

## QER - First Quarter 2007

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Amidst escalation of the conflict, the growth of the economy slowed down during the first quarter of 2007. This was the fourth consecutive drop in quarterly growth rate. The first quarter GDP growth was negligibly lower than the preceding quarter, and significantly lower than the corresponding quarter last year. While the agriculture sector recorded negative growth, industrial sector growth was lower than the preceding quarter. Services sector growth was lower than the corresponding quarter last year.

In the agriculture sector, tea and coconut outputs during the quarter under review were lower and rubber output higher than the previous quarter. While the tea output was lower, rubber and coconut outputs were higher than the same quarter last year. Tea production was negatively affected due to drought and trade union action in December. Paddy output also dropped during the Maha season due to drought and escalation of the conflict in the East. Tea auction price was significantly higher than in the previous quarter as well as the corresponding quarter last year because of production shortfall.

In the industrial sector, while the private sector industrial production index dropped, the public sector industrial production index increased in the first quarter compared to the preceding quarter. In comparison to the corresponding quarter last year, the private sector industrial production index was higher, but public sector industrial production index was lower in the first quarter 2007. Total industrial export during the quarter under review was considerably higher than the corresponding quarter last year, but considerably lower than the preceding quarter. Depreciation of the rupee since October 2006 had helped boost industrial exports.

The Central Bank raised the interest rates in order to stem the rise in cost of living as part of a tight monetary policy adopted since early-2007. Therefore, interest rates were consistently higher than the previous quarter and the same quarter last year. Nevertheless, real interest rates were negative, because inflation was greater than the nominal interest rates. The interest rate rise had negatively affected economic growth.

The rate of inflation, in terms of both the SLCPI and CCPI, continued to rise during the first quarter. That is, both the point-to-point and annual average rate of inflation were on the rise, except in February when the point-to-point rate of inflation in terms of CCPI dropped compared to January. Inflation was also higher than the corresponding quarter last year. In spite of a tight monetary policy pursued by the Central Bank, since the beginning of the year, cost of living continues to rise.

Public debt incurred, during the quarter under review, was significantly lower than the previous quarter, but significantly higher than the corresponding quarter last year. Amidst declining foreign aid, the share of domestic debt is increasing. Rising domestic debt fuels inflation, and crowds out private investment.

In international trade, both exports and imports dropped in the first quarter 2007. The drop in the total import value was greater than the drop in the total export value. Therefore, the trade deficit declined considerably. Further, the total export value was considerably higher, and the total import value was lower than in the same quarter last year. Hence, the trade deficit during the first quarter 2007 was considerably lower than in the corresponding period last year.

Gross official reserve continued to rise during the quarter under review. In spite of declining foreign aid and income from tourism, the gross official reserve increased due to lower trade deficit, increasing flow of private remittances, and the sale of foreign currency denominated Treasury bonds. Lower world oil price had also helped bolster the foreign exchange reserve of the government.

Capital market continued to be buoyant in spite of the escalation in conflict. This was mainly due to negative real interest rates. Although the capital market drops immediately after violent acts in and around Colombo, it recovers quickly.

Although at the macro level the economy of the conflict region has not been much affected during 2006, according to the Provincial Gross Domestic Product data, at the local and household levels impact has been severe. Mass displacements and loss of livelihoods have been witnessed throughout the North&East Province. In the Jaffna peninsula and the LTTE-controlled Vanni mainland escalation of food and non-food items has been an additional burden for the people. Nevertheless, consumer prices in Jaffna have halved in February and March compared to January.

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