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# **Press Release**

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## **The Central Bank Governor unveils the Road Map for Monetary and Financial Sector Policies for 2013 and Beyond**

Governor of the Central Bank of Sri Lanka announced its Road Map for Monetary and Financial Sector Policies for 2013 and Beyond at a function held at the Central Bank premises today. 2013 is the seventh consecutive year that the Central Bank is presenting its policy direction and work plan for the upcoming period. Governor's presentation comprised an assessment of the macroeconomic developments in the previous year, policy direction for 2013 and for the medium term, particularly to ensure a smooth transition into the post-US\$ 4,000 per capita era.

### ***2012: A Year of Consolidation following the Strong Post-Conflict Recovery***

A major growth momentum was witnessed in the aftermath of the conflict with the economy recording growth rates of above 8 per cent for two consecutive years for the first time ever in 2010 and 2011. While the policymakers allowed for this rapid expansion to carry on during these two years, a mix of stringent policy measures

aimed at macroeconomic stabilisation was adopted in early 2012. These measures were needed to face the challenges of a protracted recovery in the global economy as well as rapidly rising domestic credit, which fuelled a higher than desired import demand, while adverse weather conditions also hindered economic performance. Consequently, economic growth declined to some extent, as expected, and it is projected that overall economic growth in 2012 would be about 6.5 per cent.

The economy has been responding well to the policy measures taken. In the external sector, cumulative expenditure on imports declined by 4.5 per cent in the first eleven months of 2012 from the corresponding period of 2011 while the cumulative deficit in the trade account declined by 2.1 per cent. As a result of the contraction of the trade deficit and the increase in other earnings such as higher workers' remittances and earnings on account of tourism, the current account deficit reduced substantially in 2012 leading to the BOP improving to a surplus of over US\$ 100 million in 2012 from a deficit of US\$ 1,061 million in 2011.

Higher policy rates, credit ceiling and lower levels of liquidity led to higher market interest rates during the year helping to curtail the rapid expansion in credit and import demand. Growth of credit to the private sector showed a broad-based deceleration, declining from above 35 per cent in the early months of the year to 20.7 per cent by November 2012. As a result, growth of broad money also decelerated to 18.1 per cent by November from a peak of 22.9 per cent in April this year. Inflation moved upwards during the year due to several reasons including supply disruptions on account of drought conditions and the one-off direct impact of some of the policy measures taken. Nevertheless, prudent conduct of monetary policy enabled inflation to remain at single digit levels during the year, and in December 2012, year-on-year inflation was at 9.2 per cent while annual average inflation was 7.6 per cent. By end 2012, both headline and core inflation have remained at single digit levels continuously for 47 months.

Continued strong commitment towards fiscal consolidation by the Government is expected to have brought down the overall fiscal deficit from 6.9 per cent of GDP in 2011 mainly due to expenditure containment. However, the Government maintained public investment at a level sufficient to sustain the high growth momentum of the economy by supporting the infrastructure drive. Public debt has been managed prudently, and the Debt to GDP ratio is estimated to be 81 per cent in 2012 in comparison to 78.5 per cent of GDP in 2011 mainly due to the one-off increase on account of the depreciation of the rupee. Nevertheless, the fact that risk indicators of Sri Lankan public debt have improved at a time where global risk has been rising is commendable.

Despite challenges and shocks to the economy, Sri Lanka's financial system maintained stability, while expanding. Banking sector stability and strength remained unaffected, performance of financial institutions improved, efficiency of the payment and settlement systems increased while regulations were strengthened and streamlined further during the year to promote the stability of Sri Lanka's financial system.

Towards the end of the year, with the tight monetary policy yielding the expected stabilisation objectives, the Central Bank was able to reduce policy rates and allow the credit ceiling to expire by end 2012 to provide some stimulus to the economy. The multi-pronged policy package helped the economy get back on track swiftly, and to record the shortest tightening cycle since 2001.

### ***Planning for the Second Wave of Growth***

Overall, the country's macroeconomic fundamentals have strengthened over time while moving in the right direction. As a consequence, the country is well on track to achieving its target of doubling the per capita income to US\$ 4,000 by 2016. As such, the Central Bank is now focusing on preparing for the post US\$ 4,000 era by

ensuring that Sri Lanka progresses along a steady growth path by carefully planning a second wave of growth to avoid the “middle-income trap.” The key strategy identified to avoid such an outcome is to encourage greater diversification of the economy. In this regard, the Central Bank expects the “5+1 Hub” concept, envisaged in the *Mahinda Chintana* policy document would provide the necessary footing for the economy to pursue this strategy.

Towards this end, the Central Bank’s medium term macroeconomic framework has been carefully prepared to foster the expected growth path while giving priority to ensuring inflation is maintained at mid-single digits in the next five years.

In preparing its policy stance for 2013, projections for key macroeconomic variables are as follows:

- Real GDP to grow by 7.5 per cent
- Inflation to stabilise at mid-single digit levels
- Trade deficit to improve from 15.1 per cent of GDP to 14.4 per cent of GDP
- Current account deficit to improve from 5.5 per cent of GDP to 4.7 per cent of GDP
- Reserve adequacy in months of imports to remain around 4 months
- The overall budget deficit to reduce to 5.8 per cent of GDP
- Continuous improvement in productivity levels

Accordingly, targeted growth of broad money will be 15 per cent, which is consistent with the expected growth of nominal GDP. At the same time, the Central Bank’s monetary policy will continue to be conducted within a monetary targeting framework while the policy rate corridor will continue to guide short term interest rates. However, operationally, the following modifications will be considered in 2013:

- Lengthening the current one week reserve maintenance period to two weeks, thereby allowing greater flexibility for banks to manage their day-to-day liquidity; and
- Conducting regular term auctions to manage structural liquidity along with fine-tuning operations to facilitate day-to-day liquidity management.

The flexible exchange rate will be allowed to reflect market conditions. The Central Bank intervention in supplying and absorbing foreign exchange directly, will be limited to reducing excessive fluctuations and maintaining external reserves at desired levels. In order to provide greater flexibility in the exchange rate, the following regulatory changes have been made with effect from 2 January 2013:

- NOP limits of LCBs will be increased to give LCBs more flexibility in managing their foreign exchange transactions
- Limits on forward market transactions will be relaxed

In addition, selected derivative products will be allowed to be developed within broad guidelines that will be issued during 2013.

With the expected further diversification in the economy in the years ahead, the key sources of foreign exchange earnings would shift towards more service based exports. The Central Bank will endeavour to promote the competitiveness of both exports of merchandise goods as well as services while indirectly facilitating other foreign exchange flows, which would have an impact on the exchange rate.

Going forward, steps will be taken to bridge the high savings-investment gap through medium to long term measures, for the economy to realise its true potential. Long-term domestic savings will be encouraged through positive real interest rates and through the promotion of pension funds and life insurance.

In the long-run, productivity growth will be a vital instrument of improving living standards as productivity growth will be a positive supply shock to the economy. In

particular, the continued decline in unemployment in Sri Lanka in recent years, compels re-thinking of the future employment strategies, warranting careful attention to areas of high labour force concentration and new approaches to enhance productivity of such areas. At the same time, such efforts will need to be supported by extensive socio-economic and physical infrastructure development as well.

In the meantime, to reach a US\$ 100 billion economy by 2016, banks and non-bank financial institutions (NBFIs) will have to play a critical role. In that regard, the Central Bank will:

- Review and amend the regulatory framework to facilitate the business models of banks and NBFIs
- Encourage the adoption of policies for diversification of business and income, through fee-based services
- Encourage consolidation in the banking and the NBFIs sectors
- Strengthen the regulatory regime, while encouraging diversification of sources of funding and business operations mainly through foreign sources
- Enhance the quality and frequency of bank and NBFIs examinations
- Identify and regulate the risk profiles of banks and NBFIs in order to ensure stability of the financial sector and enhance public confidence

Moreover, the Governor also elucidated proposed near to medium term policies in the areas of exchange control relaxation, development of the payment and settlement systems, the management of Employees' Provident Fund (EPF), foreign reserve management and currency management.

The Central Bank will also continue its efforts to develop a vibrant and liquid bond market in Sri Lanka, facilitating the development of the Government securities market while encouraging the development of the equity and corporate bond markets.

***Implementation of these policies is key to success as the next “Break-out Nation”***

2012 was an extraordinary year which, once again underscored the resilience of the Sri Lankan economy. External and domestic challenges prompted the Central Bank to adopt strong measures to stabilise the economy and the economy adjusted swiftly to these measures allowing the Bank to relax the policy stance before the end of the year.

Today, the Central Bank is in a position to steer the economy along a more stable and sustainable path to achieve its objectives of maintaining economic and price stability and financial system stability to support sustainable and inclusive growth.