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ECONOMIC, PRICE AND FINANCIAL SYSTEM STABILITY, OUTLOOK AND POLICIES

1.1 Overview

The Sri Lankan economy faced its most onerous year in its post-independence history in 2022, comprising severe economic hardship that led to both public anxiety and political upheaval. The impoverished conditions in the economy warranted immediate and coordinated policy initiatives by the Government and the Central Bank to preempt a further escalation of the situation. Although the corrective measures affected the vast citizenry in the near term, they were necessary to safeguard the economy and economic agents from potentially devastating consequences of unrestrained economic instability, such as hyperinflation, collapse of economic activity to a much deeper level, and a complete disconnect of the country from the rest of the world, with far worse consequences to the people and businesses. The outcomes of these efforts have eventuated since late 2022. The country managed to transition to a workable equilibrium in the near term, focused on restoring socio-economic stability, while the envisaged assistance from the international financial institutions begins to materialise.

Having run an unsustainable macroeconomic model in tandem with the longstanding deficits in the budget balance and the external current account, the economy had fully exhausted its buffers by early 2022 as it was straddled by a myriad of vulnerabilities that emanated from both global and domestic sources. Several inherent weaknesses of the economy, further exacerbated by policy lapses, steered the country towards a multifaceted disaster. Ill-timed tax reductions, an ill-equipped attempt to swiftly adopt organic agriculture, the depletion of the country's official reserves amidst futile attempts to maintain an untarnished debt servicing record, the delay in the exchange rate adjustment, and the failure to pay heed to several early warning signals caused tremendous shockwaves across the economy. Consequently, the economy was battered by excessive balance of payments (BOP) pressures with acute shortage of foreign exchange liquidity and pressured exchange rate, spiralling inflation and dampened economic activity amidst mass loss of livelihoods, large fiscal imbalances, public debt reaching unsustainable levels with extraordinarily high risk premia, devastating sovereign rating downgrades that constrained access to external finance, unprecedented heightening of socio-economic and socio-political tensions, and rapidly deteriorating business confidence, among others. Businesses and the general public alike were in severe distress amidst shortages and rationing of essentials, the ballooning cost of living and cost of production, and the loss of welfare and livelihoods. Consequently, the rapid unfolding of social unrest resulted in political instability, warranting an urgent need for redefining policy priorities to steer the economy away from further turmoil.

Amidst mounting BOP pressures, the exchange rate was allowed a measured adjustment in early March 2022. However, the subsequent floating of the exchange rate resulted in an overshooting, fuelled by speculative activity. The Central Bank adopted aggressive monetary policy tightening in April 2022 to rein in demand pressures, complemented by a robust communication strategy aimed at anchoring inflation expectations, while taking measures to stabilise the exchange rate amidst exhausted levels of useable reserves by April

2022. Meanwhile, the Central Bank provided foreign exchange to the market to meet the demand for essential imports to the greatest extent possible amidst a dearth of foreign exchange inflows and significantly low levels of official reserves. Moreover, the Central Bank initiated measures to prioritise essential imports and restrict capital outflows through appropriate control measures, while continuing the requirement for the mandatory sale of foreign exchange to the Central Bank by licensed banks, based on the conversion of repatriated foreign exchange, and commenced providing daily guidance on the exchange rate to curtail undue intraday volatilities. Moreover, the Central Bank's continuous financial sector oversight and adoption of appropriate regulatory measures along with effective communication ensured financial system stability amidst severe socio-economic distress.

The Government initiated measures in early 2022 to seek assistance from the International Monetary Fund (IMF) after months of indecisiveness. The IMF had already assessed that Sri Lanka's public debt had reached unsustainable levels, hence, any funding assistance from the IMF needed to be preceded by efforts to restructure public debt. Subsequently, when it reached a critical point of inability to service debt payments, the Government announced a debt standstill in mid-April 2022, thereby suspending the servicing of external debt, mainly bilateral and commercial debt, as an interim measure, while soliciting support from official and private creditors to restructure outstanding debt. Simultaneously, several initiatives were made by the Government to enhance government revenue, curtail expenditure, introduce reforms to major State Owned Enterprises (SOE), implement import controls, and ration energy supply, while exploring bridging finance from bilateral and multilateral partners for essential expenditures as well as supporting the most vulnerable segments. In September 2022, a staff level agreement was reached for an Extended Fund Facility (EFF) from the IMF, followed by efforts to secure financing assurances from official creditors towards the restructuring of debt, in line with the debt sustainability targets envisaged under the IMF-EFF supported programme. In March 2023, the Executive Board of the IMF approved the EFF supported programme of 48-months, amounting to approximately US dollars 3 billion, along with an economic adjustment programme that was aimed at putting Sri Lanka back on a recovery path, while addressing structural impediments that constrained the country's growth potential over the past decades. With a multitude of goals to be achieved under the IMF-EFF arrangement, restoring public debt sustainability through the debt restructuring process will be one of the key milestones in the path towards attaining a sustained growth in the economy. However, debt restructuring could pose near term challenges in the financial sector that need to be addressed proactively by the Government and Central Bank, thereby reinforcing the financial system stability in the period ahead.

Policy measures and reforms implemented by the Government and the Central Bank have yielded notable success thus far. Inflation returned to an impressive disinflation path following a historic peak in September 2022, and the exchange rate remained stable and registered an appreciation in early 2023, having depreciated sharply during the first half of 2022. Further, the external current account deficit remained modest alongside the gradual accumulation of official reserves, thereby enabling the reinstatement of exchange rate flexibility from early March 2023. The envisaged normalisation of foreign exchange flows and the completion of the debt restructuring process during 2023, and the sweeping reforms in the public sector, are expected to pave way for the country's progress towards improved and sustainable economic prospects.

The socio-economic crisis in 2022 underlined many lessons that the country failed to grasp, despite the recurrence of such macroeconomic failures throughout its post-independence history. This economic episode reiterated the essentiality of data-driven policymaking; devastating implications of ad hoc policy experiments; crippling welfare impacts of myopic populist policies; and the cost of policy delays, disregarding evidence-based policy analysis, well-established economic fundamentals and expert opinions. The general public and businesses at large had to bear the cost of a one-time adjustment of delayed structural reforms. Against this backdrop, the Government, the Central Bank, and all other stakeholders need to extend their support towards the implementation of essential reforms at this juncture, to resolve the structural hindrances that have rooted in the economy over the last seven and a half decades. Failing to execute such reforms would lead to perpetual bailouts, endless cycles of external borrowing and recurring debt restructuring alongside unsustainable and highly volatile business cycles, which would cause undue pressure on citizenry, preventing the country from achieving longstanding economic progress and prosperity. Hence, in the country's efforts to emerge from the current crisis, consistent and well-coordinated policies, including those outlined in the IMF-EFF supported programme, should be executed in a timely manner to avert another crisis in the period ahead.

Figure 1.1
The Socio-Economic Crisis in 2022, Policy Actions and Outcomes Towards Restoring Stability

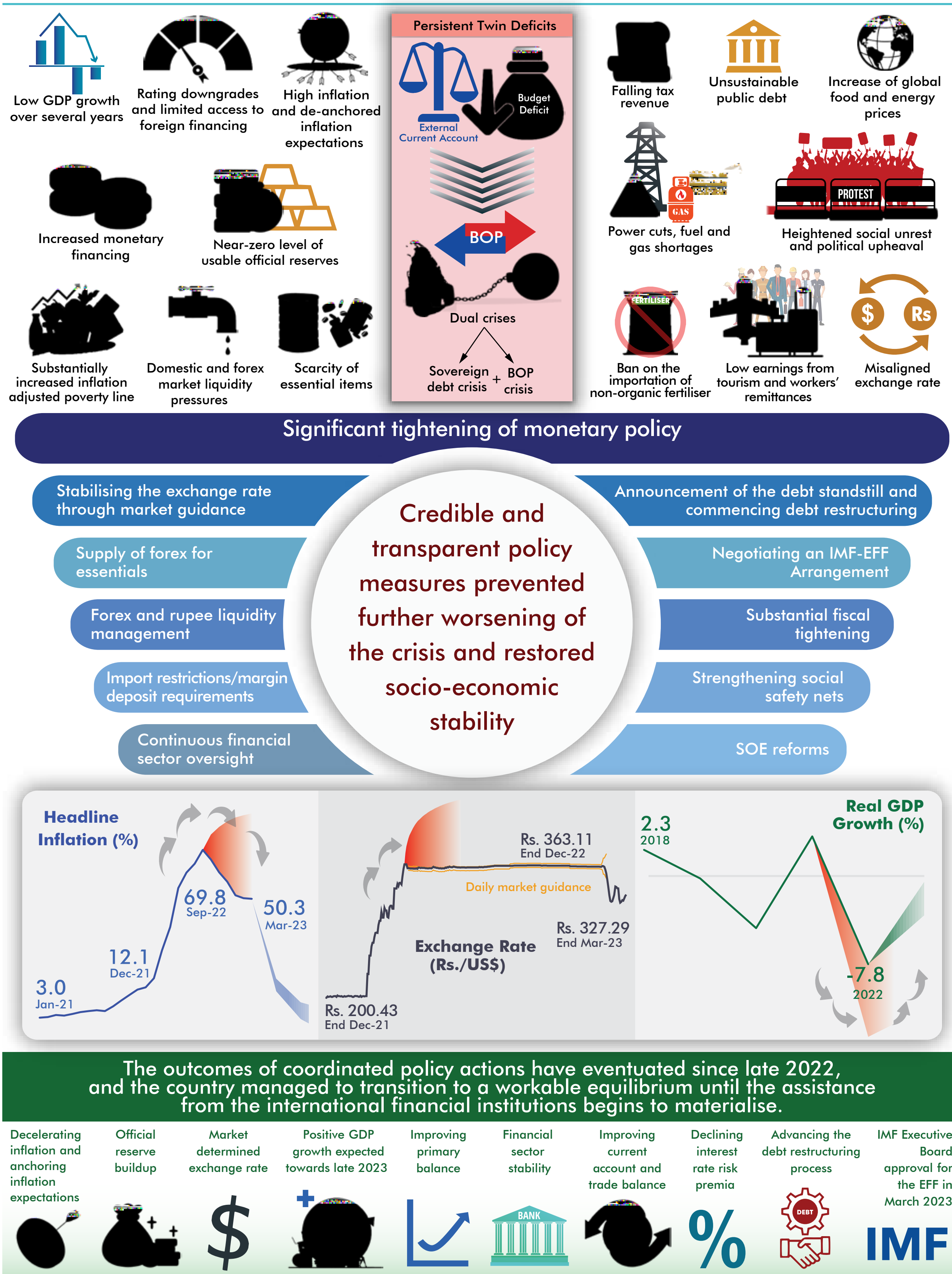

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Table 1.1
Macroeconomic Performance (2018-2022)

Indicator	Unit	2018	2019	2020	2021 (a)	2022 (b)
Real Sector (c)						
Real GDP Growth	%	2.3	-0.2	-4.6	3.5 (b)	-7.8
GDP at Current Market Price	Rs. bn	15,352	15,911	15,672	17,600 (b)	24,148
Per Capita GDP (d)	US$	4,372	4,082	3,858	3,997 (b)	3,474
External Sector						
Trade Balance (c)(d)	% of GDP	-10.9	-9.0	-7.1	-9.2	-6.7
Current Account Balance (c)(d)	% of GDP	-3.0	-2.1	-1.4	-3.7	-1.9
Overall Balance	US$ mn	-1,102.9	376.6	-2,327.7	-3,966.6	-2,806.1
External Official Reserves	US$ mn	6,919.2	7,642.4	5,664.3	3,139.2	1,897.6
Fiscal Sector (c)						
Current Account Balance	% of GDP	-1.1	-3.4 (e)	-7.5	-7.3	-6.4
Primary Balance	% of GDP	0.6	-3.4 (e)	-4.4	-5.7	-3.7
Overall Fiscal Balance	% of GDP	-5.0	-9.0 (e)	-10.6	-11.7	-10.2
Central Government Debt (f)	% of GDP	78.4	81.9	96.5	100.1	113.8 (g)
Monetary Sector and Inflation						
Broad Money Growth (M_{2b}) (h)	%	13.0	7.0	23.4	13.2	15.4
Private Sector Credit Growth (in M_{2b}) (h)	%	15.9	4.2	6.5	13.1	6.2
Annual Average Inflation (i)	%	4.3	4.3	4.6	6.0	46.4

(a) Revised
(b) Provisional
(c) GDP estimates (base year 2015) released in March 2023 by the Department of Census and Statistics have been used.
(d) Based on quarterly GDP in US$ terms calculated using quarterly average exchange rate from 2015 onwards.
(e) According to the Ministry of Finance, the fiscal sector statistics of 2019 have been restated as announced in the Budget Speech for 2020.
(f) Includes Treasury bonds of Rs. 78,441 million issued to the Ceylon Petroleum Corporation (CPC) in January 2012 of which Rs. 21,778 million matured on 01 January 2017 and Rs. 25,217 million matured on 01 January 2022 and the current outstanding is Rs. 31,446 million.
(g) The outstanding central government debt excludes several debt service payments that became overdue after 12 April 2022, the date on which the Interim Policy regarding the servicing of Sri Lanka's external public debt was announced by the Ministry of Finance, Economic Stabilisation and National Policies. These debt service payments comprise overdue interest payments of affected debt which deemed to be capitalised as per the Interim Policy and several overdue interest payments in relation to Sri Lanka Development Bonds.
(h) Year-on-year growth based on end year values.
(i) Based on the CCPI (2013=100)

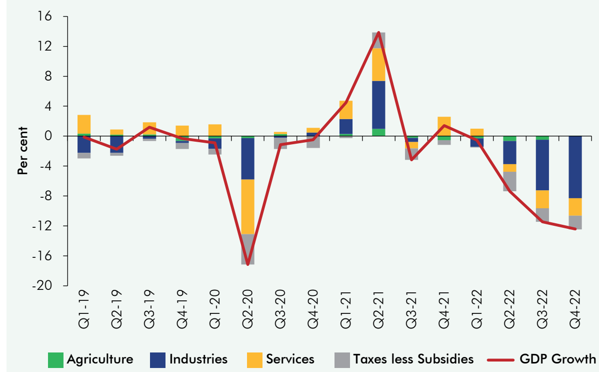
Sources: Department of Census and Statistics
Ministry of Finance, Economic Stabilisation and National Policies
Central Bank of Sri Lanka

1.2 Macroeconomic Developments in 2022

Real Sector Developments and Inflation

In 2022, the Sri Lankan economy registered its deepest economic contraction since independence, mainly driven by the ripple effects of the unprecedented economic crisis amidst the domestic and global headwinds that reversed the post-pandemic recovery. As per the provisional estimates of the Department of Census and Statistics (DCS), the real GDP contracted by 7.8 per cent in 2022, compared to the growth of 3.5 per cent in 2021. Longstanding macroeconomic weaknesses, characterised by deeply entrenched twin deficits, due to persistent budget deficits and external current account deficits, worsened during 2022, reflecting the impact of policy delays in addressing these imbalances over the years, particularly in recent years, amidst ill-timed and ill-equipped reforms in taxation and agricultural policies, among others. Acute fuel shortages due to the dearth of foreign exchange caused a significant drag on activities, as a result of hampered supply chains, prolonged power outages, scarcity of raw materials amidst imports compression, and a surge in the cost of production. Further, significant upward revisions in major utility prices amidst soaring global energy prices and the depreciation of the exchange rate exacerbated supply side pressures, while accelerated inflation and tax hikes affected the disposable income of households. Against this backdrop, the Government and the Central Bank initiated several containment and remedial policy measures aimed at preempting a major economic catastrophe that would otherwise have occurred, leading to hyperinflation and depression in the economy. The significant monetary policy tightening measures, along with the other measures to contain the balance of payments (BOP) pressures, and the unprecedented fiscal reforms in taxation and utility prices, along with the fuel rationing system, among others, helped contain demand side related excessive price pressures, improve foreign exchange liquidity conditions, minimise external and fiscal sector stresses, support economic activity, and steer the economy towards stability, albeit with some significant adjustment costs in the near term. Meanwhile, the Government sought assistance from the IMF for a funding arrangement and announced a debt standstill as an interim measure, pending negotiations on debt restructuring with bilateral and commercial creditors. These swift and remedial measures of the Government and Central Bank helped contain the fall of economic activity and instil confidence in the economy.

Figure 1.2
Activity-wise Contribution to GDP Growth



Source: Department of Census and Statistics

Real economy witnessed a broad-based contraction in 2022, reversing the post-pandemic recovery in 2021. The agriculture sector, which had been experiencing lacklustre performances since 2019, contracted by 4.6 per cent in 2022, compared to a year earlier. This mainly reflected the severe shortages in chemical fertiliser and other agrochemicals, increased cost of raw materials, as well as the disruptions of supply networks. The subsectors of growing of rice, tea, vegetables, animal production, and marine fishing and marine aquaculture largely contributed to the

Table 1.2
Gross National Income by Industrial Origin at Constant (2015) Prices (a)(b)

Economic Activity	Rs. billion		As a percentage of GDP (%)		Growth (%)		Contribution to Growth (%)	
	2021(c)	2022	2021(c)	2022	2021(c)	2022	2021(c)	2022
Agriculture, Forestry & Fishing	**949.9**	**906.5**	**7.3**	**7.5**	**0.9**	**-4.6**	**0.1**	**-0.3**
Agriculture and Forestry	812.4	783.4	6.2	6.5	0.8	-3.6	0.1	-0.2
Fishing	137.6	123.1	1.1	1.0	1.5	-10.5	0.0	-0.1
Industries	**3,937.9**	**3,309.8**	**30.2**	**27.5**	**5.7**	**-16.0**	**1.7**	**-4.8**
Mining and Quarrying	288.0	198.7	2.2	1.7	1.4	-31.0	0.0	-0.7
Manufacturing	2,247.2	1,963.3	17.2	16.3	7.4	-12.6	1.2	-2.2
Electricity, Gas, Water and Waste Treatment	230.0	220.0	1.8	1.8	2.2	-4.3	0.0	-0.1
Construction	1,172.8	927.7	9.0	7.7	4.4	-20.9	0.4	-1.9
Services	**7,414.3**	**7,265.1**	**56.9**	**60.5**	**3.5**	**-2.0**	**2.0**	**-1.1**
Wholesale and Retail Trade, Transportation and Storage, and Accommodation and Food Service Activities	3,149.8	3,230.3	24.2	26.9	1.3	2.6	0.3	0.6
Information and Communication	421.8	415.9	3.2	3.5	18.0	-1.4	0.5	0.0
Financial, Insurance and Real Estate Activities including Ownership of Dwellings	1,375.3	1,163.3	10.5	9.7	7.5	-15.4	0.8	-1.6
Professional Services and Other Personal Service Activities	1,294.6	1,286.3	9.9	10.7	1.8	-0.6	0.2	-0.1
Public Administration, Defence, Education, Human Health and Social Work Activities	1,172.8	1,169.4	9.0	9.7	2.2	-0.3	0.2	0.0
Gross Value Added at Basic Price	**12,302.1**	**11,481.4**	**94.4**	**95.5**	**4.0**	**-6.7**	**3.7**	**-6.3**
Taxes less Subsidies on products	735.9	536.5	5.6	4.5	-3.6	-27.1	-0.2	-1.5
Gross Domestic Product at Market Price	**13,037.9**	**12,017.8**	**100.0**	**100.0**	**3.5**	**-7.8**	**3.5**	**-7.8**
Net Primary Income from Rest of the World	-294.1	-304.2			12.6	-3.5		
Gross National Income at Market Price	**12,743.8**	**11,713.6**			**4.0**	**-8.1**		

(a) Based on the GDP estimates (base year 2015)
(b) Provisional
(c) Revised

Source: Department of Census and Statistics

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overall contraction in the agriculture sector, while growing of oleaginous fruit and forestry, and logging recorded growths during the year. In 2022, the industry sector contracted notably by 16.0 per cent, year-on-year, primarily due to the dampened performance of the construction and manufacturing subsectors amidst severe shortages in raw materials and input cost escalations. The energy crisis and tighter monetary conditions also weighed on the performance of the industry subsectors. The construction subsector, which accounted for 28.0 per cent of the industry sector, registered a year-on-year contraction of 20.9 per cent, while overall manufacturing activities, which accounted for about 59 per cent in the total industry sector, contracted by 12.6 per cent, year-on-year, in 2022. Within the manufacturing sector, manufacture of coke and refined petroleum products, and manufacture of food, beverages, and tobacco products registered notable contractions of 58.2 per cent and 14.2 per cent, respectively, while the subsector of manufacture of textiles, wearing apparel, leather, and other related products registered a year-on-year growth of 8.1 per cent in 2022. Meanwhile, mining and quarrying activities also reported a notable year-on-year contraction of 31.0 per cent in 2022. Despite the resilient performance in the services sector during the first quarter of 2022, supported by the gradual normalisation of services sector activity following the COVID-19 pandemic, economic headwinds that intensified thereafter, hindered a further expansion in the services sector, resulting in an overall contraction of 2.0 per cent, year-on-year, in 2022. Although the subsectors of accommodation, food, and beverage, as well as transportation of goods and passengers, witnessed a strong rebound with year-on-year growths of 27.0 per cent and 3.5 per cent, respectively, the services sector performance was hampered by notable contractions in the subsectors of wholesale and retail trade, financial services, and real estate activities during the year.

In nominal terms, the Sri Lankan economy recorded a significant expansion of 37.2 per cent in 2022, year-on-year, compared to that of 12.3 per cent in the preceding year, reflecting the large deflator during the year. However, the overall size of the economy in US dollar terms contracted to US dollars 77.1 billion in 2022, compared to US dollars 88.5 billion in 2021, due to the large depreciation of the exchange rate. Per capita GDP also declined to US dollars 3,474 in 2022 from US dollars 3,997 in 2021. As per the expenditure approach, consumption expenditure, which accounted for 69.2 per cent of the GDP, expanded by 34.3 per cent, year-on-year, in 2022, compared to the expansion of 8.4 per cent in 2021, largely contributing to the overall nominal growth of the economy. Accordingly, reflecting the sharp acceleration in inflation during the period, household consumption expenditure grew at a higher rate of 39.0 per cent in 2022, compared to the 9.4 per cent expansion recorded in the preceding year. Government consumption expenditure also grew by 3.8 per cent in 2022, in comparison to 2.3 per cent recorded in 2021. Meanwhile, investment expenditure grew by 28.4 per cent, year-on-year, during the year, compared to the 25.1 per cent growth recorded in 2021. Accordingly, investment as a percentage of nominal GDP stood at 34.4 per cent in 2022, compared to 36.7 per cent in the previous year. Reflecting the impact of notable expansion in exports, buttressed by the depreciation in domestic currency, and restrained imports amidst

Figure 1.3
Investment and Savings (as a percentage of GDP)

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

Table 1.3
Aggregate Demand and Savings-Investment Gap at Current Market Prices (a)(b)

Item	Rs. billion		Growth (%)		As a percentage of GDP (%)	
	2021(c)	2022	2021(c)	2022	2021(c)	2022
1. Domestic Demand	**18,901.2**	**25,005.2**	**13.6**	**32.3**	**107.4**	**103.6**
1.1 Consumption	12,434.3	16,700.6	8.4	34.3	70.6	69.2
Private	10,769.7	14,973.3	9.4	39.0	61.2	62.0
Public	1,664.6	1,727.3	2.3	3.8	9.5	7.2
1.2 Investment (Gross Capital Formation)	6,467.0	8,304.6	25.1	28.4	36.7	34.4
2. Net External Demand	**-1,301.0**	**-857.5**	**-34.7**	**34.1**	**-7.4**	**-3.6**
Exports of Goods and Services	2,980.3	5,187.9	23.2	74.1	16.9	21.5
Imports of Goods and Services	4,281.3	6,045.4	26.5	41.2	24.3	25.0
3. Total Demand (GDP) (1+2)	**17,600.2**	**24,147.7**	**12.3**	**37.2**	**100.0**	**100.0**
4. Domestic Savings (3-1.1)	**5,165.9**	**7,447.2**	**22.9**	**44.2**	**29.4**	**30.8**
Private	6,456.3	8,987.6	19.9	39.2	36.7	37.2
Public	-1,290.4	-1,540.4	-9.3	-19.4	-7.3	-6.4
5. Net Primary Income from the Rest of the World (d)	**-395.5**	**-621.4**	**6.5**	**-57.1**	**-2.2**	**-2.6**
6. Net Current Transfers from the Rest of the World (d)	**1,034.7**	**1,159.5**	**-10.1**	**12.1**	**5.9**	**4.8**
7. National Savings (4+5+6)	**5,805.1**	**7,985.3**	**17.7**	**37.6**	**33.0**	**33.1**
8. Savings-Investment Gap						
Domestic Savings-Investment (4-1.2)	-1,301.0	-857.5				
National Savings-Investment (7-1.2)	-661.9	-319.3				
9. External Current Account Balance (2+5+6) (d)(e)	**-661.9**	**-319.3**				

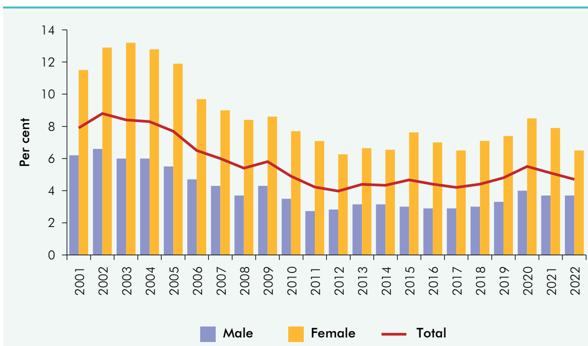
(a) Based on the GDP estimates (base year 2015)
(b) Provisional
(c) Revised
(d) Any difference with the BOP estimates is due to the time lag in compilation.
(e) Please refer to Table 5.1 of Chapter 5 of this Report for the annual estimate of the external current account balance, as a percentage of GDP, calculated in US$ terms, which is different from the same being calculated in domestic currency terms in 2022, due to the significant volatility in the exchange rate.

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

import controls and subdued aggregate demand, the net external demand for goods and services at current prices improved notably by 34.1 per cent, year-on-year, during 2022. Accordingly, the net nominal external balance of goods and services, as a percentage of GDP, stood at -3.6 per cent in 2022, compared to -7.4 per cent in 2021.

In 2022, unemployment levels in the economy declined marginally, despite the challenges to labour productivity, caused by fragile macroeconomic conditions. The labour force participation rate (LFPR), which is the ratio of the labour force to the working age population, decreased marginally to 49.8 per cent in 2022, compared to 49.9 per cent in 2021, with an increase in the economically inactive population during the year. The male LFPR recorded a decline to 70.5 per cent in 2022, from 71.0 per cent recorded in the previous year. On a positive note, the female LFPR increased to 32.1 per cent in 2022, compared to 31.8 per cent in 2021. Nevertheless, the annual unemployment rate declined to 4.7 per cent in 2022, compared to 5.1 per cent in 2021, despite an increasing trend in the unemployment rate that was observed in the second and third quarters of 2022. Meanwhile, persistent disruptions to supply channels, caused by acute fuel shortages, intermittent power outages, as well as shortages of inputs due to import restrictions, hindered the optimal use of labour

Figure 1.4
Unemployment Rate



Source: Department of Census and Statistics

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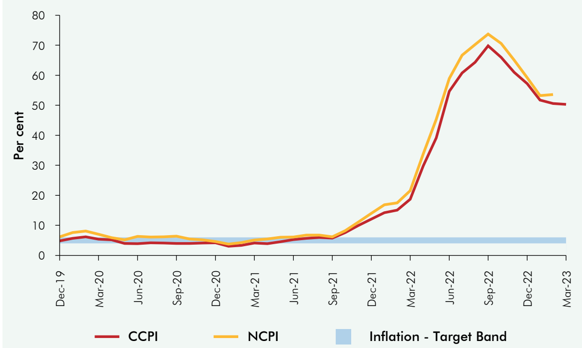
during the period under review, partially contributing to the slowdown in value additions to the economy. Accordingly, labour productivity, measured in terms of Gross Value Added (GVA) (in 2015 prices) per hour worked, declined by 10.6 per cent, to Rs. 686.57 per hour worked in 2022, from Rs. 768.08 per hour worked in 2021.

Consumer price inflation reached a historic high in September 2022 and commenced a descending path thereafter, with the realisation of the impact of tight monetary conditions and the gradual easing of supply side disruptions. During the nine months ending September 2022, headline inflation was on a rapid acceleration path reflecting price pressures from multiple fronts, including price hikes in food, energy, and transport sectors and their spillovers, stemming from supply disruptions, rapid adjustments to administered prices, sharp depreciation of the Sri Lanka rupee, and aggregate demand pressures owing to the lagged impact of monetary accommodation undertaken over the past few years, among others. However, the impact of significantly tight monetary policy and other demand management measures, such as prioritising essential imports, along with the softening of food and energy prices helped moderate the pace of headline inflation from the latter part of 2022. Accordingly, year-on-year headline inflation, as measured by the Colombo Consumer Price Index (CCPI, 2013=100), which was recorded at 12.1 per cent at the end of 2021, accelerated to 69.8 per cent in September 2022, before moderating to 57.2 per cent by December 2022. Following a similar trend, year-on-year headline inflation, based on the National Consumer Price Index (NCPI, 2013=100), was recorded at 73.7 per cent by end September 2022 and 59.2 per cent by end 2022, compared to 14.0 per cent registered at end 2021. The DCS revised the base year of both the CCPI and the NCPI from 2013

Figure 1.5
Headline Inflation (Year-on-Year) (a)



(a) The Department of Census and Statistics (DCS) commenced publishing the NCPI and the CCPI with the new base year, 2021=100, from the data releases of January 2023 and February 2023, respectively, and discontinued the publication of the NCPI and the CCPI with the old base year, 2013=100. Accordingly, data commencing January 2023 in the chart are based on the series with the new base year, 2021=100.

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

to 2021, in order to accommodate the changing expenditure patterns and to incorporate changes in goods and services available in the market. The downward trend of headline inflation observed in the latter part of 2022 continued into 2023 as well. Accordingly, year-on-year headline inflation, based on the CCPI (2021=100), decelerated further to 50.3 per cent in March 2023, although the pace of deceleration was slower than in recent months, due to the full impact of the electricity price revision being accounted for during March 2023. Meanwhile, year-on-year headline inflation, based on the NCPI (2021=100), stood at 53.6 per cent by February 2023. Signs of further easing of prices of certain imported goods were observed recently with the appreciation of the Sri Lanka rupee, and the revisions of petroleum prices in late March 2023 would help quicken disinflation in the ensuing months. Core inflation, which excludes the volatile food and energy prices, and measures the underlying demand pressures, also increased during the nine months ending September 2022 before trending downward. The rise in core inflation was mainly due to the pent-up demand stemming from the lagged impact of monetary accommodation in recent

BOX 1
Sri Lanka's Disinflation Process

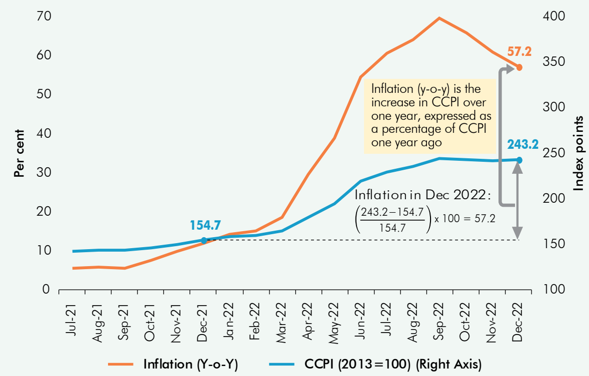
High inflation during 2022 was a global phenomenon. Global inflation accelerated to 8.8 per cent in 2022 (IMF, 2023) reflecting the impact of the lagged effects of ultra easy monetary and fiscal support following the COVID-19 pandemic, shortages of fuel and nonfuel commodities, exacerbated by the Russia-Ukraine War and capacity constraints along with supply chain issues. Affected by global as well as domestic factors, Sri Lanka also experienced inflation at unprecedented levels in the year 2022, recording the largest increase in price levels in its history since independence. However, in late 2022, inflation started moderating from its peak levels, showing early signs of a disinflation process. This process is expected to be supported by several factors, eventually bringing inflation down to the targeted levels in the period ahead. Against this backdrop, it is important to understand the concepts of inflation, disinflation and the characteristics of past global disinflation episodes, and more importantly, the envisaged disinflation process of Sri Lanka, as various misconceptions and misinterpretations have come to the fore resulting in confusion and affecting inflation expectations of the public.

The Concept of Inflation

A change in inflation is sometimes misinterpreted as a corresponding change in the price level. The general price level represents an average of all prices in the economy as measured by a consumer price index. The most commonly used measures of the level of prices in Sri Lanka are the Colombo Consumer Price Index (CCPI) and the National Consumer Price Index (NCPI). In contrast, inflation is the rate at which the general price level increases over time, which is typically denoted as the percentage change in a consumer price index between two periods. Therefore, a decline in inflation compared to the previous period may not necessarily mean a drop in the general price level, but rather a reduction in the pace of increase in the general price level.

The most commonly used measures of inflation are the year-on-year change and the month-on-month change in a consumer price index. The month-on-month measure of inflation provides an assessment of price movements in the most recent month under consideration, compared to the preceding month. Hence, this measure is also referred to as the 'price momentum' or the 'momentum of inflation'. Inflation measured by the year-on-year change in a consumer price index, however, depends on two factors: the price movements in the current month and the price movements recorded one year ago. The latter is referred to as the 'base effect', which is the contribution to the change in the year-on-year inflation that stems from the month-on-month inflation in the base period (i.e., one year ago). The recent movements of the CCPI (Base: 2013 = 100)[1] and year-on-year inflation are depicted in Figure B 1.1. The figure illustrates that the year-on-year inflation in a given month (e.g., Dec. 2022) depends upon the consumer price index in the corresponding month and the value of the same 12 months earlier (i.e., Dec. 2021).

Figure B 1.1
Movements of the CCPI and Inflation



Source: Department of Census and Statistics

Furthermore, the change in year-on-year inflation can be approximated by the month-on-month inflation in the current period (momentum effect), less the month-on-month inflation twelve months ago (base effect).[2] Hence, in order to assess the dynamics of inflation in Sri Lanka, especially the envisaged

1 Compilation of the CCPI (2013=100) was discontinued by the Department of Census and Statistics (DCS) in February 2023 and it was replaced by the CCPI (2021=100). Inflation (year-on-year) based on the CCPI (2021=100) is available from January 2023.

2 As shown in the mathematical representation below, the year-on-year inflation (π_t) depends on the consumer price index in a given month (P_t) and the value of the same 12 months earlier (P_{t-12}).

$$\pi_t = \left[\frac{P_t - P_{t-12}}{P_{t-12}}\right] \times 100 \approx [\ln P_t - \ln P_{t-12}] \times 100$$

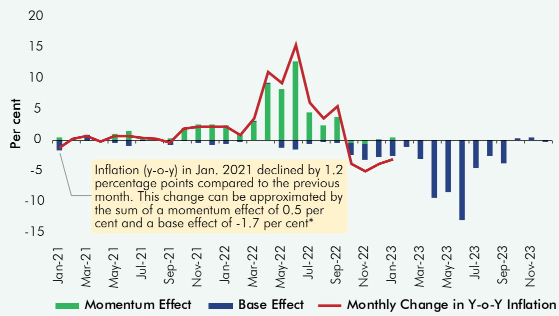
Once the mathematical representation of the year-on-year inflation is approximated using natural logarithms (ln), the difference between the year-on-year inflation in two successive months can be written as follows.

$$\pi_t - \pi_{t-1} \approx \{[\ln P_t - \ln P_{t-12}] - [\ln P_{t-1} - \ln P_{t-13}]\} \times 100$$

$$\pi_t - \pi_{t-1} \approx \{[\ln P_t - \ln P_{t-1}] - [\ln P_{t-12} - \ln P_{t-13}]\} \times 100$$

It is noteworthy that the approximation using natural logarithms is valid only when the variable under consideration (i.e., inflation) is a small number in percentage terms.

Figure B 1.2
Inflation Dynamics in terms of Momentum and Base Effects (Based on the CCPI, 2013=100)



* This approximation is valid only when inflation is a small number in percentage terms

Source: Department of Census and Statistics

disinflation process, one should have a clear understanding of the movements in price levels in the past one year period, i.e., the base effects, and the expected future path of price levels, i.e., the expected price momentum. Figure B 1.2 depicts inflation dynamics in recent times in terms of momentum and base effects. The figure illustrates that the monthly change in year-on-year inflation can be approximated by the summation of the momentum effect and the base effect, particularly during periods where the year-on-year inflation is small.

Sources of Inflation in Sri Lanka

Being a small open economy, Sri Lanka's overall inflation is a combination of both domestic and imported inflation. Domestic inflation is affected by demand side factors, supply side factors, and the economic agent's expectations on the future course of inflation. Demand side factors are typically the outcomes of a growing economy, public expectations of future price movements, and macroeconomic policies (i.e., monetary policy and fiscal policy) aimed at influencing the aggregate demand conditions of the economy, whereas supply side factors could be the outcomes of either the supply side policies of the Government or some exogenous circumstances, such as natural disasters, global events, etc. As the people of Sri Lanka consume a considerable share of imported items, the country's inflation is also affected by the movements in global commodity prices. In addition, exchange rate movements affect inflation. For instance, a depreciation of the Sri Lanka rupee against the US dollar (since most imports are valued in US dollar terms) will increase the price of imports in domestic currency terms.

What is Disinflation?

Disinflation is interpreted as a slowdown in the rate of increase of the general price level in an economy. Alternatively, it can be defined as a sustained decrease in year-on-year inflation. Disinflation is a process that typically takes place over the short to medium term until inflation reaches the desired level and price stability is restored. It is important to note that disinflation, following an episode of high inflation, is different from deflation, which refers to a sustained decrease in the general price level. Disinflation results in a lower level of inflation where the prices are still rising, but at a slower rate.

In general, gradual disinflation is brought about by contractionary monetary policy as well as supply conditions turning favourable. The objective of contractionary monetary policy is to bring back inflation to the targeted level and sustain it thereafter. Disinflation policies could be associated with short term costs in terms of subdued economic activity and rising unemployment. However, the long term gains for the economy on account of reduced distortions due to high inflation outweigh the short term costs. In the meantime, policymakers must also be vigilant of threats of future deflation during disinflation episodes, as sustained deflation can be highly destructive to a modern economy (Bernanke, 2012).

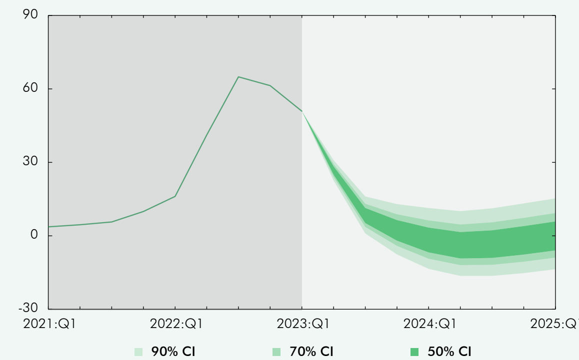
Globally, there have been several noticeable disinflation episodes. The reduction in inflation in the US in the early 1980s, when the US Federal Reserve was headed by Paul Volcker, remains a widely discussed macroeconomic outcome (commonly referred to as 'Volcker disinflation'). During the 1970s and early 1980, the general price levels in the US rose significantly. However, following the implementation of aggressive monetary policy measures by the US Federal Reserve, the annual inflation rate was brought down from a peak of 13.5 per cent in 1980 to 3.2 per cent by 1983. The US experienced two recessions during this period, which are generally attributed to disinflationary policies. However, 'Volcker disinflation' laid the foundation for the long economic expansions of the 1980s and 1990s in the US. In the meantime, Japan and Germany also experienced heightened levels of inflation in the early 1970s. However, by the late 1970s both countries recorded low inflation relative to other advanced economies. The success of this disinflation process is attributed to the strong discipline of the respective governments and monetary authorities, based on the understanding that inflation in the long run is a monetary phenomenon (Nelson, 2007). Furthermore, productivity improvements can also help the disinflation process. Aggregate demand pressures can be lessened due to the expansion of the potential GDP in the long run through effective supply side policies. Moreover, higher productivity, deregulation and increased globalisation are also weighed as possible causes for the considerable drop in global inflation from the elevated levels in the 1970s and early 1980s (Rogoff, 2004).

The Envisaged Disinflation Process in Sri Lanka

Sri Lanka's inflation started moderating from its peak levels of around 70 per cent (year-on-year) in September 2022, confirming that the disinflation process had started as envisaged. In terms of economic factors, this process is expected to be supported by subdued aggregate demand conditions due to tight monetary and fiscal policies, expected improvements in domestic supply conditions, improved external sector performance, normalisation of global commodity prices, and the timely passthrough of such reductions to domestic prices. Statistically, the disinflation process is anticipated to be influenced by both the momentum effect and the base effect, with a higher contribution expected from the latter.

Moreover, the effects of statistical factors can be assessed within the context of sources of inflation and expected economic developments. The IMF (2023) expects global inflation to fall in 2023 and 2024. If the envisaged moderation in global commodity prices is passed on to domestic prices via timely and transparent adjustments, the price momentum of imported inflation could be kept at a considerably low level in 2023. Furthermore, the stability of the exchange rate amidst an improved Balance of Payments (BOP) position would be helpful in this regard. The recent appreciation of the Sri Lanka rupee against the US dollar, if continued, could help lower imported inflation and reduce second-round effects associated with these imports, thereby supporting the disinflation process. In the meantime, Sri Lanka's import prices increased disproportionately during 2022 reflecting the substantial depreciation of the Sri Lanka rupee and the increase in global commodity prices. This resulted in large month-on-month increases in prices of imported commodities, particularly around mid-2022. In the year 2023, this will influence imported inflation favourably through a sizeable negative base effect supporting the disinflation path (please see Figure B 1.2). On the other hand, with respect to domestic inflation, the price momentum is estimated to be

Figure B 1.3
Headline Inflation Projections
CCPI* (Quarterly Average, Year-on-Year, %)



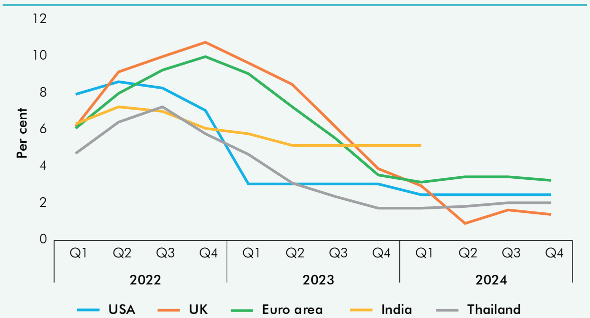
*Note: Realised data up to Q4 2022 are based on the CCPI (2013=100), while data for Q1 2023 are based on the CCPI (2021=100). Projections are based on all available data.

Source: Central Bank Staff Projections

significantly low on account of unprecedented monetary policy tightening measures and an extremely tight fiscal policy stance. In addition, some improvements were witnessed in domestic supply conditions over the last couple of months. As a result, the price momentum relating to food inflation recorded even negative values in certain months. The improved supply conditions are expected to continue through 2023, supporting the efforts to bring inflation to lower levels. Meanwhile, the adjustments made by the Government on various taxes as well as the revisions made to utility tariffs in 2022 and early 2023, together with their second-round effects, resulted in one-off upward adjustments in the general price level. Moreover, the supply side factors remained considerable in 2022 due to numerous shortages and bottlenecks witnessed in domestic supply conditions associated with the BOP crisis. The month-on-month increases in domestic prices in 2022 due to supply bottlenecks as well as tax and tariff revisions will influence inflation favourably in 2023 via a sizeable base effect (please see Figure B 1.2). Therefore, the moderation in domestic inflation in the period ahead is expected to be supported by a combination of subdued price momentum and a considerable base effect. The overall inflation of the country, which is an outcome of the expected dynamics of both imported and domestic inflation, along with the improving supply conditions, among others, is envisaged to reduce sustainably in 2023, enabling the realisation of the anticipated disinflation path.

The Central Bank's 'inflation fan chart' presents the projections for future inflation, on a quarterly basis, in the form of confidence intervals (CI). The confidence intervals illustrate the uncertainty surrounding the

Figure B 1.4
Global Disinflation Projections



Sources: USA - Monetary Policy Report Mar. 2023; UK - Monetary Policy Report Feb. 2023; Euro area - Eurosystem staff macroeconomic projections Dec. 2022; India - Monetary Policy Report Sep. 2022; Thailand - Monetary Policy Report Q4 2022

inflation forecast, with the degree of uncertainty widening as the forecast horizon increases. The Central Bank's latest projections for year-on-year headline inflation, based on CCPI (2021=100), are depicted in Figure B 1.3 in the form of an inflation fan chart.

Global inflation, which is estimated to have peaked in 2022, is expected to decline in 2023 and remain at subdued levels in 2024, in light of substantial monetary tightening and the resultant slowing of activity, normalisation of supply chains, and moderating prices of energy and other commodities. Figure B 1.4 depicts inflation projections of selected countries as per their most recent monetary policy reports. The figure shows that in many countries, inflation increased substantially in 2022, beyond the central banks' inflation targets. However, these countries are expecting a sharp disinflation in 2023, as is the case with Sri Lanka, in a synchronous manner.

The Role of Inflation Expectations and Inflation Forecasts

The disinflation process of the country is also expected to be reinforced by well-anchored inflation expectations. Inflation expectations reflect the rate at which the stakeholders in an economy expect prices to change in the future. Inflation expectations matter because actual inflation depends, in part, on what the public expects it to be, as expectations could influence spending, borrowing and investment decisions today. Therefore, the disinflation process involves a deliberate course of action by a central bank to change the prevailing expectations of economic agents, if such expectations are higher than the medium term inflation target. In Sri Lanka, inflation expectations destabilised to some extent following the high inflation episode in 2022. However, with the proactive implementation of remedial monetary policy measures, along with an effective and transparent monetary policy communications strategy, including the publication of medium term inflation projections, a persistent reduction in the expected level of inflation was observed recently among the public, which in turn has helped improve the credibility of the Central Bank as well. As the disinflation process progresses, a further improvement in this regard can be expected, affirming the anchoring of medium term inflation expectations in line with the Central Bank's inflation target.

Frequent communication of the estimated short to medium term inflation path remains a key element of the disinflation process. Towards this end, the Central Bank will continue to publish its inflation fan chart in press releases following regular monetary policy reviews and in other communiqués as appropriate. Any discrepancy between the medium term inflation forecast and the inflation target prompts policy measures to close the gap. Frequent and transparent communication of the inflation path would also serve as a mechanism to ensure commitment from the Central Bank to restore and maintain price stability.

Further, the Central Bank will commence publishing a forward looking semi-annual monetary policy report from the second half of 2023. This report will mainly display medium term projections for inflation and the underlying factors for the projections as well as an explanation of the deviation of actual inflation from the published forecast, if any.

A key factor for the disinflation process is the credibility of the central bank, as discussed above. This will help anchor inflation expectations. The credibility of the Central Bank is highly related to the independence of the Bank. In this regard, the envisaged enactment of the new Central Bank of Sri Lanka Act will contribute immensely to improving the independence and credibility of the Central Bank, which in turn will support the current disinflation episode and further strengthen the anchoring of inflation expectations.

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years, the surge in imported prices, as well as increases in the cost of non-food categories, such as restaurants and hotels, health, and education, etc. Accordingly, year-on-year core inflation, based on the CCPI (2013=100), was recorded at 47.7 per cent by December 2022, compared to 8.3 per cent recorded at end 2021. The NCPI (2013=100) based core inflation also accelerated to 57.5 per cent, year-on-year, by December 2022, in comparison to 10.8 in December 2021. Similar to headline inflation, core inflation also continued to trend downwards during early 2023. Accordingly, the CCPI (2021=100) based year-on-year core inflation decreased to 39.1 per cent by March 2023, while the NCPI (2021=100) based year-on-year core inflation decreased to 50.1 per cent by February 2023. This continued reduction in core inflation was attributed to the strong policy measures taken by the Central Bank to address the build-up of demand driven inflationary pressures and adverse inflation expectations. Meanwhile, inflation expectations, which remained at elevated levels during the inflation acceleration period up to September 2022, broadly followed a downward trend during the disinflation period.

External Sector Developments

Sri Lanka's external sector met with severe BOP stresses in 2022 amidst constrained foreign financial inflows, depleted gross official reserves, and overshooting of the exchange rate, necessitating a myriad of policy measures to avoid further aggravation of the situation and restore external balance. The Government sought assistance from the IMF for a funding arrangement and announced a debt standstill as an interim measure, pending negotiations on debt restructuring with bilateral and commercial creditors during early 2022. The Government and the Central Bank initiated measures to limit foreign exchange outflows, while taking initiatives to promote inflows. Import demand was reduced notably, reflecting the impact of significantly tightened monetary policy and subdued demand conditions. A series of import prioritisation measures was initiated, while continuing the existing restrictive measures. These restrictions included temporary suspensions and imposition of licensing and margin deposit requirements on selected imports. Also, restrictions on selected import payment methods were imposed with a view to discouraging grey market activities. Limitations on certain foreign exchange outflows of capital nature were also continued. Further, workers' remittances through official channels were encouraged through cash based and non-cash based targeted incentives for migrant workers. The large depreciation of the exchange rate, restrictions on imports under certain payment terms, such as open account terms, and subdued demand for imports led to a correction in the large spread between the official exchange rate and rates offered in the informal market. This further encouraged remittances through formal channels. A significant reduction in the trade deficit was observed in the second half of 2022 as import expenditure declined and export earnings remained resilient. The surplus in the services account increased to some extent due to the increase in earnings from tourism. However, all other sectors in the services account, including air and sea freight, transportation, and services inflows to the Information Technology and Business Process Outsourcing (IT/BPO) sector remained significantly subdued compared to the previous year. The secondary income account surplus reduced in 2022 despite the significant improvement in workers' remittances towards the second half of 2022, while the primary income account deficit, compiled on an accrual basis, marginally moderated during the year compared to the previous year. With these developments, the

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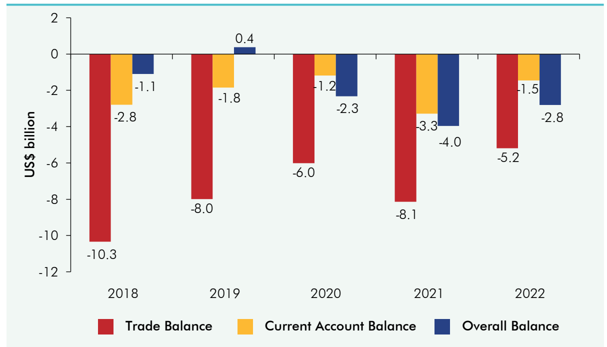
current account deficit narrowed to 1.9 per cent of GDP in 2022, from 3.7 per cent of GDP in 2021. Despite net foreign investment inflows into the Colombo Stock Exchange (CSE) (including primary market purchases) and the government securities market, inflows to the financial account remained modest due to the decline in foreign inflows to the Government. Meanwhile, gross official reserves declined to US dollars 1.9 billion as at end 2022, in comparison to US dollars 3.1 billion recorded in the previous year. However, this included the swap facility from the People's Bank of China equivalent to around US dollars 1.4 billion as at end 2022, which is subject to the conditionalities on its usability. The Central Bank absorbed US dollars 2.1 billion from the domestic foreign exchange market during 2022, mainly from mandatory sales by licensed banks, while supplying US dollars 2.7 billion mainly to meet foreign exchange required for importing essential commodities, such as fuel, coal, cooking gas, etc. The Central Bank played a major role in managing foreign exchange to ensure the supply of essential goods and services under extremely challenging circumstances during 2022. Meanwhile, total external debt of the country amounted to US dollars 49.7 billion as at end 2022, compared to US dollars 51.8 billion recorded as at end 2021, reflecting the impact of lack of access to foreign funding sources and large valuation changes in commercial debt. Despite the notable increase in the outstanding foreign loans of the Government, the total external debt of the Government remained at similar levels due to the reduction in the outstanding value of ISBs issued by the Government that were valued at market prices. The Government obtained a number of emergency credit facilities for the importation of essential goods, including fuel, medicine and fertiliser, from regional countries in the form of bilateral loans, resulting in significant foreign loan disbursements during 2022. The temporary suspension of debt servicing to bilateral and commercial creditors provided some respite in terms of lesser foreign loan repayments. The significant shortage in liquidity in the domestic foreign exchange market exerted pressures on the exchange rate, necessitating a measured adjustment in the exchange rate in early March 2022 by the Monetary Board. However, market speculation resulted in an overshooting of the exchange rate subsequently. Accordingly, the Sri Lanka rupee depreciated substantially by 41.4 per cent against the US dollar by end April 2022. From mid-May 2022, with the aim of curbing any significant intraday volatility due to excessive speculation, the Central Bank commenced offering market guidance by publishing a middle rate and a variation margin applicable to the interbank weighted average spot exchange rate. This measure was effective in stabilising the exchange rate since then, helping to mitigate the adverse macroeconomic implications of excessive depreciation and volatility of the currency. Reflecting these developments, the Nominal Effective Exchange Rate (NEER) and Real Effective Exchange Rate (REER) indices, which measure the movement of the Sri Lanka rupee against a basket of currencies and thus the external competitiveness, declined notably in 2022. Overall, the REER indices declined substantially below the threshold of 100 index points, signalling that the exchange rate remained sufficiently competitive for international trade.

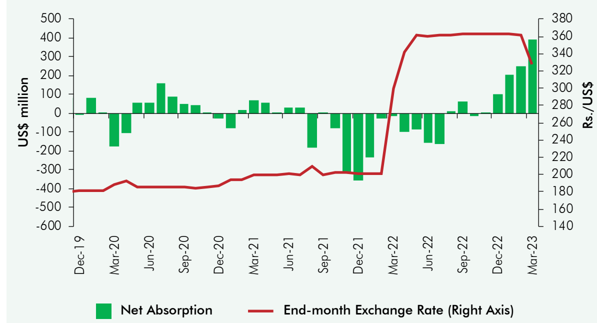
Figure 1.6
Balance of Payments



Source: Central Bank of Sri Lanka

Sri Lanka secured IMF Executive Board approval for the EFF arrangement of SDR 2,286 million (approximately US dollars 3,000 million) in March 2023, and the first tranche of SDR 254 million (approximately US dollars 333 million) was disbursed under the programme in late March 2023. Following the staff level agreement reached with the IMF for the EFF supported programme in September 2022, Sri Lanka commenced a dialogue with bilateral creditors to secure financing assurances, while engaging with commercial creditors in good faith negotiations. Further, Sri Lanka initiated measures to complete all prior actions needed to secure the approval of the IMF Executive Board. Towards the finalisation of the IMF-EFF arrangement, several favourable developments were initiated from early 2023. With a view to encouraging activity in the domestic forex market and restoring a market driven exchange rate in line with the flexible inflation targeting framework of the Central Bank, the Central Bank commenced a gradual relaxation of the daily variation band, while also loosening the mandatory sales requirement by licensed banks, before completely removing this requirement from early March 2023. Foreign exchange market liquidity conditions started to improve from early 2023, supported by foreign currency inflows to the services sector, workers' remittances and financial flows to portfolio investment, and return of market confidence following the finalisation of the IMF-EFF arrangement. Reflecting the impact of improving foreign exchange market conditions, the exchange rate showed a large appreciation bias during early March 2023, correcting the exchange rate overshooting witnessed in early 2022 and helping the build-up of official reserves

Figure 1.7
Exchange Rate and Central Bank Intervention in the Domestic Foreign Exchange Market



Source: Central Bank of Sri Lanka

through the intervention of the Central Bank in the market, with sizeable purchases. With the funding assistance under the IMF-EFF arrangement and the purchases of foreign exchange from the market, gross official reserves strengthened to about US dollars 2.7 billion by end March 2023, and the Sri Lanka rupee appreciated against the US dollar by 10.9 per cent by end March 2023, reflecting the improved market sentiments. Reflecting the greater flexibility that was allowed in the determination of the exchange rate, the Sri Lanka rupee showed some volatility from late March 2023.

The funds disbursed under the EFF arrangement are proposed to constitute budget support, with a view to helping the domestic financing needs of the Government. However, proceeds so received will also help cushion BOP constraints due to their availability for the repayment of foreign currency obligations of the Government that are not subject to debt restructuring, which would otherwise have been made from the Central Bank's reserves, and possible strengthening of official reserves that could facilitate financing essential imports.

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BOX 2

Sri Lanka's Economic Adjustment Programme Supported by an Extended Fund Facility Arrangement of the International Monetary Fund

Introduction

The Sri Lankan economy has been experiencing frequent incidences of vulnerabilities and instability conditions instilled by structural macroeconomic problems coupled with global and domestic shocks. The conditions weakened drastically since 2020 with the onset of the pandemic, along with *ad-hoc* policy changes that exacerbated stresses in the economy. As a result, the country experienced severe Balance of Payments (BOP) distress and subsequently multiple crises in 2022. Several policy interventions were rolled out since early 2022 to guide the economy towards greater stability. Seeking financial assistance subject to macroeconomic stabilisation and related commencement of debt restructuring efforts to restore public debt sustainability are key steps that have been taken towards this journey. Before 2022, Sri Lanka had entered into numerous International Monetary Fund (IMF) programmes from time to time for various purposes including supporting the BOP and the Government's reform agenda. However, unlike on previous occasions, Sri Lanka initiated discussions with the IMF in early 2022 for an Extended Fund Facility (EFF) arrangement under the direst economic conditions. The success of policy interventions was constrained by debt overhang as well as persistently large fiscal and BOP financing needs. Amidst continuous downgrades in sovereign ratings, Sri Lanka was cut off from avenues for external financing, making new fundraising and servicing existing loans extremely challenging. Usable reserves depleted to near zero levels, the exchange rate depreciated at an unprecedented scale, access to fuel, electricity and other essential imported items by the public was limited, general price levels escalated to new heights with demand pressures and supply shortages, financial system stability was under threat, and social and political clashes were recurring in early 2022. Against this backdrop, the need for economic stabilisation with external assistance was required and the Sri Lankan authorities initiated discussions with the IMF. Continuous engagements over a year with the IMF staff team on the finalisation of the proposed economic and financial policies and successful completion of prescribed prior actions under the programme and the receipt of financial assurances from the official creditors enabled the approval of an EFF in late March 2023. Salient features of this economic adjustment programme, expected developments under the EFF arrangement, the country's commitment to the reforms in the ensuing period, and necessity of continuing this programme over four years are discussed briefly in the following sections.

Programme Objectives and Modalities of the IMF-EFF

The current IMF-EFF arrangement spans 48 months with the total disbursement amounting to SDR 2.286 billion (about US dollars 3 billion) to be utilised for budget support for the Government. However, the proceeds under the EFF would also help cushion the BOP by supplementing the Gross Official Reserves (GOR). The disbursement will be equally divided into nine tranches subject to semi-annual reviews and subsequent Executive Board approvals. The first tranche was received in March 2023 immediately following Board approval. The programme aims at restoring macroeconomic stability at large. This overall economic stability is designed to be achieved through building strong pillars on critical areas of restoring debt sustainability, advancing revenue based fiscal consolidation, restoring price stability and building external buffers, ensuring financial stability, reducing corruption vulnerabilities, and raising potential growth.

Prior Actions and Structural Benchmarks

Since the commencement of negotiations for the IMF-EFF arrangement in early 2022, Sri Lanka has completed nine prior actions by March 2023 and has formulated a mechanism for meeting the structural benchmarks. The completion of these prior actions was instrumental in paving the way for broader reforms to be implemented in the next four years under the EFF. The prior actions that have been already completed by Sri Lanka include, obtaining Cabinet approval for revenue measures to support fiscal consolidation during 2023 in line with programme parameters, obtaining Parliamentary approval for a revised 2022 budget, submission of the 2023 Appropriation Bill to the Parliament, obtaining Cabinet approval to automate monthly retail fuel price adjustment, to automate semi-annual cost-recovery based electricity price adjustment, Cabinet approval of the new Central Bank Act, Cabinet approval for the amendments to the Banking Act, strengthening key elements of the Central Bank's crisis management powers, hiring an independent firm to conduct banking sector diagnostic exercise, and increasing policy interest rates by 100 basis points to ensure forward looking real policy interest rates are on a firm upward path.

In addition to the above, three important upfront measures were also implemented which include Parliamentary approval of the 2023 budget that was in line with programme parameters, Parliamentary approval of necessary legislative revisions to implement the 2023 revenue measures, and updating the Emergency Liquidity Assistance framework for banks. Further, Sri Lanka is required to implement several structural benchmarks related to fiscal matters, State Owned Enterprises (SOEs), social safety net reforms, and monetary and exchange rate policies and reforms related to fiscal sector and governance in the period ahead, as detailed in Figure B 2.1.

Monitoring of Programme Progress

Performance of the EFF arrangement will be monitored in terms of a comprehensive mechanism that comprises Quantitative Performance Criteria (QPCs), Continuous Performance Criteria (CPC) related to external arrears and Article VIII obligations, Indicative Targets (ITs), and

Figure B 2.1

Structural Benchmarks under the IMF-EFF Arrangement

Fiscal, SOE, and Social Safety Net Reforms

- Continuous: **Set retail fuel prices to their cost-recovery levels with monthly formula-based adjustments**
- Continuous: **Adjust the end-user electricity tariff schedule to its cost-recovery level with semi-annual formula-based adjustments**
- End-May 2023: **Parliamentary approval of the welfare benefit payment scheme** and new eligibility criteria for beneficiary identification
- End-June 2023: **Cabinet approval of a comprehensive strategy to restructure the balance sheets of the CEB, CPC, SriLankan Airlines, and the Road Development Authority**
- End-July 2023: **Cabinet approval of revenue measures to support fiscal consolidation during 2024,** in line with programme parameters
- End-Sep. 2023: **Completion of the rollout of the ITMIS,** expanding its coverage to all 220 heads (national budget execution agencies)
- End-Oct. 2023: **Parliament submission for the first reading of the 2024 Appropriation,** in line with programme parameters
- End-Dec. 2023: **Parliamentary approval of the 2024 Appropriation Act and the spending allocations,** in line with programme parameters
- End-Dec. 2023: **Parliament submission of a new Public Financial Management (PFM) law,** in consultation with IMF staff
- End-Dec. 2023: **Improve the Bulk Supply Transaction Account (BSTA)** to accurately measure the electricity subsidy, and start using it to determine the cost-recovery based electricity tariff and government transfer requirement

Financial Sector

- End-Apr. 2023: **Completion of the asset quality review component of the bank diagnostic exercise** for the two largest state banks and the three largest private sector banks
- End-June 2023: **Cabinet approval of a full revision of the Banking Act** in consultation with IMF staff
- End-July 2023: **Development by the CBSL of a roadmap for addressing banking system capital and FX liquidity shortfalls and intervening in banks assessed to be non-viable**
- End-Oct. 2023: **Determination by the MOF of the size, timing, instruments, and terms and conditions for potential government recapitalisation of viable banks which are unable to close capital shortfalls from private sources**
- End-Dec. 2023: **Parliamentary approval of a full revision of the Banking Act** in consultation with IMF staff

Monetary and Exchange Rate Policies

- End-Apr. 2023: **Parliamentary approval of the new Central Bank Act** prepared in consultation with IMF staff

Governance

- End-June 2023: **Enact new anti-corruption legislation to harmonise it with the United Nations Convention Against Corruption,** pending comprehensive asset recovery provisions, in consultation with IMF staff
- End-Sep. 2023: **Publication of the report of an IMF-led governance diagnostic technical assistance mission** to assess Sri Lanka's anti-corruption framework

Source: IMF. (2023). Sri Lanka: Request for an Extended Arrangement Under the EFF - Press Release, Staff Report, and Statement by the Executive Director for Sri Lanka.

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the monetary policy consultation clause. The QPCs that Sri Lanka is expected to achieve are the requirement to generate a primary surplus in the Government's budget, improve the gross official reserve levels by building net international reserves, and gradually phase out Net Credit to the Government by the Central Bank. A CPC applies to the non-accumulation of new external payments arrears on external debt which will be monitored continuously by the authorities and any non-observance will be immediately reported to the IMF. In addition, another QPC includes the prohibition of imposing or intensifying restrictions on the making of payments and transfers for current international transactions, introducing or modifying multiple currency practices, concluding bilateral payment agreements that are inconsistent with Article VIII of the IMF's Articles of Agreement, and imposing or intensifying import restrictions for BOP purposes. A monetary policy consultation clause (MPCC) has also been included to monitor year-on-year inflation on specified target dates to ensure that Sri Lanka is moving on a steady disinflation path to reach the targeted level to restore price stability. Further, ITs have been specified mainly on central government tax revenue, social safety net spending, cost of non-commercial obligations for fuel and electricity as well as on treasury guarantees. More importantly, in order to ensure the achievement of objectives envisaged in attaining debt sustainability, the progress on the debt restructuring will be assessed at each programme review, with a view to completing debt restructuring within a reasonable time frame. The QPCs and ITs pertaining to the programme are detailed in Figure B 2.2.

External Financing Gap and Financing Sources

The programme is expected to trigger additional financing assistance with budget support from the World Bank and the Asian Development Bank of US dollars 3.75 billion, of which US dollars 900 million is expected in 2023. It is also expected that with the recovery in the economy and buildup of buffers, Sri Lanka would be able to access international markets to raise funds in terms of sovereign bond issues in 2027. These resources, together with external public debt service relief, will close the external financing gap and allow Sri Lanka to rebuild its gross international reserves.

Figure B 2.2

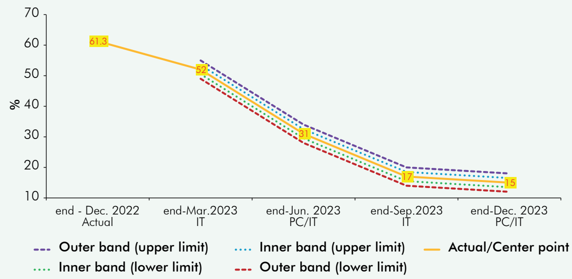
Sri Lanka: Proposed Quantitative Performance Criteria (QPCs), Continuous Performance Criteria (CPC), and Indicative Targets (ITs)

(Cumulative from the beginning of the year, unless otherwise noted)

		2022	2023			
Proposed quantitative performance criteria		end - Dec. Actual	end - Mar. IT	end - Jun. PC/IT	end - Sep. IT	end - Dec. PC/IT
Central government primary balance (floor)	Rs. bn	-895	-56	-113	-160	-209
Program net official international reserves (Program NIR, floor, end of period stock)	US$ mn	-3,540	-3,188	-2,830	-2,068	-1,592
Net credit to the government of the CBSL (ceiling, end of period stock)	Rs. bn	2,834	2,890	2,890	2,840	2,740
Stock of expenditure arrears of the central government (ceiling)	Rs. bn	60	30	0	0	0
Proposed continuous performance criteria (cumulative from beginning of the programme)						
New external payment arrears by the nonfinancial public sector and the CBSL (ceiling)	US$ mn	0	0	0	0	0
Proposed indicative targets						
Central government tax revenue (floor)	Rs. bn	1,751	650	1,300	2,100	2,940
Social spending by the central government (floor)	Rs. bn	142	35	70	120	187
Cost of non-commercial obligations (NCOs) for fuel and electricity (net of government transfers) (ceiling)	Rs. bn	-	0	0	0	0
Treasury guarantees (ceiling)	Rs. bn	1,159	1,700	1,700	1,700	1,700

Source: IMF. (2023). Sri Lanka: Request for an Extended Arrangement Under the EFF - Press Release, Staff Report, and Statement by the Executive Director for Sri Lanka

Figure B 2.3
Proposed Monetary Policy Consultation Clause Year-on-Year Inflation Based on the CCPI



Source: IMF. (2023). Sri Lanka: Request for an Extended Arrangement Under the EFF - Press Release, Staff Report, and Statement by the Executive Director for Sri Lanka.

Expected Developments under the IMF-EFF Arrangement

Some of the key expected outcomes of the IMF-EFF arrangement are as follows:

- **Achieving debt sustainability:** To achieve debt sustainability, Sri Lanka needs to achieve specific debt financing and debt servicing related targets. Further, the debt restructuring process will be guided by quantitative targets developed under the IMF Sovereign Risk and Debt Sustainability Framework (SRDSF) in order to ensure debt reduction, manage rollover risks, avoid a renewed buildup of external pressures from debt service needs, and ensure that financing gaps during the programme period are closed. Meeting these requirements would ensure Sri Lanka's public debt returning to sustainable levels in the eyes of creditors and the international community, thus easing difficulties and risk premia attached to Sri Lanka's future borrowings.

  The debt sustainability targets as per the Debt Sustainability Analysis (DSA) carried out by the IMF that needs to be achieved by Sri Lanka through the debt restructuring process are as follows:

  - Debt stock: Public debt to decline below 95 per cent of GDP by 2032.
  - Post-programme gross financing needs: Average annual gross financing needs of the central government in 2027-2032 to remain below 13 per cent of GDP.
  - Post-programme forex debt service: Annual forex debt service of the central government to remain below 4.5 per cent of GDP in each year over 2027-2032.
  - Programme financing gaps: Debt service reduction during 2023-2027 to be sufficient to close external financing gaps.

- **Improved fiscal performance and discipline:** With the emphasis given in the programme on the fiscal front and the relevant structural benchmarks, it is expected that the Government will persist with its fiscal consolidation efforts to meet the fiscal targets through revenue enhancement measures and rationalisation of expenditure further. With constrained access to monetisation of deficits going forward, the Government is expected to make required adjustments during the available

Figure B 2.4
External Financing Gap and Programme Financing (2022-2027)

US Dollars million

	2022	2023	2024	2025	2026	2027	Total 2022-27
Financing Gap (A)	-2,834	-4,939	-4,843	-5,018	-3,608	-3,911	-25,153
Programme Financing (B)	2,834	4,939	4,843	5,018	3,608	3,911	25,153
IMF EFF	0	663	665	663	662	329	2,982
IFI budget support	0	900	850	700	700	600	3,750
World Bank		250	400	400	400	300	1,750
ADB		650	450	300	300	300	2,000
Other		0	0	0	0	0	0
Debt moratorium: External arrears accumulation	2,834						2,834
Debt relief		3,376	3,328	3,655	2,246	1,482	14,087
Sovereign bond (market access)		0	0	0	0	1,500	1,500
Shortfall (A+B)	0	0	0	0	0	0	
Gross International Reserves	1,898	4,431	6,128	8,520	10,888	14,208	
Project loans	1,473	1,400	1,542	1,585	1,633	1,682	

Source: IMF. (2023). Sri Lanka: Request for an Extended Arrangement Under the EFF - Press Release, Staff Report, and Statement by the Executive Director for Sri Lanka.

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transitory period to ensure that such requirements would not arise. In the meantime, unwarranted leakages from the fiscal revenue are addressed through the envisaged broad-based programme for SOEs.

- **Legislative changes for enhanced governance and accountability framework:** New pieces of legislation, such as the proposed Central Bank Act, Banking Act, and other revisions to existing legislations are expected to strengthen the institutional and regulatory framework relating to the economic management of the country. A new anti-corruption law is to be introduced harmonising the United Nations Convention against Corruption, the first such law in South Asia, providing for the creation of an independent Anti-Corruption Commission. A new Public Financial Management (PFM) law will be enacted to streamline the budget formulation process and to enhance accountability mechanism in public finance.
- **Reforming social safety nets:** Despite an increase in social safety nets related spending and beneficiaries in recent years, it has been identified that there is significant scope for improvement regarding the coverage and selection. Considering the issues prevailing in the existing social safety nets framework, the IMF-EFF arrangement has specified certain institutional reforms to improve efficiency, coverage, and targeting of social safety nets programmes.
- **Restoring price stability:** The Central Bank is expected to restore price stability by driving inflation in a steady disinflation path to bring it back to the targeted range under the Flexible Inflation Targeting (FIT) framework through appropriate monetary policy actions. As a part of this process, monetary financing to the Government is expected to be phased out. The price stability commitment also entails maintaining more flexibility in the exchange rate and rebuilding reserves to withstand future shocks.
- **Strengthening financial institutions and financial system stability:** The IMF is of the view that Sri Lanka's financial system is heavily exposed to the public sector, moderately capitalised, and could face material capital and forex shortfalls following a debt restructuring. Consequently, there is a possibility that banks could face significant capital and forex shortfalls as a result of a sovereign debt restructuring. Therefore, plans are under way for the capital restoration of systemic banks following asset quality reviews to strengthen the resilience of the state owned banks. Meanwhile, financial sector supervision and the crisis management framework will be strengthened to make Sri Lanka's financial system more robust.

In addition to these specific benefits, the IMF supported programme would bring several positive spillovers to the economy through improved investor confidence, possible sovereign rating upgrades, and reopening of access to markets, among others. Considering the challenging nature of the targets set out, the authorities will have to put in a lot of effort and show commitment to ensuring the successful completion of the programme throughout the programme period. Also, in view of the maintenance of political and social stability during the programme period, especially considering the possible initial unpopularity of the reform measures and consequent public dissent, public awareness of how initial sacrifices would lead to long term economic benefits needs to be created.

Reforms Agenda Beyond the IMF-EFF Arrangement

The success of the IMF-EFF arrangement will largely rest on the extent to which the long neglected structural reforms are implemented. The structural reforms are anticipated to boost the competitiveness of the economy, provide a foundation for productivity enhancement, increase the efficiency in resource utilisation, and thereby enhance the growth potential. The severity of the current economic crisis faced by Sri Lanka highlights the importance of addressing the longstanding structural issues in a sustainable manner beyond the reforms agenda in the IMF programme through national policies which are formulated in consultation with stakeholders and free from political influences with vested interests. In this regard, the reforms agenda should focus on improving the productivity and output of the economy through technological innovations and increased economic connectivity to the world over trade and investment, by enhancing diversity in merchandise exports and potential services export sectors including tourism, IT/BPO sectors, and attracting FDI. It is also necessary to strengthen legal frameworks to ensure public accountability of state institutions, exercising available legal powers in policy formulation and implementation by relevant authorities to ensure lasting economic welfare in the country. These would complement the reforms agenda in the IMF-EFF arrangement to ensure that Sri Lanka attains and sustains macroeconomic stability in the earliest possible timeframe.

Conclusion

Despite being part of sixteen programmes since the first in 1965, only a few IMF programmes in Sri Lanka have been successfully implemented by authorities. This has been mainly due to the lack of commitment to meeting the conditionalities attached to such programmes, especially those related to structural reforms, which required painful macroeconomic adjustments and unpopular policies that were aimed at long term welfare enhancements. Therefore, it is imperative that Sri Lanka internalises these reforms in its policy formulation and implements the major areas of reforms in the current IMF programme as well as reforms beyond the programme to help the economy transform into greater stability and a higher growth path at the earliest while circumventing the need for repeated access to IMF bailouts and several rounds of debt restructuring in the future.

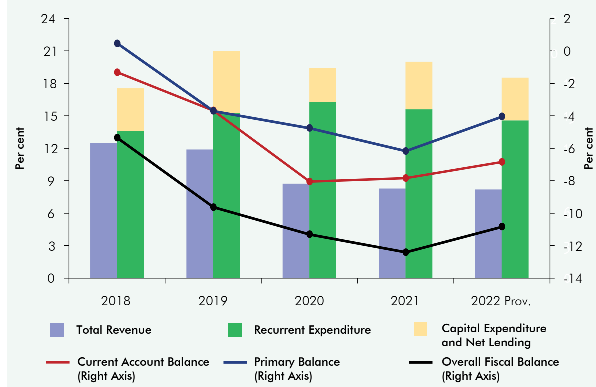
Reference

1. International Monetary Fund. (2023). Sri Lanka: Request for an Extended Arrangement Under the EFF - Press Release; Staff Report; and Statement by the Executive Director for Sri Lanka. 116. International Monetary Fund, Washington D.C.

Fiscal Sector Developments

The Government initiated major fiscal reforms to address fiscal sector vulnerabilities, while taking measures to restructure public debt aimed at ensuring debt sustainability over the medium term. The budgetary estimates presented in the Budget 2022 were proved unachievable, due to low revenue collection during the first half of 2022 and expenditure overruns owing to high domestic interest rates and inflation. The Government implemented an array of fiscal consolidation measures since April 2022 and obtained Parliamentary approval for an Interim Budget 2022 in September 2022, aimed at strengthening revenue enhancement measures and fiscal consolidation efforts. Supported by the revenue enhancement measures implemented in 2022 and the elevated price level in the economy, government revenue recorded a year-on-year growth of 35.8 per cent to Rs. 1,979.2 billion in 2022. However, owing to the substantial increase of nominal GDP with a large deflator, government revenue as a percentage of GDP fell to 8.2 per cent in 2022 from 8.3 per cent in 2021. Increased revenue mobilisation from income taxes, Value Added Tax (VAT), Ports and Airports Development Levy (PAL), and excise duties on liquor and cigarettes contributed to the nominal growth in government tax revenue. However, revenue collection from import duty, Special Commodity Levy (SCL), and CESS declined during 2022, reflecting the impact of moderation of import expenditure. Meantime, collection from non tax revenue increased on account of higher fees and charges, and profits distributed by the Central Bank based on annual financial statements of 2021. The implementation of several revenue enhancement measures during the second half of 2022 and in early 2023 is expected to deliver its full impact during 2023. On the other hand, government expenditure and net lending, in nominal terms, increased by 27.0 per cent, year-on-year, in 2022, despite the Government's expenditure rationalisation measures. However, with the notable nominal GDP growth, government expenditure, as a percentage of GDP, decreased to 18.5 per cent in 2022 from 20.0 per cent in the previous year. Higher expenditure on account of domestic interest payments, salaries and wages, and subsidies and transfers contributed to the increase in recurrent expenditure. Simultaneously, capital expenditure and net lending also registered a year-on-year growth of 23.1 per cent, especially on account of lending to the Ceylon Petroleum Corporation (CPC), through the Indian Credit Line, to import fuel, and the lending to SOE using the funding from the World Bank to import fertiliser and liquified petroleum (LP) gas. Accordingly, the overall fiscal deficit in nominal terms widened to Rs. 2,460.0 billion in 2022, from Rs. 2,057.9 billion in the previous year. As a percentage of GDP, the fiscal deficit declined from 11.7 per cent in 2021 to 10.2 per cent in 2022 owing to the notable growth in nominal GDP. The current account deficit, which reflects the dissavings of the Government, declined from 7.3 per cent of GDP (Rs. 1,290.4 billion) in 2021 to 6.4 per cent of GDP (Rs. 1,540.4 billion)

Figure 1.8
Summary of Fiscal Sector Performance
(as a percentage of GDP)



Source: Ministry of Finance, Economic Stabilisation and National Policies

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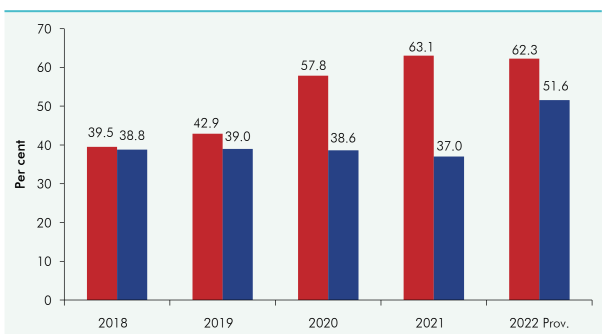
in 2022. Meanwhile, the primary deficit narrowed both in GDP and nominal terms, from 5.7 per cent of GDP (Rs 1,009.5 billion) in 2021 to 3.7 per cent of GDP (Rs. 894.8 billion) in 2022, reflecting the impact of fiscal consolidation measures.

Restrained foreign financing, that reflected the impact of adverse sovereign credit ratings and the announcement of debt standstill, compelled the Government to rely mainly on domestic financing sources, especially the banking sector to finance the budget deficit during 2022. Accordingly, during 2022, net financing through domestic sources amounted to 82.7 per cent of the total financing (8.4 per cent of GDP), compared to 100.7 per cent of the total financing (11.8 per cent of GDP) in 2021. The Central Bank continued to be the largest financing source to the Government, recording a net financing of Rs. 1,338.4 billion in 2022, owing to its direct subscription at Treasury bills auctions, amidst subdued market appetite for government securities, and direct issuances of Treasury bills to the Central Bank. Net foreign financing amounted to Rs. 424.8 billion (1.8 per cent of GDP) during 2022 due to the receipt of multilateral and bilateral funding for lessening the hardships of the public caused by the economic crisis. In 2021, foreign financing recorded a net repayment of Rs. 13.9 billion (0.1 per cent of GDP). Meanwhile, with the Parliamentary approval, the limit of Treasury bills stock was increased from Rs. 3,000 billion to Rs. 4,000 billion in June 2022, and in view of the rising borrowing requirement in face value terms due to high market interest rates, this limit was further raised to Rs. 5,000 billion in November 2022.

The outstanding central government debt increased from Rs. 17,614.2 billion (100.1 per cent of GDP) by end 2021 to Rs. 27,492.0 billion (113.8 per cent of GDP) by end 2022. This reflected the impact of a large budget deficit, parity loss due to the sharp depreciation of the exchange rate, and reclassification of selected debt liabilities under central government debt that were previously recorded under State Owned Business Enterprises (SOBE). In nominal terms, domestic debt and foreign debt increased by 35.5 per cent and 91.2 per cent, respectively, by end 2022. While the share of Treasury bonds continued to dominate the composition of domestic debt stock with a share of 57.9 per cent by end 2022, compared to 62.8 per cent by end 2021, less market appetite for longer tenure government securities and speculation over the possibility of domestic debt restructuring resulted in a substantial increase in the stock of Treasury bills to Rs. 4,113.9 billion by end 2022.

Increased gross financing needs and large foreign debt service obligations that are due in the near and medium term amidst critically low gross official reserves and inadequate foreign financing flows compelled the Government to suspend debt servicing of bilateral and commercial external debt and announce a debt standstill as an interim policy on 12 April 2022, pending debt restructuring efforts. As a result, foreign debt service payments declined to Rs. 487.4 billion (2.0 per cent of GDP) in 2022, in

Figure 1.9
Outstanding Central Government Debt
(as a percentage of GDP)



Sources: Ministry of Finance, Economic Stabilisation and National Policies
Central Bank of Sri Lanka

comparison to the Rs. 786.3 billion (4.5 per cent of GDP) foreign debt service payments made in the preceding year. Domestic debt service payments increased to Rs. 2,510.3 billion (10.4 per cent of GDP) in 2022, compared to Rs. 1,594.3 billion (9.1 per cent of GDP) in 2021, primarily due to the sharp increase in domestic interest rates and the increase in domestic debt during the period under review. Accordingly, the total debt service payments increased from Rs. 2,380.6 billion in 2021 (13.5 per cent of GDP) to Rs. 2,997.6 billion (12.4 per cent of GDP) in 2022. During the period under review, interest payments and capital repayments amounted to 6.5 per cent and 5.9 per cent of GDP, respectively. The Government shared more information on domestic debt optimisation perimeters in late March 2023 in order to assuage concerns associated with domestic debt restructuring, which dampened sentiments in the government securities market. The overall debt restructuring strategy of the Government is expected to be announced to creditors in the near term, thereby expediting the debt restructuring process along the debt sustainability targets envisaged in the IMF-EFF arrangement.

Monetary Sector Developments

The Central Bank continued the tight monetary policy stance throughout 2022 with a significant increase in policy interest rates of 700 basis points in April 2022. Such large monetary policy tightening was necessitated to contain rising inflationary pressures, address vulnerabilities in the external sector and anchor inflation expectations, thereby preventing possible hyperinflation and prolonged loss of economic activity. Accordingly, since the monetary tightening cycle that began in August 2021, the Central Bank's key policy interest rates, i.e., the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR), were raised by 10 percentage points by end 2022. The unprecedented upward adjustment of policy interest rates by 700 basis points in April 2022 helped arrest the further build-up of demand driven inflationary pressures, thereby preempting the escalation of adverse inflationary expectations, easing the pressure on the external sector, and correcting anomalies observed in the market interest rate structure. In addition, regulatory measures, including the removal of maximum interest rates imposed on selected lending products, and foreign currency deposits were also taken by the Central Bank, enabling the effective passthrough of policy interest rate changes to tighten monetary conditions. Meanwhile, liquidity levels in the domestic money market continued to remain at high deficit levels, particularly during the first half of 2022, due to foreign exchange sales by the Central Bank for facilitating imports of essentials, net foreign loan repayments of the Government, net currency withdrawals by the public from the banking system, and maturities of foreign currency buy-sell swaps with domestic banks. However, reflecting the impact of the primary purchases of government securities by the Central Bank and an increase in currency deposits to the banking system with high deposit interest rates, amidst the conduct of long term reverse repo auctions on a need basis, a gradual improvement in the domestic money market liquidity was observed towards the latter part of 2022. Due to the combined impact of a faster passthrough of the increase in policy interest rates, tight liquidity conditions in the domestic money market and elevated risk premia, market deposit and lending interest rates rose significantly in 2022. Subsequent to the sharp increase in key policy interest rates, amidst the increased borrowing requirement of the Government and heightened uncertainty in market conditions surrounding domestic debt restructuring concerns, the yields on government securities increased significantly during 2022, disproportionate to the adjustment in policy interest rates and other market interest rates.

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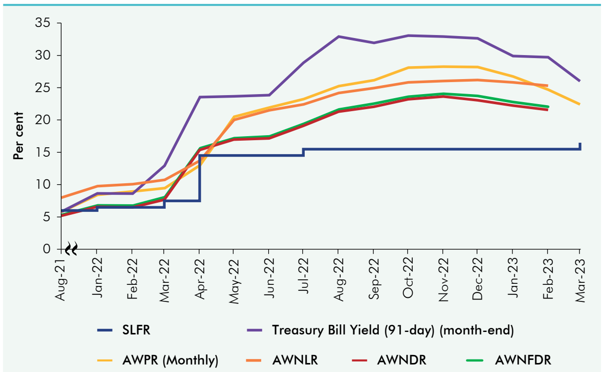
Figure 1.10
Movements in the Standing Lending Facility Rate and Selected Market Interest Rates



Source: Central Bank of Sri Lanka

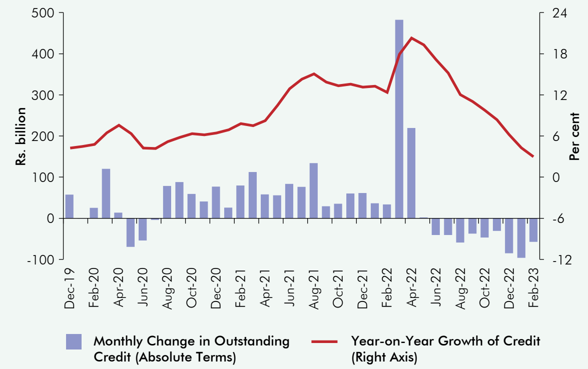
Moreover, while providing liquidity to banks through open market operations on need basis, measures were introduced in January 2023 to reduce the Licensed Commercial Banks' (LCBs) over-reliance on the Central Bank's standing facilities, thereby reducing asymmetries in the distribution of liquidity in the domestic money market. Consequently, overnight liquidity in the domestic money market and activity in the interbank call and repo markets improved. Along with improved rupee liquidity conditions and the improvement in investor sentiment in anticipation of the successful finalisation of the IMF-EFF arrangement, a notable moderation in yields on government securities was observed towards the end of 2022 and early 2023. Other market interest rates also started to ease gradually from late 2022, correcting the disorderly upward adjustment in the market interest rates. However, given the necessity of fulfilling all the 'prior actions' in order to move forward with the finalisation of the IMF-EFF arrangement, and concerns raised by the IMF staff about the need to further tighten policy interest rates, the Central Bank and the IMF staff reached a consensus and raised policy interest rates by 100 basis points in early March 2023, compared to a larger upward adjustment proposed by the IMF during the finalisation of the staff level agreement in September 2022. With this policy action, the Central Bank communicated to the market the need to lower the spread between policy interest rates and high market interest rates, while underscoring the possible downward adjustment in risk premia, as more information becomes available on domestic restructuring perimeters. The market interest rate movements continued to decline, narrowing the spread between the policy interest rates and other market interest rates as anticipated. Meanwhile, the Government shared more information on the domestic debt optimisation perimeters in late March 2023, which led to a notable adjustment in the Treasury bill yields, subsequently.

The growth of broad money supply (M_{2b}), which accelerated notably in early 2022, amidst the substantial expansion of credit to the public sector and the revaluation effects of foreign currency denominated domestic credit, decelerated thereafter, largely on account of the contraction of credit to the private sector. By end 2022, the year-on-year growth of M_{2b} was recorded at 15.4 per cent, and once adjusted for the impact of the rupee depreciation,[1] the same is estimated to have decelerated to around 7 per cent by end 2022 from 13.2 per cent at end 2021. Although outstanding credit to the private sector by LCBs increased notably, in rupee terms, during early 2022 mainly on account of the revaluation effects of foreign currency denominated loans and advances amidst the substantial depreciation of the rupee, credit extended to the private sector by LCBs continued to contract from mid-2022 in response to the tight monetary conditions and the moderation in economic activity. Accordingly, by end 2022, the year-on-year growth of credit extended to the private sector decelerated to 6.2 per cent (an estimated contraction of 3.3 per cent, year-on-year, after adjusting for the depreciation of the rupee[2]).

1 Under this scenario, the growth of money supply is estimated by valuing all foreign currency denominated balances using the exchange rate that prevailed at end February 2022.

2 Under this scenario, the growth of credit to the private sector is estimated by valuing all foreign currency denominated credit using the exchange rate that prevailed at end February 2022.

Figure 1.11
Credit Granted by Commercial Banks to the Private Sector (a)

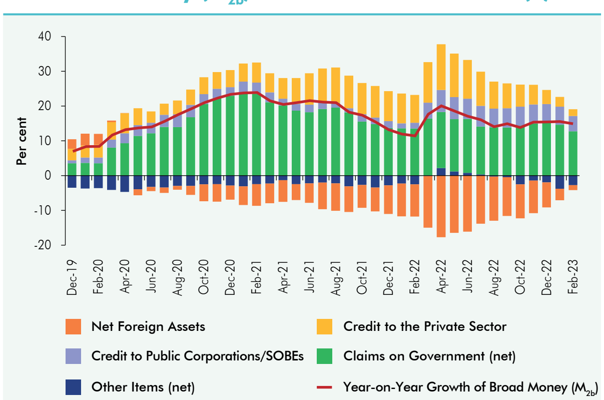


(a) The significant depreciation of the Sri Lanka rupee against the US dollar during March-May 2022 mainly contributed to the notable expansion of monetary and credit aggregates during that period.

Source: Central Bank of Sri Lanka

Nevertheless, reflecting the continued reliance of the Government on domestic financing, particularly on the Central Bank, Net Credit to the Government (NCG) by the banking system expanded notably during 2022 amidst low government revenue and limited access to foreign financing sources. Further to the expansion of Rs. 1,284.4 billion in 2021, NCG by the banking system increased significantly by Rs. 1,638.7 billion during 2022, with NCG by the Central Bank contributing the most towards this expansion. Credit obtained by the SOBEs from the banking system also expanded considerably, reflecting their weak financial performance and the revaluation effects of foreign currency denominated

Figure 1.12
Broad Money (M_{2b}) Growth and Contribution (a)



(a) The significant depreciation of the Sri Lanka rupee against the US dollar during March-May 2022 mainly contributed to the notable expansion of monetary and credit aggregates during that period.

Source: Central Bank of Sri Lanka

debt. Meanwhile, net foreign assets (NFA) of the banking system contracted significantly during 2022, driven by the decline in NFA of the Central Bank as official reserves were utilised for debt repayments in early 2022 and to finance imports of essentials throughout the year, due to the limited availability of foreign exchange liquidity in the market. However, a marginal improvement in NFA of the Central Bank was observed in late 2022. Moreover, NFA of LCBs recorded an improvement in 2022, particularly during the latter part of the year.

Financial Sector Developments

Amidst multifaceted headwinds from the prevailing economic crisis, the stability of the financial system was preserved during 2022. Sovereign rating downgrades, high sovereign exposure of the banking sector, economic contraction, acute foreign exchange shortage and high level of inflation, along with the announcement of the standstill on external debt servicing on account of bilateral and commercial debt by the Government in April 2022 created a significant and unprecedented adverse impact on the activities of the financial sector. Nevertheless, prudent regulatory measures along with regulatory forbearances facilitated the preservation of financial system stability during the year. The stability of the banking sector was maintained during 2022, despite the looming challenges arising from continuously declining credit quality, acute pressure on liquidity, low level of profitability due to high impairments, and deteriorating capital buffers. The Licensed Finance Companies (LFCs) and Specialised Leasing Companies (SLCs) sector managed to continue its expansion during 2022 in terms of assets and deposits with adequate capital and liquidity buffers, amidst challenges stemming from the contraction of credit growth, declining profitability and increase

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in non-performing loans as indicated by Stage 3 loans. Meanwhile, the insurance sector reported a modest growth in terms of the asset base and Gross Written Premium (GWP), with a decline in insurance penetration during 2022. Primary Dealer Companies, Licensed Microfinance Companies, Superannuation Funds and other subsectors demonstrated a mixed performance during the period, mainly owing to headwinds from the economic crisis.

Financial markets also managed to withstand pressures from multiple fronts during 2022 and showed signs of revival from late 2022. Money market liquidity, which remained at a persistently high level of deficit during the first half of 2022, improved considerably by end 2022, mainly due to the measures taken by the Central Bank. Meanwhile, money market activities recorded a lacklustre performance with the continuous reliance of the participatory institutions on the standing facilities provided by the Central Bank to borrow funds or deposit excess funds and increased risk aversion among participants. The measures adopted by the Central Bank to limit the reliance on standing facilities from early 2023 helped activate the interbank call money market and repo market to a large extent. The domestic foreign exchange market experienced strained liquidity conditions with a large depreciation of the exchange rate due to BOP stresses and unfavourable market sentiments during 2022, while improvements were witnessed from early 2023, with measures to remove daily market guidance on the exchange rates and mandatory sales requirements of foreign exchange to the Central Bank, along with the positive market sentiments following the finalisation of the IMF-EFF arrangement. The equity market recorded a dismal performance during 2022, reflecting the high yield for fixed-income securities and negative market sentiments against the backdrop of prevailing adverse macroeconomic conditions. However, the equity market registered net foreign inflows during the year. Financial infrastructure continued to support the functioning of the financial sector under the challenging economic environment.

1.3 Global Economic Environment and Outlook

Global economic activity is estimated to have decelerated sharply in 2022 due to synchronous policy tightening by central banks globally, aimed at containing elevated inflation, stemming from the Russia-Ukraine war and a resurgence of COVID-19 in China. According to the World Economic Outlook (WEO) update of the IMF released in January 2023, global economic growth is forecast at 3.4 per cent in 2022, a significant decline, compared to the 6.2 per cent growth estimated for 2021. Economic conditions deteriorated substantially in advanced economies in 2022 as high inflation eroded household

Table 1.4
Global Economic Developments and Outlook (a)

Item	2021 (b)	2022 (c)	2023 (Proj)	2024 (Proj)
World Output	**6.2**	**3.4**	**2.9**	**3.1**
Advanced Economies	5.4	2.7	1.2	1.4
United States	5.9	2.0	1.4	1.0
Euro Area	5.3	3.5	0.7	1.6
United Kingdom	7.6	4.1	-0.6	0.9
Japan	2.1	1.4	1.8	0.9
Emerging Market and Developing Economies	6.7	3.9	4.0	4.2
Emerging Market and Developing Asia	7.4	4.3	5.3	5.2
China	8.4	3.0	5.2	4.5
India	8.7	6.8	6.1	6.8
World Trade Volume (Goods and Services)	**10.4**	**5.4**	**2.4**	**3.4**
Price Movements				
Consumer Prices				
Advanced Economies	3.1	7.3	4.6	2.6
Emerging Market and Developing Economies	5.9	9.9	8.1	5.5
Commodity Prices				
Oil	65.8	39.8	-16.2	-7.1
Non Fuel	26.4	7.0	-6.3	-0.4

(a) Annual percentage change unless otherwise indicated
(b) Revised
(c) Estimates

Source: World Economic Outlook (January 2023), IMF purchasing power and dented confidence, while rapid monetary policy tightening weighed on demand. The Russia-Ukraine war resulted in severe energy supply disruptions in the euro area, pushing up energy prices and prices of some food items, thereby hampering production and consumption and fuelling uncertainty. Economic activity in China slowed in 2022 amidst large and repeated COVID-19 outbreaks and accompanying lockdowns. Furthermore, activity in emerging market and developing economies decelerated sharply in 2022, due to tight global financial conditions, reduced consumer spending amidst high inflation, dampened external demand, and spillovers from the Russia-Ukraine conflict.

Tightening financial conditions amidst the global fight against inflation and the continuation of the Russia-Ukraine war are expected to impact global economic activity in 2023, while reopening of China is expected to partially offset this impact. As per the WEO update of January 2023, global growth is projected to fall to 2.9 per cent in 2023 and thereafter record an upturn of 3.1 per cent in 2024. Growth in advanced economies is predicted to fall drastically from 2.7 per cent in 2022 to 1.2 per cent in 2023. A majority of advanced economies, including the United States (US), the Eurozone economies and the United Kingdom, are forecast to experience slower growth rates in 2023. However, growth in advanced economies is expected to pick up modestly in 2024, as headwinds due to tighter monetary policy subside and energy markets stabilise. Subdued economic activity in advanced economies could have an impact on Sri Lanka's exports, as low external demand could result in reduced exports of major items, mainly textiles and garments. As the US and the European Union serve as the largest export destinations for Sri Lanka, any reduction in demand from these regions would have a sizeable negative impact on export performance, thereby affecting economic growth. Furthermore, a lower growth in income levels in advanced economies could mean a reduction in global tourist movements originating from such nations. Meanwhile, economic activity in emerging market and developing economies is projected to increase marginally from 3.9 per cent in 2022 to 4.0 per cent in 2023, mainly due to the anticipated growth rates in emerging and developing Asia, particularly in China, and a higher growth rate projected for Russia. However, in around half of emerging market and developing economies, the economic growth in 2023 is projected to be lower than it was in 2022. In addition to tightening financial conditions and geopolitical tensions, emerging market and developing economies contend with diverse headwinds, including spillovers from subdued demand conditions in advanced economies and continued fiscal consolidation measures. The expected pick-up in economic activity in China and the resilience in economic growth in India could be beneficial to Sri Lanka, as Sri Lanka has had longstanding economic linkages with both nations in areas such as tourism and foreign investment, particularly in construction related sectors.

Global inflation is estimated to have peaked in 2022 and projected to be easing in 2023 amidst weakening demand and easing commodity prices. Consumer prices in the world, according to the WEO update of January 2023, rose by 8.8 per cent in 2022, compared to 4.7 per cent in 2021. Soaring inflation in 2022 reflected a combination of demand and supply factors, where on the demand side, the lagged effects of ultra easy monetary and fiscal support following the pandemic contributed to persistent price pressures. With respect to the supply side, shortages of key commodities, exacerbated by the Russia-Ukraine war, along with capacity constraints and supply chain disruptions contributed substantially to higher prices. However, in the light of substantial monetary tightening, slowing activity, easing supply chain disruptions, and moderating prices of energy and other commodities, inflation is projected to decline in the period ahead. Accordingly, global inflation is expected to decline to 6.6 per cent in 2023 and to 4.3 per cent in 2024. Nonetheless, the forecast levels of inflation are still higher than the pre-pandemic levels of around 3.5 per cent. Moderating global energy and other commodity prices would be beneficial for Sri Lanka, as the contribution of these global prices on domestic price increases in 2022 was notably high. If the envisaged moderation in global prices is passed on to domestic prices via timely and transparent adjustments, imported inflation could be kept at a considerably low level, supporting the anticipated disinflation process in the country.

Many central banks around the world started raising their key policy rates during 2022, gradually rolling back pandemic related stimuli, in view of rising inflationary pressures and unfavourable inflation expectations. Inflation has risen faster and more persistently than expected since 2021. In 2022, inflation in advanced economies reached its highest rate since 1982. Rising price pressures have triggered synchronised monetary policy tightening across advanced economies and most emerging market and developing economies. The Federal Reserve of the US, which had held the federal funds rate at around zero during the COVID-19 pandemic, raised the federal funds target rate significantly by 425 basis points in 2022, followed by a 50 basis point increase thus far in 2023. In addition, the Federal Reserve continued to reduce its holdings of Treasury securities, agency debt, and agency mortgage-backed securities in a move to unwind the accommodative financial conditions created in response to the pandemic. Similarly, the Bank of England (BoE) has increased the bank rate by a total of 325 basis points in 2022 and by 75 basis points so far in 2023, recording the highest level since late 2008, despite projecting weak economic growth. The European Central Bank (ECB) also implemented a steady increase in its policy interest rates from a level of zero in 2022 to 3.5 per cent by March 2023. Further, the ECB announced a reduction in its holdings of securities under the Eurosystem's asset purchase programme. Further, major advanced economies provided forward guidance on the anticipated path and the continuing tighter monetary conditions in 2023 and most of 2024. Real economic activity and financial markets have responded to the tightening of monetary conditions as the interest rates have risen across the yield curve in many countries, while the momentum in labour markets has been slowing and the housing markets are showing signs of cooling. However, tighter monetary policy in advanced economies could weigh on capital flows to emerging market and developing economies, including Sri Lanka. Meanwhile, central banks in most emerging market and developing economies also adopted restrictive policies in 2022 to fight against rising inflationary pressures. Accordingly, the Reserve Bank of India (RBI), the Bank Negara Malaysia (BNM), the Bank of Thailand (BoT), the Bangko Sentral ng Pilipinas (BSP), and Bank Indonesia (BI), among others, increased their benchmark policy interest rates in 2022, as well as in early 2023, to control inflation. In contrast, the People's Bank of China (PBoC) continued to relax monetary policy in 2022 in an attempt to revive the economy affected by extended COVID-19 lockdowns and issues in the real estate sector.

Amidst heightened interest rates, particularly the high yields on government securities, the banking sector in advanced economies showed signs of financial distress. In March 2023, the Silicon Valley Bank (SVB) in the US collapsed, recording the second largest bank failure in the US history and the biggest bank failure since the global financial crisis in 2008. As the Federal Reserve raised interest rates sharply in 2022 to curb rising inflation, the market value of the US Treasury securities declined substantially. Since many banks had investments in the US Treasury securities, the decline in market value caused losses in their investment portfolio, depleting capital reserves and weakening their balance sheets. The lending portfolio of SVB was heavily biased towards Fintech companies and startups, thus raising its concentrated risk. Several other US banks, including First Republic, which was rescued by a collective of large US banks, also witnessed financial distress due to the same phenomenon. In addition, Silvergate Bank of the US also failed in March 2023, on account of its increased exposure to cryptocurrency related firms, while the operations of Signature Bank in the US have been suspended by the regulators for the same reason. In response to these failures, the Federal Reserve of the US and the US government agencies announced a series of measures to ensure the availability of liquidity to banks in financial distress and to honour deposits of failed banks. Apart from the US banking sector, Credit Suisse (CS), a global investment bank and financial services firm based in Switzerland, showed signs of financial distress in March 2023. However, its collapse was averted by an emergency loan facility provided by the Swiss National Bank to shore up finances. CS was later taken over by UBS, the largest banking institution in Switzerland, a deal which was fast tracked by the Swiss National Bank and the Swiss government. Moreover, the ongoing banking crisis has triggered market panic in advanced economies and resulted in significant losses in the share values of the US and European banking sectors. Meanwhile, the US Federal Reserve, the Bank of Canada, BoE, the Bank of Japan, ECB, and the Swiss National Bank announced a collaborative action later in March 2023, to enhance the provision of liquidity via the standing US dollar liquidity swap line arrangements to stem liquidity concerns in the global financial system and ensure smooth cross border settlements. Nonetheless, the current distress in global banking institutions and the consequent contagion effects could become a source of significant downside risk to the economic outlook, and its spillovers could also impact the emerging market and developing economies. Moreover, this financial turmoil could lead to a deviation from anticipated tighter financial conditions globally, as this could make major central banks to rethink their policy direction or the pace of any future policy rate adjustments. Meanwhile, large scale liquidity provision to address financial distress could resume demand pressures going forward, threatening largely believed disinflation trends across the world.

Risks to the global economic outlook, on an aggregate basis, indicate possible lower than expected global growth and higher than expected inflation. On the upside, pent-up demand, supported by the stock of surplus private savings, particularly from the pandemic related fiscal aid, as well as extremely tight labour markets and strong wage growth, leaves scope for an increase in consumption. Furthermore, faster disinflation on account of an easing in labour market conditions in advanced economies, cooling wage inflation, and a sharp decline in the prices of goods is another possible favourable outcome. However, many downside risks could affect the global outlook in 2023. A slow recovery in China amidst the prolonged effects of the COVID-19 pandemic and the deepening real estate crisis could have spillovers to the rest of the world in terms of lower demand and supply chain issues. The Russia-Ukraine crisis remains a major source of risk, particularly for Europe and lower-income

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nations, as a further escalation in the war could lead to a possible spike in energy and food prices. An increasing number of countries are currently either in debt distress or at high risk of such distress. This, together with lower growth and higher borrowing costs, could aggravate the vulnerabilities of these economies, affecting the global outlook. Meanwhile, due to the persistent tightness of the job market and higher than predicted prices for food and energy as a result of the war in Ukraine or a speedier rebound in China's economy, inflation could once again soar and persist at elevated levels, de-anchoring inflation expectations. Furthermore, any premature easing of financial conditions and the associated increase in financial market volatility and geopolitical fragmentation remain other downside risks to the global outlook. In addition, the ongoing distress in the global banking system and the possible spillover effects could become a major source of downside risks to the global growth outlook and financial conditions.

1.4 Macroeconomic Outlook[3]

The medium term outlook of the Sri Lankan economy depends heavily on the timely and effective fulfilment of performance criteria and structural benchmarks and reforms envisaged in the macroeconomic adjustment programme outlined in the IMF-EFF arrangement. Effective implementation of reforms in a timely and consistent manner would be essential to create a conducive business environment in the period ahead. Further, the realisation of the baseline scenario of the macroeconomic outlook could be subject to unanticipated external and domestic shocks. The medium term macroeconomic outlook that has been published by the Central Bank in the past had assumed the implementation of necessary reforms to remedy the structural impediments. However, the failure in implementing the required reforms delayed the realisation of the benign macroeconomic outlook envisaged in the past. As Sri Lanka has reached crossroads in its post-independence economic journey, there is some reasonable expectation at present that policy commitment to implementing long overdue reforms and public support for such decisive reforms will prevail in the ensuing period. Nevertheless, the envisaged medium term path is fraught with uncertainties due to possible risks associated with the timing of completion of the ongoing debt restructuring negotiations, the pace and magnitude of the post-restructuring economic recovery, the successful completion of the IMF-EFF supported programme targets, etc. The progress of the reforms implemented thus far is notable. The resolve of policymakers to continue the reforms agenda in the period ahead, and the understanding of the public of the need to pursue painful reforms are imperative to ensure a sustained stability in the medium to long term.

The Sri Lankan economy is poised to recover gradually from its deepest economic contraction witnessed in 2022. This recovery would be buoyed by the macroeconomic adjustment programme under the IMF-EFF arrangement, which is aimed at restoring macroeconomic stability, debt sustainability, safeguarding financial system stability, strengthening governance and unlocking the growth potentials of the economy, while also alleviating the adverse impact of the economic crisis on the poor and vulnerable segments of the population. Meanwhile, the frontloaded stabilisation measures adopted by the Government and the Central Bank helped contain demand pressures, and rein in spiralling inflation and exchange rate depreciation, thereby forestalling further

3 The Medium term macroeconomic framework presented in this section is based on the policy scenario with the assumption of successful continuation of the IMF-EFF supported programme, including the completion of the debt restructuring process before end of September 2023, thereby unlocking further assistance from international financial institutions. It is pertinent to mention that there could be differences in the medium term macroeconomic projections published by the international financial institutions for Sri Lanka based on information available at different timelines and underlying assumptions.

Table 1.5
Medium Term Macroeconomic Framework (a)

Indicator	Unit	2021 (b)	2022 (c)	2023	2024	2025	2026	2027
Real Sector (d)								
Real GDP Growth	%	3.5 (c)	-7.8	-2.0	3.3	4.0	4.5	5.0
GDP at Current Market Price	Rs. tn	17.6 (c)	24.1	28.5	31.0	33.8	37.1	40.9
Per Capita GDP	US$	3,997 (c)	3,474	3,489	3,621	3,811	4,030	4,281
Total Investment	% of GDP	36.7 (c)	34.4	34.9	35.4	35.9	36.4	36.9
Domestic Savings	% of GDP	29.4 (c)	30.8	30.9	30.8	32.0	33.0	33.8
National Savings	% of GDP	33.0 (c)	33.1	33.8	34.1	34.6	35.3	36.0
External Sector (d)								
Trade Gap	% of GDP	-9.2	-6.7	-6.9	-7.4	-6.7	-6.1	-5.9
Exports	US$ bn	12.5	13.1	14.1	15.5	17.1	18.8	20.2
Imports	US$ bn	20.6	18.3	19.4	21.6	22.9	24.4	26.0
Current Account Balance	% of GDP	-3.7	-1.9	-1.1	-1.3	-1.2	-1.1	-0.9
External Official Reserves	Months of Imports	1.8	1.2	3.0	3.4	3.8	4.2	4.5
Fiscal Sector (d)(e)								
Total Revenue and Grants	% of GDP	8.3	8.3	11.0	13.3	14.9	15.0	15.1
Expenditure and Net Lending	% of GDP	20.0	18.5	19.0	19.7	19.9	19.9	19.6
Current Account Balance	% of GDP	-7.3	-6.4	-4.5	-2.1	-0.7	-0.4	0.0
Primary Balance	% of GDP	-5.7	-3.7	-0.7	0.8	2.3	2.3	2.3
Overall Budget Deficit	% of GDP	-11.7	-10.2	-8.0	-6.4	-5.0	-4.8	-4.5
Central Government Debt	% of GDP	100.1	113.8	100.0	101.6	103.3	102.2	97.6
Monetary Sector and Inflation								
Broad Money Growth (M_{2b}) (f)	%	13.2	15.4	10.5	10.9	10.8	10.7	10.2
Private Sector Credit Growth (in M_{2b}) (f)	%	13.1	6.2	0.9	8.5	9.5	10.5	10.5
Annual Average Inflation	%	6.0 (g)	46.4(g)	20.6(h)	5.0 (h)	5.0 (h)	5.0 (h)	5.0(h)

(a) Based on information available up to end March 2023.
(b) Revised
(c) Provisional
(d) GDP estimates (base year 2015) released in March 2023 by the Department of Census and Statistics have been used.
(e) IMF projections (Restructuring Scenario)
(f) Year-on-year growth based on end year values
(g) Based on the CCPI (2013=100)
(h) Based on the CCPI (2021=100)

Sources: Department of Census and Statistics
Ministry of Finance, Economic Stabilisation and National Policies
Central Bank of Sri Lanka

deterioration of the economy. These improvements, coupled with the domestic supply side developments and easing foreign exchange liquidity pressures, are expected to provide a strong impetus for the near term recovery in economic activity. However, the tightened monetary and fiscal policies and the BOP constraints could slow the pace of recovery in 2023. The economy is likely to face global headwinds, stemming from broad-based slowdown in global economic growth in 2023 and burgeoning financial market distress, which could impede the country's trade potential and discourage prospective foreign exchange inflows and foreign investment. Nevertheless, the improved sentiments following the approval of the IMF-EFF arrangement in March 2023 and the ongoing debt restructuring efforts, and the resultant stabilisation of macroeconomic conditions, are expected to support the recovery in momentum from late 2023. The growth trajectory on an elevated potential in the medium term is expected to be contoured by instituting the planned growth enhancement strategies stipulated under the IMF-EFF arrangement. Moreover, the implementation of targeted revenue-based fiscal consolidation strategy coupled with the institutional reforms of SOBEs and execution of cost recovery pricing mechanisms for provisioning of public utilities are expected to foster fiscal consolidation and bolster economic stability in the period ahead. Further, restoration of debt sustainability through a comprehensive debt restructuring process is expected to create space for foreign financing opportunities once sovereign ratings are improved, while the substantial financing support expected from the international financial institutions will help strengthen investor confidence in the period ahead. The projected stabilisation of inflation is likely to create a conducive environment for investments

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over the medium term, while greater flexibility in the exchange rate is also expected to spur stability in the external sector and trade competitiveness of the economy in the ensuing period. However, lower than expected external demand and the continuation of global supply chain issues could pose a risk of delayed normalisation of economic activities in Sri Lanka. Strengthening social safety nets, by improving efficiency and adequate budgetary allocations, is expected to build resilience and enable individuals to seize opportunities for economic empowerment and sustainable development, promoting inclusive growth in the medium term. While the recovery and growth of the economy are contingent upon the resolute commitment of the policymakers spearheading the Government to institute long overdue structural reforms, policy continuity and certainty remain critical to pave the way for harnessing the economy's potential and facilitating the sustainable and equitable distribution of benefits of growth across all segments of the population.

Inflation is expected to stabilise at the targeted levels over the medium term, following the rapid disinflation in 2023, supported by subdued aggregate demand, owing to tight monetary and fiscal policies, abating supply disruptions both globally and domestically, along with the favourable statistical base effect. Large monetary tightening, implemented by the Central Bank, would contain the growth of credit to the private sector, thereby restraining demand pressures, while the substantial revenue-based fiscal consolidation measures undertaken by the Government may lead to a considerable reduction of the spending power of the public in the near future. Meanwhile, the improved availability of fertiliser and fuel would contribute to easing supply-related constraints. The strengthening of the Sri Lanka rupee, if persists, could also contribute to lower price pressures in the near term. These factors, together with the favourable statistical base effect, are expected to contribute to lowering inflation significantly over the short term. Although the second round impacts of the recent electricity tariff revisions could affect the disinflation process, the low spending power of the public and the formula-based downward revision of fuel and gas prices could work to offset such inflationary pressures to a large extent. With the support of funding from the IMF and other multilateral agencies, along with the successful implementation of the debt restructuring process, the country would be able to gradually relax the prevailing import restrictions prioritising essential needs, thereby further easing supply bottlenecks. However, possible depreciation pressure on the exchange rate after such relaxation may need to be carefully managed as it could affect the general price level swiftly. Meanwhile, the expected enactment of the proposed Central Bank Act would allow more independence to the Central Bank, limiting monetary financing, and thereby strengthening policies targeted at managing inflation and inflation expectations. The global supply conditions are also anticipated to normalise over the medium term, though the direction and the impact of the recent financial turmoil and the ongoing Russia-Ukraine war remain largely uncertain. Any possible increase in global food and energy prices has the possibility of slowing down the disinflation process in Sri Lanka. Most major central banks in the world are expected to maintain tight monetary conditions throughout 2023 and possibly in early 2024 to arrest inflationary pressures, although the volatilities in global financial conditions could affect the conduct of global monetary policy to some extent. The Central Bank remains committed to bringing down the prevailing high inflation towards single digit levels by late 2023. However, the successful continuation of the IMF-EFF supported programme, along with efforts to sustainably strengthen the fiscal and external buffers, and the implementation of the proposed structural reforms to improve the economic potential, remain instrumental to ensuring economic and price stability over the medium term.

Monetary policy will remain focused on ensuring price stability over the medium term, while giving due regard to stabilising economic growth towards its potential, under a flexible inflation targeting (FIT) policy framework. Yields on government securities, particularly Treasury bills, and the market interest rates applicable on both deposit and lending products are expected to moderate in the period ahead, supported by the favourable inflation outlook, improving domestic money market liquidity conditions and the reduction in the risk premia attached to government securities, as the uncertainty on the domestic debt restructuring concerns has been largely cleared after the public announcement on 30 March 2023 on domestic debt optimisation, pending the announcement on the overall debt restructuring strategy of the Government in the near term. Nonetheless, monetary conditions would remain reasonably tight until inflationary pressures are sufficiently and credibly contained, and inflation expectations are anchored in line with the inflation objective of the Central Bank. With deposit interest rates reducing from their peak levels, the growth of deposits mobilised by the banking sector is expected to remain subdued in the period ahead. Meanwhile, relatively high market lending interest rates are expected to contain the growth of credit to the private sector, resulting in a contraction in its overall stock in the near term. However, with the expected normalisation of interest rates, the gradual recovery in economic activity and the improvements in business sentiments, credit to the private sector is envisaged to expand from late 2023. Meanwhile, the envisaged fiscal reforms and the anticipated receipt of foreign financing by the Government are expected to reduce the Government's reliance on financing from the banking sector, especially monetary financing in the period ahead. In addition, the planned structural reforms in SOBEs, along with the productivity improvements, are expected to gradually reduce their reliance on the Government's budget as well as the banking sector. Accordingly, the expansion of net domestic assets (NDA) of the banking system is expected to be benign in the period ahead. Driven by the efforts of the Central Bank to gradually rebuild its external reserves and enhancements of external asset positions of LCBs (net of liabilities), the NFA position of the banking system is expected to improve in the forthcoming period. Going forward, the conduct of monetary policy will continue to be based on a forward-looking and data-driven approach, supported by recent and expected macroeconomic developments and projections, both domestic and global. Timely adjustments to policies and strategies of the Central Bank will be made under the FIT framework, as and when new information becomes available. Restoration of price stability and maintenance of inflation at a low and stable level thereafter would eliminate large volatilities of interest rates, thus creating an enabling environment for business planning and investments to support economic growth. With the expected enactment of the Central Bank Act, the independence and accountability of the Central Bank will be further strengthened, thereby reinforcing its prime objective of ensuring price stability. Meanwhile, the Central Bank will continue to engage with the public via effective and transparent communication on current economic conditions and the outlook. The Central Bank will also start publishing a forward looking Monetary Policy Report to better inform the public on the outlook of the economy, thereby further improving the transparency on monetary policy actions.

The external sector outlook for 2023 and beyond will largely depend on the progress of debt restructuring, continuation of the IMF-EFF supported programme, and global economic and financial outlook. The trade deficit is likely to

BOX 3

Highlights of 'the Central Bank of Sri Lanka Act'

Background

The Monetary Law Act (MLA), No. 58 of 1949 established the Central Bank of Ceylon in 1950 (it was renamed the Central Bank of Sri Lanka in 1985) with multiple objectives focusing on both stabilisation and development. The MLA was drafted based on the recommendations of the *Exter Report*.[1] However, considering the difficulties in achieving inconsistent multiple objectives and in keeping with the trends in central banking, the Central Bank embarked on a modernisation programme in the early 2000s. Accordingly, the objectives were streamlined to two core objectives, namely, the maintenance of economic and price stability and financial system stability.

The Need for a New Central Bank Act

The MLA has not been comprehensively reviewed and revised in the past 74 years, except for the amendment in 2002 mentioned above, which mainly streamlined the objectives of the Central Bank. Hence, several provisions of the MLA, amidst economic developments and the evolution of central banking in general, necessitated reassessment and amendments in line with the international best practices. This paved the way for the Central Bank of Sri Lanka Act (CBA) to be drafted to include provisions strengthening the Central Bank independence, enhancing transparency and accountability and strengthening the monetary policy framework to ensure sustained price stability in Sri Lanka. Meanwhile, the CBA is also expected to strengthen the financial sector and macroprudential oversight and improve the governance of the Central Bank. The amendments to the MLA and subsequent CBA are expected to be in line with international best practices in central banking and address shortcomings of the MLA as well.

1 The *Exter Report* was prepared by John Exter, an eminent economist from the Federal Reserve System – USA and the first Governor of the Central Bank of Ceylon. The report can be accessed on https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/about/Exter%20Report%20-%20CBSL.pdf

Key Highlights of the Central Bank Act

The CBA bears several important amendments compared to the MLA, in several areas, mainly the objectives of the Central Bank and monetary policy framework, its governance and organisational structure recognising the Central Bank as the macroprudential authority, and the Central Bank's accountability to the Parliament, the Government, and the public.

Domestic Price Stability as the Primary Objective

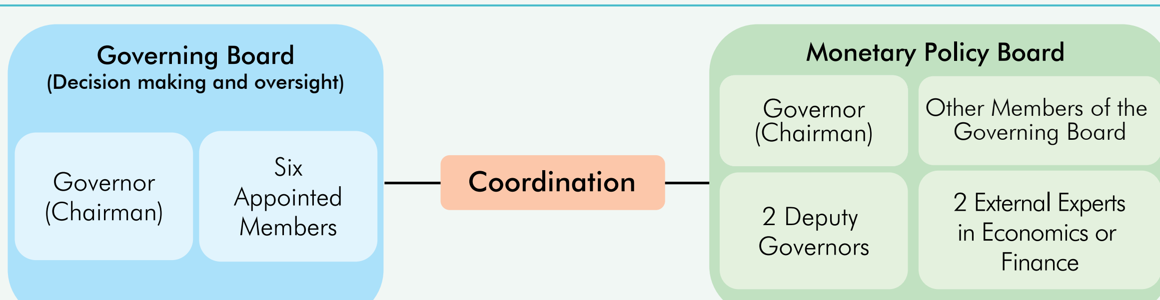
As opposed to the two equally weighted objectives mentioned in the MLA, the CBA gives prominence to achieving and maintaining domestic price stability. This ensures that the Central Bank will be committed to delivering low and stable inflation in the future. Experiences have shown that the economy performs well when inflation is low and is expected to be low. Low and stable inflation helps to keep stable levels of interest rates. Such an environment allows an economy to achieve its growth potential. Further, in pursuing the primary objective, the Central Bank shall take into account the stabilisation of output towards its potential level. These arrangements are in accordance with the Flexible Inflation Targeting (FIT) framework that aims at stabilising inflation around the inflation target while minimising disturbance to the real economy. Further, on a rare occasion where the attention of both price stability and financial system stability is required, and the policy decision concerning either side is subject to a tradeoff, the Central Bank is expected to prioritise its primary object of price stability.

Governance Structure

Under the MLA, the Monetary Board is entrusted with making monetary policy decisions along with other policy and operational decisions. However, under the CBA, the powers are vested with two parallel decision making bodies, namely the Governing Board (GB) and the Monetary Policy Board (MPB), where the latter is entrusted with the responsibility of formulating and

Figure B 3.1

Governance and Organisation of the Central Bank Under the CBA



implementing the FIT framework along with the flexible exchange rate regime to achieve domestic price stability, while the former is charged with the responsibility of determining the general policy of the Central Bank other than monetary policy.

As per the CBA, the Secretary to the Treasury (ST) is no longer a member of any of the decision making bodies of the Central Bank. However, in order to ensure greater fiscal-monetary-financial stability policy coordination, a Coordination Council will be instituted and ST will be a member of the Coordination Council. The separation of the MPB from the GB that oversees other functions and formulates financial sector and other policies of the Central Bank, and technical representation of the Board with two internal members (Deputy Governors) and external experts facilitates efficient formulation of monetary policy. It is an accepted international practice to have an MPB with both external and internal members with the required knowledge and expertise on monetary policy formulation. Also, having a dedicated decision making body to achieve the primary objective provides space for the members to get engaged in detailed policy deliberations at early stages, thereby strengthening monetary policy formulation.

Improved Central Bank Autonomy and Accountability

The provisions of the CBA were put forward with the broader view of strengthening the autonomy and accountability of the Central Bank in its policy and operational decision making. The CBA has explicit provisions ensuring administrative and financial autonomy, which would emphasise more operational independence in policymaking at the Central Bank. Further, external influences on the Governor, appointed Members to the GB, MPB, and employees are categorically prohibited under the CBA.

In order to ensure autonomy in monetary policymaking, the CBA ensures no government representation in the Central Bank's decision making bodies in any form. However, the Coordination Council is expected to facilitate information sharing and the exchange of views on events posing significant risks to financial stability or economic activity. Meantime, the Central Bank will remain as the financial advisor, fiscal agent, and banker to the Government. However, the fiscal dominance on monetary policymaking, the major impediment on monetary policy in the past, has been avoided by restricting monetary financing of the fiscal deficit and a check on provisional advances to the Government, which is essential for the success of FIT. Accordingly, the Central Bank is restricted from granting direct or indirect credits to the Government, to any government owned entity, or to any other public entity, not incur costs on behalf of the Government except for expenses related to the Central Bank's functions, and not purchase securities issued by the Government, by any government owned entity, or any other public entity in the primary market.[2] However, the CBA allows the granting of provisional advances to the Government to finance expenditures at the beginning of the year,[3] subject to several restrictions to limit new direct credits to the Government. The outstanding amount of such provisional advances granted shall not exceed ten per cent of the revenue of the first four months of the preceding financial year and will have to be remunerated at market related interest rates.

Meanwhile, providing required independence for operational and financial independence, the CBA ensures a greater accountability of the Central Bank to the Parliament and the public with regard to its policies, outcomes, and failures. Checks and balances, which create a separation of powers and ensure that no authority control too much power, are important to improve independent decision making, ensure accountability, and maintain public confidence. Thus, the CBA includes provisions aiming at improving accountability through statutory public disclosure requirements, periodic submissions of reports to the Parliament and the arrangement that the Governor to be heard by the Parliament or by any of its committees, periodically. In this regard, the Central Bank is expected to submit several reports to the Parliament and public on the implementation of monetary policy and achievement of the Central Bank objects, specifying the reasons for any failures in terms of achieving the Central Bank's objects, recent developments, and outlook of the economy.

FIT as the Monetary Policy Framework

The Central Bank adopted FIT as the monetary policy framework in 2020, after following a hybrid monetary policy framework with features of both monetary targeting and FIT since 2015. However, the MLA did not explicitly recognise FIT as the relevant monetary policy framework in Sri Lanka even though the enabling conditions for successful implementation of FIT were facilitated under the MLA. The CBA provides for formal adoption of FIT with enabling conditions. Under this arrangement, a monetary policy framework agreement, which includes the inflation target and key parameters, is jointly signed by the Central Bank and the Minister of Finance and published in the Gazette within a period of one week from the date of such agreement. According to the monetary policy framework agreement, the MPB is to determine the appropriate monetary policy and monetary policy instruments relating to the implementation of the monetary policy of the Central Bank and have the authority to adjust such instruments for the purpose of implementing the monetary policy. The inflation target and related parameters will be reviewed every three years or in such other intervals under exceptional circumstances. Moreover, if the

2 Temporary relaxation on primary market purchases of government securities by the Central Bank has been allowed within a period of six months from the appointed date of the Act, taking into consideration the current fiscal constraints.

3 A transitional provision is included on the treatment of outstanding credits of the Central Bank to the Government.

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Central Bank fails to meet the inflation target by the margin determined at the time of setting the inflation target, for two consecutive quarters, the MPB should submit a report to the Parliament through the Minister of Finance, which shall also be made available to the public. Meanwhile, under the CBA, the Central Bank shall publish a Monetary Policy Report, once every six months, explaining recent movements in inflation, sources of inflation, and medium term projections for inflation and key risks to such projections.

Supervision and Resolution of Financial Institutions and the Macroprudential Authority

The Central Bank continues to be the key responsible apex financial institution for the regulation, licensing, registration, and supervision of financial institutions as well as the resolutions of financial institutions in order to ensure financial system stability. Moreover, the CBA attributes the macroprudential authority to the Central Bank, with the view to securing the stability of the financial system in line with the macroprudential policy. In this regard, the Central Bank will establish a Financial System Oversight Committee (FSOC), and it is expected to examine the macroprudential policy to mitigate identified buildup of systemic risks affecting the financial system, issue recommendations to relevant public authorities on corrective actions while coordinating the implementation of macroprudential policy.[4]

4 Refer Box 10 for further reference on the role of the Central Bank as the macroprudential authority.

Public Debt Management

As per the CBA, the Central Bank's agency function of public debt management is to be removed from the Central Bank's mandate once the relevant law relating to a public debt management agency or office comes into operation. However, until such date the Central Bank will continue the management of public debt as an agent of the Government.

Summary

Under the CBA, the autonomy of the Central Bank is respected at all times, enabling independent policymaking and implementation by the Central Bank to achieve the mandated objectives of maintaining domestic price stability and securing financial system stability. In the meantime, the CBA endorses more accountability and transparency of the Central Bank making it answerable to the legislature and the public. The primarily mandated objectives of price stability and increased accountability of the Central Bank would protect the country from disruptive effects of high and volatile inflation, and associated sharp movements in interest rates, thus fostering sustainable long term economic growth.

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widen moderately in 2023 with a projected increase in merchandise imports triggered by the gradual normalisation of economic activity and possible relaxation of some trade restrictions going forward. The forecast of the trade deficit for 2023 could also be affected by a possible economic downturn in the United Kingdom, the European Union, and the United States, possibly dampening external demand. In addition, any further escalation of the Russia-Ukraine war could impact global supply chains, thereby increasing import expenditure. The services account surplus is likely to increase in 2023 with the projected increase in earnings from tourism as well as the envisaged improvement in competitiveness of other services exports with the gradual normalisation of domestic economic activity and expected reduction in domestic inflation during the second half of 2023. The primary income account deficit is likely to widen marginally in 2023 due to the possible rise in borrowing costs caused by monetary policy tightening in advanced economies. The secondary income account surplus is expected to widen in 2023 due to the persistently high departures for foreign employment and the expected rise in workers' remittances. The possible expansion in the trade deficit and primary income account deficit would be cushioned by the envisaged improvements in the services and secondary income accounts, resulting in the current account deficit to likely remain at a modest level in 2023. Inflows to the financial account are expected to strengthen in 2023 with the recommencement of certain infrastructure projects, envisaged Foreign Direct Investments (FDIs), and foreign portfolio investment in the CSE and government securities markets along with other foreign financing flows from multilateral and bilateral partners. These inflows are expected to strengthen confidence among foreign investors in the prospects of economic engagement with the Sri Lankan economy in the period ahead. Moreover, the external sector is expected to revert to a sustainable path over the medium term, supported by the envisaged successful progress of the debt restructuring as well as the economic adjustment programme under the IMF-EFF arrangement. The trade deficit is expected to narrow down over the medium term as the growth in exports is expected to outpace the increase in imports. Meanwhile, with the gradual normalisation of the global economy as well as increased mobility of people across the globe, Sri Lanka is likely to benefit from the prospects of its booming tourism industry reaching its potential in the period ahead. This, together with the expected rebound of activities in transport services and high growth in the IT/BPO services subsector, is envisaged to strengthen the surplus in the services account over the medium term. The primary income account deficit is expected to moderate in the period ahead with the expected reduction in interest payments due to the debt restructuring programme. Further, workers' remittances are expected to improve steadily over the medium term with the gradual improvement in departures for foreign employment, increased demand for migrant labour, and continued recovery in the flow of remittances through official channels. Consequently, the external current account deficit is expected to decline gradually to a sustainable low level over the medium term. Moreover, financial flows are expected to strengthen over the medium term with the envisaged non debt creating inflows to the Colombo Port City, Colombo West Container Terminals, and the development of industrial zones, such as the Hambantota Industrial Zone. Inflows to the financial account are expected to be supported by enhanced investor confidence following the successful finalisation of the debt restructuring and the economic adjustment programme supported by the IMF-EFF arrangement. Portfolio investment as well as other foreign financing flows are expected to recover gradually supported by the envisaged improvement in the macroeconomic performance and positive investor sentiments over the medium term. Consequently, the gross official reserves are envisaged to strengthen over the medium term.

The Government is envisaged to continue its commitment towards fiscal consolidation and economic reform programme with the aim of achieving the medium term fiscal targets set out under the IMF-EFF supported programme. The Government has announced an ambitious revenue target exceeding 15 per cent of GDP by 2027 along with the achievement of primary surpluses over the medium to long term. To this end, the Government has already implemented strong revenue enhancement measures by raising the VAT rate, telecommunication levy, and personal and corporate income tax rates, expanding the VAT and personal income tax base, increasing the excise duty on petroleum products, liquor, and tobacco products, and imposing the social security contribution levy, among others. These revenue enhancement measures are expected to yield benefits in the near to medium term by reversing the trend of dismal revenue performance observed in the recent years. However, strengthening the revenue administration measures is crucial to achieve medium term revenue targets of the Government, while providing some relief to taxpayer segments who are already subject to an extremely high tax burden. Meanwhile, the Government has taken steps to rationalise and reduce expenditure, which is imperative to curtail the fiscal deficit. However, prioritisation of capital projects, identification and

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curtailment of unproductive recurrent expenditure, limiting public sector recruitment, improved targeting of social safety nets, and expeditious completion of the debt restructuring process are imperative to contain government expenditure and strengthen fiscal consolidation efforts in the medium term, while minimising any potential negative impact on economic activity. The completion of the ongoing debt restructuring is expected to result in a notable reduction in the Government's debt service burden and limit the annual gross financing needs to below 13 per cent of GDP, on average, during 2027-2032, as envisaged under the IMF-EFF arrangement. Further, foreign currency debt servicing of the central government is expected to be maintained below 4.5 per cent of GDP in any year during 2027-2032, thereby easing debt servicing pressures to a large extent. Moreover, public debt is envisaged to reduce to around 95 per cent of GDP by 2032. The ambitious primary surplus path in the medium term would assist in reducing the debt accumulation over the medium term. At the same time, divestments of non-strategic SOEs and continuation of cost reflective prices for utilities and other SOE reforms are envisaged to improve the efficiency of SOEs and reduce the burden of such entities on the government budget. Moreover, the management of government finances is expected to improve under the IMF-EFF supported programme with the envisaged enactment of the new public financial management legislation, which would further strengthen fiscal rules. With the completion of the proposed debt restructuring and implementation of broad-based economic reforms for efficiency, accountability, and transparency in the public sector, the fiscal sector performance is envisaged to improve sustainably over the medium term, thereby overcoming major impediments to economic growth that impacted the economy over decades.

1.5 Issues and Policies

From being one of the most promising nations in the developing world a few decades ago to one that is struggling to overcome multiple crises in the present day, successive governments have failed to steer the island nation towards sustained socio-economic progress and prosperity. Despite the many initiatives taken since independence, the country has faced difficulties in thriving due to the lack of a robust and consistent national policy framework, resulting in poor macroeconomic performance, sustained twin deficits reflecting legacy issues and slow evolution, adaptability and transformation, thereby losing pace and falling behind peer economies, especially in the most recent decades. Although the end of the three decades long internal conflict provided the country with the opportunity to make a new beginning, the lack of far-sighted policies and dearth of coherence in implementing corrective policy actions and reforms, alongside numerous social, political, and macroeconomic challenges have been impediments to the economy in reaching its potential. To overcome many of these challenges and longstanding issues, policymakers and relevant authorities need to urgently embark on implementing several potentially painful yet essential reforms. Most importantly, a crisis presents several opportunities to bring about change and implement reforms to address structural issues, i.e., an opportunity to 'reset' the economy. While commending several measures that have been recently undertaken to address some of these lasting issues, it is necessary for the Government to remain committed to the structural reform agenda over the medium term and ensure that remaining actions are fulfilled and such actions in the near term are aligned with the medium term agenda, irrespective of political agendas.

Sri Lanka's resolve and commitment to carrying out long overdue reforms would be a major factor in shaping the direction of the economy over the medium to long term. The IMF-EFF arrangement, amounting to approximately US dollars 3 billion, approved in March 2023, along with the envisaged support from other international financial institutions, is expected to provide the policy space needed for the economy to transition out of the unprecedented sovereign debt and BOP crises in the near term. However, the non-recurrence of such crises in the future and the medium to long term sustainability of economic recovery would hinge on the successful implementation of the macroeconomic adjustment programme outlined under the IMF-EFF arrangement that needs to be underpinned by strong political will and commitment. The integral elements of this macroeconomic adjustment programme include, (i) an ambitious fiscal consolidation led primarily by revenue, accompanied by reforms to social safety net, fiscal institutions and SOEs, aimed at restoring fiscal sustainability and strengthening fiscal discipline, (ii) a sovereign debt restructuring strategy aimed at restoring public debt sustainability, (iii) a multi-pronged strategy to restore price stability and rebuild international reserves amidst greater exchange rate flexibility, (iv) policies to safeguard financial stability, (v) focused reforms to address governance and corruption vulnerabilities, (vi) broader structural reforms to unlock Sri Lanka's growth potential. Despite having engaged in sixteen IMF programmes since 1965, Sri Lanka has an unsatisfactory track record on the completion of such programmes and the implementation of reforms, due to abrupt abandoning of the reform agenda. This has resulted in a futile cycle of entry into such programmes during periods of economic hardship and premature exit with short-lived improvements in the economy. Against this backdrop, it is vital that policymakers show increased commitment and discipline in meeting the envisaged time-bound targets during each review under the present IMF-EFF arrangement, while garnering public support for necessary economic adjustments through improved awareness and transparent communication. This will not only give an opportunity to implement long neglected structural reforms but will also put the economy on a strong footing to transition to a sustainable growth path over the medium term, without having to go through extreme volatilities and painful adjustments frequently. Successful implementation of the necessary structural reforms would circumvent the need to repeatedly approach the IMF for emergency funding and prevent the need for debt restructuring. The rapid normalisation of economic conditions from the dire straits in the most part of 2022 is expected to facilitate the implementation of the aforementioned reforms. Notably, unlike previous IMF programmes, many painful reforms have been frontloaded in the current EFF arrangement; hence, it is expected that the continuation of such reforms will be relatively smoother, thereby enabling the economy to be more successful at completing the ongoing programme.

Going forward, Sri Lanka needs to ensure effective prioritisation and utilisation of external financing to maintain external debt sustainability in the post-restructuring period. Sri Lanka had issued a total of US dollars 17.6 billion of ISBs from 2007 onwards and US dollars 17.2 billion of Sri Lanka Development Bonds (SLDBs) from 2001 onwards. The proceeds of ISBs and SLDBs were primarily used for development purposes only in the early issuances, while the proceeds of most of the subsequent issuances were primarily used for budget support or for debt repayments and interest payments on such debt due to the significantly large budget deficits and mounting external debt that escalated the gross financing needs of the Government, compelled further foreign currency borrowings from global markets at commercial rates. Accordingly, it

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is vital that Sri Lanka's debt strategy evolves away from reliance on highly commercial foreign currency debt towards equity based foreign financing, amidst envisaged improvements in international sovereign ratings and country's economic conditions. The foreign financing mix and strategy need to be carefully crafted by identifying purposes for which such funds are used with a view to improving the capacity to generate foreign exchange inflows. For instance, attracting foreign financing into strategically important projects, such as renewable energy, would be vital in addressing energy sector vulnerabilities without imposing excessive strains on the fiscal and external sectors. Moreover, future attempts to resort to any form of debt financing need to be evaluated objectively against costs and benefits and the need for such financing in order to ensure that debt vulnerabilities do not arise in the future.

Successful implementation of the debt restructuring process, in line with the debt sustainability targets outlined under the IMF-EFF arrangement, remains crucial prior to opening the country to global financial and capital markets. Sri Lanka needs to finalise the debt restructuring process expeditiously in line with the debt sustainability targets set out under the IMF-EFF arrangement. Plans are underway to publicly announce Sri Lanka's debt restructuring strategy in the near term following the public announcement on the envisaged treatment of domestic debt in late March 2023, enabling commencement of the debt restructuring process at the earliest. Finalisation of this process is anticipated before September 2023. Even after successful debt restructuring, any improvement to international ratings will be a gradual process and will depend on the success of rebuilding the economy. International experience suggests that after debt restructuring, countries have taken considerable time to improve sovereign ratings and build up confidence prior to attracting foreign financing from bilateral and commercial creditors. Against this backdrop, the country must endeavour to move away from debt financing in the near to medium term and find ways to attract non debt creating funding sources, such as equity financing, primarily through foreign direct investment and public-private partnership arrangements.

Long overdue structural reforms need to be carried out expeditiously to turn around lossmaking SOEs and eliminate the fiscal burden as well as the over-reliance on commercial banks, thereby containing the risks arising from these institutions that hinder the fiscal and macroeconomic, and financial stability. Although SOEs perform key roles in numerous strategic economic sectors, such as electricity, petroleum, water, banking, transportation, and aviation, a significant share of these entities continues to grapple with an array of issues, including operational inefficiencies, poor governance and mismanagement, lack of accountability and transparency, weak market orientation, continuing political interference through high level appointments and excessive workforce. These issues, in turn, have culminated in the weak financial performance of SOEs, thereby resulting in a multifaceted macroeconomic burden to the country through their adverse implications on state owned banks, and more recently on some private banks as well, draining of public finances via capital infusions, mounting contingent liabilities of the Government, and with no satisfactory quality of service to the general public. For instance, credit to public corporations from the banking sector amounted to Rs. 1.7 trillion[4] as at the end of 2022, while the Government was compelled to provide around Rs. 80 billion to the Ceylon Electricity Board (CEB) as equity during 2022 to ease its liquidity stresses. Although SOEs in Sri Lanka are generally established by an Act of Parliament, several SOEs have been

4 Includes outstanding balance of the government guaranteed foreign currency debt of the Ceylon Petroleum Corporation that was absorbed into central government debt w.e.f. December 2022.

incorporated under the Companies Act, potentially allowing them to bypass Parliamentary oversight. In addition, timely preparation of financial accounts of the large majority of SOEs and the disclosure of these statements are largely absent, thereby hindering transparency and public scrutiny. Despite the identification of fraud, corruption, mismanagement, and negligence in certain SOEs, such issues have hardly been addressed promptly at respective Board levels or at the Parliamentary committee levels. In addition, successive governments have used SOEs to implement populist policies. For example, utilities and public sector services, including energy, petroleum, water, transportation, etc., have been provided to the general public at below cost recovery prices for a long time. The costs of these untargeted subsidies were borne by the SOEs, resulting in large accumulated losses, which were mostly covered by transfers from the central government budget. Non-cost reflective prices have been the major reason for the bleak financial performance and poor market orientation of the major SOEs in the country. All the aforementioned issues have disincentivised SOEs to operate as profitable commercial ventures, thereby imposing an undue burden on the Government, banks and the public. When borrowings of SOEs were at unsustainably high levels, in the past, the Government has been compelled to step in to relieve such debt burden using its revenue collection. As part of the actions agreed under the IMF-EFF arrangement, the outstanding foreign currency debt of Rs. 884.1 billion of the Ceylon Petroleum Corporation (US dollars 2,434.8 million) was absorbed into central government debt by end 2022. In addition, the outstanding balance of eight loans amounting to Rs. 518.3 billion (US dollars 1,427.3 million), obtained from China's Export-Import (EXIM) Bank and recorded under Sri Lanka Ports Authority, CEB, and Airport and Aviation Services (Pvt) Ltd., were also absorbed into central government debt by end 2022. Against this backdrop, institutional reforms are highly warranted in relation to SOEs to improve their efficiency, financial viability, and accountability. Recognising the need to make SOEs financially viable, the IMF-EFF arrangement prescribed the introduction of cost reflective price revisions of several key utilities. Such pricing mechanisms need to continue with enhanced transparency to ensure that the SOEs are not only generating increased revenues but are also striving to reduce costs, without passing on their inefficiencies by way of higher prices. Further, non-strategic SOBEs should be considered for divestiture or listing in the CSE to reduce the fiscal burden of such entities and ensure improved institutional and commercial efficiency. The institutional transparency and accountability of remaining SOEs should be enhanced through mandatory and regular Parliamentary oversight. The SOEs should be provided with binding institutional goals and targets that are linked to key performance indicators, for which the management of SOEs should be held accountable. The perks and benefits received by the respective Boards, the management and employees of these SOEs should be linked to their performance and achievement of institutional goals. Accordingly, it is vital that the Government remains committed to implementing the SOE reform agenda to ensure that such enterprises emerge as growth facilitators in the economy. Moreover, as already identified by the Government, the energy sector will need drastic reforms through unbundling of generation, transmission, and distribution subsectors to achieve operational efficiency in the electricity sector. It is also necessary for SOEs, such as CEB, to review commercial contracts entered into with private power suppliers ensuring that undue benefits are not passed onto such companies at significant costs to CEB. These institutional reforms of SOEs should be implemented without delay to ensure efficiency and transparency of SOEs, while minimising burden on central government finances.

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Reforms to taxation policies and tax administration and the strengthening of the legal compliance framework are paramount to achieving the revenue targets of the Government, thereby restoring the macroeconomic balance in the period ahead. Recognising the persistently lacklustre revenue performance in Sri Lanka, compared to peer economies, the Government has already adopted several measures to increase tax rates while also expanding the tax base. However, additional reforms, especially in relation to the application of advanced information and communication technology to further enhance government revenue mobilisation on a sustainable basis are essential. The tax system in Sri Lanka has been plagued by inconsistent and *ad hoc* policy changes that are targeted to serve as short term fixes, mainly in light of revenue shortfalls each year. The introduction of retrospective surcharge tax and frequently changing government policy on taxes on business turnover are examples of such inconsistent tax policies. As a result, submitting tax returns and forecasting tax liabilities have become cumbersome for businesses and individuals, in turn discouraging taxpayers from maintaining voluntary tax compliance. A weak tax administration system could serve to mobilise a high tax revenue from easy to tax sectors, whereas the need is to implement an equitable tax system, where the burden of taxes is distributed fairly among the population. Accordingly, the tax policies in the country should be formulated considering the revenue requirements of the Government, development objectives of the country, equity of tax policies, and convenience for both the taxpayer and tax administrator. Meanwhile, tax administration should be strengthened to minimise administration costs, tax avoidance, tax evasion, and various tax frauds. While existing weaknesses in the Revenue Administration and Management Information System (RAMIS) that have resulted in substantial revenue losses to the Government need to be rectified expeditiously, new technologies should be introduced for tax revenue collection of both direct and indirect taxes. For example, the introduction of a real time invoicing system will help prevent frauds related to value added and turnover taxes and provide opportunities to conduct tax audits efficiently. In addition, linking databases of revenue collection agencies, financial institutions, and other property registration institutions would help reduce tax evasion, thereby expanding the taxpayer base. The introduction of cutting edge technologies, such as blockchains, integrated customs management systems, cargo scanners, and trackers have helped many countries to minimise cross border tax evasion. Sri Lanka has a large informal sector, which is hardly captured by the tax net, while many in the formal sector are also evading taxes due to cash transactions since revenue collecting agencies are unable to track income received through cash payments by individuals and businesses. Therefore, revenue collection agencies will be able to track tax evaders as well as those who engage in *benami* transactions by promoting a 'cashless economy'. Meanwhile, the tax collection process is significantly burdened by the current appeal and grievance handling process, which is highly time consuming and prevents revenue collection agencies from achieving their revenue collection targets. There appears to be a large number of unsettled cases in respect of tax avoidance, non-payment of taxes, and extended time periods given for tax evaders. For purposes of transparency, Inland Revenue Department (IRD) should publish the number of pending and settled tax cases on a periodic basis to enable the general public to understand efforts made by the IRD to expedite tax collections. Further, the introduction of an efficient appeal process and expeditious judicial process to resolve tax disputes will drastically cut down tax losses to the Government. Besides, to enhance voluntary compliance, strict penalties should be introduced, while improving services to taxpayers with proper guidance. Recent efforts of the

Government to make the filing of personal income tax returns mandatory and payment of personal income taxes electronically are welcome initiatives to improve the efficiency in tax administration. The Government should increase its efforts to improve tax administration, which, in turn, would enable the Government to expand the tax base and raise government revenue without significantly burdening its existing taxpayers.

Recently introduced painful tax reforms should be complemented with proper expenditure management strategies to ensure a sustained fiscal consolidation in the medium to long run. Although tax reforms are imperative to improve government finances, such measures could even be counterproductive if not accompanied by efficient public expenditure reforms, as additional revenue from taxes could be allocated for inefficient public expenditure programmes due to lack of expenditure curtailment and rationalisation strategies. A large fraction of government expenditure in Sri Lanka remains rigid in nature with a significant share of expenses allocated for salaries and wages, pension and subsidies, and interest payments. However, the implementation of appropriate expenditure management techniques can create leeway for expenditure curtailment. In preparation of the annual budget of the Government, traditional budgeting techniques, such as the incremental budgeting process,[5] need to be replaced by more effective counterparts, i.e., a zero-based budgeting[6] mechanism, which would enable the Government to identify unnecessary and less productive activities and eliminate such expenses, while allocating scarce resources to meet the pressing needs of the economy, thereby paving way for growth and development. While some attempts have already been taken by the Government to implement zero-based budgeting techniques, concerted efforts are needed to effectively adopt and implement this budgeting process, especially by training the staff of spending agencies, who contribute to the preparation of government budgets. Further, in lieu of imposing a blanket approach to the curtailment of expenditure of all spending agencies, measures should be implemented with due consideration to the priority of each economic activity within the development agenda, its resource requirements, and resource availability. A customised and case-by-case assessment is required when implementing expenditure rationalisation in order to ensure that effective spending agencies receive the required resources, while inefficient ones are required to assess their effectiveness and adopt rationalisation measures. Meanwhile, the prioritisation of capital expenditure based on ‘value for money’ and the importance of the projects within the development agenda are key to ensure the effective allocation of funds for capital expenditure projects. Therefore, improved budgeting techniques and rational resource allocation will be pivotal in achieving a primary balance surplus by the Government in the medium term in line with the IMF-EFF programme parameters.

Energy security in the country was challenged by the recent economic crisis, underscoring the need to address inefficiencies in the energy sector. Reflecting the poor resilience of the energy sector to external shocks and limited diversification of energy generation despite the vast potential, provisioning of electricity and other energy services was largely disrupted in 2022, leading to an energy crisis with long power outages and severe fuel shortages, thereby affecting economic activity. Although hydropower remains the most cost effective source of power generation, Sri Lanka’s larger reliance on hydropower generation continues to be a concern in terms of sustainability of electricity

5 In the incremental budgeting process, the previous year’s budget is considered as the base and adjustments are made to this base by adding certain percentages mainly on an arbitrary basis to maintain the current level of operations.

6 Zero-based budgeting is a budgeting technique in which all expenses must be justified for a new period or year starting from zero, versus starting with the previous budget and adjusting it as needed.

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provisioning with its extreme susceptibility to climatic dynamics. Further, the power generation is also heavily exposed to volatilities in global energy prices with its high reliance on imported thermal power sources of coal and petroleum products. Despite the numerous efforts to expand the share of Non-Conventional Renewable Energy (NCRE) for power generation, private investors in the renewable energy sector continued to grapple with numerous challenges, such as difficulties in obtaining approvals from multiple institutions, environment impact concerns as well as the absence of regular revisions in feed in tariff systems, thereby hindering the private sector led expansion in the NCRE sector. In this context, urgent measures are needed to strike a balance between the availability in the energy generation sources and the generation cost of those sources, enabling a choice of an efficient generation mix going forward. In order to expand the share of renewable energy in the generation mix, attracting investments from private and foreign sources for clean energy sources, such as solar, wind, etc., which are abundant in Sri Lanka, remains vital, facilitated by a conducive investment climate with straightforward approaches on regulations and taxation, adequate infrastructure, and good governance, among others. As per the Sustainable Development Goals Investor Map - 2022 of the United National Development Programme, Sri Lanka's renewable energy sector has been recognised as one of the priority sectors with high investment potential, highlighting the need for measures targeted at encouraging investments in the renewable energy sector. In this regard, policymakers should focus on enabling peer-to-peer power purchase agreements and power wheeling facilities for the private sector, which ensure market determined pricing for the renewable energy sector. In the meantime, improving energy infrastructure in the form of developments to the transmission and distribution networks, upgradation and modernisation of power generation facilities, smart grid management, and enhancement of energy storage solutions are needed to reduce energy losses and enhance the reliability of power supply. Meanwhile, energy efficiency in the transport sector must be improved through the introduction of technologies to enhance the fuel efficiency of vehicles, such as hybrid technologies, while exploring alternatives for clean energy sources for the transport sector. Further, a more focused policy approach is essential to improve and expand the public transportation system to reduce energy consumption in the transport sector. Accordingly, public transport modes and road infrastructure should be modified and expanded, aimed at minimising energy wastage with traffic congestion in urban areas. Also, increasing awareness among the public on energy efficiency and conservation measures and implementation of energy efficiency standards and practices in households, businesses, and industries would promote efficient utilisation of energy. In essence, energy security can be achieved by improving the availability of energy supply without disruptions and meeting the rising energy demand at an affordable price for consumers. In this regard, enhancing the resilience of the energy sector to promptly respond to abrupt changes in the supply and demand is required in the near term. Similarly, in the long run, fostering investments to supply energy commensurate with economic developments and environmental needs, is imperative, in addition to concerted efforts of all the stakeholders in the economy.

Institutional and legislative reforms as well as enforcement of rules and regulations are needed to strengthen the oversight of public expenditure management and increase fiscal sector accountability. Although fiscal rules have been enacted in Sri Lanka about a couple of decades ago, they have not been adhered to, resulting in imprudent fiscal management by successive governments. Therefore, legislative reforms are needed to introduce fiscal rules that are binding with realistic targets, while distinctly identifying the responsible authorities to comply with those rules. Under the IMF-EFF supported programme, a new Public Financial Management Act is to be enacted, which will specify the roles and responsibilities of the Ministry of Finance and spending agencies and establish information and accountability requirements. In addition, government entities should be encouraged not only to limit spending within the budget, but also to boost efficiency and effectiveness. Further, performance based accountability and public disclosure should be introduced for government entities and public officials, while audit functions need to be further strengthened to promote transparency, enhance credibility, and support good governance. Further, under the IMF-EFF supported programme, anti-corruption legislation that is harmonised with the United Nations Convention against Corruption (UNCAC) is to be introduced with technical assistance from the IMF. This is particularly pertinent considering that Sri Lanka ranked 101 out of 180 countries in the Corruption Perceptions Index (CPI)[7] – 2022, reflecting a high level of perceived corruption. Strengthening corruption control measures and transparency of procedures can also play a key role in the curtailment of unproductive government expenditure. Hence, in the period ahead, fiscal prudence along with continued commitment to strengthening the oversight of public finances and implementation of corruption control measures will be centric to garnering public support for fiscal consolidation measures and ensuring overall sustainability and discipline of the fiscal sector.

Export sector policies need to focus on improving the sophistication of goods and services to increase domestic value addition and to strengthen export competitiveness. Although Sri Lanka recorded its historically highest export earnings in 2022, such earnings are meagre when compared to those recorded by similar sized economies in the region. Sri Lankan products are losing market shares in global markets due to the stagnant sophistication of products and increasing production costs eroding the country's competitiveness. Producing higher quality products helps compete in global markets by building on existing comparative advantages to boost export revenues and productivity. Export industries need to aim at differentiation, value addition, branding, and increasing the quality of exports, while meeting quantity requirements. Export promotion policies need to focus on exporting improved quality goods with high value addition at lower costs of production, backed by Research and Development (R&D) led innovation over the medium to long term. R&D should be enhanced to identify the innovations in the export sectors and to transition from simple products to complex products. Also, Sri Lanka needs to upgrade its product quality with the objective of tapping into regional and global supply chains and capturing market shares in emerging market economies. In addition, the Government needs to provide incentives to indirect exporters and domestic industries, which can competitively substitute imported raw materials, as input quality has a significant bearing on the quality of the final output. Further, the downward trend observed in agricultural exports in recent years necessitates the importance of improving the quality of agricultural products to be competitive globally. In this regard, policies and measures focusing on promoting the production of export oriented regional speciality agricultural products are needed in order to form a strong quality and brand advantage in the global markets. Methods of farmer societies may be used to improve the ability of R&D and achieve economies of scale through high production at lower costs. Development of a national level agricultural research strategy on improving crop breeds with high yields and better quality with the farmer level engagement would be necessary. The establishment of commercial logistics and warehouse facilities needs to be promoted in the major agricultural regions to reduce post-harvest damage to agricultural products. Further, policies

7 The country with the least level of corruption is ranked at the first place in the CPI.

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should focus on enhancing institutional quality, maintenance of liberal and consistent trade policies, promotion of FDI inflows to the export sector, development of human capital capable of upgrading export quality, and creation of a conducive domestic environment to conduct quality upgrading, while improving access to high end export markets.

The country needs to make sacrificial structural adjustments to move away from heavy import reliance and become more export oriented through a significant reorientation of national trade policy. Sri Lanka is heavily reliant on imports for consumption and investment needs and for inputs needed for the production of key exports and domestic production. Since 2009, the expenditure on imports has nearly doubled. Meanwhile, the composition of the export basket remained the same over decades, limited to traditional agricultural exports and low value added industrial exports, such as garments. The revised National Export Strategy (NES) 2018 – 2022, launched in July 2018, was aimed at transforming Sri Lanka into an export hub driven by innovation and investment. It was expected to improve the business environment for all export sectors through logistics, information and promotion, national quality infrastructure, and innovation and entrepreneurship. The specific mandate of NES was promoting innovation and diversification in six export sectors, including IT/BPO and wellness tourism. Resolving issues in relation to provisioning of labour for export industries, consistency in import policies, clear and transparent tax policies, outreach to foreign governments to attract investment into Sri Lanka, and development of entrepreneurship among the youth remain some of the immediate priorities in the tradable sector. Measures were needed to impose import restrictions and suspensions amidst BOP crises. However, such *ad hoc* measures can be avoided in the future by lessening reliance on imports and promoting industries in the economy. Backward integration of possible intermediate inputs, discouraging clearly identified non-essential consumer goods with domestic substitutions, removing concessions granted on imports, and maintaining a market determined flexible exchange rate remain important elements in this aspect.

Sri Lanka's experience in terms of the magnitude and growth in FDI over the last few decades has been disappointing, despite FDI being identified as the top priority in the country's development strategies by successive governments. Sri Lanka has managed to attract only around US dollars 1.2 billion as FDI, including foreign loans to Direct Investment Enterprises (DIEs), per annum, on average, since 2010, despite offering superabundant tax holidays. Also, the FDI to GDP ratio has remained significantly low, compared to other peer countries. In addition, in the current context of the Sri Lankan economy, there is very little incentive for corporates to shift their bases to Sri Lanka due to the disruptions to economic activities, high corporate income tax rates, high cost of production, including that of labour and utilities, scarcity of skilled labour, unavailability of readily available land, bureaucratic and multiple approval procedures, and perceived corruption. The Government's recent efforts, such as the proposed amalgamation of the Board of Investment (BOI) and Export Development Board (EDB), among others, to streamline the institutional structure applicable to this sector is a welcome move. Yet, it is essential to empower such authorities to attract investments and grant approvals in an efficient manner. In the meantime, close diplomatic collaboration with friendly nations would be instrumental in exploring investment opportunities for financing strategic investment projects, such as projects enhancing energy security, food security, and export oriented industries that have broader spillover effects on the overall economy. The country's investment needs should be clearly identified and promoted among prospective investors and such investment approvals and implementations should be expedited through adoption of one-stop shop approach. An Investor Facilitation Centre (IFC) established under the Board of Investment in October 2022 is a welcome initiative in this regard. The IFC is dedicated to providing an efficient service to investors by streamlining the investment approval process and enhancing interagency coordination for investor facilitation. Exploiting investment based non-liability creating inflows should be one of the key elements of Sri Lanka's economic revival strategy going forward.

Measures to increase tourist arrivals and a proper network to capture tourism earnings are urgently needed at a time when Sri Lanka aggressively promotes tourism. Sri Lanka has been heavily reliant on the tourism sector for foreign exchange earnings and has been using tourism earnings to partly setoff the burden of heavy trade deficit experienced since 2011. The country should attempt to get the maximum benefit from tourism earnings as tourist arrivals are gradually recovering. However, the estimate of foreign exchange earnings from tourism is compiled by the Sri Lanka Tourism Development Authority (SLTDA) based on the average number of guest nights of a tourist and how much a tourist spends on average in Sri Lanka on a day based on data provided by hotels and an exit survey at the airport. The outcome of this exit survey is used to determine the per day spending which, however, is relatively higher than many other popular tourism destinations in the region, questioning its accuracy. Also, the daily spending could vary among different tourist categories, types of accommodation, and nature of the source country, among many other factors. Therefore, an appropriate information network is vital to accurately capture how much is being earned by separate stakeholders of the tourism industry. The Tourism Satellite Account initiative in collaboration with the Department of Census and Statistics and SLTDA under technical guidance from the United Nations may support to develop a better understanding of tourist earnings although it is still being developed in Sri Lanka. Further, as many tourists book their accommodation through websites, such as Airbnb, Agoda, and Booking.com, they would be useful in obtaining information. Meanwhile, a tourism travel app for tourists to book accommodation and obtain tourism related information is being developed by the SLTDA. However, tourists trust bookings made through well known apps, especially when it comes to making payments, protecting individual information, and obtaining loyalty discounts. Therefore, finding methods to ensure that there are corresponding foreign exchange inflows to the country via bookings made through international websites and apps and from informal accommodation providers listed in these websites and apps is necessary, while developing local booking websites and apps. Further, a proper mechanism is needed to obtain foreign exchange earnings records of all parties involved in the tourism industry and enter them into the banking system, while the inclusion of unregistered establishments in the system should be expedited to eliminate the high level of informality in the sector.

Mass migration of professionals and skilled workers is likely to lead to a scarcity of labour in selected industries alongside a substantial drop in productivity, thus affecting the economic growth of the country significantly during the recovery phase and beyond. There has been a mass emigration of qualified personnel, such as doctors, engineers, bankers, and IT professionals, prompted by the worst economic crisis. As per the statistics of the Sri Lanka Bureau of Foreign Employment (SLBFE), the total number of registered departures for foreign employment has increased by more than 37 per cent in 2022 to 311,056, compared to the annual average of 226,510 during 2015-2019,

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while the corresponding increase in professionals migration has been over 87 per cent. In addition to the temporary migration for employment, the permanent human capital flight has been more prominent since 2022, although official statistics on this are limited. Available statistics at SLBFE further reveal that the number of professionals, as a share of total labour migration, has been increasing steadily over the post-war period, recording a year-on-year growth of over 20 per cent on average. This suggests that the phenomenon of brain drain in Sri Lanka may span since much before the current economic crisis. In the current context, falling real wages and the decline in quality of life amidst the economic and financial uncertainties due to the contraction in the economy have prompted Sri Lankans to migrate. The longstanding structural issues of the country, which have severely weakened the institutional infrastructure in the areas of healthcare, law enforcement, government administration, public transport, etc., have also contributed to the deterioration of socio-economic conditions. The large outward migration of workers disrupts business activity and such loss of expertise creates the need to continuously train new employees, which requires substantial time and resources, leading to a loss of capacity and output over the short term. In fact, some studies have quantified the logistical cost of recruiting and training new employees itself to be over 20 per cent of the cost due to the output lost until new employees are trained to an optimal level.[8] The long term impact of large skilled migration could be substantial due to the loss of productivity in the country, especially considering the overall ageing population. Literature also identifies positive spillovers of brain drain, particularly due to improved networks, skill transfer, and remittances.[9] However, in the Sri Lankan context, costs may outweigh such benefits. Most individuals, who migrated over the recent past, have been internationally employable and highly qualified personnel with substantial entrepreneurial capacity, and therefore, in some instances, their migration may result in the relocation or closure of entire businesses, including some export businesses. As a result, the economic cost of such outward migration may far outweigh the loss of direct contribution of respective individuals. In the public sector, the unavailability of professionals can have multifaceted implications in the periods ahead as it adds to the lacuna of skills which can thereby exacerbate the low levels of efficiency in many such institutions. The recent changes introduced in the public sector, such as allowing government employees to obtain no-pay leave to undertake foreign employment, could further exacerbate these issues, though they could vary substantially depending on the institution and level of skills and expertise of the migrants. In addition to the economic cost due to the loss of contribution of these workers, the country also bears significant losses due to inadequate returns on investment made on free provisioning of education and healthcare. Although there are deficiencies in many areas, Sri Lanka is among a small group of countries in the world that provides free education to its citizens until the university level. However, the country has not been able to reap the full benefits of this large investment, for which brain drain is also a major contributing factor. Amid these issues, several short term measures have been adopted by certain sectors to retain their employees, such as pay hikes and other benefits including flexible working conditions, non-cash benefits to reduce the tax burden, inflation linked wages, and US dollar linked wages, among others. Such short term measures to address the prevailing economic crisis could be helpful. However, rectifying longstanding structural weaknesses in the economy which affect the quality of life, including the creation of sustained growth, will be essential to putting an end to the brain drain phenomenon that

8 Oxford Economics, (2014). *The cost of brain drain: understanding the financial impact of staff turnover*, February [Online] (Accessed 22 March 2023).

9 Docquier, F. and Rapoport, H., (2012). Globalization, brain drain, and development. *Journal of Economic Literature*, Vol. 50, No. 3.;
Gibson, J. and McKenzie, D., (2012). The economic consequences of 'brain drain' of the best and brightest: Microeconomic evidence from five countries. *The Economic Journal*, Vol. 122, No. 560.

has accelerated during the last year. Moreover, the Government could explore the possibility of opening up the country for foreign skilled professionals for needy sectors in the near term to support economic activity amidst mass migration. Coupled with such attempts, targeted measures, such as special benefit schemes and research funding to qualified personnel, could motivate migrant professionals to return to the country.

The Micro, Small and Medium scale Enterprises (MSME) sector has been among the most affected sectors in the economy during the recent and ongoing economic crises, stressing the importance of improving the resilience of the sector for overall economic development and welfare. The MSME sector, which is the backbone of the Sri Lankan economy, has endured numerous challenges over the past several years with consecutive adverse events, such as the Easter Sunday attacks in 2019, the COVID-19 pandemic in 2020 and 2021, and the subsequent economic crisis in 2022. Activity of MSMEs that operate in a wide range of segments was critically impacted by reduced demand amidst uncertainties, rising inflation and wages, a depreciated exchange rate, unavailability of raw materials, interruptions to power and other utilities, and heightened financing costs, among others. As a result, national output, employment and livelihoods were severely affected, raising the need for the implementation of urgent remedial measures to support MSMEs through this difficult period. Several measures, such as offering concessions on the loans obtained and the granting of debt moratoria, were provided to the sector to temporarily overcome the cashflow challenges. However, lasting solutions are essential to enhance the capacity and resilience of MSMEs to weather unfavourable financial and economic conditions. Accordingly, the setting up of a Credit Guarantee Institution (CGI), which was identified as an essential requirement to serve the funding considerations of MSMEs, has reached its final stages and the expeditious establishment is expected. Once the CGI is in operation, funding constraints of MSMEs are expected to ease notably going forward, while participating financial institutions will also be encouraged to lend to MSMEs as the associated credit risk will be shared. In addition, banks and other financial institutions are also expected to identify MSMEs as a priority sector in their lending operations, which would avail funding for the sector. In order to support local MSMEs to become large scale enterprises, relevant authorities should make use of existing international relations and take advantage of Free Trade Agreements (FTAs), thereby paving the way for MSMEs to integrate into global value chains as well as trade internationally. Such opportunities would not only help them attain global standards but would also contribute towards enhancing foreign exchange inflows to the country. To support this endeavour, steps should be taken to enhance the financial and technical know-how, while also building skills and capacity to use e-commerce technologies, which open the gateway to the world market. Also, in order to foster growth in the MSME sector, the Government and relevant authorities should create an entrepreneurially enabling environment and ecosystem by way of easing rules, regulations, and bureaucratic red tape. While the above initiatives would assist MSMEs to build resilience, overcome the challenges posed by unfavourable socio-economic developments, and prosper as useful business entities that contribute to the betterment of Sri Lanka, a blanket approach to implementing the same may be suboptimal. Therefore, a mechanism should be in place to identify and recognise affected MSMEs that display potential and contribute positively to the economy, from those that are unviable and less productive, so that support could be targeted to useful MSMEs, as assisting the unviable ones would be unhealthy and costly. Further, it is imperative that insolvency laws are established and further strengthened, particularly in relation to the MSME sector, among others.

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The downward rigidity in domestic prices of imported goods remains a concern in lowering the domestic cost of living, considering the disproportionate increase in prices of imported items in the recent past. Over the past year or so, prices of several food and non-food items, which have closely been driven by prices of petroleum oil, gas, and other imported goods, increased sharply due to immediate and more than complete transmission of price increases of global commodity prices and local currency depreciation. However, the reduction in global prices, reduction in costs of logistics and adjustments in operational costs, and the recent improvement in the exchange rate have not been fully reflected in the imported prices of goods and services even with a reasonable lag. The uncertainty prevailing over the current economic conditions of the country could be a major contributory factor for this apparent downward stickiness of prices, where merchants may be reluctant to adjust prices due to factors such as high costs of old inventories, pre-agreed contracts, limited confidence over policy direction and concerns over the sustainability of positive developments, and partly to offset the revenue losses related to lower demand. Nevertheless, inflated prices of some import related goods and services need to be adjusted downwards along with the return of stability in overall economic conditions if the economy is to derive full benefits of the same. Such adjustments would be beneficial for all parties since the demand conditions would also be normalised with appropriate movements of prices. Meanwhile, the adjustment of energy prices, which is a primary channel through which global price developments are transmitted to the domestic economy, is an essential factor in this regard. Alignment of domestic energy prices with global prices and transparent adjustment to prices, as it happens at present, would help ensure that domestic energy prices remain predictable. This would aid businesses to confidently plan their future costs, leading to stability in overall price levels, thereby reducing the risk of unexpected inflationary pressures, and contributing to managing inflation expectations. Further, producing robust inflation projections is vital to set the inflation targets and support monetary policy decisions under the FIT of the Central Bank. Since these projections are often conditional on global price movements, a proper reflection of global price trends in domestic prices is crucial to limit policy errors. In view of the above, relevant authorities, including the authorities involved with domestic energy price adjustments and other regulatory authorities, such as the Consumer Affairs Authority, among others, are required to be vigilant about imported prices of goods where fair passthrough of downward price adjustments needs to take place. Such passthrough will help reduce the high cost of living with a faster disinflation process as anticipated.

The lingering impacts of the deepened economic crisis on the welfare of the citizens of Sri Lanka have been significant, underscoring the urgent need to reformulate policy strategies to ensure the welfare of the most vulnerable groups. The burden of the economic crisis has fallen disproportionately. Living conditions of the vulnerable population have deteriorated to a greater extent through various channels, including the loss of livelihoods and the acceleration of inflation, among others. The updated national poverty line for Sri Lanka surged to Rs. 13,777 in 2022, registering an annual increase of 74 per cent. This surge implies that the costs of necessities in the form of basic food, clothing, and shelter have risen, resulting in an increase in the minimum monthly expenditure per person. According to the remote household food security survey of the World Food Programme, 85 per cent of the population was estimated to be relying on livelihood based coping strategies, such as borrowing money, reducing spending on education and health, spending savings, or deferring due debt payments. Whilst a larger share of employment is occupied in the informal sector and 14.3 per cent of the population is living below the poverty line, the brunt of the crisis is likely to be devastating and causing broad based driving of people into poverty. Also, the current crisis widens the socio-economic inequalities among population groups, spurring generational poverty. This is because as households become poorer, lower wealth accumulation negatively affects the education and healthcare that these households avail which in turn affects their future income generating capacity, thereby creating a vicious cycle. In this context, although the Government has taken several measures to safeguard vulnerable communities in the population and to avoid further worsening of poverty levels by increasing subsidy levels under the prevailing social safety net programmes and providing cash and in-kind grants with the support of international financing agencies, among others, the efficiency of such programmes has been challenged due to their weak targeting. While vulnerable communities as well as groups on the edge of poverty in the country, continued to grapple with income losses since the onset of the pandemic, the delay in recognising new poverty pockets in the population, who are desperate in need of government assistance, due to the absence of a reliable updated database, have resulted in inefficient allocation of limited fiscal funds and foreign assistance. Therefore, it is vital to expedite the measures that have already been implemented under the Welfare Benefit Board to develop a registry of needy people without further delay to ensure that assistance reaches the intended beneficiaries in time. Meanwhile, with the completion of reforms in relation to Social Safety Nets (SSN) under the IMF-EFF arrangement, including operationalising of the Welfare Benefit Board, developing eligibility criteria along with the ongoing efforts to develop a social registry as well as the introduction of new welfare benefit payment scheme are expected to support vulnerable people from the impact of the economic crisis and policy adjustments. Under this, the Government's commitment to operationalising reforms, such as obtaining Parliamentary approval for the welfare benefits payment system and eligibility criteria by May 2023 and its plan to expand spending floor on SSN would be vital in alleviating poverty on a long term basis. While pursuing these reforms, enforcement of a government led multisectoral policy approach with the collaboration of all the stakeholders of the economy remains important in eradicating poverty, thereby assuring the equitable benefits of future growth prospects to all the segments of the population. Further, the recent initiatives taken by the Government with the collaboration of the Department of Census and Statistics to conduct a household survey on the impact of the economic crisis are commendable in this regard, which is expected to deliver a proper assessment of the vulnerabilities of the families. Such databases and survey findings would enable effectiveness of policy interventions on poverty eradication through the improved quality, adequacy, and timeliness of data, thereby strengthening evidence based informed policy decisions in the future, and improvements to existing social safety net mechanisms also remain important. Under this, the digitalisation of subsidy distribution mechanism, via the introduction of digital banking systems, payment cards as well as digital identity options would support to minimise inefficiencies and possible leakages in welfare payments. Further, in the midst of the Government's expenditure rationalisation drive, a holistic assessment of existing poverty eradication strategies is required to improve the efficacy of expenditure. Such an assessment can help identify areas in which the Government may seek collaborations with the private sector and relevant multilateral organisations. Poverty eradication efforts should also comprise other multisector interventions, such as the promotion of value additions in the agriculture sector, expanding education opportunities for poor and vulnerable groups to ensure future income opportunities, promoting livelihood development programmes along with the improvement of the participation of women in labour markets as well as the adoption of a systematic policy framework for existing safety net programmes alongside the gradual improvements to income levels.

The national policy planning mechanism and holistic implementation need to be strengthened in order to support the country to embark on a strong economic recovery and growth. A major predicament for promoting both domestic and foreign investments in the country is the lack of policy consistency, which is detrimental to economic and financial decision making and planning ahead for businesses. As changes in governments often bring about major policy reversals, policy formulation needs to be completely detached from political cycles to maintain consistency. National planning needs to be focused on productivity improvements across the economy where all resources are optimally utilised. A national plan needs to be formulated by experts, both in the public and private sectors, in each area and be consented to by the Parliament before adoption. It is also important to develop strategic policy clusters, where there exist synergistic outcomes, e.g., a policy that recognises the synergies in nutrition agriculture and livestock production, land use, and environmental policies with an emphasis on countering the effects of climate change that could ensure optimum long term outcomes in those areas. Also, the export policy should be related to the foreign affairs, investment promotion, industrial and agricultural policies, while the mineral use policy should be related to the industrial policy. Over-reliance on few bilateral partners for exports, investments, workers' remittances, and foreign funding could give rise to vulnerabilities that could have reverberations on foreign policy, national security, and the country's sovereignty at large. An independent policy monitoring mechanism should also be in place, where individuals who fail to implement policies to reach desired outcomes are held accountable.

The reliance of the public sector on the banking system has continued relentlessly over the recent years resulting in the crowding out of private sector investment, increasing inflationary pressures and stresses in the financial system. Poor fiscal performance and the loss of access to external financing amidst sovereign rating downgrades, necessitated the Government to seek funding mainly from the Central Bank and state owned commercial banks to finance its budget deficit and debt servicing since the onset of the pandemic. Meanwhile, the delayed implementation of regular formula based price revisions of fuel and electricity and legacy issues related to inefficiencies and low productivity have made SOBEs financially weak, thus burdening the government coffers as well as the entire banking system. As a result of such sustained financing over the years, the exposure of the banking system to the public sector has increased notably posing risks to the stability of the financial system. Moreover, rising public sector borrowing requirements have also exerted upward pressures on market interest rates, while excessive public sector financing is likely to be inflationary. Sizeable funds obtained by the Government through monetary financing and by SOBEs in the form of borrowings, without any commensurate improvement in productivity and output, will exert upward pressures on prices. This would, therefore, impale the effectiveness of monetary policy, particularly at times when the monetary policy stance is tight. Some of the recent remedial measures outlined previously in this Chapter are likely to reduce the public sector's reliance on the banking system. Meanwhile, further measures could be taken to enhance public sector finances and reduce the need for excessive bank financing. A performance driven public sector would increase productivity and enhance financial feasibility, thereby lessening the need for bank financing. Meanwhile, leveraging on the improved domestic macroeconomic conditions and the country standing, the Government should actively engage in securing low cost funding from other bilateral and multilateral creditors, thereby reducing their dependency on the domestic banking system for funding. Also, SOBEs should seek other sources of financing, perhaps even foreign financing in the form of investment and project based financing, no sooner than when multilateral fundings open up to the Government. Alternatively, the Government could consider transforming loss-making, yet strategic, SOBEs into profit centres through public-private partnership (PPP) arrangements, which would bring in the management expertise of the private sector, thereby enhancing the productivity and profitability of such SOBEs. Further, reducing undue wastage and corruption in the public sector and appointing qualified and capable officials with experience and expertise in those respective fields is necessary. As a result of these measures, the public sector's continued dependency on the domestic banking system would subside, thereby providing greater space and opportunity for such scarce funds in the banking system to be utilised for productive activities of the private sector.

Recent experiences of growing vulnerabilities in the food supply systems in Sri Lanka due to *ad hoc* policy interventions reiterate the need for strong commitment of the Government towards a coordinated and consistent policy approach to resolve issues in the domestic agriculture sector and ensure food security of the country. Despite the continuous support extended by successive governments to the agriculture sector in terms of subsidies, especially the fertiliser subsidy, guaranteed prices, supply of high yielding varieties as well as agriculture extension services in the past several decades with a view to promoting its productivity, the country's agriculture sector productivity remains stagnant and vulnerable to both climatic and manmade shocks. While provisioning of fertiliser subsidies remains a crucial intervention in the agricultural sector, it has become a highly politically sensitive matter in the country, thereby forcing successive governments to continue such policies irrespective of the outcome yielded from such policies. Accordingly, there is a growing need to adopt a sustainable and efficient fertiliser policy to prevent the excessive use of chemical fertiliser and promote organic farming, while reducing the burden on the country's import bill. Yet, the abrupt ban on chemical fertiliser importation in 2021 had devastating impacts on staple food production in the country, almost leading to a food crisis in 2022, which was further exacerbated by limited food imports amidst the dearth of foreign exchange liquidity. Nevertheless, after being in force for six months, the fertiliser ban was revoked in identifying the need for the gradual phasing out of inorganic fertiliser use in agriculture. Although policies on price controls could play a significant role in ensuring that food remains affordable and accessible to everyone, price controls implemented by the Government showed limited success in easing food price pressures in Sri Lanka amidst the food shortages in 2022, reflecting the lack of coordination among stakeholders and absence of resilient buffer stocks to avert price pressures as well as rising cost elements of food supply resulted from the economic crisis. The government paddy purchasing programme, which was carried out during late 2022 to purchase paddy at higher prices to support the farmers, failed to deliver envisaged outcome due to the lack of funds with the Paddy Marketing Board. Further, the ban on use of paddy or rice in animal feed production, which aimed at ensuring the high availability of rice for human consumption, had adverse consequences on the poultry sector with limited availability of imported animal feeds. This may have partially contributed to the exorbitant increase in prices for poultry products, in turn affecting the quality of diets, which is a major aspect of food security in the country. Although the Government introduced maximum prices for poultry products to ensure their affordability to the public, resultant poultry product shortage in the market raised concerns about availability. Drawing attention to lapses of *ad hoc* and fragmented policymaking for the agriculture sector, Sri Lanka's recent experiences show that many of the agricultural policies implemented have been counterproductive. Although Sri Lanka was not fully self sufficient in food, the country was not severely threatened by issues of food security in recent decades, in terms of food availability, affordability, accessibility and stability. Due to successive loss or reduced harvest of paddy and vegetables following *ad hoc* policies adopted during 2021-2022, Sri Lanka experienced a food insecurity situation which is being continued to date at a lower scale. This problem needs to be addressed in consultation with the farmer community and remedied as early as possible given the critical importance of food requirements of the country. The farming community need to be made aware of the proposed policies of the Government and be trained on agricultural adaptations. This alarming status of the agricultural sector demands a holistic and sustainable strategy for the agricultural sector with enhanced coordination among all agriculture related government institutions, private sector stakeholders, and farmers to reorient agricultural sector to effectively facilitate development and ensure food security. Such broad-based policy approach should be targeted at solving deep rooted issues of low agriculture productivity, high post-harvest losses, suboptimal agriculture practices, poor value addition, price distortions, and weak marketability of the agriculture produce, thereby enabling the formation of a sustainable agriculture sector that is capable of generating healthy income levels for the stakeholders in the agriculture value chain, while ensuring food security and efficient ecosystem management of the country.

Expediting the long overdue factor market reforms remains vital in accelerating economic recovery in the aftermath of the crisis and fostering growth over the medium term. Land and labour markets of the country continued to face challenges and limitations with the inflexibility of policies and inadequacy of law enforcement in such areas, which have impeded the country's ability to seize emerging opportunities in the global market and obstructed the smooth inflow of FDIs. In the labour market, existing laws and regulations tend to favour the protection of employees. This could have a negative impact on both utilisation and productivity of the workforce. Meanwhile, public sector employment offers attractive employment benefits with a non-contributory pension scheme, which discourages the movement of labour towards more productive sectors and activities. Further, persistent rigidities in the labour market, such as absence of flexible working hours and compressed work hours, gender barriers, lack of performance based remuneration packages, skill gaps in the labour force, etc., have largely impacted employability and labour productivity in the country during the past several decades. Therefore, urgent action is needed to modernise and liberalise labour market laws and regulations in line with international labour standards, in order to facilitate the revival of the Sri Lankan economy. Within this framework, major policy areas for improving labour market functionality include reducing the cost of severance and making job termination/switching easier, enhancing temporary employment, providing flexibility in minimum and statutory retirement ages, aligning the retirement age with life expectancy, and increasing the employability of females. At the same time, these regulations should encompass emerging areas of employment to match contemporary requirements, while necessary impetus, such as unemployment insurance schemes, flexible working hours, safe public transport, and daycare/childcare, should be encouraged to enhance female labour force participation. Moreover, measures are needed to control excessive human capital flight during the crisis, and a review of existing immigration rules is vital to attract global talent and address skill gaps in the country's labour market. It would also be necessary to focus attention on internal and external labour migration issues impacted by the economic downturn, which may result in unintended disruption to family life and migrant health issues. The land market faces longstanding bottlenecks due to various complexities, including different levels of ownership systems created by numerous land laws, the presence of multiple land law enforcement agencies, differences in rules followed by land management related agencies, issues in land titles, and lengthy and inefficient procedures to obtain approvals for utilisation of land in projects. Streamlining the legal enforcements pertinent to lands may contribute to simplifying the existing complexities of the land market along with the establishment of a centralised agency to consolidate the functions of various institutions under a single entity to streamline the process and improve efficiency in managing unutilised/ unproductively used lands, and lands available for development. Further, a centralised digital database of land information that ensures clear and unambiguous ownership may resolve inefficiencies in the land allocation process by improving access to land data, so as to facilitate investments in the country. In this regard, the Government's initiative to establish an e-land registry is a commendable effort that is expected to ensure convenient, safe, and efficient registration of land, while providing speedy access to land information and related services to necessary parties including government agencies, the private sector, and the general public. Further, the development of a comprehensive land use policy framework and strengthening of the land administration systems are also critical for the effective functioning of the land market in the country. Therefore, expediting the implementation of long overdue structural reforms in the labour and land markets could enhance the allocation and utilisation efficiencies in the factor market, thereby boosting employment, investment, and the overall growth momentum of the economy.

Sri Lanka has great potential to transform its economy towards a digital economy, and rapid adoption of developments on the global digital front remains vital to unlock the gains of the digital age to facilitate the envisaged economic recovery. A digital economy represents a technology driven economic paradigm, where digital technologies are leveraged to improve economic activity, resulting in economy wide efficiencies and growth achieved through increased connectivity and transparency, enhanced convenience for the public, greater efficiency in resource allocation, and real time access to data, enabling evidence based policy responses and speeding up development. The digital economy in Sri Lanka is on a gradual rise, witnessing notable strides in software and IT services, e-government services, and fintech via the development of digital infrastructure, with many global companies setting up operations in the field, creating fresh prospects for innovation and entrepreneurship. Moreover, the COVID-19 pandemic has accelerated the adoption of digital technology and many businesses and individuals turning to online platforms for work and communication. In addition, e-government services have enabled better citizen engagement and increased transparency and accountability, while fintech has offered opportunities for innovative financial services, promoting financial inclusion. Meanwhile, digital inclusion in Sri Lanka witnessed a progressive transformation with various initiatives aimed at providing affordable internet connectivity and digital literacy training to underserved communities across the country. The Government's initiative of the National Digital Transformation Strategy (2021-2024), which is based on the three pillars of Digital Government, Digital Economy, and Digital Services, remains a commendable effort in this regard. Meanwhile, the enactment of the Personal Data Protection Act, No. 9 of 2022 and initiatives taken to establish a Data Protection Authority, as announced in the Budget 2023, are essential ingredients for digital transformation. Although Sri Lanka has made progress in digitalising the economy, the digital transformation of the country is still in its early stage of development, compared to peer economies, as reflected by the Digital Quality of Life (DQL) Index, where Sri Lanka ranked 89th out of 117 countries in 2022 based on various criteria, including internet affordability, internet quality, e-government, e-security, and e-commerce. To gather digitalisation momentum, there are still challenges to be overcome with significant room for improvement in many areas. Accordingly, Sri Lanka must pursue its efforts to invest in digital infrastructure, promote digital literacy and skills development to address the digital divide, and create a supportive regulatory environment that encourages innovation, technology transfer and foreign investment, to fast-track progress. Digitalisation provides an opportunity for Sri Lanka to address structural bottlenecks in its economy, such as poor targeting of people under safety nets, challenges in tax administration and monitoring, inefficiencies in supply channels, barriers to marketing, and coordination and transparency issues within the government sector, while creating numerous prospects for productivity improvement in the human capital of the economy. Further, digitalisation enhances accessibility and facilitates integration into global value chains, ultimately bolstering the country's ability to seize market opportunities and drive economic recovery in the period ahead. Although the Government is driving digital transformation, the private sector bears a significant responsibility in digital development. This includes investments, innovation, technology transfer and human capital development aimed at bridging various levels of the digital divide to promote widespread digital usage within the society, in line with the evolution of technologies. Accordingly, a multifaceted, coordinated, and consistent policy approach, with active collaboration among all stakeholders including the Government, regulators, legal authorities, and the private sector, is crucial in developing secure and reliable digital systems, which are expected to bridge the current digital divide, while simultaneously generating positive spillovers to other clusters of economic activities. It would also be necessary to enact the cyber security law, which would help frame appropriate rules and regulations to safeguard the wider financial system.

Striving towards rising from the economic crisis and strategising for stability and growth are essential, yet due regard to preserving the environment is also vital for ensuring sustainable growth. Longstanding environmental issues, such as deforestation, the human-elephant conflict, illegal mining, unorganised garbage dumping, carbon emissions, and crop losses due to wildlife and weather disruptions, have many socio-economic reverberations. Evidence shows that Sri Lanka has experienced a significant temperature rise, while annual precipitation and consecutive dry days have also increased in the recent decades. Several international studies have also identified Sri Lanka as one of the most vulnerable countries to climate change. The economy has suffered significantly from climate related issues in the past two decades, such as floods, droughts, erratic rainfall patterns, heat waves, landslides, and pest outbreaks. Rising temperatures and ocean acidification affect fish availability, which is an important source of proteins for our citizens, while also earning export incomes. Loss of food supply in turn leads to inflation, low welfare of the rural farmer community, having to expend scarce foreign currency on food importation, and loss of export income from agricultural products. The effects of climate change on energy generation have been severe, considering Sri Lanka's high dependence on hydropower (33.7 per cent in 2022) and recent changes in rain patterns. This issue is severe when global oil prices are high, given Sri Lanka's persistent foreign currency deficiency and energy insecurity. Further, over 2 million metric tonnes of coal are imported for energy generation annually because of the inability to increase the share of fuel oils used to generate electricity due to foreign currency shortages. Adverse climate, natural disasters, and pollution have a negative impact on tourism, which is an industry that Sri Lanka is unfortunately heavily reliant on. The Government and the Central Bank have been taking several initiatives, lately, to support the environmental preservation drive, reduce the adverse impact on the environment from economic activities and direct fund flow to activities that support environmental preservation. The Central Bank worked with the International Finance Corporation of the World Bank to create a Sustainable Finance Roadmap and Taxonomy. A Climate Prosperity Plan was recently launched. Improving the country's economic resilience is also needed to make investments to improve environmental resilience. Comprehensive, centralised periodic reporting about the environment, covering all aspects of the environment, such as climate, atmospheric warming, forest cover, wildlife, mineral resources, pollution, etc., needs to be made available to the public by an identified authority. It can improve awareness among people about environmental concerns, and effectively coordinate policy actions. Foreign investments and grants should be enticed in relation to environmentally friendly projects and environment conservations that would have positive spillovers on several sectors, such as renewable energy, water management, and garbage management, among others. Domestic financial institutions should be encouraged to fund green and blue projects for sustainable and inclusive growth. Showcasing the consciousness of environmental protection would unlock several concessional financing options from multilateral, bilateral, and responsible private sector donors, which would be appealing in the country's current effort to restore debt sustainability. In the long run, innovative steps to increase environmental accountability, such as Green Gross Domestic Product, a GDP calculation that makes adjustments for environmental damage caused, need to be explored.

Sustainable recovery of growth hinges on undertaking much needed reforms expeditiously in key areas of the economy, while benefiting from the ongoing debt restructuring efforts. Evidence on the possible impact of debt restructuring on a country's growth prospects in the post-debt restructuring period is mixed. The process of debt restructuring can be associated with negative economic effects, such as worsening investor and business confidence, lack of access to commercial credit, higher borrowing costs associated with low sovereign rating, and reduced government spending. However, debt restructuring can help to reduce government borrowing in the medium term and increase the availability of credit for private sector investment, which can have a positive growth impact. Economic growth remains a major factor in the post-debt restructuring period as it affects the ability of a country to pay its debt obligations, even after restructuring. When a country fails to revive its economic growth, it may be more difficult for it to meet its debt obligations and to sustain the benefits of debt reprofiling without falling into similar debt unsustainability issues in the post-restructuring period. The economic performance of a country during the post-debt restructuring period could fall below its potential due to several factors: unfavourable economic conditions, which could be due to both external or domestic growth impediments; implementation challenges, where reaching agreements with creditors or successfully implementing the re-profiling could be difficult; insufficient policy measures, in particular, those aimed at supporting growth failing to have the desired impact; and political instability, the possibility of which could be high during a debt crisis, and in turn could undermine investor confidence. There are several examples of countries that have implemented policies to support growth after a sovereign debt restructuring, with varying degrees of success. In Ireland, the Government implemented a range of policy measures to

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support growth after its debt restructuring in 2010, including tax cuts, increased government spending, and structural reforms aimed at improving competitiveness. These measures, along with the recovery in the global economy and the rebound in the technology sector, helped boost demand and support economic growth. Another example is Ecuador that implemented a series of policies aimed at boosting growth, including increased government spending, investment in infrastructure, and targeted social spending programmes. These actions helped stimulate demand and support economic growth after the restructuring, although the country has faced challenges in maintaining fiscal sustainability in recent years. Despite facing a range of economic, political, and social challenges, Sri Lanka has demonstrated a remarkable ability to bounce back and recover from setbacks. This resilience is due in part to the country's strong cultural and social fabric, as well as its highly educated and skilled workforce. Sri Lanka's resilience is a testament to the strength and resilience of its people and institutions and provides a strong foundation for future growth and development after debt restructuring. Yet, several challenges remain in recovering growth expeditiously. Firstly, Sri Lanka is facing its first experience of defaulting on a selected range of debt and engaging in the process of debt restructuring. The lack of experience could be a shortcoming in carefully planning and executing debt restructuring and timely formulating post-restructuring strategies for revival. Moreover, unlike many other countries, Sri Lanka's status is much more complex. Public debt unsustainability and the resulting preemptive default are coupled with many other instabilities and difficulties, including a BOP crisis, escalated inflation, notably weakened currency, social unrest, and political turmoil. The measures already taken and envisaged to address this multifaceted crisis are not aimed at growth promotion, but rather focused on restoring macroeconomic stability. Hence, in parallel to progressing on debt restructuring, it is vital for the Government to devise a growth enhancement vision with the assistance of external and domestic stakeholders. Financing assistance from the IMF and other multilateral agencies would be instrumental in building a strong foundation for regaining confidence in Sri Lanka. Ongoing reforms and restructuring of the state sector and SOEs would help enhance productivity and efficiency in this sector, while also indirectly supporting the private sector. Fighting corruption and improving adherence to law and order are also essential enablers, the demand for which however needs to originate from the wider society, and it would undoubtedly improve the doing business environment and thereby the attractiveness of the country as an investment destination. Formation and consistent execution of national policies across key sectors, such as agriculture, industry, international trade, and investment policies would be growth positive. Debt restructuring would undoubtedly create the much needed space for the Sri Lankan economy to regain stability. However, sustaining this space and reaching its economic potential would be the key to reaping the full benefit of this historic moment.

In this context, while acknowledging the measures already taken to address some of the issues highlighted over the years, concerted efforts should be taken by the Government, relevant authorities, and policymakers to formulate strategies to address and overcome other long-standing structural issues to ensure the economy makes a gradual and sustainable economic recovery. It is imperative that all stakeholders in the economy realise that the IMF-EFF supported programme alone will not be a panacea to the issues that the country is grappling with at this time. Rather, the country needs to make use of this opportunity to rectify and remedy the legacy missteps by implementing the required reforms with the support of all stakeholders, thereby preventing the need for recurring bailout programmes.

Therefore, fervent efforts and perseverance by all stakeholders are required to initiate and institute the necessary fiscal and SOBE reforms, improve the country's growth potential, restore and ensure price and financial stability while rebuilding external buffers, restore public debt sustainability, and most importantly reduce corruption while supporting vulnerable groups through appropriate social safety net schemes. In this process, it is up to all stakeholders, including the public, to remain informed about what is best for the country, and collectively ensure that the aforesaid pillars of reform are not reneged for short term political gains. This would ensure that the economy makes steady progress in the journey towards sustainable growth, while safeguarding the country's macroeconomic stability.