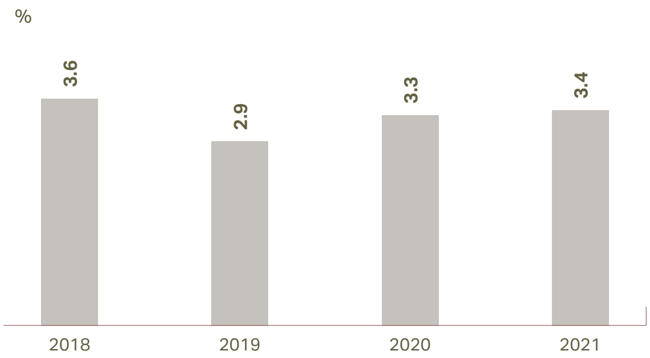
Operating Environment

Global economy

After a low pace of growth in 2018, the weakest since 2009, the global economy is set for a marginal recovery in 2020, especially driven by emerging markets. According to the World Economic Outlook update complied by the International Monetary Fund (IMF), global growth is expected to reach an estimated 2.9% in 2019. Subdued growth is expected for advanced economies, while emerging markets and developing economies should register growth acceleration.

Global economic growth



Source: International Monetary Fund's World Economic Outlook (January 2020)

2019 figure is an estimate by the International Monetary Fund, while 2020 and 2021 numbers are IMF projections.

The year was marked with trade policy uncertainty, geopolitical tensions, and idiosyncratic stress in key emerging market economies affecting global economic output, especially in the manufacturing and trade sectors. Weather-related disasters also weighed heavily in global growth like hurricanes in the Caribbean to drought and bushfires in Australia, floods in eastern Africa, and drought in southern Africa.

US-China trade war and Brexit fears took centre stage in 2019, they will continue to impact 2020 growth as well. However, there are signs of stabilisation with recovery in manufacturing and global trade with US-China trade negotiations and diminished fears of no-deal Brexit. The United Kingdom will leave the EU on 31 January 2020, after which a transition period will set in.

The IMF revised down the October forecasts on 2020 growth to 3.3%. The downward revision was mostly due to lower growth in India. For 2021, the Fund has forecast a growth rate of 3.4%.

However, further trade tensions between the US and Europe or the return of the US-China trade war could affect the stabilising economic conditions. The IMF emphasises on stronger multilateral cooperation and national-level policies to support a sustained recovery that will benefit the global economy.

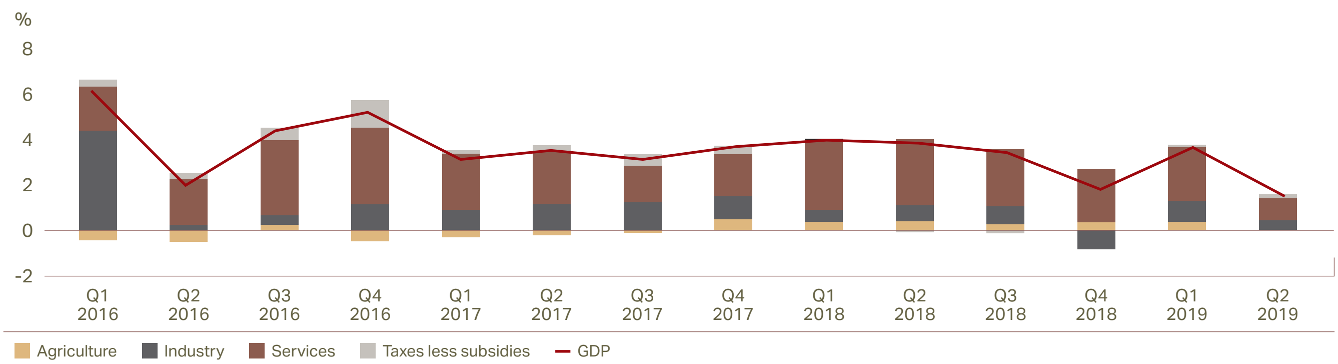
The spread of COVID-19 virus has had an adverse effect on trade and tourism in Asia. Consequently the epidemic may impact supply chains in the region.

Sri Lanka's economy

In the recent past, the Sri Lankan economy grew below potential due to a number of exogenous shocks and intractable political difficulties. The country experienced a brisk growth within the first quarter of 2019, yet the Easter Sunday Attacks severely impacted the economy as a whole. Meanwhile, persistent fiscal deficits, a large debt stock, and rising interest servicing cost eroded policy buffers and reduced fiscal capacity to support a slowing economy.

For the 3rd quarter of 2019, the economy recorded a growth of 2.7% and the rate of growth for 2019 is estimated at 2.8%. The agriculture and fisheries industry experienced growth in 2019. Services was mainly driven by the expansion in financial services, wholesale and retail trade activities, and other personal services. Expansion in industry activities was primarily supported by the recovery in construction and mining and quarrying activities. The Easter Sunday attacks substantially affected accommodation, food and beverage service activities, and transportation services.

Quarterly real GDP growth (YoY)



Source: Department of Census and Statistics

The banking sector

The banking sector experienced a modest growth in 2019. Amidst challenging domestic and global conditions, the sector was able to maintain capital and liquidity levels well above the regulatory requirements.

CBSL maintained an accommodative monetary policy stance in view of subdued economic growth, muted inflationary pressures and rapidly decelerating private sector credit amidst high nominal and real market interest rates. The Statutory Reserve Ratio (SRR) applicable to all Rupee deposit liabilities of commercial banks were reduced by a total of 2.50 percentage points in November 2018 and in April 2019. The objective was to provide adequate levels of liquidity to the domestic money market. Policy interest rates were also reduced by a total of 100 basis points in two steps, first in May and then in August 2019.

Asset quality of the sector deteriorated in 2019 due to the challenging operating conditions. The Non-Performing Loans (NPLs) continued to rise, growing by 44% up to October 2019. The gross NPL ratio for the sector continued to rise. In addition, the stock of rescheduled loans has also been growing, indicating that asset quality could continue to remain weak.

Consistent with the past decade, Sri Lanka once again experienced single digit levels of inflation. Sri Lanka successfully issued International Sovereign Bonds (ISBs) amounting to US Dollars 4.4 billion during 2019. The Rupee has shown greater stability in foreign exchange markets after its significant depreciation in 2018.

Banking sector – selected indicators

Item	End Aug. 2017	End Aug. 2018	End Dec. 2018	End Aug. 2019 (a)	YoY Change (%) Aug. 2018	YoY Change (%) Aug. 2019 (a)
Total Assets (LKR Bn)	9,901.5	11,039.9	11,794.0	12,071.8	11.5	9.3
Loans and Advances (LKR Bn)	6,140.2	7,104.4	7,693.4	7,796.0	15.7	9.7
Investments (LKR Bn)	2,588.4	2,608.1	2,697.4	2,951.7	0.8	13.2
Deposits (LKR Bn)	7,063.5	8,088.6	8,492.4	8,836.3	14.5	9.2
Borrowings (LKR Bn)	1,604.2	1,548.2	1,763.4	1,621.4	-3.5	4.7
Capital Funds (LKR Bn)	823.2	958.9	1,030.4	1,095.7	16.5	14.3
Tier 1 Capital Adequacy Ratio (%) (b)	12.3	12.8	13.1	13.3		
Total Capital Adequacy Ratio (%) (b)	15.1	16.0	16.2	16.5		
Gross Non-performing Loans Ratio (%)	2.8	3.6	3.4	4.9		
Net Non-performing Loans Ratio (%)	0.9	1.7	1.5	2.6		
Return on Assets (Before Tax) (%)	2.0	1.9	1.8	1.5		
Return on Equity (After Tax) (%)	17.6	14.6	13.2	10.8		
Statutory Liquid Assets Ratio (DBU) (%)	31.2	30.0	27.6	31.2		
Liquid Assets to Total Assets (%)	29.0	27.4	25.7	29.3		

Source: Central Bank of Sri Lanka

(a) Provisional

(b) As at end June

Outlook

Economic growth is estimated to improve from its current cyclical weak patch to reach an estimated 4% in 2020, driven by recovering tourist arrivals as well as stronger consumption and investment spending. The fiscal stimulus implemented by the interim Cabinet, including steep cuts to the Value Added Tax (VAT) rate and the elimination of several tax items is expected to boost private consumption and investment activity.