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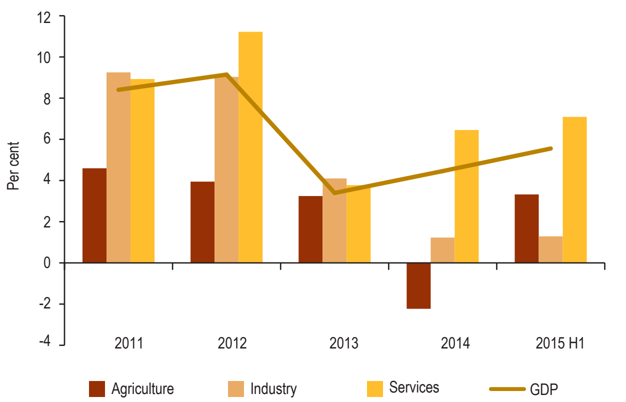
OVERVIEW

The Sri Lankan economy recorded a growth of 5.6 per cent in the first half of 2015 with positive contribution from agriculture, industry and service related activities. Inflation declined further as a result of the downward price revisions in key consumer items, including energy, low commodity prices in the global market and improved domestic supply conditions. In view of the continued low inflation environment as well as favourable inflation expectations, the Central Bank continued its accommodative monetary policy stance during 2015 to encourage a smooth flow of credit to the private sector, thereby supporting economic activity. Along with the revival of growth in credit to the private sector in a low interest rate environment, the Central Bank removed the restrictions placed on access to its Standing Deposit Facility (SDF) in March 2015, and lowered policy interest rates by 50 basis points in April 2015. Meanwhile, in the external sector, the decline in export performance as a result of weak global demand, coupled with an increase in imports, resulted in an expansion in the trade deficit. Despite increased inflows to the services account, the moderation of workers' remittances and the widening deficits in the trade and primary income accounts weighed heavily on the expansion of the external current account deficit. Net foreign inflows to the financial account of the balance of payments (BOP) also moderated, and consequently, the BOP is estimated to have recorded a deficit of US dollars 2.3 billion by the end of the third quarter of 2015. Gross official reserves were estimated at US dollars 6.8 billion (equivalent to around 4.2 months of imports) at end September 2015. The decline of the stock of external reserves during the first nine months of 2015 was mainly due to the continuous supply of foreign exchange to the market by the Central Bank in order to reduce the pressure in the foreign exchange market. The anticipated hike in US interest rates, which prompted foreign investors to move funds out of the domestic government securities market as in other emerging market economies together with the higher demand for imports, placed undue pressure on the rupee, warranting the intervention of the Central Bank. However, in September 2015, the Central Bank allowed greater flexibility in the determination of the exchange rate, based on demand and supply conditions of the market. Overall, in the first ten months of the year, the Sri Lankan rupee has depreciated by above 7 per cent against the US dollar, leading to a depreciation in the Real Effective Exchange Rate (REER) indices. In the fiscal sector, the focus of fiscal policy in 2015 was on strengthening the fiscal consolidation process and correcting fiscal imbalances on both revenue and expenditure fronts. Fiscal management continued to be challenging mainly due to the lower than expected increase in government revenue and the significant increase in the recurrent expenditure. In financing the budget deficit, the government relied largely on domestic sources, although the receipt of the proceeds of the successful issuance of the ninth International Sovereign Bond (ISB) is likely to ease pressure on domestic financing in the last two months of the year. Meanwhile, the financial sector remained stable and the performance of all key subsectors except the insurance subsector improved during the first eight months of the year.

Chart 1.1 GDP and Gross Value Added (Growth Rates) (a)



(a) Based on revised GDP estimates (2010 base) of DCS

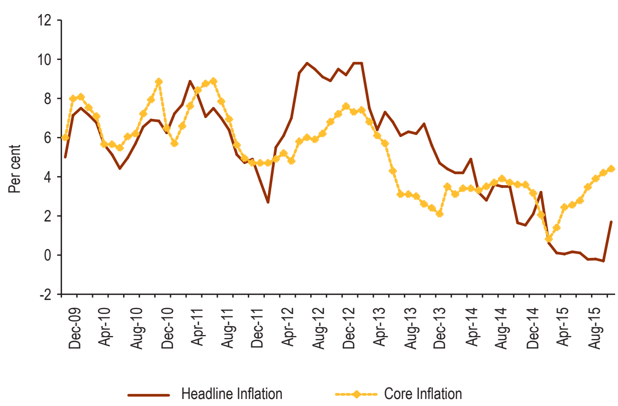
- **During the first half of 2015, the economy grew by 5.6 per cent, in comparison to the growth of 1.3 per cent recorded in the first half of the previous year.** Agriculture, Forestry and Fishing related economic activities rebounded, recording a positive growth of 3.3 per cent during the first half of 2015, compared to the contraction of 0.7 per cent in the corresponding period of 2014. The revival of agricultural activities was mainly a result of the significant improvement in the paddy sector amidst negative growth rates recorded in relation to tea, rubber and spices. Meanwhile, Industry related activities, which contracted by 4.5 per cent in the first half of 2014, recorded a growth of 1.3 per cent in the first half of 2015. The recovery in manufacturing activities mainly contributed to this growth, while construction activities as well as mining and quarrying contracted. The growth momentum of Services related activities continued, with an expansion of 7.1 per cent during the first half of 2015, compared to 4.2 per cent in the first half of the previous year. The acceleration of value added in Services was driven by real estate, financial services, and wholesale and retail trade activities as well as other personal services.

- **In comparison to the real GDP growth rate of 4.5 per cent recorded in 2014, the economy is projected to grow by 5.7 per cent in 2015, supported by increased value addition in all three sectors of the economy.** Consumption expenditure, which comprises private and public sector consumption, is projected to grow by around 11.2 per cent in 2015 in nominal terms, compared to the estimated 6.4 per cent growth in 2014. Both domestic and national savings are expected to grow at a slower pace during 2015 than in the previous year, and national savings are projected at 25.5 per cent of GDP in 2015 compared to 27.1 per cent in 2014. The nominal growth of investment expenditure, which is estimated at 8.0 per cent in 2014, is expected to slow down to around 2.9 per cent during 2015, mainly as a result of the deceleration in the progress of large scale public investment projects. Gross investment is projected at 27.8 per cent of GDP in 2015 compared to an estimated 29.7 per cent of GDP in 2014.

- **The unemployment rate was 4.6 per cent in the first half of 2015, compared to 4.3 per cent in the corresponding period of the previous year.** The number of unemployed persons during the period increased by 9.2 per cent, while the number of employed persons grew marginally by 1.7 per cent. The increase in unemployment was a result of the increased female unemployment rate of 7.6 per cent in the first half of 2015 compared to 6.4 per cent in the corresponding period of the previous year. Youth unemployment (15-24 years) remained high at 21.6 per cent during the period, while in terms of the level of education, the highest unemployment rate of 9.3 per cent was recorded amongst persons with GCE (Advanced Level) and higher levels of educational attainment.

- **Inflation remained at single digit levels for the seventh consecutive year, and year-on-year headline inflation declined to negative territory during the third quarter**. The continued low inflation could be attributed to prudent demand management policies of the Central Bank, improved domestic supply conditions and low international commodity prices. Nevertheless, the very low headline inflation in 2015 was also the result of sharp downward adjustments to domestic administered prices of fuel and energy as well as the reductions in prices of selected essential food items by the government. Year-on-

Chart 1.2 **Year-on-Year Inflation**



year headline inflation that remained below zero levels from July to September 2015, increased to 1.7 per cent in October 2015 with the dissipation of the base effect of the domestic energy price adjustments in September/October 2014. During the months of September and October 2015, headline inflation was 0.7 per cent on an annual average basis, its lowest level since the introduction of open economy policies in 1977. Meanwhile, core inflation also remained below 5 per cent, although a continued upward trend was observed in its year-on-year change since March 2015, reflecting the gradual firming up of underlying demand pressures in the economy. In October 2015, core inflation was 4.4 per cent on a year-on year basis and 2.9 per cent on an annual average basis.

- **The external sector performance moderated in the first half of the year with a widening current account deficit and modest inflows to the financial account of the BOP**. Significantly high domestic demand for imported goods, including vehicles and consumer durables, resulted in an expansion of the trade deficit. Inflows on account of trade in services improved with a notable increase in receipts from tourism. Meanwhile, workers' remittances moderated sharply, exacerbating the pressure on the external current account during the first half of the year. Along with the deterioration of the current account, the decline in the receipt of foreign direct investments (FDIs) and portfolio investments, as well as the reversal of foreign investments in government securities, led the BOP to record a deficit of US dollars 792 million by end June 2015, and a deficit of US dollars 2,316 million by end September 2015.

- **The merchandise trade deficit widened during the first eight months of 2015 as a result of weakening global demand and significantly high domestic demand for imported goods.** Accordingly, earnings from exports during this period declined by 3.4 per cent, year-on-year, to US dollars 7,147 million, while expenditure on imports remained largely unchanged at US dollars 12,559 million. Despite the significant improvement in earnings from exports of transport equipment and spices, lower earnings from tea, seafood and rubber product exports largely contributed to the decline in exports. Earnings from textiles and garments, the main export product category of Sri Lanka, also declined marginally reflecting lower exports to the European Union (EU). The growth in import expenditure was led by a 89.9 per cent growth in vehicle imports for personal use as well as business purposes. Import expenditure on almost all consumer goods, textiles and textile articles and machinery and equipment also increased significantly. However, with the significant decline in international oil prices and a decline in the volume, the expenditure on fuel imports fell by US dollars 1.7 billion during the first eight months of 2015, a 48.1 per cent decline from the corresponding period in the previous year. As a result of these developments, the trade deficit widened by 5.0 per cent, year-on-year, to US dollars 5,412 million during the first eight months of 2015.

- **The surplus in the services account increased marginally during the first half of 2015**. In comparison to the surplus of US dollars 898 million in the first half of 2014, the services account recorded a surplus of US dollars 1,003 million during the first half of 2015. The surplus in the travel account improved further with increased earnings from tourism by 14.1 per cent to US dollars 1,321 million during the first half of the year, while inflows from transport services grew by a modest 4 per cent to US dollars 998 million during this period. The moderation of inflows from transport services mainly stemmed from the slowdown in sea and port related transportation activity, which was also reflected in the moderate increase in volumes of container and cargo handled during the first half of the year. Meanwhile, during the first nine months of the year, tourist arrivals increased by 18.8 per cent, year-on-year, to 1,315,839 tourists, and earnings from tourism during this period amounted to US dollars 2,095 million.

- **Higher dividends and interest payments resulted in an increase in the deficit in the primary income account of the BOP in the first half of 2015.** The inflows to the primary income account declined marginally in the first half of 2015 while outflows on account of dividend payments on FDIs and interest payments on account of coupons on ISB and bonds issued by licensed banks increased. Consequently, the deficit in the primary income account increased to US dollars 839 million during the first half of 2015 from US dollars 768 million in the corresponding period of 2014.

- **The growth of workers' remittances were below the expected levels during the first nine months of the year.** Workers' remittances, which account for most of the secondary income inflows, increased marginally by 1.8 per cent during this period, compared to the growth of 9.1 per cent recorded in the corresponding period of 2014. This decline could be partly attributed to the drop in income of oil exporting countries, as a result of the decline in global oil prices, and geopolitical tensions in the Middle East.

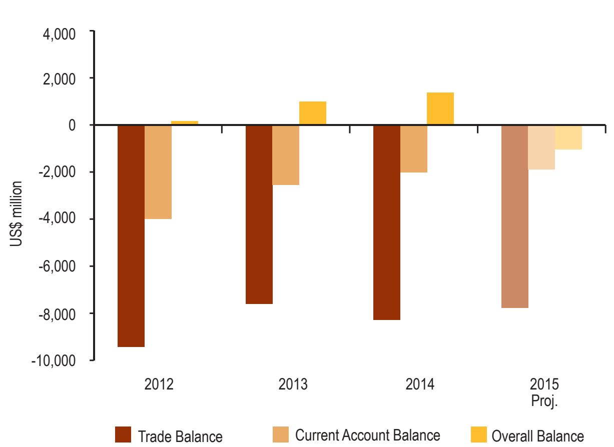
- **The country's external current account deficit widened during the first half of 2015 to US dollars 905 million from US dollars 435 million recorded during the corresponding period of 2014.** Widened deficits in the trade and primary income accounts, as well as the moderation in the growth of workers' remittances were the main contributors towards the expansion of the current account deficit during the first half of the year.

- **In the financial account of the BOP, both net incurrence of liabilities and net acquisition of financial assets were significantly lower in the first half of 2015 than in the corresponding period of 2014.** Net incurrence of liabilities in the first half of 2015 amounted to US dollars 848 million, compared to US dollars 2,908 million in the first half of the previous year. Further, net acquisition of assets amounted to US dollars 235 million in the first half of 2015, compared to US dollars 2,969 million in the first half of 2014. Total FDI related inflows declined to US dollars 544 million in the first half of 2015, from US dollars 846 million recorded during the corresponding period of 2014. Portfolio equity flows moderated recording a net incurrence of liabilities of US dollars 16 million during the first half of 2015. The settlement of the matured five year ISB of US dollars 500 million in early 2015 reduced the net effect of the issuance of the ISB of US dollars 650 million in June 2015, although the receipt of the proceeds from the ninth ISB of US dollars 1.5 billion in October 2015 will reduce the pressure on the financial account of the BOP. Further, the government rupee securities market experienced a net outflow mainly due to the anticipated policy rate hike by the United States Federal Reserve that prompted foreign investors to withdraw their investments from emerging markets. Meanwhile, net inflows to major government projects declined to US dollars 107 million during the first half of 2015, compared to a net inflow of US dollars 609 million during the first half of 2014. The Central Bank received US dollars 400 million in April 2015 under the foreign currency swap facility with the Reserve Bank of India (RBI), while a further sum of US dollars 1,100 million was received from the RBI in September 2015 under this facility.

- **The BOP, which recorded a surplus in 2014, turned to a deficit in the first half of 2015.** This was primarily a result of the widening of the current account deficit and the moderation of inflows to the financial account of the BOP. Accordingly, in comparison to the surplus of US dollars 1,954 million during the first half of 2014, the deficit in the BOP amounted to US dollars 792 million in the first half of 2015, and is estimated to have widened further to US dollars 2,316 million by the end of the third quarter.

- **The country's gross official reserves at US dollars 6.8 billion by end September 2015, were equivalent to 4.2 months of imports.** The settlement of the ISB that matured in January 2015, foreign currency debt service payments, payments under the International Monetary Fund – Stand by Arrangement (IMF-SBA), net outflows in relation to the Asian Clearing Union (ACU), valuation losses and net supply of foreign exchange to the domestic market by the Central Bank were the main reasons for the decline of gross official reserves during this period. The receipt of US dollars 1.5 billion under the swap arrangement with the RBI helped buoy the level of reserves. It is also expected that the proceeds of the ISB issuance of US dollars 1.5 billion in late October 2015 will further strengthen the reserve position of the country. The issue was oversubscribed by 2.2 times signaling continued confidence of investors in the Sri Lankan economy.

Chart 1.3 Balance of Payments



- **The Sri Lankan rupee that remained broadly stable during the first eight months of the year supported by Central Bank intervention, depreciated thereafter as the Central Bank allowed greater flexibility in the determination of the exchange rate.** The increased demand for foreign exchange mainly due to higher imports and debt service payments, the reversal of foreign investments in the government rupee securities market, the moderation of workers' remittances and modest inflows to the financial account, added pressure on the exchange rate. In this context, the Central Bank supplied US dollars 1,870 million to the domestic foreign exchange market, on a net basis, during the first eight months of the year to prevent a large depreciation of the Sri Lankan rupee. On 03 September 2015, the Central Bank decided to limit its intervention in the domestic foreign exchange market, and allowed the exchange rate to be largely determined by market forces since then. This resulted in a depreciation of the Sri Lankan rupee against the US dollar by 4.5 per cent during the period from 04 September 2015 to end October 2015. Overall, the Sri Lankan rupee depreciated by 7.0 per cent against the US dollar during the first ten months of the year. Reflecting cross currency movements, the Sri Lankan rupee depreciated against the pound sterling (5.4 per cent), the Japanese yen (5.8 per cent), and the Indian rupee (4.1 per cent), while appreciating against the euro (3.1 per cent) during this period.

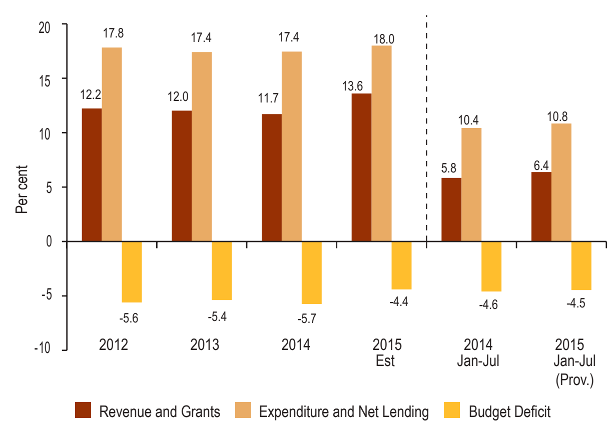
- **The 5-currency and 24-currency effective exchange rate indices depreciated during the first ten months of the year.** The 5-currency and 24-currency Nominal Effective Exchange Rate (NEER) indices depreciated by 3.0 per cent and 2.2 per cent, respectively, while the 5-currency and 24-currency REER indices depreciated by 2.2 per cent and 2.8 per cent, respectively, by end October 2015. The depreciation of the NEER indices and the relatively subdued levels of domestic inflation compared to trading partners and competitors, resulted in the depreciation of the REER indices. These changes in REER indices are expected to help Sri Lanka improve its competitiveness in the global market in terms of the exchange rate.

- **The fiscal sector showed a mixed performance during the first seven months of 2015.** Government revenue as a percentage of GDP improved slightly while recurrent expenditure increased significantly as a percentage of GDP. Government revenue as a percentage of estimated GDP increased to 6.4 per cent during the period under review, compared to 5.8 per cent in the corresponding period in 2014 mainly due to an increase in revenue from import related taxes. Revenue from import duties, and excise taxes on motor vehicles, liquor, cigarettes and tobacco as well as the Nation Building Tax (NBT) on domestic economic activities recorded an increase. A decline in revenue was observed from corporate and non-corporate income taxes and value added tax (VAT). Meanwhile, total expenditure and net lending as a percentage of GDP increased to 10.8 per cent during the first seven months of 2015, compared to 10.4 per cent in the same period in 2014, due to an overrun in recurrent expenditure as public investments recorded a decline during this period. As a result, the overall fiscal deficit during the first seven months of 2015 was 4.5 per cent of GDP, compared to 4.6 per cent of GDP in the corresponding period in 2014 and the annual target of 4.4 per cent of GDP envisaged in the Interim Budget for 2015.

- **The overall fiscal deficit of Rs. 504.8 billion during the first seven months of the year was entirely financed through domestic sources, as net foreign financing recorded a repayment during this period.** Accordingly, net domestic financing increased significantly by 195.6 per cent to Rs. 559.7 billion during the first seven months of 2015, with a majority contribution from the domestic banking sector. Net foreign financing recorded a repayment of Rs. 54.9 billion during the first seven months of 2015 compared to net foreign borrowing of Rs. 283.2 billion in the corresponding period in 2014, mainly due to relatively low disbursements of foreign project loans and the continuous outflows from foreign investments in government securities. Meanwhile in October 2015, the government successfully issued the ninth ISB of US dollars 1.5 billion with a 10 year maturity and a yield of 6.85 per cent per annum. This was in addition to the US dollars 650 million ISB issued in May 2015, which had a maturity period of 10 years and a yield of 6.125 per cent per annum.

- **The Central Bank continued to maintain a relaxed monetary policy stance during the first ten months of 2015, with a view to supporting domestic economic activity against the backdrop of benign levels of inflation and inflation expectations.** Several adjustments were made to the monetary policy stance during the year in order to provide the necessary impetus to economic activity by making adequate credit flows available to the private sector. In March 2015, with the revival of private sector credit growth, the Central Bank removed the temporary restriction placed in September 2014 on access to its Standing Deposit Facility (SDF) under open market operations (OMO). Subsequent to the removal of the restriction on access to SDF, the overnight interest rates moved upwards and settled close to the lower bound of the policy rate corridor. However, considering the intermittent

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



increase in interest rates in certain market segments following the removal of restrictions on the SDF and also the sharp decline in inflation, the Central Bank signalled the continuation of the accommodative policy stance by reducing its Standing Deposit Facility Rate (SDFR) and Standing Lending Facility Rate (SLFR) by 50 basis points each in April 2015. Since then, the SDFR and the SLFR remained at 6.00 per cent and 7.50 per cent, respectively. Meanwhile, as a macroprudential measure, a maximum loan to value (LTV) ratio was introduced in respect of loans and advances granted for the purpose of purchase or utilisation of motor vehicles by banks and financial institutions supervised by the Central Bank, and this measure is to be effective from 01 December 2015. In addition, a minimum cash margin requirement of 100 per cent was imposed against letters of credit (LCs) opened with commercial banks for the import of motor vehicles with effect from 30 October 2015 until 01 December 2015.

- **Reserve money increased by 19.8 per cent on a year-on-year basis by end August 2015 compared to 18.3 per cent recorded at end 2014.** The expansion in reserve money during the first eight months of 2015 was entirely due to an expansion in net domestic assets (NDA) of the Central Bank, as net foreign assets (NFA) of the Central Bank contracted during this period. Accordingly, NDA of the Central Bank, which contracted during 2014, increased significantly by Rs. 296.4 billion during the first eight months of 2015. Within NDA, net credit to the government (NCG) by the Central Bank increased by Rs. 94.9 billion due to a surge in holdings of government securities amounting to Rs. 86.0 billion and provisional advances amounting to Rs. 9.1 billion. In addition, other liabilities reduced significantly by end August 2015, mainly due to the non-reliance on borrowed bonds by the Central Bank in view of increased Treasury bill holdings, contributing positively to the increase in NDA. Meanwhile, NFA of the Central Bank declined by Rs. 237.1 billion during the first eight months of the year, reflecting the impact of foreign currency sales by the Central Bank in the domestic foreign exchange market, increased foreign liabilities to international institutions and repayments made under domestic currency swap arrangements.

Table 1.1 Recent Monetary Policy Measures

Date	Measure
03-Feb-2012	Repurchase rate and Reverse Repurchase rate increased by 50 bps to 7.50% and 9.00%, respectively.
09-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.
05-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 01-Jul-2013.
15-Oct-2013	Repurchase rate and Reverse Repurchase rate reduced by 50 bps to 6.50% and 8.50%, respectively.
02-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 (SDF) uncollateralised with effect from 01-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 was accepted at a special interest rate of 5.00%.
02-Mar-2015	The 5.00% special SDF rate was withdrawn.
15-Apr-2015	The SDFR and SLFR reduced by 50 bps to 6.00% and 7.50%, respectively.
03-Sep-2015	The exchange rate was allowed to be determined based on demand and supply conditions in the foreign exchange market (a).

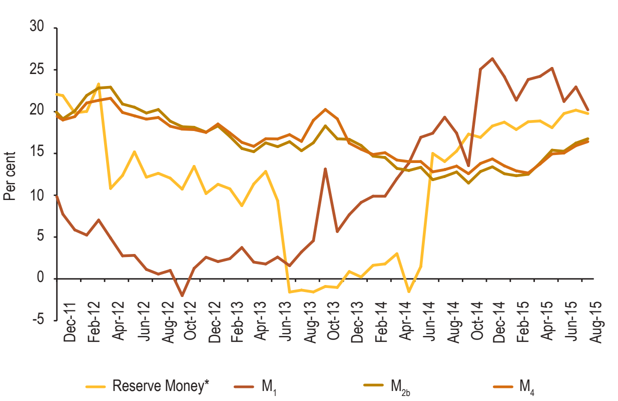
Source: Central Bank of Sri Lanka

(a) In addition, the Central Bank imposed:
  i. a maximum Loan to Value (LTV) ratio of 70 per cent in respect of loans and advances granted for the purpose of purchase or utilisation of motor vehicles by banks and financial institutions supervised by the Central Bank with effect from 01 December 2015, as a macro-prudential measure, and
  ii. a minimum cash margin requirement of 100 per cent on 30 October 2015 against Letters of Credit opened with commercial banks for the importation of motor vehicles to be effective until 01 December 2015.

- **Broad money supply (M_{2b}) continued to increase during the first eight months of 2015 led by a significant expansion in domestic credit.** Broad money recorded a year-on-year growth of 16.8 per cent by end August 2015 compared to 13.4 per cent recorded at end 2014, while the average growth during the first eight months of 2015 was 14.4 per cent compared to 13.6 per cent in the corresponding period in 2014. Increases in NDA of the banking system, which include credit flows to the private sector, the government as well as public corporations, contributed entirely to the monetary expansion during the first eight months of the year, as NFA of the banking system recorded a contraction. Accordingly, NDA of the banking system increased significantly by Rs. 670.6 billion during the period under review, whereas NFA of the banking system recorded a contraction of Rs. 294.0 billion. Moreover, in addition to the decline in NFA of the Central Bank, NFA of commercial banks also declined during the first eight months of the year reflecting a decline in foreign currency placements with banks abroad, increased foreign borrowings and foreign currency deposits.

- **Net credit to the government (NCG) from the banking system increased significantly during the first eight months of 2015.** Accordingly, NCG increased by Rs. 299.7 billion during the first eight months of 2015, compared to an increase of Rs. 60.9 billion in the corresponding period of the previous year and in comparison to the annual budgetary estimate of Rs. 70 billion for bank borrowings in 2015.

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

The increase in NCG was the combined out come of a significant increase in net credit granted to the government by commercial banks, amounting to Rs. 204.9 billion, and an increase in net credit granted by the Central Bank amounting to Rs. 94.9 billion. Lower than expected disbursement of foreign financing to the government and a low revenue collection led the government to resort to increased domestic financing, thereby raising NCG from the banking system. Meanwhile, credit obtained by public corporations from commercial banks increased by Rs. 36.5 billion during the first eight months of 2015, compared to the contraction of Rs. 27.2 billion observed during the same period in 2014, mainly due to an increase in borrowings by SriLankan Airlines, the Road Development Authority, and the Ceylon Petroleum Corporation. However, the Ceylon Electricity Board recorded a net repayment during the period under review.

- **The growth of credit extended to the private sector by commercial banks, which rebounded towards end 2014, accelerated further during the first eight months of 2015, driven by low market lending rates, increased real wages, as well as increased import demand**. Accordingly, credit to the private sector increased by 21.3 per cent on a year-on-year basis by end August 2015, compared to 8.8 per cent recorded at end 2014. The high year-on-year growth rate in private sector credit in 2015 is also attributed to the lower levels of credit extended to the private sector during the first eight months of the previous year. In absolute terms, credit increased by Rs. 310.5 billion during the first eight months of 2015, suggesting a strong demand for banking sector funds. Meanwhile, as per the Quarterly Survey of Commercial Banks' Loans and Advances to the Private Sector, credit flows to all major sectors recorded an expansion during the first half of 2015. Accordingly, credit to Industry and Services sectors on a year-on-year basis increased by 27.8 per cent and 25.6 per cent, respectively, during the first half of 2015.

Credit to the Agriculture and Fishing sectors recorded a moderate increase of 3.9 per cent, while Personal Loans and Advances increased by 3.1 per cent by end June 2015.

- **Market interest rates continued to remain at low levels in the first ten months of 2015, benefiting from prevailing relaxed monetary conditions.** The Average Weighted Call Money Rate (AWCMR) displayed somewhat mixed movements in the first ten months of 2015. Even though the AWCMR declined below the SDFR following the rationalisation of access to the SDF in September 2014, the AWCMR peaked at 7.00 per cent on 02 March 2015 with the removal of this restriction, and then remained around 6.70 per cent until mid-April 2015. However, with the reduction in policy interest rates in April 2015, the AWCMR declined immediately by 42 basis points to 6.23 per cent and continued its declining trend thereafter towards the lower bound of the policy rate corridor. By mid-August 2015, with the decline in excess liquidity in the domestic money market, the AWCMR witnessed some upward movement and stabilised at around 6.35 per cent thereafter. Although the yields on government securities continued to remain relatively low, some pressures were observed during the first ten months of 2015 due to the increased borrowing requirement of the government from domestic sources. Accordingly, compared to the yields observed at end 2014, the 91-day, 182-day and 364-day Treasury bill yields increased by 87 basis points, 115 basis points and 105 basis points, to 6.61 per cent, 6.99 per cent and 7.06 per cent, respectively, by end October 2015. With regard to other market interest rates, average lending rates continued their declining trend, benefitting from the prevailing monetary relaxation. Accordingly, the average weighted lending rate (AWLR) declined by 88 basis points to 11.03 per cent by end September 2015, from 11.91 per cent recorded at end 2014. However, the weekly average weighted prime lending rate (AWPR) increased to 7.24 per cent by end October 2015, compared to 6.26 per cent recorded at end 2014. Meanwhile, interest rates pertaining to new loans as indicated by the average weighted new lending rate (AWNLR) declined to 10.63 per cent by August 2015, compared to 10.68 per cent in December 2014. Deposit interest rates also continued their declining trend up to April 2015, although some marginal increase was witnessed in average interest rates thereafter, indicating the impact of the special interest rate of 15 per cent offered for senior citizens' deposits. Overall, the average weighted deposit rate (AWDR) declined to 6.05 per cent by end October 2015, compared to 6.20 per cent at end 2014, while the average weighted fixed deposit rate (AWFDR) remained unchanged at 7.33 per cent by end October 2015, compared to that in end 2014. However, the average weighted new deposit rate (AWNDR) increased to 6.55 per cent in August 2015, compared to 5.45 per cent in December 2014. Meanwhile, the corporate debt market witnessed some downward adjustments in rates during the first nine months of 2015.

- **The stability and soundness of the financial sector was maintained during the period under review, with improved performance in all major sectors.** The banking system as well as the non-bank financial institutions (NBFIs) regulated by the Central Bank recorded an accelerated growth in assets and profitability, while accessibility has also improved with the expansion in the branch and ATM network. The rapid growth in loans and advances, for consumption related activities as well as for Industry and Services sectors, contributed towards this improvement. Liquidity has been maintained at adequate levels, although the reliance on short-term funding has increased. Even though an increase in the volume of non-performing loans (NPL) was observed since early 2015, the NPL ratio remained relatively low with adequate provision coverage. Further, the banking system has been in compliance with the new capital requirements under Basel III. The Central Bank continued to introduce new prudential policy measures with the view of enhancing the stability and soundness of the banking system and the NBFI sector. In addition, the primary dealer industry, the unit trust industry and the superannuation funds sector continued to grow with improved operating performance. However, the stock broking sector showed a mixed performance with subdued activity in the Colombo Stock Exchange (CSE), while the operating performance of the insurance sector has been affected by low interest rates. Meanwhile, the interbank call money market experienced a sharp decline in excess liquidity levels, while some volatility was observed in short term interest rates till April 2015. Similarly, there was a gradual reduction of liquidity in the domestic foreign exchange market, with increased outflows mainly through government securities and import bills. The corporate debt securities market activities improved with increased issuances and listings during the first half of 2015, even though activities in the commercial paper market continued to slow down. Performance in the domestic equity market deteriorated with increased volatility in price indices. With regard to payments and settlements systems, an increased volume of transactions has been facilitated during the period under review, with a high degree of reliability.

International Economic Environment

- **Global economic growth is projected at 3.1 per cent in 2015 in comparison to the growth of 3.4 per cent in the previous year, as per the IMF World Economic Outlook – October 2015**. The latest growth projections by the IMF for both 2015 and 2016 are 0.2 percentage points lower than its projections in July 2015, and reflect a further slowdown in emerging market economies and a weaker recovery in advanced economies. Relative to 2014, the outlook for advanced economies has improved on account of monetary policy support and the return to fiscal neutrality. In contrast, growth in emerging market and developing economies is projected to dampen further as a result of declining commodity prices and geopolitical tensions in some regions. The slowdown in emerging market economies is expected to push the global economy into its weakest expansion since 2009, triggering concerns about the risk of a global recession. The Organisation for Economic Co-operation and Development (OECD) also downgraded its global economic growth projections for 2015 to 2.9 per cent, although OECD expects the world economy to gradually strengthen and grow at 3.3 per cent in 2016 line with projections of the IMF.

- **Divergences across major advanced economies are expected to narrow in 2015-16 with modest growth in the medium-term**. Although growth is expected to be stronger in 2016, medium-term prospects remain subdued as a result of low investments, weak growth in productivity and unfavourable demographics. Real economic growth projected by the IMF for advanced economies is 2.0 per cent in 2015 followed by 2.2 per cent in 2016. The expected recovery of growth is largely driven by the robust growth in the United States (US) and the recovery in the Euro area. Although economic activity in the US stalled during the first quarter of the year, contributing to a substantial downward revision of the global growth forecasts, the US economy is experiencing a rebound in the second half of 2015 with lower energy prices, increased household spending, increased business fixed investment and an improving housing market. Accordingly, the IMF growth projections for the US are 2.6 per cent in 2015 and 2.8 per cent in 2016, compared to 2.4 per cent in 2014. The economy of the United Kingdom (UK), which registered a growth of 3.0 per cent in 2014, is expected to grow at a slightly slower rate of 2.5 per cent in 2015 and 2.2 per cent in 2016. The Japanese economic growth is expected to return to positive territory, recording 0.6 per cent in 2015 and 1.0 per cent in 2016. The recovery in the Euro area has progressed more rapidly than expected since 2014, as a result of the weakening euro, monetary easing and lower oil prices. Accordingly, the growth projections have been revised upwards for a number of Euro area economies, although asymmetries persisted within these economies with regard to economic performance. The IMF projects growth in the Euro area to increase from 0.9 per cent in 2014 to 1.5 per cent in 2015 and 1.6 per cent in 2016.

- **Growth in emerging market and developing economies is expected to decelerate further in 2015**. This expectation reflects the slowdown of the Chinese economy, the weak economic growth of commodity exporters and geopolitical tensions. Monetary policy normalisation in the US will supplement the general trend of reduced financial inflows to emerging markets, and a reversal of capital flows in some instances, causing a further tightening of external financial conditions. Despite these concerns, emerging markets and developing economies are projected to rebound in 2016 mainly as a result of spillovers from stronger growth in advanced economies. Growth in China is envisaged to slow down to 6.8 per cent in 2015 and even further to 6.3 per cent in 2016 in spite of the recent efforts to revive the economy, including six interest rate cuts in less than a year. Domestic demand in India is projected to remain strong, and consequently a growth of 7.3 per cent is expected in 2015 and 7.5 per cent in 2016. Structural vulnerabilities, geopolitical uncertainties, falling commodity prices and economic sanctions cloud the outlook for the Commonwealth of Independent States, the Middle East and Sub-Saharan Africa. The commodity price shock also caused the sharp slowdown of economic activity in Latin America.

- **Global consumer price inflation is expected to ease as a result of falling commodity prices**. Consumer price inflation in advanced economies is expected to decelerate to 0.3 per cent in 2015 from 1.4 per cent in 2014. Even though inflation is likely to increase to 1.2 per cent in 2016, it will broadly remain below the central bank targets in most advanced economies, signalling the presence of substantial output gaps. In emerging market economies, inflation is expected to remain subdued in 2015, mainly on account of low oil prices, despite sizable nominal exchange rate depreciations. Overall, consumer price inflation in emerging market and developing economies is expected to remain at around 5.6 per cent in 2015 and 5.1 per cent in 2016, in comparison to the 5.1 per cent inflation observed in 2014.

- **Currencies of major advanced and emerging economies depreciated against the US dollar during the first nine months of 2015, due to the strengthening economic outlook of the US and the anticipated hike in the Fed funds target rate**. The euro weakened against the US dollar as a result of persistently sluggish economic conditions in some Eurozone economies and the further easing of monetary policy by the European Central Bank (ECB). The Pound sterling displayed a similar trend against the US dollar. Meanwhile, the Japanese yen continued to lose its value at a faster pace against the US dollar since launching additional quantitative and qualitative easing by the Bank of Japan. In the context of emerging economies, China devalued its currency by 1.9 per cent against the US dollar on 11 August in a surprise move in response to weakening exports and plummeting factory prices in a softening economy. Meanwhile, escalating geopolitical tensions, slow economic growth and a further round of sanctions by the US and the European Union caused the Russian ruble to depreciate against the US dollar. The Indian rupee as well as a number of other emerging market currencies depreciated against the US dollar as a result of capital flow reversals, in response to increasing yields in the US and the anticipated hike in the Fed funds target rate.

- **Prices of most commodities recorded their lowest levels in six years during the first ten months of the year**. The glut in crude oil supply amidst weak demand from emerging market economies is seen as the main driver for the sharp decline in oil prices. Oil production in the US surged during the year, while the oil cartel OPEC decided not to cut production. As increases in non-OPEC supply were expected to exceed the moderate growth in global demand for crude oil in 2015, the crude oil price that averaged at US dollars 96.3 per barrel in 2014, is estimated to decline to around US dollars 51.6 per barrel in 2015. The demand-supply gap is expected to widen in 2016, further suppressing crude oil prices to around US dollars 50.4 per barrel in 2016. The slowdown in global demand weighed on metal prices as well. Prices of food commodities also declined substantially until around August-September 2015, although some upward movements were observed thereafter.

- **According to the IMF, the distribution of risks to the projected modest global economic growth for 2015 and 2016 remains tilted to the downside as new risks related to financial stability and growth have emerged.** Financial markets have become increasingly volatile in the wake of uncertainty over monetary policy normalisation in the US and the UK, a possible increase in stimulus by the ECB and the sharp decline in commodity prices. Such conditions expose advanced economies and emerging markets to significant vulnerabilities in the short term. The main risk is the prospects of weak growth coupled with tight global financial conditions causing financial stress especially in commodity-exporting economies. Geopolitical tensions, especially the fear of spillovers of the political situation in Iraq, Libya and Syria to other major oil exporters, remain a major downside risk for the global economic outlook.

Expected Developments

- **The Sri Lankan economy is expected to return to a higher growth trajectory in the medium term, with positive contribution from all major sectors of the economy.** The slowdown in public sector construction activities and the conservative sentiment of investors in view of national elections had some impact on growth in 2015. Accordingly, the economy is expected to grow by around 5.7 per cent during 2015. Annual GDP growth is expected to accelerate thereafter with new policy initiatives of the government along with the expansion in private sector investments, encouraged by policy clarity and the improving investor friendly environment. Accordingly, the economy is projected to expand by around 6.5 per cent in 2016, and to grow at an annual rate of over 7 per cent thereafter. Growth is expected to be broad based. The envisaged expansion in the Industrial sector is expected to emanate from increased productivity through the adoption of advanced technology and investment initiatives of the private sector. At the same time, improved technology, better infrastructure facilities, and increased skilled labour would enhance the value addition of the Services and Agriculture related activities. It is also expected that improved conditions in key export markets would also support the Sri Lankan economy to realise its medium term growth projections.

- **Sustaining the benign low inflation environment, year-on-year headline inflation is projected at 2.0-3.0 per cent by end 2015 and stabilise at low single digit levels in the medium term.** Although inflation declined to negative levels in the third quarter of 2015, it rebounded in October with the dissipation of the impact of price adjustments made in the last quarter of 2014 and the impact of the depreciation of the Sri Lankan rupee against the US dollar since September 2015. Although inflation could firm up with rising aggregate demand, appropriate and preemptive monetary policy measures by the Central Bank, as well as improved supply conditions would help maintain inflation in low single digit levels in the medium term.

- **Sri Lanka's external sector is projected to strengthen in 2016.** Following a setback in 2015, earnings from exports are expected to rebound in 2016 and follow a steady growth path thereafter, mainly supported by the gradual recovery of major export destinations, improvements in bilateral trade relations with the country's key trading partners and increased competitiveness.

The possible regaining of the GSP+ facility as well as the likely removal of the ban on fish exports to the European Union are expected to strengthen earnings from exports further. At the same time, earnings from the export of services are projected to increase steadily over time. The ongoing efforts to focus on value added services such as design and brand development, parallel to the development of traditionally structured services sectors would position Sri Lanka up in the global value chain. At the same time, the annual expenditure on imports is expected to continue its expansion, with the import requirement of intermediate and investment goods to support domestic economic activity. Nevertheless, as exports are expected to increase at a higher rate than the projected growth in imports, the trade balance is expected to improve in the period ahead. Workers' remittances are expected to record a moderate growth in the medium term. Notwithstanding the slowdown in workers' remittances, expected developments in merchandise trade, and trade in services, including tourism, would lead to a gradual contraction in the external current account deficit in 2016 and in the medium term. Meanwhile, during 2016, inflows to the financial account, mainly on account of FDIs, loan capital to the government and the private sector and portfolio investments, are expected to increase substantially, thereby enhancing the financial account balance of the BOP. Overall, the external position is expected to improve, yielding a sizable surplus in the BOP and improving external reserves of the country, thus helping to maintain stability in the domestic foreign exchange market and enhance the country's resilience to external shocks.

- **The government's commitment towards maintaining greater fiscal consolidation is expected to yield enhanced revenue collection and rationalised expenditure thus resulting in a decline in the overall budget deficit**. An increase in government revenue is expected in the medium term with the expected further simplification of the tax system, rationalisation of tax exemptions, and improvements in tax compliance and tax administration. At the same time, further rationalising of recurrent expenditure will enable the allocation of necessary funds for essential capital investments by the government. Consequent to this decline in the budget deficit, the government debt to GDP ratio is also expected to decline gradually.

- **Broad money growth is expected to decelerate to fall in line with the envisaged growth of nominal GDP in the medium term**. Broad money growth is projected at around 16.0 per cent by end 2015, on a year-on-year basis, with an average growth of 15.0 per cent. This growth is expected to be a result of the expansion in credit to both the private sector as well as the public sector. By end 2016, broad money is expected to grow by around 11.0 per cent, on a year-on-year basis, mainly underpinned by the expansion in credit to the private sector, which is projected to increase by around 16.5 per cent during the period. At the same time, in 2016, net foreign assets of the banking sector are projected to increase along with enhanced foreign inflows and resultant surplus in the BOP. It is also expected that the realisation of revenue targets of the government and the improved performance of state owned enterprises would reduce the reliance on banking sector funds by the public sector, enabling the private sector to utilise financial resources effectively for investment activity. Meanwhile, in conducting monetary policy, the Central Bank will follow a forward looking monetary policy stance, increasingly relying on a flexible inflation targeting framework, while paying close attention to price stability, with due regard to macroeconomic stability. At the same time, monetary aggregates would continue to serve as key indicative variables to guide the conduct of monetary policy, while the overnight interbank interest rate will serve as the operating target of monetary policy.

- **In the context of tightening policy spaces in the fiscal as well as monetary fronts, it is essential to maintain prudent, consistent and dynamic economic policies that would guide private sector investments into more productive activities, in order to sustain high economic growth over the medium term**. The fiscal and monetary authorities are expected to co-ordinate policies closely to maintain an appropriate level of aggregate demand in the economy without giving rise to demand driven inflationary pressures, which could, in fact, trigger an adverse cycle of high inflation, high interest rates and slower economic growth. In the meantime, strengthening external and domestic policy buffers that could enhance the resilience of the economy in the midst of volatile global economic conditions would be of paramount importance to sustain the envisaged growth trajectory over the medium to long term.