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

1.1 Overview

The economy grew by 8.3 per cent in 2011, the highest in Sri Lanka's post independence history, sustaining a growth momentum of over 8 per cent for the first time in two consecutive years. Improved consumer and investor confidence arising from the peace dividend, favourable macroeconomic conditions, increased capacity utilisation, expansion of infrastructure facilities and renewed economic activity in the Northern and Eastern provinces underpinned this growth. The Industry and Services sectors were the drivers of the high growth momentum in 2011. The Agriculture sector rebounded from the output loss recorded due to adverse weather conditions during the beginning of the year. The expansion in economic activity was reflected in the unemployment rate, which declined to the lowest recorded level of 4.2 per cent in 2011.

Inflation remained at single digit levels for the third consecutive year supported by improved domestic supply conditions, prudent liquidity management by the Central Bank and benign inflation expectations. Annual average inflation was 6.7 per cent while year-on-year inflation was 4.9 per cent in December 2011. Year-on-year inflation trended upwards during the first few months of the year due to adverse weather conditions that disrupted domestic food supply. However, the trend reversed from May with the significant recovery in domestic food production and inflation was maintained at mid single digit levels by the end of the year.

Low inflation and subdued inflationary expectations allowed the Central Bank to continue to ease monetary policy in January 2011, but cautious and gradual tightening was initiated thereafter as credit and monetary aggregates continued to grow at a rate higher than projected. Given the benign inflation environment, monetary policy was relaxed further in mid January by reducing policy interest rates, the Repurchase rate and the Reverse Repurchase rate by 25 and 50 basis points, respectively, to 7.00 per cent and 8.50 per cent, respectively, in January 2011, to facilitate a growing economy. However, high excess rupee liquidity and the possible emergence of demand driven inflationary pressures necessitated the raising of the Statutory Reserve Ratio (SRR) on all rupee deposits of commercial banks by one percentage point to 8 per cent in April 2011. Both reserve money and broad money (M_{2b}) grew by a higher quantum than projected due to increased demand for money as reflected by the expansion in economic activities. The average growth of broad money during the year increased to 19.3 per cent compared to the target of 14.5 per cent in the monetary programme for 2011,

Chart 1.1 Annual Real GDP Growth Rate

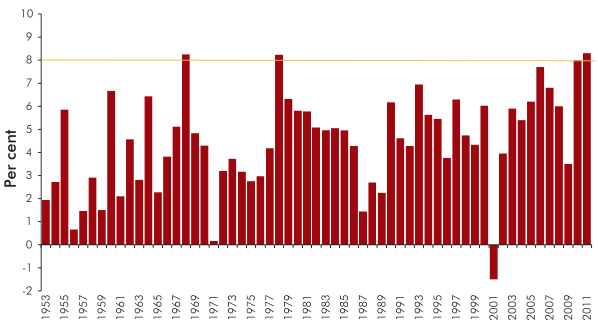
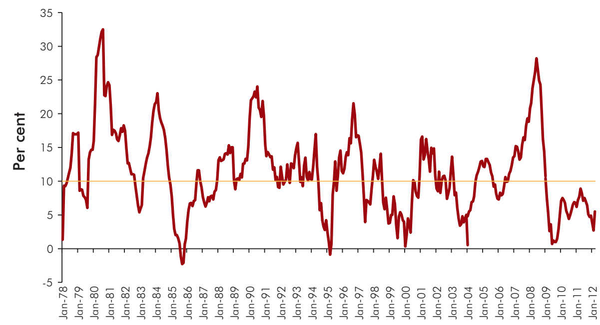


Chart 1.2 Year-on-year Inflation (Based on CCPI, Spliced)



mainly due to the expansion in credit extended to the private sector by the banking system, which grew by 32.4 per cent on average during the year. Credit growth to the private sector reflected the pent-up demand for credit and the increased access to credit, including in the Northern and Eastern provinces, as a result of the peace dividend. Credit to the government and public corporations also expanded significantly during the year contributing to high monetary expansion. As credit continued to grow unabated, in February 2012, the Central Bank raised the Repurchase rate and the Reverse Repurchase rate by 50 basis points to 7.50 per cent and 9.00 per cent, respectively. The Central Bank also issued a Direction in March 2012 to licensed banks as per Section 101(1) of the Monetary Law Act to limit credit growth to 18 per cent with an additional 5 per cent allowed for credit financed through funds sourced abroad, to rein in possible demand fuelled inflationary pressures and to contain import related credit in order to safeguard external sector stability.

The government reiterated its commitment to the fiscal consolidation process by maintaining the key fiscal indicators broadly in line with the budgetary estimates for 2011. Despite the shortfall in revenue collection, prudent management of recurrent expenditure helped maintain the fiscal deficit at 6.9 per cent of GDP, marginally above the budgetary target of 6.8 per cent of GDP. The budget for 2011 introduced major tax reforms to simplify the tax system, broaden the tax base and improve tax compliance with the objective of strengthening tax collection, while creating an environment to attract private investment. In addition, various tax incentives were provided to encourage investment in specific sectors while changes to the tax structure were intended to develop key sectors in the economy such as the financial sector. While tax reforms are expected to enhance revenue mobilisation in the medium term, the abolition of several taxes and the reduction in tax rates resulted in a decline in the tax revenue collection during the year. Rationalisation of recurrent expenditure and a slower growth in interest expenditure given the favourable interest rate environment helped contain recurrent expenditure while investment on public infrastructure was maintained at a level to support the high growth momentum. Reflecting the improvement in the fiscal sector, the debt to GDP ratio declined to 78.5 per cent in 2011 from 81.9 per cent in 2010.

The external sector, which strengthened in the first half of 2011, came under pressure during the latter part of the year due to adverse global developments and rapid growth in imports. Despite the healthy growth in exports by 22.4 per cent during the year, significantly high import expenditure reflecting high oil prices and a surge in investment and intermediate good imports by 50.7 per cent, led to a rise in the trade deficit to an unprecedented high level. Although improved foreign inflows through private remittances and other inflows to the services account, including earnings from tourism, helped to cover a substantial part of the trade deficit, the current account deficit as a percentage of GDP, increased to 7.8 per cent in 2011 from 2.2 per cent in 2010. Meanwhile,

BOX 1

The Economy in 2011 at a Glance

Growth, Inflation and Unemployment

- Economic growth increased to its highest level of 8.3 per cent - the first time the country recorded above 8 per cent growth in two successive years.
- Per capita income increased to US dollars 2,836 from US dollars 2,400 in the previous year.
- Inflation remained subdued at single digit levels for the third consecutive year.
- Unemployment declined to 4.2 per cent, the lowest level recorded thus far.
- Substantial improvements in youth unemployment.

External Sector

- Growth of exports, which was at 22.4 per cent was far outpaced by the growth of imports at 50.7 per cent
- Trade deficit widened sharply to 16.4 per cent of GDP.
- Tourist arrivals crossed 850,000 with earnings recording US dollars 830 million.
- Workers' remittances reached US dollars 5.1 billion
- Current account deficit remained substantially higher at 7.8 per cent of the GDP compared to the average deficit of around 3.1 per cent over the last ten years.
- Foreign direct investments in the country exceeded US dollars 1 billion for the first time.
- The balance of payments recorded a deficit of US dollars 1.1 billion.
- Gross official reserves by year end were US dollars 6.0 billion compared to US dollars 6.6 billion as at December 2010.
- The rupee depreciated by 2.6 per cent against the US dollar by year end.

Fiscal Sector

- Emphasis on fiscal consolidation continued in 2011.
- A shortfall in revenue was reflected in the decline in the revenue to GDP ratio to 14.3 per cent from 14.6 per cent in 2010.
- Total expenditure and net lending was maintained at 21.4 per cent of GDP.
- Overall fiscal deficit was 6.9 per cent of GDP, marginally above the targeted level.
- Government debt to GDP ratio fell to 78.5 per cent from 81.9 per cent in 2010, the first time in nearly 30 years that the ratio was lower than 80 per cent.
- Government issued the fourth international sovereign bond, amounting to US dollars 1 billion.

Monetary and Financial Sector

- Key policy interest rates were reduced in January 2011 to enhance investments by the private sector.
- The Statutory Reserve Ratio was raised by 1 percentage point to 8 per cent in April in order to permanently absorb a part of excess liquidity.
- Monetary expansion, at 19.3 per cent on average, continued to remain above the targeted level.
- Market interest rates were broadly stable during the first three quarters of the year but began increasing thereafter.
- Stability of the financial system continued to be well safeguarded.
- A new Finance Business Act was enacted while several new Directions were issued.
- Non-performing loan ratios declined over the year.
- Banking system remained well capitalised despite a decline in the capital adequacy ratios.
- Further progress was made towards improving access to finance with the expanding branch network of financial institutions.

inflows of private long term investments including foreign direct investments (FDIs) and inflows to the government remained healthy. However, as these inflows were not sufficient to offset the deficit in the current account, the balance of payments (BOP) that recorded a surplus by August 2011 turned to a deficit of US dollars 1.1 billion by end 2011. As the demand for foreign exchange in the domestic foreign exchange market increased reflecting the high trade deficit, the Central Bank intervened to reduce the pressure on the exchange market. As a result, gross official reserves, which stood at US dollars 8.2 billion by mid August 2011 declined to US dollars 6 billion by end 2011. To further strengthen external stability, in February 2012, the Central Bank allowed greater flexibility in the exchange rate by limiting its intervention in the domestic foreign exchange market. In addition, with the adoption of greater flexibility in the exchange rate, the Central Bank introduced prudential measures to reduce likely speculative activity by limiting the daily net open position of commercial banks in relation to daily working balances in foreign exchange and the tenure of forward contracts to a maximum 90 days. In addition, several measures including further relaxation of exchange control regulations were taken to encourage foreign exchange inflows to the country.

The stability of the financial system further improved supported by conducive macroeconomic conditions and strengthened supervision and regulation. The performance of financial institutions improved significantly, while prudential indicators were maintained with adequate capital and liquidity buffers and healthy profit levels. The asset quality of the banking sector improved, as reflected by the positive development in non performing loans (NPLs), lowering the credit risk. The banking, finance and leasing and insurance sectors expanded their branch network including in the Northern and Eastern provinces, thereby increasing access to financial services. During the year, the Central Bank further strengthened its supervisory and regulatory framework to improve risk management systems in banks and to enhance customer protection. In order to combat the problem of unauthorised deposit taking and finance business activities, a new Finance Business Act was enacted replacing the Finance Companies Act and the definition of deposits was widened to cover a broad range of fund mobilisation activities. A series of new and revised directions were issued to the non bank financial sector in line with the new Finance Business Act. The proposed amendments to the Banking Act, with provisions to enable the consolidated supervision of banking groups and measures to facilitate mergers and acquisitions for consolidation and resolution, were submitted to the Cabinet of Ministers for approval. During the year, the payments and settlements system was developed further, while the regulatory framework was broadened to encompass emerging electronic payment mechanisms.

Given the uncertain outlook for global commodity prices, especially with regard to oil, the challenge ahead would be to maintain inflation at a low and stable level. Although, the recently implemented policy measures would moderate growth and ease demand pressures to some extent, monetary policy will need to continue to focus on restraining demand pressures to maintain inflation at a mid single digit level. Managing supply side shocks to ensure an adequate domestic food supply would also be required to complement demand management strategies. Developing quality seed varieties to suit local conditions, expanding cultivation to different agro climatic zones to ensure uninterrupted supply, increasing storage facilities and improving supply chains to ensure a reasonable price for producers and consumers are some areas that may need to be addressed in this regard.

Sri Lanka's sustained growth momentum has taken the country to a high growth trajectory placing the country among middle income economies in the world. Against this background, challenges, which can have a downside risk on potential growth, become focal to economic policy management. The weak recovery in the global economy as well as geopolitical uncertainties in Sri Lanka's traditional export markets are likely to affect export growth. Demand for exports needs to be improved through diversification of both markets and products. Also, foreign inflows must be strengthened, particularly in the areas of service inflows and FDIs through appropriate policies and macroeconomic environment. High oil prices in international markets can have a significant impact on an oil dependent economy like Sri Lanka. Policies need to be put in place to mitigate the impact of high oil prices by promoting energy efficient production technologies, increasing the use of renewable energy sources and energy conservation. Moreover, a price mechanism that reflects movements in international energy prices may need to be considered to help avoid the need for large adjustments of domestic energy prices while lessening the burden on public enterprises. In the labour market, the substantial decline in

BOX 2

Recent Policy Measures adopted by the Central Bank

Impressive Macroeconomic Performance

Sri Lanka's macroeconomic performance during the post conflict period has been impressive. By end 2011, the strong growth momentum across all key sectors of the economy resulted in two consecutive years of over 8 per cent economic growth for the first time in Sri Lanka's post-independence history. Inflation was at single digit levels for almost three years. Comparatively low interest rates and stable exchange rates were observed over a considerable period. Fiscal indicators such as the debt to GDP ratio and the budget deficit to GDP ratio continued to improve. The financial sector expanded and its stability was strengthened. Amidst increased export income, remittances, tourist earnings, and investment inflows, a large portion of which was absorbed the Central Bank to prevent the rupee from appreciating excessively, the external reserves reached a historic peak in August 2011. Significant progress in the development of physical infrastructure was seen while social indicators such as poverty and unemployment improved substantially raising the standard of living of Sri Lankans. These positive developments provided a cushion for the Sri Lankan economy that could be utilised to dampen the impact of any unforeseen external and internal risks.

Challenges faced in 2011

Meanwhile, towards the end of the third quarter, certain imbalances were emerging in the economy. The global economic situation continued to worsen in 2011 and international energy and other commodity prices continued to remain high. Despite export earnings growing at a healthy rate of over 22 per cent during 2011, gross import expenditure grew rapidly by over 50 per cent due to continued robust domestic economic growth. Around 80 per cent of the increase in import expenditure was due to higher imports of intermediate and investment goods, reflecting enhanced investor confidence and improved economic activity including large scale infrastructure development projects. With crude oil prices in 2011 being substantially higher than the average price in 2010 and owing to the high volume of imports for generating thermal power, the petroleum import bill increased considerably. With rising household incomes, expenditure on import of motor vehicles and consumer durables too increased. As a result, the trade deficit in 2011 increased significantly to US dollars 9.7 billion from US dollars 4.8 billion in 2010. In the monetary sector, improved economic activity reflecting the conducive environment for investments, higher domestic demand, increased access to credit and improved soundness of financial institutions, and enhanced business confidence led to a rebound in credit obtained by the private sector, which grew on average at over 32 per cent during 2011. Within credit growth, import credit grew substantially while a rapid increase in credit driven by import related items such as motor vehicles, machinery, consumer durables and gold was also observed during the period. Although headline inflation and core inflation were at single digits, high growth of credit extended by the banking sector was a matter for concern given its potential to generate demand driven inflation and further increase the demand for imports.

The overall effect of these developments was increased pressure on the exchange rate and foreign reserves, and the Central Bank prudently utilised a part of its international reserves, which was in excess of the required levels, to supply foreign exchange to the market and thereby smooth the impact of global shocks while supporting increased demand for imports. The intervention by the Central Bank in the market by way of supplying foreign exchange also prevented excessive volatility in the exchange rate.

Addressing Challenges through Decisive Policy Measures

It was expected that the high credit growth and the high trade deficit would moderate towards the end of the year. However, due to strong business confidence domestically, credit growth and the widening of the trade deficit continued unabated. Accordingly, the Central Bank announced a series of monetary and external sector policy measures in February and March 2012 with the intention of reducing the trade and current account deficits, thereby strengthening the external sector while effectively ensuring that inflation will be maintained at single digit levels in 2012 and beyond. These include the following:

1. On 3 February 2012, the main policy interest rates of the Central Bank, the Repurchase rate and the Reverse Repurchase rate, were both increased by 50 basis points each to 7.50 per cent and 9.00 per cent, respectively.
2. During the period from 3-9 February 2012, the Central Bank also allowed the rupee to depreciate against the US dollar by 87 cents (0.75 per cent) to Rs. 114.94 through an upward shift of the exchange rate band.
3. On 9 February 2012, the Central Bank decided to move away from a price based intervention strategy and allow more flexibility in the exchange rate and limit market intervention through a quantity based strategy
4. On 1 March 2012, authorised dealers in foreign exchange were directed to limit forward contracts for the sale and/or purchase of foreign exchange to a

maximum period of 90 days with no renewal allowed. It was also stipulated that any forward contract must be backed by an underlying transaction, either in relation to trade in goods or services, or in relation to a permitted capital transaction.

5. On 2 March 2012, limits on the daily net open position of commercial banks in relation to the daily working balances in foreign exchange were reduced to 1/3rd of the exposure limit prevailing by then, subject to a minimum of US dollars 1 million.
6. On 12 March 2012, an Order under Section 101(1) of the Monetary Law Act was issued to all licensed banks directing them to moderate their credit disbursements so that the overall rupee denominated credit growth in 2012 would not exceed 18 per cent of their respective loan book outstanding at the end of 2011 or Rs. 800 million, whichever is higher, while credit growth of up to 23 per cent or Rs. 1 billion, whichever is higher, will be allowed for those banks that finance the excess credit growth, from funds mobilised from overseas.

In parallel, the Ceylon Petroleum Corporation (CPC) and the Ceylon Electricity Board (CEB) revised their domestic petroleum prices and electricity tariff to reflect the true production costs and rising energy prices in the international market, which would ensure the commercial viability of the CPC and the CEB, and reduce the pressure on the banking system. This would also encourage economic agents to base their behaviour on a more realistic cost of energy thus easing pressure on the balance of payments (BOP). The upward revision of excise duties on motor vehicles by the government on 31 March 2012 is also expected support the reduction in imports.

Impact of Recent Policies on Macroeconomic Variables

The policy measures implemented by the Central Bank and other authorities were sequenced and timed so as to utilise the spaces built up within the economy during the past two years to minimise any negative impact that such measures would have on the economy. In that context, the projections for some macroeconomic variables, which were announced at the beginning of the year in the "Road Map: Monetary and Financial Policies for 2012 and Beyond" were revised, taking into account the impact of these policy measures. In particular, consumer price inflation is expected to increase due to these measures, but as aggregate demand moderates, inflation is expected to settle close to the originally projected mid-single digit levels. Meanwhile, economic growth in 2012 has been revised downward to 7.2 per cent from the originally projected 8.0 per cent. However, when realised, these revised projections themselves would be remarkable achievements given the current bleak and dismal economic performance elsewhere in the global economy.

In respect of external trade, the required reduction in import expenditure is expected following the recent policy measures. The projection for expenditure on imports for 2012, which was originally estimated to be US dollars 23.4 billion, is revised downward to US dollars 20.9 billion. At the same time, earnings from exports are now projected to reach US dollars 11.7 billion. Accordingly, the trade deficit is expected to narrow to US dollars 9.2 billion.

Way forward

The Central Bank also recognises the need to rebuild the spaces to counter adverse developments that may arise in future, and thereby maintain continued macroeconomic stability. In this regard, the Central Bank has already adopted further measures to improve foreign exchange inflows. Local corporates were encouraged to tap international markets to supplement the limited availability of resources in the domestic market by relaxing some of the exchange control regulations. In addition, the threshold for foreign investments in Treasury bills and bonds was raised from 10 per cent of the outstanding Treasury bill and bond stock to 12.5 per cent. Meanwhile, commercial banks were permitted to raise Tier 2 debt capital from abroad amounting to about US dollars 1 billion, thus strengthening their capital base. Further, with a view to attracting foreign equity investment into the Colombo Stock Exchange (CSE), road shows were conducted by CSE in several countries, where prospective investors were apprised of the investment opportunities in Sri Lanka. The Central Bank will monitor these initiatives on a regular basis to ensure that these inflows would materialise, thereby enabling the BOP to record an increased surplus in 2012.

In the meantime, concerted efforts from other institutions will also be required during the year. Discussions with the Board of Investments (BOI) indicate that they are confident about attracting foreign direct investments (FDIs) to the value of around US dollars 2 billion in 2012. Further, the CPC and CEB have embarked on projects to promote energy conservation through raising public awareness, which is expected to reduce the requirement of petroleum imports substantially in 2012.

These measures would help moderate the growth of credit, import expenditure, trade and current account deficits, improve the surplus in the BOP and increase foreign reserves, and thereby strengthening external sector stability while supporting a sustainable high economic growth and low inflation.

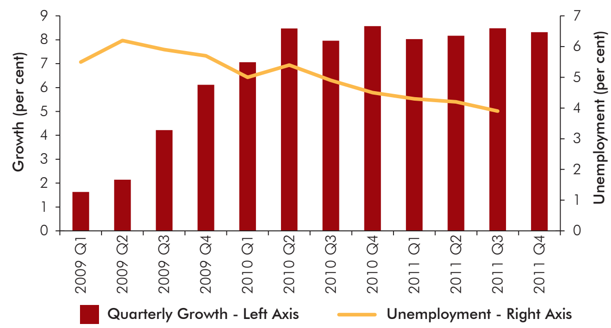
unemployment is expected to tighten labour market conditions. Policies need to be put in place to improve labour productivity and to address structural rigidities in the labour market while increasing capital intensity to deal with any manpower shortages. Attention should also be paid to realign Sri Lanka's education system to generate a human capital base with the skills necessary to sustain this new growth momentum.

1.2 Macroeconomic Developments, Stability and Policy Responses in 2011

Real Sector Developments

The Sri Lankan economy grew by an impressive 8.3 per cent, in real terms in 2011, following a growth of 8 per cent in 2010. Strong growth in the Industry and Services sectors, amidst a setback in the Agriculture sector, underpinned the high economic growth. The Industry and Services sectors grew by 10.3 per cent and 8.6 per cent, respectively, in 2011. The Industry sector growth was largely propelled by factory industry and construction activities. The growth in the Industry sector in 2011 was the highest growth recorded during the past 33 years in value added terms. Consequently, the

Chart 1.3 Quarterly Real GDP Growth and Unemployment



Industry sector increased its share in GDP to 29.3 per cent in 2011 from 28.7 per cent in the previous year. Meanwhile, the Services sector maintained its growth momentum, with notable contributions from wholesale and retail trade, transport and communication, and banking, insurance and real estate subsectors. The Agriculture sector recorded a moderate growth of 1.5 per cent due to severe crop damage from the adverse weather conditions that prevailed during the first quarter of the year. However, the Agriculture sector made a remarkable recovery during the second half of the year.

Improved performance in all key sectors of the economy helped to generate a higher level of employment in 2011. Accordingly, the

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

Sector	Value (Rs. million)		As a Share of GDP (%)		Rate of Change (%)		Contribution to Change (%)	
	2010 (a)	2011 (b)	2010 (a)	2011 (b)	2010 (a)	2011 (b)	2010 (a)	2011 (b)
Agriculture	**315,610**	**320,346**	**11.9**	**11.2**	**7.0**	**1.5**	**10.4**	**2.2**
Agriculture, Livestock and Forestry	283,203	282,916	10.7	9.9	6.4	-0.1	8.7	-0.1
Fishing	32,407	37,431	1.2	1.3	12.2	15.5	1.8	2.3
Industry	**760,334**	**838,932**	**28.7**	**29.3**	**8.4**	**10.3**	**30.2**	**36.0**
Mining and Quarrying	60,079	71,191	2.3	2.5	15.5	18.5	4.1	5.1
Manufacturing	458,660	494,990	17.3	17.3	7.3	7.9	16.0	16.6
Electricity, Gas and Water	63,682	69,547	2.4	2.4	8.0	9.2	2.4	2.7
Construction	177,912	203,204	6.7	7.1	9.3	14.2	7.7	11.6
Services	**1,569,598**	**1,704,576**	**59.3**	**59.5**	**8.0**	**8.6**	**59.4**	**61.8**
Wholesale and Retail Trade	613,358	676,565	23.2	23.6	7.5	10.3	21.7	29.0
Hotels and Restaurants	13,845	17,501	0.5	0.6	39.8	26.4	2.0	1.7
Transport and Communication	368,643	410,402	13.9	14.3	11.9	11.3	19.9	19.1
Banking, Insurance and Real Estate etc.	234,255	252,677	8.9	8.8	7.5	7.9	8.4	8.4
Ownership of Dwellings	74,692	75,607	2.8	2.6	0.9	1.2	0.3	0.4
Government Services	202,187	204,704	7.6	7.1	5.4	1.2	5.3	1.2
Private Services	62,617	67,119	2.4	2.3	5.8	7.2	1.8	2.1
Gross Domestic Product	**2,645,542**	**2,863,854**	**100.0**	**100.0**	**8.0**	**8.3**	**100.0**	**100.0**
Net Factor Income from Abroad	-32,939	-31,536			-16.6	4.3		
Gross National Product	**2,612,603**	**2,832,318**			**7.9**	**8.4**		

(a) Revised
(b) Provisional

Source: Department of Census and Statistics unemployment rate declined to its lowest level of 4.2 per cent in 2011 from 4.9 per cent in 2010. The total number unemployed was estimated at 342,000 in 2011 compared to 401,000 in the previous year. The Services sector, which made the largest contribution to economic growth during the last few years, continued to generate more employment opportunities in 2011 as well. A notable decline in youth unemployment among the age groups of 15-19 years and 20-29 years was observed with unemployment falling to 15.4 per cent and 12.4 per cent, respectively, in 2011 from 20.3 per cent and 13.8 per cent, respectively, in 2010.

Domestic agriculture recovered significantly in the second half of the year from the setback experienced during the first half while export agriculture registered a mixed performance during the year. The Maha paddy production and other field crop output, which were adversely affected by severe flooding in the first quarter of the year, recorded a substantial decline. The recovery in the second half of the year is largely attributable to the favourable performance in paddy cultivation in the Yala season and increased output in vegetables and highland crops supported by conducive weather conditions. Fish production increased by 15.6 per cent boosted by a recovery in fishing activities in the Northern province. Meanwhile, total milk production also increased due to the strong commitment of the government to increase domestic milk production. Within export agriculture, tea production recorded a marginal decline due to adverse weather conditions while rubber production continued to increase due to attractive prices and an increase in the extent of land under rubber tapping. The coconut sub sector, which suffered a significant setback in 2010, recovered strongly in 2011 supported by favourable weather conditions. The production of cinnamon, cocoa, cardamom and betel increased while the production of pepper and cloves declined in 2011.

The Agriculture sector benefited from favourable prices that prevailed in 2011. Rubber prices increased significantly during the first three quarters of the year to the highest ever levels with the increase in demand for natural rubber from emerging economies. Meanwhile, tea prices at the Colombo tea auction, which increased during the first quarter of 2011, decelerated thereafter due to geopolitical tensions in major tea importing destinations in the Middle East. Paddy prices remained largely stable with the support of the paddy purchasing scheme of the government. During the first half of the year, coconut prices rose significantly due to the decline in production, particularly in the last quarter of 2010, but prices decelerated thereafter.

Policy measures introduced by the government improved agricultural production in 2011. The fertilizer subsidy granted for a few selected crops was extended to cover all crops from May 2011. The subsidy for tea replanting and new planting was increased while steps were taken to expand rubber cultivation in non-traditional areas. A programme named “Kapruka Purawara” was introduced with a view to enhancing the coconut yield while measures were taken to expand the extent of coconut cultivation. The substantial increase in the minimum farmgate price of milk to Rs.50 per litre encouraged domestic milk production. With respect to other export agriculture crops, several measures were introduced by the Export Agriculture Department (EAD) to increase replanting and new planting while improving the yield on existing cultivation.

The Industry sector remained resilient in a challenging international environment recording impressive growth of 10.3 per cent in 2011. The industry sector growth was propelled largely by factory industry and construction activities. Strong aggregate demand conditions primarily emerging from low inflation and declining interest rates in the domestic economy spurred the growth in demand for industrial products while enhanced competitiveness of industrial exports led to a healthy growth in export oriented industries despite the sluggish recovery in the global economy. Improved productivity, enhanced quality, adoption of best practices in green manufacturing and strengthened strategic partnerships with key customers helped export market oriented industries to maintain their growth momentum. The government extended its support to industrialists through fiscal policy measures and other programmes aimed at enhancing value addition, export orientation, import substitution and

Table 1.2 Aggregate Demand and Savings Investment Gap

Item	Rs. billion		Growth %		As a percentage of GDP	
	2010 (a)	2011 (b)	2010 (a)	2011 (b)	2010 (a)	2011 (b)
1. Domestic Demand	**6,069.7**	**7,494.9**	**17.9**	**23.5**	**108.3**	**114.6**
1.1 Consumption	4,524.2	5,536.1	14.0	22.4	80.7	84.6
Private	3,651.6	4,568.4	17.2	25.1	65.2	69.8
Public	872.6	967.7	2.5	10.9	15.6	14.8
1.2 Investment (Gross Domestic Capital Formation)	1,545.5	1,958.8	30.8	26.7	27.6	29.9
Private	1,200.8	1,549.6	39.1	29.0	21.4	23.7
Public	344.7	409.2	8.4	18.7	6.2	6.3
2. Net External Demand	**-465.6**	**-952.3**	**-48.3**	**-104.5**	**-8.3**	**-14.6**
Exports of Goods and Services	1,254.0	1,508.6	21.6	20.3	22.4	23.1
Imports of Goods and Services	1,719.6	2,460.8	27.8	43.1	30.7	37.6
3. Total Demand (GDP) (1 + 2)	**5,604.1**	**6,542.7**	**15.9**	**16.7**	**100.0**	**100.0**
4. Domestic Savings (3 - 1.1)	**1,079.9**	**1,006.6**	**24.5**	**-6.8**	**19.3**	**15.4**
Private	1,199.7	1,078.4	14.5	-10.1	21.4	16.5
Public	-119.8	-71.9	33.4	40.0	-2.1	-1.1
5. Net Factor Income from Abroad	**-69.8**	**-72.0**	**-25.1**	**-3.3**	**-1.2**	**-1.1**
6. Net Private Current Transfers	**413.9**	**513.2**	**23.0**	**24.0**	**7.4**	**7.8**
7. National Savings (4 + 5 + 6)	**1,424.0**	**1,447.7**	**24.0**	**1.7**	**25.4**	**22.1**
8. Savings Investment Gap						
Domestic Savings - Investment (4 - 1.2)	-465.6	-952.3			-8.3	-14.6
National Savings - Investment (7 - 1.2)	-121.5	-511.1			-2.2	-7.8
9. External Current Account Deficit without Official Grants (2 + 5 + 6)	**-121.5**	**-511.1**			**-2.2**	**-7.8**

(a) Revised
(b) Provisional

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

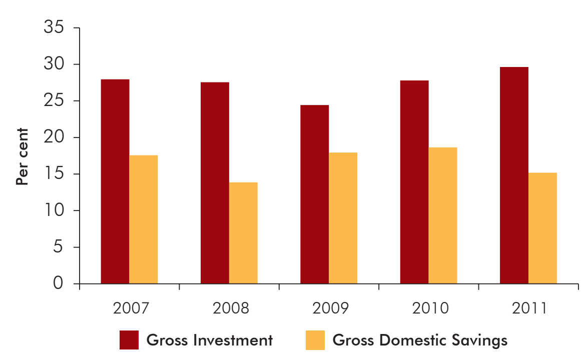
SME development. Fiscal incentives were offered to firms carrying out research and development activity while the SME sector benefitted from cluster development programmes, which were aimed at promoting selected industries.

The construction sector grew at a high rate of 14.2 per cent in 2011 compared to the 9.3 per cent growth in 2010 reflecting the major infrastructure development activities undertaken by the government and increased construction activities of the private sector. Major infrastructure projects implemented by the government included port and airport development, road construction and power generation projects. Private sector construction activities increased due to construction of both commercial and residential buildings supported by credit facilities provided by banks and other financial institutions under the prevailing low interest rate environment.

The Services sector contributed 61.8 per cent to the overall economic growth expanding at 8.6 per cent in 2011. The wholesale and retail subsector recorded an impressive growth with improved performance in import and export sectors and healthy growth in domestic trade. The transport and communication sector grew with improved performance in all three sub sectors, namely; transport, cargo handling, port and civil aviation and post and telecommunications. The banking, insurance and real estate sector expanded with increased income from both banking and non banking sectors as well as the insurance sector reflecting increased demand for financial services with growing economic activities.

Total consumption expenditure increased significantly by 22.4 per cent while domestic savings contracted widening the savings investment gap in 2011. Private consumption as

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



BOX 3 Savings - Investment Gap

The aggregate demand (Y) in an economy consists of private and government consumption (C), private and government investment (I) and net export of goods and services (NX). This could be represented as

$$Y=C+I+NX$$

When net income from abroad such as dividend and interest income (Y_f) and net transfers (Y_{tr}) such as remittances are added, gross national disposable income can be derived as follows:

$$GNDI = C+I+NX+Y_f+Y_{tr}$$

In this equation, $NX+Y_f+Y_{tr}$ reflects the current account balance (CAB) of the balance of payments (BOP). Therefore,

$$GNDI = C+I+CAB$$

Rearranging gives,

$$GNDI-C=I+CAB$$

$$\Rightarrow S=I+CAB$$

$$\Rightarrow S-I=CAB$$

This clearly illustrates that the level of consumption, which comprises private and government consumption, affects the level of savings (S). A lower level of consumption would result in a higher level of savings, which leads to a higher level of investment. If national savings is not adequate to meet the total investment requirement of a country, that gap has to be met through foreign savings, which is the mirror image of a country's current account deficit in the BOP.

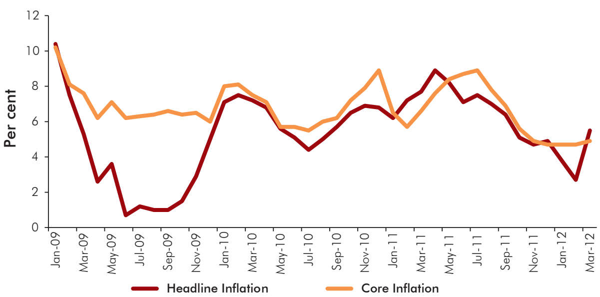
In Sri Lanka, on average, total consumption as a percentage of GDP has been around 82 per cent in recent years. Accordingly, national savings as a percentage of GDP has been around 18 per cent. However, as per the national accounts data published by the Department of Census and Statistics for 2011, Sri Lanka's domestic consumption as a percentage of GDP increased from 80.7 per cent in 2010 to 84.6 per cent in 2011, as a combined outcome of private consumption increasing from 65.2 per cent to 69.8 per cent and government consumption declining from 15.6 per cent to 14.8 per cent. As a result, domestic savings declined from 19.3 per cent in 2010 to 15.4 per cent in 2011.

The substantial increase in consumption demand in 2011 could be largely attributed to the low interest rates that prevailed in 2011 enabling people to borrow at relatively cheaper rates for consumption purposes and the significant reduction in import duty on consumer durables such as motor vehicles, and electrical and electronic items. This was reflected in the sharp increase in credit extended by financial institutions and an unprecedented increase in imports of consumer durables during 2011. For example, personal motor vehicle imports during 2011 increased by 94 per cent to US dollars 881 million. Increased domestic demand particularly in the Northern and Eastern provinces, where the demand had remained suppressed for many years, could also have contributed to the increased domestic consumption. Meanwhile, the decline in government consumption is attributed to the government efforts to rationalise recurrent expenditure leaving more resources for capital expenditure.

As the country's total investment was 29.9 per cent of GDP, compared to national savings of 22.1 per cent of GDP (domestic savings + net factor income from abroad + net private current transfers) in 2011, the savings-investment gap was met through foreign savings, which was reflected in the widened current account deficit of 7.8 per cent of GDP. During the first quarter of 2012, the Central Bank and the government took several measures to reduce high credit demand, which would dampen the demand for non-essential consumer goods imports. Also, relative to 2011, market interest rates moved upward reflecting monetary policy tightening by the Central Bank and the decline in the rupee liquidity in the banking system. With these changes, it is expected that domestic consumption would decelerate supporting increased domestic savings and facilitating investment required for maintaining the envisaged high economic growth. This would also lower the external current account deficit as projected in the Medium Term Macroeconomic Framework (Table 1.5).

a per cent of GDP increased to 69.8 per cent in 2011 from 65.2 per cent in 2010, while government consumption expenditure declined marginally from 15.6 per cent to 14.8 per cent in 2011. Both domestic and national savings declined from 19.3 per cent to 15.4 per cent and 25.4 per cent to 22.1 per cent, respectively. As a percentage of GDP, private investment increased from 21.4 per cent in 2010 to 23.7 per cent in 2011 while public investment increased marginally to 6.3 per cent

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



from 6.2 per cent in 2010. With these developments, total investment as a percentage of GDP increased from 27.6 per cent in 2010 to 29.9 per cent in 2011. Accordingly, the gap between national savings and investment widened from -2.2 per cent of GDP in 2010 to -7.8 per cent of GDP in 2011, which was reflected in the higher deficit in the current account of the BOP.

Consumer price inflation was maintained at single digits during the year. Year-on-year inflation, as measured by the Colombo Consumers' Price Index (CCPI: 2006/07=100), declined to 4.9 per cent in December 2011 from 6.8 per cent in December 2010 while the annual average rate of inflation stood at 6.7 per cent in 2011 as compared to 6.2 per cent in 2010. Inflation remained at single digit levels for the third consecutive year reflecting the substantial increase in domestic food supply in the country including supply from the Northern and Eastern provinces. The Central Bank managed its monetary policy cautiously to prevent a buildup of inflationary pressures while fiscal policies through the downward revision of tariffs on some consumer items helped maintain inflation at single digit levels.

External Sector Developments

The external sector encountered heightened challenges in 2011 with unfavourable global developments and rapid growth in import demand domestically. Globally, the intensified sovereign debt crisis in the Euro area, sluggish recovery in the world economy and geopolitical uncertainty in some oil producing Middle Eastern and North African countries exerted pressure on oil prices and financial flows. Domestically, expansion in aggregate demand led to a rapid growth in imports, and as a result, the trade deficit widened substantially despite significant growth in exports. Although inflows to the capital and financial account remained strong, those inflows were insufficient to offset the high current account deficit. Inflows of private long term investments including FDIs and inflows to the government remained healthy. However, the higher current account deficit resulted in the overall BOP recording a deficit of US dollars 1.1 billion by end 2011.

Earnings from exports increased by 22.4 per cent while the expenditure on imports increased at a faster pace of 50.7 per cent in 2011, compared to the corresponding period of 2010. The expansion in exports amidst a fragile global economic recovery in Sri Lanka's traditional markets such as the USA, European Union, North Africa and the Middle East, which faced social and political uncertainties, reflected the resilience of Sri Lankan exports. Industrial goods exports grew by 31.1 per cent, accounting for 75.7 per cent of total exports in 2011. Textiles and garments continued to be the foremost industrial export followed by rubber products and petroleum products. The sharp increase in imports was due to the high demand for all major categories of imports; consumer, intermediate and investment goods as well as increased international commodity prices. Imports of intermediate goods accounted for 60.6 per cent of total imports in 2011 driven by higher expenditure on petroleum imports due to the increase in both international oil prices and the volume of imports. Investment goods, which accounted for 21.2 per cent of total imports, increased by 55.4 per cent in 2011 mainly due to the accelerated implementation of several infrastructure development projects. Increased real incomes and the reduction in the effective tax rates applicable on motor vehicles and selected electronic items supported by enhanced access to credit at competitive rates contributed to a 47.5 per cent growth in consumer goods imports in 2011. The substantial increase in import expenditure relative to export earnings led to a significant widening of the trade deficit to US dollars 9.7 billion in 2011 from US dollars 4.8 billion in 2010.

The surplus in the services account increased significantly in 2011. All subsectors of the services account, mainly transportation, computer and information, travel, construction and insurance performed well in 2011. Earnings from tourism increased remarkably to US dollars 830 million, registering an increase of 44.2 per cent. Meanwhile, the deficit in the income account widened to US dollars 647 million in 2011 from US dollars 617 million in 2010. The increase in interest payments on foreign loans and outflows on account of foreign direct investments mainly due to repatriation of profits and dividends, which exceeded receipts on interest income from the investment of official reserves and profits earned on trading of foreign currency and securities resulted in income account recording a deficit.

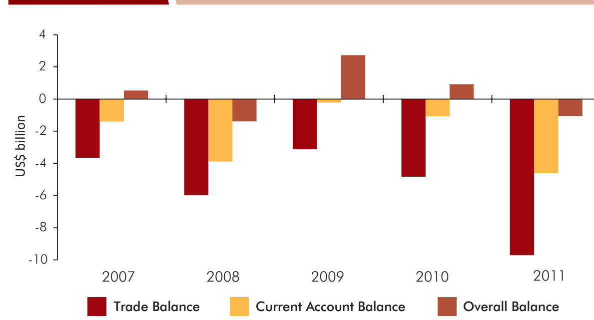
Workers' remittances, which constitute a greater share of private transfers, continued to be the foremost foreign exchange earner in 2011, surpassing the export earnings from textiles and garments for the third consecutive year. Gross workers' remittances increased notably by 25 per cent to US dollars 5.1 billion, from US dollars 4.1 billion in 2010. The repatriation of savings by migrant workers owing to the uncertainty that prevailed in the Middle Eastern countries, the increase in average wages of workers, an increase in migration to high wage paying countries such as Korea, Malaysia and Singapore, and higher labour migration in the professional categories as well as the entering into collective agreements on the welfare of migrant workers with several countries contributed to the growth in workers' remittances. Further, the expansion of formal channels to remit funds to Sri Lanka with the expansion of banking facilities in the Northern and Eastern provinces also contributed to the increase in workers' remittances in 2011.

The current account deficit increased considerably to US dollars 4.6 billion in 2011 from US dollars 1.1 billion in 2010. In terms of GDP, the current account deficit increased to 7.8 per cent of GDP in 2011 from 2.2 per cent of GDP in 2010 reflecting a widening savings-investment gap. The larger current account deficit was mainly a reflection of the widened trade deficit, about two-thirds of which was offset by higher inflows of workers' remittances and the surplus in the services account.

Inflows to the capital and financial account increased with inflows to the private sector as well as to the government. Reflecting positive investor confidence, Sri Lanka recorded its highest ever gross inflows of FDI in 2011. FDI, including loans, increased to a record level of US dollars 1.1 billion in 2011 compared to US dollars 516 million in 2010. Foreign inflows to the government increased significantly to finance major infrastructure projects. Also, Sri Lanka's fourth international sovereign bond amounting to US dollars 1 billion was successfully issued in 2011. Short term foreign inflows to the government on account of investments in Treasury bills and Treasury bonds in 2011 reached the threshold level of 10 per cent of the outstanding amount of each instrument and therefore in December 2011, it was raised to 12.5 per cent considering the increased demand and in order to support the growth momentum of the economy by increasing the availability of funds. Meanwhile, inflows to the private sector increased supported by the gradual relaxation of exchange control regulations effected by the Central Bank, enabling corporates to borrow from foreign sources.

The high current account deficit, which exceeded the surplus in the capital and financial account, resulted in a deficit of US dollars 1.1 billion in the BOP by end 2011. The BOP recorded a healthy surplus of US dollars 1.2 billion by August 2011 supported by inflows to the services account, workers' remittances and other financial flows to the

Chart 1.6 Balance of Payments



government and the private sector. The substantial increase in import expenditure mainly on account of oil imports and investment goods resulted in the trade deficit expanding significantly in the second half of 2011, turning the overall surplus in the BOP into a deficit by end 2011.

Gross official reserves (excluding Asian Clearing Union (ACU) balances) which include international reserves of the Central Bank and the government amounted to US dollars 5,958 million by end 2011, compared to US dollars 6,610 million by end 2010. The reserve position at year end was equivalent to 3.5 months of imports compared to 5.9 months of import coverage recorded in 2010. The Central Bank's intervention in the domestic foreign exchange market in absorbing foreign exchange inflows, the receipts to the government including the Sovereign bond proceeds and the receipts under the IMF Stand-By Arrangement (SBA) resulted in gross official reserves reaching a historically high level of US dollars 8.2 billion by mid August 2011. However, during the latter part of 2011, a widening trade deficit necessitated the Central Bank to supply foreign exchange to meet the increased demand in part, despite increased receipts on account of workers' remittances, tourism and inflows to the capital and financial accounts. Meanwhile, several measures were initiated by the Central Bank to attract more foreign inflows to the country. By relaxing exchange control regulations, local enterprises were encouraged to borrow directly from international financial markets, while commercial banks were permitted to raise foreign funds for Tier 2 capital. Further, foreign inflows to the government securities market were encouraged by raising the threshold on investments in Treasury bills and Treasury bonds.

Total external debt of the country declined to 41.3 per cent of GDP in 2011 from 43.3 per cent in 2010. In US dollar terms, the total external debt increased by 14.1 per cent to US dollars 24.5 billion in 2011 from US dollars 21.4 billion in 2010, mainly due to an increase in medium and long term debt. The higher level of disbursements to the government, including the US dollars 1 billion international sovereign bond issue in July 2011, resulted in the government's foreign debt stock increasing by 15 per cent in 2011. Meanwhile, concessional debt as a percentage of total government external debt declined to 63 per cent by end 2011, from 71 per cent at end 2010. Short term debt declined marginally to US dollars 2.58 billion from US dollars 2.62 billion in 2010. This was mainly due to lower outstanding value of trade credits to the Ceylon Petroleum Corporation (CPC), despite the marginal increase in the outstanding stock of Treasury bills and Treasury bonds. Meanwhile, the ratio of short term debt to total debt and liabilities declined to 9 per cent by end 2011. Foreign debt service payments, consisting of amortisation and interest payments, declined in nominal terms to US dollars 1.7 billion in 2011 from US dollars 1.8 billion in 2010. Further, as a percentage of exports of goods and services, total foreign debt service payments declined to 12.6 per cent in 2011, compared to 15.9 per cent in 2010.

Exchange rate policy in 2011 continued to focus on preventing undue fluctuations in the exchange rate and reducing pressure in the domestic foreign exchange market. In order to prevent fluctuations in the exchange rate, while ensuring adequate liquidity in the domestic foreign exchange market, the Central Bank intervened on both sides of the domestic foreign exchange market during the year. The rupee appreciated by 1.23 per cent vis-à-vis the US dollar in the first half of the year supported by substantial receipts on account of remittances, tourism and inflows to the capital and financial accounts while depreciating by 0.54 per cent during the third quarter of 2011 due to the sharp increase in import expenditure including outlays on petroleum. With the intention of improving export competitiveness, the rupee was depreciated by a further 3 per cent in November 2011. Accordingly, by end 2011, the rupee depreciated against the US dollar by 2.59 per cent to Rs.113.90. The annual average exchange rate against the US dollar in 2011 was Rs. 110.57 compared to Rs. 113.06 in 2010. In February 2012, the Central Bank decided to limit its intervention in the domestic foreign exchange market, so as to limit the supply of foreign exchange to the extent needed to settle part of the petroleum import bills, and to absorb the surplus

Table 1.3 External Sector Developments

Item	US$ million 2010 (a)	US$ million 2011 (b)	Rate of Change (%)
Exports	8,626	10,559	22.4
Agricultural Products	2,306	2,528	9.6
Industrial Products	6,096	7,992	31.1
Mineral Exports	24	33	35.7
Other Exports	199	7	-96.7
Imports	13,451	20,269	50.7
Consumer Goods	2,476	3,654	47.5
Intermediate Goods	8,054	12,275	52.4
Investment Goods	2,758	4,286	55.4
Other	162	54	-66.8
Trade Balance	*-4,825*	*-9,710*	*101.2*
Services (net)	707	1,099	55.4
Receipts	2,474	3,084	24.7
Payments	1,768	1,985	12.3
Income (net)	-617	-647	4.9
Receipts	323	467	44.6
Payments	940	1,114	18.5
Current Transfers (net)	3,660	4,643	26.9
Private Transfers (net)	3,608	4,583	27.0
Receipts	4,116	5,145	25.0
Payments	508	562	10.6
Official Transfers (net)	52	60	15.4
Current Account	*-1,075*	*-4,615*	*329.3*
Capital Account	*164*	*164*	*0.0*
Financial Account	*2,713*	*4,097*	*51.0*
Direct Investment (net)	435	896	106.0
Inflows	478	956	100.0
Outflows	43	60	39.5
Private, Long-term (net)	149	153	2.7
Inflows	580	364	-37.2
Outflows	431	211	-51.0
Government, Long-term (net)	1,796	2,244	24.9
Inflows	2,460	3,029	23.1
Outflows	665	785	18.0
Private, Short-term (net)	-198	572	-388.8
of which: Portfolio Investment (net)	-230	-171	-25.7
Government, Short-term (net)	531	233	-56.1
Errors and Omissions	-881	-707	
Overall Balance	*921*	*-1,061*	
Gross Official Reserves (c)	6,610	5,958	
Months of Imports	5.9	3.5	
Total External Reserves (c)	8,035	7,199	
Months of Imports	7.2	4.3	
Export Price Index	100.0	110.9	10.9
Import Price Index	100.0	122.4	22.4
Terms of Trade	100.0	90.7	-9.3
Exchange Rates (Average)			App(+)/Dep(-)
Rs./US dollar	113.06	110.57	2.3
Rs./Japanese yen	1.29	1.39	-7.2
Rs./Euro	150.10	153.86	-2.4
Rs./Pound sterling	174.81	177.23	-1.4

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

Source: Central Bank of Sri Lanka

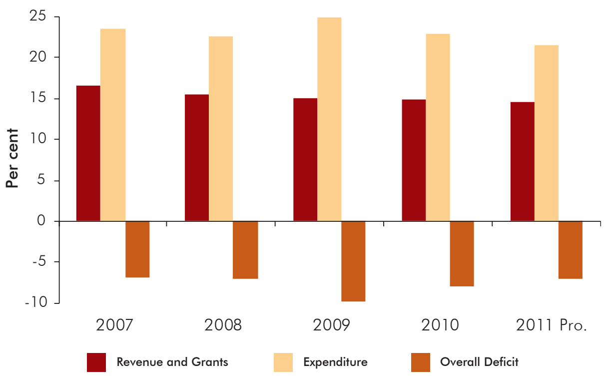
foreign exchange liquidity that would flow into the market from various sources including the receipts of Tier 2 capital by commercial banks, inflows to equity and bond markets etc., that may otherwise lead to an undue appreciation of the rupee. The intention of this policy was to discourage imports while encouraging exports, enabling a reduction in the trade deficit, as well as, the current account deficit. Further, the Central Bank, in March 2012, directed commercial banks to limit the period of forward contracts on foreign exchange transactions to a maximum of 90 days and current exposure limits on net open positions were revised downward with a view to addressing the excess volatility of the exchange rate and the speculative behaviour in the domestic foreign exchange market. During 2011, both the Nominal Effective Exchange Rate and the Real Effective Exchange Rate appreciated, following the trend observed in 2010.

Fiscal Sector Developments

The focus of the budget for 2011 was to create a conducive environment to enhance investment to maintain high economic growth, while continuing the fiscal consolidation process. The budget for 2011 announced major reforms to simplify the tax system and to broaden the tax base to enhance revenue mobilisation in the medium term. Further, the government reiterated its commitment to fiscal consolidation by rationalising recurrent expenditure, while maintaining public investment at a high level. Accordingly the overall fiscal deficit in 2011 as a percentage of GDP was reduced to 6.9 per cent from 8 per cent in 2010. Despite the revenue shortfall, restraints on recurrent expenditure and prioritisation of capital expenditure helped to maintain the fiscal balances during the year broadly in line with the estimates for 2011.

Revenue collection in 2011 suffered a setback with the abolition of several taxes, the reduction in tax rates and the upward revision in tax thresholds. However, the major reforms that were introduced in the budget for 2011, to simplify the tax system and to broaden the tax base, are expected to enhance revenue mobilisation in the medium term although in the short term these measures are likely to result in some reduction in the tax/GDP ratio. Exemptions granted, particularly on imports of petroleum and milk powder, to mitigate the pressure on the domestic market from rising international prices, also adversely affected

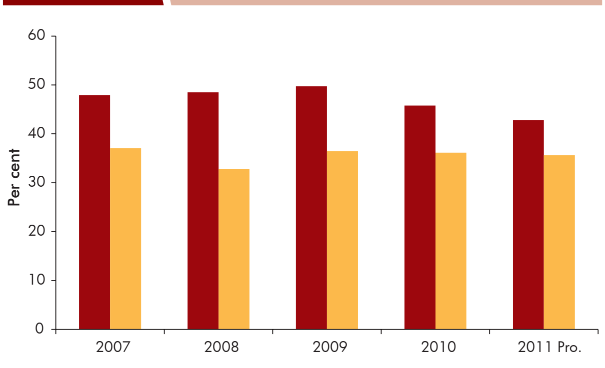
Chart 1.7 Revenue, Expenditure and Overall Fiscal Deficit (as a percentage of GDP)



revenue mobilisation in 2011. Consequently, the revenue to GDP ratio declined to 14.3 per cent in 2011 from 14.6 per cent in 2010.

Measures taken by the government to rationalise recurrent expenditure, while prioritising public investment to strategically important infrastructure development projects helped to reduce total expenditure and net lending to 21.4 per cent of GDP in 2011 from 22.9 per cent of GDP in 2010. The reduction in total expenditure and net lending by 1.5 percentage points of GDP was the combined outcome of a reduction in recurrent expenditure by 1.4 percentage points and capital expenditure and net lending by 0.1 percentage points. The fiscal consolidation measures taken in the previous year as well as the low interest rate environment slowed the growth in interest expenditure, largely helping to moderate recurrent expenditure in 2011. However, investment on key infrastructure projects in the areas of roads, ports, power and energy, railways, water supply and irrigation were continued to enhance economic activity.

Chart 1.8 Government Debt (as a percentage of GDP)



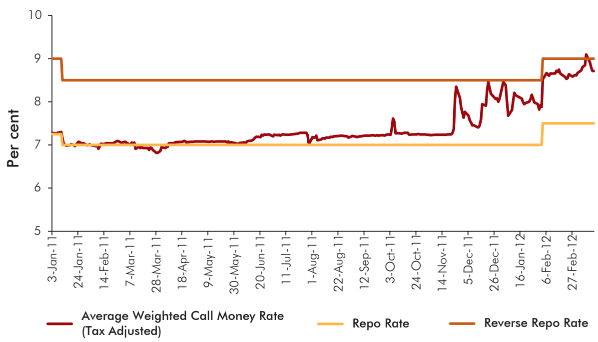
The fiscal deficit was mainly financed through domestic sources with the banking sector contributing a major portion of the required funds. The limited resources available with the non bank sector, as part of their funds were invested in alternative investments, and the tight rupee liquidity in the domestic market during the latter part of the year, increased the purchase of government securities by the Central Bank from the primary market. Considering the favourable response from foreign investors and the relatively low interest rates that prevailed in the international market, a 10-year international sovereign bond was issued to reduce the crowding out impact of budgetary financing and to reduce pressure on domestic interest rates. Consequently, net domestic financing in 2011 amounted to 3.5 per cent of GDP, while net foreign financing amounted to 3.4 per cent of GDP.

Continued improvement in government debt sustainability was reflected in the outstanding debt to GDP ratio, which declined to 78.5 per cent from 81.9 per cent in the previous year. Fiscal consolidation efforts together with higher economic growth contributed to the reduction in the debt burden, although the depreciation of the rupee against major foreign currencies towards the end of the year had some adverse impact on the outstanding debt stock.

Monetary Sector Developments

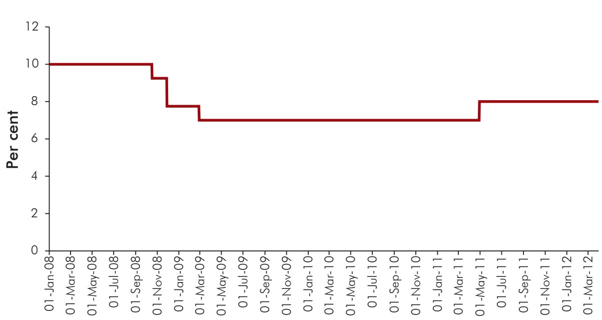
The Central Bank eased its monetary policy stance in January 2011, but in view of the continued expansion of credit and monetary aggregates at a rapid pace, the Central Bank adopted a more cautious approach in the conduct of monetary policy during the rest of the year. The Repurchase rate and the Reverse Repurchase rate, which were reduced from 7.25 per cent and 9.00 per cent, respectively, to 7.00 per cent and to 8.50 per cent, respectively, in January 2011, were held unchanged thereafter during the year. As rupee liquidity in the domestic money market

Chart 1.9 Policy Rate Corridor of the Central Bank and the Average Weighted Call Money Rate



continued to remain high, the SRR applicable on all rupee deposit liabilities of commercial banks was adjusted in April 2011 to absorb a part of excess liquidity permanently while signalling a change in the direction of monetary policy. With credit extended to the private sector by commercial banks expanding rapidly, the Central Bank resorted to moral suasion to restrain the expansion while daily auctions under open market operations (OMO) were recommenced towards the latter part of the year to maintain short term interest rates at desired level amidst declining excess liquidity. Considering emerging macroeconomic imbalances, particularly the high growth of imports and credit and to ensure that inflation continues to remain at single digit levels, the Central Bank raised the Repurchase rate and the Reverse Repurchase rate by 50 basis points each to 7.50 per cent and 9.00 per cent, respectively, in February 2012 while directing commercial banks in March 2012 to restrain the credit growth.

Chart 1.10 Statutory Reserve Ratio on Rupee Deposit Liabilities of LCBs



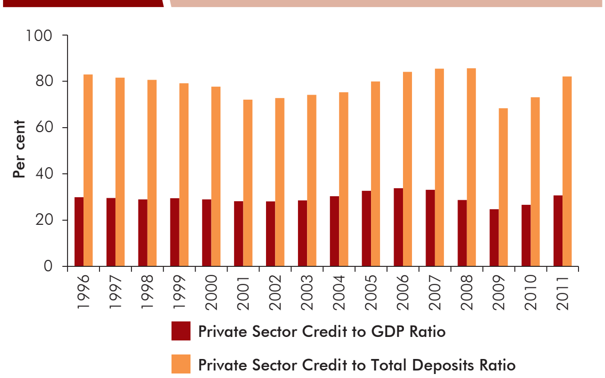
A sharp decline in excess rupee liquidity in the domestic money market was observed towards the latter part of 2011. Excess liquidity, which amounted to Rs. 113.5 billion at end 2010, turned to a deficit of Rs. 5.4 billion by end 2011. In addition to the expansion in credit disbursed by commercial banks, the increase in SRR in April 2011 and sale of foreign exchange by the Central Bank absorbed a considerable amount of liquidity from the market, although there was a substantial injection of liquidity following the issue of the US dollars 1 billion international sovereign bond by the government in July and the Central Bank purchase of Treasury bills from the primary market during the last quarter of the year. The Central Bank managed liquidity on an overnight basis through standing facilities under OMO throughout the year and through the recommencement of daily OMO auctions in September 2011.

The monetary policy framework of the Central Bank was further strengthened with a more comprehensive economic and monetary analysis enabling the capturing of ongoing structural changes in the economy together with changes in the financial practices of the general public. The Central Bank continued to focus on broad money as the intermediate target of monetary policy, which is linked to reserve money, the operating target, through the money multiplier. The monetary programme, which was prepared based on all macroeconomic developments of the economy, envisaged an average growth of 14.5 per cent of broad money, which was consistent with the nominal growth of GDP. Initial projections for real GDP indicated a growth of about 8.5 per cent while the implicit GDP deflator for the year was anticipated to be about 6 per cent, which formed the basis for the stipulated growth of broad money. Growth of reserve money, however, was expected to be higher at around 16.4 per cent due to the low money multiplier on account of the rise in the currency to deposit ratio since 2009. However, the annual average growth target for reserve money was raised to 19.5 per cent in view of the upward revision to the SRR in April 2011 in order to offset the contractionary impact it would have on the money multiplier and thereby, on broad money.

The growth of both reserve money and broad money (M_{2b}) exceeded the projected path in 2011. While the year-on-year growth of reserve money was below 18 per cent in the first three months of the year, it accelerated to over 20 per cent thereafter due to the expansion in net domestic assets (NDA) of the Central Bank while net foreign assets (NFA) of the Central Bank declined during the year. Average daily reserve money stood at Rs. 409.2 billion in 2011 recording a growth rate of 22.1 per cent compared to the targeted growth of 19.5 per cent. Broad money (M_{2b}) expanded at a higher rate than expected in 2011 recording a year-on-year growth of 19.1 per cent by end December 2011, compared to a growth of 15.8 per cent at end 2010. The average growth of broad money during the year increased to 19.3 per cent in 2011, compared to the target of 14.5 per cent as per the monetary programme for the year.

The expansion of broad money (M_{2b}) was entirely due to the increase in NDA of the banking system, which was driven by credit granted to both the private sector and the public sector. Compared to the growth of 24.9 per cent in December 2010, credit extended to the private sector grew at rates over 30 per cent on year-on-year bases since April 2011 recording the highest growth rate of 34.5 per cent in December 2011. Credit to the private sector increased by around Rs. 515 billion during the year, compared to Rs. 297 billion in 2010. The high demand for credit was due to increased economic activity reflecting the conducive environment for both investment and consumption, low interest rates and improved access to credit. Credit extended to the private sector as a percentage of GDP and as a percentage of total deposits stood at 30.7 per cent and 82.1 per cent, respectively. Public sector borrowings from the banking system also increased contributing to credit and monetary expansion. Net credit to the government from the banking system (NCG) increased by Rs. 206 billion during the year, exceeding the estimate in the government budget of Rs. 42 billion while credit granted to public corporations increased by Rs. 54 billion to Rs. 198 billion in 2011 from Rs. 145 billion at end 2010.

Chart 1.11 Ratio of Private Sector Credit to GDP and Total Deposits



The contraction in NFA of the banking system dampened the expansion of broad money to some extent. During 2011, NFA of the banking system declined substantially by around Rs. 279.4 billion, to Rs. 98.1 billion from Rs. 377.4 billion at end 2010. While the supply of foreign exchange by the Central Bank to the domestic market to contain the undue fluctuations of the exchange rate led to the diminution in NFA of the Central Bank, the decline in NFA of commercial banks was mainly due to the shifting of foreign assets of commercial banks towards domestic assets in the form of increased investments in Sri Lanka Development Bonds (SLDBs) and facilitating the Ceylon Petroleum Corporation (CPC) to settle its outstanding oil import bills. In addition, the outflow of foreign exchange to finance increased expenditure on imports contributed to the decline in NFA of commercial banks.

Tightening monetary conditions, as reflected by declining excess rupee liquidity in the domestic money market exerted upward pressure on the interest rate structure towards the end of the year. In the interbank market, the average weighted call money rate (AWCMR) remained broadly around the middle of the policy interest rate corridor in the first three quarters of the year, but moved upward during the last quarter. With regard to deposit rates, the average weighted deposit rate (AWDR), which was 6.23 per cent in December 2010, recorded an increase of 101 basis points during the year reaching 7.24 per cent by December 2011. The average weighted fixed deposit rate (AWFDR) remained in a range of 8.11-8.24 per cent during January-November 2011, before increasing significantly to 8.95 per cent in December 2011. During the year, the weekly average weighted prime lending rate (AWPR) hovered within a range of 8.92-9.96 per cent until early November, before increasing substantially to reach 10.77 per cent for the last week of the year. Yield rates pertaining to government securities in the primary market also increased towards the end of the year. The secondary market yield curve for government securities shifted upwards, although it was flatter than that of the previous year by the end of 2011.

Financial Sector Performance and System Stability

The financial system remained stable and resilient underpinned by strong domestic economic growth amidst increased risks emanating from the global macrofinancial environment. Domestic macroeconomic conditions remained favourable with expanding economic activity, and accelerated demand for credit in 2011, while liquidity pressures began to surface in the domestic financial markets towards the latter part of the year. The performance of financial institutions improved significantly, and prudential indicators were maintained with adequate capital, liquidity and profitability buffers. Money and credit markets remained liquid and interest rates remained stable during most of the year. The price indices of the Colombo Stock Exchange (CSE) declined after the upsurge in the previous two years, while funds raised by way of Initial Public Offerings (IPOs) and Rights Issues (RIs) increased significantly in 2011. The systemically important payments and settlements system operations continued with efficiency while improvements to business continuity arrangements were adhered to. The regulatory framework was strengthened and prudential requirements were enhanced.

The overall financial conditions and soundness of financial institutions improved, reflecting the increase in financial transactions to facilitate the growing economy. The banking, finance and leasing and insurance sector expanded their branch network around the country, particularly in the Northern and Eastern provinces, thereby increasing access to financial services. The activities of the banking sector further accelerated through robust credit expansion with strengthened risk management practices. The asset quality of the banking sector improved. As reflected by the positive development in NPLs, credit risk declined. The banking sector remained well capitalised, despite a marginal decline in capital adequacy ratios on account of high credit expansion. The profitability of the banking system was maintained despite a marginal decline in profitability indicators on account of the decline in interest margins. With regard to the non bank financial sector, capital and prudential requirements of finance and leasing institutions continue to be enhanced to facilitate the provision of credit and financial services to the wider economy. The profitability and assets quality of non bank financial institutions sector improved, while the level of capital was maintained above the minimum regulatory requirement. Insurance companies experienced growth in premium income and assets. However, the investment income of insurance companies declined on account of the low interest rates environment and the price decline in the CSE.

The domestic financial market was broadly stable during the year. Liquidity became constrained and there was upward pressure on interest rates towards the latter part of the year. The equity price indices of the CSE declined in 2011, following the impressive performance recorded in the stock market in 2009 and 2010. Measures such as restrictions on credit extended by brokers, continued net foreign outflows, liquidity drain on account of several IPOs, RIs and private placements and the impact of the development in global financial markets impacted negatively on the performance of the share market. The market price to earnings ratio (PER) of the CSE declined and foreigners were net sellers in the market continuing a downward trend which started in the latter part of 2009. There was a considerable increase in the amount of funds mobilised from the market through IPO activity and RIs.

The regulatory framework for the financial system was strengthened. During the year, the Central Bank further strengthened its supervisory and regulatory framework to improve the risk management systems in banks and customer protection. The Finance Companies Act was replaced with the new Finance Business Act to combat the problems of unauthorised finance business and deposit taking. A series of new and revised directions were issued for the non bank financial sector in line with the Finance Business Act. A new law to regulate microfinance institutions was finalised. The proposed amendments to the Banking Act were submitted to the Cabinet for approval, with provisions to enable the consolidated supervision of banking groups and measures to facilitate mergers and acquisitions for consolidation and resolution. The regulatory framework of the insurance sector was strengthened with the enactment of amendments to the Regulation of Insurance Industry (RII) Act in January 2011. Directions were also issued to amend the solvency margin rules, particularly with regard to the valuation of assets. With regard to the stock market, regulations relating to the provision of credit by brokers were introduced and a new Unit Trust Code was issued to provide for the regulation of exchange traded funds.

During the year, the payments and settlements system was developed further while the regulatory framework was broadened to encompass emerging electronic payment mechanisms. The LankaSettle system expanded in terms of participating institutions, with two new LCBs and one primary dealer obtaining membership in the system. As the regulator of the payments and settlements system, the Central Bank issued two separate sets of guidelines for bank led mobile payment services and custodian account based mobile payment services, in order to ensure safety, efficiency and stability of such payment mechanisms. With the intention of providing a national level platform for clearing and settlement of electronic retail payments, the Central Bank together with LankaClear (Pvt) Ltd initiated action for the establishment of a Common Card and Payment Switch (CCAPS). Further, in order to strengthen the information security of payment cards, i.e., credit cards and debit cards, the Central Bank encouraged Payment Cards Industry Association of Sri Lanka to introduce a line encryption mechanism for payment cards in Sri Lanka.

1.3 Global Economic Environment and Outlook

The global economic recovery continued to remain fragile with renewed challenges in 2011. The advanced economies, which showed a slower-than-expected recovery at the beginning of the year were hit by another wave of shocks due to fiscal and financial uncertainty towards the latter part of the year. Global financial conditions deteriorated, particularly with intensified strains in the Euro area, reflecting the downgrade of sovereign ratings in many countries by international rating agencies and further escalating downside risks to global economic activity. Consequently, the world economy, which was growing at 5.2 per cent in 2010, is estimated to have expanded only by 3.8 per cent in 2011.[1] Compared to economic growth in 2010, almost all major economic regions have experienced a lower growth in 2011. However, as seen in the past several years, a noticeable feature of global economic activity is its uneven nature, where advanced economies are estimated to have expanded by 1.6 per cent while emerging and developing economies are estimated to have grown by 6.2 per cent in 2011. Economies in developing Asia marked a decline in their average growth to 7.9 per cent in 2011 compared to the strong recovery at 9.5 per cent in 2010.

The continued divergence in economic performance among advanced economies and emerging economies warrant significant 'rebalancing' in order to deliver strong and sustainable growth.[2] The rebalancing needs

[1] As per the estimates by International Monetary Fund (IMF), reported in the World Economic Outlook Update, January 2012

[2] See World Economic Outlook (WEO), September 2011.

Table 1.4 Global Economic Developments and Outlook (a)

Item	Actual 2009	Actual 2010	Projections 2011	Projections 2012
World Output	**-0.7**	**5.2**	**3.8**	**3.3**
Advanced Economies	-3.7	3.2	1.6	1.2
United States	-3.5	3.0	1.8	1.8
Euro Area	-4.3	1.9	1.6	-0.5
United Kingdom	-4.9	2.1	0.9	0.6
Japan	-6.3	4.4	-0.9	1.7
Emerging and Developing Economies	2.8	7.3	6.2	5.4
Developing Asia	7.2	9.5	7.9	7.3
China	9.2	10.4	9.2	8.2
India	6.8	9.9	7.4	7.0
World Trade Volume (Goods and services)	**-10.7**	**12.7**	**6.9**	**3.8**
Imports				
Advanced Economies	-12.4	11.5	4.8	2.0
Emerging and Developing Economies	-8.0	15.0	11.3	7.1
Exports				
Advanced Economies	-11.9	12.2	5.5	2.4
Emerging and Developing Economies	-7.7	13.8	9.0	6.1
Price Movements				
Consumer Prices				
Advanced Economies	0.1	1.6	2.7	1.6
Emerging and Developing Economies	5.2	6.1	7.2	6.2
Commodity Prices (US$)				
Oil	-36.3	27.9	31.9	-4.9
Non fuel	-15.7	26.3	17.7	-14.0
Six-month London Interbank Offered Rate (per cent) on US dollar Deposits	**1.1**	**0.5**	**0.5**	**0.9**

(a) Annual percentage change unless otherwise indicated.

Source: World Economic Outlook (January 2012 & September 2011), IMF

to take place both 'internally' and 'externally'. Internally, a shift from fiscal stimulus to private demand needs to take place in many advanced economies. Externally, the current account deficit economies need to increase demand for their exports while current account surplus economies (notably emerging market economies) should focus more on increasing domestic demand.

However, the required rebalancing in emerging market economies seems to be slower than expected, as per the projected current account balances. Particularly, as IMF's Regional Economic Outlook (April 2011) highlights, the rebalancing of growth towards private domestic demand in the Asia Pacific region needs to be accompanied by measures to address structural constraints on domestic demand, such as investing more on infrastructure development and strengthening social safety nets. Nonetheless, the emerging market economies will continue to drive global growth over the medium term, albeit the pace of their economic growth would slow down and adjust to long run equilibrium levels. In particular, according to the latest World Economic Outlook (WEO) estimates by the IMF, the growth in emerging and developing economies slowed down, more than the forecast in 2011, possibly due to the effects of macroeconomic policy tightening.

Oil prices remained high in the international market in 2011, although other commodity prices showed a deceleration towards the latter part of the year. The rising trend in commodity prices that started in the second half of 2010 extended into 2011. Accordingly, consumer prices in advanced economies, and emerging market and developing economies increased to 2.7 per cent and 7.2 per cent, respectively, in 2011, from 1.6 per cent and 6.1 per cent, respectively, in 2010. International oil prices, which remained at elevated levels in 2011 mainly due to supply side constraints, are expected to further increase during 2012 despite slower than expected global recovery. Price increases in food and energy remain the main concern over the near term, particularly in the context of geopolitical factors in oil exporting countries. Nonetheless, the IMF's forecasts show some signs of moderation of consumer price pressure in 2012 due to a weaker economic outlook where advanced economies and emerging market and developing economies are expected to record average inflation rates of 1.6 per cent and 6.2 per cent, respectively.

Short term interest rates continued to remain low in many advanced economies in 2011 while some emerging market economies raised policy rates amidst rising inflationary pressures, mainly due to rapid growth in credit and asset prices. Advanced economies took further measures to ease monetary conditions given the slow and fragile economic recovery and low business confidence. However, some emerging market economies such as China, India and Malaysia continued to curb inflationary pressures through policy tightening.

The currency markets experienced significant volatility during 2011. The appreciating trend observed in 2010 in many major currencies against the US dollar was reversed during 2011, with a few exceptions. The Pound sterling and euro, which appreciated substantially during 2010, fell in value in 2011 amidst the sovereign debt crisis and fears of contagion in the Euro area. Thus, Pound sterling and euro depreciated by 0.73 per cent and 2.29 per cent, respectively, ending at 1.54 US dollars and 1.29 US dollars, respectively, as at end 2011. Meanwhile, Japanese yen continued to rise against the US dollar in 2011 (by 5 per cent), albeit at a moderate pace relative to 2010, possibly due to aggressive measures to restructure the country's finances and stimulate the economy, including the quantitative easing and issuance of sovereign bonds. Further, China's renminbi also gained value against the US dollar in 2011, by about 5 per cent, in the backdrop of increasing policy interest rates, which moved up three times during 2011 to curb the pace of rising commodity prices and prevent overheating of the economy. Also, China's central bank increased the statutory reserve requirement in order to tighten credit and excess money in the economy. The renminbi ended at 0.16 of a US dollar (i.e., 6.31 renminbi per US dollar) at the year end. Meanwhile, some regional currencies depreciated substantially against the US dollar during 2011. In particular, Indian rupee and Bangladesh taka, depreciated by about 15 per cent and 14 per cent, respectively.

Private capital flows displayed greater volatility owing to uneven global recovery and worsening of the European debt crisis, causing a liquidity freeze in the European interbank market. Meanwhile, official flows such as official development assistance (ODA) have been affected by stringent austerity measures and sovereign debt problems in advanced economies. The persistence of a lower interest rate regime in many advanced economies may have diverted capital flows to emerging market and developing economies. Under these circumstances, capital flows in excess of the absorptive capacity of emerging market and developing economies, or with speculative motive, could lead to exchange rate misalignment, credit booms and asset price bubbles, thus, posing significant challenges to macroeconomic stability. Such concerns have led emerging market and developing economies to build 'self insurance' stocks of international reserves, by US dollars 1.1 trillion during 2011, totalling over US dollars 7 trillion as of year end.[3] However, a larger amount of these international reserves were invested in low yielding treasuries in advanced economies (mainly in US Treasury securities) due to their perceived 'safe haven' status for global investors, thus, contributing to increasing global imbalances.[4]

The global economic outlook for 2012 is mixed, while downside risks to global economic recovery continue to persist. The uneven global economic expansion is expected to continue in 2012 as well. In the United States, growth prospects are improving, underpinned by fiscal policy stimulus, accommodative monetary conditions, and gradual strengthening of investment and private consumption. Meanwhile, the adverse effects of the earthquake and tsunami in Japan in March 2011 caused less supply chain disruptions than previously expected, thus, easing pressure on the global recovery. However, the latest projections by IMF indicate that the Euro area would experience a mild recession in 2012, amidst growing concerns over financial sector stability and fiscal sustainability. The growth prospects for emerging market and developing economies during 2012 are expected to moderate due to a likely deterioration in the external environment and possible threats to domestic demand due to continuation of macroeconomic policy tightening. Nonetheless, growth in emerging market and developing economies is expected to remain relatively robust during 2012 as they would be able to counter weaker foreign demand through appropriate policy measures. Also, high credit and asset price growth remains a major concern in a number of emerging and developing economies while any disruption to the global oil supply due to geopolitical factors could dampen activity throughout the world.

[3] See World Economic Situation and Prospects 2012, United Nations, 2012.

[4] See Box 10 entitled 'Global Imbalances', in Chapter 5.

1.4 Medium Term Macroeconomic Outlook, Challenges and Policies

The Sri Lankan economy is projected to grow at a slower rate of 7.2 per cent in 2012 compared to the impressive growth rate of 8.3 per cent recorded in 2011. The original growth projection for 2012 was revised downward from 8.0 per cent to 7.2 per cent, considering the likely impact of the developments in the domestic and global environment and the policy measures that were taken in early 2012 to curtail aggregate demand and strengthen the external sector. The increase in policy interest rates, the limiting of domestic credit expansion and raising domestic fuel prices are likely to slowdown the country's economic activity. The recent depreciation of the exchange rate is expected to curtail imports, but the expected increase in export competitiveness is likely to contain the impact of reducing external demand originating from the turbulent conditions in trading partner economies. Further, the high international energy prices, particularly of petroleum, the sluggish recovery of the global economy and weakening investor sentiments on a global scale too have been factored into the downward revision of the growth forecast for 2012.

The economy is expected to expand by around 8 per cent in 2013 and continue to grow over 8 per cent per annum over the medium term, with the expected revival in the global economy. The increase in capacity utilisation, improved productivity and diversification supported by continued development of infrastructure facilities, and continued expansion in income generating activities in the Northern and Eastern provinces will provide the basis for sustained growth over the medium term. In order to sustain the expected high growth, investments are required to be raised gradually to around 32-33 per cent in the medium term, and this level of investment is mainly expected from domestic savings. Meanwhile, per capita income, which amounted to US dollars 2,836 in 2011 is expected to surpass US dollars 4,000 in 2015, one year ahead of the time target set under the "Mahinda Chintana – Vision for the Future".

Policy measures are in place to moderate the robust growth in credit and monetary aggregates that was observed in 2011, thus ensuring that inflation remains at the envisaged mid single digit levels in the medium term. Within domestic assets of the banking sector, net credit extended to the government is expected to remain at budgeted levels, while a substantial reduction in the growth rate of private sector credit is expected in 2012 as a result of the limits imposed on credit disbursements and higher interest rates. Meanwhile, foreign assets of the banking sector are expected to improve in the medium term with the realisation of envisaged foreign capital inflows.

The focus of fiscal policy has been to create an environment that will enable the economy to move along a sustainable high growth path while continuing the fiscal consolidation process. Improved revenue mobilisation with the full implementation of tax reforms and the rationalisation of recurrent expenditure is expected to reduce the overall fiscal deficit to below 5 per cent of GDP by 2016, thus generating savings and improving the debt to GDP ratio to 60 per cent during this period. Recognising the fact that a higher level of investment is required to sustain the current growth trajectory, the government would place priority on implementing a sound public investment programme. Improved infrastructure facilities are expected to provide impetus to private sector investment thus raising overall investment to the desired level.

The external sector, which faced significant challenges in 2011, is expected to rebound in 2012 and strengthen further over the medium term. In line with the envisaged higher growth trajectory, external trade will continue to maintain its thrust over the medium term. The growth of exports will continue with recent fiscal policy measures taken to encourage the expansion in exports, the continuous diversification efforts by exporters in terms of products and markets, and recent industry adherence to productivity improvements and export sophistication. Industrial exports are expected to gain from Cess and duty concessions granted for machinery, equipment and raw material imports enabling domestic industries to access improved technology and deliver globally competitive products. The apparel industry has strengthened by increasing its niche capabilities and raising domestic value addition, and will enhance its existing and new plant capacities and industry wide ethical positioning. The expenditure on imports would grow, but at a decelerating pace over the medium term. Trade in services is expected to generate increasing surpluses supported by the booming tourism industry and transportation including port and airport related activities. Workers' remittances, which are estimated to grow substantially in 2012, are expected to moderate its growth in the medium term in line with expanding domestic economic activities. With the tight domestic labour market conditions, migration for foreign employment is expected to decline gradually resulting in a deceleration of workers' remittances in 2013 and beyond in contrast to the substantially high growth rates recorded since 2009. Despite the trade balance in favour of imports, inflows to the services account and workers' remittances are expected to reduce the current account deficit gradually. With further relaxation of exchange control regulations, direct and portfolio investment inflows to the private sector and financial inflows to the government are expected to increase significantly in 2012 and beyond. By end 2011, the government had a cumulative financial commitment of around US dollars 7.3 billion from Sri Lanka's development partners in comparison to US dollars 7.1 billion

Table 1.5 Medium Term Macroeconomic Framework (a)

Indicator	Unit	2010 (b)	2011 (c)	Projections 2012	2013	2014	2015
Real Sector							
GDP at Market Prices	Rs. bn	5,604	6,543	7,504	8,631	9,909	11,290
Real GDP Growth	%	8.0	8.3	7.2	8.0	8.3	8.5
GDP Deflator	%	7.3	7.8	7.0	6.5	6.0	5.0
Per Capita GDP	US$	2,400	2,836	2,939	3,435	3,969	4,574
Total Investment	% of GDP	27.6	29.9	30.5	31.6	32.0	32.3
Domestic Savings	% of GDP	19.3	15.4	18.3	21.9	23.8	25.0
National Savings	% of GDP	25.4	22.1	26.7	30.2	31.6	32.5
External Sector							
Trade Gap	US$ mn	-4,825	-9,710	-9,183	-9,110	-9,433	-9,994
Exports	US$ mn	8,626	10,559	11,703	13,030	14,557	16,302
Imports	US$ mn	13,451	20,269	20,885	22,139	23,990	26,296
Services (net)	US$ mn	707	1,099	1,617	2,028	2,415	2,788
Trade and Services Balance (net)	US$ mn	-4,118	-8,611	-7,566	-7,082	-7,018	-7,206
Workers' Remittances	US$ mn	4,116	5,145	6,481	7,341	8,079	8,876
Current Account Balance	US$ mn	-1,075	-4,615	-2,325	-995	-336	168
Current Account Balance	% of GDP	-2.2	-7.8	-3.8	-1.4	-0.4	0.2
Overall Balance	US$ mn	921	-1,061	1,250	1,700	2,400	2,500
External Official Reserves (d) (e)	US$ mn	6,610	5,958	7,945	9,157	10,776	12,823
Debt Service Ratio (f)	%	15.9	12.6	16.1	15.7	16.8	16.6
Fiscal Sector							
Total Revenue and Grants	% of GDP	14.9	14.5	15.0	15.1	15.6	15.7
Total Revenue	% of GDP	14.6	14.3	14.7	15.0	15.5	15.6
Grants	% of GDP	0.3	0.2	0.3	0.1	0.1	0.1
Expenditure and Net Lending	% of GDP	22.9	21.4	21.2	20.9	20.8	20.7
Current Account Balance	% of GDP	-2.1	-1.1	0.0	0.5	1.0	1.0
Overall Budget Deficit	% of GDP	-8.0	-6.9	-6.2	-5.8	-5.2	-5.0
Domestic Financing	% of GDP	3.6	3.5	3.6	3.6	3.5	3.6
Government Debt	% of GDP	81.9	78.5	77.7	73.2	69.0	65.4
Financial Sector (g)							
Reserve Money Growth	%	18.8	21.9	15.0	15.0	15.0	14.0
Broad Money Growth (M_{2b})	%	15.8	19.1	15.0	15.0	15.0	14.0
Change in Credit to Government	Rs. bn	-13.1	206.4	64.0	25.0	15.0	10.0
Change in Credit to Private Sector	Rs. bn	296.9	514.8	380.4	334.3	431.9	456.1
Growth in Credit to Private Sector	%	24.9	34.5	19.0	14.0	15.9	14.5

(a) Based on the information available by mid March 2012
(b) Revised
(c) Provisional
(d) Excluding receipts of Asian Clearing Union
(e) External official reserves include the proceeds from the IMF Stand-by Arrangement facility-2009.
(f) Total debt service payments as a percentage of earnings from exports of goods and services
(g) Year-on-year growth in end year values

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

BOX 4 The Challenges in the External Sector in 2012 and the Way Forward

Sri Lanka has been experiencing deficits in both the trade account and external current account during the last five decades.[1] These deficits have widened substantially since the adoption of open economic policies in 1977. This phenomenon of deficits in the trade and current accounts is common to most developing economies, which are exporters of primary agricultural products and importers of essential commodities. Sri Lanka's economic and export structure was mainly agriculture based. Since the early 1990s, industrial exports became dominant led by garments and textiles. However, even this structural shift in export composition could not offset the expenditure on imports. Accordingly, the trade deficit averaged around 11 per cent of GDP since 1977, while the current account deficit was around 5 per cent of GDP on average, during the same period (Chart B 4.1).

In 2011, the deficits in the trade account and current account were above the historical averages, mainly due to the sharp growth of import expenditure (about 51 per cent compared to 2010), despite an impressive growth of exports, which grew by about 22 per cent, over the previous year. Such a growth in import expenditure can be mainly attributed to the increased demand for intermediate and investment goods, owing to rapid infrastructure development activities and also the sharp increase in the price and volume of petroleum imports. Nonetheless, the expansion in imports at a faster pace than exports, and net inflows on account of services and transfers resulted in a deficit in the current account in 2011, which stood at 7.8 per cent of GDP. The current account balance reflects the savings-investment gap and a current account deficit is not necessarily bad, as it may arise from valid reasons such as high imports of investment goods. However, maintaining the current account deficit at a sustainable level over the medium term is important in order to avoid risks of large financial disruptions (Blanchard and Milesi-Ferretti, 2011).

Sri Lanka's economy is poised to record a growth rate of above 8 per cent on average over the medium term, hence, both exports and imports are expected to grow at above trend levels. Import demand may need to be accommodated to the extent needed to facilitate the required level of investment. Boosting exports may also take place with enhanced productivity and diversification of exports, but with a time lag.

1 Trade balance is the difference between the monetary value of merchandise exports and imports in an economy over a certain period. A deficit in the trade balance occurs when total imports are greater than total exports. Current account balance is the difference between a country's total exports of goods, services, income and transfers, and its total imports. A current account deficit occurs when a country's total imports of goods, services, income and transfers are greater than the country's total export of goods, services, income and transfers.

Chart B 4.1 Trade Balance and Current Account Balance (1977-2011)

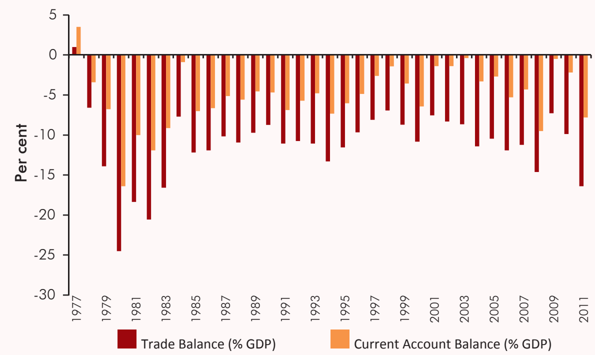
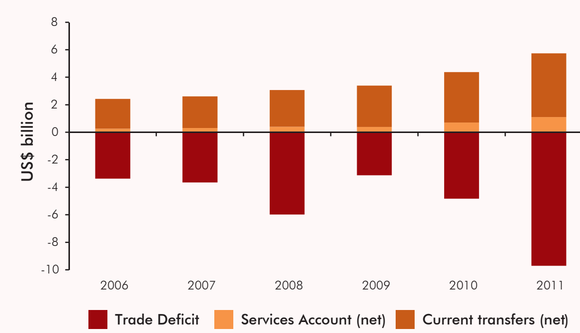


Chart B 4.2 Trade Balance, Services Account and Current Transfers



Therefore, it would be necessary to reduce the current account deficit through other measures, than entirely depending on a reduction in the trade deficit. Towards this end, a noteworthy development is taking place in the current account, particularly in recent years. As Chart B 4.2 shows, the widening trade deficit has been offset substantially by the surplus in the services account and current transfers. For instance, the trade deficit in 2011 stood at US dollars 9.7 billion, while the sum of net services and net current transfers amounted to US dollars 5.7 billion. While net current transfers (mainly workers' remittances) are already making a substantial contribution to offsetting the trade deficit, the services account has a huge potential to positively impact on the current account balance. Therefore, Sri Lanka's medium term strategy would be to tap this potential in services exports.

The major components in the services account are shown in Table B 4.1. The main contribution comes from the transportation category. Recent developments in port services have enabled Sri Lanka to leverage from transshipment and entrepot trade. The apparel industry has recognised the importance

Table B 4.1 Major Components in the Services Account

(US$ mn)

	2006	2007	2008	2009	2010	2011
Transportation	751	838	1000	865	1162	1392
Travel	410	385	342	350	576	830
Communication	68	72	81	80	83	85
Computer and IT	98	175	230	245	265	355

Note: Gross numbers are reported

of entrepot trade as a potential area for high foreign exchange earnings. Moreover, industries such as vehicle assembly, fertilizer mixing and packaging and tea blending industries will benefit from entrepot trade. Access to efficient transportation facilities and adequate infrastructure within a free port area makes it profitable for industries located in such areas to compete in the international market. The Magampura port at Hambantota envisages a free port with an international airport and a surrounding industrial estate. The proposed Trincomalee industrial park is another initiative earmarked for a free port for heavy industry development activity.

While earnings from tourism have increased markedly in recent years, tourism has the potential to become a key source of foreign exchange earnings for Sri Lanka. To promote tourism, the Sri Lanka Tourism Development Authority has already initiated measures to promote tourism on the basis of several selected themes. It is expected that earnings from tourism will exceed US dollars 1 billion in 2012 and increase further thereafter.

In addition, Sri Lanka is being increasingly recognised as one of the leading outsourcing hubs and hence, industries which provide IT Enabled Services (ITES) like Business Process Outsourcing (BPO) and Knowledge Process Outsourcing (KPO) have been identified as sectors with high growth potential. Sri Lanka could capitalise on its competitive advantage and the availability of a large pool of highly qualified professionals in engineering, medicine, management, accountancy etc., which will enable Sri Lanka to attract industries such as engineering, pharmaceuticals, healthcare, telecommunication, and research and development.

In view of the factors discussed above, the thrust of 2012 and medium term strategy would be to improve the surplus in the services account, thereby enabling a reduction in the current account deficit to a sustainable level.

Reference:

Blanchard, O. and Milesi-Ferretti, G.M. (2011): (Why) Should Current Account Balances Be Reduced? IMF Staff Discussion Note, SDN/11/03

at end 2010. These commitments are mainly for infrastructure projects and project implementation duration is in the range of 2-5 years. With the realisation of these inflows, the BOP is expected to record a surplus in the overall balance while the country's international reserves will be maintained at comfortable levels, equivalent to around 5 months of imports over the medium term.

The key challenge facing Sri Lanka in 2012 is managing the numerous risks arising from global developments. Clear signs of global recovery are yet to be seen while geopolitical tensions in some oil-producing countries, adverse weather and climatic conditions and higher demand from emerging economies would continue to keep energy and other commodity prices in the international market elevated. In the past two years, Sri Lanka has been able to withstand the external shocks with improved domestic supply conditions, robust domestic demand and improvements in key macroeconomic variables. However, Sri Lanka's ability to resist these persistent uncertainties in the global economy is likely to be rigorously tested yet again in 2012, and further advances in productivity and quality of production, export diversification, promotion of renewable energy use and energy conservation and improving domestic food supplies further along with effective demand management policies are required to address exogenous disturbances effectively.

The Central Bank and the government took a number of bold decisions at the onset of 2012 to address emerging imbalances, particularly in the external sector of the economy. The adjustments to domestic energy prices could help correct external sector imbalances and improve the balance sheets of public corporations, although there could be a one-off increase in domestic price levels and the cost structure of domestic industries and services. The freer movement of the exchange rate would help address the imbalance in the trade deficit by restraining imports and stimulating exports of both goods and services. The trade balance is likely to benefit from the increase in excise duty on motor vehicles as well. Higher interest rates and lower disbursement of credit by commercial banks could contain trade related credit and future inflation, but would have an impact on economic growth. However, these adjustments were essential to ensure maintaining the macroeconomic balance needed for sustained growth, and any resultant diversion from the original medium term macroeconomic targets would be transitory.

To sustain further improvements in domestic supply conditions and increase agricultural productivity with greater contribution from all provinces, it is essential to ensure that local producers make sufficient profit margins. Particularly in the case of agricultural produce such as rice and fresh vegetables, farmers continue to experience downward pressure on prices during periods of bumper harvests, sometimes even below the costs of production. As agriculture is still the principal means of livelihood for a substantial fraction of the population, efforts are needed to protect incomes of domestic farmers, and thereby ensure a continued domestic supply of agricultural produce. Some policy measures that could be implemented are educating farmers to diversify production, encouraging research on food preservation and packaging, exploring avenues to export excess stocks of rice, fruit and vegetables, strengthening the domestic forward and futures markets, improving storage facilities of private and public sector wholesalers, and promoting partnerships between the farmer community, government and the private sector to improve agriculture marketing.

Appropriate policy measures are required to unravel the potential of the fisheries sector as a major industry that caters to domestic and export markets. In addition to climatic reasons, the difficulty to tap offshore resources largely due to lack of facilities in the multi day fishery fleet is responsible for lower than potential marine fish production. Sri Lanka's Exclusive Economic Zone (EEZ) remains heavily underutilised, and the National Aquatic Resources Agency (NARA) observes a declining trend in the catch per trip of the large pelagic fishery boats over the years. Therefore, it is imperative to modernise and/or replace existing boats with a new fleet, fitted with facilities such as Refrigerated Sea Water (RSW) systems, Chilled Sea Water (CSW) systems along with other facilities such as fish finders, satellite navigators, Single Side Band (SSB) receivers, longlines, etc. Further development of onshore infrastructure facilities such as the establishment of new ice plants, fish canning facilities, new cold chain systems and miscellaneous harbour facilities in the vicinity of landing sites, is also a priority area, which could improve the quality of the produce. The expansion of commercial aquaculture such as finfish culture, sea weed culture, sea bass culture, bivalve culture, fresh water prawn culture, oyster culture and sea cucumber fattening in pens could also be supported to meet the demands of the tourist industry and export markets.

Sri Lanka's tea industry, traditionally a leading foreign exchange earner for the country, faces a number of challenges from global developments as well as domestic issues. The average productivity of the tea sector in Sri Lanka remains low compared to competitors mainly due to the decline in fertility in soil, aging of tea bushes, and delays in replanting. Yield cannot be improved merely by increasing fertiliser application unless the soil is rehabilitated through complete uproot and replantation, as around 90 per cent of the seedling tea bushes in the bearing extent of regional plantation companies (RPCs) is over 60 years of age while over 53 per cent of vegetatively propagated (VP) tea bushes of smallholders are between 20 to 40 years of age. At the current price levels, it costs around Rs.2.0 million for replanting a hectare, which is prohibitive, especially as it takes at least three years to earn profits from new tea bushes. The increased cost of production with the revised wage package for plantation workers, high energy prices and the increased cost of packaging material, is another issue faced by producers. The global uncertainties, in particular the geopolitical tensions in the Middle East have added to the woes of the tea industry. Thus it is necessary that new markets are explored, investment in research is raised, and a mass scale agenda to propagate the consumption of pure Ceylon tea in selected potential markets is undertaken through public private partnership arrangements. To address supply side issues, it is essential to support targeted replanting, improve manufacturing processes in order to reduce the amounts of refuse tea, and link any wage adjustments in plantations to productivity.

It has been well recognised that Sri Lanka's education system requires substantial modernisation to create the required human capital base to sustain the growth momentum of the economy. The benefits of the education system can only be reaped if education services are aimed at fulfilling the requirements of the labour market. Thus, it is essential to realign the education system to move away from an examination-centric, content based curriculum towards a competency based curriculum, helping children to gain life skills and to encourage independent thinking. Reforms in the university system can also help alleviate the mismatch between the skills of graduates and the requirements of the labour market, which can help reduce youth unemployment and underemployment. While increased government investment in higher education alone may not be sufficient to transform Sri Lanka into a knowledge hub, it is essential to take a holistic perspective where private sector investment in higher education has a pivotal role to play. The recent efforts by higher education authorities to internationalise Sri Lankan universities through increased web presence, collaborating with reputed international universities on student and staff exchange programmes and opening up postgraduate opportunities for foreign students are commendable. Meanwhile, the network of technical and vocational training institutions in Sri Lanka has eased the pressure on youth unemployment somewhat, but needs vigorous expansion to facilitate the school-to-work transition of students who are deprived of university education. As technical and vocational training is also shown to deliver greater marginal returns for an additional year of education, further expansion of these opportunities must be encouraged.

The existing public passenger transport system in Sri Lanka is insufficient to accommodate the growing demand for transportation, both in terms of quantity and quality, and has forced the public to opt for more expensive and inefficient private modes of transportation. The transport network of a country must be able to support economic growth, growing population in cities and increased movements between urban, suburban and rural sectors. The inefficiency of the public passenger transport system has resulted in increasing numbers of private vehicles on the roads transporting fewer numbers of passengers per vehicle leading to heavy traffic congestion, causing increased fuel costs to households and to the economy and a substantial loss of productive man hours. Although the government has invested heavily in transportation infrastructure development, such as building of roads and adding fleets of buses, the issue of congestion persists due to the lack of good quality and reliable mass transport options. Hence, it is important to take appropriate measures to improve the existing road and rail transportation systems especially in urban areas. Measures such as the establishment of a high capacity monorail system, which connects commercial areas with peripheral cities even for a short distance initially, may be a viable solution to the heavy congestion in urban areas. Promoting alternative modes of transport, such as establishing safe and clearly demarcated cycle routes and promoting the effective use of the canal network, which is now being renovated, for public transportation, could reduce congestion to some extent.

Proper pricing mechanisms are required to maintain the financial viability of state owned enterprises (SOEs). In 2011, policy measures were initiated by the government to reform SOEs and raise their return on investment through developing an economically feasible cost reflective pricing structure, persuade them to explore innovative Public Private Partnership

(PPP) strategies and attract private investments to catalyse the development process. These measures could improve the financial position of public enterprises, which continue to depend on the banking sector and the government budget to meet the operating losses incurred by them. In particular, adopting appropriate flexible pricing policies by public enterprises would ensure that their prices reflect true costs of production and international price movements, and help avoid the need for large adjustments of prices which may have an adverse effect on economic activities.

In view of the escalating international petroleum prices, limited low-cost generation capacity, and the growing energy requirement of the economy, it is essential to step up efforts on energy conservation. Although, certain ad hoc measures have been implemented to promote energy conservation, it is essential that an integrated energy conservation policy that features energy pricing policy, tax policy and public transport policy is introduced. At the same time, the promotion of low-cost renewable energy sources also require to be encouraged to reduce the vulnerability of the economy to high international petroleum prices.

While Sri Lanka was able to attract a landmark FDI inflow of over US dollars 1 billion in 2011, compared to other comparable countries in the region, FDI inflows remain significantly below the potential level, and the country is yet to establish itself as a key destination for new FDIs. FDI inflows in 2012 are projected to reach US dollars 2 billion, financing a number of key projects. However, a greater effort needs to be placed in attracting more FDIs over the coming years through efficient business facilitation, investment promotional activities overseas in key potential markets and prompt availability of information on potential investment prospects. Business facilitation in all stages of investment must be considered as a significant policy priority, which includes the provision of administrative support for foreign investors at all stages of the approval process, during the implementation of the project as well as the provision of post implementation services. A continuous update on potential and emerging areas for investments, such as renewable energy generation, nanotechnology, ship and boat building, tourism, IT and BPO sector, and service based industries in education, health and financial services, is essential in attracting new investments. Such measures together with ongoing efforts of the government including measures to improve the "Doing Business" environment and the establishment of a "One-stop-unit" in the administration of FDI approvals will be beneficial in attracting further foreign investments inflows.

As the external sector is expected to contribute significantly to economic growth in the medium to long term, the strategies focused on creating an enabling environment for foreign exchange earning industries is essential. Sri Lanka still exports mostly primary or relatively low value added industrial products, and this needs to be addressed through increased export sophistication through a targeted national industrial strategy channelling more resources to technologically sophisticated industries. The value addition to exports must be supported by market diversification. Also, some additional strategies to increase export earnings, include increasing access to established markets through high earning products and utilising untapped opportunities within these markets to increase the market share, encouraging domestic enterprises to identify and utilise trade opportunities in preferential and free trade agreements, and investing in research and development to support production and process innovation. Another area that requires attention is harnessing the potential of the demarcated free port area to encourage entrepot trade for selected industries relating to import, processing and re-export, transshipment, the provision of front end services, and providing incentives for leading buyers to establish regional operation centres in Sri Lanka.

Sri Lanka's tourism sector is at crossroads with an increased number of tourist arrivals and a rapidly evolving tourism infrastructure. The tourism industry expanded substantially in 2011, both in terms of arrivals and earnings, and major international hotel chains are being established in Sri Lanka while several reputed airlines have added Sri Lanka as one of their destinations. Over the medium term, the industry is poised to achieve the target of attracting over 2.5 million tourists by 2016 and the spending target of US dollars 150 per night by 2016 by facilitating high end tourists and infrastructure. To sustain the expected growth in the industry and to further facilitate the promotion of Sri Lanka under the eight unique themes, namely, Heritage, Festive, Scenic, Essence, Thrills, Bliss, Pristine and Wild, the industry requires continuous infrastructure development mainly to support increasing traffic at the existing international airport, diverting some traffic to the international airport being built in Mattala, and improving transport links between attractions. Further, the industry requires a rapid expansion of room capacity, upgrading of existing facilities, and the training of professionals in hospitality industry. The impact of tourism on domestic demand and consumer prices, as well as the impact of the industry on the environment also need to be given due consideration by the authorities.

A major challenge in the fiscal sector would be to continue the revenue and expenditure reforms so as to create the fiscal space necessary to support a higher economic growth. The full potential of the major tax reforms carried out by the government is likely to be realised only in the medium term. Low tax rates and a simplified tax system as well as the widening of the tax base are expected to enhance revenue mobilisation. However, tax reforms need to be supported by measures to bring in all those liable into the tax net, while streamlining tax procedures to create a taxpayer friendly environment, which will encourage greater tax compliance. Tax reforms however, need to be supported by expenditure rationalisation measures. Improved targeting of subsidies and cost reflective pricing would need to be actively pursued to reduce recurrent expenditure so that more resources could be made available for investment in infrastructure which is essential to sustain the envisaged high economic growth. Further remaining committed to the fiscal consolidation process is essential to keep the debt to GDP ratio at a sustainable level.

Increased economic activity has absorbed a majority of the labour force resulting in a continued low rate of unemployment, and further tightening of labour market conditions may pose challenges to economic and price stability as well as social stability. Sri Lanka's unemployment rate has been below 5 per cent in each quarter since the second half of 2010, and greater foreign employment opportunities, in spite of adverse global economic conditions, continue to tighten labour market conditions further. This could give rise to a wage-price spiral where wage pressures may lead to upward pressure on prices as well, although the continued low consumer price inflation, which has remained at a single digit level during the past three years, remain a dampening factor. Hence, to sustain the growth momentum of the economy it is essential to support improvements in labour productivity and increase capital intensity. The labour force participation rate, which was 48.2 per cent in 2011, still has room for improvement and ease pressure in the labour market through absorbing population currently not in the labour force into the market. Therefore, it is essential that physical infrastructure and social infrastructure facilities including good quality public transportation, urban housing, and childcare facilities continue to be developed to promote labour productivity and increased labour force participation. Recent advances in Sri Lanka's information and communication technology could also provide alternative flexible work arrangements for some types of work, which may also help in reducing labour costs while attracting those not in the labour force into the labour market.

The rapidly ageing population in the country may have several economic and social implications for the near future, and measures are required to minimise the impact of these demographic changes. Sri Lanka has one of the fastest ageing populations among developing countries, due to the ongoing rapid demographic transition. The country has experienced an increasing trend in the population aged over 60 years, primarily as a result of higher life expectancy. It is expected that the proportion of the population over 60 years of age would reach 25 per cent by

2030, inverting the demographic pyramid leading to several economic and social repercussions in terms of labour availability, structure of the labour force, productivity, investments, consumption, savings and a substantial increase in welfare expenses on elderly care. The change in the patterns of consumption and savings by the aged would have an impact on aggregate consumption and investment as well. Increased demand for health care will raise government's expenditure on health, while increased cost of pensions, could affect the government expenditure adversely. Hence, timely actions are required to design and implement suitable policies, such as the necessary amendments to labour regulations and ensuring the sustainability of pension funds, while improving elderly care facilities and ensuring that the real value of savings is protected.

Following many notable achievements during the past two years, the Sri Lankan economy is likely to experience a year of moderation and consolidation in 2012. The issues that emerged in the external sector and the monetary sector were addressed through strong policy reaction in early 2012. These policy measures along with uncertain global developments are likely to have some adverse transient effect on economic growth and consumer price inflation in 2012, but the economy is expected to sustain growth rates of over 8 per cent thereafter. Measures that are being taken to strengthen the macroeconomic fundamentals further, along with the effective addressing of structural bottlenecks highlighted above, would improve the resilience of the economy to adverse developments externally and internally while ensuring the sustainability of high economic growth in a low inflation environment.