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OVERVIEW

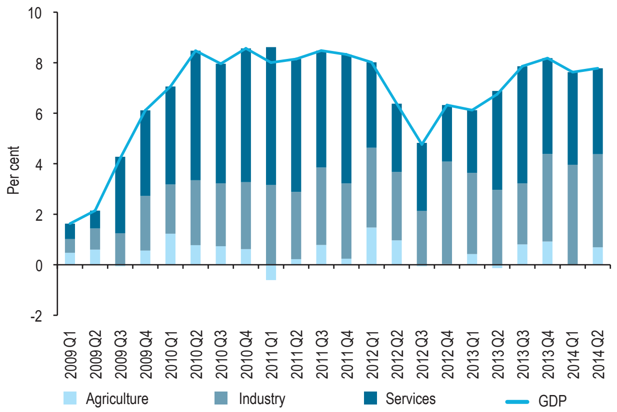
The Sri Lankan economy grew by 7.7 per cent in the first half of 2014, reflecting increased domestic economic activity and rising external demand. The conducive macroeconomic policy environment contributed to the strengthening of the growth momentum while global economic conditions continued to improve, particularly in export destinations, which supported domestic economic activity. Well managed demand pressures, favourable inflation expectations and supply side improvements resulted in consumer price inflation remaining below 5 per cent on a year-on-year basis thus far during the year. In the context of low inflation and benign inflation outlook, the Central Bank maintained a relatively eased monetary policy stance to provide further stimulus to economic activity and reduced the Standing Lending Facility Rate (SLFR) by 50 basis points in January 2014. Nevertheless, the reliance of the private sector on bank credit to finance economic activity moderated with increased availability of other domestic and foreign sources of financing. In this context, the Central Bank rationalised access to the Standing Deposit Facility with effect from 23 September 2014, to urge commercial banks to pursue credit disbursements more actively at reasonable interest rates.

The external sector strengthened further with improving global demand. Exports recorded a healthy growth while the growth of imports decelerated, resulting in a lower trade deficit. Improved performance in trade in services and increased workers' remittances largely offset the deficit in the merchandise trade account, thus containing the current account deficit to a sustainable level. Continued inflows to the private and public sectors strengthened the financial account of the Balance of Payments (BOP). Reflecting these developments, the BOP recorded a surplus of US dollars 1,954 million by end June 2014. Consequently, gross official reserves reached a historically high level of US dollars 9.2 billion at end August 2014. Meanwhile, the Sri Lankan rupee recorded a marginal appreciation against the US dollar so far during the year.

The thrust of fiscal policy in 2014 has been the continuation of the fiscal consolidation process while supporting growing economic activity and a more balanced distribution of benefits of growth. So far during the year, fiscal performance has been broadly on target, in spite of challenges posed by a shortfall in government revenue as a percentage of GDP.

The stability of the financial system was maintained while the sector expanded. The process of financial sector consolidation, aimed at strengthening financial institutions further, progressed as planned. Domestic financial markets remained liquid, and the stock market and the corporate debt market gathered further momentum.

Chart 1.1 Real GDP Growth and Sectoral Contribution to Growth



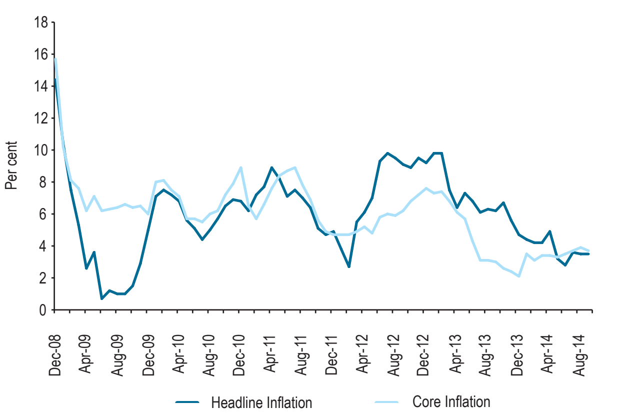
- **The Sri Lankan economy recorded a growth of 7.7 per cent in real terms during the first half of 2014.** Strengthening domestic economic activity and improving external demand contributed to the growth momentum. In the first quarter of 2014, the Agriculture sector grew only by 0.2 per cent due to adverse weather conditions, but the sector rebounded to record a growth of 6.4 per cent in the second quarter, resulting in a growth of 3.1 per cent in the first half of the year. The Industry sector grew by 12.4 per cent with continued high performance in Construction, Mining and quarrying and Manufacturing sub sectors. The Services sector grew by 6.1 per cent with improved performance in the Wholesale and retail trade, Transport and communication, and Hotels and restaurants sub sectors. The growth momentum is expected to continue in the second half of the year resulting in an annual real GDP growth rate of around 7.8 per cent in 2014.

- **Domestic savings are projected to increase to around 22.6 per cent of GDP in 2014 from 20 per cent in 2013, while gross investment is projected to reach 30.1 per cent of GDP in 2014, up from 29.6 per cent recorded in the previous year.** National savings are projected to increase to 28.4 per cent of GDP from 25.7 per cent in 2013 with increased workers' remittances. Private savings are expected to increase along with a reduction in government dissavings. Public investment is expected to reach 6.7 per cent of GDP with continued government investment in infrastructure projects.

- **The unemployment rate declined to 4.1 per cent during the first quarter of 2014 from 4.6 per cent in the first quarter of 2013.** The decline in unemployment among females to 6.1 per cent in the first quarter of 2014 compared to 7.0 per cent in the corresponding period of the previous year mainly contributed to this improvement. Unemployment amongst males also declined to 3.0 per cent from 3.3 per cent in the corresponding period of the previous year.

- **Both headline and core inflation remained below 5 per cent during the first nine months of 2014.** Headline inflation (year-on-year) continued to record single digit levels for the 68th consecutive month, while core inflation remained equally subdued, indicating well contained demand driven inflationary pressures. Marginal variations in inflation were observed during the period due to domestic supply disruptions stemming from adverse weather conditions, although global commodity prices moderated. Year-on-year inflation was 3.5 per cent in September 2014 while core inflation was recorded at 3.7 per cent. Going forward, particularly with the recent downward revisions

Chart 1.2 Year-on-Year Inflation



to domestic energy prices, inflation is projected to remain around 4 per cent during the remainder of 2014.

- **External merchandise trade, which rebounded in the second half of 2013, continued to perform well during the first eight months of 2014.** Earnings from exports during the first eight months of 2014 recorded an increase of 14.8 per cent to US dollars 7,385 million driven by textile and garments, tea and coconut exports. Favourable developments in major export markets, continuous improvements in domestic industries with new technologies, and accommodative macroeconomic environment contributed to the improved performance in exports. Meanwhile, the expenditure on imports for the first eight months of 2014 increased at a slower pace of 4.6 per cent to US dollars 12,555 million from US dollars 12,002 million recorded in the corresponding period of 2013. The lower dependency of the textile and garment industry on imported raw material and the availability of machinery and equipment imported in the past few years also lowered the import demand during this period. Accordingly, the trade deficit narrowed to US dollars 5,170 million during the first eight months of 2014 from US dollars 5,568 million in the corresponding period of the previous year.

- **Trade in services (net) continued to expand recording a notable growth of 49.9 per cent to US dollars 817 million during the first half of the year compared to US dollars 545 million recorded in the corresponding period of 2013.** This growth was broadbased with all sub sectors in the services account performing well during the period. Inflows on account of transport services recorded a growth of 16.1 per cent to US dollars 1,024 million during the first half of the year while gross inflows on account of computer and information services increased by 13.4 per cent to US dollars 337 million during this period. During the first nine months of the year, earnings from tourism amounted to US dollars 1,600 million, recording a 31.4 per cent increase over the corresponding period of 2013, driven by the growth in tourist arrivals and increased spending by tourists.

- **The primary income account of the BOP recorded a higher deficit during the first half of 2014 as a result of increased dividend payments, reinvestment of retained earnings and interest payments.** The deficit in the primary income account during the first half of 2014 was US dollars 918 million in comparison to US dollars 813 million in the corresponding period of 2013. During this period, outflows on account of dividend payments and reinvestment of retained earnings increased substantially by 27.7 per cent to US dollars 365 million while interest payments increased to US dollars 69 million primarily on account of coupon payments on bonds issued by licensed commercial and licensed specialised banks.

- **Workers' remittances, which account for a greater share of the secondary income account, grew by 10.0 per cent to US dollars 4,515 million during the first eight months of 2014.** The increase in labour migration under skilled and professional categories as well as increased awareness on remitting money through formal channels have contributed to the significant growth in workers' remittances. Meanwhile, labour migration under unskilled categories including domestic workers decreased by 10.9 per cent during the first half of the year, partly due to increasing employment opportunities locally.

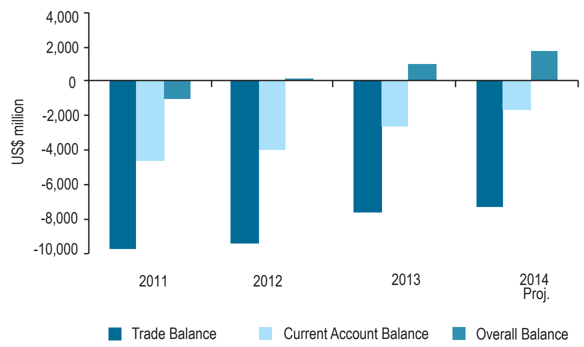
- **The external current account deficit contracted to US dollars 677 million during the first six months of 2014 compared to a**

deficit of US dollars 2,060 million during the corresponding period of 2013. A substantial increase in earnings from export of goods and also the export of services such as tourism, port and airport related services and computer and information services, together with an increase in workers' remittances, helped reduce the external current account deficit.

- **Inflows to the financial account continued to increase during the first half of 2014.** The financial account recorded a net acquisition of assets of US dollars 2.8 billion and a net incurrence in liabilities of US dollars 3.2 billion during this period. Total FDI including foreign loans to BOI companies increased by 54.8 per cent to US dollars 850 million during the first six months of 2014 from US dollars 549 million received during the corresponding period of 2013. Meanwhile, net inflows to the Colombo Stock Exchange (CSE) included US dollars 43.7 million to the secondary market and US dollars 4.4 million to the primary market, while the proceeds of the International Sovereign Bond issues amounting to US dollars 1.5 billion and foreign investments in Treasury bills and Treasury bonds at US dollars 196 million also contributed to the expansion of the financial account during the period. In addition, inflows to the government on account of long term loans during the first half of 2014 amounted to US dollars 601 million in comparison to US dollars 525 million during the corresponding period of 2013.

- **The BOP recorded a surplus of US dollars 1,954 million during the first half of 2014 as against a deficit of US dollars 169 million recorded during the corresponding period of 2013.** Improved trade balance, other inflows to the current account and enhanced inflows to the financial account contributed to this significant improvement in the BOP.

Chart 1.3 Balance of Payments



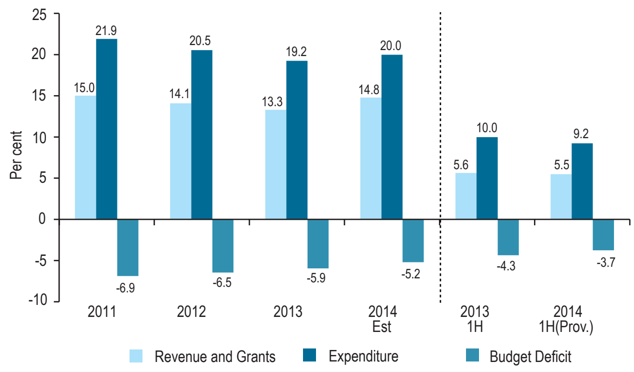
- **The improved performance in the external sector helped strengthen gross official reserves to a historic US dollars 9.2 billion at end August 2014.** The proceeds of the International Sovereign Bonds, disbursements under foreign funded projects and the purchases of foreign exchange from the domestic market mainly helped improve foreign reserves. In terms of months of imports, gross official reserves were sufficient to finance 5.9 months of imports at end August 2014. Adequacy of gross official reserves in terms of short term debt and liabilities, with and without Treasury bonds, is estimated to have improved to 76 per cent and 103 per cent, respectively.

- **The Sri Lankan rupee remained stable against the US dollar during the first nine months of the year, appreciating marginally by 0.3 per cent.** Continued inflow of foreign exchange by way of current, capital and financial flows helped maintain the stability of the rupee during this period. Reflecting the cross currency exchange rate movements, the Sri Lankan rupee appreciated against the Japanese yen by 4.5 per cent, the pound sterling by 1.8 per cent and the euro by 9.1 per cent, while depreciating against the Indian rupee by 0.3 per cent by end September 2014. The Central Bank intervention in the domestic foreign exchange market was mainly to absorb excess foreign exchange liquidity in order to prevent undue appreciation of the Sri Lankan rupee, particularly in the first eight months of the year. Accordingly, the Central Bank purchased US dollars 985 million from the domestic foreign exchange market on a net basis during the first nine months of 2014.

- **The effective exchange rate indices appreciated during the first nine months of the year.** Reflecting cross currency exchange rate movements and the nominal appreciation of the Sri Lankan rupee against most of the currencies in the currency basket, both the 5-currency and the 24-currency Nominal Effective Exchange Rate (NEER) indices appreciated by 3.2 per cent and 2.9 per cent, respectively, by end September 2014. The Real Effective Exchange Rate (REER) indices also appreciated during this period by 6.0 per cent and 5.4 per cent, respectively.

- **Fiscal management in 2014 remained challenging mainly due to the shortfall in government revenue as per centage of GDP despite government expenditure being maintained as a percentage of GDP during the first half of 2014 in line with the budgetary estimates.** Government revenue as a percentage of estimated GDP declined to 5.4 per cent in comparison to 5.6 per cent of GDP in the first half of 2013. A decline was observed in the collection of excise tax on petroleum products and cigarettes/tobacco and Economic Service Charge (ESC). Meanwhile, total expenditure and net lending as a percentage of estimated GDP declined to 9.2 per cent during the first half of 2014 from 10 per cent of GDP during the same period in 2013. Accordingly, the overall budget deficit during the first half of 2014 was 3.7 percent of estimated GDP compared to 4.3 per cent of GDP recorded during the first half of 2013 and the annual target of 5.2 per cent for 2014.

Chart 1.4 Government Revenue, Expenditure and Overall Fiscal Deficit (as a percentage of GDP)



- **During the first six months of the year, the overall fiscal deficit of Rs. 371.8 billion was financed mainly through foreign sources, which accounted for 65.1 per cent of the total financing requirement.** As a result, during the first half of 2014, net foreign financing increased significantly by 65.5 per cent to Rs. 242.1 billion while net domestic financing decreased by 44.1 per cent to Rs. 129.7 billion in comparison to the first half of 2013.

- **The monetary policy stance has remained relatively eased during the first eight months of 2014 supported by benign inflation levels, which reflected well contained demand pressures as well as improved supply conditions.** Several adjustments were introduced to streamline the policy interest rate corridor at the beginning of the year in line with the policies unveiled in the 'Road Map: Monetary and Financial Sector Policies for 2014 and Beyond'. Accordingly, the Central Bank established a Standing Rate Corridor (SRC) in place of the policy rate corridor while introducing Standing Deposit Facility Rate (SDFR) and Standing Lending Facility Rate (SLFR) that replaced, respectively, the Repurchase rate and the Reverse Repurchase rate of the Central Bank. Further, in consideration of the Central Bank's zero credit risk in rupee transactions, the standing deposit facility (SDF) was uncollateralised from February 2014, while all other Open Market Operations (OMO) transactions continued to remain collateral based. Reflecting the Central Bank's desire to curtail the volatility of interest rates in the short term money market further, on 2 January 2014, the Standing Rate Corridor was compressed to 150 basis points from 200 basis points by reducing the SLFR by 50 basis points. Since then, the SDFR and the SLFR have remained at 6.50 per cent and 8.00 per cent, respectively. In addition to these measures, considering the improvements in the external sector, the Central Bank decided to remove the minimum cash margin requirement of 100 per cent against Letters of Credit opened with commercial banks for the import of certain categories of motor vehicles, imposed on

Table 1.1 **Recent Monetary Policy Measures**

Date	Measure
3-Feb-2012	Repurchase rate and Reverse Repurchase rate increased by 50 bps to 7.50% and 9.00%, respectively.
9-Feb-2012	Greater flexibility in the determination of the exchange rate allowed
12-Mar-2012	Direction issued to licensed banks to limit rupee denominated credit growth to 18% or Rs. 800 mn during the year. Additional 5% (23% or Rs. 1 bn) allowed to banks that bridge the gap with funds raised abroad.
5-Apr-2012	Repurchase rate increased by 25 bps to 7.75% and Reverse Repurchase rate increased by 75 bps to 9.75%.
12-Dec-2012	Repurchase rate and Reverse Repurchase rate reduced by 25 bps to 7.50% and 9.50%, respectively.
31-Dec-2012	Ceiling on rupee denominated credit growth allowed to expire.
10-May-2013	Repurchase rate and Reverse Repurchase rate reduced by 50 bps to 7.00% and 9.00%, respectively.
26-Jun-2013	Statutory Reserve Requirement 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 bps to 6.50% and 8.50%, respectively.
2-Jan-2014	The Policy Rate Corridor was renamed as the Standing Rate Corridor (SRC), and the Repurchase rate and the Reverse Repurchase rate of the Central Bank were renamed as the Standing Deposit Facility Rate (SDFR) and Standing Lending Facility Rate (SLFR), respectively. SLFR reduced by 50 bps to 8.00%. The Standing Deposit Facility uncollateralised (with effect from 1-Feb-2014).
23-Sep-2014	Access to Standing Deposit Facility (SDF) rationalised. Accordingly, access to SDF by an OMO participant at the SDFR of 6.50% was limited to 3 times per calendar month. Any deposit in excess of 3 times will be at 5.00% p.a.

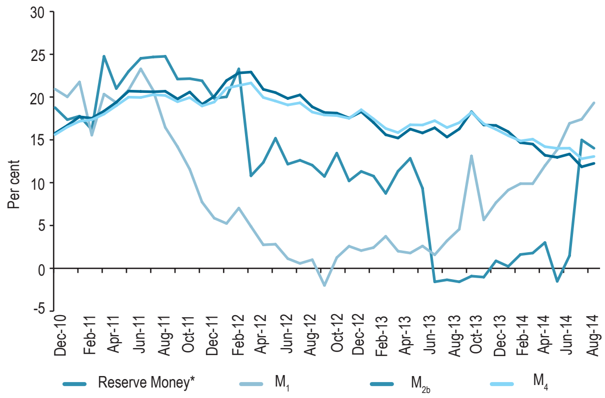
Source: Central Bank of Sri Lanka

30 August 2013, with effect from 2 January 2014. To encourage banks to lend more actively to the private sector, access to the SDF was rationalised as a temporary measure with effect from 23 September 2014. Accordingly, OMO participants including commercial banks would earn a lower rate of 5 per cent if they access the SDF of the Central Bank more than 3 times per calendar month.

- **Reserve money, on a quarterly average basis, was broadly in line with projections of the monetary programme during the first nine months of 2014.** Reserve money expanded during the period due to the expansion in net foreign assets (NFA) of the Central Bank. NFA of the Central Bank increased significantly by around Rs. 262 billion during the first eight months of the year, mainly as a result of the purchase of foreign exchange from the domestic foreign exchange market as well as from the proceeds of the International Sovereign Bond. Within net domestic assets (NDA), net credit to the government (NCG) from the Central Bank increased by Rs. 31.7 billion with the increase in provisional advances extended to the government by Rs. 36.9 billion, amidst a decline in the stock of Treasury bills held by the Central Bank. However, the increase in NDA was substantially dampened by the increase in other liabilities of the Central Bank, which was caused mainly by the increase in bonds borrowed for OMO purposes.

- **Monetary expansion was consistent with the continued growth momentum of the economy and moderating inflation.** The year-on-year growth of broad money (M_{2b}) decelerated to 12.3 per cent in August 2014 while the average growth of broad money during the first eight months of 2014 was 13.6 per cent. The deceleration in the expansion of monetary aggregates was largely due to the contraction in

Chart 1.5 Year-on-Year Growth of Monetary Aggregates



* Sudden changes in reserve money growth in particular months are due to revisions to SRR and seasonal factors

NDA of the banking system during first eight months of the year, led by the decline in credit extended to public corporations and to the private sector by commercial banks. However, the substantial increase in NFA of the banking system by Rs. 289 billion during the first eight months of 2014, outpaced the decline in NDA of the banking system. Partial settlement of foreign currency bank loans by domestic entities in particular, resulted in NFA of commercial banks increasing by Rs. 26.8 billion during this period.

- **Credit extended to the government remained within the levels envisaged in the Budget 2014.** NCG from the banking system was Rs. 60.9 billion during the first eight months of the year. NCG from commercial banks amounted to Rs. 29.2 billion and this was mainly a result of surplus bank funds being invested in government securities. Further, higher overdrawn balances of the government during this period also raised outstanding NCG from commercial banks. NCG by the Central Bank expanded by Rs. 31.7 billion during the first eight months of the year, entirely due to provisional advances to the government. Conversely, credit obtained by public corporations from commercial banks declined by Rs. 29.4 billion during this period following partial settlements by Ceylon Petroleum Corporation (CPC) and reduced borrowings by Ceylon Electricity Board (CEB), reflecting their improved financial performance. Road Development Authority (RDA), Sri Lanka Ports Authority (SLPA) and the two fertilizer corporations were among net borrowers during the first eight months of the year.

- **Eased access to foreign financial markets and improved domestic corporate debt and equity markets as well as the impact of lower gold prices that affected the pawning portfolio of the banking sector were reflected in the moderation of the growth of credit extended to the private sector by commercial banks during the first eight months of 2014.** Accordingly, the year-on-year growth of credit extended to the private sector decelerated to 2.6 per cent in August 2014 from 7.5 per cent at end 2013. As per the monthly survey on security-wise advances by commercial banks to the private sector, the year-on-year growth of credit excluding gold backed advances was 12.6 per cent in August 2014 in comparison to 15.1 per cent at end 2013. Further, as per the Quarterly Survey of Commercial Banks' Loans and Advances to the private sector, although credit to the Agriculture sector, and the Personal Loans and Advances categories contracted mainly due to the decline in pawning advances, there was a growth of credit to the Industry and the Services sectors, on a year-on-year basis. Growth of credit to the Industry sector increased to 14.2 per cent in June 2014 from 7.7 per cent in the corresponding period of the previous year while the growth of credit to the Services sector increased to 12.0 per cent in June 2014, compared to 6.9 per cent in the previous year. The continued downward adjustment of market lending rates is likely to generate increased demand for bank credit from the private sector during the remainder of the year, and signs of such increase were visible particularly in the month of August.

- **Reflecting monetary policy easing, market interest rates further adjusted downwards in the first nine months of 2014.** The average weighted call money rate (AWCMR), which moved towards the lower bound of the SRC during the year due to high levels of rupee liquidity in the market, declined further with the announcement of rationalising access to the SDF of the Central Bank. Yield rates on government securities declined significantly during the first nine months of 2014 to reach historically low levels due to excess liquidity in the domestic money market coupled with subdued demand for bank credit from the private sector. The average weighted deposit rate (AWDR) reduced to 6.83 per cent by end September 2014 from 9.37 per cent at end 2013. The average weighted fixed deposit rate (AWFDR), also declined to 8.18 per cent by end September 2014 compared to 11.78 per cent at end 2013. Commercial banks' lending rates also continued to adjust downward along with other market interest rates during the period under review with some rigidity in rates applicable on longer term advances being observed in the early part of the year. The weekly average weighted prime lending rate (AWPR) declined significantly by 381 basis points to a historically low level of 6.32 per cent by end September 2014 from 10.13 per cent at end December 2013. The monthly average weighted lending rate (AWLR) also decreased by 189 basis points to 13.29 per cent by end August 2014 from 15.18 per cent by end 2013.

- **The financial sector expanded and remained stable during the period under review.** The overall soundness of financial institutions improved with adequate capital and liquidity levels and an enhanced regulatory and risk management framework. The deceleration of credit growth however, impacted on the profitability of financial institutions. The financial sector consolidation process that was announced at the beginning of the year progressed well, and is expected to enhance the stability of the financial sector with strong and dynamic financial institutions. Domestic money market as well as the domestic foreign exchange market remained substantially liquid. The price indices of the CSE improved during the period under consideration, and market capitalisation surpassed a record level of Rs. 3 trillion by end September 2014. The corporate debt securities market continued to improve mainly as a result of recent tax incentives provided by the government. The payment and settlement system continued to support the smooth functioning of the financial system, operating with a high degree of availability and safety.

International Economic Environment

- **Although the indications that the global recovery is regaining momentum are stronger than in the previous years, some region- and country-specific concerns remain.** The weaker than expected economic performance in the first half of the year prompted the IMF to revise the global economic growth downward further by 0.1 per cent to 3.3 per cent for 2014 in its World Economic Outlook: October 2014. This follows a downward revision to the world growth forecast by 0.3 per cent in July by the IMF. The impact of factors such as disruptive weather and inventory correction that were observed in the first quarter has diminished and policies have already responded to weaker growth. However, the global economic performance in the second quarter was uneven. A modest increase in global growth to reach 3.8 per cent in 2015 is expected, with the anticipated stronger growth performance in some advanced economies and emerging economies. Nevertheless, geopolitical uncertainties, threat of deflation, increased volatility in financial markets, high debt levels and high unemployment in certain regions and countries continue to threaten a full recovery in global economic activity.

- **With a stronger performance in the second half of the year, advanced economies are projected to grow at a rate of 1.8 per cent in 2014 and 2.3 per cent in 2015 in comparison to a growth of 1.4 per cent recorded in 2013.** The United Kingdom is expected to record the highest growth amongst advanced economies, with a growth of 3.2 per cent in 2014 and 2.7 per cent in 2015. In the United States (US), adverse weather conditions at the beginning of the year resulted in a negative growth of 2.1 per cent in the first quarter. However, the US economy recovered strongly in the second quarter with a growth of 4 per cent prompting the IMF to revise its growth forecast for the US upwards to 2.2 per cent in 2014 and 3.1 per cent in 2015. The Japanese economy displayed a strong performance in the first quarter, but the increase in consumption tax in April 2014 dampened growth prospects for Japan. The Japanese economy is now expected to grow at 0.9 per cent in 2014 compared to the previously envisaged 1.6 per cent. Within advanced economies, the Euro Area is expected to record the weakest growth performance with a growth of 0.8 per cent in 2014, and the IMF has downgraded growth projections for all major economies in the Euro region. It is expected that the Euro Area would grow at 1.3 per cent in 2015.

- **Emerging market and developing economies are projected to grow at 4.4 per cent in 2014 and 5.0 per cent in 2015, in comparison to the growth of 4.7 per cent in 2013.** Many emerging markets and developing economies are in the process of adjusting to tighter global financial conditions. Domestic demand in China moderated more than expected, and consequently, a growth of 7.4 per cent is expected in 2014 followed by a 7.1 per cent growth in 2015. In India, the post-election recovery in business sentiment is expected to move the economy forward with growth in 2014 projected at 5.6 per cent in 2014 and 6.4 per cent in 2015. In the Commonwealth of Independent States and the Middle East, geopolitical uncertainties continued to cloud the economic outlook, while the growth momentum in Sub-Saharan Africa is expected to gather gradually in 2014-15. Growth is expected to remain weak in Latin America, mainly as a result of tighter financial conditions.

- **Global inflation is expected to remain low in 2014-15 with excess capacity in advanced economies, weaker domestic demand in several emerging markets and subdued commodity prices.** Consumer price inflation in advanced economies is expected to gradually increase from 1.4 per cent in 2013 to 1.6 per cent in 2014 and 1.8 per cent in 2015. In the Euro Area and the United States, headline inflation is expected to remain below longer term inflation expectations. With inflation declining continuously, the possibility of deflation has become a serious threat in the Euro Area, which has prompted increased monetary stimulus by the European Central Bank (ECB). Meanwhile, in Japan, inflation started to increase with stronger growth in the first quarter and the higher consumption tax. Subdued world commodity prices are expected to help reduce price pressures in emerging market and developing economies. However, this reduction will be more than offset by the depreciation of domestic currencies in some economies. Inflation in emerging market and developing economies is expected to remain at 5.5 per cent in 2014 and 5.6 per cent in 2015, in comparison to around 6 per cent inflation observed in 2012-13.

- **The US Federal Reserve continued the gradual tapering of its Quantitative Easing (QE) programme as signs of economic recovery became stronger, although the ECB moved in a different direction due to deflationary fears.** The Federal Reserve limited its monthly securities purchases to US dollars 15 billion during the month of October 2014, and is expected to conclude its QE tapering by end October 2014. The Bank of England, which has maintained its policy interest rate unchanged since March 2009, is expected to commence tightening monetary policy by early 2015. In contrast, the ECB reduced its key policy rates, as deflationary fears threatened the recovery of the Eurozone. Accordingly, the interest rate on the ECB's deposit facility was reduced by 10 basis points to -0.10 per cent in July 2014. The ECB relaxed monetary policy again in September, reducing its refinance rate, marginal lending facility rate and deposit facility rate to 0.05 per cent, 0.30 per cent and -0.20 per cent, respectively, from September 2014. In addition, the ECB launched an asset-backed securities purchase programme in October 2014, which is expected to continue for a period of two years. The "asynchronous" monetary policy adjustments in advanced economies have resulted in increased volatility in global financial markets resulting in large exchange rate variations between advanced economies as well as in emerging market and developing economies.

- **Capital flows to most of the emerging economies have declined sharply during the first half of 2014, mainly due to concerns about the recovery of Eurozone economies, intensified geopolitical tensions in emerging economies and the gradual unwinding of monetary stimulus in the US.** During this period, cumulative net capital inflows to emerging markets have witnessed a sharp drop, reflecting political tensions in Turkey, Ukraine and Russia. Additionally, the Chinese government's efforts to discourage short term capital inflows also led to lower inflows to the Chinese economy. However, portfolio flows broadly have been more resilient, in line with the return of global risk appetite. Scaling back of the QE programme of the US has led to higher bond yields, reversing the direction of capital flows.

Prospects for 2015

- **The Sri Lankan economy is projected to grow at a rate of around 8 per cent in 2015, with all sectors contributing to this growth.** Both public and private investments are expected to expand further, thereby inducing economic activity covering all three sectors of the economy. Private and public sector investments to strengthen the traditional sectors as well as new emerging sectors are expected to raise the growth potential of the economy. Improving physical and social infrastructure is likely to enhance productivity of the economy further, resulting in sustainable and inclusive growth.

- **Inflation is expected to remain at around 4 per cent during the remainder of 2014 and below 5 per cent in the medium term.** The recent reduction in domestic energy prices would have a direct as well as an indirect downward impact on inflation in the period ahead. The benign outlook for inflation is also supported by relatively stable international commodity prices and well anchored inflation expectations. Appropriate forward looking monetary policy measures are expected to be implemented to maintain inflation at a level below 5 per cent.

- **Sri Lanka's external sector performance is expected to strengthen further in 2015, enhancing resilience to external shocks.** Imports are projected to increase in 2015 with a rise in both intermediate and investment goods imports, mainly due to higher import demand arising from major economic activities such as development projects in tourism, port and airport sectors and infrastructure development projects. However, earnings on exports are projected to increase at a higher rate than the growth in expenditure on imports, thereby reducing the trade deficit further. Export earnings are expected to benefit from higher value addition, diversification of products and markets and increased global demand. The growth momentum in the services account is expected to continue facilitated by port and airport related activities, information technology services and continued high performance of the tourism industry. Meanwhile, the expected increase in labour migration under skilled and professional categories along with the expansion of formal channels for remitting money are expected to increase workers' remittances further in 2015, albeit at a lower rate in comparison to the past few years. The significant increase in earnings from exports of goods and services, along with a steady increase in workers' remittances, are expected to reduce the current account deficit substantially in 2015. This, together with envisaged inflows to the financial account by way of FDI and portfolio investment flows and foreign loans to the government and the private sector, are expected to generate a BOP surplus of around US dollars 2.2 billion in 2015, compared to the anticipated surplus of US dollars 1.8 billion in 2014. Accordingly, gross official reserves are estimated to reach US dollars 10 billion in 2015, which is equivalent to around 5.7 months of imports.

- **The government is expected to continue its fiscal consolidation programme as envisaged in the Medium Term Macroeconomic Framework**. Accordingly, the budget deficit is targeted at 4.4 per cent of GDP in 2015. A strong commitment is required to achieve the government revenue targets while rationalising recurrent expenditure in order to continue the fiscal consolidation process. Further, public investment needs to be maintained at a level required to support the envisaged high economic growth. Government debt is expected to be reduced to 71 per cent of GDP in 2015 from 75 per cent of GDP projected for 2014.

- **The monetary programme envisages a broad money growth of 13.5 per cent in 2015, in line with projections for economic and price developments for the year.** Given the continued low inflation environment, the implicit GDP deflator is expected to be lower at 5.5 per cent, while a higher real GDP growth rate of around 8 per cent is projected for 2015. Credit disbursements to the private sector are expected to recover in the second half of 2014 and continue to expand in 2015.

- **The Sri Lankan economy is expected to move along a higher, non-inflationary growth path in the medium term, with the vastly improved physical infrastructure, improving social infrastructure, efforts to enhance overall productivity of the economy and the recovery of the global economy**. Accordingly, Sri Lanka is expected to surpass the US dollars 4,000 per capita threshold in 2015 and to exceed US dollars 7,000 by 2020. Given the continued low inflation and rising growth potential of the economy, space for additional monetary stimulus is available to accelerate economic activity further, if required. However, social concerns such as the effect of low nominal interest rates on the elderly population, who solely rely on interest income from deposits, continue to hamper such stimulus. A gradual shift in savings habits towards market oriented pension and insurance products is taking place, but measures to address social concerns in the interim are also necessary. Such adjustments, along with efforts to ensure continued fiscal consolidation, would enable greater flexibility in the conduct of macroeconomic policies allowing them to be directed at enhancing the overall welfare of the masses more effectively.