

State of the Economy as reflected in the Central Bank Annual Report 2014

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The Statutory Requirement

Section 35 of the Monetary Law Act:

...Within four months after the end of each financial year, the Monetary Board shall submit to the Minister in charge of the subject of Finance and shall publish an annual report on the condition of the Central Bank and a review of the policies and measures adopted by the Monetary Board during the financial year and an analysis of the economic and financial circumstances which prompted those policies and measures...

Contents of the Annual Report

- Part 1 -** The state of the economy, its performance, policies and issues
- Part 2 -** Accounts and operations of the Central Bank
- Part 3 -** Major administrative measures adopted by the Monetary Board in 2014
- Part 4 -** Major legislative enactments in 2014 relating to the functions and operations of the Central Bank and banking institutions in Sri Lanka

Appendix Tables

Special Appendix Tables



Part 1

State of the Economy, Its Performance, Policies and Issues

- 1. Economic, Price & Financial System Stability, Outlook & Policies**
- 2. National Output & Expenditure**
- 3. Economic & Social Infrastructure**
- 4. Prices, Wages, Employment & Productivity**
- 5. External Sector Developments & Policies**
- 6. Fiscal Policy & Government Finance**
- 7. Monetary Policy, Money, Credit & Interest Rates**
- 8. Financial Sector Developments & System Stability**

In 2014, the Sri Lankan economy showed its resilience in the face of domestic as well as external headwinds



Highlights of the Economy

Real sector and inflation

- Industry and Services sectors sustained the growth momentum in 2014
- Inflation remained at single digit levels for the 6th consecutive year
- GDP amounted to US\$ 74.9 bn in 2014, compared to US\$ 67.2 bn in 2013
- GDP per capita increased to US\$ 3,625 in 2014 from US\$ 3,280 in 2013

Fiscal sector

- The overall fiscal deficit as a percentage of GDP increased for the first time in the post conflict period
- The continued decline in revenue as a percentage of GDP led to an increase in the overall fiscal deficit to 6.0 per cent of GDP in 2014

Monetary Policy and Monetary sector

- Low inflation enabled CBSL to ease monetary policy further
- Monetary expansion was in line with expectations during the year
- Private sector credit growth was impacted by the decline in gold backed advances, but recovered
- Most market interest rates declined to historically low rates

External sector

- The current account deficit narrowed with inflows from trade in services and workers' remittances
- The balance of payments (BOP) and gross official reserves (GOR) strengthened
- Sri Lankan rupee, which remained broadly stable against the US dollar in the first nine months of the year, depreciated thereafter

Financial sector

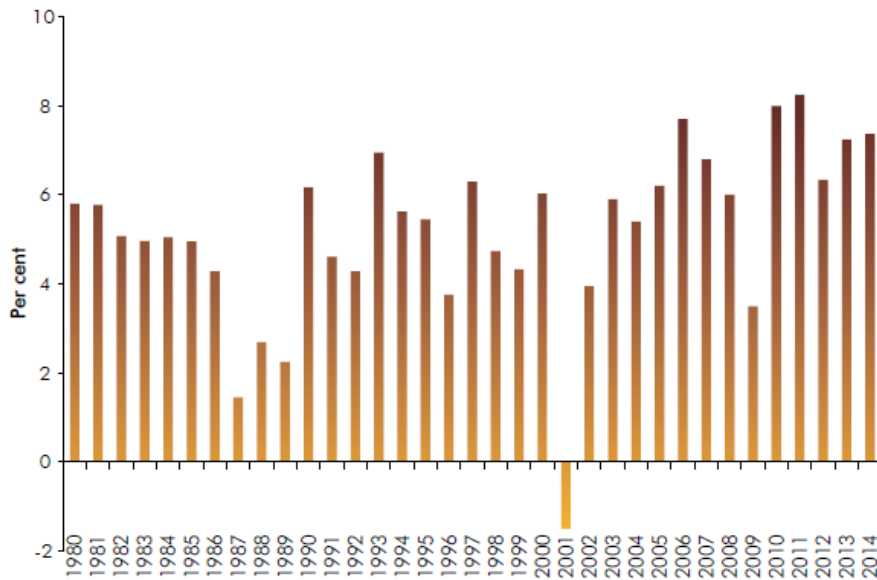
- The capital of the banking sector was maintained at a healthy level
- Total assets and asset quality of the banking sector improved
- The performance of superannuation funds, insurance companies, primary dealers in government securities, and unit trusts also improved during the year



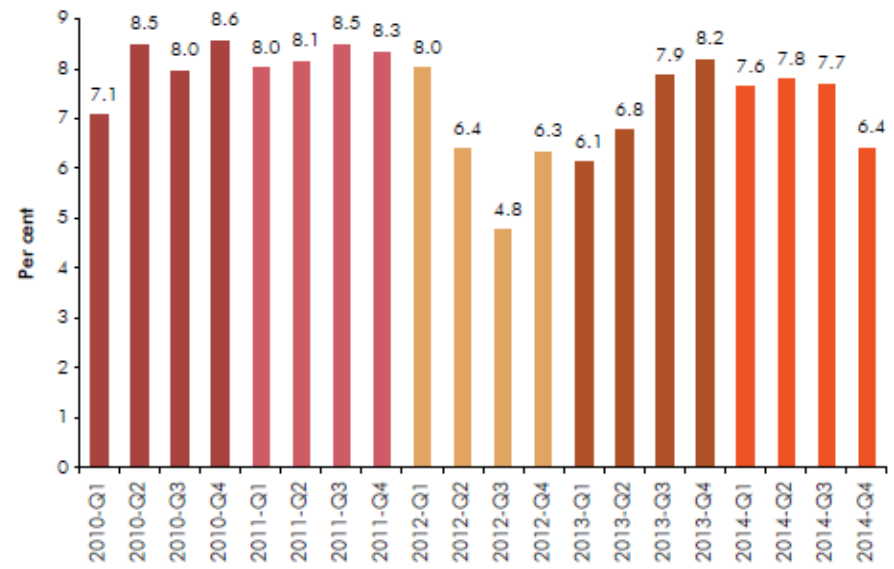
Real GDP grew by 7.4% in 2014, in comparison to the growth of 7.2% in 2013

- Continued domestic economic activity sustained the growth momentum, amidst adverse developments in the global economy.

Annual GDP Growth



Quarterly Real GDP Growth



- Economic growth was driven by domestic consumption expenditure.
- The growth in private consumption expenditure was supported by lower domestic interest rates and higher disposable incomes.
- Investments, particularly on construction, also gave an impetus to the economic expansion during the year.
- Higher contribution from the growth in imports relative to exports, however, resulted in a deterioration of net external demand.



Sectoral Growth Performance - 2014

Services (GDP share 57.6%): 6.5% ↑

- Wholesale and Retail Trade: 8% ↑
- Transport and Communication Services: 7.3% ↑
- Hotels and Restaurants: 11.5% ↑
- Banking, Insurance and Real estate: 6.6% ↑

Industry (GDP share 32.3%): 11.4% ↑

- Construction: 20.2% ↑
- Manufacturing: 8.0% ↑

Agriculture (GDP share 10.1%): 0.3% ↑

- Paddy: 16.7% ↓
- Tea: 1.2% ↑
- Rubber: 32.3% ↓
- Coconut: 7.9% ↑
- Other food crops: 7.0% ↑

Sectoral Growth Rates

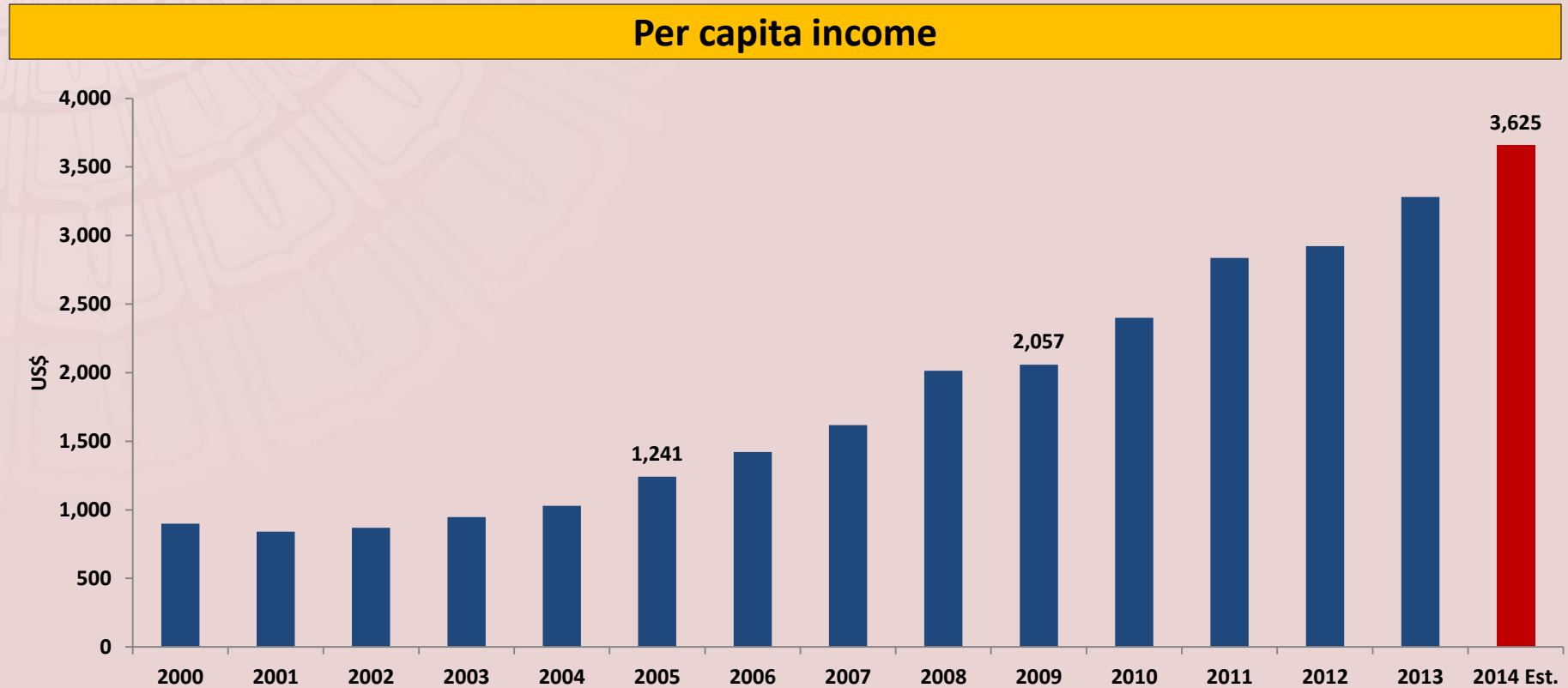
Sector	2012	2013 (a)	2014 (b)
Services	4.6	6.4	6.5
Industry	10.3	9.9	11.4
Agriculture	5.2	4.7	0.3
GDP	6.3	7.2	7.4

(a) Revised

(b) Provisional



GDP per capita increased to US\$ 3,625 in 2014...



The country is well on the path to reach the upper middle income status in the period ahead.



Inflation remained at single digit levels for the sixth consecutive year

By end 2014...

- Headline inflation (year-on-year): 2.1% *(down from 4.7% at end 2013)*
- Annual average headline inflation: 3.3% *(down from 6.9% in 2013)*
- Core inflation (year-on-year): 3.2% *(up from 2.1% at end 2013)*

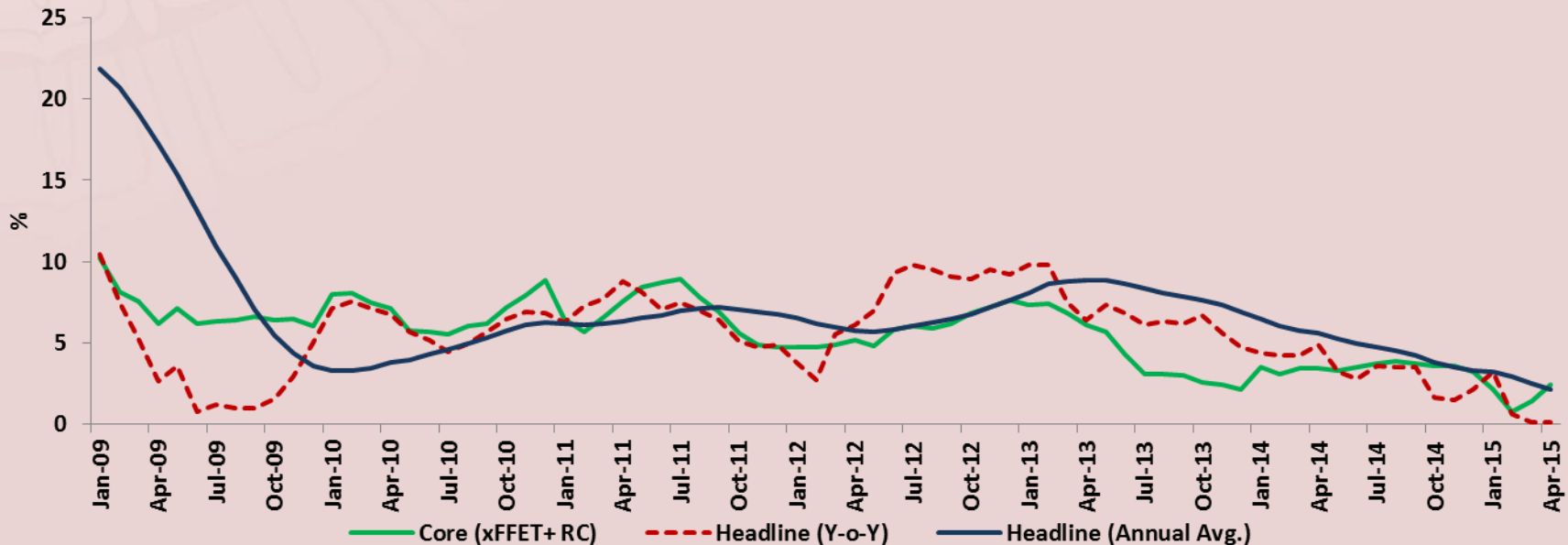
April-2015

0.1%

2.1%

2.4%

Movement of Headline and Core Inflation



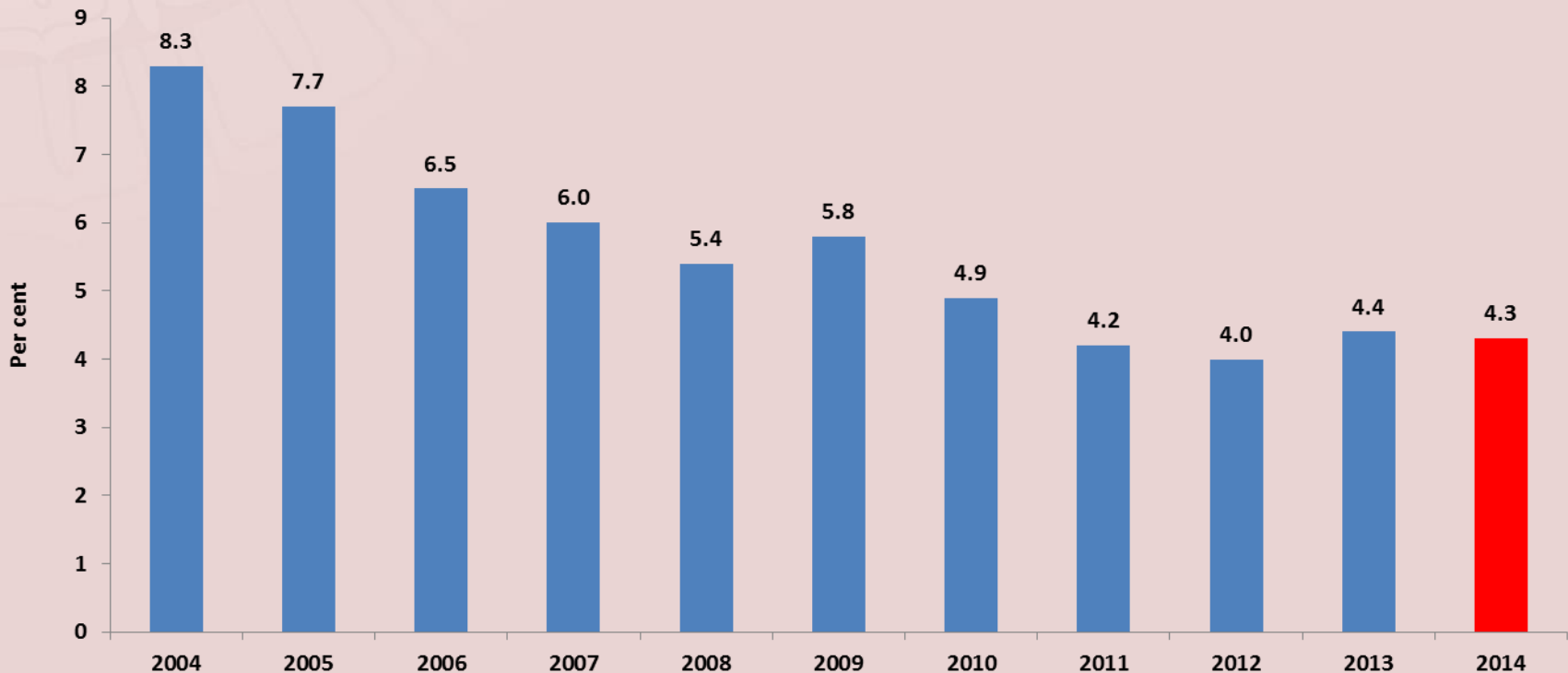
Prudent monetary policy as well as the considerable decline in global commodity prices in the second half of the year facilitated inflation to remain at low single digit levels during the year



The unemployment rate declined with increased employment opportunities as well as a reduction in the Labour Force Participation Rate (LFPR)

- The unemployment rate marginally declined to 4.3% in 2014 from 4.4% in the previous year.

The Unemployment Rate (%)





Physical and social infrastructure continued to be a key priority in the government's development agenda

- **Public investment in the infrastructure development programme was 4.5% of GDP in 2014.**
 - Phase I of the Colombo Outer Circular Highway and Phase II of the Southern Expressway were opened for traffic in March 2014
 - Operations of Phase II of the Norochcholai Coal Power Plant commenced in September 2014
 - Northern railway line to Jaffna was opened in September 2014
 - Jaffna–Kankesanthurai sector and the Madhu–Thalaimannar sector of the Northern railway line were completed in the first quarter of 2015
- **Other mega infrastructure development projects in progress.**
 - Phase II and III of Colombo Outer Circular Highway
 - East Container Terminals of the Colombo South Harbour Project
 - Phase II of the Magam Ruhunupura Port Project
 - The Lotus Tower Project
- **Several small scale rural road improvement programmes and housing development programmes were continued to facilitate regional development.**

The government is currently in the process of reviewing the ongoing and proposed mega infrastructure projects to ensure their financial viability, environmental feasibility, equitability, and their overall contribution to the economy.



Sri Lanka's social indicators continued to improve, enabling the country to maintain its foremost position amongst emerging markets and regional peers

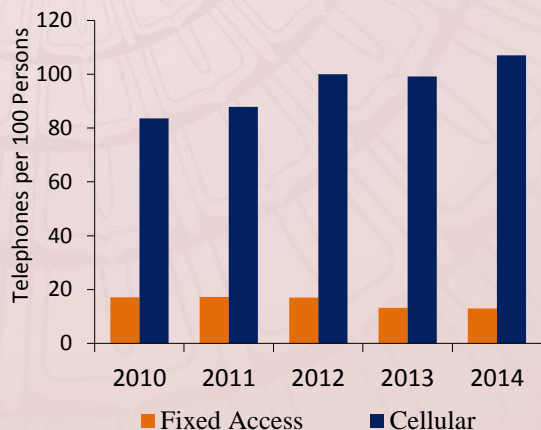
	2013	2014
Human Development Index (HDI)*	0.745	0.750
HDI World Rank*	75	73
Number of persons per doctor (public health service)	1,167	1,155
Number of hospital beds available per 1,000 persons	3.6	3.7
School density (area covered by a school) (sq. km)	6.5	6.5
Student teacher ratio in govt. education service	18	18
Level of electrification (per cent)	96	98
Telephone penetration (connections per 100 persons)	112.4	120.0
	2009/10	2012/13
Accessibility to safe drinking water (per cent)	87.7	89.7
Poverty head count ratio (per cent)	8.9	6.7

* Based on data of previous year

Telecommunication, Electricity and Ports Infrastructure

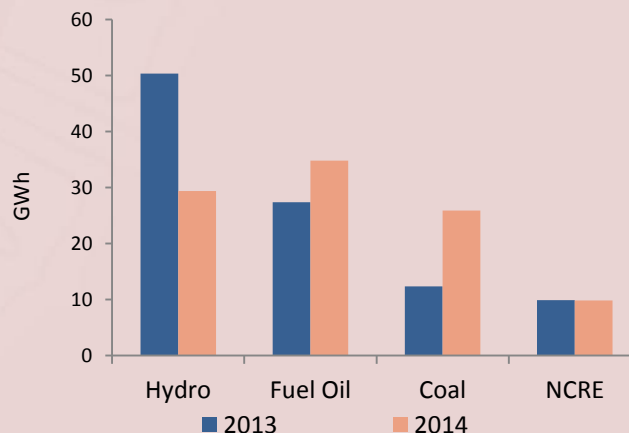


Telephone Density



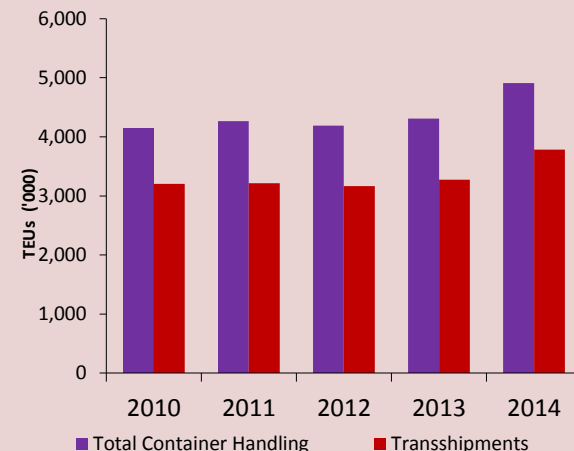
- Telephone density increased to 120.0 in 2014 from 112.4 in 2013.
- The number of mobile telephone connections increased by 8.9% while fixed access telephone connections fell by 1.0% in 2014.

Electricity Generation



- Energy mix has been significantly improved.
- Hydro: Fuel oil: Coal: NCRE ratio was 29:35:26:10 compared to 50:27:12:10 in 2013.
- Electricity generation and sales increased by 3.9% and 4.2% in 2014, largely due to higher demand from Services and Industry sectors

Container Handling and Transshipment Volumes



- Cargo handling increased by 12.3% to 74.4 mn metric tons.
- Container handling increased by 14% to 4.9 mn TEUs.
- Number of containerised transshipment increased by 15.5%.

Earnings from Exports improved by a healthy rate of 7.1% in 2014 over 6.4% growth in 2013

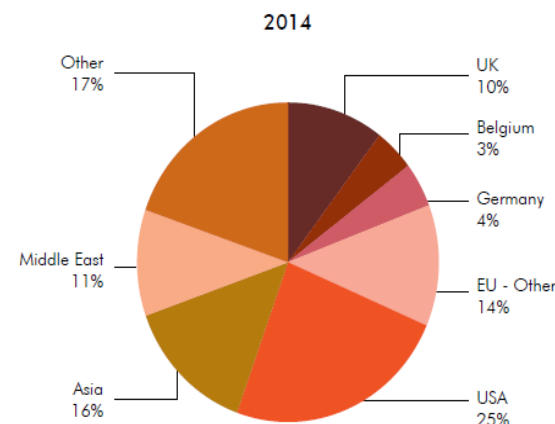


- The expansion reflects the increased demand from the US and the Euro region and conducive conditions that prevailed in the domestic economy for producers.
- However, the growth in exports, which improved significantly in second half of 2013 and first half of 2014, decelerated in the second half of 2014 mainly due to the base effect.

Export Performance (US\$ mn)

Category	2013	2014	Growth (%)
Agricultural Products	2,581.1	2,793.9	8.2
o/w Tea	1,542.2	1,628.3	5.6
Coconut	204.6	356.4	74.2
Spices	355.4	264.6	-25.6
Industrial Products	7,749.4	8,262.0	6.6
o/w Textiles and Garments	4,508.3	4,929.9	9.4
Leather, Travel Goods & Footwear	76.8	138.9	80.8
Food, Beverages and Tobacco	235.2	289.3	23.0
Petroleum Products	427.7	338.0	-21.0
Mineral Products	51.6	59.5	15.3
Exports	10,394.3	11,130.1	7.1

Exports by destination



Expenditure on imports increased by 7.9% in 2014 after recording contractions in two consecutive years

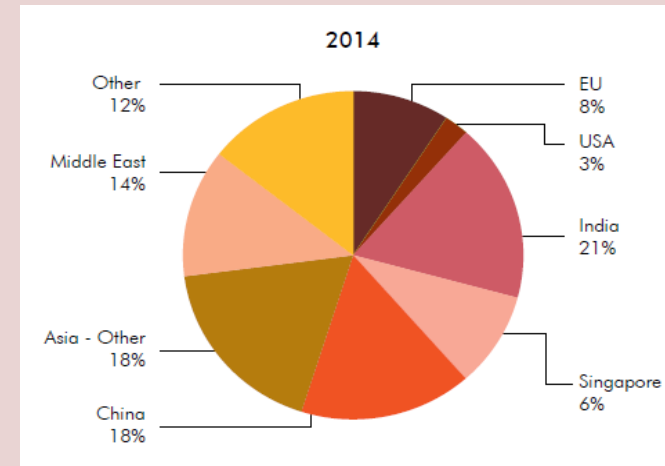


- Higher demand for consumer and intermediate goods contributed to the growth in imports.
- Expenditure on imports of oil increased despite the fall in international oil prices.
- In consumer goods, motor vehicles and rice imports contributed to the increase in imports.

Expenditure on Imports (US\$ mn)

Category	2013	2014	Growth (%)
Consumer Goods	3,182.5	3,852.5	21.1
Food and Beverages	1,368.1	1,633.7	19.4
o/w Rice	17.9	281.7	
Other Consumer Goods	1,814.4	2,218.8	22.3
o/w Vehicles	582.2	896.7	54.0
Intermediate Goods	10,553.7	11,397.7	8.0
Fuel	4,308.2	4,597.3	6.7
Textiles and Textile Articles	2,045.8	2,327.6	13.8
Investment Goods	4,252.7	4,152.2	-2.4
Machinery and Equipment	2,221.9	2,131.0	-4.1
Building Materials	1,357.2	1,308.9	-3.6
Transport Equipment	667.8	707.3	5.9
Imports	18,002.8	19,416.8	7.9

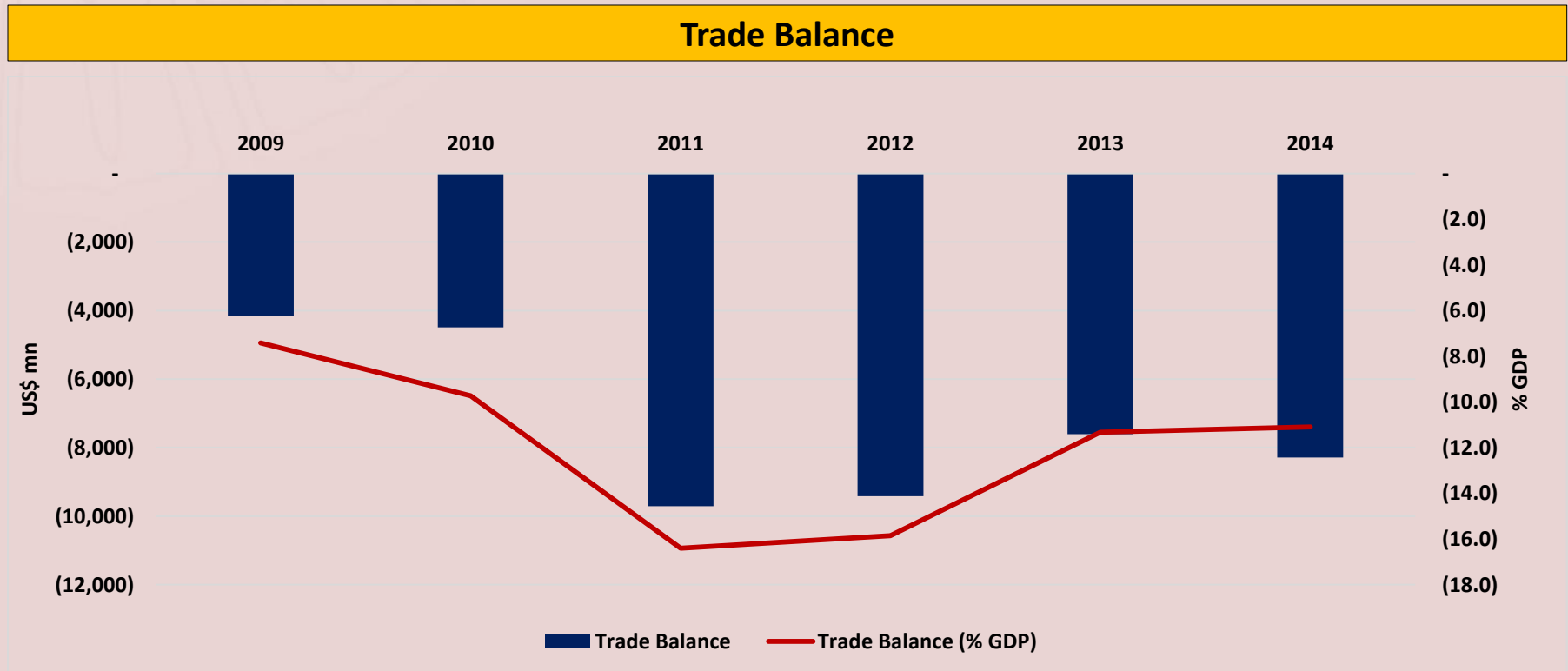
Imports by Origin





Trade deficit expanded in nominal terms in 2014, although as a percentage of GDP a marginal improvement was recorded

- The trade deficit increased to US\$ 8,287 mn in 2014 from US\$ 7,609 mn in 2013.
- However, as a percentage of GDP, the trade deficit improved from 11.3% in 2013 to 11.1% in 2014.



Earnings from tourism increased to US\$ 2.4 bn while remittances surpassed the US\$ 7 bn mark in 2014

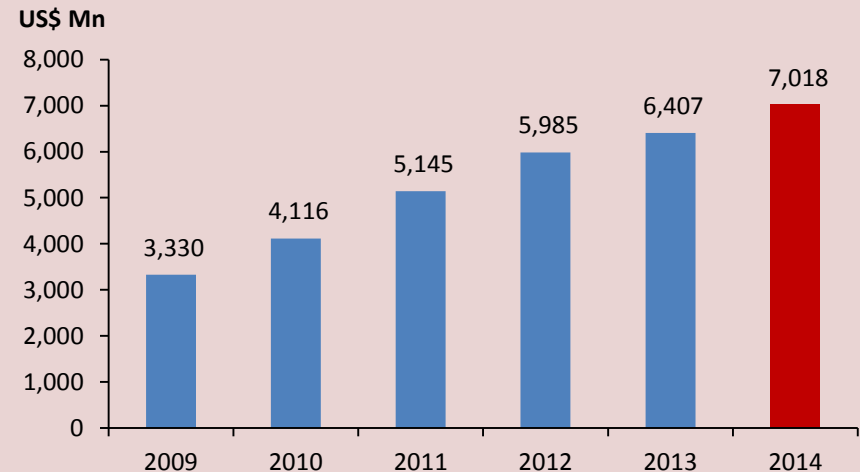


- Tourist arrivals in 2014 increased by 19.8% to 1,527,153 arrivals.
- Earnings from tourism increased
 - due to rise in tourist arrivals together with higher spending and increased duration of stay by tourists.
- Earnings from tourism grew by 41.7% to US\$ 2,431 mn.
- Remittances grew by 9.5% to US\$ 7,018 mn in 2014.
- Remittances grew
 - due to increased labour migration, particularly under professional and skilled categories.

Tourist Arrivals and Earnings from Tourism



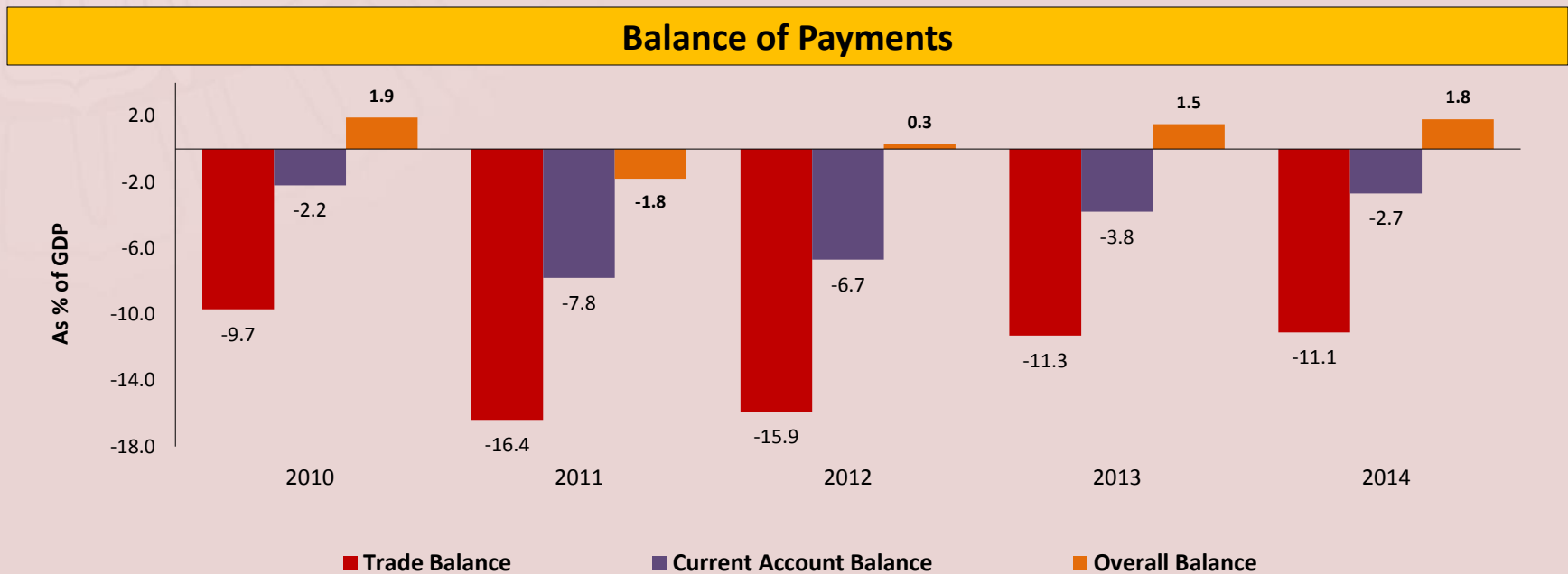
Workers' Remittances





Inflows from trade in services and workers' remittances supported the reduction of the deficit in the current account

- The current account deficit narrowed to US\$ 2.0 bn in 2014 from the deficit of US\$ 2.5 bn in the previous year.
- As a percentage of GDP, the current account deficit declined to 2.7% in 2014 from 3.7% in 2013.
- These inflows, together with other financial inflows, helped strengthen the balance of payments (BOP), and hence gross official reserves.



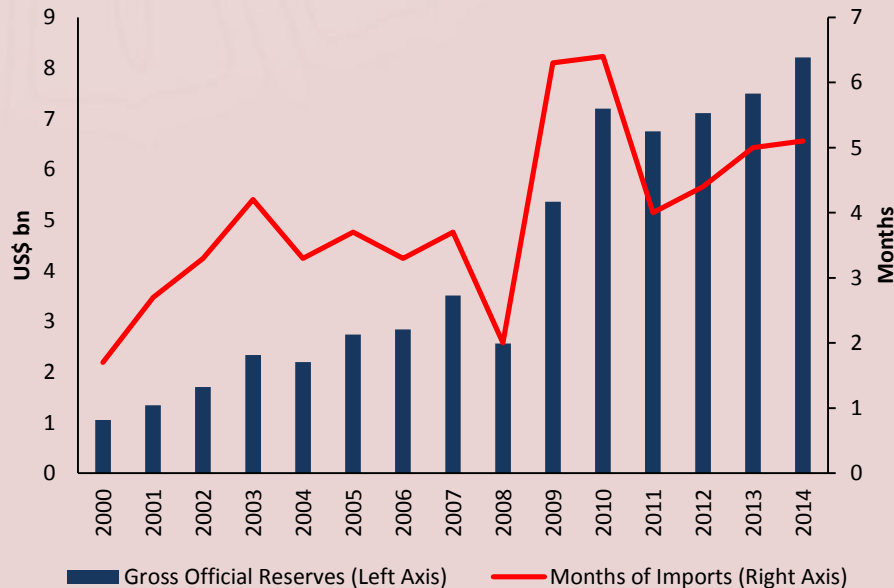
The continued inflows of funds in the form of remittances and investments aided an increase in national savings, which helped narrow the National Savings-Investment gap



Financial inflows, together with the improvement in the current account, helped improve the overall surplus of the BOP

- The overall surplus of the BOP increased to US\$ 1,369 mn in 2014 from US\$ 985 mn in the previous year.
- Accordingly, Gross Official Reserves (GOR) improved to US\$ 8.2 bn at end 2014 in comparison to US\$ 7.5 bn at end 2013.
- Gross official reserves were adequate to cover 5.1 months of imports.

Gross Official Reserves and Months of Imports



	US\$ mn	
	End Dec 2013	End Dec 2014
Overall Balance	985.4	1,368.9
Gross Official Reserves (with ACU)	7,495.3	8,208.4
Months of Imports	5.0	5.1
% Short term Debt	64.5	64.3
% Short term Debt (excluding T-bonds)	82.0	80.8



The Sri Lankan rupee, which remained broadly stable against the US dollar in the first nine months of the year, depreciated thereafter

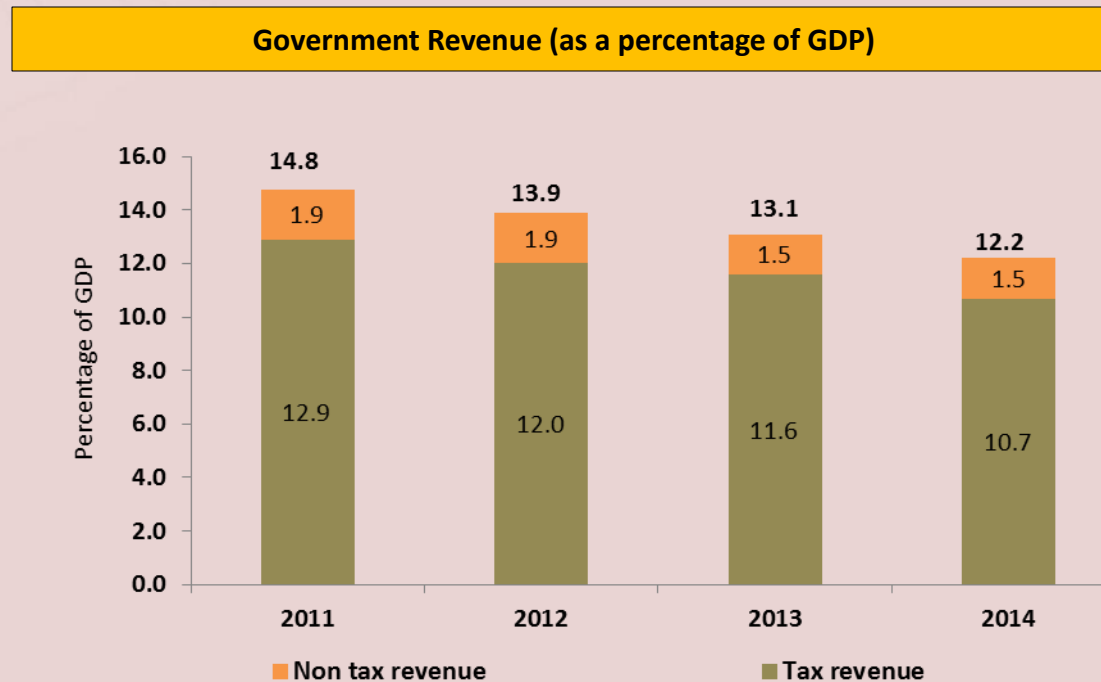
- Although the rupee appreciated by 0.3% against the US dollar by the end of third quarter of 2014, it recorded an annual depreciation of 0.23%.

Exchange Rate Movement – Rupees per US\$



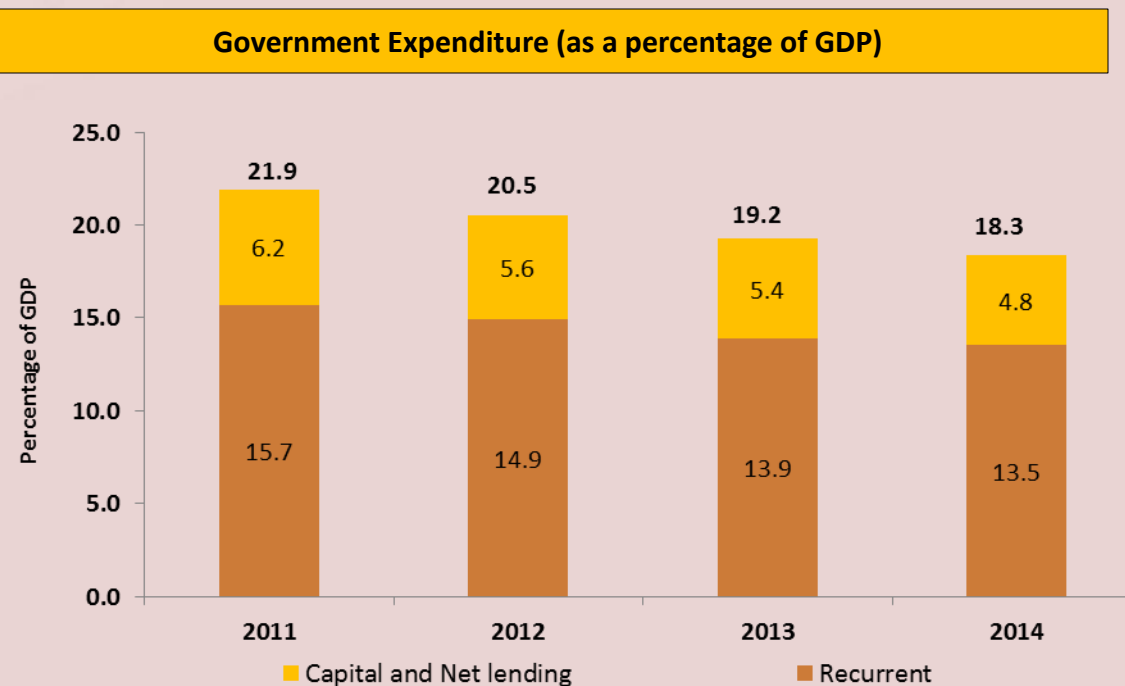
Government Revenue

- Government revenue increased by 5.1% in 2014 to Rs. 1,195 bn from Rs. 1,137 bn in the previous year.
- However, government revenue to GDP ratio declined further to 12.2% in 2014 from 13.1% in 2013, and 14.5% projected in the budget.
 - This was mainly due to a decline in direct taxes such as corporate and non corporate income tax, personal income tax, withholding tax and Economic Service Charge.



Government Expenditure

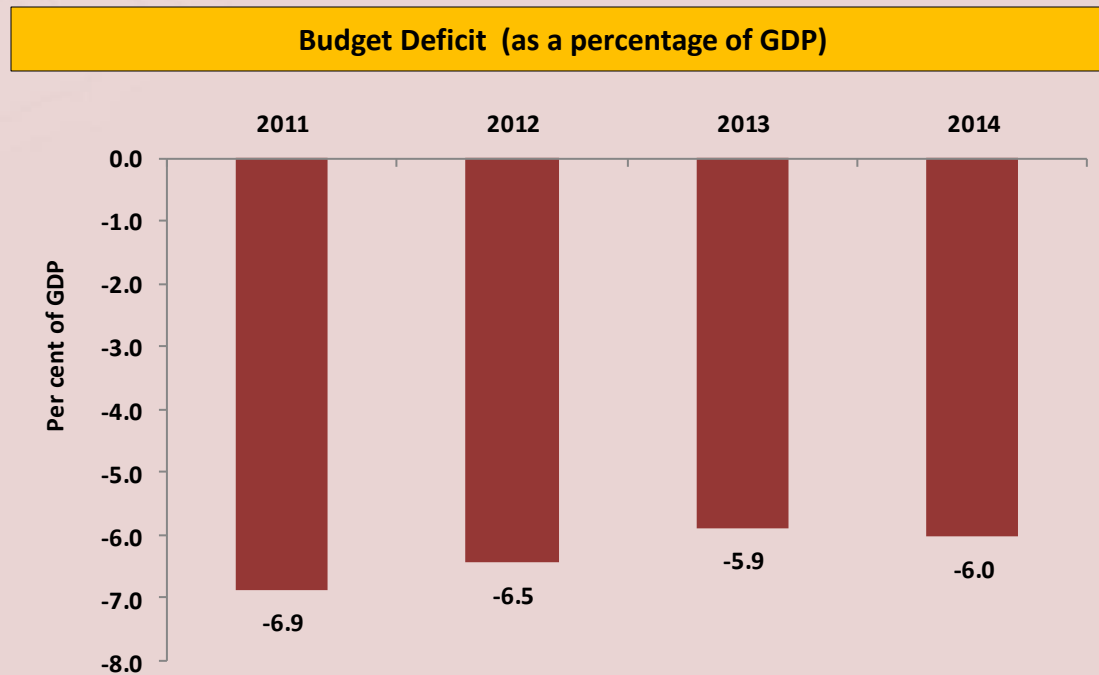
- Total expenditure increased by 7.6% to Rs. 1,796 bn in 2014 from Rs. 1,669 bn in 2013. However, as a percentage of GDP, it declined to 18.3% of GDP in 2014 from 19.2% of GDP in 2013.
- Recurrent expenditure, as a percentage of GDP declined to 13.5% in 2014 from 13.9% in 2013, reflecting the government commitment to maintain recurrent expenditure within the target stipulated in the budget.
- Public investment was maintained at 5.0% of GDP in comparison to 5.5% in 2013.





Despite the government's announced commitment towards fiscal consolidation, the overall budget deficit increased

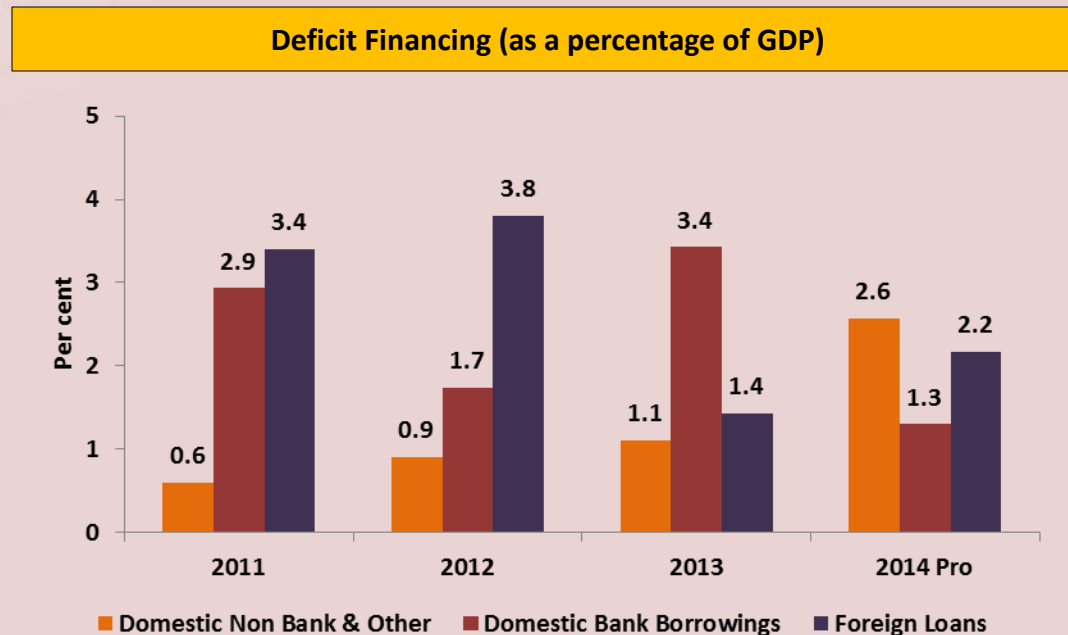
- The overall deficit was 6.0% of GDP in 2014 compared to 5.9% of GDP in the previous year.
- The increase in deficit was mainly a result of the continued shortfall in revenue collection.





Government relied more on domestic sources to finance the overall deficit

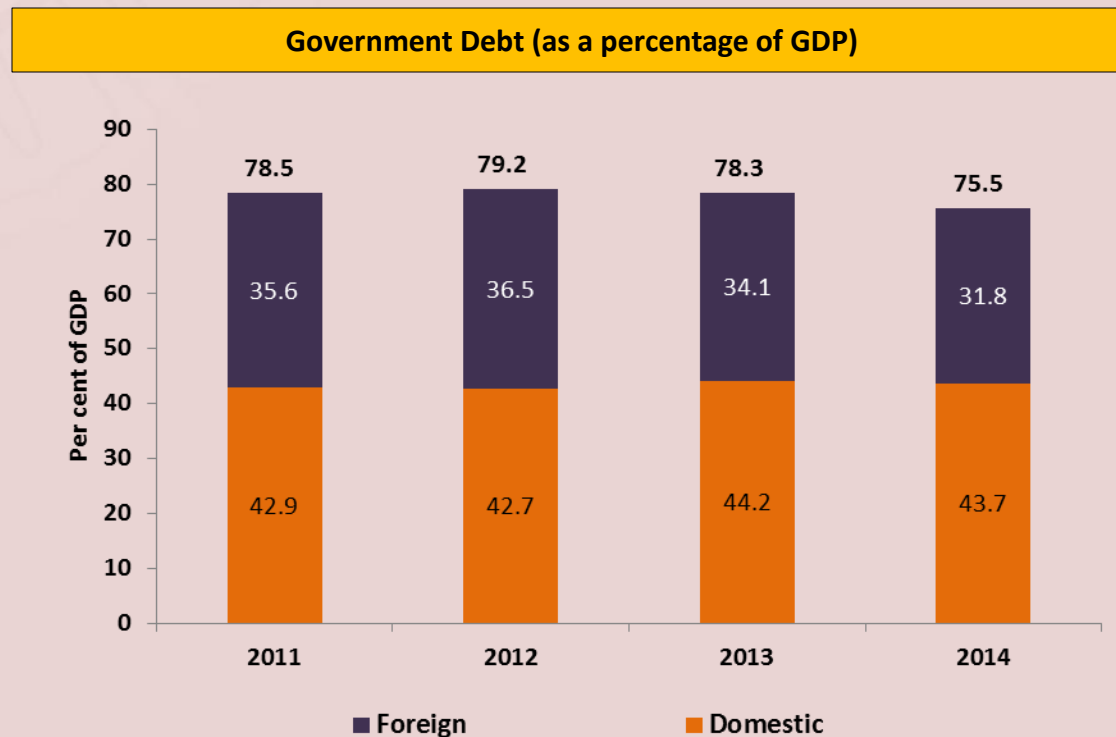
- Net domestic financing amounted to Rs. 378.7 bn in 2014 in comparison to the original estimate of Rs. 229.3 bn and Rs. 394.2 bn in the previous year.
- Net foreign financing at Rs. 212.5 bn in 2014, was below the original estimate of Rs. 286.8 bn.
- Domestic borrowings were mainly from non expansionary sources amounting to 66.5% of net domestic financing.





Central government debt as a percentage of GDP declined to 75.5% by end 2014 from 78.3% by end 2013

- The reduction in debt to GDP ratio was consistent with the declining trend observed in the recent past.





The Financial Position of key State Owned Enterprises

- The decline in the global oil prices has supported the CPC to improve its financial performance while low rainfall at the beginning of the year and the reduction of electricity prices from September 2014 has resulted in CEB incurring losses.

Financial Performance of CEB

	2013	2014 prov.	Growth (%)
Total Revenue (Rs. bn)	194.15	204.50	5.3
Operating Expenditure (Rs. bn)	169.52	216.20	27.5
Operating Profit/(Loss) (Rs. bn)	24.62	(11.70)	(147.5)

- Low rainfall during the first half of 2014 and 25% price reduction for domestic sector hindered the profitability of CEB in 2014.
- 25% tariff reduction to the industry and hotels sector consuming less than 300 units and 15% reduction to other categories increased losses.
- However, it is anticipated that CEB would be able to turn around this position in 2015 with the addition of coal power generation capacity.

Financial Performance of CPC

	2013	2014 prov.	Growth (%)
Total Revenue (Rs. bn)	494.01	533.13	7.9
Total Expenditure (Rs. bn)	501.96	531.38	5.9
Profit/(Loss) (Rs. bn)	(7.95)	1.75	122.0

- CPC started making profits in 2014 largely supported by the significant decline in global oil prices beginning from June 2014.
- The domestic fuel prices of Petrol, Diesel and Kerosene were adjusted downwards in September by Rs.5, Rs.3 and Rs.20 and in December by Rs.7, Rs.7 and Rs.5, respectively.



The Central Bank maintained its relaxed monetary policy stance

Monetary Policy Measures

2-Jan-2014: The Standing Lending Facility Rate (SLFR) was reduced by 50 bps to 8.00% and the Standing Deposit Facility (SDF) was uncollateralised (with effect from Feb 2014)

- These measures were aimed at facilitating greater stability in short term interest rates while lowering the interest rate spread.

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 by an OMO participant at the SDF window exceeding three times were accepted at a special interest rate of 5.00%

- This measure was aimed at encouraging banks to lend more actively to the private sector.

2-Mar-2015: The 5.00% special SDF rate was withdrawn. The SDFR and SLFR was at 6.50% and 8.00%, respectively

- Rationalised access to SDF was removed with the revival of credit growth.

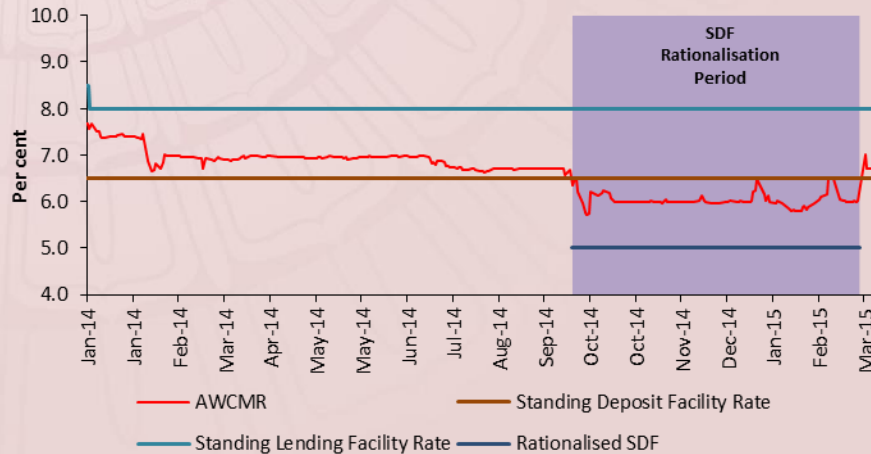
15-Apr-2015: SDFR and SLFR was lowered by 50 bps to 6.00% and 7.50%, respectively

- This measure was taken in consideration of continued low inflation and was aimed at stabilising market interest rates.

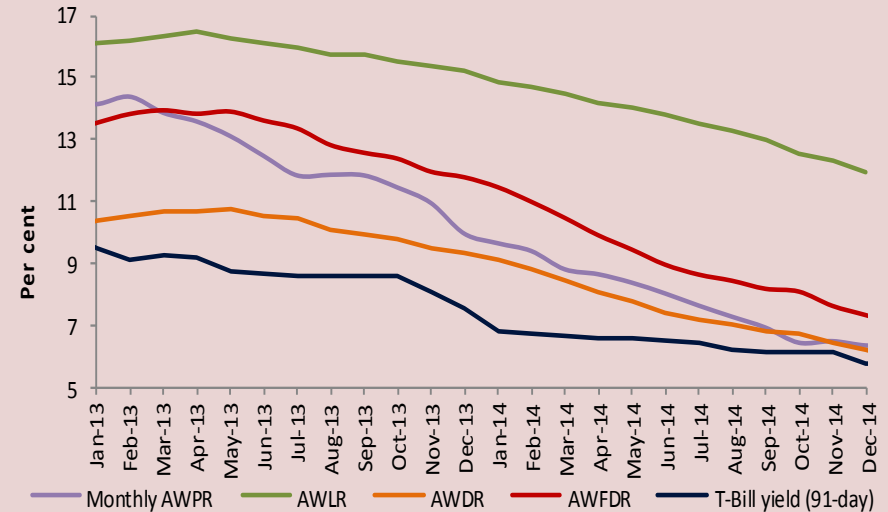
The effects of monetary policy easing measures were reflected in historic low market interest rates



Policy Interest Rates and the Call Money Market Rate



Movement of Selected Market Interest Rates



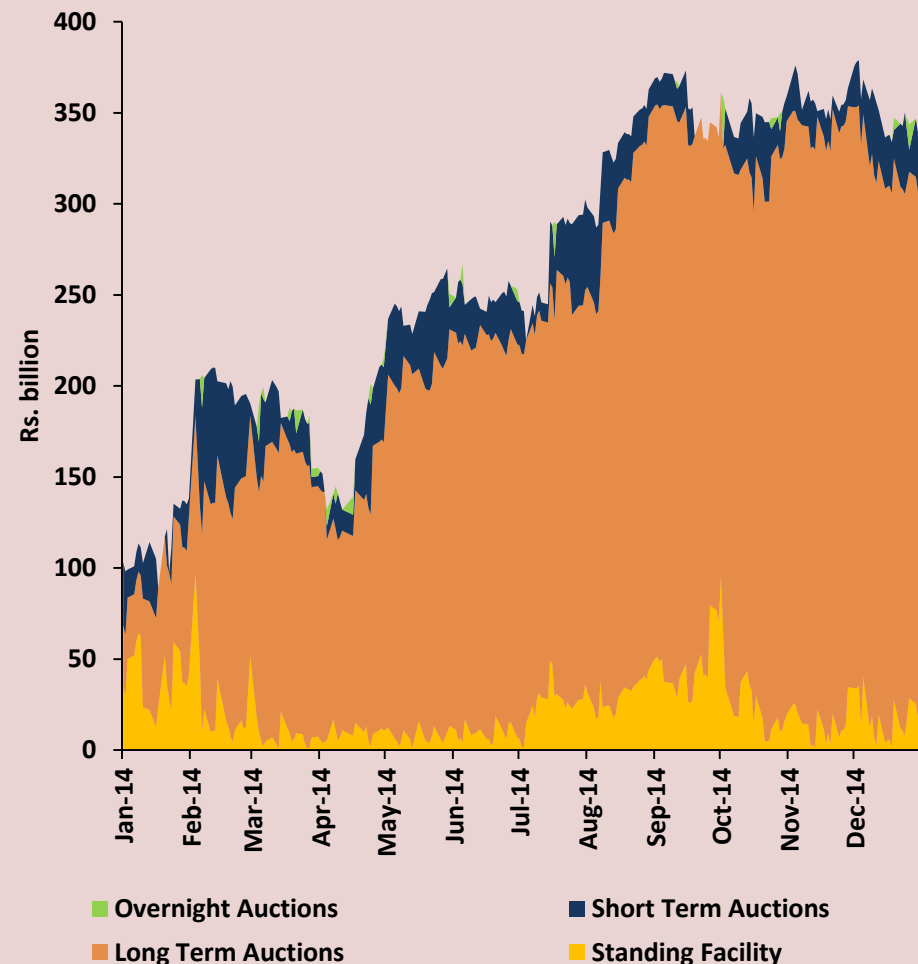
- AWCMR declined below the lower bound of the SRC since the last week of September 2014 due to the effect of the rationalisation of the SDF.
- Other market interest rates declined to historically low levels during 2014.

Sustained low inflation helped the economy to experience a low interest rate environment.

Excess rupee liquidity remained high throughout 2014

- Total excess liquidity rose to Rs. 330.9 bn in 2014 from Rs. 71.7 bn at end 2013.
- Liquidity was injected mainly from:
 - Purchases of foreign currency from the domestic forex market
 - Purchase of part of the proceeds from the International Sovereign Bond
 - Entering into swap arrangements with commercial banks.
- The Central Bank absorbed excess liquidity on overnight and term bases.

Rupee Liquidity in the Domestic Money Market and Liquidity Absorption

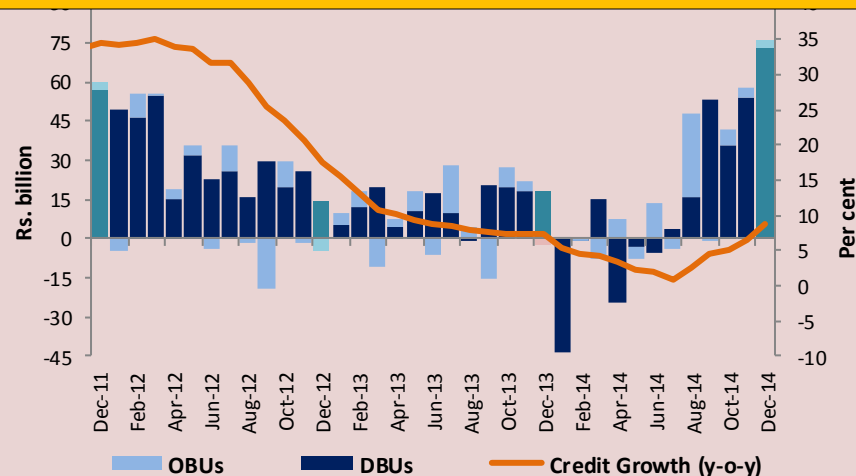


Central Bank adopted several measures to support the revival in credit flows to the private sector

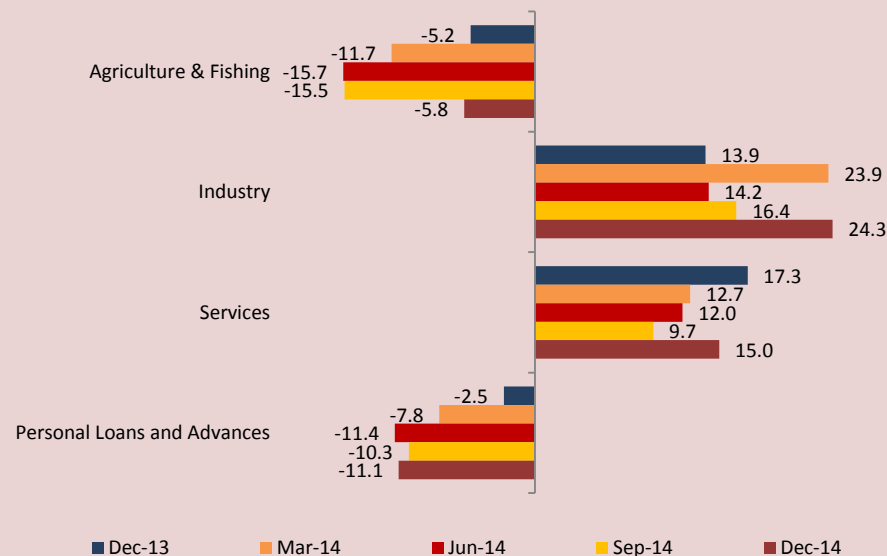


- A credit guarantee scheme for pawning advances was introduced in June 2014.
- A temporary restriction was placed on the access to the Standing Deposit Facility (SDF) of the Central Bank in September 2014.
- Regular discussions were held with lending institutions.
- As a result, the overall increase in credit disbursements to the private sector amounted to Rs. 223.9 bn in 2014, in comparison to Rs. 175.9 bn in the previous year.

Volume of Loans and Advances Granted to the Private Sector by Commercial Banks



Year-on-Year Growth of Credit to Key Sectors (%)

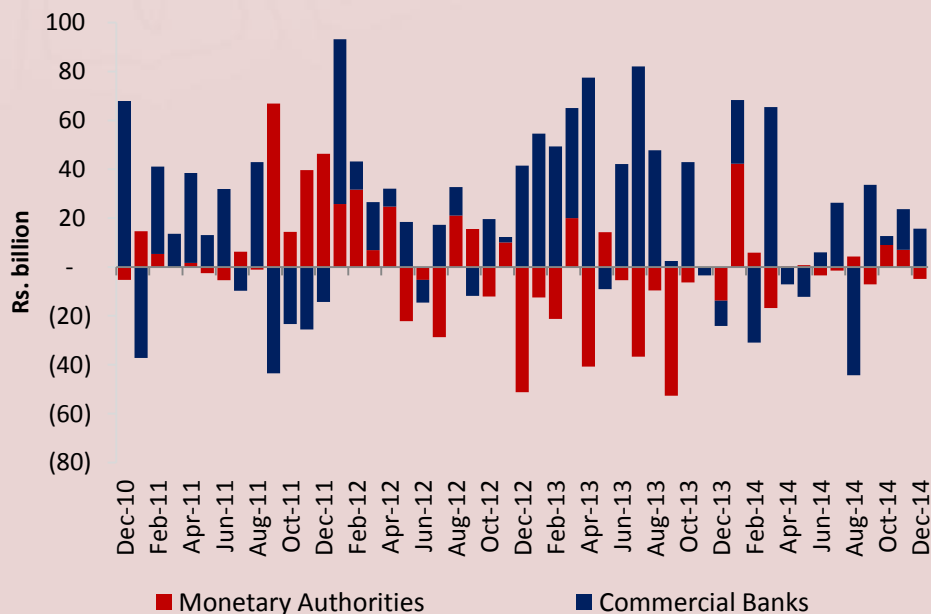


The increase in credit obtained by the public sector moderated in 2014

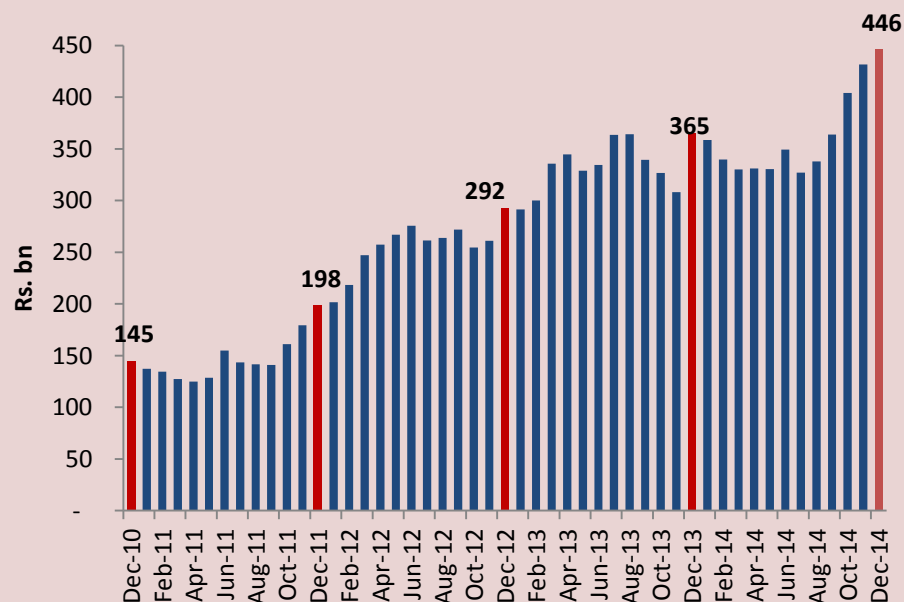


- Credit granted to the government (NCG) increased by Rs. 134.6 bn in 2014 compared to Rs. 236 bn in 2013.
- Credit obtained by government corporations increased by Rs. 80.9 bn in 2014 compared to Rs. 72.6 bn.
- The total increase in credit granted to the public sector amounted to Rs. 215.5 bn compared to Rs. 328.7 bn in 2013.

Monthly Change in Net Credit to the Government

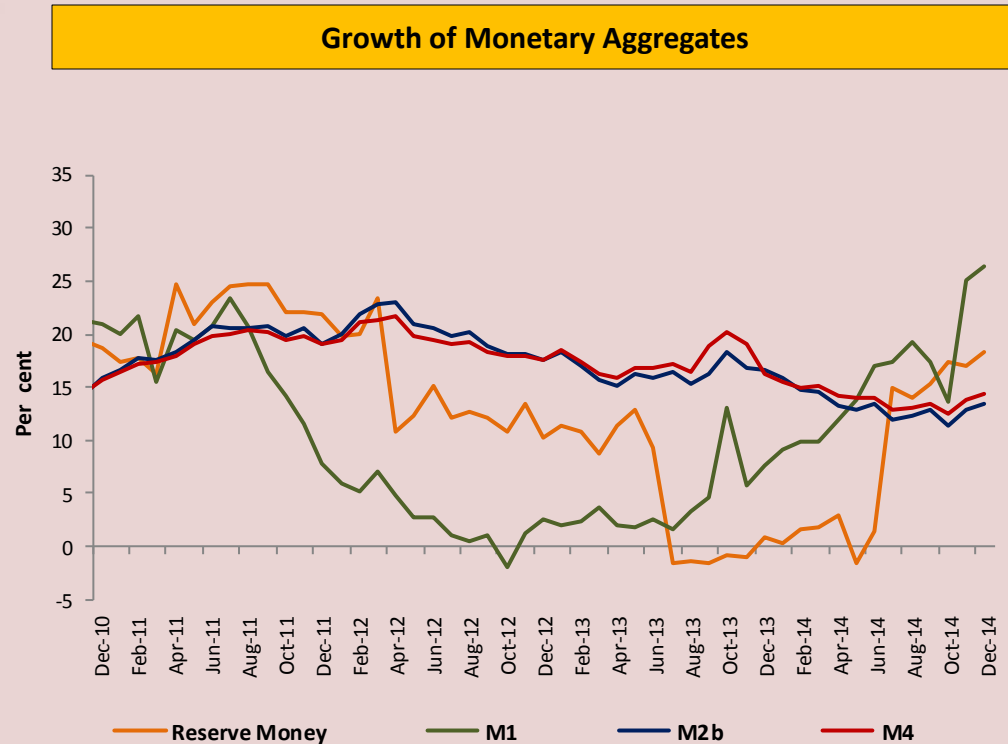


Overall Credit Obtained by Public Corporations



Monetary expansion was in line with expectations during the year

- Lower growth of credit extended to the private sector by commercial banks during the first eight months of 2014 moderated the growth in broad money aggregates.
- **Broad money grew by 13.4% by end December 2014 compared to 16.7% by end 2013.**
- Both net foreign assets (NFA) and net domestic assets (NDA) of commercial banks contributed positively to broad money growth in 2014.



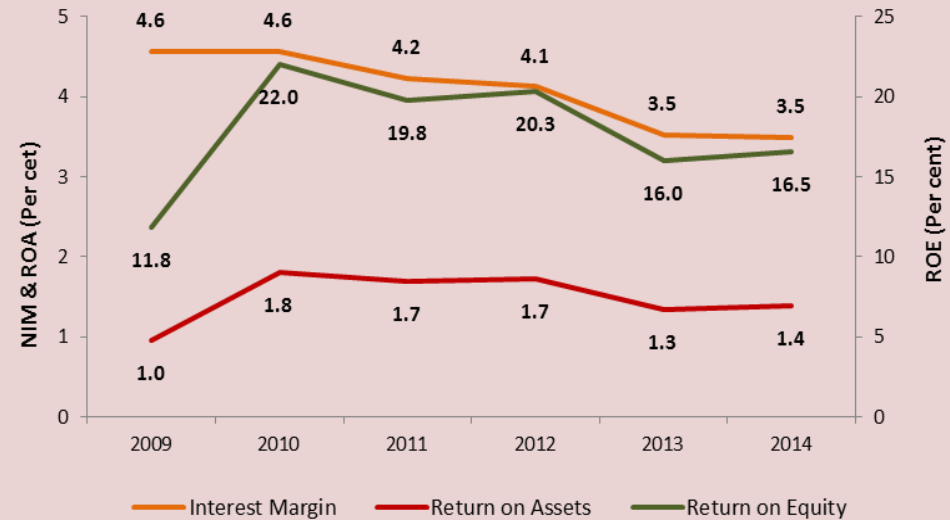
The monetary policy framework of the Central Bank is being increasingly aligned with a Flexible Inflation Targeting (FIT) regime

The financial sector remained resilient during the year

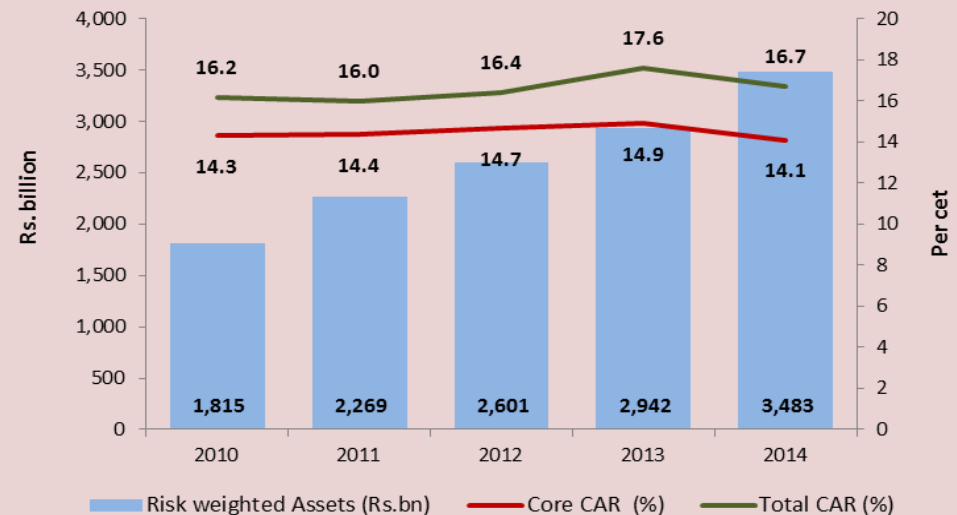


- Asset quality of banks improved, as a result of the decline in non-performing loans in relation to the pawning portfolio.
- Asset growth in LFCs and SLCs picked up in 2H 2014.
- Several prudential policy measures and regulations were introduced by the Central Bank during the year, with a view to ensure financial systems stability.
- The national payment infrastructure operated smoothly, with several measures taken to enhance the efficiency and soundness of payment and settlement systems.

Profitability Indicators of the Banking Sector



Capital Adequacy Ratios of the Banking Sector

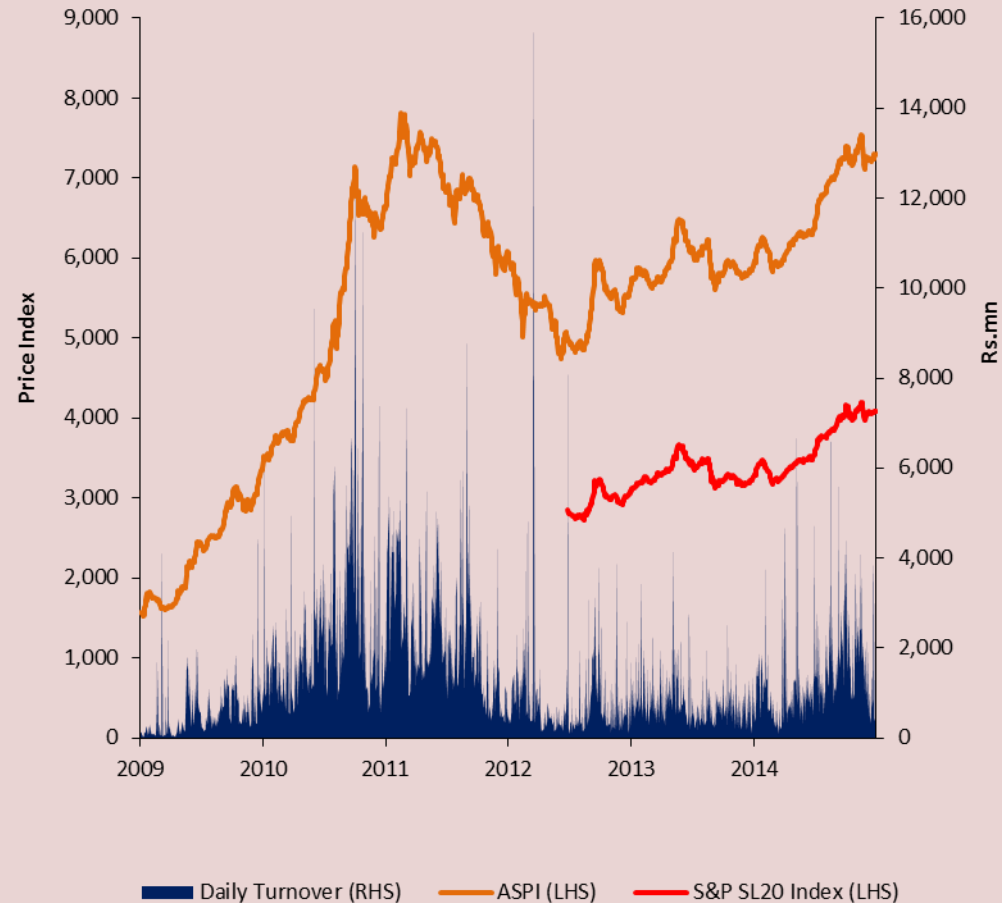


Performance of the Colombo Stock Exchange (CSE) improved considerably



- The All Share Price Index (ASPI) increased by 23.4% to 7,299 points.
- Market capitalisation increased to unprecedented levels during the year, and was Rs. 3.1 trillion by end 2014.
- The net cumulative foreign inflows (secondary market) to the stock market amounted to US\$ 158.3 mn.
- Activity in the corporate debt market remained high, although there was a slowdown compared to the takeoff observed in 2013.

ASPI, S&P SL20 Index & Daily Turnover at the CSE





Going forward, the Sri Lankan economy is projected to sustain the favourable high growth and low inflation nexus in the medium term, supported by appropriate economic policies

Medium Term Macroeconomic Framework

Indicator	Unit	2014 (Prov)	Projections			
			2015	2016	2017	2018
Real Sector and Inflation						
Real GDP Growth	%	7.4	7.0	7.5	8.0	8.0
Annual Average Inflation	%	5.1	3.0	4.0	4.0	4.0
GDP per capita	%	3,625	4,009	4,469	4,997	5,624
External Sector						
Trade Gap	% of GDP	-11.1	-7.8	-8.1	-7.6	-7.1
Current Account Balance	% of GDP	-2.7	-1.0	-1.4	-1.0	-1.0
External Official Reserves	Months of Imports	5.1	6.2	5.2	5.0	5.0
Fiscal Sector						
Overall Budget Deficit	% of GDP	-6.0	-4.4	-4.2	-4.0	-3.8
Public Debt	% of GDP	75.5	72.0	69.0	66.0	63.0
Monetary Sector						
Broad Money Growth (M _{2b})	%	13.4	12.0	12.5	13.0	13.0
Growth in Credit to the Private Sector	%	8.8	15.5	15.0	15.0	15.0



Issues and Policies

- Industrial policy should focus more on moving manufacturing up the value chain in order to enhance industrial growth in the long term.
- **A buoyant export performance is imperative for sustaining the growth momentum of the economy.**
- Special attention is required to upgrade the small and medium scale enterprise (SME) sector in line with the overall development strategy of the country.
- **Harnessing the Services sector growth potential would be an integral part of maintaining future economic growth.**
- Greater focus should be on promoting market based alternative financing methods than predominantly relying on traditional bank based financing to ensure adequate availability of long term financing.



Issues and Policies

- Despite reforms to transform the higher education sector in Sri Lanka, increasing high level R&D output to sustain economic growth remains a challenge.
- Efforts need to be intensified to adopt measures to increase tax revenue collection and further consolidate government expenditure.
- The changing demographic profile of the country has highlighted the need for forward looking labour reforms to sustain the high growth momentum.
- The need for maintaining policy consistency to ensure a favourable doing business environment with the aim of attracting non-debt creating foreign investment flows.
- Encouraging the policies of better governance and transparency as key catalysts in the process of equitable economic development.

Box Articles

- **Increasing Tax Revenue in Sri Lanka: Challenges and Policies**
- **Upgrading the National Accounts Compilation Process in Sri Lanka**
- **Direct Cash Transfers as an Alternative Method to Disburse the Fertiliser Subsidy**
- **Launch of a Producer's Price Index**
- **Importance of Improving Female Labour Force Participation in Sri Lanka**
- **Improvements in External Sector Statistics in Sri Lanka**
- **Recent Developments in the Global Regulatory and Supervisory Standards on Banks to Strengthen Financial System Stability**
- **Developing a Strategy for Financial Inclusion in Sri Lanka**
- **Real Estate Investment Trusts (REITs)**
- **Major Economic Policy Changes and Measures : 2014**