regulatory framework governing the financial sector was upgraded with several directives and measures introduced to strengthen the soundness of both banks and non-bank financial institutions. The preparatory work for the implementation of the Basel II Capital Adequacy Framework for banks from 2008 was completed (Box 20). The adoption of Basel II is expected to improve the soundness and risk management of banks by better aligning the bank's capital with its risk profile and by providing more comprehensive capital coverage for credit, market and operational risks. A Direction on corporate governance for banks was issued by the Central Bank (Box 19) and a mandatory code for companies listed on the CSE was issued by the Securities and Exchange Commission (SEC). Further, compliance-based supervision was shifted towards risk-based supervision. Proposals to diversify the activities of primary dealers, subject to appropriate regulatory and prudential safeguards, were also approved in 2007.

The legal framework supporting the financial system was reinforced and updated, to further strengthen the stability of the financial sector. The Finance Leasing Act was amended to enable specialised leasing companies to raise funds from the public through the issue of debt securities. In addition, revisions to the Finance Companies Act were drafted to strengthen the Central Bank's regulatory and investigative powers with respect to finance companies. A new Securitisation law has been drafted to enable the issuance of asset-backed securities through bankruptcy remote special purpose vehicles and for the regulation of structured finance products. The Securities and Exchange Commission Act is being amended to bring financial derivatives under its ambit. Further, the Regulation of Insurance Industry Act is being amended to strengthen prudential supervision

Box 1

Moving towards Inflation Targeting from a Monetary Targeting Framework

Inflation Targeting in Global Context

Inflation targeting (IT) is a monetary policy framework, which aims to achieve publicly announced official quantitative inflation targets (target ranges or ceilings) within one or more pre-designated time horizons, using available policy instruments. Hence, IT is a monetary policy strategy aimed at attaining the price stability objective directly by focusing on deviations in inflation forecasts from an announced inflation target. The IT framework has three main characteristics: (i) an inflation target, which is designed with a medium to long-term perspective, (ii) an inflation forecast, and (iii) an operating target, usually a short-term interest rate, without any explicit intermediate target to achieve the announced inflation target.

Amongst several monetary policy regimes such as exchange rate targeting, monetary targeting or multiple - indicator targeting used for achieving price stability, IT has become increasingly popular among monetary authorities across the globe. The maiden initiative taken by the Reserve Bank of New Zealand in 1989, and since then several advanced countries[1] have adopted the IT framework. In recent years, several emerging market economies[2] have also started adopting monetary policy frameworks of formal, explicit or full-fledged IT. The increasing interest in emerging economies has been led by the achievement of lower inflation after adopting IT by countries, which were previously known as high inflation countries. Hence, a number of academics, economists and policy makers consider IT as a framework that can improve the design, implementation and performance of the monetary policy framework that is consistent with both the recent developments in theory and practice of monetary policy.

The IT frameworks existing in countries have unique and country specific features although those frameworks have been developed on similar fundamentals. Such specifications can be identified in terms of either the overall objective or the operating procedures and conduct of monetary policy. For example, the Bank of England's monetary policy objective is to deliver price stability, and subject to that, to support the government's economic objectives including growth and employment. The Bank of Thailand's overriding objective of monetary policy is maintaining the inflation target and Bank Indonesia's IT framework has been designed to achieve the goal of Rupiah stability, which is reflected in the inflation rate and exchange rate. Both central banks intervene in the foreign exchange market to prevent excessive and persistent volatility in the exchange rate. Accordingly, the inflation target performs the role of a nominal anchor for monetary policy while flexibility in exchange rates helps to absorb shocks to the economy.

Inflation Targeting in Sri Lanka

At present, monetary management and monetary policy conduct of the Central Bank of Sri Lanka is based on the monetary targeting (MT) framework. Under the MT framework, price stability is to be achieved by influencing changes in the broad money supply, which is linked to reserve money through the money multiplier. It assumes that demand for money as reflected by the velocity, remains stable. Over the years, the MT framework has been gradually developed and modified in line with global and domestic developments in monetary policy and macroeconomic management with a view to moving into an IT regime in the future.

The main motivation for most of the countries to adopt IT was either instability of the demand for money function due to an increased sophistication in the financial system following a revolutionary development in technology or a need for emerging out of a crisis situation. In such instances, it is necessary to make a stronger commitment to an inflation target, thereby reining rising inflation expectations.

Notwithstanding the fact that the demand for money in Sri Lanka is fairly stable as the financial system has not yet reached such an advanced stage of sophistication, the Central Bank of Sri Lanka has also kept abreast of the widespread discussion on new developments in monetray policy conduct and has been examining and researching on the feasibility of adopting IT. Several research activities have been undertaken during last few years and such research outcomes have been presented in various publications of the Central Bank ranging from annual reports to occasional papers to Staff Studies.

[1] Canada (1991), United Kingdom (1992), Sweden, Finland and Australia (1993), Spain (1994), Republic of Korea (1998), Norway (2001)

[2] Mexico (1995), Israel and Czech Republic (1997), Poland, Brazil, Chile and Colombia (1999), South Africa and Thailand (2000), Hungary and Iceland (2001), Peru and Philippines (2002), Indonesia (2005)

The following are measures the Central Bank has already taken with a proactive view of moving to an IT regime:

1997 - Commenced research on IT and the results are published in Staff Studies (1997, 1999 and 2002) and Annual Reports (1999) of the Central Bank.

2001 - Adopted the floating exchange rate regime in order to ensure the facilitation of effective monetary policy conduct.

2002 - Streamlined the Central Bank objectives to economic and price stability and financial system stability and expanded the Monetary Board to strengthen the independence by having the majority of the Monetary Board members (3 out of 5) from the private sector.

- Established a Monetary Policy Committee in order to strengthen the monetary policy decision making process.
- Started issuing regular monetary policy statements according to an advanced release calendar.

2003 - Commenced active Open Market Operations in order to ensure the effective monetary policy operations.

2006 - Developed the communication strategy through improving awareness of stakeholders and providing adequate training to financial professionals.

2007 - Started to enunciate Central Bank policies through a public policy document (Road Map), which would eventually cover an inflation report as well, under a future IT framework.

- Established a Monetary Policy Consultative Committee in order to receive inputs from private sector experts and academics.
- Developed in-house inflation forecasting models with the technical assistance of other central banks that have adopted inflation targeting frameworks.
- Started publishing inflation forecasts and underlying assumptions of forecasts.
- Encouraged the Department of Census and Statistics to introduce an appropriate inflation index, which will serve in developing core inflation index and representative island-wide price index.
- Commenced conducting inflation expectation surveys enabling to design effective policies to maintain price stability.
- Formally recognised the need for moving towards an IT framework in the medium-term in the Central Bank's Strategic Plan for 2007-2011, which was published in early 2007.

2008 - Commenced the process of preparing a inflation index for monetary policy purposes as several inflation targeting countries do not target headline inflation, but the core inflation.

These measures were complemented by the enactment of the new legislation [Fiscal Management (Responsibility) Act] in 2003 designed to bring down the fiscal deficits to a sustainable level to facilitate the monetary policy conduct.

The Central Bank considers moving to an IT framework from MT framework a gradual and cautious process as it is not a simple switching option. Accordingly, the Central Bank will be prudent and follow the process of fulfilling the prerequisites so as to be able to adopt a country specific and full-fledged IT framework in the medium-term.

and to permit the appointment of banks and other financial institutions as agents for the distribution of insurance products. The Credit Information Bureau Act is being revised to broaden the scope of its services to more diverse user groups and to provide value added services.

Structural Policy Issues and Challenges

The *"Ten-year Horizon Development Framework 2006-2016" (THDF)*, the policy document of the Government, envisages maintaining a sustainable high growth path in excess of 8 per cent in the medium-term. This is a challenging task, which requires a further expansion of the productive capacity of the economy, addressing existing bottlenecks in infrastructure and utility services, and achieving significant productivity improvements to utilise available resources more efficiently. Achieving these objectives entails channelling enhanced investment to ensure continuous supply of competitively priced energy, telecommunication services, drinking and irrigation water, roads, ports and airports and health and education facilities, etc.

The slow progress in the implementation of some planned infrastructure projects announced in the THDF needs to be addressed as a matter of

priority sooner rather than later. Cost escalations in power generation and their potential adverse impact on the economy have brought about some satisfactory progress in the implementation of certain crucial power sector projects such as Kerawalapitiya, Norochcholai and Upper Kotmale. However, other flagship projects such as the Colombo South Port Expansion Project, Hambantota Sea Port Development, Colombo-Katunayake Expressway, Colombo-Kandy Expressway, Southern Expressway, the Colombo Outer Circular Road, Weerawila Airport, etc., have been making slower progress than expected. These projects need to be expedited to achieve sustainable high economic growth in the medium term and to prevent cost escalations.

Public-Private Partnerships (PPPs) need to be promoted in developing infrastructure facilities to maintain a more sustainable debt level in the medium-term. Continuation of the existing practice of the government financing infrastructure projects tends to widen the budget deficit and increase outstanding government debt. PPPs are becoming a popular method of financing infrastructure projects in developing and emerging market economies. The government can facilitate PPPs by providing land, licences, safeguards, sovereign guarantees, etc., and thereby create an enabling environment for the private sector to undertake financing, implementation and operation of projects. On this basis, PPPs can provide more efficient infrastructure services, provided the private sector partners are selected on competitive bidding processes and are properly regulated to prevent unfair trade practices arising from monopolistic or oligopolistic competition (Box 7).

More efficient provision of services by SOEs without being a burden on the public is a prerequisite for macroeconomic stability. A major source of macroeconomic imbalance has been arising from inefficient operations of SOEs, in providing utility services such as electricity, water, transport services, petroleum products and marketing services such as purchasing paddy and selling essential commodities through state owned marketing networks. Such SOEs burden the general public by their reliance on budgetary financing or bank borrowings. In addition to the policy of non-privatisation of existing enterprises, there is a recent trend of the government venturing into new SOEs or reviving hitherto troubled SOEs, e.g., Mihin Air, the Central Transport Board (CTB), Paddy Marketing Board, Co-operative Wholesale Establishment (CWE) and Co-operative marketing networks. The expectation is that those SOEs would be able to provide services to the general public in a more competitive and efficient manner than the private sector without being a further burden to the general public. It is essential that proper governance and pricing structures are established in managing those SOEs if they were to achieve the intended objectives through commercially viable operations without relying on government subsidies.

The declining trend in unemployment to its lowest recorded level brings to focus the need for more efficient use of labour through productivity improvements and the need to address the mismatch between labour supply and demand. It has been encouraging to observe the continuous improvements in labour productivity over the years, especially in the industry and services sectors that have contributed to higher economic growth in recent years. However, an increasing mismatch in labour supply and demand is reflected by the high rate of youth unemployment, including graduates, and their desire to join the already large public service, while certain sectors in the private sector are finding it difficult to recruit necessary skilled labour. Meanwhile, improving productivity in the agriculture sector is a prerequisite to achieve the envisaged target growth in the agriculture sector and a more balanced regional development in view of the declining labour force available for agriculture employment.

Although Sri Lanka's educational achievements in terms of literacy rates, primary and secondary education are commendable and on par with developed countries, tertiary education, particularly the university education, is lagging behind regional peers. The admission to university education in Sri Lanka is extremely competitive, and not more than 15 per cent of those qualified for university education gain admission to local public universities. Even those 15 per cent of best students have to face a supply driven university education system which has little relevance to labour market requirements and entrepreneurial culture, creating a mismatch between labour supply and demand. About 65 per cent of the students admitted to local universities study social sciences and humanities and a substantial proportion of such graduates encounter difficulties in finding productive employment. They remain unemployed or underemployed for a long period, leading to frustration and social problems. Financial or resource constraints also limit the improvement of the public university system, highlighting the need for securing alternative sources of financing. Therefore, the higher education system requires urgent reforms to provide a more relevant higher education for all and to address the mismatch in labour supply and demand (Box 8).

1.3 External Economic Environment and Outlook

The global economy continued to expand by over 4 per cent for the fifth consecutive year amidst a tight monetary policy stance adopted by several countries in the first half of 2007. During the second half of 2007, higher international oil and commodity prices and turbulence in financial markets resulting from the subprime meltdown that originated in the US, dented the growth momentum. The global economy, which grew at a healthy rate during the first three quarters of 2007 slowed markedly in the last quarter, largely due to turbulence in the financial markets. According to the World Economic Outlook (WEO, Update - January 2008) of the International Monetary Fund (IMF), the world economy is estimated to have grown by 4.9 per cent in 2007 as compared to a growth of 5.0 per cent in 2006. Economic growth in the US slowed significantly in the fourth quarter with the weakening of manufacturing and housing sector activity. However, rapid growth in China, India, Russia and Brazil has offset the moderate growth in US and these countries together accounted for about one-half of global growth over the past year. The other emerging market and developing countries have also maintained robust growth. Growth has slowed in the Euro area, partly due to the strengthening of the euro and the slowing down of the US economy. In Japan, growth has been dampened due to slowing construction industry arising from tightening in building standards, slower global growth and relatively stronger yen.

The global financial market conditions have become more volatile since the emergence of the subprime crisis triggered by defaults in the US subprime mortgage market (Box 18). The coordinated operations by a number of central banks in the developed countries in the form of rate cuts and liquidity injections have helped ease liquidity shortages in the inter-bank markets. Emerging markets have remained resilient so far, as underlying growth and better policy environments have supported the continuation of strong capital inflows, though recent falls in equity prices suggest that some emerging markets may not be able to avoid spill-overs.

The short-term interest rates had been rising in many countries prior to the subprime crisis as they had been tightening their monetary policy stance to check rising inflation. Short-term interest rates had been rising until July as central banks around the world were raising policy rates to contain inflationary pressures arising largely from excess liquidity in the market and rising commodity prices. The international prices of essential food items increased at an exceptionally rapid pace due to increased use of corn and other food items for bio-fuel production, poor weather conditions and supply disruptions in a number of countries. However, with the turbulence in the international financial markets since July 2007, central banks in the major advanced economies injected a substantial amount of liquidity through open market operations to stabilise the overnight interest rates. Meanwhile, countries such as Japan, Australia, Korea, China, Chile, Mexico and Euro area raised their policy rates during the year. The turbulence in the global financial markets has heightened uncertainties and poses challenges to the conduct of monetary policy, especially for developing and emerging market countries.

The major currencies have been largely following the same trends observed in 2006. The US dollar continued to weaken against other major currencies during 2007 with the higher current account deficit and slowing down of the economy. During 2007, the dollar weakened at a faster rate against the euro and Indian rupee, while it depreciated at a lower rate against the sterling pound and the Japanese yen. The renminbi continued to strengthen against the US dollar with the soaring international reserves of China, resulting from a higher current account surplus and strong financial inflows. Higher capital inflows to India by way of portfolio investment and continuing growth momentum led to the appreciation of the Indian rupee. The euro strengthened due to a relatively lower inflation and a more modest slowdown in the euro area economies as compared to other advanced countries.

The global economy is projected to grow at 4.1 per cent in 2008, a growth rate above 4.0 per cent for the sixth consecutive year, but lower than the 4.9 per cent growth in 2007. The moderating global economic expansion is due to financial strains in the advanced economies following from the US subprime sector and possible spill-over effects of slowing down of financial inflows to emerging market economies. The advanced economies are projected to grow at a lower rate of 1.8 per cent in 2008 as compared to a growth of 2.6 per cent in 2007. The US and Euro areas, the major export destinations for Sri Lanka's exports, are projected to grow at a moderate rate of 1.5 per cent and 1.6 per cent, respectively in 2008, compared to an estimated growth of 2.2 per cent and 2.6 per cent, respectively, in 2007. Growth in emerging market and developing economies is also expected to moderate from 7.8 per cent in 2007 to 6.9 per cent in 2008. Growth in emerging market economies that are dependent on foreign capital flows may be affected

Table 1.4 **Global Economic Development and Outlook**
(Annual percentage change unless otherwise indicated)

Item	Actual		Projections	
	2005	2006	2007	2008
World output	4.4	5.0	4.9	4.1
Advanced economies	2.5	3.0	2.6	1.8
United States	3.1	2.9	2.2	1.5
Euro area	1.5	2.8	2.6	1.6
United Kingdom	1.8	2.8	3.1	2.3
Japan	1.9	2.4	1.9	1.5
Developing countries	7.0	7.7	7.8	6.9
Developing Asia	9.0	9.6	9.6	8.6
China	10.4	11.1	11.4	10.0
India	9.0	9.7	8.9	8.4
World trade volume (Goods and services)	7.5	9.2	6.6	6.7
Imports				
Advanced economies	6.1	7.4	4.3	5.0
Developing economies	12.1	14.9	12.5	11.3
Exports				
Advanced economies	5.8	8.2	5.4	5.3
Developing economies	11.1	11.0	9.2	9.0
Price Movements				
Consumer prices				
Advanced economies	2.3	2.3	2.1	2.0
Developing economies	5.2	5.1	5.9	5.3
Commodity prices (US dollars)				
Oil	41.3	20.5	6.6	9.5
Non-fuel	10.3	28.4	12.2	-6.7
Six-month London Inter-Bank Offered Rate (per cent) on US dollar deposits	3.8	5.4	5.4	5.5

Source: World Economic Outlook (January 2008 & October 2007), IMF

due to the global credit crunch and liquidity squeeze. However, these economies are likely to benefit from the strong momentum of domestic demand and more disciplined macroeconomic policy frameworks. The economies which are commodity exporters continue to benefit from high food and energy prices. The downside risks to the global growth projections are intensifying with the spill-over effects of the subprime crisis. In order to avoid a slowdown or to avert a recession, the US Federal Reserve has initiated sharp rate cuts and the US government has introduced a fiscal stimulus package to boost consumption and investment.

Global inflation is likely to increase further in 2008 with the rising international commodity prices, narrowing output gaps and the expansionary fiscal and relaxed monetary policies implemented by advanced economies to address the economic slowdown and subprime related liquidity shortages. Rising international prices of crude oil and essential food items have been sources of rising inflation globally, especially in emerging market and developing countries, where food items often represent 35-40 per cent or more of their consumption basket (Box 17). Although the global economy is projected to slow down marginally in 2008, oil prices are expected to remain high as emerging and developing countries are projected to grow at a higher rate in 2008. Any supply shocks or heightened geo-political concerns could lead to further price hikes and cause higher inflation. Another source of inflation is the closing output gaps in several developed and emerging market countries, where the continuous higher growth recorded in those countries in recent years has resulted in full utilisation of production capacities. Any further expansion in these countries is likely to lead to demand for higher wages and cost-push inflation. However, the recent strains in global financial markets may lead to a slowdown in these countries and ease pressure in the labour markets. Therefore, inflation pressures in advanced countries are expected to subdue as economies slow, although there are serious concerns about possible second-round effects in some countries. In some emerging market countries inflation will continue to remain a major policy concern.

1.4 Medium Term Macroeconomic Outlook, Challenges and Policies

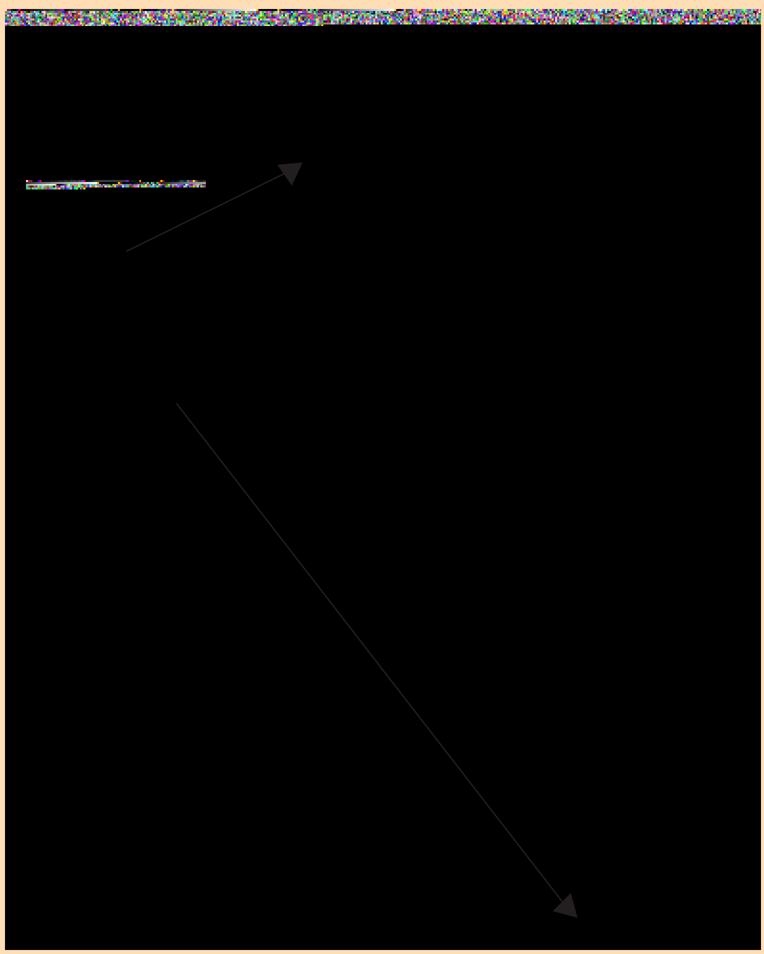
The *"Ten-year Vision"* targets a growth rate of above 8 per cent in the medium-term with a broad-based growth in all three sectors of the economy. The growth momentum in the economy is expected to continue further in the medium-term with the implementation of planned infrastructure projects by the government in the regions and various projects already implemented and expected to be implemented under the "*Reawakening of the East*" programme in the Eastern province (Box 2). Private investments are also expected to increase further in the medium-term, supporting the higher growth. Total investment as a percentage of GDP is projected to rise to over 30 per cent in the medium-term. Private investment as a percentage of GDP is projected to exceed 22 per cent, while that of the government is projected to rise over 8 per cent. In order to encourage both domestic and foreign investment, it is essential to develop basic infrastructure facilities to international standards.

The FDI flows, which have increased significantly in recent years, are also expected to continue at a similar pace in the medium-term as evidenced by the number of agreements approved and contracted by the Board of Investment in 2007. In the medium-term, the private sector is expected to raise more capital from international capital markets for their investments as the government now

Box 2 — The Development of the Eastern Province: Potential and Strategies

The Eastern Province (EP) of Sri Lanka, which comprises the districts of Trincomalee, Batticaloa and Ampara, is rich in resources, ranging from paddy fields, forests, scrublands, wetlands, bays and lagoons.[1] It also boasts of one of the largest natural harbours of the world. However, the internal conflict over the past two and a half decades has taken a toll in terms of economic development and stymied the EP growth rates to about 5 per cent during the period 2002-2006.[2] Although the EP accounts for 15 per cent of the country's land area, and 7.9 per cent of the total population, its contribution to GDP remains abysmally low at 4.7 per cent as the EP continues to be a poverty ridden, lagging region. Towards the end of 2007, however, the government wrested control of the lands that were being dominated by the terrorist groups and created a conducive environment for the resumption of normalcy in the region.

Figure B 2.1 — **Map of the Eastern Province**



Source : Three-year Eastern Province Development Plan: 2007-2010, Department of National Planinng, Novmber 2007

[1] The EP covers a land area of 9,361 square kilometres accounting for about 15 per cent of the total land area of the country. The agricultural land of 450,450 hectares in the EP accounts for about 26 per cent of the agricultural land in the entire country. The population is about 1.6 million, which is about 7.9 per cent of the total population. In 2006, the services sector contributed to about 50 per cent of the GDP in the EP while agriculture and industry sector shares were 23 per cent and 27 per cent, respectively.

[2] Sri Lanka Socio-Economic Data 2007

Table B 2.1
Summary of Investment Plan in Eastern Province by Main Sectors/Programmes

Amounts in Rs. billion

Sector/Programme	2007	2008	2009	2010	Total	Per cent of Total
Resettlement of returnees	3.7	4.8	6.0	7.0	21.5	10.8
Revitalising productive sectors and regional economy	2.1	8.7	10.9	12.2	33.9	17.1
Improving economic infrastructure	11.8	21.3	25.8	24.9	83.8	42.2
Strengthening social infrastructure and fostering social services	2.0	6.4	5.3	5.4	19.1	9.6
Human settlements development	6.5	9.3	11.1	11.1	38.0	19.1
Public institutions capacity building	0.5	0.5	0.6	0.6	2.2	1.2
Total	**26.6**	**51.0**	**59.7**	**61.2**	**198.5**	**100.0**

Source: Three-year Eastern Province Development Plan: 2007-2010, Department of National Planning, November 2007.

Consequently, it has been reported that an increasing number of internally displaced persons (IDPs) in the EP has returned to their former living areas.[3]

The vast potential in the EP suggests that, with time, if the available resources are tapped appropriately, it could unleash a new source of growth that would be a huge boost to the national economy. The agricultural, fisheries, forestry and mining sectors, in particular, have a significant potential that can make an important contribution to economic growth, and thereby improve the living standards of the people in the region.

The potential in the EP, which is mostly based on rich endowments, could be summarised into several areas. First and foremost, the Trincomalee Port has the potential of becoming a major commercial and industrial hub for the South Asian region. The coastline that stretches 436 km, harbouring large stretches of beautiful beaches and ecological conservation areas, could be tapped to support a vibrant tourism industry. Access to vast stretches of sea offers opportunities to develop the fisheries resources. The rich soil conditions, the high level of precipitation brought about by the Northeast monsoons and the large extents of sparsely populated areas make the EP an ideal place for high intensity agricultural practices.

In line with this, the government has introduced a "Three-year Eastern Province Development Plan: 2007-2010" (Neganahira Navodaya or Eastern Revival), which intends to improve and upgrade the infrastructure and supportive services in the province, enabling a sustainable economic revival. The plan, envisages the immediate restoration of fundamental rights and ensuring the safety of the people and communities of the region before delving into reinstating their livelihoods. The Neganahira Navodaya (NN) programme intends to develop the agriculture, fisheries, industries, tourism sectors through the development of economic infrastructure, human and natural resources over the next three years.

As indicated in Table B 2.1, the total investment required for the implementation of the strategies in the NN programme is estimated to be Rs. 198.5 billion, including the allocation of Rs. 26.6 billion made for the financial year 2007. The highest amount (Rs. 83.8 billion) would be allocated for improving economic infrastructure, while Rs. 33.9 billion would be allocated for revitalizing productive sectors and the regional economy. Rs. 59.5 billion would be allocated for the development of human settlements and re-settlement of returnees. With respect to financing the NN Programme, about 52 per cent of the total investment cost will be borne by the Treasury, from foreign resources, while 30 per cent will be directly allocated by the Treasury, out of its own funds. The balance 18 per cent will be available for investment by the private sector and Non-Governmental Organizations.

The short-term initiatives include a 180 day programme undertaken by the Ministry of Nation Building,which ended by December 2007, for the restoration of civil administration and service delivery in the EP. The programme included clearing landmines to allow for the resumption of farming, re-establishing road connections and restoring basic needs such as water supply, sanitation and electricity, as well as setting up police posts, hospitals and civil administration, to allow for returnees to settle back.

With respect to developing the industries, under the NN, the government has already introduced a number of incentives to encourage investments in the EP. Through Budget 2008, it introduced new tax relief measures for

[3] According to the reports by the United Nations High Commission for Refugees (UNHCR), as at end of January 2008, the number of IDPs who returned to the East was 170,763.

investments over Rs. 50 million in the EP that provide employment opportunities for more than 50 people. In respect of such investments, the profits and income will be exempted from income tax for a period of 5 years commencing from; (a) the year of assessment in which the relevant new undertaking commences to make profits, or (b) the year of assessment in which the undertaking completes 3 years from the commencement of the commercial operations of that undertaking; whichever occurs earlier. In addition, pre-identified plant and machinery that are imported for the use of the new undertakings which will be established in the EP are entitled for customs duty waivers and VAT exemptions.

The NN intends to develop the rural areas through the revitalisation of the productive sectors of the economy. This includes developments in crop agriculture, irrigation, fisheries and livestock sectors through enhancing productivity, improving the quality of products and increasing accessibility to markets, which are expected to motivate investments in the production, processing and value addition in these sectors. The Government intends to establish industrial zones and estates to facilitate industrial development. The NN has also devised strategies to develop the domestic and international tourism sectors in the EP through the rehabilitation of existing resorts along the coast.

This would be followed by measures aimed at improving the economic infrastructure of the region. With respect to power, only 58 per cent of the households in the EP have access to electricity from the national grid. Hence, the NN envisages increasing the power generation capacity through the construction of a 500 MW coal fired power plant in Trincomalee. It also envisages the construction of several substations and transmission lines to enhance the existing circuit and the extension of the rural electrification grid through nearly 300 schemes to light up the villages of the EP. With respect to the road sector, 17 ongoing projects to rehabilitate and improve the existing roads and bridges network and the proposed new roads and bridges are expected to improve connectivity between the consumers and the producers, reduce the cost of transport, improve linkages with other provinces and open backward areas to economic development. Public transport services are also expected to be revitalized to provide better transport services and strengthen coordination of railway and bus services.

Trincomalee harbour is expected to be developed through a public-private-partnership, and its port is to be developed to a Port City using 10,565 acres of land surrounding it. A fisheries harbour is also being developed at Oluvil in the Ampara District, through the construction of two breakwaters and the dredging of the harbour basin to accommodate larger vessels. In addition to these large scale infrastructure projects, NN also expects to improve the water supply and sanitation conditions of the region through enhanced access to pipe borne water.

The revival of the EP would not only improve the livelihoods of the people in the EP, but would also contribute towards the development of the adjacent provinces through the trickle down effect and in this manner, would contribute towards the development of the entire country.

References:

1. Three-year Eastern Province Development Plan: 2007-2010, Department of National Planning, Ministry of Finance and Planning, November 2007.

2. Budget Speech: 2008, Ministry of Finance and Planning, November 2007.

encourages PPPs and intends to relax restrictions on foreign borrowings by the private sector as announced in the Budget 2008. The external demand for Sri Lanka's major exports is projected to grow with continued global growth, and support the achievement of higher growth.

Although the global economic growth is expected to moderate to around 4.1 per cent in 2008 with the ongoing subprime issue and credit crunch, it is expected to rebound in the medium-term. By end 2007, the government had a financial commitment from development partners amounting to around US dollars 4.2 billion in the pipeline. Emerging market economies such as China, India and Iran are emerging as new development partners in addition to traditional multilateral and bilateral partners. Negotiations are also under way for new financial commitments from both bilateral and multilateral sources to fund various projects. Meanwhile, avenues to attract foreign funds for the government have also increased with the issuance of the international sovereign bond and foreign investment being permitted in rupee denominated Treasury bonds. The proceeds of these bonds could be used for providing counterpart funds and bridging finance relating to key infrastructure projects, leading to faster implementation and cost savings.

On the fiscal front, the government is aiming to increase revenue to around 19 per cent of GDP, in excess of current expenditure, to generate a revenue surplus, to limit government expenditure at around 23 per cent of GDP and contain the budget deficit at around 5 per cent of GDP in the medium-term. In order to increase the tax revenue and to contain tax evasion and avoidance, the government needs to implement the necessary measures to broaden the tax base, modernise and strengthen the tax administration and further strengthen the legal and regulatory framework. Meanwhile, the debt to GDP ratio is expected to be brought down to around 67 per cent of GDP in 2011 with the projected higher growth in the medium-term.

Bringing down inflation to a single digit from the current high levels would be a challenging task in view of rising commodity prices in international markets. The Central Bank in its "*Road Map for Monetary and Financial Sector Policies for 2008 and Beyond*", has announced strategies to bring down the inflation rate to around 10-11 per cent by end 2008. However, the achievement of this target will be significantly affected by various developments in the global economy, especially movements in the international prices of oil and other essential

Table 1.5 **Medium Term Macroeconomic Framework 2007 - 2011 (a)**

Indicator	Units	2006	2007(b)	Projections 2008	2009	2010	2011
Real Sector							
GDP at Market Prices	Rs. bn	2,939	3,578	4,307	5,047	5,923	6,911
Real GDP Growth	%	7.7	6.8	7.0	7.5	8.2	8.5
Inflation-GDP Deflator	%	11.3	14.0	12.5	9.0	8.5	7.5
Total Investment	%of GDP	28.0	27.9	30.0	31.5	32.5	33.2
Private Investment	%of GDP	20.9	20.7	22.0	23.0	24.4	25.2
Public Investment	%of GDP	7.1	7.2	8.0	8.5	8.1	8.0
Incremental Capital Output Ratio (ICOR)		3.4	4.1	4.0	4.0	3.8	3.8
Domestic Savings	%of GDP	17.0	17.6	20.4	22.1	23.3	24.5
Private Savings	%of GDP	19.4	19.2	19.5	20.3	20.8	21.6
Public Savings	%of GDP	-2.4	-1.6	0.9	1.8	2.5	2.9
National Saving	%of GDP	22.3	23.4	25.7	27.4	28.5	29.5
External Sector							
Trade Gap	US$ mn	-3,371	-3,560	-3,970	-4,365	-4,803	-5,149
Exports	US$ mn	6,883	7,740	8,529	9,395	10,339	11,356
Imports	US$ mn	10,254	11,301	12,499	13,760	15,142	16,505
Services	US$ mn	257	238	312	370	414	478
Receipts	US$ mn	1,625	1,712	1,938	2,156	2,364	2,592
Payments	US$ mn	1,368	1,474	1,626	1,786	1,949	2,114
Current Account Balance	US$ mn	-1,498	-1,369	-1,545	-1,664	-1,881	-1,974
Current Account Balance	%of GDP	-5.3	-4.2	-4.0	-3.9	-3.9	-3.7
Overall Balance	US$ mn	204	531	400	396	388	376
External Official Reserves (Months of Imports)	Months	3.0	3.3	3.3	3.2	3.2	3.2
Debt Service Ratio (c)	%	12.8	13.0	14.9	13.3	9.6	8.8
Fiscal Sector (d)							
Revenue	%of GDP	16.3	15.8	17.4	18.0	18.5	18.5
Expenditure	%of GDP	24.3	23.5	24.2	23.9	23.7	23.3
Current Account Balance	%of GDP	-2.4	-1.6	0.9	1.8	2.5	2.9
Overall Budget Deficit	%of GDP	-8.0	-7.7	-6.8	-5.8	-5.2	-4.8
Domestic Financing	%of GDP	5.6	3.6	3.6	2.6	2.2	2.1
Financial Sector (e)							
Reserve Money Growth	%	21.2	10.2	15.0	15.0	14.5	14.5
Broad Money Growth (M2b)	%	17.8	16.6	15.5	15.5	15.0	15.0
Narrow Money Growth (M1)	%	12.6	2.7	5.5	5.5	5.0	5.0
Growth in Credit to Private Sector	%	24.0	19.3	17.5	17.0	16.5	16.8
Growth in Credit to Public Sector	%	38.8	8.9	-3.1	-0.7	-0.7	-0.7

(a) Based on the information available as at mid-March 2008.
(b) Provisional.
(c) Total debt service payments as a percentage of earnings from merchandise exports and services.
(d) Projected Fiscal sector ratios from 2008 are different from the ratios published in the Budget 2008 due to the revised nominal GDP estimates.
(e) Point-to-point growth in end-year values.

Sources: Ministry of Finance and Planning
Central Bank of Sri Lanka
Department of Census and Statistics

commodities. Currently, serious inflationary pressures are building up world-wide, largely due to a sharp rise in commodity prices, including higher food prices resulting from increased use of certain food crops for bio-fuel production, and adverse weather conditions. In this context, monetary policy will be directed towards containing inflationary pressures arising from higher domestic demand, without affecting the continuous higher growth prospects. The Central Bank has been modifying and improving the monetary targeting framework in line with global developments with a view to moving towards inflation targeting framework in the medium-term (Box 1).

Fiscal policy measures are expected to supplement the conduct of monetary policy in order to bring down inflation to a reasonable level. In order to facilitate monetary management aimed at achieving sustainable low inflation to support a higher and sustainable economic growth and stabilise the exchange rate, it is vital that the government follows a prudent and sustainable fiscal management strategy. Increased borrowings by the government and SOEs from the banking sector to finance their revenue deficits not only crowd-out private sector investment and retard the country's growth potential, but also weakens the effectiveness of monetary management, as these borrowings are insensitive to market interest rates. Currently, salaries and wages, pension and interest payments of the government alone absorb about 75 per cent of fiscal revenue, leaving little for other government expenses including vital public investment. Continuous recruitment to the public service and increased government borrowings would further raise the current account deficit with higher payments of salaries and wages and increased interest payments. Meanwhile, the government would need to continue passing on the rising international commodity prices to the final consumers gradually, with sufficient safeguards for vulnerable groups in the society, to reduce government's subsidy costs and subsidy induced higher consumption. Therefore, the government fiscal strategy should primarily focus on rationalising the recurrent expenditure of the government and maximising government tax revenue. Any favourable outcome in fiscal management would help the conduct of sound monetary management, leading to higher growth and low inflation in the medium-term.

A sound public debt management strategy is essential to reduce the cost of borrowing of the government and to lengthen the maturity period of debt. In recent years, the government's domestic borrowing has been largely concentrated on shorter maturities, as the market preference has been for shorter maturities in view of higher inflation expectations. This led to the bunching of loan repayments, warranting the re-issue of government securities at higher rates. In order to further develop the government debt securities market and to reduce the cost of borrowing to the government, the public debt management strategy should focus on raising required funds through issuing longer-term securities in the market, thereby improving the yield curve and government cash flow management. At the same time, public awareness on government securities should be further enhanced to increase public subscriptions to these securities, which provide relatively higher yields as compared to bank deposits.

The country's widening savings-investment gap needs to be filled with more non-debt creating foreign inflows as debt flows would increase the future debt burden of the country. In addition, investment flows generally bring in sophisticated technology, managerial skills, overseas market access, etc. Increased market access to the highly populated Indian and Pakistani markets under the free trade agreements (FTAs) could act as an incentive to attract FDIs. Local companies should also be encouraged to list on the CSE, which remains one of the better performing markets in Asia, in order to attract more foreign inflows. In order to promote a sustainable growth, it is essential to promote trade and FDI, while encouraging FDI in mega projects to develop basic infrastructure facilities to international standards. In this regard, maintaining law and order, easing procedures in doing business, strengthening the legal system and dispute settlement mechanisms, removing bureaucratic hurdles, simplifying customs procedures, maintaining a stable macroeconomic environment and providing better infrastructure facilities could act as better incentives, rather than providing tax holidays and tax exemptions. Moreover, tax holidays and numerous tax exemptions given to the investors need to be rationalised to enhance the government tax revenue as the government invests substantially for the development of infrastructure and other facilities.

The structural weaknesses in the energy sector remain a serious concern and need to be addressed without further delay to support the future growth prospects of the country and to improve the commercial viability of the Ceylon Electricity Board (CEB) and CPC. The unit cost of power in Sri Lanka is relatively high compared to other countries in the region and trade competing countries. As power is an essential input in manufacturing, agro processing, small industries and services sector industries, it is essential to ensure an uninterrupted power supply at a reasonable cost to sustain the growth in these industries. The power sector remains a government monopoly with numerous structural weaknesses, raising concerns on the commercial viability of the CEB. The private sector has been engaged in thermal power generation on unfavourable terms and conditions to the CEB, further increasing the cost of power generation beyond reasonable levels (Box 7). In order to ensure uninterrupted power supply at a reasonable cost and to ensure commercial viability of the CEB, it is essential for the CEB to procure cheaper power from the private sector power producers, under properly structured PPP arrangements on the basis of competitive bidding mechanisms. Further, to address the structural issues at the CEB to ensure its commercial viability, new strategies need to be introduced and implemented. Any delay in implementing the necessary improvements would weaken the financial viability of the CEB further, and adversely impact on the future growth of the country by retarding growth in all industries through higher tariff and, inadequate and unreliable power supply.

Sri Lanka, being an importer of petroleum products, has been effectively meeting challenges from the continuous rise in global oil prices. However, the external sector vulnerability may increase if oil prices exceed sustainable levels. The oil import bill is projected to exceed US dollars 3 billion in 2008, accounting for about 25 per cent of total import expenditure, and is likely to exert pressure on the balance of payments, unless the country receives sufficient foreign flows. In this context, reducing oil imports by encouraging efficient use of energy through the introduction of energy saving devices, discouraging imports of fuel inefficient motor vehicles, streamlining traffic congestion, passing on international price increases to final consumers, economising on the use of power and motor vehicles in the state and local government institutions, and educating the general public on the need for saving energy would help to mitigate the adverse impact of rising oil prices on macroeconomic stability.

Inefficient transport facilities, poor road network and traffic congestion in almost all major cities remain serious problems and adversely impact on economic growth through reduced productivity. The road network has not been expanded sufficiently to keep pace with higher economic growth and increasing vehicle stock. The existing road network is not properly maintained, leading to poor quality of roads and traffic congestion. The public bus passenger transport services have not improved, notwithstanding the private sector involvement in this sector. The railway still suffers losses due to low fares, which have not been revised for a considerable period, despite increases in oil prices and operational costs. The cost of transportation of goods is also high due to poor roads and traffic congestion leading to high cost of consumer goods. In addition, the traffic congestion results in wastage of fuel, which costs the country dearly. As an efficient transport system with a better road network is necessary to support higher economic growth and improve total factor productivity of the economy, the government should accelerate the implementation of highways and expressway projects, while implementing necessary measures to improve the public transport system. An improvement in road networks and transportation would also contribute to the poverty alleviation efforts of the government by providing increased market access to goods produced in the provinces.

Unemployment, which is estimated to have declined to the lowest recorded level in the fourth quarter of 2007, indicates a potential hindrance to future higher growth prospects unless labour productivity is improved substantially. The higher expansion of the economy in recent years, together with a sharp rise in public sector recruitments led to a significant reduction in the unemployment rate to 6.0 per cent at end 2007 from a rate of 7.7 per cent in 2005. The recruitment to the public sector on an *ad hoc* basis and the availability of non-performance based benefits in the public sector not only discourage unemployed youth from joining the private sector, but also encourage those already engaged in the private sector to join the public sector. Increasing public sector employment, not only leads to overstaffing of public services, resulting in higher underemployment and higher recurrent expenditure to the government, but also creates a shortage of workers in the private sector. Hence, it is necessary for the government to formulate an effective recruitment policy to select only the required cadre for public service on a merit basis.

The continuing higher global food prices provide an immense opportunity for the agricultural sector to grow strongly. Both domestic and plantation agriculture benefited from higher prices during 2007 and this trend is likely to continue in the medium-term. Tea exports exceeded the US dollars 1 billion mark in 2007, thereby encouraging further value addition in this sector rather than exporting in bulk form. Penetrating into the vast Indian and Pakistani markets under FTAs would also help this industry to harness its full potential. Paddy, coconut and several other agricultural products fetched higher prices in 2007 and in that context, government should move away from providing fertiliser subsidies for selected crops. Instead, the government should invest in agri-infrastructure such as irrigation facilities, tanks, extension and advisory services, a better road network in the backward regions and in research and development to ensure productivity improvement in the sector. Promoting the forward contracts concept among farmers and traders and effectively tackling the problems in marketing produce in major agricultural areas would ensure stable prices (Box 11). The agriculture sector is currently facing labour shortages and hence it is essential to introduce mechanisation in certain processes of cultivation. Therefore, implementation of a sound and dynamic agricultural policy to address the issues in this sector and increase agricultural production will ease the cost of living through improvements in the supply of essential food items.

As an island nation surrounded by the sea, Sri Lanka has not yet harnessed the full potential of its invaluable marine resources. Despite various incentives provided by successive governments, the country's fish production still remains well below the full potential. An effective fishing sector development strategy by the government involving the private sector would lead to the development of this sector, resulting in higher production as well as earning foreign exchange from exports of fish produce. Such a strategy would lead to increased sea based economic activities creating more employment opportunities, especially for youth in the fishing community and would contribute to higher future economic growth. It is important that the development strategy for this sector should aim to involve both foreign and local investors to increase the domestic value addition in this sector with the government facilitating the process by developing necessary infrastructure and encouraging the use of new technology (Box 5).

The process of oil exploration in the Mannar Basin was launched in 2007. An analysis of seismic data acquired by the government shows a significant potential of presence of hydrocarbons (oil/gas) in the surveyed area in the Mannar Basin. Out of the eight blocks demarcated, two blocks have already been reserved for India and China for exploration, while the Petroleum Resources Development Committee (PRDC) has called for international competitive bids for exploration licences for three blocks and bids are currently being evaluated. The petroleum resources, if explored successfully, would be the most valuable natural resource of the country and would have a significant commercial value. This would generate major economic and social benefits to the country, provided that exploration of petroleum resources are managed professionally and prudently. Hence, maximisation of benefits to the country in a sustainable manner should be of utmost priority in the whole process of petroleum resources development. In this respect, marketing effectively and thereby attracting credible investors, maintaining transparency and accountability, designing constructive long-term policies and strategies, setting up an effective institutional framework, strengthening data management and analysis, managing, regulation and monitoring effectively etc., would be crucial in successful exploration of petroleum resources. At the same time, action needs to be initiated to explore petroleum resources in other areas off the shores of Sri Lanka, including the Cauvery Basin, which is considered to be an area where hydrocarbon resources have been proven to exist (Box 3).

Box 3

Oil Exploration in the Mannar Basin

Sri Lanka's efforts in oil exploration dates back to 1960s, when Sri Lanka acquired first offshore reflective seismic data in the Northwestern region in 1967. Thereafter, between 1974 and 1981 seven exploratory wells (3 onshore and 4 offshore-shallow water) were drilled with assistance from Russian and US companies. Although some evidence of presence of hydrocarbons was found, no serious efforts were made to extract oil, as it was said to be commercially unviable, given the depth of reserves and technology available at the time. Lack of a long-term committed and consistent policy and appropriate institutional framework also led to abandon first attempts of oil exploration.

Recent efforts of oil exploration commenced with a 2-D (Two Dimensional) seismic survey programme carried out by TGS-NOPEC, a Norwegian oil company, in the Mannar Basin in 2001 (phase I) and 2005 (phase II) under an agreement entered into between the government of Sri Lanka and TGS-NOPEC. The seismic surveys covered the area from the coastline of Western Sri Lanka to the maritime boundary with South-eastern India. Water depths of the study area ranged from 50-3000 metres. The seismic survey data were subsequently acquired by the government in 2006 and analysis of these data show significant potential of the presence of hydrocarbons (oil/gas) in the surveyed area. Although not studied in detail, it is believed that there is a high potential of hydrocarbons in the Cauvery basin and other offshore areas of the country. A satellite gravity survey has also been conducted in 2002 by a Swedish Company.

The Ministry of Petroleum and Petroleum Resources Development functions as the overall policy setting institution in petroleum exploration. The Petroleum Resources Act No. 26 of 2003 is in place to provide the legal framework. The Petroleum Resources Development Committee (PRDC), which is set up under the Act and mainly comprises of Secretaries of relevant ministries, is charged with the responsibility of effective implementation of the provisions of the Act. The Petroleum Resources Development Secretariat (PRDS), headed by a Director General assists PRDC.

The 2-D seismic survey in the Mannar basin covers an area of 33,715 sq. km. divided into 8 blocks as shown in Table B 3.1. According to available information, two of these blocks i.e., block No. 1 and No. 8, have been reserved for India and China, respectively, on nomination basis for oil exploration. The PRDC has called international competitive bids for exploration licences in respect of 3 of the remaining 6 blocks (Block No. 2, 3 and 4) and certain bids have been received already.

Table B 3.1
Mannar Basin Licensing Round 1 – Details of Blocks

Block	Area (Sq.Km)	Remarks
1	3,501	Reserved
2	3,338	Bids called
3	3,572	Bids called
4	4,127	Bids called
5	6,644	
6	3,567	
7	3,970	
8	4,995	Reserved
Total	**33,714**	
Excluding Blocks 1 & 8	**25,218**	

Source: Ministry of Petroleum and Petroleum Resources Development

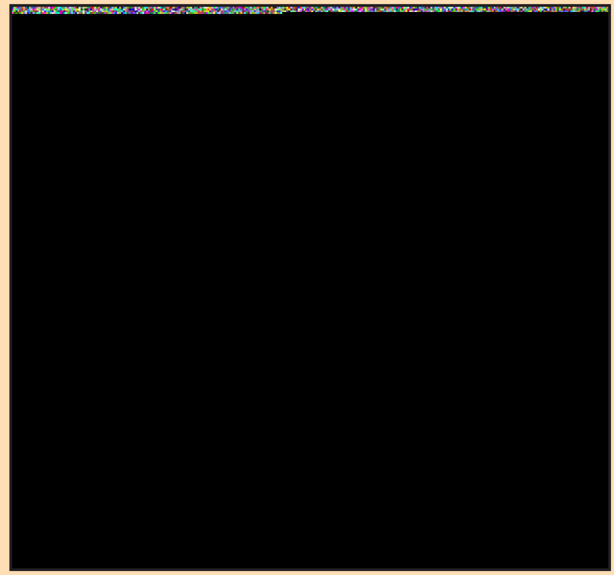
These petroleum resources, if explored successfully, would be the most valuable natural resource of the country that has a significant commercial value. It would generate massive economic and social benefits to the country provided that exploration, development and production of petroleum resources are managed prudently. Hence, maximisation of benefits to the country in a sustainable manner should be of utmost priority in the whole process of petroleum resources development. Some countries, which have not been able to develop petroleum resources in a prudent manner, have not been able to derive the potential benefit through development of such resources. Hence, effective marketing, attracting credible investors, maintaining transparency and accountability, designing constructive long-term policies and strategies, setting up an effective institutional framework, strengthening data management and analysis, effective regulation, management and monitoring etc. would be crucial in the successful exploration of petroleum resources.

As shown in seismic surveys, hydrocarbon deposits are expected in the deep sea (400 – 1,500 metres) and ultra-deep sea (>1,500 metres) areas of Mannar basin, making oil exploration more difficult and expensive. As per estimates, it would cost around US dollars 60 million to drill a well in the deep sea. Generally, it takes about 7-8 years for exploration, development and production of oil

Figure B 3.1
Mannar Basin

Source: Ministry of Petroleum and Petroleum Resources Development

Figure B 3.2
Mannar Basin Licensing of Blocks



Source: Ministry of Petroleum and Petroleum Resources Development

even in a proven field. At the same time, given the high oil prices in the world market, many countries have opened new fields for oil exploration and have introduced various incentives to attract investors. Hence, Mannar basin being a virgin field, Sri Lanka would need to pay more attention on marketing and attracting good investors. More than fiscal incentives, maintaining credibility, transparency and accountability will be crucial in attracting reputed investors.

A well-structured institutional arrangement should exist for policy formulation, management, regulation, and supervision of oil exploration, development and production. In this respect, a high-capacity decision making body would be required for policy making at macro level and guiding oil exploration to become a dynamic and well-positioned industry in the long run. Given the high national importance of oil exploration, such institutions are headed by none other than the head of the state in some countries of successful oil exploration.

The mobilisation and strengthening of the human resources required for all areas of oil exploration such as Geology, Geo-Physics, Energy Economics and Risk Analysis, etc., and the acquisition of the necessary technical know-how are also very important for successful implementation of oil exploration projects. At the same time, with the start of oil exploration, there will be new demand for goods and services as well as labour that is needed for the oil industry, creating strong forward and backward linkages in economic activities. The new demand will be interalia, in the areas of banking, insurance, construction, transportation, utility services, technical and other infrastructure related services.

Hence, considering the national importance of oil exploration and consistently rising oil prices in the world market, there is a pressing need for encouraging investments and embarking on oil exploration as early as possible. Creating a healthy competition along with prudential setting of the business environment would ensure maximum benefits to the country. Long-term planning and maintaining credibility, transparency and accountability in the decision making process would play a vital role in attracting investments. At the same time, actions need to be initiated to explore petroleum resources in other areas of offshore Sri Lanka including Cauvery basin, which is considered to be a proven area of existence of hydrocarbon.