

Operating Environment

The Global Economy

Global growth, which was 3.1% in 2016, was virtually the same as that of the previous year. However, the performance was uneven across different country groups. Advanced economies outperformed expectations, bolstered by recoveries in manufacturing output and a decreased lag in inventories. On the other hand, emerging market and developing economies (EMDEs) showed unexpected slowdowns.

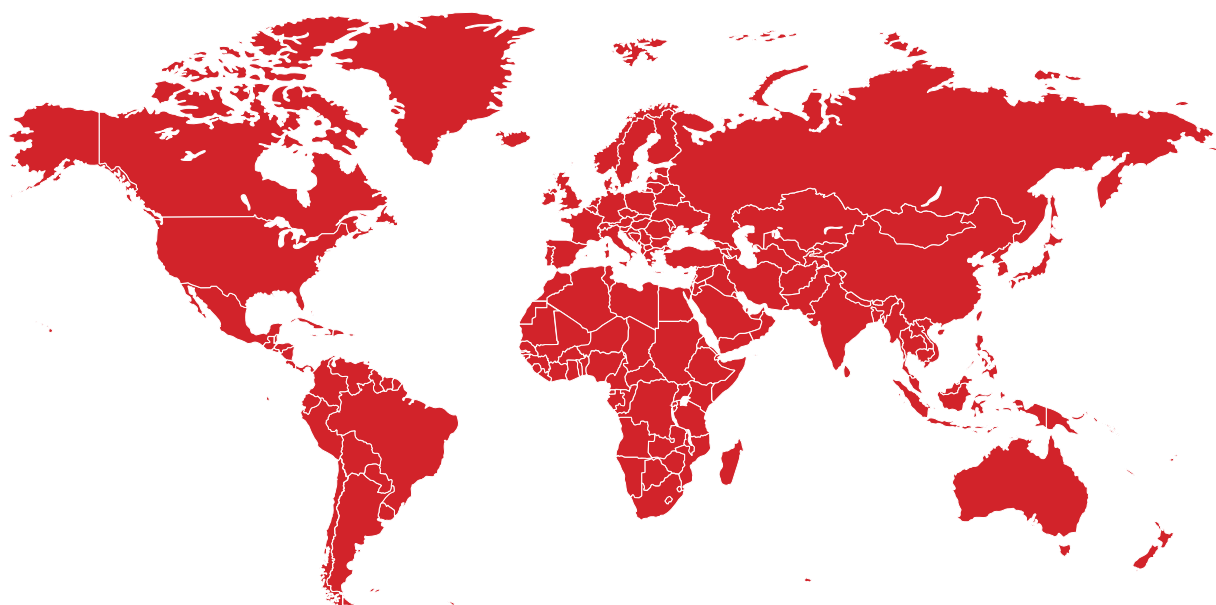
The outlook for 2017 is somewhat bright, with growth projections for 2017 and 2018 estimated at 3.4% and 3.6% respectively. This growth is expected to be mainly fuelled by resurgence in growth of EMDEs. This reflects anticipated easing of conditions in some large economies that are currently undergoing macroeconomic strains. Only a modest growth is expected in advanced economies; this however could be changed by the policies of the new administration in the US.

China's performance was considerably better than expected and continued growth is expected based on anticipated policy support. Nevertheless the situation is also beset by uncertainties. Dependence on policies favourable to expansion of credit, lack of progress in addressing corporate debt and difficulties in imposing budgetary constraints on state-owned enterprises are some of the issues.

Regarding India, the growth forecasts for 2016 and 2017 have been trimmed due to adverse impact of cash shortages and the recent currency note withdrawal. Policy stimulus in the United States and/or China, could have positive impacts which could spill over to their respective trade partners. Nevertheless, some uncertainty hangs over this optimistic scenario due to the possibility of protectionist trade policies.

Headline inflation rates picked up in advanced economies with the recovery in commodity prices; core inflation rates have remained static and have generally been below inflation targets. Inflation in China showed an upwards trend buoyed by capacity cuts and higher commodity prices. The situation in other EMDEs was varied depending on exchange rate movements and factors peculiar to each country.

Uncertainties caused by political events resulted in major currency price movements. 'Brexit', the decision of the United Kingdom to leave the European Union, caused wide fluctuations in the pound; the outcome of the US election had similar effects on the US Dollar and the Mexican Peso. There were also unexpected changes in policy such as the withdrawal of the US from the Trans-Pacific partnership. An increase in geopolitical tensions, anti-globalisation sentiments and fears of terrorism have come to the forefront at the end of 2016. Proliferation of these in the years to come could have a dampening effect on economic confidence and worldwide market sentiments.



The Sri Lankan Economy

The Sri Lankan economy showed a lacklustre performance in 2016, recording only a 3.9% growth rate in the first six months of the year, compared with an annual growth of 4.8% in 2015. The prospects for 2017 are more favourable, with the World Bank anticipating results from reforms in key policy issues. Driven by private consumption and deferred foreign direct investment (FDIs), GDP is expected to grow at 5% in 2017. There are however, some threats on the horizon, such as slowdowns in key export markets, shifts in tourism and latent increases in global commodity prices.

According to the Colombo Consumer Price Index (CCPI), inflation as measured on a year-on-year basis increased from 3.4% in November 2016 to 4.1% in December 2016. Inflation on an annual average basis was reported as being at 3.7% in December 2016.

Coming to the external sector, growth rates for exports in September was 5.7%. This was despite a cumulative decrease of 3% up until September when compared with the preceding year. Overseas workers' remittances for the period January-September recorded an increase of 3.9% over the corresponding period in 2016. Tourism earnings continued to increase, continuing a trend from the previous year.

As per the Central Bank of Sri Lanka, the Balance of Payments (BOP) recorded a surplus for the period up to September 2016, compared to a deficit recorded for the corresponding period of 2015. Gross official reserves as at end September 2016 stood at USD 6.5 billion, amounting to an average of 4.1 months of imports. Total international reserves, comprising both gross official reserves and foreign assets of deposit-taking corporations were USD 9,200 million as at the end of August 2016.

The Rupee slid by 4.23% against the US Dollar during the year. The Dollar stood at LKR 150.00 as at 31 December 2016 compared to LKR 143.90 as at 31 December 2015. Regarding cross currency exchange rates the depreciation against the Japanese Yen, the Euro and the Indian Rupee was 15.5%, 3.7% and 1.4% respectively. On the other hand the Rupee appreciated by 17% against the British Pound; this was a result of the depreciation of the Pound against the US Dollar after the 'Brexit' vote in mid-2016.

The Banking Sector

The asset base of the Sri Lankan banking sector continued to expand during the year while maintaining capital and liquidity at requisite levels.

As in the preceding year deposits, which constituted 82.8% of the asset portfolio, represented the main source of funding of the sector for growing the lending portfolio during the first eight months of the year.

Total loans and advances reported an increase as at the end of August 2016. This growth was generated by increased lending by banks to the private sector, which more than compensated for a decrease in lending to the Central Government and state-owned enterprises.

Total non-performing loans (NPLs) showed a decrease at the end of the first eight months in 2016, compared to the corresponding period in 2015, reflecting the improved asset quality of the banking sector.

The profits of the sector increased during the first eight months of 2016 compared with the corresponding period in 2015. This was mainly driven by an increase of net interest income arising from expansion of lending and investment activities.

