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OVERVIEW

The Sri Lankan economy faced renewed challenges emanating from global market developments, which disrupted the steady stabilisation path observed up to the first quarter of the year. The economy grew at a moderate pace of 3.6 per cent in the first half of 2018, following relatively low growth of 3.3 per cent recorded during the year 2017. Agricultural activities continued their rebound in the first half of 2018 supported by favourable weather conditions that prevailed during this period. The growth in industrial activities slowed, mainly due to the subdued performance in the construction and mining and quarrying subsectors. The expansion in services activities was broad-based, driven mainly by the growth of financial services, wholesale and retail trade and other personal services activities. Meanwhile, an increase in the unemployment rate was observed during the first half of 2018. Consumer price inflation has remained subdued thus far in 2018, although temporarily edging up in some months, mainly as a result of movements in volatile food prices and upward adjustments to domestic petroleum products and other administered prices. Meanwhile, monetary and credit expansion decelerated gradually, in response to the tight monetary policy stance maintained in the past. The Central Bank maintained a prudent approach in relation to monetary policy and operations, whereby the upper bound of the policy interest rates corridor was revised downwards in April 2018 and the interbank call money market rate was allowed to adjust within the corridor in line with evolving market conditions through appropriate open market operations (OMOs). In the external sector, the trade deficit widened further as the growth in import expenditure outpaced the rise in earnings from exports, although earnings from services exports, including tourism, and workers' remittances helped cushion the external current account deficit to some extent. Amidst the widened trade and current account deficits, which was partly due to the increased expenditure of fuel imports and imports of motor vehicles and gold, the balance of payments (BOP) also experienced pressure from the emerging market selloff caused by tightening global financial conditions and the strengthening of the US dollar. These developments resulted in a sharp depreciation of the Sri Lankan rupee, and the Central Bank intervened in the market at times to prevent disorderly adjustment of the exchange rate while allowing demand and supply conditions to determine its direction. In the meantime, the performance was mixed on the fiscal front, with the overall budget balance and the primary balance improving during the first eight months of the year, while the current account balance deteriorated marginally. Nevertheless, the lower than expected revenue collection is likely to challenge the achievement of the targeted budget deficit for 2018, despite the slowdown observed in expenditure. In the financial sector, the growth momentum continued during the first half of 2018 without major macroprudential concerns, while measures are being taken to address long standing issues with a few distressed financial institutions. Meanwhile, the programme under the Extended Fund Facility (EFF) with the International Monetary Fund (IMF) continued, with the country achieving the Quantitative Performance Criteria (QPC) for June 2018 in relation to the primary fiscal balance and inflation, although missing the target on international reserves due to volatile global conditions. Several notable structural benchmarks were also achieved under this programme including the automatic price formula for fuel. Going forward, the economy is expected to gather steam gradually responding to the measures taken to facilitate domestic production, merchandise and services exports, as well as domestic and foreign investment. At the macro level, the maintenance of low and stable inflation under the envisaged Flexible Inflation Targeting (FIT) framework, the competitive exchange rate, and the continuation of the government's fiscal consolidation efforts are expected to ensure macroeconomic stability in the medium term.

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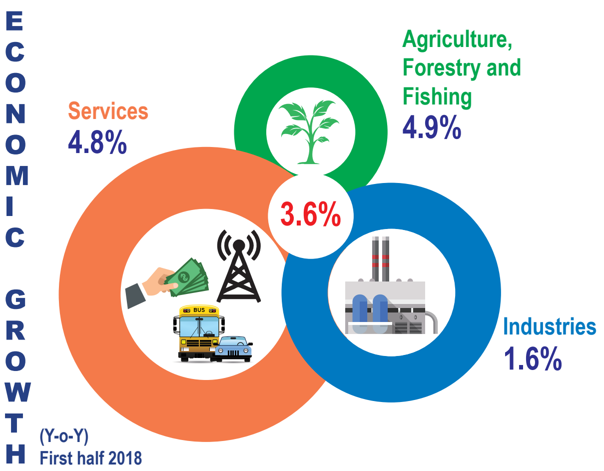
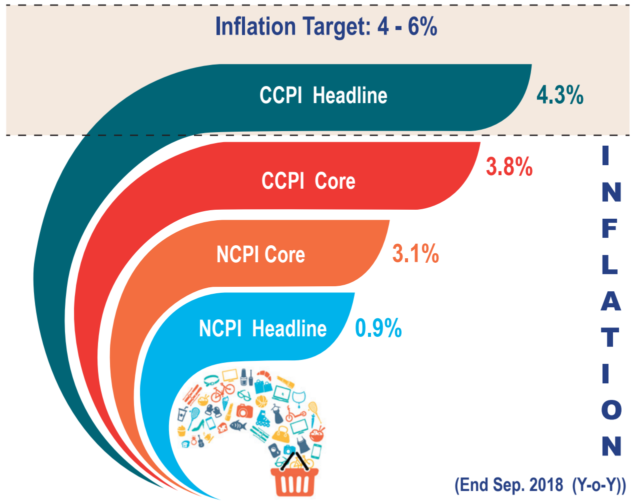
Figure 1.1

Snapshot of the Sri Lankan Economy

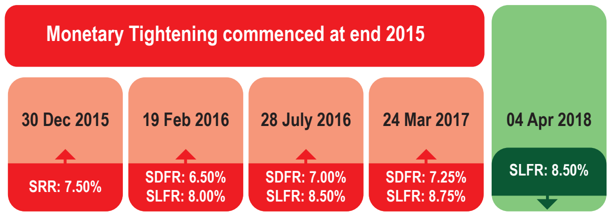
Sri Lanka's growth performance remained subdued, in spite of positive growth in all three major sectors of the economy…



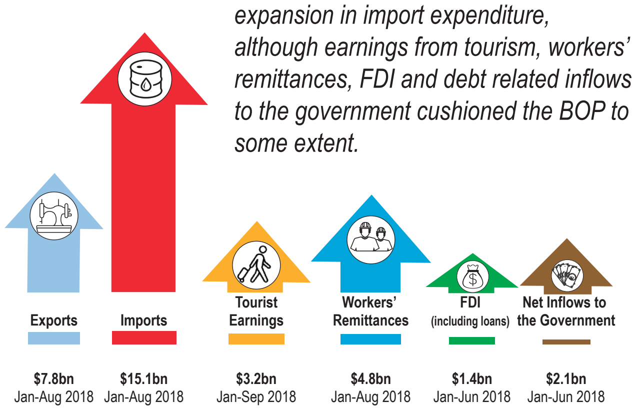
Inflation remained low in spite of some ups and downs due to volatile food prices and administrative price adjustments…



…these conditions, along with favourable inflation expectations, prompted the Central Bank to reduce the Standing Lending Facility Rate (SLFR) on 04 April 2018, after tightening monetary policy from end 2015.

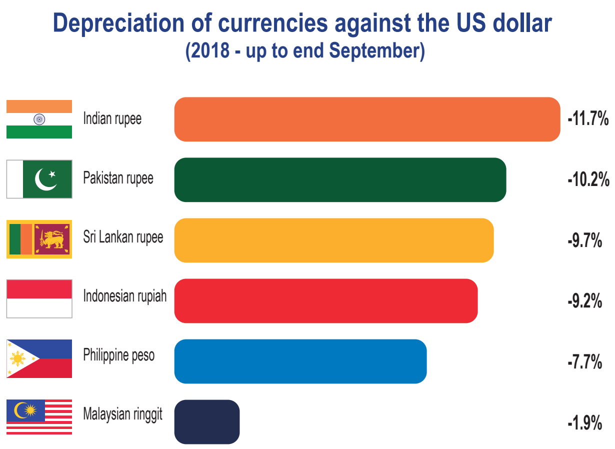


On the external front, the growth in export earnings was outpaced by the expansion in import expenditure, although earnings from tourism, workers' remittances, FDI and debt related inflows to the government cushioned the BOP to some extent.

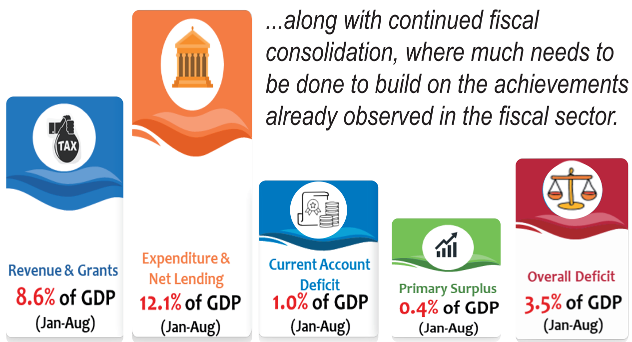


Increased volatility in global financial markets, higher crude oil prices and rising import expenditure caused a depreciation of the rupee, similar to the pressure observed in other emerging market economies with current account deficits.

The government and the Central Bank took several short term measures to address the external pressure, although this has once again highlighted the need for far reaching structural reforms to boost the production economy and enhance merchandise and services exports…



…along with continued fiscal consolidation, where much needs to be done to build on the achievements already observed in the fiscal sector.



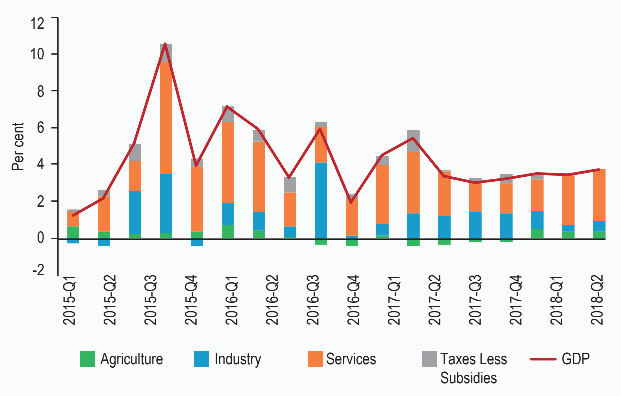
Sectoral Developments

Real Sector and Inflation

- **As per the provisional estimates of the Department of Census and Statistics, the Sri Lankan economy recorded a modest growth of 3.6 per cent during the first half of 2018 compared to the growth of 3.2 per cent during the corresponding period of 2017.** Agriculture, forestry and fishing activities recorded a turnaround with a 4.9 per cent growth in the first half of the year, indicating a recovery from adverse weather conditions that hampered growth during the first half of 2017. Accordingly, growing of rice, vegetables and cereals supported the expansion. Growth in industrial activities remained subdued with an expansion of 1.6 per cent, particularly with the decline in construction and mining and quarrying activities amidst the moderate expansion in the manufacturing activities. Meanwhile, services activities grew by 4.8 per cent supported by the significant growth in financial services together with the expansion in wholesale and retail trade activities and other personal services activities. However, public administration and defence related activities recorded a decline during the period.

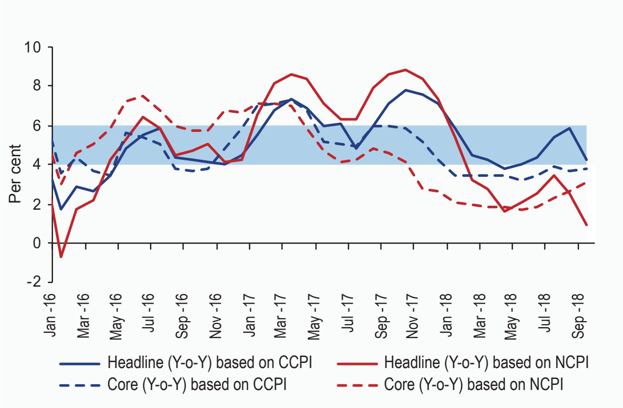
- **The unemployment rate increased to 4.5 per cent during the first half of 2018 from 4.3 per cent during the first half of 2017.** Both male and female unemployment rates increased to 3.0 per cent and 7.4 per cent, respectively, during the first half of 2018 from 2.9 per cent and 6.8 per cent, respectively, in the corresponding period of 2017. Moreover, the unemployment rate among youth in the age range of 15-24 years was 22.1 per cent during the period under review, while unemployment among females with education attainment of GCE Advanced Level or above was also relatively high at 13.4 per cent. These highlight the structural issues in the labour market that need to be addressed in meeting the labour demand of the economy. Meanwhile, the labour force participation rate (LFPR) also declined to 51.5 per cent during the first half of 2018 compared to 54.3 per cent in the same period of 2017. Both male and female LFPRs declined to 73.0 per cent and 33.0 per cent, respectively, during the first half of the year, from 74.8 per cent and 36.7 per cent, respectively, in the first half of 2017. The employed population also fell to 7.97 million during the first half of 2018 from 8.18 million in the corresponding period of 2017.

Figure 1.2
Quarterly Real GDP Growth (Y-o-Y)



- **Consumer price inflation remained subdued during the first nine months of 2018 in spite of a transitory uptick in prices due to the upward adjustments to the prices of domestic petroleum products and other administered prices.** Headline inflation, based on the National Consumer Price Index (NCPI, 2013=100) and the Colombo Consumer Price Index (CCPI, 2013=100), decelerated to low levels by April 2018 mainly due to the decline in food prices as a result of favourable supply side developments with the dissipation of weather related disturbances. Nevertheless, upward adjustments to domestic petroleum prices and the increased pressure on domestic food supplies during the off-season caused an acceleration in headline inflation during some months of the year. However, by September 2018, headline inflation, as measured by the year-on-year change in NCPI decelerated to 0.9 per cent while headline inflation based on CCPI decelerated to 4.3 per cent, mainly as a result of improved domestic food supplies. Meanwhile, core inflation remained below 4 per cent thus far during the year, reflecting well contained

Figure 1.3
Movements in Headline and Core Inflation (Y-o-Y)

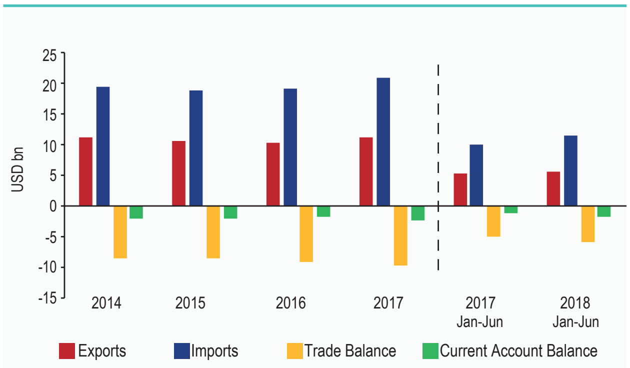


underlying demand pressures and anchored inflation expectations. Accordingly, year-on-year core inflation based on NCPI remained at 3.1 per cent while year-on-year core inflation based on CCPI remained at 3.8 per cent in September 2018.

External Sector

- **Sri Lanka's external sector experienced a setback in the second and the third quarters of 2018, with moderate foreign exchange inflows amidst increased import expenditure and higher capital outflows**. Higher than expected growth in import expenditure outpaced the increase in export earnings, resulting in a considerable widening of the trade deficit during the first eight months of 2018. In addition, the deficit in the primary income account also expanded with the increase in reinvested earnings and dividend payments on foreign direct investments (FDIs) as well as the increase in interest payments on foreign loans. However, the increase in earnings on services exports, mainly driven by the rebound in earnings from tourism, and the surplus in the secondary income account dampened the expansion in the current account deficit to some extent. Nevertheless, the current account deficit widened to US dollars 1,813 million in the first half of 2018 from US dollars 1,037 million in the first half of 2017.

Figure 1.4
Trade Balance and Current Account Balance



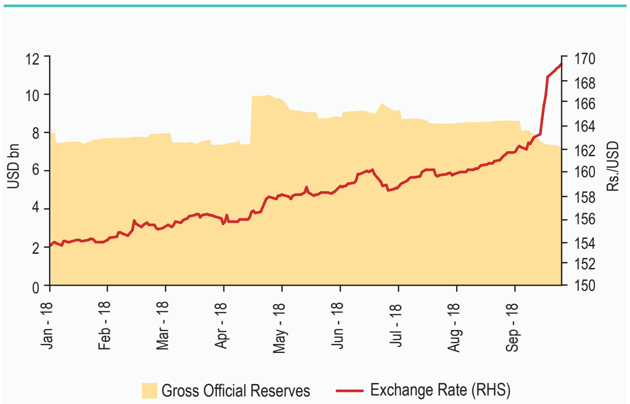
- **The deficit in the trade account expanded substantially during the first eight months of 2018 as the increase in export earnings was outpaced by the rise in import expenditure**. Earnings from exports increased by 5.8 per cent, year-on-year, to US dollars 7,842 million while expenditure on imports grew significantly by 10.9 per cent, year-on-year, to US dollars 15,083 million during the first eight months of the year. The restoration of the European Union's Generalised System of Preferences plus (EU-GSP+) facility, higher commodity prices in the international market, conducive external trade policies together with improved institutional support and the flexible exchange rate policy of the Central Bank helped export earnings to increase during the period concerned. The growth in export earnings mainly emanated from industrial exports amidst lower earnings from agricultural exports. Meanwhile, the expansion in import expenditure was driven by the surge in the import of fuel, vehicles and textiles and textile articles. Consequent to these developments, the trade deficit widened to US dollars 7,240 million during the first eight months of 2018 from US dollars 6,184 million in the corresponding period of 2017.

- **The financial account strengthened with higher foreign exchange inflows during the first half of 2018**. Proceeds of International Sovereign Bonds (ISBs), the receipt of the fifth tranche of the IMF-EFF and FDI inflows including proceeds from the divestiture of the Hambantota Port supported the financial account. However, outflows of foreign investments from the

Government securities market and the secondary market of the Colombo Stock Exchange (CSE) led by rising global interest rates exerted pressure on the BOP, especially since the second quarter of 2018. These developments together with higher foreign currency debt service payments contributed to the overall balance to record a deficit of US dollars 650 million by end September 2018.

- **Gross official reserves, which reached the historically highest level of US dollars 9.9 billion at end April 2018, moderated thereafter**. Relatively stable domestic foreign exchange market conditions enabled the Central Bank to absorb US dollars 459 million from the market on a net basis during the first four months of the year. This, together with the receipt of ISB proceeds, proceeds from the Hambantota Port divestiture and receipt of the fifth tranche of the IMF-EFF complemented the buildup of gross official reserves to US dollars 9.9 billion as at end April 2018. However, the tightening of global financial conditions and the resultant reversal of capital flows from the Government securities market and the CSE exerted significant pressure on the domestic foreign exchange market, requiring the Central Bank to supply foreign exchange to the market from end April 2018. This development, together with outflows on account of debt service payments and Asian Clearing Union (ACU) payments, caused the gross official reserves to decline to US dollars 7.2 billion by end September 2018, which is equivalent to 3.8 months of imports.

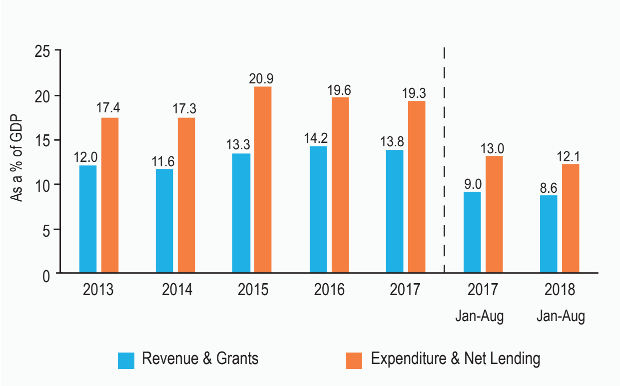
Figure 1.5
Gross Official Reserves and Exchange Rate



In addition, gross official reserves covered 54 per cent of the country's short-term debt and liabilities as at end September 2018. Subsequent securing of the foreign currency term financing facility by the government amounting to US dollars 1 billion boosted gross official reserves in October 2018.

- **The Central Bank pursued a market based exchange rate policy and allowed the exchange rate to align with demand and supply conditions in the domestic foreign exchange market**. Nevertheless, the exchange rate, which remained relatively stable in the first four months of 2018 came under significant pressure thereafter due to both domestic and external factors. Domestically, the widening trade deficit reflected a higher foreign exchange demand from importers. In the external front, the broad-based strengthening of the US dollar in the global market and foreign investment outflows added pressure on currencies of a number of emerging market economies. This phenomenon was also witnessed in Sri Lanka, with foreign investment outflows from the Government securities market and the CSE. Despite the significant pressure on the exchange rate, the Central Bank allowed greater flexibility in the determination of exchange rate, permitting a depreciation in line with market fundamentals. The Central Bank intervened in the market only to mitigate excessive volatility in the exchange rate. As a result, the Central Bank limited its market interventions to a net supply of US dollars 185 million during the first nine months of 2018. With these developments, the Sri Lankan rupee depreciated by 9.7 per cent against the US dollar during the year up to end September 2018. Reflecting cross currency exchange rate movements, the Sri Lankan rupee depreciated against the pound sterling (7.1 per cent), the Japanese yen (9.0 per cent), the euro (7.4 per cent) while appreciating against the Indian rupee (2.3 per cent) by end September 2018. With the nominal depreciation of the Sri Lankan rupee against some major currencies, together with the movements in cross currency exchange rates, both 5-currency and 24-currency Nominal Effective Exchange Rate (NEER) declined during the first nine months of 2018. Further, the Real Effective Exchange Rate (REER) index, which is an indicator of Sri Lanka's external competitiveness that considers the inflation differential among countries in addition to the variation in nominal exchange rates, remained marginally under the threshold of 100 index points, indicating an improvement in Sri Lanka's external competitiveness compared to the rates that prevailed in the base year 2010.

Figure 1.6
Government Revenue Vs. Expenditure



Fiscal Sector

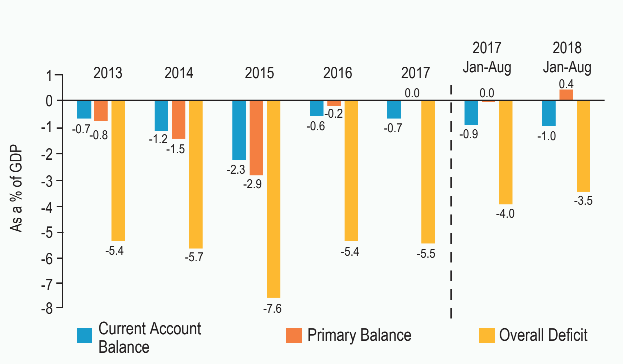
- **Several policy measures were introduced by the government during the first eight months of 2018 to enhance its fiscal consolidation programme**. Accordingly, the new Inland Revenue Act No. 24 of 2017 was enacted with effect from 01 April 2018, supporting the fiscal consolidation process of the government through broadening the direct tax base and simplifying and rationalising the existing income tax structure. In line with this, several tax administrative measures were also introduced to strengthen revenue collecting agencies while improving tax compliance and tax collection. Accordingly, the Revenue Administration Management Information System (RAMIS), which was set up at the Inland Revenue Department (IRD), is being upgraded to incorporate the provisions of the new Inland Revenue Act. In addition, steps were taken to establish a National Single Window (NSW) at the Sri Lanka Customs to facilitate importers and exporters. Further, the Integrated Treasury Management Information System (ITMIS) was introduced to modernise Public Financial Management (PFM) in Sri Lanka. Accordingly, ITMIS is being used as the primary system for the preparation of the budget 2019 and as such, all ministries, departments and district secretariats submitted their 2019 budget estimates to the National Budget Department through ITMIS. On the expenditure front, quarterly expenditure and income outcome reports for the first quarter of 2018 were presented to the Parliament, strengthening Parliamentary control on public finances. A multipurpose database is being developed by the Ministry of Finance and Mass Media (MOF) incorporating all information relevant to development projects to facilitate improved policymaking with accurate and up to date information. Further, in consultation with the MOF, the National Agency for Public Private Partnerships (NAPPP) is engaged in drafting required legislation to promote Public Private Partnerships (PPPs) as a national strategy to develop infrastructure, thus lowering pressure on the national budget. Meanwhile, the government took several initiatives to reform State Owned Enterprises (SOBEs) in order to further improve their financial strength and long term financial viability. In this respect, performance reports of five key SOBEs[1] for the first half of 2017 were forwarded to the Cabinet of Ministers in May 2018. Subsequent to the approval of the Cabinet of Ministers to implement the automatic cost reflective fuel pricing mechanism in May 2018, the government revised domestic petroleum prices on several occasions with the aim of improving the financial viability of the Ceylon Petroleum Corporation (CPC) while ensuring transparency in petroleum pricing. An automatic pricing mechanism for electricity is also expected to improve the financial performance of the Ceylon Electricity Board (CEB). During the year, several measures were also taken to improve public debt management and the transparency in the government securities market. Accordingly, the Active Liability Management Act No. 08 of 2018 (ALMA) was enacted in March 2018 and a Medium Term Debt Management Strategy (MTDS)

1 Ceylon Electricity Board, Ceylon Petroleum Corporation, National Water Supply and Drainage Board (NWS&DB), Airport and Aviation Services (Sri Lanka) Ltd. and Sri Lanka Ports Authority

is being articulated for the period 2019-2023, and the process of establishing an electronic trading platform and a central counterparty clearing house is underway.

- **Outcome of the government's fiscal consolidation efforts was mixed during the first eight months of 2018 as reflected by key fiscal indicators**. Government revenue as a percentage of estimated GDP declined to 8.6 per cent from 9.0 per cent in the corresponding period of 2017 reflecting a decline in tax revenues, mainly from import duties and Cess levy. Total revenue in nominal terms increased by 6.0 per cent to Rs. 1,242.2 billion during the first eight months of 2018 from Rs. 1,172.4 billion in the corresponding period of the previous year. Revenue generated from income taxes, excise duty on motor vehicles, tobacco and cigarettes, Value Added Tax (VAT) and the Ports and Airports Development Levy (PAL) positively contributed to this increase in revenue collection. Meanwhile, total expenditure and net lending during the first eight months of 2018 declined to 12.1 per cent of the estimated GDP from 13.0 per cent reported during the same period of last year, due to a slowdown in both recurrent and capital expenditure. As a result, the overall budget deficit and the primary surplus as a percentage of estimated GDP exhibited improved performance during the first eight months of 2018, although the current account deficit increased marginally during the period. The overall budget deficit declined to 3.5 per cent of the estimated GDP during the first eight months of 2018 from 4.0 per cent in the corresponding period of 2017, while the primary account recorded a surplus of 0.4 per cent of the estimated GDP (Rs. 57.6 billion) during the period under review. The current account deficit increased marginally to 1.0 per cent of the estimated GDP during the first eight months of 2018 from 0.9 per cent recorded in the same period of 2017.

Figure 1.7
Key Fiscal Balances



- **The overall budget deficit of Rs. 510.9 billion recorded in the first eight months of the year was financed mainly through foreign sources.** Net foreign financing increased to Rs. 271.3 billion during the period under consideration compared to Rs. 246.7 billion recorded in the same period of 2017. However, net domestic financing during this period declined to Rs. 239.5 billion in comparison to Rs. 273.5 billion in the corresponding period of 2017. The central government debt, in nominal terms, increased to Rs. 11,052.0 billion as at end August 2018 from Rs. 10,313.0 billion reported as at end December 2017. The outstanding domestic debt increased by 3.3 per cent to Rs. 5,776.3 billion, while outstanding foreign debt increased substantially by 11.8 per cent to Rs. 5,275.7 billion during the first eight months of the year. The expansion of the outstanding foreign debt stock in rupee terms could be attributed to the impact of the depreciation of the Sri Lankan rupee against major foreign currencies and to increased net foreign financing.

Monetary Sector

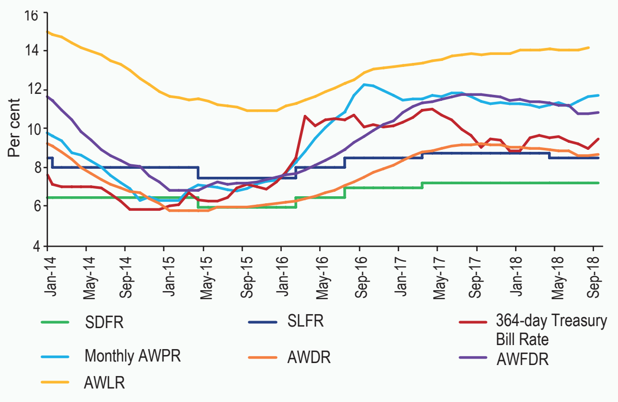
- **In line with the move towards Flexible Inflation Targeting (FIT), the Central Bank conducted monetary policy within an enhanced policy framework, with the aim of stabilising inflation at mid single digit levels over the medium term, thereby facilitating a sustainable growth trajectory**. Under the current enhanced monetary policy framework, the average weighted call money rate (AWCMR) serves as the operating target while broad money (M_{2b}) continues to serve as a key indicative intermediate variable for the conduct of monetary policy. The Central Bank followed a cautious approach in conducting monetary policy during the first nine months of 2018, in view of the current and expected

Table 1.1
Recent Monetary Policy Measures

Date	Measure
10-May-2013	Repurchase rate and Reverse Repurchase rate reduced by 50 basis points to 7.00% and 9.00%, respectively.
26-Jun-2013	Statutory Reserve Requirement (SRR) reduced by 2 percentage points to 6% with effect from 1-Jul-2013.
15-Oct-2013	Repurchase rate and Reverse Repurchase rate reduced by 50 basis points to 6.50% and 8.50%, respectively.
2-Jan-2014	The Policy Rate Corridor renamed as the Standing Rate Corridor (SRC), and the Repurchase rate and the Reverse Repurchase rate of the Central Bank renamed as the Standing Deposit Facility Rate (SDFR) and Standing Lending Facility Rate (SLFR), respectively. SLFR reduced by 50 basis points to 8.00%. The Standing Deposit Facility (SDF) uncollateralised with effect from 1-Feb-2014.
23-Sep-2014	Access to the SDF of the Central Bank by OMO participants at 6.50% rationalised to a maximum of three times per calendar month. Any deposit at the SDF window exceeding three times by an OMO participant accepted at a special interest rate of 5.00% .
2-Mar-2015	The 5.00% special SDF rate was withdrawn.
15-Apr-2015	The SDFR and SLFR reduced by 50 basis points to 6.00% and 7.50%, respectively.
3-Sep-2015	The exchange rate allowed to be determined based on demand and supply conditions in the foreign exchange market.
30-Dec-2015	SRR increased by 1.50 percentage points to 7.50% to be effective from the reserve period commencing 16-Jan-2016.
19-Feb-2016	The SDFR and SLFR increased by 50 basis points to 6.50% and 8.00%, respectively.
28-Jul-2016	The SDFR and SLFR increased by 50 basis points to 7.00% and 8.50%, respectively.
24-Mar-2017	The SDFR and SLFR increased by 25 basis points to 7.25% and 8.75%, respectively.
4-Apr-2018	The SLFR reduced by 25 basis points to 8.50%. Accordingly, the width of the SRC narrowed to 125 basis points from 150 basis points.

Source: Central Bank of Sri Lanka

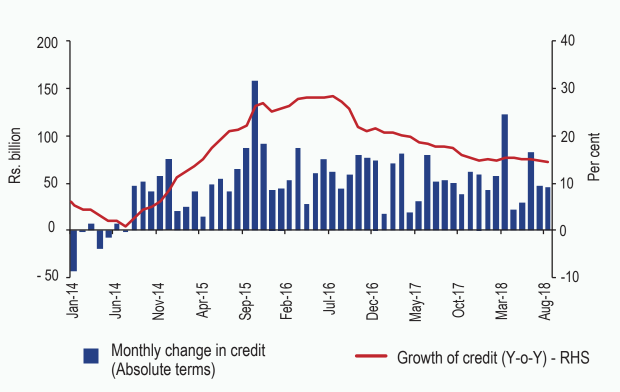
Figure 1.8
Movements in Selected Market Interest Rates



developments in the domestic economy amidst the gradual tightening of global financial conditions. The tight monetary policy stance pursued by the Central Bank since end 2015, by way of raising the Statutory Reserve Ratio (SRR) applicable on rupee deposit liabilities of licensed commercial banks by 1.50 percentage points to 7.50 per cent and policy interest rates by a total of 125 basis points, yielded the desired outcomes especially in relation to demand driven inflation and monetary expansion. The favourable developments in inflation, inflation outlook and the trends in the monetary sector, in an environment of lacklustre performance in economic growth, induced the Central Bank to reduce the Standing Lending Facility Rate (SLFR) by 25 basis points to 8.50 per cent in April 2018, while maintaining the Standing Deposit Facility Rate (SDFR) unchanged at 7.25 per cent. However, tightening global economic conditions and the pressure on the exchange rate compelled the Central Bank to follow a neutral monetary policy stance with closely monitored monetary conditions since April 2018 and allow appropriate adjustments in AWCMR within the policy rate corridor. Most deposit and lending rates of commercial banks continued to remain at high levels during the first nine months of the year. Yields on Government securities showed mix movements during the first nine months of 2018, reflecting the changes in market sentiments as well as the funding requirement of the government and availability of foreign financing.

- **In response to the tight monetary policy stance pursued by the Central Bank in the past, monetary and credit expansion decelerated to desired levels in 2018**. The year-on-year growth of broad money (M_{2b}) decelerated to 13.5 per cent by end August 2018 from 16.7 per cent at end 2017, while the average growth stood at 15.4 per cent during the first eight months of 2018 in comparison to a growth of 20.1 per cent in the corresponding period of 2017. Deceleration of the growth of private sector credit in response to high interest rates was the key contributory factor for the decline in broad money growth. Accordingly, the growth of credit to the private sector by commercial banks decelerated to 14.3 per cent by end August 2018 in comparison to the growth of 17.8 per cent by end August 2017 and 14.7 per cent by end 2017. In absolute terms, credit to the private sector increased by Rs. 449.1

Figure 1.9
Credit Granted by Commercial Banks to the Private Sector



billion during the first eight months of 2018 as compared to the increase of Rs. 404.7 billion in the corresponding period of 2017. Meanwhile, reflecting some improvements in the borrowing pattern of the government, credit obtained by the government (net) from the banking sector (NCG) moderated, recording an increase of Rs. 103.4 billion during the first eight months of 2018 compared to the increase of Rs. 265.4 billion during the corresponding period of 2017. Contributing to the overall expansion in credit to the government, NCG by the Central Bank increased by Rs. 20.7 billion, entirely due to the increase in provisional advances to the government by the Central Bank during the first eight months of 2018. NCG from commercial banks also showed a notable decline during the period under review. NCG from commercial banks increased only by Rs. 82.7 billion in the first eight months of 2018 in comparion to the significant increase of Rs. 384.9 billion recorded in the corresponding period of 2017. The increase in NCG by commercial banks during the first eight months of 2018 was mainly due to higher investments in Treasury bills and Treasury bonds as well as Sri Lanka Development Bonds (SLDBs). Meanwhile, credit to public corporations increased at a faster pace during the first eight months of 2018 due to the weak financial performance of key public corporations. Accordingly, credit obtained by public corporations increased by Rs. 102.5 billion during the first eight months of 2018 compared to the increase of Rs. 7.7 billion recorded in the corresponding period of 2017.

Financial Sector

- **The financial sector continued to expand without causing major macroprudential concerns**. The asset base of the banking sector increased in the first eight months of 2018, albeit at a lower rate than in the corresponding period of the previous year. The growth of the asset base was driven mainly by the increase in credit granted by the banking sector, which moderated since late 2017 in response to the tight monetary policy stance. The banking sector maintained adequate capital in the first eight months of 2018, in order to absorb any adverse shocks while maintaining liquidity levels well above the statutory minimum requirement. An increase in nonperforming loans was observed in the first eight months of the year partly as a result of high credit growth in previous years and elevated market interest rates. Further, a marginal drop of profitability of the banking sector was reflected by some deterioration in return on assets (ROA) and return on equity (ROE).

- **Performance of the Licensed Finance Companies (LFCs) and Specialised Leasing Companies (SLCs) sector moderated during the first eight months of 2018 in an environment of high interest rates, low economic growth and natural calamities**. The asset base of the sector slowed down with low credit growth, the reduction in the investment portfolio due to a substantial sale of assets by a distressed LFC and the decline in available liquid assets. Capital and liquidity levels of the LFC and SLC sector were well above the minimum regulatory requirement. However, asset quality declined during the first eight months of the year reflecting the impact of flood, nationwide drought and slow economic growth. Necessary action has been taken by the Central Bank to initiate key prudential measures with a view to reviving companies with weak financial positions and cease or limit finance business operations of weak finance companies to safeguard depositors and to ensure the long term stability of the financial sector. Other non bank financial institution sectors, namely, insurance, primary dealers, unit trusts and stock brokers, continued to expand business operations without major stability concerns during the reference period.

- **Liquidity conditions in the domestic money market and the domestic foreign exchange market were relatively volatile in the first nine months of the year**. Considerable liquidity shortages were observed in the domestic money market at times, resulting in higher interest rates. Reflecting the changes in market sentiments as well as the funding requirement of the government and the availability of foreign financing, yields on Government securities showed mixed movements during the first nine months of the year. Stock market performance slowed during this period with foreign investment outflows while the corporate debt market improved considerably. Meanwhile, payments and settlement systems continued to develop with the measures taken to facilitate digital payment mechanisms in the country in order to cater to the growing payment and settlement needs of individuals and institutions.

International Economic Environment

- **According to the October 2018 release of the World Economic Outlook (WEO) of the IMF, global growth is projected to plateau during 2018 and 2019, impacted by the slowdown in economic performance of both key advanced economies and several emerging market and developing economies**. Accordingly, the global economy is projected to grow at a slower than expected pace of 3.7 per cent in 2018 and 2019, as in 2017. Intensifying trade tensions between economic superpowers amplifying into major geopolitical tensions, mounting political and policy uncertainty, and tightening of global financial conditions and associated pressures on currencies of certain economies, particularly of emerging market and developing economies, are likely to weigh down on global growth prospects in 2018 and 2019. This could be further protracted by the unwinding of US fiscal stimulus in 2020 and the waning of associated spillovers on their trading partners.

- **Although growth among advanced economies has become increasingly unsynchronised and challenged on account of the larger than expected moderation in economic activity in the Euro area, the United Kingdom (UK) and Japan, economic performance in this group is projected to continue to fare above potential in 2018 and 2019**. As a result, advanced economies are forecast to grow by 2.4 per cent in 2018, before easing to 2.1 per cent in 2019. Although rising trade tensions between the US and China would have some dampening effect on growth prospects in the medium term, the overall positive growth performance of advanced economies is expected to be driven by the US economy that has gathered momentum, underpinned by expansive fiscal policy measures and improved domestic demand. Accordingly, the US economy is expected to grow by 2.9 per cent in 2018 before moderating to 2.5 per cent in 2019. With the moderation in economic activity particularly in Germany, France, Italy and Spain, the growth in Euro area is projected to slowdown in 2018 and ease further in 2019. The downward revision to the growth projections of the UK for 2018 is driven by the weak growth in the first quarter while higher trade barriers anticipated following the Brexit are expected to weigh down the growth for 2019. Meanwhile, the rebound in growth during the second quarter of 2018 reinforced Japan’s growth prospects during the year, in spite of the weak economic performance during the first quarter.

- **Growth of emerging market and developing economies is expected to remain fairly robust in 2018 and 2019, although marginal downward revisions to projections were observed in view of the many economic and political headwinds**. As per the October 2018 release of the WEO, growth in emerging market and developing economies is expected to remain stable at 4.7 per cent in 2018 and 2019. While positive spillover effects from the rebound in US economic growth and higher commodity prices are expected to contribute favourably towards this growth path, consequences of trade retaliatory measures, tight global financial conditions and rising oil prices faced by oil importing countries are expected to be a drag on growth in these countries. China's growth is forecast to moderate to 6.6 per cent in 2018 from 6.9 per cent in the previous year on account of tightened financial sector regulations and subdued external demand resulting from dented trade relations, followed by a further slowdown in growth to 6.2 per cent in 2019. In spite of the dampened demand owing to higher oil prices and a faster than expected tightening of monetary policy, growth in India is projected to accelerate in 2018 and 2019 underpinned by the dissipation of the adverse effects of demonetisation and the imposition of the goods and services tax (GST). Economic growth in Latin America and Caribbean region is projected to decline in 2018 and rise in 2019, while the growth in Sub-Saharan Africa is expected to accelerate benefitting mainly from the stronger global growth and improved outlook for commodity prices, particularly oil. However, growth projections for the Middle East, North Africa, Afghanistan and Pakistan were revised downward on account of the potential re-imposition of US sanctions on Iran, although expectations that growth in the region in 2018 and 2019 will be higher than in 2017. Growth projections of the economies in the ASEAN-5 group are expected to remain at 5.3 per cent in 2018 supported by strong domestic demand and the recovery in exports, but will moderate marginally to 5.2 per cent in 2019.

- **While the outlook on global growth remains steady in the October 2018 release of the WEO of the IMF, the balance of risks is clearly inclined towards the downside indicating the possibility of some slowdown in the global economy going forward**. Central banks in most advanced economies have taken measures to tighten monetary policy with a view to contain inflationary pressures arising from the favourable economic outlook, stronger labour markets and ensuing firming up of demand. However, such tightening is likely to act as a drag on growth among advanced economies as well as emerging market and developing economies, through negative spillover effects, particularly in the form of higher capital outflows from emerging market and developing economies, which are bound to adversely impact economies with weak external positions. Such outflows of capital are likely to affect macroeconomic stability of these economies and warrant tighter monetary policy in the region thereby further stalling global growth. Moreover, escalating trade tensions between the US and China would bring in greater political and policy uncertainties, which could further scourge the overall growth prospects of the global economy.

- **Meanwhile, inflation in advanced economies as well as emerging market and developing economies is projected to accelerate in 2018 impacted by rising commodity prices, particularly oil, but stabilise somewhat thereafter as oil price pressures ease and monetary conditions tighten**. In advanced economies, headline consumer price inflation, which was at 1.7 per cent in 2017, is expected to accelerate to 2.0 per cent in 2018 driven by the rising international oil prices, before stabilising in 2019. However, core inflation in the Euro area and Japan remained weak and well below targeted levels, contrary to that of the US and the UK, where core inflation was closer to targets reflecting strengthened demand. A similar trend in inflation was observed in emerging and developing economies, where inflation is expected to edge up to 5.0 per cent in 2018 and 5.2 per cent in 2019 from 4.3 per cent in 2017 impacted by rising energy prices and associated second-round effects and a rise in imported inflation through depreciated domestic currencies. Although looming US sanctions on Iran caused global oil prices to increase above US dollars 80 a barrel, the IMF projects an easing of oil prices to around US dollars 68 a barrel, on average, in 2019 in view of the increased global supply of oil, particularly from Russia and Saudi Arabia.

- **As per the Global Monetary Policy Tracker of the US based think tank, Council on Foreign Relations (CFR), the monetary policy stance of the world has further tilted**

towards tightening by end September 2018 as key advanced economies undertook a steady path of monetary policy normalisation amid several downside risks and uncertain global conditions. In the wake of strengthening economic activity and labour markets, the Federal Reserve raised the target range for the Federal funds rate on three occasions during the first nine months of 2018. Further rate hikes are expected in December 2018 as well as in 2019, in line with the expected expansion of economic activity, robust labour market conditions and a sustained return to the inflation target of 2 per cent. Meanwhile, the Bank of England raised its Bank Rate by 25 basis points in August 2018, against the backdrop of a stronger economic outlook and inflation remaining slightly above the targeted 2 per cent level due to external pressures. However, the UK economy remains wary of any negative spillovers that may stem from Brexit negotiations and wider global uncertainty resulting from tighter financial conditions and escalating trade woes. Although the European Central Bank (ECB) announced the winding down of its net asset purchases commencing October 2018, it continued to maintain an accommodative policy stance, while noting that risks from a growing global trade conflict remained prominent and that the Euro zone still required significant monetary policy stimulus. The ECB signalled the maintenance of record low interest rates until the summer of 2019 to ensure the continued sustained convergence of inflation to levels that are below, but in the proximity of 2 per cent over the medium term. Meanwhile, Bank of Japan (BoJ) continued to maintain its policy rates unchanged in negative levels, while continuing its asset purchases in a flexible manner to support financial markets through the lowering of risk premia. The Reserve Bank of Australia also continued to maintain an accommodative monetary policy stance with the intention of supporting growth, lowering unemployment and bringing inflation closer to the target.

- **Central Banks of most emerging market economies tightened monetary policy in response to the ongoing monetary policy normalisation in advanced economies, pressures on the exchange rate, reversal of capital flows and mounting trade tensions**. The Reserve Bank of India (RBI) increased its policy repo rate under the liquidity adjustment facility (LAF) by 25 basis points to 6.25 per cent in June 2018 for the first time since 2014 and tightened further to 6.50 per cent in August 2018 with a view to containing inflationary pressures and support the currency in the backdrop of global financial market uncertainty. However, RBI decided to leave policy rates unchanged in early October citing lower than expected inflation as well as the need to support growth. Bank Indonesia raised policy rates on five occasions so far during 2018 to 5.75 per cent with a view to maintaining inflation within the target corridor in 2018 and 2019, as well as to improve its external resilience. Meanwhile, the Central Bank of Philippines (Bangko Sentral ng Pilipinas) also raised its policy rates on four occasions thus far during 2018 with a view to curbing inflationary pressures arising from a depreciated currency and to further anchor inflation expectations so as to achieve the inflation target over the policy horizon. Bank Negara Malaysia also raised its Overnight Policy Rate by 25 basis points to 3.25 per cent in January 2018 to prevent the build-up of risks arising from low interest rates for a

Table 1.2

Changes in the Policy Interest Rates of Selected Central Banks

Per cent

Country	Key Policy Rate	End 2015	End 2016	End 2017	23 Oct 2018
Sri Lanka	Standing Deposit Facility Rate	6.00	7.00	7.25	7.25
	Standing Lending Facility Rate	7.50	8.50	8.75	8.50
Emerging Market Economies					
India	Repo rate	6.75	6.25	6.00	6.50
Malaysia	Overnight policy rate	3.25	3.00	3.00	3.25
Thailand	1-day bilateral repo rate	1.50	1.50	1.50	1.50
China	1-year yuan lending rate	4.35	4.35	4.35	4.35
Indonesia *	7-day Reverse Repo Rate	7.50	4.75	4.25	5.75
Philippines	Overnight Reverse Repo Rate	4.00	3.00	3.00	4.50
Advanced Economies					
USA	Federal funds rate	0.25-0.50	0.50-0.75	1.25-1.50	2.00-2.25
UK	Bank rate	0.50	0.25	0.50	0.75
ECB	Refinance rate	0.05	0.00	0.00	0.00
Japan	Overnight call rate	0.00	-0.10	-0.10	-0.10
Australia	Cash rate	2.00	1.50	1.50	1.50

Source: Websites of respective central banks

*Bank Indonesia introduced a new policy rate, i.e. BI 7-Day (Reverse) Repo Rate, effective from 19th August 2016 instead of Benchmark Interest Rate.

prolonged period while remaining vigilant of risks in the external front. However, Bank of Thailand kept its policy rates unchanged at 1.50 per cent to support a more robust economic growth and foster inflation toward the medium-term target, although highlighting that the need for such accommodative monetary policy would be reduced gradually. Central Bank of the Republic of Turkey increased its one week Repo rate three times so far during 2018 to 24.00 per cent with a view to curbing mounting inflation and preventing a currency crisis. Meanwhile, reversing the easing of the monetary policy stance in January 2018, the Central Bank of Argentina increased its Benchmark rate on five occasions in the first ten months of 2018 by a total of 37.75 percentage points to 65.00 per cent in response to excessive depreciation of the Argentinian peso against the US dollar. Due to the limited success of the use of policy interest rates, the Central Bank of Argentina implemented a new monetary policy regime commencing October 2018, switching its focus towards controlling the growth of monetary aggregates from targeting inflation, while limiting forex intervention.

Expected Developments

- **The successful implementation of growth strategies already laid out by the government in a consistent and coordinated manner with active private sector participation would support the gradual improvement in the growth trajectory in the medium term**. Economic growth in recent years has been modest and the projected economic growth for 2018 remains subdued at 4.0 per cent in the backdrop of an expansion of 3.6 per cent in the first half of the year. However, growth in the medium term horizon is expected to recover supported by increased investment activities by domestic and foreign investors. These investments are expected to be channelled to high value added manufacturing sectors and knowledge based services, which would spur economic growth on a sustainable basis. The gradual evolution of a commercially viable agriculture sector would also support this growth drive. Government initiatives aimed at improving the economic and social infrastructure of the country are also expected to be closely aligned to support the growth and development process through productivity improvements. Upscaling skill levels of the labour force with greater emphasis on STEM (Science, Technology, Engineering and Mathematics) and vocational education would enable higher growth while reducing the mismatch between labour demand and supply. Moreover, measures aimed at promoting increased female labour force participation through better childcare facilities, reorientation programmes and flexible working arrangements would also increase the production capacity of the country. Enhanced domestic production capacities would facilitate the exploitation of trade links forged through numerous free trade agreements and thereby supporting sustained growth through increased external demand. However, the facilitation of a conducive environment through timely implementation of consistent and coordinated policies would be essential to ensure the realisation of these targets. Maintaining stable macroeconomic conditions supported by low and stable inflation, continued adherence to fiscal discipline and a market based exchange rate would facilitate high and sustained growth in the medium term.

- **Although the widened trade deficit is likely to weaken the performance of the external current account in 2018, the policy measures initiated to curtail the expansion in import expenditure complemented by the adjustment of the exchange rate are expected to improve the external current account performance in 2019**. Exports of merchandise goods, which rebounded strongly since March 2017, are expected to maintain an upward momentum underpinned by the establishment of trade relations with new trading partners, conducive external trade policies together with strong institutional support and the competitive exchange rate. On the downside, escalating trade tensions in advanced economies may undermine the global trade prospects and in turn have an indirect impact on Sri Lanka's export earnings. Import expenditure is projected to grow in the period ahead albeit at a slower pace. While the measures adopted by the government and the Central Bank to discourage imports and the exchange rate adjustment are likely to reduce the demand for non-essential imports in the short term, further trade liberalisation and higher global petroleum prices together with the projected increase in exports are expected to drive import growth in the medium term. With these prospective developments, the trade deficit is projected to narrow in 2019. The deficit in the primary income account is expected to expand with increased outflows of dividend payments and reinvested earnings originating from higher levels of FDI. In addition, interest payments on foreign loans are also expected to grow with the increased external debt stock in an environment of rising global interest rates. However, inflows from services exports are projected to grow steadily with the continued growth in earnings from tourism, transportation services and computer and information technology related services. Meanwhile, workers' remittances are also expected to rebound and support the current account with the gradual pick up in oil prices and the potential rise in demand from the Middle Eastern region for Sri Lankan migrant workers. Accordingly, the external current account is projected to improve in 2019 and beyond. Although monetary policy normalisation of advanced economies leading to portfolio rebalancing by foreign investors would result in weaker foreign investment flows to the CSE and the government securities market, the financial account of the BOP is expected to strengthen with FDIs as well as debt flows. The development activities in the Colombo Port City project and Hambantota industrial zone are expected to bring in a steady inflow of FDIs in the medium term. In the meantime, bunching of debt service payments over the period from 2019-2023, particularly with the maturity of ISBs poses a challenge to the external sector. However, the successful implementation of the provisions in the Active Liability Management Act No. 08 of 2018 (ALMA) and the Medium Term Debt Management Strategy (MTDS) of the government is expected to provide proactive solutions to manage future external refinancing requirements. In the medium to long term, it is essential to reduce the present heavy reliance on external debt as the source of financing the current account deficit. This requires the exploitation of the full potential of merchandise and services exports while creating a favourable investment climate to attract FDIs to bolster the financial account and build external buffers.

- **The government's commitment towards continued fiscal consolidation, as reflected by the decisive measures introduced to improve revenue, rationalise expenditure and streamline debt management, is expected to result in an overall improvement in the fiscal sector in the medium term**. Enactment of the new Inland Revenue Act, automation of revenue collecting agencies together with deployment of better practices in tax administration are expected to broaden the tax base, simplify the tax system, rationalise tax exemptions, and improve tax compliance. These measures are aimed at enhancing government revenue to around 16 per cent of GDP in the medium term. On the expenditure front, initiatives were taken to better target welfare programmes, rationalise recurrent expenditure, strengthen Parliamentary control over public finances and to enhance transparency of the budgetary process. These measures would facilitate the government to allocate necessary resources for essential capital investment at 5-6 per cent of GDP in the medium term, but further rationalisation of recurrent expenditure is desirable. As a result of these measures, the government expects to lower the budget deficit to 3.5 per cent of GDP by 2020, while maintaining surpluses both in the current account and the primary account. Consequent to the rise in the primary surplus, the government debt to GDP ratio is also expected to decline gradually, improving the overall macroeconomic stability of the country. In addition, initiatives were taken to implement structural reforms in SOBEs with a view to improving their long term financial viability.

- **The Central Bank's move to adopt FIT as its monetary policy framework is on track, and it is essential that the government's commitment towards fiscal consolidation continues for the success of this endeavour**. The Central Bank, in the *Road Map: Monetary and Financial Sector Policies for 2018 and beyond*, announced its intention of adopting FIT by 2020. Key stages in the process include introducing necessary legal reforms, improving institutional and technical capacity, enhancing the autonomy of the Central Bank, strengthening monetary-fiscal policy coordination, maintaining exchange rate flexibility, improving monetary operations and enhancing public and stakeholder awareness. Since the announcement of the transition towards adopting a FIT regime, the Central Bank has taken several measures to address these requirements. However, institutionalising the FIT framework by reaching an agreement on the medium term inflation target and enacting the required amendments to the Monetary Law Act (MLA) remain crucial for the successful implementation of FIT. It is expected that the government would remain committed to the ongoing revenue-based fiscal consolidation process to facilitate the expected transition to FIT. With monetary policy adjustments made in a forward looking framework, inflation is envisaged to remain in mid single digit levels in the medium term while sufficient levels of monetary and credit expansion are expected to facilitate private sector led economic growth.

- **In the backdrop of tightening policy spaces in the monetary, fiscal and external fronts amidst subdued economic performance, it is important to facilitate private sector led growth with prudent, consistent and far reaching reforms that support increased productivity in the economy**. Recent experience has once again displayed the importance of strengthening the economy through structural transformation, while improving the country's macroeconomic fundamentals. The postponement of much needed structural reforms will only lead to the Sri Lankan economy lagging behind its regional peers, amidst increased vulnerability to internal and external disturbances. Therefore, it is essential that such reforms are expeditiously implemented within a transparent framework for Sri Lanka to progress as an upper middle income economy where its human and physical resources are fully utilised in a more productive manner.