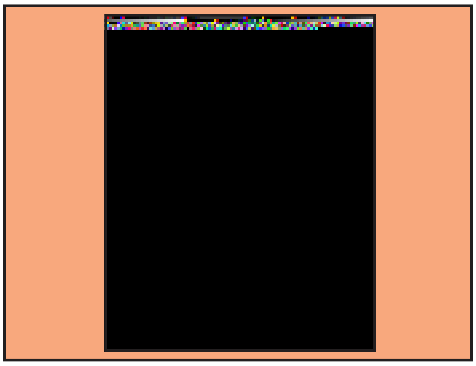


Chapter 1

ECONOMIC, PRICE AND FINANCIAL SYSTEM STABILITY, OUTLOOK AND POLICIES

1.1 Macroeconomic Developments, Stability and Policy Responses in 2006

Sri Lanka continued on an economic expansion path in 2006 demonstrating its sustained resilience recording a 7.4 per cent growth rate, the highest since 1978 and an unemployment rate of 6.5 per cent, the lowest ever. Despite these favourable developments, emerging inflationary threats posed a serious challenge for policy makers. Therefore, the monetary policy thrust was persistently directed towards curbing the rising inflation pressure and inflation expectations.

Even in the midst of such threats to price stability, the salutory feature of the financial sector was its continuous expansion while remaining resilient to withstand challenges. The economic expansion was commendable as it was achieved amidst several major challenges: the highest international oil prices; escalation of terrorist activity; increased counter terrorism measures; natural disasters such as floods and landslides; need to accelerate the post tsunami reconstruction; and intense competition for exports. The country's per capita income rose to US dollars 1,355. Exports continued to grow with the enhanced global competitiveness, and imports grew to support the growing expansion of the production capacity of the economy. The highest ever growth in worker remittances and highest ever inflows of foreign direct investment and external financing to the government helped to finance growing trade and current account deficits, resulting in a surplus of US dollars 204 million in the country's balance of payments in 2006. The fiscal consolidation process continued with further improvement in government revenue and a decline in government debt as a percentage of GDP while accommodating high public investment on multiple infrastructure development projects. The decelerating trend in inflation experienced during the early part of the year reversed from April, mainly due to high monetary expansion. The upward revision in administered prices caused a one-off increase in price levels, but it was conducive for controlling inflation in the long term by closing avenues for further monetary expansion. Meanwhile, the supply disturbances that arose from adverse weather conditions during the latter part of the year resulted in negative supply shocks exerting pressure on prices. The continuation of the tight monetary policy measures, supplemented by some prudential measures, contained the demand driven inflation to some extent. In January 2007, the Central Bank introduced further measures, aimed at lowering inflation to a single digit level by end 2007. The further expansion in the financial markets was reflected in higher trading volumes, especially in stock and foreign exchange markets. The financial infrastructure was further strengthened and improved during 2006 together with the introduction of several legal enactments and the broadening of prudential regulations to enhance resilience of the financial system.

Continuous improvements in productivity is the key to achieving sustainable high growth with low inflation. Fundamental forces of productivity improvement are infrastructure development, technological improvement, human capital development and research and development. Sri Lanka needs to improve the economic and social infrastructure while providing the enabling environment to promote productivity improvements at firm level. All production sectors need to be conscious of the intensifying international competition, limitations in providing protection and the need for improving labour productivity to enhance competition. Such productivity improvements will help lower inflation, provide resources to compensate for wage increases while enhancing international competitiveness. It is also to be noted that Sri Lanka's productivity growth has been lower compared with emerging market economies especially in Asia. Had there been substantial improvements in productivity in the past, Sri Lanka may have been enjoying a higher per capita income at a lower rate of inflation.

Continuous efforts need to be made to maintain a sustainable high growth in excess of 8 per cent in the medium-term as projected in the Ten-year Horizon Development Framework 2006-2016 (Ten-year Vision) – the policy document of the Government. The Ten-year Vision has been prepared through an intensive consultative process involving all stakeholders of the economy in line with the *"Mahinda Chintana"* overall policy vision. The overall policy strategy has been designed to integrate the positive attributes of market based economic policies with domestic aspirations by providing the necessary support to domestic enterprises and encouraging foreign investments.

Box 1

Dealing with Inflationary Pressures in 2007 and Beyond

With respect to maintaining economic and price stability which is one of its main objectives, the Central Bank has formulated and is now implementing a policy strategy to achieve a non-inflationary high growth by maintaining monetary growth at a level appropriate for the growth in real output. The high monetary expansion and the surge in inflation experienced in 2006 were the two factors that had to be taken into consideration when monetary policy strategies for 2007 and beyond were formulated. Table B 1.1 shows quarterly reserve money targets on the basis of expected end-period values. Even though it is customary to set monetary targets on end period values, the end period measure may sometimes be misleading due to large daily fluctuations arising from long weekends, aberration of actual reserve money on the last day of the reserve week etc. Therefore, the comparison of the targets against the actual monthly averages, for the purpose of assessing the performance of monetary policy measures is also very useful, since the inflationary impact is closely correlated with the monthly average as well.

The monetary programme set for the medium term is based on the high growth path targeted by the government in the medium term. It therefore requires to contain the growth in money supply to reduce inflation to a low and a stable level during the period. Accordingly, as the long term policy, inflation has been targeted to gradually decline to a level of 4 per cent within the next 10-year period which is also consistent with the Ten-year vision of the government.

With the objective of enhancing the policy predictability and transparency by keeping the public informed in advance, the Central Bank announced the "Road Map for Monetary and Financial Sector Policies for 2007 and beyond" on 2nd January 2007[1]. It sets out the developments in the economy and the conduct of monetary and financial sector policies in the year 2006, challenges in meeting monetary policy objectives and financial stability in 2007, a detailed account of the Central Bank's monetary policy strategy in 2007 and beyond, policies for financial system stability in 2007 and beyond and policies for strengthening the economy.

As highlighted in the Road Map, the achievement of monetary targets in 2007 needs to be facilitated by the realisation of several key macro-economic targets which represent the developments in external, fiscal and monetary sectors in the economy. Hence, to ensure the realisation of the targets in 2007, a monitoring mechanism of key macroeconomic variables in these sectors has also been initiated. The key variables are given in Table B 1.2.

Table B 1.1
Quarterly Targets for Reserve Money

	2006 Actual	2007 Targets			
	Dec	Mar	Jun	Sep	Dec
Reserve Money (Rs. billion)	239.8	254.6	250.4	257.8	267.6
Point to point Change (End month) %	21.2	17.3	17.9	16.1	11.6

The government and the Central Bank have already established a mechanism to monitor these variables on a monthly basis to minimise the deviations from the given targets and take early policy measures to avoid any significant deviations.

As a further step in improving the monetary policy decision making process, a Monetary Policy Consultative Committee (MPCC) was established at the beginning of 2007 as announced in the Road Map on 2 January 2007, comprising of 7 stakeholders and economists representing the private sector. The monetary policy and implementation processes are expected to be strengthened further by the expertise and insight of the private sector members who will provide very useful insights into the monetary policy decision making process of the Bank. The US Fed Reserve also announced an appointment of a similar committee on 17 January 2007 for monetary policy purposes[2].

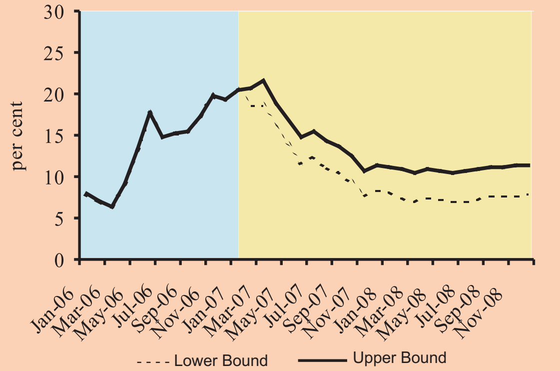
[1] The full report has been published in the Central Bank's website "www.cbsl.lk"
[2] The Wall Street Journal, 17 January 2007, "Central Bankers, Economists, to Meet in New Forum on Monetary Policy"

Table B 1.2
Key Variables in the Monitoring Mechanism

1. Net international reserves of the Central Bank
2. Government revenue
3. Recurrent expenditure of the government
4. Primary fiscal balance of the government
5. Net domestic financing of the government budget deficit
6. Reserve money of the Cenral Bank
7. Treasury bill holdings in net domestic assets of the Central Bank.
8. Banks' net claims on government
9. Credit to public corporations by the banking system

The concerted and combined efforts by all these stakeholders are expected to ensure the achievement of a low and stable inflation in the coming years, comparable with a sustainable high economic growth. The expected path of headline inflation in 2007 and 2008 are given in the Chart below.

Chart B 1.1
Forecast of Headline Inflation 2007-2008



Recognising the need for maintaining macroeconomic stability in achieving a sustainable and broadbased economic growth, the Ten-year Vision targets low and stable inflation of around 4 per cent and fiscal consolidation by reducing the budget deficit below 4 per cent and public debt to around 50 per cent of GDP by 2016. The thrust of the policy strategy is to unleash the growth potential of the country by addressing existing infrastructure and service bottlenecks by channelling a larger quantum of investment to ensure the continuous supply of energy, telecommunication services, drinking and irrigation water, roads, ports and airports and health and education facilities, etc. It is encouraging that all stakeholders including international development partners have now endorsed the Ten-year Vision and demonstrated their commitment by pledging necessary financial assistance for almost all planned infrastructure projects.

The implementation of planned infrastructure projects within the stipulated period is a prerequisite to achieving high growth. In the past, delays in the implementation of projects have been cited as one of the major reasons for achieving lower than potential growth. It is encouraging to note that the new policy strategy has placed a greater emphasis in addressing implementation issues. The continuation of such efforts is necessary to ensure the timely completion of major infrastructure projects in order to reap the benefits expected from infrastructure developments.

A significant improvement in operations of the state owned enterprises (SOEs) is critical to achieve the goals set out in the Ten-year Vision. SOEs are responsible for the management of several strategically important services such as electricity by the Ceylon Electricity Board (CEB); railways by the Sri Lanka Railways (SLR); water supply and drainage services by the National Water Supply and Drainage Board (NWSDB); over 80 per cent share of petroleum products importation (above 20 per cent of the country's imports) and distribution by the Ceylon Petroleum Corporation (CPC); over 50 per cent of banking services by the two state commercial banks; and 30 per cent of bus transport by the Sri Lanka Transport Board (SLTB). In that context, the assurance by the government of non-privatisation of SOEs should not be considered as a cover by those SOEs to continue enjoying monopolistic or large market shares in providing those services without concentrating on improvements of their services for the general public while ensuring efficient and cost effective infrastructure services. The non-privatisation policy imposes a serious corporate commitment on these enterprises to operate more efficiently, and thereby generating a reasonable rate of return to the government, while providing good quality services to the public without being a burden on the taxpayers. The provision of such level of services on an internationally competitive basis is a prerequisite to achieving high growth rates for a small open economy like Sri Lanka, which critically depends on its ability to compete in international markets in exporting goods and services. It is heartening to note that the Ten-year Vision has clearly recognized the importance of these services and has allocated a large quantum of public investment to expand the infrastructure managed by SOEs. The government being the owner of these SOEs has to depend on appointed agents and/or boards to manage these SOEs. Thus, there has to be mechanisms to ensure that those agents perform their tasks to generate benefits to the country rather than concentrating on the organizational and personal benefits only. It is therefore essential for the government to obtain these SOEs' serious commitments to generate a sufficient return on the investment and ensure a reasonable level of future cash flows from such massive investments. The lack of such a commitment would worsen fiscal and debt sustainability, thereby jeopardising the medium-term macroeconomic stability envisaged in the Ten-year Vision.

Economic expansion was broadbased in 2006 as all sectors grew at healthy rates. The Agriculture sector grew by 4.7 per cent contributing 11.1 per cent to the overall growth while the Industry sector grew by 7.2 per cent contributing to 27 per cent to the overall growth. Contribution from the Services sector was the highest at 62.6 per cent as the sector grew by 8.3 per cent during the year.

The agriculture sector continued its recovery in 2006, benefiting from strengthening partnership between public and private sectors together with favourable weather. The efforts to increase agriculture productivity by adopting new technologies such as usage of rain guards,

Table 1.1 **Gross National Product at Constant (1996) Prices**

SECTOR	Value (Rs. In million)		As Share of GDP (%)		Rate of Change (%)		Contribution to Change (%)	
	2005(a)	2006(b)	2005(a)	2006(b)	2005(a)	2006(b)	2005(a)	2006(b)
Agriculture	179,278	187,729	17.2	16.8	1.9	4.7	5.8	11.1
Agriculture	148,712	149,506	14.3	13.4	9.4	0.5	21.6	1.0
Forestry	17,400	18,253	1.7	1.6	1.7	4.9	0.5	1.1
Fishing	13,166	19,970	1.3	1.8	-42.2	51.7	-16.3	8.9
Industry	280,868	300,982	27.0	27.0	8.3	7.2	36.6	26.3
Mining and quarrying	19,334	20,888	1.9	1.9	14.1	8.0	4.0	2.0
Manufacturing	169,336	178,359	16.3	16.0	6.0	5.3	16.3	11.8
Electricity and water	17,784	21,368	1.7	1.9	24.5	20.2	5.9	4.7
Construction	74,414	80,367	7.2	7.2	8.9	8.0	10.3	7.8
Services	579,618	627,504	55.7	56.2	6.2	8.3	57.6	62.6
Wholesale and retail trade and hotels and restaurants	225,103	238,322	21.6	21.4	2.8	5.9	10.3	17.3
Transport, storage and communication	159,484	180,307	15.3	16.2	11.7	13.1	28.4	27.2
Financial services, real estate and business services	122,127	133,958	11.7	12.0	6.5	9.7	12.6	15.5
Public administration, other government services and defence and other community, social and personal services	72,903	74,918	7.0	6.7	5.4	2.8	6.4	2.6
Gross domestic product	1,039,763	1,116,215	100.0	100.0	6.0	7.4	100.0	100.0
Net Factor Income from Abroad	-16,526	-21,666			-46.2	-31.1		
Gross national product	1,023,237	1,094,550			5.6	7.0		

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

drip irrigation and poly tunnels etc., switching to optimal usage of land and water resources, making available inputs such as seed and fertiliser at subsidised prices, provision of credit facilities for agricultural activities, provision of tax concessions for importation of modern machinery and equipment required for agriculture related activities contributed to this recovery. Further, the livestock sector performed well with increased private sector activities and various incentives and assistance provided by the government including the Dairy Farmer Empowerment Project. The production of other field crops (OFC) such as maize, big onions and soya beans reported sharp increases in 2006 benefiting from increasing domestic production. Providing post-harvest handling links and equipment such as plastic crates and technical advice to farmers, and enhancing marketing facilities too supported the increase in agriculture production. Paddy output in 2006 recorded a new high level of 3.3 million metric tons benefiting from favourable weather and subsidised fertiliser. However, farmers continued to face marketing problems as the government led paddy purchasing scheme faced several constraints. Rubber production registered the highest level after 1996 supported by attractive prices and productivity improvements. Fish production continued to recover following the set-back experienced due to the tsunami. However, a few instances of labour unrest led to the decline of tea production marginally during the year.

A sustainable growth in agriculture requires productivity enhancement, facilitating marketing and related infrastructure facilities, adopting consistent trade policies, providing rural financing and integration of crops and livestock. Productivity enhancement could be strengthened through further development of agricultural research and extension services. A close collaboration between researchers, extension service providers, formal corporate sector and farmers is necessary for the optimal benefit of new innovations. An aggressive strategy for the dissemination of technical, economic and environmental information is necessary to better educate farmers. Minimising post-harvest losses would benefit farmers, intermediaries and consumers. Promoting and providing incentives for value addition would help employment generation in agro processing industries. The government has already established an authority to purchase agriculture products. However, a persistent drop in farm gate prices of paddy, many varieties of vegetables and subsidiary food crops during the harvesting period indicates the existence of an insufficient marketing mechanism. Agricultural product marketing needs to be further enhanced by strengthening farmer organisations and increasing private-public partnerships through promoting forward purchasing arrangements.

Policy initiatives aimed at increasing farmer income would be more beneficial than providing subsidies. The continuation of providing subsidies to products with relatively low value additions at market prices such as paddy would not ensure the long-term increase in farmers' incomes, since such crops have limited capacity to do so. Further, such policies may also hinder crop diversification, which is a need of the time. Optimal benefits from the limited resources such as land and water could also be better harnessed by encouraging farmers to also undertake more profitable high value added crops and animal husbandry rather than by providing them subsidies for crops where the value addition is rather low.

The Industrial sector benefited from increasing external and domestic demand for factory industry products. The growth arose mainly from textiles, wearing apparel and leather products, rubber based products, food, beverages and non-metallic mineral products and the higher growth of the construction sector driven by the greater performance of infrastructure development projects in the areas of roads and highways, telecommunication, housing and property development, hotels and restaurants, power generation and the continuation of tsunami reconstruction activities. The growth of the construction sector was evident from the higher growth of non-metallic mineral products including cement, ceramics and building materials. The diamond processing, gem and jewellery industry also performed well in the export market in 2006. The restructuring of the industrial sector took place through improvements in labour productivity through cost economising, product specialisation, acquisitions and mergers, process improvements, technology developments, strategic alliances, developing backward linkages and improved marketing capabilities in 2006.

The sustainable long-term growth in the Industrial sector requires the sector to transform itself into a globally competitive, dynamic and technologically sophisticated sector as Sri Lanka's comparative advantage in labour-intensive industries is diminishing. Therefore, further diversification and productivity improvements in the industrial sector are essential to successfully face intense competition in the global market. In the recent past, the textile, wearing apparel and leather products export category, the largest sub-sector within the factory industry faced severe competition in the global market after the termination of the Multi-Fibre Arrangement (MFA), mainly in the USA market. Nevertheless, the textile and apparel sector successfully withstood this competition through specialisation and productivity gains. The fact that the textile and apparel sector still attracts new foreign investment reflects investor confidence in the sector. The highest contribution by the Services sector was underpinned by healthy expansion in telecommunication, cargo handling and financial services. Continuous rapid growth in these sectors reflects the benefits of infrastructure developments, and liberalisation with proper regulatory mechanisms.

The achievement of an 8-10 per cent growth rate in the medium-term also critically depends on the establishment of a vibrant Services sector catering to the needs of globalised industry, trade and commerce.

Table 1.2 **Aggregate Demand and Savings Investment Gap - 2005 & 2006**

Item	Rs. Billion		Growth %		As per cent of GDP	
	2005 (a)	2006 (b)	2005 (a)	2006 (b)	2005 (a)	2006 (b)
1. Domestic Demand	2,584.5	3,125.2	16.8	20.9	109.3	111.5
1.1 Consumption	1,957.0	2,321.9	14.8	18.6	82.7	82.9
Private	1,761.9	2,068.5	14.4	17.4	74.5	73.8
Public	195.1	253.4	18.3	29.9	8.2	9.0
1.2 Investment (Gross Domestic Capital Formation)	627.5	803.4	23.5	28.0	26.5	28.7
Private	465.3	632.7	15.3	36.0	19.7	22.6
Public Corporations	62.9	62.9	6.1	0.0	2.7	2.2
Public	99.3	107.8	119.2	8.5	4.2	3.8
2. Net external demand	-218.9	-323.4	-18.7	-47.7	-9.3	-11.5
Exports of goods and non-factor services	792.7	885.9	7.6	11.8	33.5	31.6
Imports of goods and non-factor services	1,011.6	1,209.4	9.8	19.6	42.8	43.2
3. Total Demand (GDP) (1) + (2)	2,365.6	2,801.8	16.6	18.4	100.0	100.0
4. Domestic savings (3) - (1.1)	408.6	479.9	26.3	17.5	17.3	17.1
Private	472.2	550.1	17.4	16.5	20.0	19.6
Public	-63.6	-70.1	-18.7	-10.3	-2.7	-2.5
5. Net factor income from abroad	-30.0	-40.8	-45.1	-35.6	-1.3	-1.5
6. Net private transfers from abroad	174.4	215.1	27.7	23.3	7.4	7.7
7. National savings (4) + (5) + (6)	553.0	654.3	25.8	18.3	23.4	23.4
8. Savings investment Gap						
Domestic savings - investment (4) - (1.2)	-218.9	-323.4			-9.3	-11.5
National savings - investment (7) - (1.2)	-74.6	-149.1			-3.2	-5.3
9. External Current Account Deficit without official grants (2) + (5) + (6)	-74.6	-149.1			-3.2	-5.3

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

This has been well recognised in the Ten-year Vision as it expects the services sector to grow at the highest rate of around 10-12 per cent in the medium-term. With a highly literate and easily trainable workforce, Sri Lanka is in a relatively advantageous position to promote the Services sector. Encouraging investments in information and communication technology (ICT) infrastructure and promoting education on knowledge based global services would harness Sri Lanka's potential to become a service oriented economy. It would also facilitate the achievement of the envisaged growth in both Industrial and Agricultural sectors through productivity improvements in service delivery of those sectors.

Investments improved and the savings-investment gap widened during 2006 highlighting the importance of foreign investments and worker remittances in achieving a desirable rate of economic growth given the limitations in raising domestic savings. A significant increase in private investment mainly contributed to the rise in gross investment to 28.7 per cent of GDP from 26.5 per cent of GDP in 2005. The increase in investment coupled with the marginal drop in private savings by 0.4 per cent of GDP to 19.6 per cent contributed to the widening domestic savings-investment gap, which was reflected as the current account deficit without grants of the balance of payments. Savings by Sri Lankan residents abroad by way of worker remittances helped to reduce the gap to 5.3 per cent of GDP. The remaining gap was financed through FDI inflows, loans and grants to the government and portfolio inflows. Incremental Capital-Output Ratio[1] (ICOR) has declined from around 5 in the 1990s to 4 during the recent years indicating that on average, Sri Lanka needs at least 4 per cent of investment as a per cent of GDP to increase GDP growth rate by one percentage point. This implies that to maintain 8-10 per cent growth, the economy needs to raise the level of investments at least to 32-40 per cent of GDP if the ICOR remains at around current levels. Improvement in ICOR in the recent years reflects increasing private sector investments that are more productive in generating economic growth. Encouraging more private sector investments and highly productive public sector investments could improve ICOR further in the future which would help achieve higher economic growth. Given the current levels of domestic savings and limitations in raising savings in the short-term, attracting foreign investments is an important strategy if the country is to achieve such a high level of investment and growth.

The external sector continued to expand, supported by sustained strong global growth and preferential access through bilateral and multilateral trade agreements. Sri Lanka's exports continued to grow, taking advantage of the higher growth in its major export destinations, increased access to several selected markets under bilateral trading arrangements and continuous efforts by exporters to penetrate into new and high value niche markets. In the meantime, accelerated investment by public and private sectors and higher petroleum prices resulted in imports growing at an even higher rate. The exceptionally high oil prices experienced during the year led to the deterioration of the terms of trade by 3.5 per cent. A substantial increase in worker remittances helped to finance a larger part of the trade deficit and the remaining deficit in the current account was financed through FDI inflows and inflows to the government generating a surplus in the overall balance of payments (BOP). Reflecting these developments, the external official reserves improved, thereby strengthening the resilience of the country to external shocks. The continuation of the floating exchange rate regime helped to cushion the impact of external shocks on the economy, by

Table 1.3 External Sector Developments

	US$ Mn 2005	US$ Mn 2006	% Change
Exports	6,347	6,883	8.4
Agricultural products	1,154	1,293	12.1
Industrial products:	4,948	5,383	8.8
Mineral exports	143	136	-5.1
Other exports	101	70	-30.8
Imports	8,863	10,253	15.7
Consumer goods	1,644	1,980	20.4
Intermediate goods	5,317	5,962	12.1
Investment goods	1,870	2,246	20.1
Other	32	65	100.7
Trade balance	*-2,516*	*-3,370*	*34.0*
Services, net	338	257	-24.1
Receipts	1,540	1,625	5.5
Payments	1,202	1,368	13.8
Income, net	-303	-388	28.0
Receipts	35.6	311.2	774.6
Payments	339.0	699.6	106.4
Private current transfers, net	1,828	2,169	18.6
Private remittances, net	1,735	2,068	19.2
Receipts	1,968	2,326	18.2
Payments	233	257	10.5
Current account balance	*-654*	*-1,334*	*104.1*
Capital account	*250*	*291*	*289.0*
Financial account	*974*	*1,517*	*55.7*
Direct investment, net	234	451	93.0
Inflows	272	480	76.5
Outflows	38	29	-23.5
Private long-term,net	11	-35	-418.2
Inflows	199	139	-30.2
Outflows	188	174	-7.5
Government, long-term,net	553	491	-11.3
Inflows	747	932	24.7
Tsunami related inflows	93	-	
Outflows	194	441	127.9
Short-term:	176	610	246.8
of whuich:Portfolio investment, net	60	51	-15.6
Errors and Omissions	-69	-270	
Overall balance	*501*	*204*	
Gross official reserves (without ACU)	2,458.1	2,524.7	
Months of imports	3.3	3.0	
Total gross reserves (without ACU)	3,923.6	3,572.5	
Months of imports	5.3	4.2	
Debt moratorium	264.0	-	
Export price	98.9	103.1	4.2
Import price	98.9	106.9	8.0
Terms of trade	100.0	96.5	-3.5
Exchange rates (Average)			App(+), Dep(-)
Rs/US$	100.50	103.96	-3.3
Rs/Yen	0.91	0.89	1.8
Rs/Euro	125.10	130.63	-4.2
Rs/STG	182.87	191.53	-4.5

Source: Central Bank of Sri Lanka

allowing the exchange rate to adjust according to the unfolding economic fundamentals.

In 2006, the fiscal policy continued to be focused on achieving fiscal sustainability in the long term while promoting pro-poor and pro-growth development. The fiscal policy strategy was formulated in line with the overall macroeconomic vision enunciated in the government medium term macro-fiscal policy framework. These fiscal policy objectives had to be met in the midst of challenges that arose from high international oil prices, the need for strengthening national security, relatively high inflationary pressures and increasingly high interest rates. Despite these challenges, several improvements were observed in fiscal operations. At the same time, some concerns, in particular the overrun of recurrent expenditure, under-performing public investment and high bank financing of the deficit remain to be addressed.

The strong efforts made by the government to sustain the increasing trend in revenue to GDP ratio were successful for the third consecutive year. Total revenue in 2006 reached 17.0 per cent of GDP compared to 16.1 per cent in the previous year. Tax revenue continued its increasing trend for the third consecutive year amounting to 15.3 per cent of GDP compared to 14.2 per cent in 2005 responding to government's attempts in the areas of tax policy, tax administration and timely enactment of relevant legislation. Public investment remained high at 6.3 per cent of GDP. The improvement of economic and social infrastructure continued to be the high priority areas in the public investment programme. However, the government exceeded its target on recurrent expenditure due to higher than budgeted expenditure on national security, humanitarian relief, salaries and wages, pensions and fuel and ferteliser subsidies. Consequently, the recurrent expenditure to GDP ratio increased to 19.5 per cent from 18.7 per cent in the previous year. The overall budget deficit in 2006 declined to 8.4 per cent of GDP from 8.7 per cent in 2005. Financing the budget deficit was challenging, given the rising domestic interest rates and higher inflation expectations, particularly during the second half of the year. The government partly mitigated the exposure to rising domestic interest rates by switching into more foreign currency denominated domestic financing. This coupled with higher overdraft balances with the state banks raised government's borrowings from the banking sector to a higher than expected level, making monetary management difficult. Financing from the domestic sources was 5.8 per cent of GDP while the balance 2.6 per cent of GDP was financed through external sources.

The outstanding public debt to GDP ratio continued to decline for the third consecutive year and stood at 93.0 per cent of GDP at end 2006 compared to 93.9 per cent at end 2005. The higher growth in nominal GDP, which outpaced the nominal growth in outstanding debt stock helped achieve this improvement. Nevertheless, total government debt, in nominal terms, increased by Rs. 384 billion to Rs. 2,606 billion. With the ending of the debt moratorium granted by foreign lenders, the debt service indicators reverted to their pre-tsunami levels. Nevertheless, a number of debt service indicators improved compared to pre-tsunami levels.

Notwithstanding the improvements recorded in 2006, several major drawbacks continue to prevail in the fiscal sector. These include the relatively high recurrent expenditure, under-performance in the public investment programme, high borrowings from the banking system and relatively high government debt burden. Of these drawbacks, the higher and increasing recurrent expenditure warrants special attention. The high recurrent expenditure is often due to continued increase in expenditure on salaries and wages, pension payments and transfers to households and public corporations and institutions. This situation tends to negate the positive achievements in the revenue front, as expenditure on these three items absorbs about 67 per cent cent of the total revenue thereby reducing the manoeuvrability of fiscal operations. Also, the contribution that could be made by the government revenue to the country's future development through public investment seems to be not at the potential level due to the high recurrent expenditure. The overrun in the recurrent expenditure amounted to Rs. 38 billion (1.4 per cent of GDP) in 2006 compared with the budgeted expenditure. If, however, such amount, instead of being utilised towards recurrent expenditure, was allocated for public investment it could have contributed to increase GDP growth in the future by several percentage points.

It is encouraging that the government is strongly committed to address the above deficiencies as envisaged in both the Medium-term Budgetary Framework 2006-2009 and Ten-year Vision 2006-2016. Timely implementation of necessary measures as planned is essential as any delays could spill over through excessive resource requirements, crowding out of private investment and high inflationary pressures, thereby endangering the achievement of expected high economic growth path to reduce poverty and regional economic disparities in a sustainable manner.

The conduct of monetary policy in 2006 was aimed at containing high money and credit expansion to reduce the threat of surging demand driven inflationary pressures, while supporting the continued growth momentum of the economy. Therefore, the tightening of monetary policy was continued while minimising the build up of excess liquidity in the market by absorbing excess liquidity on a day-to-day basis as well as on a permanent basis through aggressive Open Market Operations (OMO). The policy interest rates of the Central Bank viz., the repurchase and the reverse repurchase rates were raised by 125 basis points in the latter half of 2006, in addition to the 175 basis points increased during 2004 and 2005. In addition to these measures, the margin requirement against letters of credit for some selected imported items was imposed while banks were instructed not to grant credit to meet such margin requirements. As a further step of restraining high credit expansion, moral suasion was actively applied to discourage commercial bank borrowings from the Central Bank through the reverse repurchase facility. These efforts were complemented by the prudential requirements imposed on banks such as a general provisioning requirement on all performing loans and an increase in risk weights in respect of loans for capital adequacy purposes. The elimination of the petroleum subsidy was also another step that was taken in that direction since the continuation of the subsidy would have exerted further pressure on budgetary financing resulting in higher monetary expansion.

These measures were instrumental in decelerating monetary expansion to a certain extent. However, meeting monetary targets was a tough proposition as borrowings by the public sector from the banking system increased substantially towards the end of the year.

As a result, the decelerating trend in the growth of both reserve money and broad money reversed during the last quarter of the year. Inflation, which had a decelerating trend till March 2006, began to increase thereafter, reflecting the impact of high monetary expansion. It was further aggravated by the changes in administrative prices, which had a one-off price adjustment on the cost of living as well. However, these price adjustments obviated the necessity for subsidising through an expansion in money supply, having a desirable impact towards combating long-term inflation. The excessive growth in monetary aggregates in 2006 was taken into careful consideration in setting the monetary targets for 2007 when the Central Bank announced the planned monetary policy path for 2007 in its policy announcement in January 2007, "The Road Map for Monetary and Financial Sector Policies for 2007 and Beyond". In addition to the monetary targets, the Central Bank also took several other measures to ensure that the expected targets were met.

Financial system stability strengthened further in 2006 with continued enhancement of financial infrastructure, regulatory and supervisory measures over the key financial institutions and improved risk management. The Cheque Imaging and Truncation (CIT) System was introduced in 2006 for the processing of retail and low value payments which would improve the operational efficiency of the clearing process. A National Payments Council was set up, comprising representatives of all major stakeholders to facilitate the formulation of a national payments policy for the country and to take forward the modernisation of the payments and settlements infrastructure. The payment and settlement systems were further strengthened by the introduction of legislation to deter illegal and hazardous practices relating to payment devices. The Monetary Law Act was amended to strengthen the powers of the Monetary Board in relation to the credit operations of Licensed Commercial Banks (LCBs) and Licensed Specialised Banks (LSBs). The regulation and supervision of specialised leasing companies were intensified in 2006. The preparation for the implementation of Basel II Capital Adequacy Framework was facilitated by issuing guidelines to banks for the parallel computation of the capital charge. In line with the Basel Capital Accord, a capital charge for market risk was introduced in 2006. To promote the integrity of, and confidence in, the financial system and to respond to the risks posed by money laundering and terrorist financing, Sri Lanka introduced comprehensive legislation to combat these emerging new threats. The prudential norms relating to finance companies were further strengthened by the imposition of new minimum core capital requirement and a capital adequacy ratio. Measures are being taken to modernise and widen the scope and improve the coverage of the Credit Information Bureau (CRIB).

The financial sector expanded further in 2006 supporting higher economic activity. Performance in the financial sector institutions improved in 2006 in terms of profitability, capital levels and asset quality and the range of products and services offered. Several policy initiatives were taken during the year to enhance access to finance, mainly in the Agriculture sector and small and medium enterprises (SMEs). Activities in the financial markets expanded, recording higher trading volumes especially in stock and foreign exchange markets. A further development in the domestic financial market was the opening up of Treasury bonds for foreign investors, which would broaden the investor base, and increase the competition in the bond market.

Box 2 Strengthening Public Confidence in Banks

The importance of public confidence

Public confidence in banks is the key for banks to be in business. Banks' core business is financial intermediation by accepting money from those who save and deposit and lending such monies to those who invest or use funds for other purposes. The public keep deposits in banks because of the trust that banks will repay the deposits or monies when needed. Most depositors treat banks as fiduciary agents to keep their savings. Banks are, therefore, privileged to use such deposits and offer financial services to earn profits. Experience shows that public confidence may be lost or affected not only due to a failure of a bank to meet its financial obligations because of weak risk management but also due to the contagion effects of bank failures across the entire banking system and economic turmoil. Therefore, the fundamental behind the public confidence is the safety and soundness of banks.

In this context, banking authorities world over resort to various regulatory and supervisory measures encompassing both gate-keeping and house-keeping of the banking system to promote a safe and sound banking system. The gate-keeping involves requirements relating to entry and exit of banks, primarily the minimum entry capital and licensing requirements. The house-keeping covers various prudential requirements aimed at promoting risk management of banks such as minimum capital adequacy ratios, minimum liquidity ratios, loan loss provisions, single borrower limits, ownership limits, close supervision and resolution of problems. In addition, the authorities oversee the financial system stability to prevent any potential contagion risk of bank failures.

Specific measures taken to maintain public confidence

The Central Bank has effected a series of standard regulatory measures to protect and strengthen public confidence in banks in line with international best practices including the adoption of Basel standards. In addition, specific measures have been initiated to address specific problems of banks, such as capital inadequacy and shortfall of liquidity. Since the early 1990s, several rounds of re-capitalisation of state banks by the Government have been effected to build up public confidence in the state banks. Consequent to the failure of a small bank, i.e., Pramuka Savings and Development Bank Ltd. in October 2002, some public concerns over the viability and soundness of small banks were raised, although the Pramuka Bank's market share was insignificant to have any impact on the wider financial system or cause any material damage to the public confidence. The government's policy decision implemented in 2006 and 2007 to establish a new state bank, Sri Lanka Savings Bank Ltd., to vest the business of the failed Pramuka Bank was a major step taken towards re-building public confidence in small banks. In addition, the Central Bank took several measures to boost public confidence in banks and mitigate potential risks to the wider financial system. Among them, the restructuring of two small banks in 2003 with the support of two established banks and the announcement of enhanced minimum entry capital requirement of banks in April 2005 were significant moves and these measures helped to promote consolidation among banks.

Similarly, issues relating to dominant ownership in a few private banks also raised new fears among the saving public and financial community. The Central Bank was able to successfully deal with such fears by introducing new policy guidelines for regulation of bank ownership in January 2007. Accordingly, the broad-basing of ownership in banks by requiring large ownerships held by single shareholders or groups to be reduced to 15 per cent within a maximum period of five years was a major policy measure towards avoiding conflicts of interest in Boards of Directors. An unprecedented growth in consumption credit has also been witnessed since the latter part of 2006 and the need for monetary policy to respond through appropriate prudential regulation was considered necessary in order to arrest the high concentration of consumer credit. The high rate of credit expansion which could result in a deteriorating quality of credit was also a regulatory concern.

To address this concern, a general provision of 1 per cent of all performing loans was required to be maintained in addition to existing provisioning rules. However, in view of the adverse impact of this measure on the profitability of banks, the implementation of this general provision was staggered over a period of ten quarters requiring banks to make a provision of 0.1 per cent each quarter begining fourth quarter of 2006.

The prudential requirements on maximum amount of accomodation were also revised in February 2007 and this was envisaged to widen distribution of credit, mitigate credit concentration risk and promote risk management by banks and customers by taking into consideration capital adequacy ratios of banks and credit ratings of customers and banks.

Among other major regulatory measures yet to be implemented are the mandatory code of corporate governance and adoption of Basel II. A mandatory corporate governance is to be implemented in place of the current voluntary corporate governance to make banks' board of directors responsible and accountable for banks' performance and risk management of banks while attaching high priority to depositors' interest as major stakeholders. Introduction of Basel II with Standardised Approach in 2008 with a plan to moving towards advanced approaches in the medium term will promote integrated risk management of banks keeping adequate capital as risk cover.

A high level Inter- Regulatory Institutions Council (IRIC) and a Working Committee consisting of representatives of financial regulators was also established to promote coordinated arrangement for regulation and supervision of banks and other financial institutions. The Working Committee and the IRIC would help to establish regulatory exchange of information in a multi-regulatory set-up. These measures will be supplementary to the close monitoring and supervision of banks which enables the Central Bank to identify problems and arrange appropriate remedial actions in terms of the relevant statutes and moral suasion powers of the Central Bank.

Measures to improve market discipline

The Safety net provided through regulatory measures by themselves are today considered insufficient and there is growing attempts to improve market discipline so that the public is prepared to assess the risks relating to their decisions by themselves as well. Otherwise, the moral hazard problem of regulation, i.e., situation that encourages the public to accept more risks because of the availability of regulatory protection for their interests, will at some stage become too costly. In this regard, the Central Bank has continuously promoted public awareness progammes through the media and the issue of various publications to educate the public of risks involved in transactions with banks and other financial institutions. Three annual Financial Stability Reports were published releasing information and analysis on risks in the financial system as a whole. Banks have been required to publish their financial statements in the press on a quarterly basis to disclose their key performance indicators. In addition, the banks are required to obtain credit ratings from approved Rating Agencies and publish such ratings in all advertisements aimed at soliciting deposits. All such measures are intended to make the depositors and investors understand that it is imperative that they too assess the risks and returns on their money deposited or invested in a particular bank or a financial institution. It is also important to note that regulation does not mean that the regulator guarantees the safety of individual deposits and investments of those who save and invest, but it attempts to promote market discipline and prudent risk management by banks, financial institutions and customers in the interest of the stability of the financial system.

1.2 External Economic Environment

The world economy continued to register a strong growth for the fourth consecutive year in 2006, in spite of rising short-term interest rates, high commodity prices including higher oil prices, and increased financial market volatility. The higher growth was achieved despite a slowing down of the US economy and high oil and commodity prices mainly due to the acceleration in recovery in Europe and Japan and very strong expansion in developing countries, especially in India and China. According to the World Economic Outlook (September 2006), the global real GDP was projected to grow by 5.1 per cent in 2006 from 4.9 per cent in 2005. In line with this higher growth, world trade in volume terms was projected to grow at a higher rate of 8.9 per cent in 2006 from 7.4 per cent in 2005. Sri Lanka's external sector benefited from this higher trade growth in 2006. Global short-term interest rates rose gradually with the tightening of policy rates by several developed and emerging economies to contain inflationary pressures. The global inflation has been showing signs of rising with the continuing higher global growth leading to narrowing of the output gap in several developed and emerging economies. The headline inflation in many of the major advanced economies has been rising fuelled by mainly rising oil prices and even the core inflation in those countries has shown increases.

The world economy is poised to continue the current higher growth momentum for the fifth consecutive year in 2007. This represents a significant expansion of the global economy and probably one of the longest sustained periods of growth in the post-Bretton Woods era. The US, one of Sri Lanka's major export markets is projected to slow down in 2007 responding to continuous monetary tightening and due to the slowing down housing market, which would dampen the private consumption and residential investment. However, the spillovers from a slower US economy to other economies will be minimal. The broadened recovery in the Euro area will offset any adverse impact of possible

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

	Actual		Projections	
	2004	2005	2006	2007
World output	5.3	4.9	5.1	4.9
Advanced economies	3.2	2.6	3.1	2.7
United States	3.9	3.2	3.4	2.9
Euro area	2.1	1.3	2.4	2.0
United Kingdom	3.3	1.9	2.7	2.7
Japan	2.3	2.6	2.7	2.1
Developing countries	7.7	7.4	7.3	7.2
Developing Asia	8.8	9.0	8.7	8.6
China	10.1	10.2	10.0	10.0
India	8.0	8.5	8.3	7.3
World trade volume (Goods and services)	10.6	7.4	8.9	7.6
Imports				
Advanced economies	9.1	6.0	7.5	6.0
Developing economies	16.4	11.9	13.0	12.1
Exports				
Advanced economies	8.8	5.5	8.0	6.0
Developing economies	14.6	11.8	10.7	10.6
Price Movements				
Consumer prices				
Advanced economies	2.0	2.3	2.6	2.3
Developing economies	5.6	5.3	5.2	5.0
Commodity prices (US dollars)				
Oil	30.7	41.3	29.7	9.1
Non-fuel	18.5	10.3	22.1	-4.8
Six month London interbank offered rate (percent)				
On US dollar deposits	1.8	3.8	5.4	5.5

Source: World Economic Outlook (September 2006), IMF

slowdown in the US. While the emerging market economies and developing countries are projected to grow at a higher rate, India and China will continue to expand strongly. As a small open economy, Sri Lanka is expected to benefit continuously from the projected healthy global economic growth. However, there are some downside risks to these projections too. The global imbalance may increase, with the US current account projected to widen further to 6.9 per cent of its GDP in 2007. Any disorderly adjustment in the US dollar may worsen the imbalance leading to unforeseen financial crises. At the same time, monetary tightening by several countries in 2006 to contain inflationary pressures may slow down the economic growth in 2007. In some countries, where the economies are operating at near maximum production capacity, further expansion will necessarily lead to higher wage demands and cost push inflation. Any geopolitical factors leading to disturbances in the Middle East could also push up the oil prices further.

Several countries raised short-term interest rates to control inflationary pressures. However, long-term interest rates remained low due to abundant global liquidity. The Euro area, the UK, Australia, China, India, Korea, US, Canada, Japan, Malaysia and Mexico raised their policy rates. The US paused its policy rate adjustment after seventeen increases by 25 basis points each between June 2004 and June 2006 as growth moderated from lagged effects of prior tightening and housing market slow down. Japan raised its policy rates by 0.25 per cent in July 2006 after maintaining a zero interest rate policy since September 2001.

The US dollar weakened in the global market in 2006 due to widening current account deficit and slowing down of the economy. The dollar weakened against major currencies. It depreciated at a higher rate against the sterling pound and euro, while it appreciated marginally against the Japanese yen. The Chinese renminbi, which along with the Malaysian ringgit, was allowed to be more flexible against the US dollar in 2005 continued to appreciate gradually against the US dollar in 2006. The Chinese international reserves crossed US dollars one trillion in 2006 requiring the further appreciation in renminbi. Even some other emerging and developing Asian countries continued to build up their reserves. Emerging markets attracted record amounts of foreign financing in 2006.

Multilateral trade negotiations by the World Trade Organisation (WTO) under the Doha Development Agenda (DDA), which commenced in late 2001 as a result of agreement at the Doha Ministerial Conference at Doha, Qatar, collapsed in July 2006. The DDA was aimed at creating a new world trade agreement with lower barriers to trade around the world, with a focus on making trade fairer for developing countries. The differences in opinion among major member states on negotiations on market access for agricultural products, domestic agricultural subsidies and non agricultural market access (NAMA) have led to create a three-way impasse on multilateral trade negotiations. For the Doha round negotiations to succeed, developed countries have to agree to deeper cuts to domestic farm supports and increase agricultural market access to developing countries, while developing countries have had to lower industrial tariffs. However, there is little indication of any strong commitment by any of the major world players on this formula.

1.3 Medium Term Macroeconomic Outlook, Challenges and Policies

The Ten-year Horizon Development Framework (Ten-year Vision) based on the overall policy vision of *"Mahinda Chintana"*, targets a higher growth over the medium term with a stable macroeconomic environment. The growth is expected from the improvement of productivity in all three sectors of the economy. Agriculture is projected to grow around at 5 per cent, while both industrial and services sectors are projected to grow at higher rates of over 8 per cent and 9 per cent in the medium-term. Achievement of these targets requires higher investments

Table 1.5 **Medium Term Macroeconomic Framework 2006 - 2010[a]**

Indicator	Units	2006(b)	Projections 2007	2008	2009	2010
Real Sector						
GDP at Market Prices	Rs. bn	2,802	3,267	3,777	4,336	4,965
Real GDP Growth	%	7.4	7.5	8.0	8.3	8.5
Inflation-GDP Deflator	%	10.3	8.5	7.0	6.0	5.5
Total Investment	%of GDP	28.7	32.0	32.5	33.0	33.5
Private Investment	%of GDP	22.6	23.8	24.5	24.9	25.3
Public Investment	%of GDP	6.1	8.2	8.0	8.1	8.2
Incremental Capital Output Ratio (ICOR)		3.6	4.0	4.0	3.9	3.9
Domestic Saving	%of GDP	17.1	19.8	20.1	20.7	21.5
Private Saving	%of GDP	19.5	19.7	19.0	18.5	18.9
Public Saving	%of GDP	-2.4	0.1	1.1	2.1	2.6
National Saving	%of GDP	23.4	26.8	27.6	28.3	29.1
External Sector						
Trade Gap	US$ mn	-3,370	-3,961	-4,583	-5,170	-5,649
Exports	US$ mn	6,883	7,569	8,343	9,210	10,168
Imports	US$ mn	10,253	11,531	12,927	14,380	15,817
Services	US$ mn	257	320	404	512	575
Receipts	US$ mn	1,625	1,855	2,099	2,377	2,612
Payments	US$ mn	1,368	1,535	1,694	1,865	2,037
Current Account Balance	US$ mn	-1,334	-1,481	-1,555	-1,703	-1,827
Current Account Balance	%of GDP	-4.9	-5.0	-4.6	-4.5	-4.3
Overall Balance	US$ mn	204	300	372	393	530
External Official Reserves						
(Months of Imports)	Months	3.0	2.9	2.9	2.9	3.0
Debt Service Ratio (c)	%	12.8	10.8	11.4	11.8	8.8
Fiscal Sector						
Revenue	%of GDP	17.0	18.9	19.0	19.2	19.3
Expenditure	%of GDP	25.4	26.4	25.4	24.5	24.3
Current Account Balance	%of GDP	-2.5	0.1	1.1	2.1	2.6
Overall Budget Deficit	%of GDP	-8.4	-7.6	-6.3	-5.3	-5.0
Domestic Financing	%of GDP	5.8	4.7	3.7	3.1	2.9
Monetary Sector (d)						
Reserve Money Growth	%	21.2	11.6	14.8	14.3	14.0
Broad Money Growth (M2b)	%	17.8	14.8	15.0	14.5	14.4
Narrow Money Growth (M1)	%	12.6	12.8	13.0	12.5	12.4
Growth in Credit to Private Sector	%	24.8	17.5	15.8	14.5	13.9
Growth in Credit to Public Sector	%	39.4	2.1	-0.6	-0.4	-0.7

(a) Based on the information available as at mid March 2007.
(b) provisional
(c) Total debt service payments as a percentage of earnings from merchandise exports and services
(d) Point-to-point growth in end year values.

Sources: Ministry of Finance and Planning
Central Bank of Sri Lanka

from both public and private sectors in areas such as infrastructure, human capital, agriculture, industries and services. The current growth momentum is expected to continue in the medium-term as a result of the construction of several key infrastructure projects, supported by robust global growth as well. The external sector performance is expected to strengthen further in the medium-term, supporting a higher growth path. FDI, which reached a record level in 2006, is expected to increase further in the medium-term responding to the several initiatives of the Board of Investment to attract higher investment, and the opportunities available under the free trade arrangements with India and Pakistan. By the end of 2006, the government had development partner commitments in the pipeline amounting to around US dollars 4.5 billion and at the Sri Lanka Development Forum held in Galle, during January 2007, it commenced further negotiations with development partners to receive a further US dollars 4.5 billion development support, thereby aiming to increase the total development project assistance to US dollars 9 billion over the medium-term. On the fiscal front, revenue collection is expected to increase gradually to around 19 per cent, while current expenditure is targeted to rationalise with improvement in debt management, reduction of the interest cost and enhancement of the public service delivery. In the medium term, fiscal consolidation efforts are expected to reduce the budget deficit to around 5 per cent of GDP, while the total public debt stock is expected to decline to below 85 per cent of GDP, as envisaged in the Fiscal Management (Responsibility) Act.

Ten-year Vision targets to bring down inflation to a single digit level by end 2007 and further moderation to around 4-6 per cent in the medium-term. As announced in the Road Map for Monetary and Financial Sector Policies for 2007 and beyond, the monetary policy will be directed towards containing inflation pressures and reducing inflation to a single digit in the year 2007, while supporting higher economic growth. Low and stable inflation is a prerequisite for achieving the economic growth targets.

To achieve the higher growth targets, both the public and private investments need to be increased substantially. Timely implementation of identified key infrastructure projects by the government would remove infrastructure bottlenecks facilitating higher investments. However, this would require massive financial resources. To finance these projects, the government needs to maximise the utilisation of committed foreign development partner loan funds, while mobilising required funds through international sources without crowding out the private sector in the domestic market. Maintaining a conducive investment climate and a sound macroeconomic environment are necessary to stimulate private investment in the economy. In this regard, containing inflation at a single digit while maintaining a flexible exchange rate policy would improve investor confidence.

Improvement of national productivity is essential to accelerate economic growth especially in view of declining unemployment. The unemployment rate declined significantly in 2006 reflecting higher economic expansion in recent years and risks of demand for higher wages due to shortage of labour for some sectors of the economy. Any substantial wage increases would result in cost-push inflationary pressures leading to the deterioration of the country's external competitiveness. To mitigate the impact of rising wages and to sustain the competitiveness, it is necessary to improve the productivity in all sectors of the economy. In this regard, concerted efforts on educating all stakeholders and increasing their awareness on productivity improvement would help to improve national productivity in all sectors of the economy. Increased spending on Research and Development (R&D) would further improve the productivity and product quality leading to the prosperity of the country through innovation, generation of technology and creation of wealth.

Sufficient and reliable supply of electricity at competitive prices is essential to achieve the targeted economic growth. Studies show that a 1 per cent increase in the GDP would require 1.5 – 2.0 per cent growth in the electricity supply. Though decisions have been taken to implement long delayed large-scale coal power and hydropower plants, those will commence supplying electricity only after 2010. The planned 300 MW Kerawalapitiya thermal power plant, which is due to be implemented urgently, will be available for power generation only in the second half of 2008. Therefore, urgent precautionary measures need to be taken to avoid any power shortages, as any interruptions to the power supply will have severely adverse economic and social implications. Further the use of emergency power at an exorbitant price to meet the power shortages as done in the past, will only serve to deteriorate the already weak financial position of the CEB. Hence, urgent alternative measures such as the efficient management of water release in hydro reservoirs, maximum use of available thermal capacity, reactivation of self-generation schemes, and even more importantly, energy conservation programmes, etc., need to be quickly implemented to avoid any power shortages.

Sri Lanka needs to undertake several new initiatives to improve the investment climate further in order to be competitive in the region. To attract higher investments, several initiatives are necessary in the areas of human resource management, taxation and tax administration, judicial system and dispute settlement, business registration, customs procedures, education, etc. At the same time, it is also important to improve the overall governance levels by improving transparency of entities through better disclosure and dissemination of information to stakeholders and updating and improving regulations to minimise waste and opportunities for rent seeking.

Sri Lanka's export strategy in the medium-term needs to be focused on diversification of exports towards more service oriented exports and more value addition in export of goods, particularly agricultural exports. Since Sri Lanka's comparative advantage being a low wage country is diminishing rapidly with increasing per capita incomes and a well educated labour force, continuous growth in export of goods and services requires promoting more knowledge based exports such as IT related services and professional services. Due to natural constraints in further expanding output of traditional agricultural commodities such as tea, rubber and coconut, value addition and branding and crop diversification are necessary to achieve a sustainable growth in exports in the medium-term.

The apparel exports, which successfully faced quota free trading environment during the last two years, are likely to face intense competition in 2008 with the removal of restrictions on China's exports to the USA market. Sri Lanka's apparel industry needs to continue its efforts at enhancement of quality of products, compliance with international labour standards and good governance, assurance of on time delivery, offer of competitive pricing, improvement of skills of the labour force and the development of reputed international customer bases. In addition, continuous efforts to get some relaxation of current Rules of Origin (ROO) criteria imposed under GSP+ scheme, which requires Sri Lanka to add at least 50 per cent value addition in case of apparel exports in order to be qualified for such benefit, would be an added advantage.

Although the government already has committed financing for major infrastructure projects, emerging infrastructure needs of the economy need to be financed through public-private partnerships. Continuation of the current practice of government financing of infrastructure developments would tend to widen the fiscal deficits and increase the cost of borrowings as concessional financing is gradually declining. It would also serve to increase the outstanding government debt further and place the repayment capacity under serious stress, thereby inhibiting the simultaneous development of infrastructure facilities. Therefore, Public-Private Partnerships need to be actively and quickly promoted to support infrastructure investment to maintain long-term fiscal sustainability. The projects implemented under PPPs could also be a future source of government revenue *via* dividends, tax revenues and capital gains. Better skills of the private investors in managing projects will lead to increased efficiency and productivity, resulting in better quality and lower costs and increasing the government's equity capital stock.

To move the economy to a higher growth path of 8-10 per cent in the medium-term from the current 7-8 per cent, it is necessary to undertake critical structural improvements in several key areas, both in the public and private sectors. The private sector needs to be better prepared to face emerging challenges in an increasingly globalised environment through productivity improvements without seeking subsidies and protection from the government. The Education sector needs to be able to provide skills to match the dynamic needs of the labour market as required for the next stage of development. Improvements in human resource management have to be aimed at encouraging more employment while accommodating some flexibility for employers and employees to adjust their operations in line with diversification of their needs and activities. Implementation of new management practices aimed at removing bottlenecks in doing business is a prerequisite to unlock the maximum potential of the private sector. Although 80 per cent of country's land is still owned by the state, there is a lack of available land for investments as there is no proper mechanism to allocate lands for investments. The delays in dispute settlements of private lands through the judicial system often leads to the inefficient usage of limited available private lands. At the same time, a highly efficient public sector consistent with the needs of a modern economy is necessary for the economy to take off from the current 7-8 per cent growth to 8-10 per cent growth in the medium-term.

Sri Lanka has a greater potential to grow in several areas than envisaged in the Ten-year Vision. Tourism industry has the potential to earn more than US dollars one billion within a short period if necessary infrastructure is developed with a well-targeted promotional campaign. Sri Lanka has much more diverse tourist attractions than in currently popular tourist destinations in the region. Tea exports has the potential to become a US dollars 2 billion industry if the industry focuses on more value addition and promoting the brand rather than exporting in bulk form. With the continuous improvements in specialisation, backward linkages, and marketing strategies, the Sri Lankan apparel industry can become a US dollar 5 billion industry sooner. Foreign exchange earnings from worker remittances could reach US dollars 4 billion with the continuous effort being taken to enhance remittances. Potential in FDI is already visible, above the US dollar 4 billion mark. Achievements of such targets can move Sri Lanka in to a higher growth path than envisaged in the Ten-year Vision, sooner than expected.

Box 3

Ten-year Horizon Development Framework: 2006 -2016

The Ten-year Horizon Development Framework (Ten-year Vision) issued in November 2006 along with the Budget 2007 is a broad policy framework consistent with the *"Mahinda Chintana"*. It was developed through a consultative process among the Ministry of Finance and Planning and all stakeholders. The framework highlights strategic policy directions of the government during the next 10 years, aimed at infrastructure and knowledge based accelerated economic progress to provide an enabling environment to promote growth and reduce regional economic disparities and poverty on a sustainable basis.

The underlying macroeconomic framework of the Ten-year Vision targets an 8 per cent economic growth during the next six years and a 9-10 per cent growth thereafter accompanied by beneficial developments, viz., gradually reducing inflation and improving productivity. Investment is expected to increase significantly utilising improved savings by the private sector, external resources and funds saved through the gradually reducing budget deficit. Monetary policy is employed to avoid demand fuelled inflation, while providing required credit for sustained economic activity. The floating exchange rate system will continue supported by a comfortable level of official reserves.

The following Table provides the salient components of Ten-year Vision.

Table B 3.1
Sectorwise Summary of the Ten-year Horizon Development Framework of the Government: 2006-2016

Sector and Development Thrust/ Vision/Objective	Policy Framework/Policy Direction/Strategies/ Key Targets
Agriculture: *Transform traditional subsistence agriculture to a commercially oriented and highly productive sector.*	- Transforming low productive subsistence farming to high productive advanced agriculture, including agro-based industries - Increasing productivity, production and competitiveness of export based agriculture sectors, including plantations - Increasing return to labour, land and other factors of production in the sector which would directly contribute to rural poverty reduction - Enhancing agriculture productive efficiency through mechanisation and technological transformation - Developing a market oriented pricing and incentive environment - Growing at a faster rate of 4-5 per cent with the higher contribution from the non-plantation sector while increasing commercial orientation of small and medium scale operations of the sector
Irrigation: *Transform irrigated agriculture into a commercially viable and technologically advanced sector through increasing water productivity.*	- Improving productivity and efficient use of irrigated water - Investing in rehabilitation of existing irrigation systems and development of new irrigation systems - Improving water allocation systems - Rehabilitation of small tank/minor irrigation schemes - Institutional reforms and capacity building

Industrial Development: *A base of vibrant and competitive manufacturing industrial firms to generate higher value addition, higher productivity and sustainable employment to offer wider opportunities.*	- Developing national capacity to manage industrial solutions - Strengthening national innovation system to enhance competitiveness of industries and improving competitiveness of Small and Medium Industries (SMEs) - Improving micro enterprises - Developing infrastructure facilities to create competitive advantages for industries - Promoting geographical industrial clusters and industrial exports - Promoting foreign direct investments and harnessing of industrial complementarities
Power and Energy: *Sustainable development of energy sources, conversion facilities and delivery systems to enable access to and use of energy services by the entire population at competitive prices through commercially viable institutions subject to independent regulation.*	- Increasing fuel diversity and security through investing in both conventional sources of electricity and non conventional renewable energy - Investing in grid and off-grid energy systems to ensure access to electricity to 95 per cent of households by 2016 - Introducing cost reflective tariffs and a common subsidy for energy used for lighting - Restructuring sector debts to minimize the burden - Improving fuel diversity and energy security in bulk power generation through the provision of moratorium on oil/oil related fuel burning power plants and diversification to coal and non conventional renewable energy (NCRE) - Relieve grid constraints and arrange finances to accelerate NCRE development - Invest in transmission and distribution to ensure safety, quality and reliability of supply
Telecommunications: *A modern advanced telecommunications network, freely available to all citizens at a reasonable cost.*	- Encouraging a level playing field to maintain the competitiveness in the sector - Improving human resource development - Revising tariffs annually through a transparent method - Managing the spectrum to ensure that it is utilised efficiently, economically and optimally
Water Supply and Sanitation: *Provision of safe drinking water and sanitation for all people without restriction.*	- Reducing the dependence on government investment gradually by promoting alternative sources of financing - Introducing cost recovery tariffs for pipe borne water with subsidies only for low income communities - Establishment of regulatory and institutional framework - Implementation of demand management policies - Introducing appropriate rural and urban water supply management strategies

Roads: *To provide accessibility to all population in the country and to have a high quality mobility road network for the transportation of passengers and goods.*	- Giving high priority for maintenance and rehabilitation of existing road network - Building carefully selected and economically maintainable new major roads and expressways - Launching a programme for traffic management and increasing road safety - Continuing the *"Maga Neguma"* programme to develop rural road network - Introducing traffic management measures such as road pricing, construction of flyovers and establishment of signal lights etc. - Opening investment opportunities for Public Private Partnerships (PPPs) for the development of expressways
Transport Services: *Provision of efficient and safe transport systems at an affordable cost and responsive to the needs of social and economic development.*	*Highlights of overall transport policy:* - Relating transport tariffs to costs of providing such services - Granting government subsidies to transport services and transport users only on economic and social grounds - Avoiding cross subsidies *Rail Transport: Less travel time* - Improving existing services provided to passengers - Improving the financial situation - Improving the railway system in the medium to long term through the construction of new railway lines and extending selected lines, introduction of modern technology and electrified train services and facilitation of container transport by train *Bus Transport: Comfortable and safe journey* - Improving the existing capital assets through a rehabilitation programme - Strengthening state bus services by adding new buses, providing coordinated rail bus services and encouraging National Transport Commission and Provincial Councils to develop and implement common regulatory process
Ports: *Developing Sri Lanka as the leading navigational, trading and commercial centre in South Asia.*	- Developing main ports of the country to facilitate international trade - Decongesting the Colombo International Port by constructing South Port, Galle and Hambantota ports - Developing ports in identified provinces - Encouraging the improvement of capacity, efficiency and productivity of ports, while continuing the state ownership of the existing ports - Managing the increasing operational cost of ports to operate as commercial entities - Establishment of container terminals outside the harbour as PPPs

Aviation: *Maintain a competitive civil aviation environment which ensures safety and security in accordance with international standards and promote efficient, cost effective and orderly growth in air transport.*	- Focusing government investment on improvement of traffic control, safety and security in the Bandaranaike International Airport - Confining private sector involvement in provision of landside services - Providing adequate world class airport infrastructure capacity in accordance with demand - Improving connectivity between Sri Lanka and other countries by entering into bilateral agreements on open sky - Encouraging multiple local carriers for international air services - Promoting PPPs to develop new airports and to improve existing airports
Postal: *Ensure better quality service, greater responsiveness to customer needs, financial sustainability and optimum utilisation of postal infrastructure.*	- Increasing the accessibility and providing postal services through every "Jana Sabha" Secretariat and focusing on other sources of income by providing various services - Reducing financial deficit through streamlining key management support systems - Developing the tariff system considering increasing cost, competition and volume of letters delivered. - Preparing a Business Plan for the Postal Department and implementing it from 2007 onwards - Adopting different market strategies to arrest declining market share
Tourism: *Make Sri Lanka the foremost leisure destination in the South Asian region.*	- Promoting Sri Lanka as a regional hub in tourism industry. - Developing tourist zones with increased activities and special concessions for both international and local tourists - Adopting a consistent marketing and advertising policy to aggressively promote Sri Lanka in the fast emerging key markets - Developing state of the art infrastructure to achieve the targeted room capacity of 30,000 by 2015
Urban Development and Human Settlements: *Systemic urbanisation process, which will ensure that the lives of all citizens will be comfortable, decent and healthy.*	- Developing and modernising Colombo and its environs to suit the international standards and improving under-served settlements in the city of Colombo through private developers and liberate prime lands for commercial and development purposes by private sector. - Developing regional cities on appropriate themes enabling to activate the regional growth process - Establishing national level growth centres to ensure geographically balanced development in the country - Developing small and medium townships throughout the country as second and third order cities - Establishing/improving regulatory frameworks at national and regional level to arrest haphazard development and unlawful development and commercial activities.

Livelihood Development and Social Protection: *A country in which people are empowered to develop and sustain their livelihoods and improve their standards of living.*	- Focusing on livelihood development to provide sustained income avenues for the poor - Creating a conducive environment for the poor to develop livelihood opportunities through the provision of funding, technical know-how, improved infrastructure and marketing facilities - Investing in special poverty reduction projects and programmes in the poor rural areas to address severe regional disparities in development and poverty incidence with improved coordination - Continuation of "Gama Neguma" programme - Using micro financing as an effective instrument for livelihood development and poverty reduction - Continuing the relief assistance aimed at economically and socially disadvantaged people through payment of direct cash grants
Education: *Transforming education system into one that will promote the technological skills required for rapid economic growth and national development.*	*General Education:* - Protecting free education for all children while providing widest possible opportunities to every person to acquire a quality education according to their ability and preference - Promoting equitable opportunities in access, participation, achievement and outcomes in basic and secondary education and improving quality - Strengthening governance, efficiency and service delivery *Technical and Vocational Education:* - Improving the quality and relevance of programmes - Increasing enrolment in technical and vocational institutions from secondary schools and the workforce - Improving the operational and management efficiency of technical and vocational education institutions *Higher Education:* - Keeping state university system in the long run as the predominant institutional system providing university education. Allowing degree granting institutions and non-state universities to operate, side-by-side, in collaboration with the state universities under the surveillance of state laws - Encouraging multiple sources of funding for higher education with the state continuing as the main provider. Universities will be modernised by way of laboratory and experimental resource enhancement and attraction of experts in the disciplines of special education, research and consultancy capacity in chosen areas of national priority

	- Encouraging universities to specialise in priority areas of national development and thus become centres of excellence in the region. The government may establish six or more specialised universities to provide direct human resource support to the country's economic development efforts - Introducing new degree programmes to meet unmet demand for human resources and knowledge while encouraging universities to reform their existing curricula to suit the changing employment opportunities
Health: *Fostering a healthier nation that contributes to it's economic, social, mental and spiritual well-being.*	- Health promotion, prevention and control of diseases, both communicable and non-communicable diseases - Serving the needs of underprivileged, under-served and vulnerable groups - Encouraging private investment in healthcare provision - Human resources development - Strengthening quality and range of existing services with emphasis on bridging the gaps therein - Minimising regional differences in healthcare delivery system - Reforming organisational structure and management to improve efficiency, effectiveness and accountability - Assuring that health resources are utilised optimally
Employment: *A future of peace and prosperity in which Sri Lankans enjoy a better quality of life free from poverty and deprivation, through the promotion of opportunities to obtain productive work in conditions of freedom, equity, security and human dignity.*	- Generating employment: Concentrating employment in informal sector, reducing underemployment, promoting private sector as an employment source, realising potential in micro, small and medium size enterprises and managing labour migration - Developing skills and labour productivity: Matching labour demand and supply, establishing labour market information system, increasing competitiveness and productivity of labour force and realising the challenge of youth employment in conflict affected areas - Increasing the flexibility of labour laws and regulations: Extending social protection to the informal sector, increasing employment flexibility, providing social security for unemployed, concentrating the impact of ageing on labour force and combating child labour - Increasing employer – employee relationships: Promoting industrial relations and prioritising tripartite consultation at national level

Science and Technology: *Sri Lanka to be a knowledge and science based, newly developed country by 2017, advancing towards rural poverty alleviation, with full computer literacy and penetration, excellent science education and leading edge science and technology effectively transferred.*	- Fostering a national science culture that effectively reaches every citizen in the country - Building up, sustaining and progressively increasing the resource base of scientists and technologists necessary to respond to the country's development needs - Fostering scientific and technological activities in all relevant fields - Encouraging research in fundamental and applied aspects of science and technology - Encouraging the utilisation and further development of indigenous and local knowledge and technologies - Encouraging and rewarding science and technology based innovations and inventions and ensuring the protection of intellectual property rights - Encouraging and strengthening co-operation in science and technology between Sri Lanka and other countries
Environment: *Building land that is in harmony with nature.*	- Developing partnerships with all resource users - Promoting sustainable land use for state lands - Developing private forests and tree resources - Developing forest products, industries and marketing - Supporting institutional development and inter-sectoral linkages
Reforms: *Establishing a productive and efficient, customer friendly, uncorrupt, transparent and accountable public service, which will help to realize economic goals and ensure social justice and socio-economic stability.*	- Getting a collaborative government: Clear demarcation of responsibility and authority between the three levels of governance; national, provincial and local, while eliminating overlapping in responsibilities and authority between the levels of governance - Cooperative delivery of public services with improvements in contract management skills, techniques of performance measurement, strategic planning skills and sensitivity to voice of the citizens - Efficient public financial management: Fiscal discipline, strategic allocation, and good operational management - Creating an efficient public service - Managing public sector performance effectively - Improving and strengthening the administrative system: Comprehensive reforms, sectoral reforms and specialised reforms
Development of Conflict Affected Areas: *Developing North and East as a hospitable and attractive place and create an environment where people can live in freedom and pursue livelihoods of their choice where peace and ethnic harmony will prevail in a way that will permit rapid social and economic development.*	- Restoring livelihoods - Reactivating services and facilities - Rehabilitation of infrastructure facilities - Development of human capabilities and capacities - Targeting vulnerable groups to provide sustainable livelihoods to ensure their dignity - Establishment of good governance