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Press Release

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The Summary of the Annual Report of the Central Bank of Sri Lanka for the Year 2013

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. Accordingly, the 64th Annual Report of the Monetary Board was submitted to H.E. the President of Sri Lanka and the Minister of Finance and Planning, today, 8th April 2014. Following are some of the highlights of the report.

The Sri Lankan economy rebounded recording 7.3 per cent growth in 2013, while inflation remained at single digit levels for the fifth consecutive year, gradually declining to mid-single digit levels by end 2013. Economic growth was broad based with positive contributions from all sectors, supported by favourable weather conditions and improved global demand. With the steady rise in economic growth during the year, GDP per capita income rose to US dollars 3,280 in 2013. In spite of cost reflective upward adjustments to domestic energy prices, prudent monetary management and improved domestic food supply

led to a gradual decline in headline inflation while core inflation moderated to its lowest level by the end of the year. Monetary aggregates decelerated toward desired levels by end 2013, while the lagged effect of the previous year's tight monetary policy measures and the steep decline in gold backed loans lowered credit disbursements to the private sector. Low inflation enabled the Central Bank to ease monetary policy further during the year to facilitate economic growth. The improvement in the trade account and higher receipts from workers' remittances and trade in services, together with increased inflows to the financial account as a result of improved investor confidence resulted in a significant improvement in the balance of payments (BOP) enabling a buildup of foreign reserves and supporting exchange rate stability. Continued commitment of the government to fiscal consolidation resulted in a further reduction in the fiscal deficit and debt to GDP ratio during the year. The financial sector remained sound and resilient amidst uncertainties that increased volatility in the global financial markets during 2013.

The realisation of the desired stabilisation objectives of the macroeconomic policy package that was adopted in 2012 coupled with favourable inflation outcomes and expectations, allowed the Central Bank to ease monetary policy further during the year. Accordingly, the easing of monetary policy that commenced in December 2012 with the reduction of the Central Bank's key policy interest rates by 25 basis points, continued in 2013. Overall, policy interest rates were reduced by a further 100 basis points during 2013 while increased liquidity also reflected the accommodative policy stance. Throughout the year, maintaining inflation at single digit levels remained the overarching objective of monetary policy, and declining inflation and benign inflation expectations allowed monetary policy to support the revival of economic activity. Monetary policy decisions taken in a forward looking framework proved effective, with inflation declining to mid single digit levels at the end of the year coupled with a pick up in economic activity during the year.

Economic growth in 2013 was broad based, with strong growth in the Industry sector, continued expansion in the Services sector, and recovery in Agricultural activities during the second half of the year despite weak performance due to adverse weather conditions during the first half of the year. Stabilisation policies that were adopted in 2012 impacted economic activity during the first half of the year, but continued development of physical infrastructure, favourable weather conditions and the recovery in advanced economies supported an increase in economic activity during the second half of 2013. Continued expansion in construction activities and the

manufacturing sector supported by strong external demand, enabled the Industry sector to record a growth rate of 9.9 per cent, raising its share in GDP to 31.1 per cent. The Services sector improved from the previous year recording a growth of 6.4 per cent, mainly due to improved performance in wholesale and retail trade and transport and communications sub sectors. The weak performance of the Agriculture sector during the first half of the year due to extreme weather conditions dragged its annual growth rate down to 4.7 per cent. With the strong performance of the Industry sector during the year, the share of the Services sector and the Agriculture sector in GDP declined to 58.1 per cent and 10.8 per cent, respectively.

Inflation remained at single digit levels for the fifth consecutive year. Headline inflation, which remained close to double digit levels during the first two months of the year, decelerated thereafter to mid-single digit levels by the end of the year supported by improved domestic supply conditions and prudent demand management policies. Accordingly, by end 2013, headline inflation was 4.7 per cent on a year-on-year basis and 6.9 per cent on an annual average basis. Meanwhile, reflecting effective management of aggregate demand, core inflation, moderated gradually during the year and declined to its lowest level in the last quarter of 2013, ending the year at 2.1 per cent on a year-on-year basis and 4.4 per cent on an annual average basis. The moderation in inflation and inflation expectations helped reduce wage pressures in the economy and raise investor confidence.

The unemployment rate remained low during 2013 at 4.4 per cent, albeit increasing marginally from 4 per cent in the previous year largely due to the entry of new job seekers to the labour market. An increase in both the number of employed as well as unemployed persons resulted in an expansion of the labour force by 4.1 per cent in 2013. A salutary development was the rise in the labour force participation rate (LFPR) to 53.8 per cent in 2013 from 52.6 per cent in the previous year. The significant rise in the female LFPR, as a result of the entry of rural females into the labour market seeking job opportunities, mainly contributed to the rise in the overall LFPR.

With the support of an enabling domestic environment and gradual recovery in the global economy, the external sector performed well in 2013. The significant increase in earnings from exports coupled with a decline in expenditure on imports led to a sharp contraction in the trade deficit. The rebounding of global trade and the increase in demand from major export destinations from the second half of the 2013 had a favourable impact on export

earnings, while the decline in imports was mainly on account of lower petroleum imports. Continued high growth in workers' remittances together with an increase in earnings from services including tourism, transport and information technology related services helped narrow the deficit in the external current account substantially to 3.9 per cent of GDP in 2013 from 6.7 per cent of GDP in 2012. These developments, together with inflows to the financial account in the form of foreign direct investments (FDI), foreign investments in government securities, and long term debt inflows to the government, the banking sector and the corporate sector, resulted in the BOP recording a surplus of US dollars 985 million in 2013 compared to the surplus of US dollars 151 million in 2012. Consequently, the level of gross official reserves rose to US dollars 7.5 billion at end 2013, providing a 5-month import cover. The improvement in the BOP and international reserve position resulted in the Sri Lanka rupee remaining relatively stable during the year despite increasing volatility in the currencies of other emerging market economies. Accordingly, during the year, the Sri Lanka rupee depreciated by only 2.75 per cent against the US dollar, while appreciating against several other major currencies.

Fiscal policy continued to focus on promoting sustainable and regionally balanced growth in the medium term, while the government remained committed to fiscal consolidation efforts leading to a gradual improvement in key fiscal indicators. Accordingly, the fiscal deficit declined significantly to 5.9 per cent of GDP in 2013 from 6.5 per cent in 2012, although marginally higher than the budget estimate of 5.8 per cent. Despite the sluggish growth in revenue, fiscal consolidation was the result of concerted efforts made by the government to manage expenditure. A significant reduction in recurrent expenditure and prioritisation of capital expenditure, which nonetheless maintained public investment at 5.5 per cent of GDP, helped reduce the budget deficit in line with the Medium Term Macro Fiscal Framework. However, government revenue as a percentage of GDP declined further to 13.1 per cent of GDP, and the continued shortfall in revenue collection from projected levels in recent years remained a major concern of the government. In financing the resource gap, more reliance was placed on domestic sources, with the banking sector contributing 58 per cent of the total financing requirement. The debt to GDP ratio improved to 78.3 per cent in 2013 from 79.2 per cent in 2012, continuing the declining trend observed in the recent past.

Monetary policy was conducted with a focus on maintaining inflation at single digit levels while supporting economic activity. Accordingly, broad money (M_{2b}) was envisaged to grow

by 15 per cent during 2013 in line with the projected growth in real GDP of 7.5 per cent at the beginning of the year and a GDP deflator of 7.0 per cent. The growth of reserve money was set at 16.5 per cent due to the base effect of lower growth in reserve money during 2012. However, the reduction in the SRR effective from 01 July 2013 necessitated a downward revision to the projected reserve money path for the remainder of the year to maintain broad money along the targeted path. Consequently, year-on-year growth of reserve money, which averaged around 10.7 per cent during the first half of the year turned negative with the reduction in the SRR and remained on average, within the revised projection of 5.5 per cent during the year. Growth in broad monetary aggregates moderated towards desired levels with broad money (M_{2b}) decelerating to 16.7 per cent on a year-on-year basis at end 2013 from 17.6 per cent at end 2012, and averaging 16.5 per cent during the year.

The easing of the monetary policy stance from December 2012 and the excess rupee liquidity in the money market facilitated the downward adjustment in market interest rates during the year. Short term market interest rates were quick to adjust downwards, although long term market interest rates exhibited some downward rigidity during the first few months of the year, before declining thereafter. The average weighted call money rate (AWCMR), which fluctuated around the upper bound of the policy rate corridor until the first week of June, gradually moved towards the middle of the corridor during the year. Deposit rates, which continued to rise until May 2013, began to decline thereafter in response to the easing of the monetary policy stance. Lending rates also adjusted downward, albeit with a considerable time lag, in response to the relaxed monetary policy stance, the increase in rupee liquidity and the decline in the cost of funds. Yield rates on government securities across all maturities declined throughout the year reflecting the reduction in policy rates, the excess liquidity in the market and moderating inflation and inflation expectations.

Stability of the financial system was preserved amidst uncertainties arising from global market developments, while the regulatory and supervisory framework was strengthened further. Strong capital and liquidity buffers and sound risk management practices ensured that the financial sector remained resilient during the year although non-performing pawning advances affected the asset quality of the financial sector. Total assets of the financial sector rose as a result of an increase in investments, while the expansion of the branch network, particularly outside the Western Province, improved access to finance and financial inclusiveness. The money market was liquid during much of 2013. The foreign exchange

market remained stable despite the turbulence in global financial markets, while renewed investor confidence saw net inflows to the Colombo Stock Exchange. Activity levels in the corporate bond market improved significantly, led by a significant increase in the number of debenture issues while the unit trust sector expanded with the establishment of a number of new funds in 2013. The insurance sector recorded growth in terms of profits, total assets and premium income. The Central Bank also took measures to improve the payment infrastructure and its efficiency. The regulatory and supervisory framework was further strengthened and disclosure requirements were enhanced in line with international standards and best practices to ensure that the potential risks to financial stability are addressed in a timely manner. During the year, the Central Bank unveiled a Master Plan for financial consolidation, which was formulated with the aim of building a strong, dynamic and internationally competitive financial sector with cross-border linkages and significant overseas presence.

Looking ahead, the Sri Lankan economy is expected to maintain a high growth momentum in the medium term supported by an increase in investment, a favourable macroeconomic environment and continued recovery in the global economy. Sri Lanka's economic progress in the medium term is not without challenges, and structural adjustments are necessary for sustaining the growth momentum over the medium term and beyond. Given the vast improvements in physical infrastructure and the resulting enhancement in productive capacity, the country's potential output has improved substantially in the post conflict period, although greater involvement of the private sector in economic activity is required to maximise this enhanced growth potential. These improvements need to be complemented by enhancing the human capital base of the country to meet the needs of the emerging sectors in the economy, thereby sustaining economic growth. Government policies that are in place to diversify economic activity further along the lines of the 5+1 hub strategy, are expected to facilitate a smooth transition of the economy through the 'middle income trap' in the medium term. As a result of these policies as well as the projected recovery in trading partner economies, the external sector is expected to improve further, led by increasing merchandise and services exports. With increased capital market openness, it is necessary to strengthen the buffers required to face possible challenges arising from external developments. On the fiscal front, the government's commitment to further reduce the budget deficit and public debt as envisaged in the Medium Term Macro Fiscal Framework is a welcome development. Public investment is expected to enhance the country's capital stock, while the expected

improvement in savings as a percentage of GDP is likely to reduce the need for external resources to bridge the savings-investment gap. The financial sector is expected to strengthen further with the adoption of international best practices and the planned consolidation programme. With prudent and forward looking monetary policy decisions, supported by favourable domestic supply conditions and improvements in productivity, inflation is expected to stabilise at mid-single digit levels in the medium term, thereby supporting the goals of economic and price stability.