2017

ශ්‍රී ලංකා මහ බැංකුව

இலங்கை மத்திய வங்கி

CENTRAL BANK OF SRI LANKA

ROAD MAP

MONETARY AND FINANCIAL SECTOR POLICIES FOR 2017 AND BEYOND

Road Map:

Monetary and Financial Sector Policies for 2017 and Beyond

Delivered by

Dr. Indrajit Coomaraswamy

Governor

Central Bank of Sri Lanka

3 January 2017

1. Introduction

Your Excellencies, Members of the Monetary Board, Deputy Governors and Officials of the Central Bank, Distinguished Invitees, Ladies and Gentlemen,

The presentation of the **Road Map** is a very important tradition that was initiated by the Central Bank in 2007 and this is the 10th statement in that tradition that we are presenting today. It is our belief that sharing our **policy direction** would make our policies for the medium-term more **predictable** and **transparent**, and would help you in shaping your own plans and operational modalities in the future. It will also ensure **greater clarity** regarding our policies and actions.

In this context, we believe that **harmonisation of purpose and better coordination among private sector and public sector operations** would enhance the effective implementation of our policies and measures, thereby helping to achieve our common development goals.

So, let me warmly welcome you to the presentation of this year's Road Map.

Ladies and Gentlemen, as you aware, the **core objectives of the Central Bank are the attainment of economic and price stability and the maintenance of financial system stability** with a view to encouraging and promoting the development of productive resources of Sri Lanka. We attach the highest priority to delivering collectively on the mandates given to us. The considerable resources of the Central Bank of Sri Lanka are focused on achieving these objectives on a sustained basis and on performing the important agency and ancillary functions bestowed upon us effectively.

During 2016, we have implemented several proactive policy measures in order to ensure economic and price stability. These policies have helped **curb demand pressures in the economy and maintain inflation at a low level.** At the same time, we have introduced several policies related to the **financial sector** with the view of **strengthening**

institutions and ensuring effective and active markets as well as safe and sound **payment mechanisms**.

In addition to our core functions related to the key objectives I have just outlined, we have performed a number of **agency and ancillary functions**, thus contributing to enhance the overall performance of the economy.

The Central Bank manages the **Public Debt** to ensure that the government's financing needs and its payment obligations are met at the lowest possible cost over the medium- to long-term, consistent with a prudent degree of risk. The **Exchange Control** Department also initiated a number of measures in order to create a more conducive environment for both local and foreign investors. The new **Foreign Exchange Act** is designed to effect further improvements in this regard. A number of measures will be taken in the medium term to further relax foreign exchange transactions. The Central Bank is also the manager of the **Employees' Provident Fund**, which is the largest superannuation fund in the country. Through the activities of the **Regional Development** Department and the provincial offices, the Central Bank seeks to strengthen the delivery of credit to the agriculture sector and to small and medium scale enterprises as well as the microfinance sector, thus facilitating greater financial inclusion. Also, as the sole authority for issuing **currency**, the Bank has continued to ensure that all cash transactions take place smoothly.

We consider that communication is an integral part in pursuing policy actions and discharging our responsibilities. Considering the utmost importance of **clear communication** and **enhanced transparency**, we attach priority to formulating our policies in a **forward looking manner**, which will help economic agents to make their economic decisions in a more informed manner.

Ladies and Gentlemen, today, we are living in a **challenging world**. Sri Lanka is gradually transforming to an upper middle income economy. However, the objectives of the government and the aspirations of the people cannot be met through "**business as usual**" on the part of the public and private sectors. Government policy making needs to be **proactive**. It has to be **more data driven** and **less influenced by short-term political expedience**. Equally, the private sector needs to **recalibrate its risk appetite** and take advantage of opportunities generated by improving macroeconomic policies and a more conducive, enabling environment for business. We would all like progress to be faster but the direction of travel is clearly positive. There is also the likelihood that, as the reforms gain momentum, the pace of change will accelerate, provided there is the commitment to persist with the measures that are necessary to place the economy on a higher trajectory of growth, employment generation and incomes.

As the Central Bank, we have **a pivotal role to play** while being at the heart of this **much needed transformation**. The government is putting forward many new initiatives to develop the country. This is happening at a time when the global economy is undergoing yet another transitional period. Hence, this is truly **a challenging time**, which calls us to be proactive and focused on clear outcomes.

At this juncture, I would like to share some of my thoughts on the Sri Lankan economy in a **broader perspective**.

When we review Sri Lanka's post-independence economic performance, it is clear we could have done better. In the Central Bank's context, the **perennial excess aggregate demand** in the economy, created by large fiscal deficits, has **complicated monetary and exchange rate policies**.

However, I believe **Sri Lanka now faces one of its best chances since independence,** to correct this situation. In particular, the country does not have a drag in terms of an internal conflict or regressive policies.

Today, Sri Lanka is poised for a **fresh leap of development**. In that context, it is the responsibility of the Central Bank to provide a stable foundation to leverage the country's excellent **geographical location** and **favourable international relations** to attract investment to foster more robust and sustainable growth and employment generation. Sri Lanka is twenty miles from the fastest growing large economy, India; in the middle of China's Maritime Silk Route; and fortunate to have excellent relations with a number of capital surplus countries in the world.

As I have repeatedly emphasised, sustained growth requires **strengthening macroeconomic fundamentals**, implementing **structural reforms** that increase the competitiveness of the economy, and **improving the business environment.**

The challenge that we are having right now is to put in place policies that give us **sustained stabilisation** of macroeconomic fundamentals in the country, amidst uncertain global conditions.

It is important to recognise that stabilising the economy after decades of fundamentally unstable macroeconomic policies cannot be achieved without discipline. This will inevitably result in **some pain in the short-term**. However, there is every possibility that a **more promising future** can be realised through the policies and programmes that are already in the pipeline. For this to happen, **consensus** must be built among **politicians, policy makers and the general public** on the **need for cohesive reforms** around the three pillars of robust macroeconomic fundamentals, improving productivity/competitiveness and the improved business environment.

We have to establish a **solid foundation** for the nation to meet the imperatives of a **new economic growth model,** built on the core tenets of high value-added entrepreneurship, creativity and innovation to generate benefits for all Sri Lankans.

The country has a number of **structural problems** that have been amplified over the years by the large fiscal and trade deficits, which are the core weaknesses of the Sri Lankan economy. Being a **twin deficit country** increases vulnerability in an uncertain and volatile global economic environment.

Unsustainable budget deficits boost **excess and untenable demand** in the economy. When there is excess demand, it leads to **inflationary pressures** and **higher nominal interest rates** in the economy and there is also a higher propensity to import, given the limitations in domestic supply. That in turn, exerts pressure on the balance of payments and the exchange rate.

This has been the Sri Lankan experience over several decades, which stands in marked contrast to the policies of the successful East and South East Asian countries. Those countries achieved

robust fiscal outcomes, low inflation, low interest rates and **competitive exchange rates**.

We cannot continue with repeating stop-go cycles, with each successive trough becoming more dangerous. **We have to change** with vigour in order to achieve our objectives. We have missed enough opportunities and we cannot afford to miss them repeatedly. We need **decisive policy initiatives** implemented with **commitment**. More importantly, we need to take a **longer term view** and act accordingly.

It is naïve to believe economics can be separated from politics. No country, no society has been able to achieve this. However, we need to ask why **Sri Lanka**, which was second to Japan in Asia, on most socio-economic indicators, has **slipped so far behind today**.

We need to ask why this is. In what is often termed the Asian century, Sri Lanka is the only country, other than Afghanistan, in the Asia/Pacific region with an IMF programme – having an IMF programme is the economic equivalent to being in hospital. We are not in the ICU but clearly in hospital. The **remedial treatment is known** and it is encouraging that it has commenced. The International Monetary Fund (IMF) itself has recognised that progress has been made in stabilising the economy. **Improved fiscal performance** has been at the heart of this improvement. Honourable Finance Minister and his team deserve credit for this. However, the continuing challenge is to have the clarity of purpose, focus and determination to implement the necessary changes. It has to be a **national effort**.

The potential for accelerated development is clearly evident. The government's plans, programmes and projects, as set out in the Honourable Prime Minister's Statement and the Budget Speech have sign-posted the way ahead. However, the task now is to continue to turn the good intentions into reality. This journey ahead also requires a **rebalancing of economics and politics in economic decision-making**, if we are to stay on course.

The government has commenced a strong **revenue-based fiscal consolidation programme.**

Trade and investment policies are also being changed to harness our untapped potential.

We at the Central Bank, are changing and upgrading many of our processes and policies.

Frameworks are being developed for proactive monetary and exchange rate policymaking on a data driven basis.

In this context, the **Road Map 2017** reviews developments in the economy and the policy actions that have been pursued during the past year. More importantly, it seeks to enunciate policies and programmes for the forthcoming period.

Accordingly, the outline of the Road Map 2017 is as follows:

- ***Section 2:*** Review of the developments in the economy along with the progress in the real, fiscal, external, monetary and financial sectors during 2016
- ***Section 3:*** An analysis of the Central Bank's monetary policy strategy and policies for 2017 and beyond
- ***Section 4:*** A discussion on the Central Bank's policies related to the financial sector performance and stability in 2017 and beyond
- ***Section 5:*** Key policies related to strengthening the broader economy through the Central Bank's agency and ancillary functions
- ***Section 6:*** Concluding remarks

2. Developments in the Economy in 2016

The **Sri Lankan economy** achieved a **moderate growth** rate of 4 per cent during the first nine months of 2016. Among major sectors, **Agricultural** activities remained subdued, driven mainly by the contraction in the value addition of rice, tea and rubber. Adverse weather conditions during the second and third quarters of the year and subdued demand conditions in the major export destinations affected this growth. **Industry**-related activities grew substantially in 2016 with considerable contribution from the recovery of the construction sector. Notable growth was also witnessed in manufacturing, and mining and quarrying activities. Meanwhile, the growth in **Services** activities also remained buoyant, supported by improvements in financial services, and wholesale and retail trade activities. Based on these developments so far, it is projected that the economy would grow by around 4.5 – 5.0 per cent in 2016. We anticipate a growth of 5.5 – 6.0 per cent in 2017.

Inflation continued to remain at low levels although there were some upward pressures during 2016. Supply side pressures due to adverse weather conditions and revisions to the government tax policy partly contributed to the increase in inflation during the year. The relaxed monetary policy stance pursued in the past and the increase in wages in the economy also exerted some demand pressures on prices. Accordingly, headline inflation, as measured by the year-on-year change in the Colombo Consumers' Price Index (CCPI, 2006/07=100), was 4.1 per cent in December 2016 compared to 2.8 per cent in December 2015. Headline inflation, as measured by the year-on year change in the National Consumer Price Index (NCPI, 2013=100), was 4.1 per cent in November 2016 compared to 4.2 per cent at end 2015. Accordingly, overall inflation has been contained within our mid-single figure target of 4 – 6 per cent. Meanwhile, core inflation continued its upward trend in 2016, reflecting the firming up of demand conditions in the economy and the revisions made to the tax structure in the latter part of the year. **Core inflation**, based on CCPI, increased to 6.3 per cent, year-on-year, at end 2016 in comparison to 4.5 per cent at end 2015, while NCPI based core inflation was 6.8 per cent, year-on-year, in November 2016.

In response to preemptive monetary policy measures, **monetary aggregates**, which expanded at a high rate, decelerated, while growth of **credit to the private sector** showed some slowdown, mainly reflecting the impact of increased **market interest rates**.

Sri Lanka's **external trade performance** was modest during 2016, although some improvement was observed towards the latter part of the year. Earnings from exports declined by 2.6 per cent during the first ten months of 2016, while the expenditure on imports increased marginally by 0.2 per cent. As a result, the cumulative deficit in the trade account increased by 3.7 per cent to US dollars 7.2 billion during the first ten months of 2016. Supporting the external sector, **earnings from tourism** is estimated to have increased to around US dollars 3.0 billion during the first eleven months of 2016, an increase of 14.7 per cent over the previous year. **Workers' remittances** recorded a moderate growth of 3.1 per cent during the first eleven months of 2016 and amounted to around US dollars 6.6 billion. With these developments, there was a narrowing of the **savings – investment gap** as reflected in the lower **current account deficit** during the first nine months of 2016. **Foreign investment** in the government securities market saw a net outflow, while long-term loans to the government recorded a net inflow. Meanwhile, during 2016, Sri Lanka entered into a three year **Extended Fund Facility (EFF)** of SDR 1.1 billion (approximately US dollars 1.5 billion) with the IMF to strengthen the external position of the country and to support the government's broad economic reform agenda. Reflecting these developments, the level of **gross official reserves** is estimated to be around US dollars 6.0 billion by end 2016. Moreover, despite considerable depreciation pressure on the rupee during some months, the rupee remained relatively stable in 2016 compared to the previous year. It has depreciated by 3.8 per cent during the year.

Fiscal policy in 2016 has been directed towards strengthening the **fiscal consolidation process**. Reflecting the positive impact of the strenuous efforts of the government, fiscal performance has indicated an improvement during 2016. Government revenue has continued its increasing trend while maintaining expenditure at the desired level. The government is certain that the announced budget deficit of 5.4 per cent of GDP will be achieved in 2016, and it will be reduced further to 4.6 per cent in 2017.

During 2016, several policy measures were implemented by the Central Bank, in line with **international standards** and **best practices**, to strengthen the regulatory and supervisory framework pertaining to licensed banks. Key **banking sector indicators** remained at healthy levels, while the nonbank sector performed despite stringent fiscal and macroprudential measures.

Meanwhile, the **national payment systems** of the country operated smoothly without any major disruption while facilitating the growing and changing payment needs of the financial sector with improved efficiency and safety.

3. Monetary Policy Strategy and Policies for 2017 and Beyond

A coherent and clear macroeconomic framework, is important to achieve our objectives.

Among the key elements of the overall macroeconomic framework, price stability is an important pillar. **Price stability** is interpreted to mean low, stable and predictable levels of inflation, which is conducive for fostering sustainable long-term economic growth and employment in a country. Price stability is instrumental in keeping nominal interest rates low, thereby enabling an economy to exploit its **growth potential**, while both consumers and producers can make economic decisions with confidence and certainty. Therefore, modern central banks predominantly focus on achieving price stability as a pre-condition for sustainable growth.

In this context, I would like to indicate that the Central Bank and the government are working towards establishing **a well-designed macroeconomic policy framework** in the country, built upon three key areas.

The government is in the process of taking decisive measures to address the long felt deficiencies in its budgetary operations through a new **fiscal framework**, aimed at strengthening fiscal sustainability in the medium-term. This framework is embedded in the IMF-EFF arrangement.

These efforts will complement the expected improvements of the Central Bank with regard to two key policy frameworks in relation to monetary policy.

a. The conduct of monetary policy will be strengthened through the move towards a **flexible inflation targeting (FIT) framework.**

b. A properly designed and widely accepted **framework for exchange rate management** will also be introduced to establish a market-based exchange rate system in the country.

The broad-based reform actions under the EFF arrangement with the IMF will complement these efforts.

The Central Bank, since the 1980s, has been pursuing **monetary targeting (MT)** as its monetary policy framework to achieve price stability. Under this framework, monetary aggregates were used as a key nominal anchor in the conduct of monetary policy and the final objective of price stability was expected to be achieved by influencing money aggregates. Reserve money was considered the operating target and broad money was used as the intermediate target of monetary policy under this framework.

Nevertheless, **monetary targeting** has become a less meaningful framework for monetary policy conduct, given issues such as the instability in the money demand function amidst financial innovations and the weakening relationship between money and inflation.

Hence, countries, which were dependent on monetary targeting frameworks, have been moving away towards new frameworks, such as inflation targeting.

In line with this global tendency, the Central Bank of Sri Lanka has also been improving its monetary policy framework over the years.

In particular, the Central Bank has officially announced that the monetary targeting framework would be gradually replaced by migrating towards a **flexible inflation targeting framework**.

Under this enhanced monetary policy framework, the Central Bank would focus on stabilising **inflation in mid-single digits over the medium-term**, while supporting growth objectives and flexibility in exchange rate management.

Generally, an inflation targeting framework is characterised by an announced numerical inflation target, a medium-term inflation forecast, which facilitates forward looking monetary policy decision making and a higher degree of transparency and accountability.

Inflation targeting is known to be operationally complex. It requires greater awareness of the whole

monetary transmission mechanism (MTM) and is based on a working link from policy interest rates to interbank interest rates and to long-term interest rates. Under our enhanced monetary policy framework, we expect to predominantly employ market-based instruments, particularly **policy interest rates** and **open market operations (OMO)** to guide the **average weighted call money rate (AWCMR)**, which is considered as the **operating target,** along the desired path. This would ensure effective transmission of monetary policy.

Within this enhanced framework, the Central Bank does not set any monetary targets explicitly. However, broad money (M_{2b}) will remain as the key **indicative intermediate variable**, which reflects the broad liquidity conditions in the economy, to guide the conduct of monetary policy of the Central Bank.

To implement the new framework, **macroeconomic projections**, including **inflation projections**, are currently being strengthened using short-term as well as medium-term structural forecasting tools and techniques. In this endeavour, continued efforts are being made to upgrade the technical capabilities of the Central Bank staff.

With a view to strengthening its policy formulation and modelling capacity, the Central Bank of Sri Lanka has been obtaining technical assistance from the IMF in the area of macroeconomic forecasting, modelling and policy analysis. As such, a joint effort has been made by the Central Bank and the IMF in developing a structural model-based **Forecasting and Policy Analysis System (FPAS)** to strengthen the monetary policy decision making process and to support Sri Lanka's transition to a flexible inflation targeting regime. The FPAS is a medium-term, pre-emptive policy analysis system, which brings together information and judgment in a coherent and logical manner.

Under the FPAS, the Central Bank has already finalised the development of the baseline version of a semi-structural **Quarterly Projection Model (QPM)** for forecasting and analysing monetary policy.

Meanwhile, the Central Bank is in the process of implementing several organisational changes necessary for the effective implementation of the model. To this end, a separate **Modelling and Forecasting Division** has been setup in the Economic Research Department and relevant processes are being developed while equipping the staff with adequate training.

More importantly, we intend to introduce several changes in the monetary policy formulation process as well. Accordingly, we will reduce the number of **Monetary Policy Committee (MPC) meetings to 8 meetings** per year from the current level of 12 meetings per year. Consequently, around 5-6 weeks will be devoted for analysing the latest developments in the economy and developing model-based macroeconomic forecasts, thereby facilitating the provision of in-depth and more forward looking insights to the monetary policy formulation process.

The above improvements envisaged in the monetary policy decision making process are expected to be implemented before the end of 2017. This will entail revising the Monetary Law Act to accommodate some of the new changes to be introduced in this process in the medium-term.

Moreover, we also intend to reintroduce the **Monetary Policy Consultative Committee (MPCC)** in 2017, comprising eminent academics, professionals as well as representatives from the private sector. We expect to benefit from the views and inputs of the MPCC in better calibrating the monetary policy decision making process.

In addition, we also intend to establish **two other important consultative committees** in relation to financial system stability and private sector views on Central Bank policies and regulations. We are of the view that the inputs of such committees would also be helpful in devising appropriate monetary policy decisions.

We will continue to monitor developments in the monetary sector closely and adopt **timely and effective monetary policy measures**, supported by other **macroprudential measures** in order to ensure stable monetary conditions and price stability, thus facilitating envisaged economic growth.

At the same time, we will continue to actively engage in **liquidity management** operations in the money market to guide the short-term interest rates within the desired path.

In order to ensure the effective implementation of monetary policy, we expect to introduce certain measures with regard to OMOs, such as **introducing fixed rate and variable rate auctions**, and **fine tuning auctions** after examining their need and feasibility in line with other country experiences and market needs. We will evaluate alternative instruments to strengthen OMOs.

Reflecting these measures, **inflation is expected to remain at mid-single digit levels in the medium-term**. As such, it is expected that the low inflation environment that prevailed for several years would be sustained **in a range of 4 – 6 per cent** in the medium-term, which is also consistent with the **inflation target bands** stipulated under the EFF arrangement with the IMF.

We would also continue to strengthen the technical capability, particularly with regard to the compilation methodologies of **macroeconomic statistics** in line with international standards. This will promote sound economic analyses for the purpose of formulating effective policies, while improving the transparency of monetary policy and policy communication.

At the same time, in the process of making more informed policy decisions, we look forward to enhancing statistical inputs by introducing new indices on **property prices** as well as modifying **wage indices,** while improving the coverage of existing surveys to better track developments in the private sector.

The Central Bank will continue to communicate policy decisions among market participants and the general public through multiple means providing greater clarity and understanding about policy. Moreover, launching of the **revamped corporate website of the Central Bank** is expected to provide high quality content with dynamic and interactive features.

At the same time, continuing the practice that has been followed in the past, we intend to make monetary policy announcements according to an advance announcement calendar. The calendar for 2017 is set out below.

Monetary Policy Announcements in 2017

1	7 February, Tuesday
2	24 March, Friday
3	9 May, Tuesday
4	27 June, Tuesday
5	3 August, Thursday
6	26 September, Tuesday
7	7 November, Tuesday
8	28 December, Thursday

Volatile global market conditions and Sri Lanka's vulnerability as a twin deficit country underscore the vital importance of having a **flexible exchange rate policy** to adjust to external pressures. Recent experience has clearly demonstrated that it is unsustainable to maintain an **overvalued exchange rate** at the expense of external reserves. A smooth **market based exchange rate** would prevent highly disruptive adjustments after a period of stable rates artificially maintained by continuous intervention by the Central Bank, as experienced in the 2011-12 period when the currency depreciated by around 14 per cent after expending US dollars 4.0 billion of scarce external reserves in a **futile attempt to defend the external value of the rupee** through market intervention. There was a similar experience in 2015 when the currency depreciated by 6.5 per cent after spending US dollars 2.1 billion of our reserves. Wasting large amounts of the country's external reserves, much of it borrowed, in a vain effort to defend the currency, which has to be ultimately depreciated anyway, is clearly unsustainable. It is time to stop this pattern and commence building up of external reserves through sustainable foreign exchange inflows.

The impact of **global developments**, such as Brexit, recent Presidential elections in the United States (US) as well as interest rate hikes by the US Federal Reserve, the forthcoming elections in France and Germany in Europe, the projected slowdown in the Chinese economy, as well as economic conditions in Sri Lanka's major trading partners, including India, Japan, Russia and the Middle East, will also have a significant influence on the domestic economy.

Trends in oil prices and international capital flows, following the normalisation of interest rates in the US are likely to be particularly important.

We also expect that changes to **government tax structure** and **supply shortages** stemming from weather-related developments as well as shocks that could arise due to **possible reversal of global commodity prices** could cause temporary variations in price levels. In particular, if current drought conditions prevail, there could be adverse implications on price levels, while impacting on economic activities, notably agriculture and power generation.

As in the past, it is expected that the government would take timely measures to counter the adverse supply side effects on prices, thus mitigating adverse **inflation expectations** of the general public.

Accordingly, it is anticipated that inflation expectations would **broadly remain anchored** in the medium-term with appropriate demand management policies, supported by timely supply side measures.

4. Financial Sector Policies for 2017 and Beyond

The financial system remains important for efficient allocation of resources and hence in facilitating strong economic performance of the country. In particular, **a broader, deeper and a liquid financial system is vital** as economies grow more sophisticated.

A stable financial system creates a trusted, enabling environment favourable to savers and investors; helps the transmission of monetary policy; encourages efficient financial intermediation, which eventually promotes investment and growth; and encourages effective and efficient operation of markets while improving the allocation of resources in the economy.

Financial system stability is founded on the **confidence of the public** in the financial system and depends on the **soundness and resilience** of principal components of the financial system to collectively withstand risks emanating from various internal and external developments.

The Central Bank has sought to preserve the soundness, efficiency and stability of the financial system primarily through the **regulation and supervision** of all major categories of financial institutions, ensuring **sound and safe payment and settlement systems** as well as **establishing risk management systems** and **instilling good corporate governance standards and practices** in the financial sector while **promoting financial inclusion**.

In the medium-term, our overall aim is to ensure the stability in the financial sector through identifying emerging vulnerabilities in this sector; adopting early corrective actions; and implementing a series of measures to further strengthen financial institutions, markets, infrastructure and safety nets.

Our medium-term plan is to have a financial system, which offers the full range of **financial products and services** to all economic sectors, including agriculture, infrastructure, manufacturing, particularly small and medium enterprises (SMEs), and trade to achieve broader economic objectives of our country. We need to have a well-planned and an ambitious **agenda for financial sector development and reforms** ranging across financial sector policies with a vision of innovative, robust and competitive financial systems.

As a priority, we expect to strengthen the **regulatory framework** pertaining to all financial institutions, including licensed banks, licensed finance companies (LFCs), specialised leasing companies (SLCs) and primary dealers. It will further ensure the stability of the financial sector by promoting the safety and soundness of those institutions to face unforeseen challenges in the growing business environment.

In this regard, the Central Bank wishes to implement the following policies in 2017 and beyond.

Since the last amendment to the existing **Banking Act in 2006**, the banking sector landscape has undergone a significant change, both nationally and internationally. Considering the need for upgrading of statutes in line with these developments, we expect to initiate amendments to the existing Banking Act. Accordingly, steps will be initiated to streamline and strengthen the regulatory and supervisory framework through the proposed **Banking Act amendments.** We will consider provisions for reinforcing the **Central Banks's enforcement powers** for violations of the Act and the Directions issued under it. In this regard, we wish to seek **views from the banking sector** as well.

In line with these reforms, we intend to review all key regulations in the medium-term. In this regard, we will review **key Banking Act Directions**, such as share ownership, foreign borrowings, and corporate governance, and these will be amended where necessary.

In order to maintain financial stability in the country and in line with regulatory reforms, we have identified the need for further strengthening of the supervisory function of the Central Bank. Accordingly, we expect to enhance the **bank examination methodology** to focus on the efficiency, effectiveness and sustainability of individual banks and the banking sector, based on the **Bank Sustainability Risk Index (BSRI).** Accordingly, amendments will be introduced to the existing risk-based supervision framework based on a **mix of quantitative and qualitative indicators** to enhance focus on sustainability and operational efficiency of banks. We will conduct the pilot run of the Risk Index on large banks during the first quarter of 2017 and subsequently, the index will be extended to the other segments of the banking sector.

In 2018, the Risk Index will be incorporated to all examination reports and we intend to assign a supervisory rating, based on this index. By 2019, a **comprehensive pre-risk assessment** will be conducted for all banks and a **risk-based examination plan** will be formulated.

In addition, we intend to strengthen **capital positions** in line with minimum requirements and **Basel III capital standards**. Implementing Basel III capital and liquidity standards were identified as key policy measures in the Road Map for 2014 with a view to further strengthening the resilience of licensed banks. We have already issued Directions on the **Basel III Liquidity Coverage Ratio** in April 2015.

We have just issued the **Direction on Basel III Minimum Capital Requirements** for implementation on a staggered basis, commencing 01 July 2017, and to be fully implemented by 01 January 2019 in line with the international timeline.

With a view to creating a more resilient banking sector, we expect banks to maintain a stable funding profile. Accordingly, we plan to introduce the **Net Stable Funding Ratio (NSFR**) and the **Leverage Ratio** for banks. NSFR will be applicable by 01 January 2018 and the necessary Banking Act Directions on NSFR will be issued in line with the international timeline. By implementing the Leverage Ratio, it is intended to restrict the build-up of excessive leverage in the banking sector. Accordingly, in 2017, we will begin to monitor the level of compliance under the leverage ratio.

It is also our intention to finalise the **Crisis Preparedness Plan**, and **Recovery**

and Resolution Framework as a precondition for effective supervision. Accordingly, guidelines will be issued on recovery and resolution frameworks of banks and the crisis management frameworks will be strengthened and streamlined in order to minimise the adverse impact, both on the troubled banks and, on the banking and financial sectors as a whole.

In line with the developments in the banking sector and the guidelines from the **Basel Committee on Banking Supervision**, we will be taking steps to review the existing criteria and mechanism for the selection of the panel of qualified auditors in order to strengthen the current assessment process and enhancement of audit quality.

In recent years, the Central Bank has introduced a broad range of prudential regulations to strengthen risk management, corporate governance, capital adequacy and internal controls of the non-bank financial institutions. Going forward, the stability of the financial sector will also be strengthened by enhancing the existing **regulatory framework of non-bank financial institutions**.

The capital levels of licensed finance companies (LFCs) and specialised leasing companies (SLCs) are expected to be strengthened further. Accordingly, existing LFCs and SLCs will be required to maintain a higher **minimum core capital** than the prevailing requirement of Rs. 400 million and Rs. 300 million, respectively. These will be increased to Rs. 2 billion and Rs. 1 billion, respectively on a staggered basis to facilitate the smooth transition. This will serve as a structural capital buffer for further consolidation of this sector. It is expected to improve the existing **framework on capital adequacy,** which will be more risk sensitive, focusing on credit risk based on borrowers' risk profiles as well as operational and market risk in the trading book.

Further, in order to strengthen the governance framework of the non-bank financial sector, we will introduce appropriate policy changes to the existing **Corporate Governance Direction**.

The **risk management framework of non-bank financial institutions** will also be strengthened. We will amend the existing Directions on classification and provisioning for non-performing loans and advances in line with the **new Accounting Standards** in order to harmonise the differences between regulatory provisioning and accounting impairment. In order to mitigate undue exposures and reduce high concentration risks on investments, guidance will be given for **valuation of immovable properties** of LFC/SLC sector. Further, minimum liquidity requirement for the sector is expected to be more stringent to create additional liquidity buffers.

Measures will also be taken to enhance **disclosures and transparency** through the introduction of a new regulatory framework for the preparation, presentation and publication of the Annual Audited Accounts/Quarterly Financial Statements and periodical returns.

Our objective is to reduce the overall risk of the financial sector by maintaining **fewer companies but a stronger sector** to avoid any **contagion effect**. As such, with the proposed changes to the existing regulatory framework, we encourage companies to pursue **organic consolidation** in order to strengthen the non-bank financial sector.

In addition, more attention will be given to distressed finance companies, by resolving the difficulties largely through **mergers and recapitalisation** in 2017. We intend to establish an **Enforcement Unit** to prosecute the Board of Directors and senior management of failed finance companies who are involved in fraudulent activities and malpractices.

With a view to strengthening the existing **enforcement framework on prohibited schemes**, the Central Bank intends to establish a unit comprising officers with specialised skills in the areas of law, forensic and investigation skills and accounting, to liaise and assist law enforcement authorities on related investigations. This Unit will also deal with matters relating to unauthorised deposit taking institutions. In addition, the Central Bank will continue to enhance awareness of the general public on the dangers of engaging in unauthorised investment schemes, and institutions authorised by the Central Bank to accept deposits from the general public through an effective public awareness campaign involving mass media.

Primary dealers play a vital role in trading of government securities and market making. Further, there is high potential to deepen the debt securities market in the country. Hence, we need to have a clearly stated policy framework for Primary Dealers. This will further enhance the safety of investments in the government securities market. Accordingly, we have already revisited the existing **regulatory framework of primary dealers** and based on those findings, we will introduce an appropriate regulatory framework for primary dealers in line with the latest developments in the market by benchmarking the global standards. We also expect to establish and implement a **restructuring mechanism** for distressed primary dealers.

The **Macroprudential Surveillance Department (MSD)** of the Central Bank is being strengthened to keep a close tab on the developments in the financial system as a whole. In this regard, we expect to strengthen the institutional framework for macroprudential surveillance, which includes: (1) collecting macroeconomic and financial data by customising the existing **FInNet Data Reporting System** of the Central Bank; (2) expanding the statistical analysis to identify **system-wide vulnerabilities and threats** to the financial stability from the build-up of risks and **interconnectedness of financial institutions**; and (3) improving the **early warning framework** with a focus on **stress tests and financial system stability indicators**, to identify and assess **systemic risks and vulnerabilities** in order to ensure formulation and implementation of **proactive macroprudential policies** to maintain **financial stability**.

The Central Bank has continued to take measures to strengthen the **payment and settlement infrastructure** of the country and to develop an efficient and stable payment and settlement system, capable of catering to the growing payment needs.

Continuing to discharge this important function, we expect to improve the **national payment system** to promote **electronic payments** to establish **a less-cash dependent society**. In this regard, a payment platform is being developed to effect government payments, particularly the payments to Sri Lanka Customs, through the **Common Electronic Fund Transfer Switch (CEFTS)** in real time. A **National Card Scheme (NCS)** is being introduced as a cost effective alternative to currently available international card schemes and a **Common Point-Of-Sale Switch (CPS)** is being developed to facilitate clearing and switching of payment cards issued under the National Card Scheme. A **Common Mobile Switch (CMobs)** will be implemented to ensure interoperability between mobile wallets. Further, we will **monitor the progress** of licensed banks and other financial institutions joining the **CEFTS, CPS and CMobs** and **adopt policies** with a view of increasing the efficiency of electronic retail payment systems and minimising risks associated with such payment systems.

Going forward, we will strengthen the supervisory framework and carryout on-site and off-site supervision of **licensed service providers of payment cards** and **mobile payment systems** to ensure compliance with regulations and guidelines. We also intend to introduce **Internet Banking Guidelines and Security Standards** for mobile applications to strengthen security of electronic payments.

In year 2016, the Central Bank adopted the Cabinet approved **National Policy on Anti-money Laundering and Countering the Financing of Terrorism**. Currently, all the stakeholders are in the process of developing their internal frameworks to support the national policy on Anti-Money Laundering and Countering the Financing of Terrorism (AML/CFT).

Sri Lanka needs to strengthen the AMF/CFT regime by effectively implementing **Financial Action Task Force (FATF)** recommendations in order to upgrade the country rating. If Sri Lanka fails to achieve the expected level of compliance, the country may be considered as a high risk country, resulting in adverse implications on the financial sector.

In order to overcome such challenges and hence to ensure compliance, the Central Bank will focus on a number of strategic actions in the medium-term.

I would also like to note that the **Microfinance Act** came into effect on 15 July 2016. In line with this, the **Department of Supervision of Microfinance Institutions** (DSMI) was established at the Central Bank of Sri Lanka to carry out the responsibilities, as stipulated in the **Microfinance Act No. 06 of 2016** and implement policies approved by the Monetary Board to ensure good governance, transparency and stability of Microfinance Institutions (MFIs).

The Central Bank is ready to receive duly completed applications from eligible companies, which would be submitted to the Monetary Board. Continuous surveillance and on-site examinations of Licensed Microfinance Companies (LMFCs) will be conducted by the Central Bank. We expect to maintain a constant dialogue with the LMFCs and increase awareness on regulations.

While we are proposing policies and plans for the financial sector, as the apex financial institution in the economy, we also need to ensure the stability, continuity and safety of our own house. In particular, it is important to foster **a risk culture within the Central Bank** as central banks are considered as the trustee of public assets.

In line with this endeavour, the Central Bank of Sri Lanka intends to continue to apply the **"Three Lines of Defense" risk management model**, where the operational managers form the first line of defense, and the Risk Management and Internal Audit Departments constitute the second and third lines of defense, respectively.

Moreover, in view of the need to build a governance and risk management framework that balances return objectives with prudent risk management and controls, **Strategic Asset Allocation (SAA)** for the international reserves, managed by Central Bank, has been developed and a new **Investment Policy Statement** has been drafted in line with it. The **Investment Guidelines** have been reviewed to reflect the revised investment criteria.

Going forward, we expect to ensure a proper **Enterprise Risk Management (ERM) Framework** for the Central Bank, which involves setting up a **new Risk Governance Structure** and developing systems and procedures to monitor financial and non-financial risks of the Bank by engaging in **risk mapping** of all departments in order to develop a **risk profile** for the Central Bank of Sri Lanka.

5. Policies to Strengthen the Broader Economy

Currency Management: We want to make sure that the Sri Lankan Rupee notes and coins are available to the public in required denominations upon demand without any shortage. We plan to **develop a new mechanism for islandwide coin distribution** and arrange programmes with banks to collect the coin tills issued to the public.

In 2017, the Central Bank plans to **issue a new coin series** to reduce the cost of minting. In addition, measures are also being taken to improve the quality standards of currency notes issued by the Central Bank.

As in the past, the **currency management policy** of the Central Bank will be focused on **maintaining quality standards**. Accordingly, the Central Bank plans on **strict enforcement of law** as per the Monetary Law Act on wilful mutilation, alteration and defacement of currency notes in order to improve the quality of currency notes in circulation to reflect the image of the emerging Sri Lankan economy.

Management of the Employees' Provident Fund: Employees' Provident Fund (EPF) is the largest superannuation fund of the country having total assets of Rs. 1.8 trillion. During the last year, we have introduced several initiatives to enhance the overall risk management framework and greater oversight over the organisational performance of the Fund. In addition, the completion of Phase I of the **Image Scanning Project** and the **automation of certain functions** will improve the operational efficiency of the Fund. Going forward, we intend to strengthen the EPF operations by expanding member services to the regional level through EPF units established in the **Central Bank Regional Offices**. Initiatives have also been taken to **re-register all members with the new biometric National Identity Card** in consultation with the Ministry of National Policies and Economic Affairs.

In line with the government policy agenda, we are in the process of **reviewing investment policies** by incorporating international best practices, focusing on proper assets diversification and risk management with the assistance of the Asian Development Bank (ADB) and the World Bank.

Going forward, the EPF will also focus on the following;

- **Improving web based ICT technologies** to link employers, employees and other stakeholders
- Enhancing the quality of existing database
- Improving the efficiency of the refund payment system
- Improving awareness among stakeholders on EPF operations to improve the level of service delivery
- **Establishing e-accounts** for both employers and employees
- Introducing a **web based data** collection and contribution payment system facility to employers for real-time validation of member accounts
- **Identification of new markets and asset classes** for investments and maintaining appropriate asset allocations to generate the highest level of risk adjusted return
- **Enhancing the institutional capacity** to ensure effective and efficient fund management
- Improving the framework for **managing financial risks**

***Public Debt Management*:** As you know, the Central Bank manages public debt on behalf of the government. In delivering this responsibility, we want to make sure that our debt management operations are conducted in a professional way with the highest level of integrity.

In this context, the Monetary Board has come up with a list of actions to develop the debt market and debt management operations. Some of these have already been implemented.

In July 2016, we resumed **Pre-bid Meetings** with all the primary dealers to provide them the relevant information in relation to the forthcoming auction. We hope that the availability of such market information would enhance transparency.

We are working towards publishing an **Annual Auction Calendar** with more information with the collaboration of the Ministry of Finance, which will be reviewed quarterly. This will enhance the transparency and predictability of the **primary auction process** in the government securities market. Such initiatives will provide the same information to all market participants thereby ensuring the availability of information on potential transactions well in advance.

Further, with the intention of enhancing the transparency of our operations, since June 2016, a decision is in place **not to accept more than the aggregated offered amount at an auction** although the Central Bank may accept less than the amount offered.

The **Bloomberg Trading Platform** has also been introduced for government securities trading. Greater price discovery and transparency in the system, as well as increased confidence, have resulted in a significant increase in the volume of trading on the platform, in the secondary market.

Further, the **Bloomberg e-Trading Platform** will be extended for repurchase transactions, and **two-way quotes** will be made mandatory. This will enhance price guidance to the market and would result in increased liquidity due to price discovery and transparency.

The **Primary Auction Rules** for government securities will also be published in order to improve transparency and the standardisation of the procedures.

Meanwhile, the **current auction process** is being reviewed, and the draft outcome of this review has been shared with the World Bank and the IMF. The Central Bank expects to get the **draft auction system** validated by these international organisations before going live with it. We hope to do this in the first quarter of 2017. We have also invited a consultant from the US Treasury to look into a number of areas, including the auction process, cashflow management and debt management strategies, as well as establishing a good database for government securities.

The possibility of **active debt management initiatives**, such as buy-backs, switching and swap arrangements, which are also a part of liability management initiatives, will be explored to improve the debt management process, with changes in relevant legislation.

The Central Bank will establish an **Electronic Trading Platform** and a **Central Counter Party (CCP)** arrangement for government securities along with required legal reforms to deepen and broaden the secondary market for government securities. Similarly, a mechanism to disseminate secondary market information on debt instruments will also be established through the proposed e-trading platform and the **clearing house**. Hence, we will have a **new set of operational processes** for government securities in the secondary market as well, in the near term.

The Treasury is already in the process of studying the possibility of implementing **liability management** for US dollar as well as Rupee denominated borrowings. The Central Bank will work closely with the Treasury in this process.

We should access the **international capital market** when market conditions are favourable to Sri Lanka to build a buffer to avoid unwarranted domestic market pressure due to limited resource availability. This would broaden and diversify the **foreign investor base** as well. We have already seen growing confidence in the currency among some large international investors, which means that in the near future, we should be able to issue international bonds in rupees, which would minimise our exposure to exchange rate movements. In this endeavour, we are working to cooperate with the **Euroclear System** to facilitate us to trade our bonds in their system in the future. Such an initiative will increase the efficiency and effectiveness of settlement for investors and increase the pool of savings available for investment in domestic securities.

There will be a new **Public Debt Act.** A team of professionals is consolidating all the statutes relating to debt management and a **separate Debt Management Unit** is being set up at the Ministry of Finance.

This, in our view, is a positive development, because for years now, the Central Bank has had to cope with the conflict of interest of trying to conduct an independent monetary policy while at the same time, raising funds for the government as cheaply as possible. This conflict of interest **poses challenges to the monetary policy**

conduct of the Central Bank. Therefore, taking away the debt management function would enable the Central Bank to have a greater room to manoeuvre to conduct an **independent monetary policy**.

Foreign Exchange Management: With a view to further relaxing foreign exchange transactions, the Central Bank has implemented several new policy measures in the recent past with the support of the government. We want to emphasise that all our policy measures are in line with the current policy stance to promote the competitive advantages of Sri Lanka in global business activities resulting in the enhancement of investor confidence, strengthening of foreign reserves and stabilising the foreign exchange market.

The government has identified that it is timely to have a new **Foreign Exchange Act**. As proposed in the Budget 2017, the new Foreign Exchange bill will be presented to the Parliament during 2017.

In addition, the Central bank is in the process of **further relaxing foreign exchange transactions.**

Regional Development: The Central Bank, as the agent of the Government of Sri Lanka, implements a number of concessionary development credit schemes through Participating Financial Institutions (PFIs), with a view to uplift living standards to enhance financial literacy as well as financial inclusion, and to ensure balanced regional growth and equitable development.

- *A New Loan Scheme for the Micro, Small and Medium Scale Enterprises (MSMEs):* A **new loan scheme for the MSME sector development** and employment generation has been designed jointly by the Central Bank and the Ministry of National Policies and Economic Affairs. It constitutes a government-led support mechanism to address financial, technical, marketing and entrepreneurship needs, especially of youth and young graduates, women and differently abled people. The unique feature of this Scheme is the inclusion of a special grant element for start-up enterprises to meet the initial expenses. The maximum amount of the grant will be Rs. 50,000 and the maximum loan amount of Rs. 250,000 will be given at an interest of 5.5 per cent per annum. The Scheme intends to allocate Rs. 4.0 billion to the needy sectors of the economy and is expected to commence in January 2017.

- *National Strategy for Financial Inclusion:* Based on the findings of the Financial Inclusiveness Survey (FIS), a comprehensive draft of **National Strategy for Financial Inclusion** will be developed considering the contemporary national financial inclusion strategies of peer countries. The views of domestic stakeholders, obtained through continuous dialogue, will be considered in drafting the proposed national strategy.

- *Promoting Commercial Scale Organic Agriculture and Dairy Entrepreneurship:* Addressing the increased concerns of the public and the government on organic agriculture, mainly due to the multiple benefits that accrue from it, the Central Bank expects to promote commercial scale organic agriculture and dairy entrepreneurs through the establishment of **formal agribusiness societies** and **multi-stakeholder enterprises**.

- *A Loan Scheme for Promoting Rooftop Solar Power Generation:* A new loan scheme, funded by ADB, will be implemented with the collaboration of the Ministry of National Policy and Economic Affairs, Ministry of Power and Renewable Energy, Sustainable Energy Authority and other stakeholders, with the intention of **promoting rooftop solar power generation** in the country.

- *Promoting Green Financing:* In addition, the Central Bank will promote **Green Financing** through enhancing awareness to encourage enterprises to protect the environment, conserve resources and to achieve carbon neutrality. Banks will also be encouraged to provide financial facilities to green enterprises with the intention of protecting the environment.

In line with the international appetite to promote green financing, the Central Bank has also joined the **Sustainable Banking Network (SBN)** of the **International Finance Corporation (IFC)**, which is a knowledge and capacity building platform for financial regulators and banking associations of emerging markets on sustainable finance. As a member of the SBN, we would focus on sustainable banking practices to help banks to effectively manage environmental and social risks in the projects they finance and support businesses that are greener, climate friendly and socially inclusive. As an important step towards sustainable finance, with the support of IFC, we intend to conduct a workshop for the senior staff of banking institutions in Sri Lanka during the first quarter of 2017.

6. Concluding Remarks

Ladies and Gentlemen,

I hope the policies and the outlook unveiled in this Road Map will be a catalyst in planning your activities and formulating relevant policies in the period ahead. At the same time, I would like to mention that we would not be hesitant to introduce new policies and plans depending on the requirements of the economy and as contingencies arise. Such initiatives would be adopted with necessary consultation and will be clearly communicated to the stakeholders.

Now, let me conclude this statement by emphasising some important points.

It is clear that stability in the economy is broadly on track as evident in the improving macro-fundamentals. As the monetary authority and the apex regulator of the financial system of Sri Lanka, **we are making our best efforts to ensure stable economic conditions on a sustainable basis.**

Some of these policies may be perceived as painful in the short run, but they are meant to strengthen medium-term **stability of the economy.** This is crucial for the long-term prosperity of all Sri Lankans.

As an agent for stability, the Central Bank would continue to play its role through **clear and consistent policies** to **ensure overall macroeconomic stability in the country**. The frameworks that are being developed are intended to support this.

Our role in relation to the country's economic performance is primarily as a facilitator. As a facilitator, we would continue to support the new growth model of the government, which focuses on the central role of the private sector.

Our policies aim at supporting the **overall thrust of the government** to promote investments, domestic and foreign, and enhance exports. To this end, we would be contributing through our efforts to improving the investment climate and facilitating trade, thereby creating the conditions to harness the benefits of the investment-trade nexus.

In this context, I believe the initial impetus **to harness the country's considerable potential** must come from the domestic private sector, particularly in the next year or two. The **Megapolis Development Project** as well as **Master Plans**, that have been drawn up by the government for the **development of Hambantota, Trincomalee and Kandy**, and various regional development programmes **will open up tremendous investment opportunities for both domestic and foreign investors**.

We are also mindful that while the overall development thrust is on track, there exists disparity in the incidence of poverty across the provinces and districts, despite the progress that has so far been made in reducing overall poverty in the country. Recognising the urgent need to pay attention to this, the government has declared 2017 as the **"Year of Alleviating Poverty"** to eradicate poverty in all its forms from Sri Lanka in line with the **Sustainable Development Goals (SDGs)**.

Priority needs to be attached to **equitable and inclusive growth**, which is key to achieving this objective. Hence, the Central Bank will continue its role in regional development to complement these efforts. Special attention will be paid to enhancing **financial literacy** as a means of promoting inclusion.

I should also mention that the government has announced its intention to **restructure the Central Bank**. We would very much welcome a constructive restructuring process, which would **upgrade processes** and **result in the reform** of the Monetary Law and Banking Acts, particularly to give greater powers to the Central Bank to regulate the financial system. We are confident that **such moves would be instrumental in enhancing the credibility of the Central Bank, while preserving the independence it needs to perform its roles effectively.**

Before concluding, let me express my sincere gratitude to a number of people who are instrumental in supporting our efforts to achieve economic and price stability and financial system stability as well as to deliver our agency and ancillary functions. I am grateful, to His

Excellency the President Maithripala Sirisena, and Honourable Prime Minister Ranil Wickremesinghe for their leadership and guidance, and Honourable Finance Minister Ravi Karunanayake for his support, as close coordination between the Ministry of Finance and the Central Bank is essential for sound economic management.

I am privileged to have unstinted support and prudent inputs from the Members of the Monetary Board. Therefore, my deep gratitude is due to Secretary to the Treasury, Dr. R H S Samaratunga, Mrs. Manohari Ramanathan, Mr. Chrisantha Perera and Mr. Nihal Fonseka. They have been giving up an enormous amount of their time to address the challenging issues of the day. I am also thankful to Deputy Governors Dr. Nandalal Weerasinghe, Mr. P. Samarasiri and Mr. S. Lankathilake for their continuous support and excellent and highly professional advice. Last but not least, let me commend and congratulate the Assistant Governors, Heads of Departments, particularly the Director of Economic Research and the Staff of the Economic Research Department for today's effort in formulating the policy document, as well as all Staff of the Central Bank who are committed to fulfilling the key objectives of the Central Bank with utmost diligence, proficiency and professionalism. On my first day in office, I said that professionalism, technical excellence and integrity are crucial guiding principles for any institution and its staff. I am very pleased to say I have seen plenty of these characteristics among the staff of the Central Bank of Sri Lanka.

Thank you and I wish you all a Happy and Prosperous New Year 2017.