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OVERVIEW

The economy expanded by 6.3 per cent during the first half of 2013, largely supported by domestic economic activity, as external demand remained weak. The moderation in the economy after the strong growth averaging over 7.5 per cent recorded during the last three years was due to both external and domestic factors. On the external front, weak external demand slowed export growth, while the policy measures adopted in 2012 and adverse weather conditions had a dampening impact on domestic demand and supply. Prudent demand management policies, stable international commodity prices and significant improvements in domestic food supply helped moderate inflationary pressures in 2013, with inflation remaining at single digit levels for 56 months. The moderation in inflation and inflation expectations and indications that growth was falling below potential, enabled the Central Bank to ease its monetary policy stance from December 2012 by removing the credit ceiling on licensed banks and by reducing policy interest rates by 25 basis points. Policy interest rates were further reduced by 50 basis points each in May and October 2013 and the Statutory Reserve Requirement (SRR) was reduced by 2 percentage points in July 2013 to support domestic economic activity.

The external sector strengthened in 2013 with the policy measures adopted in 2012 to address imbalances in the sector. Although exports did not pick up as expected due to the slow recovery in the global economy, the trade deficit narrowed during the first half of 2013 as import expenditure declined at a faster pace. Supported by higher earnings from the export of services and workers' remittances, the current account deficit declined to US dollars 1,583 million during the first half of 2013 from US dollars 2,180 million during the corresponding period of 2012. Reflecting these developments, the Balance of Payments (BOP) recorded a lower deficit of US dollars 169 million during the first half of 2013, compared to a deficit of US dollars 320 million recorded during the corresponding period of 2012. With an increase in inflows to the capital and financial account, including the receipt of proceeds from the National Savings Bank (NSB) bond issue in September, the BOP recorded a surplus of US dollars 585 million during the first nine months of 2013. Accordingly, gross official reserves increased to US dollars 7.0 billion at end September 2013, which was equivalent to 4.4 months of imports.

Fiscal management became challenging in 2013 due to a shortfall in government revenue, although government expenditure was maintained within the budgetary allocation, reflecting the government's commitment to meeting the budget estimate targets.

- **The Sri Lankan economy grew by 6.3 per cent in real terms during the first half of 2013.** The impact of unfavourable weather conditions, subdued global growth and the lag effect of tight monetary policy measures introduced during the first half of 2012 slowed the growth momentum, although Sri Lanka continues to grow faster than most emerging market economies. The Industry sector continued to post strong growth of 10.4 per cent, largely driven by construction and manufacturing sub-sectors. The continuation of major public infrastructure programmes and an increase in private sector construction activities contributed to the strong growth in the construction sector. The gradual recovery in Sri Lanka's major trading partners and higher demand from the tourist sector contributed to the growth in factory industry. The Services sector grew by 5.5 per cent, despite the continuing slowdown of wholesale and retail trade activity, as transport and financial services continued to expand. The Agriculture sector recorded a marginal growth of 0.5 per cent compared to the relatively high growth of 10.4 per cent recorded during the first half of 2012. The adverse weather conditions prevailing at the beginning of the year affected domestic agricultural production, particularly paddy and other food crops which include vegetables and highland crops and export agricultural production such as rubber and coconut, although tea performed favourably. The economy is projected to expand at a faster pace during the second half of the year supported by favourable weather conditions, further recovery in external trade and manufacturing activities, as well as continued growth in construction, transport, mining and quarrying and tourism.

- **Domestic savings are projected to increase to around 19.2 per cent of GDP in 2013 due to an increase in private savings and a reduction in government dis-savings.** Private savings are expected to rise, particularly due to the lower demand for imported goods. Further, national savings are projected to increase to 25.8 per cent of GDP from 24.0 per cent in 2012 on the back of higher workers' remittances.

- **Investment as a percentage of GDP is projected to increase to around 31 per cent in 2013 with the highest contribution arising from the construction sector.** Construction activity which recorded a robust growth during the first half of the year is expected to provide the highest contribution to investment growth, while a substantial contribution is also expected from the importation of machinery and equipment. Meanwhile, public investment, which increased by 9.3 per cent during the first half of 2013 supported by ongoing government investment in infrastructure projects, is expected to continue to contribute significantly to capital formation.

Chart 1.1 GDP and Sectoral Performance (Growth Rates)

Chart 1.2 Savings and Investment

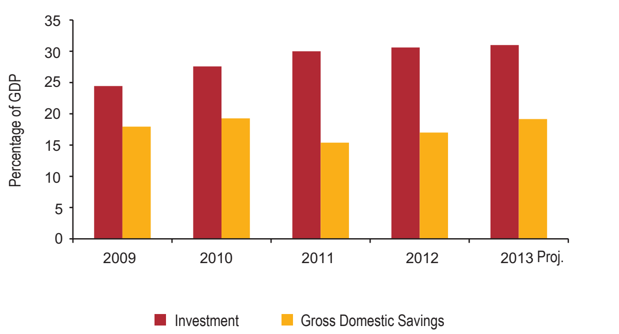


Chart 1.3 Unemployment Rate (% of Labour Force)

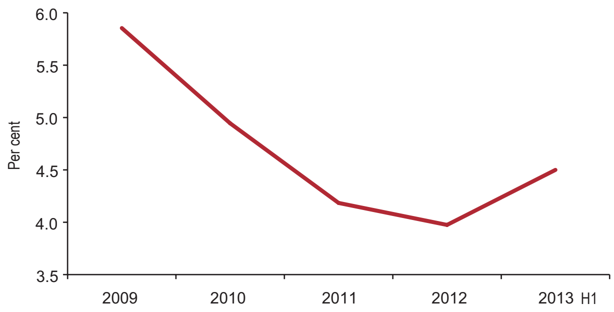
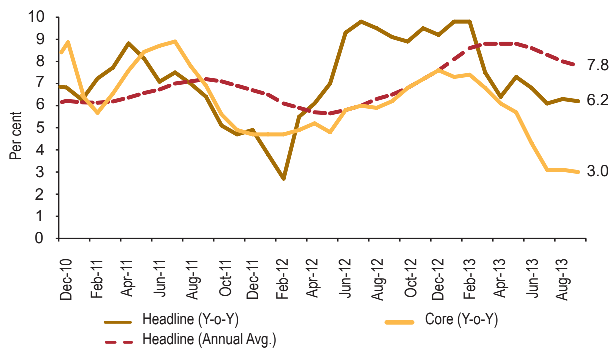


Chart 1.4 Inflation



An increase in Foreign Direct Investment (FDI) is also expected to support a higher rate of investment during the year.

- **Although more employment opportunities have been generated, the increase in the labour force, which is defined as those actively seeking employment, has raised the unemployment rate to 4.5 per cent during the first half of 2013, from 3.9 per cent during the first half of 2012.** The entry of females in the rural sector and full time students into the labour force has mainly contributed to this increase. Structural factors such as the mismatch between the availability of jobs and the aspirations of job seekers have contributed to the rise in unemployment, particularly among youth.

- **Inflation has remained at single digit levels for over four and a half consecutive years, while core inflation has declined to record low levels, indicating well contained demand driven inflationary pressures.** The lagged effect of the tight monetary policy stance, moderation of global commodity prices, together with the absence of significant supply-side shocks domestically, contributed to inflation remaining within single digits during the first nine months of 2013. Year-on-year headline inflation declined to 6.2 per cent in September 2013 from 9.8 per cent in January 2013, while core inflation declined to a record low level of 3.0 per cent in September 2013, on a year-on-year basis. Going forward, inflation is projected to remain at single digit levels during the remainder of 2013.

- **The trade deficit during the first eight months of 2013 contracted by 5.6 per cent, on a year-on-year basis, to US dollars 5,998 million, compared to an increase of 7.8 per cent during the first eight months of 2012.** Earnings from exports recorded positive year on year growth from June 2013, accelerating to 10.7 per cent in August 2013, due to strong growth in tea exports and a gradual recovery in export of textiles and garments. However, cumulative earnings from exports during the first eight months declined by 1 per cent to US dollars 6,437 million, largely due to weak external demand arising from the protracted economic slowdown in several key export destinations. Meanwhile, expenditure on imports during the first eight months of 2013 declined by 3.3 per cent to US dollars 12,435 million from the corresponding period in 2012. The impact of policy measures adopted in 2012 to rationalise imports, lower demand for intermediate goods, mainly of petroleum and petroleum related products due to lower thermal power generation and revisions to customs duties together with reduced input demand from export industries and moderating international commodity prices, contributed to the decline in overall import expenditure.

- **Services exports have performed well indicating the strong growth potential of this sector.** The services account recorded a surplus, growing by 32.1 per cent during the first half of 2013, as earnings from transport, travel, and computer and information services sectors increased. Gross earnings from transportation services, which comprise passenger fares, freight charges, port and airport related activities, grew by 10.8 per cent to US dollars 906 million, while gross inflows into the computer and information services sub sector increased by 17.1 per cent to US dollars 248 million during the first half of the year. Tourist arrivals increased during the first nine months of 2013 by 15.5 per cent to 801,210, while earnings from tourism grew by 24.2 per cent to US dollars 883 million.

- **Workers' remittances continued to be the foremost foreign exchange earner in Sri Lanka.** Workers' remittances, which constitute a major share of private transfers, increased by 11.4 per cent to US dollars 4,922 million during the first nine months of 2013 from the corresponding period of 2012. The continued growth in remittances is partly due to higher labour migration in the professional and skilled categories as well as improved awareness and increased availability of formal channels to remit money to the country.

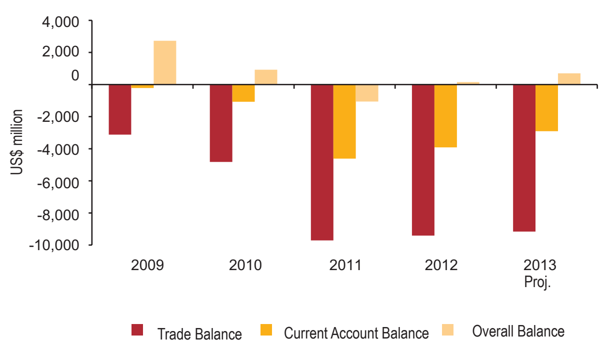
- **The deficit in the income account widened during the first half of 2013 compared to the first half of 2012 due to higher interest payments.** Interest payments on long term loans of the government as well as coupon on payments on Treasury bonds increased, while total earnings of the Central Bank declined primarily due to a fall in trading profits, as interest earnings on Central Bank reserves remained unchanged. Although, dividend payments to non-resident investors of FDI enterprises also increased, a large part of these dividends have been reinvested in those enterprises, contributing to the expansion of existing operations.

- **The external current account deficit narrowed, primarily due to the contraction of the deficit in the trade account, higher inflows to the services account and an increase in private transfers.** The deficit in the current account contracted to US dollars 1,583 million during the first half of 2013 compared to the deficit of US dollars 2,180 million during the corresponding period of 2012. Higher inflows to the services account from tourism, transportation, computer and information services as well as increased inflows on account of workers' remittances, which alone helped cushion more than 70 per cent of the trade deficit, strengthened the current account.

- **Inflows to the capital and financial account increased, supported by higher inflows to the private sector.** Positive investor sentiment and the relaxation of foreign exchange regulations on capital account transactions helped increase foreign inflows into both the debt and equity markets. FDI, including foreign loans to Board of Investment (BOI) companies, amounted to US dollars 540 million during the first half of 2013 compared to US dollars 452 million during the same period of 2012. Long term loan inflows to the private sector, including foreign loans raised by State Owned Enterprises (SOEs), BOI companies and other private sector corporates increased to US dollars 360 million during the first half of 2013 from US dollars 176 million during the first half of 2012. Banks were active players in the international capital market in 2013 with the Bank of Ceylon (BOC) raising US dollars 500 million through a 5-year bond issue in April 2013 and the NSB raising US dollars 750 million through a 5-year bond issue in September 2013. Net foreign inflows into the stock exchange during the first nine months of 2013 amounted to US dollars 156 million. However, net foreign inflows to the government during the first nine months of 2013 amounted to US dollars 1,178 million which was lower than the net inflow of US dollars 2,838 million during the corresponding period of 2012. The non-issuance of a sovereign bond in the international market of 2013 compared to the sovereign bond of US dollars 1 billion raised in 2012, and the full utilisation of the foreign investment threshold of the outstanding government securities were the main reasons for lower net foreign inflows to the government during the first nine months of 2013.

- **The overall BOP is estimated to have recorded a surplus of US dollars 585 million during the first nine months of 2013**. Although the BOP recorded a deficit of US dollars 169 million during the first half of 2013, an improvement in the trade account and higher receipts from tourism and workers' remittances as well as increased inflows to the corporate and banking sectors, including the receipt of proceeds from the NSB bond issue in September resulted in a turnaround in the BOP. With expected inflows to the banking sector and an improvement in the export of goods and services during the balance period of the year, the BOP is expected to generate a surplus of US dollars 700 million by end 2013.

Chart 1.5 Balance of Payments



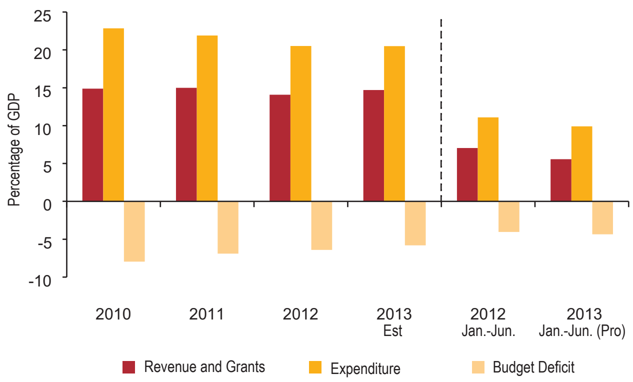
- **By end September 2013, gross official reserves had increased from the level recorded at end 2012.** Debt service payments, including repayments on account of the IMF-SBA facility, a gradual pick up in import demand and valuation losses as a result of the significant depreciation of reserve currencies and the sharp decline in the price of gold impacted on reserve accumulation. However, with the placement of proceeds from the NSB bond issue with the Central Bank and the receipt of other foreign inflows, gross official reserves increased to US dollars 7.0 billion at end September 2013, which was equivalent to 4.4 months of imports, from US dollars 6.9 billion at end 2012. Total international reserves which comprise gross official reserves and foreign assets of commercial banks amounted to US dollars 8.3 billion by end September 2013, which was equivalent to 5.3 months of imports. With the forecasted surplus in the balance of payments, gross official reserves are estimated to increase to US dollars 7.1 billion at end 2013, which is equivalent to 4.5 months of imports.

- **The exchange rate policy in 2013 was focused on maintaining flexibility in the determination of the external value of the Sri Lanka rupee.** The Sri Lanka rupee which was stable until mid-June 2013, depreciated through August 2013, due to the demand for foreign exchange to settle import bills and the expectation of unwinding by foreign investors from the government securities market in response to the announcement of a possible tapering of the US Federal Reserve's quantitative easing measures. However, with the receipt of higher foreign exchange inflows to the banking sector, the rupee stabilised thereafter. Consequently, the Sri Lanka rupee depreciated against the US dollar only by 2.9 per cent during the year to end October 2013, unlike other Asian currencies such as the Indian rupee and the Indonesian rupiah, which have depreciated by 10.7 per cent and 14.2 per cent, respectively against the US dollar during the corresponding period. Given cross currency exchange rate movements during the year up to end October 2013, the rupee appreciated against the Indian rupee (8.74 per cent), the Australian dollar (6.24 per cent) and the Japanese yen (11.19 per cent) but depreciated against the euro (6.55 per cent) and the pound sterling (2.19 per cent).

- **Although the Nominal Effective Exchange Rate (NEER) marginally depreciated, due to comparatively higher domestic inflation, the Real Effective Exchange Rate (REER) appreciated during the year to end October 2013.** The 5-currency and the 24-currency NEER marginally depreciated by 0.24 per cent and 0.11 per cent, respectively during this period as a result of a nominal depreciation of the Sri Lanka rupee against the US dollar, the pound sterling and the euro. However, as the inflation differential increased due to relatively higher domestic inflation compared to Sri Lanka's trading partners and competitors, both the 5-currency and 24-currency REER appreciated by 1.22 per cent and 1.53 per cent, respectively during the year to end October 2013.

- **Fiscal management became challenging during the first half of 2013, mainly due to the shortfall in government revenue, although government expenditure was contained within budgetary targets.** As a result, the overall budget deficit during the first half of 2013 was 4.3 per cent of projected GDP compared to the budget estimate of 5.8 per cent for 2013. Government revenue in terms of GDP declined to 5.5 per cent during the first six months of 2013 from 6.9 per cent of GDP during the corresponding period of 2012. Government revenue also declined in nominal terms by 7.6 per cent to Rs.481.7 billion. The decline in taxes on imports reflecting the contraction of imports, a decline in revenue from the Economic Service Charge as a result of raising the threshold and the granting of exemptions as well as reduced profit and dividend transfers from government institutions were the main reasons for the decline in revenue during the first half of the year. Total expenditure and net lending as a percentage of GDP declined to 9.9 per cent during the first half of 2013 from 11.1 per cent during the corresponding period of 2012, mainly due to a reduction in recurrent expenditure, while capital expenditure and net lending marginally declined.

Chart 1.6 **Government Revenue, Expenditure and Budget Deficit**



- **The overall fiscal deficit was mainly financed through domestic sources during the first half of the year**. During this period, borrowing from the banking sector to finance the resource gap exceeded the amount envisaged in the budget for 2013. Although there was a decline in the holdings of government securities with the Central Bank, higher borrowings from commercial banks contributed to the increase in bank financing.

- **With demand driven inflationary pressures and inflation expectations well contained, the Central Bank eased its monetary policy stance to address the sluggish growth in credit and economic activity.** The Central Bank's policy interest rates, i.e., the Repurchase (Repo) rate and the Reverse Repurchase (Reverse repo) rate, were reduced by 25 basis points each and the ceiling on the expansion of rupee credit by licensed banks was removed in December 2012. The Central Bank further lowered its policy interest rates by 50 basis points each in May and October 2013 to stimulate economic activity. Accordingly the Repo rate and the Reverse repo rate now stand at 6.50 per cent and 8.50 per cent, respectively. In order to accelerate the reduction in market lending rates, which were downward rigid during the first few months of the year, the Central Bank reduced the SRR on all rupee deposit liabilities of commercial banks by 2 percentage points to 6 per cent in July 2013. The efforts to bring down market interest rates, particularly on medium to long term lending facilities, were further strengthened by regular discussions between the Central Bank and market participants.

- **Reflecting the easing of monetary policy, liquidity conditions improved during the year.** Market liquidity which was broadly in balance at the beginning of the year increased thereafter, with daily excess rupee liquidity averaging around Rs.22.4 billion during the first ten months of 2013. The purchase of Treasury bills from the primary market and the absorption of foreign currency from the domestic foreign exchange market by the Central Bank largely contributed to the excess liquidity during the first few months of the year. However, with the outright sale of Treasury bills and the reversal of foreign exchange swap arrangements, excess rupee liquidity gradually declined. The reduction of the SRR by 2 percentage points released additional liquidity of around Rs. 44 billion to the market and with the placement of the proceeds of the bond issue by the NSB with the Central Bank, excess liquidity rose to Rs. 88 billion by 23 September. However, the Central Bank has conducted term repo auctions and retired a part of its holdings of Treasury bills to maintain liquidity at a level consistent with the monetary programme.

Table 1.1 Recent Monetary Policy Measures

per cent per annum

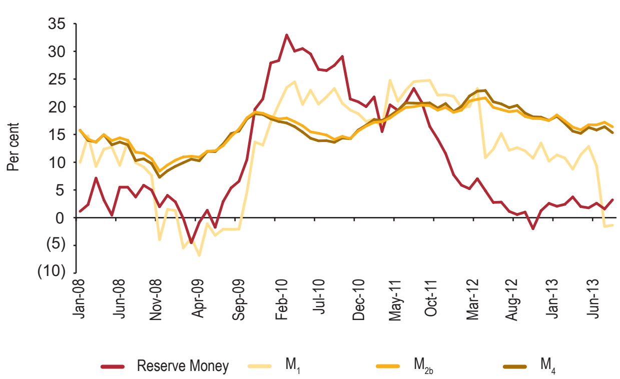
Date	Repurchase rate	Reverse Repurchase rate	SRR (a)
09 July 2010	7.25 (b)	9.50 (b)	
20 August 2010		9.00	
11 January 2011	7.00	8.50	
12 April 2011			8.00(c)
03 February 2012 (d)	7.50	9.00	
05 April 2012	7.75 (b)	9.75 (b)	
12 December 2012	7.50	9.50	
10 May 2013	7.00	9.00	
26 June 2013			6.00(e)
15 October 2013	6.50	8.50	

Source : Central Bank of Sri Lanka

(a) To be maintained as a percentage of rupee deposit liabilities
(b) Effective from the close of business
(c) Effective from the reserve week commencing 29 April 2011
(d) In March 2012, a direction was issued to licensed banks to limit rupee denominated credit growth to 18%. An additional 5% was allowed to banks that bridge the gap with funds raised abroad. The credit ceiling was allowed to expire on 31 December 2012.
(e) Effective from 01 July 2013

- **An average broad money growth rate of 15 per cent was targeted for 2013 based on a projected real GDP growth of 7.5 per cent and expected inflation, as measured by the implicit GDP deflator, of 7 per cent.** The monetary programme was subsequently revised taking into consideration the sluggish growth of credit to the private sector and the reduction in the SRR during the year. While the targeted average growth in broad money was maintained at 15 per cent, the target for reserve money

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



growth was revised down to 3.1 per cent, taking into consideration the increase in the money multiplier as a result of the reduction in the SRR. To provide licensed commercial banks (LCBs) with greater flexibility in managing their liquidity, the period for reserve maintenance was extended to approximately 15 days with effect from May 2013.

- **Reserve money was maintained within the targets stipulated under the monetary programme during the first and third quarters of 2013, while remaining marginally above the targeted level during the second quarter**. In July 2013, the Central Bank revised down its target for reserve money taking into consideration the higher money multiplier as a result of the reduction in the SRR. On a year on year basis to September 2013, reserve money contracted by 1.6 per cent. The sluggish growth in currency in circulation reflected the slowdown in economic activity, while commercial bank deposits with the Central Bank contracted as a result of the reduction in the SRR. On the source side, the contraction in reserve money was the result of a decline in net domestic assets (NDA), as net foreign assets (NFA) of the Central Bank increased. The sharp reduction in the holdings of government securities of the Central Bank contributed to an overall decline in NDA of the Central Bank, despite the decline in other liabilities as a result of a reduction in retained earnings, a transfer of profits to the government and valuation changes due to exchange rate movements, which led to an increase in NDA. NFA of the Central Bank declined up to end July due to the repayment of foreign loans, valuation losses caused by the reduction in the price of gold in the international market and a reduction in the market value of foreign investments, particularly of US Treasuries. However, NFA increased in August as a result of the Central Bank entering into foreign currency swap agreements with commercial banks.

- **In response to the tight monetary policy measures adopted in 2012, year-on-year growth in broad money (M_{2b}) moderated to 15.3 per cent in August 2013 from 17.6 per cent at end 2012.** The growth of broad money was mainly on account of the expansion in NDA of the banking system, as NFA of the banking system contracted during this period. In the first eight months of the year, NFA declined by Rs. 191 billion due to a contraction in NFA of commercial banks, while the NFA of the Central Bank increased marginally. The decline in NFA of commercial banks was mainly due to the utilisation of commercial bank assets abroad to settle import bills, the utilisation of funds raised abroad for swap arrangements with the Central Bank, and an increase in investments in Sri Lanka Development Bonds (SLDBs). NDA of the banking system increased significantly by around Rs. 506 billion during the first eight months of 2013 due to the substantial increase in credit to the government, as credit to the private sector and public corporations moderated.

- **Responding to the easing of the monetary policy stance, market interest rates adjusted downwards during the ten months to October 2013, albeit with varying time lags.** The average weighted call money rate (AWCMR) declined by 197 basis points to 7.86 per cent by end October 2013 reflecting the impact of overall monetary policy easing, including the lowering of policy interest rates and the SRR, while remaining broadly within the policy rate corridor. The reduction of policy interest rates in December 2012 and in a further two steps in May and October 2013, increased levels of liquidity, improved foreign investor appetite and lower credit disbursement by banks to the private sector exerted downward pressure on the yield rates of government securities. Consequently, yield rates on 91-day, 182-day and 364–day bills declined by 144, 232 and 186 basis points, respectively during the year, to 8.56 per cent, 9.00 per cent and 9.83 per cent, respectively by end October 2013. Deposit rates, which continued to rise with increased competition in the banking sector and aggressive deposit mobilisation by commercial banks, gradually responded to the reduction in policy rates. The average weighted deposit rate (AWDR), which reflects interest rates on all interest bearing deposits held by the public with commercial banks, declined during the year by 31 basis points to 9.79 per cent by end October 2013. The average weighted fixed deposit rate (AWFDR), which reflects the movement of interest rates on all interest bearing time deposits held by the public with commercial banks declined during the year by 83 basis points to 12.38 per cent by end October 2013. Except the prime lending rate, other lending rates of commercial banks were slow to adjust to the easing of monetary policy. The monthly average weighted prime lending rate (AWPR), which reflects the interest rate on new loans and advances granted by commercial banks to their prime customers, declined by 284 basis points during the year to 11.45 per cent by end October 2013, while the average weighted lending rate (AWLR) declined by only 27 basis points during the year to 15.71 per cent by end September 2013.

- **The soundness and stability of the financial sector was maintained, while the sector continued to facilitate economic growth.** The outreach of the financial sector also widened with the expansion of the branch network of banks as well as licensed finance companies (LFCs). The key indicators of financial stability, i.e., the capital adequacy ratio and the liquidity ratio of the banking sector were maintained at healthy levels, well above statutory requirements. However, banks experienced a slowing down of credit as well as some deterioration in asset quality and profitability. Tight monetary policy measures adopted in 2012 continued to affect credit to the private sector. The deterioration in asset quality was mainly in the pawning portfolio, resulting from the sharp fall in the price of gold. The narrowing of interest rate margins as well as increased provisioning and write-offs contributed to the decline in profitability of the banking sector. The Central Bank strengthened the regulatory and supervisory framework through continuous supervision of the banking sector to identify the buildup of potential risks and by adopting regulations to minimise risks. Deposit mobilisation and credit growth in LFCs and specialised leasing companies (SLCs) expanded despite strong competition in the financial sector, although asset quality in the sector deteriorated. The capital and liquidity positions of these companies were also further strengthened. The insurance industry grew in terms of total assets and premium income, although profitability in the industry declined. The slowdown in motor vehicle registrations, high operational costs and the decline in investment income in the general insurance sector, had a significant bearing on the profitability of the industry. The performance of the Colombo Stock Exchange improved during the period ending October 2013 with all key indicators rising. The All Share Price Index (ASPI) and the S&P SL 20 index increased by 5.2 per cent and 6.0 per cent, respectively, during the first ten months of 2013, while market capitalisation increased to Rs.2.5 trillion by end October 2013 from Rs. 2.2 trillion at end 2012. Four rights issues which raised Rs. 1.4 billion mainly contributed to the increase in market capitalisation. Declining domestic interest rates, improved investor confidence and healthy earnings of coporates contributed to the growth in the equities market. Activity in the corporate debt market also increased during the year supported by the exemption of the withholding tax on interest earned from investments in listed debt as proposed in the budget for 2013.

International Economic Environment

- **While the global economy is expected to remain subdued, the key drivers of global growth are shifting from emerging and developing markets to advanced economies.** The global economy grew at 2.5 per cent during the first half of 2013, the same pace as in the second half of 2012. According to the IMF's forecast in the World Economic Outlook published in October 2013, the global economy is expected to expand by 2.9 per cent, 0.4 percentage points lower than the forecast made in April 2013 and below the 3.2 per cent growth recorded in 2012. While growth is expected to pick up in advanced economies, emerging market economies will continue to account for a larger share of global growth. However, there are several risks arising from the continued uncertainty regarding the US debt ceiling and the impact of the possible tapering of quantitative easing measures on emerging market economies.

- **Recent developments indicate that while growth in advanced economies is picking up, emerging economies are entering a slow phase of economic growth.** Advanced economies are projected to expand by 1.2 per cent in 2013 and 2 per cent in 2014. A large share of this growth is expected from the US with the easing of fiscal consolidation measures and a continuation of supportive monetary policy measures. The euro area is expected to further recover as indicated by continued improvement in business indicators. The global economy faces new downside risks from the political impasse in the United States which led to a shutdown of the US federal government for 16 days in October 2013. Growth in Japan is expected to remain subdued as the expansionary policy stance will be offset to some extent by higher consumption taxes.

- **Emerging market economies are expected to slowdown, reversing the strong growth seen in the recent past with the slowdown in Brazil, China, and India accounting for most of this decline.** According to the latest forecasts by the IMF, emerging market economies are expected to grow by 4.5 per cent in 2013, which is 0.8 percentage points lower than the forecast in April 2013, and pick up marginally to 5.1 per cent in 2014. Tightening credit conditions in response to the expected unwinding of quantitative easing measures adopted by advanced economies, capacity constraints and less room for policy to support growth are some of the reasons for the expected slowdown in emerging market economies. However, an increase in exports as a result of the recovery in advanced economies and stronger domestic consumption could support economic activity in emerging market economies. The announcement of a possible tapering of the quantitative easing measures undertaken by the Federal Reserve Bank resulted in a reversal of capital flows from emerging markets to advanced economies increasing the volatility of global financial markets and currencies in emerging markets. Since this was the result of a one-time re-pricing of risk mainly due to the possibility of increasing bond yields in the US, the recent increase in financial market volatility is expected to dissipate gradually. However, if portfolio shifts persist, emerging markets could be exposed to higher financial market volatility.

- **Global inflation has moderated and is expected to remain subdued with the easing of commodity prices and continued negative output gaps in advanced economies.** However, risks to the inflation outlook may emerge due to the ongoing instability in the Middle-East, as it could affect international oil prices. In advanced economies, inflation remains below target and is not expected to return to the targeted level until growth reaches its potential. In the euro area, sluggish growth and downward pressure on wages are expected to maintain inflation below targeted levels, while Japan is expected to experience a temporary rise in inflation in response to the increase in consumption taxes in 2014. In emerging economies, declining commodity prices and slowing growth will weaken inflationary pressures, although capacity constraints may exert some upward pressure on prices.

Prospects for 2014

- **The Sri Lankan economy is projected to grow at a higher rate of around 8 per cent in 2014**. The recovery in the global economy, continued expansion of domestic economic activity and the impact of growth oriented policy measures adopted in 2013 are expected to accelerate economic growth in 2014. Domestic output is expected to increase in line with changing lifestyles of people and increasing penetration into global markets. In order to increase the production capacity of the country, investment activities are expected to expand continuously while greater emphasis on manufacturing output is also expected to stimulate demand for services such as trade, transportation, communication and banking. The expansion in tourism and related services is also expected to contribute to higher economic growth. Favourable weather conditions and continued government support are expected to raise output in the agriculture sector in 2014.

- **Inflation is projected to remain at mid-single digit levels during 2014**. However, a rebound in the growth of credit aggregates without a commensurate decline in credit to the public sector, and the possible strengthening of global commodity prices, aided by a gradual increase in global growth continue to pose upside risks to inflation in the period ahead. With favourable supply side developments in both domestic and external sectors and prudent monetary management, inflation on both year-on-year and annual average bases are projected to remain below 6 per cent at end 2014.

- **With the gradual recovery of Sri Lanka's main export markets in 2014, export earnings are expected to expand, while imports are envisaged to rise to cater to the demand created by an increase in production of exports and higher economic growth.** Earnings from exports are expected to grow by 12.7 per cent to US dollars 11.2 billion in 2014. This growth will be driven by all three sectors. Industrial exports, which account for the largest share of exports, are expected to increase significantly. This growth is largely due to the expected recovery in the US and EU economies, which continue to be the main markets for Sri Lanka's industrial exports. Agricultural exports are also expected to increase supported by higher prices and volumes for tea, rubber and coconut exports, while export of minor agricultural products and spices are expected to increase due to improved promotional activities in international markets, and higher global demand due to changing consumption patterns in major markets. Meanwhile, expenditure on imports is expected to increase by 13.1 per cent to US dollars 21.6 billion in 2014 reflecting an increase in all categories. Increased consumer spending due to economic growth and higher per capita incomes, higher imports of intermediate goods for production of exports and power generation as well as an increase in imports of investment goods for infrastructure development will drive import expenditure in 2014. As expenditure on imports is expected to increase at a higher rate than the increase in earnings from exports, the trade deficit is expected to increase by 13.5 per cent in 2014. This increase is somewhat high due to the low base in 2013, as the trade deficit is expected to decline by 2.6 per cent in 2013. However, as a percentage of GDP, the trade deficit is expected to increase only marginally to 13.8 per cent in 2014.

- **The expected gradual recovery in the global economy, improved infrastructure facilities, the gradual relaxation of capital controls and improved investor confidence amidst a stable macroeconomic environment are expected to yield a surplus in the BOP in 2014.** The satisfactory performance in the services account in recent years is expected to continue, facilitated by higher earnings from tourism, improved port and airport related activities and information technology services. Workers' remittances, which have grown at a rapid pace during the recent past, are expected to maintain the momentum, supported by an increase in labour migration under the professional and skilled categories, improved awareness regarding the benefits of transferring money through formal channels and the introduction of new web based money transferring systems. This, along with the expected improvement in the trade account following a recovery in global economic activity, is expected to contribute considerably to narrowing the external current account deficit in 2014 to around 3.1 per cent of GDP, from the 4.3 per cent projected for 2013. Meanwhile, the increase in foreign financing raised by the government and the private sector and expected higher FDI, inflows to the capital and financial account are projected to increase in 2014. Reflecting these improvements, the overall BOP is expected to record a surplus of around US dollars 1.1 billion in 2014, compared to the expected surplus of US dollars 700 million in 2013. Accordingly, gross official reserves are expected to reach US dollars 7.6 billion in 2014, which is equivalent to 4.2 months of imports.

- **As envisaged in the Medium Term Macro Fiscal Framework, further consolidation is expected in the fiscal sector, with the budget deficit expected to be reduced to 5.2 per cent of GDP in 2014 from 5.8 per cent of GDP estimated for 2013.** In this context, a strong commitment would be necessary to increase government revenue and to rationalise recurrent expenditure, while maintaining public investment at a level that will support the envisaged high economic growth.

- **The Monetary Programme envisages broad money to grow by 15 per cent in 2014, driven by a pick up in credit to the private sector, while credit granted to the public sector is projected to moderate.** The government's continued commitment to the fiscal consolidation process accompanied by the downward adjustment in market interest rates in 2014 is expected to raise credit to the private sector to desired levels. However, the higher volume of credit available to the private sector should be directed towards productive sectors of the economy, thereby minimising the risk to macroeconomic stability.