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NATIONAL OUTPUT AND EXPENDITURE

The Sri Lankan economy grew by 6.3 per cent during the first half of 2013 compared to the 7.2 per cent growth recorded during the first half of 2012. This was achieved despite a number of challenges faced by the economy including the lagged effect of tight policy measures introduced during the first half of 2012, the impact of unfavourable weather conditions and weak global demand. The sluggish growth in private sector credit and the downward revision in global growth estimates were main indicators of subdued domestic and external demand respectively. The expansion in construction activities, transport services and increased factory industry output were the main contributors to economic growth during the first half of the year. However, growth momentum is projected to accelerate during the second half of the year due to favourable weather conditions which will help to improve domestic agricultural output and hydro power generation together with the expansion of domestic economic activities with the easing of the monetary policy stance and improvements in the external sector with the gradual recovery in advanced economies. Further, the continued expansion in construction, transport, manufacturing and tourism sectors would also contribute to the growth during the remainder of the year supporting to achieve the annual growth projection of over 7 per cent in 2013.

Developments in 2013

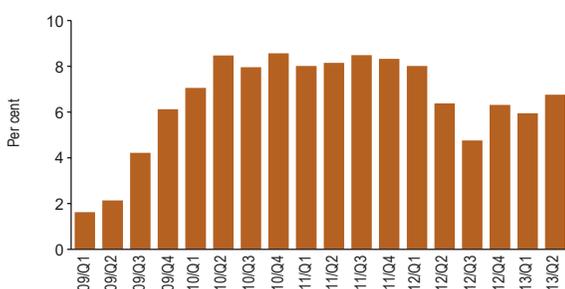
Output

- **Gross Domestic Product (GDP) growth of 6.3 per cent registered during the first half of 2013 was well supported by the growth of the Industry sector, with the continuous expansion of construction and mining and quarrying sub sectors.** The Industry sector grew by 10.4 per cent while factory industry, which is the largest sub sector within the Industry sector, recorded a positive growth rate albeit at a marginally slower pace than during the first half of 2012. The Services sector recorded a growth of 5.5 per cent during the first half of the year. Wholesale and retail trade sub sector, which accounts for the largest share in the GDP, slowed down during the first half of the year due to the contraction in external trade activities. However, the higher growth registered in transport activities together with the healthy expansion in domestic trade, financial services, government services and private services supported growth in the Services sector. Meanwhile, the Agriculture sector recorded a marginal growth of 0.5 per cent over the relatively high growth of 10.4 per cent recorded during the first half of 2012. Unfavourable weather conditions constrained the output in the domestic agriculture sector particularly in paddy production and other food crops,

which includes vegetables, highland crops and fruits. Within the export agriculture sector tea production recorded a positive growth, while rubber and coconut production contracted during the first half of 2013.

- **The economy is projected to grow at over 7 per cent in 2013 compared to the 6.4 per cent growth recorded in 2012.** Higher growth during the second half of the year over the relatively low growth of 5.5 per cent in the corresponding period of 2012 would be supported by an increase in agricultural production, particularly due to the higher production in both paddy and other food crops in the Yala season as a result of favourable weather conditions. Within the Industry sector, the construction sub sector is projected to grow at a healthy level while the growth momentum in the mining and quarrying sub sector is expected to continue. The factory industry sub sector is also expected to grow at a higher rate during the second half of 2013 with the expansion of industries such as textiles and wearing apparels, rubber based products, ceramics including floor and wall tiles, and ships and boats. Services sector growth is also projected to increase at a higher rate than in the second half of 2012 particularly with the expected expansion in the external trade sector, which recorded a negative growth in the previous year. Further, transportation, financial services and hotels and restaurants sub sectors are also expected to perform favourably during the second half of the year.

Chart 2.1 Quarterly GDP Growth Rates



Sectoral Performance

Agriculture

- **The Agriculture sector recorded a marginal growth of 0.5 per cent during the first half of 2013 over the high growth of 10.4 per cent in the first half of 2012.** This slowdown in the Agriculture sector was mainly due to

Table 2.1

Agriculture Production Index
(2007-2010=100)^a

Item	2012 First Half(b)	2013 First Half(c)	% Change
Agriculture and Fishing	124.6	125.0	0.3
1 Agriculture	122.3	122.2	-0.1
Tea	105.4	111.6	5.8
Rubber	123.0	93.1	-24.3
Coconut	105.6	90.0	-14.7
Paddy	145.3	152.2	4.8
Other Crops	129.9	128.0	-1.5
Livestock	114.1	125.8	10.3
2 Fishing	135.3	138.4	2.2

Source: Central Bank of Sri Lanka

(a) The average values used for the base value in the half year production index was changed from the period 1997-2000 to 2007-2010.
(b) Revised
(c) Provisional

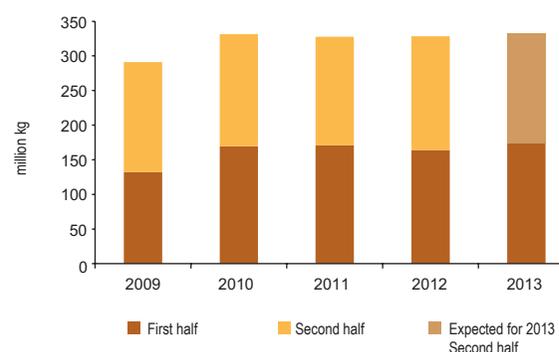
the significant decline in the value added contribution of coconut and rubber sub sectors while output of paddy and other food crops also slowed down during the period. Fish production increased albeit at a lower rate than in 2012 due to the adverse weather conditions that prevailed during the second quarter of the year. However, the marginal growth in the Agriculture sector was mainly due to an increase in tea, livestock and minor export crops. The Agriculture sector is projected to record a growth of around 4.5 per cent during the year with the significant growth in paddy production during the Yala season by about 37 per cent and increased output in other food crops. However, tea is expected to contract during the second half of the year, while fishing is also projected to slowdown.

Export Agriculture

- Tea production during the first half of 2013 increased by 6 per cent to 173.8 million kg with the highest growth of 6.5 per cent recorded in low grown areas. This was mainly due to favourable weather in all major growing areas particularly during the first five months with rain continuing even in months which are normally considered dry periods. Despite the setback recorded in tea production in June 2013, total production of tea during the first half of 2013 was the highest recorded output

Chart 2.2

Tea Production



during the corresponding periods of the last five years. The increase in tea production during this period was evident in all three elevations. The production of smallholders increased by 8 per cent to 123 million kg from 114 million kg during the first half of 2013. The average yield of smallholders also increased to 2,112 kg per hectare during the first half of 2013 from 1,960 kg per hectare during the same period of 2012 supported by favourable weather conditions and high prices for green leaf. Total tea production in 2013 is estimated to increase by 0.5 per cent to 330 million kg in comparison to the previous year.

- Average price of tea remained high at the Colombo Tea Auction (CTA) over the previous year. In the first quarter of 2013, high and medium grown tea prices increased by around 25 per cent (y-o-y), to Rs. 417.50 per kg and Rs. 389.70 per kg, respectively and low grown tea prices increased by 19 per cent to Rs. 441.70 per kg. However, the average tea price of high and medium grown teas declined to Rs. 354.65 per kg and Rs. 378.63 per kg, respectively, during the second quarter, while low grown tea prices increased to Rs. 452.27 per kg. The average net sales price of tea increased to Rs. 422.80 per kg during the first half of 2013 from Rs. 375.90 per kg during the corresponding period of the previous year, enabling producers to

withstand the increased cost arising from higher wages, revision to electricity tariffs and higher green leaf prices. The average price received by smallholders for green leaf increased from Rs. 54.96 per kg during the first half of 2012 to Rs. 61.82 per kg during the first half of 2013.

- **Total rubber production declined by 24 per cent to 62,451 metric tons during the first half of 2013 compared to the corresponding period of 2012.** The decline in total rubber production was largely due to torrential rainfall which prevailed right through this period reducing the number of tapping days. The relatively low producer prices also contributed to some extent to the lower levels of production of smallholders. During the first half of 2013, sheet rubber production declined by 13.6 per cent to 27,885 metric tons and latex crepe rubber declined by 60.8 per cent to 7,168 metric tons.
- **The declining trend in rubber prices which started from the beginning of 2012 continued during the first half of 2013 as well.** Improvements in supply from major producing nations leading to increased stockpiles, together with a decline in demand from countries like China, due to a slowdown in growth in major export markets such as the Euro region have contributed to the decline in international rubber prices. The price at the Colombo Rubber Auction (CRA) followed the trend in global markets. At the CRA, the average price of Ribbed Smoked Sheet 1 (RSS1) declined by 12 per cent to Rs. 383.30 per kg and latex crepe 1X declined by 10 per cent to Rs. 383.70 per kg, during the first half of 2013 compared to the corresponding period of 2012. During this period, the export price of RSS1 and latex crepe 1X also declined by 7 per cent to Rs. 426 per kg and 9 per cent to Rs.389 per kg, respectively. Domestic rubber consumption also declined to 51,847 metric tons from 57,009 metric tons during the first half of 2013 reflecting the

contraction in industrial production partly due to falling export demand as well as the lack of availability of quality latex rubber.

- **Coconut production declined significantly by about 14.7 per cent to 1,275 million nuts during the first half of 2013 from 1,495 million nuts during the corresponding period of 2012.** The decline in coconut production was mainly due to the lag effect of lower rainfall in major coconut growing areas during the previous year. Accordingly, coconut oil production also declined by around 33 per cent to 25,786 metric tons during the first half of 2013 from 38,498 metric tons during the first half of 2012. The decline in coconut oil production in the domestic market was met by an increase in palm oil imports despite the upward revision in the Special Commodity Levy (SCL) on palm oil imports to Rs. 115 per kg with effect from February 2013, as even after taxes, the average palm oil price remained below the coconut oil price during this period. Accordingly, the import of palm oil increased by 30 per cent to 39,537 metric tons during the first half of 2013. Meanwhile, desiccated coconut (DC) production also declined sharply by 54 per cent to 11,186 metric tons during the first half of 2013 due to the slowdown in export demand and reduced coconut supply. Given the present cost structure, Sri Lanka has not been able to expand its share of DC in the international market. Therefore, it would be necessary to take measures to increase the production and export of products such as virgin coconut oil, coconut milk powder and coconut cream, in line with the projected increase in coconut production over the medium term.
- **The price of coconuts and coconut products which include copra, coconut oil and desiccated coconut increased during the first half of 2013 due to the decline in coconut production.** The average auction price of coconuts increased

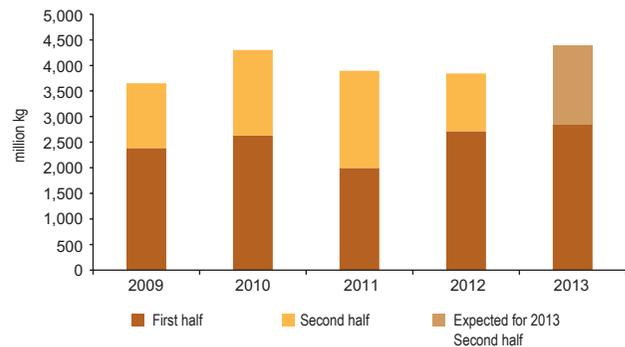
to Rs. 36 per nut during the first half of 2013 from Rs. 25 per nut during the same period in 2012. The average price of coconut oil increased to Rs. 244.30 per kg from Rs. 211.40 per kg during the corresponding period of 2012 largely due to the shortage of coconut supply which caused copra prices to increase considerably. The average DC price at the Colombo Coconut Auction also increased to Rs. 218 per kg from Rs. 177 per kg during the corresponding period of 2012. Despite the increase in DC prices, the average export price of DC declined during the first half of 2013 to US dollars 1.36 per kg from US dollars 1.77 per kg during the first half 2012 reflecting a contraction in the profit margins of DC producers during the first half of 2013.

Domestic Agriculture

- **Despite the significant crop damage, paddy production in the 2012/13 Maha season increased by 4.8 per cent to 2.846 million metric tons mainly due to an increase in the extent cultivated in the North Central, Eastern and Northern provinces.** The total extent cultivated during the season grew by 11 per cent, to 779,635 hectares over the previous Maha season supported by favourable weather conditions and an increase in the guaranteed price of paddy in the government budget for 2013. The provinces with the highest extent under cultivation such as the North Central, Eastern and Northern provinces also reported significant crop damage due to floods and heavy rains. As a result, paddy yield of these provinces also declined to 3,894 kg per hectare from 4,531 kg per hectare during the previous Maha season. This also affected the national average yield of paddy which declined to 4,281 kg per hectare in the Maha season from 4,444 kg per hectare in the previous Maha season. In the North Western Province, the extent sown increased by 35 per cent, and accordingly paddy production grew significantly by 74 per cent supported by less

Chart 2.3

Paddy Production



crop damage. Paddy production in the 2013 Yala season is expected to increase significantly by 37 per cent to 1.54 million metric tons due to sufficient rainfall and high water levels in reservoirs in major cultivating areas and remunerative paddy prices. Accordingly, total paddy production in 2013 is estimated to increase by 14.1 per cent to 4.389 million metric tons from the previous year.

- **Total production of other field crops (OFCs) declined by 7 per cent to 528,238 metric tons in 2012/13 Maha season over the previous Maha season.** Although the Special Commodity Levy (SCL) on imports which continued from 2012 helped many domestic OFC varieties to fetch high producer prices, the production of major OFCs such as maize, green gram, cow pea, black gram, gingelly, ground nuts, sweet potatoes, potatoes, red onion and chillies declined during the Maha season mainly due to adverse weather conditions that prevailed from October 2012 to January 2013, the period during which cultivation is normally undertaken. It is estimated that around 8,358 hectares of lands of OFCs were affected by floods during the Maha season. Further, high paddy prices also encouraged farmers to increase the extent under paddy cultivation in some of the lands where OFCs are otherwise grown. Notably, the cultivated extent of OFCs declined by 4,950 hectares in the 2012/13 Maha season from the 2011/12 Maha season. In anticipation

of a better harvest during the Yala season, the SCL on certain imports such as potatoes and big onions was increased in May, June and August 2013 in order to protect domestic farmers.

- **Vegetable production improved only marginally by 0.4 per cent to 557,032 metric tons in 2012/13 Maha season due to flood damage during December 2012 and also due to heavy rains in January 2013 which resulted in a loss of harvest.** As a result of the heavy rain from October 2012 to January 2013 along with the flood in December 2012, the actual commencement of cultivation in the Maha season was delayed by almost two months. This delayed the commencement of the 2013 Yala cultivation to May 2013 in many major producing areas. However, the heavy rains at the early stage of the Yala season increased yields in all low country vegetable producing areas.

Fishing

- **Growth in fish production moderated during the first half of 2013. During this period, total fish production increased by 2.3 per cent to 230,860 metric tons.** This was a combined outcome of an increase in marine fish production by 5.6 per cent and a decline in inland fishing by 23 per cent. Of the increase in marine fish production, deep sea and coastal fish production grew by 4.7 per cent and 6.1 per cent, respectively. However, in the first quarter, total marine fish production increased significantly by 15.1 per cent to 110,910 metric tons largely due to favourable weather conditions in the Southern coast. During the first quarter, marine fish production in the Southern Province grew by 34.5 per cent to 34,820 metric tons. However, in the second quarter, total marine fish production declined by 9.1 per cent to 93,770 metric tons due to extreme weather conditions in May and June. The contribution of all the provinces declined considerably during the second

quarter except in the Southern Province, which registered a growth of 26.5 per cent to 31,510 metric tons, despite the destruction caused by adverse weather conditions. This was largely due to the unloading of fish by multiday boats operating in the deep seas in the Southern fishery harbours. The share of the Northern Province in total marine production declined during the first half of 2013 partly due to adverse weather conditions. During this period, marine fish production of the Northern Province declined by 17 per cent to 26,060 metric tons. During the first half of 2013, inland fish production declined by 23 per cent partly due to the lagged effect of the drought which resulted in a depletion of resources in inland reservoirs.

Industry

- **The Industry sector continued to perform well, growing by 10.4 per cent in value added terms during the first half of 2013, over the growth of 10.2 per cent during the corresponding period of 2012.** Two major sectors namely, electricity, gas and water, and construction grew at higher rates compared to the first half of 2012, while the other two major sectors, mining and quarrying, and manufacturing, recorded a marginal slowdown. The sector is projected to register a growth of around 10 per cent during the year.

Mining and Quarrying

- **The mining and quarrying sub sector expanded by 15.5 per cent during the first half of 2013, compared to the 20.6 per cent growth recorded during the corresponding period of 2012.** Gem and other mining activities grew by 4.8 per cent and 19 per cent respectively. The growth observed in other mining activities was mainly due to the expansion in extraction of construction related materials including sand which grew in line with increased demand associated with

growth in the construction sector. Meanwhile, the slowdown in growth observed in this sub sector, was due to the decline in production of mineral sand, graphite and phosphate. Further, the lower value added contribution in gem mining was associated with the decline in gem exports during the first quarter of the year.

Manufacturing

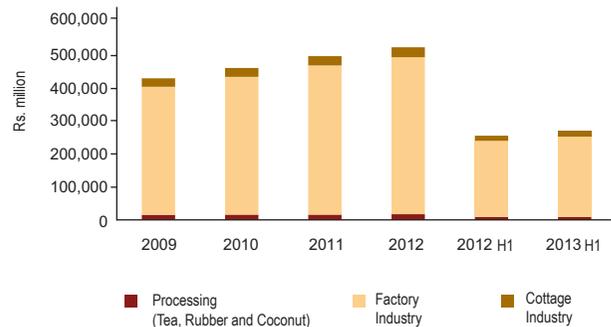
Processing

- The processing sub sector, which consists of tea, rubber and coconut processing, grew marginally by 0.9 per cent, compared to the growth of 6.5 per cent recorded during the first half of 2012. This slowdown in growth in the processing industry was mainly due to the deceleration of rubber and coconut production even though tea production expanded during the first half of 2013. The contraction of the rubber processing industry was mainly due to the reduction of rubber production on account of adverse weather conditions together with price reductions, which discouraged producers. The coconut processing industry also contracted during the first half of 2013 owing to the decline in coconut production due to the lagged effect of the drought that prevailed during the last year.

Factory Industry

- In terms of value addition, factory industry which is the major contributor to the manufacturing sub-sector grew by 6.2 per cent during the first half of 2013. Food, beverages, textiles, wearing apparel, rubber and plastic products, cement, ceramic products and fabricated metal products largely contributed to factory industry output during this period. The improved external environment for Sri Lankan exports together with favourable domestic demand, buttressed by increased tourism activities and sustained infrastructure

Chart 2.4 Value Added in Manufacturing Sector

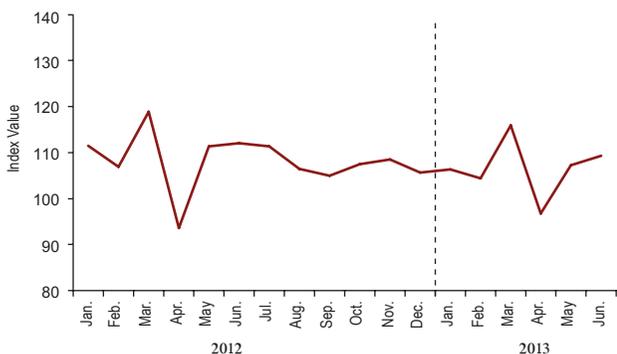


development initiatives, supported the increase in value addition of factory industry during the first half of 2013. Food, beverages and tobacco products and non-metallic mineral products categories, which mainly focus on the domestic market, grew by 6.2 per cent and 4.9 per cent, respectively while the textile, wearing apparel and leather products category catering to demand from the export market, grew by 6.5 per cent during the first half of 2013. Meanwhile, chemical, petroleum, coal, rubber and plastic products and fabricated metal products categories, which focus on both domestic and international markets, increased their value addition by 6.1 per cent and 6.0 per cent respectively, during the first six months of 2013.

Factory Industry Production Index

- Factory Industry Production Index (FIPI), a leading indicator of industrial output, showed a mixed performance during the first half of 2013. Textile, wearing apparel, basic metal products, fabricated metal products and electrical equipment are the major sub-sectors that positively contributed to factory industry output during the first half of 2013. However, food products, beverages, tobacco products, coke and refined petroleum products, chemicals and chemical products, rubber and plastic products and other non-metallic mineral products sub-sectors negatively contributed to the output

Chart 2.5 Factory Industry Production Index (FIPI) (2010 = 100)



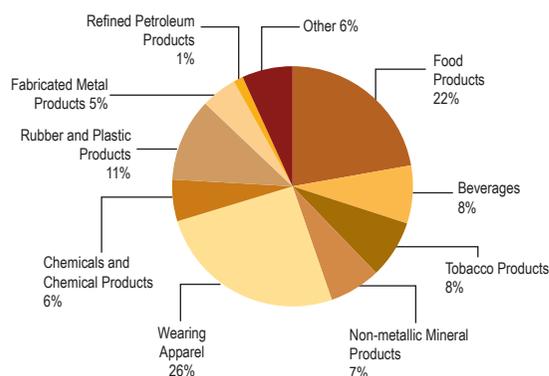
of the factory industry. Accordingly, year-on-year change of FIPI declined by 2.2 per cent during the first half of 2013.

- Export oriented industries continued to focus on quality and productivity enhancing initiatives to maintain competitiveness in the international market.** Wearing apparel and ship building and repairing industries which focus on export markets contributed positively towards increasing factory industry output during the first half of 2013. The wearing apparel sub-sector index recorded an increase of 0.8 per cent during the first six months of 2013 reflecting the demand for niche Sri Lankan products which are produced utilising ethical and environmentally sustainable production processes. Moreover, the focus on innovation and design capabilities together with the sourcing of materials and delivery of garments in short time cycles at lower cost has enabled the apparel industry to maintain its competitiveness. Meanwhile, the textile industry benefited from the demand arising from the wearing apparel industry and increased demand for local fabrics from tourists. The shipbuilding and repairing industry also performed well with increased export orders during the first half of 2013.
- Domestic market oriented industries were supported by increased economic activities including construction and renovation of housing and business places.** Better tourist

demand for leather based products and expanded sales of leather based footwear products especially in the Northern and Eastern provinces helped to enhance the output of leather and related products which recorded a 2.9 per cent increase during the first six months of 2013. The indices of basic metal products and wood products, except furniture, recorded increases of 1.4 per cent and 12.1 per cent during the first half of 2013 compared to the corresponding period of 2012, respectively, supported by increased housing and construction activities including in the Northern and Eastern provinces.

- Food, beverages and tobacco products sub-sectors, which contribute more than 40 per cent to factory industry output, recorded a mixed performance during the first half of 2013.** According to the FIPI, production of preserved fish and meat, prepared meals and dishes, noodles, and similar products, manufactured cocoa, chocolate and sugar confectionery contributed positively to the output of the food product sub-sector during the first half of 2013. However, indices of a few sub sectors such as starches and starch products, dairy products and bakery products recorded a decline during the first six months of 2013, which was partly reflected in the lower output of wheat flour during the first half of 2013 in comparison to the corresponding period of the

Chart 2.6 Composition of Factory Industry Production Index (FIPI) - First Half 2013



previous year. Meanwhile, based on the FIPI, the output of milk powder also declined during the first six months of 2013 with continued institutional support given for increasing the local production of fresh milk. Similarly, indices related to beverages and tobacco sub-sectors also declined reflecting the contraction of demand during the first six months of 2013.

- **Several geo political developments and domestic factors such as increased cost of production and contraction of demand also influenced the output of factory industry during the first half of 2013.** Refined petroleum products and chemicals and chemical products sectors contracted during the first half of 2013 mainly due to the sanctions imposed by the US on Iran, which led to disruptions in the supply of crude oil to Sri Lanka, resulting in a decline in oil being refined by the CPC and a decline in the production of fertilizer. Even though gloves production posted a strong growth during the first half of 2013, manufacture of the rubber and plastics products sector declined by 3.3 per cent due to the deceleration in the production of tyres, tubes and plastic products resulting from the decline in demand from both domestic and international markets. Further, high energy costs affected production of glass and glass products and non-metallic mineral products which led to a decrease in the production level during the first half of 2013.
- **Government initiatives to promote regional industrialisation continued during the first half 2013.** Industrial estates play a significant role to support investors including small and medium entrepreneurs. At present, there are 26 industrial estates in operation island wide which contribute towards regional industrialisation. Entrepreneurs who were affected by the conflict in the Northern and Eastern provinces were supported by the '*Wadakkil Wasantham*' and '*Nagenahira Navodaya*' programmes of

which, stage I of the Trincomalee industrial estate has been completed and 3 industries are now in commercial operation, providing 450 employment opportunities. Meanwhile, Thiraimadu has been identified as a location to establish an industrial estate in the Batticaloa district. Considering the potential for salt based industries, manufacturing fishing gear, boat manufacturing, fish processing and palmyrah based industries, the government has taken initiatives to establish industrial estates in Mannar and Mullativu districts in the Northern Province. Meanwhile, BOI has approved the establishment of a garment factory in the Northern Province with an investment commitment of Rs.506 million which is expected to provide around 2,500 employment opportunities.

- **Several incentives were given by the government through the budget and its line ministries to promote domestic industries.** Small and medium enterprises (SMEs) were exempted from the Nation Building Tax (NBT) and the Value Added Tax (VAT), if their turnover was less than Rs.12 million. Meanwhile, credit facilities were extended to small and medium enterprises through several participating financial institutions at concessional interest rates. Further, the government has recognised the importance of encouraging local canned fish and vegetable oil producers. With a view to supporting them, the Special Commodity Levy (SCL) on imports of canned fish and vegetable oil was increased in the budget for 2013. In addition, to facilitate the expansion of export oriented industries, the 2013 budget has given tax relief to export oriented industries by allowing a deduction of fifty per cent of the cost of acquisition of any plant, machinery or equipment from their assessable income per year over a period of two years for the calculation of corporate tax.
- **SMEs were encouraged by the government in order to support employment generation and livelihood development in rural areas.** The SME sector was strengthened by the activities

of the National Enterprise Development Authority (NEDA) through its District Enterprise Forums and ‘Gamata Obina Viyapara’ programme. Further, NEDA conducted business development service fairs in regions with the support of regional chambers to establish the relationship between business development service providers and SMEs. In addition the Ministry of Traditional Industries and Small Enterprise Development has taken the initiative to reactivate the Achchuveli small and medium scale industrial estate in the Jaffna District to facilitate small and medium industries.

Cottage Industry

- The value added in the cottage industry sub sector expanded by 4.4 per cent during the first half of 2013, compared to 5.5 per cent growth observed in the first half of 2012. This sub sector largely benefited from the growth in the construction sub sector and the activities undertaken by the cottage industries promotion segment of the Divi Neguma National Programme.

Electricity, Gas and Water

- The electricity, gas and water sub sector grew by 13.6 per cent during the first half of 2013, compared to a growth of 5 per cent during the corresponding period of 2012. The growth in the electricity, gas and water sector was largely supported by a 15.2 per cent increase in the value added of the electricity sub sector, which was mainly due to the increase in hydro power generation. Hydro power generation increased significantly by 142.6 per cent due to favourable weather conditions as well as the low base of the previous year. Meanwhile, thermal power generation decreased by 38.6 per cent due to increased reliance on hydro power for electricity generation. The addition of Upper Kothmale power plant to the national grid during the

second half of 2012 and the Uthuru Janani project that commenced operations during the first half of 2013 contributed to the increase in generation capacity and a more cost effective power generation mix. However, with the reduction of gas sales, value added from the gas sub sector declined by 1.2 per cent while the water sub sector contributed to the overall growth expanding by 3.9 per cent.

Construction

- During the first half of 2013, value added in the construction sub sector expanded by 18 per cent, continuing the growth momentum of 17.9 per cent recorded during the corresponding period of 2012. The key indicator of growth in this sub sector, construction material availability which is mainly represented by cement availability, grew by 9.9 per cent during the first half of 2013. The growth in this sub sector is also reflected in the import volume indices of building materials which grew by 15.7 per cent. Meanwhile, credit granted by banks to the private sector for construction activities increased reflecting the momentum of private sector construction activities. According to the price index compiled by the Institute of Construction, Training and Development (ICTAD), the cost of construction activities marginally slowed down during the first half of 2013 when compared to the corresponding period of 2012. Public sector construction projects which includes road developments such as the Outer Circular highway and the Colombo-Katunayake expressway as well as other road network improvement and rehabilitation projects, the construction of bridges and development of rail roads together with regional development programmes contributed substantially to the growth momentum in this sector.

Services

- The Services sector, which has the largest contribution to the economy, recorded a growth of 5.5 per cent during the first half of 2013 compared to the growth of 5.1 per cent during the corresponding period of 2012. This was achieved amidst an unfavourable external trade environment; spearheaded by the persistently sluggish recovery of the global economy. However, the deceleration in external trade was more than compensated by strong domestic growth especially in transport and communication, hotels and restaurants and domestic trade. Nevertheless, better performance in the Services sector could be expected during the second half of the year with support from external trade activities.

Wholesale and Retail trade

- Wholesale and retail trade sub sector, the major contributor of the Services sector, expanded by 3.5 per cent during the first half of 2013 against a growth of 5.3 per cent recorded during the corresponding period of 2012. This sub sector was experiencing restrained growth for the second consecutive year after achieving double digit growth in 2011. The slowdown in external trade due to the slower than anticipated global recovery was the main cause for the slow growth of this sub sector. This was also reflected in the export and import trade indices during the first half of the year. Consequently, both import and export trade sub sectors contracted by 0.2 per cent and 0.4 per cent, respectively in value added terms during the first half of the year. Conversely, the domestic trade sub sector continued its growth momentum expanding by 7.2 per cent during this period. With the recovery of external trade towards the end of the second quarter better performance in this sub sector is expected during the second half of 2013.

Hotels and Restaurants

- Hotels and restaurants which is one of the thriving industries in post-conflict Sri Lanka kept up to its expectations by recording a substantial growth of 19.8 per cent during the first half of 2013. The growth achieved by this sub sector during the first half of 2013 was marginally below the 22.6 per cent growth in the corresponding period of 2012. Despite the slow recovery from the world economic downturn, both tourist arrivals and earnings from tourism grew during the first half of the year. The momentum continued to the second half of the year, increasing the total number of tourist arrivals during the first three quarters by 15.5 per cent to 801,210 resulting in an encouraging growth in cumulative earnings from tourism by 24.2 per cent to US dollars 883.1 million. Hotel occupancy levels continued to be low in city hotels reflecting an increase in occupancy in unregistered hotels, guest houses and home stays; particularly outside Colombo. Meanwhile, hosting of the 23rd Commonwealth Heads of Government Meeting (CHOGM) in Sri Lanka in November would be a key opportunity to showcase the tourism industry.

Transport and Communication

- The transport and communication sub sector recorded a 9.5 per cent growth during the first half of 2013 against the 6.1 per cent growth recorded during the corresponding period of 2012. This growth was largely due to the 9.9 per cent growth in the transport sub sector, which includes railway, passenger and goods transportation. The passenger kilometres operated by the Sri Lankan Railways and both the Sri Lanka Transport Board and private bus operators grew by 27.8 per cent and 7.4 per cent, respectively during the period. Further, significant improvements could be seen in domestic air transport with an increase in passenger kilometres operated domestically

by airlines, supporting the tourist industry. Passenger kilometres operated by the two national airlines also expanded by 8.6 per cent during the first half of the year.

- **Cargo handling - ports and civil aviation sub sector grew marginally by 1 per cent during the first half of 2013 compared to the growth of 8.8 per cent recorded during the corresponding period of 2012.** The Port of Colombo transshipment throughput (excluding re-stowing) in terms of twenty-foot equivalent units (TEUs) improved by 4.4 per cent during the period. However, domestic container handling slowed down to 3.6 per cent. Further, the total cargo tonnage handled in the ports of Colombo, Galle, Trincomalee and Magam Ruhunupura Mahinda Rajapaksa (MRMRP) recorded a marginal improvement.
- **The post and telecommunication sub sector grew by 9.8 per cent during the first half of 2013 compared to the growth of 6 per cent in the corresponding period of the previous year.** Telephone density (fixed and cellular connections per 100 persons) marginally declined to 108.8 at end June 2013 from 111.7 at end June 2012 mainly due to the change in classification of a valid subscriber from this year. The main reduction was in Wireless Local Loop (WLL) phone subscribers, as fixed access wired subscribers and cellular mobile subscribers gradually increased. Further, considering the past trend and density levels, the industry could be reaching saturation level indicating a low level of future growth. However, there is a further scope for improvement in the industry with industrial innovations.

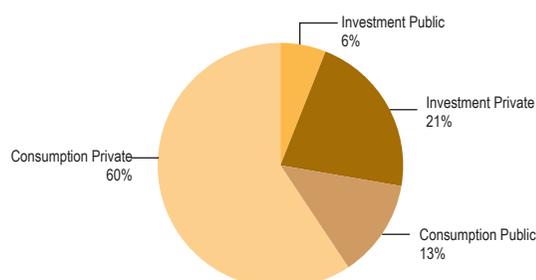
Banking, Insurance and Real estate

- **Value added in the banking, insurance and real estate sub sector improved by 6.2 per cent during the first half of 2013 compared to the 6.8 per cent growth achieved during the corresponding period of 2012.**

Restrictive monetary policy measures implemented in 2012 to stabilise the economy slowed down private sector credit reducing the profitability in the banking sector. Moreover, narrowing of interest margins, an increase in provisioning and write-offs together with higher operating expenses further reduced banking sector profits during the first half of 2013. Similar impact was observed in the performance of non-bank financial institutions during the period. Further, profit of the insurance industry also declined during the first half of 2013 compared to the corresponding period of 2012, despite the increase in gross written premiums of both life and general insurance segments.

Expenditure

- **According to the expenditure approach estimates, aggregate demand is projected to increase in nominal terms in 2013 but at a lower rate than in the previous year.** Both consumption and investment expenditure would slowdown, particularly with the anticipated deceleration in prices as reflected by an expected growth of around 7 per cent in the GDP implicit deflator when compared to the 8.9 per cent during 2012. As a result Gross Domestic Expenditure (GDE), which is the total expenditure on consumption and investment in the economy, is expected to expand by around 13.1 per cent in 2013. Further, GDP at market prices given by the sum of GDE and net exports is estimated to grow by 15 per cent to Rs. 8,716 billion. The relatively higher growth in GDP, compared to GDE, is due to the expected favourable performance in external trade, where exports of goods and services are projected to increase at a higher rate than imports in value terms during the year.
- **Consumption expenditure which includes both private and public spending is projected to record a growth of 11.9 per cent in 2013.** Private consumption expenditure (PCE) which

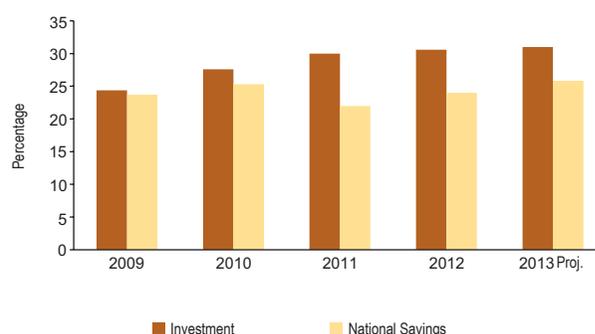
Chart 2.7 Composition of Domestic Demand - 2013

accounts for a share of around 82 per cent of total consumption expenditure would increase albeit at a lower rate than in 2012. This would be as a result of a slowdown in price levels and real expenditure on private consumption during 2013. Further, indicators such as consumer goods imports and banking sector credit for consumption purposes also reflect the lower level of growth in PCE to some extent as well. Increasing domestic income levels would also lead to changes in consumption patterns. As reflected by the preliminary report of the Household Income and Expenditure Survey 2012/13 which reveals that the share of consumption categories, such as transport, personal care and health, and clothing, textiles and footwear, in household expenditure has increased.

- According to provisional budget estimates, government consumption expenditure during 2013 is projected to increase at a higher rate than in 2012. Current expenditure of the government on salaries has risen by 11 per cent during the first half of the year. The increase in the Cost of Living Allowance from the beginning of the year and the full impact of the 2012 salary increase together with the absorption of graduate trainees accounted for the increase in the wage bill during this period. However, it is expected that public sector spending would remain in line with budget estimates for 2013.

Investment

- Investment, which provides an impetus for future economic expansion, is projected to increase during 2013. Gross domestic capital formation (investment) is projected to grow by 16.3 per cent during 2013 over the growth of 18.5 per cent in 2012. The construction sector which recorded a significant growth during the first half of the year is expected to provide the highest contribution to the expansion in investment activities with continued growth during the remainder of the year as well. Meanwhile, machinery and equipment imports that grew significantly in volume terms during the first nine months of the year also reflects the positive expansion in investment activities. Hence, investment as a percentage of GDP is expected to be around 31 per cent as projected.
- Private sector investment activities, which account for over 78 per cent of total investment, are expected to sustain investment growth in 2013. Investment on construction activities which account for a share of over 60 per cent of total investment, would be supported by private sector participation as reflected in the growth of credit for housing during the first half of 2013. Foreign direct investment have also improved reflecting higher private sector investment activity during the first half of the year. Meanwhile, the lower interest rates in the domestic economy and the decline in

Chart 2.8 Investment and Savings as a Percentage of GDP

prices of investment goods in the international market would be contributory factors towards the expansion of investment activities. An improvement in these indicators together with an increase in credit growth would further develop investment prospects during the latter part of the year.

Foreign Direct Investment

- **Infrastructure projects, manufacturing and service sectors are the major sectors attracting Foreign Direct Investment (FDI) absorbed US dollars 540 million during the first half of 2013.** FDI registered an increase of around 28 per cent during the first half of 2013 compared to the corresponding period of the previous year. More than 50 per cent of total FDI (US dollars 284.2 million) was on account of infrastructure development projects such as the construction of the Colombo South Port container terminals, telephone and telecommunication network development, housing property development and construction of office complexes. Meanwhile, around 32 per cent of total FDI inflows (US dollars 174.4 million) were on account of investments in sectors relating to chemical, coal and petroleum products; rubber based products; food, beverages and tobacco products; textiles, wearing apparel and leather products; and non-metallic mineral products during the first half of 2013.

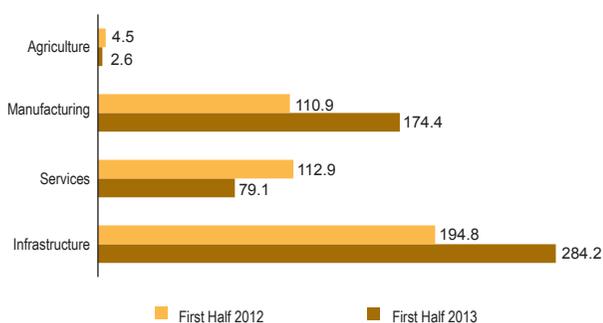
The Services sector which includes hotels and restaurant and IT and BPO sub-sectors absorbed US dollars 79.1 million of FDI during the first six months of 2013. In terms of origin, China (US dollars 125 million), Hong Kong (US dollars 79 million), Singapore (US dollars 54 million), Netherlands (US dollars 48 million) and India (US dollars 47 million) contributed the largest FDI inflows during the first half of 2013.

- **Public investment programme has been continuing in 2013.** According to provisional information, public investment increased by 9.3 per cent during the first six months of 2013. Government investment was mainly in infrastructure development projects such as road development and bridges, irrigation and water management and water supply and sanitation projects. Meanwhile, the government continued its investment in improving power generation, distribution facilities and transmission systems with the target of achieving 100 per cent access to electricity. Further, investments to improve the transport system were also undertaken during the first half of the year.

Savings

- **On the resource side, the domestic savings ratio is projected to improve further in 2013 to around 19.2 per cent as a percentage of GDP.** The positive contribution from private sector savings together with the improvement in government dis-savings are expected to contribute to this growth. The enhancement in domestic savings will be sustained through the expected lower growth in imports during the year, as in 2012. Meanwhile, national savings are also projected to improve as a percentage of GDP to 25.8 per cent. The improvement in foreign remittances and the lower rate of deterioration in net factor income from abroad are expected to contribute towards achieving this improved level of savings.

Chart 2.9 Foreign Direct Investment of BOI Enterprises (USD million)



Prospects 2014

- The Sri Lankan economy is projected to return to a higher growth trajectory of around 8 per cent in 2014. Growth is expected to be broad based with all major sectors of the economy contributing to this growth with conducive conditions in both the domestic economy and the external sector. Relatively low interest rates and low and stable inflation on the domestic front together with the gradual recovery in the external front would support economic growth in 2014. Further, domestic output particularly in the manufacturing sector would expand with the continuation of the growth momentum in construction activities. Meanwhile, exports of apparel, food and beverages, and rubber products are also expected to increase in 2014 together with a significant growth in services exports particularly from high value added information technology and related industries.
- Agriculture output is envisaged to grow at a higher rate in 2014 with the continuous commitment of the government to improve the agriculture sector and favourable weather in 2014. Remunerative producer prices and productivity improvements appear to be the way forward for developing the agriculture sector. Domestic production of many field crops such as Maize, Potato, Red onion, Black gram and Big onion etc, would continue to grow thereby reducing the imports of such crops. External demand for major agriculture crops like rubber and desiccated coconuts are expected to recover with the recovery in major export destinations such as USA and European countries. The domestic dairy industry is expected to enhance investment in the sector to increase supply capacity to cater to the increased demand for milk products. It is also likely that fish production and exports of sea foods would move to a high growth trajectory from 2014 supported by the expected increase in offshore sea fishing with the expansion of infrastructure facilities, strategic investment and increasing demand for sea food exports.
- The growth momentum of factory industry observed in the later part of 2013 is expected to continue in 2014 with the improvement in international and domestic markets. The recovery of crisis stricken economies in the European region, benign inflation outlook, lower interest rates, stable exchange rates, development of infrastructure, economic and political stability and improved institutional support for investment are expected to increase the output of the factory industry in 2014. Tax concessions which have been provided in the recent budgets are also expected to contribute to growth in both domestic and export market oriented industries during 2014. Domestic policy measures taken to open up free ports and bonded areas are also expected to increase the volume of factory production with expected new trade opportunities with neighbouring countries especially assembling of electric and electronic based industries. Meanwhile, market diversification, increasing competitiveness and productivity are the major areas which need to be addressed by stakeholders to expand the market share in the international market. Benefits which are expected from the Nanotechnology and Science Park are expected to increase the quality of factory industry products through enhanced research and development (R&D) activities.
- The Services sector is projected to grow at a higher rate thus sustaining overall growth in 2014. The external trade sector, which has been growing at relatively lower levels during the first half of 2013, is expected to expand at a higher rate with the expected recovery in global markets. The growth momentum of the Service sector would be further supported by the healthy growth in the tourism sector. The demand for private services would also expand as rising purchasing power leads to changes in the lifestyles of people while services such as transport and financial services would also expand in line with the increase in demand.

- **The continuous growth in the construction sector and imports of machinery and equipment would help the high growth momentum of investment in 2014.** The construction sector that has been experiencing a boom during the past couple of years would be the main driver of investment with higher activity from both private and public sectors. Meanwhile, increased investment in machinery and equipment would also contribute towards the expansion of the capital stock in the country together with advanced technology coming with foreign direct investment.
- **Government sector investment activities would continue in 2014 with significant emphasis on rural and regional infrastructure development.** Major construction projects such as road development, short term projects on rehabilitation and improvement of the road network, construction of bridges and railway lines together with water supply improvement projects and energy transmission and generation projects would continue to be the main areas of public sector investment.
- **Savings would have to increase in order to sustain the higher growth in investment during 2014.** The negative savings - investment gap could further widen if savings do not support the required level of investment, which would lead to more external financing to sustain investment activities. However, the expected higher growth in exports compared to imports would improve domestic savings. Meanwhile, continued growth in net private transfers through foreign remittances and the improvement in net factor income would improve national savings in 2014.