ශ්‍රී ලංකා මහ බැංකුව
இலங்கை மத்திய வங்கி
CENTRAL BANK OF SRI LANKA

Communications Department
30, Janadhipathi Mawatha, Colombo 01, Sri Lanka.
Tel : 2477424, 2477423, 2477311
Fax: 2346257, 2477739
E-mail: dcommunications@cbsl.lk, communications@cbsl.lk
Web: www.cbsl.gov.lk

Press Release

Issued By **Economic Research Department**
Date **09 April 2013**

THE SUMMARY OF THE ANNUAL REPORT OF THE CENTRAL BANK OF SRI LANKA FOR THE YEAR 2012

Section 35 of the Monetary Law Act requires the Monetary Board of the Central Bank of Sri Lanka to submit a report giving details of the state of the economy, the condition of the Central Bank and the policies and measures adopted by the Monetary Board during the year to the Minister in charge of the subject of Finance within four months of the commencement of the following year. The 63rd annual report of the Monetary Board was submitted to H.E. the President of Sri Lanka and the Minister of Finance and Planning today, the 9th of April 2013. Following are some of the highlights of the report.

The Sri Lankan economy grew at a healthy rate of 6.4 per cent in 2012 while inflation was maintained at single digits for a fourth consecutive year, despite several global and domestic challenges. Improved business and consumer confidence, which supported a robust economic growth of 8 per cent in the preceding two consecutive years, was accompanied by high credit and monetary expansion and a widening trade deficit fuelled by high import demand.

To further strengthen the macroeconomic environment, by containing the rapid expansion of monetary aggregates and the widening trade deficit, the Central Bank and the government implemented a comprehensive policy package in early 2012. Accordingly, the Central Bank adopted a tight monetary policy stance by raising policy interest rates and issuing a Direction under Section 101(1) of the Monetary Law Act in March 2012 to moderate credit growth by licensed banks. The Central Bank also allowed greater flexibility in the determination of the exchange rate and limited its intervention in the domestic foreign exchange market. To curtail imports, tariffs on selected imports were raised. Further, in order to reduce the losses being incurred by state owned enterprises and their impact on overall macroeconomic stability, several administratively determined prices, mainly relating to energy, were revised.

Inflation was maintained within single digit levels in 2012 for the fourth consecutive year. Inflation declined to a low level of 2.7 per cent in February 2012. However, the upward adjustment of energy prices and transport fares in February 2012 to reflect the rise in oil prices in the international market, the pass-through of the depreciation of the rupee, supply disruptions on account of adverse weather conditions that prevailed in major cultivation areas and the impact of past high monetary expansion resulted in inflation edging up to end the year at 9.2 per cent. Nevertheless, within a relatively short period of time the impact of the policy measures adopted was evident with the trade deficit and credit granted to the private sector decelerating while managing inflation expectations also helped, containing inflation at single digit levels throughout the year. By end 2012, the annual average rate of inflation stood at 7.6 per cent.

Reflecting the government's continued commitment to the fiscal consolidation process, the overall fiscal deficit was contained significantly below the previous year's level, although it marginally exceeded the target in the budget. The slowdown in economic activity and the decline in imports had a negative impact on government revenue collection. However, by maintaining a tight rein on recurrent expenditure and scaling back on capital expenditure, the overall fiscal deficit was contained at 6.4 per cent of GDP, marginally above the targeted level of 6.2 per cent of GDP and significantly below the 6.9 per cent of GDP in 2011. Raising the tax to GDP ratio by broadening the tax base and improving tax compliance would be critical to sustaining the fiscal consolidation process in the medium term. Although major tax reforms resulted in a simplification of the tax structure, revenue collection remained weak.

The external sector strengthened during the year benefiting from the policy measures that were adopted in early 2012 to improve macroeconomic stability. Import expenditure declined by 5.4 per cent with non-fuel imports declining at a faster rate of 8.6 per cent. Despite the decline in exports by 7.4 per cent due to weak external demand and the decline in international commodity prices, the trade deficit contracted to 15.8 per cent of GDP in 2012. The improvement in the trade account, increased inflows from trade in services including tourism and transportation, and continued high growth in workers' remittances helped contain the current account deficit to 6.6 per cent of GDP in 2012. The improvement in the current account together with higher inflows to the capital and financial account from the proceeds of the fifth international sovereign bond, higher inflows to the government to finance infrastructure development projects and increased foreign borrowing by commercial banks and the private sector as a result of the relaxation of exchange control regulations, resulted in the BOP recording a surplus of US dollars 151 million in 2012. Accordingly, gross official reserves rose to US dollars 6.9 billion by end 2012.

The financial sector remained resilient and continued to support domestic economic activity despite the elevated risks from global and domestic developments. The financial sector expanded during the year with increased access to finance although asset growth moderated as the credit ceiling was imposed early in the year. Nevertheless, soundness of financial sector institutions improved with higher capital levels, adequate liquidity buffers and healthy earnings. With the raising of funds abroad, the banking sector was able to diversify its sources of funding, further strengthening its balance sheet. Significant attention was directed over the year towards strengthening the effectiveness of the regulatory and supervisory framework, in line with international standards and best practices, and providing an enhanced focus on governance practices and risk management to address potential risks to financial stability. The payments and settlement system too continued to operate with a high degree of availability and safety, facilitating the financial intermediation function.

Real Sector Developments

The economy grew by 6.4 per cent in real terms in 2012 amidst the slow recovery in global demand and the multi-pronged policy measures introduced to strengthen macroeconomic stability. All key sectors contributed positively to economic growth in 2012. The Industry sector was the main driver of growth with the construction sub sector making the most significant contribution, reflecting the massive public investment programme and several private sector real estate projects. Growth in the Services sector moderated largely on account of the slowdown in external trade and the deceleration in the transport sub sector. Despite adverse weather conditions in the second half of the year, the Agriculture sector performed better in 2012 than in 2011. Reflecting the expansion in economic activities, the unemployment rate declined to 4 per cent in 2012 from 4.2 per cent in 2011.

The Agriculture sector grew by 5.8 per cent in 2012, recovering from a slow growth of 1.4 per cent in 2011, amidst drought conditions in the third quarter of the year and heavy monsoonal rains and floods in the latter part of the year. The favourable weather conditions that prevailed in the early part of the year produced a bountiful paddy harvest in the Maha season, contributing to the recovery of the paddy despite the significant setback in paddy production in the Yala season due to adverse weather conditions. The performance of the agriculture sector was also driven by the improvement in vegetable production, highland crops, livestock and a significant increase in fish production during the year. The fisheries sub sector also contributed significantly towards the growth in the Agriculture sector while milk production supported by concerted efforts by the government to promote the dairy industry. In the export agricultural sector, coconut production increased largely due to the lag effect of favourable weather conditions that prevailed in major coconut growing areas. However, tea production was adversely affected by the drought while rubber production declined due to the torrential rainfall. Within the minor export crops sector, pepper production increased significantly while the production of cinnamon and cloves declined in 2012. Most agricultural commodities benefited from the favourable prices that prevailed in 2012.

The Industry sector grew by 10.3 per cent, contributing substantially to the expansion of the economy in 2012. The sustained increase in construction activities, which accelerated the growth momentum of the construction sub sector spurred the growth in the Industry sector. The continuation of major government funded infrastructure development projects and increased construction activities of the private sector, including tourism related new construction and renovation activities, contributed to this growth. A high level of activity in the construction sector bolstered demand for minerals and construction material enabling the mining and quarrying sub sector to increase its share in GDP. Manufacturing, the largest sub sector within the Industry sector, decelerated in terms of value added growth due to subdued domestic and external demand. The factory industry sub sector, which accounted for around

90 per cent of manufacturing output, decelerated in 2011. The apparel industry has been able to sustain its performance despite the slowdown in major export destinations due to the high quality of export products and strong domestic demand arising from the tourism sector. The contribution from the electricity, gas and water sub sector to industry growth was also lower in comparison to the previous two years, partly due to the drop in value addition from hydro power generation during the second and third quarters of the year. Government initiatives in the form of regional industrial development, productivity improvements, support for small and medium enterprises (SME) and research and development for innovation continued to be the focus of industrial policy in 2012.

Services sector growth moderated to 4.6 per cent in 2012 from an expansion of 8.6 per cent in 2011 mainly due to the deceleration in the wholesale and retail trade sub sector. As a result, the relative share of the Services sector in GDP reduced to 58.5 per cent in 2012 from 59.5 per cent in 2011. The wholesale and retail trade sub sector grew by a modest 3.7 per cent in 2012 from 10.3 per cent in the previous year. The slowdown in import trade, reflecting the impact of policy measures taken to curb imports, and the decline in exports due to the sluggish recovery in the global economy largely contributed to the deceleration in this sub sector. Transport and communications, banking, insurance and real estate and hotels and restaurants sub sectors grew at a positive, albeit slower pace in 2012, also contributing to the modest growth in the Services sector.

Domestic and national savings improved considerably as a result of the improvement in the current account deficit. The lower growth in consumption expenditure mainly on account of imports resulted in an increase in the domestic savings rate to 17 per cent of GDP in 2012 from 15.4 per cent of GDP in 2011. However, there was a deterioration in government dis-savings during the year. The continued growth of private remittances from abroad raised the overall national savings rate to 24 per cent of GDP in 2012 from 22 per cent of GDP in 2011. Hence, despite the increase in investment as a percentage of GDP to 30.6 per cent, the savings-investment gap as a percentage of GDP, improved to 6.6 per cent in 2012, from 7.9 per cent in 2011.

External Sector Developments

Overcoming the challenges encountered towards the latter part of 2011, the external sector performed well during 2012 benefiting from the comprehensive policy package implemented by the Central Bank and the government during early 2012. These policy measures mainly aimed at reducing the widening trade deficit in 2011 and early 2012, by curtailing non-essential imports and improving export competitiveness. The imposition of the ceiling on credit growth, and the upward revision to policy interest rates and tariff rates on selected imports helped curtail expenditure on imports during the year. However, due to the sluggish economic recovery in the US and in the euro area, the major markets for Sri Lankan exports, as well as the decline in the price of major export commodities, earnings from exports declined during the year. Nevertheless, in absolute terms, the decline in import expenditure was larger than the decline in export income, resulting in a contraction of the trade deficit. Further, the current account deficit improved as a substantial portion of the trade deficit was cushioned by increased inflows on account of trade in services and private current transfers. Long term inflows to the financial account, including the proceeds from the fifth international sovereign bond, FDI inflows, and other inflows to the banks and private sector, helped strengthen the BOP to record a surplus of US dollars 151 million by end 2012.

Earnings from exports contracted by 7.4 per cent in 2012. Industrial exports declined by 7.8 per cent mainly due to the reduction in textiles and garments, which has the largest share (around 40 per cent) in total export earnings, by 4.8 per cent. The sharp decline in international cotton prices from the peak levels recorded in March 2011 also resulted in a drop in the average unit price of garments. Garment exports to EU, which constituted approximately 50 per cent of total garment exports, declined by 9.2 per cent in 2012, while garment exports to the US, Sri Lanka’s second largest market for garments, also declined by 4 per cent in 2012. Earnings from agricultural exports declined by 7.8 per cent in 2012. Earnings from tea, which accounts for about 15 per cent of total earnings from merchandise exports, declined mainly due to geo-political tensions that continued to hamper demand from some Middle Eastern countries.

Expenditure on imports in 2012 declined by 5.4 per cent, year-on-year, while that on non-fuel imports, declined at a faster pace of 8.6 per cent. As a consequence of the higher import tariff imposed on vehicle imports and the depreciation of the rupee, expenditure on imports of motor vehicles declined by 43.8 per cent to US dollars 495 million in 2012, in contrast to the sharp increase recorded in 2011. This largely contributed to lowering expenditure on the importation of consumer goods in 2012. Expenditure on intermediate goods imports declined in 2012, mainly as a result of lower expenditure on the importation of gold. However, the expenditure on petroleum products increased due to higher dependence on thermal power generation. Also, the continuing US sanctions against Iran curtailed Sri Lanka's import of crude oil for its refineries, resulting in higher imports of refined petroleum products at a relatively high cost partly contributing to the increased expenditure on petroleum products during the year. Investment goods imports increased with continued development activities in the country in 2012. In absolute terms the decline in import expenditure was much higher than the decline in export earnings, reflecting the effectiveness of concerted policy measures adopted to reduce import expenditure. As a result, the trade deficit declined from 16.4 per cent of GDP in 2011 to 15.8 per cent of GDP in 2012.

The services account recorded a significant improvement in 2012 mainly due to increased earnings from transportation, information technology services, travel and tourism. Remittances by migrant workers increased by 16.3 per cent to US dollars 6 billion during the year, continuing to be the largest single source of foreign exchange inflows to Sri Lanka. The improvement in the trade balance and increased inflows from trade in services and current transfers helped restrain the current account deficit of the BOP. Accordingly, the current account deficit was contained at US dollars 3.9 billion (6.6 per cent of GDP) in 2012 from US dollars 4.6 billion (7.8 per cent of GDP) in 2011. In the capital and financial account, inflows to the private sector as well as to the government were substantial in 2012. The narrowing of the external current account deficit and increased inflows into the capital and financial account resulted in a surplus in the BOP, amounting to US dollars 151 million in 2012, thereby boosting external reserves of the country.

The receipt of the last two tranches under the IMF Stand-by Arrangement (IMF-SBA) obtained in 2009 and proceeds of the fifth international sovereign bond led to a sizeable increase in gross official reserves to a comfortable level in 2012, thereby improving the resilience of the economy to external shocks. Gross official reserves (excluding ACU balances) increased to US dollars 6.9 billion by end 2012 from US dollars 6.0 billion in 2011. Meanwhile, total international reserves of the country increased to US dollars 8.4 billion from US dollars 7.2 billion in 2011.

The increase in official reserves reduced the country's vulnerability to external shocks as reflected in the measures of reserve adequacy. The import coverage of gross official reserves (excluding ACU balances) was 4.3 months in 2012, compared to the internationally accepted norm of 3 months of imports. Reserve adequacy, as measured by the ratio of gross official reserves to short term external debt (with remaining maturity of one year or less) improved to 63 per cent by end 2012

Fiscal Sector Developments

The fiscal policy strategy in 2012 focused on strengthening the fiscal consolidation process while maintaining a high level of investment to facilitate sustained economic growth. Accordingly, the budget deficit for 2012 was targeted at 6.2 per cent of GDP with revenue (including grants) and expenditure and net lending as a percentage of GDP, set at 15 per cent and 21.2 per cent, respectively. However, budgetary operations during the year became challenging in an environment of high interest rates, rising debt service payments due to exchange rate movements, reduced imports, and moderate economic growth. Nevertheless, the government succeeded in reducing the budget deficit to 6.4 per cent of GDP in 2012 from 6.9 per cent of GDP in 2011, further consolidating the achievements made in the recent past to lower the fiscal deficit. Despite a shortfall in revenue, a tight rein on recurrent expenditure together with the curtailment of non-priority capital expenditure, enabled the government to steer fiscal operations close to the 2012 budget target. Expenditure restraint in both current and capital outlays reduced total expenditure and net lending of the government from 21.4 per cent of GDP in 2011 to 19.7 per cent of GDP in 2012. While public investment, as a percentage of GDP, was maintained at 5.5 per cent, the reduction in recurrent expenditure to 14.4 per cent of GDP in 2012 from 15.4 per cent of GDP in 2011 was an over-performance in terms of the 2012 budget target of 14.8 per cent. Consequently, the primary balance, which excludes interest payments declined to a deficit of 1.1 per cent of GDP in 2012 from a deficit of 1.4 per cent of GDP in 2011. Despite the reduction in current expenditure, the current account deficit, increased to 1.4 per cent of GDP in 2012 from 1.1 per cent of GDP in 2011 due to lower tax revenue mobilisation. Revenue as a percentage of GDP declined to 13 per cent in 2012 from 14.3 per cent in the previous year, reflecting the slowdown in domestic economic activity and the impact of policy measures adopted. In financing the budget deficit, the government relied primarily on foreign sources with foreign financing increasing to 59 per cent of the total financing requirement. Financing from domestic sources was largely through bank borrowings, which accounted for 65 per cent of the domestic financing requirement, exceeding the level of bank financing envisaged in the budget for 2012.

Government revenue as a percentage of GDP declined to 13 per cent from 14.3 per cent in the previous year although revenue increased by 5.7 per cent in nominal terms. The lacklustre performance of government revenue was entirely due to a reduction in tax revenue as a percentage of GDP to 11.1 per cent in 2012 from 12.4 per cent in 2011. Tax revenue was significantly below the original estimate for 2012 owing to a reduction in import related taxes resulting from a decline in imports, especially consumer goods including motor vehicles, and a slowdown in economic activity. Non tax revenue remained at 1.9 per cent of GDP as in the previous year.

Current and capital expenditure of the government declined from 21.4 per cent of GDP in 2011 to 19.7 per cent of GDP in 2012. The decline in expenditure is a reflection of the government's efforts to rationalise recurrent expenditure and curtail non-priority capital expenditure. The reduction in recurrent expenditure was mainly on account of the rationalisation of expenditure in respect of salaries and wages and government purchases of goods and services. Capital expenditure, as a percentage of GDP declined to 5.3 per cent in 2012 from 6 per cent in the previous year, mainly due to resources being channeled to strategically important infrastructure development projects.

The resource gap was financed mainly by foreign sources through higher foreign investments in government securities, the issue of an international sovereign bond and project loans, which accounted for 59 per cent of the total financing requirement. The balance 41 per cent was financed through domestic sources. With respect to domestic financing, the government relied heavily on the banking sector in 2012. Borrowings from the banking sector in 2012 were significantly higher amounting to Rs. 131.5 billion compared to the budget estimate of Rs. 64 billion, although the share of banking sector borrowings in total domestic financing declined to 65 per cent in 2012 from 81 per cent in the previous year.

The debt to GDP ratio by end 2012 increased to 79.1 per cent, reversing the declining trend observed in the recent past, largely due to exchange rate movements. In nominal terms, the outstanding government debt increased notably by 16.9 per cent to Rs. 6,000 billion at end 2012 from Rs. 5,133 billion at end 2011. The total foreign currency denominated debt stock increased by Rs. 207 billion (2.7 per cent of GDP) during 2012 due to the depreciation of the rupee against major foreign currencies.

Monetary Sector Developments

The Central Bank followed a stringent monetary policy stance during the year to contain the rapid expansion in monetary aggregates and thereby preserve macroeconomic stability but was able to relax its policy stance by December as the policy measures yielded the desired outcomes. Monetary policy was tightened significantly by the policy rates being raised twice and by a ceiling on the growth of rupee credit being imposed in order to stem the high growth in monetary and credit aggregates. Accordingly, the policy interest rates of the Central Bank were increased by 50 basis points in February. A second round of policy tightening was carried out in April, where the Repurchase rate was raised by 25 basis points to 7.75 per cent and the Reverse Repurchase rate was increased by 75 basis points to 9.75 per cent, thus widening the policy interest rate corridor to 200 basis points. At the same time, to effect a more rapid curtailment of credit, the Central Bank imposed a ceiling on the growth of rupee denominated credit by licensed banks in 2012. Accordingly, a Direction was issued under Section 101(1) of the Monetary Law Act (MLA) restricting the growth of credit to 18 per cent while an additional 5 per cent was allowed to banks that brought in funds from abroad to bridge the difference. In view of the asymmetric impact it could have on some banks, alternative limits of Rs. 800 million, or Rs. 1 billion for banks that mobilise funds from abroad, were imposed. As the growth of credit and monetary aggregates decelerated, the Central Bank was able to signal an early exit from the tight policy stance in December 2012 by easing its policy interest rates by 25 basis points and allowing the credit ceiling to expire at the end of the year. Consequently, the tightening cycle in the year 2012 was one of the shortest experienced by the Sri Lankan economy in recent years.

Excess rupee liquidity in the domestic money market remained in a moderately surplus position until August 2012 compared to the large excess experienced in 2011, but declined to a broadly balanced position thereafter. Excess liquidity was about Rs. 12 billion on average during the first eight months of the year increasing significantly to Rs. 59 billion by end July with the Central Bank purchasing a part of the proceeds from the fifth international sovereign bond issue. However, in view of the need to maintain tight liquidity conditions in the market in line with the prevailing monetary policy stance, the Central Bank took measures to unwind the excess liquidity through term repurchase agreements and the outright sale of Treasury bills from its portfolio, albeit with limited success due to insufficient participation by market players. However, market liquidity declined from end August, ranging between surplus and deficit positions with the reversal of foreign exchange swaps and the continued sale of Treasury bills necessitating injection of liquidity through term reverse repurchase agreements. By the last quarter, the purchase of Treasury bills from the primary market and foreign exchange from the domestic foreign exchange market, particularly in December, improved market liquidity to a balanced position. The Central Bank continued to hold auctions under open market operations (OMO) and offer standing facilities on a daily basis to manage overnight liquidity and guide market interest rates.

The Monetary Programme was prepared according to the expected developments in the macroeconomy and was used to guide monetary operations during the year. Nominal GDP was originally projected to be about 15 per cent, on account of a projected growth in real GDP of 8 per cent and a GDP deflator of 6 per cent. Based on these projections, the targeted growth of broad money and reserve money were set at 15 per cent as the money multiplier was expected to remain broadly stable. Credit extended to the private sector was expected to expand by about 19 per cent, which formed the basis for the subsequent Direction issued by the Central Bank capping the growth of rupee denominated credit. Growth of real GDP was revised downwards on several occasions during the course of the year on account of the tight policies adopted, the protracted global economic recovery and the impact of adverse weather conditions. However, the growth targets for monetary aggregates were maintained unchanged given that growth of nominal GDP remained broadly at the same level.

Market interest rates were allowed to move up to facilitate the desired deceleration in credit and monetary aggregates in line with the Central Bank's policy direction. The overnight interbank market rates remained around the upper bound of the policy rate corridor during the year until the relaxation of policy from mid-December 2012. Both deposit and lending rates in the market moved up further in 2012, continuing the trend from the last quarter of 2011, reflecting the increased policy interest rates, the ceiling on credit and the tight liquidity conditions in the market. Yield rates across all maturities of Treasury bills in the primary market increased till around mid-year before remaining stable until December 2012. Excess funds from banks were being invested in government securities as the credit ceiling necessitated some banks to pace out their lending to the private sector. The upward movement in market interest rates was also reflected in the secondary market yield curve for government securities, which moved above the level in 2011 by year end.

Financial Sector Developments

The financial sector expanded during the year maintaining its stability in spite of vulnerabilities arising from the fragile conditions in the global financial markets and possible threats from the domestic economy. Several measures were taken early in the year to curb domestic demand and safeguard stability in the economy. The cap on credit growth placed in March 2012 also helped stem the potential adverse impact of continued high credit growth on the stability of the banking industry and thereby, the entire financial sector. The overall soundness of the financial sector improved in terms of capital and liquidity levels. The branch network increased further, promoting access to finance facilitating the efforts to achieve a balanced regional growth. However, compared to the previous year, domestic financial markets remained sluggish due to stringent measures taken by the authorities, although improved investor confidence was evident by the net inflows to the Colombo Stock Exchange. As in previous years, the Central Bank continued to strengthen the supervisory and regulatory environment to promote the safety of the financial system while fostering innovation and modernisation.

The overall soundness of the financial sector improved with institutions retaining adequate capital and liquidity levels while the branch network widened further and the asset base broadened over the year. The banking sector continued to dominate the financial sector landscape with its share of assets increasing in 2012. Growth of assets of the banking sector remained unchanged from 2011 largely due to the cap on credit growth placed in March 2012 but profitability was higher in 2012. The increase in profits helped build up the capital funds of banks. The total capital adequacy ratio of the banking sector is expected to remain at a level well above the minimum threshold placed by the regulator. The declining trend in non-performing loans (NPL) observed since 2009 slowed in 2012, largely reflecting the high interest rate environment. As at end 2012, the Sri Lanka Deposit Insurance Scheme (SLDIS) comprised 78 member institutions and a fund balance of approximately Rs. 9.7 billion. The non-bank financial institution (NBFI) sector consisting of Licensed Finance Companies (LFCs) and Specialised Leasing Companies (SLCs) expanded its asset base while increasing its branch network with improved soundness of the institutions within the sector. The Central Bank’s continued efforts to promote the risk management practices at NBFIs helped improve the overall soundness of these institutions. The Central Bank closely monitored the progress made by distressed finance companies in restructuring their business while continuing efforts to stem the conduct of unauthorised finance businesses. The key performance indicators of Primary Dealers in government securities improved during the year. Despite the subdued performance in the equity market, the unit trust industry recorded significant growth in terms of total assets and net asset value benefiting from portfolio diversification. Insurance companies maintained their soundness with key indicators such as total assets, premium income, investment income and profitability all on an upward trend. The main superannuation funds continued to experience a growth in their asset base and membership, while being able to maintain a healthy return on investments. The funds of the Employees' Provident Fund (EPF), which accounts for about 79 per cent of the superannuation sector assets, reached Rs. 1,144 billion by end 2012.

Conditions in the domestic financial markets remained subdued compared to the previous year largely due to the stabilisation policies adopted by the authorities. Money market liquidity fluctuated from surplus to deficit positions reaching a broadly balanced position, particularly towards the latter part of the year. The interbank call market rate increased during the first half of 2012 responding to tight policy measures adopted including the credit ceiling imposed on banks, and thereafter hovered around the upper bound of the Central Bank's policy interest rate corridor, declining towards the middle of the corridor with the easing of policy interest rates in mid-December. A notable feature during the year was the increased activity in the commercial paper market, which could be attributed to the credit restrictions imposed on bank lending and the resultant high interest rates charged by banks. A similar trend was mirrored by the corporate bond market. Net foreign inflows to the CSE increased significantly in 2012 despite the continuation of a fragile performance. Amongst factors that affected activity at the stock exchange were the relatively higher yields on fixed income securities, volatility in the exchange rate, tight liquidity conditions in the market and the knock-on effects of uncertainties prevailing in global financial markets. The limits imposed on credit by stock brokers, although relaxed subsequently, also hampered market performance during the early months of the year.

The supervisory and regulatory framework was further strengthened during the year to promote the stability of the financial system and safeguard customers. Several Directions 22 were issued to licensed banks during the course of the year pertaining to standards of business conduct and market practices in foreign exchange transactions, outsourcing of businesses, operations and classifications. Licensed Finance Companies were issued Directions in relation to information systems security and upper limits for interest rates offered on deposits. Similarly, the Specialised Leasing Companies were issued directions on assessment of fitness and propriety of directors and key management personnel and changes to definitions in the compilation of key indicators. In order to strengthen the audit process and to meet the required standards, a panel of external auditors was appointed to conduct external audits of non-bank financial institutions.

Outlook

The deficit in the external current account needs to be narrowed to a sustainable level over the medium term. Improved access to international capital markets and a more flexible exchange rate helped cushion the external sector in 2012. However, policies should focus on narrowing the current account deficit to a more sustainable level by reducing import dependence, improving export competitiveness and diversifying goods and services exports as well as markets. Expenditure on the importation of food and beverages could be significantly reduced through policies being taken to encourage domestic production, particularly in the areas of dairy and sugar production. Further, the importation of oil is expected to decline over the medium term with the shifting to coal power and other alternative sources of energy. In the area of exports, merchandise trade needs to penetrate into emerging market economies to benefit from the rebalancing of the global economy, while retaining and increasing market share in traditional export destinations. Policies to promote value addition into fast expanding supply chain industries and entrepôt trade are expected to sustain earnings from exports. Further, earnings from trade in services are poised to grow with the 5-hubs namely, the maritime, aviation, knowledge, commercial and energy sectors and tourism emerging as key growth sectors in the economy.

Inflation is expected to moderate in 2013 with the easing of demand driven inflationary pressures and favourable supply side developments. Maintaining price stability is important for investor and consumer confidence as well as to maintain macroeconomic stability. Going forward, monetary policy will be carefully calibrated to balance between maintaining inflation at a low and stable level and stimulating growth towards its full potential. In this respect, the continued fiscal consolidation process and the implementation of appropriate policies to address supply side bottlenecks that increase the volatility of prices are expected to provide the required space for the smooth implementation of monetary policy.

The Sri Lankan economy is expected to continue on a high growth path benefitting from improved infrastructure facilities and favourable macroeconomic fundamentals. Encouraging the private sector to reap the benefits of the government’s investments in infrastructure and facilitating them to expand productive capacity would be vital to achieving the envisaged medium term growth targets. Maintaining consistent policies and a conducive business environment will attract higher foreign direct investment (FDI) helping to bridge the gap between the current level of domestic savings and investment required to sustain the projected high growth momentum. Policies to improve productivity and encourage innovation are also needed to move to higher value added economic activities.