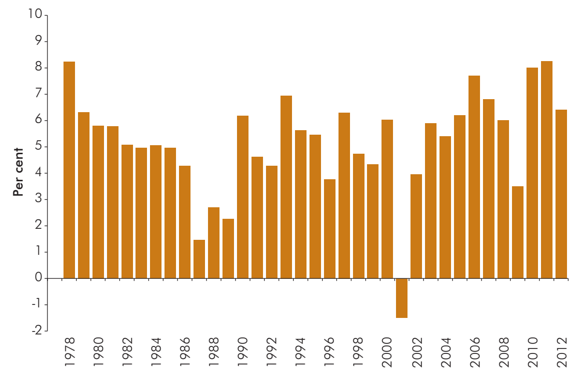
1 ECONOMIC, PRICE AND FINANCIAL SYSTEM STABILITY, OUTLOOK AND POLICIES

1.1 Overview

The Sri Lankan economy grew at a healthy rate of 6.4 per cent in 2012 while inflation was maintained at single digits for a fourth consecutive year, despite several global and domestic challenges. Improved business and consumer confidence, which supported a robust economic growth of 8 per cent in the preceding two consecutive years, was accompanied by high credit and monetary expansion and a widening trade deficit fuelled by high import demand. To further strengthen the macroeconomic environment, the Central Bank and the government implemented a comprehensive policy package in early 2012. Within a relatively short period of time the impact of the policy measures was evident with the trade deficit and private sector credit decelerating. The tight policy environment and the sluggish recovery in the global economy moderated aggregate demand in 2012, as expected. Further, the unfavourable weather conditions, which disrupted agricultural output and significantly reduced hydro power generation, also had a negative impact on value addition while exerting pressure on prices. In light of these developments, the achievements on the growth and inflation fronts were commendable. The external sector strengthened during the year with the narrowing of the deficits in the trade and current accounts and higher inflows to the capital and financial account leading to a surplus in the balance of payments (BOP), thereby raising the level of foreign reserves to a comfortable level. The government remained committed to the fiscal consolidation process, by reducing the overall fiscal deficit further to 6.4 per cent of GDP in 2012 from 6.9 per cent of GDP in 2011. The growth in monetary and credit aggregates decelerated in response to policy measures. Favourable developments in the monetary sector as well as an improved inflation outlook provided space for the Central Bank to relax its monetary policy stance in December 2012.

The comprehensive policy package implemented by the Central Bank and the government in early 2012 to contain the rapid expansion in monetary aggregates and the widening trade deficit included monetary policy, exchange rate policy and fiscal policy as well as adjustments to administratively determined prices. The Central Bank adopted a tight monetary policy stance by raising policy interest rates and imposing a ceiling on rupee lending by licensed banks to moderate credit growth. In February 2012,

Chart 1.1 Annual Real GDP Growth Rate (1978-2012)

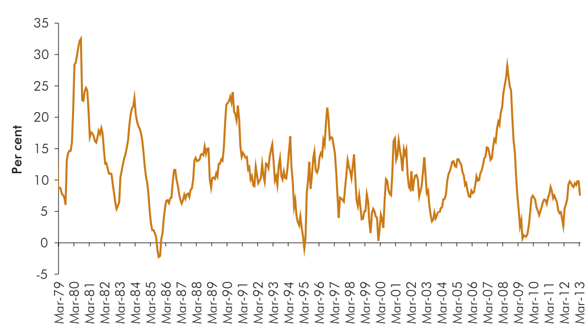


the Repurchase rate and the Reverse Repurchase rate were raised by 50 basis points each, and again in April the Repurchase rate was raised by 25 basis points to 7.75 per cent and the Reverse Repurchase rate by 75 basis points to 9.75 per cent. To bring about a more rapid deceleration in credit, the Central Bank issued a Direction under Section 101(1) of the Monetary Law Act in March 2012, restricting rupee credit growth by licensed banks to 18 per cent, while a 23 per cent increase was allowed for banks that mobilised funds from abroad. Further, from February 2012, the Central Bank allowed greater flexibility in the determination of the exchange rate and limited the intervention in the foreign exchange market. To curtail imports, tariffs on selected imports were raised. Further, in order to reduce the losses being incurred by state owned enterprises and their impact on overall macroeconomic stability, several administratively determined prices, mainly relating to energy, were revised. In response to the policy measures adopted, the growth in credit to the private sector and accordingly monetary aggregates decelerated during the year while non-fuel imports declined substantially, contracting the trade deficit. The deceleration in monetary aggregates and improved inflation outlook prompted the Central Bank to relax its monetary policy stance in December 2012. Accordingly, the credit ceiling was allowed to expire and the Repurchase rate and the Reverse Repurchase rate were reduced by 25 basis points each to 7.50 per cent and 9.50 per cent, respectively.

All key sectors contributed positively to economic growth in 2012. The Industry sector was the main driver of growth with the construction sub sector making the most significant contribution, reflecting the massive public investment programme and several private sector real estate projects. Growth in the Services sector moderated largely on account of the slowdown in external trade and the deceleration in the transport sub sector. Despite adverse weather conditions in the second half of the year, the Agriculture sector performed better in 2012 than in 2011. Reflecting the expansion in economic activities, the unemployment rate declined to 4 per cent in 2012 from 4.2 per cent in 2011.

Inflation was maintained within single digit levels in 2012 for the fourth consecutive year although there was some upward pressure on inflation from the second quarter of the year largely due to supply side factors. Year-on-year headline inflation, as measured by the Colombo Consumers' Price Index (CCPI), declined to a low level of 2.7 per cent in February 2012, as a result of improved domestic food production as well as the moderation of international prices of food

Chart 1.2 Year-on-year Inflation (Based on CCPI, Spliced)



commodities. However, the upward adjustment of energy prices and transport fares in February 2012 to reflect the rise in oil prices in the international market, the pass-through of the depreciation of the rupee, supply disruptions on account of adverse weather conditions that prevailed in major cultivation areas and the impact of past high monetary expansion resulted in inflation edging up to end the year at 9.2 per cent. Supply side price pressures were somewhat mitigated by the reduction of some administered prices and duties on imported items. On the demand side, inflation was restrained by adopting a tight monetary policy stance, which also helped manage inflation expectations, thus containing inflation at single digit levels throughout the year. Annual average inflation, which declined during the first five months of 2012 to 5.6 per cent by May, increased gradually thereafter to 7.6 per cent by December 2012.

The external sector strengthened during the year benefiting from the policy measures that were adopted in early 2012 to improve macroeconomic stability. Import expenditure declined by 5.4 per cent with non-fuel imports declining at a faster rate of 8.6 per cent. Despite the decline in exports by 7.4 per cent due to weak external demand and the decline in international commodity prices, the trade deficit contracted to 15.8 per cent of GDP in 2012 from 16.4 per cent in 2011. The improvement in the trade account, increased inflows from trade in services including tourism and transportation, and continued high growth in workers' remittances helped contain the current account deficit to 6.6 per cent of GDP in 2012 from 7.8 per cent of GDP in 2011. The improvement in the current account together with higher inflows to the capital and financial account from the proceeds of the fifth international sovereign bond, higher inflows to the government to finance infrastructure development projects and increased foreign borrowing by commercial banks and the private sector as a result of the relaxation of exchange control regulations, resulted in the BOP recording a surplus of US dollars 151 million in 2012 compared to a deficit of US dollars 1,061 million in 2011. Accordingly, gross official reserves rose to US dollars 6.9 billion (4.3 months of import cover) in 2012 from US dollars 6 billion in 2011 (3.5 months of import cover).

Reflecting the government's continued commitment to the fiscal consolidation process, the overall fiscal deficit was contained significantly below the previous year's level, although it marginally exceeded the target in the budget. The slowdown in economic activity and the decline in imports had a negative impact on government revenue collection. However, by maintaining a tight rein on recurrent expenditure and scaling back on capital expenditure, the overall fiscal deficit was contained at 6.4 per cent of GDP, marginally above the targeted level of 6.2 per cent of GDP and significantly below the 6.9 per cent of GDP in 2011. Raising the tax to GDP ratio by broadening the tax base and improving tax compliance would be critical to sustaining the fiscal consolidation process in the medium term. Although major tax reforms resulted in a simplification of the tax structure, revenue collection remained weak. To ensure that the government remains on the announced fiscal consolidation path, greater effort needs to be made to realise the benefits of the comprehensive tax reforms introduced recently through effective measures to broaden the tax base and to improve tax administration, while making appropriate fiscal adjustments.

The growth in credit and monetary aggregates decelerated significantly with the policy measures introduced at the beginning of the year and market interest rates moved upwards during the year. The overall growth of reserve money was maintained within the targeted levels, while broad money growth decelerated towards the target. The year-on-year growth of broad money moderated to 17.6 per cent by December 2012 from 19.1 per cent a year ago, mainly as a result of the year-on-year growth of credit to the private sector decreasing significantly to 17.6 per cent in December 2012 from 34.5 per cent at end 2011. Although credit to the public sector increased its impact on monetary growth was offset by the decline in net foreign assets (NFA). As a result of tight monetary conditions, interest rates moved up during the year.

The financial sector remained resilient and continued to support domestic economic activity despite the elevated risks from global and domestic developments. The financial sector expanded during the year with increased access to finance although asset growth moderated as the credit ceiling was imposed early in the year. Nevertheless, soundness of financial sector institutions improved with higher capital levels, adequate liquidity buffers and healthy earnings. With the raising of funds abroad, the banking sector was able to diversify its sources of funding, further strengthening its balance sheet. Significant attention was directed over the year towards strengthening the effectiveness of the regulatory and supervisory framework, in line with international standards and best practices, and providing an enhanced focus on governance practices and risk management to address potential risks to financial stability. The payments and settlement system too continued to operate with a high degree of availability and safety, facilitating the financial intermediation function.

Improving the financial viability of state owned enterprises would be crucial towards strengthening macroeconomic stability and financial system stability. Continuous operational losses at the two key state owned enterprises (SOEs), i.e., the Ceylon Electricity Board (CEB) and the Ceylon Petroleum Corporation (CPC) have led these entities to rely heavily on bank borrowings to cover their losses and to continue operations. While revisions to energy prices are a step in the right direction, measures need to be taken to improve the operational efficiency of these entities and introduce a cost reflective flexible pricing policy to transform these enterprises into commercially viable entities and to reduce pressure on commercial banks, thereby making available more resources to the private sector. Cost reflective pricing would also result in more efficient resource allocation and encourage the conservation of energy as well as the adoption of energy efficient technologies. Development of low cost power generation sources and the gradual reduction of system losses by the CEB in recent years are welcome developments. Timely implementation of planned projects and further reduction of system losses to targeted levels, as well as improvements to financial operations would be required to ensure the reliability and affordability of these services. Promoting the development of alternative sources of energy will also be important in terms of ensuring energy security and environmental sustainability in the medium to long term.

The deficit in the external current account needs to be narrowed to a sustainable level over the medium term. Improved access to international capital markets and a more flexible exchange rate helped cushion the external sector in 2012. However, policies should focus on narrowing the current account deficit to a more sustainable level by reducing import dependence, improving export competitiveness and diversifying goods and services exports as well as markets. Expenditure on the importation of food and beverages could be significantly reduced through policies being taken to encourage domestic production, particularly in

BOX 1 Bridging the Savings-Investment Gap to Sustain High Economic Growth in Sri Lanka

The savings-investment gap is generally referred to as the difference between the savings and capital formation of an economy over a given period. A negative savings-investment gap implies the need for external financing, because for a given level of capital formation, the funds generated from internal sources are inadequate.

Sri Lanka's Savings-Investment Gap Narrowed

The Sri Lankan economy was able to narrow its savings-investment gap to an average of 4.2 per cent of Gross Domestic Product (GDP) during 2000 to 2012, from 10.7 per cent of GDP in the 1980s, and 5.3 per cent of GDP in the 1990s. As shown in Table B 1.1, this was largely due to the improvement in national savings, supported by increased net current transfers by means of private remittances from foreign employment, and improvement in net factor income from abroad. Three key observations stand out in Table B 1.1; (i) the average level of domestic savings has improved only marginally between the 1990s through the period 2000 to 2012, compared to the 1980s through the 1990s, (ii) the average level of national savings has increased from the 1980s through the period 2000 to 2012, with the support of the increasingly important role of net private current transfers and improving net factor income from abroad, and (iii) the average level of investment has remained relatively stagnant since the 1980s through the period 2000 to 2012.

Table B 1.1 Average Savings and Investment Rates (as a % of GDP)

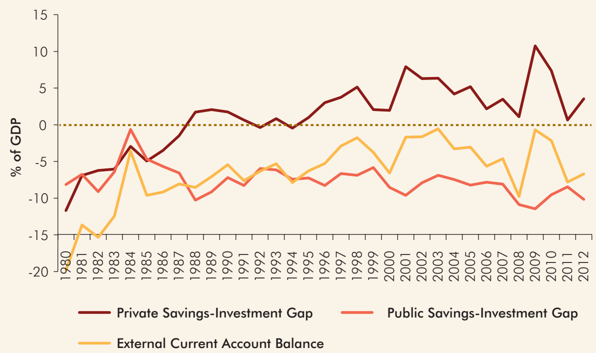
	1980-89	1990-99	2000-12
Domestic Savings (1)	12.9	16.0	16.6
Net Factor Income from Abroad (2)	-2.1	-1.5	-1.4
Net Private Current Transfers (3)	4.6	5.1	6.9
National Savings (1+2+3)	15.5	19.6	22.1
Investment (private and public)	26.2	24.9	26.3
National Savings-Investment Gap	**-10.7**	**-5.3**	**-4.2**

Sources: Central Bank of Sri Lanka
Department of Census and Statistics

Savings-Investment Gap and Changes in Sri Lanka's External Current Account

The saving and investment behavior of an economy is reflected in the movement of the external current account balance.[1] The interrelationship of the current account balance with the savings and investment gap is clearly seen by distinguishing between the private and government sectors (Chart B 1.1).[2] During the period since 1980, public sector dissavings have not been offset by net saving on the part of the private sector, thus the external current account remained in deficit. Further, as shown in Chart B 1.1, while the public savings-investment gap has slightly worsened over the years, the growing imbalance between private savings and investment have led to sharp fluctuations in Sri Lanka's external current account deficit. This points to the need for continuous fiscal tightening (which has been seen in recent years), and policy measures to enhance savings in the private sector.

Chart B 1.1 Private and Public Savings-Investment Gaps and External Current Account Balance



Source: Central Bank of Sri Lanka

Note: Domestic private savings and public savings have been augmented with net current transfers and net factor income from abroad, respectively, to segregate national savings between the private and public sectors.

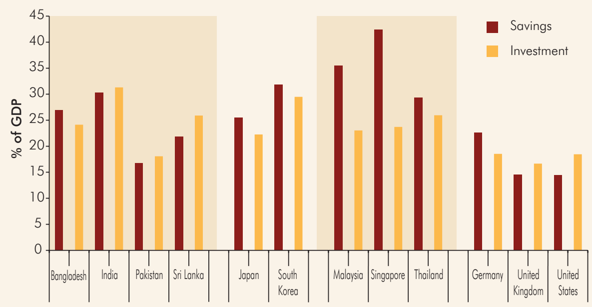
Sustaining High Economic Growth while Mitigating External Vulnerability

A deficit in the external current account implies that a country invests more than it saves. Such a negative savings-investment gap is financed through external financing, either in the form of borrowings or direct investments. In such a situation, low domestic savings demand higher financing from abroad, resulting in increased external vulnerability if financed through excessive borrowing and other unsustainable means such as short term investments, i.e., portfolio equity and bond investments, which may be susceptible to external shocks.

1 According to the National Income Accounting Identities: Gross National Income (GNI) = C + G + I + NX + NFI + NCT, where C = Consumption, G = Government Expenditure, I = Investment, NX = Net Exports, NFI = Net Factor Income from abroad, NCT = Net Current Transfers; and Current Account Balance (CAB) = NX + NFI + NCT or GNI – C – G – I. Therefore, GNI = C + G + I + CAB. Since the Gross Savings (S) = GNI – C – G; it follows that S = I + CAB; hence, S – I = CAB.

2 CAB = (Sp – Ip) + (Sg – Ig), where Sp and Sg are private and public saving, respectively, and Ip and Ig are private and public investment, respectively.

Chart B 1.2 Average National Savings and Total Investment of Selected Countries During 2000-2011



Source: World Economic Outlook Database

Setting the Policy Framework

To attain higher economic growth, Sri Lanka needs to enhance the level of national savings and investment over the medium to long term. With the economy expected to reach a level of over US$ 4,000 per capita before 2016, gross investment needs to rise to above 33 per cent of GDP, from the current level of around 30 per cent of GDP. Chart B 1.2 compares the average national savings and investment during the period 2000 to 2011 of some selected developing and emerging market economies in Asia and a few newly industrialised economies and advanced economies. As depicted in the Chart, Sri Lanka's savings and investment have been relatively low compared to some developing and emerging market economies in Asia. Hence, the policy framework is now focused on elevating the level of savings and investment of the economy in order for the economy to realise its potential, while bridging the gap between savings and investment through medium to long term measures, in a way that sustains the high economic growth trajectory over the long term. Towards that end, Sri Lanka has been making significant progress during the recent years in several areas.

Sri Lanka has demonstrated a strong commitment to maintain inflation at low levels for the last four years despite severe supply side shocks, thus, anchoring inflation expectations and yielding a positive return on medium and long term financial savings. Accordingly, the market determined real positive interest rates are expected to mobilise existing resources from savers and channel them to productive investments, while lower inflation will lead to higher real wages and growth in labour productivity. These improvements will result in increased labour utilisation and labour productivity, thus providing greater impetus for economic growth. Further, Sri Lanka has introduced far reaching measures to liberalise and develop the financial market through relaxation of exchange control regulations, widening the range of financial instruments offered, increasing the efficiency and accessibility of commercial banks, and strengthening the legal and institutional framework. These measures would encourage increased participation of the corporate sector, both domestic and foreign, in Sri Lanka's capital market. Meanwhile, Sri Lanka has placed a lot of emphasis on promoting the corporate bond market by encouraging market participants to obtain and disclose their ratings and allow quality bond issuances in foreign capital markets, thereby improving liquidity, transparency, and efficiency of the corporate bond market. Further, the Services Account of the Balance of Payments is poised to record a significant improvement over the medium term with sizable infrastructure developments taking place in tourism and transportation sectors, while rapidly growing education, communications and information technology sectors are also expected to contribute substantially. Such measures would lead to a substantial improvement in the external current account balance, while raising the savings and investment levels of the economy and also narrowing the savings-investment gap.

A Cautious Approach

While appropriate measures are in place to bridge the savings-investment gap, Sri Lanka needs to adopt a cautious approach in order to counter any downside risks. For instance, while real positive interest rates would mobilise domestic resources for capital formation, overly positive real interest rates may jeopardise economic growth through increasing the cost of credit and reducing the expected yield on investment. Also, foreign capital may be used to partly bridge the savings-investment gap, yet, it may not necessarily constitute a perfect substitute for domestic savings, because of the external finance premium attached to it. Hence, over the long term, increasing the economy's potential income by improving productivity of capital may yield sustainable outcomes. Further, for the corporate sector, financing investments from external sources may not be difficult in good times, but the possibility of a reversal in capital inflows could create economic vulnerabilities due to the building up of a large foreign exchange liability in corporate balance sheets, thus, warranting continuous adhering to macroprudential measures. Finally, larger inflows of external financing could partly bridge the savings-investment gap, although, such inflows may lead to an appreciation of the domestic currency, eroding external competitiveness, thereby, constraining growth over the medium to long-run. Therefore, managing downside risks in bridging the savings-investment gap is of paramount importance to sustain the higher economic growth momentum over time.

the areas of dairy and sugar production. Further, the importation of oil is expected to decline over the medium term with the shifting to coal power and other alternative sources of energy. In the area of exports, merchandise trade needs to penetrate into emerging market economies to benefit from the rebalancing of the global economy, while retaining and increasing market share in traditional export destinations. Policies to promote value addition into fast expanding supply chain industries and entrepôt trade are expected to sustain earnings from exports. Further, earnings from trade in services are poised to grow with the 5-hubs namely, the maritime, aviation, knowledge, commercial and energy sectors and tourism emerging as key growth sectors in the economy.

Inflation is expected to moderate in 2013 with the easing of demand driven inflationary pressures and favourable supply side developments. Maintaining price stability is important for investor and consumer confidence as well as to maintain macroeconomic stability. Going forward, monetary policy will be carefully calibrated to balance between maintaining inflation at a low and stable level and stimulating growth towards its full potential. In this respect, the continued fiscal consolidation process and the implementation of appropriate policies to address supply side bottlenecks that increase the volatility of prices are expected to provide the required space for the smooth implementation of monetary policy.

The Sri Lankan economy is expected to continue on a high growth path benefitting from improved infrastructure facilities and favourable macroeconomic fundamentals. Encouraging the private sector to reap the benefits of the government's investments in infrastructure and facilitating them to expand productive capacity would be vital to achieving the envisaged medium term growth targets. Maintaining consistent policies and a conducive business environment will attract higher foreign direct investment (FDI) helping to bridge the gap between the current level of domestic savings and investment required to sustain the projected high growth momentum. Policies to improve productivity and encourage innovation are also needed to move to higher value added economic activities.

1.2 Macroeconomic Developments, Stability and Policy Responses in 2012

Real Sector Developments

The economy grew by 6.4 per cent in real terms in 2012 amidst the slow recovery in global demand and the multi-pronged policy measures introduced to strengthen macroeconomic stability. After an impressive growth of 8 per cent in 2010 and 2011, economic growth moderated in 2012 mainly due to the sluggish recovery in the global economy resulting in lower external demand for goods and services produced by domestic industries and adverse weather conditions that affected export and domestic agriculture sectors. The comprehensive policy package introduced by the Central Bank and the government to reduce the widening trade deficit and credit growth contributed to some extent to the deceleration in domestic economic activity although it has helped strengthen macroeconomic stability, thus facilitating a sustainable high economic growth with low inflation. Although economic growth decelerated to 6.4 per cent in 2012, it remained well above the growth of many regional and advanced economies.

All key sectors contributed to the growth in the economy in 2012. The Industry sector contributed the most to the expansion of the economy in 2012 mainly due to the acceleration in the construction sub sector. Services sector growth in 2012 was modest in comparison to the high growth

Table 1.1 Gross National Product by Industrial Origin at Constant (2002) Prices

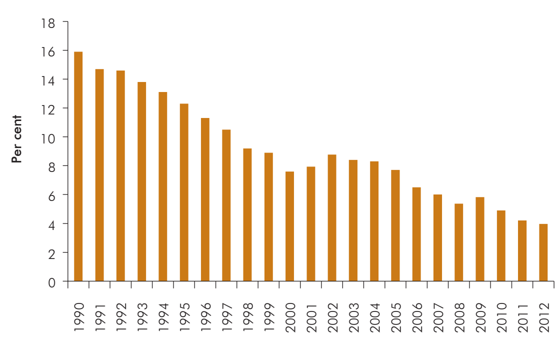
Sector	Value (Rs. million)		As a Share of GDP (%)		Rate of Change (%)		Contribution to Change (%)	
	2011(a)	2012(b)	2011(a)	2012(b)	2011(a)	2012(b)	2011(a)	2012(b)
Agriculture	**320,178**	**338,625**	**11.2**	**11.1**	**1.4**	**5.8**	**2.1**	**10.0**
Agriculture, Livestock and Forestry	282,748	297,730	9.9	9.8	-0.2	5.3	-0.2	8.2
Fishing	37,431	40,894	1.3	1.3	15.5	9.3	2.3	1.9
Industry	**838,932**	**925,335**	**29.3**	**30.4**	**10.3**	**10.3**	**36.0**	**47.1**
Mining and Quarrying	71,191	84,672	2.5	2.8	18.5	18.9	5.1	7.3
Manufacturing	494,990	520,938	17.3	17.1	7.9	5.2	16.7	14.1
Electricity, Gas and Water	69,547	72,634	2.4	2.4	9.2	4.4	2.7	1.7
Construction	203,204	247,091	7.1	8.1	14.2	21.6	11.6	23.9
Services	**1,704,605**	**1,783,318**	**59.5**	**58.5**	**8.6**	**4.6**	**61.9**	**42.9**
Wholesale and Retail Trade	676,565	701,408	23.6	23.0	10.3	3.7	29.0	13.5
Hotels and Restaurants	17,501	21,029	0.6	0.7	26.4	20.2	1.7	1.9
Transport and Communication	410,402	435,872	14.3	14.3	11.3	6.2	19.1	13.9
Banking, Insurance and Real Estate etc.	252,706	269,744	8.8	8.9	7.9	6.7	8.5	9.3
Ownership of Dwellings	75,607	76,926	2.6	2.5	1.2	1.7	0.4	0.7
Government Services	204,704	207,559	7.1	6.8	1.2	1.4	1.2	1.6
Private Services	67,119	70,779	2.3	2.3	7.2	5.5	2.1	2.0
Gross Domestic Product	**2,863,715**	**3,047,277**	**100.0**	**100.0**	**8.2**	**6.4**	**100.0**	**100.0**
Net Factor Income from Abroad	-31,526	-59,649			4.3	-89.2		
Gross National Product	**2,832,189**	**2,987,628**			**8.4**	**5.5**		

(a) Revised
(b) Provisional

Source: Department of Census and Statistics

recorded in 2011. The slowdown in both import and export trade largely contributed to the deceleration in the Services sector as a result of a reduction in the growth of the wholesale and retail trade sub sector, the largest component of the Services sector. However, this was partly buttressed by the relatively good performance of banking, insurance and real estate activities. Despite the prolonged drought which was experienced in the third quarter of the year and affected the Yala paddy harvest, growth in the Agriculture sector accelerated in 2012 from the low growth in the previous year due to substantial improvements in the Maha season paddy harvest, other field crops, coconut, livestock and fisheries sub sectors.

Chart 1.3 Annual Unemployment Rate (1990-2012)



Reflecting the continuing expansion in economic activity, the unemployment rate declined to 4 per cent in 2012 from 4.2 per cent in 2011. This is the lowest annual unemployment rate covering the entire island that has been recorded since the inception of the Quarterly Labour Force Survey (QLFS) in 1990. Broad based economic growth, the implementation of several new and ongoing infrastructure development projects, reconstruction and rehabilitation programmes, increase in self-employment opportunities and livelihood development programmes contributed to the reduction in the unemployment rate.

The Agriculture sector grew by 5.8 per cent in 2012, recovering from a slow growth of 1.4 per cent in 2011, amidst drought conditions in the third quarter of the year and heavy monsoonal rains and floods in the latter part of the year. The favourable weather conditions that prevailed in the early part of the year produced a bountiful paddy harvest in the Maha season, contributing to the recovery of the paddy sub sector from a contraction of 8.4 per cent in 2011 to register a growth of 1.3 per cent in 2012, despite the significant setback in paddy production in the Yala season due to adverse weather conditions. The performance of the agriculture sector was also driven by the improvement in vegetable production, highland crops, livestock and a significant increase in fish production during the year. The increase in the production of vegetables and highland crops contributed to a high growth of 10 per cent in the other field crops sub sector. The fisheries sub sector also contributed significantly towards the growth in the Agriculture sector expanding by 9.3 per cent, while milk production increased by 16 per cent, supported by concerted efforts by the government to promote the dairy industry. In the export agricultural sector, coconut production increased largely due to the lag effect of favourable weather conditions that prevailed in major coconut growing areas. However, tea production was adversely affected by the drought while rubber production declined due to the torrential rainfall. Within the minor export crops sector, pepper production increased significantly while the production of cinnamon and cloves declined in 2012.

Most agricultural commodities benefited from the favourable prices that prevailed in 2012. Paddy prices increased mainly due to the higher paddy purchasing price announced through the budget for 2013 and the lower than expected paddy harvest during the Yala season. Although vegetable prices declined during the Maha season owing to a bumper harvest, the drought and unusually heavy monsoon rains disrupted cultivation and supplies to the market pushing vegetable prices to substantially high levels towards the latter part of 2012. Further, the upward revision to several administratively determined prices, such as energy and transport, impacted on domestic prices, while the imposition of tariffs and other levies on imported food items, such as potatoes, onions, and chillies as well as the depreciation of the rupee also contributed to the high price of imported food varieties, thereby increasing the demand for domestic substitutes. In export agriculture, tea prices increased on account of supply shortages resulting from the impact of drought conditions and the lower production in competitor countries. However, rubber prices remained subdued reflecting the slowdown in global demand from major natural rubber consumers such as China and lower demand from domestic rubber based industries. Coconut prices also remained below the levels recorded in 2011 due to higher production in the early part of the year.

The government's commitment to improve agriculture output continued in 2012 with the implementation of several major policy measures. The budget for 2013 proposed the rescheduling of loans to paddy farmers whose crops were affected by adverse weather conditions, while providing seed paddy free of charge to continue cultivating in the upcoming Maha season. Further, it proposed the implementation of a Crop Insurance Scheme for all farmers who are beneficiaries of the existing fertilizer subsidy scheme. Paddy prices under the government's paddy purchasing scheme were increased to ensure stable market prices for farmers. Tariffs and the Special Commodity Levy (SCL) on selected commodities were increased during the year to protect local production and to ensure that farmers receive remunerative prices for their products. A fuel support scheme for fishermen was also introduced in March 2012 to partly offset the increase in costs arising from the fuel price revision. To promote the export agriculture sector the Tea Factory Modernising Subsidy Scheme was expanded in 2012 to cover a total of 240 tea factories and the subsidy for replanting and new planting was increased by Rs.50,000 per hectare and Rs.100,000 per hectare, respectively. In order to increase the area under rubber cultivation, 10,000 hectares of smallholder rubber lands in the

Ampara and Maha Oya areas are to be cultivated, of which 550 hectares have been completed in 2012. Institutional support for the coconut sector was strengthened to enabling the eradication of diseases such as Weligama Coconut Leaf Wilt Disease (WCLWD) and coconut mite infection.

The Industry sector grew by 10.3 per cent, contributing substantially to the expansion of the economy in 2012. The sustained increase in construction activities, which accelerated the growth momentum of the construction sub sector to 21.6 per cent in 2012 from 14.2 per cent in 2011, spurred the growth in the Industry sector. The continuation of major government funded infrastructure development projects and increased construction activities of the private sector, including tourism related new construction and renovation activities, contributed to this growth. A high level of activity in the construction sector bolstered demand for minerals and construction material enabling the mining and quarrying sub sector to increase its share in GDP to 2.8 per cent in 2012 from 2.5 per cent in 2011. Manufacturing, the largest sub sector within the Industry sector, decelerated in terms of value added growth from 7.9 per cent in 2011 to 5.2 per cent in 2012, due to subdued domestic and external demand. The factory industry sub sector, which accounted for around 90 per cent of manufacturing output, decelerated to 5.2 per cent in 2012 from 8.3 per cent in 2011. The apparel industry has been able to sustain its performance despite the slowdown in major export destinations due to the high quality of export products and strong domestic demand arising from the tourism sector. The contribution from the electricity, gas and water sub sector to industry growth was also lower in comparison to the previous two years, partly due to the drop in value addition from hydro power generation during the second and third quarters of the year.

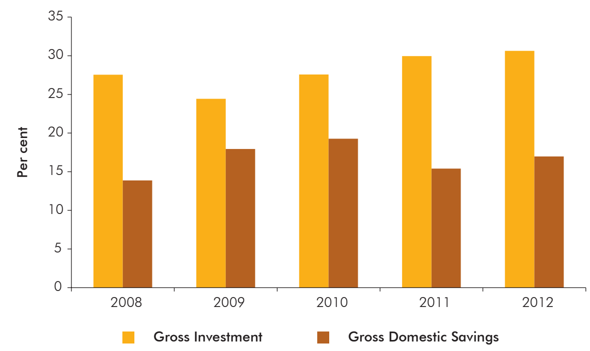
Government initiatives in the form of regional industrial development, productivity improvements, support for small and medium enterprises (SME) and research and development for innovation continued to be the focus of industrial policy in 2012. Development of infrastructure needed for promoting industries in regions through a number of projects such as *Wadakkil Wasantham* and *Nagenahira Navodaya* continued. The productivity improvement strategies concentrated on improving energy efficiency, waste management and quality enhancement. The SME sector was promoted via the *Gamata Obina Viyapara* programme and the *Divineguma* cottage industry development programme aimed at promoting potential regional industries. Further, the investment incentive structure coming under the purview of the Board of Investment of Sri Lanka (BOI) was rationalised in 2012 in order to streamline tax incentives for all types of industries irrespective of whether they were BOI or non BOI companies.

Services sector growth moderated to 4.6 per cent in 2012 from an expansion of 8.6 per cent in 2011 mainly due to the deceleration in the wholesale and retail trade sub sector. As a result, the relative share of the Services sector in GDP reduced to 58.5 per cent in 2012 from 59.5 per cent in 2011. The wholesale and retail trade sub sector grew by a modest 3.7 per cent in 2012 from 10.3 per cent in the previous year. The slowdown in import trade, reflecting the impact of policy measures taken to curb imports, and the decline in exports due to the sluggish recovery in the global economy largely contributed to the deceleration in this sub sector. Transport and communications, banking, insurance and real estate and hotels and restaurants sub sectors grew at a positive, albeit slower pace in 2012, also contributing to the modest growth in the Services sector.

Domestic and national savings improved considerably as a result of the improvement in the current account deficit. The lower growth in consumption expenditure mainly on account of imports resulted in an increase in the domestic savings rate to 17 per cent of GDP in 2012 from 15.4 per cent of GDP in 2011. However, there was a deterioration in government dis-savings during the year. The continued growth of private remittances from abroad raised the overall national savings rate to 24 per cent of GDP in 2012 from 22 per cent of GDP in 2011. Hence, despite the increase in investment as a percentage of GDP to 30.6 per cent, the savings-investment gap as a percentage of GDP, improved to 6.6 per cent in 2012, from 7.9 per cent in 2011.

Consumer price inflation remained at single digit levels for over forty consecutive months, although moving upwards during the year, due to supply side constraints and administrative price revisions. Year-on-year

Chart 1.4 Savings and Investment (as a percentage of GDP)



inflation, as measured by the Colombo Consumers' Price Index (CCPI) (2006/07=100) recorded 9.2 per cent in December 2012, while the annual average rate of inflation stood at 7.6 per cent in December 2012. The increase in inflation was mainly due to price increases in the non-food category. Several administered prices such as fuel, LP gas, wheat flour and milk powder were revised upward in line with price movements in international markets exerting upward pressure on the CCPI. Volatile

Table 1.2 Aggregate Demand and Savings Investment Gap

Item	Rs. billion		Growth %		As a percentage of GDP	
	2011(a)	2012(b)	2011(a)	2012(b)	2011(a)	2012(b)
1. Domestic Demand	7,496.3	8,618.6	23.5	15.0	114.6	113.7
1.1 Consumption	5,536.1	6,295.9	22.4	13.7	84.6	83.0
Private	4,568.4	5,274.5	25.1	15.5	69.8	69.6
Public	967.7	1,021.4	10.9	5.6	14.8	13.5
1.2 Investment (Gross Domestic Capital Formation)	1,960.2	2,322.7	26.8	18.5	30.0	30.6
Private	1,550.7	1,798.1	29.1	16.0	23.7	23.7
Public	409.5	524.6	18.8	28.1	6.3	6.9
2. Net External Demand	-952.3	-1,036.3	-104.5	-8.8	-14.6	-13.7
Export of Goods and Services	1,508.6	1,729.0	20.3	14.6	23.1	22.8
Import of Goods and Services	2,460.8	2,765.3	43.1	12.4	37.6	36.5
3. Total Demand (GDP) (1+2)	6,544.0	7,582.4	16.8	15.9	100.0	100.0
4. Domestic Savings (3-1.1)	1,007.9	1,286.5	-6.7	27.6	15.4	17.0
Private	1,079.8	1,392.9	-10.0	29.0	16.5	18.4
Public	-71.9	-106.4	40.0	-48.1	-1.1	-1.4
5. Net Factor Income from Abroad	-72.0	-148.4	-3.2	-106.0	-1.1	-2.0
6. Net Private Current Transfers	506.6	681.7	24.2	34.6	7.7	9.0
7. Natinal Savings (4+5+6)	1,442.5	1,819.8	1.7	26.2	22.0	24.0
8. Savings Investment Gap						
Domestic Savings - Investment (4-1.2)	-952.3	-1,036.3			-14.6	-13.7
National Savings - Investment (7-1.2)	-517.7	-503.0			-7.9	-6.6
9. External Current Account Deficit without Official Grants (2+5+6)	-517.7	-503.0			-7.9	-6.6

(a) Revised
(b) Provisional

Source: Department of Census and Statistics
Central Bank of Sri Lanka

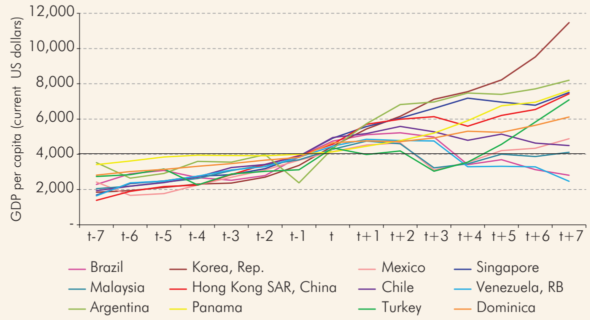
BOX 2 Challenges to Increasing Per Capita Income Beyond US dollars 4,000

The per capita income (PCI) in US dollar terms gives an indication about the average amount of goods and services that an individual of a particular country could purchase throughout the globe assuming no restrictions on currency conversion and trade. Further, it is an important measure as it is an indicator which could be used to compare countries, by removing the impact of population size. PCI estimates form the basis for classification of countries according to income, by various institutions. Sri Lanka has already graduated from a low income country to a lower middle income country. The next step, in terms of PCI is the upper middle income country status which Sri Lanka envisages to attain by 2016. But reaching the status of an upper middle income country would also bring about a unique set of challenges in moving further up the income ladder.

It has been observed that the US dollar 4,000 PCI level is a divergence point in terms of future growth momentum as some countries that have reached this threshold have continued to expand rapidly, while others have languished in the middle income level for a prolonged period. The issues in advancing further along the income ladder upon reaching the middle income level are captured by the term "middle income trap". This refers to countries that have overcome challenges posed by lower income levels but face issues that prevent them from advancing to a higher income status. This could be explained as the loss of favourable factors, which initially propelled the economy towards a higher income state and the lack of other growth stimuli required to drive the economy to the next stage. One of the key features of a low income country is the existence of low wages, which is a favourable factor for economic expansion based on low cost agriculture and manufacturing. This attracts investment for high labour intensive production activities which shift the low cost labour force from less productive sectors like agriculture to more productive activities like manufacturing and services. Consequently, wages rise and the market advantage created by the low wage rate environment erodes and economic expansion through this avenue loses its momentum. This results in a dwindling of growth in labour intensive sectors as new business opportunities move to lower income countries. This could create a slowdown in such sectors, thereby resulting in a deceleration in economic growth and a stagnation of PCIs in the middle income range.

Some South East Asian countries have been stuck in the middle income trap during the last two decades. The unchanged nature of the labour intensive production process and export structure in these nations could be the reason for this situation. Further, competition from recently emerging economies, which have the advantage in terms of cost pose further challenges. Some countries in the Latin American region also face a similar situation, which could be due to their high dependence on low-value added industries and the lack of development into new sectors.

Chart B 2.1 Movement in Per Capita GDP



Source: The World Bank

Countries such as Taiwan, Hong Kong SAR China, Republic of Korea and Singapore have avoided the middle income trap and advanced to high income status. The lessons from these countries and others highlight the importance of diversification, increasing productivity through higher value added products and services, continuous industrial upgrading and innovations. The Republic of Korea is an example for formulating and putting in place necessary strategies to overcome the middle income trap through improving connectivity and linkages, higher productivity, stable macroeconomic conditions with export promotion and complementary polices in the area of education and financing with high concentration on research and development.

Sri Lanka would have to monitor a number of key areas to ensure a continuous growth of its per capita income beyond US dollars 4,000 by avoiding the middle income trap. The continuous introduction of new and better technology to existing industries and the upgrading of existing ones from labour intensive to modern and more capital intensive industries would be necessary. A potential issue that Sri Lanka would have to address is the declining unemployment rate together with the changing structure of the labour force. This highlights the need to improve the productivity in the agriculture sector, which employs almost one third of the labour force while only contributing about 11 per cent to the GDP. The need for increasing productivity in the agriculture sector, would uplift the living standard of the people who are engaged in these activities and the excess labour created could be employed in other sectors avoiding the unnecessary build up of wage pressures in the economy. Furthermore, diversification of the economy into high value added activities, including the five hubs strategy (maritime, aviation, commercial, energy and knowledge) together with tourism would broaden the production structure of the country. This is an important step in the evolution process. An important part of this is to attract foreign investments which are supplemented by the transfer of advanced technology and access to wider markets.

The labour force of the country would have to be developed in tandem to acquire the necessary skills to facilitate growth through diversification into higher value added economic activities. Another key consideration is the cultivation of an innovation culture which would sustain the growth momentum in the long run. This would require a cohesive effort in a number of areas like education, investment in research and development and strengthening of the legal framework to be conducive towards creating and rewarding new innovations. In line with these developments, it would be necessary to implement a comprehensive set of reforms covering areas such as labour, property and contractual rights and doing business to facilitate the transformation and progress of the economy. Hence by putting in place an appropriate framework Sri Lanka would be able to avoid falling into the middle income trap and sustain growth in terms of PCI.

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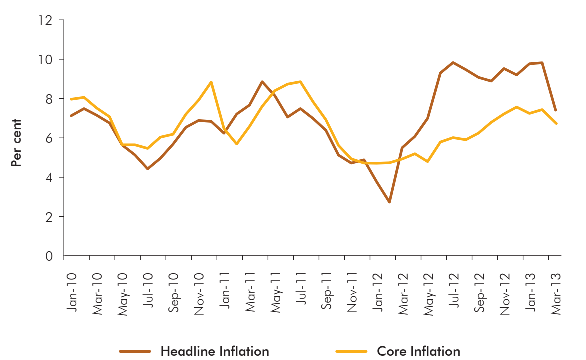
1. Agénor, P-R and O Canuto (2012), "Middle-Income Growth Traps", World Bank Policy Research Working Paper, 6210.
2. Jankowska, A., A. Nagengast and J. Perea (2012), "The Middle-Income Trap: Comparing Asian and Latin American Experiences", OECD Development Centre Policy Insights, No. 96, OECD Publishing.

Chart 1.5 Year-on-year Inflation (Based on CCPI:2006/07=100)

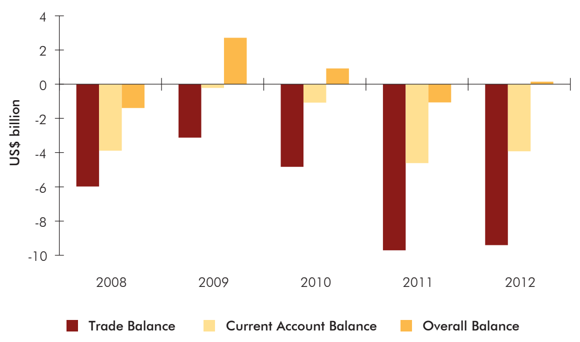


vegetable prices, due to disruptions to supply as a result of the severe drought conditions experienced in the middle of the year and the subsequent floods towards the latter part of the year, also contributed to the upward movement in the CCPI.

External Sector Developments

Overcoming the challenges encountered towards the latter part of 2011, the external sector performed well during 2012 benefiting from the comprehensive policy package implemented by the Central Bank and the government during early 2012. These policy measures mainly aimed at reducing the widening trade deficit in 2011 and early 2012, by curtailing non-essential imports and improving export competitiveness. The imposition of the ceiling on credit growth, and the upward revision to policy interest rates and tariff rates on selected imports helped curtail expenditure on imports during the year. However, due to the sluggish economic recovery in the US and in the euro area, the major markets for Sri Lankan exports, as well as the decline in the price of major export commodities, earnings from exports declined during the year. Nevertheless, in absolute terms, the decline in import expenditure was larger than the decline in export income, resulting in a contraction of the trade deficit. Further, the current account deficit improved as a substantial portion of the trade deficit was cushioned by increased inflows on account of trade in services and private current transfers. Long term inflows to the financial account, including the proceeds from the fifth international sovereign bond, FDI inflows, and other inflows to the banks and private sector, helped strengthen the BOP to record a surplus of US dollars 151 million by end 2012.

Chart 1.6 Balance of Payments



The deficit in the trade account declined in 2012, reflecting the effectiveness of concerted policy measures adopted to reduce import expenditure. Earnings from exports, which grew at a healthy rate in 2011, contracted by 7.4 per cent in 2012, due to the fall in the price of key export items and subdued global demand due to the faltering recovery of economic activity in advanced economies. Industrial exports declined by 7.8 per cent mainly due to the reduction in textiles and garments, which has the largest share (around 40 per cent) in total export earnings, by 4.8 per cent. The sharp decline in international cotton prices from the peak levels recorded in March 2011 also resulted in a drop in the average unit price of garments. Garment exports to EU, which constituted approximately 50 per cent of total garment exports, declined by 9.2 per cent in 2012, while garment exports to the US, Sri Lanka's second largest market for garments, also declined by 4 per cent in 2012. Earnings from agricultural exports declined by 7.8 per cent in 2012. Earnings from tea, which accounts for about 15 per cent of total earnings from merchandise exports, declined mainly due to geo-political tensions that continued to hamper demand from some Middle Eastern countries.

Expenditure on imports in 2012 declined by 5.4 per cent, year-on-year, while that on non-fuel imports, declined at a faster pace of 8.6 per cent. As a consequence of the higher import tariff imposed on vehicle imports and the depreciation of the rupee, expenditure on imports of motor vehicles declined by 43.8 per cent to US dollars 495 million in 2012, in contrast to the sharp increase recorded in 2011. This largely contributed to lowering expenditure on the importation of consumer goods in 2012. Expenditure on intermediate goods imports declined in 2012, mainly as a result of lower expenditure on the importation of gold. However, the expenditure on petroleum products increased due to higher dependence on thermal power generation. Also, the continuing US sanctions against Iran curtailed Sri Lanka's import of crude oil for its refineries, resulting in higher imports of refined petroleum products at a relatively high cost partly contributing to the increased expenditure on petroleum products during the year. Investment goods imports increased with continued development activities in the country in 2012. In absolute terms the decline in import expenditure was much higher than the decline in export earnings, and as a result, the trade deficit declined from 16.4 per cent of GDP in 2011 to 15.8 per cent of GDP in 2012.

The improvement in the trade balance and increased inflows from trade in services and current transfers helped restrain the current account deficit of the BOP. The services account recorded a significant improvement in 2012 mainly due to increased earnings from transportation, information technology services, travel and tourism. Earnings from tourism grew by 25.1 per cent, with tourist arrivals increasing by 17.5 per cent to over 1 million tourists and an increase in the average spent by tourists. Transportation services, which include passenger fares, freight, port and airport related earnings increased by 17.4 per cent mainly with the increase in tourist arrivals and transshipment cargo handling. Information technology enabled services and Knowledge and Business Process Outsourcing (IT/KPO/BPO) industries also performed well in

Table 1.3 External Sector Developments

Item	US$ million		Growth
	2011 (a)	2012 (b)	Rate (%)
Exports	10,559	9,774	-7.4
Agricultural Products	2,528	2,331	-7.8
Industrial Products	7,992	7,371	-7.8
Mineral Exports	33	61	86.4
Other Exports	7	10	48.1
Imports	20,269	19,183	-5.4
Consumer Goods	3,654	2,995	-18.0
Intermediate Goods	12,275	11,570	-5.7
Investment Goods	4,286	4,590	7.1
Other Imports	54	28	-48.6
Trade Balance	-9,710	-9,409	-3.1
Services (net)	1,099	1,250	13.8
Receipts	3,084	3,788	22.8
Payments	1,985	2,538	27.9
Income (net)	-647	-1,148	77.5
Receipts	467	321	-31.2
Payments	1,114	1,469	31.9
Current Transfers (net)	4,643	5,392	16.1
Private Transfers (net)	4,583	5,339	16.5
Receipts	5,145	5,985	16.3
Payments	562	646	15.1
Official Transfers (net)	60	53	-11.1
Current Account Balance	-4,615	-3,915	-15.2
Capital Account (net)	164	130	-20.7
Financial Account (net)	4,098	4,554	11.1
Direct Investment (net)	896	813	-9.3
Inflows	956	898	-6.1
Outflows	60	85	41.7
Private, Long-term (net)	175	562	220.6
Inflows	310	891	187.7
Outflows	135	329	144.9
Government, Long-term (net)	2,237	1,497	-33.1
Inflows	3,026	2,869	-5.2
Outflows	789	1,372	73.8
Private, Short-term (net)	-414	-358	-13.6
of which:Portfolio Investment (net)	-171	305	-278.0
Government, Short-term (net)	233	843	261.7
Commercial Bank (net)	971	1,196	23.2
Assets (net)	183	-239	-230.4
Liabilities (net)	788	1,435	82.0
Errors and Omissions	-708	-617	
Overall Balance	-1,061	151	
Gross Official Reserves (c)	5,958	6,877	
Months of Imports	3.5	4.3	
Total External Reserves (c)	7,199	8,357	
Months of Imports	4.3	5.2	
Export Price Index	111.2	103.3	-7.1
Import Price Index	122.3	115.2	-5.8
Terms of Trade	90.9	89.7	-1.3
Exchange Rates (Average)			App(+)/Dep(-)
Rs./US dollar	110.57	127.60	-13.3
Rs./Japanese yen	1.39	1.60	-13.1
Rs./Euro	153.86	164.01	-6.2
Rs./Sterling pound	177.23	202.28	-12.4

(a) Revised
(b) Provisional
(c) Excluding Asian Clearing Union balances

Source: Central Bank of Sri Lanka

2012 underscoring the tremendous potential of this sector to emerge as a key driver of economic growth for Sri Lanka. Remittances by migrant workers increased by 16.3 per cent to US dollars 6 billion during the year, continuing to be the largest single source of foreign exchange inflows to Sri Lanka. Several factors contributed to this development such as the increase in the number of Sri Lankans employed abroad, especially the increase in migration to high wage paying countries and higher labour migration in professional categories, an increase in the average wages of workers and the entering into collective agreements with several countries. Further, the expanding formal channels to remit money also contributed to the increase in remittances through the banking sector. The surplus in the trade in services and net current transfers was able to offset more than two-thirds of the trade deficit in 2012. Accordingly, the current account deficit was contained at US dollars 3.9 billion (6.6 per cent of GDP) in 2012 from US dollars 4.6 billion (7.8 per cent of GDP) in 2011.

In the capital and financial account, inflows to the private sector as well as to the government were substantial in 2012. FDI, including loans, recorded the highest ever gross inflow of US dollars 1.3 billion in 2012, reflecting positive investor sentiment, underpinned by the continuous improvement in Sri Lanka's business environment and improved macroeconomic fundamentals. Long term foreign inflows to the government, including the proceeds of the international sovereign bond of US dollars 1 billion, increased during the year to US dollars 2.9 billion in 2012. These inflows were mainly directed to finance major infrastructure projects supporting the long term development goals of the country. Foreign financing to the government on account of investments in Treasury bills and Treasury bonds increased substantially in 2012. Inflows to the private sector also increased during 2012 benefitting from the gradual relaxation of exchange control regulations effected by the Central Bank. This initiative facilitated foreign borrowings by the private sector with 28 companies obtaining approval for raising foreign loans during

2012. Meanwhile, commercial banks raised US dollars 973 million by way of long term foreign financing in 2012, including a US dollars 500 million international bond issued by the Bank of Ceylon. A notable feature of short term capital flows in 2012 was the net inflow of US dollars 305 million to the Colombo Stock Exchange (CSE) in contrast to the net outflow of US dollars 171 million recorded in 2011.

The narrowing of the external current account deficit and increased inflows into the capital and financial account resulted in a surplus in the BOP, amounting to US dollars 151 million in 2012, thereby boosting external reserves of the country. The receipt of the last two tranches under the IMF Stand-by Arrangement (IMF-SBA) obtained in 2009 and proceeds of the fifth international sovereign bond led to a sizeable increase in gross official reserves to a comfortable level in 2012, thereby improving the resilience of the economy to external shocks. Gross official reserves (excluding ACU balances) increased to US dollars 6.9 billion by end 2012 from US dollars 6.0 billion in 2011. Meanwhile, total international reserves of the country increased to US dollars 8.4 billion from US dollars 7.2 billion in 2011.

The increase in official reserves reduced the country's vulnerability to external shocks as reflected in the measures of reserve adequacy. The import coverage of gross official reserves (excluding ACU balances) was 4.3 months in 2012, compared to the internationally accepted norm of 3 months of imports. Reserve adequacy, as measured by the ratio of gross official reserves to short term external debt (with remaining maturity of one year or less) improved to 63 per cent by end 2012 from 60.6 per cent at end 2011. Despite the significant improvement in reserves, the relatively high increase in short term debt, particularly the increase in Treasury bills and Treasury bonds (of which 80 per cent constituted Treasury bonds with tenors from 1 year up to 20 years), resulted in the reserve adequacy ratio improving only marginally. According to the international classification, short term external debt used in assessing reserve adequacy ratio should include Treasury bonds, even though the tenor are over 1 year. However, since 2009, only around 8 per cent of the total investment in Treasury bonds has been prematurely withdrawn, within a period of 1 year. Therefore, if Treasury bonds are excluded from short term debt, the reserve adequacy would improve to 81.7 per cent in 2012 from 73.7 per cent in 2011.

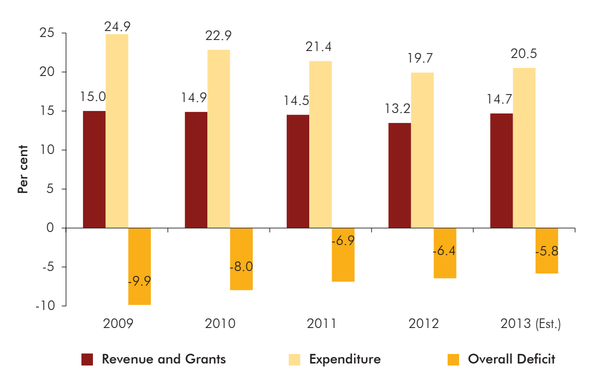
Total external debt and debt service payments of the country increased in 2012. In US dollar terms, total outstanding external debt, which consists of medium and long term debt and short term debt, increased by 13.8 per cent to US dollars 28.4 billion in 2012 from US dollars 25 billion in the previous year. Foreign capital inflows to the government in the form of medium and long term loans including the proceeds of the international sovereign bond and disbursements under the IMF-SBA facility, foreign inflows to the government securities market, and medium and long term foreign loans to public corporations resulted in total outstanding external debt rising to 47.9 per cent of GDP in 2012 from 42.2 per cent of GDP in 2011. Short term debt, increased by 23 per cent, primarily due to the increase in the outstanding stock of foreign holdings of government securities in 2012. However, 80 per cent of these holdings comprise Treasury bonds, which have maturities over 1 year up to 20 years. Foreign debt service payments, as a percentage of receipts from the export of goods and services increased to 21.2 per cent in 2012 from 12.7 per cent in 2011. The repayment of medium to long term loans by the government, particularly the repayment of the US dollars 500 million debut sovereign bond issued in 2007 and an increase in interest payments on government medium and long term loans, including interest and coupon payments on Treasury bills and Treasury bonds, as well as the marginal decline in the export of goods and services in 2012 mainly contributed to this increase.

The exchange rate policy in 2012 focused on allowing greater flexibility in the determination of the exchange rate by limiting the Central Bank's intervention in the domestic foreign exchange market. Further, to address any possible excessive volatility in the exchange rate arising from speculative activity, particularly after the announcement made in February 2012 to allow greater flexibility in the exchange rate, the Central Bank imposed restrictions on forward contracts and tightened exposure limits on net open positions (NOP) of commercial banks in March 2012. Reflecting the initial overshooting after the policy change, the rupee depreciated by 14.56 per cent against the US dollar in the first half of 2012. However, the rupee appreciated thereafter by 4.83 per cent in the second half of the year, in response to the prudent policy measures and higher foreign currency inflows to the market. Overall, the rupee depreciated against the US dollar by 10.43 per cent to Rs. 127.16 by end 2012. Reflecting cross currency exchange rate movements the rupee also depreciated against other major currencies in 2012. Meanwhile, the Nominal Effective Exchange Rate (NEER) and the Real Effective Exchange Rate (REER) depreciated substantially in 2012 compared to the appreciation observed in 2011 thereby improving the competitiveness of the external sector. The premia on three month and six month forward contracts remained marginally lower than the interest rate differential during a major part of the year, indicating market expectations of continued inflows into the domestic foreign exchange market.

Fiscal Sector Developments

The fiscal policy strategy in 2012 focused on strengthening the fiscal consolidation process while maintaining a high level of investment to facilitate sustained economic growth. Accordingly, the budget deficit for 2012 was targeted at 6.2 per cent of GDP with revenue (including grants) and expenditure and net lending as a percentage of GDP, set at 15 per cent and 21.2 per cent, respectively. However, budgetary operations during the year became challenging in an environment of high interest rates, rising debt service payments due to exchange rate movements, reduced imports, and moderate economic growth. Nevertheless, the government succeeded in reducing the budget deficit to 6.4 per cent of GDP in 2012 from 6.9 per cent of GDP in 2011, further consolidating the achievements made in the recent past to lower the fiscal deficit. Despite a shortfall in revenue, a tight rein on recurrent expenditure together with the curtailment of non-priority capital expenditure, enabled the government to steer fiscal operations close to the 2012 budget target. Expenditure restraint in both current and capital outlays reduced total expenditure and net lending of the government from 21.4 per cent of GDP in 2011 to 19.7 per cent of GDP in 2012. While public investment, as a percentage of GDP, was

Chart 1.7 Revenue, Expenditure and Overall Fiscal Deficit
(as a percentage of GDP)



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ECONOMIC, PRICE AND FINANCIAL SYSTEM STABILITY, OUTLOOK AND POLICIES maintained at 5.5 per cent, the reduction in recurrent expenditure to 14.4 per cent of GDP in 2012 from 15.4 per cent of GDP in 2011 was an over-performance in terms of the 2012 budget target of 14.8 per cent. Consequently, the primary balance, which excludes interest payments declined to a deficit of 1.1 per cent of GDP in 2012 from a deficit of 1.4 per cent of GDP in 2011. Despite the reduction in current expenditure, the current account deficit, increased to 1.4 per cent of GDP in 2012 from 1.1 per cent of GDP in 2011 due to lower tax revenue mobilisation. Revenue as a percentage of GDP declined to 13 per cent in 2012 from 14.3 per cent in the previous year, reflecting the slowdown in domestic economic activity and the impact of policy measures adopted. In financing the budget deficit, the government relied primarily on foreign sources with foreign financing increasing to 59 per cent of the total financing requirement. Financing from domestic sources was largely through bank borrowings, which accounted for 65 per cent of the domestic financing requirement, exceeding the level of bank financing envisaged in the budget for 2012.

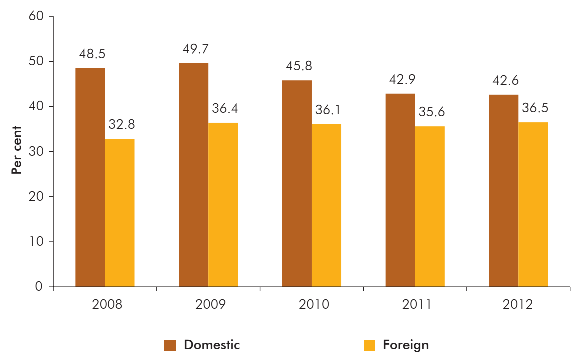
Government revenue as a percentage of GDP declined to 13 per cent from 14.3 per cent in the previous year although revenue increased by 5.7 per cent in nominal terms. The lacklustre performance of government revenue was entirely due to a reduction in tax revenue as a percentage of GDP to 11.1 per cent in 2012 from 12.4 per cent in 2011. Tax revenue was significantly below the original estimate for 2012 owing to a reduction in import related taxes resulting from a decline in imports, especially consumer goods including motor vehicles, and a slowdown in economic activity. Non tax revenue remained at 1.9 per cent of GDP as in the previous year.

Current and capital expenditure of the government declined from 21.4 per cent of GDP in 2011 to 19.7 per cent of GDP in 2012. The decline in expenditure is a reflection of the government's efforts to rationalise recurrent expenditure and curtail non-priority capital expenditure. The reduction in recurrent expenditure was mainly on account of the rationalisation of expenditure in respect of salaries and wages and government purchases of goods and services. Capital expenditure, as a percentage of GDP declined to 5.3 per cent in 2012 from 6 per cent in the previous year, mainly due to resources being channeled to strategically important infrastructure development projects.

The resource gap was financed mainly by foreign sources through higher foreign investments in government securities, the issue of an international sovereign bond and project loans, which accounted for 59 per cent of the total financing requirement. The balance 41 per cent was financed through domestic sources. With respect to domestic financing, the government relied heavily on the banking sector in 2012. Borrowings from the banking sector in 2012 were significantly higher amounting to Rs. 131.5 billion compared to the budget estimate of Rs. 64 billion, although the share of banking sector borrowings in total domestic financing declined to 65 per cent in 2012 from 81 per cent in the previous year.

The debt to GDP ratio in 2012 increased to 79.1 per cent, reversing the declining trend observed in the recent past, largely due to exchange rate movements. In nominal terms, the outstanding government debt increased notably by 16.9 per cent to Rs. 6,000 billion at end 2012 from Rs. 5,133 billion at end 2011. The total foreign currency denominated debt stock increased by Rs. 207 billion (2.7 per cent of GDP) during 2012 due to the depreciation of the rupee against major foreign currencies. However, five out of six external debt indicators in 2012 as defined in the Manual on

Chart 1.8 Government Debt (as a percentage of GDP)



Effective Debt Management of the UN-ESCAP confirm Sri Lanka as a less indebted country (See Table 6.7 for details).

Monetary Sector Developments

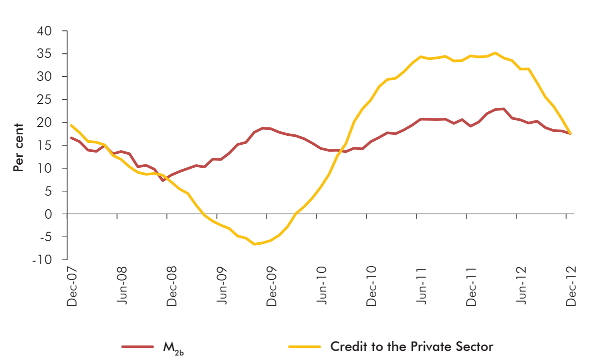
The Central Bank followed a stringent monetary policy stance during the year to contain the rapid expansion in monetary aggregates and thereby preserve macroeconomic stability but was able to relax its policy stance by December as the policy measures yielded the desired outcomes. Monetary policy was tightened significantly by the policy rates being raised twice and by a ceiling on the growth of rupee credit being imposed in order to stem the high growth in monetary and credit aggregates. Accordingly, the policy interest rates of the Central Bank were increased by 50 basis points in February. A second round of policy tightening was carried out in April, where the Repurchase rate was raised by 25 basis points to 7.75 per cent and the Reverse Repurchase rate was increased by 75 basis points to 9.75 per cent, thus widening the policy interest rate corridor to 200 basis points. At the same time, to effect a more rapid curtailment of credit, the Central Bank imposed a ceiling on the growth of rupee denominated credit by licensed banks in 2012. Accordingly, a Direction was issued under Section 101(1) of the Monetary Law Act (MLA) restricting the growth of credit to 18 per cent while an additional 5 per cent was allowed to banks that brought in funds from abroad to bridge the difference. In view of the asymmetric impact it could have on some banks, alternative limits of Rs. 800 million, or Rs. 1 billion for banks that mobilise funds from abroad, were imposed. As the growth of credit and monetary aggregates decelerated, the Central Bank was able to signal an early exit from the tight policy stance in December 2012 by easing its policy interest rates by 25 basis points and allowing the credit ceiling to expire at the end of the year. Consequently, the tightening cycle in the year 2012 was one of the shortest experienced by the Sri Lankan economy in recent years.

Excess rupee liquidity in the domestic money market remained in a moderately surplus position until August 2012 compared to the large excess experienced in 2011, but declined to a broadly balanced position thereafter. Excess liquidity was about Rs. 12 billion on average during the first eight months of the year increasing significantly to Rs. 59 billion by end July with the Central Bank purchasing a part of the proceeds from the fifth international sovereign bond issue. However, in view of the need to maintain tight liquidity conditions in the market in line with the prevailing monetary policy stance, the Central Bank took measures to unwind the excess liquidity through term repurchase agreements and the outright sale of Treasury bills from its portfolio, albeit with limited success due to insufficient participation by market players. However, market liquidity declined from end August, ranging between surplus and deficit positions with the reversal of foreign exchange swaps and the continued sale of Treasury bills necessitating injection of liquidity through term reverse repurchase agreements. By the last quarter, the purchase of Treasury bills from the primary market and foreign exchange from the domestic foreign exchange market, particularly in December, improved market liquidity to a balanced position. The Central Bank continued to hold auctions under open market operations (OMO) and offer standing facilities on a daily basis to manage overnight liquidity and guide market interest rates.

The Monetary Programme was prepared according to the expected developments in the macroeconomy and was used to guide monetary operations during the year. Nominal GDP was originally projected to be about 15 per cent, on account of a projected growth in real GDP of 8 per cent and a GDP deflator of 6 per cent. Based on these projections, the targeted growth of broad money and reserve money were set at 15 per cent as the money multiplier was expected to remain broadly stable. Credit extended to the private sector was expected to expand by about 19 per cent, which formed the basis for the subsequent Direction issued by the Central Bank capping the growth of rupee denominated credit. Growth of real GDP was revised downwards on several occasions during the course of the year on account of the tight policies adopted, the protracted global economic recovery and the impact of adverse weather conditions. However, the growth targets for monetary aggregates were maintained unchanged given that growth of nominal GDP remained broadly at the same level.

Growth of monetary aggregates decelerated from the second quarter onwards responding to the tight policy measures in place. Growth in reserve money remained largely subdued recording a year-on-year growth of 10.2 per cent in 2012 compared to the high growth observed in the two previous years. Although reserve money exhibited significant volatility during the year it remained within the targeted levels recording an annual average growth rate of 14.8 per cent. Growth of broad money (M_{2b}), which exceeded targeted levels, reached a peak of 22.9 per cent in April 2012. However, benefiting from the turnaround in credit to the private sector from April onwards, growth of broad money moderated to 17.6 per cent by year end. Growth of broad money, on an average basis, however remained high at 20.2 per cent given the high rates of growth recorded in the early months of the year.

Chart 1.9 Year-on-Year Growth of Money and Credit to the Private Sector



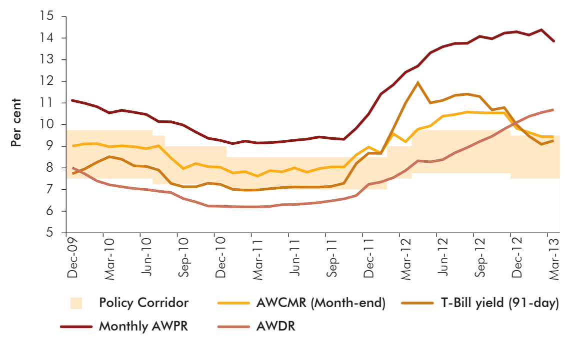
The expansion in domestic assets of the banking system underpinned the expansion in broad money during the year. Within domestic credit, both credit obtained by the private sector and the public sector increased during the year. Credit utilised by the private sector accelerated during the first quarter of the year to peak at 35.2 per cent in March 2012, continuing the trend observed in 2011. However, with the implementation of policy measures, credit growth declined rapidly thereafter to 17.6 per cent by year end, which was even below the target for the year. In contrast, credit obtained by the government, which remained high in the early months of the year, continued to increase during the rest of the year, although at a slower pace. Net credit to the government (NCG) extended by the banking sector in 2012 amounted to Rs. 211.6 billion, substantially higher than the level of bank borrowing envisaged in the budget. Similarly, credit obtained by public corporations also increased notably by Rs. 94 billion on account of heavy borrowing by the CPC and the CEB from the banking sector.

The net foreign assets (NFA) of the banking system declined due to the drop in foreign assets of commercial banks while the Central

Bank's foreign assets increased during the year. Commercial banks mobilised more funds from abroad to meet the resource needs of a growing economy. As a result, even though foreign assets declined, an increase in domestic foreign currency assets was witnessed in the balance sheets of commercial banks. Notable amongst these were foreign currency loans extended to the CPC and increased investments in Sri Lanka Development Bonds (SLDB), which were also reflected in the increase in credit to the public sector. A part of the funds raised by commercial banks abroad was also swapped with the Central Bank. During the year, the Central Bank's holdings of foreign assets increased due to the purchase of a part of the sovereign bond proceeds, purchases of foreign currency from the domestic foreign exchange market and foreign exchange swaps entered into with domestic banks during the year.

Market interest rates were allowed to move up to facilitate the desired deceleration in credit and monetary aggregates in line with the Central Bank's policy direction. The overnight interbank market rates remained around the upper bound of the policy rate corridor during the year until the relaxation of policy from mid-December 2012. Both deposit and lending rates in the market moved up further in 2012, continuing the trend from the last quarter of 2011, reflecting the increased policy interest rates, the ceiling on credit and the tight liquidity conditions in the market. Yield rates across all maturities of Treasury bills in the primary market increased till around mid-year before remaining stable until December 2012. Excess funds from banks were being invested in government securities as the credit ceiling necessitated some banks to pace out their lending to the private sector. The upward movement in market interest rates was also reflected in the secondary market yield curve for government securities, which moved above the level in 2011 by year end.

Chart 1.10 Policy Interest Rate Corridor and Selected Market Interest Rates



Financial Sector Developments

The financial sector expanded during the year maintaining its stability in spite of vulnerabilities arising from the fragile conditions in the global financial markets and possible threats from the domestic economy. Several measures were taken early in the year to curb domestic demand and safeguard stability in the economy. The cap on credit growth placed in March 2012 also helped stem the potential adverse impact of continued high credit growth on the stability of the banking industry and thereby, the entire financial sector. The overall soundness of the financial sector improved in terms of capital and liquidity levels. The branch network increased further, promoting access to finance facilitating the efforts to achieve a balanced regional growth. However, compared to the previous year, domestic financial markets remained sluggish due to stringent measures taken by the authorities, although improved investor confidence was evident by the net inflows to the Colombo Stock Exchange. As in previous years, the Central Bank continued to strengthen the supervisory and regulatory environment to promote the safety of the financial system while fostering innovation and modernisation.

The overall soundness of the financial sector improved with institutions retaining adequate capital and liquidity levels while the

branch network widened further and the asset base broadened over the year. The banking sector continued to dominate the financial sector landscape with its share of assets increasing in 2012. Growth of assets of the banking sector remained unchanged from 2011 largely due to the cap on credit growth placed in March 2012 but profitability was higher in 2012. The increase in profits helped build up the capital funds of banks. The total capital adequacy ratio of the banking sector is expected to remain at a level well above the minimum threshold placed by the regulator. The declining trend in non-performing loans (NPL) observed since 2009 slowed in 2012, largely reflecting the high interest rate environment. As at end 2012, the Sri Lanka Deposit Insurance Scheme (SLDIS) comprised 78 member institutions and a fund balance of approximately Rs. 9.7 billion. The non-bank financial institution (NBFI) sector consisting of Licensed Finance Companies (LFCs) and Specialised Leasing Companies (SLCs) expanded its asset base while increasing its branch network with improved soundness of the institutions within the sector. The Central Bank's continued efforts to promote the risk management practices at NBFIs helped improve the overall soundness of these institutions. The Central Bank closely monitored the progress made by distressed finance companies in restructuring their business while continuing efforts to stem the conduct of unauthorised finance businesses. The key performance indicators of Primary Dealers in government securities improved during the year. Despite the subdued performance in the equity market, the unit trust industry recorded significant growth in terms of total assets and net asset value benefiting from portfolio diversification. Insurance companies maintained their soundness with key indicators such as total assets, premium income, investment income and profitability all on an upward trend. The main superannuation funds continued to experience a growth in their asset base and membership, while being able to maintain a healthy return on investments. The funds of the Employees' Provident Fund (EPF), which accounts for about 79 per cent of the superannuation sector assets, reached Rs. 1,144 billion by end 2012.

Conditions in the domestic financial markets remained subdued compared to the previous year largely due to the stabilisation policies adopted by the authorities. Money market liquidity fluctuated from surplus to deficit positions reaching a broadly balanced position, particularly towards the latter part of the year. The interbank call market rate increased during the first half of 2012 responding to tight policy measures adopted including the credit ceiling imposed on banks, and thereafter hovered around the upper bound of the Central Bank's policy interest rate corridor, declining towards the middle of the corridor with the easing of policy interest rates in mid-December. A notable feature during the year was the increased activity in the commercial paper market, which could be attributed to the credit restrictions imposed on bank lending and the resultant high interest rates charged by banks. A similar trend was mirrored by the corporate bond market. Net foreign inflows to the CSE increased significantly in 2012 despite the continuation of a fragile performance. Amongst factors that affected activity at the stock exchange were the relatively higher yields on fixed income securities, volatility in the exchange rate, tight liquidity conditions in the market and the knock-on effects of uncertainties prevailing in global financial markets. The limits imposed on credit by stock brokers, although relaxed subsequently, also hampered market performance during the early months of the year.

The supervisory and regulatory framework was further strengthened during the year to promote the stability of the financial system and safeguard customers. Several Directions were issued to licensed banks during the course of the year pertaining to standards of business conduct and market practices in foreign exchange transactions, outsourcing of businesses, operations and classifications. Licensed Finance Companies were issued Directions in relation to information systems security and upper limits for interest rates offered on deposits. Similarly, the Specialised Leasing Companies were issued directions on assessment of fitness and propriety of directors and key management personnel and changes to definitions in the compilation of key indicators. In order to strengthen the audit process and to meet the required standards, a panel of external auditors was appointed to conduct external audits of non-bank financial institutions.

Several innovations were introduced to the payments and settlements system while continuous improvements were carried out to cater to the demand for safe and expedient financial transactions. Payments and settlement system was broadened further by introducing mobile phone based e-money systems to the telecommunication networks in June 2012 under the supervision of the Central Bank of Sri Lanka. The LankaSettle system operated by the Central Bank of Sri Lanka, one of the two systemically important payment systems, was upgraded in 2012 by carrying out several system enhancements to improve operational functionality, system security and monitoring capabilities. Furthermore, an assessment to gauge whether the systemically important payment systems were operating in accordance with international standards and best practices was undertaken during the year. The emergence of innovative schemes and improvements to existing practices necessitated the Central Bank of Sri Lanka to broaden its role as a regulator and facilitator to keep abreast of the new developments in the payments and settlements arena. During the year, the Central Bank's attention was focused on retail payment systems and electronic fund transfer mechanisms with the intention of mitigating risks arising from innovative payment methods and encouraging such developments further. Given the concerns on account of rising payment card related frauds, the Central Bank of Sri Lanka mandated the adoption of line encryption technology for institutions that engage in financial acquisitions as a means of mitigating fraud risk associated with cardholder data theft while in transit.

1.3 Global Economic Environment and Outlook

Four years after the onset of the global financial crisis, global economic growth weakened further in 2012, pushing several advanced economies into a double dip recession, while adversely affecting economic growth in most other economies. A growing number of advanced economies experienced downward spiraling dynamics due to high unemployment, sluggish domestic demand amidst risks of excessive near-term fiscal tightening, high public debt burdens, heightened sovereign risks, and financial sector fragility. Further, growth in major emerging markets and developing economies also decelerated notably, pointing to both external vulnerabilities and domestic challenges. Meanwhile, growth in most low income economies performed relatively better, despite the risk of adverse spillover effects from a severe slowdown in advanced and major emerging market economies.

The growth of world output is estimated to have declined to 3.2 per cent in 2012, from 3.9 per cent in 2011. Growth in advanced economies, in particular, slowed to 1.3 per cent in 2012, from 1.6 in 2011, with the euro area slipping back into recession contracting by 0.4 per cent, dragged mainly by negative growth in Italy, Portugal and

Table 1.4 Global Economic Developments and Outlook (a)

Item	2010	2011	2012 (Estimates)	2013 (Projections)
World Output	**5.1**	**3.9**	**3.2**	**3.5**
Advanced Economies	3.0	1.6	1.3	1.4
United States	2.4	1.8	2.3	2.0
Euro Area	2.0	1.4	-0.4	-0.2
United Kingdom	1.8	0.9	-0.2	1.0
Japan	4.5	-0.6	2.0	1.2
Emerging and Developing Economies	7.4	6.3	5.1	5.5
Developing Asia	9.5	8.0	6.6	7.1
China	10.4	9.3	7.8	8.2
India	10.1	7.9	4.5	5.9
World Trade Volume (Goods and Services)	**12.6**	**5.9**	**2.8**	**3.8**
Imports				
Advanced Economies	11.4	4.6	1.2	2.2
Emerging and Developing Economies	14.9	8.4	6.1	6.5
Exports				
Advanced Economies	12.0	5.6	2.1	2.8
Emerging and Developing Economies	13.7	6.6	3.6	5.5
Price Movements				
Consumer Prices				
Advanced Economies	1.5	2.7	2.0	1.6
Emerging and Developing Economies	6.1	7.2	6.1	6.1
Commodity Prices (US$)				
Oil	27.9	31.6	1.0	-5.1
Non-Fuel	26.3	17.8	-9.8	-3.0
Six-month London Interbank Offered Rate (per cent) on US dollar deposits	**0.5**	**0.5**	**0.7**	**0.5**

(a) Annual percentage change unless otherwise indicated.

Source: World Economic Outlook (January 2013 & October 2012), IMF

Spain, while the rest of the euro area was also affected, albeit to a lesser extent. The US economy continued its sluggish recovery in 2012, although growth in the second half was more positive. For the year as a whole, the economy grew by 2.3 per cent in 2012, from 1.8 per cent in 2011. The main contributors to growth were private consumption, and public spending on employment and defence, with the new round of quantitative easing launched by the Federal Reserve Bank of the US (Fed) expected to improve the employment situation in the near to medium term. In 2012, the Japanese economy is expected to have improved with the economy growing by 2 per cent in 2012 from a contraction of 0.6 per cent in 2011, mainly driven by reconstruction activities and the recovery from the earthquake in 2011, in addition to measures taken to stimulate private consumption. Meanwhile, growth in emerging markets and developing economies fell to 5.1 per cent in 2012, from 6.3 per cent in 2011, with growth in China and India in developing Asia slowing to 7.8 per cent and 4.5 per cent, respectively, in 2012, from 9.3 per cent and 7.9 per cent, respectively, in 2011. Growth in Latin America and the Caribbean moderated to 3 per cent in 2012, from 4.5 per cent in 2011. However, the economies in the Middle East and North Africa marked an impressive growth of 5.2 per cent in 2012, up from 3.5 per cent in 2011, underpinned by strong performance in oil exports, continued fiscal spending in infrastructure projects, and expanding economic ties with Asian economies.

Major central banks adopted an accommodative monetary policy stance taking some bold actions to support economic activity in 2012. The Fed announced that it would continue the bond buying programme at a pace of US dollars 85 billion a month until the end of 2014. Further, the Fed showed a firm commitment to consider additional asset purchases and employ its other policy tools until economic conditions improved, while also extending its low interest rate guidance until such time as unemployment falls below 6.5 per cent and as long as the outlook for inflation remains less than 2.5 per cent. The European Central Bank (ECB) launched a new Bond Purchase Programme (Outright Monetary Transactions-OMT) to purchase government bonds of euro zone countries, which are in need of financial assistance. The Bank of England expanded its quantitative easing programme, while various advanced economies including Australia, Czech Republic, Israel and South Korea, cut policy rates or postponed rate hikes. The Bank of Japan's Asset Purchase Programme is expected to deliver a monetary expansion of about 5 per cent of GDP in the coming year, pushing inflation up to its 2 per cent target.

Oil prices fluctuated during 2012, as weaker global demand tended to push prices down, while heightened geopolitical tensions

in several oil exporting countries put upward pressure on prices. Global oil supply was somewhat affected by the sanctions imposed on Syrian and Iranian oil exports by the European Union and the United States. However, the impact was cushioned to a great extent by the increase in oil production by Saudi Arabia, the resumption of oil production in Libya and higher than expected output in North America, Latin America and the Russian Federation. Meanwhile, food prices increased substantially towards July 2012 due to the severe drought and poor weather conditions in the United States, the Russian Federation, and several other countries. With slowing global demand, food prices are expected to moderate over the near-term. According to IMF estimates growth in consumer prices in advanced economies fell by 2 per cent in 2012 from 2.7 per cent in 2011, while emerging market and developing economies recorded a 6.1 per cent increase in 2012, compared to an increase of 7.2 per cent in 2011. However, in various advanced economies and a number of emerging market and developing economies, pressure on prices remain elevated.

Confidence in the global financial system remained fragile in 2012. Bank lending remained sluggish across advanced economies and emerging markets due to more stringent lending standards, increasing sovereign and corporate bond spreads, while most emerging economies continued to experience volatile capital flows. During 2012, net private capital inflows to emerging economies were estimated to have declined by about 10 per cent to US dollars 1 trillion from 2011, reflecting the ongoing deleveraging in advanced economies, as well as domestic factors specific to emerging market economies. These factors include slower growth in China and other Asian economies; uncertainties in North Africa and the Middle East in the wake of political transformations and, in some cases, ongoing conflicts; and rigorous capital account regulations in Latin American countries such as Brazil in order to limit short term capital inflows and mitigate volatility in capital flows and the exchange rate. Meanwhile, investment abroad by emerging market economies amounted to US dollars 1.3 trillion, amidst concerns over securing buffers against any shocks due to volatility in world commodity prices, and capital and exchange markets.

Major currencies experienced significant volatility during 2012, amidst volatile capital flows and several rounds of quantitative easing programmes by major central banks. The euro which depreciated against the US dollar during the first half of 2012 due to the escalation of the debt crisis in the euro area rebounded during the second half supported by the OMT programme and further quantitative easing by the ECB. The Pound sterling saw a similar trend vis-à-vis the US dollar, ending 2012 at US dollars 1.62 per Pound sterling, from US dollars 1.54 at end 2011. Meanwhile, the Japanese yen, which continued to rise against the US dollar during the recent past, reversed this trend by depreciating by about 10 per cent, possibly in response to expectations of further easing of monetary policy to support a weak economy and a higher trade deficit. However, a sizable depreciation of the Japanese yen sparked concerns about competitive devaluations, despite continued strengthening of the Japanese yen against the US dollar in the past several years. Notwithstanding widespread expectations of an appreciation, the China's renminbi depreciated in the first half of 2012 against the US dollar, although this trend reversed in the second half of the year, resulting in an overall appreciation of 1.5 per cent in 2012. Meanwhile, major currencies in South Asia particularly, currencies in India and Pakistan depreciated by 3.2 per cent and 7.8 per cent, respectively, in 2012. This was mainly driven by weak output growth, slow capital inflows, high inflation, and high trade deficits. However, the Bangladesh taka appreciated by 2.57 per cent against the US dollar in 2012, supported by lower import payments and higher growth of inward remittances.

The global economic outlook for 2013 points to a gradual upturn of world output as financial market conditions improve, supported by policy actions that are expected to bolster investor confidence and mitigate near term risks. ECB's announcement of the OMT programme, the commitment of the US to keep interest rates exceptionally low at least as long as unemployment rates fall to desired levels, the open ended asset purchase programme by the Bank of Japan and postponement of monetary tightening by many emerging market economies may result in accommodative monetary conditions that will continue to support global economic recovery. However, concerns over financial stability risks in many advanced economies, monetary and macroprudential policies in emerging market economies, as well as fiscal consolidation efforts across the globe may lead to a slower than expected transmission of monetary conditions into the real economy. Against this backdrop, global real GDP growth is projected to reach 3.5 per cent in 2013 (up from 3.2 per cent in 2012) and increase further to 4.1 per cent in 2014. The growth prospects of the US economy for 2013 and 2014 remain elevated at 2 per cent and 3 per cent, respectively, with expected improvements in the housing sector, supported by a new round of quantitative easing. The euro area poses a large downside risk to the global outlook, as it is projected to continue to be in recession in 2013, contracting by 0.2 per cent, although it is expected to record a mild positive growth of 1 per cent in 2014. The Japanese economy is expected to perform better than previous projections owing to export recovery backed by the weak Japanese yen and gradually improving global demand, and expected surge in domestic demand with the support from the sizable economic stimulus package. In emerging and developing market economies, more broad based economic activity is expected, as these economies continue to grow at 5.5 per cent in 2013 and 5.9 per cent in 2014. China is expected to grow at 8.2 per cent and 8.5 per cent in 2013 and 2014, respectively, while the Indian economy is projected to expand by 5.9 per cent and 6.4 per cent in 2013 and 2014, respectively. However, important downside risks to global economic outlook may emerge from delays in policy implementation in the euro area and unchecked fiscal positions in the US and Japan over the medium term. Further, lower expectations for medium term growth for some emerging market economies may also result in further cutbacks in investment and capital outflows, thereby reducing near term growth.

1.4 Medium Term Macroeconomic Outlook

The economy is projected to expand at a rate of 7.5 per cent in 2013 and gradually move to a higher growth trajectory of over 8 per cent in the medium term. Robust external demand would be vital for sustaining a high growth momentum over the medium term, with the expected support from the gradual recovery of the global economy and the diversification of Sri Lanka's export structure to higher value added goods and services. Sustaining this higher growth momentum requires raising investments to a level of around 31–33 per cent of GDP. The growth in the medium term needs to be supported by capacity expansion and adapting and upgrading the technology used in the production process, diversifying into higher value added sectors and broadening export destinations. Proactive policy measures are expected to bring about low and stable inflation with the GDP deflator declining to around 5 per cent, thereby creating an environment conducive for investment. With the projected rapid economic growth, Sri Lanka is expected to surpass the US dollars 4,000 threshold of per capita income by 2015.

The country's external sector is expected to strengthen over the medium term, enhancing its resilience to external shocks. Export of goods is expected to regain the upward momentum over the medium term underpinned by the recovery in world economic activity and positive effects brought about by the timely implementation of policy measures to enhance exports. Imports are projected to increase at a moderate rate. Import of oil, which is a major challenge in curtailing expenditure on imports, is expected to decline over the years with the commissioning of the Norochcholai and Sampur coal power plants. This, together with the envisaged growth momentum of exports, would result in a substantial contraction in the trade deficit in the medium term. Meanwhile, the growth momentum maintained over the past decade in the trade in services indicates that the

Table 1.5 Medium-term Macroeconomic Framework (a)

Indicator	Unit	2011 (b)	2012 (c)	Projections 2013	2014	2015	2016
Real Sector							
GDP at Market Prices	Rs. bn	6,544	7,582	8,722	9,985	11,356	12,939
Real GDP Growth	%	8.2	6.4	7.5	8.0	8.3	8.5
GDP Deflator	%	7.9	8.9	7.0	6.0	5.0	5.0
Per Capita GDP	US$	2,836	2,923	3,348	3,790	4,267	4,814
Total Investment	% of GDP	30.0	30.6	31.0	32.0	32.5	33.0
Domestic Savings	% of GDP	15.4	17.0	19.9	23.4	25.7	28.4
National Savings	% of GDP	22.0	24.0	26.9	30.1	32.0	34.2
External Sector							
Trade Gap	US$ mn	-9,710	-9,409	-9,813	-10,010	-10,384	-10,113
Exports	US$ mn	10,559	9,774	10,799	12,890	15,210	17,605
of which; Textiles and Garments	US$ mn	4,191	3,991	4,010	4,530	5,180	5,955
Gems, Diamonds and Jewellery	US$ mn	532	559	594	745	895	1,090
Imports	US$ mn	20,269	19,183	20,612	22,900	25,595	27,718
of which; Textiles	US$ mn	2,321	2,266	2,547	2,929	3,368	3,671
Project Related (Public and Private Sector)	US$ mn	3,821	4,300	4,743	5,237	5,876	6,550
Services (net)	US$ mn	1,099	1,250	2,213	3,263	4,318	5,379
Export of Goods and Services	US$ mn	13,643	13,562	15,949	19,558	23,696	28,093
Export of Goods and Services	% of GDP	23.1	22.8	23.2	24.9	26.5	27.6
Workers' Remittances	US$ mn	5,145	5,985	6,664	7,453	8,223	9,059
Current Account Balance	US$ mn	-4,615	-3,915	-2,766	-1,439	-411	1,277
Current Account Balance	% of GDP	-7.8	-6.6	-4.0	-1.8	-0.5	1.3
Overall Balance	US$ mn	-1,061	151	725	2,063	3,235	6,110
External Official Reserves (d)(e)	US$ mn	5,958	6,877	7,146	8,486	11,166	16,773
Fiscal Sector							
Total Revenue and Grants	% of GDP	14.5	13.2	14.7	14.9	15.2	15.4
Total Revenue	% of GDP	14.3	13.0	14.5	14.8	15.1	15.3
Grants	% of GDP	0.2	0.2	0.2	0.1	0.1	0.1
Expenditure and Net Lending	% of GDP	21.4	19.7	20.5	20.0	19.8	19.9
Current Account Balance	% of GDP	-1.1	-1.4	0.1	0.8	1.4	1.7
Overall Budget Deficit	% of GDP	-6.9	-6.4	-5.8	-5.2	-4.7	-4.6
Domestic Financing	% of GDP	3.5	2.7	4.1	3.7	3.6	3.5
Government Debt	% of GDP	78.5	79.1	75.0	71.1	67.7	64.3
Financial Sector (f)							
Reserve Money Growth	%	21.9	10.2	16.5	15.0	14.0	14.0
Broad Money Growth (M_{2b})	%	19.1	17.6	15.0	15.0	14.0	14.0
Change in Net Credit to the Government	Rs. bn	206.4	211.6	70.0	55.0	20.0	15.0
Change in Credit to the Private Sector	Rs. bn	514.8	352.6	435.0	517.5	613.0	690.0
Growth in Credit to the Private Sector	%	34.5	17.6	18.5	18.5	18.5	17.6

(a) Based on information available by mid March 2013
(b) Revised
(c) Provisional
(d) Excluding Asian Clearing Union balances
(e) Includes receipts under the Stand-by Arrangement facility of the International Monetary Fund obtained in 2009
(f) Year-on-year growth in end year values

Sources: Department of Census and Statistics
Ministry of Finance and Planning
Central Bank of Sri Lanka

services sector has the potential to become the next engine of growth. The 5-hubs plus tourism strategy that seeks to promote the maritime, aviation, knowledge, energy and commercial sectors, is gaining ground, while tourism is emerging as a key thrust industry. Earnings from transportation services are expected to increase in the future with the commissioning of a new sea-air transportation hub in the Southern Province and the completion of other major development projects. With the expected export revenue of US dollars 1 billion by 2015, the IT and BPO industries are also expected to generate more foreign inflows over the medium term, augmenting the surplus in the services account. The number of migrants for foreign employment is likely to decline with the tightening labour market conditions in the country. However, workers' remittances are expected to increase further in the medium term especially due to the projected increase in labour migration in skilled and professional categories. Significant increases in earnings from the export of goods and services, together with inward workers' remittances are expected to lower the deficit in the current account substantially in the medium term.

Foreign inflows to the government and to the private sector including FDI flows are expected to increase in 2013 and beyond, off-setting the current account deficit, thereby resulting in significant BOP surpluses in the medium term. Foreign capital flows are highly sensitive to the country's macroeconomic fundamentals, investment climate and investor confidence, exchange controls, infrastructure facilities and global liquidity conditions. Therefore, ongoing policy orientation in these areas, and expected recovery in the global economy are expected to provide the required impetus to attract foreign inflows, including FDI, in the medium term. Surpluses are expected to be generated in the overall balance of the BOP underpinned by higher inflows to the capital and financial account boosting external reserves of the country to a comfortable level to cover over 6 months of imports in the medium term, thereby strengthening the stability of the foreign exchange market and reducing vulnerability to external shocks.

The conduct of monetary policy in the medium term will focus on maintaining inflation at mid-single digit levels while supporting the economy to grow along its potential path. The growth of broad money is expected to be consistent with the anticipated growth in nominal GDP. Net credit extended to the government by the banking sector is expected to decline with continued fiscal consolidation. To support increasing economic activity in the medium term, a substantial amount of credit is expected to be released to the private sector by commercial banks. NFA of the banking sector are expected to improve over the medium term with increased foreign currency inflows and the resulting BOP surplus.

The government has shown its commitment to achieving the fiscal targets set out in the Medium Term Macro Fiscal Framework for 2012 to 2015. Accordingly, the fiscal strategy of the government has been designed to reduce the budget deficit below 5 per cent of GDP in the medium term and to generate current account surpluses, thereby improving the debt to GDP ratio to around 65 per cent by 2015 and lowering it further thereafter. Further, the tax base is expected to be broadened and revenue performance enhanced over the forthcoming years through the implementation of more focused legislative, administrative and institutional development measures. It is also expected that high priority will be given to addressing issues in loss making state owned enterprises to make them commercially viable.

As the country moves steadily towards achieving a per capita GDP of US dollars 4,000 before 2016, it has now become necessary to expedite the structural changes needed to steer the economy to avoid a possible middle income trap and maintain sustained high economic growth through raising productivity in all sectors of the economy. Higher average economic growth of 7.5 per cent during the post-conflict period compared to the post-liberalisation period average of 5 per cent, together with subdued demand pressures on inflation, confirm the economy's higher growth potential. However, to sustain high economic growth over the medium term, it is essential to maintain prudent, consistent and dynamic economic policies that would stimulate private sector investments in more productive activities. Further, diversification of economic activity to enhance the resilience of the economy against external shocks, improving specialisation in selected areas where the economy is identified to have a comparative advantage, facilitating new synergies to take the economy forward to a new stage of development, and supporting human capital and entrepreneurial skills development to maximise productivity of domestic human resources are necessary to accelerate economic growth.

As Sri Lanka aims to be a regional economic hub, driving GDP growth through increased and diversified export of goods and services, requires harnessing the full potential of infrastructure developments, locational advantages and natural resources through a strong human capital base and an enabling institutional environment, which promotes innovation and attracts investments and technology. Increasing skill levels, changing education preferences and demography has created labour shortages in factory level employment. Rising labour costs have added to the increase in manufacturing costs, reducing the competitiveness of Sri Lankan exports especially as key competitors have obtained greater market access through reciprocal and non-reciprocal trading arrangements in addition to lower production costs compared to Sri Lanka. However, leading Sri Lankan manufacturers such as apparel manufacturers, have implemented lean manufacturing systems, innovative production practices while strengthening human resources and gradually progressing in product value chains in order to remain competitive amidst continuous challenges in the global environment. Learning from these experiences it is important that both the manufacturing and services sectors focus on transforming into offering higher value innovative products focusing on cost efficiencies. Thus, policies must enable innovation, provide necessary impetus to move into new industries using the growing connectivity, while optimising on the myriad of high potential natural resources by using nanotechnology and efficient production methods. In this context, policies may need to refocus on facilitating increased industrialisation, aiming to transform Sri Lanka to the next level of competitiveness. Sectors such as auto assembly and manufacturing, consumer electronics, processed food and spices, entrepôt trade, heavy machinery assembly, and air freight cargo handling and processing could be promoted in this regard. Policies should also focus on the rising importance of services exports with a view to facilitating such exports as Sri Lanka has tremendous growth potential in services such as IT/BPO/KPO activities, health and education services and shipping and aviation related services. While developing the services sector, it is imperative that Sri Lanka positions itself not as a low cost producer but as a high value destination and provide innovative and competitive products that can charge a premium price even in a challenging global economic environment. These developments are already taking place in the software industry and these trends must be expanded into other industries as well.

Transforming the economy into a US dollar 100 billion economy by 2016 demands the improvement of all public utilities to a level that could cater to a modern economy effectively and efficiently. The current capacity of public utilities such as electricity, water supply, sewerage and solid waste disposal as well as transportation need to be significantly improved to facilitate a growing economy. Assessing the demand for these major utilities and taking steps to address the shortfall is an immediate policy priority. Pricing policies for the provision of these utilities need to reflect costs and be sustainable so as to encourage further investments and ease the financial burden on the service provider. In this regard, the existing mix of power generation sources needs to be critically re-examined with the focus on developing cheaper and sustainable sources of energy in the medium to long term. Hydro power has served as a valuable source of energy for the country, but its heavy reliance on uncertain weather conditions and the inability to increase energy supply to support a growing economy have highlighted the need to expedite the current efforts to diversify the energy sector. In this regard, the existing energy mix should be reviewed with a view to gradually reducing oil in the energy mix, and replacing it with cheaper viable options such as coal, and cleaner and more energy efficient options such as natural gas. Furthermore, encouraging public-private partnerships while enhancing private investment would be necessary to meet the growing demand, create healthy competition, and improve the doing business environment.

The growth of the agriculture sector, which is vital for food security, providing employment, reducing import dependence and enhancing export earnings, has continuously been affected by adverse weather conditions, highlighting the need to strengthen the sector against such vulnerabilities. Volatility in production and prices affects inflation, the income streams of farmers, servicing bank loans by farmers and subsidy costs to the government. The effective utilisation of developments achieved through scientific research could mitigate possible adversities faced by the farmer. These include, the use of strains of crops more resistant to adverse weather and diseases, new improved strains that could produce higher yields, and skillful management of crop cycles through extensive awareness campaigns and dissemination of timely and accurate information with regard to expected weather patterns and seasonal trends in prices. Also, the agricultural sector would benefit from specific medium to long term improvements, such as structural upgrades to irrigation canals, resuscitating the ancient reservoir and irrigation systems, promoting awareness in water management and sustainable cultivation methods, improving the forward and futures markets for agricultural commodities to hedge against price fluctuations, promoting crop insurance at reasonable premia, and eliminating market distortions caused at intermediate stages. The fisheries sector possesses a high potential to be developed as a significant foreign exchange earner and an important stabiliser of domestic prices. Substantial space remains for the upgrading of fisheries production through harnessing advances in technology and increasing production in value added industries such as canning and processing. Domestic production of canned fish, which currently accounts for less than 20 per cent of the total domestic consumption of canned fish, should be encouraged further as this could have a significant downward impact on domestic price levels and has the potential to grow into a major export industry. Inviting foreign investors to engage in profit sharing joint ventures, and increasing private sector participation in value added industries aimed at the export and domestic markets would result in growth in this area. Non-traditional fisheries sector, such as sea cucumber, sea urchin and bivalve cultivation, once popularised, may provide a source of foreign inflows as these products command high prices in niche markets.

The high expenditure incurred on the importation of food and beverages, of which, almost 50 per cent is on dairy products and sugar, indicates the potential savings that could be generated through promoting their domestic production. The measures undertaken to increase milk production in Sri Lanka are salutary and may be further strengthened by increasing high quality products and ensuring that producers receive remunerative prices that would further encourage private sector investment in this sector. Similarly adopting policies to increase sugar production would result in a substantial reduction in the cost of imports. Sugar production could be increased with the revitalised sugar cane processing plants, as well as by increasing the area under sugar cultivation, and improving the sugar recovery rate by introducing the latest technologies and maintaining remunerative prices. Higher farm gate prices could draw in more local producers and attract the labour force required for production. With the utilisation of areas in the Northern Province to cultivate sugar cane, upgrading to a more efficient distribution and purchasing network, while introducing private investment into the sector will ensure the future success of the sugar industry in Sri Lanka.

The tourism industry is one of the fastest growing sectors in the economy, and its future potential needs to be supported through effective marketing campaigns and addressing causes for adverse publicity. Projecting a positive image of the country as an ideal tourist destination for both leisure and business would be vital for attracting the envisaged number of tourists to the country. At the same time, increased quality of service and greater value for money would also encourage repeat arrivals resulting in achieving the short term and medium term goals set for the sector. Increasing the availability of entertainment and recreational activities for tourists by promoting international sporting events and other mega-scale landmark events, such as an annual international film festival, and promoting a night economy could attract more tourists and increase earnings from tourism. Facilitating conferences and private events of foreigners, such as weddings and get-togethers could provide niche opportunities for the tourism sector. Improving language skills of potential employees of the sector, upgrading facilities at landmark tourist destinations, and promoting domestic tourism are further steps that could be taken to promote the industry on a sustainable basis.

In spite of the government's efforts towards fiscal consolidation, the continued revenue shortfall has led to increased reliance of the public sector on the banking system over the past few years, crowding out the resources available for private sector activity. Revenue collection, particularly through taxation, has declined over the past few years to a very low level raising concern over the sustainability of the fiscal consolidation process. The expected positive fiscal outcome from recent tax reforms are yet to be fully realised. Further efforts are needed to widen the tax base, strengthen tax compliance, and simplify tax collection mechanisms. Moreover, improving the financial viability of SOEs in the short term and transforming them into net revenue generating institutions in the medium term would strengthen public sector sustainability. These measures could increase the general price level in the short term, but the overall benefit to the economy over the medium term could be greater. Reduced borrowing by the public sector from banks could increase the resources available for the private sector to enhance its investments in productive sectors.

A diversified, efficient and stable financial sector is essential to support the goal of a US dollar 100 billion economy by 2016. Strengthening the financial sector will require facilitating the deepening of capital markets and accommodating complex financial instruments, a long term yield curve, resilient and dynamic banking and non-banking finance institutions (NBFIs), an efficient online auction system that encourages wide market participation for secondary market activities of corporate and public debt and developing auxiliary financial service providers such as rating agencies and advisory services. In addition, a firm yet supportive supervisory regime and flexible market oriented tax reforms that facilitate market growth would contribute to the development of the financial sector. Business diversification and revenue growth from fee-based services would enhance profitability in the financial sector. Consolidation would allow for new investment ventures in large scale projects in the country. The availability of alternative domestic and foreign financial sources for corporates could reduce intermediation costs, thus increasing efficiency and productivity of the overall financial system of the country. Foreign financing directly available to the banking sector would encourage investments in long term projects, and strengthen the capital base of banks enabling the sector to meet the rising credit demand and cushion any potential risk.

The labour migration policies need to be more focused on promoting earnings from the export of professional services, gradually moving from unskilled labour, which face high risk working conditions. Welfare of the migrant worker is of paramount importance for the sustainability of remittances as well as for the benefit of the society. Managing the considerable social cost incurred due to unskilled female migrant workers leaving the household and adopting the role of the main income earner for the family has remained a major socio-cultural challenge. Promoting awareness of savings and routing such savings for entrepreneurial work after the end of their employment outside Sri Lanka are necessary. Implementing enforceable memoranda of understanding (MOU) with relevant foreign counterparts to secure worker safety prior to employment would ensure continued welfare of the migrant worker. Entering into semi-skilled and skilled worker contracts with other regions of the world would reduce the exposure of Sri Lankan foreign remittances being sourced largely from the Middle East region. Greater labour flexibility domestically could encourage professionals to export their services for short periods of time while retaining human capital in the country in the long run. This could help increase foreign exchange inflows, upgrade and update skills, and project a better image of the country's human resource base to the world.

A notable transformation of the country's main cities has taken place in the post-conflict period, where cities have become increasingly cleaner and greener under the ongoing city beautification projects. Roads, sidewalks, signposts and buildings have seen remarkable improvements while recreational parks and facilities have been renovated or newly established providing ample opportunities for city dwellers to embark on healthier lifestyles. Reduction of traffic congestion through active traffic management systems, streamlining parking facilities, establishing cycle lanes, and improving public transport could reduce pollution and facilitate city beautification further.

Having established Hambantota as a city with required physical infrastructure, it is necessary to encourage private sector-led commercial activities, which could effectively use such infrastructure productively. The physical infrastructure already in place along with the improved doing business environment, could be effectively utilised to establish a global commercial centre in Sri Lanka that complements the country's ambitious plan to become a shipping and aviation hub in Asia. Encouraging the private sector to establish financial institutions that offer offshore services that specialise in shipping and aviation related financing could generate skilled employment opportunities and support increased economic activity. In parallel, a conducive legal infrastructure to facilitate operations of the global commercial centre should be developed in order to promote financial flows, which fall within the broad provisions of the Financial Action Task Force (FATF) and the Financial Intelligence Unit (FIU) of Sri Lanka.

Moving towards achieving the full potential of being a knowledge hub, Sri Lanka's education system must focus on encouraging free and independent thinking and innovation from primary to tertiary levels and improving the quality of output to meet the demands of a rapidly transforming economy. Benefitting from the changing population structure, the focus of primary and secondary education sector should be on quality improvements using international best practices in school education. At the university level, the advent of new private universities as local-foreign collaborations could increase competition between state-run universities and their new counterparts, which could lead to a better output from the university system. However, it is necessary to streamline accreditation further and invite collaborations with top ranked international universities, thus enabling inflow of foreign students and related foreign exchange flows for education services. Exposing Sri Lankan universities to internationally acclaimed accreditation systems would enable the country to attract students from the region in addition to benefitting local students. Web based ranking systems domestically for education institutions at all levels could encourage these institutions to improve while providing guidance to potential students, their parents and employees as to the quality of education.

Sri Lanka's labour market needs to be reoriented to face the challenges of achieving sustainable high economic growth. The unemployment rate, which has remained below 5 per cent since 2010, reached a historic low of 4 per cent in 2012. Although such low rates of unemployment could give rise to wage pressures, low labour force participation rates and possible underemployment in some sectors indicate that there is still room for the supply of labour to improve. The Agriculture sector employs about 31 per cent of the labour force, while generating only 11 per cent of the country's GDP. This shows the extent of underemployment in this sector and the vulnerability of a large share of population and their relatively low incomes to supply disruptions caused by adverse weather conditions. Productivity improvements are necessary to release excess labour in agriculture to other sectors of the economy. Also, to increase the country's overall labour productivity, it is essential that measures to improve the productivity of the public sector, which currently accounts for over 15 per cent of all employed, are taken by focusing on raising the quality of public services provided. With regard to unemployment and labour force participation, the female population is unequally affected, and improving the provision of child care facilities and dependable public transport systems could help address the causal factors for such asymmetry. In addition, it is essential that physical infrastructure be improved and socio-economic practices changed to absorb differently-abled citizens into the workforce. Meanwhile, constantly reviewing and making required amendments to existing labour legislation is necessary to develop a more dynamic labour market that caters to the needs of a growing economy and benefits both employers and workers fairly.

BOX 3

The Divineguma National Programme: The National Drive to Create a Prosperous Village with Healthy and Economically Empowered Households

Introduction

In line with the national policy framework 'Mahinda Chintana – Vision for the Future', the Budget 2011 proposed the launch of a National Food Production Drive to overcome the challenge of food insecurity, improve the nutrition level of families and provide self-employment opportunities. Accordingly, the Divineguma National Programme (DNP), a novel initiative by the government was initiated in 2011 encouraging households to engage in a wide range of economic activities to empower themselves. The DNP aims to establish one million household economic units (HEUs) covering all the villages in the country.

The programme was initiated with four specific objectives: improving the nutrition level of a family; reducing the daily cost of living of a family; ensuring family food security; and creating an additional source of income for the family. With these objectives, the programme is being implemented under three main sectors, namely, Agriculture, Fisheries/Animal Husbandry and Cottage Industries. To promote agriculture production, vegetable and fruit plants, seeds, green houses, bee boxes and some financial assistance are provided under the DNP. To develop the animal husbandry sector cows, goats, pigs and one month old chicks as well as animal sheds are provided to households. Further, support is given to establish fisheries units in the areas of fresh water fishery/prawns in ponds and ornamental fish breeding. With respect to the cottage industry, support is given to commence and promote cottage industries to enhance family incomes. Food processing, chemical and leather related industrialists are provided with required training and they are referred to relevant banks and financial institutions, enabling them to meet their financial requirements. Further, awareness programmes are conducted for potential small industrialists to make them independent and to commence their own businesses.

Organisational Structure

The organisational structure of the DNP spans from national to regional level. At the national level, the programme is coordinated by the Ministry of Economic Development with the assistance of other relevant ministries and government institutions, while three senior cabinet ministers are in charge of three sub committees pertaining to the major sectors. Provincial chief ministers, district secretaries and divisional secretaries with other relevant political authorities and government officials coordinate the programme at the provincial, district and divisional level, respectively. Community based organisations such as voluntary organisations (i.e. pension societies, senior citizens' societies, women's societies, Samurdhi societies, youth societies, village development societies) and village level committees are responsible for the programme at the ground level. Four field level government officers; Grama Niladhari (GN), Samurdhi Development Officer (SDO), Agriculture Research and Production Assistant (ARPA) and the Family Health Service Officer (FHSO) handle ground level implementation of the programme. The main duties of the field level officers are to identify beneficiary families at the GN division level, provide required inputs to selected families, conduct close monitoring of HEUs, evaluate progress and report, provide advice and coordinate other government programmes such as Gama Neguma and Maga Neguma programmes and liaise with other institutions relevant to the DNP.

Implementation and Progress of the Programme

In 2011 and 2012, the DNP was implemented under four stages. The first phase of the DNP, which was launched under the theme "A Self Reliant Household - A Wonderful Motherland", focused on establishing one million HEUs throughout the country. The HEUs were identified, paying special attention to the ability of the economic unit, to carry out DNP activities, interest of potential beneficiaries to engage in the DNP, their dedication and competency level, availability of skilled and/or non-skilled labour within the household, resource availability in the home environment, and market potential for the relevant home based industry, in the region in order to ensure smooth implementation of the programme in a sustainable manner. In the second phase of the DNP, 2.1 million HEUs benefited by receiving vegetable seeds, fruit plants and other commercially viable plants. After observing the strong positive feedback and public enthusiasm, the Ministry of Economic Development decided to increase the number of HEUs to 2.5 million in the third phase of the programme. Divineguma enterprise villages, which consist of 200 families in each village were set up to establish livestock farms, storage facilities, small rice mills and food processing centres. Training was provided to selected cottage industrialists and potential entrepreneurs. Further, production of liquid milk was given priority under the third phase of the programme and high quality cows were imported to improve this sector. The programme also targeted the production of export items. Under the fourth phase of the programme, seed bags and fruit, coconut, minor export crops and herbal plants were distributed. In addition, people with ¼ to 2½ acres of land were given assistance to grow commercial crops and provided with seeds/plants, fertilizer, equipment as well as the required technical knowledge. By the end of 2012, the total number of beneficiaries under this programme amounted to 5 million and Rs. 5.9 billion had been spent on the programme.

Way Forward

Steps have been taken to prepare a legal framework for the DNP by enacting the Divineguma Act, No. 1 of 2013 to ensure the effective implementation and continuation of the programme as a national drive in the economy. Consequently, a Gazette Notification will be issued to establish the Divineguma Development Department by amalgamating the Samurdhi Authority, Southern Development Authority and the Udarata Development Authority, to carry out development activities to alleviate poverty, ensure food security, empower people to speed up national development, through providing micro-finance facilities, developing physical and social infrastructure, and human capital to uplift living standards and develop the livelihood of people. Commercial units beyond home gardening in the areas of fruits, vegetables, flowers, ornamental plants and export crops are planed to be established. On the industry front, further support will be given to develop storage facilities, organic processing as well as to establish food processing centres. A Divineguma Enterprise Credit Scheme through community based banks and banking societies is expected to be set up. The continued improvements to the DNP would support the country to reach self sufficiency in agriculture production, increase income levels of the people, assist in export diversification, and improve health and nutrition levels, supporting the country to move to a more sustainable higher growth path.

The challenge of an ageing population caused by the slow population growth needs to be addressed with a long term focus through strengthening retirement benefit schemes and reforming the health sector. The decline in both fertility and mortality has resulted in Sri Lanka undergoing a demographic transition with the proportion of population aged over 60 years expected to double from its current level in 30 years. The projected increase in the ageing population and increased longevity underscore the need to have a viable strategy to sustain the increased health and social costs of an ageing population while strengthening the superannuation benefits and welfare of retirees. Increasing cost of health care and medication borne by the government strengthens the case for new measures to upgrade existing health and social security systems in a sustainable manner. Introducing measures to implement joint employee/employer diversified benefit schemes, allowing for increased returns for existing funds to maintain their long term viability, encouraging the development of private retirement funds and other retirement plans and increasing awareness of savings and possible post-retirement investments are several measures that could be considered in this regard.

Sri Lanka's achievements in reducing absolute poverty, even while facing an internal conflict, are well documented, but focused policies to eradicate poverty and reduce income inequality need to continue. The poverty headcount ratio has declined from 28.8 per cent in 1995/96 to 8.9 per cent in 2009/10, surpassing the targets set under the Millennium Development Goals (MDGs). However, income inequality, as measured by the Gini coefficient, has remained high at 0.49 during the 2006/07 and 2009/10 Household Income and Expenditure Surveys (HIESs). As income inequality is known to increase during phases of high economic growth, it is necessary that appropriate policies are in place to allow the benefits of growth to trickle down to low income segments without affecting the growth momentum. The continued low rates of unemployment and increased contribution to economic growth from the provinces would support further reduction in poverty and income inequality. The government's efforts to lift the living standards of backward segments of the population through targeted livelihood development programmes such as *Divineguma* would help reduce poverty and inequality on a sustainable basis. Monitoring the trends in these social indicators and taking further steps as required is essential for the growth momentum to continue without being disrupted by any possible social unrest.

Sri Lanka's target of becoming a US dollar 100 billion economy in the medium term is well established and appears feasible given the development strategy and policy measures adopted by authorities in the post-conflict period. It is essential to strengthen the framework for sustained economic growth based on the strategy of 5 hubs (aviation hub, maritime hub, energy hub, commercial hub and knowledge hub) plus tourism to diversify the economy and improve the resilience of the economy to external and internal shocks. The implementation of required structural adjustments including tax reforms and exchange control liberalisation, strengthening of institutions, and the continuation of the fiscal consolidation process are essential for Sri Lanka to sustain this high growth momentum. The stabilisation measures that were adopted in early 2012 confirm the commitment shown by authorities to take difficult policy measures to ensure long term economic and price stability even at the risk of short term challenges. The readiness, the ability, and the availability of space to take such decisive policy actions by the government and the Central Bank would provide necessary comfort to all economic agents to enhance productive economic activity, thereby benefitting the country as a whole.