Central Bank of Sri Lanka

Announcement of

Road Map: Monetary and Financial Sector Policies for 2012 and beyond

on

Tuesday, 3 January 2012

Programme

10.00 a.m.
Welcome Address
Chandra Premaratne
Deputy Governor

10.10 a.m.
Presentation of Policy Statement
Ajith Nivard Cabraal
Governor

11.30 a.m.
End of Programme

1. Introduction

Your Excellencies, Members of the Monetary Board, Deputy Governors and Officials of the Central Bank, Ladies and Gentlemen,

It has now become customary at the Central Bank to present the strategies and policies we propose to implement during the year through our Road Map for the year and the period beyond, to the key stakeholders of the economy.

So let me welcome you to the presentation of this year's Road Map and also take this opportunity to wish you the very best for the New Year. This year marks the sixth consecutive occasion that we communicate our plans for the forthcoming period. As in the previous years, it is our belief as well as intention that sharing our projections and policy directions would help you as you make your own plans for the future, and in that context, we believe that better coordination of private sector operations and public sector policies would enhance the effectiveness of both parties, leading to sustainable economic growth.

When we enunciated our policy proposals at the beginning of last year, we, along with the rest of the world, were somewhat confident that the world economy, although fragile, would slowly head towards recovery. However, with the protracted issues of sovereign debt and other concerns brewing in the world economy, fresh concerns emerged about the pace of recovery since of late, and the divergence in economic activity amongst regions has become more pronounced. Today, it is widely believed that the world economy would yet again undergo a period of comparatively slow activity, before gathering momentum around next year, bolstered by the robust Asian growth. The timing and magnitude of these occurrences, however, could vary greatly from the initial projections and require us to be vigilant as it could pose potential risks to our economy as well. Considering Sri Lanka's integration into the world economy, any change in direction or pace in global economic activity would impact us through the external and real sectors and, through other sectors. Against this backdrop, we would like to emphasise that our own projections and policy propositions have been based on assumptions and judgements, which

Chart 1.1
GDP Growth of Selected Countries

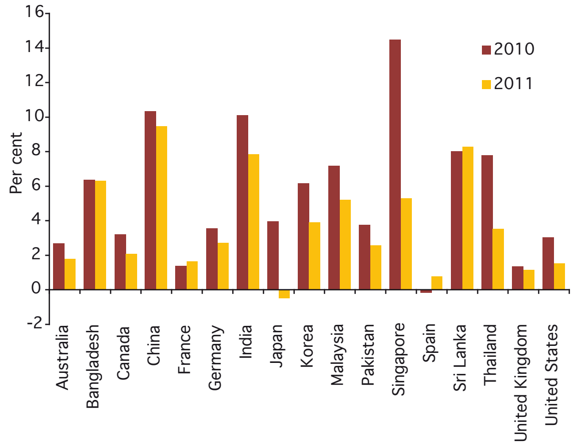
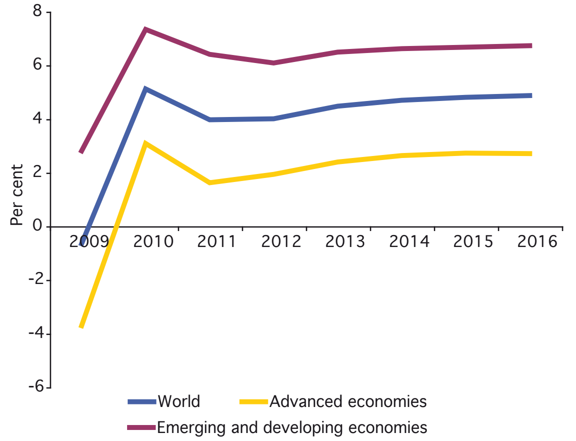


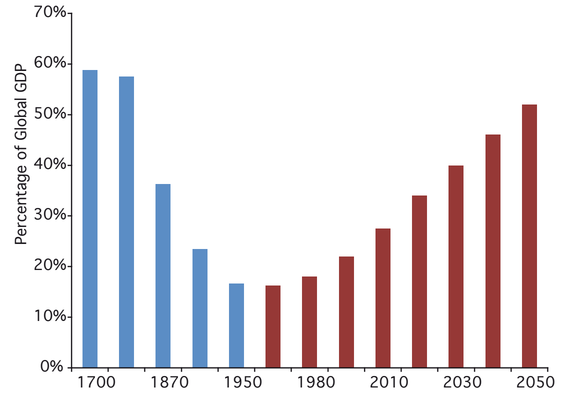
Chart 1.2
GDP Growth Estimates



would need to be modified in line with emerging developments in the global as well as Sri Lankan economy. Therefore, we would continue to watch closely for any deviations in trends in the economy and alter our policies and strategies as best suited. However, as in previous occasions, we will continue to keep all our stakeholders informed of any changes along with the reasons and our expectations behind such changes, if and when such changes are made.

We believe that clear and coherent communication is an integral part of successful policy

Chart 1.3
Asia's Share of Global GDP, 1700-2050



Source: Asia 2050 – Realising the Asia Century, ADB 2011

implementation. Towards that end, we will also continue to carry out regular policy dialogue with our various stakeholders, counterparts and consultative committees to enhance transparency as well as predictability and effectiveness of our policies. We will also continue to periodically publish various reviews and updates about the progress of the economy in addition to the statutory publications in order to keep you informed of new developments and emerging trends.

The Sri Lankan Economy Over Time

Before we present to you our strategies and policies for the period ahead, it may be useful to glance back in order to understand the evolution of our economy. Sri Lanka's economy has come a long way since the time we embraced open economic policies in 1978 and it would be true to say that the rapid transformations that we have seen in the recent past have been facilitated by the foundation provided through the various policy measures implemented from time to time.

In 1978, Sri Lanka introduced open economic policies and adopted a more market oriented approach promoting greater private sector participation in economic activity. Controls and regulations were relaxed to a large extent where interest rates and prices were allowed to be determined in a more market based manner while controls on foreign exchange transactions were relaxed and quantitative restrictions on imports were lifted. The banking sector was opened up with foreign banks being allowed to open branches in Sri Lanka and new private banks being permitted to enter the banking industry. Domestic production was geared towards the export markets and investments by both the private sector and foreign parties were encouraged.

A further relaxation of these policy measures took place in the 1990s and up to 2005. An extensive privatisation programme that was pursued by the governments of that time, sought to reduce the budget deficit in the medium term through fiscal consolidation, using privatisation proceeds. Full liberalisation of current account transactions within the balance of payments took place in 1994, followed by the selective liberalisation of the capital account from 1997 onwards. The Sri Lanka rupee was made an independently floating currency in 2001. In the meantime, the export oriented industrialisation policy was further strengthened while various tax reforms and incentives were extended to the private sector in order to enhance its investment capacity.

From 2006 onwards, the policy measures were based on the overall vision for the country set out under the Mahinda Chintana policy document. The overall policy focus of the government was geared towards uplifting the lives of the people through the promotion of inclusive growth, balanced regional development and development of hitherto underserved areas with particular attention to the Northern and Eastern provinces. Addressing supply bottlenecks and embarking on mega-infrastructure development drives were considered as a means towards enhancing productivity. A fiscal consolidation process was to be implemented while tax reforms and incentives to encourage greater private sector participation in economic activity were to be continued. Meanwhile, the monetary policy and the exchange rate policy were implemented in a manner that facilitated stability in the economy while supporting the growth momentum of the economy.

The present economic goals for the country include the doubling of per capita income to US dollars 4,000 by 2016, and transforming Sri Lanka into an economic hub in South Asia. The realisation of Sri Lanka's aim to become a vibrant economic hub is expected to be supported by the creation of five hubs in the areas of aviation, commerce, knowledge, energy and maritime activity. Individual goals have been designed and implemented under each of these areas and substantial progress has already been made towards the realisation of such goals.

Today's Statement

As in previous occasions, the Road Map for 2012 will include an evaluation of the economy's performance during the past year, and an analysis of the policy measures pertaining to monetary and financial sectors expected to be implemented in the forthcoming period.

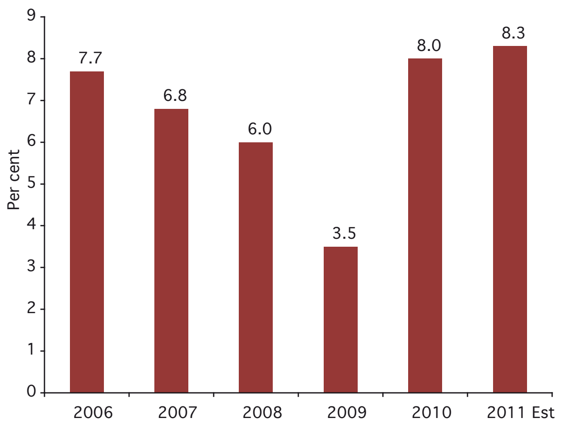
Accordingly, today's statement is structured as follows. The next section, Section 2 will review the economy's performance in 2011 while Section 3 will analyse the developments in the financial system in 2011. Section 4 will contain the macroeconomic strategy and proposed monetary policy strategy for 2012 followed by the proposed financial system stability policies for 2012 and beyond in Section 5. Section 6 will discuss policies to strengthen the economy in 2012 and beyond. The statement will end with some concluding remarks given in Section 7.

2. Macroeconomic Developments in 2011

The buoyancy of the Sri Lankan economy continued with improved macroeconomic environment, increased capacity utilisation together with expansion of economic activity in the former conflict affected areas and enhanced performance in the external sector. The growth in the first three quarters of 2011 was impressive and the economy is projected to grow by around 8.3 per cent for the year. The growth of over 8 per cent for two consecutive years for the first time in its history is no mean achievement and places Sri Lanka in the spotlight of emerging market economies.

The impressive GDP growth is expected to improve per capita income in both current market prices as well as at Purchasing Power Parity (PPP) adjusted prices to reach new heights. The unemployment rate recorded its lowest level of 4.3 per cent in the first half of 2011 since the inception of the Quarterly Labour Force Survey (QLFS).

Chart 2.1
Real GDP Growth



Inflation remained at mid-single digit level, largely reflecting improved domestic supply conditions and liquidity management policies of the Central Bank. In the external front, the exports recorded healthy growth, while imports continued to expand at a faster pace owing to the broad basing of economic activities and higher imports of intermediate and investment goods. Monetary policy continued to be accommodative while fiscal performance was broadly in line with budgetary targets. The public investment programme of the government progressed with accelerated implementation of major infrastructure development projects.

Sri Lanka's sovereign rating was upgraded by international credit rating agencies in line with overall macroeconomic developments and investor confidence. Sri Lanka's presence in the international capital markets further strengthened with the fourth International Sovereign Bond issued in July 2011.

Real Sector

The Agriculture sector marginally expanded by 0.8 per cent during the first nine months of 2011 from its slump in the first half of 2011 mainly due

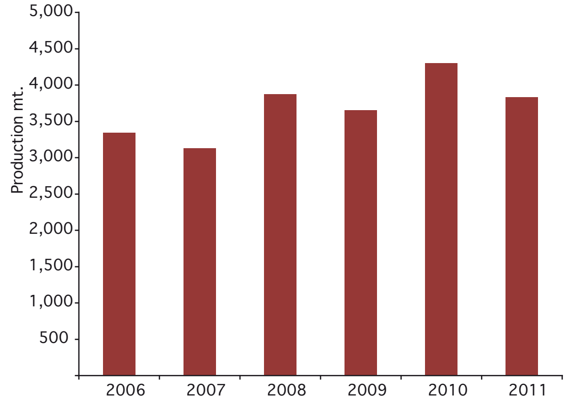


Chart 2.2
Paddy Production

to adverse weather conditions. The cultivation of paddy and other food crops were affected adversely during the first quarter of the year due to the adverse weather conditions that prevailed. However, the sector recovered during the second half of the year with the government fertilizer support scheme and the release of water in time for cultivation. The growth in agriculture is mainly driven by fishing during the first three quarters of 2011 which recorded a 15.7 per cent growth due to expanded fishing activities in the Northern and Eastern provinces. The agriculture sector is

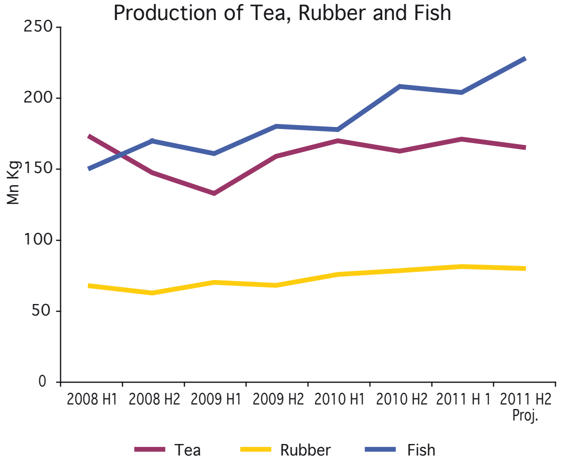


Chart 2.3
Production of Tea, Rubber and Fish

projected to expand by 2.1 per cent during 2011 compared to 7.0 per cent during 2010.

The industry sector recorded a higher growth of 10.5 per cent in value added terms during the first nine months of 2011 compared to 8.3 per cent recorded in the corresponding period of 2010. The growth in the industrial sector was largely driven by the manufacturing and construction sub-sectors which expanded by 8.1 per cent and 14.2 per cent, respectively, during the period. The industrial sector is expected to grow by 10.3 per cent in 2011.

Chart 2.4
Factory Industry Quarterly Growth Rates (2009-2011)

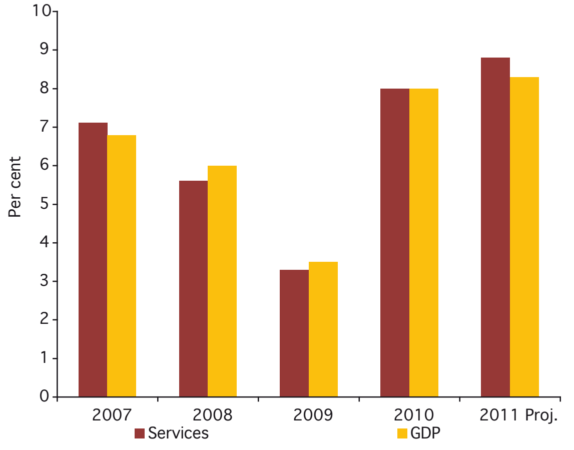
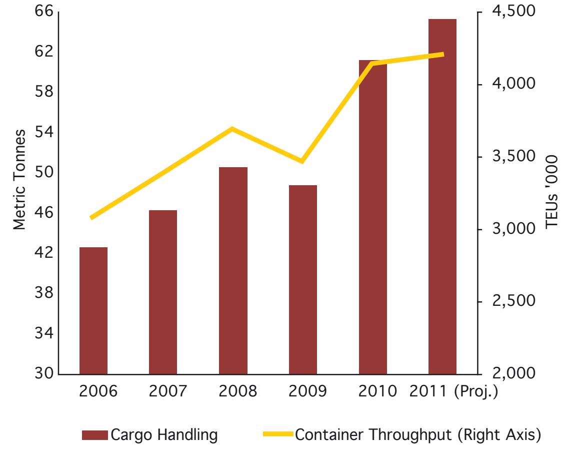


Chart 2.5
Services Sector and GDP Growth

Chart 2.6
Performance of the Ports



The services sector grew by 8.7 per cent during the first nine months of 2011 supported by increased growth in domestic and foreign trade, transport and healthy performances in financial services generated from higher consumer demand for services with increasing real income. The hotels and restaurants sub-sector expanded by 31.8 per cent for the first nine months of 2011 with the booming tourism industry to drive services sector growth. For the same period, the wholesale and retail trade which covers domestic and foreign trade, transport and communication and banking,

Chart 2.7
Unemployment Rate

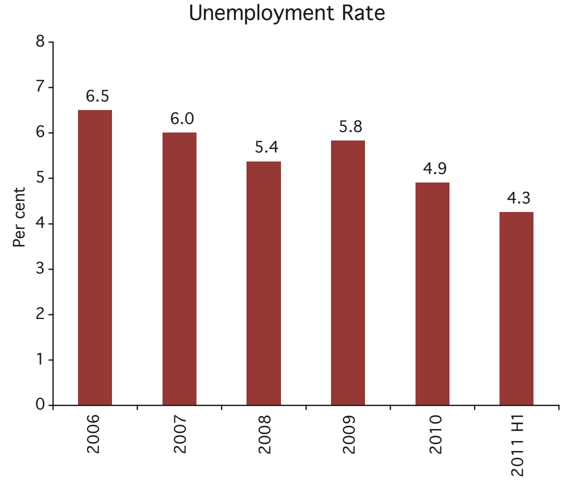
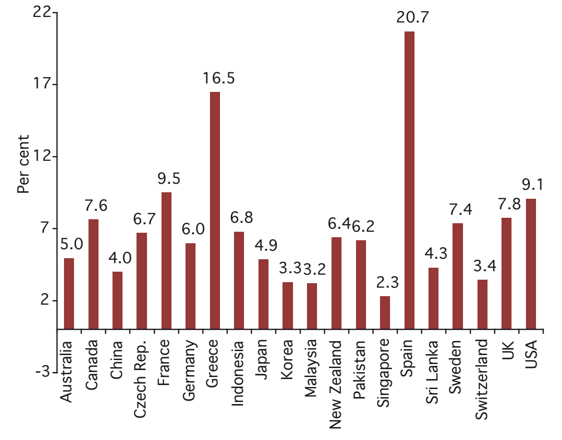


Chart 2.8
Unemployment Rates of Advanced and Some Emerging Economies - 2011 Est.



insurance and real estate sub-sectors grew by 10.5 per cent, 11.4 per cent and 7.6 per cent, respectively. The services sector is projected to expand by 8.5 per cent during 2011 over the growth of 8.0 per cent in 2010.

The unemployment rate declined appreciably to 4.3 per cent during the first half of 2011, compared to 5.2 per cent in the corresponding period of the previous year. This is the lowest unemployment rate recorded since the inception of the Quarterly Labour Force Survey. The decline in unemployment reflects the creation of new

Chart 2.9
Labour Productivity by Sector

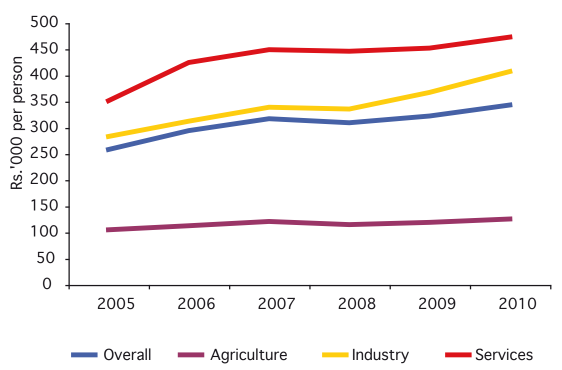
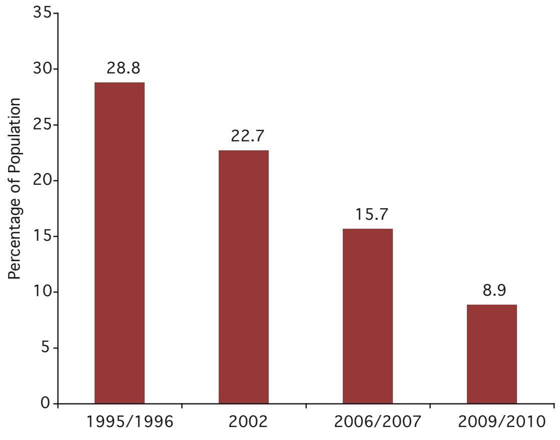


Chart 2.10
Poverty Headcount Index



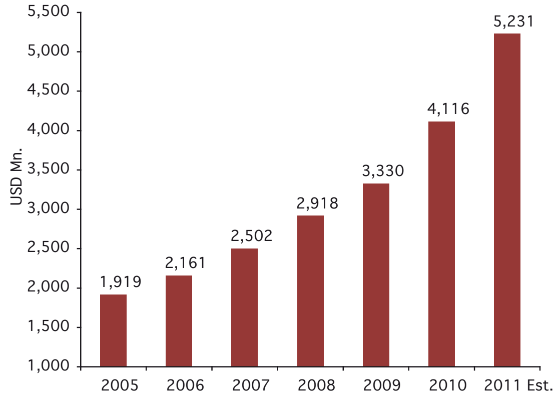
employment opportunities in the reconstruction, infrastructure development, and broad basing of economic activities. Also, the foreign employment continued to contribute to the decline in unemployment although departures for foreign employment in the first nine months of 2011 decelerated by 4.4 per cent to 197,738 compared to the same period in 2010, reflecting the increasing demand for employment in productive sectors of the economy.

The overall labour productivity, measured by GDP per worker, continued to improve in both industry and services sectors. The Poverty Head Count Index, measured as a percentage of population, continued to improve to record 8.9 per cent for 2009/10 from 15.2 per cent in 2006/07.

External Sector

The external sector expanded amidst many external challenges during the first eleven months of 2011. Export growth, remained strong despite the fragile recovery in the world economy. Earnings from exports increased by 22.2 per cent largely due to the growth in industrial exports. Meanwhile, expenditure on imports increased sharply by

Chart 2.11
Workers' Remittances



53.2 per cent with imports of investment and intermediate goods increasing at a rapid pace. This reflects expanding economic activity, including reconstruction and rehabilitation activities in the former conflict affected areas, continuation of several key infrastructure development projects, and the sharp increase in price and volume of petroleum imports. Reflecting the increasing consumption level of people with rising income, imports of consumer goods also increased. Expansion in imports took place at a rapid pace compared to the expansion in exports, which

Chart 2.12
Tourist Arrivals

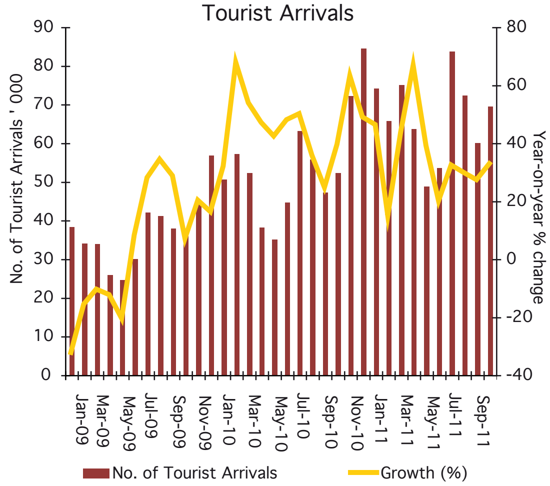
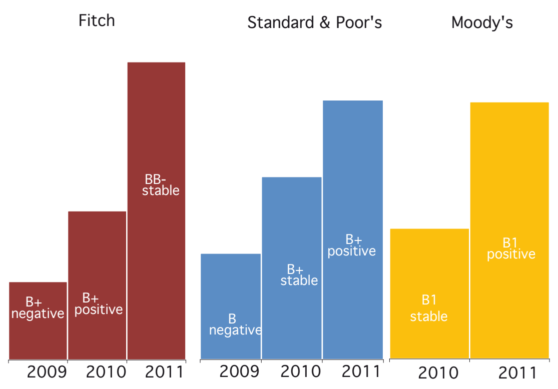


Chart 2.13
Earnings from Exports

widened the trade deficit. At the same time the expectation of the moderation of the import demand towards the latter part of the year did not take place, perhaps due to the favourable sentiment that has been visible in the economy.

The services exports expanded supported by healthy growth in the transportation and tourism sectors, while inward workers' remittances increased substantially and continued to be the key foreign exchange earner. These inflows supported to cover approximately 62 per cent of the trade deficit, thereby helping to contain the current account deficit of around US dollars 4 billion by end November 2011. The resurgence in inflows of private long-term investments and inflows to the government including the proceeds of the International Sovereign Bond issued in July 2011 helped contain the impact of the current account deficit in the balance of payments.

Chart 2.14
Ratings

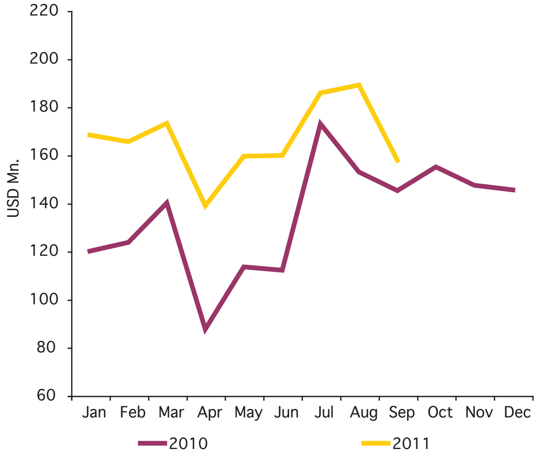


International rating agencies upgraded the sovereign rating for Sri Lanka, owing to the increasingly evident peace dividend reflected in greater macroeconomic and financial stability, the improving external sector and reduction in political risk following the end to the internal conflict in 2009. Fitch Ratings has upgraded Sri Lanka's Long-Term Foreign and Local Currency Issuer Default Ratings (IDRs) to 'BB-' from 'B+', and the Country Ceiling to 'BB-' from 'B+'. Further, Moody's Investors Service, has upgraded the outlook of Sri Lanka's 'B1' foreign currency sovereign rating from 'Stable' to 'Positive', while, Standard & Poor's Ratings (S&P) Agency has raised its outlook on Sri Lanka's long-term foreign currency sovereign credit rating to 'Positive' from 'Stable'. The rating upgrades will further facilitate in attracting foreign investments to the country.

Exports

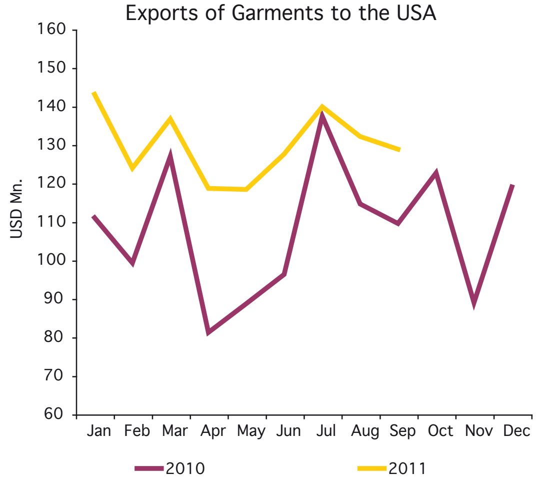
The earnings from exports increased at a commendable pace. For the first eleven months of 2011, the cumulative earnings from exports increased by 22.2 per cent to US dollars 9.6 billion compared with the same period of 2010. The earnings from exports of industrial goods increased by 30.4 per cent during the period and within this category, the exports of textiles and garments to Europe and USA continued to increase recording growths of 25.3 per cent and 21.3 per cent, respectively. The agricultural exports grew by 9.8 per cent for the first eleven months of 2011

Chart 2.15
Exports of Garments to the EU



compared with the same period of 2010 amidst the decline in export volume of tea. Among the agricultural exports, rubber, coconut and minor agricultural products increased by 23.8 per cent, 56.7 per cent and 12.6 per cent, respectively, for the same period. For the year 2011, the exports are expected to grow by over 22 per cent.

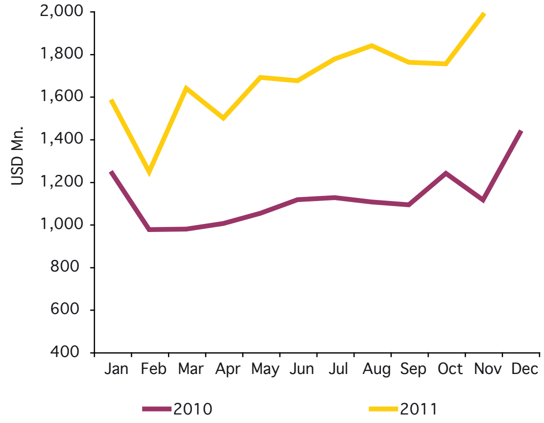
Chart 2.16
Exports of Garments to the USA



Imports

The cumulative expenditure on imports for the first eleven months of 2011, driven by high

Chart 2.17
Expenditure on Imports



growth in investment and intermediate goods, increased by 53.2 per cent to US dollars 18.4 billion, compared with the corresponding period of 2010. The substantial increase in investment goods imports is largely due to machinery and equipment for infrastructure development projects of the government and the increase in intermediate goods imports is due to sharp increase in price and volume of petroleum imports. In addition, gold and motor vehicle imports contributed substantially to the overall increase in expenditure on imports. The gold imports increased more than six fold to US dollars 553 million while the expenditure on imports of motor vehicles almost doubled to US dollars 913 million during the first eleven months of 2011, compared with the same period of 2010. The imports are expected to grow by around 50 per cent in 2011.

The trade deficit for the first eleven months of 2011 stood at US dollars 8.8 billion compared with US dollars 4.2 billion during the same period in 2010.

Current Account

The current account recorded a deficit of around US dollars 4 billion in the first eleven months of

2011. About two thirds of the deficit in the trade account was offset by higher inflows of workers' remittances and the surplus in the services account, thereby supporting to contain the deficit in the current account. The services account recorded a surplus of US dollars 661 million during the first nine months of 2011 compared to the surplus of US dollars 486 million recorded during the corresponding period of 2010, supported by rapid expansion in the transportation, travel and tourism sub-sectors. Tourist arrivals increased by 31 per cent to 855,975 in 2011, while earnings from tourism increased by 44.2 per cent to US dollars 830 million in 2011. Meanwhile, inward workers' remittances increased by 23.8 per cent to US dollars 4.6 billion during the first eleven months of 2011.

Capital and Financial Account

The capital and financial account recorded a surplus of US dollars 3.6 billion during the first nine months of 2011. Foreign Direct Investment (FDI), which declined during 2009 and 2010 due to the impact of global financial crisis recovered in 2011. Realised FDIs, including loans, during the first nine months of 2011 increased to US dollars 679 million compared to US dollars 310 million in the corresponding period of 2010. FDIs are estimated to have exceeded US dollars 1 billion in 2011. The total foreign inflows to the Government during the first eleven months of 2011, including the proceeds of the International Sovereign Bond, amounted to over US dollars 4 billion.

Meanwhile, long-term loan inflows to the private sector, excluding funds received for the Puttalam coal power project is estimated at US dollars 179 million in the first nine months of 2011 compared to US dollars 67 million in the corresponding period of 2010. During the first nine months of 2011, US dollars 33 million was received on account of the Puttalam coal power project, compared to the receipt of US dollars 445 million during the corresponding period of 2010. The exchange control relaxation measures enabling the private sector to borrow from foreign sources resulted in 14 private companies obtaining foreign loans amounting to US dollars 197 million by mid-September 2011, while the permission granted for foreign companies to open places of business resulted in 20 new foreign companies commencing business in Sri Lanka in the first nine months of 2011.

International Sovereign Bond Issue

Sri Lanka successfully issued the fourth International Sovereign Bond of US dollars 1 billion in July 2011. This bond was issued at a fixed-rate yield of 6.25 per cent per annum, which is a comparatively lower yield, with a maturity of 10 years and attracted an order book of over seven and a half times, reflecting enhanced investor confidence in Sri Lanka's economy and the robust growth prospects for the country.

Chart 2.18
Investor Mix of 2011 Sovereign Bond Issue

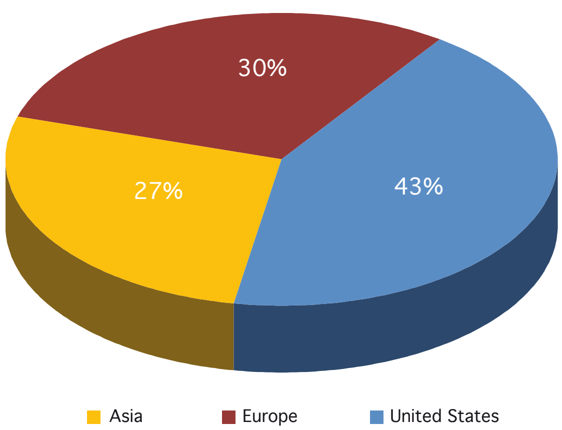


Chart 2.19
Sovereign Bond Issues - Amount & Coupon Rate

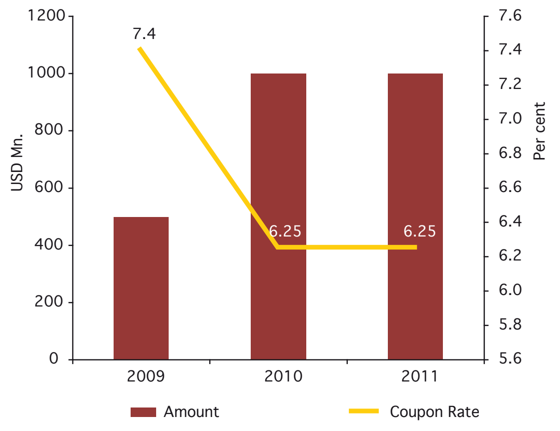
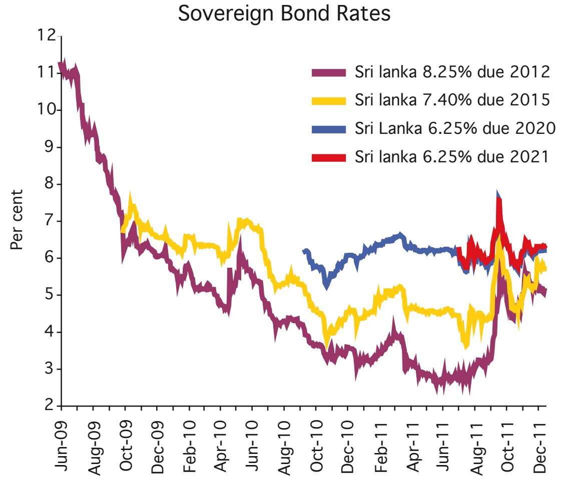


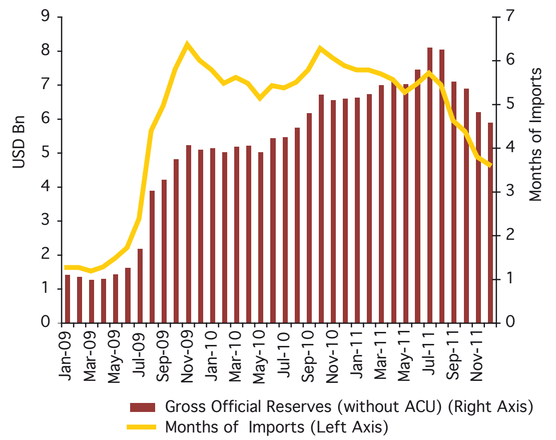
Chart 2.20
Sovereign Bond Rates



Balance of Payments and International Reserves

Balance of Payments (BOP) which recorded a surplus of around US dollars 1 billion in August 2011, declined subsequently with the widening trade gap. Despite the significant surplus in the financial account, the high current account deficit led the overall BOP to record a deficit of about US dollars 1 billion by end 2011. The gross official reserves (excluding Asian Clearing Union (ACU) balances) amounted to US dollars 5.9 billion by

Chart 2.21
Gross Official Reserves and Months of Imports



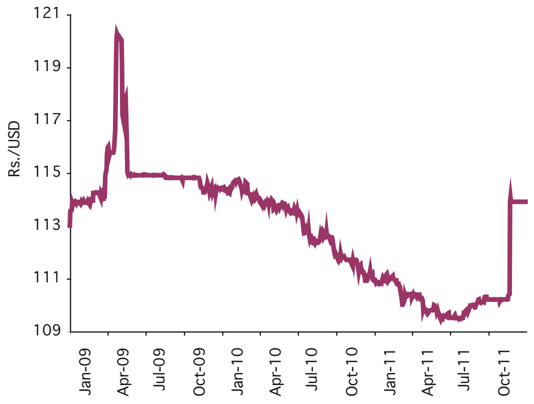
end 2011, which was equivalent to 3.6 months of imports.

In 2011, Sri Lanka received two tranches under the IMF-SBA facility to the value of US dollars 434.9 million. Accordingly, the country has received seven tranches under the SBA facility, totalling to US dollars 1.7 billion. The IMF re-structured the reviews under the SBA facility from quarterly to semi-annual basis, effective from March 2011.

The Exchange Rate

The exchange rate policy in 2011 was focused on maintaining stability in the domestic foreign exchange market. The rupee which appreciated by 1.23 per cent vis-a-vis the US dollar in the first half of 2011 due to increased foreign currency inflows, depreciated by 0.54 per cent during the third quarter of 2011 reflecting increased demand for foreign exchange in the market. In November 2011, the rupee was allowed a one-off depreciation of 3 per cent. Accordingly, the overall depreciation of the rupee during the year was 2.59 per cent. Reflecting the cross currency exchange rate movements, the rupee has depreciated against Pound sterling (2.30 per cent) and Japanese yen (7.21 per cent), while

Chart 2.22
Daily Sri Lanka Rupee/US Dollar Exchange Rate Movements



appreciating against the Indian rupee (15.01 per cent) and Euro (0.10 per cent) during 2011.

In the second half of the year, the Central Bank intervened in the foreign exchange market to mitigate the excessive volatility in the domestic foreign exchange market and to ensure adequate foreign exchange liquidity in the face of increased outflows arising particularly from the settlement of petroleum bills and substantial imports of intermediate and investment goods. Accordingly, CBSL supplied US dollars 2,840 million on net basis to the domestic foreign exchange market in 2011.

Chart 2.23
Daily Sri Lanka Rupee/Sterling Pound
Exchange Rate Movements

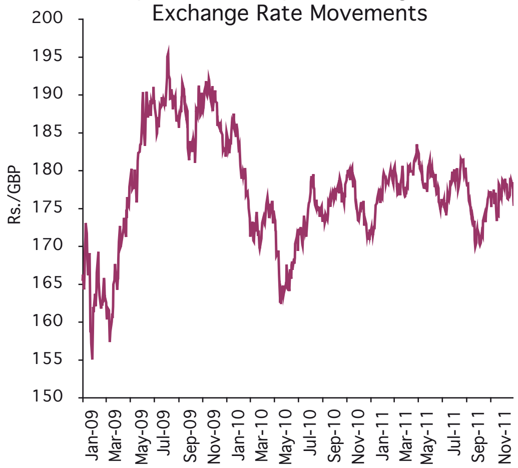


Chart 2.24
Daily Sri Lanka Rupee/EURO Exchange Rate Movements

Fiscal Sector

The budget in 2011 expected to reduce the fiscal deficit to 6.8 per cent of GDP from 8.0 per cent of GDP in 2010 continuing the commitment to fiscal consolidation by rationalising recurrent expenditure, while maintaining public investment at the targeted level. Major tax reforms were introduced in the budget aimed at simplifying the tax system and broadening the tax base to improve revenue mobilisation. This, together with the commitment to contain recurrent expenditure was expected to contribute towards maintaining

Chart 2.25
Overall Fiscal Deficit

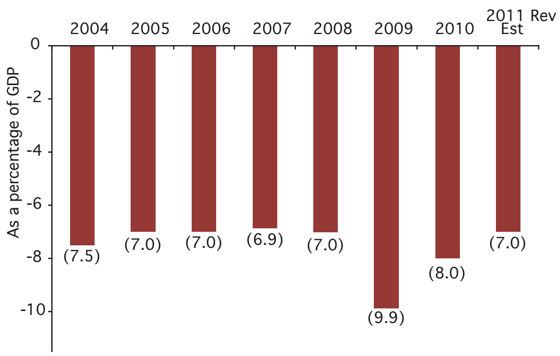
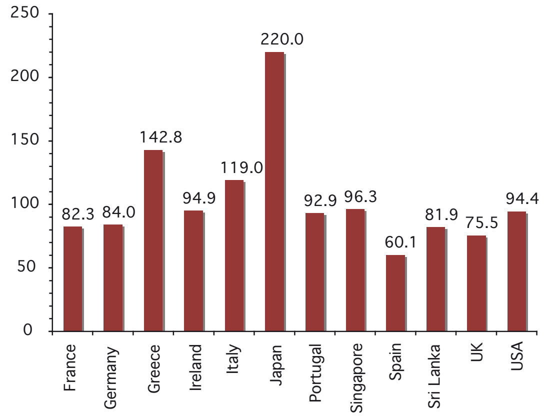


Chart 2.26
Selected Countries Debt to GDP Ratios - 2010



Source: IMF WEO September 2010

the budget deficit as targeted.

Total revenue during the first ten months of 2011 increased by 11.4 per cent compared to the corresponding period of the previous year. Increases in tax revenue due to continued expansion in economic activity and external trade mainly contributed to this increase. Major tax revenue sources such as income tax, excise duty and import related taxes performed reasonably well compared to the corresponding period of the previous year.

However, taking into account the developments during the year, the budget deficit estimate for 2011 has been revised to 7.0 per cent of GDP. Total revenue and grants for 2011 has been revised to 14.3 per cent of GDP from 15.6 per cent of GDP in the original budget, while total expenditure has been revised to 21.4 per cent of GDP from 22.4 per cent of GDP in the original budget.

Total expenditure and net lending during the ten months to October 2011 declined to 17.9 per cent of estimated GDP from 18.7 per cent of GDP during the same period in 2010 due to the continuous efforts by the government to control recurrent expenditure, while maintaining the public investment programme at a targeted level. As a percentage of estimated GDP, recurrent expenditure declined to 13.2 per cent during the first ten months of 2011 from 14.1 per cent in the corresponding period in the previous year while capital expenditure and net lending, as a percentage of estimated GDP marginally declined to 4.6 per cent during the first ten months of 2011 from 4.7 per cent in the corresponding period in 2010.

Chart 2.27
Oustanding Government Debt

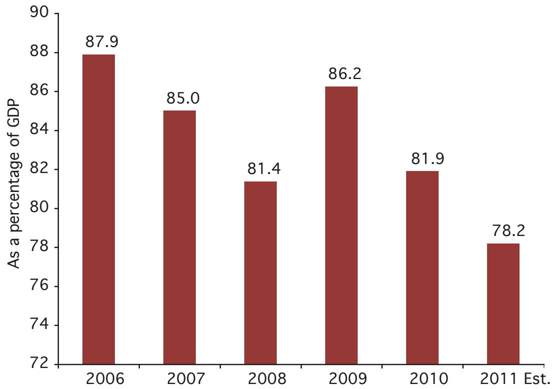
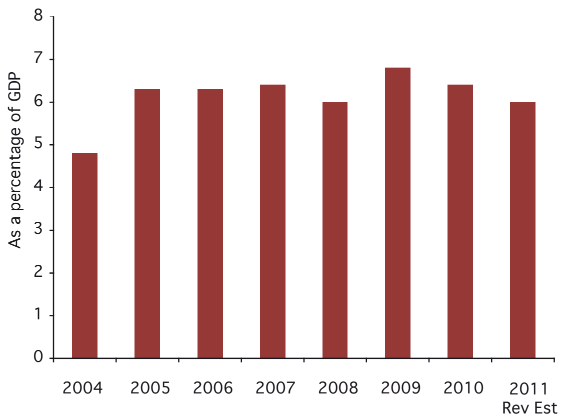


Chart 2.28
Public Investment



The public investment programme in 2011 was directed towards strategically important infrastructure development projects such as road development, ports, power and energy, irrigation, and water supply and sanitation. In addition, successful continuation of rural development initiatives such as "Gama Neguma" and "Maga Neguma", Northern Province development initiatives under "Uthuru Wasanthaya" and flood related reconstruction activities under irrigation and roads were some of the major projects carried out in 2011.

The overall fiscal deficit in the first ten months was 6.5 per cent of GDP. During this period, domestic sources accounted for 59.2 per cent of the total financing of the deficit. Bank sources contributed 69.1 per cent while non-bank sources contributed the balance of total domestic financing.

The outstanding government debt is expected to decline to about 78.2 per cent of GDP by end 2011 from 81.9 per cent of GDP in 2010. The systematic decline in debt to GDP ratio is a welcome sign given the continuous surge in debt to GDP ratios in most of the countries.

According to the budget for 2012, the overall budget deficit in 2012 is estimated to decline to 6.2 per cent of GDP. The expected improvement in the overall fiscal deficit in 2012 is the combined outcome of an increase in government revenue (including grants) to 15.0 per cent of GDP from 14.3 per cent of GDP in the revised estimate for 2011, and a decline in government expenditure to 21.2 per cent of GDP from 21.4 per cent of GDP in the revised estimate for 2011. The decline in expenditure is expected from recurrent expenditure, while public investment is expected to be increased to 6.6 per cent of GDP in 2012 from 6.0 per cent in the revised estimate for 2011.

The budget for 2012 is a development oriented budget covering all sectors of the economy ranging from small and medium enterprises to large scale factory industries. Emphasis was placed on improving the productive capacity of the economy, enhancing backward integration, encouraging the development of import replacement industries in strategic areas and widening the export base by tapping new export markets, while expanding the market share in traditional markets. Recognising the importance of food security, the budget also placed special emphasis on the need to improve domestic agriculture production.

Monetary Developments

The monetary policy stance in 2011 was cautious and consistent with the aim of containing the build-up of inflationary pressures while facilitating the growth momentum of the economy. The inflation was managed at mid-single digit level and an overall market liquidity level was maintained in line with expected monetary developments. Policy interest rates in 2011 remained unchanged after one downward adjustment in January 2011. The policy interest rates, namely, the Repurchase rate was reduced by 25 basis points to 7.0 per cent

Chart 2.29
Policy Rates and Average Weighted Call Money Rate

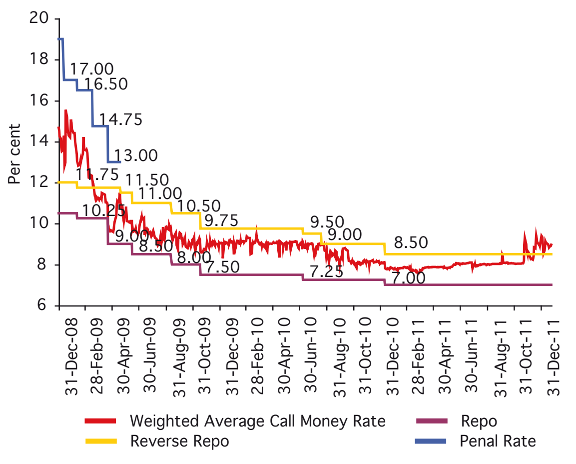
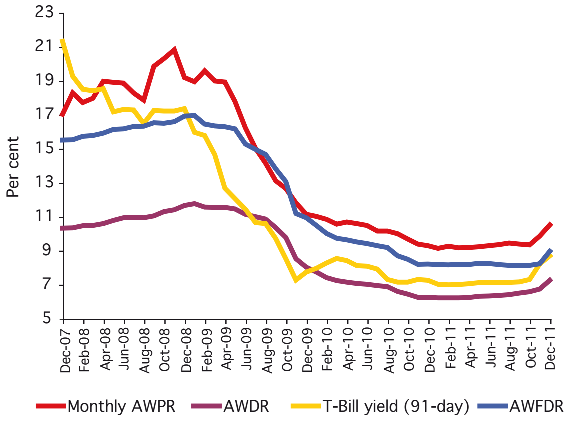


Chart 2.30
Deposit Rates of Commercial Banks, Treasury Bill Yield Rate and Monthly AWPR



and the Reverse Repurchase rate was reduced by 50 basis points to 8.50 per cent in January 2011. The short-term money market interest rates, the average weighted call money rate (AWCMR), continued to remain largely stable within the policy rate corridor. Market interest rates remained broadly stable although a slight increase in rates was witnessed towards the end of 2011.

Excess liquidity in the market remained high at Rs.124 billion at the beginning of the year and considering its adverse impact on future monetary expansion and inflation, the Central Bank raised the Statutory Reserve Ratio (SRR) on all rupee deposit liabilities of commercial banks by 1 percentage point to 8.0 per cent in April 2011 and absorbed permanently about Rs. 18 billion.

By the end of 2011, the market liquidity declined below Rs.10 billion. The Central Bank commenced overnight reverse repurchase auctions towards year-end to contain pressure on market interest rates and uneven distribution in market liquidity among banks. The yield rates of government securities that declined in response to the reduction in policy interest rates in January 2011 trended downwards until end April 2011 and remained stable thereafter. Considering the improved investment climate, the government issued Treasury bonds with different maturities which enabled to reconstruct the term structure of interest rates in 2011.

Average reserve money by end November was Rs.432 billion compared to the target of Rs.424.5 billion for the last quarter of the year. Although it is above the targeted level, the expansion in reserve money slowed down since about mid-October. Broad money (M2b) continued to expand at a rapid pace in 2011. M2b recorded a year-on-year growth of 20.6 per cent in November 2011, up from 15.8 per cent in 2010. The average growth of

Chart 2.31
Excess Money Market Liquidity absorbed by the Central Bank through OMO

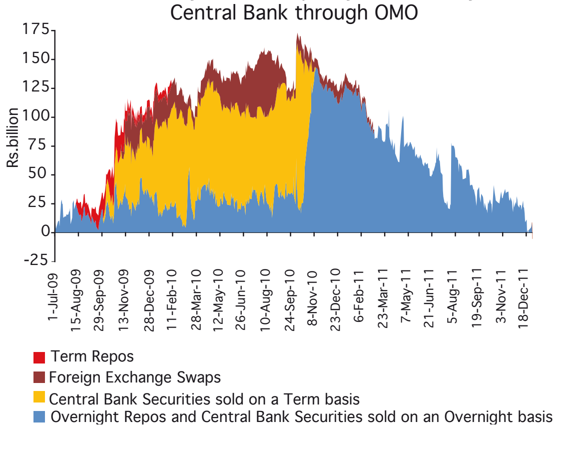


Chart 2.32
Expansion of Monetary Aggregates

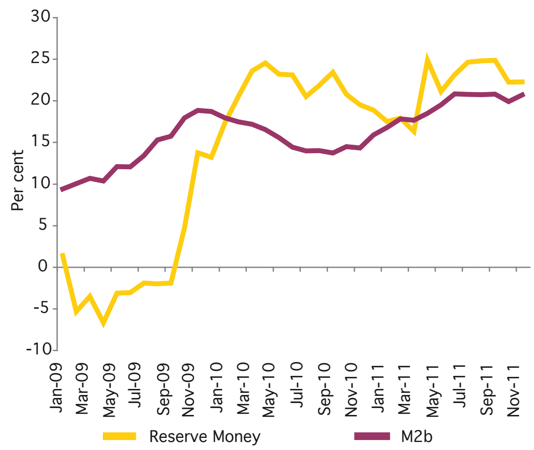
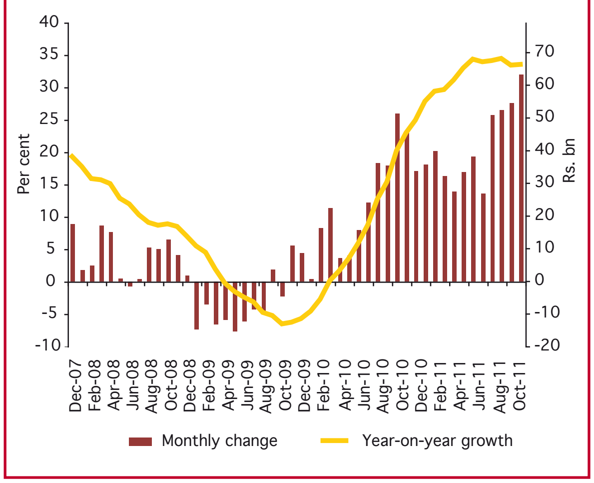


Chart 2.33
Credit to the Private Sector



broad money during the first 11 months was 19.3 per cent, higher than the projected average growth of 14.5 per cent. The expansion in broad money was entirely due to the increase in Net Domestic Assets (NDA) of the banking system as reflected by higher growth in credit to the private sector and the government during the period. Credit to the private sector grew steadily with an average rate of 32.2 per cent during the first eleven months of the year. Meanwhile, credit to the government increased by Rs.174.3 billion during the first eleven months of the year. Net Foreign Assets (NFA) of the banking system also declined by around Rs. 210 billion during the first eleven months of 2011.

Chart 2.34
Commercial Banks Loans and Advances
to the Private Sector

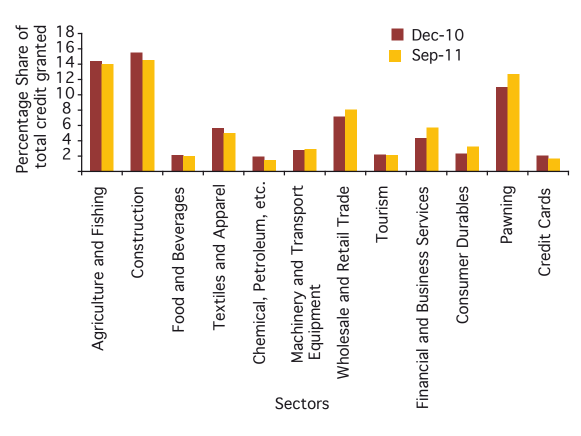
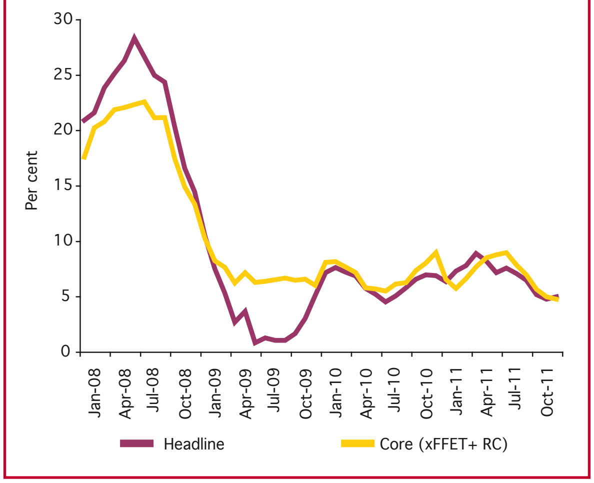


Chart 2.35
Movement of Headline and Core Inflation



Inflation, which showed some upward movement during the early part of the year on account of supply disruptions, declined to 4.9 per cent in December 2011 from 6.8 per cent at end December 2010. Annual average inflation in December 2011 was 6.7 per cent. The core inflation measured by the exclusion of fresh food, energy, transport, rice and coconut x(FFET+RC) from the CCPI (base=2006/07) also declined significantly to 4.7 per cent in December 2011.

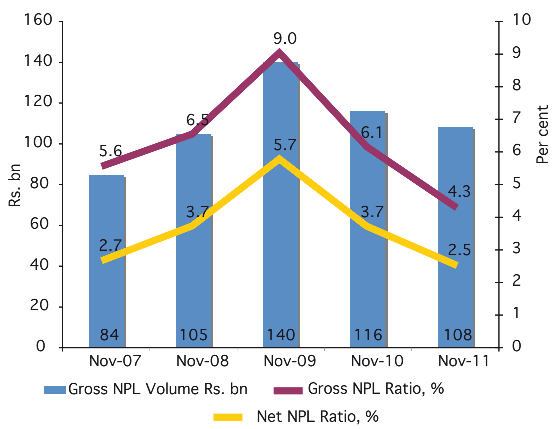
Chart 2.36
Investors' 12 Month ahead Inflation Expectations

While inflation and inflation outlook in Sri Lanka remain within the mid-single digit level in line with monetary policy expectations, the regional economies in South Asia, India and Bangladesh, have been on an anti-inflationary stance and have taken several measures to tighten the monetary policy. The emerging market economies in Asia, China, Malaysia, Thailand, Indonesia and Vietnam, also tightened their monetary policy stance to combat rising inflationary pressures.

3. Analysis of Financial System and Economic Environment in 2011

The Central Bank continued to promote sound corporate governance and risk management practices through effective supervisory arrangements and processes, concentrating mainly on risk based supervision with a view to strengthening the stability of the financial system. The early warning systems and monitoring of timely rectification of supervisory concerns were intensified to ensure the resilience of the financial system to meet challenges of a growing economy.

Chart 3.1
Trends in NPL



Banks as financial intermediaries are exposed to several risks that are interconnected. The Central Bank believes that such risks have to be managed in an integrated manner continuously, proactively and systematically with an organization-wide perspective. Accordingly, the Central Bank issued Integrated Risk Management Guidelines for licensed banks, requiring banks to have in place, a robust institutional framework for managing banking risks in an integrated manner. Past experience clearly indicates that excessive exposures of banks to sensitive sectors such as real estate and stock market, adversely affects the asset quality, liquidity, profitability and capital, threatening the stability of the overall financial system eventually. Therefore, the Central Bank issued Directions to limit banks' exposure to margin trading of shares and issue of guarantees for the purpose of purchasing shares at Initial Public Offerings (IPOs). In the meantime, Board of Directors of licensed banks were required to formulate robust risk management policies, guidelines and internal controls on exposures to

Chart 3.2
Loan Growth - Year-on-Year

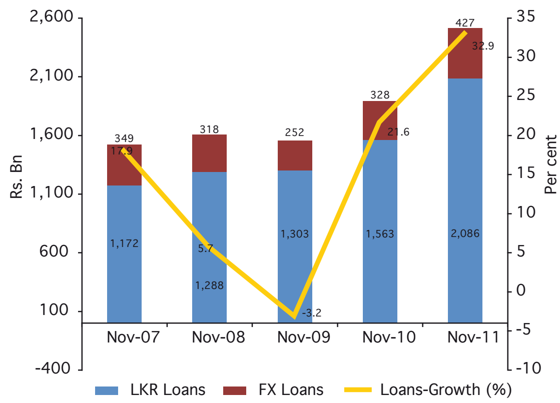


Chart 3.3
Assets Growth - Year-on-Year

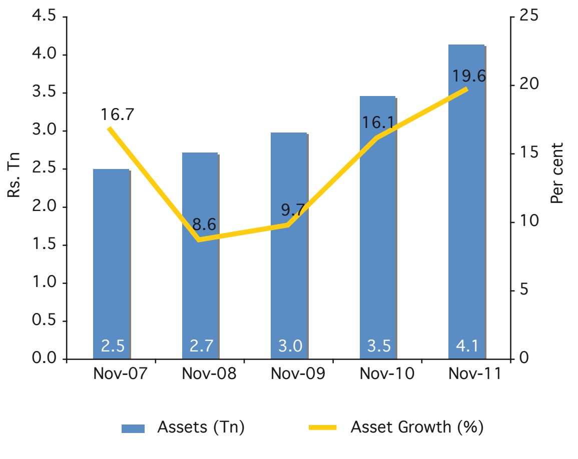
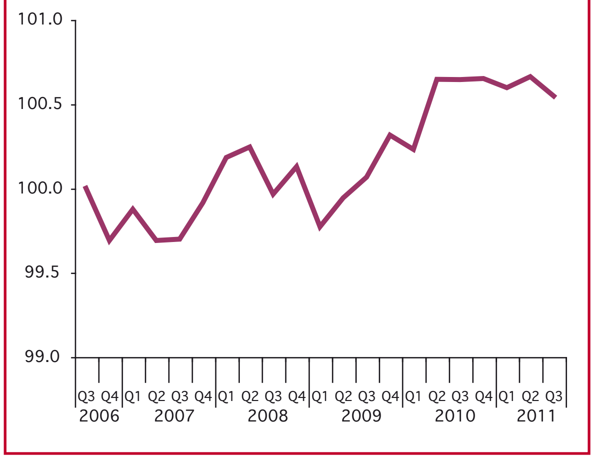


Chart 3.4
Banking Soundness Index (2006 Q3 = 100)



sensitive market sectors, including prudential limits for total exposure relative to Tier I capital, with appropriate management information on such exposures on an ongoing basis.

The Central Bank developed and utilized a number of techniques to identify and analyse systemic risk in the financial sector. Stress testing of the banking sector was carried out to gauge its resilience to shocks relating to credit risk, market risk, and liquidity risks. Macro stress testing commenced in 2011 with the adoption of a credit risk model to assess the impact of macroeconomic variables on the asset quality of the banking sector.

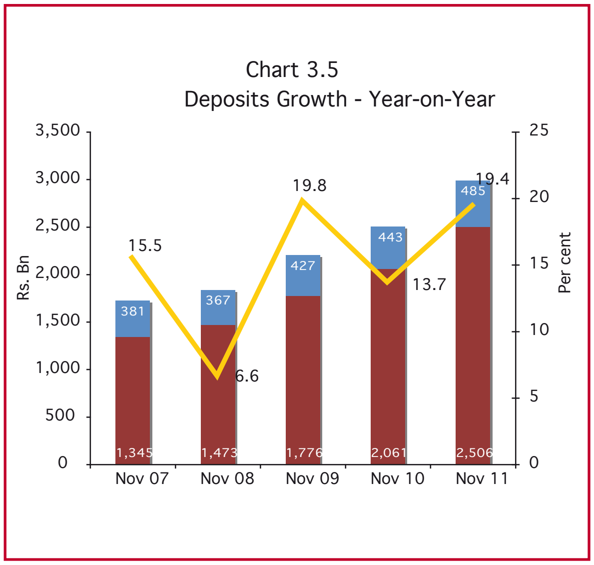
The Banking Soundness Indicator (BSI), an aggregate indicator with variables relating to capital, credit quality, earnings, liquidity and sensitivity to market risk, measures the level of soundness of the banking sector. The Financial Stress Indicator (FSI) was constructed in 2011. The FSI measures the level of stress in financial markets and the banking sector. The variables included in the FSI represent the money market, the bond market, the foreign exchange market, the stock market and the banking sector.

As a measure to promote financial intermediation and broaden the permissible activities undertaken

Table 3.1 Banking Sector Interest Margin in Sri Lanka (2006-2011)

Item (% of Avg. Assets)	2007	2008	2009	2010	Sep-11
Interest Income	12.0	13.2	12.8	10.1	9.1
Interest Expenses	7.6	8.8	8.2	5.5	4.9
Net Interest Income (Interest Margin)	4.4	4.4	4.6	4.6	4.2
Non Interest Income	1.7	2.1	2.1	2.1	1.6
Non Interest Expenses	3.2	3.4	3.4	3.2	3.0

Source: Central Bank of Sri Lanka



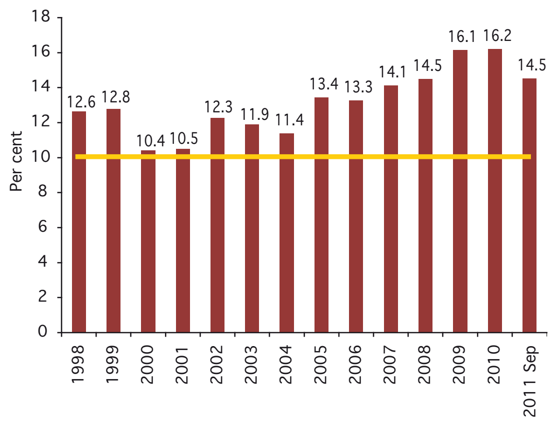
by Off-shore Banking Units (OBUs) of the licensed commercial banks, residents were permitted to transfer funds between Exporters' Foreign Currency Accounts (EFCAs) and accounts maintained by non-residents in OBUs. This helps smoothen exports and import related payments while reducing intermediary costs and improving trade relationships. Permission was also granted to credit an account maintained by a non-resident at OBU with fund transfers in any designated currency from the Domestic Banking Units (DBUs) on bona-fide current account transactions falling under the general or specific permission of the Controller of Exchange. The Central Bank also declared the Chinese Renminbi (RMB) as a designated currency for foreign exchange transactions of commercial banks considering China's importance as an investor, lender and trading partner of Sri Lanka.

The Central Bank has been able to work towards an effectively coordinated work programme with other regulators in the financial sector. In this connection, the Inter-Regulatory Institutions Council (IRIC), chaired by the Governor of the Central Bank, has been able to draft an appropriate legal framework for information sharing between financial sector regulators. The proposed framework would facilitate identifying and resolving common issues relating to banks and other financial institutions which are falling within the regulatory purview of the Central Bank, the Insurance Board of Sri Lanka and the Securities & Exchange Commission of Sri Lanka.

In order to ensure that the tax savings proposed in Budget 2011 are efficiently channelled for economic activities, the Central Bank issued necessary guidelines to the banks for the operation of the Investment Fund Account (IFA). The Central Bank continues to monitor the progress achieved by banks in this connection. Strong customer-bank relationship is considered as the key to promoting financial inclusion and financial system stability. In this context, the adoption of minimum standards and norms for the banking sector, specifying the responsibilities of banks towards their customers and the customers' responsibility towards banks was seen as necessary to safeguard the interests of both banks and customers. Accordingly, the 'Customer Charter of Licensed Banks', specifying rights and obligations of banks and customers was issued as a Directive mandating a 'Code of Conduct' in banking operations.

With the view to enhancing the Central Bank's authority and necessary regulatory powers to discharge its responsibility for ensuring financial system stability, a number of amendments have been brought in to the Banking Act, taking into account new developments in the domestic and international financial markets. These amendments have been approved by the Cabinet of Ministers and the Amendment Bill is being drafted to be presented to the Parliament. The proposed amendments will strengthen the Bank's capacity to supervise bank dominated financial groups on a consolidated basis, so that intra-group transactions and exposures, risk concentrations, corporate governance, and capital levels are monitored according to regulations. There will also be provisions to facilitate mergers and acquisitions of licensed banks and strengthen bank resolution measures.

Chart 3.6
Capital Adequacy Ratio (1998-2011)



The Central Bank continued to monitor the implementation of Basel II Capital Adequacy Standard in Banks with a view to improving the safety and soundness of the banking system and made necessary preparations to move forward in implementing the Internal Capital Assessment Process (ICAAP) and Supervisory Review Process (SREP) under Pillar 2 of the Basel II framework. The qualifying criteria for classifying loans as SMEs under retail claims were amended to enable banks to take advantage of lower risk weights for capital adequacy purposes thereby facilitating lending to SMEs at more favourable terms. Draft guidelines on moving to advanced approaches with respect to computation of capital charge for operational risk were issued to the industry for comments and will be finalized in due course.

The Central Bank commenced the assessment of fitness and propriety of officers performing executive functions in banks in addition to Directors and chief executive officers. Accordingly, the fitness and propriety of over 500 officers performing executive functions in licensed banks have been assessed during 2011.

The Central Bank continued to administer the Sri Lanka Deposit Insurance Scheme implemented as a safety net mechanism especially to protect small depositors from failure of financial institutions. The member institutions, i.e., licensed banks and registered finance companies, paid the interest premium due and the Deposit Insurance Fund has grown to about Rs. 4.5 billion.

The Central Bank also monitored the banks' compliance with the enhanced minimum capital requirements of Rs.3 bn and Rs.2 bn for commercial banks and specialised banks, respectively. Subsequent to the requirement of the Central Bank to list all the locally incorporated private licensed banks at the Colombo Stock Exchange (CSE) to enhance the ability of the banks to raise additional capital in a more transparent manner, two commercial banks have already obtained listings in the CSE and another is in the process of obtaining the listing. Further, considering the potential benefits of transparency and market discipline, banks were also required to list their debentures in the Colombo Stock Exchange.

The Strategies of the Central Bank also aimed at addressing the issues of balanced regional development and its sustainability through providing access to financial services, resources to increase the economic activity in the less developed regions. The regional development strategies pay attention to community development and financial inclusiveness particularly in the Northern and Eastern provinces.

The Central Bank continued permitting banks to open banking outlets island-wide including the Northern and the Eastern provinces. In addition, the Central Bank, taking into consideration the growing Islamic market segment (local and global) and the global developments and trends in Islamic Banking, issued a banking licence to a Bank that practices Islamic Banking and also permitted licensed banks to operate Islamic Banking units. Further, a new banking licence was granted to Axis Bank Ltd., India to open a branch in Sri Lanka. Accordingly, during 2011 the total number of licensed commercial banks increased to 24. Two more provisional licences were also granted for two domestic entities to open new banks and another approval was granted to a foreign bank to open its representative office.

Table 3.2: Expansion of Financial Services

Item	As at end 2010	New Outlets	
		In 2011	In North & East (2011)
Banking Sector			
No. of Branches	1,955	110	35
No. of Extension Offices	970	68	26
No. of Other Banking Outlets	2,976		
No. of ATMs	2,020	161	43
Non-Banking Sector			
No. of Branches of NBFIs	600	48	22

Source: Central Bank of Sri Lanka

With the increased Participatory Financial Institutions (PFIs), the Central Bank continued to provide affordable finance for the needy sectors under a number of refinance schemes which range from Small and Medium Enterprises to micro-finance or group lending. All Registered Finance Companies RFC were required to list on the Colombo Stock Exchange (CSE) by end June 2011, in order to improve the transparency and accountability in the sector. As at end September 2011, 28 RFCs were listed. The Monetary Board extended the listing deadline for the 5 distressed companies. One company was exempt from the listing requirement pending a merger and two were given a one year period to obtain the listing. In the meantime, two more companies are expected to be listed by end 2011.

During the period, the Monetary Board issued three Directions each to the RFCs and SLCs to ensure financial system stability. The directions to RFCs include Minimum Core Capital requirement, assessment of fitness and propriety of key management personnel of RFCs and an amended direction on reporting requirements which introduced sanctions for violations on reporting RFC information. The directions to Specialised Leasing Companies include gradual increase of the minimum core capital from Rs. 75 million up to Rs. 300 million gradually by 01.01.2016, gradual improvement of liquid asset portfolios and the prior approval from the Central Bank with regard to selling of the business, establishment

Chart 3.7
Total Assets - Amount and Growth

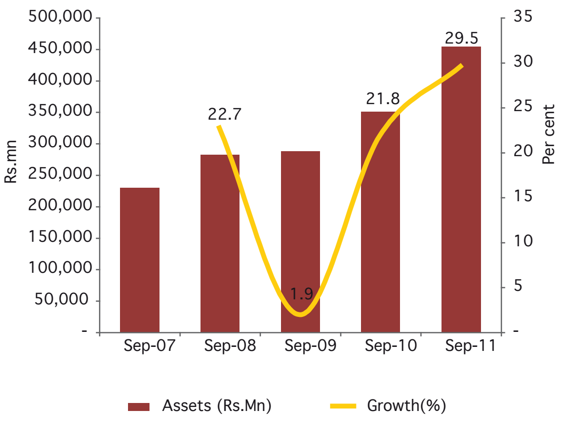
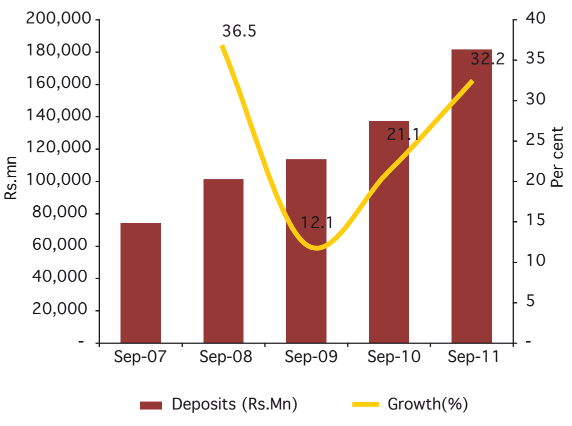


Chart 3.8
Total Deposits - Amount and Growth



of subsidiary companies and any other specified structural changes. In addition, all the NBFIs were requested to consider listing any future debenture issues on the Colombo Stock Exchange in view of better market transparency and discipline.

In order to strengthen the regulatory framework and to overcome existing deficiencies in the Finance Companies Act (FCA), new legislation in the name of Finance Business Act, was introduced repealing and replacing the FCA. The Finance Business Act No. 42 of 2011 (FBA) was passed by the Parliament in September 2011.

Chart 3.9
Loans and Advances - Amount and Growth

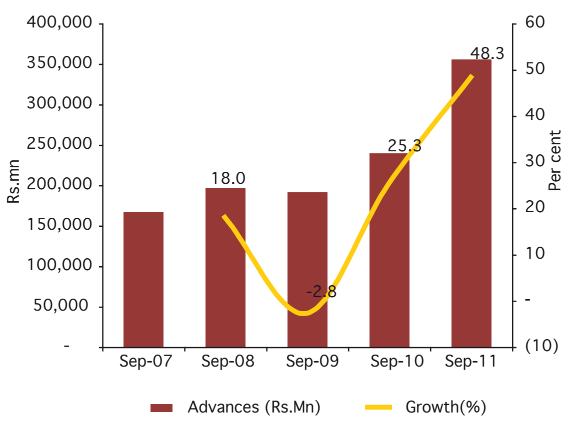
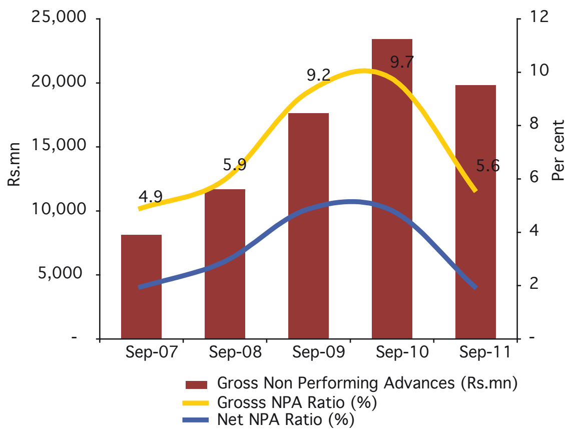


Chart 3.10
Non Performing Advances - Amount and Ratios



In order to set up a mechanism to regulate and supervise micro-finance institutions (MFIs) in the country, a new legislation was drafted and is under consideration by the Ministry of Finance and Planning. This draft bill proposes to establish an independent regulatory and supervisory authority to regulate and supervise MFIs. The Legal Draftsman has issued the 2nd draft of the Bill in July and the Central Bank observations have been sent to the MOFP in August 2011. Introducing a regulatory and supervisory framework for the microfinance sector would further ensure that unauthorised finance business is minimised, thus facilitating financial system stability.

During the year 2011, 7 distressed companies affected by the liquidity crisis were revived in varying degrees. The major measures included restructuring of the balance sheets and bringing in strategic investors. The balance sheets of 4 companies have been restructured by way of converting deposits and debt into equity (one is completed and three are in progress). Strategic investments have been made in 6 companies. Boards of Directors have been reconstituted in six companies and special directions have been issued to facilitate the revival of the businesses. Four companies have commenced normal business operations and managing agents have been released from 4 companies. All distressed NBFIs are envisaged to revitalise their businesses fully during 2012 and obtain listings by mid-2013.

The Central Bank continued to take further measures to strengthen the payment and settlement infrastructure in the country to ensure safety, efficiency, competitiveness and stability of the Payment and Settlement System (PSS) to foster financial system stability.

With the objective of promoting electronic retail payment systems in the country, the Central Bank initiated action to provide a safe and secure environment while regulating such systems to ensure customer protection. Accordingly, with the increased interest shown by bank and non-bank entities in providing mobile payment systems, the Central Bank issued two mobile banking guidelines to regulate such systems. Mobile payment guideline No.1 was issued to regulate bank led mobile payment systems and mobile payment guideline No.2 was issued to regulate non-bank led mobile payment systems.

To ensure compliance of credit card issuers to the credit card operational guidelines, the Central Bank examined the self- evaluation reports prepared by them. Further, supervision was carried out to ensure that the credit card issuers have complied to the web disclosure requirements stipulated in the credit card operational guideline. The Central Bank assisted credit card issuers to prepare a code of conduct which will be the benchmark service standard in their dealings with individual customers. As per a decision taken at the National Payments Council (NPC), service providers of payment cards who are functioning as financial acquirers were instructed to migrate to line encryption technology to protect electronic payment cards used in Sri Lanka. As a result, payment card service providers commenced the applying of encryption technology in 2011.

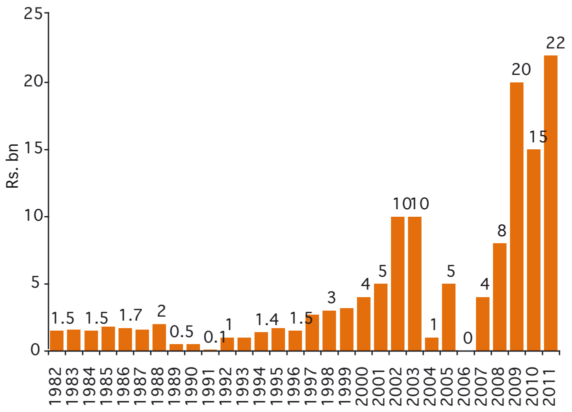
As per a decision taken by the NPC, Lanka Clear (Pvt) Ltd. took steps to establish the Common Card and Payment Switch (CCAPS) under the guidance of the Central Bank to reduce the cost of ATM and Card transactions by sharing payment infrastructure and the Central Bank designated CCAPS as the National Payments Switch in Sri Lanka.

Having considered the increased usage of internet banking services to settle financial transactions and risks associated with such systems, the Central Bank drafted a guideline to regulate Internet banking services. The draft Internet banking guideline will be finalized after obtaining views from all relevant parties.

Measures were taken with the support of the Treasury to encourage several departments to effect payments through electronic payment mechanisms whenever possible. Accordingly, the Treasury issued a circular to government departments instructing them to use electronic payment systems to make payments higher than Rs. 100 mn.

With a view to strengthening the financial intelligence environment, several measures were taken in 2011. These include the completion of the Legislative amendments to the Prevention of Money Laundering Act and Convention on the Suppression of Terrorist Financing Act and fulfillment of the compliance requirements imposed by the Financial Action Task Force and International Cooperation Review Group. Steps

Chart 3.11
Profit Transfers by the Central Bank to the Government



were taken to enhance international cooperation in exchanging financial intelligence. As a result, MOUs were signed with South Africa, Canada, Slovenia and Fiji Islands. Accordingly, the total number of MOUs signed increased to 16 as at end of 2011.

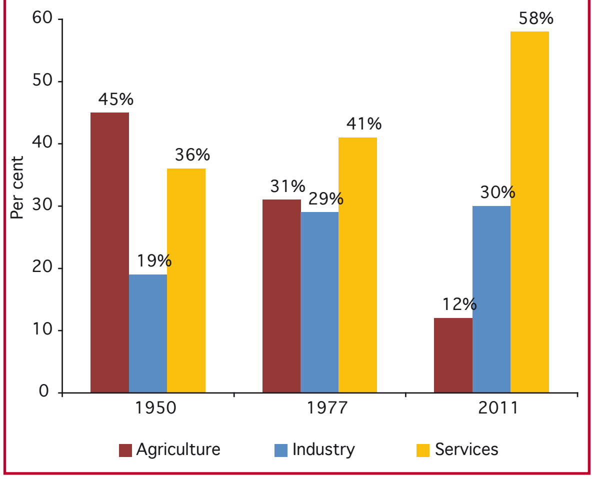
The Central Bank in collaboration with the Insurance Board of Sri Lanka prepared the regulatory framework for prudential supervision of superannuation funds to enable them to participate in the capital market with necessary safeguards. It will also facilitate the development of the capital market as these funds have the potential to be major institutional investors. In 2011, more intensive public awareness campaigns were conducted by the Central Bank to educate the public on the negative implications of promoting and participating in prohibited schemes, to increase finance literacy among the public, to promote the usage of advanced payment mechanism and also to prevent Money Laundering and Financing of Terrorism. During the period 2006-2011 the Central Bank has been able to appropriate a sum of Rs.64 billion to the Government from the surpluses the Bank generated, mainly from its international operations. In contrast, during the 1976-2005 period of 30 years, the Central Bank was able to transfer a sum of Rs. 60 billion. From 1950 to 1975 period, the total transfers amounted only to about Rs. 1 billion.

4. Monetary Policy Strategy for 2012 and beyond

Domestic Economy

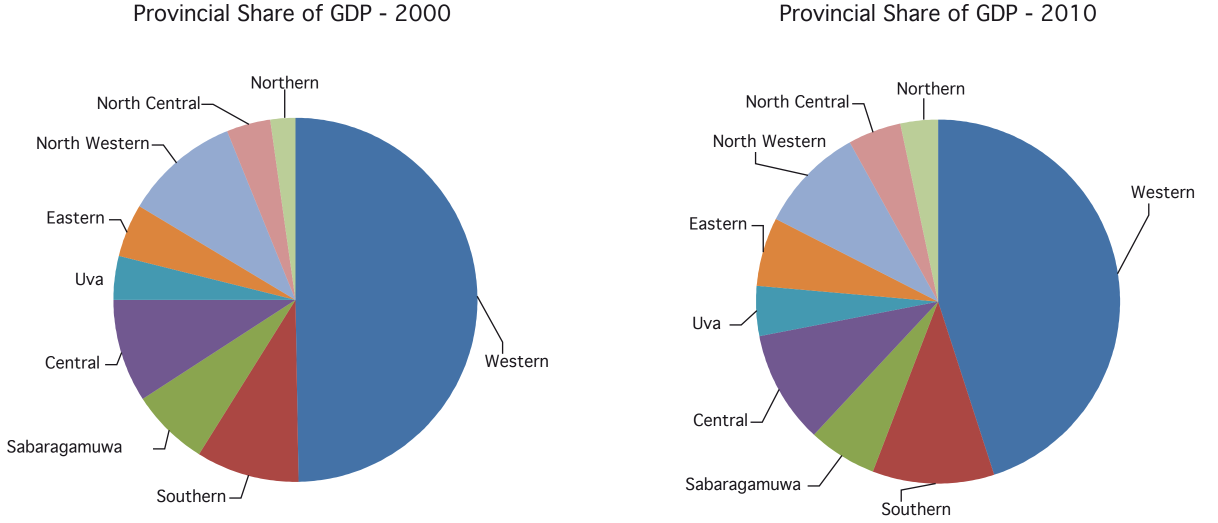
Sri Lanka's economy has undergone a significant structural change in recent years. While the share of agriculture in the GDP has declined gradually over the years with activity in the industrial and services sectors increasing, by 2011, the services sector has emerged to be the dominant sector, contributing more than a half of the GDP. The services sector has the potential to make a larger contribution in the years to come with sectors such as tourism expanding rapidly. Meanwhile, provincial shares of the GDP indicate that economic activity in rural areas has increased along with increased inter-province mobility, given the peaceful environment in the country.

Chart 4.1
Sectoral GDP



As a result, the share of most provinces in the GDP have increased, thus reducing the dominance

Chart 4.2



of the Western Province. Increased economic prosperity and improved quality of life across the country were reflected in other indicators too. Performance of selected indicators are given in the Table below.

Whilst recording these favourable developments, Sri Lanka's economy had remained on a high growth path in recent years and, in 2011, Sri Lanka's GDP had increased by an estimated 8.3 per cent. Consumer price inflation meanwhile, had remained around mid-single digit levels since February 2009 and was 6.7 per cent at end 2011.

Table 4.1: Selected Economic and Social Indicators

Indicator	Units	2005	2011 (Est/ Prov)
Real GDP growth	%	6.2	8.3
GDP	US $ bn	24.4	59.1
GDP per capita	US $	1,241	2,830
Consumer Price Inflation	%	11.0	6.7
Trade: Exports	US $ bn	6.3	10.5
Imports	US $ bn	8.9	20.0
Workers' Remittances	US $ bn	1.9	5.2
Tourist Arrivals	'000	549	850
Earnings from tourism	US $ bn	0.3	0.8
FDI	US $ bn	0.3	1.0
Government Inflows	US $ bn	0.7	2.7
Debt/GDP	%	91	78
Public Investment/GDP	%	6.3	6.0

Source: Central Bank of Sri Lanka

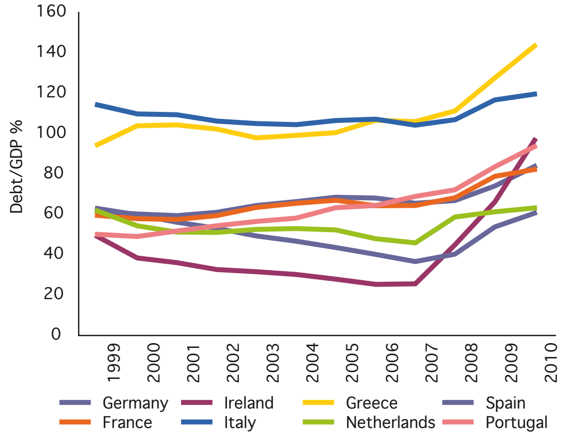
The external sector has also made a significant contribution to the country's increased prosperity. By 2011, earnings from tourism amounted to more than USD 800 million (compared to around USD 300 million in 2005); worker remittances amounted to an estimated USD 5.2 billion (compared to USD 1.9 billion in 2005); while FDI amounted to around USD 1 billion (compared to about USD 300 million in 2005). It is expected that these favourable developments would continue through 2012 and beyond, with development efforts aimed at improving economic and social infrastructure continuing, supported by resource inflows from foreign sources.

Alongside the above mentioned developments in the economy, the financial sector has undergone significant development, thereby strengthening monetary policy transmission. Many other pre-conditions identified by the Central Bank for moving into a framework such as inflation targeting have also been accomplished. For example, the budget deficit has been gradually reduced, thus reducing the inflationary impact of budgetary financing; the consumer price index has been re-based taking into account the changing consumption patterns; a measure of core inflation which helps identify demand driven inflationary pressures has been introduced; inflation forecasts have been improved; methods for identifying inflation expectations have been developed; and monetary policy decision making has been made more transparent through enhanced communication. Given these strengths, the Central Bank is now in a better position to adopt a more advanced framework for monetary policy, which could even include inflation targeting.

Global Developments

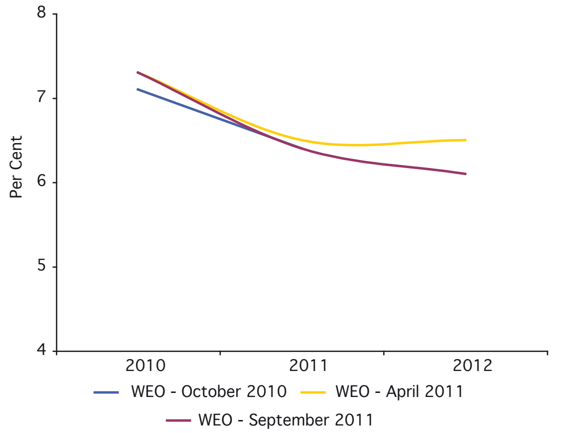
In formulating monetary policy, the Central Bank would of course be cognizant of the ongoing structural changes in the domestic economy as well as developments in the global economy. The stresses in global financial markets and commodity markets have persisted into 2012. Geo-political tensions in some parts of the Middle East and North Africa have continued to exert pressure on

Chart 4.3
Eurozone Government Debt



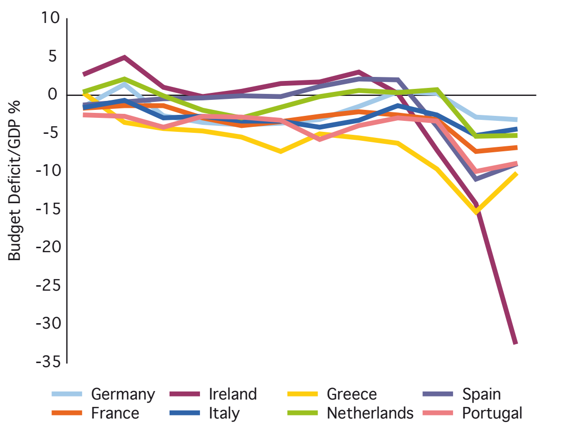
Source: Eurostat

Chart 4.5
Revisions to IMF Projections for Economic Growth in Emerging and Developing Economies



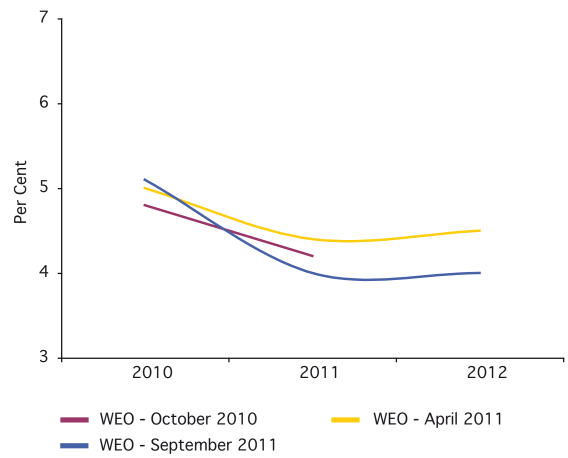
petroleum prices as well as some other commodity prices. Strains in global financial markets, stemming largely from the sovereign debt related issues in several advanced countries, meanwhile have led to volatility in global commodity prices, as investors flee to safe havens in the face of heightened risks and uncertainty, thereby impacting on the exchange rates pertaining to major currencies in terms of which key commodities are priced. Natural calamities have added to these pressures on commodity prices. Although the impact of these developments would subside eventually, with large populations in developing nations emerging from poverty, demand for commodities would continue to rise, exerting pressure on their prices. On the growth front meanwhile, growth prospects for the global economy in the years 2011 and 2012 have been lowered by international agencies such as the IMF due to turmoil and uncertainty prevailing in global markets. Weaker global demand of course, would have a dampening effect on commodity prices.

Chart 4.4
Eurozone Budget Balances



Source: Eurostat

Chart 4.6
Revisions to IMF Projections for Global Economic Growth



Outlook for the Domestic Economy in 2012

Sri Lanka's economy is expected to continue to perform well in the years ahead. The expansion of the country's productive capacity along with the structural changes taking place is expected to support the forecast of high growth of the economy. Accordingly, although uncertainty and turmoil continues to weigh down on global economic performance, Sri Lanka's GDP growth in 2012 is expected to be high at around 8 per cent. The Agriculture sector, which grew at an estimated 2 per cent in 2011 is expected to grow by 7.3 per cent in 2012, supported by a further expansion of paddy cultivation, fisheries activity as well as plantations crops.

The industry sector is expected to grow by a further 9 per cent following its 10.1 per cent growth last year. The continued high growth of construction activity, and in turn, the accompanying high growth of mining and quarrying, expansion of cottage industry, particularly in the North and the East, as well as the expansion of electricity generation using coal, are expected to mainly contribute to the projected growth of the Industry sector. The Services sector is projected to grow by 7.7 per cent following its 8.6 per cent growth last year. Hotels and restaurants, domestic trade, post and telecommunication, and financial services are expected to drive the growth of the Services sector in 2012. The expected favourable performance of activity in all key sectors would also be supported by prudent macroeconomic management, strengthened investor confidence, promotion of Sri Lanka's exports in both traditional and non-traditional markets, support schemes of the government, and promotion of FDI.

Chart 4.7
Revisions to GDP Growth Projections

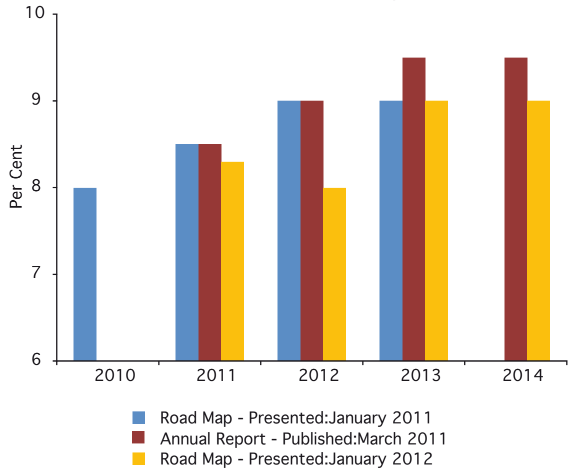


Table 4.2: Macroeconomic Fundamentals

Indicator	Unit	2005	2011 (Est/ Prov)	2012 (Expectation)
Real GDP growth	%	6.2	8.3	8.0
GDP	US $ bn	24.4	59.1	66.0
GDP per capita	US $	1,241	2,830	3,129
Consumer Price Inflation	%	11.0	6.7	5.5
Trade: Exports	US $ bn	6.3	10.5	12.5
Imports	US $ bn	8.9	20.0	23.4
Workers' Remittances	US $ bn	1.9	5.2	6.5
Tourist Arrivals	000	549	850	Over 1,000
Earnings from tourism	US $ bn	0.3	0.8	1.2
FDI	US $ bn	0.3	1.0	2.0
Government Inflows	US $ bn	0.7	2.7	2.5
Debt/GDP	%	91	78	75
Public Investment/ GDP	%	6.3	6.0	6.6
Foreign funds into Banks - Tier II capital	US $ bn	-	0.1	1.0

Source: Central Bank of Sri Lanka

The Central Bank's monetary policy will continue to focus on checking inflationary pressures in the economy, but of course would continue to support the expansion of economic activity on a sustainable basis. While it is expected that inflation would remain around mid-single digit levels in 2012, going forward into the medium term, the bank's monetary policy would target mid-single digit rates of inflation. Given that Sri Lanka is a developing country, a target of low single digit inflation would not be optimum as structural bottlenecks still persist. In 2012, domestic supply-side conditions are expected to be favourable and international commodity prices including that of oil are expected to remain relatively stable at their current levels. These factors would support achieving the expected mid-single digit rate of inflation. Consumer price inflation as measured by the CCPI is expected to be around 5 to 6 per cent. Inflation as measured by the GDP deflator, which is expected to be around 7.7 per cent in 2011 compared to its level of 7.3 per cent in 2010, is expected to moderate to around 6.5 per cent in 2012 along with a moderation in price pressures.

With respect to fiscal performance, as per the national budget for 2012, the overall budget deficit is expected to decline to 6.2 per cent of GDP in 2012 from the revised estimate of 7.0 per cent of GDP in 2011. Domestic financing is expected to amount to Rs. 271.6 billion in 2012, an increase of Rs. 16.5 billion compared to 2011. Within domestic financing, non-bank borrowings are expected to increase in 2012 with non-bank sources showing greater appetite for government securities. Correspondingly, bank borrowings by the Government are targeted to decline substantially to Rs. 64 billion in 2012 compared to 2011. The reduction in net credit granted by the banking system to the government will impact favourably on both the availability of funds to the private sector as well as domestic interest rates.

The external sector is expected to perform well while undergoing significant structural change in 2012. The balance of payments is expected to be a surplus amounting to around USD 825 million in 2012. Without any major policy measures, although the deficit in the trade balance is likely to remain high, higher earnings from tourism amounting to around USD 1.2 billion, higher inflows on account of worker remittances, which are projected at around USD 6.5 billion, increased FDI inflows amounting to around USD 2 billion, and high net inflows to the government are expected to cushion the impact of the trade balance on the balance of payments. Reflecting these inflows, the net foreign assets of the banking system are expected to increase in 2012. These inflows of course, will support the continued expansion of domestic economic activity. Further, by impacting favourably on domestic monetary conditions, the higher inflows will help create a favourable investment climate in the country, which in turn will augment the country's growth potential.

Monetary Policy in 2012

With respect to monetary operations, in implementing monetary policy, the Bank will continue with its current policy interest rate corridor approach. Accordingly, the policy interest rates of the Central Bank would be the main monetary policy instrument. Open market operations, the Statutory Reserve Ratio and moral suasion are the other key monetary policy instruments with which the Bank would manoeuvre its monetary policy stance. The exchange rate meanwhile, would be considered a stabilisation factor in the economy while steps to enhance productivity and capacity utilisation would be encouraged further. With respect to monetary policy decision making, the Bank will continue to seek the views of all stakeholders before deciding on an appropriate policy stance. Accordingly, the Bank will continue to engage in policy discussions with different stakeholders of the economy, including the Monetary Policy Consultative Committee (MPCC) comprising of representatives of the private sector, to strengthen its monetary policy decision making process. As in the past, all monetary policy decisions taken by the Monetary Board will be communicated to the public promptly, enabling the public to make informed financial decisions.

Following its monetary analysis, the Central Bank has projected the money multiplier to be around 5.6 in 2012, taking into consideration the past trends as well as current monetary developments. The money multiplier, which remained relatively high at an average of 6.1 and 5.8 respectively, in 2009 and 2010, has decreased since raising the SRR by one percentage point to 8 per cent in April 2011. The money multiplier averaged 5.6 in the ten months to October 2011. As GDP growth in 2012 is expected to be around 8 per cent and the GDP deflator is expected to be around 6.5 per cent, nominal growth of broad money is expected to be around 15 per cent, on average, in 2012. It is believed that this growth of the money supply would adequately facilitate the expansion of economic activity in the year ahead. Given the envisaged 15 per cent growth of broad money and the projected money multiplier of 5.6, reserve money would be targeted to grow by around 15 per cent on a daily average basis, in 2012.

With respect to components of broad money, credit obtained by the private sector is expected to decelerate significantly over the year 2012. Year-on-year growth of credit obtained by the private sector, which has remained above 30 per cent since April 2011, is expected to decline to around 16 per cent by end 2012. This deceleration in credit obtained by the private sector will mainly contribute to the expected deceleration in broad money growth in 2012. On the contrary, net foreign assets of the banking sector are expected to increase as foreign fund inflows will be actively encouraged to address the savings-investment gap.

Monetary Policy in the Medium term

In the medium term, the Central Bank envisage a higher rate of economic growth as Sri Lanka's economic potential is likely to increase on several fronts. On the monetary front, the Bank's monetary operations would continue to be aimed at preserving the real value of savings. Hence, economy-wide inflation as measured by the GDP deflator is expected to be maintained around mid-single digit levels in the approaching years.

Table 4.3: Annual Average Growth of Broad Money (M2b): 2011 - 2013
(Percentage change over previous year)

	2011	2012	2013	2014
GDP Growth	8.3	8.0	9.0	9.0
GDP Deflator	7.7	6.5	5.5	5.0
Broad Money (M_{2b}) - Annual Average	19.0	15.0	15.0	14.5

Source: Central Bank of Sri Lanka

At this point, it must also be reiterated that the Central Bank's projections and targets as stipulated above would hold only if the economy is not subject to any significant unforeseen supply side shocks, or major policy intervention. Any significant deviations in economic fundamentals from those projected would require the Bank to review its strategies and revise its targets for 2012.

Communication

The Central Bank will continue with its practice of close communication with all stakeholders and the public, to facilitate informed decision making by economic agents in relation to their investments and savings. Policy announcements will continue to be made available online at www.cbsl.gov.lk and through other media.

Table 4.4: Dates of Monetary Policy Announcement in 2012*

Month	Date of Announcement
January	11th Wednesday
February	3rd Friday
March	14th Wednesday
April	18th Wednesday
May	15th Tuesday
June	12th Tuesday
July	10th Tuesday
August	8th Wednesday
September	18th Tuesday
October	16th Tuesday
November	8th Thursday
December	6th Thursday

* Any changes to these announcement dates will be communicated to the public in advance.

While the Central Bank will continue to seek the views of all stakeholders in implementing monetary policy, it would continue with discussions with the Monetary Policy Consultative Committee (MPCC) to strengthen the policy decision making process. At this point, the Central Bank wishes to thank the members of the MPCC for sharing their views with us at the monthly meetings of the MPCC. In particular, the Bank's gratitude is due to Mr. Mahen Dayananda for agreeing to continue to serve as the Chairman of the MPCC. In 2012, other members of the MPCC would be Mr.Sohli Captain, Chairman, CEI Plastics Ltd.; Mr. Cubby Wijetunge, Director & Chairman Emeritus, Nestle Lanka Pvt. Ltd.; Mr. Raja Senanayake, Chairman, SKM Lanka Holding Ltd.; Mr.Preethi Jayawardane, Jt. Managing Director, Chemanex Ltd.; Mr. Amal Cabraal, Chairman, Unilever – Sri Lanka; Mrs. Nirmali Samaratunga, Co-Chairperson & Jt. Managing Director, Mackwoods (Pvt.) Ltd.; Mr. Sujeewa Rajapakse, President, Institute of Chartered Accountants of Sri Lanka; and Mr.Mohan Pandithage, Chairman and CEO, Hayleys Group. Meanwhile, discussions with Chambers, Financial Institutions, Industrialists etc. will also continue.

5. Proposed Financial System Stability Policies for 2012 and beyond

The Central Bank will continue to facilitate an inclusive growth within the financial sector, particularly through policies that would support a financial system of a US dollars 100 billion economy by 2016. By 2016, assets of the banking sector and lending by the banking sector are expected to double, while net interest margin is projected to decline by 20 per cent and the corporate bond market is expected to increase by 10 times the current levels. Market capitalization of the CSE is also projected to increase to reach around 70 per cent of GDP by 2016. In doing so, the Central Bank would continue to strengthen the regulatory regime while encouraging banks to realign their business models through an internationalized approach for funding new business opportunities and harness the required resources to support the government's vision by expanding capacities, resources, service and delivery channels, range of products, competencies and profitability.

The risk profiles of banks are also subject to frequent changes with the rapid changes in the financial markets. In order to mitigate risks in a rapidly changing financial environment and to prescribe appropriate corrective measures, the Central Bank intends to conduct the Statutory Examinations of banks more frequently from 2012 onwards. Further, a Prompt Corrective Action (PCA) framework will be implemented based on the extant supervisory rating system from mid-2012 onwards in order to address issues identified in weak banks.

As per the lessons learnt from the current global financial crisis, regulations and supervision focused solely on individual institutions alone do not necessarily deal with systemic risks to the financial markets. In this context, the Central Bank will further develop its prudential regulatory framework to regulate the exposure of banks to sectors that are vulnerable to potential economic shocks. The Central Bank will also continue to monitor the sources of risks and exposure of banks to such risks with a view to proactively putting prudential regulations in place.

The Central Bank will continue its effort to establish a legal framework for effective coordination between financial sector regulators with a view to identifying and monitoring the risks arising from inter-connectedness of bank and other financial institutions which are coming under the regulatory purview of the Central Bank, the Insurance Board of Sri Lanka and the Securities and Exchange Commission of Sri Lanka.

With a view to enhancing the safety and soundness of the banking system and promoting risk management in the banking sector, the Central Bank will continue to develop the framework for banks to adopt advanced approaches under Pillar 1 of the Basel II framework in 2013. Further, preparations are being made to implement ICAAP along with SREP under Pillar 2 of Basel II during 2012. The implementation of Pillar 2 of Basel II would discipline the capital planning of banks while enhancing the efficiency of capital by aligning the level of capital with associated risks.

Following the recent global financial crisis, the Basel Committee on Banking Supervision (BCBS) has collectively reached an agreement on reforms to "strengthen global capital and liquidity rules with the goal of promoting a more resilient banking sector" referred to as "Basel III". This new regulatory standard strengthens bank capital requirements with the introduction of new requirements on bank liquidity and leverage. Work is also under way to introduce appropriate reforms in line with the Basel III framework and monitor and assess the readiness of the banks.

Banks will be encouraged to adopt a policy for diversification of banking business and income through fee-based services and retail products within a group and agency framework together with prudential safeguards. Considering the banking business expansion and diversification under the proposed internationalised approach, the Central Bank will review and amend the regulatory framework to facilitate new business models of banks to support the economic growth of the country while safeguarding the stability of the financial system.

In the meantime, the Central Bank has also identified capacity building and skills development both in the banking industry and among supervisory staff in the Central Bank to ensure that the banking sector is well geared to meet the challenges ahead. In this regard, it is planned to provide more frequent and intense training and exposure to the supervisory staff in the areas such as regulatory standards, risk management standards and Know Your Customer/ Customer Due Dilligence (KYC/ CDD) standards. Further, the Central Bank expects to conduct technical seminars and meetings for key bank officials to ensure banks engage in capacity building for their staff.

Some risks that could arise in the process of implementation of new policy measures in the banking sector have been identified. To mitigate such risks, measures will be taken by the Central Bank such as conducting training programmes for bank staff on new policy initiatives, monitoring the implementation progress continuously, developing a resolution plan for weak banks and ensuring banks have adequate resources to meet new policy requirements.

As an early warning system to identify weak companies, a rating system will be developed to identify companies susceptible to failure and a threat to financial system stability. At present, companies are mainly evaluated on the prudential directions issued under respective legal provisions. The existing and new prudential directions and guidelines for RFCs will be reviewed in line with the new Finance Business Act, with the change in the business landscape and future requirements. Business standards for Specialised Leasing Companies (SLCs) will be issued to provide a framework with a proper code of ethics and best practices since most SLCs are operating with unwarranted practices which ultimately burden the customers. Follow up activities will be strengthened in the areas of implementation of corporate governance, risk management strategies and adoption of new accounting standards. Further, the bank needs to ensure that the Non-bank Financial Institution sector is fully geared to adopt the IFRS by mid-2012.

In terms of the Service Providers of Payment Cards Regulation, service providers of payment cards will be monitored to ensure compliance to the said regulation and guidelines. To facilitate the development of electronic retail payment systems, action will be taken to encourage the use of CCAPS for the settlement of ATM, debit card and mobile payment transactions. Draft paper on PSS Oversight Practices in Sri Lanka will be finalized during the year 2012. Existing Legal documents (Acts, Regulations, guidelines etc.) will be reviewed and revised as and when required, depending on practical issues and to cover issues relating to emerging retail payment systems. Action will be taken to ensure the smooth functioning of the retail payment, settlement and clearing systems operated by LankaClear (Pvt) Ltd. Functions of the Lanka Financial Service Bureau will be monitored to ensure smooth operations of the SWIFT system to mitigate operational risks. The Central Bank will continue its business continuity policy in 2012 to ensure operational reliability of systemically important LankaSettle system by carrying out off-site surveillance on BCP and DR site arrangements of LankaSettle participants.

The legal review process of amending the Financial Transactions Reporting Act No.6 of 2006 will be completed in 2012. Further, a mechanism will be established to implement the United Nations Security Council Resolution (UNSCR) 1373 and 1267 on an urgent basis. Measures will be taken to strengthen the enforceability capacities of the FIU to address the deficiencies identified in the FTRA through issuance of general rules/ guidelines to cover all financial sector institutions and the designated non-financial sector. A country risk assessment will also be carried out on AML/ CFT vulnerabilities. Further, action will be taken to issue rules and guidelines on KYC/CDD to the sectors which are not yet covered, to be in compliance with the levels expected by the ICRG/ FATF evaluations, APG and Egmont meetings and to enhance International cooperation in exchanging financial intelligence through entering into MOUs.

The involvement of the Central Bank in regional activities will be further encouraged in terms of allocating additional funds for refinance in supporting income generating small and medium level economic activities. A higher volume of refinance will be disbursed in 2012 to the schemes exclusively designed for the Northern and Eastern provinces as the demand for finance projects and other income generating activities is expected to be higher from those areas. For these schemes, the anticipated increase is around 48 per cent in 2012, over 2011. As in the previous year, the Regional Development Department will actively arrange the provision of training and other facilities to the entrepreneurs in the Northern and Eastern provinces.

The Regional Development Department will also be engaged in forming groups with a view to linking them with the formal financial sector, thereby contributing to the government objective of reducing poverty through enhanced financial inclusiveness and the knowledge on financial literacy. To do so, the use of electronic media tools to increase the level of knowledge and awareness of banking and finance as well technical matters relating to project financing including the SME sector, will also be promoted.

6. Policies to Strengthen the Economy Further

The Central Bank acts as the economic advisor, banker and agent to the Government of Sri Lanka to perform several functions. The Central Bank is the sole authority to issue legal tender. In addition, agency functions such as the management of the Employees' Provident Fund, Public Debt, Foreign Exchange and promotion of Regional Development are also performed by the CBSL. The Central Bank is also proactively involved in disseminating information on economic developments both in relation to money, banking and finance.

Currency Management

The Central Bank, being the sole authority for issuing legal tender, successfully met the demand for currency in a cost efficient manner during 2011, facilitating payments and settlements in domestic currency, while meeting any contingency requirements.

The 11th currency note series on the theme of Development, Prosperity and Sri Lankan Dancers was issued in February 2011. This note series issued in convenient sizes, includes new security features to enhance public confidence in the currency. Recognizing these features and advancement of the note series, the Central Bank was awarded the 2011 Best New Banknote Series Finalist award at the International Association of Currency Affairs (IACA) Conference held in Singapore in October 2011.

Steps were taken to educate the public on the issuance of the new currency note series and their enhanced security features through Electronic and print media. In addition, several seminars were conducted for cash handlers, law enforcement officers and the general public on the security features of currency notes and detection of counterfeit notes. Enhancing knowledge of the public on currency notes will continue in 2012 as well, through various publications and the three money museums of the Central Bank. In 2012, under the clean note policy, the Central Bank will focus on ensuring that notes in circulation will be of a high quality standard. While continuing to remove unserviceable notes from circulation, high priority will also be given to educating the public on the proper handling of currency. Arrangements have been made to improve the efficiency of currency processing by introducing more technologically advanced currency processing machines in 2012, while ensuring that commercial banks adhere to instructions issued by CBSL regarding sorting standards of currency notes. Initiatives will also be taken to efficiently manage currency operations, which will create an effective contribution to the stability of the financial system. In 2012, a new series of currency coins will also be issued depicting regional features of the districts in Sri Lanka.

Public Debt Management

Several measures were taken in 2011 to strengthen public debt management through effective implementation of approved debt management strategies in order to meet borrowing targets at the lowest possible cost consistent with a prudent degree of risk. The government borrowing programme to finance the budgetary requirements in 2011 was successfully implemented by raising Rs. 957.8 billion (Rs.691.1 billion from domestic sources and Rs. 266.7 billion from external sources) as at end October 2011.

Chart 6.1
Projections of Outstanding Public Debt

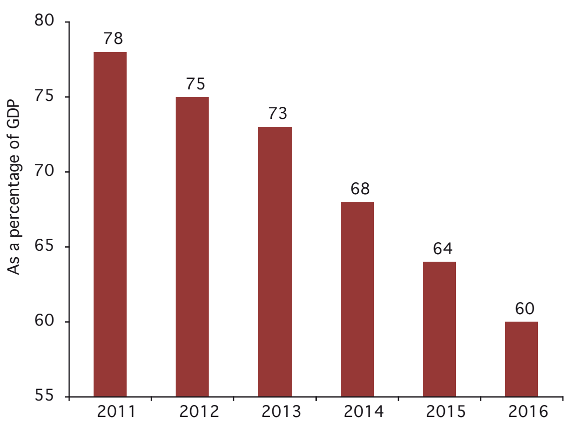
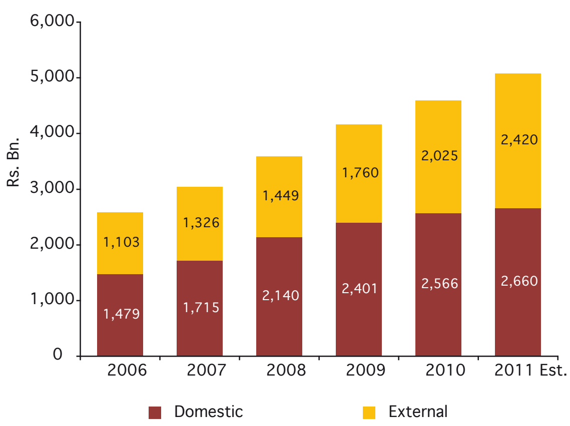


Chart 6.2
Outstanding Public Debt



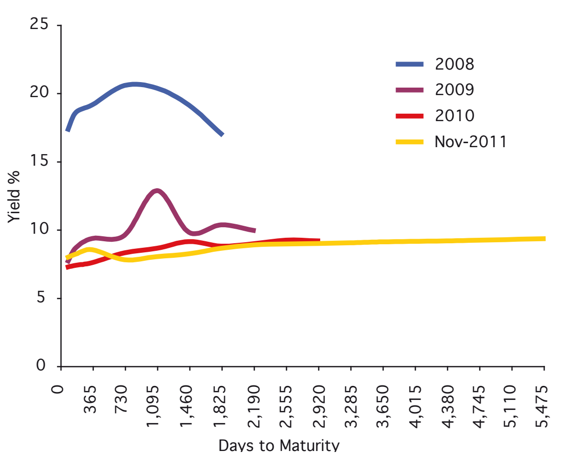
A high level of liquidity and low inflation expectations prevailed throughout the year resulting in lower yields on government securities. The downward shift in the yield curve in Treasury bills and Treasury bonds was approximately 27 -30 basis points and 15 – 89 basis points, respectively. However, during the last quarter of 2011, short-term yields were on an upward trend due to tightness in liquidity positions stemming from high credit growth and external pressure. Foreign investors continued to invest in Rupee denominated Treasury bills and Treasury bonds. During the year, the total outstanding of foreign investments in both Treasury bills and Treasury bonds reached Rs. 263 billion. This is the maximum amount allowed for foreign investors to invest in Treasury bills and bonds, in terms of the aggregate ceiling of 10 per cent of the total outstanding issued amount. However, in order to ease the domestic savings - investment gap and to mitigate any pressure of interest rates, the threshold of 10 per cent was raised to 12.5 per cent, with effect from 5th December 2011.

Sri Lanka's sovereign rating was upgraded by international rating agencies during 2011 while Sri Lanka successfully finalized its fourth International Sovereign Bond issue of US$ 1 billion with a coupon rate of 6.25 per cent and a maturity of 10 years, in July 2011. The proceeds from the bond issue were mainly used to restructure the existing debt stock of the Government to improve overall public debt management. Reflecting growing investor confidence consequent to the end of the internal conflict in the country, the Sri Lanka Development Bond (SLDB) issues were oversubscribed as yield margins declined and the tenure was extended. In 2011, the Public Debt Department issued three, four and five year SLDBs worth US$ 547 million (Rs. 60.2 billion), at yield margins ranging from 3.65 – 3.90 per cent over 6 months LIBOR.

The issuance of Treasury bonds to the persons who were entitled to receive compensation for lands acquired by the Government for road development, continued. During the year 2011, Treasury bonds worth of Rs.865 million were issued to the respective land owners. In strengthening the risk management framework, a part of the maturing Treasury bills with high yields were replaced with medium and long-term Treasury bonds. As a result, the weighted average maturity of domestic debt issuances during 2011 increased to 2.46 years from 2.10 years seen in the previous year. In 2011, the extension of the yield curve up to a 15 year horizon was witnessed in the government securities market. In order to promote investments in government securities, 13 public awareness programmes were conducted through public seminars.

During the period under consideration, high performance in the LankaSecure was observed, with the number of accounts registered with LankaSecure standing at 76,111 as at end November 2011 and the value of transactions settled through LankaSecure increasing by 14 per cent in 2011, compared to 2010.

Chart 6.3
Primary Market Yield Curve



The Public Debt Department was also actively involved in maintaining the stability of the Primary Dealer System by conducting on-site comprehensive and spot examinations and off-site surveillance and having regular monthly meetings with the Chief Executive Officers of Primary Dealer institutions. Accountability and transparency of debt management activities were also improved by publishing the fourth Public Debt Management Report in 2011 in line with the international best practices.

The public debt management strategy will be further developed and strengthened in 2012 through:

- Effective implementation of approved debt management strategies in order to meet borrowing targets at the lowest possible cost consistent with a prudent degree of risk.
- Servicing government debt on time with 100 per cent accuracy.
- Enhancing the sovereign rating of the country.
- Broadening and diversifying the investor base.
- Establishment of price discovery mechanism for government securities in order to improve and develop the government securities market in the country.
- Improving accountability and transparency of debt management.
- Ensuring a sound regulatory framework.
- Improving sound and credible operations of the LankaSettle and Primary Dealer Systems.
- Enhancing secondary market trading of Government Securities.

Foreign Exchange Management

The liberalization of exchange control regulations was continued by the Central Bank in 2011 with a view to facilitating foreign currency transactions by integrating domestic investors with international capital markets. Following the successful implementation of proposals announced in the Road Map for 2010 to relax restrictions on capital account transactions, a series of additional measures to further liberalize exchange control regulations were implemented in 2011. These include:

- Permission for individuals resident in Sri Lanka, and partnerships and companies incorporated in Sri Lanka, to invest in shares of foreign companies and sovereign bonds issued by foreign governments.
- Permission for partnerships registered in Sri Lanka and companies incorporated in Sri Lanka to make payments to non-residents in respect of setting up and maintenance of places of business outside the country.
- Relaxation of Exchange Control restrictions on foreign investments in unit trusts.
- Permission for Sri Lankan students to obtain loans from foreign financial and educational institutions.
- Permission for selected supermarkets to engage in money changing business.
- Permission for Sri Lankan residents to make payments to non-residents in respect of purchase of real estate properties in Sri Lanka.
- Permission to convert salaries and other benefits paid in Sri Lankan rupees to expatriate employees into foreign currency and credit such amounts to Resident Non-National Foreign Currency (RNNFC) account.
- Relaxation of approvals for companies to borrow from foreign sources.
- Permission for service exporters to borrow foreign exchange from domestic banks.
- Grant of new facilities to resident Non-National Foreign Currency Account Holders.
- Permission for foreign exchange earners to open and operate foreign currency accounts.
- Streamlining of foreign exchange transactions through NRFC and RFC accounts.
- The following changes are expected to be implemented in 2012 and beyond;
- Increase of the limit of importation of goods for personal use by using EFTC.
- Permission to invest in shares of foreign companies based on export proceeds brought into the country by merchandise exports.
- Increase of the current limit applicable for listed companies to invest abroad.
- Introduction of a common account for foreign investments in Sri Lanka by amalgamating all investment accounts.
- Increase of the limit, related to carrying of Sri Lanka currency notes when travelling abroad.
- Grant of permission for local companies to be listed in foreign stock exchanges.
- Grant of permission for issuance of redeemable preferential shares to non-residents with a specific minimum redemption basis.
- Issue of money changing licences to hotels and restaurants registered with the Tourist Board.

- Grant of permission to Licensed Specialized Banks and Registered Finance Companies to open and maintain NRFC and RFC accounts.

Employees' Provident Fund

The asset value of the Fund reached Rs. 1 trillion with nearly 2.2 million active members. During 2011, the Employees' Provident Fund (EPF) paid a high rate of return of 12.5 per cent to its members on their balances while continuing the diversification of the investment portfolio to provide a positive long-term real rate of return in a low and stable interest rate environment. As a result, investments in government securities reduced from 95 per cent in 2010 to 91 per cent of the total portfolio and it invested more in other sources including shares listed in the Colombo Stock Exchange. The investment portfolio was diversified further to reap the benefits of the fast growing sectors of the economy.

Chart 6.4
Value of the Fund

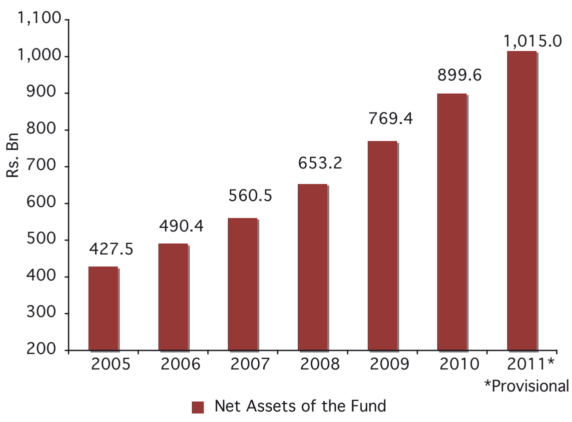
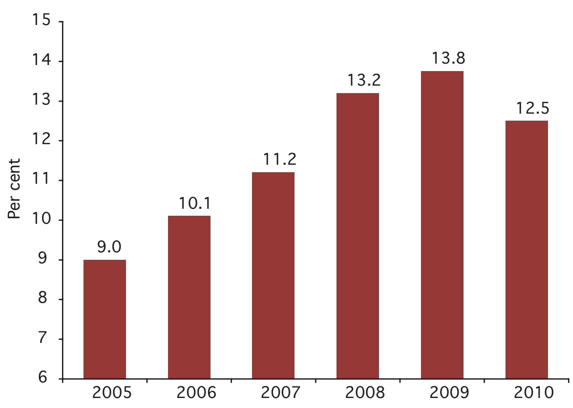
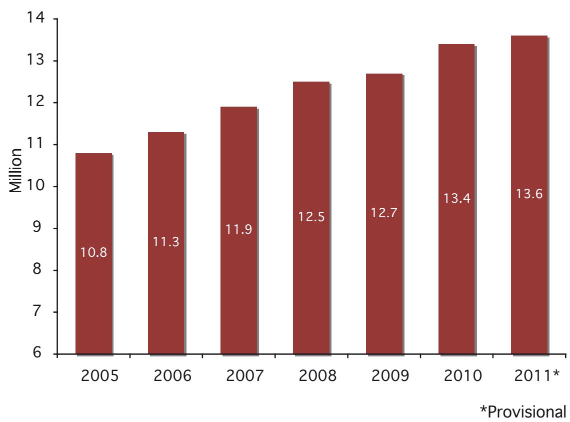


Chart 6.5
Interest rate Paid to Members



In the process of re-engineering of the EPF functions, the live implementation of the newly developed EPF accounting system commenced in January 2011. The Fund expects to convert the existing system into a semi-automated banking model in the future.

Chart 6.6
Employees Prvident Fund:Total Number of Accounts



Regional Development

As the economy of Sri Lanka moves on to a high growth path of around 8 per cent, the strategies of the Regional Development Department (RDD) will focus on balanced regional development which will enhance the contribution of the regions to Gross Domestic Product (GDP) of the country while ensuring the sustainability of such contributions. These regional development strategies will pay further attention to community development, financial inclusiveness and to disadvantaged groups of society, particularly those who were affected by the three decade long conflict. Successful implementation of the strategies of RDD will help achieve per capita income of US dollars 4,000 by 2016, and also support the progress of all the regions to move beyond the Millennium Development Goals.

The Central Bank will continue to provide affordable finance to the needy sectors under various refinance schemes which range from Small and Medium Enterprises to micro-finance or group lending. The Central Bank with the innovative Participatory Financial Institutions (PFIs) will continue to identify, evaluate and introduce new SMEs capable of supporting a modern economy including those which can support the flourishing tourist industry. The RDD will take initiatives to conduct entrepreneurship development training with the assistance of leading training institutions and trainers to fill knowledge gaps among existing and potential entrepreneurs and to continuously upgrade the knowledge of existing entrepreneurs in the areas of management, finance, marketing, leadership and productivity improvements etc. With the impetus provided by the Central Bank refinance schemes, the PFIs are expected to enhance financing agriculture, livestock, and micro-enterprise projects. The ongoing refinance schemes will support the PFIs further in 2012 in these areas and special attention will be paid to lagging areas. In 2012, loan disbursements are expected to increase by 23 per cent to Rs.15,242 bn in comparison to 2011, to carry out those activities in rural and semi-urban areas in the regions excluding the refinance schemes exclusively designed for the Northern and Eastern provinces.

Table 6.1: Special Credit Lines in the Northern Province in 2011

Credit Line	No of Loans Granted	Total (Rs. mn)
Awakening North	15,508	2,000
Prabodhini	7,543	401
Sarusara	26,187	2,535
Abhiwurdhi	533	70
Provincial Development	816	461
Saubhagya	53	60
Total	50,640	5,527

Source: Central Bank of Sri Lanka

The involvement of the Central Bank will be increased by allocating additional funds for refinance to support income generating economic activities. A higher volume of refinance will be disbursed in 2012 to the schemes exclusively designed for the Northern and Eastern provinces as the demand for funds to finance various projects and income generating activities are expected to increase by 37 per cent in 2012 from those areas. As in the previous year, the RDD will be actively engaged in arranging the provision of training and other facilities to the people in the Northern and Eastern provinces.

The RDD will also engage in forming groups with a view to linking them with the formal financial sector thereby contributing to the government objective of reducing poverty through enhanced financial inclusiveness and the knowledge on

Table 6.2: Special Credit Lines in the Eastern Province		
Credit Line	**No of Loans Granted**	**Total (Rs. mn)**
Eastern Development	6,892	1,000
Prabodhini	16,721	749
Sarusara	9,758	591
Abhiwurdhi	1,173	253
Provincial Development	314	110
Saubhagya	48	27
Post Tsunami Credit Lines	35	2
Total	34,941	2,732

Source: Central Bank of Sri Lanka

financial literacy. In addition, the RDD will use electronic media tools to increase the level of knowledge and awareness of banking and finance as well as the technical matters related to project financing including the SME sector.

Communications

The Central Bank continued to provide data and information on economic development, with a high level of accuracy and integrity, facilitating economic agents to make informed decisions. The provision of information on a timely and regular basis enables the Central Bank to influence market expectations, resulting in effective conduct of monetary policy. In order to achieve the aforesaid objectives, the Central Bank continued to regularly release data information and publications providing

Table 6.3: Programmes Conducted by the Central Bank in 2011	
Programmes	**Number**
Educational Seminars Publications	39 53
Data Releases	
Weekly Economic Indicators	51
Monthly Economic Indicators	12
Media Releases	
Newspaper Advertisements	326
Press Releases Issued (Including Daily Press Releases)	1,595
Media conference/ Seminars	60
Gazette Notifications	14
Web Communication	
Average unique Visitors per Month	145,702
Social Media	
Face Book	Likes 226 Posts 273
Twitter	Followers 174 Tweets 273
YouTube	Views 482 Videos 15

Source: Central Bank of Sri Lanka

a detailed assessment of the developments in the economy, as well as timely press releases on policy changes. Meanwhile, the Central Bank organized several public lectures, seminars and workshops throughout the year. The information disseminated through different media, covering detailed assessments on the developments in the economy and immediate press releases on policy changes, continued to improve understanding on related macroeconomic issues among the public. Further, the Central Bank integrated itself with social media networks such as Facebook, Twitter and YouTube enhancing its presence in the web sphere and assimilating new developments in the media arena.

As in the past, the Central Bank will continue to perform the above functions with commitment to ensure maximum benefits to the stakeholders and highest contributions to the economic growth. The coordinated policy actions of the Central Bank and the government, that was successful in stimulating the rapid growth whilst dealing with inflationary pressures, will ensure that the higher growth thrust that is being experienced at present will be sustained throughout the medium term.

7. Concluding Remarks

Your Excellencies, Ladies and Gentlemen, we have outlined the policy path that we propose to take in 2012 in particular and in the years ahead, in relation to our core objectives of economic and price stability and financial system stability, and the agency functions that we discharge.

2011 was a challenging year. The growth momentum in the US and Euro region weakened significantly. The sovereign debt crisis in the Euro region and the consequent uncertainty in financial markets were gradually transmitted to emerging market economies. Amidst tense global developments, Sri Lanka was able to maintain a favourable macroeconomic environment. The economy grew at over 8 per cent for the second consecutive year. Despite the rise in crude oil prices and the price of other commodities in international markets, appropriate demand management policies as well as favourable domestic supply conditions helped maintain inflation at a mid-single digit level for the third consecutive year. The expansion of economic activity resulted in a decline in unemployment to 4.3 per cent in the first half of 2011. On the external front, international reserves rose to 4.6 months of imports at end October. The fiscal consolidation process continued with the overall deficit declining to under 7 per cent of GDP and the debt to GDP ratio was estimated to decline to 78 per cent of GDP. The financial sector was further strengthened as reflected in the improvement in safety and soundness indicators.

While reflecting on these achievements, we are mindful that it has been a collective effort, and therefore we take this opportunity to thank all those who have strived with us to make this a reality.

In particular, we appreciate the leadership and guidance given by His Excellency the President, Mahinda Rajapaksa as the Minister of Finance. We also take this opportunity to thank the Deputy Minister of Finance, Hon. Geethanjana Gunewardena for his support. We also wish to express our deep appreciation to the Members of the Monetary Board, Dr. P.B. Jayasundera, Secretary to the Treasury, Mrs. Mano Ramanathan, Mr. Nimal Welgama and Mr. Neil Umagiliya for all their assistance to me during the last year. Let us also express our gratitude to the staff of the Central Bank; to Deputy Governors, Mr. K.G. D.D. Dheerasinghe and Mr. P.D.J. Fernando who retired from the bank in 2011 and to Deputy Governors, Dr. P.N. Weerasinghe, on release at the IMF, Mr. B.D.W.A. Silva and Mrs. C. Premaratne; the Assistant Governors, Heads of Departments and the staff of the Economic Research Department, and all the staff of the Central Bank who have worked with dedication, commitment and professionalism to fulfill the mandate of the Central Bank.

We also wish to acknowledge the contribution of the Consultative Committees on Monetary Policy and Financial System Stability to the policy discussion at the Bank. We welcome the discussions we have with various stakeholders in our economy as it helps us to refine and further improve our policies. We look forward to continuing this dialogue in the New Year.

In closing, let us reiterate the Central Bank's commitment to the core objectives of economic and price stability and financial system stability.

Thank you.