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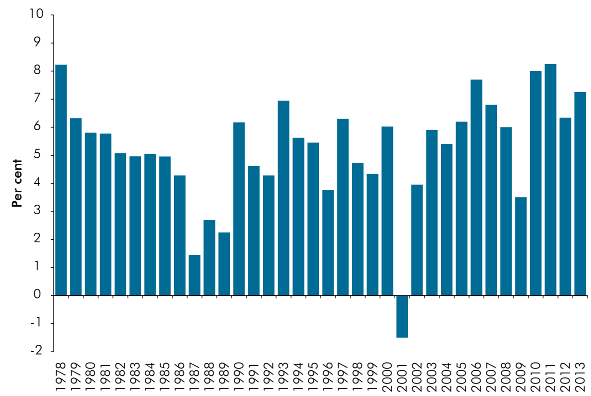
ECONOMIC, PRICE AND FINANCIAL SYSTEM STABILITY, OUTLOOK AND POLICIES

1.1 Overview

The Sri Lankan economy rebounded strongly in 2013 with an annual real GDP growth of 7.3 per cent, while inflation, which remained at single digit levels for the fifth consecutive year, gradually declined further to reach mid single digits by the end of the year. All sectors of the economy contributed positively to growth, and favourable weather conditions and the gradual recovery in external demand supported the steady rise in economic growth over the four quarters of the year. GDP in nominal terms grew by 14.5 per cent to Rs. 8,674 billion or US dollars 67 billion, raising GDP per capita to US dollars 3,280 in 2013. In spite of significant upward adjustment to domestic energy prices, prudent monetary management and improved domestic food supply resulted in a gradual decline in headline inflation while core inflation moderated to its lowest level. Monetary expansion decelerated towards desired levels in 2013 while the lag effect of tight monetary policy measures in the previous year and a steep decline in gold backed advances lowered credit disbursements to the private sector by commercial banks. Continued low inflation allowed the Central Bank to ease monetary policy further during the year to facilitate economic activity. Policies put in place by the government and the Central Bank in 2012, along with the gradual recovery in major export markets, resulted in a marked improvement in the balance of payments (BOP), enabling a buildup of official reserves and supporting exchange rate stability. Continued commitment of the government to fiscal consolidation helped further reduce the fiscal deficit and debt to GDP ratio in 2013. The financial sector remained sound and resilient amidst increased volatility and uncertainties in global financial markets.

The realisation of the desired stabilisation objectives of the macroeconomic policy package that was adopted in 2012 coupled with favourable inflation outcomes and expectations, allowed the Central Bank to ease monetary policy further during the year. Accordingly, the easing of monetary policy that commenced in December 2012 with the reduction of the Central Bank's key policy interest rates by 25 basis points, continued in 2013. Overall, policy interest rates were reduced by a further 100 basis

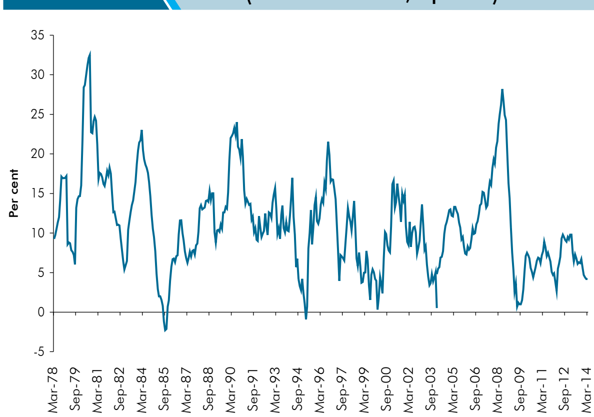
Chart 1.1 Annual Real GDP Growth



points during the year while increased liquidity also reflected the accommodative policy stance. Throughout the year, maintaining inflation at single digit levels remained the overarching objective of monetary policy, and declining inflation and benign inflation expectations allowed monetary policy to support the revival of economic activity. Monetary policy decisions taken in a forward looking framework proved effective, as reflected in mid single digit inflation recorded at the end of the year coupled with higher economic growth during the second half of the year.

Inflation remained at single digits for the fifth consecutive year, reducing wage pressures in the economy and also raising investor confidence. Headline inflation, which

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



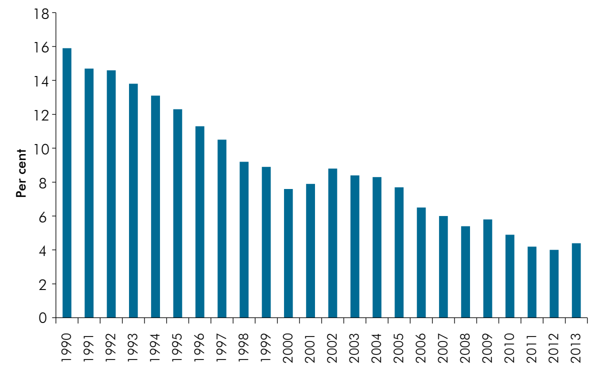
remained close to double digit levels during the first two months of the year, decelerated thereafter to mid single digit levels by the end of the year supported by improved domestic supply conditions and prudent demand management policies. Accordingly, by end 2013, headline inflation was 4.7 per cent on a year-on-year basis and 6.9 per cent on an annual average basis. Displaying effective management of aggregate demand, core inflation, meanwhile, moderated gradually during the year and declined to its lowest values during the last quarter of 2013. Core inflation was 2.1 per cent on a year-on-year basis and 4.4 per cent on an annual average basis by end 2013. Supported by continued benign inflation and inflation expectations, wage pressures remained subdued, and this was reflected in the moderate rise in the nominal wages of most categories of employees.

Economic growth in 2013 was broad based, with a strong growth in the Industry sector, a recovery in the Services sector, and a revival in the Agriculture sector during the second half of the year. Stabilisation policies that were in place in 2012 continued to impact economic activity during the first half of the year, but continued physical infrastructure development, favourable weather conditions and the recovery in advanced economies supported increased economic activity in the second half of 2013. Aided by robust construction and manufacturing activities, the Industry sector recorded a growth rate of 9.9 per cent, raising its share of GDP to 31.1 per cent. Services sector growth was higher than the previous year at 6.4 per cent, mainly due to improved performance in wholesale and retail trade and transport and communication sub sectors. The weak performance of the Agriculture sector during the first half of the year due to extreme weather conditions dragged its annual growth rate down to 4.7 per cent. Consequent to the stronger performance of the Industry sector during the year, the share of the Services sector and the Agriculture sector in GDP declined to 58.1 per cent and 10.8 per cent, respectively.

Improvements in economic and social infrastructure remained an integral part of the government's strategy to achieve sustained economic growth while ensuring that the benefits of growth trickle down through all regions of the country and all segments of the population. The year 2013 saw the completion and continuation of many key infrastructure projects including the country's second international airport, harbour and port development projects, expressway and highway development projects, the Northern railway project, power projects, as well as several rural infrastructure development projects. A number of measures were taken to improve health and education services provided by the government, while the provision of these services by the private sector was also encouraged and streamlined. The Colombo city beautification and countrywide township development projects aided the wellbeing of the population among several other benefits associated with such improvements, such as promoting Sri Lanka as an upmarket tourist destination. The government also spearheaded many housing development programmes. Reflecting the continued growth momentum, low inflation and development activities targeted at poverty alleviation, the poverty headcount ratio declined to 6.5 per cent as per the preliminary findings of the Household Income and Expenditure Survey (HIES) 2012/13.

The labour force expanded by 4.1 per cent during the year, which caused the number of employed as well as unemployed persons to increase, while labour productivity continued to improve. Increased entry of rural females into the labour market seeking local job opportunities resulted in an increase in the labour force

Chart 1.3 Annual Unemployment Rate



participation rate (LFPR) in 2013. The total number of employed persons increased, and a shift of the workforce from the Agriculture sector to the Services sector was observed during the year. The unemployment rate rose to 4.4 per cent in 2013 from its historic low in the previous year, mainly as a result of the entry of new job seekers to the labour market. The total number of departures for foreign employment continued to grow. However, departures under the housemaid category declined substantially during the year, which contributed to the higher female LFPR. With the sectoral shift observed in employment, labour productivity in the Agriculture and Industry sectors improved, while that of the Services sector declined. The increasing trend in overall labour productivity continued due to focused policies in place, but further potential exists in productivity improvements in all sectors.

The stability of the external sector of the economy improved significantly in response to domestic economic policies and improved export demand during the second half of the year. A notable reduction in the trade deficit was observed following the significant increase in earnings from exports coupled with the decline in expenditure on imports. The rebounding of global trade and the increase in demand from major export destinations from the second half of 2013, had a favourable impact on export earnings. The increase in earnings from the export of textiles and garments was particularly impressive. The decline in import expenditure was mainly a result of lower petroleum imports. The travel and tourism sector led the improvement in trade in services, while earnings from transportation, information technology (IT), business process outsourcing (BPO) and knowledge process outsourcing (KPO) also grew, reinforcing the growth potential of these emerging sectors. Workers' remittances also increased with a more diversified migration profile. As a result of improved earnings from merchandise and service exports and workers' remittances, the external current account deficit narrowed to 3.9 per cent of GDP in 2013 from 6.7 per cent in the previous year. These developments, together with inflows to the financial account in the form of foreign direct investment (FDI), foreign investments in government securities, and long term debt inflows to the government, the banking sector and the non financial sector, resulted in the BOP recording a surplus of US dollars 985 million in 2013 compared to the surplus of US dollars 151 million in 2012. Consequently, gross official reserves increased to US dollars 7.5 billion at end 2013, providing a 5-month import cover. Improved BOP and international reserve position enabled the Sri Lankan rupee to remain relatively stable during the year amidst increasing volatility in other emerging market economies. Accordingly, the Sri Lanka rupee depreciated only by 2.75 per cent against the US dollar during the year while appreciating against several other major currencies.

While fiscal policy focused on promoting sustainable and regionally balanced growth in the medium term, gradual improvements were observed in key fiscal indicators as a result of continued efforts at fiscal consolidation. The government reduced recurrent expenditure as a percentage of GDP substantially, although public investment remained high at 5.5 per cent of GDP buttressing the overall investment level of the country. However, government revenue as a percentage of GDP declined further to 13.1 per cent of GDP, and the continued shortfall in revenue collection from projected levels in recent years remained a major concern of the government. As a result, further reforms were introduced to broadbase the tax system while reducing its inefficiencies and leakages. Despite the relatively low revenue collection, expenditure rationalisation helped the fiscal deficit to be maintained at 5.9 per cent of GDP, marginally higher than the budget estimate of 5.8 per cent. The government's decision not to mobilise funds through the issuance of an International Sovereign bond in 2013, resulted in the budget deficit being mainly financed through domestic sources. The declining trend in the debt to GDP ratio continued, with the ratio improving to 78.3 per cent in 2013.

The year 2013 witnessed a marked improvement in the financial position of key public corporations. While relatively stable energy prices in the international market and the exchange rate along with favourable weather conditions aided the financial performance of vital public corporations, the improvement was also complemented by further cost reflective petroleum price revisions and electricity tariff revisions introduced in the months of February and April 2013. Consequently, the Ceylon Electricity Board (CEB) generated an operating profit in 2013 while a substantial decline in losses of the Ceylon Petroleum Corporation (CPC) was observed. The improved financial position of the CEB and CPC allowed these institutions to settle a part of their financial obligations to the banking sector and plan essential expansion and modernisation work, which would in turn enhance their service provision to the economy.

Monetary expansion moderated towards desired levels while the easing of the monetary policy stance from December 2012 gradually transmitted to market interest rates. Short term market interest rates were quick to adjust downwards, although longer term market interest rates showed some rigidity during the first few months of the year, before declining thereafter. Aided by revisions to administratively determined energy prices and favourable weather conditions, credit obtained by public corporations also moderated during the year. While net credit to the government (NCG) from the Central Bank declined substantially, NCG from commercial banks increased, reflecting the government's higher reliance on bank borrowings to finance the fiscal deficit in 2013. Credit disbursements to the private sector by commercial banks decelerated during the year due to the lag effect of tight monetary policy in 2012 as well as a sharp decline in agriculture and personal consumption related pawning advances. However, credit to the Industry and Services sectors increased by Rs. 201.1 billion in 2013. Increased access to the domestic and global capital markets by the private sector in 2013 also contributed to the deceleration of credit obtained from commercial banks. In this regard, it is noteworthy that approval was granted to the private sector (except licensed banks) to obtain loans amounting to US dollars 335.5 million from abroad in 2013 while they mobilised Rs. 34.9 billion through listed debentures during the year.

Stability of the financial system was preserved amidst uncertainties arising from global market developments, while the regulatory and supervisory framework was strengthened further. Strong capital and liquidity buffers and sound risk management practices ensured that the financial sector remained resilient during the year although non-performing pawning advances affected the asset quality of the financial sector. Total assets of the financial sector rose as a result of increased investments, while the expansion of the branch network, particularly outside the Western Province, improved access to finance and financial inclusiveness. Reflecting the easing of monetary policy, market interest rates adjusted downwards gradually, and markets broadly remained liquid throughout the year. The regulatory and supervisory regime was further strengthened and disclosure requirements were enhanced in line with international standards and best practices to ensure that the potential risks to financial stability are addressed in a timely manner. The Central Bank also took measures to improve the payment infrastructure and its efficiency. Activity levels in the corporate bond market improved significantly, led by a significant increase in the number of debenture issues while the unit trust sector expanded with the establishment of a number of new funds in 2013. Foreign inflows to the stock market and the government securities market continued in spite of uncertain global market conditions. The insurance sector recorded growth both in terms of assets and premium income.

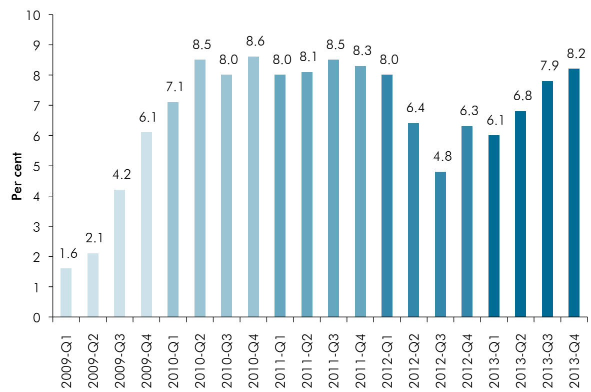
Looking ahead, the Sri Lankan economy is expected to continue its growth momentum in the medium term underpinned by increased investment, improved macroeconomic stability and improving global economic conditions. Sri Lanka's economic progress in the medium term is not without challenges, and structural adjustments are necessary for a continued growth momentum at a sustainable pace. Given the vast improvements in physical infrastructure and the resultant enhancement in productive capacity, the country's potential output has improved substantially in the post conflict period, and greater involvement of the private sector in economic activity is required to realise this potential. Improving total factor productivity, enhancing the human capital base of the country with emphasis on emerging sectors, and creating an enabling environment for productive activity to prosper are essential ingredients for sustained economic growth. Such improvements are likely to facilitate the necessary diversification of economic activity, and products and services offered while expanding the country's external market base. Government policies that are in place to diversify economic activity further along the lines of the 5+1 hub strategy, are expected to facilitate a smooth transition of the economy through the 'middle income trap' in the medium term. As a result of these policies as well as the projected recovery in trading partner economies, the external sector is expected to improve further, led by increasing merchandise and services exports. With increased capital market openness, it is necessary to strengthen buffers available to face possible challenges arising from external developments. On the fiscal front, the government's commitment to further reductions in the budget deficit and public debt as envisaged in the medium term macro fiscal framework is a welcome development. Public investment is expected to supplement the country's total investment, while the expected improvement in savings as a percentage of GDP is likely to reduce the reliance on external sources to bridge the savings-investment gap. The financial sector is expected to strengthen further with the adoption of international best practices and the planned consolidation programme. With prudent and forward looking monetary policy decisions, supported by improved domestic supply conditions and productivity, inflation is expected to consolidate its mid single digit levels further in the medium term, thereby supporting continued economic and price stability.

1.2 Macroeconomic Developments, Stability and Policy Responses in 2013

Real Sector Developments and Inflation

The economy rebounded to a higher and sustainable growth trajectory with GDP recording a 7.3 per cent growth in 2013 compared to 6.3 per cent in 2012. Policy

Chart 1.4 Quarterly Real GDP Growth



measures that were in place in 2012 aimed at macroeconomic stabilisation, were eased from December 2012, creating a more conducive environment for economic growth in 2013. Improved macroeconomic conditions, including low inflation, declining interest rates and the relatively stable exchange rate contributed to the acceleration of economic growth. Favourable weather conditions were conducive to growth with its positive impact on domestic agriculture and the significant expansion in high value added hydropower generation. The continued infrastructure development programme of the government also contributed to the realisation of a higher economic growth. The revival of growth in advanced economies, particularly during the second half of the year, impacted trade performance favourably, resulting in an acceleration of economic growth towards the latter part of the year. Sri Lanka's growth performance is notable amidst the slowdown in growth experienced by most emerging market and developing economies, including the South Asian region in 2013.

The broad based growth in all three key sectors supported the overall economic growth in 2013. The Services sector remained the leading contributor to growth during 2013 with the transport and communication sub sector recording the highest contribution within the Services sector, followed by the wholesale and retail trade sub

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 (%)	
	2012 (a)	2013 (b)	2012 (a)	2013 (b)	2012 (a)	2013 (b)	2012 (a)	2013 (b)
Agriculture	**336,817**	**352,641**	**11.1**	**10.8**	**5.2**	**4.7**	**9.2**	**7.2**
Agriculture, Livestock and Forestry	295,923	309,192	9.7	9.5	4.7	4.5	7.3	6.0
Fishing	40,894	43,449	1.3	1.3	9.3	6.2	1.9	1.2
Industry	**925,152**	**1,016,886**	**30.4**	**31.1**	**10.3**	**9.9**	**47.5**	**41.5**
Mining and Quarrying	84,672	94,388	2.8	2.9	18.9	11.5	7.4	4.4
Manufacturing	520,938	559,843	17.1	17.1	5.2	7.5	14.3	17.6
Electricity, Gas and Water	72,452	79,913	2.4	2.4	4.2	10.3	1.6	3.4
Construction	247,091	282,742	8.1	8.7	21.6	14.4	24.2	16.1
Services	**1,783,318**	**1,896,572**	**58.6**	**58.1**	**4.6**	**6.4**	**43.3**	**51.3**
Wholesale and Retail Trade	701,408	739,826	23.0	22.7	3.7	5.5	13.7	17.4
Hotels and Restaurants	21,029	25,715	0.7	0.8	20.2	22.3	1.9	2.1
Transport and Communication	435,872	476,721	14.3	14.6	6.2	9.4	14.0	18.5
Banking, Insurance and Real Estate etc.	269,744	285,750	8.9	8.7	6.7	5.9	9.4	7.2
Ownership of Dwellings	76,926	79,175	2.5	2.4	1.7	2.9	0.7	1.0
Government Services	207,559	213,439	6.8	6.5	1.4	2.8	1.6	2.7
Private Services	70,779	75,946	2.3	2.3	5.5	7.3	2.0	2.3
Gross Domestic Product	**3,045,288**	**3,266,099**	**100.0**	**100.0**	**6.3**	**7.3**	**100.0**	**100.0**
Net Factor Income from Abroad	-62,253	-88,454			-97.4	-42.1		
Gross National Product	**2,983,034**	**3,177,645**			**5.3**	**6.5**		

(a) Revised
(b) Provisional

Source: Department of Census and Statistics

sector. The expansion in financial services also strengthened the growth in the Services sector. The Industry sector recorded the highest sectoral growth during the year with the manufacturing sub sector remaining the highest contributor to growth in the sector supported by the improvement in external demand. The construction sub sector also recorded a high growth rate during 2013. The growth in the Agriculture sector, which remained subdued in the first half of the year, improved during the second half with the expansion of paddy, other food crops and fishing sub sectors.

The unemployment rate increased to 4.4 per cent in 2013 from 4.0 per cent in the previous year, with the increase largely attributed to the entry of new job seekers to the labour market. The labour force expanded by 4.1 per cent in 2013 with the LFPR increasing to 53.8 per cent in 2013 from 52.6 per cent in the previous year. Within this, the female LFPR increased substantially while there was a marginal decline in the male LFPR. With the expansion of the labour force, the number of employed as well as unemployed persons increased. Unemployment among females and males increased to 6.6 per cent and 3.2 per cent, respectively, in 2013 from 6.2 per cent and 2.9 per cent, respectively, in 2012. Foreign employment opportunities, being a major source of employment and the foremost earner of foreign exchange for the country, continued to increase in 2013.

The Agriculture sector registered a 4.7 per cent growth in 2013 with increased production of many agricultural commodities. Government policies to improve the sector, remunerative producer prices and favourable weather conditions contributed to this growth. Paddy production grew by 20 per cent to 4.62 million metric tons while vegetable and other highland crops as well as sugar and milk production also improved considerably during the year benefitting from government policies aimed at encouraging domestic production. Moreover, tea production recorded a healthy growth of 3.6 per cent to 340 million kg in 2013, which is an all time high. However, the output of rubber and coconut sectors in 2013 declined by 14.2 per cent and 14.5 per cent, respectively, dampening the Agriculture sector growth. The decline in coconut production was mainly due to the lagged impact of the drought in the previous year while rubber production suffered from heavy rainfall, which adversely impacted tapping activities in the first nine months. Although the fisheries sector was subject to extreme weather conditions that prevailed during May to July, fish production improved, recording a satisfactory growth of 5.5 per cent in 2013.

Government policy on agriculture was focused on improving value addition of emerging sectors and promoting rapid growth in sectors operating below potential. New varieties of rice were introduced to promote rice exports and to improve productivity. Subsidy programmes to promote replanting and new planting in the tea sector continued along with a programme to modernise tea factories. The cultivation of rubber and coconut in nontraditional areas continued to be supported through the distribution of high quality materials and seeds. Sugar cane cultivation was expanded. The importation of high quality breeds of cows helped fresh milk production to increase and to speed up the multiplication of new hybrid cow herd in the country supported by a concessionary loan scheme. Fishery harbours that commenced operations in 2013 would provide necessary facilities for large vessels being used in deep sea fishery operations. Diyawara Diriya loan scheme, which aims at infusing the latest technology into the fisheries sector, continued for the second consecutive year in 2013. Meanwhile, the maintenance of high tariffs on imported food commodities with domestic substitutes provided stable and remunerative prices to domestic growers.

Factory industry output, which accounts for about 90 per cent of the manufacturing output, recorded a positive growth in 2013 driven by the recovery in global trading partner economies, an increase in tourist arrivals, a conducive business environment and productivity improving measures adopted by industrialists. Output of the wearing apparel sub sector, which is the largest export market oriented factory industry sub sector, recorded a significant growth during the year propelled by improved external demand particularly from the United States of America (US) and the European Union (EU), adoption of productivity improvement measures and greater backward integration, which enhanced value addition in the sector. The rubber products sector recorded a favourable growth with a pick up in factory industry output in the US and the EU. Uninterrupted supplies of crude oil from alternative sources such as the United Arab Emirates (UAE) and Oman during the year resulted in an increase in the output of refined petroleum products in 2013. There was also a marked growth in the output of fabricated metal products and electrical equipment sub sector during 2013 reflecting increased product diversification.

The industrial policy thrust of the government during 2013 was directed towards the promotion of knowledge based technology intensive industry, while supporting the development of Small and Medium Enterprises (SMEs) and regional industrialisation. The first ever Nanoscience Park in Sri Lanka was declared open in October 2013, facilitating strategically focused research and development initiatives. Further, the government took preliminary steps towards the establishment of a Technology Development Fund (TDF) as a measure towards promoting technological innovation and infusing technologies into SME sector industries. The establishment of the Achchuveli Industrial Estate and the upgrading and modernisation of 20 main and mini industrial estates were steps taken in 2013 to uplift SME industries while promoting regional industrialisation.

The Services sector achieved a commendable growth of 6.4 per cent in 2013 compared to 4.6 per cent growth recorded in 2012. The Services sector growth was a result of the overall buoyance seen in all sub sectors during the year. Noteworthy expansion in the sub sectors

Table 1.2 Aggregate Demand and Savings Investment Gap

Item	Rs. billion		Growth (%)		As a percentage of GDP	
	2012 (a)	2013 (b)	2012 (a)	2013 (b)	2012 (a)	2013 (b)
1. Domestic Demand	**8,614.1**	**9,500.3**	**14.9**	**10.3**	**113.7**	**109.5**
1.1 Consumption	6,295.9	6,934.8	13.7	10.1	83.1	80.0
Private	5,274.5	5,797.5	15.5	9.9	69.6	66.8
Public	1,021.4	1,137.3	5.6	11.3	13.5	13.1
1.2 Investment (Gross Domestic Capital Formation)	2,318.3	2,565.5	18.3	10.7	30.6	29.6
Private	1,794.6	1,969.1	15.8	9.7	23.7	22.7
Public	523.6	596.4	27.9	13.9	6.9	6.9
2. Net External Demand	**-1,035.6**	**-826.4**	**-8.8**	**20.2**	**-13.7**	**-9.5**
Exports of Goods and Services	1,730.5	1,949.3	14.7	12.6	22.8	22.5
Imports of Goods and Services	2,766.1	2,775.7	12.4	0.3	36.5	32.0
3. Total Demand (GDP) (1+2)	**7,578.6**	**8,673.9**	**15.8**	**14.5**	**100.0**	**100.0**
4. Domestic Savings (3-1.1)	**1,282.7**	**1,739.1**	**27.3**	**35.6**	**16.9**	**20.0**
Private	1,362.2	1,806.8	28.0	32.6	18.0	20.8
Public	-79.6	-67.7	-39.5	14.9	-1.0	-0.8
5. Net Factor Income from Abroad	**-154.9**	**-234.9**	**-115.1**	**-51.6**	**-2.0**	**-2.7**
6. Net Private Current Transfers	**688.6**	**728.7**	**34.2**	**5.8**	**9.1**	**8.4**
7. National Savings (4+5+6)	**1,816.3**	**2,232.8**	**25.4**	**22.9**	**24.0**	**25.7**
8. Savings Investment Gap						
Domestic Savings - Investment (4-1.2)	-1,035.6	-826.4			-13.7	-9.5
National Savings - Investment (7-1.2)	-501.9	-332.7			-6.6	-3.8
9. External Current Account Deficit without Official Grants (2+5+6)	**-501.9**	**-332.7**			**-6.6**	**-3.8**

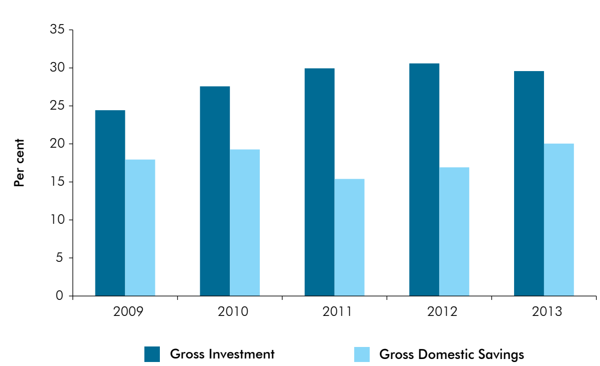
(a) Revised
(b) Provisional

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

of transport, wholesale and retail trade, hotels and restaurants as well as banking, insurance and real estate, led to the substantial service sector growth in 2013. The transport sub sector expansion was in line with increased internal mobility and the rapid development seen in the country's physical infrastructure. The revival of external trade during the second half of the year due to improved global market conditions together with robust domestic trade activities contributed to the strong recovery in the wholesale and retail trade sub sector. Hotels and restaurants sub sector surpassed the previous year's growth. The banking, insurance and real estate sub sector recorded a substantial growth, although certain lagged effects of the stabilisation policy measures adopted in 2012 persisted. The Services sector, with a share of 58.1 per cent of GDP, continued to be the dominant sector of the economy, although its importance has continued to decline from 58.6 per cent in 2012 and 59.5 per cent in 2011, due to the expansion of the Industry sector at a higher rate.

From the perspective of expenditure, the growth in GDP was supported by increased consumption as well as investment in 2013. However, the growth in consumption decelerated during 2013 due to lower growth in private consumption expenditure while public sector consumption expenditure grew at a higher rate than in the previous year. The expenditure on investment activities grew indicating increased confidence in the economy with higher growth

Chart 1.5 Savings and Investment (as a percentage of GDP)

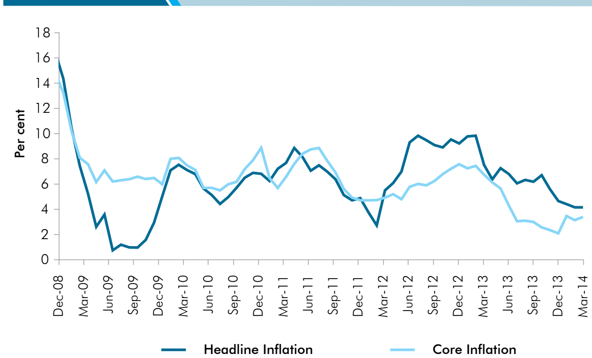


prospects. External sector demand improved resulting in a high growth in exports of goods and services while imports of goods and services grew marginally in nominal terms.

Domestic savings improved to 20.0 per cent of GDP signalling a continuation of the momentum set in 2012. The improvement in domestic savings was the combined outcome of an improvement in private savings as well as a decline in government dissaving due to the narrowing of the current account deficit of the government sector. With the continued growth in workers' remittances, national savings also improved in 2013. However, the deterioration of net factor income from abroad (NFIA) with increased outflows, dampened the growth in national savings. Meanwhile, the resource gap narrowed further during 2013, reducing the dependence on the external sector to finance investments.

Consumer price inflation (year-on-year) remained at single digits for the fifth consecutive year, continuing the declining trend in 2013. Year-on-year inflation, as measured by the Colombo Consumers' Price Index (CCPI) (2006/07=100), remained relatively high at the beginning of the year with 9.8 per cent being recorded in January and February 2013, largely as a result of disruptions to food supply resulting from adverse weather conditions. Within the year, improved domestic supply, moderation of international commodity prices and prudent monetary policy resulted in inflation easing from March 2013. The moderation of prices observed in the non-food category in 2013 dominated price increases in the food category. Upward revisions to several administered prices during the year exerted some price pressures, which were well managed resulting in marginal second round effects. Year-on-year headline inflation reached 4.7 per cent in December 2013, its lowest level during the year, while annual average headline inflation also decelerated to 6.9 per cent at end 2013, compared to 7.6 per cent at end 2012. Reflecting well contained demand conditions, year-on-year core inflation remained low declining to its lowest recorded level of 2.1 per cent in December 2013.

Chart 1.6 Year-on-Year Inflation



External Sector Developments

With the support of an enabling domestic environment and favourable developments in the global economy, the external sector performed well during 2013. Increased export earnings and lower import expenditure narrowed the trade deficit considerably. Workers' remittances and earnings from tourism grew significantly, cushioning the trade deficit substantially. These developments, together with increased earnings from other services exports, narrowed the deficit in the external current account. Substantial inflows to the financial account in the form of FDI and receipts to the government, the banking sector and other private corporates in 2013 helped strengthen the BOP to record an overall surplus of US dollars 985 million in 2013, thereby improving the reserve position of the country. Meanwhile, the flexibility in the determination of the exchange rate continued while absorption of foreign exchange on a net basis from the domestic foreign exchange market also reduced volatility in the rupee in 2013. This was in contrast to many other regional currencies, which experienced larger depreciations with net foreign exchange outflows following the announcement of scaling down of the US quantitative easing programme.

The deficit in the trade account contracted sharply in 2013 with a pickup in exports together with the continued decline in imports, reflecting the impact of the policy measures adopted by the government and the Central Bank. Earnings from exports, which contracted by 7.4 per cent in 2012, increased by 6.4 per cent in 2013 with the gradual recovery in major trading partners. Contributing 61 per cent to the overall export growth, industrial exports increased by 5.1 per cent in 2013, mainly due to the improved performance in textiles and garments. Earnings from textile and garment exports, which contributed 43.4 per cent of total exports, increased by 13 per cent in 2013. Export of garments to the EU and US, which are the major export destinations for garments, grew by 6.8 per cent and 21.0 per cent, respectively. Earnings from agricultural exports increased by 10.7 per cent in 2013, mainly due to the strong growth in the export of tea and spices, which accounts for nearly 74 per cent of agricultural exports. Ceylon tea and spices commanded premium prices in the international market due to the high quality of products even though the price of most other commodities declined due to low global demand.

Expenditure on imports in 2013 declined by 6.2 per cent while that of non-fuel imports declined by 3.2 per cent. The largest contribution to the decline in expenditure on imports came from intermediate goods which declined by 8.8 per cent in 2013 led by imports of fuel, and textile and textile articles. Expenditure on fuel imports declined by 14.6 per cent in 2013, mainly due to lower thermal power generation during the year. As a result of higher local value addition in the garment industry arising from backward integration, imports of textile and textile articles declined by 9.7 per cent. Expenditure on imports of investment goods also declined by 7.3 per cent during the year, owing to a significant decline in transport equipment and machinery and equipment. However, expenditure on consumer goods imports increased by 6.3 per cent, reflecting an increase in imports of food and

Table 1.3 External Sector Developments (a)

Item	US$ million		Percentage Change
	2012 (b)	2013 (c)	
Current Account	**-3,982**	**-2,607**	**-34.5**
Trade Balance	**-9,417**	**-7,609**	**-19.2**
Exports	**9,774**	**10,394**	**6.4**
Agricultural Exports	2,331	2,581	10.7
Industrial Exports	7,371	7,749	5.1
Mineral Exports	61	52	-15.9
Other Exports	10	12	26.6
Imports	**19,190**	**18,003**	**-6.2**
Consumer Goods	2,995	3,182	6.3
Intermediate Goods	11,578	10,554	-8.8
Investment Goods	4,590	4,253	-7.3
Other	28	14	-50.0
Services (net)	**1,262**	**1,180**	**-6.5**
Receipts	3,800	4,685	23.3
Payments	2,538	3,505	38.1
Primary Income (net)	**-1,219**	**-1,817**	**49.1**
Receipts	142	148	4.1
Payments	1,361	1,965	44.4
Secondary Income (net)	**5,392**	**5,639**	**4.6**
Private Transfers (net)	5,339	5,619	5.2
Receipts	5,985	6,407	7.0
Payments	646	788	22.0
Official Transfers (net)	53	21	-60.5
Capital Account (net)	**130**	**71**	**-45.6**
Current and Capital Account	**-3,851**	**-2,536**	**-34.2**
Financial Account (net)	**4,263**	**3,126**	**-26.7**
Net Acquisition of Financial Assets	**1,177**	**955**	**-18.8**
Direct Investment	64	65	1.8
Portfolio Investment	-10	...	
Debt Securities	-10	...	
Other Investment	363	-222	-161.1
Currency and Deposits	162	-459	-383.4
Trade Credit and Advances	90	195	116.0
Other Accounts Receivable	111	42	-61.8
Reserve Assets	760	1,112	46.2
Net Incurrence of Liabilities	**5,440**	**4,081**	**-25.0**
Direct Investment	941	916	-2.7
Portfolio Investment	2,116	2,106	-0.5
Equity and Investment Fund Shares	272	263	-3.4
Debt Securities	1,844	1,843	-0.1
Other Investment	2,384	1,060	-55.5
Currency and Deposits	447	108	-75.9
Loans	3,070	949	-69.1
Trade Credit and Advances	-571	-54	-90.5
Other Accounts Payable	-563	58	-110.2
Special Drawing Rights	-	-	
Errors and Omissions	-412	-590	
Overall Balance	**151**	**985**	
Gross Official Reserves	**7,106**	**7,495**	
Months of Imports	**4.4**	**5.0**	
Total Foreign Assets	8,586	8,574	
Months of Imports	5.4	5.7	
Export Price Index (2010=100)	103.1	103.5	0.4
Import Price Index (2010=100)	115.2	108.4	-5.9
Terms of Trade	**89.5**	**95.5**	**6.7**
Exchange Rate (Average)			App(+)/Dep(-)
Rs./US dollar	127.60	129.11	-1.2
Rs./Japanese yen	1.60	1.32	20.7
Rs./Euro	164.01	171.51	-4.4
Rs./Sterling pound	202.28	202.08	0.1
Rs./Indian rupee	2.39	2.21	8.2

(a) The classification used in this Table follows the Balance of Payments Manual 6th edition (2009) of the IMF.
(b) Revised
(c) Provisional

Source: Central Bank of Sri Lanka

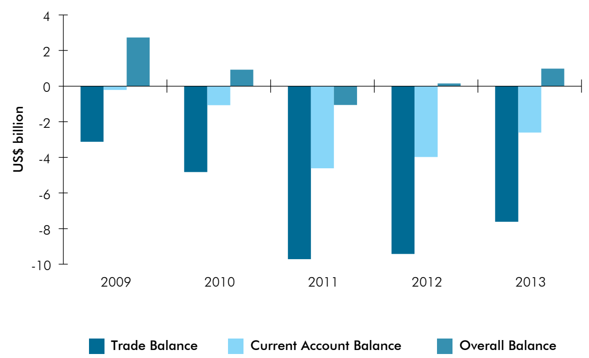
beverages as well as non-food items. Expenditure on imports of non-food consumer goods increased, largely due to the 17.6 per cent increase in the importation of motor vehicles.

Improved performance in the trade account, higher gross earnings on account of export of services and elevated workers' remittances contributed to narrow the external current account deficit significantly during 2013. The services account continued to record a surplus in 2013 primarily as a result of buoyancy in travel and tourism, transport and computer and information services sub sectors. Gross inflows to the transport sector, the key sector within the services account which comprises passenger fares, freight, port and airport related activities, grew steadily by 9.2 per cent in 2013. Higher tourist arrivals, enhanced volume of cargo handling and an increase in the number of destinations served by local airlines contributed largely to the growth in the transport sub sector. Effective promotional campaigns and improved infrastructure enabled Sri Lanka to attract a higher number of tourists in 2013 and with an increase in the average spending by tourists, earnings from tourism witnessed a rapid growth of 65.1 per cent in 2013 compared to 2012. Telecommunications, computer and information services also demonstrated improved performance. Sri Lanka was awarded the 'Outsourcing Destination of the Year' award by the National Outsourcing Association (NOA), UK in October 2013 highlighting Sri Lanka's vast potential in Software and Information Technology Enabled Services (ITES) such as BPO and KPO. A proposal was also made to set up an Information and Communication Technology (ICT) zone in Hambantota as the emerging ICT Hub of South Asia. Meanwhile, workers' remittances continued to be a substantial foreign exchange earner for Sri Lanka in 2013, helping to cushion the trade deficit substantially. It is noteworthy that the profile of Sri Lankan migrant worker is gradually shifting towards more professional and skilled worker categories from unskilled and domestic worker categories. In line with these developments, the deficit in the external current account continued to narrow considerably by 34.5 per cent to US dollars 2,607 million in 2013 from US dollars 3,982 million in 2012. As a percentage of GDP, the current account deficit declined to 3.9 per cent of GDP in 2013 from 6.7 per cent of GDP in 2012. Meanwhile, the capital account of the BOP recorded a net inflow of US dollars 71 million in 2013 compared to US dollars 130 million in 2012.

Substantial financial inflows were recorded during 2013, reflecting the gradual recovery in the world economy and improved investor confidence in Sri Lanka. The FDI including foreign loans to BOI companies grew by 2.8 per cent to US dollars 1,421 million in 2013, with infrastructure and manufacturing sectors attracting the highest FDI inflows. Meanwhile, debt securities issued by the banking sector in foreign capital markets resulted in substantial financial flows in 2013. The National Savings Bank (NSB), Bank of Ceylon (BOC) and Development Finance Corporation of Ceylon (DFCC) raised US dollars 1.35 billion in total in 2013,compared to US dollars 500 million in 2012 by BOC. Financial inflows in the form of foreign loans were also significant, totaling US dollars 2.9 billion in 2013. Inflows to the government in the form of project loans, particularly for major infrastructure projects such as the rehabilitation of priority roads and railway reconstruction and extension, recorded a marginal decrease in 2013 compared to the previous year. Meanwhile, deposit taking corporations placed less reliance on foreign loans during the year, with a number of banks opting to issue long term debt securities in international capital markets.

With the improvement in the external current account balance and significant inflows to the financial account, the BOP recorded a

Chart 1.7 Balance of Payments



notable surplus in 2013. Compared to a surplus of US dollars 151 million in 2012, the BOP recorded an overall surplus of US dollars 985 million in 2013. Reflecting the improved BOP position, the reserve asset position of the country improved further to US dollars 7.5 billion by end 2013 from US dollars 7.1 billion at end 2012. Accordingly, reserve assets were equivalent to 5.0 months of imports of goods and 4.2 months of imports of goods and services. In addition, increased foreign financial assets of deposit taking corporations resulted in total foreign assets rising to US dollars 8.6 billion by end 2013, which was equivalent to 5.7 months of imports of goods and 4.8 months of imports of goods and services.

Inflows to the private sector and deposit taking corporations resulted in an increase in the total external debt position in 2013. Foreign loans obtained by the private sector increased by 16 per cent during 2013, while relaxation of exchange control regulations and improved macroeconomic fundamentals of the country enabled the banking sector to raise funds in international capital markets by issuing debt securities amounting to US dollars 1.35 billion during the year. The total external debt position of the country recorded an outstanding of US dollars 39.7 billion as at end 2013, a 7.1 per cent increase from US dollars 37.1 billion recorded as at end 2012. However, total outstanding external debt as a percentage of GDP declined to 59.2 per cent in 2013 from 62.5 per cent of GDP in 2012. With more emphasis on long term borrowing by both the government and the private sector, composition of short term debt as a percentage of total external debt declined from 17.3 per cent in 2012 to 16.4 per cent in 2013. In the meantime, total foreign debt service payments increased in 2013. Total foreign debt service payments as a percentage of receipts from exports of goods and services increased to 25.3 per cent in 2013 from 19.7 per cent in 2012. This was primarily due to increased capital payments such as repayment of the IMF SBA facility, increased maturity of government securities and higher repayments on private sector loan liabilities and an increase in interest payments in 2013.

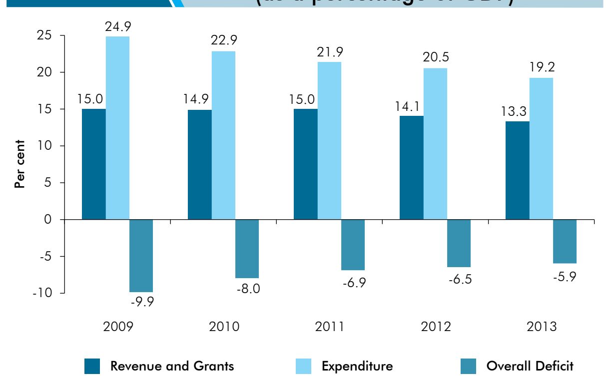
Exchange rate policy in 2013 focused on maintaining flexibility in the determination of the exchange rate. The rupee which was stable against the US dollar during most of the first half of the year, depreciated vis-à-vis the US dollar by around 5 per cent during mid June through end August mainly due to higher import demand in June and July and the anticipation of possible tapering of the US bond buying programme. However, the Sri Lanka rupee was less volatile compared to other emerging market currencies such as the Indian rupee and Indonesian rupiah which experienced severe depreciations following the US Federal Reserve Bank's indication of likely scaling down of its quantitative easing programme. Nevertheless, since early September, the Sri Lanka rupee appreciated against the US dollar supported by increased inflows to the banking sector. Overall, the rupee depreciated against the US dollar by 2.75 per cent to Rs. 130.75 by end 2013. Reflecting cross currency exchange rate movements, the Sri Lanka rupee showed mixed performance against major currencies during 2013. Meanwhile, the effective exchange rate indices showed a modest appreciation as opposed to the depreciation observed in 2012. Accordingly, both the Nominal Effective Exchange Rate (NEER) and the Real Effective Exchange Rate (REER) based on the 24-currency basket and REER based on the 5-currency basket appreciated at a moderate rate, while NEER based on the 5-currency basket depreciated marginally by end December 2013. Further, indicating the market expectation of an appreciation of the rupee in the near term, the forward premia for three-month and six-month contracts remained lower than the interest rate differential, on average, in 2013.

Fiscal Sector Developments

The fiscal policy strategy in 2013 was formulated to further strengthen the fiscal consolidation process while supporting broad based development objectives in line with the country's vision for the medium to long term. Accordingly, the budget deficit was expected to be reduced to 5.8 per cent of GDP in 2013 from a deficit of 6.5 per cent of GDP recorded in 2012, thus continuing the deficit reduction path adopted since 2009. Government revenue including grants was expected to increase to 14.7 per cent of GDP in 2013, reversing the decreasing trend recorded during recent years, while maintaining expenditure and net lending at around 20.5 per cent of GDP. In order to achieve these projections, several policy measures were implemented on the revenue and the expenditure fronts. However, the underperformance in government revenue due to slow growth in import related taxes affected the smooth functioning of fiscal operations, especially in the early part of the year. With the pick up in import related taxes and the expansion of domestic economic activity during the latter part of the year, this trend reversed enabling the government to maintain the budget deficit at 5.9 per cent of GDP, marginally above the budgetary target of 5.8 per cent, thus continuing the fiscal consolidation path achieved in the recent past. Despite the sluggish improvement in revenue, fiscal consolidation was a result of the concerted efforts by the government to manage expenditure. A reduction of total expenditure and net lending in real terms was recorded in both recurrent expenditure and capital expenditure. However, since revenue was lower than the expected level, the government prioritised its Public Investment Programme and public investment was maintained at 5.5 per cent of GDP, reflecting its commitment to implement several infrastructure projects throughout the year and the continuation of donor funded foreign financing. In financing the resource gap, domestic sources contributed 76 per cent, mainly through the banking sector.

Government revenue as a percentage of GDP declined to 13.1 per cent of GDP in 2013 compared to the estimated 14.5 per cent of GDP and 13.9 per cent of GDP recorded in the previous year, although revenue increased by 8.2 per cent over 2012 in nominal terms. A drop in import related taxes during the first half of the year and a significant reduction in profit transfers from state owned enterprises (SOEs) were the key reasons for the weak performance in government revenue. Total revenue collection in 2013 at Rs. 1,137.4 billion was significantly below the annual estimate in the budget. Tax revenue as a percentage of GDP declined to 11.6 per cent from 12.0 per cent in the previous year. This was

Chart 1.8 Revenue, Expenditure and Overall Fiscal Deficit (as a percentage of GDP)

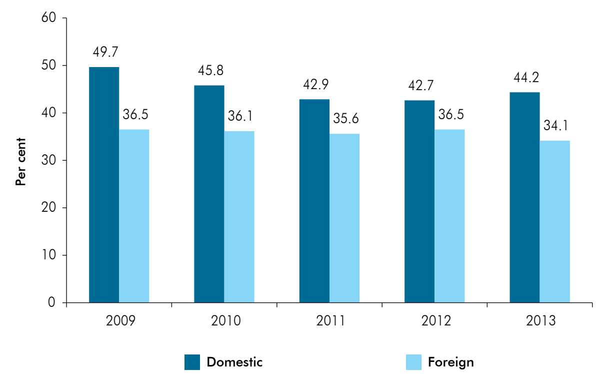


mainly attributed to the reduction in revenue from the Economic Service Charge (ESC), Ports and Airport Development Levy (PAL) and the excise taxes on petroleum products. Non tax revenue as a percentage of GDP declined to 1.5 per cent from 1.9 per cent in the previous year, while the decline was 7.7 per cent in nominal terms reflecting the significant moderation in profit and dividend transfers from SOEs and the Central Bank.

Total government expenditure and net lending as a percentage of GDP declined to 19.2 per cent in 2013 from 20.5 per cent in 2012. This was the combined outcome of a reduction in recurrent expenditure, with restrictions imposed on expenditure on other goods and services, and the prioritisation of capital expenditure in response to the weak performance in government revenue. Current expenditure reduced to 13.9 per cent of GDP in 2013 from 14.9 per cent in the previous year, while capital expenditure and net lending as a percentage of GDP declined to 5.4 per cent in 2013 from 5.6 per cent in 2012.

In financing the budget deficit, the government relied more on domestic debt instruments benefitting from the low interest rates that prevailed in the domestic securities market. Accordingly, net domestic financing (NDF) contributed 76 per cent to total financing in comparison to 41.4 per cent in the previous year with the remaining 24 per cent financed through foreign sources. Net borrowings from the domestic banking sector at Rs. 297 billion, accounted for 75.7 per cent of the total NDF. This surpassed the sum of Rs. 70 billion of bank financing estimated in the budget for 2013 and Rs. 131.5 billion of bank financing recorded in the previous year. Total financing from the domestic non bank sector amounted to Rs. 95.4 billion during the year. Foreign financing, which includes foreign project financing and foreign investments in rupee denominated domestic debt instruments, amounted to Rs. 123.7 billion.

Chart 1.9 Government Debt (as a percentage of GDP)



Outstanding government debt as a percentage of GDP as at end December 2013 declined to 78.3 per cent from 79.2 per cent at end 2012. In nominal terms, the total debt stock increased by 13.2 per cent to Rs. 6,793.2 billion as at end 2013.

Monetary Sector Developments

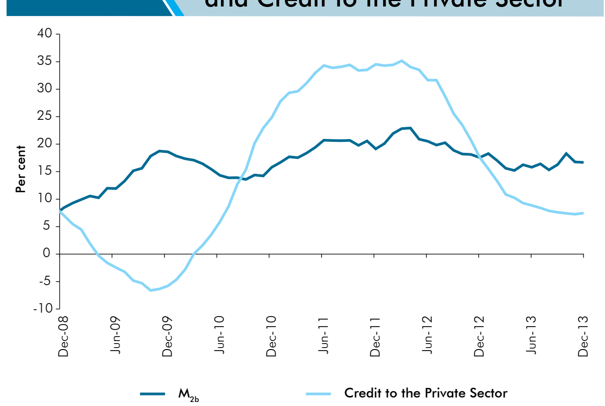
Easing of the monetary policy stance, which commenced in December 2012, continued in 2013 with the aim of supporting economic activities to adjust and graduate to a higher growth trajectory given the low inflation environment. The policy interest rates of the Central Bank were reduced by 100 basis points in two steps during 2013. Although short term market interest rates showed an immediate response to the reduction in policy interest rates by 50 basis points in May, market lending interest rates remained somewhat rigid during the first half of the year. Consequently, policy interest rates were eased further by another 50 basis points in October 2013. In the meantime, in order to complement the reduction in policy interest rates and to reduce the spread between deposit and lending rates of commercial banks, the Central Bank reduced its Statutory Reserve Ratio (SRR) by 2 percentage points to 6 per cent, with effect from July 2013. In response to these monetary policy measures, market lending rates declined considerably, although the pace of credit growth remained low.

In line with the easing of monetary policy, rupee liquidity in the domestic money market rose significantly and remained in excess throughout 2013. Excess rupee liquidity averaged around Rs. 23 billion during the year. Buoyant capital inflows led by the issuance of international bonds by licensed banks, foreign investments in several domestic corporate debt and equity issuances and the subsequent absorption of these funds by the Central Bank increased domestic liquidity. The additional liquidity released to the market with the reduction of SRR in July 2013 was around Rs. 48 billion. The Central Bank absorbed excess liquidity on a continuous basis through overnight auctions, and regular term repo auctions were conducted to absorb liquidity on a long term basis from the third quarter. These liquidity absorption measures were complemented by the outright sale of Treasury bills held by the Central Bank and consequently, the Treasury bill holdings of the Central Bank were almost completely depleted during the year. Therefore, the Central Bank utilised borrowed securities to absorb excess liquidity through open market operations.

With the focus of maintaining inflation at single digit levels, the conduct of monetary policy continued to be based on a monetary targeting framework with reserve money as the operating target and broad money as the intermediate target. Broad money (M_{2b}) was envisaged to grow by 15 per cent during 2013 in line with the projected growth in real GDP of 7.5 per cent at the beginning of the year and a GDP deflator of 7.0 per cent. The growth of reserve money was set at 16.5 per cent due to the base effect of lower growth in reserve money during 2012. However, the reduction in the SRR effective from 01 July 2013 necessitated a downward revision to the projected reserve money path for the remainder of the year to maintain broad money along the targeted path. The year-on-year growth of reserve money, which averaged around 10.7 per cent during the first half of the year turned negative with the reduction in the SRR and remained within the revised average projection of 5.5 per cent for the year. Broad money growth moderated to 16.7 per cent on a year-on-year basis by end 2013 from 17.6 per cent at end 2012, and averaged 16.5 per cent during the year.

In terms of assets of the banking sector, the increase in public sector credit contributed to the expansion of broad money, while credit extended to the private sector moderated. Net credit to the government (NCG) increased by Rs. 256 billion in 2013 mainly on account of increased holdings of government securities by the banking sector, while loans and advances to the government also increased. However, the expansionary impact of higher credit granted to the government by commercial banks was somewhat contained as the Central Bank reduced its Treasury bill holdings by around Rs. 163 billion. The increase in credit extended to public corporations was lower at Rs. 72.6 billion in 2013 compared to Rs. 94 billion in 2012, due to interim repayments by two key SOEs. The decline in the growth of credit to the private sector from commercial banks remained a concern during the year. The sluggish downward adjustment in market lending rates and a sharp decline in pawning advances in absolute terms caused the growth of credit to the private sector to decelerate.

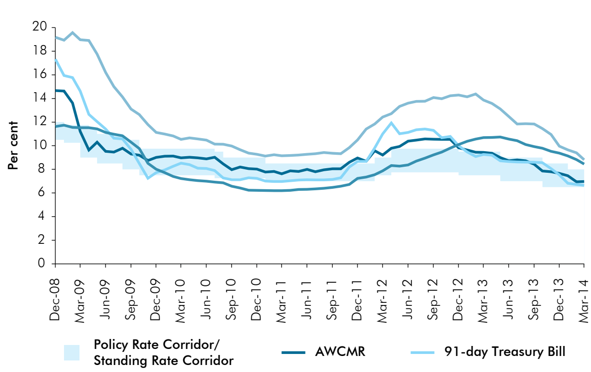
Chart 1.10 Year-on-Year Growth of Money and Credit to the Private Sector



Increased access to domestic and foreign capital markets also contributed to a decline in demand for bank credit from the private sector. By end 2013, the year-on-year growth of credit to the private sector was at 7.5 per cent in comparison to the growth of 17.6 per cent observed at end 2012. Net foreign assets (NFA) of the banking system declined in 2013 due to the reduction in foreign assets of commercial banks while NFA of the Central Bank increased. Mobilisation of funds from abroad, which were then invested in domestic assets contributed to the decline in NFA of commercial banks. NFA of the Central Bank reversed its decelerating trend observed during the first seven months of the year and recorded an increase of Rs. 132.7 billion by end 2013. The net absorption of foreign exchange, following transactions in the domestic foreign exchange market as well as forex swaps with commercial banks, raised NFA of the Central Bank during the latter part of the year.

The reduction in policy interest rates and the excess liquidity in the money market facilitated the downward adjustment in market interest rates during the year. Short term market interest rates adjusted sharply, although the adjustment in longer term rates was slow. The average weighted call money rate (AWCMR), which fluctuated around the upper bound of the policy rate corridor until end June, gradually moved

Chart 1.11 Policy Interest Rate Corridor and Selected Market Interest Rates



towards the middle of the corridor, declining by 217 basis points during the year. The weekly average weighted prime lending rate (AWPR) declined by 427 basis points in 2013. Meanwhile, the yield across all maturities of Treasury bills in the primary market declined and a similar pattern was observed in the secondary market as reflected in the downward shift in the secondary market yield curve for government securities. Commercial banks reduced their deposit and lending rates gradually during 2013. Accordingly, the average weighted lending rate (AWLR) declined by 80 basis points in 2013 while the average weighted deposit rate (AWDR) and the average weighted fixed deposit rate (AWFDR) declined by 73 basis points and 143 basis points, respectively, during the year. The declining trend in interest rates continued as the accommodative monetary policy stance of the Central Bank continued into 2014, and the Standing Rate Corridor (SRC) was compressed by reducing the Standing Lending Facility Rate (SLFR) by 50 basis points in January 2014.

Financial Sector Developments

The financial sector remained resilient, facilitating the investment and financial needs to support the growth momentum of the economy. The Central Bank continued to ensure the robustness and resilience of the financial sector through supervisory and regulatory policy formulation focused on risk based supervision and calibrating the business models and processes of licensed banks and non bank financial institution (NBFI) sector, which consists of licensed finance companies (LFCs) and specialised leasing companies (SLCs), to cater to the emerging needs of the growing economy. Financial markets remained liquid during much of 2013 and market interest rates adjusted downwards gradually. Given the diversified lending portfolios and strong capital and liquidity buffers, financial institutions continued to remain sound. Reflecting continued investor confidence, net inflows to the Colombo Stock Exchange (CSE) were sustained amidst volatility in global financial markets while the Government securities market also witnessed significant capital inflows. The domestic corporate debt market took off with an unprecedented number of long term debt instruments being issued. The Central Bank also took measures to increase the efficiency of the payment infrastructure. During the year, the Central Bank unveiled the Master Plan for consolidation in the financial sector, which was formulated with the aim of building a strong, dynamic and internationally competitive financial sector with cross-border linkages and a significant overseas presence.

The financial sector expanded and the soundness of financial institutions improved in terms of key performance indicators. During 2013 the banking sector expanded both in terms of business volumes and outreach. The branch network of the banking sector expanded further in 2013 with emphasis placed on areas outside the Western Province, enhancing access to financial services and promoting inclusive growth. Amidst continued fiscal consolidation, reforms in SOEs and a reduction of the exposure to pawning advances, credit growth of banks moderated during the year. Healthy capital and liquidity levels, improved management efficiency and good governance practices further reinforced the resilience of the banking sector. Given the availability of adequate resources in the form of capital, credit risk of the banking sector remained at a manageable level, despite the increase in non-performing loans (NPLs) during the year. Assets of the NBFI sector increased and its branch network expanded. The performance of primary dealers in terms of asset growth, capital and profitability increased in 2013. The gradual downward shift in the yield curve enabled primary dealers to earn capital gains on their trading portfolios thereby increasing the profitability of the sector. With a view to increasing competition in the sector, the Central Bank allowed licensed commercial banks (LCBs) to operate as primary dealers in government securities without having to maintain the minimum capital requirement applicable to standalone primary dealers. The unit trust industry expanded with the establishment of 16 new funds during 2013 and the profitability of the sector increased due to tax concessions given to the sector. Insurance companies maintained their soundness with key indicators such as total assets, premium income, investment income and profitability recording an upward trend during the year. The assets under management performed well and the membership of the superannuation funds sector expanded further during 2013. The Employees' Provident Fund (EPF), the main retirement benefit fund for the private sector, expanded with an increase in income generated through the effective and prudent management of the EPF, and by end 2013, the total value of the fund increased by 13.6 per cent to Rs. 1,300 billion.

Domestic financial markets remained liquid and stable in 2013. Rupee liquidity in the domestic money market was in a surplus position during much of 2013. Responding to the surplus liquidity in the domestic money market, the AWCMR adjusted downwards during the year and gradually moved towards the middle of the corridor during the last quarter of the year thus facilitating the effectiveness of monetary policy transmission. The market for commercial paper was less active in 2013 when compared with the previous year. In the corporate bond market, activity levels in the market for debentures increased substantially in 2013, with both the value and the number of debentures issued increasing significantly. Tax exemptions provided in the budget for 2013 for the issue of corporate debt primarily caused the significant increase in the supply of debentures during the year. Having recorded two consecutive years of sluggish performance, the All Share Price Index (ASPI) and the S&P Sri Lanka 20 Index of the CSE recorded gains in 2013. The downward trend in domestic interest rates, which resulted in a significant drop in interest rates during the year, relatively stable exchange rate, and the favourable impact of the gradual recovery of the global economy on domestic macroeconomic performance supported the favourable performance in the stock market. The increased participation by foreign investors including institutional investors, which resulted in a net inflow of foreign investments, was noteworthy in the context of many regional markets recording net outflows in view of the outlook for monetary policy in advanced economies.

The regulatory framework and the supervision and enforcement regime pertaining to the financial sector were further strengthened in 2013. The Central Bank introduced several regulations to address potential risks in the banking sector, including the implementation of the Supervisory Review Process for banks in accordance with the Basel II Capital Accord and the enhancement of disclosure requirements with a view to enhancing transparency and comparability in line with new Sri Lanka Accounting Standards (LKAS) and Sri Lanka Financial Reporting Standards (SLFRS). In the non bank finance sector, the Central Bank issued directions to seek prior approval with respect to writing off of accommodations to related parties, and a supervisory framework was introduced in respect of debt instruments issued by finance companies, especially to deal with areas such as liquidity and interest rates. The Central Bank adopted several measures to build the capacity of the LFC and SLC sector to facilitate the expansion of economic activity as well as to strengthen its ability to manage and absorb risks. Key amongst these measures were the steps taken by the Central Bank to promote consolidation of the LFC and SLC sector. These measures would help secure financial system stability whilst facilitating the continued expansion of economic activity in future.

The payment infrastructure of the country improved further in 2013, enhancing efficiency, security and soundness of the national payment system. The Central Bank revised the regulatory framework governing the country's payment and settlement systems in 2013 in view of the changing risk profile of the national payment system and to provide guidance and support for payment and settlement system development. The System Rules pertaining to the LankaSettle System, operated by the Central Bank were updated in accordance with international standards and best practices. In discharging its responsibilities as the regulator of the national payment system, the Central Bank focused its attention on further rationalising the regulatory framework to enhance stability, safety and efficiency of payment and settlement systems. New regulations with regard to payment cards and mobile payment systems were issued. During the year, three institutions were licensed to operate as service providers of payment cards while a telecommunication network operator was also granted a licence to operate a mobile phone based e-money system.

1.3 Global Economic Environment and Outlook

The global economy grew at a slower pace in 2013, despite strong signs of increased economic activity towards the latter part of the year. Economic activity in advanced economies picked up firmly particularly during the second half of the year, supported by expanding domestic demand, softer financial market conditions and slowly improving consumer and business confidence. Meanwhile, growth in some emerging market economies slowed due to weaker than expected domestic demand despite improved growth prospects for their exports. In particular, emerging market economies saw tighter financial conditions which constrained domestic demand to a greater extent and renewed market pressure weakened investor sentiment in anticipation of unwinding of unconventional monetary policies in advanced economies. The developing economies continued to maintain positive growth rates despite numerous challenges in the areas of employment generation, infrastructure development and diversification into higher value added production.

Global growth in 2013 was estimated at 3 per cent, marginally lower than the growth of 3.1 per cent recorded in 2012, although the underlying momentum appears strong. Advanced economies registered a growth of 1.3 per cent in 2013, marginally lower than the growth of 1.4 per cent recorded in 2012. The US grew by 1.9 per cent in 2013 compared to 2.8 per cent in 2012, supported by strong contributions from consumption, investment, and inventory accumulation. Meanwhile, the euro area ended the prolonged recession reducing its negative growth in 2013 to 0.4 per cent, from 0.7 per cent in 2012.

Table 1.4 Global Economic Developments and Outlook (a)

Item	2011	2012	2013 (Est.)	2014 (Proj.)
World Output	**3.9**	**3.1**	**3.0**	**3.7**
Advanced Economies	1.7	1.4	1.3	2.2
United States	1.8	2.8	1.9	2.8
Euro Area	1.5	-0.7	-0.4	1.0
United Kingdom	1.1	0.3	1.7	2.4
Japan	-0.6	1.4	1.7	1.7
Emerging and Developing Economies	6.2	4.9	4.7	5.1
Developing Asia	7.8	6.4	6.5	6.7
China	9.3	7.7	7.7	7.5
India	6.3	3.2	4.4	5.4
World Trade Volume (Goods and Services)	**6.1**	**2.7**	**2.7**	**4.5**
Imports				
Advanced Economies	4.7	1.0	1.4	3.4
Emerging and Developing Economies	8.8	5.7	5.3	5.9
Exports				
Advanced Economies	5.7	2.0	2.7	4.7
Emerging and Developing Economies	6.8	4.2	3.5	5.8
Price Movements				
Consumer Prices				
Advanced Economies	2.7	2.0	1.4	1.7
Emerging and Developing Economies	7.1	6.0	6.1	5.6
Commodity Prices (US$)				
Oil	31.6	1.0	-0.9	-0.3
Non-Fuel	17.9	-10.0	-1.5	-6.1
Six-month London Interbank Offered Rate (LIBOR) on US$ Deposits (per cent)	**0.5**	**0.7**	**0.4**	**0.4**

(a) Annual percentage change unless otherwise indicated

Source: World Economic Outlook (Oct 2013 & Jan 2014), IMF

Export growth and growing domestic demand particularly in Germany helped the recovery in the euro area. The United Kingdom (UK) expanded by 1.7 per cent in 2013 from 0.3 per cent in 2012 buoyed by easy credit conditions and improved confidence. In Japan, the set of bold stimulus policies adopted since late 2012 boosted economic growth to 1.7 per cent in 2013, from 1.4 per cent in 2012. However, further measures targeting at structural reforms, including the planned increase in the consumption tax rate beginning April 2014 over the next two years may curb domestic demand in Japan. Meanwhile, growth in emerging market and developing economies slowed to 4.7 per cent in 2013 from 4.9 per cent in 2012. In China, growth stood at 7.7 per cent in 2013, as in the previous year, supported by firm domestic demand particularly during the second half of the year. Activity in India also picked up with the economy growing by 4.4 per cent in 2013, from 3.2 per cent in 2012, as a result of a favourable monsoon season and higher export growth. However, activity in other key emerging economies such as Russia, South Africa and Mexico, among others, weakened substantially in 2013. The growth in Latin America and Caribbean regions as well as the Middle East and North Africa regions slowed to 2.6 per cent and 2.4 per cent in 2013, from 3.0 per cent and 4.1 per cent in 2012, respectively.

Monetary policy in major central banks in 2013 was largely characterised by the developments that took place in relation to large scale purchases of long term assets and the use of 'forward guidance' as a policy tool. With the intention of gradual winding down of its stimulus efforts, the US Federal Reserve announced in December 2013 a US dollar 10 billion reduction in its monthly bond purchases of US dollars 85 billion with tapering to commence in January 2014. A further reduction of US dollars 10 billion was made in February 2014, and a similar reduction is to be effected from April 2014. Meanwhile, the Bank of England continued to maintain its quantitative easing stance, with the stock of asset purchases remaining at sterling pounds 375 billion at end January 2014. The European Central Bank (ECB) continued its accommodative monetary policy stance by reducing in November 2013 the interest rate on main refinancing operations to 0.25 per cent, from 0.5 per cent in order to address lower than expected growth in economic activity. The Bank of Japan continued its asset buying programme at an annual pace of about 60-70 trillion yen. On forward guidance, the US Federal Reserve reiterated its commitment to maintaining low policy rates with the overall objective of fostering stable prices and maximum employment. An inflation rate of 2 per cent in the long term and an unemployment rate of 6.5 per cent were set as trigger points for raising federal funds rate. However, with unemployment reaching levels close to the targeted rate, the Federal Reserve updated its forward guidance as economic conditions warranted the continuation of a low interest rate regime. The revised forward guidance stance incorporates a wide range of indicators such as labour market conditions, indicators of inflation pressure and inflation expectations, and developments in the financial market in its assessment of the economy. Similarly, the Bank of England's forward guidance was slightly changed from the original position which specified that the Bank would refrain from raising the bank rate from its 0.5 per cent level at least until the unemployment rate has fallen to a threshold of 7 per cent, to indicate that the Bank would also monitor a wider range of measures in addition to the unemployment rate, amidst a rapid fall in the unemployment rate. Meanwhile, the ECB maintained the position that their current policy setting of low interest rate regime would stay in place for an extended period of time without specifying a numerical target for exiting the accommodative policy stance. The Bank of Japan maintained the position that it would continue easing monetary conditions until the CPI inflation rate reaches the target of 2 per cent. In contrast, central banks in emerging and developing economies showed no apparent common trend in monetary policy setting, as some tightened their monetary policy stance while others eased, in response to the challenges they faced, including spillovers from the changes in quantitative easing of major central banks, such as fluctuations in exchange rates, volatility in capital flows, and movements in inflation, unemployment and growth.

The global financial system is undergoing a series of transitions, as advanced economies endeavour to move towards a safer financial sector, while emerging markets face the risk of transitioning into more volatile external conditions and higher risk premiums. The expectation that major central banks would taper their purchases of long term assets provoked movements in asset prices in emerging markets and led to portfolio reallocation and capital outflows in emerging economies. The spreads between yields on sovereign bonds issued by emerging economies and the benchmark yields on government bonds of major developed countries surged by more than 100 basis points in the two weeks immediately following the US Federal Reserve announcement in May 2013 of the possible reduction of the size of its bond buying programme. During 2013, net capital inflows to emerging market economies are estimated to have declined by about 13 per cent to US dollars 1.1 trillion from US dollars 1.3 trillion in 2012. While the downside risks for capital inflows were partly triggered by the US Federal Reserve tapering announcement, waning growth prospects and macroeconomic imbalances in emerging market economies also played a role in the decline of capital inflows. Meanwhile, net capital outflows from emerging market economies are estimated to have increased by about 1.3 per cent to US dollars 1.3 trillion in 2013, as China significantly increased its outward direct investment supported by more encouraging government policies, and many Latin American economies, such as Brazil, Chile, Colombia, Mexico and Peru increased outward capital flows, mostly in the form of portfolio investments, reflecting the need to diversify their assets internationally.

Foreign exchange markets experienced heightened volatility in some currencies during 2013, a year dominated by expectations of changing monetary policy around the globe. The Japanese yen recorded a dramatic depreciation, particularly during the early part of the year, falling sharply against the US dollar by 18.1 per cent in 2013. The yen's broadly negative performance in 2013 was largely due to the Bank of Japan's large scale monetary easing programme and the government's aggressive fiscal expansion, aimed at countering persistent deflationary pressures. Meanwhile, the euro registered the biggest gains against the US dollar among major currencies in 2013, appreciating by 4.4 per cent. Similarly, the pound sterling gained 2.0 per cent against the US dollar in 2013, with the noticeable recovery in the economy. However, the Australian dollar lost its value by about 14.2 per cent against the US dollar during 2013. Following the announcement of the Federal Reserve in May 2013 on possible early scaling back of its bond buying programme, a number of emerging and developing countries saw a sharp devaluation of their currencies, particularly during end May through June 2013. Among the emerging economies, a significant depreciation of currencies was recorded in Brazil (13 per cent), India (11.7 per cent), Indonesia (20.9 per cent), South Africa (19 per cent), and Turkey (16.4 per cent). In contrast, the Chinese renminbi continued to appreciate gradually against the US dollar and other major currencies, supported by a number of factors, including larger foreign reserves, higher domestic savings, and more capital inflows in 2013. Meanwhile, a mixed performance was observed in other currencies in South Asia. The Indian rupee depreciated significantly in response to the announcement of the tapering of the US quantitative easing programme, coupled with a widening current account deficit in 2013. The Bangladesh taka appreciated gradually against the US dollar gaining by 3.1 per cent in 2013, as garment exports rose rapidly during the second and third quarters of 2013, despite several industrial accidents, which triggered international concerns over workers' rights. The Pakistan rupee depreciated by 7.9 per cent against the US dollar in 2013.

Inflation remained subdued in advanced economies in 2013 raising concerns of deflationary pressures in some countries, particularly in the euro area, while emerging market and developing economies faced no great challenge with regard to inflation, except for certain countries such as Brazil and India. Consumer price inflation in advanced economies declined to 1.4 per cent in 2013 from 2.0 per cent in 2012, while inflation in emerging market and developing economies remained broadly unchanged at around 6.0 per cent in 2013. The lower than expected inflation reflects excess capacity, high unemployment, fiscal austerity, and continued financial deleveraging in major developed economies. Meanwhile, Japan managed to end its decade long deflation, supported by policies aimed at monetary easing, fiscal expansion, and structural reforms widely known as 'Abenomics', introduced by the Prime Minister of Japan Shinzo Abe in December 2012. Oil prices were on a downward trend in 2013, despite some volatility as a result of geopolitical tensions in oil producing countries in the Middle Eastern region. Oil prices surged in January and February owing to geopolitical tensions with Iran, while another round of increases occurred in July and August as geopolitical tensions escalated in the Syrian Arab Republic. A simple average of the price of UK Brent, Dubai Fateh, and West Texas Intermediate crude oil was US dollars 104.11 a barrel in 2013, compared to US dollars 105.01 a barrel in 2012. Overall, the declining trend in oil prices mainly reflects the weaker demand for oil amidst slower world economic growth, while increasing use of alternative energy sources, such as shale gas, eased pressure on oil prices. Similarly, the price of minerals, ores and metals, as well as food and agricultural commodities generally eased during 2013.

The global economic outlook shows some strong signs of improvement since the second half of 2013. Private consumption, particularly in advanced economies, is expected to expand gradually supported by wealth effects from a recovery in house prices and rising equity prices, in addition to the increase in disposable income generated by the growth in employment. Further, firm commitment by major central banks to keep the policy rates lower for an extended period, despite some unwinding of long term asset buying programmes, is expected to strengthen investor confidence. In emerging market economies, a further mild pickup is projected for 2014 and 2015, mainly driven by a gradual recovery in exports amidst improving conditions in developed countries.In most East Asian economies, private consumption and investment are expected to expand strongly, supported by stable labour market conditions, low inflation, fairly accommodative monetary policies, and less contractionary fiscal policies. Meanwhile, developing economies would also witness some acceleration in growth in the years ahead, while measures need to be in place to counter challenges in the areas of high unemployment, lack of infrastructure, lack of diversification into higher value added activity and managing spillover effects of global shocks, particularly in the economies with large external current account deficits.

In the backdrop of improving global economic outlook, global growth is projected to increase from 3 per cent in 2013 to 3.7 per cent in 2014 and 3.9 per cent in 2015. In the US, the economy is expected to expand by 2.8 per cent in 2014 and 3.0 per cent in 2015. However, risks to the growth outlook may arise from both monetary policy and fiscal policy fronts. With regard to monetary policy, continuing long term asset purchases for too long could cause asset bubbles, while early unwinding might result in destabilising financial markets. On the other hand, risks associated with fiscal policy may be even more acute, if the political divide continues on the debt ceiling and budget issues. Meanwhile, with the ending of the protracted recession in the euro area, GDP growth for the region as a whole is estimated at 1.0 per cent in 2014 and 1.4 per cent in 2015, while risks remain on the downside due to continued fiscal tightening and a fragmented banking system. In Japan, the set of bold policies adopted since late 2012 boosted economic growth, yet the impending structural reforms along with the planned increase in the consumption tax rate may weigh on economic expansion and hence moderate growth to 1.7 per cent in 2014 and 1.0 per cent in 2015. Meanwhile, emerging market and developing economies are expected to grow by 5.1 per cent in 2014 and 5.4 per cent in 2015, underpinned by increasing consumer demand and steady recovery in exports. In China, growth is projected to moderate from 7.5 per cent in 2014 to 7.3 in 2015, amidst concerns that more progress is required on rebalancing domestic demand from investment to consumption to effectively contain the risks to growth and financial stability. Economic activity in India is estimated to expand by 5.4 per cent and 6.4 per cent in 2014 and 2015, respectively, reflecting a recovery in investment, and stronger export growth supported by improving global conditions and a depreciating currency. Overall, as prospects for global growth improve, it would be critical for advanced economies to avoid a premature withdrawal of monetary policy accommodation, as excess capacity is still large while inflation is low and fiscal consolidation continues. Further, future growth prospects hinge to a large extent on more structural reforms in the global financial system targeted at lifting investment through repairing bank balance sheets and recapitalising weak banks, which would bolster investor confidence and revive demand for credit in the near to medium term.

1.4 Medium Term Macroeconomic Outlook

The Sri Lankan economy is projected to accelerate further over the medium term benefitting from favourable economic conditions domestically and the restoration of growth globally. Steadied by 7.3 per cent growth in 2013, the economy is expected to grow by 7.8 per cent in 2014, before moving to a higher growth path of over 8 per cent in the medium term. This expansion is expected to be broad based with all major sectors, i.e., agriculture, industry and services, contributing positively in the coming years. Expansion of infrastructure facilities and adoption of advanced technology, especially in the Agriculture and Industry sectors are expected to result in greater capacity and improved productivity. Growth in trade in services especially in the areas of tourism, transport, telecommunication, ports and financial services is expected to provide the required impetus for the envisaged growth momentum. The gradual recovery in the global economy is expected to maintain Sri Lanka's external demand at favourable levels, sustaining a higher growth trajectory over the medium term. Augmenting investments to a level above 30 per cent of GDP is vital for maintaining a higher growth path. The GDP deflator is expected to decline to around 5 per cent over the medium term, supported by the added capacity in the economy and policy measures aimed at maintaining low inflation, thereby encouraging more productive investment. With the favourable developments in the economy, per capita income is expected to surpass US dollars 4,000 in 2015, highlighting the need to continue proactive measures to avoid the 'middle income trap', while fostering growth in all sectors of the economy.

Sri Lanka's external sector outlook is expected to improve further over the medium term. Exports of merchandise goods, which rebounded strongly during the second half of 2013, are expected to maintain an upward momentum, especially with the projected recovery of the US and the euro area, the major trading partners of Sri Lanka. Further, policy measures such as the establishment of 'free ports' and 'bonded areas' and tax incentives offered to export industries are expected to improve export earnings substantially over the medium term. Meanwhile, imports are also projected to grow moderately, largely due to higher imports of investment goods required to sustain the projected growth momentum. However, the envisaged higher growth of exports earnings would result in a substantial contraction in the trade deficit over the medium term. Meanwhile, the satisfactory performance of trade in services during the recent past is expected to continue with higher earnings from tourism, port and airport related activities and information technology services. Further, workers' remittances, which grew steadily in recent years, are expected to increase further over the medium term albeit at a slower pace, due to improving domestic labour market conditions that are expected to retain some of the migrating employees.

Improvements in infrastructure facilities and ease of doing business together with further relaxation of exchange control regulations are expected to bolster investments over the medium term. Investments on equity and debt securities and FDI are expected to increase

Table 1.5 Medium-term Macroeconomic Framework (a)

Indicator	Unit	2012 (b)	2013 (c)	Projections			
				2014	2015	2016	2017
Real Sector							
GDP at Market Prices	Rs. bn	7,579	8,674	9,911	11,314	12,860	14,637
Real GDP Growth	%	6.3	7.3	7.8	8.2	8.3	8.4
GDP Deflator	%	8.9	6.7	6.0	5.5	5.0	5.0
Per Capita GDP	US$	2,922	3,280	3,718	4,243	4,825	5,485
Total Investment	% of GDP	30.6	29.6	31.0	32.0	33.1	34.0
Domestic Savings	% of GDP	16.9	20.0	22.6	25.9	28.9	31.2
National Savings	% of GDP	24.0	25.7	28.4	31.1	33.2	34.2
External Sector							
Trade Gap	US$ mn	-9,417	-7,609	-8,364	-7,959	-7,326	-6,501
Exports	US$ mn	9,774	10,394	11,854	13,671	15,915	18,521
Imports	US$ mn	19,190	18,003	20,218	21,630	23,242	25,023
Services (net)	US$ mn	1,262	1,180	1,907	2,564	3,006	3,249
Export of Goods and Services	US$ mn	13,574	15,079	17,694	21,191	25,149	28,901
Export of Goods and Services	% of GDP	22.9	22.4	23.0	23.9	24.7	24.7
Workers' Remittances	US$ mn	5,985	6,407	6,999	7,632	8,287	8,825
Current Account Balance	US$ mn	-3,982	-2,607	-1,949	-831	101	268
Current Account Balance	% of GDP	-6.7	-3.9	-2.5	-0.9	0.1	0.2
Overall Balance	US$ mn	151	985	1,510	2,185	2,967	3,606
External Official Reserves	US$ mn	7,106	7,495	8,251	9,883	12,349	15,693
Fiscal Sector							
Total Revenue and Grants	% of GDP	14.1	13.3	14.8	15.5	16.6	16.8
Total Revenue	% of GDP	13.9	13.1	14.5	15.3	16.5	16.6
Grants	% of GDP	0.2	0.2	0.3	0.2	0.2	0.2
Expenditure and Net Lending	% of GDP	20.5	19.2	20.0	19.9	20.4	20.6
Current Account Balance	% of GDP	-1.0	-0.8	1.1	1.6	2.3	2.3
Overall Budget Deficit	% of GDP	-6.5	-5.9	-5.2	-4.4	-3.8	-3.8
Domestic Financing	% of GDP	2.7	4.5	2.3	2.2	2.2	2.3
Government Debt	% of GDP	79.2	78.3	74.3	70.6	65.0	62.0
Financial Sector (d)							
Reserve Money Growth	%	10.2	0.9	14.0	14.0	14.0	14.0
Broad Money Growth (M_{2b})	%	17.6	16.7	14.0	14.0	14.0	14.0
Change in Net Credit to the Government	Rs. bn	211.6	256.1	100.0	50.0	50.0	50.0
Change in Credit to the Private Sector	Rs. bn	352.6	175.9	355.0	433.0	498.0	573.0
Growth in Credit to the Private Sector	%	17.6	7.5	14.0	15.0	15.0	15.0

(a) Based on information available by mid March 2014
(b) Revised
(c) Provisional
(d) Year-on-year growth in end year values

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

over the medium term supported by a conducive business environment and initiatives taken by the Board of Investment to attract strategic investments into key economic sectors. Meanwhile, the banking and private sector is expected to raise more capital from international markets to support expanding business activities. The government's access to long term financing will be an important source of foreign capital over the medium term. These developments in the external sector are expected to yield a sizable surplus in the BOP and boost the country's external reserves to a comfortable level, thereby help in maintaining stability in the domestic foreign exchange market and enhancing the country's resilience to external shocks.

The Central Bank expects to maintain inflation at around mid single digits in the medium term, through prudent conduct of monetary policy, supported by productivity enhancing supply side measures. Maintaining headline and core inflation at single digit levels for a period of over five years has led to well anchored inflation expectations, allowing market interest rates to remain at low and stable levels in the medium term. In addition, further strengthening of the ongoing fiscal consolidation efforts and cost reflective prices of public corporations would effectively release additional banking sector resources for private investments. Meanwhile, greater inflows of foreign debt and equity capital to the banking sector are expected to augment the supply of credit from the domestic banking sector for development activities.

On the fiscal front, the medium term macro fiscal framework of the government is designed to further reduce the budget deficit and government debt to a level conducive to support broad based development objectives. The underlying fiscal strategy envisages an increase in revenue and a moderation in the growth of recurrent expenditure over the medium term, while maintaining public investments at a level to support the high growth momentum. Accordingly, government revenue is expected to reach 15 to 16 per cent of GDP over the medium term with higher revenue mobilisation envisaged from a simplified and broadened tax base, enhanced tax compliance and efficiency improvements in tax administration. Meanwhile, continuous efforts to rationalise recurrent expenditure coupled with the expected low interest rate regime would help moderate the increase in recurrent expenditure over the medium term. Consequently, the current account surplus in 2014 would be further strengthened in the medium term, creating more fiscal space to accommodate the public investment programme. As a result, public investments in the medium term would be maintained at a level above 6 per cent of GDP complementing the projected improvement in the overall investment level of the country. These developments are expected to reduce the budget deficit to a level below 4 per cent of GDP by 2016, in line with the deficit reduction path envisaged in the medium term macro fiscal framework. The lower budgetary financing requirement would reduce reliance on bank borrowing, thereby lessening crowding out of private investment and lowering demand pressures on inflation by allowing the central bank to maintain monetary expansion at a desired level. In addition, pricing strategies and business re-engineering processes adopted by SOEs to strengthen their balance sheets would enhance the financial viability of public enterprises. Meanwhile, the government's medium term debt management strategy is designed to gradually reduce the debt stock through a lower deficit supported by the anticipated higher economic growth. Accordingly, the debt to GDP ratio is expected to reduce to around 65 per cent by 2016. Further, the prudent management of public debt will lengthen the average time to maturity of the debt stock, while reducing debt servicing costs in the medium term.

1.5 Issues and Policies

Enhancing the productivity and profitability of the Agriculture sector would be vital as this sector plays a strategic role in the development of the country. While the contribution of the Agriculture sector to GDP is only around 11 per cent, it absorbs around 29 per cent of the labour force. Low productivity in the Agriculture sector raises the cost of production and reduces competitiveness. Modernisation of the Agriculture sector through the introduction of new technologies will help improve productivity while linking to global value chains will result in the adoption of new technologies. The growth of productivity in the Agriculture sector would release labour currently engaged in agricultural activities to move to new growth areas in the economy. Increasing land holding sizes by restructuring production units and encouraging better farm management practices would also help improve land-labour ratios, thereby also improving the productivity in the agriculture sector. Through more efficient use of inputs and the development of domestic input industries, it would be possible to address the high cost of production resulting from volatile imported prices of inputs such as fertilizer, agro chemicals, seeds and machinery and equipment and commodities which are inputs in the food processing and animal feed producing industries. In enhancing agricultural exports, greater focus on developing product based industries rather than commodity based industries would be necessary. In this regard, making use of global value chains will help create higher value added products, thereby maximising the contribution of this sector to national income and export earnings, while also enhancing the incomes of those engaged in this sector.

Due to the lack of insurance and credit guarantee schemes, micro, small and medium enterprises (MSME) in the Agriculture sector face difficulties in accessing bank credit. Presently, the coverage of crop insurance in the Agriculture sector remains low. Therefore, it is important to promote both traditional and nontraditional insurance schemes and credit guarantee schemes to mitigate risks thereby encouraging the expansion of credit to the Agriculture sector. Some countries have developed new financial risk transfer products such as index based insurance products and credit guarantee funds to facilitate the expansion of lending. Insurance products are linked to a weather index such as rainfall, rather than to crop failure. The transaction cost of such products is low, and therefore becomes more affordable, while also encouraging farmers to make a more informed decision with regard to the choice of crop. Lenders are also safeguarded against credit default. Credit guarantee schemes are created by pooling the contributions of well-capitalised and well-managed cooperatives, non-government organisations (NGOs), development banks and land banks. A credit guarantee scheme issues a surety cover in favour of the lending bank on behalf of the members of such cooperatives or NGOs as a security for the loan. There are several advantages of borrowing with a credit guarantee compared to borrowing directly from banks, as cooperatives or NGOs could accept collateral that are otherwise not accepted by banks such as stock in trade, agriculture land, chattel and vehicles. Further, a mortgage is not required to be made in favour of the lending institution as it is held by the cooperative or NGO. These schemes are popular in some emerging market economies and Sri Lanka could also successfully implement such schemes to promote sustainable growth in the agriculture sector.

Despite Sri Lanka being well recognised for its efficient water management systems in ancient times, it has become increasingly challenging to supply water to meet the increasing demand from expanding economic activities. As in many other countries, Sri Lanka also faces a challenge of formulating a strategy for sustainable water management. Several government agencies are involved in the country's water management efforts, including the Ministry of Water Supply and Drainage, the Ministry of Irrigation and the Mahaweli Development Authority. The latter two institutions provide water for irrigation purposes based on a seasonal operating plan where final distribution decisions are taken by a panel comprising various stakeholders including representatives from the Irrigation Department, Department of Agriculture as well as the CEB. The cultivation plan is determined according to availability of water and farmers are directed to cultivate only an approved number of hectares in a given season. If excess water is available, power generation is given priority. The complexity of water management in Sri Lanka is due to the multiplicity of institutions with varying mandates that are involved in the process. Fresh water that is released for irrigation or hydropower generation is considered a public good with the government functioning as its custodian. Being a public good, water is used by many leading to a 'tragedy of the commons', where consumption of the shared resource by individuals acting in their individual and immediate self-interest diminishes or even destroys the original resource, which in this case, is water. Therefore, it is important to establish an integrated approach where resource usage is accounted for, wherever possible, by a centralised system and ownership and the usage of water is properly vested with an agency who in turn should reciprocate through a suitable payment mechanism. Such a mechanism will not only help manage the scarce resource but also promote sustainable development. With regard to the supply and distribution of water for domestic and industrial consumption, efforts are needed to rehabilitate the existing pipelines in the distribution and transmission network to reduce leakages and improve the metering system.

As the country moves to upper middle income status there is a need for more emphasis on innovation and research and development to diversify the manufacturing base to higher value added products. With rising wages, economies lose their comparative advantage in labour intensive industries, thus requiring a move away from the current resource based-labour intensive factory industries to knowledge based-technology intensive industries. This entails promoting high technological products such as nanotechnology enabled products, biotech-products, electrical products and electronic products, which diversify the industrial base into high value added products that will generate substantially more foreign exchange for the country. The government has given various incentives to promote research and development in recent years with the objective of encouraging innovation. These incentives are in the form of reduced income tax rates, tax deductions for expenditure incurred on research and development, removal of customs duty on instruments and apparatus used for scientific research, research allowances and funding for research projects. The establishment of a Nanotechnology and Science Park has also opened an excellent opportunity to develop industries along these lines. Further, various state institutions are seeking to develop technology business incubators (TBIs) and technology transfer centres with the support of various international agencies to develop innovation based enterprises. For example, the National Enterprise Development Authority (NEDA) has recently sought to establish TBIs in collaboration with two state sector universities and the Electrical and Electronic Technology Business Incubator at Moratuwa. While these TBIs and technology transfer centres have so far played a limited role in providing technological and business support, exploiting these collaborations would lead to further diversification of the Industry sector. The experience of other countries highlights the importance of innovation and development for product diversification and penetration of export markets. In this regard, initiatives to cultivate a technopreneurial culture and boost innovation led industrial and export growth should be promoted. Moving manufacturing up the value chain would also require a labour force that is trained in the requisite skills. While education in engineering and technology related subjects needs to be promoted, the value of learning by doing cannot be ignored and firms should be incentivised to create a learning environment that encourages the acquisition of skills that will enable the Industry sector to move to the next level.

Pursuing a strategy for setting up industrial clusters will offer significant opportunities to boost the country's production as well as export earnings, thereby supporting the expansion of the economy to US dollars 100 billion by 2016. In Sri Lanka, several industrial clusters have already been developed in areas such as wearing apparel, rubber, ceramics and tea. Further, an electric/electronic cluster is being developed in joint collaboration between Japan International Cooperation Agency (JICA), the University of Moratuwa and the Ministry of Industries. With the establishment of industrial clusters, infant industries get the opportunity to collaborate with major global players in the industry. Further, working with clusters provides an opportunity for innovation and the development of particular skills, while addressing issues relating to efficiency and productivity in the industrial sector. Strong domestic industrial clusters can also help attract foreign direct investment to the country. Since the mid-1990s, countries have successfully adopted industrial cluster policies to increase business competence and develop strong regional economies. Silicon Valley in the US, the Toyota Cluster in Japan, Baden-Wuerttemberg cluster in Germany, Hsinchu Science and Industrial Park in China and Cambridge Technopole in the UK are some of the examples of large scale clusters set up by advanced countries to strengthen industrial competitiveness. Sri Lanka too can boost its technology based industries by setting up industrial clusters thereby moving to high value added products and diversifying its industrial and export base.

The challenge to developing Sri Lanka into an internationally competitive commercial hub will be the enormous pressure it would exert on existing public utilities and infrastructure facilities. The Services sector has become one of the fastest growing sectors in the global economy accounting for around 6 per cent of global output and 19 per cent of global exports. In Sri Lanka, the contribution of the Services sector to GDP is around 60 per cent while services exports account for around 30 per cent of total exports of goods and services. The growth in the export of services over the past decade highlights the scope for service exports to be a key driver of growth going forward. Capitalising on the country's strategic location and competitive advantage, the government's strategy to develop five hubs plus tourism has thrust the Services sector as the main engine of growth in the medium term. In the light of the rapid developments taking place to position Sri Lanka as a commercial hub in the region, it is necessary to ensure that the capacity of the major public utilities and infrastructure facilities such as water, electricity, sewerage and storm water drainage, fire protection services and transportation infrastructure are developed to meet the growing demand arising from the emerging economic activities.

The emergence of Sri Lanka as a viable outsourcing destination for IT/BPO/KPO services requires the creation of a brand identity and the development of skills required to move the industry forward. Despite the limited size of the workforce in relation to other large outsourcing players such as India, Sri Lanka possesses highly skilled professionals for niche services in software testing, finance and accounting. Sri Lanka is also an attractive offshore outsourcing destination with a high quality labour force that is relatively cheap and possessing a good work ethic. However, the IT/BPO industry in Sri Lanka faces numerous challenges as it seeks to become a one billion dollar industry by 2015. Showcasing Sri Lanka as a key provider of services in the region and creating a brand identity for services would be vital to enhancing the growth potential in this sector. Road shows to position the country as an emerging outsourcing destination by conducting IT fairs in major cities around the world would be an important strategy in this regard. Ensuring the availability of skilled manpower is an important pre-requisite for expanding IT services based exports. Creating awareness especially about job opportunities in IT and related sectors for talented Sri Lankans and collaborating with universities to establish degree programmes to develop the required knowledge and skills as well as capacity building are needed to expand this industry further. A sustainable growth in service based exports would also encourage reverse brain drain, thereby addressing the need for skilled labour in the emerging sectors.

Tourism which is one of the fastest growing sectors in the economy requires a clear, market driven strategy as it aims to reach its target of 2.5 million tourist arrivals by 2016. The tourist industry has witnessed a rapid growth since the end of the conflict with tourist arrivals more than doubling during that period. However, in expanding the tourism industry further, the industry faces many challenges, such as the need for more trained staff, improved service standards, an increase in room capacity and better promotional efforts particularly in non traditional markets. The number of trained hospitality staff is inadequate to meet the needs of a growing industry. Hence, there is an urgent need to establish new training schools, encourage current employees to obtain higher certification and multi-skill development and to provide incentives to Sri Lankan hoteliers working abroad to return to the country. This would increase the pool of skilled workers, thereby improving the service standards in the industry. The ongoing mega projects in the hotel sector are expected to raise the capacity in the industry to meet requirements of the targeted tourist arrivals, and hence, the timely completion of these projects is vital. The continuing collaboration between the state and private sector would be necessary for the sustainable development of the industry. Further, continuing to conduct promotional campaigns in untapped potential markets is expected to attract tourists from a wider geographic base thereby strengthening the resilience of the industry.

Diversification of export products and markets is vital to reduce the country's vulnerability to external shocks. Sri Lanka's export structure has shifted from a predominantly agriculture base in the 1960s to more light manufacturing base with exports of textiles and garments and rubber products. However, earnings from exports have continued to depend on a few commodities. In the 1960s, primary commodities such as tea accounted for around 60 per cent of total export earnings, while in 2013, both tea and textiles and garments accounted for around 58 per cent of total export earnings. Greater product diversification in the export sector would help reduce the vulnerability of export earnings to adverse external shocks such as a sharp decline in world commodity prices or a global recession as well as domestic shocks, such as a severe drought. Incentives to promote value addition and backward integration as well as institutional support for innovation are some of the policies that have been adopted to expand the product base. The five hubs strategy is a laudable initiative of the government to diversify economic activity and expand export earnings over the medium term. Providing incentives to local companies to develop global brands would be an important strategy to increasing access to non traditional markets, particularly in emerging economies. While there has been greater penetration of the garment industry into non traditional markets, the EU and the US still account for around 89 per cent of the market for textiles and garment exports from Sri Lanka. Meanwhile, in the case of tea, the Middle East and CIS countries account for around 70 per cent of total tea exports. Increasing geographic diversification of export destinations is another area that has received more attention recently. Improving the utilisation of bilateral and multilateral trade agreements and conducting awareness programmes to educate exporters regarding the rules of origin criteria, tariff and non-tariff barriers and new market access opportunities resulting from trade agreements is expected to significantly improve access to new markets. Further, continuously engaging in existing and new free and preferential trade agreements would also help maximise the benefits from these agreements. The rapid growth taking place in emerging markets and a rising middle class in these economies have caused a significant shift in trade flows towards emerging market economies. In line with these developments there has been a gradual shift in Sri Lanka's product composition and export destinations with more trade taking place with emerging and developing economies. This is expected to help increase the country's export potential, while reducing the country's vulnerability to a narrow product and market base.

BOX 1 Economic Diversification and Sustainable Growth

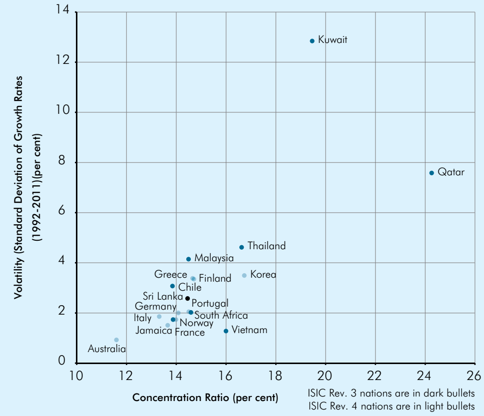
Diversification for Sustainable Growth

A sustained level of economic growth is the prime economic objective of most countries in the world. Many developing countries have been able to achieve high growth rates for short periods but only a few have been able to maintain such growth rates for a considerable period of time and ultimately reach high income levels. Irrespective of how small the growth difference is, when it is compounded over a number of years, large differences buildup in the per capita income levels resulting in large shifts in living standards of different countries.[1] Therefore, especially for emerging economies, it is important to achieve sustainable high growth rates rather than sporadic abnormally high growth for short periods.

By nature, different countries are endowed and equipped with different types and levels of resources, resulting in a concentration of economic activity in one or a few specialised areas and thereby strengthening the concept of specialisation and cross border trade. However, certain countries are able to diversify their economies so as to limit the dependence on one or few sectors of specialisation. It is often considered that such a diversified economy provides higher support for maintaining growth rates for extended periods of time.

This is apparent if the level of diversification and volatility of economic growth is analysed across a few countries. Such an analysis can be conducted by using a Concentration Ratio (CR), calculated by taking the sum of squares of per cent contributions to Gross Domestic Product (GDP) from different sectors of the economy, and the standard deviation of GDP growth rates as a measure of volatility of economic growth.[2] Table B 1.1 illustrates the CR calculated for Sri Lanka and other selected countries. A higher CR indicates a

Chart B 1.1 Concentration Ratio and Volatility of Economic Growth



Sources: National Accounts Official Country Data - United Nations Statistics Division (UNSD), World Economic Outlook Database - October 2013 – International Monetary Fund (IMF)

greater concentration of the output in a few sectors and a low CR indicates a lesser concentrated and more diversified output.

The concentration of economic activities in a few sectors can be impacted by the level of natural resources available in the country. For example, the Middle East countries are rich in petroleum resources and economic activity is concentrated in the category of 'mining and quarrying'. During favourable periods, these countries are able to achieve very high growth rates. However, the economic performance of these countries is largely linked to oil prices and therefore is substantially affected by variations in global oil price movements. On the other hand, there are some countries which are also rich in natural resources,

Table B 1.1 Concentration Ratio of Selected Countries (Based on 2011 GDP (Constant Prices in National Currencies))

Group A

Chile	13.85
Jamaica	13.87
Kuwait	19.46
Malaysia	14.50
Qatar	24.26
South Africa	14.59
Sri Lanka	**14.46**
Thailand	16.63
Vietnam	16.00

The economic sectors considered are as follows;

- Agriculture, Hunting, Forestry; Fishing
- Mining and Quarrying
- Manufacturing
- Electricity, Gas and Water Supply
- Construction
- Wholesale, Retail Trade, Repair of Motor Vehicles, Motorcycles and Personal and Household Goods; Hotels and Restaurants
- Transport, Storage and Communications
- Financial Intermediation, Real Estate, Renting and Business Activities
- Public Administration and Defence; Compulsory Social Security
- Education; Health and Social Work; Other Community, Social and Personal Services
- Private Households With Employed Persons

Group B

Australia	11.60
Finland	14.71
France	13.66
Germany	14.09
Greece	14.66
Italy	13.32
Korea	16.74
Norway	13.99
Portugal	14.51

The economic sectors considered are as follows;

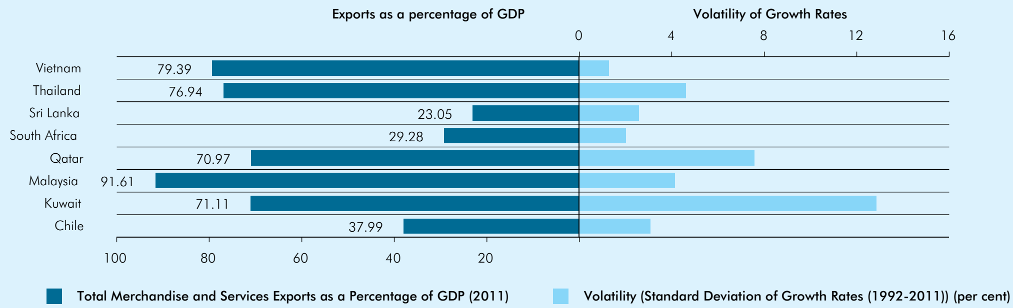
- Agriculture, Forestry and Fishing
- Manufacturing
- Mining and Quarrying and Other Industrial Activities
- Construction
- Wholesale and Retail Trade, Transportation and Storage, Accommodation and Food Service Activities
- Information and Communication
- Financial and Insurance Activities
- Real Estate Activities
- Professional, Scientific, Technical, Administrative and Support Service Activities
- Public Administration and Defence, Education, Human Health and Social Work Activities
- Other Service Activities

Data for countries in Groups A and B are classified according to the revisions 3 and 4 of the International Standard Industrial Classification (ISIC), respectively.

Source: National Accounts Official Country Data - United Nations Statistics Division (UNSD)
Notes: Data for Chile does not include category "Private households with employed persons".

1 Pritchett (1998)
2 Adapted from Shediac et.al. (2008), "Economic Diversification: The Road to Sustainable Development".

Chart B 1.2 **Exports as a percentage of GDP vs Volatility of Economic Growth**



Sources: World Economic Outlook Database - October 2013 – International Monetary Fund (IMF), World Development Indicators – The World Bank

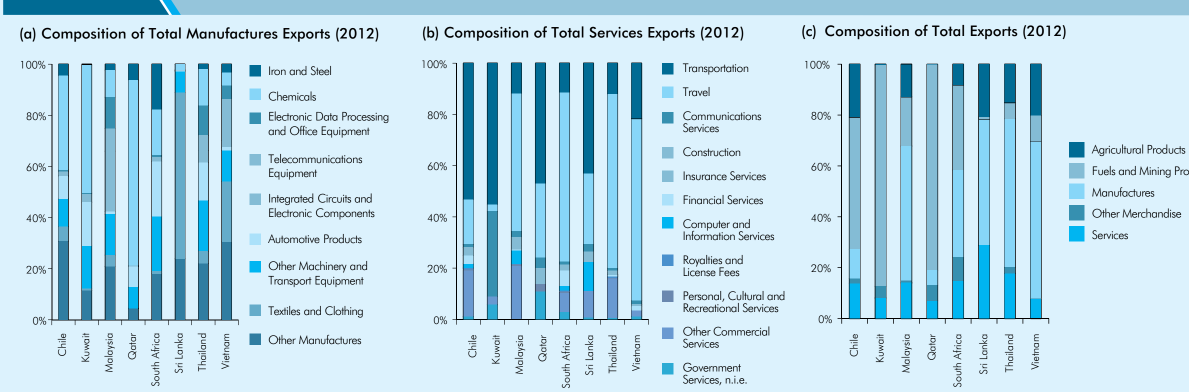
but have been able to direct the revenues obtained from such resources into other sectors as well. As a result, the economic activity in such countries is much more diversified. At the same time, there are also some countries that are not rich in natural resources but which have diversified economies.

As illustrated in Chart B 1.1, a positive relationship can be observed between the CR and the standard deviation of the growth rate. As a higher CR means an economy which is concentrated towards one or two sectors and a higher standard deviation means a more volatile growth, i.e. a less stable economy, it can be inferred that the more an economy is concentrated towards few sectors, the less stable that economy is. In other words, the economic growth of a well-diversified economy can be expected to be more sustainable than that of a concentrated economy. However, this analysis is very sensitive to the selection of the number of sectors in the economy and the time period : thus, only a generalised observation can be derived. Nevertheless, the evidence that a more diversified economy being supportive of less volatile economic growth suggests that policy makers should promote more balanced growth in the economy, rather than concentrated growth in a few sectors. Hence, countries should develop other sectors of the economy through the gains obtained from the sectors in which the particular country performs best. The above analysis points to a comparably low CR in Sri Lanka, suggesting that the output is comparatively more diversified in Sri Lanka than in some emerging economies.

There is evidence that external trade helps reduce economic volatility.[3] As illustrated in Chart B 1.2, countries in which exports as a percentage of GDP are high also have low economic volatility (e.g. Malaysia and Thailand). However, there are some countries where exports as a percentage of GDP are high and economic volatility has also been high (e.g. Kuwait and Qatar). The difference is due to export diversification. Countries such as Malaysia and Thailand have a high level of export diversification (particularly manufactures exports) while Kuwait and Qatar have not, as shown in Chart B 1.3. In the case of Sri Lanka, both exports percentage and volatility are comparably low, indicating lower contribution of exports to GDP. The diversification of exports is also quite low in comparison to some countries. This is especially the case in manufactures exports, where the export basket is dominated by clothing (apparel). In the case of services exports, there is a certain level of diversification, but improvements can be made by further diversifying services exports. In comparison to some emerging economies illustrated here, exports as a percentage of GDP is comparably low in Sri Lanka. This is an area that policy makers

3 *Shediac et.al. (2008), "Economic Diversification: The Road to Sustainable Development".*

Chart B 1.3 **Export Diversification**



Source: World Trade Organization

are focussing on as export promotion has been a successful strategy especially for small countries with a limited domestic market to progress into higher income economies. Furthermore, export diversification is being vigorously pursued to promote sustainable growth and to reduce vulnerability.

Further output and export diversification will be facilitated by investments in high quality education and skills, transfer of technology, improved infrastructure and connectivity, reducing labour market rigidities, promoting research and development, enhancing property rights, upgrading the institutional and legal framework and greater regional integration.

Strategy for Economic Diversification - The Five Hubs Programme

A major initiative launched by the Government to further diversify economic activity and to increase the level and diversity of exports is the Five Hubs Programme. This programme was introduced via the *Mahinda Chintana – Vision for the Future* with the aim of achieving sustainable economic growth and higher incomes in Sri Lanka and transforming the country into a strategically important economic centre of the world. The hubs were introduced by considering the strategic advantages that Sri Lanka possesses geographically and by considering its potential strengths as a country. Achieving competiveness in each of these areas viz., maritime, aviation, commercial and tourism, knowledge and energy, would create new strengths for the country while maintaining competiveness in the traditional strong sectors of Sri Lanka such as tea and apparel industry. The concept behind this strategy is to create new *stars* while the traditional *cash cows* are prospering so that the country can move into a higher income level smoothly.

The initiatives taken through the hub strategy are essentially driving the concept of diversification by not limiting the development efforts to one or two sectors only. In terms of the hub strategy, following can be identified as some of the key achievements and initiatives taken so far.

Maritime Hub

Sri Lanka is situated in one of the best locations in the entire world to gain competitive advantage in the naval and maritime industries. In fact, the country has been reputed to prosper from its location from ancient times, and the government expects to leverage this strategic advantage by developing maritime industries. In this regard, the Hambantota Port development (Phase I is completed), the Colombo South Port development (the breakwater and a part of the infrastructure have been completed and a terminal is in operation), the expansion of the Colombo Port via new terminals, the development of port city at Colombo are some of the initiatives in progress. Major investment has been made by the Government in developing the road network of the country which is also catalytic for the development of the Maritime Hub by way of improving connectivity among ports, air ports and main cities. At the same time, there are many challenges that the country needs to pay attention in this regard as well. Developing the skills required for maritime industries, exploring the sea bed potential, supporting logistics establishments, attracting renowned companies to Sri Lanka, developing ship building and repairing industries, developing minor ports, engaging in research activities, revisiting legislation, expanding leisure activities beyond beaches etc. are some of the areas that need to be focused upon in the future.

Aviation Hub

Sri Lanka is situated close to many of the world's main air routes. Most of the main cities can be reached from Sri Lanka within few hours and therefore the country has a high potential for becoming an aviation hub, like Dubai and Singapore. One of the main initiatives undertaken in this regard is the establishment of the Mattala Rajapaksa International Airport (MRIA). The MRIA is the second international airport of the country and has the capability to serve larger aircrafts which the Bandaranaike International Airport (BIA) cannot facilitate. Further, modernising the BIA, improving domestic airports such as Ratmalana, Ampara, Iranamadu, Anuradhapura, China Bay etc., fleet expansion, improvements in domestic passenger air transportation, improving training and research facilities are among the new measures undertaken. A strong and internationally reputed flag carrier is an essential element to becoming an aviation hub in the region. Therefore investments are required especially in developing the national airline, Sri Lankan Airlines. The fleet needs to be increased and the connectivity also has to be expanded by way of increasing number of flights together with destinations. In order to succeed, Sri Lanka has to become not only a good destination but a good transit point as well. Further, the country has to become a much better aviation services location to attract other airlines in order to develop a hub status.

Commercial and Tourism Hub

Together with the current infrastructure development programme, the commercial hub was initiated with the expectation of establishing Sri Lanka as one of Asia's foremost commercial centres in the fields of commercial services, international banking and international investment. With the ending of terrorism and with the rapid provincial development, tourism has also been re-positioned as a hub, and strategies have been devised to improve the sector. In order to promote the country as a commercial hub, Colombo City and other key cities are being improved to be on par with environment friendly modern cities in middle income countries, while also establishing these cities as commercial hubs in South Asia. Some of the steps undertaken in this regard are making Colombo a flood free clean area through the clean and green city concept; harmonising traffic by relocating the fish market and diverting heavy transport out of the Fort area, re-positioning Sri Jayewardenepura as the administrative capital by improving the city and moving some of the administrative offices to Kotte, relocating underserved dwellers to modern housing schemes, improving the Beira Lake and its environs, rehabilitation of old buildings (e.g. Dutch Hospital, Race Course, Galle Dutch Hospital, National Mutual building, Tripoli Land etc.), city development projects outside Colombo, such as Batticaloa, Jaffna, Nuwara-Eliya, Galle and other small town development projects. The private sector has also participated in some of these projects where private organisations are sponsoring development activities in certain areas (e.g. Meegahakiwula, Dankotuwa, Homagama etc.). In addition, mega projects such as the Shangri-La Hotel, Port City, Lotus Tower, Indocean Tower and several other integrated tourism development projects are also expected to attract tourists and new businesses to the Colombo city. However, infrastructure alone cannot realise the outcomes as envisaged. Investors will also consider the tax structure, legal system, the ease of doing business and consistent policies when making their investments. Therefore, Sri Lanka has to consider fine tuning these areas as well. In this regard, free ports and free trade zones will be established around ports and airports, such as in Hambantota, Colombo and Mattala. In terms of tourism, investments are being made to increase the number of hotel rooms in the country. Star class hotels are being constructed in many areas, while domestic level accommodation has also increased significantly. In the post-independence era, Sri Lanka has been reputed as an attractive tourist destination among many countries in the world. Traditionally, many of these tourists come to Sri Lanka from European countries and they are primarily attracted towards the natural beauty and cultural heritage of the country. Going forward Sri Lanka needs to attract tourists from other destinations such as India, China, Middle East and other Asian countries as well. Thus, marketing activities are being carried out by targeting these different geographic areas to achieve better results.

Knowledge Hub

The concept of a knowledge hub was introduced with the broad aim of taking advantage of well-educated youth in various professions, improving the education system and also attracting experts and foreign students into the country. Developing the education system and improving the skills of the people is of paramount importance to Sri Lanka which is aiming to move towards an upper middle income country. In fact, many experts have pointed out that investing in developing advanced skills is one of the best strategies to avoid the so called *middle income trap*. Therefore, improving the education system and promoting research activities in order to encourage innovation is important for the country at this juncture. At present, many initiatives are being taken to improve the higher education system of the country. Over the past few years new faculties have been opened, new degree courses have been introduced focussing on areas such as tourism and new higher education institutions have been established. In addition, a paradigm shift is taking place in the higher education system, which would create more employable graduates required by the industries. In addition to knowledge, skills, attitudes and mind-set (KSAM) are also given priority in the learning environment in this new paradigm. At the same time, private sector organisations are encouraged to join with higher education institutions to carry out research activities. The competitiveness of the education system needs to be improved and the link between the university system and the private sector, especially relating to research activities needs to be enhanced.

Energy Hub

The world has suffered from global oil price shocks from time to time and the dependence of many nations upon fossil fuel for the fulfilment of energy demand is very high. However, fossil fuel is a depleting resource and as such new avenues of energy creation need to be looked into. With the ending of terrorism, the Northern and Eastern seas were opened for the country and fossil fuel resources were identified. Exploration activities to identify the feasibility of extracting the oil and gas deposits that are believed to be in the Mannar Basin are now in progress. If these fossil fuel deposits can be extracted on a commercially viable basis it would be a great benefit to the country in many spheres. However, at the same time the fact that the fossil fuel era is nearing its end also needs to be considered. In this background it is essential for the country to look for renewable energy sources. Considering the fact that the potential for large scale hydro power is almost exhausted at present, it is important to consider promoting Non-Conventional Renewable Energy sources (NCRE) as well. The main drawback of these sources pointed out by many, is the higher cost compared to fossil fuel. However, with technological improvements the life time costs could be reduced over the long-term and therefore the feasibility of lowering costs needs to be analysed further.

As illustrated above, the Five Hubs Programme is gathering momentum and the government has already made significant investments in terms of developing the necessary infrastructure. However, further improvements can be made in many areas. More coordination between the activities of the hubs is required and more effort has to be made to improve the awareness and attract more investments in the respective areas. Private sector involvement is still lagging and needs to be promoted as well. Furthermore, the skills of the work-force should be in line with the newly created job opportunities.

Going forward, the synergies among the hubs also need to be identified and an overall co-ordinated policy framework and monitoring mechanism has to be put in place to facilitate the implementation of identified strategies. In this regard, it is important to recognise complementarity between the hubs. The development of one hub will facilitate the development of other hubs and there will be many spill-over benefits and positive externalities associated with this programme. The successful implementation of the Five Hubs Programme will contribute towards a more diversified economy with high, stable and sustainable growth.

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Sri Lanka's drive to upper middle income status and beyond would largely depend on the strength and dynamism of the financial sector. The development of financial institutions, markets and instruments are necessary to reduce transaction and information costs and boost lending. More diversity of financial services and greater accessibility enable a larger pool of savings to be channeled to productive investments. The financial sector developments that have taken place in relation to financial institutions, markets and instruments have played a strong supportive role in the economic growth of the country by mobilising and channeling resources into diverse economic activities. However, there is still enormous potential for further financial deepening to support the drive for sustained high economic growth. The Master Plan on Consolidation of the Financial Sector unveiled by the Central Bank aims to build stronger financial institutions that are able to meet the financing needs of a growing economy with increasing global linkages and to further strengthen financial system stability. Consolidation is expected to generate economies of scale by creating more efficient and profitable financial institutions; enhance the capacity and skills in the financial sector; upgrade IT infrastructure while improving global connectivity; lead to the adoption of international best practices and improve governance practices in the financial sector; introduce new products and improve market access both locally and globally, thereby strengthening the resilience of the sector.

As Sri Lanka moves to a higher growth trajectory, it is imperative to strengthen the role of private equity as a major source of financing for Sri Lankan enterprises. At present, bank borrowings constitute the main funding channel for Sri Lankan companies. Bank borrowings are relied upon heavily for investments in new projects as well as for working capital requirements. However, increased bank borrowings lead to high leverage of the balance sheets of enterprises increasing their overall risk, which in turn may limit the capacity of these entities to expand further by investing in new projects. Availability of private equity for businesses would enable enterprises to grow faster and be competitive in the local as well as international markets. Private equity financing can be encouraged through the establishment of Private Equity (PE) firms. PE firms act as investment vehicles, which pool funds of local or foreign high net worth individuals and financial institutions, for equity investments in mainly unlisted enterprises with a potential for growth. In addition to the provision of capital, PE firms provide expertise in various areas such as risk management, business development, market specialisation and corporate governance bringing such expertise into the investment process. PE firms invest in a company to make it more valuable over a number of years, before selling it to a buyer with enhanced value addition. The successful investee company may eventually obtain a listing on the stock exchange. Moreover, investee companies become more competitive in local as well as international markets contributing to the growth of the economy. Economic benefits to be derived from such funding would include diversification of funding sources for local companies, facilitation of large scale funding through pooling of funds and increasing the flow of foreign capital into the economy by attracting funds from foreign institutional investors.

In a low interest rate environment there is a need for the emergence of new savings and pension products to ensure workers are able to enjoy a reasonable standard of living during their retirement. The demographic transition taking place in Sri Lanka with a gradually ageing population and increasing life expectancy underscores the need for the development of savings and pensions products to cater to the requirements of a rising share of the population that are reaching retirement age. The urgency to develop these products is intensified by the low interest rates prevailing in the market and the dependence of many retirees on interest income. While a few financial institutions have already introduced some products, there is a need for further development of alternative saving and pension products, such as annuities, superannuation schemes and pension plans to cater to the needs of long term savers. The introduction of these products while providing a cushion for retirees would also facilitate the development of the financial sector and be a source of long term funding for projects with long gestation periods.

As the global economy continues to recover, there will be a gradual unwinding of the accommodative monetary policy measures which will create challenges for macroeconomic management in emerging and developing economies. World trade is expected to pick up with favourable developments envisaged in advanced economies and greater trade in the region, benefitting countries like Sri Lanka. However, monetary and fiscal policy measures adopted by major economies and in particular the size and timing of the unwinding of the quantitative easing measures by the US Federal Reserve are expected to heighten the risks for recovery in the world economy and create greater uncertainty in financial markets. In this light, there is a greater urgency for more cooperation among central banks to ensure that the nascent recovery in the global economy is not stifled by the unwinding measures. Emerging and developing economies would need to carefully manage the risks arising from tightening external financing conditions and possible reversal of capital flows, as well as the expected rise in long term lending rates and risk premia by building the necessary buffers and policy space to enhance the resilience of their economies to external shocks. The policies adopted by the Central Bank by maintaining a healthy level of reserves and flexibility in the exchange rate as well as setting limits on foreign investment in government securities helped cushion the impact of tapering on the economy and strengthened the country's resilience to external shocks. Going forward, proactive policy measures by the Central Bank and the government to strengthen contingency buffers and improve the overall productivity of the economy would help minimise risks arising from global developments.