Operating Environment

The Global Economy

The global economy continued the growth experienced towards the end of 2016. Global growth is estimated to have hit 3.6% in 2017, with growth in Europe, Japan, the United States, and Emerging Markets and Developing Economies (EMDEs) accounting for the improvement. The resurgence in growth of EMDEs played a role in improving the global economy, reaching an estimated growth of 4.6% in 2017. More moderate growth was experienced in advanced economies and China.

Going into 2018, the strengthening of the global economy is expected to continue, marking a growth of 3.7%. Pickups in investment, trade, and industrial production continue to be observed, and increasing confidence from businesses and consumers are aiding the recovery.

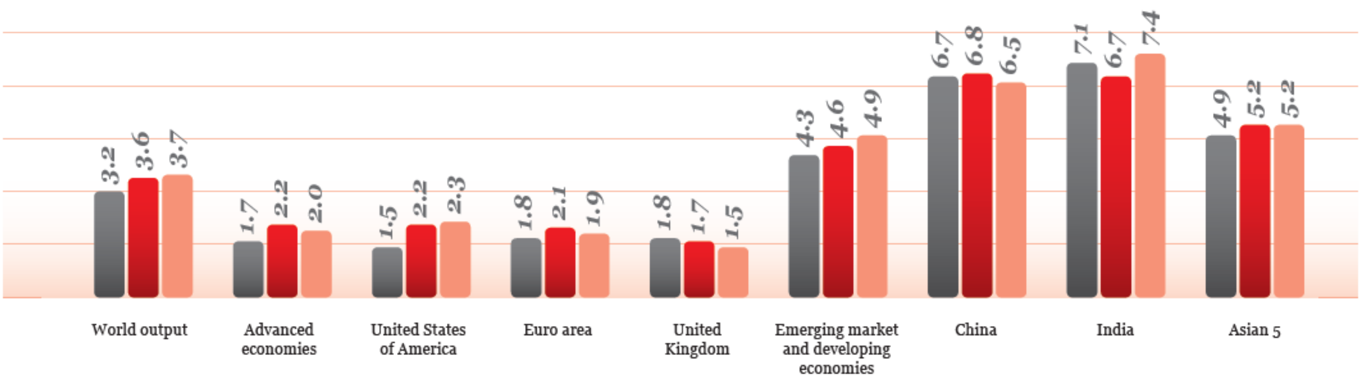
Advanced economies will likely experience a slight downturn in growth to 2.0%. Although performance was better than anticipated in 2017, the economic recovery is viewed as cyclical and expected to moderate. The potential growth of advanced economies will be affected by an ageing population slowing the growth of workforces, and productivity growth continuing its slow pace.

EMDEs are predicted to hit a growth rate of 4.9%, exhibiting a slower pace of growth and convergence than was seen in the past decade. Stronger projected activity in China and emerging Europe will primarily drive growth.

- The United States exhibited stronger-than-expected growth, despite challenging conditions, with a projected growth of 2.2%.
- Growth in the United Kingdom slowed down to 1.7%, due to Brexit-related uncertainty and inflationary pressures. The 2018 outlook looks uncertain as its economic relationship with the EU is redefined and barriers to trade, migration and cross-border financial activity are anticipated; growth is projected to fall to 1.5%.
- The Euro zone, benefitting from an increase in imports and stronger global trade activity, saw a projected growth of 2.1%. Growth is expected to moderate in 2018 at a projected 1.9%.
- China, a key investment partner of Sri Lanka, is projected to have grown at 6.8% due to improving global trade conditions and increasing household incomes and domestic demand. Growth is expected to moderate to 6.5% in 2018.
- Economic growth in India slowed to a projected 6.7% as the country continued to feel the effects of the currency exchange initiative launched in November 2016 and transition costs due to a countrywide Goods and Services Tax introduced in July 2017. The unification of India's domestic market and other key structural reforms are expected to improve growth to 7.4% in 2018.

Global Economy Highlights

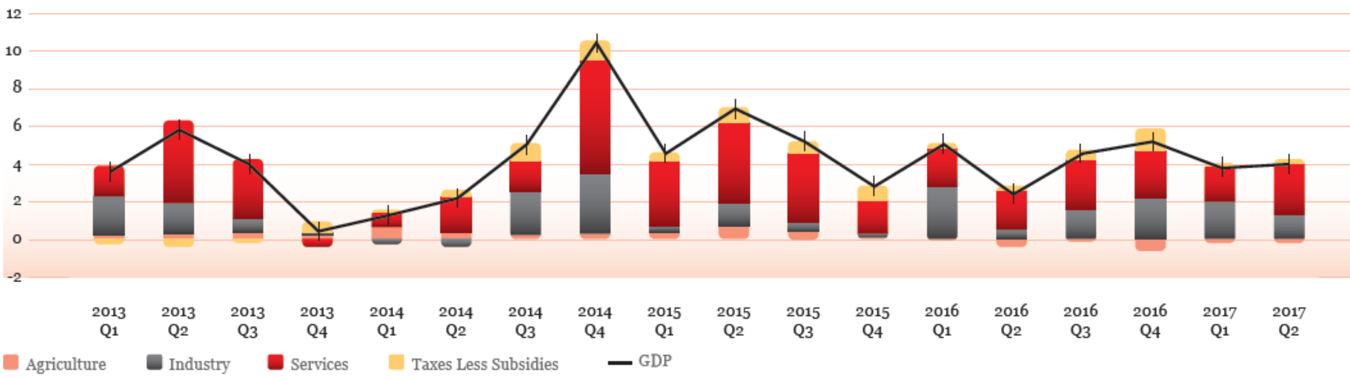
World Economic Outlook Projections – (%)



Source: World Economic Outlook

The Sri Lankan Economy

Quarterly Real GDP Growth (Year-on-year) – (%)



Source: The Central Bank of Sri Lanka

The Sri Lankan economy grew at a rate of 3.9% in the first half of 2017. The industry and services sectors propped up the economy, with the services sector turning in strong performances from financial services, wholesale and retail trade, and transportation. Adverse weather conditions continued to have a negative impact on the agriculture sector, which indirectly affected other sectors.

Positive momentum in investment and consumption expenditure contributed to GDP growth, and the country aims to take steps to keep the momentum going. With changes to the Foreign Direct Investment (FDI) Policy designed to attract investors from the US, China and India, Sri Lanka wants to seize its competitive advantages in location, skills base, and Free Trade Agreements, which the country is securing with developed and emerging markets.

Export earnings grew 7.6% year-on-year as a result of effective trade policies, a competitive exchange rate and the restoration of GSP+ concessions from the EU. Yet, increased rice and fuel imports, a result of the poor weather conditions, continued to widen the trade deficit. Imports expenditure grew 9.6% year-on-year.

The adverse weather conditions also contributed to inflation increasing to 8.6% (National Consumer Price Index, 2013=100) year-on-year in September 2017. Increasing international commodity prices and upward tax revisions led to inflation going well beyond the CBSL's 4-6% target.

The Sri Lankan Rupee depreciated 2.6% against the US Dollar (end November 2017). Increased import expenditure, debt service payments, and a reduction in foreign investments in Government securities contributed to the heavy outflows that impacted the currency. Further negative impact to the currency was stifled as a result of increased foreign investments to the Colombo Stock Exchange (CSE) and Government securities. The ongoing International Monetary Fund Extended Fund Facility (IMF-EFF) and the issuance of an International Sovereign Bond (ISB) further helped the Rupee weather the tough economic climate. The Rupee was further helped by the ongoing International Monetary Fund Extended Fund Facility (IMF-EFF) and the issuance of an International Sovereign Bond (ISB).

The Banking Sector

Sri Lanka's financial sector accounted for 9% of the country's estimated GDP in the first eight months of 2017. Profits after tax in the Banking sector grew 18.2% year-on-year.

The sector grew its asset base by 9.4% during the first eight months of 2017. Deposits accounted for 71.3% of the total assets of the sector, and was a primary source of funding. Asset quality deteriorated slightly, but stability was maintained in the first eight months of the year as capital and liquidity levels were managed well above regulatory minimum requirements.

The CBSL raised interest rates, reducing the impact of the increased supply of money and high financing requirements on the Government budget. Despite this, lending to all economic sectors increased, increasing loans and advances to LKR 6.1 trillion (end August 2017), an increase of 10.8%. Macro-prudential policies implemented by the CBSL ensured growth in the leasing portfolio which was marginal at 3.1%. Increased net income, revaluation gains, and lower operating expenses contributed to the increased profitability of the sector.