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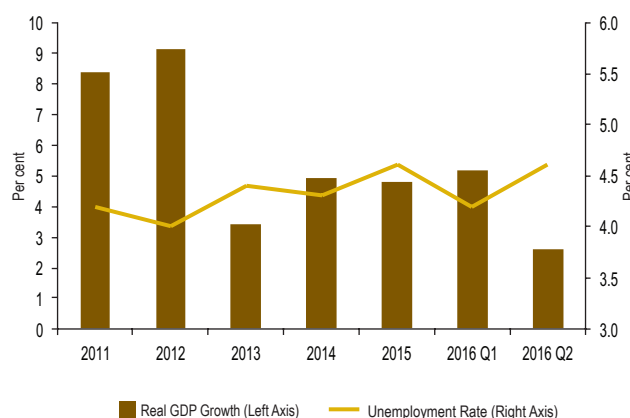
## OVERVIEW

**T**he growth in economic activity continued, with the Sri Lankan economy growing at the moderate rate of 3.9 per cent in real terms during the first half of 2016 following the annual growth of 4.8 per cent registered in 2015. The growth of the Services sector was supported by financial service activities, and wholesale and retail trade activities in addition to other personal services and public services. The Industry sector expansion was a result of higher value addition from construction and manufacturing activities. The Agriculture sector contracted due to adverse weather conditions, which also affected prices of domestic fresh food items in the first half of the year. In spite of the price pressures arising from these domestic supply side disruptions and the immediate impact of tax adjustments introduced by the government, consumer price inflation remained in single digits during the first nine months of the year. However, the upward trend in underlying inflation and average inflation during this period, along with high monetary and credit expansion and the possibility of a shortfall in government tax revenue collection required preemptive monetary policy measures from the Central Bank. Accordingly, the Central Bank tightened its monetary policy stance, first by raising the Statutory Reserve Ratio (SRR) and then by raising its main policy interest rates in two steps during the first nine months of the year. The tightening of monetary policy was also expected to support the reduction of the pressure on the external sector through the dampening of import intensive credit flows to the economy and discouraging portfolio capital outflows in the context of the normalisation of monetary policy in the United States of America. Nevertheless, external sector vulnerabilities persisted as a result of the weak recovery of the global economy and further uncertainties due to Brexit, as well as the inability of the Sri Lankan economy to attract sufficient non-debt creating long term capital flows. Meanwhile, the government and the Central Bank entered into an Extended Fund Facility (EFF) with the International Monetary Fund (IMF) with the intention of streamlining medium term fiscal performance, strengthening official international reserves and maintaining inflation at mid-single digit levels. In the fiscal sector, although some improvements were observed in the first half of 2016, lingering fiscal challenges as well as several structural weaknesses in the economy remain to be addressed. In relation to the financial sector, a continuation of its growth momentum was observed during the first eight months of 2016.

- The economy grew by 3.9 per cent during the first half of 2016 in real terms, in comparison to 5.7 per cent growth recorded in the corresponding period of 2015. This growth was mainly propelled by the continuous expansion in Services followed by the Industrial activities despite the contraction recorded in the Agriculture sector activities. Among the three major sectors, Services activities continued to be the dominant force in GDP growth, recording a 4.9 per cent increase during the first half of 2016. The sectoral performance was underpinned by the expansion in financial service activities, wholesale and retail trade activities and other personal services. Meanwhile, Industry related activities grew by 5.2 per cent during the first half of 2016, compared with the 2.5 per cent growth during the same period of 2015. The recovery in construction activities coupled with the positive performance of manufacturing activities mainly contributed to this growth. The other industrial activities too yielded positive results, albeit contributing marginally to growth. On the other hand, Agriculture activities contracted by 2.5 per cent during the first half of 2016, as opposed to the 8.1 per cent growth recorded in the corresponding period of 2015. The contraction recorded in growing of tea, rice, spices, rubber as well as fishing activities were the main contributory factors. In the meantime, taxes less subsidies on products of the economy had a dampening impact on the overall economic growth during the first half of the year, due to its contraction by 3.1 per cent during the period.
- Although some increase in the unemployment rate was observed in the second quarter of 2016, the unemployment rate during the first half of 2016 was 4.4 per cent in comparison to 4.6 per cent in the first half of the previous year. The decline in the unemployment rate among females to 6.7 per cent in the first half of 2016 compared to 7.5 per cent in the

Chart 1.1

Real GDP Growth (a) and Unemployment



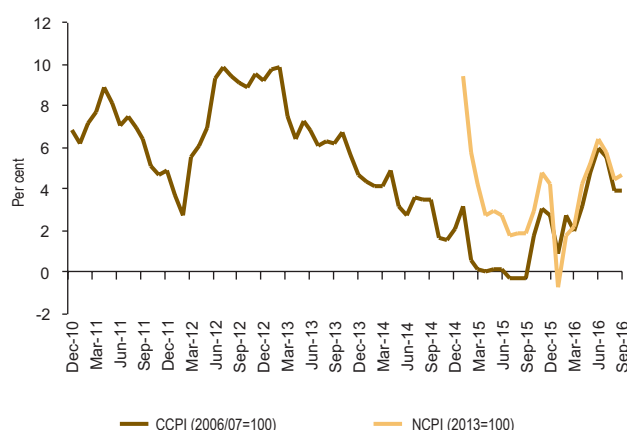
(a) Based on revised GDP estimates (2010 base) of DCS

corresponding period of the previous year mainly contributed to the improvement in the first half of the year. Unemployment amongst males increased to 3.1 per cent in the first half of 2016 from 2.9 per cent in the corresponding period of the previous year. Youth unemployment (15-24 years) at 21.8 per cent during the period continued to remain high, although a marginal decline from the respective period of last year was observed. In terms of the level of education, the highest unemployment rate of 8.2 per cent was recorded amongst persons with GCE (Advanced Level) and higher levels of educational attainment, which however has improved from the 9.3 per cent recorded during the same period of 2015.

- Consumer price inflation increased during the first half of 2016 and stabilised around mid-single digits thereafter while core inflation also indicated some stabilisation following an increasing trend. Headline inflation, as measured by both the National Consumer Price Index (NCPI, 2013=100) and the Colombo Consumers' Price Index (CCPI, 2006/2007=100), registered an increase in the second quarter of 2016 reflecting the combined impact of domestic supply side disturbances, particularly due to adverse weather conditions, and the increase in the Value Added Tax (VAT)

Chart 1.2

## Year-on-Year Inflation



rate as well as the removal of certain exemptions applicable on VAT and the Nation Building Tax (NBT). Nonetheless, inflation declined in the third quarter of 2016 mainly reflecting the impact of the normalisation in domestic supply conditions as well as the suspension of the implementation of changes to the government tax structure. Accordingly, on a year-on-year basis, NCPI based headline inflation, which increased to a peak of 6.4 per cent in June 2016, moderated to 4.7 per cent by September 2016. On an annual average basis, NCPI based headline inflation was 3.8 per cent in September 2016. Following a similar trend, CCPI based headline inflation also reached a peak of 6.0 per cent by June 2016 and gradually declined to 3.9 per cent in September 2016, while on an annual average basis, it stood at 3.4 per cent in September 2016. Meanwhile, core inflation, which measures the underlying inflationary pressures, continued its upward trend in the first half of 2016 reflecting the firming up of demand conditions in the economy, while it steepened towards the latter part of this period following the revisions made to the tax structure by the government. However, core inflation stabilised around mid-single digits in the third quarter of 2016, part of which could be attributed to the reversal of the changes made to the government tax structure. Accordingly,

core inflation, based on NCPI, was 5.7 per cent in September 2016, year-on-year, compared to a peak level of 7.5 per cent recorded in June 2016 and 5.8 per cent recorded at end 2015. CCPI based core inflation, following a similar trend, was recorded at 4.2 per cent, year-on-year, in September 2016 in comparison to 4.5 per cent at end 2015.

- **The external sector displayed a modest performance during the first half of 2016.** Both exports and imports contracted resulting in an expansion in the trade deficit during the first half of 2016. The services account recorded a surplus primarily due to the continuous growth in earnings from tourism while earnings from transportation and computer and information related services also recorded a moderate growth during the period. The deficit in the primary income account increased with lower inflows due to the decline in earnings from reserve assets as well as higher outflows on account of an increase in dividend payments by direct investment enterprises and interest payments on project loans by the government. The secondary income account continued to record a surplus despite a moderate growth in workers' remittances. With these developments, the current account deficit narrowed to US dollars 795 million in the first half of 2016 from the deficit of US dollars 953 million recorded during the corresponding period of 2015. In the financial account, limited FDI inflows, net outflows from the foreign investments in the Colombo Stock Exchange (CSE) together with the unwinding of foreign investments in government securities, on a net basis, resulted in an overall deficit in the BOP by end June 2016. Meanwhile, developments in the current and the financial accounts of BOP, along with the need to strengthen fiscal consolidation, prompted Sri Lanka to obtain a three year EFF of SDR 1.1 billion (approximately US dollars 1.5 billion)

from the IMF to strengthen the external position of the country and to support the government's economic reform agenda. The EFF supported economic programme contributed to positive investor sentiments resulting in a reversal in the net outflow from the government securities market from April 2016 onwards. Inflows to the financial account were further supplemented by the proceeds from the dual-tranche International Sovereign Bond (ISB) issuance and the syndicated loan in July 2016, strengthening the external sector in the third quarter of 2016.

- **The deficit in the trade balance increased by 1.6 per cent, year-on-year, during the first eight months of 2016, as a result of the considerable reduction in exports compared to marginal decline in imports.** Continuing the sluggish performance recorded since the latter part of 2014, earnings from exports during the first eight months of 2016 declined by 4.1 per cent, year-on-year, to US dollars 6,865 million, while expenditure on imports decreased moderately by 1.6 per cent to US dollars 12,403 million. The substantial reduction in international commodity prices contributed significantly to the decline in both exports and imports. Despite the improvement recorded in earnings from textile and garment exports, lower earnings from transport equipment, petroleum products, tea, and spices exports contributed mainly to the decline in exports. Earnings from textiles and garments exports, increased by 3.6 per cent during the first eight months of 2016, as a result of the increase in exports to both traditional and non-traditional markets compared to the corresponding period in 2015. The decline in import expenditure was led by the significant decline recorded in the importation of fuel and motor vehicles. However, import expenditure on machinery and equipment, building materials, textile and textile articles, and gold increased considerably during the period. Accordingly, the

trade deficit expanded to US dollars 5,538 million during the first eight months of 2016 from US dollars 5,449 million in the corresponding period of the previous year.

- **Sri Lanka's current account deficit moderated in the first half of 2016 by around 16.6 per cent from the corresponding period in 2015.** The improvement in the current account was a result of the increase in net inflows to the services account and the secondary income account. Alongside the increase in the deficit in the trade account, the primary income account also recorded a deficit of US dollars 955 million during the first half of 2016 compared to US dollars 925 million recorded a year earlier. Inflows to the primary income account declined marginally with a reduction in earnings from reserve assets during the period. Further, outflows from the primary income account by way of dividend payments increased while interest payments on portfolio investments declined with a significant reduction in outstanding Treasury bonds held by non residents during the period. The deficits in trade and primary income accounts were offset partially by the surplus in the services and the secondary income accounts. The improvement in services account was mainly driven by high inflows in travel and transport sub sectors while the surplus in the secondary income account recorded a moderate growth as a result of a lower than expected growth in workers' remittances. The services account of the BOP recorded a surplus of US dollars 1,228 million during the first half of 2016 compared to the surplus of US dollars 1,059 million in the corresponding period of 2015, with a higher contribution from travel and transport sub sectors. Other inflows to the services account remained moderate during the period, including net inflows on account of telecommunication, computer and information services. Net inflows to the secondary income account increased to US dollars 3,146 million in the first half of 2016



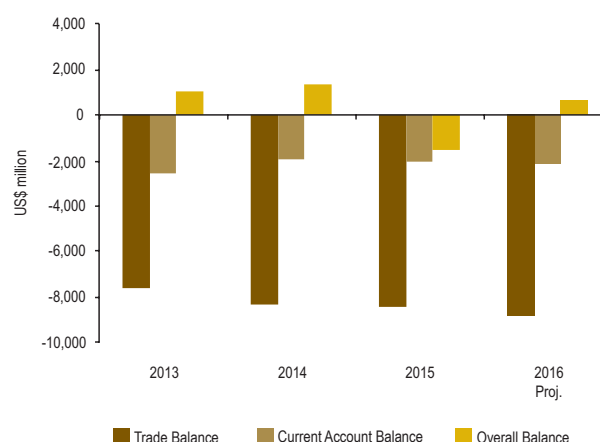
from US dollars 3,035 million in the corresponding period of 2015. Workers' remittances increased by 5.3 per cent during the first half of 2016 over the relatively low base recorded last year but remained subdued compared to the average annual growth of 13.6 per cent over the 2000-2014 period. The comparatively low growth in workers' remittances during the first half of 2016 could be partly attributed to the drop in income in oil exporting Middle Eastern countries with the decline of international oil prices, which resulted in reducing new recruitments and curtailing work hours such as over-time work. Reflecting these developments, the current account deficit moderated to US dollars 795 million in the first half of 2016 compared to the deficit of US dollars 953 million in the first half of 2015.

- Both net incurrence of liabilities and net acquisition of financial assets declined significantly in the first half of 2016.** Higher net incurrence of liabilities relative to net acquisition of assets resulted in the overall net borrowings of the financial account amounting to US dollars 967 million in the first half of 2016 compared to US dollars 667 million in the corresponding period in 2015. Total net acquisition of financial assets declined by US dollars 1,882 million in the first half of 2016 in contrast to the increase of US dollars 419 million in the first half of 2015. Net incurrence of liabilities in the first half of 2016 decreased by US dollars 915 million compared to an increase in liabilities of US dollars 1,086 million in 2015. The slow recovery of the global economy and the increase in policy rates of the US Federal Reserve prompted continuous outflows of foreign investments, especially during the first four months of 2016. This also resulted in an outflow of foreign investments from the Colombo Stock Exchange and a significant outflow of foreign investments in the government securities market in the first half of 2016. External borrowings by the government for project loans also remained moderate during the period. Total contribution

of the banking sector, corporate sector and State Owned Business Enterprises (SOBEs) to the financial account also remained modest. Further, trade credit and advances received by Sri Lankan enterprises, primarily by the Ceylon Petroleum Corporation, reduced during the first half of the year. Meanwhile, the Central Bank continued to repay the swap arrangement with the Reserve Bank of India (RBI) and the outstanding of the IMF-SBA while engaging in a new swap under the SAARCFINANCE arrangement. Further, inflows in the form of direct investments remained stagnant during the period, much in line with the low direct investment inflows in 2015. There were limited inflows as direct investments in the form of new projects, while ongoing key projects received only moderate levels of direct investments. In the backdrop of continuing pressure on the external sector in addition to the need for improving the fiscal sector, and effects of the unfavourable global economic environment, Sri Lanka entered into, a three year EFF from the IMF. The overall expectation of the EFF supported economic programme is to improve macroeconomic stability, bolster market confidence, enhance competitiveness and outward orientation while strengthening external sector resilience in a challenging global environment.

Chart 1.3

Balance of Payments

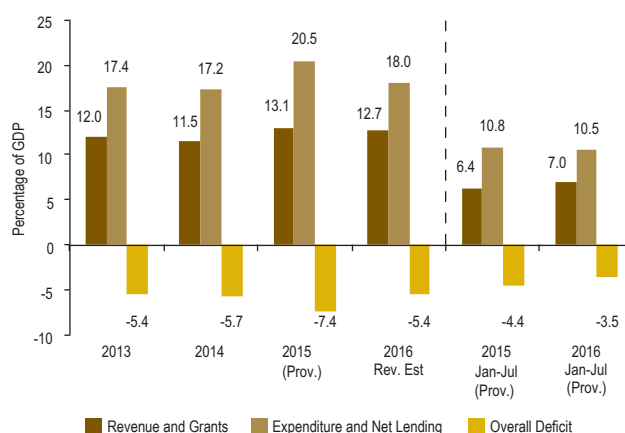


- The level of gross official reserves of the country amounted to US dollars 6.5 billion by end September 2016. The receipt of the first tranche of the IMF-EFF, proceeds from the issuance of the ISB of US dollars 1.5 billion, proceeds from syndicated loans of US dollars 700 million and rolling over of US dollars 400 million under the SAARCFINANCE currency swap arrangement contributed positively to the reserve level. Conversely, settlement of the RBI swap facility, foreign currency debt service payments, supply of liquidity to the domestic foreign exchange market and principal payments of IMF-SBA were the main drains on the reserves during the period. The country's gross official reserve level of US dollars 6.5 billion by the end of September 2016 is estimated to be equivalent to 4.1 months of imports.
- Despite considerable depreciation pressure on the rupee during the first four months of 2016, the rupee remained relatively stable during the year up to September 2016. Import expenditure, debt service payments and unwinding of investments in the government securities market exerted depreciation pressure on the rupee during the first four months of 2016 which necessitated the intervention of the Central Bank in the domestic foreign exchange market by supplying foreign currency liquidity. The gradual reversal in the outflows from the government securities market together with inflows from the IMF-EFF, the proceeds from the ISB and the syndicated loans reduced the depreciation pressure on the domestic currency gradually from May 2016 onwards. As such, the net supply of foreign exchange liquidity by the Central Bank was limited to US dollars 693 million during the first nine months of 2016. With all these developments, the Sri Lankan rupee recorded a depreciation of 1.8 per cent against the US dollar by the end of September 2016. Meanwhile, both the 5-currency and

24-currency Nominal Effective Exchange Rate (NEER) and Real Effective Exchange Rate (REER) indices depreciated during this period. The 5-currency REER and 24-currency REER indices depreciated by 0.06 per cent and 2.06 per cent, respectively, reflecting an improvement in country's external competitiveness.

- The fiscal sector exhibited a favourable performance during the first seven months of 2016. Government revenue as a percentage of estimated GDP increased to 7.0 per cent in the first seven months of 2016 in comparison to 6.4 per cent in the first seven months of 2015, reflecting an increase in tax revenue. The Value Added Tax (VAT), import duties, income taxes, Ports and Airports Development Levy (PAL), Cess, Special Commodity Levy (SCL) and other import related taxes contributed positively to the increase in tax revenue, while revenue from excise duties declined marginally during the period under consideration mainly due to the decline in revenue from excise duty on motor vehicles. Total expenditure and net lending as a percentage of estimated GDP declined marginally to 10.5 per cent during the first seven months of 2016 compared to 10.8 per cent recorded during the corresponding period in 2015, as a result of the decline in recurrent

**Chart 1.4** Government Revenue, Expenditure and Overall Budget Deficit (as a percentage of GDP)



expenditure. Consequently, the overall budget deficit declined to 3.5 per cent of estimated GDP during the first seven months of 2016 from 4.4 per cent in the corresponding period in 2015, reflecting a significant improvement in the fiscal sector.

- **The overall budget deficit of Rs. 432.7 billion during the first seven months of the year was mainly financed through domestic sources.** However, net domestic financing declined by 24.8 per cent to Rs. 409.8 billion during the first seven months of 2016, compared to Rs. 545.2 billion in the corresponding period of 2015, owing to the low financing requirement of the government during the period under consideration compared to the same period in the previous year. Net foreign financing amounted to Rs. 22.9 billion in the first seven months of 2016 compared to the repayment of Rs. 41.8 billion in the corresponding period of 2015. This was mainly on account of the utilisation of the proceeds from the ISB and improved foreign holdings of Treasury bills despite the net repayment of foreign project loans and net outflows from foreign holdings of Treasury bonds.
- **The Central Bank tightened its monetary policy stance in several stages during the first nine months of the year with the view of containing the possible emergence of demand-driven inflationary pressures in the economy stemming from high credit growth and excessive monetary expansion.** In an environment of relaxed monetary conditions that prevailed in previous years, monetary aggregates grew at a higher than projected pace. Given the higher than expected domestic credit growth and risks relating to financial system stability, several macroprudential policy measures, such as imposing cash margins and maximum loan-to-value ratios, were introduced

Table 1.1

## Recent Monetary Policy Measures

Date	Measure
3-Feb-2012	Repurchase rate and Reverse Repurchase rate increased by 50 basis points to 7.50% and 9.00%, respectively.
9-Feb-2012	Greater flexibility in the determination of the exchange rate allowed.
12-Mar-2012	Direction issued to licensed banks to limit rupee denominated credit growth to 18% or Rs. 800 mn. Additional 5% (23% or Rs. 1 bn) allowed to banks that bridge the gap with funds raised abroad.
5-Apr-2012	Repurchase rate increased by 25 basis points to 7.75% and Reverse Repurchase rate increased by 75 basis points to 9.75%, respectively.
12-Dec-2012	Repurchase rate and Reverse Repurchase rate reduced by 25 basis points to 7.50% and 9.50%, respectively.
31-Dec-2012	Ceiling on rupee denominated credit growth allowed to expire.
10-May-2013	Repurchase rate and Reverse Repurchase rate reduced by 50 basis points to 7.00% and 9.00%, respectively.
26-Jun-2013	Statutory Reserve Requirement (SRR) reduced by 2 percentage points to 6% with effect from 1-Jul-2013.
15-Oct-2013	Repurchase rate and Reverse Repurchase rate reduced by 50 basis points to 6.50% and 8.50%, respectively.
2-Jan-2014	The Policy Rate Corridor was renamed as the Standing Rate Corridor (SRC), and the Repurchase rate and the Reverse Repurchase rate of the Central Bank were renamed as the Standing Deposit Facility Rate (SDFR) and Standing Lending Facility Rate (SLFR), respectively. SLFR reduced by 50 basis points to 8.00%. The Standing Deposit Facility (SDF) was uncollateralised with effect from 1-Feb-2014.
23-Sep-2014	Access to the SDF of the Central Bank by OMO participants at 6.50% was rationalised to a maximum of three times per calendar month. Any deposits at the SDF window exceeding three times by an OMO participant was accepted at a special interest rate of 5.00%.
2-Mar-2015	The 5.00% special SDF rate was withdrawn.
15-Apr-2015	The SDFR and SLFR reduced by 50 basis points to 6.00% and 7.50%, respectively.
3-Sep-2015	The exchange rate was allowed to be determined based on demand and supply conditions in the foreign exchange market (a).
30-Dec-2015	SRR was increased by 1.50 percentage points to 7.50% to be effective from the reserve period commencing 16-Jan-2016.
19-Feb-2016	The SDFR and SLFR increased by 50 basis points to 6.50% and 8.00%, respectively.
28-Jul-2016	The SDFR and SLFR increased by 50 basis points to 7.00% and 8.50%, respectively.

Source: Central Bank of Sri Lanka

(a) In addition, the Central Bank imposed:

- a minimum cash margin requirement of 100% on 30 October 2015 against Letters of Credit (LC) opened with commercial banks for the importation of motor vehicles to be effective until 1 December 2015, and
- a maximum Loan to Value (LTV) ratio of 70% in respect of loans and advances granted for the purpose of purchase or utilisation of motor vehicles by banks and financial institutions supervised by the Central Bank with effect from 1 December 2015, as a macro-prudential measure.

by the Central Bank in the last quarter of 2015 to contain credit flows to certain sectors, while allowing the exchange rate to be determined by market forces. At the same time, the Central Bank commenced tightening its monetary policy stance gradually by raising the Statutory Reserve Ratio (SRR) applicable on all rupee deposit liabilities of commercial banks by 1.50

percentage points to 7.50 per cent, to be effective from January 2016. However, in spite of the upward adjustments observed in market interest rates following the increase in SRR, certain risks to macroeconomic stability continued to persist. Accordingly, the Central Bank further tightened its monetary policy stance by increasing its Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) by 50 basis points each, to 6.50 per cent and 8.00 per cent, respectively, in February 2016. Monetary tightening measures, coupled with declining levels of excess market liquidity, resulted in an increase in short term money market rates, while other market interest rates also started increasing gradually. However, amidst an increase in lending rates, credit disbursements to the private sector by commercial banks continued to grow unabated beyond the desired levels during the second quarter of 2016 as well. Therefore, considering the potential threats to price stability due to the sustained increase in credit and monetary aggregates amidst upward trending underlying inflation, the Central Bank tightened its monetary policy stance further in a forward looking manner by increasing SDFR and SLFR by 50 basis points each, to 7.00 per cent and 8.50 per cent, respectively, in July 2016.

- **Market interest rates moved upwards during the first nine months of 2016 reflecting transmission of the impact of tight monetary conditions in the economy.** Following the upward adjustment in SRR as well as the increase in policy interest rates in February 2016 and the subsequent decline in market liquidity levels, the Average Weighted Call Money Rate (AWCMR), which is the operating target variable under the present enhanced monetary policy framework, increased and hovered within the range of 8.15-8.24 per cent levels, while Open Market Operations (OMOs) conducted by the Central Bank helped stabilise money market rates. Following the policy rate hike in

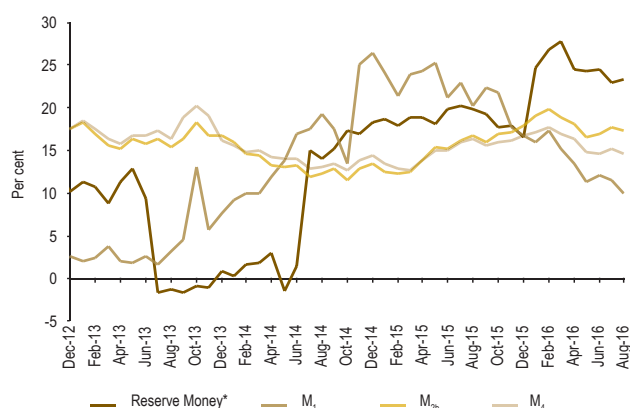
July 2016, the AWCMR increased further and remained at 8.42 per cent by end September 2016. Meanwhile, the Sri Lanka Inter Bank Offered Rates (SLIBOR) gradually increased in line with the AWCMR. Accordingly, by end September 2016, overnight and 12-months SLIBOR remained at 8.44 per cent and 11.98 per cent, respectively, compared to 6.40 per cent and 7.66 per cent, respectively, at end 2015. Following the increase in short term interest rates, lending rates and deposit rates of commercial banks have registered an upward adjustment thus far in 2016. Accordingly, the Average Weighted Lending Rate (AWLR), increased by 188 basis points to 12.88 per cent by end September 2016 from 11.00 per cent at end 2015. Similarly, the Average Weighted New Lending Rate (AWNLR) also increased to 13.97 per cent at end September 2016 from 10.79 per cent at end December 2015. Meanwhile, the weekly Average Weighted Prime Lending Rate (AWPR) increased substantially by 459 basis points to 12.12 per cent by end September 2016 compared to 7.53 per cent recorded at end 2015. Reflecting the increased funding costs of financial institutions, deposit rates also increased, albeit at a slower pace compared to lending rates. The Average Weighted Deposit Rate (AWDR) increased by 136 basis points to 7.56 per cent during the first nine months of the year while Average Weighted Fixed Deposit Rate (AWFDR) increased by 210 basis points to 9.67 per cent by end September 2016. Moreover, the Average Weighted New Deposit Rate (AWNDR), which captures the interest rates pertaining to all new interest bearing deposits, increased by 405 basis points to 11.01 per cent by end September 2016. Meanwhile, primary market Treasury bill yield rates witnessed a sharp increase during the first three months of the year and moderated thereafter. The government securities market experienced a net foreign inflow since the latter part of April 2016 reflecting positive sentiments following the



announcement of the EFF programme of the IMF. This, coupled with the enhancements of government revenue collection and the receipt of long term financial flows from abroad, particularly with the successful issuance of Sri Lanka's tenth ISB, eased the pressure on yield rates to some extent. Although there was an upward adjustment in the yields immediately after the policy interest rate hike in July 2016, the yield rates indicated a gradual decline thereafter. Accordingly, 91-day, 182-day and 364-day Treasury bill yield rates were at 8.55 per cent, 9.39 per cent and 10.11 per cent respectively, by end September 2016 compared to 6.45 per cent, 6.83 per cent and 7.30 per cent respectively, reported at end 2015. Meanwhile, interest rates applicable on debt instruments issued by the corporate sector have also showed some upward adjustment thus far in 2016. In line with the movements in global interest rates, particularly interest rates in the United States, interest rates applicable to foreign currency deposits maintained at commercial banks increased marginally in 2016.

- **Reserve money, which represents the monetary base of the economy, recorded a notable growth of 23.3 per cent (year-on-year) by end August 2016, compared to 16.5 per cent at end 2015. In absolute terms, reserve money increased**

**Chart 1.5** Year-on-Year Growth of Monetary Aggregates



\*Sudden changes in reserve money growth in particular months are due to revisions to SRR.

substantially by Rs. 112.3 billion to Rs. 785.7 billion during the first eight months of the year. From the liability side, the increase in both currency in circulation and commercial banks' deposits with the Central Bank contributed to the expansion in reserve money. The significant expansion in commercial banks' deposits with the Central Bank during this period is mainly attributable to the increase in SRR applicable on all rupee deposit liabilities of commercial banks. On the assets side, the expansion in reserve money was entirely on account of the increase in net domestic assets (NDA) of the Central Bank, as net foreign assets (NFA) of the Central Bank declined during the first eight months of the year. NDA of the Central Bank, which increased by around Rs. 260 billion during the first seven months of the year, declined in August, thereby lessening the year-to-date expansion in NDA to Rs. 189.4 billion by end August 2016 compared to the increase of Rs. 207.3 billion recorded in the previous year. The expansion was largely on account of the substantial increase in the Central Bank's holdings of government securities (by around Rs. 133 billion), which led to an increase in net credit to the government (NCG) by the Central Bank by around Rs. 166.6 billion during the first eight months of the year. Nevertheless, a sharp contraction in Central Bank's holding of government securities of Rs. 59.3 billion was observed in the month of August 2016 on account of the maturing of Treasury bills. In addition, provisional advances to the government increased by Rs. 33.5 billion during the first eight months of the year. NDA of the Central Bank improved further following a notable decline in funds placed under the Standing Deposit Facility by Rs. 51.2 billion, which led to the contraction of other liabilities of the Central Bank by Rs. 26.3 billion during the period January-August 2016. Meanwhile, NFA of the Central Bank declined by Rs. 77.2 billion reflecting a decline in foreign currency reserves during this period.

- **Buttressed by the expansion in credit extended to the private sector and the government, the growth in broad money supply ( $M_{2b}$ ) continued to remain high with an average growth of 18.1 per cent during the first eight months of 2016.** The year-on-year growth of broad money ( $M_{2b}$ ) was 17.3 per cent in August 2016 compared to 17.8 per cent at end 2015. In spite of the contraction in lending to public corporations, NDA of the banking system has remained buoyant contributing to over 90 per cent of the expansion in broad money. The significant expansion in NDA was driven by the expansion in domestic credit flows directed towards the private sector and the government. Meanwhile, with NFA of commercial banks contributing positively as a result of increased foreign currency placements abroad and reduced foreign borrowings, NFA of the banking system increased by a moderate Rs. 16.6 billion, year-to-date, by end August 2016 following a contraction during the first half of the year.
- **During the first eight months of the year, NCG increased significantly by Rs. 178.4 billion due to credit disbursements to the government by both the Central Bank and commercial banks.** NCG by the Central Bank remained high and amounted to Rs. 166.6 billion, year-to-date, by end August 2016, compared to Rs. 80.3 billion recorded at end 2015. This increase was largely on account of purchases of Treasury bills by the Central Bank from the primary market, which led to an increase in the outstanding Treasury bill holdings by around Rs. 133 billion by end August 2016. Moreover, provisional advances to the government, which is the other key component of NCG, rose by Rs. 33.5 billion thus far during the year. Meanwhile, NCG by commercial banks increased only by Rs. 11.8 billion, year-to-date, by end August 2016; substantially lower than Rs. 243.3 billion recorded in 2015.
- **On the contrary, credit extended to public corporations from commercial banks declined by Rs. 81.5 billion during the first eight months of the year compared to the increase of Rs. 76.9 billion in 2015.** This was largely on account of partial loan settlements by the Ceylon Petroleum Corporation (CPC) amounting to around Rs. 97.5 billion, followed by net repayments by the Ceylon Electricity Board (CEB) and Sri Lanka Ports Authority (SLPA) amounting to Rs. 8.4 billion and Rs. 1.7 billion respectively, during the first eight months of the year. Nevertheless, SriLankan Airlines, Ceylon Fertilizer Corporation, Colombo Commercial Fertilizer and Ceylon Shipping Corporation have borrowed Rs. 5.6 billion, Rs. 4.0 billion, Rs. 3.4 billion and Rs. 3.4 billion respectively, on a net basis, thus far during the year.
- **Credit extended to the private sector expanded significantly during the first eight months of 2016.** The year-on-year growth of credit extended to the private sector peaked at 28.5 per cent in July 2016, and ended at 27.3 per cent in August 2016, compared to 25.1 per cent at end 2015, while the average growth of credit has remained high at 27.5 per cent thus far during 2016, compared to 16.6 per cent during the corresponding period of 2015. In absolute terms, credit obtained by the private sector increased by Rs. 456.3 billion during the first eight months of the year compared to the increase of Rs. 310.5 billion in the corresponding period of the previous year. As per the Quarterly Survey of Commercial Banks' Loans and Advances to the Private Sector, credit to all major sectors of the economy recorded notable rates of growth, year-on-year, by end June 2016. Year-on-year growth of credit to the Services and Industry sectors were high at 46.1 per cent and 29.6 per cent, respectively, by end June 2016, while credit in the form of Personal Loans and Advances grew by 23.3 per cent. Credit to the Agriculture and Fishing sectors was relatively low, with growth recording 8.9 per cent,

year-on-year, by end June 2016. Security wise classification of advances indicated that credit against all major securities have increased thus far during the year. Nevertheless, credit extended by commercial banks in the form of leasing and hire purchase agreements increased only by around Rs. 18.0 billion, year-to-date, by end August 2016, compared to the increase of Rs. 65.6 billion during 2015, reflecting the impact of policy measures adopted by the Central Bank, alongside revisions to the tax structure made by the government, which caused a slowdown in demand for vehicle imports.

- The growth momentum in the financial sector continued during the first eight months of 2016 with all major sectors remaining sound.** The banking system continued its accelerated growth in assets while maintaining capital and liquidity well above the regulatory minimum requirements. The asset quality of the banking system enhanced as shown by the historically lower level of non-performing loan (NPL) ratio and improvement of accessibility to banking facilities with the expansion of branch network and ATM facilities. High domestic demand for credit mainly from construction, financial and business service and consumption has led to the expansion in loans and advances, and the profitability of the banking system. On the other hand, non-bank financial institutions (NBFIs) sector sustained its growth momentum and stability with a diversified loan portfolio as a response to the tight fiscal and macro prudential policy measures. Profitability and asset base of other financial sub sectors, such as insurance, unit trust, primary dealers and superannuation funds also recorded positive growth during the reference period, though stock brokers' performance was subdued due to the poor performance of the Colombo Stock Exchange during this period. An upward pressure on money market interest rates was observed

towards the latter part of the reference period resulting from the tight monetary policy stance of the CBSL and the liquidity shortage that prevailed in the money market. Yield rates of government securities in the secondary market too have increased and showed volatility during this period. Although liquidity shortage was observed in the domestic foreign exchange market during the first quarter of 2016, the liquidity position improved with foreign currency inflows to government securities and EFF approved by the IMF. While corporate debt securities market's growth momentum and investor base improved during the reference period, equity market's performance slowed down due to the foreign outflows and adverse investor sentiments connected to uncertainties over global economic outlook, exchange rate movements and political changes. Access to finance improved during this period as evident by several concessionary development credit schemes offered to micro, small and medium scale enterprises (MSME). The efficiency and safety of the national payment system were enhanced during this period and the national payment council has prepared a draft Road Map for the medium term development of payment systems.

### International Economic Environment

- The global economic outlook is projected to remain modest in 2016, while gradual recovery is expected in 2017, according to the IMF World Economic Outlook (WEO) – October 2016.** Global economic growth forecast has remained unchanged from July 2016 at 3.1 per cent for 2016 while gradually improving to 3.4 per cent in 2017. However, the 2016 growth projection for advanced economies was revised downwards from July 2016 in the backdrop of the lower than expected growth in the United States (US) particularly during the second quarter as well as increased uncertainty with the outcome of the

June vote in the United Kingdom (UK) to leave the European Union (Brexit). Meanwhile, the 2016 overall growth outlook for emerging market and developing economies improved marginally in comparison to the previous July estimates due to reduced concerns about China's short term growth prospects, firming of commodity prices and robust growth, particularly in India. During the medium term horizon, global growth outlook is forecast to gradually increase to 3.8 per cent by 2021 due to expected developments in emerging market and developing economies.

- **Growth outlook for advanced economies remains subdued during 2016 and 2017.** These economies are projected to grow by 1.6 per cent and 1.8 per cent during 2016 and 2017 respectively. The subdued outlook of advanced economies is partly attributable to the continuing impact of the global financial crisis and low productivity growth. Meanwhile, the Brexit vote is expected to have some negative repercussions, particularly in advanced European economies. The weaker than expected growth in the US economy during the first half of 2016 has contributed towards the muted growth in advanced economies. Although unemployment rate has declined, and housing market and consumer spending showed improvements in the US economy, the prolonged inventory correction cycle and weak business sentiments contributed towards the downward revision in economic growth. Accordingly, the IMF growth projection for the US economy is 1.6 per cent for 2016 followed by a 2.2 per cent growth in 2017. The growth outlook for the UK is projected at 1.8 per cent for 2016 and 1.1 per cent for 2017, assuming smooth post-Brexit transition. Meanwhile, the growth in the Euro area is projected to slowdown marginally during 2016-17 in comparison to 2015 in the backdrop of weaker investor confidence in the aftermath of the Brexit referendum. The loose monetary policy stance, modest fiscal consolidation in 2016 and recovery in oil prices would help maintain growth in the Euro region at 1.7 per cent and 1.5 per cent respectively, during 2016 and 2017, as per the IMF projections. The Japanese economy is projected to record a modest growth during 2016 and 2017, with projected growth rates of 0.5 per cent and 0.6 per cent respectively.
- **After five consecutive years of slow growth momentum, emerging market and developing economies are projected to perform better from 2016 onwards, although the economic outlook for these economies still remains weaker than in the past.** Economic growth in these economies is projected to increase to 4.2 per cent in 2016 and to 4.6 per cent in 2017. The relatively weak growth momentum is attributable to the slowdown in China, lower commodity prices, weak demand from advanced economies and geopolitical uncertainties in some countries. Economic growth in China is projected to slowdown from 6.9 per cent in 2015 to 6.6 per cent in 2016 and 6.2 per cent in 2017. This is mainly due to continued rebalancing of the Chinese economy from investment to consumption and from industry to services. Meanwhile, growth in India is projected to remain high among major economies with an expected growth of 7.6 per cent during 2016 and 2017. In Latin America and the Caribbean region, where several countries are in recession, a recovery in growth is expected in 2017 while the outlook for the Commonwealth of Independent States remains lacklustre. Meanwhile, the demographic transition in the emerging market and developing economies remains a major challenge to sustaining economic growth in such economies.
- **Global consumer price inflation is projected to remain diverse between advanced economies and emerging market and developing economies.** Inflation in advanced economies is



expected to increase with the gradual rise in fuel prices and narrowing output gaps enabling central banks to reach their envisaged inflation targets by 2020. Accordingly, inflation in advanced economies is expected to rise to 0.8 per cent in 2016 and further to 1.7 per cent by 2017 in comparison to 0.3 per cent in 2015. Meanwhile, inflation in emerging market and developing economies is projected to moderate to 4.5 per cent in 2016 in comparison to 4.7 per cent in 2015 and further slowdown marginally to 4.4 per cent in 2017.

- **The growth in world trade volumes have remained at relatively modest levels during recent years.** As per the WEO, global trade volumes which recorded an average growth of 6.8 per cent during the period from 1998 – 2007, grew at a relatively modest level particularly from 2012 onwards. Continuing this trend, world trade volumes are forecast to grow by 2.3 per cent in 2016 while gradually recovering to 3.8 per cent during 2017. The main reason for the modest level of trade growth is attributed to the weakness in global economic activity, particularly in terms of investment. Meanwhile, the declining momentum of trade liberalisation and increasing trend in protectionism are also hampering the growth in world trade. However, global trade is expected to recover gradually from 2017 with a medium term growth projection of 4.3 per cent. This development is expected in the backdrop of increasing economic activity and investment in emerging market and developing economies.

### **Expected Developments**

- **Sri Lanka's positive medium term macroeconomic outlook will depend on structural adjustments in the external and fiscal sectors and the implementation of sound macro-management policies.** In this backdrop,

Sri Lanka's economic growth is likely to be around 5.0-5.5 per cent in 2016, and is expected to increase to 6.3 per cent in 2017 and to grow thereafter at an annual rate of 7 per cent or above. The growth momentum is expected to be supported by major contributions from growth in the trade of merchandise goods and services; especially in the areas of tourism, transport, telecommunication, ports and financial services. The higher growth potential is envisaged to be achieved mainly through productivity improvements supported by the adoption of new technology across production sectors as well as through the digitalisation of the economy, which would pave the way for increased market access and efficient information flow in the economy. The medium term growth outlook would also be supported through the consolidation of investment activities with the participation of both the public and private sectors. Foreign investments are expected to perform an enhanced role, particularly in areas where Sri Lanka has relative advantage, such as information technology related services and logistics. The planned establishment of the Colombo International Financial City, new opportunities under the Megapolis project and the proposed establishment of Special Economic Zones, particularly in Hambantota with the participation of Chinese investors, are among the key areas that would help generate growth over the medium term. Appropriate monetary and fiscal policy measures are also expected to create an environment conducive for investment. Inflation is expected to be maintained at around mid-single digit levels, while fiscal policy will continue to focus on strengthening the fiscal consolidation process. The rise in income levels from the expected developments in all sectors of the economy would help Sri Lanka to graduate to upper middle income status, and the per capita GDP is expected to rise to over US dollars 5,500 by 2020.

- **The external sector outlook is expected to improve gradually during the medium term, despite possible downside risks mainly stemming from the global environment.** Supported by appropriate policies to promote global market linkages and diversification, exports are projected to record an expansion during the period from 2017 while imports are expected to increase at a lower rate than exports. Inflows from services exports are projected to grow steadily, further strengthening the surplus in the services account of the BOP. The growth in services exports would come from the continued growth in tourist receipts and the increase in earnings from transportation services, and computer and information technology and related services. Meanwhile, receipts from workers' remittances are projected to improve gradually albeit at a moderate rate due to the decline in migration under unskilled category and better domestic labour market opportunities. As such, the current account deficit is expected to improve over the medium term and is expected to record a marginal deficit by 2020 with the improvement in the trade deficit and projected net inflows from services exports and workers' remittances. The financial account of the BOP is also projected to improve during the medium term with continued inflows to the government and the private sector. Inflows to the government are expected through project loans and issuance of government securities, including International Sovereign Bonds. Meanwhile, private sector inflows to the economy would mainly include receipts in the form of foreign direct investments. With these developments, gross official reserves are expected to rise to a comfortable level, strengthening the country's external sector stability.
- **The government's strong commitment towards fiscal consolidation is expected to enhance revenue collection and rationalise recurrent expenditure, thus resulting in an overall improvement in the fiscal sector during the**

**medium term.** Policies taken towards strengthening the proper implementation of the proposed changes in the existing tax system by rationalising tax exemptions and improving tax compliance as well as tax administration would enhance government revenue to around 16 per cent of GDP in the medium term. This coupled with the rationalisation of recurrent expenditure would enable the government to allocate the required level of funds to maintain public investment at around 6 per cent of GDP in the medium term. Consequently, the budget deficit is expected to be around 3.5 per cent of GDP by 2020 while generating a surplus in the primary balance and current account balance during the medium term. The government debt is expected to fall below 68 per cent of GDP in the medium term. Further, planned fiscal reforms, including reforms to SOEs, are expected to address the structural weaknesses in the fiscal sector thus helping to improve the overall macroeconomic stability of the country.

- **The Central Bank will continue to follow an enhanced monetary policy framework with the view of moving towards a flexible inflation targeting (FIT) framework over the medium term to ensure price stability on a sustainable basis.** Under the ensuing FIT framework, the Central Bank would employ monetary policy to stabilise inflation around a targeted path and also to stabilise the real economy. Risks to macroeconomic stability due to demand pressures arising from high money and credit expansion are expected to moderate in the period ahead benefitting from the forward looking monetary policy measures of the Central Bank. Accordingly, in the medium term, inflation is projected to remain in mid-single digit levels of 4-6 per cent, which is also consistent with the inflation target bands stipulated under the IMF-EFF Programme. At the same time, with appropriate policies, monetary aggregates are expected to expand at a rate consistent with the expected nominal

growth of the economy. The excessive expansion in credit to the private sector above the desired levels is also expected to decelerate to a level sufficient to facilitate the growth momentum of the economy. In addition, a gradual decline in credit to the public sector is anticipated along with the government's efforts to ensure long term fiscal consolidation and improved financial position of state owned enterprises, which are crucial for the effectiveness of monetary policy measures adopted by the Central Bank as well as to encourage greater private sector participation in economic activity.

- **Sri Lanka has the potential for a fresh leap of development leveraging its geographical location and strong relations with other nations to attract investment to foster stronger growth.** However, in order to accomplish this, an environment conducive for enhanced investments should be created by strengthening macroeconomic fundamentals and other related factors, including the doing business environment and structural reforms while putting in place a set of consistent policies that could support private sector led economic growth and people-centred development.

