5

EXTERNAL SECTOR DEVELOPMENTS AND POLICIES

The widening trade deficit driven by a sharp growth in imports and a slowdown in exports due to weakening global demand was the key challenge faced by the authorities at the beginning of 2012. The Central Bank and the government therefore implemented a decisive policy package to deliver the needed adjustment in the external sector. The exchange rate was allowed to move flexibly; a ceiling was imposed on the growth of credit granted to the private sector; policy rates of the Central Bank were raised and duties on vehicle imports were increased. Meanwhile, measures were also taken to strengthen inflows to the financial account of the balance of payments (BOP). Exchange control regulations were relaxed further; local banks and corporates were encouraged to raise funds in international financial markets; and the cap on foreign investment in government securities was raised.

Policy adjustments have been successful in arresting the deterioration in the trade account, strengthening financial and capital inflows and stabilising the BOP position. Imports began to decelerate and recorded a negative growth from April through August 2012. Accordingly, the growth of the trade deficit during the first eight months of 2012 was contained to 6.3 per cent, year-on-year, compared to the 88.7 per cent growth of the trade deficit during the corresponding period in 2011. The improvement in the trade account, the steady growth of receipts on account of workers' remittances and higher earnings from tourism and transportation led to a narrowing of the current account deficit to US dollars 2,052 million for the first half of 2012, a significant deceleration from US dollars 3,139 million recorded for the second half of 2011. Inflows to the capital and financial account increased significantly on account of inflows to the government as well as to the private sector. The successful issuance of the fifth international sovereign bond and the completion of the IMF Stand-by Arrangement (SBA) in July 2012 have further strengthened investor confidence. In view of the improvement in both the current and financial accounts, the overall BOP is projected to record a surplus for 2012, leading to the gross official reserves improving to an equivalent of around 4.5 months of imports by the end of the year.

More flexibility in the exchange rate with limited intervention by the Central Bank in the domestic foreign exchange market resulted in some overshooting initially in terms of depreciation of the rupee. The exchange rate is stabilising with market forces playing a greater role in determining the rate while supporting the build-up of reserves.

Trade in Goods and Trade Balance

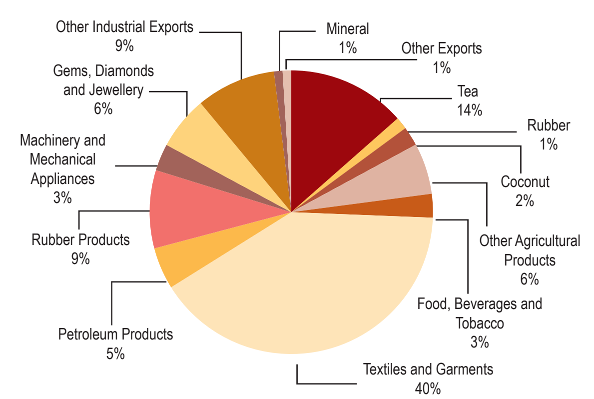
- **Earnings from exports, which grew at a robust rate in 2011, declined in the first eight months of 2012, while expenditure on imports decelerated significantly during this period.** The decline in export earnings partly reflected the lower prices of key export items as a result of declining international commodity prices. Subdued global demand in view of faltering economic activity in major economies, particularly Europe, has also weighed down on export performance. Expenditure on imports, which continued to expand in the first quarter of 2012, declined thereafter in response to policy measures taken to address the rapid expansion of both credit and import expenditure. As a consequence, the deficit in the trade balance narrowed significantly during the first eight months of 2012.

- **Earnings from exports during the first eight months of 2012 declined by 5.7 per cent, year-on-year, to US dollars 6,592 million.** Earnings from exports of industrial products as well as agricultural products, which together account for more than 95 per cent of earnings from merchandise exports, declined.

- **Given the decline in commodity prices in the world market, and the softening of global demand with sovereign debt related issues in Europe intensifying, earnings from industrial exports during the first eight months of 2012 recorded a decline of 6.3 per cent, year-on-year.** Earnings from exports of textiles and garments, which have the largest share of around 40 per cent in total export earnings, recorded a decline of 3.7 per cent, year-on-year, for the first eight months of 2012. The sharp decline in international cotton prices from the peak levels recorded in March 2011 contributed significantly to the decline in earnings from exports of textiles and garments. Slowing down of global economic activity and the consequent dampening of global demand also restrained the performance of the garments industry. With respect to other industrial exports, earnings from the export of rubber based products, which accounted for about 9 per cent of total export earnings during the first eight months of the year, grew by 2.1 per cent to US dollars 587 million. The cess on raw rubber exports and the decline in international raw rubber prices supported the domestic manufacture of rubber based products for export. Earnings from exports of gems, diamonds and jewellery grew by 20 per cent owing partly to the high prices they fetched in international markets.

- **Earnings from agricultural exports recorded a decline largely due to the decline in the prices of agricultural commodities in the world market.** Earnings from agricultural exports during the first eight months of 2012 declined by 9.9 per cent, year-on-year, to US dollars 1,511 million. Among agricultural exports, tea exports declined by 9.4 per cent, year-on-year, to US dollars 891 million. The average price of tea exported during the first eight months of 2012 meanwhile, was US dollars 4.37 per kilogram, compared to US dollars 4.65 per kilogram recorded in the corresponding period in 2011, while the total volume exported during this period also declined by 3.4 per cent, year-on-year. Earnings from rubber exports declined by 39.2 per cent, year-on-year, to US dollars 92

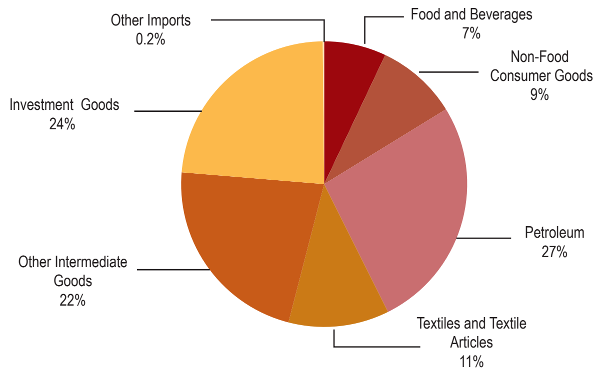
Chart 5.1 Composition of Exports (Jan-Aug 2012)



million, as a result of a significant decline in both prices and volumes exported. The average price of rubber exported during the first eight months of 2012 declined significantly to US dollars 3.57 per kilogram, from US dollars 5.03 per kilogram in the corresponding period in 2011. Export earnings from coconut kernel based products, namely, desiccated coconut, coconut oil and copra, decreased by 29.4 per cent, despite an increase in export volumes, as a result of the lower prices fetched by them during this period. The decline in earnings from coconut kernel based products however, was partly offset by the increase in earnings from fresh coconuts and non-kernel products such as fibre and yarn. Export earnings from spices also recorded a decline for the first eight months of 2012. Export earnings from seafood meanwhile, increased by 18.7 per cent to US dollars 137 million for the first eight months of the year, with increased earnings from fresh fish, processed fish, crustaceans as well as molluscs.

- **Earnings from the export of mineral products increased during the eight month period ending August 2012.** Exports of mineral products during the first eight months of 2012 grew by 46.5 per cent, year-on-year, to US dollars 34 million, with exports of both ores, slag and ash as well as precious metals increasing.

Chart 5.2 Composition of Imports (Jan-Aug 2012)

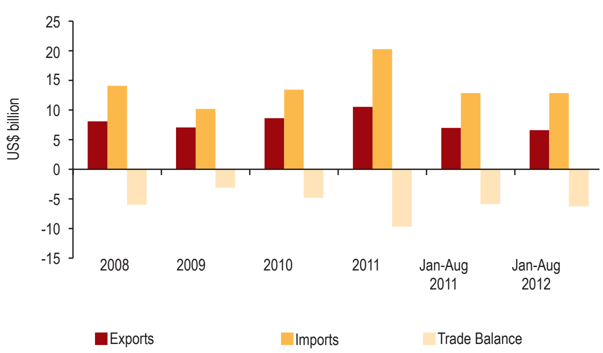


- **Expenditure on imports decelerated during the first eight months of 2012 as a result of the policy measures adopted by the government and the Central Bank earlier in the year.** Expenditure on imports during the first eight months of 2012 declined by 0.2 per cent, year-on-year to US dollars 12,859 million whereas a 50.2 per cent growth was recorded for the corresponding period of 2011. Expenditure on non-petroleum imports during this period also declined by 3.4 per cent, year-on-year, to US dollars 9,463 million.

- **The effect of policy measures taken to manage import demand was apparent in the case of consumer goods imports.** Expenditure on imports of consumer goods, which accounted for about 16 per cent of total imports, declined by 12.5 per cent during the first eight months of 2012 to US dollars 2,086 million. Expenditure on imports of food and beverages fell by 14.1 per cent, year-on-year. However, import expenditure on dairy products increased by 4.7 per cent during the first eight months of 2012, despite the imposition of a 15 per cent import duty on milk powder in May 2012. With respect to non-food consumer goods imports, import expenditure on personal motor vehicles during the first eight months of 2012 declined by 31.3 per cent to US dollars 398 million, which could be attributed to the increase in the import tariff applicable to motor vehicles from March 2012. The value of imports of medical and pharmaceutical items meanwhile, grew by 11 per cent, along with expanding healthcare facilities. With respect to other consumer goods imports, import expenditure in relation to clothing and accessories grew at a relatively high rate of 20 per cent during this period.

- **Expenditure on imports of intermediate goods during the first eight months of 2012 declined by 1.7 per cent, to US dollars 7,728 million.** Expenditure on petroleum imports, which account for approximately 25 per cent of the total expenditure on imports, increased by

Chart 5.3 Trade Performance and Trade Balance

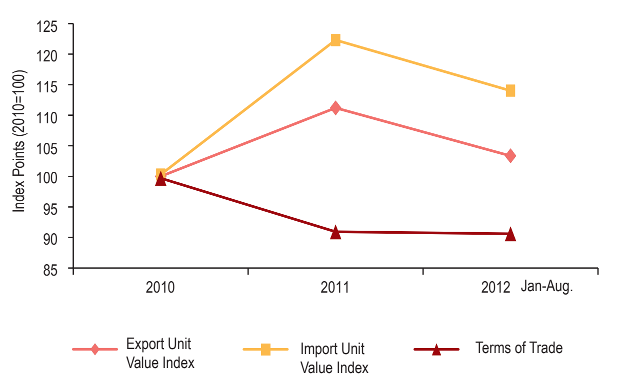


around 10 per cent, due to the higher volume of refined petroleum products imported during this period. With regard to other key imports of intermediate goods, import expenditure on textiles and textile articles, which account for around 10 per cent of total import expenditure, declined by 4.7 per cent, mainly reflecting the decline in cotton prices in international markets, and amounted to US dollars 1,465 million. Import expenditure on wheat during the first eight months of 2012 declined by 21.3 per cent, year-on-year. This decline could be attributed to the lower wheat prices in the world market during much of this period as well as the increased price of wheat flour in the domestic market which is likely to have led to a reduction in domestic demand for wheat based products. Import expenditure on diamonds as well as other precious stones and semi-precious stones recorded a decline during the first eight months of 2012, while import expenditure on gold also declined during this period partly owing to the build up of inventories last year. Import expenditure on fertiliser recorded a decline of 6.5 per cent and amounted to US dollars 233 million for the first eight months of 2012. This decline could be attributed to reduced application of fertiliser during this period due to delayed rains.

- **Expenditure on imports of investment goods continued to remain buoyant during much of the period from January to August 2012, although there was some slowdown in June and July.** Expenditure on investment goods imports increased by 15.7 per cent to US dollars 3,025 million for the first eight months of 2012. Import expenditure on transport equipment, which comprises vehicles for transport of passengers and goods, heavy-duty vehicles and small scale ships and boats, grew by 23.3 per cent to US dollars 766 million. Expenditure on imports of machinery and equipment, which comprises engineering and electronic equipment, telecommunication devices, office machinery, medical and laboratory equipment and machinery for industrial purposes, increased by 10.6 per cent to US dollars 1,457 million. Expenditure on imports of building material, which mainly comprises cement, iron and steel, aluminium articles and mineral products, increased by 18.4 per cent to US dollars 799 million during the first eight months of 2012.

- **Following the deceleration in expenditure on imports, the deficit in the trade balance for the first eight months of 2012 increased by 6.3 per cent to US dollars 6,267 million, compared to the increase of 88.7 per cent recorded for the first eight months of last year. Although, the trade balance for the first quarter of 2012 recorded a significant increase of 52.2 per cent, it contracted during much of the period since April in response to the policy measures taken to contain expenditure on imports.**

Chart 5.4 Terms of Trade and Trade Indices



Terms of Trade

- **Terms of trade for the first eight months of 2012, on average, remained broadly stable when compared with the level recorded for 2011.** Prices of petroleum products in particular, and several other key commodities imported such as wheat and fertiliser, remained elevated in world markets by August 2012. Export prices in relation to garments as well as agricultural commodities exported such as rubber and coconut meanwhile have dropped from the levels that prevailed last year, although tea prices in the world market have remained elevated since around May this year due to lower production in major producing countries. As a result of these trends in prices of commodities exported and imported, the terms of trade for the period January to August 2012, on average, was 89.9, having declined marginally from 90.9 recorded for 2011, on average.

Trade in Services

- **The satisfactory performance in the transportation, travel, and computer and information services sub sectors helped the services sector to record a surplus.** The surplus in the services account amounted to US dollars 591 million during the first half of 2012 compared to the surplus of US dollars 581 million recorded during the corresponding period of 2011. In spite of the slow recovery in the global economy, inflows on account of transportation services, consisting of passenger fares, freight charges, port and airport related activities marked a significant growth of 13.3 per cent during the first half of the year. Inflows on account of passenger fares increased mainly due to the increase in the number of passengers flown by SriLankan Airlines and other airlines and increase in airfares by SriLankan Airlines due to fuel surcharges. Meanwhile, inflows on account of port-related activities increased as a result of increased cargo handling and services delivery at the Port of Colombo.

- **Tourist arrivals from all major markets increased during the first nine months of 2012.** The number of tourists arrivals during the first nine months of 2012 increased by 16.0 per cent to 693,772, year-on-year. Western Europe continued to be the largest market for tourism accounting for around 39 per cent of tourist arrivals during the first nine months of 2012. India, however, remained the largest tourist originating country followed by the UK and Germany. Earnings from tourism during the first nine months of 2012 grew by 22.6 per cent to US dollars 711 million compared to the corresponding period. To attract larger numbers of tourists particularly from Japan, Russia, India and China, promotion campaigns have been planned by the Tourism Promotiovbn Bureau for the latter part of this year and 2013. Meanwhile, leading international hotel chains have already commenced construction of hotels in Sri Lanka. In the meantime, it is vital to upgrade existing hotels and promote home-stay tourist services in addition to the construction of new hotels, in order to facilitate the growing demands of the tourism industry. Further, skilled labour requirements of the tourism industry also need to be addressed.

Chart 5.5 Tourist Arrivals and Earnings from Tourism

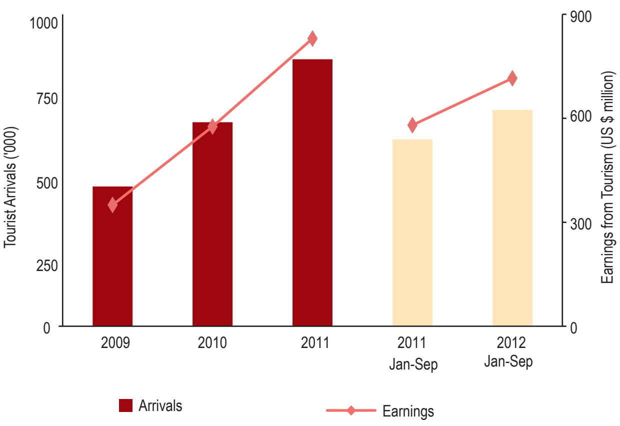
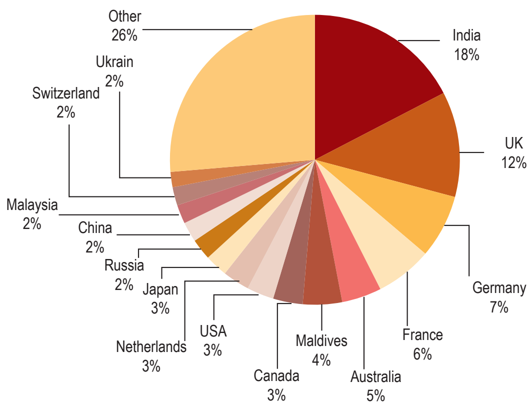


Chart 5.6 Tourist Arrivals by Country (Jan- Sep 2012)



- **Computer and information services sector has continued to record steady inflows.** Gross inflows from the export of software and information technology enabled services (ITES) such as business process outsourcing (BPO), increased by 12.8 per cent to US dollars 200 million during the first half of 2012 mainly supported by the expansion of the global BPO industry. This was further supplemented by the conducive domestic environment and availability of a high skilled workforce at a competitive cost to cater to the needs of the industry. Sri Lanka is emerging as a global IT-BPO destination in key areas such as software development, accounting, engineering and architecture, legal services in response to increased global market demands.

Inflows and Outflows of Income

- **The deficit in the income account amounted to US dollars 482 million in the first half of 2012 compared to the deficit of US dollars 144 million in the corresponding period of 2011.** Interest earned from the investment of reserves and profits earned on trading of foreign currency and foreign securities contributed to the receipts in the income account in the first half of 2012, although this was lower than the corresponding period of 2011, mainly due to lower global interest rates. Interest paid on accumulated foreign loans and coupon payments on Treasury securities have also increased at a higher pace, thereby widening the deficit in the income account. Meanwhile, outflows on account of direct investments amounted to US dollars 177 million mainly due to the repatriation of profits and dividends by foreign enterprises. However, a considerable portion of repatriated profits and dividends has been reinvested in those enterprises facilitating the expansion of existing operations.

Current transfers

- **Workers' remittances continued to be the foremost foreign exchange earner for Sri Lanka.** Inward workers' remittances in the first eight months of 2012 increased by 15.6 per cent to US dollars 3,907 million compared to US dollars 3,381 million recorded in the same period in 2011. Increased labour migration under the professional category, further expansion of formal channels for remitting money, including increased number of exchange house networks set up by the commercial banks were the main factors that contributed to the increase in inflows on account of workers' remittances during the first eight months of 2012. Further, fiscal incentives provided by the government in the Budget for 2012 such as a five - year tax exemption on investments made by migrant workers in capital goods to commence new businesses helped increase remittances during this period. Enhanced workers' remittances are estimated to have financed around 61 per cent of the trade deficit recorded in the first half of 2012.

Current Account Balance

- **The current account recorded a deficit of US dollars 2,052 million in the first half of 2012 compared to the deficit of US dollars 1,476 million in the corresponding period of 2011.** However, the deficit in the current account during the first half of 2012 was a significant improvement from the deficit of US dollars 3,139 million recorded during the second half of

2011. Moreover, the improvement in the trade deficit coupled with the inflows of services and private transfers helped the current account to improve from a deficit of US dollars 1,202 million in the first quarter to a deficit of US dollars 850 million in the second quarter of 2012. The current account deficit in the first half of 2012 was mainly due to the increase in the trade deficit led by higher import expenditure on intermediate goods and investment goods and the widening deficit in the income account. However, substantial inflows in the form of services and private transfers continued to help cushion the deficit in the current account. The current account deficit is expected to reduce to around 5.1 per cent of GDP in 2012 from 7.8 per cent of GDP in 2011.

Capital and Financial Flows

- **Realised foreign direct investments (FDI), including foreign loans, increased to US dollars 452 million during the first half of 2012 compared to US dollars 413 million during the corresponding period of 2011.** The major share of inward FDIs was to the infrastructure and utilities sectors, followed by the manufacturing and tourism sectors. Despite a moderate increase in FDIs during the first half of the year, more FDIs are expected for a number of major projects during the balance period of 2012. Inward FDI also includes reinvestment of repatriated profits and dividends by the Board of Investment (BOI) approved companies amounting to US dollars 77 million. Meanwhile, the value of outward FDI increased to US dollars 40 million during the first half of 2012. Consequently, net FDI inflows during the first half of 2012 were US dollars 395 million compared to US dollars 364 million in the same period in 2011. The value of the investment commitment of the contracted projects under FDIs increased in the first half of 2012 compared to the corresponding period in 2011. Positive investor sentiment is expected to draw substantial flows in FDIs during the second half of the year, with major inflows expected to the infrastructure, utilities and tourism sectors.

- **Foreign loan inflows to the private sector increased.** Foreign loan inflows to the private sector increased to US dollars 156 million in the first half of 2012 from US dollars 137 million in the corresponding period of 2011. The relaxation of foreign exchange regulations by the Central Bank on certain capital account transactions is expected to attract more foreign funds in the short and medium - term. Portfolio investments recorded a net inflow of US dollars 250 million in the first nine months of 2012, compared to a net outflow of US dollars 153 million recorded in the corresponding period of 2011. Improved investor confidence is expected to bring more inflows on account of portfolio investments during the remainder of the year. Meanwhile, net foreign liabilities of commercial banks increased by US dollars 1,074 million by end August 2012, driven partly due to the bond issue by the Bank of Ceylon of US dollars 500 million in May 2012.

- **Foreign financial inflows to the government increased substantially during the first eight months of 2012.** Total foreign inflows to the government during the first eight months of 2012 increased by 35.7 per cent to US dollars 4,263 million. This includes foreign loans of US dollars 2,292 million including the international sovereign bond issue of US dollars 1 billion and US dollars 214 million received from the China Development Bank for the Moragahakanda development project. Higher foreign loan inflows during the first eight months of 2012 reflected the faster disbursement of foreign loans to finance major highways and road development projects, rural electrification, water supply and drainage projects and ports expansion projects. During the first nine months of 2012, the government received a net inflow of US dollars 821 million on account of foreign investments in Treasury bills and Treasury bonds compared to US dollars 206 million in the same period in 2011. Raising the cap on foreign investments in Treasury bills and Treasury bonds from 10 per cent to 12.5 per cent of the outstanding value of the respective government securities by the

Central Bank on 6 December 2011 attracted more foreign investment into the government securities market. Inflows to the government in the form of grants increased during the first eight months of 2012 to US dollars 104 million from US dollars 90 million in the correspondence period of 2011.

- **Meanwhile, Sri Lanka's fifth international sovereign bond of US dollars 1 billion was successfully issued in July 2012.** The bond was issued at a comparatively low yield of 5.875 per cent per annum with a maturity of 10 years and attracted an order book of over ten and a half times, the largest order book for Sri Lanka, and the largest number of investors reflecting continued investor confidence in Sri Lanka's economy. This can be regarded as a considerable achievement, given the volatility observed in global capital markets in the months leading up to the bond issue.

- **External debt service payments increased in the first half of 2012.** External debt service payments, which include principal and interest payments, as a percentage of exports of goods and services increased to 12.8 per cent in the first half of 2012 from 11.1 per cent in the corresponding period of 2011. The relatively high level of principal and interest payments on government and private sector foreign loans in the first half of 2012 mainly contributed to the increase in the debt service ratio in 2012. With the repayment of the international sovereign bond issued in 2007 falling due in October 2012, debt service payments for 2012 are expected to be higher than in 2011.

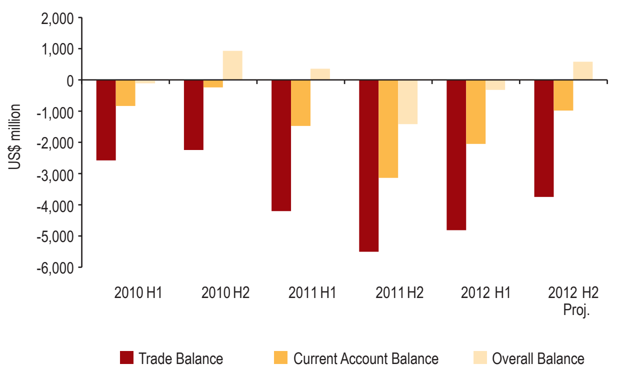
Balance of Payments

- **The BOP which recorded a significant deficit in the first quarter of 2012 has improved gradually over the last few months.** The improvement in the trade deficit coupled with the surpluses in the capital and financial account helped the BOP to improve from a deficit of US dollars 251 million in the first quarter of 2012 to a deficit of US dollars 69 million in the second quarter. Supported by inflows to the government and the private sector, the BOP strengthened further recording a surplus of US dollars 306 million by end August 2012. BOP is expected to record a surplus of around US dollars 250 million for 2012.

International Reserves

- **Gross official reserves increased to US dollars 7.1 billion by end August 2012 from US dollars 6.0 billion by end 2011.** The proceeds of the fifth international sovereign bond issue, disbursements under foreign funded projects, the receipt of two tranches under the IMF Stand-by Arrangement (SBA) facility and other inflows to BOP on account of tourism and workers' remittances raised foreign reserves during the first eight months of the year. Apart from the increase in official reserves, the build up of foreign assets by commercial banks contributed to the increase in total international reserves to US dollars 8.7 billion by end August 2012 from US dollars 7.2 billion at end December 2011. The adequacy of the current level of gross official and total international reserves as measured by months of imports is equivalent to 4.3 and 5.2 months of imports, respectively. Gross official

Chart 5.7 Balance of Payments



reserves are expected to strengthen further and be equivalent to around 4.5 months of imports by end 2012.

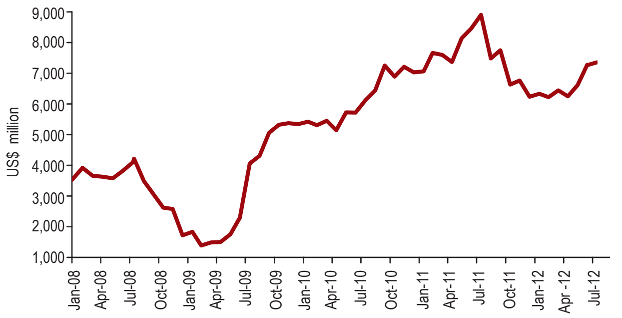
- **The SBA facility that Sri Lanka obtained from the IMF in July 2009 was successfully completed in July 2012.** The eighth and the final review of the IMF- SBA facility was completed and the ninth tranche to the value of SDR 275.6 million (US dollars 414 million) was disbursed by the IMF on 20 July 2012. Accordingly, the total amount of SDR 1,654 million (equivalent to US dollars 2,547 million), that was approved under the SBA in 2009 was received by Sri Lanka. The completion of the SBA marks the longest engagement Sri Lanka has had with the IMF and the single largest facility Sri Lanka has ever obtained from a multilateral institution.

- **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) has 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 performance.

Exchange Rate Regime and Exchange Rate Movements

- **Exchange rate policy in 2012 mainly focused on allowing more flexibility in the exchange rate by limiting the Central Bank intervention in the foreign exchange market.** The rupee depreciated by 14.56 per cent vis-a-vis the US dollar in the first half, while appreciating by 2.70 per cent during the third quarter of 2012. Expectations of further foreign currency inflows, increasing trend of domestic interest rates and curtailing import growth contributed to the rupee appreciation in the third quarter. Accordingly, in the first nine months of the year the overall depreciation of the rupee against the US dollar was 12.24 per cent. Reflecting cross currency exchange rate movements, the rupee depreciated against all other major currencies. The rupee depreciated against the pound sterling (16.84 per cent), the Japanese yen (12.37 per cent), the euro (12.23 per cent), and the Indian rupee (12.16 per cent) by end September 2012. The Central Bank has reduced its intervention in the domestic foreign exchange market substantially since February 2012. Hence the supply of foreign exchange was limited to the extent needed to settle a part of petroleum import bills, while surplus foreign exchange that flowed into the market from various sources was absorbed by the Central Bank. The Central Bank which supplied US dollars 1,309 million in the first four months, supplied only US dollars 168 million in the next four months to record an overall supply of US dollars 982 million on net basis to the domestic foreign exchange market during the first eight months of 2012.

Chart 5.8 Gross Official Reserves



- **Effective exchange rate indices depreciated.** Both the 5 - currency and 24-currency Nominal Effective Exchange Rate (NEER) indices depreciated by around 12.58 per cent and 12.75 per cent, respectively, by end September 2012, reflecting the nominal depreciation of the

Sri Lanka rupee against all other major currencies in the currency basket, while both the 5 - currency and 24 - currency, Real Effective Exchange Rate (REER) indices which takes into account the inflation differentials amongst countries in addition to the variations in nominal exchange rates also depreciated by 15.2 per cent and 8.7 per cent, respestively during the first nine months of the year.

- **The volume of domestic foreign exchange market transactions contracted during the first nine months of 2012 compared to the corresponding period of 2011.** The total volume of spot transactions declined marginally to around US dollars 7,204 million by end September 2012 from US dollars 7,789 million during the corresponding period of 2011. This was mainly due to the slowdown in external trade resulting from the weakening global demand and declining import expenditure domestically. Consistent with the trend observed in the spot market, forward transaction volumes declined to US dollars 3,155 million by end September 2012 from US dollars 4,095 million during the corresponding period of 2011.

- **Forward premia in the foreign exchange market reflected the change in exchange rate policy stance in 2012.** The one-month, three month and six-month forward premia remained

Chart 5.9 Effective Exchange Rate Indices: 24 - Currency (2010 = 100)

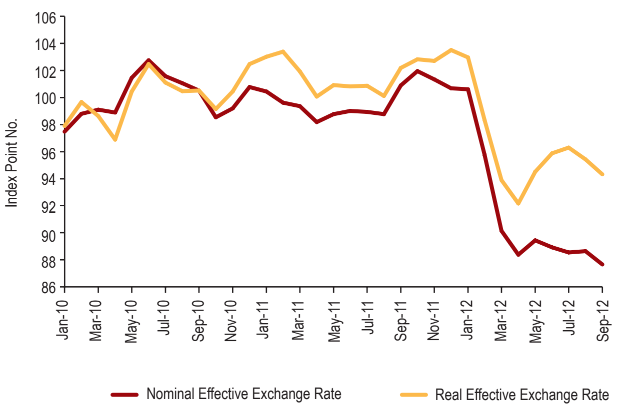
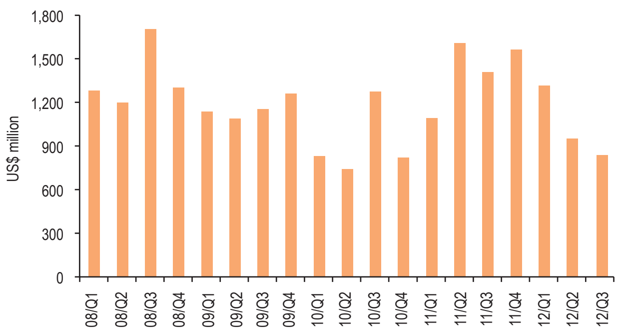


Chart 5.10 Quarterly Inter - Bank Forward Transaction Volumes



slightly lower than the interest rate differentials during the first nine months of 2012, indicating market expectations of future inflows into the domestic foreign exchange market in the short-term.

Prospects for 2013

- **Along with the gradual recovery in global economic activity and the dissipation of the impact of sharp fluctuations in commodity prices in world markets on exports, earnings from exports are expected to recover in 2013.** However, the deficit in the trade balance is expected to remain high in 2013 as domestic economic activity is expected to regain its high growth momentum, necessitating imports of intermediate and investment goods in larger quantities. The deficit in the trade balance is projected to be around US dollars 9 billion in 2013. Nevertheless, as a percentage of GDP, the deficit in the trade balance is expected to decline gradually to around 13 per cent in 2013 from 14.4 per cent projected for 2012 and 16.4 per cent recorded in 2011.

- **The satisfactory performance of the services account in recent years is expected to continue into 2013 and beyond, facilitated by the rapid expansion in transportation and travel sub sectors.** Earnings on account of freight, port and airport related activities are expected to increase substantially in 2013. Capacity expansion of existing ports, namely, the Colombo South port, the Galle port and the Oluvil port; and the maximum utilisation of Sri Lanka's second international sea port in Hambantota for unloading of imported vehicles and transhipment activities would support the expansion of earnings from port and airport related activities. With tourist arrivals expected to exceed 1.25 million in 2013, earnings from both tourism and passenger fares are expected to increase. Meanwhile, workers' remittances, which grew at a rapid pace during the recent past, are expected to increase further in 2013.

- **The current account deficit is projected to be around 3.6 per cent of GDP in 2013, improving from 5.1 per cent expected for 2012.** Even though the trade deficit in nominal terms is likely to increase marginally, the expected increase in the surplus in the services account and workers' remittances would help reduce the current account deficit in 2013. Financial flows to the government and the private sector including FDI and loan capital flows are expected to increase substantially in 2013, thus improving the financial account in 2013.

- **The overall BOP is expected to record a surplus in 2013.** Gross official reserves are expected to increase further in 2013, supported by healthy foreign exchange inflows to the government and the private sector. Although the official reserves would increase further to more sustainable levels, the higher level of import expenditure would result in reserves remaining around the same level as in 2012, in terms of equivalent months of imports.