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CENTRAL BANK OF SRI LANKA

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Press Release

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MONETARY POLICY REVIEW – MAY 2013

The policy measures adopted by the Central Bank and the authorities in early 2012 have been yielding the desired results. These measures have helped consolidate the achievements in the previous years while improving stability in the macroeconomy. At the same time, the Monetary Board has been somewhat concerned by the slower than expected pick-up in economic activity in the first few months of 2013 and has been of the view that there is now a need to stimulate the domestic economy, particularly in the light of the gradual moderation in headline inflation and subdued demand pressures in the economy. The Monetary Board has also observed that the economy has now developed greater space for policy manoeuvrability, and the capacity to return to a high growth path without fuelling inflationary pressures. A detailed analysis of the current status and recent developments is briefly set out in the following discussion.

GLOBAL ECONOMIC DEVELOPMENTS

1. The global economy has entered a three-speed recovery with emerging market and developing countries continuing along a reasonably robust growth trajectory, while advanced economies are expected to record either slow progress or to record growth that is expected to remain in negative territory in 2013.

2. As per the World Economic Outlook published by the IMF in April 2013, economic growth in the United States is forecast to be 1.9 per cent in 2013 and 3.0 per cent in 2014. However, growth in the Euro area is forecast to contract by 0.3 per cent in 2013 but return to positive levels of around 1.1 per cent in 2014. Growth in emerging market and developing economies is forecast to reach 5.3 per cent in 2013 and 5.7 per cent in 2014. In Developing Asia, both China and India are projected to record higher economic expansion, with China expected to grow by 8 per cent in 2013 followed by 8.2 per cent in 2014, while India is expected to grow by 5.7 per cent in 2013 and 6.2 per cent in 2014.

DOMESTIC ECONOMIC DEVELOPMENTS

Growth

3. The economy displayed a commendable performance in 2012 by recording a growth of 6.4 per cent in the face of significant external as well as domestic challenges. However, real sector leading indicators have indicated some moderation in economic activity in the first quarter of 2013, largely on account of the slow-down in net external demand. The slow recovery in external demand has posed some downward risks for Sri Lanka's exports, although higher receipts from export of services, such as tourism, personal services and IT related activities are likely to adequately cushion the possible fall in merchandise exports. In the meantime, subdued factory industry output and lower external trade are the key areas affected by the slow global economic recovery, and hence, there is now a growing need to enhance domestic demand and thereby provide greater stimulus to the domestic economy.

Inflation

4. Inflation has remained within single digit levels over the past 51 months, declining to 6.4 per cent, on a year-on-year basis, in April 2013. While the proposed electricity tariff adjustment will result in a modest increase in the Colombo Consumers' Price Index (CCPI), it is anticipated that such increase will not lead to inflation rising above the single digit level. At the same time, international commodity prices have softened in recent times, indicating that general price levels would remain favourable in the period ahead. Furthermore, the sharp deceleration in monetary expansion in 2012, as reflected by the decline in year-on-year core inflation to 6.1 per cent in April, is expected to keep demand driven pressures in check, which augurs well for future inflation.

Monetary Aggregates and Credit Growth

5. Monetary aggregates have continued to trend downwards with growth of credit to the private sector declining from the high levels of about 35 per cent in the early part of 2012 to about 17.6 per cent by end 2012. Despite the easing of monetary conditions, in December 2012, credit growth has continued to moderate to about 10.9 per cent by March 2013, partly reflecting the base effect, as against the targeted growth of credit to the private sector by year end of about 18.5 per cent.

6. Reflecting the decline in credit, growth of broad money, which declined to 17.6 per cent by December 2012 from the peak of 22.9 per cent in April 2012, has declined further to 15.6 per cent by March 2013. It is however projected that with the expected decline in credit to the public sector, the average growth of broad money in 2013 would record around the targeted rate of 15 per cent by year end.

Fiscal Sector Developments

7. Government borrowing was high in the first quarter of 2013 in the face of lower revenue collection with net credit to the government from the banking sector during this period amounting to Rs. 135 billion and the Central Bank’s Treasury bill holdings recording over Rs.200 billion in early April. Nevertheless, the situation has improved during the past few weeks with the Government being able to settle a part of its dues through the retirement of Treasury bills held by the Central Bank, with the outstanding Treasury bill stock declining to Rs. 119 billion by end April. In this regard, a pick-up in domestic economic activity in the balance part of the year is expected to generate higher tax revenues, thereby helping achieve the fiscal targets set out for the year. Moreover, the expected moderation in market interest rates would also ease the financing cost of the government debt, thus leaving greater resources to finance the public investment programme of the government.

Improvements in CPC and CEB operations

8. With regard to public corporations, the recent electricity tariff adjustment is expected to improve the cash-flow of the Ceylon Electricity Board (CEB) while the revision in petrol and diesel prices in February 2013 and the revision of furnace oil prices in April 2013 are expected to help improve the financial position of the Ceylon Petroleum Corporation (CPC). These developments would help reduce the debt obligations of these two key public corporations to the banking sector in the period ahead, thereby releasing greater resources for investment by the private sector.

Interest Rates

9. Market interest rates have been adjusting downward, albeit slowly, responding to the easing of monetary conditions since December 2012. Benchmark yield rates of government securities have declined by about 40-112 basis points thus far during the year, while the weekly average weighted prime lending rate (AWPR) has also declined by about 85 basis points. In the meantime, lending rates are also expected to decline further once the impact of Public Corporations' lower borrowings from the market is more evident. Such reduction in interest rates would further ease the financing cost of the private sector and state owned enterprises.

Trade Account

10. The deceleration in credit and the resultant containment of import demand has helped contain the trade deficit, and as a result the pressure on the external sector has eased considerably. Accordingly, the trade deficit has contracted sharply by about 23 per cent in the first quarter of 2013 as the decline in imports outpaced the decline in exports. Cumulative expenditure on imports during the first quarter of 2013 declined by 16 per cent, year-on-year, reflecting declines across all key categories of imports. In cumulative terms, earnings from exports during the first quarter of 2013 declined by 8.1 per cent, year-on-year.

Balance of Payments, Current Account and Reserves

11. Supported by the improvement in the current account, the balance of payments recorded a surplus of US dollars 153.6 million by end March due to inflows into government securities, net cumulative inflows into portfolio investments, and long term inflows to the Government. Reflecting these developments, the Central Bank has purchased around US dollars 547 million, on a net basis, during the first four months of the year, which has helped to raise gross official reserves of the country to US dollars 6.9 billion, equivalent to 4.5 months of imports, as at end April.

Exchange Rate

12. The favourable developments in the external sector have substantially reduced pressure on the exchange rate. The Sri Lanka rupee has appreciated against most major international currencies during the year to date (8 May 2013), recording an appreciation of about 0.86 per cent against the US dollar.

Financial Sector Developments

13. The key indicators of the banking sector such as capital adequacy and return on assets have remained at favourable levels indicating the soundness of the financial sector. The gross non-performing loan ratio, however, increased marginally by March 2013, although still remaining at comfortable levels. In this regard, an easing of monetary policy is expected to improve the repayment capacity of borrowers.

IMF Article IV Consultation and Ratings

14. International agencies have commended the progress made by the Sri Lankan economy in recent times. At the conclusion of the Article IV Consultation Mission to Sri Lanka in February 2013, the IMF reiterated that the Sri Lankan economy has made steady progress on several fronts with robust economic growth, moderating inflation and fiscal and external consolidation being underway. Meanwhile, assessing the current progress as well as the outlook for the economy, Sri Lanka's sovereign rating of BB- (Stable) was re-affirmed by Fitch Ratings at end April 2013.

MONETARY POLICY DECISION

15. Considering the macroeconomic developments discussed above, the Monetary Board is of the view that a downward adjustment to the policy rates of the Central Bank is appropriate in order to stimulate domestic economic activity, particularly since inflation and inflationary pressures are at levels that do not pose any immediate risk to the economy.

16. Accordingly, the Monetary Board decided at its meeting held on 9th May 2013 to reduce the Repurchase rate and the Reverse Repurchase rate of the Central Bank by 50 basis points, respectively, thereby placing the Repurchase Rate at 7.00 per cent and the Reverse Repurchase Rate at 9.00 per cent. In addition, the reserve maintenance period of commercial banks will also be increased to two weeks from one week with effect from 1st June 2013 in order to offer greater flexibility to commercial banks in managing their liquidity, while maintaining the Statutory Reserve Ratio at the current level of 8 per cent.

The date for the next regular statement on monetary policy for June will be announced in due course.