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OVERVIEW

In response to macroeconomic stabilisation measures taken by fiscal and monetary authorities, the Sri Lankan economy exhibited signs of improvement in the first nine months of the year, despite economy-wide effects arising from adverse weather conditions. The economy grew at a rate of 3.9 per cent in real terms in the first half of the year in comparison to the growth of 3.7 per cent in the first half of 2016. The drought- and flood-related disturbances mainly affected Agriculture activities, which contributed to overall growth negatively and spilled over to the other sectors of the economy as well. However, Industry and Services related activities positively contributed to the expansion of the economy. Activities in the Industry sector were led by the continued growth in construction and mining and quarrying activities. The growth in Services related activities was mainly supported by financial services, wholesale and retail trade activities and transportation. The negative spillover effects of adverse weather conditions were felt by the other sectors of the economy through increased expenditure on imports amidst rising international commodity prices, higher prices of domestic food supplies and costs incurred on relief measures. Both investment and consumption expenditure contributed to the expansion in economic activities, while net exports continued to weigh down the growth momentum. Meanwhile, unemployment declined in the first half of the year, on a year-on-year basis. Domestic supply disruptions, tax revisions, and increased prices of imported commodities caused consumer price inflation to remain at elevated levels during the year, but further tightening of the monetary policy stance helped curtail demand driven inflationary pressures and inflation expectations. The growth of credit extended to the private sector decelerated gradually during the year, although broad money growth remained high as a result of the buildup of both foreign assets and domestic assets of the banking system. In spite of increased earnings from exports, the expected improvement in the external current account did not materialise largely due to increased expenditure on weather related imports and the decline in workers' remittances. However, inflows to the financial account amidst positive investor sentiments resulted in an improvement in the Balance of Payments (BOP). Increased foreign exchange inflows helped the Central Bank to replenish international reserves within a more market based exchange rate policy during the year. Meanwhile, in the fiscal sector, revenue collection as well as the government's primary balance improved during the period under review. Nevertheless, some deviation from the envisaged budget deficit target is likely in 2017 mainly as a result of adverse weather related fiscal costs. Meanwhile, the financial sector remained sound. Furthermore, the performance under the Extended Fund Facility programme of the International Monetary Fund (IMF-EFF) progressed, helping to boost investor confidence. Going forward, it is expected that the forward looking approach to monetary policy, the market-based exchange rate policy, and the process of fiscal consolidation will continue. Priority is also being attached to institutionalising these processes to make them more durable. However, these processes should be complemented by the implementation of the envisaged structural adjustments aimed at promoting external trade, attracting foreign direct investments and improving the productivity and efficiency of the economy for the country to build on the improvements observed thus far during the year, enabling the economy to reach its potential.

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Sectoral Developments

Real Sector and Inflation

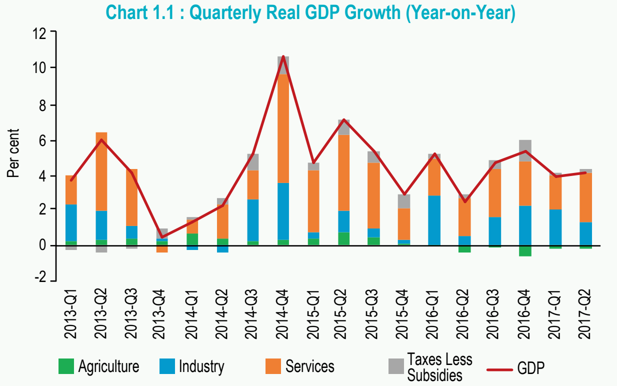
- **The Sri Lankan economy grew by 3.9 per cent in real terms during the first half of 2017 compared to the 3.7 per cent growth in the first half of 2016.** As in the previous year, adverse weather conditions hampered economic expansion during the first half of this year. Accordingly, value added growth in Agriculture related activities contracted while exerting spillover effects on other sectors of the economy. The contraction in Agriculture related activities was particularly witnessed in relation to paddy, oleaginous fruits (coconut, king coconut, oil palm), vegetables and cereals (except rice). However, both Industry and Services activities recorded an expansion during the first half of the year. The expansion in Industry related activities was mainly supported by the continued growth in construction and mining and quarrying activities. The growth in Services related activities was mainly sustained by financial services, wholesale and retail trade activities, and transportation. Meanwhile, in terms of expenditure approach estimates, the expansion in GDP was due to the increase in both investment and consumption expenditure during the first half of 2017. Net external demand continued to dampen economic growth during the first quarter of 2017, although some improvement was observed in the second quarter of the year.

- **The unemployment rate declined marginally to 4.3 per cent during the first half of 2017 from 4.4 per cent in the corresponding period of 2016.** This marginal improvement was due to the decline in the male unemployment rate amidst a marginal increase in the female unemployment rate. Moreover, unemployment among youth and educationally qualified remained high during the period under review. Although the unemployment rate declined, the total number of unemployed persons increased marginally during the first half of the year. Meanwhile, the overall Labour Force Participation Rate (LFPR) increased to 54.3 per cent in the first half of 2017 compared to 53.7 per cent in the corresponding period of 2016. The increase in the LFPR was due to the increase in the female LFPR while there was a marginal decline in the male LFPR during the first half of 2017. However, the female LFPR continued to be significantly lower than the male LFPR, emphasising the potential of the LFPR to be improved through the increase in female employment.

- **Consumer price inflation remained higher than the desired levels thus far in 2017 due to the combined effect of tax revisions, domestic weather related disturbances and rising international commodity prices**. Headline inflation, measured using the National Consumer Price Index (NCPI, 2013=100) as well as the Colombo Consumer Price Index (CCPI, 2013=100) remained high during the first quarter of 2017, impacted by supply side disruptions resulting from adverse weather conditions as well as the effect of upward tax revisions. However, a moderation in inflation was observed during the second quarter of 2017, underpinned by improvements in supply conditions and the government's initiatives to import essential food items. However, this trend reversed since August 2017 mainly due to a sharp acceleration in volatile food inflation given continued adverse weather conditions. Accordingly, NCPI based headline inflation increased to 8.6 per cent, year-on-year, in September 2017, mainly reflecting the high food inflation while CCPI based headline inflation also increased to 7.1 per cent, year-on-year. Meanwhile, the movements in core inflation were also impacted by tax revisions to some extent. However, core inflation remained low on average, indicating that demand driven inflationary pressures were broadly contained as a result of monetary policy measures adopted by the Central Bank. Accordingly, NCPI based core inflation declined to 4.6 per cent, year-on-year, by September 2017 from 6.7 per cent at end 2016. In contrast, CCPI based core inflation edged up marginally to 6.0 per cent, year-on-year, in September 2017 from 5.8 per cent at end 2016.

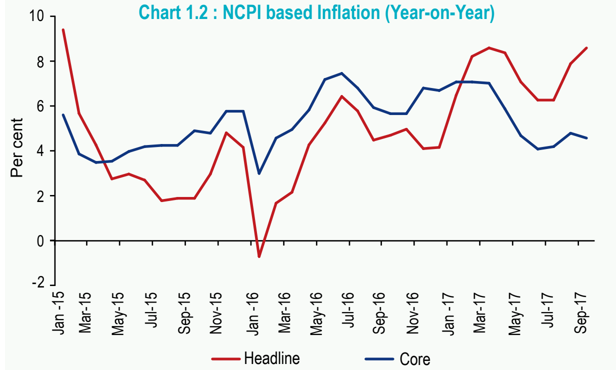
The Sri Lankan economy grew amidst weather related disturbances…

Chart 1.1 : Quarterly Real GDP Growth (Year-on-Year)



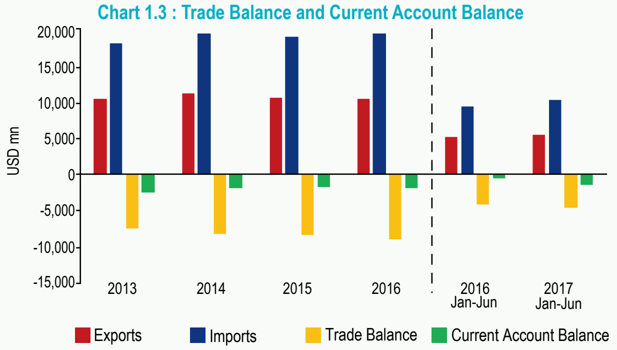
…while rising food prices pushed up headline inflation.

Chart 1.2 : NCPI based Inflation (Year-on-Year)



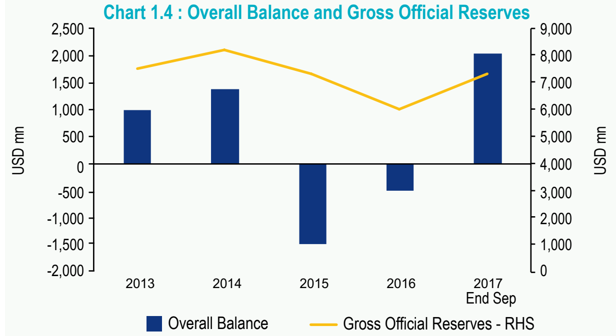
In spite of the pick up in exports, adverse weather also forestalled the anticipated improvement in the current account…

Chart 1.3 : Trade Balance and Current Account Balance



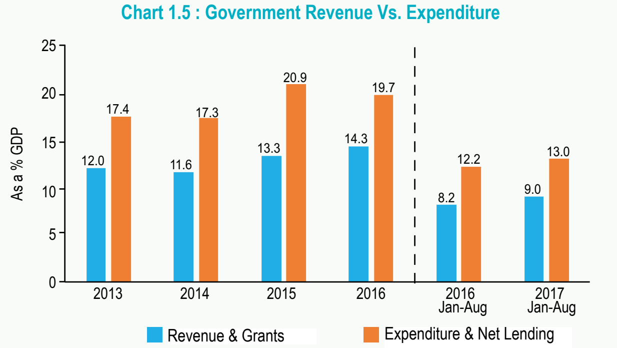
…but continued foreign financial inflows helped improve the country's BOP and foreign exchange reserves.

Chart 1.4 : Overall Balance and Gross Official Reserves



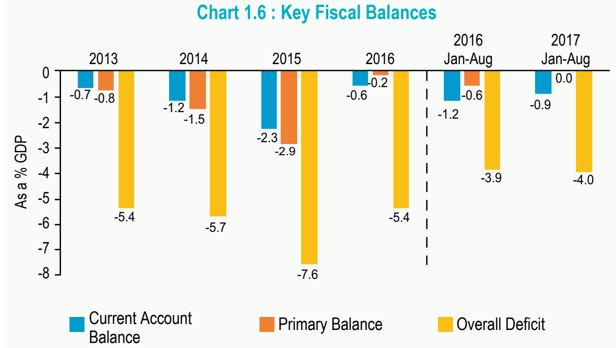
Government revenue collection increased, but expenditure also expanded, particularly with relief measures…

Chart 1.5 : Government Revenue Vs. Expenditure



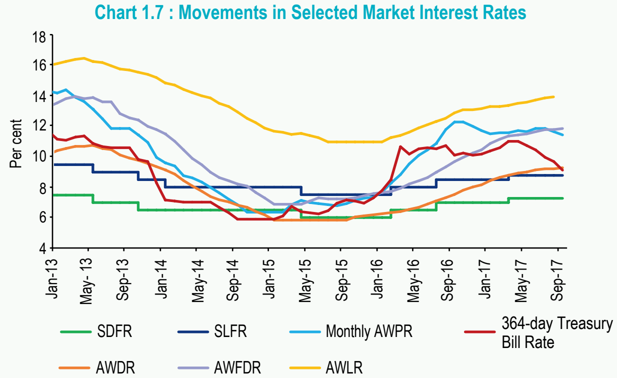
…and amidst challenges, fiscal consolidation continued.

Chart 1.6 : Key Fiscal Balances



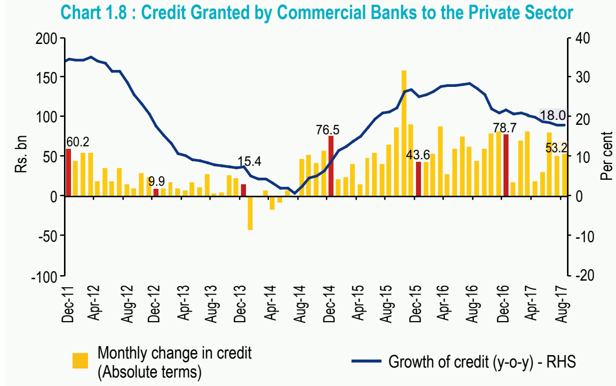
With the tight monetary policy stance, market interest rates remained high...

Chart 1.7 : Movements in Selected Market Interest Rates



...and the expansion of credit to the private sector decelerated gradually.

Chart 1.8 : Credit Granted by Commercial Banks to the Private Sector



Overall, many sectors of the economy responded well to the stabilisation measures taken, creating a conducive environment to focus more on economic growth in the period ahead.

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External Sector

- **In the external sector, the gradual pick up in export earnings contained the expansion in the trade deficit in the first eight months of 2017**. Reversing the lacklustre performance experienced during the past two years, exports recovered from March 2017, registering a 7.6 per cent growth in cumulative earnings, on a year-on-year basis, to US dollars 7,413 million in the first eight months of 2017. The gradual recovery in key export markets, increased commodity prices in international markets, the restoration of the GSP+ concessions from the European Union, conducive external trade policies together with institutional support and a more competitive exchange rate contributed towards the increase in export earnings. Accordingly, higher export earnings were received from tea, petroleum products, transport equipment, spices, seafood, and machinery and mechanical appliances. However, export earnings from textiles and garments declined moderately during the first eight months of 2017, due to the weak performance recorded in the first half of the year. Nevertheless, a notable increase in textiles and garments exports was seen during the months of July and August 2017 following the restoration of GSP+. Meanwhile, expenditure on imports also grew substantially, recording a year-on-year growth of 9.6 per cent to US dollars 13,599 million during this period. The increase in import expenditure was mainly driven by the significant increase in fuel imports, together with gold and rice imports. Increased import expenditure on fuel was mainly due to the higher demand from the domestic power generation sector in view of low hydropower generation as a result of the drought. Increased fuel prices in the international market also impacted the fuel bill. Further, rice imports continued to increase since January 2017 as a result of the measures taken by the government to encourage imports to meet the shortage in the weather affected domestic supply. The removal of the Ports and Airport Development Levy (PAL) in the previous year may have contributed to the increased volume of gold imports during the year. However, import expenditure on machinery and equipment, personal vehicles, fertiliser and mineral products declined during the period. With these developments, the trade deficit widened to US dollars 6,186 million during the first eight months of 2017 from US dollars 5,515 million in the corresponding period of the previous year.

- **In addition to developments in the trade account, the widening of the deficit in the primary income account together with the moderation of inflows to the services and secondary income accounts resulted in a widening of the external current account deficit in the first half of 2017**. The deficit in the primary income account widened during the first half of 2017, mainly driven by increased interest payments on International Sovereign Bonds (ISBs). The surplus in the services account recorded a marginal increase during the first half of 2017, primarily due to the moderate growth of earnings from tourism. The partial closure of the Bandaranaike International Airport (BIA) owing to the re-surfacing of the runway and the breakout of dengue epidemic also affected tourist arrivals. Meanwhile, the transportation services sector remained positive with a healthy growth in transhipments. The sluggish performance of the Middle Eastern economies due to persistently low oil prices and geo-political uncertainties and changes in government policies resulted in a decline in workers' remittances, leading to a reduction in the surplus of the secondary income account during the first half of the year vis-à-vis the corresponding period of 2016. The widening of the deficits in the trade and primary income accounts, together with the lacklustre performance in earnings from tourism and workers' remittances, resulted in a notable current account deficit of US dollars 1,480 million in the first half of 2017, compared to a deficit of US dollars 644 million in the corresponding period of 2016.

- **The financial account, which recorded significant outflows in the first quarter, experienced substantial inflows in the second quarter of 2017**. Outflows from the financial account in the first quarter were primarily driven by significant withdrawals of foreign investments from the government securities market. However, a reversal in financial flows was witnessed in the second quarter of the year with increased investor confidence brought by the successful conclusion of the Second Review of the IMF-EFF programme as well as the gradual stabilisation of the yields of US government securities. Inflows to the government securities market gradually improved from the second quarter of the year, offsetting the outflow recorded in the first quarter. The financial account also benefitted from higher inflows to the Colombo Stock Exchange (CSE), increased foreign direct investments (FDI) and proceeds from the eleventh ISB and the foreign currency term financing facility obtained by the government. Reflecting these developments in the external sector accounts, the BOP, which registered an overall surplus of US dollars 1,563 million by end June 2017, further improved by end September to record an estimated surplus of US dollars 2,027 million. By end 2016, the corresponding figure was a deficit of US dollars 500 million.

- **Meanwhile, gross official reserves of the country increased to US dollars 7.3 billion at end September 2017 from US dollars 6.0 billion at end 2016.** The level of gross official reserves increased at end September 2017, primarily due to net purchases of foreign currency by the Central Bank amounting to US dollars 1,161 million from the domestic foreign exchange market, together with other foreign currency inflows such as the proceeds from the ISB, foreign currency term financing facility, net borrowings through Sri Lanka Development Bonds (SLDBs) and the receipt of the third tranche under the IMF-EFF programme. The major outflows during this period included the settlement of the RBI foreign currency swap arrangement, foreign currency debt service payments, including IMF Stand-By Arrangement (SBA) principal payments, and net Asian Clearing Union (ACU) outflows. Accordingly, the country's gross official reserve level at end September 2017 is estimated to be equivalent to 4.2 months of imports. Reflecting the qualitative improvement brought about by the build-up of reserves through direct market purchases and the decline in short term liabilities, reserve adequacy in terms of short-term debt and liabilities improved to 62 per cent at end September 2017 from 52 per cent at end 2016.

- **The improved external environment facilitated the Central Bank to implement a more market based exchange rate policy in 2017, under which the Central Bank intervened in the domestic foreign exchange market to build up international reserves with minimal impact on the exchange rate**. Continued outflows in terms of import expenditure, debt service payments and unwinding of foreign investments in rupee denominated government securities exerted pressure on the rupee during the first quarter of 2017. However, market conditions improved thereafter, with inflows from foreign investments to the CSE and the government securities market, and the subsequent conversion of export proceeds. This turnaround enabled the Central Bank to absorb foreign exchange from the domestic market on a net basis during this period. Meanwhile, the depreciation pressure on the rupee further eased gradually from May 2017, with improved investor confidence following the issuance of the ISB, the obtaining of the term loan and the receipt of the third tranche under the IMF-EFF programme. Overall, the Sri Lankan rupee depreciated by 2.2 per cent against the US dollar during the year up to end September 2017. Reflecting the nominal movement of the Sri Lankan rupee against some of the major currencies, both the 5-currency and 24-currency nominal effective exchange rate (NEER) indices depreciated during the year up to end September 2017. The real effective exchange rate (REER) indices, which also take into account the inflation differential amongst countries in the currency basket, depreciated considerably during the period under review, but remained above the 100 threshold, suggesting the need for further depreciation to reach the level of competitiveness that prevailed in 2010.

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Fiscal Sector

- **Several policy measures were introduced by the government during the year 2017 to further strengthen the fiscal consolidation process and public debt management**. Accordingly, a new Inland Revenue Bill was enacted by the Parliament in September 2017 with a view to simplify and rationalise the existing income tax structure, broaden the direct tax collection by removing exemptions and strengthening tax administration. In this respect, the Revenue Administration Management Information System (RAMIS) has been set-up at the Inland Revenue Department to enable tax payers to make online payments in respect of several taxes. In addition, initial steps were also taken to establish a National Single Window System (NSWS) at the Sri Lanka Customs to facilitate external trade, while the Integrated Treasury Management Information System (ITMIS) at the Ministry of Finance and Mass Media (MOF) is expected to commence from the last quarter of 2017 as a pilot project for selected ministries. In relation to rationalising recurrent expenditure, quarterly expenditure and income outcome reports for the first and second quarters of 2017 were presented to the Parliament as announced in the Budget 2017 for strengthening Parliamentary control on public finances. Further, the National Agency for Public Private Partnership (NAPPP) was established at the MOF with a view to promoting public private partnerships (PPPs). The government also introduced several initiatives to implement structural reforms in State Owned Business Enterprises (SOBEs) in order to improve their financial strength, thereby ensuring long term financial viability. Accordingly, Statements of Corporate Intent (SCIs) were signed with five selected key SOBEs in order to improve the oversight and fiscal discipline of these SOBEs, while SCIs are expected to be signed with another ten SOBEs. During the year, several measures were taken to improve the public debt management strategy and transparency in the government securities market. A new Fiscal Liability Management Bill is also being drafted to create the space for proactive debt management.

- **The performance of the fiscal sector showed some improvement in 2017, although weather related relief expenditure is likely to cause a deviation from the envisaged fiscal targets for the year**. The government revenue to GDP ratio recorded a notable improvement increasing to 9.0 per cent during the first eight months of 2017 from 8.2 per cent in the corresponding period of 2016. This increase in government revenue was mainly due to the increase in the proceeds from goods and services related taxes, especially the Value Added Tax (VAT), excise duty on petroleum and motor vehicles, Nation Building Tax (NBT), Special Commodity Levy (SCL) and PAL. The revenue collection from income taxes also improved due to higher revenue from the Economic Service Charge (ESC). However, revenue from excise duty on liquor, cigarettes and tobacco declined during this period mainly due to the drop in sales of liquor and cigarettes. The increase in duties to an extremely high level is likely to be a significant causal factor. Total expenditure and net lending as a percentage of estimated GDP also increased to 13.0 per cent during the first eight months of 2017, in comparison to 12.2 per cent recorded in the same period of 2016, due to increases in both recurrent expenditure and public investment. As the increase in government expenditure was higher than the increase in government revenue, the overall budget deficit increased to 4.0 per cent of the estimated GDP during the first eight months of 2017 from 3.9 per cent in the corresponding period of 2016. However, both the current account and the primary account improved during this period vis-a-vis the corresponding period of the previous year and the IMF-EFF target as at 30 June 2017 was met.

- **Both domestic and foreign sources were utilised to finance the overall budget deficit of Rs. 520.2 billion during the first eight months of 2017**. However, net domestic financing at Rs. 273.5 billion during this period remained below the sum of Rs. 309.5 billion recorded during the first eight months of the previous year. Meanwhile, net foreign financing increased significantly to Rs. 246.7 billion during the period under consideration from Rs. 175.6 billion in the same period of 2016.

Monetary Sector

- **The Central Bank continued to maintain a tight monetary policy stance in the first nine months of 2017 in view of the developments in inflation as well as monetary and credit aggregates**. With a view to containing the build-up of adverse inflation expectations and reining in the excessive expansion of money supply, the Central Bank further tightened its monetary policy by raising policy interest rates by 25 basis points in March 2017. The Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) of the Central Bank stood at 7.25 per cent and 8.75 per cent, respectively, since then.

- **In response to the monetary policy stance maintained by the Central Bank and the high financing requirement of the government budget, most market interest rates moved upwards during the first nine months of 2017, although short term rates adjusted downwards with liquidity improvements in the domestic money market since mid July 2017**. The Average Weighted Call Money Rate (AWCMR) hovered around the upper bound of the policy rate corridor during the first seven months of 2017, reflecting tight monetary conditions. However, with improved liquidity conditions since mid July 2017, the AWCMR adjusted downwards towards the middle of the policy rate corridor by end September 2017. Meanwhile, Sri Lanka Inter Bank Offered Rates (SLIBOR) adjusted in line with movements in the AWCMR. The deposit interest rates of commercial banks increased particularly during the first seven months of 2017, reflecting the increased funding costs of commercial banks. Lending rates of commercial banks also increased further and stabilised at high levels by end September 2017. Yields on Treasury bills in the primary market, which increased during the first four months of 2017 reflecting the increased demand for funds by the government, declined thereafter due to increased foreign inflows to the government, improved confidence with the receipt of the third tranche of the IMF-EFF and increased government revenue collection. Similarly, yields on Treasury bonds in the primary market also declined since April 2017, reversing the upward movement witnessed during the first quarter of 2017. Secondary market yields followed suit, resulting in a downward shift in the yield curve for government securities, particularly in the long end, during the first nine months of 2017. Meanwhile, interest rates applicable on corporate debt instruments moved upwards during the first eight months of 2017. In line with the movements in global interest rates, interest rates applicable on foreign currency deposits maintained with commercial banks increased marginally during the first nine months of 2017.

Table 1.1

Recent Monetary Policy Measures

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

Source: Central Bank of Sri Lanka

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- **Broad money supply (M_{2b}) continued to expand during the first eight months of 2017**. By end August 2017, M_{2b} recorded a year-on-year growth of 21.3 per cent in comparison to a growth of 18.4 per cent at end 2016. Net domestic assets (NDA) contributed 78 per cent to the year-on-year expansion of broad money driven by credit flows to the private sector, the government and public corporations, despite the deceleration in private sector credit growth observed since July 2016. Net foreign assets (NFA) of the banking sector also expanded during the first eight months of 2017, led mainly by the NFA of the Central Bank.

- **The growth of credit extended to the private sector decelerated during the first eight months of 2017 responding to the monetary policy stance and the resultant high market interest rates**. The year-on-year growth of credit to the private sector decelerated to 18.0 per cent by end August 2017 from 21.9 per cent at end 2016 and its peak of 28.5 per cent in July 2016. In absolute terms, credit to the private sector increased by Rs. 404.6 billion during the first eight months of 2017 in comparison to an increase of Rs. 456.3 billion in the corresponding period of 2016. Credit to all major sectors of the economy continued to expand, albeit at a slower pace, during the first half of 2017 as reflected by the Quarterly Survey of Commercial Banks' Loans and Advances to the Private Sector. The growth of credit to the private sector is expected to moderate further and reach the envisaged level of 15-16 per cent by end 2017.

- **Borrowing by the public sector from the banking system remained high in the first eight months of 2017**. Net credit to the government (NCG) by the banking sector continued to increase during the first eight months of 2017, entirely on account of the expansion in NCG from commercial banks. While NCG from commercial banks increased significantly by Rs. 384.9 billion during the first eight months of 2017, NCG from the Central Bank contracted significantly by Rs. 119.5 billion during this period. Accordingly, the increase in NCG by the banking system at Rs. 265.4 billion in the first eight months of 2017 was noticeably higher than the Rs. 178.4 billion recorded in the corresponding period of 2016. Meanwhile, the increasing trend in credit granted to public corporations observed during the first five months of 2017 moderated thereafter. Credit obtained by public corporations rose by Rs. 7.8 billion by end August 2017 as against a contraction of Rs. 81.5 billion recorded in the corresponding period of 2016.

Financial Sector

- **The financial sector continued to expand during the first eight months of 2017 with all major sectors remaining sound**. The banking system continued to expand while maintaining capital and liquidity well above the regulatory minimum requirements, thereby ensuring the resilience of the sector. While the asset base of the banking sector continued to grow, a marginal deterioration was observed in asset quality, as reflected in the increase in the non-performing loans (NPL) ratio. The profitability of the sector improved during this period mainly due to higher net interest income and significant revaluation gains. The banking sector also continued to contribute to enhanced financial inclusion through the active expansion of the branch and ATM networks during this period. Moreover, implementation of the Basel III framework would further enhance the resilience of the banking sector. Although the asset base of non-bank financial institutions (NBFIs) expanded, it expanded at a slower pace compared to the performance in 2016. Lending activities of the sector were weighed down by macroprudential policy measures, while asset quality showed signs of stress although remaining at manageable levels. Other sub sectors of the financial sector such as the insurance and the superannuation fund sectors recorded a positive performance, while the unit trust sector contracted. Amidst further strengthening of capital regulations, the stock broker sector showed a mixed performance during the first eight months of 2017. While activities of financial institutions engaged in microfinance expanded, rural poverty and indebtedness remained key concerns though the latest Household Income and Expenditure Survey (HIES:2016) showed positive trends in terms of incomes, poverty and the Gini Coefficient. Meanwhile, the domestic money market and foreign exchange market remained sufficiently liquid during the year. The corporate debt securities market performed moderately during the first half of 2017. Some improvement was observed in the share price indices, market capitalisation and foreign inflows to the CSE thus far during the year, although domestic investor activity remained weak. The efficiency and safety of the national payment system continued to be enhanced during this period to effectively cater to the payment needs of institutions, corporates and individuals.

International Economic Environment

- **The upswing in global economic activity witnessed during the end of 2016 is expected to be further strengthened in 2017 and 2018, according to the IMF World Economic Outlook (WEO) – October 2017**. Synchronised growth is being experienced in Europe, Japan and the US for the first time since the Global Financial Crisis in 2007, while economic growth is expected to expand in emerging market and developing countries. The pick up in growth is supported by notable improvements in investment, trade and industrial production, coupled with strengthening business and consumer confidence. Accordingly, the IMF forecasts global growth at 3.6 per cent in 2017 and 3.7 per cent in 2018. Stronger than previously projected rebound in the Euro area, Japan and Canada is expected to drive the growth momentum of advanced economies in 2017 and 2018, while growth projections for the US and the UK have been revised downward. Meanwhile, growth in emerging market and developing economies is projected to rise in 2017 and 2018 owing to strong growth expectations for China and a host of other emerging market economies. Weak productivity and adverse demographic factors, mainly in advanced economies, remain downside risks to medium term growth.

- **Advanced economies are expected to continue to grow at a moderate pace in 2017 and 2018, buoyed by the cyclical recovery in manufacturing and trade and the upturn in financial markets**. These economies are projected to grow by 2.2 per cent and 2.0 per cent during 2017 and 2018, respectively. The IMF revised the projected growth rates upwards for 2017 based on stronger than expected growth in the Euro area and Japan, which are supported by the pick up in global trade and manufacturing. Nevertheless, the IMF revised downward the projections for the US and the UK. In spite of the downward revision, the US economy, Sri Lanka's largest export destination, is expected to grow at a healthy rate of 2.2 per cent in 2017, followed by a growth of 2.3 per cent in 2018. The growth in the UK, which is Sri Lanka's second largest export destination, is projected at 1.7 per cent and 1.5 per cent, respectively, in 2017 and 2018. Growth prospects for the UK continue to be marred by the uncertainty surrounding post-Brexit arrangements.

- **The growth momentum in emerging market and developing economies is expected to pick up markedly in 2017 and 2018, recovering from slackened activity in 2016**. This growth is expected to be mainly supported by growth enhancing structural reforms and spillover effects of growth in advanced economies and China. The IMF growth projection for emerging market and developing economies is 4.6 per cent for 2017 and 4.9 per cent for 2018, rising from the growth rate of 4.3 per cent estimated for 2016. The annual economic growth of China is expected to remain above 6.0 per cent over the medium term, supported by supply side reforms, including efforts to reduce excess capacity in the industrial sector. India's growth is projected to decelerate to 6.7 per cent in 2017, reflecting the lingering effects of the currency demonetisation in 2016

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and the imposition of the Goods and Services tax in July 2017. These effects are expected to be of a short term nature and growth is expected to accelerate from 2018. The ASEAN-5 economies are expected to sustain growth at 5.2 per cent in 2017 and 2018 propped by external demand from China and Europe.

- **Global growth projections may be affected by numerous downside risks to the strength and durability of the global economic recovery, but could also be subject to upward revisions, with stronger cyclical recovery and stronger consumer and business confidence**. Uncertainties relating to macroeconomic policies in the US could hinder the global growth, affecting asset prices and global financial market stability. Monetary policy normalisation in the US could tighten global financial conditions as well. Such an effect may result in capital outflows from emerging economies. Persistently low inflation in advanced economies could weigh on achieving full employment and potential output, and produce negative spillover effects on emerging economies, amplified by restrictions on trade. The IMF is also concerned that the strong credit growth in China, unless addressed proactively by Chinese authorities without allowing for sudden market adjustments, could adversely affect the global economy through trade and commodity price channels. Meanwhile, non-economic factors such as geopolitical tensions and terrorism, as well as extreme weather events could hamper global growth prospects as well.

- **Inflation in advanced economies, which has picked up since 2016, is expected to increase further in 2017 and 2018, while inflation in emerging market and developing economies is projected to remain broadly stable**. Consumer price inflation that stood at 0.8 per cent, on average, in advanced economies during 2016 is expected to increase to 1.7 per cent in 2017 and 2018, albeit at a slower pace than anticipated at the beginning of the year, partly reflecting weaker than expected oil prices. Notably, the headline inflation rates in all advanced economies, particularly in Japan, which experienced deflation in 2016, are expected to record positive levels in 2017. Meanwhile, consumer price inflation in emerging market and developing economies is expected to stabilise over the medium term, with forecasts reaching 4.2 per cent in 2017 and 4.4 per cent in 2018. However, several emerging economies are expected to witness a decline in inflation. Further, oil prices have become firmer due to the reduction in oil inventories and the supply limitations imposed by the Organization of the Petroleum Exporting Countries (OPEC) and Russia. The IMF projects average global oil prices at US dollars 50.28 per barrel in 2017 and US dollars 50.17 per barrel in 2018.

- **Monetary policy in advanced economies continued to move in diverse directions given uneven economic recovery**. Reflecting these divergences, the US Federal Reserve continued its policy normalisation programme, while the Bank of England (BoE) and European Central Bank (ECB) maintained accommodative monetary policies. Further to raising the target range for the Federal funds rate on two occasions so far during 2017, the US Federal Reserve has indicated its intention to reduce the size of its balance sheet substantially in the period

Table 1.2

Changes in the Policy Interest Rates of Selected Central Banks

Per cent

Country	Key Policy Rate	End 2014	End 2015	End 2016	Sep-17
Sri Lanka	Standing Deposit Facility Rate	6.50	6.00	7.00	7.25
	Standing Lending Facility Rate	8.00	7.50	8.50	8.75
Emerging Market Economies					
India	Repurchase rate	8.00	6.75	6.25	6.00
Malaysia	Overnight policy rate	3.25	3.25	3.00	3.00
Thailand	1-day bilateral repo rate	2.00	1.50	1.50	1.50
China	1-year yuan lending rate	5.60	4.35	4.35	4.35
Advanced Economies					
USA	Federal funds rate	0-0.25	0.25-0.50	0.50-0.75	1.00-1.25
UK	Bank rate	0.50	0.50	0.25	0.25
ECB	Refinance rate	0.05	0.05	0.00	0.00
Japan	Overnight call rate	0.00	0.00	-0.10	-0.10
Canada	Overnight rate	1.00	0.50	0.50	1.00
Australia	Cash rate	2.50	2.00	1.50	1.50
Sweden	Repo rate	0.00	-0.35	-0.50	-0.50

Source: Websites of respective central banks ahead. The UK is currently experiencing the lowest level of unemployment in four decades while inflation remains above the BoE's target, but the uncertainties arising from Brexit have prevented monetary policy tightening in the UK so far. Nevertheless, some withdrawal of monetary stimulus by the BoE is expected in order to maintain inflation at targeted levels in the period ahead. The ECB is expected to rationalise its asset purchase programme, given the expected economic recovery in the Eurozone. Meanwhile, the Bank of Japan (BoJ) continued with Quantitative and Qualitative Monetary Easing (QQE), aiming to achieve the inflation target of 2 per cent. Further, the Reserve Bank of Australia (RBA) also held its monetary policy stance unchanged with a view to supporting the achievement of the inflation target and sustain growth in the economy.

- **The monetary policy stances of the emerging market economies also varied in the midst of a complex global economic environment**. Some emerging economies eased monetary policy with a view to boost economic growth. The Reserve Bank of India (RBI) reduced its repo rate under the liquidity adjustment facility (LAF) by 25 basis points to 6.0 per cent in August 2017, in consonance with the objective of achieving the medium term target for inflation of 4 per cent within a band of +/- 2 per cent, while supporting economic growth. The Central Bank of Chile also reduced its benchmark rate by 100 basis points to 2.50 per cent on three occasions during the first half of 2017. Meanwhile, a number of emerging market economies gradually tightened their monetary policies to address issues such as currency depreciation, capital outflows and inflationary pressures. The Central Bank of Mexico raised its benchmark rate on multiple occasions, totaling 125 basis points to 7.0 per cent during 2017, with a view to curtailing demand pressures of inflation. The Central Bank of the Republic of Turkey also raised its overnight lending rate by 75 basis points to 9.25 per cent in January 2017, and raised the late liquidity window's lending rate by 75 basis points and 50 basis points in March and April 2017, respectively, to 12.25 per cent. Meanwhile, considering the improved growth outlook and to maintain the current growth momentum, Bank of Thailand decided to keep its policy rates unchanged at 1.50 per cent in 2017. Bank Negara Malaysia also decided to maintain its overnight policy rate unchanged at 3.0 per cent, citing improved performance of the economy during the first half of 2017, supported by stronger domestic demand and an additional impetus from exports.

Expected Developments

- **Sri Lanka's growth trajectory is expected to improve gradually in the medium term with the support of ongoing structural adjustments, improving macroeconomic stability and consistent policies**. Nevertheless, economic growth during the second half of 2017 is expected to be low, due to the effects of adverse weather conditions, although it is expected to perform better than the first half of the year. Accordingly, real economic growth during 2017 is projected to be between 4.0 - 4.5 per cent, on a year-on-year basis, in comparison to the 4.4 per cent expansion recorded in 2016. Growth is envisaged to improve thereafter with the support of conducive macroeconomic policies and the realisation of growth promoting strategies of the government, and the resultant increase in domestic and foreign investments. The macroeconomic environment is expected to improve with revenue based fiscal consolidation measures, the market based flexible exchange rate system, and mid-single digit inflation. Furthermore, initiatives aimed at harnessing higher economic growth through the development of the country as an export driven economic hub are expected to provide a major impetus towards growth. This would entail improving the production capacity of the country through mechanisation of economic activities, enhancing the skill level of the labour force and digitalisation of the economy as well as improving global linkages through entering into trade agreements and global production networks. The envisaged growth needs to be driven by the active participation of the private sector, including higher FDI inflows, which would facilitate the transfer of technological knowledge as well as improved access to global markets. The growth outlook of the country would also benefit from complementary policies that would exploit its geographical location in terms of port and airport related activities. Major development initiatives such as the Colombo International Financial City, the Western Region Megapolis Development project and the establishment of Special Economic Zones are some of the activities that would help realise the expected economic expansion in the future. With these expected developments, economic growth is projected to gradually improve to 7.0 per cent by 2020.

- **Sri Lanka's external sector is expected to improve gradually in the medium term, despite the likely widening of the current account deficit in 2017**. Slower than expected adjustment in the trade account, mainly due to the increased fuel and food import requirements caused by adverse weather conditions, and the slowdown in workers' remittances are anticipated to weigh down on previously projected improvement in the external current account in 2017. However, the current account is projected to improve thereafter with the support of the anticipated improvement in trade in goods and services. With improved global trade including growth in Sri Lanka's major export markets; the US and EU, the reinstatement of the EU GSP+ facility, enhanced trade relations expected through bilateral trade agreements, strong institutional support and consistent policies that will result in increased domestic and foreign investments in export oriented industries, exports are projected to record an expansion in the medium term. In line with the expected economic growth, imports of investment and intermediate goods are also projected to increase over the period ahead, thereby leading to increased expenditure on imports. However, the growth in expenditure on imports are expected be lower than the growth in export earnings, thus contributing to a gradual rebalance in the trade account. The services account is expected to continue its momentum, with a positive growth in tourism, transportation, and information technology – business process outsourcing (IT-BPO) sectors. However, workers' remittances are expected to remain broadly at the current levels in the medium term, due to domestic and external factors. The financial account is expected to strengthen with higher direct investment inflows as well as debt inflows to the government and the private sector. The continuation of the IMF-EFF programme is also expected to play a vital role in supporting the government's reform agenda and improving investor confidence, leading to increased foreign investment in the country. Within an environment of rising global interest rates, and in consideration of the government's debt servicing obligations falling due in the period ahead, a cautious approach towards external financing is necessary. In this regard, the pre-emptive measures to be taken by the government, particularly in terms of liability management, are an essential step towards mitigating risks faced by the external sector in the medium term, along with attracting non-debt creating foreign inflows.

- **Several decisive measures have been introduced by the government to enhance revenue while rationalising expenditure in the process of fiscal consolidation, which is aimed at improving the fiscal sector over the medium term**. Accordingly, the new Inland Revenue Act, along with ongoing digitalisation efforts, are expected to simplify and rationalise the existing income tax structure, broaden the direct tax collection by removing exemptions, strengthen administration and introduce international best practices to the Sri Lankan tax system. Further, submission of Quarterly Expenditure and Income Outcome Reports to the Parliament would strengthen Parliamentary control over public finances. In addition, the government has taken several initiatives to implement structural reforms, with a view to improving the financial strength of SOBEs, thereby ensuring their long term viability. With these developments, tax revenue is expected to increase to around 16 per cent of GDP by 2020, while maintaining public investment at 5-6 per cent of GDP in the medium term. Consequently, the budget deficit is expected to be reduced to 3.5 per cent of GDP with a surplus in the primary balance and the current account balance. Government debt is also expected to decline to a sustainable level in the medium term.

- **The Central Bank will conduct monetary policy within the current enhanced monetary policy framework, with a view to transiting towards Flexible Inflation Targeting (FIT) in the medium term**. The key stages of this transition include introducing necessary legal reforms, building institutional and technical capacity, strengthening Central Bank credibility and autonomy, enhancing monetary-fiscal policy coordination, including through strengthening of the Fiscal Management (Responsibility) Act, allowing greater flexibility in the exchange rate, improving monetary policy operations and enriching public and stakeholder awareness. Having met several prerequisites to adopt FIT, the Central Bank intends to announce a Road Map for the smooth transition towards the FIT framework in the medium term, with the support of the government. Despite the recent increase in inflation due to supply disruptions and tax adjustments, inflation is expected to remain at mid-single digit levels in the medium-term, provided that fiscal consolidation continues as envisaged. However, considering the large share of food items and imported components in the consumption basket, domestic supply disruptions and volatile international commodity prices pose a threat to maintaining inflation at desired levels, unless addressed by the government through appropriate proactive measures. With regard to monetary aggregates, it is expected that monetary expansion will normalise from the current high levels from 2018 onwards, with sufficient credit flows to facilitate private sector led economic growth.

- **Developments in monetary, external and fiscal sectors of the Sri Lankan economy during the first three quarters of the year suggest that macroeconomic stability is being gradually restored, and increased attention is required to boost economic growth to reach its potential over the medium term**. In addition to the conduct of monetary policy to maintain inflation around the targeted path of 4-6 per cent with due regard to real sector stability, the Central Bank will also maintain a competitive exchange rate driven by market fundamentals with minimal intervention. With the exchange rate acting as an automatic stabiliser, and with the realisation of expected non-debt creating foreign inflows, the external sector is expected to strengthen further with improved resilience. The structural reforms to be implemented towards improving the government's revenue mobilisation, tax administration and compliance, expenditure rationalisation, and the active management of fiscal liabilities in a forward looking framework as well as ensuring the viability of SOBEs are essential for improved fiscal discipline. In the meantime, the implementation of growth enhancing reforms identified in various country diagnostic studies must be expedited to harness the benefits of improving global economic conditions and increasing access to global markets. In this regard, the implementation of the policies aimed at improving the country's efficiency and competitiveness with a medium to long term view, is essential for Sri Lanka to move forward to become an enriched nation.