1

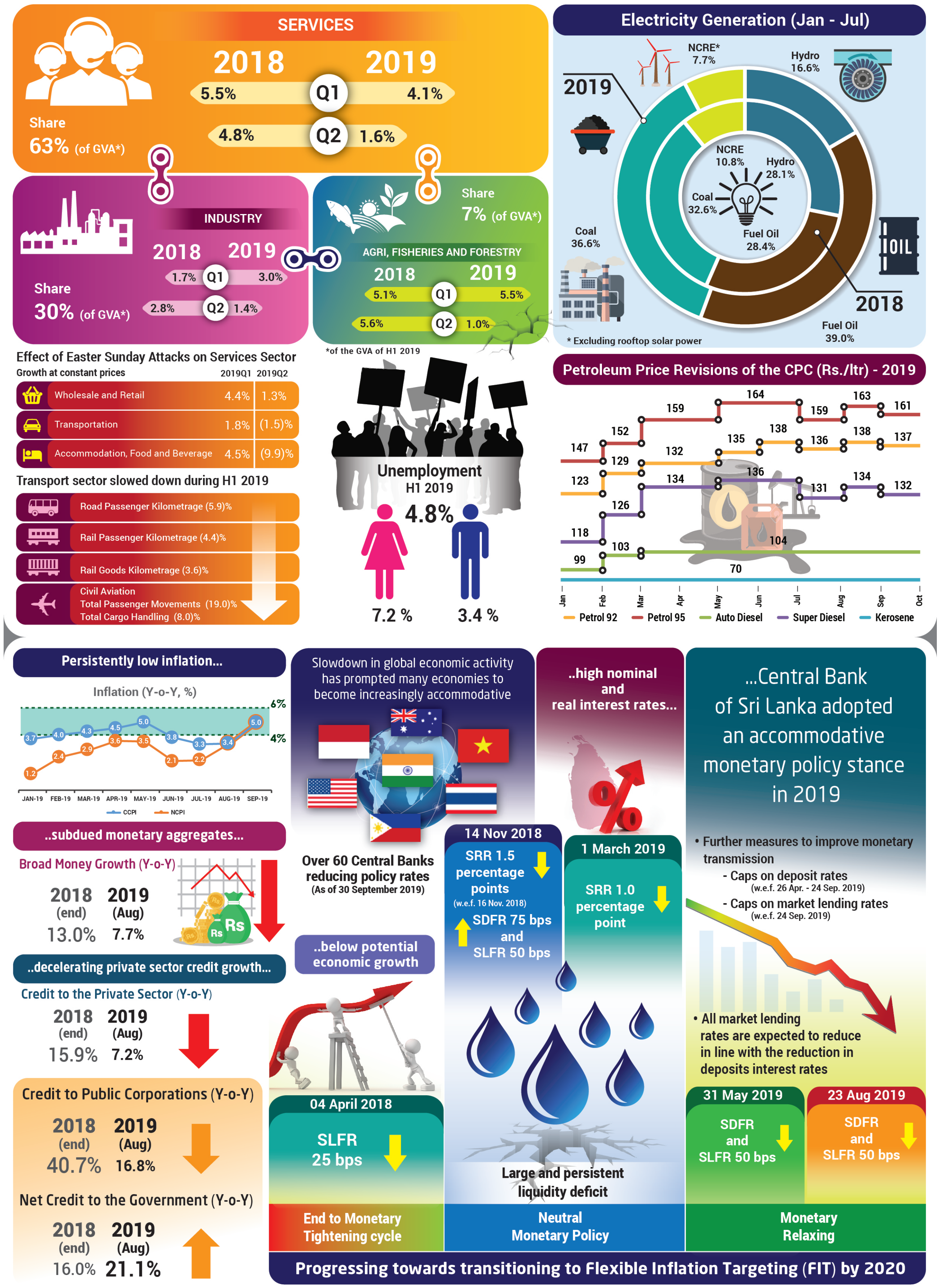
OVERVIEW

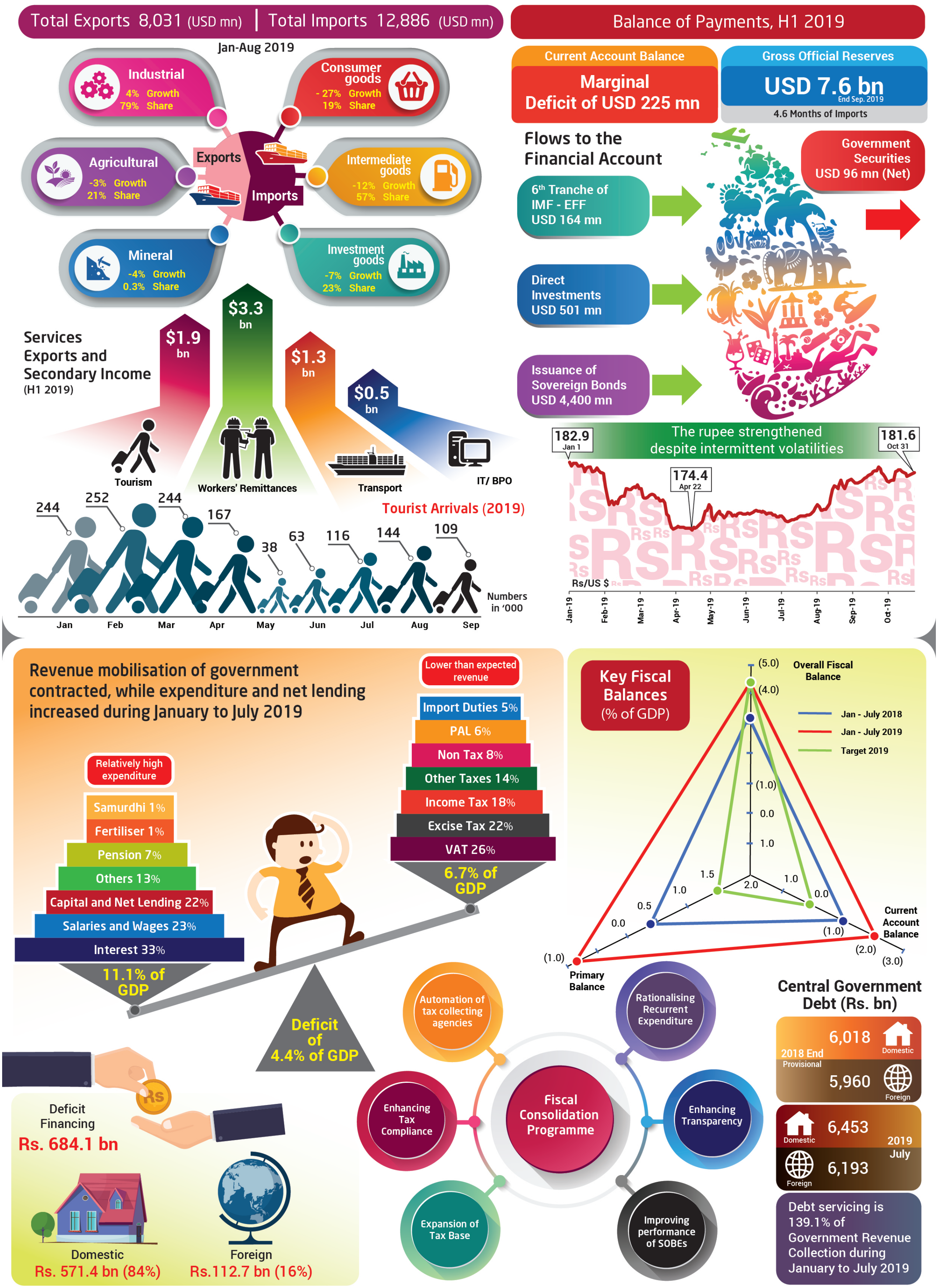
The growth of the Sri Lankan economy moderated in the first half of the year amidst challenges emanating mainly in the domestic front, including the spillover effects of the Easter Sunday attacks. Accordingly, the economy grew at a slower pace of 2.6 per cent in real terms in the first half of 2019, compared to 3.9 per cent recorded in the corresponding period in 2018. The unemployment rate also increased during the first half of 2019 in line with subdued economic growth. Headline inflation continued to remain within the anticipated range thus far during the year, with occasional volatilities due to supply side developments. Core inflation accelerated in January 2019, mainly due to a one-off adjustment in house rentals, and the impact of this adjustment is expected to wear off in January 2020. The Central Bank continued to conduct monetary policy in a forward looking manner within an enhanced monetary policy framework aimed at stabilising inflation in mid-single digit levels, while progressing rapidly towards transitioning to full fledged Flexible Inflation Targeting (FIT). Against the backdrop of well anchored inflation and inflation expectations, the Central Bank adopted an accommodative monetary policy stance in 2019, considering sluggish economic growth, the continued slowdown in monetary and credit expansion and global monetary policy easing. However, forward guidance on monetary policy needs to be tempered by the salary increase in the pipeline. In spite of monetary easing, market interest rates remained high in both nominal and real terms, prompting the Central Bank to impose caps on deposit interest rates of financial institutions, in April 2019, to expedite monetary policy transmission. With deposit interest rates and cost of funds declining, the Central Bank removed the caps on deposit interest rates of licensed banks and imposed caps on lending rates, in September, to support economic activity. In the meantime, the external sector remained resilient amidst the setback in the tourism sector following the Easter Sunday attacks. The trade deficit contracted significantly during the first eight months of 2019 in comparison to the corresponding period of 2018, with lower import expenditure and increased earnings from exports. The contraction of the trade deficit and healthy inflows to the services account helped record a surplus in the current account in the first quarter of the year, although a notable moderation in tourism earnings and workers' remittances in the second quarter caused a marginal deficit in the current account in the first half of the year. Meanwhile, the financial account improved, particularly with the issuance of International Sovereign Bonds (ISBs). With these developments, gross official reserves increased to US dollars 7.6 billion by end September 2019 from US dollars 6.9 billion at end 2018 and the Sri Lankan rupee has appreciated against the US dollar thus far during the year. On the fiscal front, budgetary operations weakened as reflected in the movement of key fiscal indicators during the first seven months of 2019, despite continued efforts of the government towards fiscal consolidation. The government revenue declined during the period, reflecting the impact of policy measures to curtail imports of personal motor vehicles, sluggish economic activity following the Easter Sunday attacks and the delay in implementing certain revenue proposals announced in the Budget 2019. Nevertheless, the collection of income tax improved due to the implementation of new Inland Revenue Act. With reduced revenue and increased expenditure, the overall budget deficit deteriorated to 4.4 per cent of the estimated GDP during the first seven months of 2019 from 3.2 per cent in the same period of 2018, while the current account deficit widened, indicating government dissavings. The primary balance, i.e., the difference between revenue and non interest expenditure, turned to a deficit in the first seven months of 2019, reversing the surplus maintained in 2017 and 2018. The financial sector in the meantime, remained sound, while measures were taken to decisively address issues in a few distressed finance companies. The government's structural reform programme supported by the Extended Fund Facility of the International Monetary Fund (IMF-EFF) continued, and upon the successful completion of the sixth review, the receipt of the seventh tranche under the facility is expected in early November 2019. The outlook for the economy, in both the short and medium term, will be determined to a significant extent by the degree of policy discipline maintained during and after the election period.

1

Figure 1.1

Snapshot of the Sri Lankan Economy





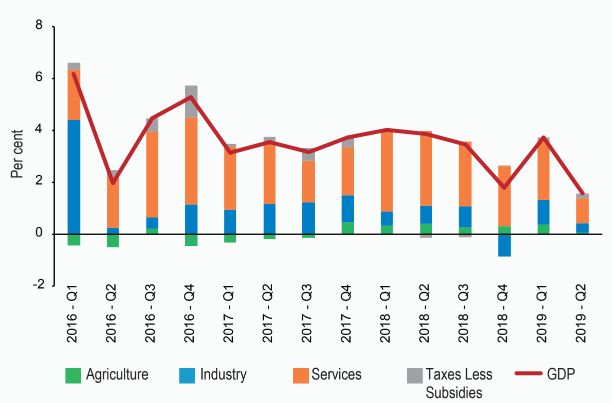
Total Exports 8,031 (USD mn) | Total Imports 12,886 (USD mn)
Jan-Aug 2019
Industrial 4% Growth 79% Share
Agricultural -3% Growth 21% Share
Mineral -4% Growth 0.3% Share
Exports
Imports
Consumer goods - 27% Growth 19% Share
Intermediate goods -12% Growth 57% Share
Investment goods -7% Growth 23% Share
Services Exports and Secondary Income
(H1 2019)
$1.9 bn
$3.3 bn
$1.3 bn
$0.5 bn
Tourism
Workers' Remittances
Transport
IT/ BPO
Tourist Arrivals (2019)
244
252
244
167
38
63
116
144
109
Numbers in '000
Jan
Feb
Mar
Apr
May
Jun
Jul
Aug
Sep
Balance of Payments, H1 2019
Current Account Balance
Marginal Deficit of USD 225 mn
Gross Official Reserves
USD 7.6 bn
End Sep. 2019
4.6 Months of Imports
Flows to the Financial Account
6th Tranche of IMF - EFF USD 164 mn
Direct Investments USD 501 mn
Issuance of Sovereign Bonds USD 4,400 mn
Government Securities USD 96 mn (Net)
182.9
Jan 1
The rupee strengthened despite intermittent volatilities
181.6
Oct 31
174.4
Apr 22
Rs/US $
Jan-19
Feb-19
Mar-19
Apr-19
May-19
Jun-19
Jul-19
Aug-19
Sep-19
Oct-19
Revenue mobilisation of government contracted, while expenditure and net lending increased during January to July 2019
Relatively high expenditure
Samurdhi 1%
Fertiliser 1%
Pension 7%
Others 13%
Capital and Net Lending 22%
Salaries and Wages 23%
Interest 33%
11.1% of GDP
Lower than expected revenue
Import Duties 5%
PAL 6%
Non Tax 8%
Other Taxes 14%
Income Tax 18%
Excise Tax 22%
VAT 26%
6.7% of GDP
Deficit of 4.4% of GDP
Deficit Financing
Rs. 684.1 bn
Domestic
Rs. 571.4 bn (84%)
Foreign
Rs.112.7 bn (16%)
Key Fiscal Balances
(% of GDP)
Overall Fiscal Balance
Jan - July 2018
Jan - July 2019
Target 2019
(5.0)
(4.0)
(1.0)
0.0
1.0
1.5
2.0
1.0
0.5
0.0
0.0
(1.0)
(2.0)
(3.0)
(1.0)
Current Account Balance
Primary Balance
Automation of tax collecting agencies
Rationalising Recurrent Expenditure
Enhancing Tax Compliance
Fiscal Consolidation Programme
Enhancing Transparency
Expansion of Tax Base
Improving performance of SOBEs
Central Government Debt (Rs. bn)
6,018 Domestic
2018 End Provisional
5,960 Foreign
6,453 Domestic
2019 July
6,193 Foreign
Debt servicing is 139.1% of Government Revenue Collection during January to July 2019

1 Sectoral Developments

Real Sector and Inflation

- **According to the provisional estimates of the Department of Census and Statistics, the Sri Lankan economy recorded a subdued growth rate of 2.6 per cent during the first half of 2019, in comparison to the 3.9 per cent growth in the corresponding period of 2018.** The agriculture, forestry and fishing activities registered a moderate growth of 3.2 per cent in the first half of 2019, compared to the 5.3 per cent growth in the same period of the preceding year, supported by increased production of oleaginous fruits (coconut, king coconut and oil palm production), rice and animal production sub-sectors. Meanwhile, subdued growth in industrial activities recorded since last year continued in the first half of 2019 registering a 2.3 per cent growth, compared to the 2.2 per cent growth in the corresponding period in 2018. Growth in industrial activities was primarily driven by growth in construction, and mining and quarrying activities. Further, services activities slowed down during the first half of 2019 with a 2.8 per cent growth, compared to the 5.1 per cent growth recorded in the corresponding period in the previous year. The Easter Sunday attacks adversely affected tourism related services activities, particularly accommodation, food and beverage service activities, transportation of goods and passengers including warehousing activities, and wholesale and retail trade activities during the second quarter of 2019, dragging down the overall growth performance of the economy during the quarter as well as the first half of the year.

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

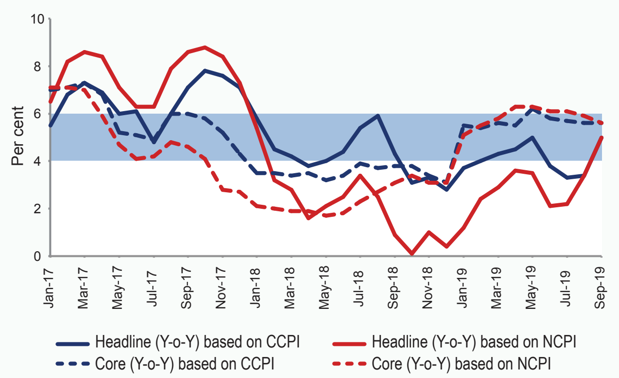


Source: Department of Census and Statistics

- **The unemployment rate increased to 4.8 per cent in the first half of 2019, compared to 4.5 per cent registered in the same period in 2018.** The unemployment rate among males and females for the first half of 2019 stood at 3.4 per cent and 7.2 per cent, respectively. Unemployment among youth in the age range of 20-29 years remained at a high level of 14.8 per cent. Further, unemployment among females with an education attainment of G.C.E. Advanced Level and above also continued to be high, recording 12.3 per cent during the period under review. Meanwhile, the labour force participation rate increased to 52.6 per cent in the first half of 2019 from 51.5 per cent recorded during the same period in the preceding year. The labour force participation rates for males and females were 73.4 per cent and 34.8 per cent, respectively. Of the total employed population, 28.3 per cent was engaged in industrial activities, while another 47.3 per cent was in the services sector during the first half 2019. The labour force engaged in the agriculture sector declined to 24.5 per cent in the first half of this year from 25.5 per cent in the corresponding period in the preceding year.

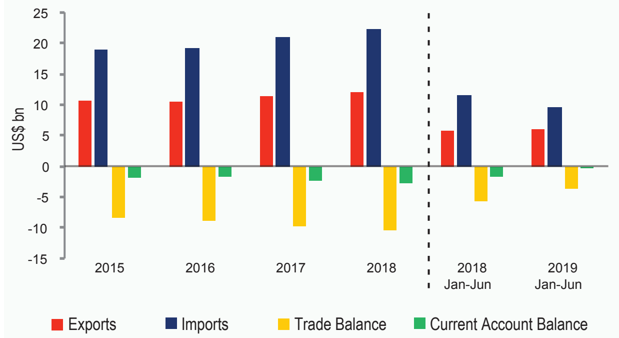
- **In line with the favourable developments in the supply side and subdued demand conditions, inflation broadly remained in the desired range during the first nine months of 2019, although core inflation witnessed an elevation since January 2019, mainly due to a one-off adjustment in house rentals.** Headline inflation accelerated to some extent until May 2019, driven by the upward adjustments to administratively determined prices, including formula based domestic petroleum prices, the increase in house rentals, tariff revisions, as the lagged effect of the sharp depreciation of the rupee in late 2018. Subsequently, headline

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



Source: Department of Census and Statistics

Figure 1.4
Trade Balance and Current Account Balance



Source: Central Bank of Sri Lanka

inflation decelerated to low levels, due to declining food prices, before accelerating again by September 2019 driven by increased food prices. Accordingly, headline inflation, as measured by the year-on-year change in both the Colombo Consumer Price Index (CCPI, 2013=100) and the National Consumer Price Index (NCPI, 2013=100) accelerated to 5.0 per cent in September 2019. Meanwhile, core inflation, which experienced an uptick in January 2019, mainly due to the one-off adjustment in house rentals, broadly remained in mid-single digit levels thereafter. Accordingly, year-on-year core inflation based on both CCPI and NCPI stood at 5.6 per cent in September 2019. The impact of this one-off adjustment is expected to continue in 2019 before wearing off in January 2020. Impacted by the food price volatility, inflation is likely to remain around the upper bound of the desired range of 4-6 per cent during the remainder of 2019. Over the medium term, inflation is expected to be maintained within the desired range supported by timely monetary policy measures and well anchored inflation expectations.

External Sector

- **Sri Lanka's external sector strengthened in 2019, recovering from a significantly volatile second half of 2018.** The external current account recorded a surplus in the first quarter of 2019, with a substantial contraction in the trade deficit along with healthy flows to the services account. However, the current account was adversely affected in the second quarter of 2019 in the aftermath of the Easter Sunday attacks, which resulted in a significant decline in earnings from tourism. Consequently, despite the continued contraction in the trade deficit, the current account recorded a deficit in the second quarter of 2019. These developments resulted in the current account recording a marginal deficit of US dollars 225 million in the first half of 2019, compared to a deficit of US dollars 1,609 million in the first half of 2018.

- **The deficit in the trade account contracted notably during the first eight months of 2019.** This was led by the substantial contraction in import expenditure and the moderate improvement in export earnings. Earnings from exports grew by 2.4 per cent, year-on-year, to US dollars 8,031 million during the first eight months of the year, while import expenditure declined by 14.6 per cent to US dollars 12,886 million. The favourable impact of the restoration of the EU GSP+ facility, conducive external trade policies together with improved institutional support as well as some trade diversion resulting from the US-China trade tensions helped increase export earnings during the period under review. The growth in exports mainly emanated from industrial exports, while agricultural and mineral exports declined during the period. Meanwhile, policy measures implemented to discourage excessive imports of gold, personal motor vehicles and certain categories of non-essential goods led to the deceleration of import expenditure during the first eight months of 2019. Consequently, the trade deficit contracted by US dollars 2,386 million to US dollars 4,854 million during the first eight months of 2019, in comparison to US dollars 7,240 million in the corresponding period of 2018.

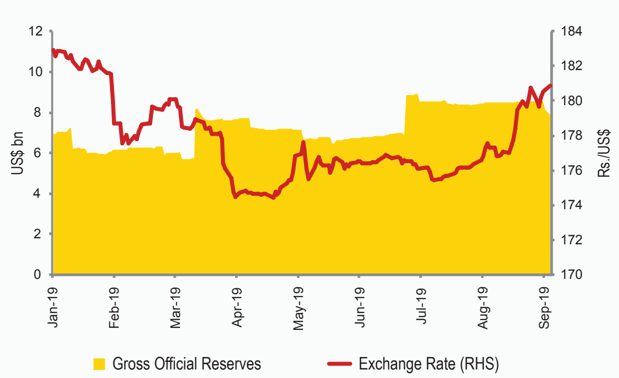
- **Other inflows to the current account remained moderate in the first half of 2019, with tourism related activities being impacted by the Easter Sunday attacks.** The surplus in the services account recorded a significant setback, with the slowdown in tourist earnings from late April. The transport services sector was also impacted in the second quarter while computer services continued to record a notable growth in the first half of the year. The deficit in the primary income account widened with outflows due to repatriation of dividends and reinvested earnings of Direct Investment Enterprises (DIEs). Workers' remittances also remained subdued in the first half of the year. Accordingly, the current account deficit in the first half of 2019 stood at US dollars 225 million compared to the deficit of US dollars 1,609 million recorded in the first half of the previous year.

- **The financial account strengthened with continued foreign exchange inflows during the first half of 2019.** The major inflow to the financial account was from the issuance of ISBs in March and June 2019, amounting to US dollars 4.4 billion, while US dollars 1.5 billion was repaid for maturing ISBs during the first half of 2019. However, most other inflows to the financial account remained moderate in the first half of 2019. Foreign direct investment (FDI), including foreign loans, amounted to US dollars 501 million in the first half of 2019, in comparison to US dollars 1.4 billion in the first half of 2018, which included the proceeds from the long-lease of the Hambantota Port. Portfolio investments in the form of equity recorded only a marginal net inflow in the first half of 2019 while foreign investments in Treasury bills and Treasury bonds recorded a net outflow in the first half of 2019. The government, deposit-taking corporations, the private sector and state-owned business enterprises (SOBEs), recorded net repayments in foreign loans in the first half of 2019. However, liabilities of the Central Bank increased with the receipt of the sixth tranche of the IMF-EFF. The private sector trade credits increased marginally, mainly due to the increase in outstanding trade credits of the Ceylon Petroleum Corporation (CPC). A strengthened financial account, together with a lower current account deficit, helped augment the overall balance in the Balance of Payments (BOP) during the first nine months of 2019.

- **Gross official reserves increased by end September 2019 with higher inflows to the financial account.** Gross official reserves increased to US dollars 7.6 billion by end September 2019 from US dollars 6.9 billion at end 2018. This was mainly due to the receipt of the ISB proceeds, purchase of foreign exchange by the Central Bank from the domestic market and the receipt of the sixth tranche of the IMF-EFF. The country's gross official reserves at end September 2019, were sufficient to finance 4.6 months of imports. Meanwhile, total international reserves, which consist of gross official reserves and foreign assets of commercial banks, also increased to US dollars 11.3 billion by end August 2019. This was sufficient to finance 6.8 months of imports.

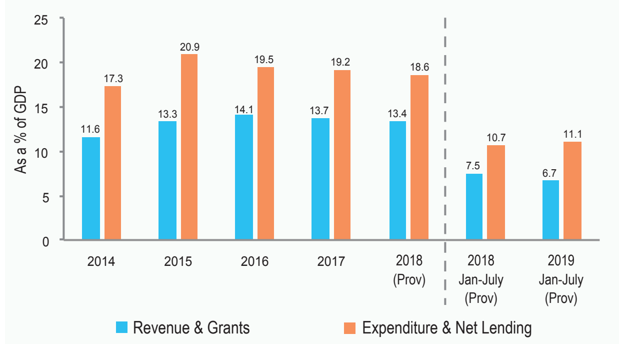
- **Following the significant depreciation in 2018, the exchange rate showed greater stability thus far in 2019.** The exchange rate appreciated by 4.6 per cent prior to the Easter Sunday attacks, supported by a significant contraction in the trade deficit and an increase of financial flows. The exchange rate experienced some pressure in the immediate aftermath of the Easter Sunday attacks and again in the second half of August reflecting the impact of heightened uncertainties in global markets, which resulted in some unwinding of foreign investment in the Government securities market, thereby offsetting some of the appreciation gains of the rupee. However, the subsequent improvement

Figure 1.5
Gross Official Reserves and Exchange Rate



Source: Central Bank of Sri Lanka

Figure 1.6
Government Revenue Vs. Expenditure



Source: Ministry of Finance

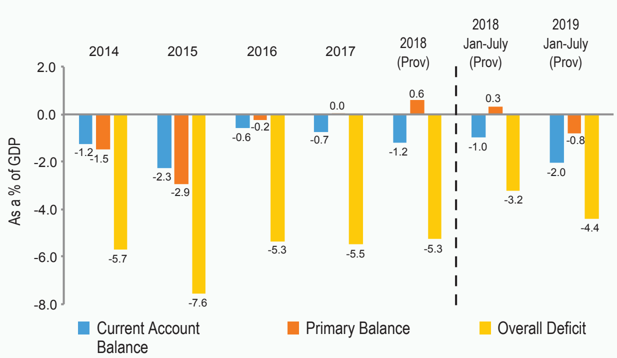
of liquidity conditions in the domestic foreign exchange market helped stabilise the exchange rate. Consequently, the rupee recorded an appreciation of 0.6 per cent by end October 2019. Meanwhile, during the year, the Central Bank was able to absorb foreign exchange from the domestic foreign exchange market when market conditions were benign. Reflecting cross currency exchange rate movements up to end October 2019, the Sri Lankan rupee appreciated against the Indian rupee (3.5 per cent) and the euro (3.1 per cent) while depreciating against the pound sterling (1.2 per cent) and the Japanese yen (1.0 per cent). During the period up to end September 2019, both the 5-currency and 24-currency Nominal Effective Exchange Rate (NEER) and Real Effective Exchange Rate (REER) indices increased, reflecting the nominal appreciation of the Sri Lankan rupee against most major currencies together with the movements in cross currency exchange rates. Meanwhile, the 5-currency and 24-currency REER indices increased by 3.65 per cent and 3.25 per cent, respectively. However, the REER indices remained below the base year level, supporting the country's trade competitiveness.

Fiscal Sector

- **The government implemented several fiscal measures primarily aimed at fiscal consolidation thus far during 2019, although the implementation of certain revenue proposals was delayed.** Several revisions were made to excise duties with a view to curtailing the importation of motor vehicles and discouraging the use of sweetened beverages and cigarettes in March 2019. In line with changes in international prices, customs duties on petroleum products and selected goods were revised, and changes were made to the Special Commodity Levy (SCL) from time to time with the aim of protecting both domestic producers and consumers. Meanwhile, fees and charges on several services, including the passport issuance fees, were increased. Measures aimed at strengthening tax administration such as the Revenue Administration Management Information System (RAMIS) and the National Single Window (NSW) continued with the objective of improving revenue mobilisation through an expansion in the tax base and enhanced tax compliance. Meanwhile, certain tax rate changes were introduced to strengthen the tourism related sectors affected by the Easter Sunday attacks. These included reducing the VAT rate on hotels and tour operators registered with the Sri Lanka Tourism Development Authority (SLTDA) to 7 per cent from the standard VAT rate of 15 per cent and granting a tax exemption for the importation of security equipment. Several amendments to the Inland Revenue Act proposed in the Budget 2019 on granting certain tax exemptions are expected to be implemented. In addition, the Ministry of Finance (MOF) instructed all ministries to limit their capital expenditure in 2019 and implement prudent expenditure control measures for rationalising recurrent expenditure. Measures were also taken by the government to promote Public Private Partnerships (PPPs) and easing the constrained fiscal space for the development of socio-economic infrastructure. Meanwhile, the selection methodology to identify low income families eligible for welfare payments under several major welfare programmes was submitted to the Parliament for approval. Public sector salaries were increased and pension anomalies were rectified with effect from 01 July 2019, while measures were also taken to enhance the efficiency of service delivery of pension payments through an automated process. Further, steps were taken to improve the financial viability of major SOBEs in order to reduce the burden on the central government budget. Meanwhile, measures were initiated to make use of the newly enacted Active Liability Management Act (ALMA) No. 8 of 2018, while a Medium-Term Debt Management Strategy (MTDS) for the period 2019-2023 was published in 2019.

- **The fiscal performance deteriorated in the first seven months of 2019 amidst challenges due to the slowdown in imports, deceleration in overall economic activity as a result of the Easter Sunday attacks, and the delay in implementing certain revenue proposals announced in the Budget 2019, while recording a rise in expenditure.** During the first seven months of 2019, government revenue as a percentage of estimated GDP declined to 6.7 per cent from 7.5 per cent in the corresponding period of 2018 due to lower tax and non tax revenue collections. Total revenue, in nominal terms, declined by 4.4 per cent to Rs. 1,031.9 billion in the first seven months of 2019. The decline in tax revenue from excise duties on motor vehicles and petroleum products, and VAT on domestic goods and services mainly led to the underperformance in the revenue collection. However, revenue from income taxes, Nation Building Tax (NBT), import duties and PAL increased, in nominal terms, during this period. Non-availability of distributable profits of the Central Bank and the reduction in profits and dividend transfers from SOBEs contributed to the decline in non tax revenue during the period under review. Total expenditure and net lending increased to 11.1 per cent of estimated GDP during the first seven months of 2019 in comparison to 10.7 per cent reported in the corresponding period of 2018 mainly due to the increase in recurrent expenditure. Reflecting the increase in interest payments and subsidies and transfers, recurrent expenditure as a percentage of estimated GDP increased to 8.7 per cent during this period from 8.4 per cent recorded in the corresponding period of 2018. Capital expenditure and net lending, as a percentage of estimated GDP, increased marginally to 2.4 per cent during the period under review. As a result, the budget deficit increased to 4.4 per cent of estimated GDP during the first seven months of 2019 from 3.2 per cent in the same period of 2018, while the current account deficit increased to 2.0 per cent of estimated GDP during the first seven months of 2019 from 1.0 per cent of estimated GDP in the corresponding period of 2018, exhibiting continuous dissavings of the government. The primary balance deteriorated to a deficit of 0.8 per cent of estimated GDP (Rs. 122.5 billion) during the period under review from a surplus of 0.3 per cent of GDP (Rs. 47.1 billion) in the same period of 2018.

Figure 1.7
Key Fiscal Balances



Source: Ministry of Finance

- **The overall budget deficit of Rs. 684.1 billion recorded during the first seven months of 2019 was financed largely through domestic sources.** Net domestic financing during this period amounted to Rs. 571.4 billion compared to Rs. 187.6 billion recorded in the same period of 2018. Net foreign financing declined to Rs. 112.7 billion during the period under consideration, in comparison to Rs. 274.1 billion in the same period of 2018. The central government debt stock, which stood at Rs. 11,977.5 billion at the end of 2018, expanded by Rs. 668.4 billion to Rs. 12,645.9 billion as at end July 2019. The outstanding domestic debt increased by Rs. 435.1 billion to Rs. 6,453.1 billion, while foreign debt increased by Rs. 233.2 billion to Rs. 6,192.8 billion. The increase in net financing owing to the expansion in the budget deficit contributed significantly to this increase in the debt stock.

Monetary Sector

- **Amidst subpar economic growth that was further affected by the Easter Sunday attacks, rapidly decelerating private sector credit and muted inflation expectations, the Central Bank moved to an accommodative monetary policy stance in 2019 in line with the increasingly accommodative global monetary policy stance.** In order to address large and persistent deficit levels in the domestic money market observed since mid September 2018, the Central Bank reduced the Statutory Reserve Ratio (SRR) applicable on all rupee deposit liabilities of commercial banks by a total of 2.50 percentage points in November 2018 and March 2019, while maintaining a neutral monetary policy stance amidst pressures mainly emanating from the external sector. As a result, domestic money market liquidity improved and turned to surplus levels from mid April 2019. Accordingly, the overnight interbank call money rate, which remained around the upper bound of the policy rate corridor due to deficit liquidity, gradually started to decline towards the middle of the policy rate corridor from March 2019. Considering subdued economic growth, muted inflationary pressures and continued deceleration in private sector credit amidst high market interest rates, the Central Bank moved to a relaxed monetary policy cycle by reducing policy interest rates, namely the Standing Deposit Facility rate (SDFR) and the Standing Lending Facility Rate (SLFR), by 50 basis points to 7.50 per cent and 8.50 per cent, respectively, in May 2019. In addition, considering the high real interest rates on deposit and lending products in the economy and the need to expedite monetary policy transmission through the financial system, temporary caps on deposit rates of financial institutions were imposed with effect from 26 April 2019. As a result of these measures as well as eased monetary conditions, market interest rates, particularly,

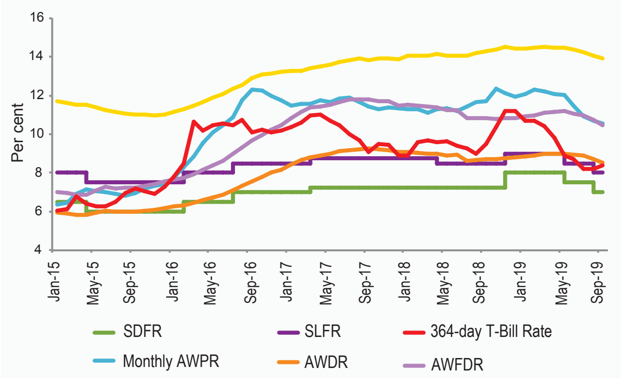
Table 1.1
Recent Monetary Policy Measures

Date	Measure
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% was rationalised to a maximum of three times per calendar month. Any deposits 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	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	SDFR and SLFR increased by 50 basis points to 6.50% and 8.00%, respectively.
28 Jul 2016	SDFR and SLFR increased by 50 basis points to 7.00% and 8.50%, respectively.
24 Mar 2017	SDFR and SLFR increased by 25 basis points to 7.25% and 8.75%, respectively.
4 Apr 2018	SLFR reduced by 25 basis points to 8.50%. Accordingly, the width of the SRC narrowed to 125 basis points from 150 basis points.
14 Nov 2018	"SRR reduced by 1.50 percentage points to 6.00% to be effective from the reserve period commencing 16 Nov 2018. SDFR increased by 75 basis points to 8.00% and SLFR increased by 50 basis points to 9.00%. Accordingly, the width of the SRC narrowed to 100 basis points from 125 basis points.
22 Feb 2019	"SRR reduced by 1.00 percentage point to 5.00% to be effective from the reserve period commencing 01 Mar 2019.
31 May 2019	SDFR and SLFR reduced by 50 basis points to 7.50% and 8.50%, respectively.
23 Aug 2019	SDFR and SLFR reduced by 50 basis points to 7.00% and 8.00%, respectively.

Note: The Central Bank imposed interest rate caps on deposit products of licensed banks and non - bank financial institutions with effect from 26 April 2019. The Central Bank imposed caps on lending rates while withdrawing caps on deposits rates of licensed banks with effect from 24 September 2019.

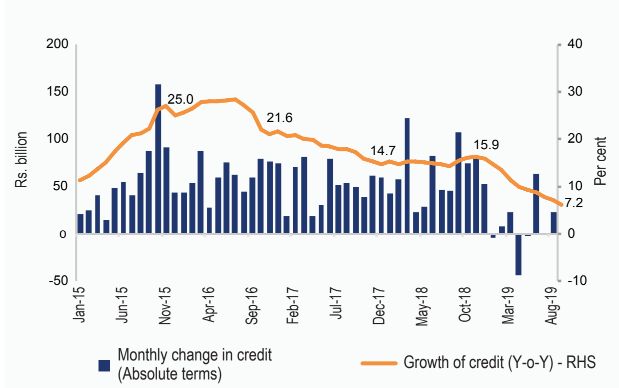
Source: Central Bank of Sri Lanka

Figure 1.8
Movements in Selected Market Interest Rates



Source: Central Bank of Sri Lanka

Figure 1.9
Credit Granted by Commercial Banks to the Private Sector



Source: Central Bank of Sri Lanka

market deposit rates and yields on Government securities started to adjust downwards. The Central Bank further reduced the SDFR and the SLFR by 50 basis points to 7.00 per cent and 8.00 per cent, respectively, in August 2019, with a view to inducing a sizable reduction in lending rates amidst favourable inflation outlook. Despite the continued accommodative monetary policy stance as well as reduced cost of funds, market lending rates did not adjust downwards commensurate to the decline observed in deposit interest rates. To address these unduly persistent lags in the transmission of policy measures to lending rates, the Central Bank imposed temporary caps on lending rates on 24 September 2019 to enhance the efficiency of the transmission of recent policy decisions to market lending rates, while removing deposit rate caps on licensed banks. Consequent to these monetary and regulatory measures of the Central Bank, a sizable reduction in lending rates is expected, which will gradually enhance the demand for credit, thereby contributing to economic activity.

- **Broad money (M2b) growth moderated during the first eight months of 2019 driven by the continued deceleration in private sector credit growth amidst subdued economic activity.** Accordingly, the year-on-year growth of M2b decelerated to 7.7 per cent by end August 2019 compared to 13.0 per cent at end 2018, while its average growth stood at 9.5 per cent during the first eight months of 2019 in comparison to a growth of 14.7 per cent during 2018. The moderate expansion in net domestic assets (NDA) of the banking sector contributed positively to M2b growth during the first eight months of 2019 while net foreign assets (NFA) of the banking sector recorded a negative year-on-year growth during the period. Within NDA, credit growth to the private sector continued to moderate during the first eight months of 2019 mainly due to the high market lending rates, subdued economic activity and monetary, fiscal and regulatory action taken by the Central Bank and the government to contain macroeconomic imbalances observed particularly in 2018. Accordingly, the year-on-year growth of credit to the private sector decelerated to 7.2 per cent by end August 2019 compared to a growth of 15.9 per cent at end 2018. In absolute terms, credit to the private sector increased only by Rs. 64.7 billion during the first eight months of 2019 compared to the substantial increase of Rs. 449.1 billion in the corresponding period of 2018. Meanwhile, credit obtained by the government (net) from the banking sector (NCG) continued to increase during the first eight months of 2019, entirely due to the increase in NCG by licensed commercial banks (LCBs) through increased investment in Government securities. Accordingly, NCG by the banking system increased by Rs. 235.7 billion during the first eight months of 2019 compared to an increase of Rs. 103.4 billion in the corresponding period of 2018. NCG by LCBs increased by Rs. 357.5 billion during the first eight months of 2019 compared to the increase of Rs. 82.7 billion during the corresponding period of 2018. Reduction of SRR by 2.50 percentage points in two occasions in November 2018 and March 2019 provided additional liquidity to LCBs in an environment of low demand for private sector credit. This resulted in a notable increase in investment in Government securities by LCBs. Due to the decline in the Treasury bill holdings (net of repurchase transactions) of the Central Bank, NCG from the Central Bank showed a notable decline by Rs. 121.9 billion during the first eight months of 2019 in contrast to an increase of Rs. 20.7 billion during the corresponding period of 2018. Following the repayments made by some key state owned business enterprises (SOBEs) to the banking sector, credit to public corporations declined during the first eight months of 2019. Accordingly, credit obtained by SOBEs from the banking system declined by Rs. 8.5 billion during the first eight months of 2019 compared to an increase of Rs. 102.5 billion in the corresponding period of 2018 and the increase of Rs. 218.4 billion in 2018.

- **While the Central Bank, through its conduct of monetary policy within an enhanced monetary policy framework, has been successful in maintaining inflation at desired levels, the envisaged transition to a Flexible Inflation Targeting (FIT) regime, is expected to facilitate and reinforce the Central Bank's efforts in stabilising inflation in mid-single digit levels over the medium term, thereby paving the way for a sustainable growth trajectory.** Substantial progress has been made by the Central Bank in institutionalising the key reforms required for the smooth transition to a FIT framework. The required amendments to the Central Bank law have already been drafted with a view to improving governance of the CBSL; strengthen Central Bank independence and facilitate the adoption of FIT as the monetary policy framework to ensure sustained price stability; and strengthen financial sector oversight. In addition, the Central Bank has allowed the exchange rate to be increasingly market based, while also allowing policymaking and policy formulation to be more forward looking and data driven, with greater transparency in monetary policy communication.

Financial Sector

- **A moderate expansion was observed in the Financial sector.** Subdued economic activity, stress caused by the Easter Sunday attacks, political uncertainties as well as policy actions taken by the government and the Central Bank to address macroeconomic imbalances that prevailed in the previous year, created a challenging business environment for financial institutions. The banking sector asset base expanded moderately compared to the corresponding period of 2018. The increase in the asset base was mainly contributed by the increase in investments, while loans and advances decelerated during this period owing to low demand for credit. Credit granted to tourism, financial services and construction sectors recorded a decline while credit granted to the other main sectors increased. Deposits continued to be the main source of funding in the banking sector, but recorded a lower growth compared to the asset growth with the imposition of caps on deposit interest rates aimed at reducing cost of funds of financial institutions. Despite challenges faced due to rising Non-Performing Loans (NPLs), the banking sector complied with the enhanced capital requirements under Basel III and maintained other prudential ratios at satisfactory levels. The Licensed Finance Companies (LFCs) and Specialised Leasing Companies (SLCs) sector performance slowed down amidst the policy measures to reduce motor vehicle imports, modest economic growth, challenging business environment and spillover effects of the Debt Relief programme launched by the Ministry of Finance in August 2018. The weakened performance of the sector was reflected by subdued credit growth, declining profitability and rising NPLs. The Central Bank continued to take action on reviving companies with weak financial positions while limiting finance business operations of certain other weak finance companies to safeguard depositors and to ensure the long term stability of the financial sector. Other financial institutions sector which includes insurance, primary dealers, unit trusts and stockbrokers showed mixed performance during the first half of 2019.

- **Overall rupee liquidity in the domestic money market remained volatile during the first nine months of the year and the Central Bank conducted OMOs to maintain adequate liquidity in the market.** While the year commenced with deficit levels of liquidity, it remained in surplus in late April through early August, before turning short again. During the first nine months of 2019, trading volumes in the domestic foreign exchange interbank market increased while the Central Bank was a net buyer in the domestic foreign exchange market. Yields on Government securities witnessed a notable decline thus far during the year. Primary market yields on Government securities declined, underpinned by the accommodative monetary policy stance and the availability of foreign financing through ISBs. Yields on Government securities in the secondary market also eased, with a steeper shift in the shorter end of the yield curve. In the meantime, with weak foreign interest, stock market performance remained sluggish thus far during the year. Meanwhile, the national payment system continued to facilitate economic activities of the country while introducing a number of measures to develop the national payment infrastructure, particularly in relation to digital payments.

International Economic Environment

- **The October 2019 release of the World Economic Outlook (WEO) of the IMF warned of the precarious status of the global economy as growth projections for 2019 and 2020 were downgraded amidst a synchronised slowdown of the global economy.** The global growth projection for 2019 was further downgraded to 3.0 per cent from its previous update of 3.2 per cent (July 2019), which is also the slowest pace of growth to be recorded since the global financial crisis. Although global growth is expected to record a modest improvement in 2020, it was also revised downward by 0.2 per cent from the April WEO projections to 3.4 per cent. The lacklustre performance of the global economy stems from rising trade tensions, geopolitical uncertainties, macroeconomic strains in several emerging market economies and structural hindrances such as aging demographics and low productivity growth in advanced economies. Against this challenging backdrop, the global economy is buoyed by the absence of inflationary pressures, which has paved way for major central banks to adopt accommodative monetary policies to support growth. Such monetary stimulus is expected to not only support global growth but neutralise some effects of the US-China trade tensions.

- **Weaker external demand, far-reaching repercussions of trade tensions, uncertainties dampening investor confidence and investment and notable slowdown in manufacturing due to climate related regulation would negatively impact the growth momentum of advanced economies, which are expected to grow by 1.7 per cent in 2019 as well as in 2020.** Growth projections for the United States were revised upward to 2.4 per cent in 2019 (from 2.3 per cent in the April 2019 WEO) followed by the expectation of a moderation in 2020 with growth of 2.1 per cent (from 1.9 per cent in the April 2019 WEO). The upward revisions reflect the recent adoption of the two-year budget deal and the benefits accruing from the Federal Reserve's accommodative monetary policy stance. Growth projections for the Euro area stood at 1.2 per cent and 1.4 per cent in 2019 and 2020, respectively, as the region is expected to be weighed down by the muted growth in foreign demand and weak industrial production. Growth projections for 2019 for key member economies such as France and

Germany were revised slightly downwards owing to weaker than expected external demand while forecasts for other countries such as Italy and Spain also depicted weak growth prospects. Despite the slowdown in the global growth momentum, the assumption of a smooth exit from the Euro Area alongside the recent announcement of higher public spending, is expected to leave growth prospects of the United Kingdom broadly unchanged, as the economy is projected to grow by 1.2 per cent in 2019 and 1.4 per cent in 2020. Japan's economy is projected to grow by 0.9 per cent in 2019 as strong private consumption and public spending during the first half of 2019 offset prevailing weaknesses in the external sector in the near term, and is to be followed by a modest growth of 0.5 per cent in 2020.

- **Among emerging market and developing economies, growth projections for all major regions except emerging and developing Europe were revised downwards, resulting in growth projections of 3.9 per cent in 2019 followed by a pick up to 4.6 per cent in 2020.** While the world economic growth is driven by emerging and developing Asia, growth in the region is softening, particularly as a result of the structural slowdown in China. Despite the impact of trade tensions and subdued external demand alongside debt accumulation, policy stimulus is expected to bolster the Chinese economy, which is now projected to grow at 6.1 per cent and 5.8 per cent in 2019 and 2020, compared to the previous projections of 6.2 per cent and 6.0 per cent for 2019 and 2020, respectively. India's growth is forecast to slow noticeably to 6.1 per cent in 2019 from its previous projection of 7.0 per cent, but is expected to gather pace in the following year. Although growth prospects for the Indian economy are negatively impacted by a weak outlook for demand, the economy is expected to be supported by the recent easing of monetary policy with a lag. Despite the upward revision to growth projections for emerging and developing Europe, its growth remains subdued, impacted by the slowdown in Russia and the plateauing of economic activity in Turkey. Growth projections for Latin America were substantially revised downward to 0.2 per cent in 2019 largely as a result of bleak growth prospects for Brazil, Mexico, Argentina, Chile and Venezuela. Despite a subdued growth forecast of 0.9 per cent for the Middle East and Central Asia region for 2019, growth is expected to recover to 2.9 per cent in 2020. The near term outlook for Saudi Arabia and Iran is surrounded by geopolitical uncertainties pertaining to oil related economic activity.

- **The medium term outlook on global growth remains fragile on account of several emerging challenges, ranging from broad based structural issues in advanced economies to more idiosyncratic factors observed in a few key emerging market economies.** Global growth projections highlight that growth remains subdued and rather precarious, with the balance of risks skewed to the downside. Amidst recent monetary policy easing measures and the possibility of easing of trade tensions and the averting of a no-deal Brexit, the recovery hinges on steady growth in several emerging market economies as growth is projected to moderate in the United States and China. Disruptions to the trade and supply chains can deepen the harm inflicted on investment and can cause dislocation of global supply chains while negating longlasting benefits that accrue from global value chains such as technology spillovers, productivity and output growth. Continuation of contemporary uncertainties, such as trade tensions, protracted fiscal policy uncertainty, deteriorating debt dynamics and a sharp slowdown in key economies can cause disruptive declines in the risk appetite of investors. New and emerging challenges such as climate change can worsen inequality within countries, even among advanced economies, despite their perceived adaptability, thereby negatively impacting growth prospects. Beyond 2020, growth in advanced economies is expected to stabilise at around 1.6 per cent as the impact of aging demographics is expected to be negated by the projected modest rise in productivity. Although the medium term outlook for emerging market and developing economies suggests stabilisation of growth at around 4.8 per cent, there are marked differences across regions and individual economies with emerging and developing Asia projected to grow at around 6.0 per cent while Latin America is projected to recover but record a growth of below 3.0 per cent. Within emerging markets, China is projected to experience a gradual slowdown to 5.5 per cent by 2024 while the Indian economic growth is expected to firm and stabilise at about 7.3 per cent over the medium term.

- **The weak global growth momentum and subdued energy prices are expected to result in an abating of inflationary pressures among advanced and emerging market and developing economies.** Accordingly, headline consumer price inflation in advanced economies is expected to slow down to 1.5 per cent in 2019 from 2.0 per cent in 2018, but will rise to 1.8 per cent in 2020. Headline inflation in a vast majority of emerging market and developing economies is also expected to decline this year with the group projected to record a headline inflation of 4.7 per cent on average. The dismal growth prospects for the global economy have led to core inflation falling below target across several advanced economies while core inflation has been below historical averages in several emerging market and developing economies. In addition, price pressures stemming from commodity price movements have also been subdued. Oil prices, which recorded a sharp rebound at the beginning of 2019 largely due to supply disruptions, receded due to high production growth in the United States and dampened demand. The IMF projects that oil prices will continue to ease from US dollars 68.33 per barrel in 2018 to US dollars 61.78 per barrel in 2019 and further decline to US dollars 57.94 per barrel in 2020.

- **The Global Monetary Policy Tracker compiled by the US based think tank, Council on Foreign Relations, notes that monetary policy stance across the globe as at end September 2019 has reversed from a tightening stance to an easing one within the last twelve months, largely driven by the slowing pace of global growth and subdued inflation.** Following the lowering of its benchmark federal funds rate in July 2019, for the first time since 2008, and the subsequent 0.25 percentage point reduction in September, the Federal Reserve reduced the target range for the federal funds rate further in October 2019 by an additional 0.25 percentage point to 1.50 – 1.75 per cent. Despite the moderate growth in the US economy alongside strong labour market conditions, rates were lowered on account of the implications of global developments for the economic outlook and muted inflation pressures. The monetary policy stance of the Bank of England (BOE) remained unchanged, as interest rates were held at 0.75 per cent amidst further intensification of the trade war between the United States and China, the weakening of the outlook for global growth and uncertainties about the potential timing and nature of Brexit. The BOE reiterated that the increased uncertainty surrounding the nature of EU withdrawal signalled the presence of several different paths over the coming years, and that the response of monetary policy would not be automatic and could be in either direction. The European Central Bank (ECB) reduced its policy rates by 10 basis points to -0.50 per cent and revived its asset purchase programme, to reinforce the accommodative impact of lower policy rates. The Bank of Japan is also expected to further ease monetary policy during the remaining months of 2019 in response to concerns over heightened overseas risks which could derail the country's fragile economic recovery.

- **Central banks of emerging market economies also adopted accommodative monetary policies, taking the lead from advanced economy central banks, to bolster economic activity.** Amongst emerging market economies in Asia, the Reserve Bank of India (RBI) undertook five consecutive rate cuts amounting to a cumulative of 135 basis points in the first ten months of 2019 as concerns about a deepening economic slowdown persisted amidst subdued inflation. Bangko Sentral ng Pilipinas also

Table 1.2

Changes in the Policy Interest Rates of Selected Central Banks

Per cent

Country	Key Policy Rate	End 2016	End 2017	End 2018	End Oct 2019
Sri Lanka	Standing Deposit Facility Rate	7.00	7.25	8.00	7.00
	Standing Lending Facility Rate	8.50	8.75	9.00	8.00
Emerging Market Economies					
India	Repo rate	6.25	6.00	6.50	5.15
Malaysia	Overnight policy rate	3.00	3.00	3.25	3.00
Thailand	1-day bilateral repo rate	1.50	1.50	1.75	1.50
China	1-year yuan lending rate	4.35	4.35	4.35	4.35
Indonesia	7-day Reverse Repo Rate	4.75	4.25	6.00	5.00
Philippines	Overnight Reverse Repo Rate	3.00	3.00	4.75	4.00
Advanced Economies					
USA	Federal funds rate	0.50-0.75	1.25-1.50	2.25-2.50	1.50-1.75
UK	Bank rate	0.25	0.50	0.75	0.75
ECB	Refinance rate	0.00	0.00	0.00	0.00
Japan	Overnight call rate	-0.10	-0.10	-0.10	-0.10
Canada	Overnight rate	0.50	1.00	1.75	1.75
Australia	Cash rate	1.50	1.50	1.50	0.75
Sweden	Repo rate	-0.50	-0.50	-0.25	-0.25

Source: Websites of respective Central Banks

reduced its benchmark interest rate for the third time during the first ten months of this year to 4.00 per cent alongside reductions in reserve requirement ratios, as it attempted to bolster a slowing economy amidst the risk of weakening global growth. Bank Negara Malaysia reduced its overnight policy rate by 0.25 percentage points to 3.00 per cent in May 2019 for the first time since July 2016 due to an unexpected slowdown in growth stemming from weakening export performance. Subpar export performance was also a key concern for Bank Indonesia, which sought to stimulate its economy by cutting interest rates over four consecutive months since July 2019 to 5.00 per cent. The People's Bank of China reduced its new one-year benchmark lending rate, the Loan Prime Rate, twice thus far in 2019 to 4.20 per cent with the view of lowering borrowing costs against the backdrop of the US-China trade war. Further easing is expected as the country grapples with low growth performance stemming from faltering domestic and external demand. Against the general trend of accommodative monetary policies, the State Bank of Pakistan (SBP) hiked its main policy rate to 13.25 per cent citing increased inflationary pressures and short term impacts of increases in utility prices. Since 2018, SBP has undertaken nine rate hikes cumulatively raising the benchmark interest rate by 750 basis points.

Expected Developments

- **Although the Easter Sunday attacks dampened the growth in tourism and related sub sectors, these negative effects are expected to be short-lived and the economy is envisaged to regain its growth momentum gradually in the medium term.** Impacted by the effects of the Easter Sunday attacks, the economy is expected to grow by 3.0 per cent in 2019, following the moderate growth rates of 3.2 per cent and 3.4 per cent recorded in 2018 and 2017, respectively. Even though Sri Lanka's growth performance has been subdued in recent years, the economy is envisaged to revive gradually with the implementation of broad-based and coordinated policy action without delays. Archaic land policies, labour market issues such as stringent labour laws and the skills mismatch in the labour market, inadequate access to finance, lack of export diversification as well as high costs of doing business are identified as hindrances for faster economic growth. Therefore, it is imperative to implement growth promoting policies that have been outlined in the government's policy statements without further delays through a well-coordinated national plan. Meanwhile, policies that aim to create macroeconomic stability, such as fiscal consolidation, flexible inflation targeting and flexible exchange rate, are expected to boost the confidence of domestic as well as foreign investors, encouraging increased investment. Further, the government's continued endeavours in infrastructure development with the support of the private sector, especially related to road networks, telecommunication networks and ports and airports, are likely to support higher growth by providing a platform to harness all available resources in the economy for production processes, while stimulating productivity growth. With the expected decline in real interest rates, aggregate demand is expected to grow along with an expansion in production capacities, boosting overall economic growth. Meanwhile, the government has already taken steps to strengthen trade linkages with the rest of the world, but these initiatives need to be fast tracked to revive the country's economic growth. In addition, taking proactive measures to mitigate and manage the impact of natural disasters and adapting to regularly occurring disasters caused by climate change are vital to build the country's resilience. Meanwhile, other structural issues in the economy such as bureaucratic inefficiencies and the lack of energy security must be resolved to sustain a higher growth momentum.

- **Sri Lanka's external sector is projected to strengthen further in 2019 and over the medium term.** The trade deficit is expected to contract in 2019 with a continued contraction in imports and sustained growth in exports. Exports of merchandise goods are expected to maintain an upward momentum underpinned by strengthened trade relations with trading partners, conducive external trade policies together with strong institutional support and a competitive exchange rate. The escalating trade tensions between major economies could have positive, albeit marginal, trade diversion effects on Sri Lanka's trade performance. Nevertheless, the possible slowdown in global trade and global growth could have negative spillover effects on Sri Lanka's export earnings. Imports are expected to increase gradually over the medium term mainly due to an increase in intermediate goods in line with the expected growth in exports and tariff liberalisations, while imports of investment goods would also pick up with the gradual increase in activity over the medium term. The trade deficit as a share of GDP is expected to decline gradually over the medium term. The surplus in the services account is expected to improve steadily over the medium term, supported by a faster than expected recovery of the tourism industry and sustained inflows from sectors such as information technology, business process outsourcing, and transport services. The deficit in the primary income account in 2019 and beyond is expected to expand with rising interest payments owing to the increasing stock of external debt and high dividend payments. Meanwhile, workers' remittances are projected to remain modest over the medium term due to the decline in migration under the unskilled category, enhanced opportunities in the domestic labour market and unfavourable developments in some traditional migration destinations. Accordingly, the current account deficit, which is expected to improve in 2019, would remain at sustainable levels over the medium term. The financial account of the BOP is projected to improve in the medium term with continued inflows to the government and the private sector. Despite the deceleration in FDIs in 2019 due to dented investor sentiment following the Easter Sunday attacks and political uncertainties, FDIs are expected to rebound over the medium term mainly with expected investment to the Colombo Port City, the Hambantota industrial zone and inflows expected under Public Private Partnership (PPP) initiatives of the government. Further, net foreign investments to the CSE and the government securities market are also expected to improve over the medium term, supported by declining yields in global financial markets. In addition, the extension of the IMF-EFF programme until June 2020 would help bolster investor confidence. However, large debt service payments over the medium term would require substantial external financing, especially in the form of non-concessional arrangements such as ISBs, syndicated loans and foreign commercial loans. Against this backdrop, the Central Bank is expected to maintain a healthy level of foreign reserves over the medium term, while allowing the exchange rate to be flexible and competitive in line with the transition to the flexible inflation targeting regime.

- **Although the fiscal sector experienced several challenges during 2019, the fiscal consolidation programme is expected to revert to its envisaged path with the implementation of measures to enhance revenue, rationalise expenditure and improve debt management, thereby enhancing the overall strength of the fiscal sector over the medium term.** While the enactment of the new Inland Revenue Act (IRA) in 2018 resulted in an increase in government revenue, the timely implementation of the required reforms to widen the tax base, improve tax compliance and enhance tax administration through required revisions to the existing tax legislation alongside the introduction of measures to prevent revenue leakages, are expected to boost government revenue to around 16 per cent of GDP over the medium term. On the other hand, measures to rationalise recurrent expenditure and the effective implementation of procedures to better target welfare programmes together with the timely implementation of the required structural reforms in state owned business enterprises (SOBEs), particularly in the form of introducing cost reflective pricing formulae for utilities, with a view to improve their financial strength, could reduce the burden on government finances going forward. While these measures are expected to reduce government expenditure somewhat, the elections in late 2019 and 2020, together with the scheduled upward revision of public sector salaries in 2020 and 2021 could challenge the fiscal consolidation efforts of the government. Further, the prioritisation of capital expenditure with a view to keeping fiscal consolidation on track, could also slow economic expansion over the medium term. This highlights the need to promote Public Private Partnerships (PPP) to meet the infrastructure requirements of the country, particularly considering the limited fiscal space of the government. In the meantime, measures have been taken to define specific binding fiscal rules for Sri Lanka, for which approval has already been granted by the Cabinet of Ministers. The incorporation of these binding fiscal rules as an amendment to the Fiscal Management (Responsibility) Act (FMRA) No. 3 of 2003, would ensure greater fiscal discipline going forward. Supported by these measures, it is envisaged that the budget deficit would reduce from its current levels to a low and sustainable level over the medium term. More importantly, a sizeable and sustainable surplus in the primary balance and the current account would be required to attain and charter along the envisaged budget deficit trajectory. The continuation of the fiscal consolidation process, along with the effective adoption of the medium term debt management strategy (MTDS) and active liability management operations would ensure that government debt would decline to a sustainable level over the medium term.

- **While the Central Bank has made substantial progress over the past few years with respect to the institutionalisation of the conditions necessary for the successful transition towards flexible inflation targeting (FIT), the focus going forward would be to sustain this achievement with a view to ensuring price stability.** As an integral part of this process, the Central Bank, in consultation with other key stakeholders, embarked on drafting a new Central Bank law with a view to improving governance of the CBSL; strengthen Central Bank independence and facilitate the adoption of FIT as the monetary policy framework to ensure sustained price stability; and strengthen financial sector oversight. Approval for the draft Central Bank Act has been granted by the Cabinet of Ministers, and is expected to be tabled in the parliament shortly. As fiscal discipline remains a key cornerstone for the successful adoption of FIT, and as effective fiscal-monetary policy coordination remains a primary focus of the proposed amendments, the continued commitment of the government towards fiscal consolidation is imperative. These developments, together with forward looking monetary policy measures, would ensure that inflation is maintained at the desired mid-single digit levels over the medium term.

- **Recent monetary and regulatory measures adopted by the Central Bank are expected to enhance demand for credit by the private sector through lower market lending rates, thereby supporting the economy to leap towards a high growth trajectory.** The sluggish adjustment of market lending rates following several monetary policy measures adopted in late 2018 and 2019 warranted appropriate regulatory measures by the Central Bank. Accordingly, deposit rate caps were introduced for a short period with the view of reducing cost of funds of the financial sector. The muted response of market lending rates following the imposition of deposit rate caps, which was reflected through subdued credit expansion, necessitated intervention by the Central Bank in the form of imposing lending rate caps. It is expected that the temporary imposition of lending rate caps would bring down the overall interest rate structure of the economy, particularly lending rates, thereby boosting demand for credit and promoting greater economic activity. Further, low interest rates are expected to provide an environment conducive for businesses and business activity along with the gradual dissipation of uncertainties in the political sphere once the current election cycle is completed. Accordingly, a drop in non-performing loans (NPLs) could also be expected as repayment capacities of borrowers would improve in a low inflation – low interest rate environment with the gradual recovery of economic activity. Such downward adjustment of market interest rates will also be compatible with the envisaged mid single digit levels of inflation under the proposed FIT framework.

- **Facilitating private sector led growth with prudent and far reaching structural reforms are required to regain the growth momentum of the economy.** Structural issues related to factors of production, policy inconsistency and lack of coordination amongst the stakeholders as well as low investor confidence due to poor doing business conditions have contributed towards the recent sluggish economic performance of the country. Therefore, the country is in dire need of well-coordinated policies and structural reforms that aim at improving the country's macroeconomic fundamentals whilst strengthening the resilience of the economy against domestic and global headwinds. Timely implementation of such policies without any delays is imperative to enhance the investor climate, productivity, exports and investments of the economy, which are expected to propel the economy to a higher growth trajectory from the below potential growth path observed at present.