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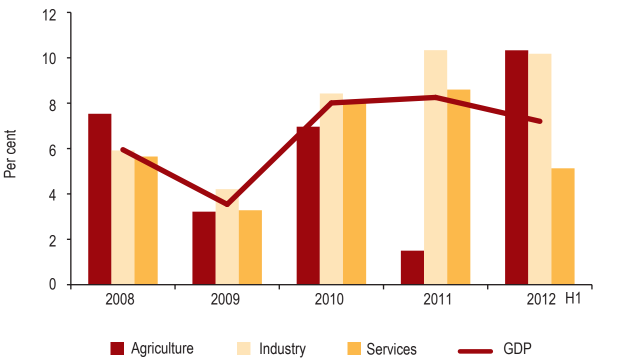
OVERVIEW

The economy expanded by 7.2 per cent in the first half of 2012, following two consecutive years of robust growth of 8 per cent in 2010 and 8.3 per cent in 2011, a commendable achievement despite the difficult global environment. Unemployment further declined to 3.9 per cent in the first half of 2012 from 4.3 per cent in the corresponding period of 2011, reflecting the sustained growth momentum across all sectors of the economy. Inflation has continued to remain at single digit levels for over 3 years from 2009 declining on a year-on-year basis to a very low level of 2.7 per cent in February 2012. Inflation gradually edged up during the year to a peak of 9.8 per cent in July 2012. This was mainly due to the upward adjustment of several administratively determined prices to reflect developments in international commodity markets; the pass-through of the depreciation of the rupee, supply disruptions on account of drought conditions that have prevailed in major cultivation areas; and the high monetary expansion in 2011. Inflation has since moderated to 9.1 per cent by September 2012. To rein in possible demand side inflationary pressures arising from high credit and monetary expansion, the Central Bank tightened its monetary policy stance by raising policy interest rates and imposing a ceiling on rupee lending during the year. Market interest rates rose during the year in line with the increase in policy interest rates and tight monetary conditions. In response to policy measures adopted, money supply growth and growth of credit extended to the private sector have begun to decelerate.

Policy reforms including the Central Bank allowing more flexibility in the determination of the exchange rate and limiting its intervention in the foreign exchange market were mainly aimed at reducing the widening trade deficit by curtailing non-essential imports and improving export competitiveness. Despite the decline in exports due to weak external demand, a sharper deceleration in imports from the second quarter of 2012 in response to policy measures resulted in a substantial narrowing of the trade deficit during this period. The improvement in the trade deficit coupled with higher inflows to the capital and financial account, as a result of enhanced investor confidence and the relaxation of exchange control regulations, helped the BOP to record a surplus of US dollars 306 million by end August 2012. Accordingly, gross official reserves rose to US dollars 7.1 billion, by August 2012, which was equivalent to 4.3 months of import.

Chart 1.1 GDP and Sectoral Performance (Growth Rates)



- **The economy continued to maintain a high growth momentum recording a growth of 7.2 per cent in the first half of 2012.** The Agriculture sector rebounded growing by 10.3 per cent in the first half of 2012 from a contraction of 1.4 per cent in the first half of 2011. The strong performance in the Agriculture sector was mainly on account of the bumper paddy harvest in the Maha season, an increase in the production of vegetable and highland crops and a substantial increase in fish production. The Industry sector also registered a robust growth of 10.2 per cent during the first half of 2012, which was on top of the growth of 10.3 per cent in the corresponding period of 2011. Expansion of construction and mining and quarrying activities mainly contributed to the high growth in this sector. The dampening effect of weak global trade on exports and the reduction of imports in response to policy measures implemented, as well as the slowing down of transportation and communication sub-sectors mainly contributed to the deceleration of the Services sector to 5.1 per cent during the first half of 2012 from 9.1 per cent in the corresponding period of 2011.

- **Domestic savings are projected to rise mainly reflecting the expected improvement in the external current account balance.** The domestic savings rate is projected to increase to 17.8 per cent of GDP in 2012 from 15.4 per cent of GDP in 2011 as a combined outcome of the expected reduction in the external current account deficit to 4.8 per cent of GDP in 2012 and the significant reduction in the government's current account balance as envisaged in the budget for 2012. National savings, which also include net factor income from abroad (NFIA) and net foreign private transfers, are also projected to improve as a percentage of GDP to 25.1 per cent in 2012 from 22.1 per cent in 2011.

- **The total investment to GDP ratio is projected to improve to 30.3 per cent in 2012 from 29.9 per cent in 2011 supporting the expected high growth momentum.** The continued implementation of several mega infrastructure projects by the government and an increase in private sector investment as a result of improved investor confidence are expected to increase investment in 2012. The projected increase in foreign direct investment (FDI) in 2012 is also expected to support a higher rate of investment during the year.

- **Unemployment continued to decline reflecting the sustained growth momentum across all sectors of the economy.** During the first half of 2012, the unemployment rate declined further to 3.9 per cent from 4.3 per cent in the corresponding period of 2011. This

Chart 1.2 Savings and Investment

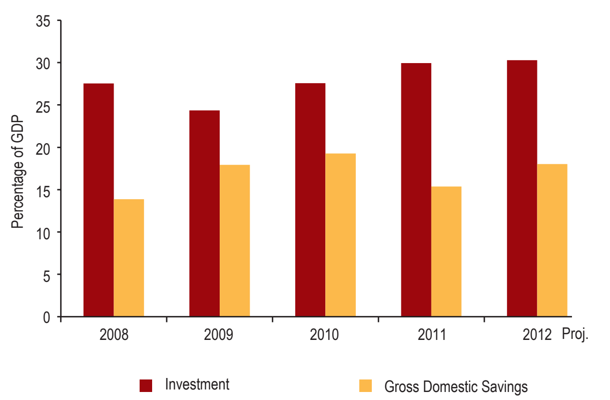
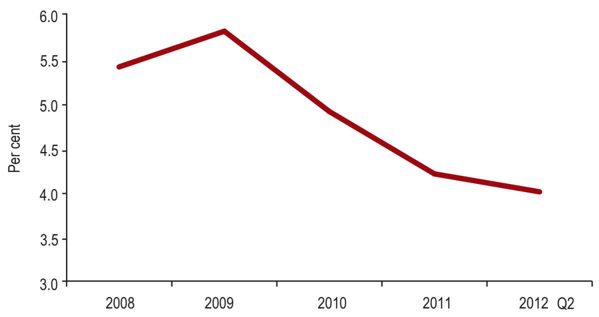
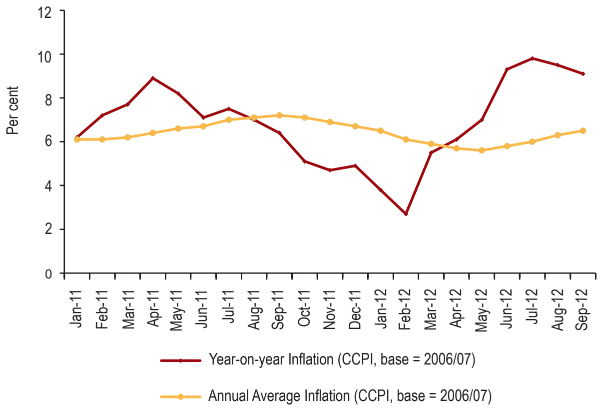


Chart 1.3 Unemployment Rate (% of Labour Force) (a)



(a) Quarterly Labour Force Survey for the 1st quarter of 2012 was not conducted by the DCS

Chart 1.4 Inflation



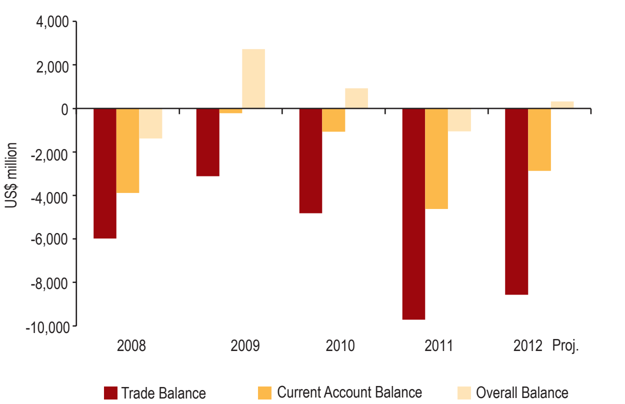
is the lowest unemployment rate recorded since the inception of the Quarterly Labour Force Survey in 1990. The full implementation of new infrastructure development projects, an increase in self-employment opportunities and broad based higher economic growth have contributed to the steady decline in the unemployment rate.

- **Year-on-year headline and core inflation have remained at single digit levels from February 2009.** Year-on-year headline inflation, which moderated to 2.7 per cent in February 2012, reached a 42 month high of 9.8 per cent in July 2012 but has since eased to 9.1 per cent by September 2012. Inflation, as measured by the annual average change, which moderated up to May 2012, gradually increased to 6.5 per cent by September 2012. The revision of administered prices, mainly energy prices, to reflect developments in the international market, the depreciation of the rupee, supply side disruptions due to the drought conditions that prevailed during the year as well as the increase in import duties on several food items, contributed to the upward pressure on prices. Core inflation, which had remained broadly stable since the last quarter of 2011, increased on a year-on-year basis to 6.2 per cent in September 2012 from 4.7 per cent in December 2011, although declining on an annual average basis to 5.3 per cent in September 2012 from 6.9 per cent in December 2011.

- **To overcome any potential risk to the balance of payments (BOP) and enhance macroeconomic stability, the Central Bank and the government implemented a decisive policy package in early 2012.** Under this policy package, more flexibility in the exchange rate was allowed since February 2012, whereby the Central Bank's intervention was limited only to financing part of the petroleum bill payment obligations. Further, policy interest rates were increased and a ceiling on rupee credit growth was imposed to curtail credit expansion which was fuelling imports, while import tariffs were also increased to curb import demand. Also, to strengthen the financial account, private sector and commercial banks were encouraged to attract long term foreign financing, while more inflows were expected to the government securities market following the raising of the limit on foreign investments in Treasury bills and Treasury bonds from 10 per cent to 12.5 per cent in December 2011. The policy package has been successful in effecting a gradual deceleration in the trade deficit and enhancing inflows to the capital and financial account, thereby strengthening the BOP position.

- **The trade deficit has narrowed since the second quarter of 2012 with the sharp deceleration in import expenditure, despite the decline in earnings from exports.** Earnings from exports, which expanded substantially in 2011, declined in the first eight months of 2012 partly as a result of a significant fall in the price of commodities such as cotton and rubber in the world market. The slowing down of economic activity in major economies, particularly in Europe, has also weighed down on export performance. Earnings from exports declined by 5.7 per cent, year-on-year, to US dollars 6,592 million during the first eight months of 2012. Expenditure on imports meanwhile, decelerated significantly in response to policy measures taken by the government and the Central Bank earlier in the year to address the high rate of growth of both credit and imports. Expenditure on imports declined by 0.2 per cent to US dollars 12,859 million during the first eight months of 2012 compared to the 50.2 per cent growth recorded in the corresponding period in 2011. While the trade deficit recorded an increase of 52.2 per cent during the first quarter of 2012, it has contracted during much of the period since April in response to the policy measures taken to contain expenditure on imports, resulting in the trade deficit declining by 12.8 per cent in the second quarter of 2012. Consequently, during the eight month period to August 2012, the deficit in the trade balance increased by only 6.3 per cent to US dollars 6,267 million compared to the significant growth of 88.7 per cent recorded during the corresponding period of 2011. The price of several key import commodities such as petroleum products, fertiliser and wheat which increased from June 2012 has remained high up to August, while the price of major export commodities such as garments and agricultural commodities, except tea, have declined from the high levels that prevailed last year. As a result of these trends, the terms of trade (TOT) for the first eight months of 2012 on average has remained broadly stable when compared with the TOT that prevailed in 2011.

Chart 1.5 Balance of Payments



- **In spite of the slow recovery in the global economy inflows to the services account continued to increase significantly supported by the expansion in transportation, travel, information technology and communication sub sectors.** Gross earnings from transportation services, which consist of passenger fares, freight charges, port and airport related earnings, increased significantly during the first half of 2012. Increased cargo handling and service delivery at the Port of Colombo, higher number of passengers flown and higher airfares as well as an increase in the export of software and information technology contributed to the higher receipts from services. The tourism sector posted an impressive performance during the first nine months of 2012 with sustained growth in tourist arrivals and higher earnings from tourism.

- **However, the deficit in the income account widened in the first half of 2012 compared to the corresponding period of 2011 as a result of lower interest earnings from investment of reserves due to the prevailing low global interest rates.** In addition, higher interest payments on accumulated foreign loans and coupon payments on government securities also contributed to the widening deficit in the income account.

- **With higher labour migration in professional categories and an increase in the use of formal channels for remitting money, workers' remittances continued to be the main source of foreign exchange earnings in Sri Lanka.** Consequently, workers' remittances grew by 15.6 per cent to US dollars 3,907 million in the first eight months of 2012 compared to the corresponding period in 2011.

- **Although the current account deficit increased to US dollars 2,052 million in the first half of 2012 from US dollars 1,476 million in the corresponding period of 2011, it was a significant improvement from the deficit of US dollars 3,139 million recorded during the second half of 2011.** Higher import expenditure on petroleum and investment goods and a widening deficit in the income account mainly contributed to the higher current account deficit in the first half of 2012. However, substantial inflows in the form of services and private transfers continued to help cushion the deficit in the current account.

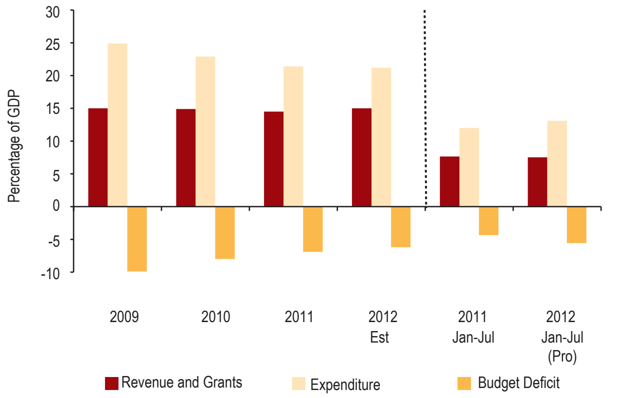
- **Inflows to the capital and financial account increased during the first half of 2012 supported by inflows to the government as well as the private sector, driven by increased investor confidence.** Foreign loan disbursements, including the international sovereign bond issue of US dollars 1 billion in July 2012 and an increase in foreign investments in Treasury bills and Treasury bonds contributed to the increase in inflows to the government. Foreign direct investments, long term loans and portfolio investments were the main sources of foreign inflows to the private sector.

- **The BOP, which recorded a deficit of US dollars 251 million in the first quarter of 2012, improved significantly in the second quarter to record a deficit of US dollars 69 million, in line with the deceleration in the trade deficit and the improvement in the capital and financial account.** The favourable developments in the trade account as a result of policy measures adopted together with inflows to the government and the private sector helped strengthen the external sector further, with the BOP recording a surplus of US dollars 306 million by end August 2012.

- **Gross official reserves, which include international reserves of the Central Bank and the government increased to US dollars 7.1 billion by end August 2012 from US dollars 6 billion at end 2011.** The improvement in official reserves was supported by the proceeds of the fifth international sovereign bond issue, the receipt of two tranches under the IMF Stand-By Arrangement (SBA) facility and disbursements on account of foreign funded projects. Gross official reserves by end August 2012 were equivalent to 4.3 months of imports. The IMF-SBA programme which commenced in July 2009 was successfully completed in July 2012 with Sri Lanka receiving all the funds approved under the SBA in 2009. A 10-year International Sovereign Bond amounting to US dollars 1 billion issued in July 2012 was oversubscribed by 10.5 times, reflecting the confidence placed by investors in international financial markets on the current developments and future prospects of the Sri Lankan economy.

- **The exchange rate policy in 2012 was aimed at allowing more flexibility in exchange rate determination, while limiting Central Bank intervention in the domestic foreign exchange market.** This policy stance was mainly intended to allow the exchange rate to adjust in line with market developments to rationalise import expenditure, while enhancing export competitiveness. Accordingly, the rupee depreciated by 12.24 per cent against the US dollar during the first nine months of 2012. Reflecting the cross currency exchange rate movements, the rupee depreciated against most other major currencies. The 5-currency and the 24-currency Nominal Effective Exchange Rate (NEER) depreciated by 12.58 per cent and 12.75 per cent, respectively, by end September 2012, reflecting the nominal depreciation of the Sri Lanka rupee against major currencies in the currency basket, while both the 5-currency and 24-currency Real Effective Exchange Rate (REER) indices, which also take into account the inflation differential between countries, depreciated by 15.2 per cent and 8.7 per cent, respectively, by end September 2012.

Chart 1.6 Government Revenue, Expenditure and Budget Deficit



- **Fiscal policy in 2012 was directed towards fiscal consolidation as articulated in the Medium Term Macro Fiscal Framework (MTMFF) with a further reduction in the overall budget deficit to 6.2 per cent of GDP from 6.9 per cent of GDP in 2011.** Fiscal consolidation was mainly expected through increasing government revenue and rationalising recurrent expenditure, while maintaining public investment at a level to support high economic growth in the medium term.

- **The budget for 2012 introduced tax measures to support economic activities and enhance government revenue.** Several income tax incentives were given to encourage strategic investment in the areas of agriculture and agro processing, fisheries and fish processing and information technology. Further, incentives were given to import replacement industries such as cement, steel, pharmaceuticals, fabric and milk powder. In addition, concessionary income tax rates were granted for the setting up of new development banking units, research and development activities, healthcare services, export of value added tea and the handloom industry. Several other measures were introduced by the government during the first seven months of the year to enhance tax revenue collection such as the upward revision of excise duties on liquor and cigarettes, the reduction of the full custom duty waiver granted on the importation of petroleum products and the upward revision of excise duties on the importation of motor vehicles, trishaws and motor cycles. Further, the Special Commodity Levy (SCL) was revised from time to time to protect domestic industries and the agriculture sector as well as to maintain domestic price stability.

- **The budget for 2012 emphasised further rationalisation of recurrent expenditure while directing public investment towards strategically important infrastructure projects to sustain a high and regionally balanced economic growth.** All ministries, departments and other government institutions were requested to make a compulsory saving of 2 per cent of recurrent expenditure from the allocation in the Appropriation Bill, while several limitations were imposed on the utilisation of fuel and electricity. Further, the salaries and wages of public sector employees were revised upward while pension allowance was increased. Meanwhile, the government continued the accelerated implementation of major development projects in the areas of roads, ports, power and energy and the aviation sector.

- **As a percentage of estimated GDP, government revenue declined to 7.4 per cent in the first**

seven months of 2012 from 7.6 per cent in the corresponding period of 2011 mainly due to lower tax revenue collection with the slowing down of imports and economic activity and the downward revision of VAT rates. In nominal terms, government revenue increased by 12.6 per cent to Rs.556 billion during the first seven months of 2012 from Rs.494 billion in the corresponding period of the previous year. Tax revenue increased by 11.9 per cent to Rs.490.4 billion during the first seven months of 2012 compared to an increase of 17.6 per cent recorded in the same period of 2011, although declining as a percentage of GDP to 6.5 per cent of GDP in the first seven months of 2012 from 6.7 per cent in the corresponding period of the previous year. Revenue from VAT, which is one of the major sources of tax revenue, grew by only 2 per cent during the first seven months of 2012 over the corresponding period of the previous year. The increase in income tax revenue was largely due to the higher collection of withholding taxes. Non tax revenue increased by 17.4 per cent to Rs.65.7 billion during the first seven months of 2012 mainly due to an increase in profit transfers by the Central Bank and higher non tax revenue collected from fees and charges.

- **During the first seven months of 2012, government expenditure and net lending increased to 13.1 per cent of estimated GDP from 12.0 per cent of GDP during the same period in 2011.** The declining trend in recurrent expenditure observed in the recent past reversed, with recurrent expenditure as a percentage of GDP increasing to 9.3 per cent in the first seven months of 2012 from 8.9 per cent in the corresponding period of the previous year mainly on account of an increase in interest expenditure. Capital expenditure and net lending also increased to 3.8 per cent of GDP during the first seven months of 2012 from 3.1 per cent of GDP in the corresponding period of 2011 reflecting the government's commitment to expediting the public investment programme.

- **The overall fiscal deficit during the first seven months of 2012 expanded to 5.6 per cent of estimated GDP from 4.4 per cent of GDP in the corresponding period of 2011.** Further, the current account deficit (government dissaving) as a percentage of GDP increased to 1.9 per cent during the first seven months of 2012 from 1.4 per cent in the corresponding period of the previous year, while the primary deficit (overall deficit net of interest payments) also increased to 2.1 per cent of GDP in the first seven months of 2012 from 1.2 per cent of GDP during the same period in 2011. In financing the overall budget deficit, foreign sources, including the proceeds of the international sovereign bond issue and foreign investments in rupee denominated government securities, contributed around 57 per cent. However, a major portion of the balance financing requirement was met through domestic banking sources.

- **The Central Bank tightened its monetary policy stance in 2012 to avert possible demand driven inflationary pressures in the future from continued credit and monetary expansion and to address the emerging imbalances in the external sector.** Monetary tightening was aimed at decelerating credit and monetary expansion to levels consistent with the projections set out in the Central Bank's Road Map for Monetary and Financial Sector Policies for 2012 and Beyond, which set the targets for the growth of both broad money and reserve money during the year at 15 per cent on average. Accordingly, the Central Bank raised its policy rates twice during the year, once in February 2012 by increasing the Repurchase rate and the Reverse Repurchase rate by 50 basis points each and again in April 2012 by raising the Repurchase rate by 25 basis points and the Reverse Repurchase rate by 75 basis points. However, to bring about a more rapid curtailment of credit, the Central Bank issued a Direction in March to all licensed banks under Section 101(1) of the Monetary Law Act, imposing a ceiling on rupee lending

Table 1.1 Recent Monetary Policy Measures

per cent per annum

Date	Repurchase rate	Reverse Repurchase rate	SRR (a)	Penal rate on Reverse Repos
11 February 2009	10.25	11.75		16.50
24 February 2009			7.00 (b)	
18 March 2009				14.75
22 April 2009	9.00			13.00
21 May 2009		11.50		Removed
16 June 2009	8.50	11.00		
11 September 2009	8.00 (c)	10.50 (c)		
18 November 2009	7.50	9.75		
09 July 2010	7.25 (c)	9.50 (c)		
20 August 2010		9.00		
11 January 2011	7.00	8.50		
12 April 2011			8.00 (d)	
03 February 2012	7.50	9.00		
05 April 2012	7.75 (c)	9.75 (c)		

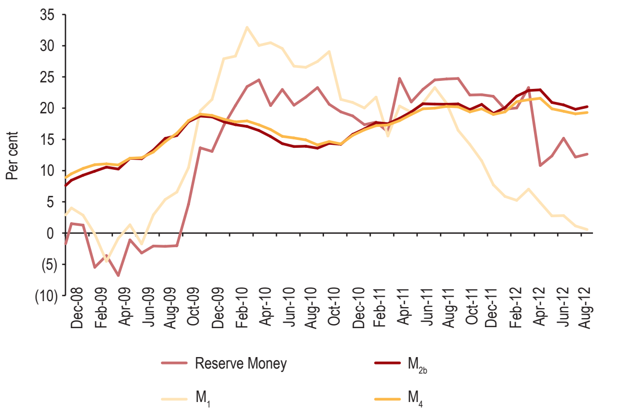
Source : Central Bank of Sri Lanka

(a) To be maintained as a percentage of rupee deposit liabilities.
(b) Effective from the Reserve Week commencing 27 February 2009. Reduced from 7.75 per cent.
(c) Effective from the close of business.
(d) Effective from the Reserve Week commencing 29 April 2011.

during the year. Accordingly, credit growth was to be restricted to 18 per cent or Rs. 800 million, whichever is higher while 23 per cent or Rs. 1 billion was allowed for banks that mobilised funds from abroad.

- **The quarterly average growth of reserve money has broadly remained within the targets set in the monetary programme for 2012.** The expansion of net domestic assets (NDA) of the Central Bank contributed entirely to the growth of reserve money during the first eight months of

Chart 1.7 Expansion of Monetary Aggregates (Year-on-year Growth)



2012 as net foreign assets (NFA) of the Central Bank declined during this period. The Central Bank's purchases of Treasury bills from the primary market and provisional advances to the government by the Central Bank contributed to the increase in credit extended to the government by the Central Bank.

- **In response to the policy measures taken by the Central Bank in the first quarter of 2012, broad money growth decelerated.** The average growth in broad money decelerated to 20.9 per cent during the period April to August 2012, from 21.6 per cent in the first quarter of 2012, although on a year-on-year basis, money supply growth increased to 20.2 per cent in August 2012 from 19.1 per cent in December 2011. Growth in credit to both the private and public sectors contributed to the expansion in broad money, although the decline in net foreign assets (NFA) of the banking system somewhat moderated the expansion. On the liabilities side, the increase in time and savings deposits held by the public contributed almost entirely to the year-on-year growth in money supply.

- **Although rupee liquidity in the domestic money market remained in excess during most of the year, volatility in market liquidity and the tight monetary policy stance were reflected in the upward movement in market interest rates.** The tax adjusted average weighted call money rate (AWCMR) which hovered near the lower bound of the policy interest rate corridor in 2011 gradually increased and remained close to the upper bound of the policy interest rate corridor during most of 2012. Consequently, during the year to September 2012, the tax adjusted AWCMR increased by 143 basis points to 9.50 per cent. The upward revision to policy interest rates, the higher borrowing requirement of the government, tight liquidity conditions and market expectations exerted upward pressure on yields in government securities in both the primary and the secondary markets.

Consequently, yield rates on 91-day, 182-day and 364-day Treasury bills increased during the year by 262 basis points to 11.30, 386 basis points to 12.57 per cent and 371 basis points to 13.02 per cent, by end September 2012. The secondary market yield curve for government securities during the first nine months of 2012 shifted upwards reflecting the rising yield rates on government securities in the primary market and changing market expectations during this period. The average weighted deposit rate (AWDR), which reflects the movement of interest rates pertaining to all interest bearing deposits held by the public with commercial banks increased during the year by 198 basis points to 9.22 per cent by end September 2012 while the average weighted fixed deposit rate (AWFDR) followed a similar trend increasing by 297 basis points so far during the year to 11.92 per cent at end September 2012. As the cost of funds of commercial banks increased, their lending rates were also revised upwards. The weekly average weighted prime lending rate (AWPR), which reflects interest rates on loans and advances granted by commercial banks to their prime customers increased and remained volatile. The monthly AWPR increased by 359 basis points during the year to 14.08 per cent at end September 2012. The average weighted lending rate (AWLR), which reflects interest rates on all lending by commercial banks to the private sector, also increased by 194 basis points during the year to 15.38 per cent at end September 2012.

- **Despite the fragile global economic environment and uncertainty in global financial markets, the domestic financial sector has remained resilient, while expanding to support the envisaged high growth momentum.** Both banking and non-banking sectors have grown as reflected in the expansion of their asset base. The sources of funding of the banking sector have been diversified with several banks raising capital from overseas. Asset quality too has improved during the year so far. Amidst the expansion, financial system stability was maintained by way of strengthened supervisory and regulatory frameworks, improved risk management, enhanced legal frameworks, reinforcing liquidity support and confidence building through financial safety nets. However, primary dealers and stock brokers experienced a contraction in their asset bases due to marked to market losses in investments in the government securities market and stock market.

- **Fitch Ratings has affirmed Sri Lanka's Foreign and Local Currency Issuer Default Ratings (IDRs) at 'BB-'. The outlook for both ratings remains 'Stable'.** The Country Ceiling has also been affirmed at 'BB-', and the Short-Term Foreign Currency IDR at 'B'. However, Standard & Poor's Ratings (S&P) revised Sri Lanka's Foreign Currency Rating Outlook from 'Positive' to 'Stable' and lowered the country's long-term local currency rating to B+ from BB- despite the necessary measures taken by the Central Bank and the government to strengthen Sri Lanka's macroeconomic environment.

International Economic Environment

- **The global economic environment continues to remain challenging in 2012, mainly due to vulnerabilities in several key economies.** Growth in the major advanced economies slowed contrary to expectations at the beginning of the year, weighed down by domestic fiscal adjustments, tight credit conditions and sluggish labour markets. The growth momentum in Asia has also moderated, particularly in the more open economies, reflecting slowing external demand. Domestic demand in the region has held up and continues to fuel economic activity.

- **According to the IMF's projections in the World Economic Outlook (WEO) Update in October 2012, the world economy is expected**

grow by 3.3 per cent in 2012, marginally lower than the projection in the July 2012 WEO update. Emerging market economies are expected to take the lead by growing at 5.3 per cent in 2012, while advanced economies are expected to grow by a more moderate 1.3 per cent in 2012. Developing Asia, which includes China, India, Indonesia, Malaysia, Philippines, Thailand and Vietnam, is expected to grow by 6.7 per cent in 2012, partly fuelled by a rebound in industrial production spurred by the restarting of the disrupted supply chain in flood affected Thailand and stronger domestic demand from Japan.

- **Global trade rebounded in the first quarter of 2012 with the re-orienting of supply chains and industrial production, benefitting trade oriented economies.** However, moderating growth, troubled by sluggish and uncertain economic recovery in the Euro area and declining commodity prices are expected to weigh on rebounding trade. Growth in world trade volumes are expected to moderate to 3.2 per cent in 2012 from a higher growth of 12.6 per cent and 5.8 per cent recorded in 2010 and 2011, respectively.

- **Conditions in international financial markets deteriorated as market confidence was affected by the European sovereign debt crisis and weakening growth prospects in several major economies.** Policy uncertainty in a number of South European economies led to a significant rise in risk aversion. As a result, many economies in Asia experienced heightened volatility in capital flows. The actions of euro area policymakers aimed at breaking the negative feedback loop between sovereign fiscal positions and conditions in the banking system somewhat offset the contagion from the Euro area to the rest of the world. However, financial markets remained highly volatile given uncertainties surrounding the implementation of the programme to recapitalise troubled banks in the Euro area and fiscal uncertainties in southern European economies.

- **Global consumer price inflation is expected to ease as global demand slows and commodity prices ease. However, sharply rising food prices remains a concern.** Overall, headline inflation in advanced economies is expected to reduce to 1.9 per cent, from 3 per cent in late 2011. Nevertheless, inflation is expected to remain high in a few economies in Asia, particularly India, Hong Kong, and Singapore due to the elevated cost of food and housing and due to abnormal weather patterns disrupting agriculture production.

Outlook for 2012

- **In 2012, economic growth is projected to moderate to 6.8 per cent from 8.3 per cent in 2011.** Given the 7.2 per cent growth in the first half of 2012, the economy is projected to grow by 6.3 per cent in the second half of the year compared to the growth of 8.4 per cent during the same period in 2011. The expected deceleration in growth for 2012 is mainly due to the relatively lower growth anticipated in the Agriculture and Services sectors during the year.

- **Inflation is expected to moderate in the balance period of 2012.** The track record of maintaining inflation at single digit levels for a continuous period of 44 months has helped moderate inflation expectations. The pressure on inflation during the balance period is expected to moderate with the monetary policy measures adopted, the restoration of domestic agriculture supply and the stabilisation of the exchange rate.

- **The external sector is expected to improve by year end despite the challenging global environment.** Although export earnings are adversely affected due to fluctuations in commodity prices in world markets as well as the slowing down of economic activity globally, the policy measures adopted by the government and the Central Bank earlier in the year are expected to significantly reduce expenditure on imports. Consequently, the trade deficit is projected to improve further in 2012. The high level of inflows on account of services and workers' remittances is expected to partially offset the trade deficit resulting in the current account deficit improving to around 5 per cent of GDP in 2012 from 7.8 per cent of GDP in 2011. The expected improvement in the trade deficit and other current account receipts, together with expected inflows to the capital and financial account from FDI flows and portfolio investments to the private sector and an increase in receipts to the government for project financing and investments in government securities, are expected to generate a surplus in the BOP in 2012.

- **Fiscal management during the remaining months of 2012 will be challenging.** To address the shortfall in revenue, the government has introduced several revenue measures to enhance revenue mobilisation during the remaining months of the year. In addition, strict measures to restrict expenditure within the budgetary estimates are being taken by the government.

- **Monetary aggregates are likely to expand at a higher rate than originally targeted.** Measures taken by the Central Bank have been successful in containing credit to the private sector. However, the expansion in credit to the public sector is expected to exert some upward pressure on money supply, although this will be somewhat mitigated by the decline in NFA of the banking system.

Prospects for 2013

- **Supported by the gradual recovery of global demand and continuation of the post-war growth momentum, the Sri Lankan economy is expected to return to its high growth trajectory, expanding by around 7.5 per cent in 2013 and by over 8 per cent in the medium-term.** Global economic recovery and less uncertainty over policy responses, especially in the Euro area, coupled with an easing of both fiscal and monetary policy measures adopted domestically to address issues in certain sectors, are expected in 2013. In addtion, over the medium-term, consolidation efforts in the fiscal, monetary and external sectors in 2012 are expected to help re-orient the economy to its post-war high growth momentum with policy space and automatic macroeconomic stabilisers to face any adverse shocks emanating from global developments or supply disruptions in the domestic market.

- **Growth is expected to be broad based in 2013 with the performance in all sectors of the economy expected to improve.** The Agriculture sector is expected to revive from the setback faced in the 2012 Yala season due to the drought conditions that prevailed in major cultivation areas. The Industry sector, especially factory industry, is expected to expand its contribution to overall economic growth with the gradual recovery of global demand. The Services sector, which was adversely affected by the decline in global demand and policy measures implemented to curb imports, is expected to bounce back with the gradual recovery of the global economy. Accordingly, the contribution from external trade and transport and communication sub sectors are expected to rise in 2013 with the increase in port and aviation activities. The contribution from the regions to the national economy is expected to increase with the accelerated implementation of regional development programmes including several mega infrastructure projects.

- **Cautious monetary and fiscal policy measures together with envisaged improvements in domestic supply conditions are expected to help maintain inflation at mid-single digit levels in 2013.** The one-off increase in consumer prices as a result of the adjustment of several administratively determined prices in March 2012 is likely to keep year-on-year inflation levels at upper single digit levels until March 2013. However, inflation is projected to decline to mid-single digit levels by end 2013.

- **Benefitting from the recent policy measures taken by the Central Bank and the government to improve export competitiveness, curtail imports and attract foreign financial flows, the external sector is expected to perform well in 2013.** Exports are expected to grow with the gradual recovery in global demand, improved export competitiveness and favourable commodity prices. Expenditure on imports, which began to decline from the second quarter of 2012 with the policy measures adopted to curtail imports, is expected to grow at a moderate pace in 2013. The combined outcome of these developments would be an overall improvement in the trade deficit.

- **The satisfactory performance in the services account in recent years is expected to continue in 2013, facilitated by higher earnings from tourism, port and airport related activities and information technology services.** Earnings from port related activities are expected to increase substantially with the expansion of the capacity of the Colombo port and the maximum utilisation of the Hambantota Port. Earnings from passenger fares and travel and tourism are expected to increase with the growth in tourist arrivals which are projected to exceed 1.25 million in 2013. Meanwhile, workers' remittances, which have grown at a rapid pace during the recent past, are expected to increase further, supported by the expansion of banking facilities, which would help increase the receipt of remittances through formal channels.

- **The current account deficit is projected to further narrow to below 4 per cent of GDP in 2013, from around 5 per cent in 2012.** In response to the policy measures taken by the Central Bank and the government to curb trade related credit and imports and to encourage exports, the trade deficit is expected to decelerate. Further, a high level of inflows on account of services and workers' remittances is expected to partially offset the trade deficit contributing to the narrowing of the current account deficit in 2013.

- **The expected gradual recovery in the global economy, improved infrastructure facilities, the gradual liberalisation of capital account transactions and improved investor confidence with a stable macroeconomic environment are expected to improve capital inflows to the country in 2013.** Consequently, the overall BOP is expected to record a surplus and accordingly, gross official reserves are expected to rise in terms of equivalent months of imports to a more comfortable level in 2013.

- **As envisaged in the Medium Term Macro Fiscal Framework, the budget deficit is expected to reduce further in 2013 with continued consolidation in the fiscal sector.** Measures to enhance revenue mobilisation and rationalise recurrent expenditure, while maintaining public investment at a level required to support the envisaged high economic growth would be necessary to ensure fiscal balances are maintained at the targeted levels.