1

ECONOMIC, PRICE AND FINANCIAL SYSTEM STABILITY, OUTLOOK AND POLICIES

1.1 Overview

Following a period of uncertainty, the Sri Lankan economy showed early signs of stabilisation during the year 2016 in response to corrective actions adopted by the government and the Central Bank. Unfavourable weather conditions and sluggish global economic recovery caused the economy to grow at a slower rate of 4.4 per cent in 2016 in real terms, in comparison to 4.8 per cent in the previous year, although a steady acceleration in quarterly growth was observed from the second quarter of the year amidst tightened fiscal and monetary policies. Increased investment expenditure, especially in the construction sector, drove economic growth during the year, while consumption expenditure slowed in response to the policy environment in place. Inflation, which remained low in the first four months of the year, increased thereafter to record an annual average of 4.0 per cent in 2016 (both National Consumer Price Index (NCPI, 2013=100) and Colombo Consumer Price Index (CCPI, 2013=100) based). The high levels of inflation observed during some months in 2016 as well as in the first quarter of 2017 were mainly due to the adverse impact of weather related disruptions, tax adjustments and rising international commodity prices, but the increasing demand pressures of the economy were evident in core inflation remaining at elevated levels. Movements in external sector balances reflected the continued domestic demand for imports from certain sectors of the economy, weak external demand for the limited basket of domestic products, persistent failure of the country to attract increased direct investment flows as well as the impact of rising global interest rates particularly on the government securities market. These developments resulted in the balance of payments (BOP) recording a deficit for the second consecutive year in spite of improvements in earnings from tourism and other service exports as well as workers' remittances. The Central Bank's heavy intervention in the foreign exchange market continued in the first four months of the year resulting in a broadly stable exchange rate during this period. However, the exchange rate was increasingly allowed to reflect market conditions thereafter by limiting Central Bank intervention to dampen the pressure on the exchange rate arising from outflows of foreign investments from the government securities market. Considering

1

the possible rise in demand driven inflationary pressures, the Central Bank continued to tighten monetary policy and monetary conditions throughout the year. Accordingly, in addition to increasing the Statutory Reserve Ratio (SRR) applicable on rupee deposit liabilities of licensed commercial banks (LCBs) in December 2015 to be effective from January 2016 and the continued application of the loan-to-value (LTV) ratio as a selective macroprudential demand management tool, the Central Bank raised its key policy interest rates by a total of 100 basis points in two steps during 2016, the first in February 2016 and the second in July 2016. Open market operations of the Central Bank also guided the short term market interest rates to move to the upper bound of the policy interest rate corridor, resulting in a considerable increase in the market interest rate structure. In response to tightened monetary conditions, the acceleration of broad money growth subsided while the growth of credit extended to the private sector by LCBs that peaked at 28.5 per cent in July 2016, on a year-on-year basis, also decelerated to 21.9 per cent by end 2016. However, the deceleration of monetary and credit expansion was below expectations, and the Central Bank again adjusted its policy interest rates upwards by 25 basis points in March 2017 with the view of signalling to the market the intent of the Central Bank in maintaining inflation in mid single digits in the medium term, within its increasingly forward looking monetary policy framework in which the management of inflation expectations plays a vital role. The financial sector, in the meantime, continued to expand during the year whilst exhibiting resilience amidst challenging market conditions both globally and domestically. Meanwhile, fiscal operations registered a notable improvement in both revenue and expenditure fronts, resulting in the containment of the overall budget deficit at the envisaged level of 5.4 per cent of Gross Domestic Product (GDP). In spite of these achievements, central government debt as a percentage of GDP increased, illustrating the narrowing fiscal manoeuvrability within the overall macroeconomic policy framework and highlighting the necessity of continued efforts to sustain the fiscal consolidation process.

The performance of the Sri Lankan economy in 2016 reconfirmed the necessity of addressing the deep rooted structural issues if the country is to progress steadily towards a higher growth trajectory, as envisaged. While the government's recent efforts, with the support of multilateral agencies including the International Monetary Fund (IMF), to formulate policy frameworks required to address these issues as well as emerging challenges are commendable, it is essential that such policies are implemented swiftly with consistency in order to improve productivity and efficiency of the economy and to attract much needed foreign direct investments (FDIs) and boost investments from the domestic private sector, while seamlessly integrating with the global production networks.

1.2 Macroeconomic Developments, Stability and Policy Responses in 2016

Real Sector Developments and Inflation

In 2016, the Sri Lankan economy grew by 4.4 per cent in real terms, amidst numerous global and domestic challenges. Unfavourable weather conditions that prevailed during the year adversely impacted economic activity, primarily in the Agriculture sector. Services related activities, which constitute 56.5 per cent of real GDP, grew by 4.2 per cent in 2016, on a year-on-year basis, supported by the expansion in financial services (12.4 per cent),

Table 1.1
Macroeconomic Performance (2012-2016)

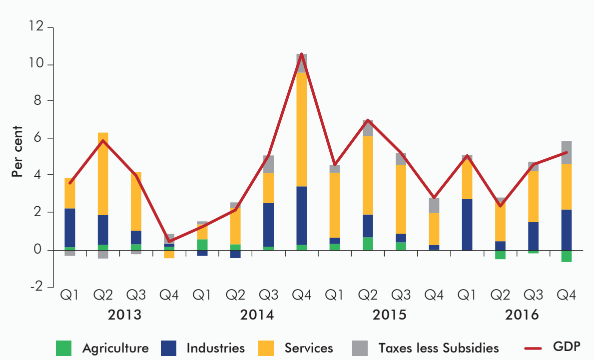
Indicator	Unit	2012	2013	2014	2015 (a)	2016 (b)
Real Sector (c)						
Real GDP Growth	%	9.1	3.4	5.0(a)	4.8(b)	4.4
GDP at Current Market Price	Rs. bn	8,732	9,592	10,361(a)	10,952(b)	11,839
Per Capita GDP (d)	US$	3,351	3,609	3,821(a)	3,843(b)	3,835
External Sector						
Trade Balance (c)	% of GDP	-13.8	-10.2	-10.4	-10.4	-11.2
Current Account Balance (c)	% of GDP	-5.8	-3.4	-2.5	-2.3	-2.4
Overall Balance	US$ mn	151	985	1,369	-1,489	-500
External Official Reserves	US$ mn	7,106	7,495	8,208	7,304	6,019
Fiscal Sector (c)(e)						
Current Account Balance	% of GDP	-0.9	-0.7	-1.2	-2.3	-0.6
Overall Balance	% of GDP	-5.6	-5.4	-5.7	-7.6	-5.4
Central Government Debt	% of GDP	68.7	70.8	71.3	77.6	79.3
Monetary Sector and Inflation						
Broad Money Growth (M_{2b}) (f)	%	17.6	16.7	13.4	17.8	18.4
Private Sector Credit Growth (in M_{2b}) (f)	%	17.6	7.5	8.8	25.1	21.9
Annual Average Inflation (g)	%	7.6	6.9	3.3	2.2	4.0

(a) Revised
(b) Provisional
(c) The data is based on the base year 2010 GDP estimates of the Department of Census and Statistics.
(d) Estimates updated with latest population figures
(e) Based on revised GDP estimates for 2014 and 2015 made available on 15 March 2017 by the Department of Census and Statistics.
(f) Year-on-year growth based on end year values.
(g) Data up to 2014 is based on CCPI (2006/07=100) while data from 2015 onwards is based on CCPI (2013=100)

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

insurance (8.5 per cent), telecommunications (8.3 per cent), as well as transportation (4.1 per cent) and wholesale and retail trade (2.5 per cent). Industry related activities, which account for 26.8 per cent of real GDP, recorded a notable growth of 6.7 per cent, year-on-year, driven by the subsectors of construction, and mining and quarrying, which grew by 14.9 per cent and 14.4 per cent, respectively, jointly contributing 10.0 per cent of GDP. Within the Industry sector, the growth in manufacturing activities was low at 1.7 per cent.

Chart 1.1
Activity-wise Contribution to GDP Growth



Source: Department of Census and Statistics

Agriculture, Forestry and Fishing related activities contracted by 4.2 per cent in 2016, resulting in a reduction in their share in real GDP to 7.1 per cent in 2016. Adverse weather conditions that prevailed in 2016 resulted in a contraction mainly in paddy, tea and rubber subsectors.

As per expenditure approach estimates, economic growth in 2016 was primarily driven by the expansion in investment expenditure during the year. Accordingly, gross domestic capital formation, which represents the level of investment activity of the economy, grew by 19.6 per cent, while accounting for 31.5 per cent of the nominal GDP. Higher investment growth predominantly emanated from the expansion in construction activities during the year. Meanwhile, consumption expenditure, which is the largest expenditure category of the economy, recorded a modest growth of 4.1 per cent in nominal terms, which was a considerable moderation compared to the growth of 10.3 per cent recorded in the previous year. The slowdown in consumption was driven by the moderation in private sector consumption expenditure due to

1

Table 1.2
Aggregate Demand and Savings-Investment Gap at Current Market Prices (a)(b)

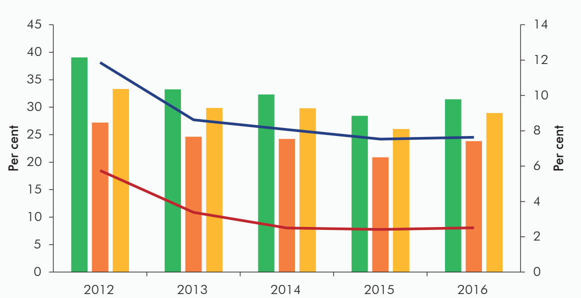
Item	Rs. billion		Growth (%)		As a percentage of GDP	
	2015 (c)	2016	2015 (c)	2016	2015 (c)	2016
1. Domestic Demand	**11,776.6**	**12,742.8**	**5.2**	**8.2**	**107.5**	**107.6**
1.1 Consumption	8,661.9	9,018.9	10.3	4.1	79.1	76.2
Private	7,677.1	8,003.8	10.0	4.3	70.1	67.6
Public	984.8	1,015.1	13.4	3.1	9.0	8.6
1.2 Investment (Gross Domestic Capital Formation)	3,114.7	3,723.9	-7.0	19.6	28.4	31.5
2. Net External Demand	**-824.9**	**-903.8**	**1.4**	**-9.6**	**-7.5**	**-7.6**
Export of Goods and Services	2,301.1	2,538.7	5.3	10.3	21.0	21.4
Import of Goods and Services	3,125.9	3,442.5	3.5	10.1	28.5	29.1
3. Total Demand (GDP) (1+2)	**10,951.7**	**11,839.0**	**5.7**	**8.1**	**100.0**	**100.0**
4. Domestic Savings (3-1.1)	**2,289.8**	**2,820.1**	**-8.8**	**23.2**	**20.9**	**23.8**
Private	2,536.6	2,891.8	-3.9	14.0	23.2	24.4
Public	-246.8	-71.7	-93.3	70.9	-2.3	-0.6
5. Net Primary Income from Rest of the World (d)	**-281.3**	**-332.8**	**-19.2**	**-18.3**	**-2.6**	**-2.8**
6. Net Current Transfers from Rest of the World	**842.1**	**939.8**	**3.6**	**11.6**	**7.7**	**7.9**
7. National Savings (4+5+6)	**2,850.6**	**3,427.1**	**-7.7**	**20.2**	**26.0**	**28.9**
8. Savings Investment Gap						
Domestic Savings-Investment (4-1.2)	-824.9	-903.8			-7.5	-7.6
National Savings-Investment (7-1.2)	-264.1	-296.8			-2.4	-2.5
9. External Current Account Balance (2+5+6) (d)	**-264.1**	**-296.8**			**-2.4**	**-2.5**

(a) The data is based on the base year 2010 GDP estimates of the Department of Census and Statistics.
(b) Provisional
(c) Revised
(d) The difference with the BOP estimates is due to the time lag in compilation.

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

tightened monetary and fiscal policies, while public sector consumption expenditure also moderated in 2016 with ongoing fiscal consolidation efforts. Although domestic demand grew by 8.2 per cent in nominal terms (6.2 per cent in real terms) during the year, net external demand declined by 9.6 per cent in nominal terms (22.5 per cent in real terms) in 2016 reflecting both weakness in Sri Lanka's export markets and a decline in the competitiveness of the economy as evidenced by the continued fall in the country's share of global exports. Amidst these developments, domestic savings improved to 23.8 per cent of nominal GDP, with an increase in domestic savings due to the improvement in both private sector savings and government dissavings during the year. National savings also improved in 2016 as a result of the expansion in net current transfers from rest of the world while net primary income from rest of the world declined. Consequently, national savings as a percentage of nominal GDP improved to 28.9 per cent in 2016 compared to 26.0 per cent in 2015. With the increase in both investment and savings, the domestic savings-investment gap as well as the national savings-investment gap remained broadly unchanged from the previous year at 7.6 per cent of GDP and 2.5 per cent of GDP, respectively, in 2016.

Chart 1.2
Savings, Investment and the Savings-Investment Gap (as a percentage of GDP)



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

The value addition in Agriculture, Forestry and Fishing related activities recorded an overall decline of 4.2 per cent in 2016 compared to the

growth of 4.8 per cent observed in the previous year. As a result, the GDP share of this sector reduced further to 7.1 per cent in 2016 from 7.8 per cent in 2015. The contraction in the sector was particularly due to adverse weather patterns experienced during the year. The production of paddy (-8.3 per cent), tea (-11.0 per cent), rubber (-10.7 per cent) and coconut (-1.5 per cent) were the worst affected during the year. The decline in paddy production following the record bumper harvest in 2015, was largely due to the decline in 2016 Yala production by 21.9 per cent, despite the marginal improvement in 2015/16 Maha production by 0.9 per cent. Tea production in 2016 witnessed a substantial decline due to both supply and demand side factors. The prolonged drought in tea growing areas during early 2016, the changes in weather patterns with overcast conditions in mid-2016 and the severe drought condition in late 2016 had a negative effect on tea production. Reductions in the application of fertiliser and weedicides may also have contributed to this decline. The average price of tea in the international market remained broadly stagnant in US dollar terms particularly during the first half of the year with lower demand from major export destinations. Rubber production declined to the lowest volume reported in the past 50 years with a drop in both the extent under tapping and the number of tapping days in response to low international prices for natural rubber owing to subdued petroleum prices. Production of coconut dipped marginally during the year and high domestic prices were observed as a result of increased demand from coconut-based industries and high export prices. Vegetable production observed an increase mainly due to an increase in the extent cultivated, as the effect of adverse weather conditions prompted a shift from other food crops to vegetable growing during the year.

The government embarked on several programmes during 2016 to promote growth and improve productivity in the Agriculture sector. The national food production programme for the period 2016-2018 focuses on several targets including making the country self-sufficient in selected crops, introducing productivity improvement measures, ensuring remunerative prices for farmers, enabling uninterrupted access to competitive markets both locally and internationally, mechanisation of farms, reducing post harvest losses, strengthening the supply chain, expanding the extent under cultivation, popularising the use of high yielding seeds and introducing improved farm management practices. The three-year national programme titled “A Wholesome Agriculture - A Healthy Populace - A Toxin Free Nation” has been initiated with the intention of preventing the use of highly toxic agrochemicals in the farming sector and reintroducing the use of traditional varieties of rice. Meanwhile, despite the high fiscal outlay, the fertiliser subsidy cash grant scheme was continued during the year. The Sri Lanka Tea Board embarked on strategic marketing action to promote generic tea under the brand of “Pure Ceylon Tea packed in Sri Lanka”, continued with its “B Leaf 60” programme and encouraged tea factories to obtain Hazard Analysis Critical Control Point (HACCP) Certification, and granted subsidies under the tea factory modernisation programme, while the Tea Research Institute introduced tea cultivars resistant to climatic change and other stress conditions. The expansion of rubber cultivation in non traditional areas was initiated by the Rubber Development Department with the intention of increasing national rubber production up to 200 metric tons by 2020. Further, an expert group was formed by the members of the Association of Natural Rubber Producing Countries (ANRPC), including Sri Lanka, to obtain recommendations on stabilising international rubber prices. The coconut industry witnessed initiatives taken by the authorities to regularise the auctions, support the establishment of new factories engaged in desiccated coconut production and explore new market opportunities. The government, with a

1

view to developing sugarcane cultivation and processing for the improvement and expansion of the industry, initiated a programme for scientific cooperation between the Sugarcane Research Institute and foreign research organisations, while making arrangements to re-establish the Kantale sugar factory. The largest multi-functional irrigation project and the final project of the Mahaweli Master Plan was completed with the Moragahakanda reservoir, which commenced as a twin project with the Kalu Ganga project with the objective of distributing water in Matale, Anuradhapura, Polonnaruwa and Trincomalee districts, to be used for agricultural needs. As a result of the measures taken by the government on restricting Illegal, Unreported and Unregulated (IUU) fishing activities, the fish ban imposed against Sri Lanka by the European Union (EU) prohibiting fish exports to the EU countries over a period of one and half years was completely lifted in June 2016. The government encouraged the establishment of Dairy Development Zones in selected districts through public-private partnerships (PPP), especially on idle and underutilised land of the National Livestock Development Board (NLDB) in order to increase domestic milk production and reduce expenditure incurred on importing of milk powder.

The value addition in Industry related activities changed course to a higher growth trajectory, expanding by 6.7 per cent in 2016 compared to 2.1 per cent in the previous year. The robust growth of 14.9 per cent in construction together with the growth in mining and quarrying; manufacture of rubber and plastic products; manufacture of basic metals and fabricated metal products; and manufacture of machinery and equipment contributed to the higher growth in the Industry sector. However, the growth in production of key subsectors such as food products, wearing apparel, beverages, tobacco products, and chemicals and chemical products was negative during this period. Although there were disruptions to the production of beverages during the first half of the year on account of the floods, the production of soft drinks, mineral and bottled water improved as a result of high demand due to drought conditions during the latter part of 2016. Tobacco products were adversely affected by higher cigarette prices with increased duties during the latter part of 2015 and further price increases during 2016.

The Industry sector received continued support from the government for growth and development as laid out in its export-oriented industrialisation strategy. These measures were implemented with a view to establishing Sri Lanka as an export driven economic hub of the region by enhancing its global competitiveness to further integrate into the global value chain. The Ministry of Industry and Commerce continued to facilitate regional industrialisation by promoting investments and provisioning of infrastructure facilities, and technical assistance at the regional level. The Export Development Board (EDB) is currently working with a number of international partners to identify new products and new markets to promote Sri Lankan products. In addition, certain initial steps were taken to set up an Innovation Accelerator during 2017, a platform that will combine the National Innovation Programmes of the Coordinating Secretariat for Science, Technology and Innovation and the National Thematic Research Programme and the technology support schemes of the National Science Foundation. A Biotechnology Innovation Park, which will provide facilities mainly for companies engaged in the pharmaceutical industry and genomics, was proposed to be established on a PPP basis. Meanwhile, the Central Bank requested all LCBs to take appropriate measures to implement the national policy approved in the Budget 2017 to allocate at least 10 per cent of their loan portfolio to the Small and Medium Enterprises (SME) sector.

1

Table 1.3
Gross National Income by Industrial Origin at Constant (2010) Prices (a)(b)

Economic Activity	Value (Rs. million)		As a Share of GDP (%)		Rate of Change (%)		Contribution to Change (%)	
	2015 (c)	2016	2015 (c)	2016	2015 (c)	2016	2015 (c)	2016
Agriculture, Forestry & Fishing	**670,106**	**641,943**	**7.8**	**7.1**	**4.8**	**-4.2**	**7.6**	**-7.4**
Agriculture and Forestry	553,360	523,294	6.4	5.8	6.5	-5.4	8.4	-8.0
Fishing	116,746	118,649	1.4	1.3	-2.6	1.6	-0.8	0.5
Industries	**2,264,673**	**2,416,276**	**26.2**	**26.8**	**2.1**	**6.7**	**11.5**	**40.1**
Mining and Quarrying	191,112	218,545	2.2	2.4	-5.2	14.4	-2.6	7.3
Manufacturing	1,359,694	1,383,461	15.7	15.4	4.9	1.7	16.0	6.3
Electricity, Gas, Water and Waste Treatment	118,752	130,665	1.4	1.4	8.8	10.0	2.4	3.2
Construction	595,115	683,604	6.9	7.6	-2.7	14.9	-4.2	23.4
Services	**4,883,444**	**5,087,452**	**56.6**	**56.5**	**5.7**	**4.2**	**66.5**	**54.0**
Wholesale and Retail Trade, Transportation and Storage, and Accommodation and Food Service Activities	1,997,097	2,064,738	23.1	22.9	4.8	3.4	23.1	17.9
Information and Communication	48,892	52,802	0.6	0.6	10.9	8.0	1.2	1.0
Financial, Insurance and Real Estate Activities including Ownership of Dwellings	1,063,819	1,152,781	12.3	12.8	13.3	8.4	31.3	23.5
Professional services and other personal service activities	1,023,879	1,030,603	11.9	11.4	1.8	0.7	4.5	1.8
Public administration, defence, education, human health and social work activities	749,757	786,529	8.7	8.7	3.6	4.9	6.5	9.7
Gross Value Added at Basic Price	**7,818,224**	**8,145,671**	**90.6**	**90.4**	**4.6**	**4.2**	**85.7**	**86.6**
Taxes less subsidies on products	815,667	866,355	9.4	9.6	7.5	6.2	14.3	13.4
Gross Domestic Product at Market Price	**8,633,890**	**9,012,026**	**100.0**	**100.0**	**4.8**	**4.4**	**100.0**	**100.0**
Net Primary Income from Rest of the World	-219,993	-250,805			-18.1	-14.0		
Gross National Income at Market Price	**8,413,897**	**8,761,221**			**4.5**	**4.1**		

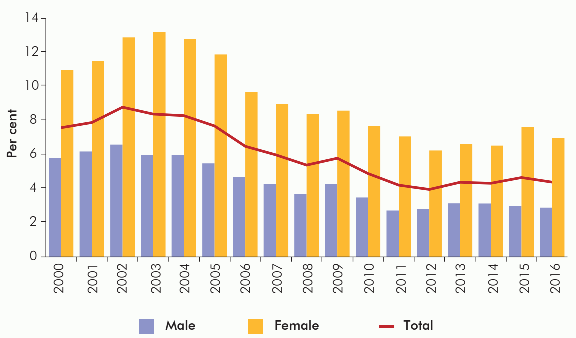
(a) The data is based on the base year 2010 GDP estimates of the Department of Census and Statistics.
(b) Provisional
(c) Revised

Source: Department of Census and Statistics

The value addition in Services related activities grew by 4.2 per cent in 2016 compared to 5.7 per cent in 2015. All services activities, except for the professional services subsector, grew in 2016. The growth in the Services sector was primarily driven by a notable expansion in financial service activities and the developments in transportation of goods and passengers including warehousing activities. A notable growth of 12.4 per cent was recorded in the value-added in financial service activities and auxiliary financial services in 2016. The wholesale and retail trade subsector, which accounts for 10.6 per cent of GDP, grew at a moderate rate of 2.5 per cent in 2016. As the value added in the wholesale and retail trade subsector is susceptible to variations in agricultural and industrial production as well as imports, the decline in agricultural and manufacturing output in 2016 deterred trade activities during the year, as did the reduction in domestic demand as a result of the tightening of fiscal and monetary policies.

The unemployment rate declined to 4.4 per cent in 2016 from 4.7 per cent in the previous year, while the number employed, increased by 1.5 per cent during the year with the expansion in the Industry and Services related activities in the economy. The reduction in female and male unemployment rates to 7.0 per cent and 2.9 per cent, respectively, in 2016, from 7.6 per cent and 3.0 per cent, respectively, in 2015, contributed to the overall decline in the unemployment rate.

Chart 1.3
Unemployment



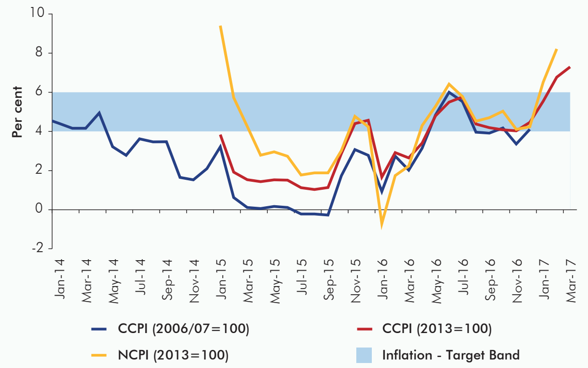
Source: Department of Census and Statistics

1

During 2016, the unemployment rates by the level of education, declined across all categories, although unemployment amongst youth (15-24 years) increased to 21.6 per cent in 2016 from 20.8 per cent in 2015. Meanwhile, the Labour Force Participation Rate (LFPR) remained unchanged in 2016 at 53.8 per cent. Responding to policy actions by the government to minimise the social impact of unskilled female migration and the subdued economic performance in a majority of Middle Eastern economies and other labour destinations, departures for foreign employment declined in 2016. However, the improvement in the skill profile of the temporary migrants contributed to a moderate increase in remittance inflows. Meanwhile, labour productivity increased marginally during the first three quarters of 2016. Labour productivity in the Agriculture sector remained at a level significantly lower than in the Industry and Services sectors.

Consumer price inflation moved upwards during the first half of 2016, although it stabilised somewhat during the remainder of the year, while core inflation broadly followed an upward trend in 2016. Headline inflation, as measured by the year-on-year change in NCPI (2013=100) was subdued in the first quarter of the year as a result of imported deflationary effects associated with low international commodity prices. Headline inflation registered an increase during the second quarter of the year reflecting the impact of domestic supply side disruptions, particularly due to adverse weather conditions, and tax adjustments. However, some deceleration was observed in inflation during the third quarter due to the suspension of the implementation of changes to the government tax structure and the recovery in domestic supply conditions. Inflation remained broadly stable thereafter although implementation of new Value Added Tax (VAT) rates with effect from November 2016 exerted some upward pressure on prices. Accordingly, year-on-year headline inflation

Chart 1.4
Headline Inflation (Year-on-Year)



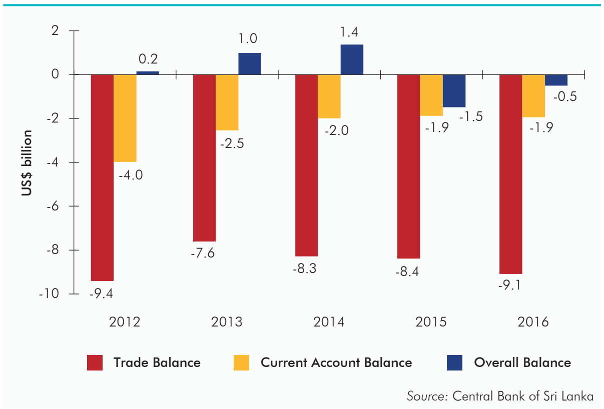
Sources: Department of Census and Statistics
Central Bank of Sri Lanka

based on the NCPI, which peaked at 6.4 per cent in June 2016, gradually decelerated to 4.2 per cent by end 2016, thus registering the same rate as at end 2015. On an annual average basis, however, NCPI based headline inflation increased to 4.0 per cent by end 2016 compared to 3.8 per cent at end 2015. Following a similar trend, CCPI (2013=100) based headline inflation also reached a peak of 5.8 per cent in July 2016, before registering 4.5 per cent at end 2016, while on an annual average basis, it stood at 4.0 per cent by end 2016. Core inflation, which measures the underlying inflationary pressures in the economy, continued an upward trend in 2016 although some volatility was observed on a monthly basis. The impact of demand driven inflationary pressures arising from the continued expansion in monetary and credit aggregates was shrouded by relatively low international commodity prices and administered price revisions, while the revision made to the tax structure had an upward effect on core inflation during the first half of 2016. Although core inflation stabilised for a few months as a result of the suspension of the changes made to the government tax structure, the reimposition of the tax changes caused core inflation to move upwards towards end 2016. Accordingly, NCPI based core inflation stood at 6.7 per cent by end 2016, year-on-year, remaining higher than 5.8 per cent recorded at end 2015. Year-on-year core inflation based on the CCPI declined from 6.7 per cent at end 2015 to 5.8 per cent by end 2016. The prevailing drought conditions, the effect of the tax changes and rising international commodity prices affected the movements in inflation in the first quarter of the year 2017 as well, although tightened monetary and fiscal policies enabled reining in of demand pressures on inflation to a great extent.

External Sector Developments

Sri Lanka's external sector performance remained subdued in 2016, with foreign exchange outflows exceeding the moderate inflows during the year. The monetary policy normalisation in the United States of America (USA), subdued external demand due to the slow pace of economic recovery in several advanced economies and emerging market economies, and persisting geopolitical tensions in the Middle East, significantly dampened the performance of the external sector. The widening of the trade deficit, particularly in the last quarter of the year, and the primary income deficit led to a deterioration in the current account deficit during 2016, despite surpluses in the trade in services and the secondary income accounts. The subdued performance of the financial account of the BOP stemmed from continued outflows on account of debt repayments amidst modest non debt inflows. Meanwhile, Sri Lanka experienced outflows of foreign holdings from the government securities market during the year, and the Central Bank intervened in the domestic foreign exchange market to dampen the depreciation pressure on the Sri Lanka rupee. The overall balance of the BOP recorded a deficit of US dollars 500 million in 2016, and the gross reserve asset position declined to US dollars 6.0 billion by end 2016, from US dollars 7.3 billion recorded at end 2015. With these developments, the rupee depreciated by 3.83 per cent against the US dollar in 2016.

Chart 1.5
Balance of Payments



Source: Central Bank of Sri Lanka

Although the trade deficit contracted on a cumulative basis during the first four months of the year, it expanded significantly towards the end of the year. The expansion in the trade deficit was driven by the reduction in earnings from exports compared to 2015 and the substantial increase in import expenditure during the last quarter of the year. Accordingly, the trade deficit widened to US dollars 9,090 million in 2016 compared to US dollars 8,388 million recorded in 2015 and the trade deficit as a percentage of GDP increased to 11.2 per cent in 2016 compared to 10.4 per cent in 2015.

Earnings from exports contracted for the second consecutive year in 2016 with a contraction in earnings from agricultural and industrial exports. Low commodity prices in the international market, modest economic recovery of Sri Lanka's major export destinations and disruptions in the domestic supply of export oriented agricultural products mainly contributed to the decline in export earnings by 2.2 per cent to US dollars 10,310 million. However, the removal of sanctions imposed on Iran by the USA in January, and the lifting of the EU's ban on seafood exports from Sri Lanka in June, cushioned the overall negative performance of exports resulting in a reversal of the year-on-year declining trend of exports towards end 2016. Despite the improvements in earnings from the export of textiles and garments (1.3 per cent) and base metals and articles (60.5 per cent), overall export earnings declined as a result of the decline in earnings from transport equipment (-46.0 per cent), petroleum products (-23.3 per cent), tea (-5.3 per cent) and spices (-16.0 per cent). The top ten export destinations remained unchanged with the USA continuing to be the main export destination, accounting for 27.3 per cent of total export earnings, followed by the United Kingdom (UK), India, Germany and Italy. Meanwhile, the overall export volume index declined marginally by 0.7 per cent in 2016, while the export price index, in US dollar terms, declined by 1.5 per cent.

Expenditure on imports increased during 2016, with a significant increase in expenditure on intermediate and investment goods imports, particularly in the last quarter of the year. The benefit of low international commodity prices in the international market and the impact of the policy measures adopted by the government and the Central Bank to rationalise imports, were somewhat negated by the increase in imports of investment goods and non fuel intermediate goods. The significant growth in imports of machinery and equipment (20.3 per cent) and building material (16.0 per cent) led to an increase in the growth in imports of investment goods (13.8 per cent) which, in turn, was the key contributor to the growth of 4.2 per cent observed in the expenditure on non fuel imports. In addition, the growth in intermediate goods (2.4 per cent), such as textiles and textile articles, and diamonds, precious stones and metals, also contributed substantially to the increase in import expenditure. Despite the rise in expenditure on coal imports, the decline in expenditure on both crude oil and refined petroleum imports resulted in an overall decline in expenditure on fuel imports. In comparison to 2015, import expenditure on consumer goods declined by 8.4 per cent during the year, primarily due to the substantial decline of 41.5 per cent in expenditure incurred on the importation of personal vehicles. As a result of these developments, expenditure on imports increased by 2.5 per cent during the year to US dollars 19,400 million. Although India had been the main source of imports since 2001, China emerged as the key source in 2016. During the year, the overall import volume index increased by 7.9 per cent while the import price index declined by 5.1 per cent in US dollar terms reflecting deflationary trends in the global economy.

Although the services account and the secondary income account recorded surpluses, the increase in the trade deficit and the primary income account deficit caused the external current account deficit to widen during 2016. The services account continued to record a surplus during the year led by the increased earnings from tourism, followed by the export of transport, and telecommunications, computer and information services. Earnings from exports of services recorded a growth of 11.6 per cent to US dollars 7,138 million in 2016. In addition to the rise in tourist arrivals, the increase in the estimated average spending per day and the improvement in the estimated average duration of stay by tourists, led to an 18.0 per cent growth in earnings from tourism amounting to US dollars 3,518 million during the year. Earnings from telecommunications, computer and information services also increased from US dollars 805 million in 2015 to US dollars 858 million in 2016. Meanwhile, higher interest payments and outflows in the form of reinvested earnings and dividend payments led to outflows from the primary income account amounting to US dollars 2,304 million. The increased level of outflows coupled with the decline in earnings from reserve assets, widened the deficit in the primary income account in 2016. Lower income levels and geopolitical uncertainties in the Middle East as well as domestic policies to discourage labour migration under the unskilled category resulted in a moderation of workers' remittances. Accordingly, workers' remittances grew at a moderate rate of 3.7 per cent to US dollars 7,242 million in 2016. Reflecting these developments, the current account deficit widened to US dollars 1,942 million, equivalent to 2.4 per cent of GDP in 2016 from 2.3 per cent of GDP in 2015.

In the financial account, both net incurrence of liabilities and net acquisition of assets remained subdued in 2016. Accordingly, net incurrence of liabilities amounted to US dollars 2,199 million in 2016 in comparison to US dollars 3,223 million in 2015 and the net acquisition of assets amounted to US dollars 82 million during 2016 in comparison to US dollars 911 million in the previous year. Total FDI inflows, which include foreign borrowings by companies registered under the Board of Investment (BOI), amounted to US dollars 1,079 million during 2016 compared to US dollars 1,160 million recorded in 2015. Foreign portfolio investments in the share market remained subdued while an outflow of foreign investments from rupee denominated Treasury bonds and US dollar denominated Sri Lanka Development Bonds (SLDBs) was observed in 2016. In July 2016, Sri Lanka successfully raised US dollars 1,500 million through its 10th International Sovereign Bond (ISB), which was its first dual-tranche issuance as well. Total inflows to the government in the form of foreign loans increased to US dollars 2,163 million in 2016. These comprised project loans amounting to US dollars 1,278 million, two foreign currency term financing facilities worth to US dollars 700 million and programme financing amounting to US dollars 185 million. Meanwhile, in view of the deterioration in the BOP and to obtain support for the government's reform agenda, Sri Lanka requested a three year Extended Fund Facility (EFF) of Special Drawing Rights (SDR) 1.1 billion (approximately US dollars 1.5 billion) from the IMF, and the first and the second tranches under this facility amounting to US dollars 332 million were received during the year. Repayments on account of the IMF Stand-By Arrangement (SBA) facility obtained in 2009 were continued and amounted to US dollars 455 million in 2016.

The overall balance of the BOP recorded a deficit in 2016 reflecting the widening of the current account deficit and relatively low level of inflows to the financial account. The overall deficit amounted to US dollars 500 million in 2016 compared to the deficit of US dollars 1,489 million recorded in 2015. Meanwhile, Sri Lanka's gross reserve asset position declined to US dollars 6.0 billion, as at end 2016, equivalent to 3.7 months of imports of goods and 3.1 months of imports of goods and services. The decline in gross official reserves was primarily due to foreign currency debt service payments, settlement of international foreign currency swap arrangements, repayment of the IMF-SBA facility and the supply of liquidity to the domestic foreign exchange market, particularly in the first half of the year. Total foreign assets stood at US dollars 8.4 billion at end 2016, which was adequate to cover 5.2 months of imports of goods and 4.3 months of imports of goods and services.

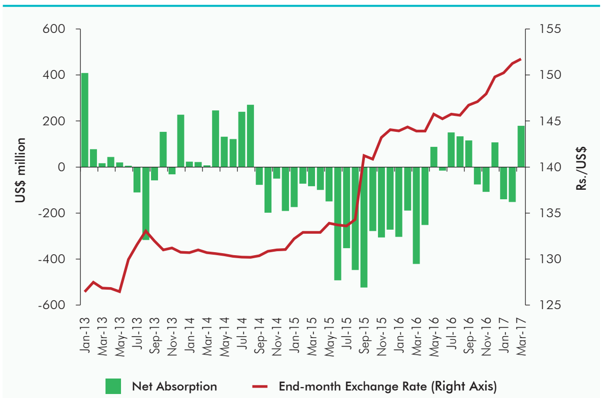
The total external debt of the country increased during 2016 primarily due to the increase in external government debt. The outstanding external debt stock increased from US dollars 44.8 billion (55.7 per cent of GDP) at end 2015 to US dollars 46.6 billion (57.3 per cent of GDP) at end 2016. External borrowings by the government increased with the issuance of ISBs, foreign currency term financing facilities and the receipt of project loans. Capital repayments on external debt remained high at US dollars 3,157 million in 2016, although this was a moderation in comparison to US dollars 3,435 million in 2015.

1

Large debt repayments during the year included the settlement of international swap facilities and repayments on account of the IMF-SBA. Further, interest payments on outstanding external debt obligations increased to US dollars 1,209 million in 2016 from US dollars 1,190 million in 2015, due to increased interest payments by the private sector and deposit taking corporations.

The rupee depreciated against all major currencies except the pound sterling in 2016. The depreciation pressure on the rupee was a result of increased imports, continued foreign debt service payments and outflows on account of reversal of foreign investments from the government securities market amidst monetary policy normalisation in the USA. The Central Bank supplied foreign currency liquidity to the market heavily in the first four months of the year, and to a lesser extent thereafter, resulting in a net supply of US dollars 768 million during the year, compared to US dollars 3,250 million in 2015. This intervention was primarily to dampen the pressure on the exchange rate arising from foreign outflows from the government securities market. The rupee, which remained broadly stable with heavy intervention by the Central Bank in the first four months of the year, was allowed to reflect market demand and supply conditions to a great extent in the second half of the year, resulting in an overall depreciation of the rupee against the US dollar by 3.83 per cent in 2016. In spite of this nominal depreciation, the 5-currency and 24-currency Real Effective Exchange Rate (REER) indices, which take into account the variations in nominal exchange rates and the inflation differentials among countries, appreciated by 2.83 per cent and 2.70 per cent, respectively, by the end of the year, reflecting an erosion in the external competitiveness of the rupee.

Chart 1.6
Central Bank Intervention in the Domestic Foreign Exchange Market and the Exchange Rate

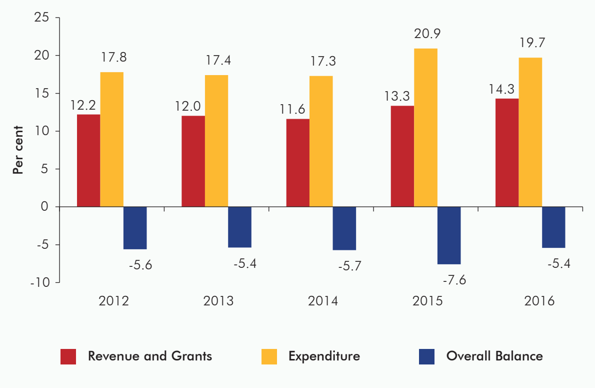


Source: Central Bank of Sri Lanka

Fiscal Sector Developments

The increase in government revenue stemming from the broadened tax base, structural reforms in tax administration and the rationalisation of government expenditure, in tandem with the government's commitment to strengthen the fiscal consolidation process contributed to the overall improvement of the fiscal sector during 2016. The improvements in fiscal operations, achieved under the government's revenue based fiscal consolidation process, helped contain the overall budget deficit at the targeted level of 5.4 per cent of GDP in 2016 in comparison to the deficit of 7.6 per cent in the previous year. In line with this, the current account deficit, that reflects government dissaving, declined to 0.6 per cent of GDP in 2016, significantly below the level of 2.3 per cent of GDP recorded in 2015. The primary deficit, which excludes interest payments from the overall deficit, declined to 0.2 per cent of GDP in 2016 from 2.9 per cent recorded in 2015. Nevertheless, several drawbacks were observed in fiscal operations primarily due to the sluggish implementation of structural reforms in tax administration. At the same time, current expenditure, which includes interest payments, salaries and wages, and subsidies and transfers

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



Source: Ministry of Finance

to the household sector remained high despite some rationalisation observed during the year. Moreover, the fiscal sector was affected, to some extent, by the increasing cost of borrowing as a result of rising interest rates in both the domestic and international markets and also the depreciation of the rupee against major foreign currencies. These developments, along with the accumulation of substantial amounts of commercial foreign debt across short to medium term maturities, highlight the need for a national consensus on sustained fiscal consolidation through timely implementation of urgent fiscal and structural reforms.

Government revenue as a percentage of GDP increased for the second consecutive year to 14.2 per cent in 2016 from 13.3 per cent recorded in 2015, mainly due to the increase in non tax revenue during the year. Tax revenue increased by 8.0 per cent to Rs. 1,463.7 billion in 2016 from Rs. 1,355.8 billion in 2015, although tax revenue as a percentage of GDP remained unchanged from the previous year at 12.4 per cent. The increase in revenue collection from VAT, Ports and Airports Development Levy (PAL) and import duties positively contributed to the increase in tax revenue, while a decline was observed in revenue generation from excise duties on motor vehicles, corporate and non corporate income tax and withholding tax. In 2016, non tax revenue as a percentage of GDP increased to 1.9 per cent from 0.9 per cent recorded in 2015, while in nominal terms, it increased by more than two fold to Rs. 222.4 billion during the year. This was mainly due to the increase in profit and dividend transfers from state owned business enterprises (SOBEs) mainly as a result of the improved performance of those in the banking and insurance sectors, and the Telecommunications Regulatory Commission of Sri Lanka (TRCSL). Accordingly, in nominal terms, government revenue increased by 15.9 per cent to Rs. 1,686.1 billion in 2016 from Rs. 1,454.9 billion recorded in 2015 reflecting increases in both tax and non tax revenue. While the share of tax revenue in total revenue accounted for 86.8 per cent, indirect taxes continued to be the key constituent of government tax revenue, accounting for 82.3 per cent of tax revenue.

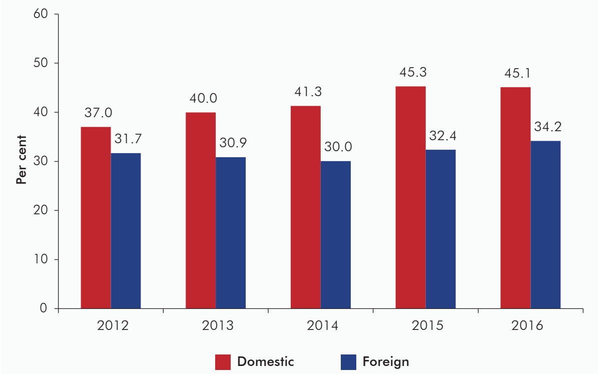
Total expenditure and net lending as a percentage of GDP declined to 19.7 per cent in 2016 from 20.9 per cent in 2015, reflecting the decline in recurrent expenditure as well as capital expenditure and net lending. The efforts of the government to rationalise recurrent expenditure and prioritise capital expenditure led to a reduction in government expenditure. Accordingly, recurrent expenditure as a percentage of GDP declined to 14.8 per cent in 2016 from 15.5 per cent in 2015. In nominal terms, however, recurrent expenditure increased by 3.3 per cent to Rs. 1,757.8 billion in 2016 from Rs. 1,701.7 billion in 2015, primarily due to the increase in interest payments, followed by the increase in expenditure on salaries and wages, current transfers and subsidies. The relatively high level of interest rates in domestic and international markets, the depreciation of the Sri Lankan rupee against major foreign currencies and the increase in the outstanding domestic debt stock caused a rise in interest expenditure during the year.

1

Consequently, interest expenditure, in nominal terms, grew by 19.9 per cent to Rs. 610.9 billion in 2016 from Rs. 509.7 billion in 2015. Salaries and wages, in nominal terms, also increased by 2.6 per cent to Rs. 576.5 billion during the year. Meanwhile, reflecting the streamlining and prioritising of public investment programmes, capital expenditure and net lending as a percentage of GDP, declined to 4.9 per cent in 2016 from 5.4 per cent in 2015, while in nominal terms, a decline of 2.1 per cent to Rs. 576.1 billion was recorded during the year. Public investment declined to 5.0 per cent of GDP in 2016 from 5.5 per cent of GDP in 2015, while in nominal terms, it declined marginally by 1.5 per cent to Rs. 594.0 billion in 2016 in comparison to Rs. 602.8 billion in 2015.

During the year, the overall budget deficit of Rs. 640.3 billion was largely financed from foreign sources. Accordingly, foreign financing contributed 61.2 per cent of total financing, while the remainder was financed through domestic sources. Accordingly, net domestic financing declined to Rs. 248.4 billion during the year from Rs. 592.7 billion recorded in 2015, while net foreign financing increased to Rs. 391.9 billion during 2016. With respect to net domestic financing, banking sector borrowings, which accounted for 56.3 per cent of net domestic borrowings, declined by 52.0 per cent to Rs. 140.0 billion in 2016 from Rs. 291.8 billion recorded in 2015. Although financing of borrowings through Treasury bonds increased significantly, borrowings from commercial banks through Treasury bills and SLDBs recorded a significant decline. However, the decline in borrowings from commercial banks was offset by the notable increase in borrowings from the Central Bank amounting to Rs. 183.1 billion compared to Rs. 80.3 billion in the previous year. Further, net financing from the non banking sector declined to Rs. 108.5 billion in 2016 from Rs. 300.9 billion reported in 2015.

Chart 1.8
Central Government Debt
(as a percentage of GDP)



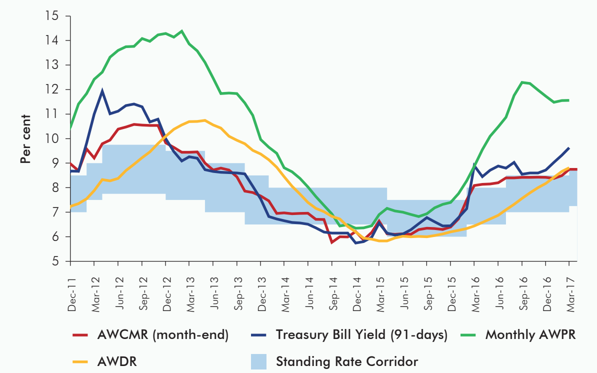
Sources: Ministry of Finance
Ministry of National Policies and Economic Affairs
Central Bank of Sri Lanka

The central government debt to GDP ratio increased to 79.3 per cent by end 2016 from 77.6 per cent as at end 2015. This was mainly due to the increase in net borrowings and the modest economic growth during the year. In nominal terms, outstanding central government debt increased to Rs. 9,387.3 billion as at end 2016 from Rs. 8,503.2 billion as at end 2015. Within this, total outstanding domestic debt increased by 7.7 per cent to Rs. 5,341.5 billion, while total outstanding foreign debt increased significantly by 14.2 per cent to Rs. 4,045.8 billion by end 2016.

Monetary Sector Developments

The conduct of monetary policy in 2016 was aimed at stabilising the economy through the containment of the possible rise in excessive demand pressures in the economy. During 2016, monetary aggregates grew at a faster pace than projected underpinned by excessive expansion in credit to both the government and the private sector. As such, the Central Bank commenced monetary tightening in several stages from end 2015. To begin with, the Central Bank raised the SRR applicable on all rupee deposit liabilities of LCBs by 1.50 percentage points to 7.50 per cent with effect from 16 January 2016 to absorb excess liquidity in the domestic money market on a permanent basis. Furthermore, policy interest rates of the Central Bank viz., the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) were raised by 50 basis points each in February 2016 to 6.50 per cent and 8.00 per cent, respectively, in light of rising inflationary pressures. Despite monetary tightening measures, credit to the private sector continued to expand while inflation indicated an upward trend, although a significant portion of inflation was attributable to tax revisions and disruptions to domestic supply conditions. To pre-empt the escalation of inflationary pressures and to support the BOP, the Central Bank further tightened the monetary policy stance in July 2016, by increasing the SDFR and the SLFR by an additional 50 basis points to 7.00 per cent and 8.50 per cent, respectively. Alongside the increased policy interest rates, open market operations (OMO) guided overnight interest rates towards the upper bound of the policy rate corridor. These efforts were complemented by the macroprudential measures adopted in late 2015 as well as the gradual adjustment in the exchange rate throughout the period. Despite these measures, headline inflation indicated an upward movement towards end 2016 with continued supply side disturbances and the reimposition of changes to the government tax structure, while core inflation also witnessed an increase. Although the growth of credit disbursements to the private sector by commercial banks decelerated to some extent, the continued supply- and tax-driven rise in inflation, particularly in early 2017, prompted the Central Bank to tighten monetary policy further in March 2017 as a precautionary measure to contain the build-up of adverse inflation expectations and second round effects within its increasingly forward looking approach to the conduct of monetary policy.

Chart 1.9
Standing Rate Corridor and Selected Market Interest Rates



Source: Central Bank of Sri Lanka

During 2016, market interest rates adjusted upwards reflecting tight monetary conditions in the economy. With the raising of SRR with effect from January 2016, the increase in policy interest rates in February 2016, and the gradual decline in excess rupee liquidity in the domestic money market, short term interest rates increased. Accordingly, the Average Weighted Call Money Rate (AWCMR), which is the operating target under the present enhanced monetary policy framework, increased to 7.50 per cent by end February 2016 compared to 6.40 per cent reported at end 2015. Despite the increase in AWCMR beyond the upper bound of the policy rate corridor reaching 8.15 per cent by early April 2016, OMOs conducted by the Central Bank helped manage volatility in short term money market rates to a large extent. AWCMR hovered in the range of 8.15-8.24 per cent thereafter until July 2016, and increased to 8.40 per cent with the policy rate hike in July 2016 before stabilising thereafter. By end 2016, AWCMR stood at 8.42 per cent. Reflecting tight monetary conditions and the high demand for funds from the government, yields on Treasury bills showed an upward trend during 2016 although some moderation was observed in the second half of the year. The impact of replacing the mixed system of auctions and direct placements to raise funds for

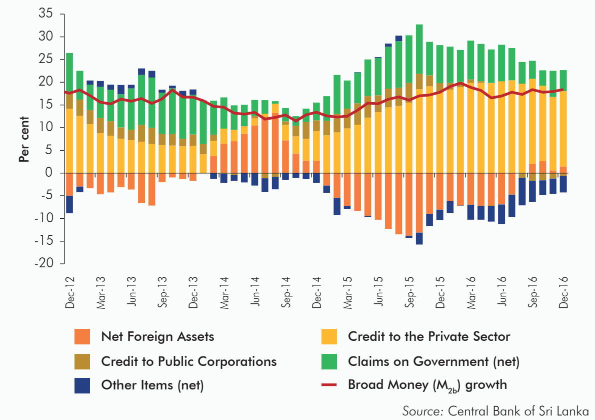
1

the government with a purely auction based system where direct placements of Treasury bills were made only with the Central Bank, also contributed to the increase in interest rates on government securities. Accordingly, 91-day, 182-day and 364-day Treasury bill yields were at 8.72 per cent, 9.63 per cent and 10.17 per cent, respectively, by end 2016 compared to 6.45 per cent, 6.83 per cent and 7.30 per cent, respectively, reported at end 2015. Yields on long term government securities also indicated a similar trend. With these developments, a considerable increase in both lending and deposit rates of commercial banks was observed in 2016. Accordingly, the Average Weighted Deposit Rate (AWDR) increased by 197 basis points to 8.17 per cent by end 2016 from 6.20 per cent at end 2015, while the Average Weighted Fixed Deposit Rate (AWFDR) also increased by 289 basis points to 10.46 per cent by end 2016 from 7.57 per cent at end 2015. Interest rates offered on new deposits also increased substantially during the year. Lending rates also increased, reflecting the impact of the tight monetary policy stance, deficit liquidity conditions and increased cost of funds due to high deposit interest rates. Accordingly, the weekly Average Weighted Prime Lending Rate (AWPR), which is based on interest rates applicable on loans and advances granted by commercial banks to their prime customers, increased by 399 basis points to 11.52 per cent by end 2016 from 7.53 per cent at end 2015, while the monthly AWPR increased by 433 basis points to 11.73 per cent by end 2016 from 7.40 per cent reported at end 2015. Similarly, the Average Weighted Lending Rate (AWLR) increased by 220 basis points to 13.20 per cent by end 2016 from 11.00 per cent at end 2015. Further, the Average Weighted New Lending Rate (AWNLR) also increased substantially to 14.37 per cent by end 2016 from 10.79 per cent reported at end 2015.

Reserve money recorded a high growth of 27.1 per cent, year-on-year, by end 2016 compared to 16.5 per cent at end 2015. In absolute terms, reserve money increased noticeably by Rs. 182.7 billion to Rs. 856.1 billion by end 2016. From the liability side, the increase in both currency in circulation and commercial bank deposits with the Central Bank reflected the expansion in reserve money. Commercial bank deposits increased significantly during 2016, mainly as a result of the upward adjustment in SRR in January 2016. On the assets side, the expansion in reserve money was entirely due to the increase in net domestic assets (NDA) of the Central Bank, while net foreign assets (NFA) declined during 2016. The expansion in NDA was largely on account of the substantial increase in the Central Bank's holdings of government securities, which led to an increase in net credit to the government (NCG) by Rs. 183.1 billion to Rs. 413.0 billion by end 2016. The current system of raising funds for the government under a purely auction based system where direct placements of Treasury bills are made only with the Central Bank was a key factor that contributed to the increase in NCG by the Central Bank.

Underpinned by the expansion in credit to both the government and the private sector, broad money supply (M_{2b}) continued to increase at a rate higher than projected in 2016. Accordingly, the year-on-year growth of broad money was at 18.4 per cent by end December 2016, compared to 17.8 per cent at end 2015, while the average growth also remained elevated at 18.1 per cent. NFA of the banking system contributed positively to the expansion in broad money supply, reversing the trend observed in the previous year. However, NDA of the banking system remained the key factor contributing 92 per cent of the expansion in broad money. This was mainly driven by the expansion in credit flows to both the government and the private sector. During the year, surpassing

Chart 1.10
Broad Money Growth and Contribution

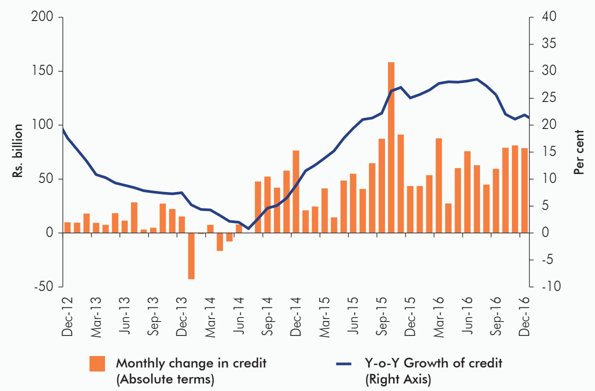


Source: Central Bank of Sri Lanka

the budgetary estimates, NCG from the banking system increased by Rs. 212.6 billion compared to the increase of Rs. 323.6 billion recorded in 2015. This increase was largely on account of the considerable increase in credit extended to the government by the Central Bank by Rs. 183.1 billion during the year compared to Rs. 80.3 billion in 2015, while NCG from commercial banks also positively contributed to the overall increase. Treasury bill holdings (net of repurchase transactions) of the Central Bank increased significantly to a historically high level of Rs. 330.0 billion compared to Rs. 79.2 billion recorded at end 2015. Moreover, provisional advances to the government, which is the other key component of NCG, averaged around Rs. 184.6 billion during the first eleven months of 2016 compared to Rs. 151.1 billion at end 2015, but declined temporarily to Rs. 83.3 billion by end 2016. This was due to the government settling a part of provisional advances using funds raised through the issuance of Treasury bills worth Rs. 100 billion to the Central Bank during the month of December 2016. This transaction, which was a temporary arrangement to facilitate the government's cashflow, was reversed in January 2017. In contrast, credit extended by the banking system to public corporations declined during 2016, reflecting improvements in the financial position of a number of SOBEs, particularly the Ceylon Petroleum Corporation (CPC). However, borrowings of SriLankan Airlines, Road Development Authority, Ceylon Fertilizer Corporation, Ceylon Shipping Corporation and Colombo Commercial Fertilizer increased during the period under review.

Credit extended to the private sector by commercial banks continued to expand during 2016 while some slowdown was observed towards the end of the year. The year-on-year growth of credit to the private sector, which was at 25.1 per cent at end 2015 peaked at 28.5 per cent by July 2016, before declining to 21.9 per cent by end 2016 in response to the monetary policy measures adopted by the Central Bank. In absolute terms, the increase in credit extended to the private sector was Rs. 754.9 billion during 2016 compared to the increase of Rs. 691.4 billion in the previous year. The contribution of state banks to this increase in credit to the private sector was considerable in 2016, as the government borrowings from these institutions were relatively low during the year. As per the Quarterly Survey of Commercial Banks' Loans and Advances to the Private Sector, credit disbursed to all major sectors of the economy expanded considerably in 2016. On a year-on-year basis, credit flows to the Services and Industry

Chart 1.11
Credit granted by Commercial Banks to the Private Sector



Source: Central Bank of Sri Lanka

1

sectors expanded by 35.4 per cent and 22.2 per cent, respectively, during 2016 compared to 34.1 per cent and 25.0 per cent, respectively, in 2015. Within credit flows to the Industry sector, the year-on-year increase in credit to the Construction subsector was notable at 26.9 per cent. Credit to the Agriculture and Fishing sector also grew by 17.0 per cent, year-on-year, by end 2016, compared to the growth of 7.5 per cent recorded in 2015. However, within Personal Loans and Advances, Pawning Advances continued to record a contraction while credit in relation to Consumer Durables, Personal Healthcare, Personal Education and Credit Card Balances recorded an increase during 2016.

Financial Sector Developments

In 2016, assets of the banking sector grew at a slower pace than in the previous year mainly reflecting the tighter monetary conditions that prevailed during the year, while the sector continued to maintain its capital and liquidity levels well above the minimum statutory requirements. The asset base of the banking sector recorded a growth of 12.0 per cent driven by increased loans and advances. Deposits of the banking sector expanded by 16.5 per cent during 2016 mainly on account of the growth in time deposits in the backdrop of a high interest rate environment, although borrowings by the banking sector recorded a decline of 3.5 per cent during the year mainly due to a reduction in foreign currency borrowings. Profitability of the banking sector as measured by the Return on Assets (ROA) and Return on Equity (ROE) improved during 2016 reflecting the increase in net interest income of the banking sector. Meanwhile, the banking sector maintained capital and liquidity at levels higher than the minimum regulatory requirements, and continued to manage risks prudently during the year. Asset quality improved during 2016 recording the lowest non performing loans (NPL) ratio in the past two decades. In the meantime, the banking sector expanded its operations during 2016 through the establishment of new banking outlets and installation of new Automated Teller Machines (ATMs).

The licensed finance companies (LFCs)/ specialised leasing companies (SLCs) sector grew in terms of assets and the branch network during 2016, while other non banking financial institutions showed a mixed performance amidst a challenging business environment. The LFC/SLC sector expanded its asset base in 2016 as the sector placed more emphasis on other loan products, gradually moving away from the core business of financing the purchase of motor vehicles. This growth was mainly funded through domestic borrowings as the sector's reliance gradually shifted towards bank borrowings from retail deposits considering its flexibility and cost. Increased business volumes and improved operational efficiency coupled with a moderately increasing net interest income enabled the LFC/SLC sector to post an increased level of profits in 2016. Risks in the LFC/SLC sector as a whole remained at manageable levels as reflected by comfortable levels of NPL, liquidity and capital. Meanwhile, Primary Dealers in government securities recorded a decline in their total investment portfolio as well as total assets. However, total capital and profitability of the Primary Dealer industry recorded a growth. In the Unit Trusts industry, total assets as well as the number of units issued recorded a decline in 2016. Investments in government securities by Unit Trusts increased significantly, while investments in equities recorded a marginal decline. Meanwhile, total assets of the insurance sector expanded in 2016 with the contribution of both long term insurance and general insurance business categories. Total profits earned by the insurance sector marked a considerable growth in 2016 led by an impressive performance in the general insurance sector. The increase in investment income amidst higher market interest rates observed in 2016 and income in terms of gross written premium contributed towards this outcome. With regard to superannuation funds, total assets of the sector recorded a modest growth in 2016 as a combined result of the increase in income generated through investments and net contributions (contributions less refund payments) by the members of these funds.

The regulatory agencies including the Central Bank, initiated several measures to strengthen the supervisory and regulatory framework for financial institutions with a view to further enhancing their safety and soundness, thereby promoting public confidence in the financial sector. The Central Bank further increased the Capital Requirements for licensed banks under Basel III to be effective from July 2017. All licensed banks were requested to disclose key information on regulatory capital, liquidity and risk management with published financial statements, while greater disclosure of fees charged for fund transfers were also requested. All licensed banks were also requested to submit reports on cybersecurity events to the Central Bank with a view to addressing risks emanating in relation to cybersecurity. Further, measures were taken to promote the secondary market for Government Securities among the banking sector by enhancing transparency and price discovery. With regard to the LFC/SLC sector, the Central Bank continued to take prudential measures keeping in line with improved local and international standards and procedures, while taking regulatory measures to resolve the concerns with respect to weak finance companies with a view to maintaining financial system stability. Meanwhile, a regulatory framework for microfinance companies was introduced by the Central Bank during 2016 in terms of the powers vested under the newly enacted Microfinance Act, No. 6 of 2016, which is intended for licensing, regulating and supervising unregulated microfinance companies and Microfinance Non Governmental Organisations (MNGOs). In the insurance sector, the Insurance Board of Sri Lanka (IBSL) took several regulatory measures in 2016 with a view to safeguarding the interests of policyholders while promoting the professionalism and reputation of the industry. In particular, all insurers and insurance brokers were requested to obtain written approval from the IBSL on changes in ownership or control, while long term insurance companies were directed to grant policyholders a 21-day cooling-off period (free-look period) to examine the terms and conditions of the policy documents.

1.3 Global Economic Environment and Outlook

According to the World Economic Outlook of the IMF,[1] the global economy gained momentum in the second half of 2016 with advanced economies registering a stronger than expected pick-up, while slackened economic activity persisted in emerging market and developing economies. While many advanced economies continued their efforts to stimulate demand, emerging market and developing economies exhibited diverse growth and exchange rate outcomes depending on BOP positions, fiscal situations and investment activities in each country, despite being affected in general by tighter conditions in global financial markets. The agreement to limit oil production by a number of major producers led to a gradual increase in oil prices during the year. However, the general

1 World Economic Outlook - April 2017 and World Economic Outlook Update - January 2017

1

consensus is that prices are unlikely to rise above US dollars 60 per barrel, as it is expected that an aggressive supply response will be triggered through fracking, particularly in the USA, at this price. Prices of most commodities including food commodities and base metals displayed an increasing trend, particularly towards the latter part of the year. Continued uncertainties in the global economy as well as volatility in international politics shrouded economic decision making for policymakers as well as private investors.

The slow economic growth, particularly in the first half of 2016, as well as low levels of inflation called for accommodative monetary policy to remain in force in advanced economies throughout most of the year. However, with the US economy increasingly showing signs of sustained growth and employment generation, the US Federal Reserve increased the Federal Funds target rate in December 2016 and March 2017, following its initial rate adjustment in December 2015. The referendum in the UK to leave the EU too created uncertainties in financial markets and the global economic outlook. Economic activity in oil producing countries including Russia, showed some improvement, with oil prices stabilising at higher levels in the second half of the year. Policy stimulus to rebalance growth in China towards improving domestic demand and lesser reliance on investment continued, creating uncertainty in global commodity markets in which China is a major buyer of key commodities such as petroleum and base metals. In the face of these developments and expectations, global interest rates moved upwards, leading to portfolio outflows from many emerging market economies during this period. During the year, the US dollar appreciated vis-à-vis other major currencies. The currencies of commodity exporting countries including those of oil producers appreciated, while the pound sterling, euro and the Japanese yen depreciated.

Table 1.4
Global Economic Developments and Outlook (a)

Item	2015	2016	2017 (Proj)	2018 (Proj)
World Output	**3.4**	**3.1**	**3.5**	**3.6**
Advanced Economies	2.1	1.7	2.0	2.0
United States	2.6	1.6	2.3	2.5
Euro Area	2.0	1.7	1.7	1.6
United Kingdom	2.2	1.8	2.0	1.5
Japan	1.2	1.0	1.2	0.6
Emerging Market and Developing Economies	4.2	4.1	4.5	4.8
Emerging and Developing Asia	6.7	6.4	6.4	6.4
China	6.9	6.7	6.6	6.2
India	7.9	6.8	7.2	7.7
World Trade Volume (Goods and Services)	**2.7**	**2.2**	**3.8**	**3.9**
Price Movements				
Consumer Prices				
Advanced Economies	0.3	0.8	2.0	1.9
Emerging Market and Developing Economies	4.7	4.4	4.7	4.4
Commodity Prices (US$)				
Oil	-47.2	-15.7	28.9	-0.3
Non Fuel	-17.4	-1.9	8.5	-1.3
Six-month London Interbank Offered Rate (LIBOR) on US$ Deposits (per cent)	**0.5**	**1.1**	**1.7**	**2.8**

(a) Annual percentage change unless otherwise indicated.

Source: World Economic Outlook (April 2017), IMF

The momentum in the global economy is expected to persist in 2017 and 2018 with the ongoing cyclical recovery in investment, manufacturing and trade. For the first time since the onset of the great recession, the first quarter of 2017 has seen a synchronised upturn in the USA, Europe, Japan and some key emerging markets. Such growth will be propelled by the effects of broadly accommodative monetary policy and expansionary fiscal policy measures of advanced economies that are expected to spillover to emerging market and developing economies. Fiscal policy is expected to be more expansionary in the USA in 2017. Expansionary fiscal and monetary policies in other advanced economies including the UK, the EU and Japan are expected to support growth in the next one to two years as well, while rising commodity prices are likely to lift global inflation and reduce deflationary pressures experienced by some of these economies.

However, current global growth projections are highly contingent on the effects of the protectionist stance on international trade that the new US administration has pledged to introduce. Therefore, global growth in the next two years will be marked by the responses that are unfolding amongst the trading partners of the USA as they search for new markets domestically and internationally and new growth stimulants. In the meantime, prospects for the UK have been clouded by the effects of Brexit while Japan will explore avenues to regain market access lost by the USA's withdrawal from the Trans-Pacific Partnership (TPP) agreement. China's high growth is expected to be supported by policy stimulus, though its effects on credit expansion and budgetary constraints may require abrupt policy adjustments in the period ahead. India's growth, which at present is considered the highest amongst large economies, is forecast to be somewhat lower than expected in 2017 due to the impact of the withdrawal of high denomination currency notes from circulation. Growth rates in economies that are dependent on oil incomes, particularly those in the Middle East, are also expected to slowdown due to lower levels of oil production, in spite of the expected increase in oil prices.

The acceleration in global growth and the resultant increase in global interest rates could have diverse effects on the Sri Lankan economy. The increase in oil prices as well as prices of other commodities in the global markets will weigh negatively in aggregate on the BOP and domestic price indices, while stagnant growth in the Middle East could reduce the income from tea exports and remittances by migrant workers. Tourist arrivals may pick up with high economic growth in Europe, China, India and Russia, which are Sri Lanka's major sources of tourism. Sri Lanka, along with other small economies in Asia, could experience higher direct investment inflows, given the rising levels of South-South FDIs. The proposed trade and economic partnership arrangements in the region could enable Sri Lanka to gain access to larger regional markets with higher income levels. The tightening of financial markets, however, pose numerous challenges to Sri Lanka, in relation to borrowing in international financial markets that are necessary to rollover previous borrowings, and in relation to payment of interest on floating rate US dollar denominated instruments that are being used to finance the budget deficit.

1.4 Medium Term Macroeconomic Outlook

The Sri Lankan economy is projected to grow at a moderate rate of around 5.0 per cent in 2017 amidst the adverse impact of unfavourable weather conditions, and is expected to improve gradually thereafter to record an annual growth rate of 7.0 per cent by 2020. The private sector is expected to play a key role in achieving this higher growth momentum by exploiting potential growth opportunities in the economy and external markets. Accordingly, economic expansion would be supported through increased investment from the private sector. Foreign investors are expected to contribute towards a higher level of investment with particular emphasis on services related activities and export oriented industries. The opportunities for the private sector would include the planned establishment of the Colombo Financial City, new opportunities under the Western Region Megapolis Project and the proposed establishment of economic corridors in the North East and South West of the island, and also in the areas surrounding the Hambantota and Trincomalee ports. In addition to these initiatives, domestic investment activities are also expected to continue with emphasis on improving productivity through the adoption of new technology including mechanisation initiatives in

1

Table 1.5
Medium Term Macroeconomic Framework (a)

Indicator	Unit	2015 (b)	2016 (c)	Projections			
				2017	2018	2019	2020
Real Sector (d)							
Real GDP Growth	%	4.8 (c)	4.4	5.0	6.0	6.5	7.0
GDP at Current Market Price	Rs. bn	10,952 (c)	11,839	12,927	14,260	15,801	17,583
Per Capita GDP	US$	3,843 (c)(e)	3,835	3,938	4,157	4,485	4,902
Total Investment	% of GDP	28.4 (c)	31.5	32.0	32.5	33.0	33.5
Domestic Savings	% of GDP	20.9 (c)	23.8	24.8	26.0	27.4	28.8
National Savings	% of GDP	26.0 (c)	28.9	29.9	30.6	31.3	32.2
External Sector							
Trade Gap (d)	% of GDP	-10.4	-11.2	-11.0	-10.6	-10.0	-9.3
Exports	US$ mn	10,546	10,310	11,425	12,796	14,465	16,414
Imports	US$ mn	18,935	19,400	20,699	22,354	24,233	26,415
Current Account Balance (d)	% of GDP	-2.3	-2.4	-2.1	-1.9	-1.7	-1.3
External Official Reserves	Months of Imports	4.6	3.7	4.3	4.5	4.7	5.3
Fiscal Sector (f)							
Total Revenue and Grants	% of GDP	13.3	14.3	15.0	15.5	16.0	16.5
Expenditure and Net Lending	% of GDP	20.9	19.7	19.6	19.8	19.8	20.1
Current Account Balance	% of GDP	-2.3	-0.6	0.5	0.5	1.3	1.6
Overall Budget Deficit	% of GDP	-7.6	-5.4	-4.6	-4.3	-3.8	-3.5
Central Government Debt	% of GDP	77.6	79.3	77.5	75.1	72.7	70.0
Monetary Sector and Inflation							
Broad Money Growth (M_{2b}) (g)	%	17.8	18.4	12.3	12.3	13.5	13.8
Private Sector Credit Growth (in M_{2b}) (g)	%	25.1	21.9	15.0	14.7	15.0	15.1
Annual Average Inflation (h)	%	2.2	4.0	6.0	5.0	5.0	5.0

(a) Based on information available by mid March 2017.
(b) Revised
(c) Provisional
(d) The data is based on the base year 2010 GDP estimates of the Department of Census and Statistics.
(e) Estimates updated with latest population figures.
(f) Based on revised GDP estimates for 2015 made available on 15 March 2017 by the Department of Census and Statistics.
(g) Year-on-year growth based on end year values.
(h) Based on CCPI (2013=100)

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

the Agriculture and Industry sectors together with the adoption of information technology (IT) related improvements. These developments are expected to be supported by complementary policy measures of the government in creating a conducive environment for economic expansion. Such policy measures would include structural adjustments in both the fiscal and external sectors together with prudent macroeconomic management policies. Further, appropriate monetary policy measures are expected to maintain inflation at around 5.0 per cent, on average. The nominal exchange rate is also being allowed to adjust to attain a real effective exchange rate (REER) index of 100 and to maintain it at that level to support the competitiveness of the economy. With these developments, the production capacity of the economy would improve supporting higher domestic production, which could be exported through improved market access supported by favourable policy initiatives. Hence, in the medium term, economic growth would be supported by all major sectors of the economy amidst increased demand from both domestic and external sectors resulting in Sri Lanka progressing towards an upper middle income economy.

The external sector outlook is projected to gradually improve during the medium term with the adoption of appropriate policy measures to ensure external sector stability. The external current account deficit is expected to improve steadily with the projected developments in the external sector. Exports are projected to increase at a higher rate than imports, resulting in a narrowing of the trade deficit in the medium term. The rise in exports is projected to emanate from higher export oriented domestic production supported through improved trade linkages, including the reinstating of GSP+ concession and proposed trade and economic partnership agreements. Imports would also continue to increase, particularly with higher intermediate goods imports with the expected increase in global oil prices and higher demand for investment goods due to the projected increase in investment expenditure. Meanwhile, the services account is projected to record a surplus in the medium term with higher inflows particularly from tourist receipts, transportation services and telecommunications, computer and information services. Realisation of these higher receipts from the rest of the world would depend on initiatives aimed at improving market access and diversification of services exports. Workers' remittances that have contributed substantially towards dampening the deficit in the current account is expected to improve further, albeit at a slower pace. The projected slowdown in workers' remittances is attributed to the decline in migration with better domestic employment opportunities, and initiatives aimed at discouraging semi-skilled and unskilled migration together with unfavourable economic developments in some traditional migration destinations. Meanwhile, the financial account of the BOP is expected to improve with higher inflows through non debt creating sources such as FDI, as well as continued foreign financing for development projects and proceeds through debt securities, such as the issuance of ISBs. Meanwhile, it is expected that the reliance on debt related inflows would gradually subside during the medium term, while more sustainable foreign inflows through higher export proceeds and foreign investment inflows would contribute to the gradual strengthening of international reserves, improving the resilience of the external sector in the medium term.

The Central Bank officially announced in its "Road Map: Monetary and Financial Sector Policies for 2017 and beyond" that the conduct of monetary policy will be strengthened by adopting a Flexible Inflation Targeting (FIT) framework in the medium term. Currently, the Central Bank conducts its monetary policy within an enhanced monetary policy framework with features of both monetary targeting and inflation targeting. Going forward, the conduct of monetary policy of the Central Bank will be based on a FIT framework with the objective of maintaining price stability with due attention to real sector stability in the context of exchange rate flexibility. The sustained low inflation environment and continued efforts towards fiscal consolidation have created an enabling environment for the smooth transition towards a FIT framework in the medium term. At the same time, the Central Bank is currently working with international agencies to implement necessary legislative and operational changes to facilitate this process. These legislative changes are expected to ensure accountability and credibility of the envisaged inflation targeting framework. Moreover, the Central Bank is in the process of enhancing its technical capabilities. In this regard, a joint effort has been initiated by the Central Bank and the IMF in developing a structural model-based Forecasting and Policy Analysis System (FPAS) to strengthen the monetary policy decision making process and to support Sri Lanka's transition to a FIT regime (See Box Article 01: *Model based Approach to Monetary Policy Analysis in Sri Lanka*). These tools are expected to provide a better understanding of the Sri Lankan economy to formulate effective policies in a forward looking manner, while enabling early detection of potential risks and their impact on the future path of key macro variables. Furthermore, it is also expected that the government's ongoing fiscal consolidation programme strongly supports the FIT

1

BOX 01
Model Based Approach to Monetary Policy Analysis in Sri Lanka

The Central Bank of Sri Lanka (CBSL) is currently improving its monetary policy framework and increasingly aligning it with a flexible inflation targeting (FIT) framework.[1] In a broad sense, FIT denotes the setting of policy rates in a manner so as to stabilise inflation around the targeted rate with due regard to the stability of the economy (Palmqvist, 2007). Therefore, within a FIT framework, the inflation forecast will be the centric element to manage and communicate the short-run output-inflation trade off.

In the transition to a FIT regime, it is essential that a central bank becomes increasingly transparent and forward-looking. The use of structural models for medium term projections and policy analysis has become indispensable for this purpose. These models would equip the central bank with the ability to determine the path of monetary policy actions needed to bring inflation to its medium term objective while stabilising real output at its potential level. The model outcomes can also pave the way for structured debate about underlying assumptions, risks and policy issues, and will permit greater transparency in policy decisions and communication (Alichi and Benes, 2015).

Inflation Targeting – An Overview

A unique advantage of inflation targeting is that it comprises a framework for monetary policy that combines elements of both 'rules' and 'discretion.' The inflation target, therefore, provides a rule-like framework on which economic stakeholders can anchor their expectations about future inflation, whilst the central bank can exercise its discretion in reacting to shocks (Hammond, 2012).

The key essential elements of an inflation targeting framework are:

(i) Public announcement of a quantitative target for inflation.

(ii) Monetary policy is based on a wide set of information, including a medium term inflation forecast, which facilitates forward looking monetary policy decision making.

(iii) High degree of transparency and the presence of accountability mechanisms.

Several pre-requisites have been identified as essential to the establishment of a successful inflation targeting framework. These include the central bank's operational independence and an explicit mandate to achieve price stability, central bank's freedom from fiscal dominance, reasonably well understood monetary transmission channels, proper coordination between monetary and fiscal policies, a flexible exchange rate regime, a sound methodology for macroeconomic analysis and forecasting, and a well-developed financial system and transparent policies to build accountability and credibility of the central bank (Schaechter et al., 2000).

The CBSL has already met certain prerequisites of an inflation targeting framework. Along with the CBSL's independence in selecting operating instruments and with a mandate to maintain price stability, it has taken several initiatives during the recent past to further equip the monetary policy framework for inflation targeting. Accordingly, the CBSL has begun to enunciate its policies through a public policy document, developed in-house macroeconomic forecasting tools, published expected path for future inflation and commenced the conducting of the inflation expectations survey (CBSL, 2017). Over this period, the CBSL has also strengthened its technical capacity in data collection and management, and modelling and forecasting of key macroeconomic variables.

Since the adoption of inflation targeting by the Reserve Bank of New Zealand in 1989, the best practices of IT evolved over time, and now all inflation targeting central banks conduct FIT rather than strict inflation targeting (Palmqvist, 2007; Svensson, 2009). The term "flexible inflation targeting" was introduced by Svensson (1999) to define a situation where the central bank minimises welfare loss to the society, as measured by inflation's deviation from its target as well as output's deviation from its potential level. However, in practice, the flexibility associated with FIT can be interpreted not only in terms of its consideration of real economic developments, but also in terms of the target horizon and how quickly the central bank tries to rein inflation back to the targeted rate following a deviation (Palmqvist, 2007).

The Need for Model based Projections and Policy Analysis for FIT

The successful implementation of FIT hinges on reliable medium term forecasts and the knowledge of the monetary transmission mechanism. Advanced macroeconomic models can help in gathering a thorough understanding of the economy and evaluating potential risks and their impact on the future path of key macro variables. Hence, these models can increase the robustness of the policymaking process. Further, monetary policy impacts inflation and output through a complex transmission mechanism which involves a number of linkages among macroeconomic variables and expectations of economic stakeholders.

1. For a detailed discussion, see Box Article 01 in the Central Bank of Sri Lanka Annual Report 2007 and Box Article 10 in the Central Bank of Sri Lanka Annual Report 2015.

Therefore, it is vital to possess reliable forecasting and policy analysis tools that also take into account the unique characteristics of the Sri Lankan economy.

It is typical of FIT central banks to possess a suite of models to determine the medium path of the economy (Black et al., 1994; Black et al., 1997; Coats et al., 2003). Although the CBSL has been engaged in macroeconometric forecasting in the past, with a view to further strengthening its policy formulation and modelling capacity, it initiated structural modelling with customised training and technical assistance from the International Monetary Fund (IMF). As such, a joint effort has been made by the CBSL and the IMF in developing a structural model-based Forecasting and Policy Analysis System (FPAS) over the medium term, to strengthen the monetary policy decision making process and to support Sri Lanka's transition to FIT.

With the creation of a permanent Modelling and Forecasting Division in the Economic Research Department (ERD), the CBSL has taken a key step in the effective implementation of FPAS. Several initiatives are underway to upgrade the technical capabilities of relevant staff so as to strengthen all macroeconomic projections, including inflation projections, using short-term and medium term forecasting tools and techniques. Accordingly, the ERD, with inputs from other departments of the CBSL, is managing a comprehensive analytical database, which will not only serve the data requirements of FPAS but highlight potential areas for research.

FPAS – An Overview

FPAS is a medium term pre-emptive policy analysis system which brings together information and judgment in a coherent and logical manner. It includes collecting, analysing and processing information and assumptions for the formulation of forward-looking policies, with preference often given to long term stabilisation. Moreover, FPAS combines several tools and processes which equip staff with the ability to conduct high-quality macroeconomic analysis and forecasting exercises that will support decision making. The structural model at the core of FPAS facilitates quality policy discussions about forecasts, potential risks to forecasts and appropriate responses to various shocks, and allows to construct policy scenarios. The prevalence of a structured FPAS system entails several other benefits. These include:

- Improved communication between all staff engaged in the forecast and policy debates, which creates important synergies and paves the way for continual improvement of the process of reaching a unanimous decision.
- A more structured debate about potential risks, allowing policymakers to better identify and communicate key policy issues.
- Development of a database to assess the efficiency of historical forecasts and thereby identify areas for new research.
- Development of a highly specialised pool of macroeconomic forecasting and research staff.
- Development of institutional knowledge about the monetary transmission mechanism and the impact of emerging shocks or disturbances.
- Potential for increased transparency about the systematic aspects of monetary policy and the means by which the forecast is developed. (Laxton, 2009)

While several central banks such as those in Canada, Brazil, Australia, Singapore, Thailand and India have successfully established FPAS, a number of other central banks are currently in the process of developing such a system.[2] An essential element of FPAS is the Quarterly Projection Model (QPM), which is a semi-structural, forward looking open economy gap model that assists in the generation of a medium term policy path that is consistent with meeting of targets under the FIT regime (RBI, 2016). It is based on the principles of new-Keynesian open economy which embody the general view that monetary policy influences aggregate demand and output dynamics in the short run. In the long run, the policy influences only nominal variables (e.g. inflation), whereas real variables (e.g. real GDP growth) are determined by factors beyond the control of the monetary policy (e.g. growth in productivity, fiscal policies affecting income redistribution, etc.). These models are also built on micro-foundations and rational expectations.

Accordingly, under FPAS, the CBSL has finalised the development of the baseline version of a semi-structural QPM for forecasting and analysis of monetary policy.[3] The benchmark model consists of four main behavioural equations, which represent aggregate demand (Investment-Saving or IS curve), aggregate supply (Phillips curve), the uncovered interest rate parity (UIP) condition, and the monetary policy-reaction function (Taylor-type interest rate rule combined with a foreign exchange rule).

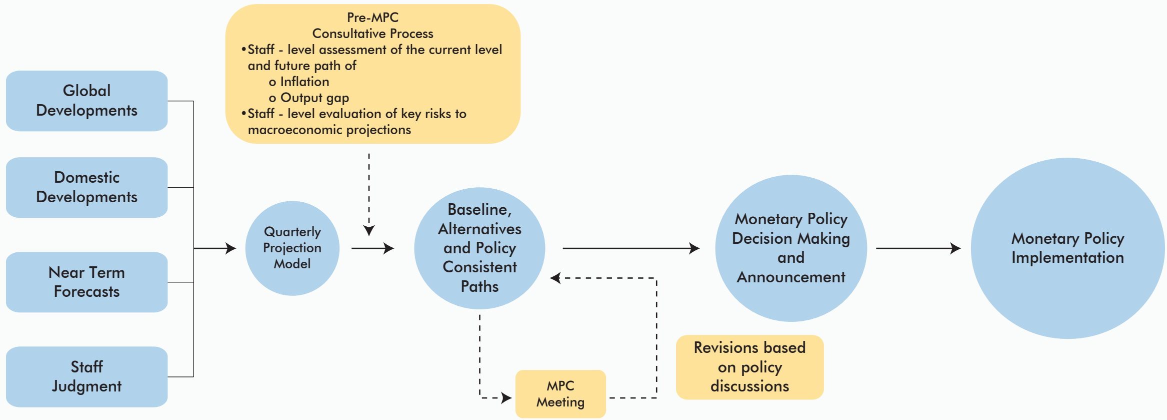
The QPM also accounts for multiple shocks that the Sri Lankan economy is prone to. These are broadly categorised as aggregate demand, supply, exchange rate, monetary policy and risk premium shocks.

Currently the CBSL utilises several econometric models to conduct near term forecasting (NTF) exercises for GDP and inflation. A set of advanced NTF models is

2. http://www.douglaslaxton.org/fpas.html
3. Amarasekara, C., Anand, R., Ehelepola, K., Ekanayake, H., Jayawickrema, V., Jegajeevan, S., Nugawela, T., Ratnavadivel, P., Remo, A., Plotnikov, S., Yatigamanna, R. An Open Economy Quarterly Projection Model for Sri Lanka. Forthcoming 2017.

1

Chart B 1.1
Proposed Monetary Policy Formulation Process



supposed to complement the QPM in better capturing the idiosyncratic shocks to inflation and GDP over the short-term.

Additionally, the implementation of FPAS will help enhance the CBSL's communication with the stakeholders and general public, as it will complement the communication of the projected medium term path, with a comprehensive analysis and explanation of assumptions and judgments underpinning the projection, and the potential risks to the realisation of such projections.

Way Forward

The complete adoption of FPAS requires material changes in the monetary policy formulation process as well (Chart B 1.1). Accordingly, the number of Monetary Policy Committee (MPC) meetings has already been reduced to 8 meetings per year in 2017 from the previously conducted 12 meetings per year. This revised MPC process will enable more time for staff to conduct a comprehensive analysis of economic developments and thereby facilitate the provision of in-depth and more forward looking insights to the monetary policy formulation process.

In the long term, FPAS will also have a pivotal role to play in the adoption and subsequent success of the FIT framework, as the CBSL will communicate the medium term forecasts of key macroeconomic variables to the public. IT central banks have referred to inflation targets and forecasts, conveyed through inflation reports, as their primary communication tools in order to anchor inflation expectations. In the past, a thorough understanding of monetary policy decisions has been a difficult task for the public. However, the publication of inflation reports in the future is expected to largely bridge this information gap between the CBSL and the public. Such reports will also compel policymakers to remain not only transparent, but also accountable for announced targets. In the event of missed targets, policymakers will be obliged to provide an exhaustive justification for the underperformance and the public will also be equipped to understand policy shortcomings. These changes are also expected to be supplemented by necessary legislative amendments aimed at strengthening the CBSL to conduct monetary policy more independently within a flexible exchange rate regime.

A coherent framework based on FPAS will equip policymakers in a FIT regime to generate proactive policy analysis that will enable the creation of a growth conducive, low-inflation environment.

References

Alichi, A. and J. Benes. 2015. "Frontiers of Monetary Policymaking: Adding the Exchange Rate as a Tool to Combat Deflationary Risks in the Czech Republic." International Monetary Fund Working Papers 15-74.

Benes, J., K. Clinton, A. T. George, P. Gupta, J. John, O. Kamenik, D. Laxton, P. Mitra, G. V. Nadhanael, R. Portillo, H. Wang, and F. Zhang. 2016. "Inflation-Forecast Targeting For India: An Outline of the Analytical Framework." RBI Working Papers, 07.

Benes, J., K. Clinton, A. T. George, J. John, O. Kamenik, D. Laxton, P. Mitra, G. V. Nadhanael, H. Wang, and F. Zhang. 2016. "Quarterly Projection Model for India: Key Elements and Properties." RBI Working Papers, 08.

Black, R., V. Cassino, A. Drew, E. Hansen, B. Hunt, D. Rose, and A. Scott. 1997. "The Forecasting and Policy System: the Core Model." Reserve Bank of New Zealand Research Papers 43.

Black, R., D. Laxton, D. Rose, and R. Tetlow. 1994. "The Steady-State Model: SSQPM: The Bank of Canada's New Quarterly Projection Model." Bank of Canada Technical Reports 72, Part 1.

Central Bank of Sri Lanka. 2017. "Road Map: Monetary and Financial Sector Policies for 2017 and Beyond."

Coats, W., D. Laxton, and D. Rose. 2003. "The Czech National Bank's Forecasting and Policy Analysis System."

Gonçalvez, C.E.S. and J.M. Salles. 2008. "Inflation Targeting in Emerging Economies: What Do the Data Say?" Journal of Development Ecnonomics, 85, pp. 312-18.

Hammond, G. . 2012. "State of the Art of Inflation Targeting." Centre for Central Banking Studies Handbooks.

International Monetary Fund. 2015. "Evolving Monetary Policy Frameworks in Low-Income and other Developing Countries."

Laxton, D., D. Rose, and A. Scott. 2009. "Developing a Structured Forecasting and Policy Analysis System to Support Inflation-Forecast Targeting (IFT) " International Monetary Fund Working Papers, 09-65.

Palmqvist, S. 2007. "Flexible Inflation Targeting: How should Central Banks take the Real Economy into Consideration?" Sveriges Riksbank Economic Review, 2:61.

Schaechter, Andrea, Mark R. Stone, and Mark Zelmer. 2000. "Adopting Inflation Targeting: Practical Issues for Emerging Market Countries." International Monetary Fund.

Svensson, L.E.O. 1999. "Inflation Targeting: Some Extensions." Scandinavian Journal of Economics, 101:3, pp. 337-61.

Svensson, L. E.O. 2009. "Flexible Inflation Targeting: Lessons from the Financial Crisis."

framework, particularly through reduced reliance on the Central Bank for financing the fiscal deficit. This would also help maintain monetary and credit aggregates at levels consistent with envisaged real economic growth and mid-single digit inflation, while avoiding undue volatility in interest rates. As the success of the monetary policy framework is also dependent on effective transmission of monetary policy through sound financial markets, the Central Bank is also expected to work in collaboration with other regulatory bodies and authorities to introduce required policies to develop and deepen the financial markets in the medium term.

The medium term fiscal strategy of the government focuses on strengthening the revenue based fiscal consolidation process by maintaining stability of the fiscal sector by reducing the budget deficit and government debt to a sustainable level. In this endeavour, the government has displayed its commitment by adopting several policy measures to enhance revenue collection and rationalise expenditure. Accordingly, the budget deficit is expected to be around 3.5 per cent of GDP by 2020. The government plans to increase the revenue to GDP ratio to around 16 per cent by 2020 with a number of policy initiatives, including the automation of revenue collecting agencies, risk based auditing, efficiency enhancing measures, simplification of tax legislation and broadening the tax base. Further, medium term strategic priorities of the government also include rationalising ineffective public expenditure, restructuring SOBEs to operate them as commercially viable entities, improving fiscal transparency and accountability in public financial management and proper targeting of subsidy schemes. Implementation of the commitment control mechanism for the ministries and submitting quarterly expenditure and income reports to the Parliament will also strengthen expenditure management efforts. The overall objective is to improve the quality of public expenditure by aligning its composition with national priorities within the medium term budgetary framework. The revenue based fiscal consolidation process will expand the fiscal space and allow for more spending on growth drivers in the medium term. This is also expected to preserve the government's fiscal space for increasing infrastructure spending and effective fiscal outlay for key social spending categories such as education, health and other social protection schemes, while maintaining public investments at a sufficient level. The medium term debt management strategy is expected to provide a framework for a prudent borrowing programme ensuring the availability of adequate funding for the government's financing needs at the lowest possible cost with minimum risks. Accordingly, central government debt is expected to be reduced to around 70 per cent of GDP by 2020.

1.5 Issues and Policies

The realisation of Sri Lanka's envisaged medium term growth path is contingent upon addressing the deep rooted structural issues in the economy, which have prevented the country from maintaining a high and sustainable real GDP growth rate over time. Along with supportive fiscal and monetary policy measures taken in a timely manner, it is necessary to implement policies to address the structural issues in the economy aimed at improving productivity and efficiency, thereby resetting the growth trajectory of the country in order to harness its full potential in the medium term and beyond.

Although declining earnings from exports as a percentage of GDP have been partly due to weak external demand, the internal factors that have contributed to the continuation of such a trend cannot be ignored. Earnings from exports

1

contracted for the second consecutive year in 2016 and remained at a level lower than the earnings recorded five years ago. Being a middle income economy with comparatively high living standards, exporting the same primary commodities and low value added merchandise over the last two decades, and the limited manufacturing of complex and knowledge-intensive products, have hindered the growth prospects of Sri Lankan exports. This highlights the need for both product and market diversification. Producing more complex, high value added and more technologically intensive products, while integrating with regional and global production networks would act as a catalyst in Sri Lanka's transition towards becoming an export oriented economy. Producing high value added products using minerals that are currently exported in primary commodity form is one strategy that needs to be pursued in this regard. It is necessary to implement a coordinated approach which stems from the current efforts of the government within its overarching development policy, to identify products and services or their components in the value chain for which Sri Lanka has a competitive edge, resurrect the manufacturing sector, attract FDI, and explore trade channels. Meanwhile, a market based exchange rate reflecting foreign exchange demand and supply conditions, reducing para-tariffs, which have contributed significantly to the economy becoming as closed as it was in 1970, and maintaining low and stable inflation as well as competitive wages would also ensure Sri Lanka's export competitiveness (See Box Article 07: *National Strategy towards Export Promotion*).

Given stagnant earnings from merchandise exports, the importance of non traditional service exports has grown significantly, although focused efforts are required to tap their full potential. In order to increase earnings from service exports, developing the information technology, business process outsourcing, and knowledge process outsourcing (IT/BPO/KPO) industry is a viable option. Sri Lanka can leverage the educated, English proficient and highly trainable workforce to develop this industry. This is an area in which Sri Lanka has a competitive edge in terms of relatively low cost labour in comparison to countries with a similar workforce. An increasing number of youth are gaining educational qualifications in the fields of accountancy, information technology, business management, law and international languages. In addition, Sri Lanka's legal system is based on the English Law, specially the law of contract and laws relating to companies, which makes the workforce easily trainable to provide secretarial and other back-office services to ventures from Commonwealth nations. In addition to IT/BPO/KPO related service provision, concerted efforts are necessary to maximise on the country's strategic location as envisaged, and expand other service exports such as maritime and aviation services by adopting a national strategy on the development of these sectors.

While capitalising on its rich cultural heritage and diverse natural attractions, Sri Lanka needs to widen its product offerings to attract high spending tourists. The tourism sector has thrived in post-conflict Sri Lanka, annually attracting over two million tourists and earnings over US dollars 3.5 billion by 2016. As a travel destination, Sri Lanka is unique in its offerings with iconic cultural and historic sites, wildlife sanctuaries, pristine beaches and picturesque landscapes. However, a coordinated strategy is necessary to diversify the range of attractions further to cater to the varied demands of tourists. Identifying different key tourist cohorts and putting in place strategies that target each individual cohort is imperative, as a single approach strategy would not attain the desired outcomes. For the general tourist, developing the periphery of isolated attractions, popularising adventure activities, setting up theme parks, expanding ayurvedic treatment facilities, and streamlining transport facilities and informal accommodation would enhance Sri Lanka's attractiveness. Special attention is required to entice high spending tourists through the establishment and promotion of boutique hotels and yacht marinas while developing the entertainment economy to cater to this niche market. Ensuring a high quality experience for tourists will inspire repeat visitation and positive word-of-mouth advertising. In addition, such increased services may result in the average stay per tourist to increase beyond the current 10 nights and generate additional tourism-related revenue while increasing direct and indirect employment opportunities.

As evidenced by realised inflows, Sri Lanka's attractiveness for FDI has remained low in spite of continued efforts to facilitate such investments. A reversal of this trend is urgently required. Failure to attract satisfactory amounts of FDI contributed to the high reliance on foreign debt to finance the current account deficit, increasing the country's already high level of indebtedness. The strategies that are being developed by the government need to be implemented expeditiously with a view to attracting higher levels of FDI to the country, particularly in the backdrop of relatively higher FDI inflows to emerging market economies such as Vietnam, Myanmar and Bangladesh. Consistent domestic policies that are aimed at improving Sri Lanka's competitiveness, strong institutional support and targeted promotional campaigns highlighting the potential of Sri Lanka as an attractive destination for investment would be instrumental in creating an enabling environment for FDI (See Box Article 02: *Improving Sri Lanka's Competitiveness within Global Markets*).

The implementation of a well-coordinated industrial policy framework is essential for the country to integrate with global value chains with the aim of enhancing manufacturing output, thereby boosting Sri Lanka's industrial exports. Although industrial policies adopted in the 1990's enabled Sri Lanka to significantly improve the share of manufacturing goods in total exports, Sri Lanka has been less successful in diversifying its manufacturing product range and upgrading from labour-intensive to high-tech manufacturing exports. As a result, Sri Lanka's manufacturing exports continue to be highly concentrated in textiles and garments while growth in the export sector, particularly manufacturing exports, has been dismal in the recent past. While Sri Lanka's industrial policies have continued to focus mainly on promoting final goods for the export market, the global approach has changed. Global production networks have come to the forefront in cross-border trade and production. This has opened up avenues for countries to specialise in different stages in the production process based on their relative cost advantages. Regional competitors, particularly East and South East Asian countries such as China, Taiwan, South Korea, Thailand, Malaysia, Vietnam and Indonesia, have dramatically increased their manufacturing exports through global production networks. India, which traditionally focused on labour intensive manufacturing exports, has integrated successfully with global production networks producing technology intensive parts and components for data processing machines, electrical machinery and semiconductor devices. Conversely, only a fraction of Sri Lanka's manufacturing exports moved through global production networks during this period. Therefore, Sri Lanka needs to revamp its industrial policy to facilitate greater integration of the domestic manufacturing sector with regional

1

BOX 02
Improving Sri Lanka's Competitiveness within Global Markets

Sri Lanka's Competitiveness in the Current Context

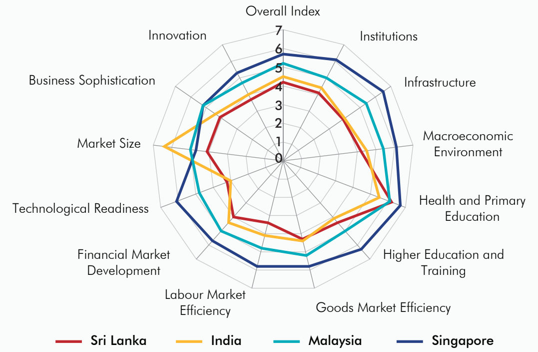
In an increasingly competitive global market, a country's national competitiveness depends greatly on its ability to position itself in the global value chain and compete successfully for a higher share in trade in goods and services, investments and human capital, all of which are crucial for a high growth trajectory. As countries compete in an increasingly challenging and demanding global market, country competitiveness has become a central theme of discussion among economists and policymakers, alike, in both advanced and emerging market economies. The World Economic Forum (WEF) defines the competitiveness of a country as 'the set of institutions, policies and factors that determine the level of productivity of a country'. Growth models suggest that productivity is the most fundamental factor determining the level of prosperity of a country and its citizens in the long run.[1]

While the three-decade long internal conflict severely hampered Sri Lanka's competitiveness, years after the ending of the internal conflict, the economy is still experiencing a stagnant external sector performance and low levels of productivity growth, resulting in the economy not being able to fully exploit its potential. The high growth experienced in the recent past stemmed from non-tradable sectors (mainly construction and real estate), which were primarily driven by public sector consumption and investments that are both unsustainable and inequitable. Although Sri Lanka was one of the most open economies in the Asian region during the late 1970s, the inward-focused restrictive trade policy stance of successive governments has resulted in a traditional exports basket of low value added and labour-intensive products for which Sri Lanka faces stiff competition from other low cost developing countries. The low technology content of Sri Lanka's exports and the low-skill products exported by the country also result in the underutilisation of Sri Lanka's educated labour force. The strategies adopted by Sri Lanka including the provision of grants, subsidies and tax concessions have not been effective in sustaining the country's attractiveness as a destination for foreign direct investments (FDI) and exports.

The prevailing weak investment climate in Sri Lanka can be attributed to a range of factors including policy uncertainty, institutional weaknesses such as corruption and weak regulations, and faltering infrastructure.[2] This has resulted in Sri Lanka attracting lower volumes of FDI as a percentage of GDP, than its lower middle-income peer economies. This has culminated in the form of limited growth potential, innovation and productivity of established firms, and the inhibition of start-ups, thus severely curtailing the country's international competitiveness. Factors such as macroeconomic imbalances, legal and procedural obstacles to foreign investment, lack of consistency in the legal and regulatory framework, and the lack of a well-coordinated mechanism to attract, retain and integrate foreign investments, continue to pose as impediments to Sri Lanka's ability to entirely benefit from rapidly expanding world trade, thereby resulting in the loss of its market base to its competitors.

The WEF's Global Competitiveness Index (GCI) - 2016/17 ranks Sri Lanka as 71st among 138 countries around the world, slipping three notches down from its position in the GCI - 2015/16 ranking. Conversely, regional economies, such as India, Malaysia and Singapore have made remarkable progress in improving their global competitiveness over the past few decades, resulting in these countries ranking at the 39th, 25th and 2nd positions, respectively, in the GCI - 2016/17. Other regional peers, such as Pakistan, Bangladesh, Nepal and Bhutan, are ranked at 122nd, 106th, 98th and 97th positions, respectively. Chart B 2.1 illustrates the performance of Sri Lanka in terms of 12 major determinants of competitiveness against its leading counterparts, Singapore, Malaysia and India.

Chart B 2.1
Comparison of Country Competitiveness GCI 2016/17



Note: Lower value implies lower comparative performance

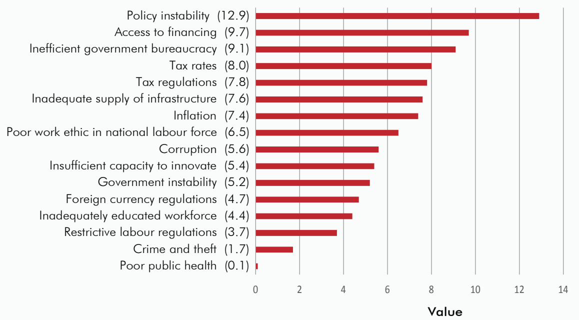
Source: The Global Competitiveness Index, World Economic Forum

Considering that the attraction of FDI is a necessary condition for the level of economic diversification that Sri Lanka aspires to achieve, there is a need for robust policy initiatives that will enable Sri Lanka to emerge as a key FDI destination. However, not all FDI is the same and their impact and spillovers in the economy vary significantly. Therefore, the policies and instruments to attract FDI to Sri Lanka should be guided by a clear vision

1. World Economic Forum and Harvard University. (1996). *The Global Competitiveness Report.* Geneva: World Economic Forum.
2. The World Bank. (2016). *Enhancing Competitiveness in Sri Lanka.* World Bank, Washington, DC. https://openknowledge.worldbank.org/handle/10986/24927

on the type of FDI that the country pursues. Investment attraction efforts however, are not enough in the absence of a stable foundation. Investors seek a stable investment climate with macroeconomic and political stability in the host country, in addition to the availability of infrastructure and linkages to global markets. Chart B 2.2 highlights the key problematic areas that the business community has identified as hindrances for country competitiveness in the GCI Report - 2016/17. Therefore, the insight offered by global investors can be used in the determination of policy priorities to enhance the country's investment climate, thus enabling Sri Lanka to attract and retain FDI.

Chart B 2.2
Most problematic factors for doing business in Sri Lanka



Source: Executive Opinion Survey 2016, World Economic Forum

Measures Towards Improving Sri Lanka's Competitiveness

Today, Sri Lanka is in a dire need of policy initiatives focused at improving its competitiveness so that it may ascend from a 'lower-middle income economy' to an 'upper-middle income economy' without a considerable delay. In analysing Sri Lanka's performance in several global competitiveness rankings, the following areas are identified as policy priorities in the reform process to improve the country's competitiveness in the global arena.

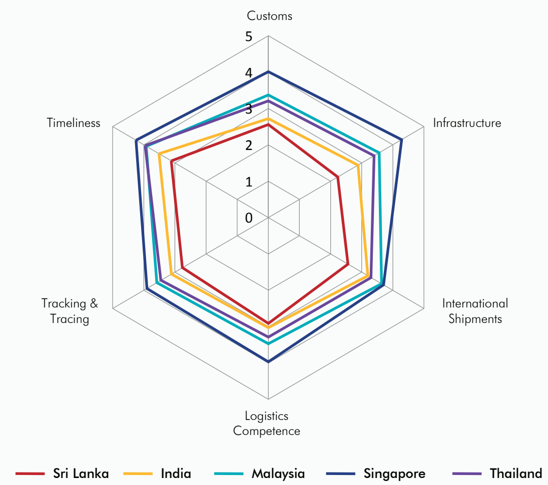
1. The Need for a Consistent, National Development Policy

The existence of a consistent national policy towards development has enabled a number of advanced and emerging economies to compete successfully in the international market by attracting FDI inflows and capturing a substantial share of international trade. However, in the context of Sri Lanka, there is a lack of national development policy consensus as they change from time to time, in line with the agenda of the political parties. However, in order to compete in a global marketplace, it is essential to draft and implement policies over the long term in a consistent and transparent manner, irrespective of the government in power. Policy inconsistency raises vulnerability to market risks, thus deterring investor confidence. This results in low levels of FDI inflows and dampening of domestic investments by the private sector. Hence, to build investor confidence in the domestic economy, it is important to move away from the stop-go policy culture that was prevalent in the past while having a coherent national development policy, implemented with strong commitment.

2. Improving the Quality of Infrastructure

In recent years, Sri Lanka witnessed a significant improvement in its infrastructure base. However, improving the infrastructure base alone will not improve competitiveness as the quality of services delivered by such infrastructure is a serious concern among potential investors. For example, though Sri Lanka has reached a significantly high level of electrification, the quality of electricity supply is questionable and is not competitively priced. Sri Lanka also holds a low rank in terms of logistics compared to its regional peers in 2014, as measured by the Logistics Performance Index (refer Chart B 2.3). This exhibits the drawbacks of the current infrastructure base. Prospective investors consider such rankings in making their business decisions as the quality and cost of infrastructure affect their profitability. Local manufacturers also experience these difficulties and as a result, business operations are primarily concentrated in the Western Province, where access to infrastructure is high. The government should focus on the development and enhancement of infrastructure within and outside the Western Province in line with its broad national development policy framework, as infrastructure is a key driver of national competitiveness.

Chart B 2.3
Logistics Performance Index (2014)



Note: Lower value implies lower comparative performance

Source: Logistics Performance Index 2014, World Bank

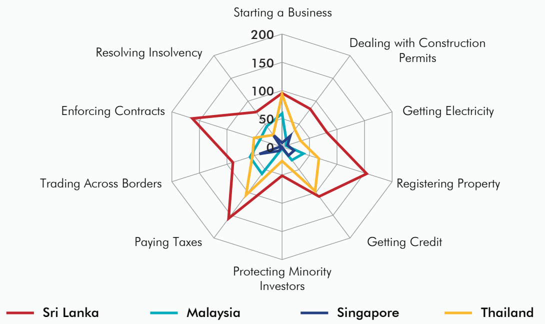
3. Bureaucratic Constraints

Bureaucratic constraints are often referred to as an obstacle for effective conduct of private sector businesses. Hence, the government has to facilitate the private sector through less bureaucratic constraints as high compliance costs are a key consideration in the business decisions of the private sector. The presence of excessive bureaucratic procedures in business start-up, enforcement of contracts,

1

property registration and obtaining credit have also placed Sri Lanka at a significantly disadvantageous position in the 'Doing Business Index', when compared to regional peers. Further, the high costs associated with compliance of regulations discourage the creation of new firms, limit the growth of existing firms, induce entrepreneurs to operate informally, limit access to finance and business processes, and paves the way for waste and corruption.

Chart B 2.4
Doing Business Rankings of Selected Countries 2016



Note: Higher ranking implies lower comparative performance

Source: World Bank Doing Business 2016

Simplification of existing procedures and associated systems would encourage entrepreneurs to start-up innovative businesses that are capable of evolving into businesses with significant international potential. Although the government has taken several progressive steps towards this end, especially with regard to tax administration and the improvement of public sector efficiencies, rapid reforms are needed in the legal and tax environments of the country.

4. Research and Development (R&D), and Innovation

Innovation and entrepreneurship are key drivers of competitiveness. Accordingly, Sri Lanka should provide impetus to encourage knowledge-intensive enterprises that can successfully develop and sell goods and services with high value addition, in both domestic and global markets. To this end, policy initiatives such as (i) energising export-oriented small and medium enterprises (SMEs); (ii) fast-tracking the formation and scaling of growth-oriented start-ups; and (iii) rationalising and upgrading the R&D sector are key for Sri Lanka. These three strategies require distinct, yet complementary set of policy initiatives that are essential for the economic modernisation process of Sri Lanka and to improve its competitiveness vis-à-vis its competitors in the global economy. To enable export oriented SMEs, it is needed to introduce incentives for technology adoption, develop channels for greater access to supply chains and international markets, strengthen the quality of national infrastructure and address technological skills gaps to enable both traditional and emerging industries. Growth-oriented start-ups are often the source of innovative business models, products and services that can have a transformative economic impact. Having access to seed funding to validate innovative business models, and access to venture capital to commercialise and expand businesses are crucial for innovations to thrive. Many countries are already ahead in the innovation race by enabling their start-up communities through comprehensive ecosystem approaches. If Sri Lanka wishes to attract and raise regionally or globally oriented start-ups, it must focus on creating a simplified and enabling business environment with a policy mix that promote entrepreneurship and innovation.

Sri Lanka's investment in R&D is dismally low. Yet, institutions such as the Sri Lanka Institute of Nano Technology (SLINTEC) - a unique Public-Private Partnership, Industrial Technology Institute (ITI), and the University of Moratuwa have all made considerable progress in developing R&D capabilities to deliver value to Sri Lankan enterprises. Sri Lanka should further emulate these practices in the domestic economy to enhance R&D. To cater to the technology adoption by firms, Sri Lanka needs to have a skilled labour force ready. The education policy needs to be reoriented to cater to this need.

Improving Macroeconomic Stability

The uncertainty created by increasing inflation, overvalued real exchange rate, persistent fiscal deficits, high government debt levels and persistent external current account deficits create macroeconomic instability hindering investor confidence. Sri Lanka has maintained low inflation for eight consecutive years, and this has been positively recognised in the GCI - 2016/17. However, Sri Lanka's competitiveness has been scored poorly in terms of government budget balance, public debt levels and credit ratings. The government has adopted policies to curtail the fiscal deficit by implementing revenue based fiscal consolidation measures to arrest debt accumulation. Lowering the fiscal deficit reduces the need for external financing at high market rates, resulting in mitigating external sector vulnerabilities. In addition, the Central Bank has clearly articulated its exchange rate policy to the public that would also help to build investor confidence. Given that the root cause for current macroeconomic imbalances of Sri Lanka is mostly related to the country's fiscal performance, the revenue based fiscal consolidation process need to be continued with utmost political commitment.

Way Forward

Sri Lanka has had many missed opportunities to transform itself into a developed nation, and thus, cannot afford to delay any further in regaining competitiveness in the global market. Although the government has recognised this need, the speed at which policies are being implemented should be hastened. To this end, Sri Lanka is in need of a comprehensive action plan that receives the support of all stakeholders. Sustaining and advancing reforms to enhance competitiveness require a strong political commitment, while it is necessary to obtain the support of the public for implementing national plans. To achieve this, changing the mindset of the public is also essential.

and global production networks. Towards this end, entering into trade agreements with economies that have increased presence in global production networks and removal of para-tariff barriers are crucial in improving cross-border trade and reducing domestic production costs which could improve Sri Lanka's prospects of integrating with global production networks. Further, human resources should be adequately trained to meet the increasing demands of the export manufacturing sector. Industrial policies need to be well harmonised with infrastructure development. In addition, ensuring property rights and strengthening the enforcement of contracts are important for Sri Lanka to engage in global production sharing (See Box Article 03: *Towards a Manufacturing Sector Development Strategy*).

A disproportionately large share of the total labour force in Sri Lanka is engaged in agriculture related activities, and the sector is plagued with stagnant productivity, lack of diversification, land fragmentation, inefficient water management, poor storage and marketing mechanisms and climate change related issues. Protectionist policies in relation to the agriculture sector have continued to be in place through the provision of fertiliser subsidies, free water, minimum farm-gate prices and high import duties. These policies have discouraged farmers from moving towards other productive sectors in the economy while preventing diversification into more productive cultivation. Agricultural subsidies, such as those for fertiliser, are fiscally ineffective, environmentally unsustainable and economically inefficient. Instead, attention is required on developing appropriate infrastructure and institutional facilities that increase productivity levels in the agriculture sector and develop effective marketing mechanisms, particularly for the paddy sector. Farmer organisations must be strengthened to improve their bargaining power, to set up processing facilities that are owned and operated by them and to efficiently market their final produce. Transforming research knowledge into farmers' knowledge is key for improving the efficiency and productivity of the agriculture sector. Moreover, extension services should be improved in all research agencies, including those of tea, rubber and coconut. Through such services, organic farming techniques that use no pesticides and less fertiliser could be promoted while disseminating knowledge about alternative use of agricultural byproducts. Agricultural policies should strive to improve productivity not only at the farmer level but in the entire value chain, thereby increasing value addition in the agriculture sector. To this end, improving storage facilities, enhancing processing mechanisms for agricultural products and reducing post-harvest losses are essential aspects that need to be addressed through collaborative action of research institutes, extension services and farmers. Further, policies to increase access to credit by farmers through the formal financial sector at reasonable interest rates must be strengthened. Innovative value addition mechanisms and stronger marketing strategies are also crucial to boost agricultural exports. Moreover, priority should be given for sustainable environmental policies and practices in all sectors with the long term view of reducing the adverse effects of climate change on agriculture and food security.

In spite of the government's commitment to fiscal consolidation, fiscal performance continued to reflect several structural weaknesses. The key challenge lies in the below par performance of the government in relation to revenue collection, which has been insufficient even to cover the government's recurrent expenditure. Despite recent improvements, evidence shows that Sri Lanka's poor performance with regard to revenue collection is largely attributable to

1

weak tax collection stemming from numerous tax exemptions, tax avoidance and the weaknesses in tax administration. On the expenditure front, interest payments and expenditure on salaries accounted for over two-thirds of recurrent outlays. Moreover, the high level of transfer payments and welfare expenditure continue to weigh on the government budget. These developments have resulted in limited fiscal space being available for the accommodation of other urgent priorities of the government, thereby creating several new challenges to the prevailing socioeconomic environment. Emerging demands of the economy tend to add further pressure on the budget unless curtailed or prioritised within the envisaged fiscal consolidation path. Any deviation of fiscal targets from the desired levels will create a vicious cycle of revenue shortfalls, expenditure overruns, high budget deficits, increase in government debt and debt service payments, and lower expenditure on public investment. Therefore, the timely implementation of essential reforms as outlined in recent policy documents to revamp budgetary operations is necessary for the government to free itself from this vicious cycle. The rising stock of foreign commercial debt also necessitates the adoption of a prudent and forward looking approach towards debt management.

In the context of the relatively low government revenue to GDP ratio amidst low tax compliance and a narrow tax base, policy measures aimed at bringing the informal economy into the tax net and increasing direct taxation could yield significant benefits in the long run. At present, more than 80 per cent of tax revenue is derived from indirect taxes, such as VAT and import duties. Indirect taxes distort optimal resource allocation based on market forces and affect low-income households adversely, as most of these taxes are imposed on essential consumer items, leading to increased income and expenditure disparities within the economy. Therefore, the government needs to continuously focus on strengthening tax collection, particularly income tax, as it envisages increasing revenue on a sustainable basis while improving the ratio of direct to indirect taxes. Furthermore, among many factors that contributed to the declining trend in tax revenue as a percentage of GDP observed until the recent past, tax evasion and avoidance have been significant. In this context, devising mechanisms to bring the informal sector, which forms a large share of GDP, into the tax net could form a useful source of government revenue in the medium to long term, although the direct revenue benefits of taxing the informal sector are likely to be relatively modest initially mainly due to associated high administrative costs. Moreover, there is growing evidence that taxing the informal sector can enhance the growth of micro, small and medium scale enterprises (MSMEs). The payment of taxes by firms in the informal economy may be a method of engaging firms with the state, thereby promoting legitimacy and good governance among such firms, while facilitating increased integration of such firms with the financial system. Simplification of the tax structure, expediting dispute resolution mechanisms and mandatory registration of businesses are some measures that would help bring the informal sector to the tax net. The adoption of policies aimed at increasing voluntary tax compliance can also be useful in improving informal sector revenue collection. Moreover, government tax reforms need to be supported by measures to bring in all those liable into the tax net, while streamlining tax procedures to create a taxpayer friendly environment, which will encourage greater tax compliance. Transparency in government spending is also important to demonstrate the effective use of tax revenue, thereby encouraging the public to pay taxes.

While focusing on enhancing tax collection from income and profits, widening the tax net on relatively immobile bases such as land and property would enhance the progressive nature of the tax structure and support the efforts of the government to improve revenue from direct taxes. At present, property taxation in Sri Lanka consists of the Assessment Tax or rates levied on immovable property by local authorities and stamp duty imposed on transactions of property. While local rates are levied for services rendered by local authorities, stamp duty revenue is contingent on the level and value of the property transaction. Moreover, transaction based taxes such as stamp duties impose a bias against economic activities. In this context, imposition of a land value tax, which is a recurring tax on the unimproved value of residential land, could provide a predictable and stable flow of government revenue. A relatively low tax rate would help the land value tax to be levied on a broader tax base, while maintenance of an official valuation database by the government to guide the determination of property value could minimise the subjectivity inherent with land valuation. Furthermore, land value taxes enhance the progressive nature of the tax structure as higher value lands are subject to higher taxes. Moreover, direct taxes that are based on stocks of wealth such as land and property are relatively less predisposed to tax evasion than direct taxes that are levied on flow of wealth such as income taxes. In view of the above, concerted efforts to implement a broad-based land value tax is crucial to improve revenue from direct taxes, as envisaged by the government, thereby reducing market inefficiencies and income disparities in the economy.

Better targeting of government subsidy and transfer programmes is necessary to maximise their intended benefits in the context of the limited resource envelope in the fiscal sector. In the recent past, the government has been spending around 3-4 per cent of GDP on subsidy and transfer programmes with the intention of improving living standards and livelihoods of low income households and economically vulnerable segments of the population. Nevertheless, it is often argued that some government subsidy and transfer programmes are ineffective in reducing poverty and inequality because higher income families receive a large share of benefits under these schemes. For example, a large fraction of the Samurdhi benefit receivers may not necessarily belong to the income group that is targeted by the programme, and it is expected that the implementation of the Welfare Benefits Act No. 24 of 2002 after a lag of 14 years would help streamline the safety net programmes to a great extent. Moreover, although the government does not provide direct subsidies for the users of petroleum products and electricity, the financial losses made by the SOBEs ultimately become a burden on the government budget, and thereby on the general public. With regard to petroleum pricing, in general, diesel and kerosene users are cross subsidised by petrol users although diesel users are not essentially low income earners. Similarly, households with low electricity usage are being cross subsidised by high usage households, but this subsidy does not necessarily target the low income households. In addition, ineffective targeting of production subsidies leads to resource misallocation. For example, the fertiliser subsidy, which was streamlined during the past two years, was earlier granted without a targeting mechanism, and it failed to generate expected benefits to the economy due to inefficiencies in subsidy distribution and excessive use of fertiliser. The fertiliser subsidy provided by successive governments also caused the continuation of the agriculture sector's low productivity, by incentivising a higher fraction of the labour force to remain in the sector and preventing the resource reallocation to more productive sectors. Similar to the recent streamlining of the fertiliser subsidy, proper targeting of the other subsidy and transfer programmes is essential to maximise their intended benefits. Periodic monitoring of the income status of the recipients of safety net benefits is necessary. The direct cash transfer systems could also be extended to cover consumption subsidies rather than generic product -wise cross subsidisation in relation to the provision of public utilities and petroleum products.

The sustainability of the public sector pension scheme needs to be ensured taking into consideration the rising fiscal burden due to population ageing and the significant increase in the size of the public service over the last 12 years, while encouraging market oriented pension and superannuation schemes to meet the needs of the overall labour force. It can be argued that the current pension scheme constitutes a fiscal time-bomb, which will place a massive burden on future generations. Sri Lanka's unfunded public service pension liabilities could become a significant fiscal burden in the context of accelerating population ageing and the increase in the size of the public service. The rise in the number of pensioners amidst gradually ageing population and increasing life expectancy, and increasing pension allowances are exerting significant pressure on recurrent expenditure of the government. As the government pays its pension obligations out of recurrent expenditure rather than from a separate fund to which it has contributed over time, there is no clear understanding of the exact pension liability of the government. It is imperative, therefore, to estimate the future pension liability of the government. Such estimations are also recommended under international statistical methodologies including Government Finance Statistics (GFS) standards of the IMF. In many advanced economies, the outstanding public sector pension liabilities are estimated to be more than 100 per cent of GDP. Taking into consideration the magnitude of pension liabilities, governments in advanced economies, as well as emerging market economies, have set up pension funds so that returns from investment of assets in the pension fund will pay the pension obligations for the foreseeable future. Given the rapidly changing demographic profile and the substantial increase in the size of the public sector, it is essential that Sri Lanka also sets up a pension fund urgently, as envisaged by the government. Another step to improve the sustainability of the public sector pension scheme would be to gradually increase the retirement age of government employees. Meanwhile, with regard to the majority of the labour force, who are working in the formal and informal private sector, the challenge of an ageing population needs to be addressed with a long term focus through strengthening the retirement benefit schemes and reforming the health sector. In particular, it is necessary to enable the financial market to develop sustainable pension, insurance and superannuation products with a long term view supported by targeted fiscal incentives, in spite of the fact that the current market interest rate structure has dampened the immediate demand for such products.

The effective implementation of necessary restructuring programmes to address already identified issues and challenges faced by the SOBEs and considering the options for divestiture of non strategic and underutilised state assets are of paramount importance to ensure fiscal sustainability in the medium to long term. Sri Lanka’s fiscal performance is affected by the significant amount of accumulated losses of SOBEs, while weak financial positions of large SOBEs could also have a detrimental impact on the banking sector of the country. Therefore, causes behind such weaknesses of SOBEs need to be addressed through the implementation of the recently drafted statements of corporate intent in order to revive these entities. The implementation of a formula based pricing for SOBEs, particularly for those dealing with energy related products, would minimise the macroeconomic impact of future global energy price fluctuations. Adopting cost reflective pricing mechanisms would strengthen the commercial viability of SOBEs, while setting up a mechanism to transparently pass the effects of global price variations to domestic users. Meanwhile, the adoption of the PPP model for the operation of certain SOBEs would help ease the fiscal burden as PPPs can induce crowding in of private sector investment. Further, successful PPPs infuse new technology and management knowhow leading to more effective and efficient service provisioning with an enhanced value proposition in the offering. Meanwhile, divestment of non strategic state assets, such as hotels, would allow greater government focus on key SOBEs. Allowing foreign equity infusions to non strategic and/or underutilised state assets would also strengthen the external sector of the country. It is also necessary to encourage concentration of private sector-led commercial activities around the already built infrastructure, thereby catalysing economic development. Reforms in SOBEs, however, should be undertaken within the country’s socio-economic context, particularly by clearly communicating the rationale behind such actions to the stakeholders and the general public through appropriate public consultation processes.

Continued investment in physical infrastructure is essential to sustain the growth momentum of the economy, and alternative funding arrangements for such investment must be sought actively. Although the quality and availability of physical infrastructure have improved markedly in the post-conflict era, continued investment in new infrastructure and the maintenance of existing infrastructure are essential as the demand for all types of infrastructure will increase in tandem with rising income levels and urbanisation trends. Infrastructure financing has traditionally been dominated by the public sector. However, considering the limited fiscal space, it is imperative to encourage private sector investments in infrastructure development. International experience shows that subsectors of infrastructure, such as toll roads, public transportation, power generation and distribution, telecommunication, ports, water supply and treatment, and garbage disposal have the potential of being attractive opportunities for private investment. Sri Lanka is also yet to fully realise the benefits of PPPs, in spite of the success of early PPPs in sectors, such as telecommunication, ports, aviation and energy. In recognition of the fact that PPPs are an essential means of attracting private investment in infrastructure, several policy measures have been taken to create an enabling environment for PPPs to thrive. Addressing the remaining regulatory and institutional gaps, seen in the forms of policy inconsistencies and lack of domestic capacity in aspects related to planning and project design, feasibility studies and project implementation, as well as increasing the awareness of the public and the existing workforce in these sectors, would increase the attractiveness of PPPs. Active engagement with multilateral development banks must continue as these institutions not only bring financial assistance but also advanced technologies and technical skills while drawing upon their vast international experience to distil good practice.

Supporting further deepening of the financial sector is imperative to promote economic growth, reduce poverty and inequality,

1

enhance resilience of economic agents to minimise the effects of shocks, and to improve macroeconomic policy effectiveness. Over time, the global financial sector has evolved rapidly into state-of-the-art multi-faceted financial systems to include an assortment of banks, mutual funds, venture capital firms, insurance companies and many other types of non-bank financial institutions. These developments have facilitated economic agents to diversify savings and raise funds for productive purposes. The efficiency of and access to these financial services help shape the level and rate of increase in economic prosperity. However, in the Sri Lankan context, the less advanced debt markets and private equity and venture capital industries remain a serious concern in spite of continued efforts by successive governments to develop such markets and industries. As the Sri Lankan economy expands, substantial improvements in currency, derivatives and commodities markets are necessary to accommodate complex financial instruments developed within a dynamic regulatory regime setup based on international best practices. At the same time, the development of deep and liquid corporate debt and equity markets over the medium term is essential, through increased market participation of both local and foreign investors. Moreover, economically backward and marginalised regions should also be actively integrated into the mainstream financial system, through which their specific unmet needs such as easy access to finance should also be taken into consideration.

The country's imminent graduation to an upper middle income economy also necessitates rethinking of financial sector consolidation, with emphasis on non-bank financial institutions and small state banks, to build a strong and dynamic financial sector. At present, Sri Lanka has 46 LFCs and 7 SLCs in addition to the 32 licensed banks, within the financial institutions regulated by the Central Bank. The large disparity in size of these institutions, and the presence of a large number of small institutions has made regulation and supervision complex, while making them less resilient to shocks, thereby undermining financial system stability. Encouraging market driven financial sector consolidation will enable financial institutions to mobilise funds from the international market, leverage on the scale of operations, upgrade technology to strengthen efficiency and thus reduce intermediation costs, while strengthening their resilience. The enhanced capital requirements are expected to encourage small and medium sized banks to merge in the medium term, whilst the small state owned banks, five of which account for only around 2.5 per cent of banking sector assets, are expected to merge with larger banks to enable them to contribute to the economy in a more meaningful manner. Concurrently, the regulatory and supervisory framework is also expected to be strengthened further.

The envisaged shift to a Flexible Inflation Targeting (FIT) framework to conduct monetary policy will require addressing the remaining barriers to its successful adoption. The success of inflation targeting depends on increased central bank independence, improved public perception of the ability of a central bank to contain inflation, and enhanced efficiency in monetary policy transmission. Globally, the legal framework for inflation targeting provides substantial autonomy to central banks in the conduct of monetary policy, with provisions for enhanced transparency and accountability. In the context of Sri Lanka, the Monetary Law Act mandates the Central Bank of Sri Lanka to achieve economic and price stability in the conduct of monetary policy, while providing a considerable level of institutional independence. However, as the Central Bank of Sri Lanka moves towards FIT, the related legal and institutional frameworks need to be further strengthened, supported by continued efforts towards fiscal consolidation. Central bank legal frameworks in many emerging market economies including all inflation targeters, explicitly limit or prohibit financing of budget deficits, as monetisation of such deficits could induce inflationary pressures. In this regard, while facilitating price discovery, it is necessary to revamp the current system of raising funds for the government under a purely auction based system where direct placements are made only with the Central Bank. Such revamping could also help address some distortions currently observed in monetary policy transmission by allowing the containment of speculative behaviour of market participants without a cost to the Central Bank, and thereby on the general public. It may also be useful to develop instruments to influence the longer end of the yield curve, which appears to be as volatile as its shorter end in response to short term policy adjustments, in underdeveloped financial markets such as in Sri Lanka. In the meantime, as Sri Lanka adopts inflation targeting by moving away from money growth and the exchange rate as traditional anchors for inflation, management of inflation expectations has become extremely important in maintaining low and stable inflation, particularly in the context of allowing the exchange rate to adjust to reflect a competitive REER.

While the efficacy of demand management policies are being improved, emphasis on policies aimed at managing the supply side is equally important to ensure that the effects stemming from disturbances to the supply of essential goods do not result in excessive volatility in domestic consumer prices. Supply shortages stemming from weather related developments and shocks that could arise due to possible reversal of global commodity prices could result in temporary variations in price levels, which have the potential to translate into second round inflationary and BOP pressures. Therefore, it is important that the government adopts relevant short and long term measures to counter adverse supply side effects on domestic prices, while taking necessary policy actions to curb imported inflation emanating from external shocks. As the extent of land available for the expansion of food crop cultivation is limited, short term measures are required for enhancing crop productivity to ensure food security in the medium term. Moreover, the yields of certain domestically grown food crops have stagnated at unimpressive levels for many years. Therefore, yield potential requires a further increase with varieties having higher efficiencies and resistance to biotic stresses (pests, diseases) as well as abiotic stresses (drought, nutrient deficiency). Meanwhile, strengthening the linkage between financial markets and the agriculture sector, and popularising financial products, such as forward contracts, are crucial factors to improve the supply side of the economy. Further, promotion of commercial agriculture, as already mooted by the government, would help strengthen the supply side through increased production with mechanisation of farm operations, product quality management and efficient soil health management.

The increased occurrence of weather related disturbances arising from climate change has made policymaking complex, warranting enhanced disaster preparedness to mitigate the impact of such disturbances on all sectors of the economy. In the past few years, monsoons not only failed to bring sufficient rainfall but the distribution of rainfall was also highly concentrated over a very short period, increasing the severity of the drought as well as floods and landslides across the country. Consequences of these changes in climatic conditions were felt in the production and prices of food crops, water supply for drinking, irrigation and hydropower generation. Hence, proactive policy measures with a medium and long term view are required to mitigate the adverse effects of climate change. In the agriculture sector, water use efficiency should be enhanced while drought tolerant and high-yield paddy varieties must be promoted. Crop insurance schemes among farming communities could be promoted as a risk transfer mechanism. In addition, maintaining rolling buffer stocks for main food grains is required to enable uniform distribution of food supplies across the country at a fairly stable price. Moreover, incentives would also be required to promote non conventional renewable energy sources such as solar energy systems to reduce reliance on mainstream power generation. In order to minimise the effects of weather related disruptions to livelihoods of the population, the disaster monitoring and management mechanisms must be strengthened with the participation of regional level public officials and international development agencies.

Sri Lanka's general education policy has to be reoriented to meet the dynamic requirements of a middle income economy. The continued government investment in education has helped the expansion of the country's human capital base. The provision of universal education has helped attain a literacy rate of 93.2 per cent, high completion rates in both primary and secondary education, and gender parity in general education. However, most of the economic benefits from investment in education are derived from student learning rather than years of schooling completed. Since skills formation is a cumulative life cycle process that proceeds in stages with each building on the previous one, poor achievement in basic cognitive skills can affect the success of post-primary education, including the ability to acquire job-specific skills. This reiterates the need to improve the quality and relevance of pre-school, primary and secondary education to ensure that students have a solid foundation in science and technology, numeracy, languages, and literacy. This will help in the creation of a more trainable and flexible labour force. There is scope to improve the quality of learning through pedagogical interventions that directly address barriers to learning stemming from constraints faced by schools and teachers in improving the classroom environment. This may include improvement of the effectiveness of lessons, revision of the curriculum and method of delivery, provision of additional material, introduction of new technology and improvement of the quality of teachers through training, incentives and changes to recruitment practices. The quality of education is conditioned by the quality of teachers, thereby making it essential for policymakers to develop long term strategies to popularise teaching as a profession amongst high performing graduates. International research has demonstrated that the quality of principals is an important determinant of the success of schools in delivering good learning outcomes. Special attention should therefore, be paid to upgrade the state of school principals. In addition, studies show that despite the provision of free education, people from poorer backgrounds had fewer years of education than their higher income counterparts, and those who live in rural areas had lower educational attainment, highlighting the presence of significant inequalities in education and training for the poor and those living in rural areas. Further, inequities arising in service delivery of public schools have resulted in excessive demand for placements in popular schools while resources in others remain underutilised. While recent government policies to promote the quality and attractiveness of peripheral schools are commendable, the success of such policies is yet to be realised. Furthermore, the increasing role of private schools in fulfilling the excess demand for school placements in urban areas need to be facilitated while ensuring the quality and uniformity in service provision as a large majority of these schools do not fall under the purview of any regulatory body. The operation of sub-optimal education institutions can result in pockets of the population significantly lagging behind their peers, despite having incurred a significant financial cost.

Several issues arise as a result of increased demand for higher education in a system dominated by the public sector, while mismatches between the needs of the economy and the output of the higher education system persist. Limited capacity of public universities has prevented all eligible GCE Advanced Level students from being admitted to such institutions. In 2016, despite 155,550 students being eligible to be admitted to state universities, only 18.6 per cent of those eligible gained admission to the university system. This problem of inadequate access to higher education locally will continue to hinder the optimal development and use of human resources required for the country's future. Considering the limited fiscal space, it is vital to encourage private higher education institutions to expand their service provision. Private sector participation is unlikely to create inequities in access to higher education as a sizable portion of students who possess the financial capacity continue to pursue higher education abroad while incurring a significant foreign exchange cost to the economy. Despite the fact that increased participation of private educational institutes is essential to fill supply gaps, the quality of education provided by such institutes should not be compromised. In this context, strengthening the higher education quality assurance and accreditation framework to cover public and private higher education could play a significant role in standardising the services offered by such institutes while ensuring that all beneficiaries receive a high quality learning experience. This would also encourage healthy competition between higher educational institutions, paving the way for them to become world class universities in future. It is important for policy to be based on a pragmatic approach to public, private and mixed provision of education. Meanwhile, Sri Lanka's competitiveness will greatly hinge on higher education and training in its transition from factor-driven to efficiency-driven development. The presence of major skills shortages and mismatches will erode productivity and weaken the prospects for growth. Sector-wide skills assessments highlight lack of sufficient cognitive, technical and soft skills among graduates, which not only affects their employability but also results in underemployment. Focused interventions are required to improve the quality and relevance of undergraduate as well as technical education programmes so that the skills gap prevalent in key value-adding industries can be bridged. Meanwhile, considering the low level of investment in research and development (R&D), tertiary institutions could play a more proactive role, in partnership with the private sector, in conducting more R&D that is aligned with industrial needs. Strengthening postgraduate academic programmes across a wide range of disciplines can also help promote R&D while helping domestic tertiary education institutions to gain international recognition. This marks the need for a clear policy direction to leverage the higher education sector to develop a highly skilled and competent labour force that will drive Sri Lanka's transition to an upper middle income economy.

Despite universal health coverage, the ongoing epidemiological transition poses varied challenges, which need to be addressed through the development of sustainable healthcare improvement strategies. Commitment to universal health coverage by successive governments helped Sri Lanka to make significant strides in the achievement of several health indicators outlined in the Millennium Development Goals (MDGs). However, the ongoing demographic and economic transition

1

poses several new challenges. The increase in average life expectancy, increased urbanisation and the resultant transition to more sedentary lifestyles have made the population increasingly vulnerable to Non Communicable Diseases (NCD), which are the largest contributor to the disease burden of the country. Due to their chronic nature, NCDs are relatively expensive to cure resulting in a large portion of NCD care being financed by out-of-pocket spending, which can be extremely burdening, particularly for the poor. Meanwhile, the rapidly ageing population would also pose a burden to the public healthcare system as they tend to require more expensive long term geriatric treatment. On the other end of the population spectrum, Sri Lanka faces significant concerns related to child nutrition across a range of standard indicators such as rates of anaemia, low birth weight and underweight children, including stunting and wasting. Nutrition levels during the first 1,000 days of an infant's life are crucial determinants of cognitive capacity. This places a high premium on good nutrition for pre- and post-natal mothers and their infants. Despite universal health coverage, inequality in health outcomes are prevalent across the country due to regional disparities in public health service delivery. Therefore, a multipronged approach has to be adopted to provide the required assistance to lagging regions and to strengthen the delivery of public services to sustain 'universal health coverage' status. The government must also consider improving the accreditation system of public and private healthcare providers as it would improve the quality, efficiency and effectiveness of organisations providing healthcare services.

In the context of rapid urbanisation in Sri Lanka, waste management has increasingly become challenging, requiring the introduction of low cost solutions with minimal environmental impact involving private sector participation. A recent World Bank study on infrastructure services found that investment in waste management yielded a higher potential rate of return among infrastructure projects. At present, a substantial amount of solid waste is generated daily within the municipality areas, while the Western Province accounts for a major share of solid waste generated in the country. While emphasising the need to reduce, reuse and recycle, careful attention needs to be given to waste disposal, i.e., resource recovery, incineration and landfill. Although several measures have been introduced to transform open dumping into recycling, composting and mass-scale processing, a substantial amount of waste reaches landfills daily. Given the scarcity of land, Sri Lanka needs to explore other options available in solid waste management. Waste-to-energy is a process of generating energy in the form of electricity and heat from the primary treatment of waste and is part of the non-hazardous waste management hierarchy. Not only can this process create a source of renewable energy, but it could also help reduce carbon emissions by offsetting the need for energy from fossil sources as well as reduce methane generation from landfills. Furthermore, the heat generated from this process could be repurposed for economic activities. It has been found that waste-to-energy incineration process results in lower emission of carbon dioxide, in comparison with a substantially higher amount of methane gas generated from solid waste in landfill. In addition, the ash generated from the incineration process is rich in heavy metals and may be used to extract secondary resources such as iron, aluminium, copper, zinc and other metals from its residue. The US Energy Information Administration data shows that one metric ton of municipal solid waste generates 481 kilowatt-hours (kWh) of electricity, on average, which is equivalent to electricity consumed by over 200 average Sri Lankan households in a day. Hence, exploring opportunities to convert waste-to-energy would not only support municipal solid waste management, but would also form an alternative source of renewable energy.

Although Sri Lanka has been ahead of its regional counterparts in achieving the MDGs, renewed challenges could be expected in achieving the more broad-based Sustainable Development Goals (SDGs) by the target year of 2030 whilst moving towards a higher growth trajectory. In addition to issues covered by MDGs such as extreme poverty, gender equality and universal primary education, SDGs seek to address several other modern-day challenges such as human-induced climate change, loss of biodiversity, poor governance and corruption. Therefore, SDGs are particularly relevant to Sri Lanka in the context of the increased pace of growth in the post-conflict era as they revolve around the creation of a development process through the sustainable use of resources by a peaceful and inclusive society. In addition, despite the country's success in achieving MDGs, inequalities that prevail particularly across regions and income levels, remain a continuing development challenge despite heavy government involvement in the provision of universal education and health, high levels of literacy and progress towards gender parity. In this context, aligning development policies with SDGs can be beneficial to the growth process of the country and help overcome the challenges associated with rising incomes, changing consumer lifestyles, population ageing, urbanisation and the overall transition towards an upper middle income economy, especially in terms of addressing geographical and income-related disparities and environmental conservation. The pursuit of SDGs will also complement the stance of the government to improve economic freedom that will support wider socioeconomic participation and create a cycle of inclusive growth, enabling all stakeholders not only to benefit from the growth process but also actively contribute to it (See CBSL Annual Report 2015, Box Article 02: *The Socioeconomic Challenges of Poverty, Income Inequality and Child Under-nutrition in Sri Lanka*).

The structural challenges faced by the Sri Lankan economy, including those discussed above, have been consistently highlighted by the Central Bank of Sri Lanka in its previous Annual Reports and regular reports to the government, and also by the research community and international development agencies on numerous occasions in the past. Along with strengthening macroeconomic fundamentals through improved fiscal performance and the conduct of monetary policy in a forward looking framework, it is essential that these structural issues are addressed decisively without delay with broad public consensus, as the postponement of these essential reforms is no longer feasible if the country is to progress along a sustainable and equitable growth trajectory.