1

ECONOMIC, PRICE AND FINANCIAL SYSTEM STABILITY, OUTLOOK AND POLICIES

1.1 Overview

The Sri Lankan economy recovered in 2021 from the pandemic induced contraction in 2020, albeit with several deeply entrenched structural problems and vulnerabilities inherited over several decades coming to the forefront, thereby resulting in unprecedented socio-political tensions in early 2022. The economy was already in a fragile state lacking the necessary buffers to withstand shocks, when it was hit by the COVID-19 pandemic and other multifaceted headwinds that emanated from the global and domestic fronts. Such vulnerability of the economy can be mainly attributed to the lack of fiscal space, which was further constrained by the changes introduced to the tax structure in late 2019. Sri Lanka was not an exception in the world in deploying countermeasures to face the pandemic and safeguard the economy to forestall a lasting economic fallout and scarring effects on livelihoods. However, given particular vulnerabilities in the economy, the Central Bank had to be heavily involved in shielding the economy through extraordinary responses, in the form of monetary policy easing, ample liquidity provision to the markets and the Government, and adopting several external sector and financial sector policies, in the absence of adequate policy space in the fiscal sector or an adequately prompt response from the fiscal sector. The ultra easy macroeconomic policy package unveiled by the Central Bank and the Government helped the economic recovery in 2021 from the historical contraction recorded in 2020, while also helping cushion the impact of the pandemic on a broader segment of the stakeholders. Both public and private sectors enjoyed the comfort of low cost funds for working capital and investment that helped them stay afloat during this difficult time, and keep industries viable, even witnessing some growth, which in turn ensured uninterrupted provision of public services, utilities and goods and services to the public as well as other essential supply chains. However, unprecedented policy responses taken during the peak of the pandemic together with the inability to withdraw the policy measures due to expected fiscal responses not coming through adequately, caused a limited space for reversal measures and led to some unintended effects on macroeconomic stability in 2021, which were further aggravated in early 2022. Further, the pressures witnessed on the exchange rate amidst dried up liquidity in the domestic foreign exchange market were amplified in 2021 and early 2022, warranting a measured adjustment that was allowed in the exchange rate in early March 2022, compared to the level that prevailed in the market amidst concerns about the adverse impact of any large *depreciation of the exchange rate on the society. However, the outcome of the exchange rate flexibility that was thereafter allowed also in early March 2022, fell short of expectations due to the large overshooting by market forces, reflecting the significant liquidity pressures that prevailed in the domestic foreign exchange market as well as the delay in market correction.*

Price stability, which was the strongest pillar for macroeconomic stability over the last decade or so, was challenged since the second half of 2021 due to the combined impact of global and local supply driven causes as well as the build-up of excessive demand pressures on prices, primarily caused by the lagged impact of extraordinary monetary accommodation, including unprecedented monetary financing that became required due to the lack of fiscal space. Moreover, the external sector remained on the brink of a precarious state since late 2021 due to the mounting Balance of Payments (BOP) pressures reflected in the meagre level of official reserves amidst significant debt servicing obligations along with the dire need to finance essential imports at a time when the domestic foreign exchange market remained largely illiquid. Calamities in the power and energy sector, acute shortages of essentials and raw materials and the spillover effects of these on every nook and cranny of the economy could disrupt economic activity excessively unless resolved urgently. The actions and policy measures taken on a piecemeal basis to fix or postpone these severe conditions have proven to be unsuccessful or created novel issues. Any notable intervention by fiscal authorities to ease these domestic economic conditions to restore normalcy remained a remote possibility due to historically high public debt levels, further weakening of fiscal balances and extremely low sovereign rating. As a result, the Central Bank took swift measures in early April 2022 to preempt further deterioration of macroeconomic stability and to restore price stability through a significant tightening of monetary policy, among others. These policy initiatives would be imperative to commence bold structural reforms to revitalise medium to long term macroeconomic stability, which remains a necessary condition for long term inclusive growth.

In this regard, the implementation of several structural reforms is vital at this juncture by the Government to complement the Central Bank's remedial policies. Implementing strong fiscal adjustments, which have been long delayed and often reversed in the past, will lead to a visible turnaround in the current complex economic turmoil. Sustainable containment of the budget deficit through an upward level shift to government revenue along with the rationalisation and prioritisation of government expenditure would help contain the expansion of government borrowing going forward. Further, a comprehensive and coherent approach to achieving and maintaining public debt sustainability is a must to take any step forward in addressing the current economic problem. These essential fiscal adjustments have to be supported by financially independent and autonomous State Owned Business Enterprises (SOBEs) by introducing, among others, cost reflective pricing structures, institutionalisation of good governance and accountability mechanisms, notable productivity enhancement and service delivery in the overall public sector, and strengthening of well targeted social safety net schemes. While it is necessary to strengthen legal frameworks to ensure public accountability of state institutions, exercising existing legal powers in policy formulation and implementation by relevant authorities would ensure lasting economic welfare in the country. These changes would ensure increased participation of the private sector with ease, while the public sector continues to play a facilitator role in the economy.

The persistent twin deficit dilemma experienced by Sri Lanka highlights the importance of addressing the BOP issues on a sustainable basis. National policies, which are free from changing political regimes, formed with the support of relevant stakeholders aiming at reducing the external current account deficit and budget deficit to a manageable level are imperative in this endeavour. Further, other non debt creating foreign exchange generating sources need to be explored and established to build-up official reserves, while reducing the need for external debt financing of the BOP. A conducive doing business environment and Foreign Direct Investment (FDI) promotions must supplement this external sector stabilisation package.

Recent events experienced in Sri Lanka reveal how macroeconomic stability, social cohesion and political stability are intertwined and how the effect of one aspect could spillover to another. Thus, the overall solution to the prevailing triple plights, i.e., economic turmoil, social unrest, and political instability, should cover all these elements to reboot Sri Lanka to new heights. The ongoing efforts to resolve the economic issues, including the suspension of external debt servicing by the Government for an interim period pending orderly and consensual restructuring of debt obligations, seeking an economic adjustment programme from the International Monetary Fund (IMF), a commitment to rationalising government expenditure and enhancing government revenue, and continuing non aligned political and economic diplomacy, among others, are expected to restore macroeconomic stability in the period ahead. The overall success of these efforts is conditional on reassuring social coherence and restoring political stability and an enduring political will, to take this reform agenda forward.

Table 1.1
Macroeconomic Performance (2017-2021)

Indicator	Unit	2017	2018	2019	2020 (a)	2021 (b)
Real Sector (c)						
Real GDP Growth	%	3.6	3.3	2.3 (a)	-3.6 (b)	3.7
GDP at Current Market Price	Rs. bn	13,328	14,291	14,997 (a)	15,027 (b)	16,809
Per Capita GDP (d)	US$	4,077	4,057	3,848 (a)	3,695 (b)	3,815
External Sector						
Trade Balance (c)	% of GDP	-11.0	-11.8	-9.5	-7.4	-9.6
Current Account Balance (c)	% of GDP	-2.6	-3.2	-2.2	-1.5	-4.0
Overall Balance	US$ mn	2,068	-1,103	377	-2,328	-3,967
External Official Reserves	US$ mn	7,959	6,919	7,642	5,664	3,139
Fiscal Sector (c)(e)						
Current Account Balance	% of GDP	-0.7	-1.2	-3.6 (f)	-7.9	-7.7
Primary Balance	% of GDP	0.02	0.6	-3.6 (f)	-4.6	-6.0
Overall Fiscal Balance	% of GDP	-5.5	-5.3	-9.6 (f)	-11.1	-12.2
Central Government Debt (g)	% of GDP	77.9	84.2	86.9 (f)	100.6	104.6
Monetary Sector and Inflation						
Broad Money Growth (M_{2b}) (h)	%	16.7	13.0	7.0	23.4	13.2
Private Sector Credit Growth (in M_{2b}) (h)	%	14.7	15.9	4.2	6.5	13.1
Annual Average Inflation (i)	%	6.6	4.3	4.3	4.6	6.0

(a) Revised
(b) Provisional
(c) Based on the GDP estimates (base year 2010) of the Department of Census and Statistics.
(d) Estimates updated with latest population figures
(e) Based on the revised GDP estimates for 2019 and 2020 made available on 29 March 2022 by the Department of Census and Statistics.
(f) According to the Ministry of Finance, the fiscal sector statistics of 2019 have been restated as announced in the Budget Speech for 2020.
(g) Includes Treasury bonds of Rs. 13,125 million issued to capitalise SriLankan Airlines in March 2013 (matured on 01 June 2018) and Rs. 78,441 million issued to the Ceylon Petroleum Corporation (CPC) in January 2012 (of which Rs. 21,778 million matured on 01 January 2017 and the current outstanding is Rs. 56,662 million)
(h) Year-on-year growth based on end year values.
(i) Based on CCPI (2013=100)

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

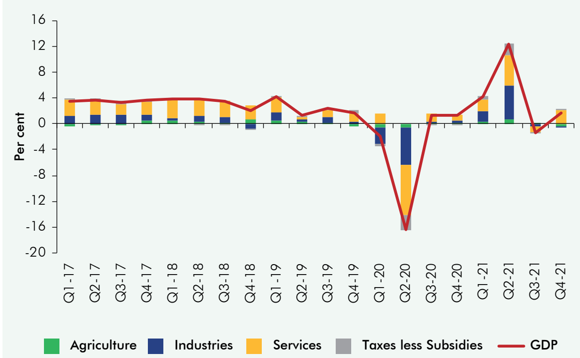
1

1.2 Macroeconomic Developments in 2021

Real Sector Developments and Inflation

The Sri Lankan economy rebounded in 2021, following the COVID-19 induced contraction in 2020. As per the provisional national accounts estimates of the Department of Census and Statistics (DCS), the Sri Lankan economy recorded a growth of 3.7 per cent in 2021, in real terms, compared to the contraction of 3.6 per cent recorded in the preceding year. All sectors of the economy registered growth during the year (agriculture, forestry and fishing by 2.0 per cent; industry by 5.3 per cent; and services by 3.0 per cent). The performance of the agriculture, forestry and fishing sector was buoyed by the notable growth recorded in the subcategories of growing of cereals (except rice), oleaginous fruits, and tea, while the contraction in the growing of rice and other beverage crops weighed negatively on the sectoral performance. The majority of subcategories within the industries sector registered robust growth. A notable exception was manufacturing activities related to coke and refined petroleum products which recorded a contraction of 30.5 per cent due to occasional refinery shutdowns during the year. All subcategories in the services sector registered growth with IT programming, consultancy, and related activities, and the telecommunications sectors recording sizeable growth of 21.7 per cent and 16.2 per cent, respectively, highlighting the

Figure 1.1
Activity-wise Contribution to GDP Growth



Source: Department of Census and Statistics

Table 1.2
Gross National Income by Industrial Origin at Constant (2010) Prices (a)(b)

Economic Activity	Rs. million		As a percentage of GDP (%)		Growth (%)		Contribution to Growth (%)	
	2020 (c)	2021	2020 (c)	2021	2020 (c)	2021	2020 (c)	2021
Agriculture, Forestry & Fishing	**672,930**	**686,478**	**7.1**	**6.9**	**-2.2**	**2.0**	**-0.2**	**0.1**
Agriculture and Forestry	578,407	590,632	6.1	6.0	0.6	2.1	0.0	0.1
Fishing	94,522	95,845	1.0	1.0	-16.6	1.4	-0.2	0.0
Industries	**2,427,872**	**2,556,998**	**25.5**	**25.9**	**-6.9**	**5.3**	**-1.8**	**1.4**
Mining and Quarrying	202,873	208,505	2.1	2.1	-12.5	2.8	-0.3	0.1
Manufacturing	1,481,325	1,587,489	15.5	16.1	-3.9	7.2	-0.6	1.1
Electricity, Gas, Water and Waste Treatment	150,702	156,595	1.6	1.6	-0.8	3.9	0.0	0.1
Construction	592,972	604,410	6.2	6.1	-13.2	1.9	-0.9	0.1
Services	**5,595,176**	**5,760,308**	**58.7**	**58.3**	**-1.6**	**3.0**	**-0.9**	**1.7**
Wholesale and Retail Trade, Transportation and Storage, and Accommodation and Food Service Activities	2,158,494	2,187,426	22.6	22.1	-5.0	1.3	-1.2	0.3
Information and Communication	83,444	97,636	0.9	1.0	13.7	17.0	0.1	0.1
Financial, Insurance and Real Estate Activities including Ownership of Dwellings	1,470,197	1,552,626	15.4	15.7	4.7	5.6	0.7	0.9
Professional Services and Other Personal Service Activities	1,061,663	1,073,914	11.1	10.9	-5.9	1.2	-0.7	0.1
Public Administration, Defence, Education, Human Health and Social Work Activities	821,378	848,706	8.6	8.6	2.0	3.3	0.2	0.3
Gross Value Added at Basic Price	**8,695,978**	**9,003,784**	**91.2**	**91.1**	**-3.2**	**3.5**	**-2.9**	**3.2**
Taxes less Subsidies on products	836,931	877,612	8.8	8.9	-8.1	4.9	-0.7	0.4
Gross Domestic Product at Market Price	**9,532,909**	**9,881,397**	**100.0**	**100.0**	**-3.6**	**3.7**	**-3.6**	**3.7**
Net Primary Income from Rest of the World	-263,075	-238,607			8.3	9.3		
Gross National Income at Market Price	**9,269,834**	**9,642,790**			**-3.5**	**4.0**		

(a) Based on the GDP estimates (base year 2010) of the Department of Census and Statistics
(b) Provisional
(c) Revised

Source: Department of Census and Statistics increased usage of telecommunications services amid the pandemic and growth in the Information Technology/ Business Process Outsourcing (IT/ BPO) sector. The taxes less subsidies component of GDP grew by 4.9 per cent in 2021 driven by improvements in tax revenues, when compared to 2020, in line with the post COVID-19 recovery in economic activity and declines in subsidies.

In nominal terms, the Sri Lankan economy recorded a notable growth of 11.9 per cent in 2021, compared to the tepid expansion of 0.2 per cent observed in 2020. Accordingly, the overall size of the economy expanded to US dollars 84.5 billion in 2021 from US dollars 81.0 billion in the previous year. Per capita GDP grew to US dollars 3,815 in 2021 from US dollars 3,695 in 2020. On the expenditure front, final consumption expenditure recorded a significant growth of 9.9 per cent at current prices in 2021, compared to the relatively modest growth of 2.0 per cent seen in 2020. This growth was largely driven by household consumption expenditure which grew by 10.8 per cent during the year, compared to just 1.0 per cent growth during the previous year. However, government consumption expenditure at current prices grew at a relatively modest pace of 3.7 per cent in 2021, compared to the growth of 9.9 per cent that was observed in 2020. The share of consumption expenditure in GDP at current prices stood at 79.9 per cent in 2021. Meanwhile, gross domestic capital formation registered a growth of 23.2 per cent in 2021, compared to the contractions recorded in both 2020 and 2019. The share of gross capital formation in nominal GDP improved marginally to 27.7 per cent in 2021. Net external demand for goods and services deteriorated sharply, registering a decline of 31.6 per cent in 2021 with the growth in imports outweighing the growth in exports. While a rise in private savings led to a notable growth of 20.3 per cent in domestic savings, the low government revenue led to an increase in government dissavings. Accordingly, domestic savings as a percentage of GDP stood at 20.1 per cent in 2021, compared to 18.7 per cent in 2020.

Table 1.3

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

Item	Rs. billion		Growth (%)		As a percentage of GDP (%)	
	2020 (c)	2021	2020 (c)	2021	2020 (c)	2021
1. Domestic Demand	**15,993.3**	**18,081.0**	**0.5**	**13.1**	**106.4**	**107.6**
1.1 Consumption	12,214.3	13,425.2	2.0	9.9	81.3	79.9
Private	10,662.0	11,814.9	1.0	10.8	71.0	70.3
Public	1,552.3	1,610.3	9.9	3.7	10.3	9.6
1.2 Investment (Gross Capital Formation)	3,779.1	4,655.8	-4.2	23.2	25.1	27.7
2. Net External Demand	**-966.0**	**-1,271.7**	**-5.1**	**-31.6**	**-6.4**	**-7.6**
Exports of Goods and Services	2,418.5	2,981.6	-30.3	23.3	16.1	17.7
Imports of Goods and Services	3,384.5	4,253.3	-22.9	25.7	22.5	25.3
3. Total Demand (GDP) (1+2)	**15,027.4**	**16,809.3**	**0.2**	**11.9**	**100.0**	**100.0**
4. Domestic Savings (3-1.1)	**2,813.1**	**3,384.2**	**-7.0**	**20.3**	**18.7**	**20.1**
Private	3,993.5	4,674.6	12.2	17.1	26.6	27.8
Public	-1,180.4	-1,290.4	-121.2	-9.3	-7.9	-7.7
5. Net Primary Income from Rest of the World	**-423.1**	**-406.6**	**4.2**	**3.9**	**-2.8**	**-2.4**
6. Net Current Transfers from Rest of the World (d)	**1,150.8**	**1,030.3**	**11.7**	**-10.5**	**7.7**	**6.1**
7. National Savings (4+5+6)	**3,540.8**	**4,007.9**	**-2.1**	**13.2**	**23.6**	**23.8**
8. Savings-Investment Gap						
Domestic Savings-Investment (4-1.2)	-966.0	-1,271.7			-6.4	-7.6
National Savings-Investment (7-1.2)	-238.2	-648.0			-1.6	-3.9
9. External Current Account Balance (2+5+6) (d)	**-238.2**	**-648.0**			**-1.6**	**-3.9**

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

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

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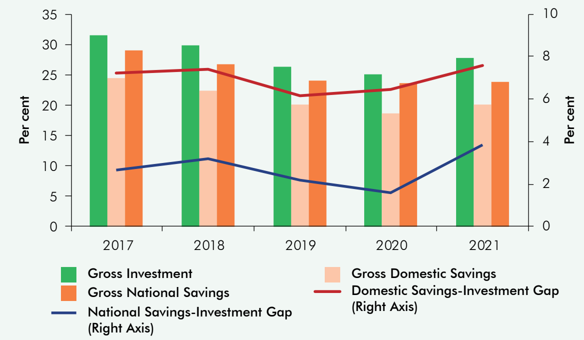
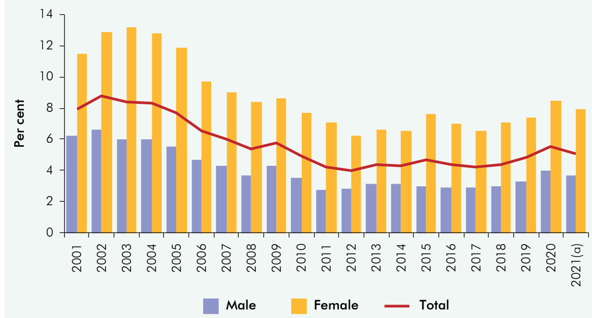
Figure 1.2
Savings, Investment and the Savings-Investment Gap (as a percentage of GDP)



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

Figure 1.3
Unemployment Rate



(a) Average of four quarters of 2021

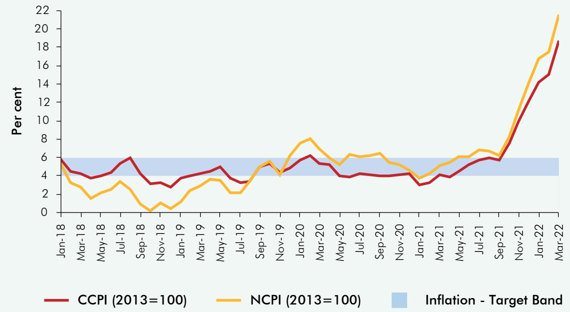
Source: Department of Census and Statistics

The domestic savings-investment gap widened to -7.6 per cent of GDP in 2021, compared to -6.4 per cent of GDP in 2020. The national savings-investment gap widened from -1.6 per cent of GDP in 2020 to -3.9 per cent of GDP in 2021, driven by the growth in investment expenditure.

While the steady recovery of the economy led to the decline in the unemployment rate, the increase in both the labour force and inactive population led to a decline in labour force participation during the year. The unemployment rate declined to 5.1 per cent in 2021 from the 5.5 per cent recorded during the previous year. Unemployment rates amongst males and females also followed suit, declining to 3.7 per cent and 7.9 per cent, respectively, in 2021, from 4.0 per cent and 8.5 per cent, respectively, in 2020. Meanwhile, the economically inactive population increased by 3.7 per cent to 8.6 million in 2021, compared to 2020 with dampened interest in active job search and pandemic induced hardships on usual routines. This development, alongside the marginal increase of 1.0 per cent in the labour force resulted in a decline in the overall labour force participation rate (LFPR) to 49.9 per cent in 2021 compared to 50.6 per cent in 2020. LFPR of both males and females declined from 71.9 per cent and 32.0 per cent, respectively, in 2020, to 71.0 per cent and 31.8 per cent, respectively, in 2021. The agriculture, industry, and services sectors accounted for 27.3 per cent, 26.0 per cent, and 46.7 per cent of the total employment, respectively.

Headline inflation accelerated in 2021 driven mainly by global and domestic supply side disturbances, the surge in global commodity prices and upward revisions to administered prices, while core inflation also accelerated reflecting the lagged effect of significant monetary accommodation. As reflected by the year-on-year change in both the National Consumer Price Index (NCPI, 2013=100) and the Colombo Consumer Price Index (CCPI, 2013=100), the acceleration in headline inflation was attributed to the acceleration in both food and non food inflation, though food inflation accounted for a larger share. Several upward revisions made to energy prices and other administrative prices reflected the rise in prices in the international market as well as volatile food prices stemming from the pandemic related supply side disruptions and the loss of production of certain items, mostly contributed to such acceleration in inflation. Spillover of the aforementioned revisions alongside external shock absorption methods, such as the removal of maximum retail prices also partly contributed to the rise in inflation. Accordingly, year-on-year headline inflation, as measured by the CCPI, which was recorded at 4.2 per cent at end 2020, accelerated to 12.1 per cent by end 2021, breaching

Figure 1.4
Headline Inflation (Year-on-Year)



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

the target level of 4-6 per cent. Following a similar trend, year-on-year headline inflation, based on the NCPI, also accelerated and was recorded at 14.0 per cent by end 2021, compared to 4.6 per cent at end 2020. The upward trend of headline inflation has continued thus far in 2022. Accordingly, year-on-year headline inflation based on the CCPI accelerated to 18.7 per cent in March 2022, while that of NCPI also accelerated to 21.5 per cent in March 2022. Core inflation, which measures underlying demand pressures, also accelerated sharply from mid 2021, reflecting demand driven inflationary pressures triggered by the impact of the lagged effects of pandemic related significant monetary policy accommodation. Accordingly, year-on-year core inflation, based on the CCPI accelerated to 8.3 per cent by end 2021 from 3.5 per cent recorded at end 2020. NCPI based core inflation accelerated to 10.8 per cent, year-on-year, by end 2021 in comparison to 4.7 per cent at end 2020. Further, continuing the same trend, CCPI based year-on-year core inflation rose to 13.0 per cent by March 2022, while NCPI based year-on-year core inflation rose to 17.3 per cent by March 2022. The strong proactive policy measures taken by the Central Bank are expected to arrest further build-up of demand driven inflationary pressures and adverse inflation expectations, supporting to revert inflation rates towards the target range in the period ahead.

External Sector Developments

Sri Lanka's external sector continues to face numerous challenges, including a sharp widening of the current account deficit, limited inflows to the financial account, depletion of gross official reserves (GOR) as a result of large debt servicing requirements and significant depreciation of the Sri Lanka rupee. Regardless of the notable momentum in merchandise exports compared to the previous year, a high increase in merchandise imports, which outpaced the growth in exports, widened the trade deficit in 2021. Increased import expenditure was mainly due to the combined effect of sharp revival in imports, particularly in the latter part of the year, primarily driven by higher commodity prices, including prices of fuel, increased demand for imported items due to normalisation of economic activity, higher importation of medical and pharmaceutical items such as vaccines, and the relaxation of some of the restrictions on importation of non essential goods. The services sector surplus remained subdued, compared to the pre-pandemic level. However, there was a gradual increase in earnings from tourism towards the end of the year whilst a healthy growth was observed in exports of computer services. The deficit in the primary income account recorded a contraction with a reduction in interest and coupon payments as well as dividend payments. Meanwhile, the surplus in the secondary income account reduced as a result of a notable contraction in workers' remittances received by the banking system. With these developments, the deficit in the external current account widened significantly to US dollars 3.3 billion in 2021 (4.0 per cent of GDP), compared to US dollars 1.2 billion in 2020 (1.5 per cent of GDP). The financing of the current account deficit was achieved by drawing down GOR amidst

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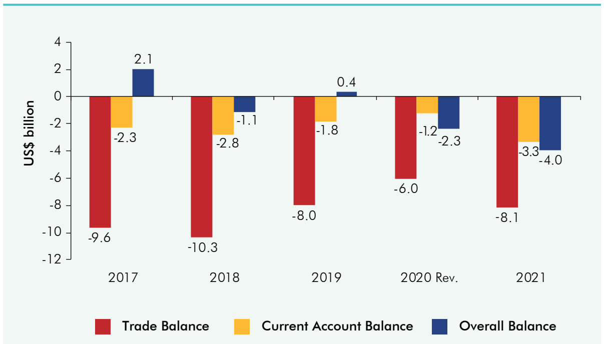
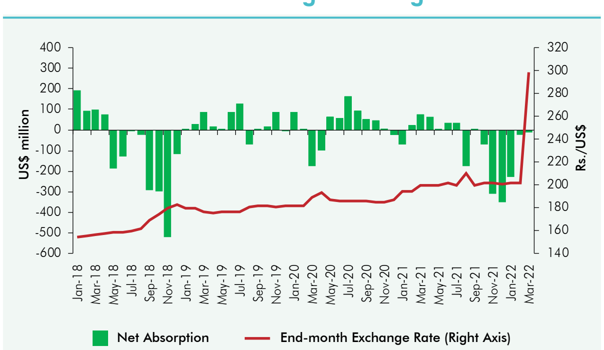
Figure 1.5
Balance of Payments



Source: Central Bank of Sri Lanka

moderate inflows to the financial account and continuous foreign debt service payments. Foreign investment in the form of FDI remained modest while foreign investment to the stock market and the government securities market recorded net outflows during the year. Amidst significant debt servicing obligations falling due during the year, the Government and the Central Bank received some inflows that enabled replenishment of the GOR to a certain extent. These included the Special Drawing Rights (SDR) allocation by the IMF, two foreign currency term financing facilities from the China Development Bank, and international currency swap agreements with the People's Bank of China (PBOC) and the Bangladesh Bank. However, there were substantial outflows from official reserves due to debt service payments as well as the supply of foreign exchange to the domestic foreign exchange market to facilitate the importation of essential goods. As a result, the GOR declined to US dollars 3.1 billion by end 2021, compared to US dollars 5.7 billion recorded as of end 2020. Accordingly, the overall balance of the BOP recorded a significant deficit of around US dollars 4.0 billion in 2021. Meanwhile, the total external debt of the Government, based on market value, declined marginally as a result of the combined effect of the decline in market prices of Sri Lanka's outstanding International Sovereign Bonds (ISBs) and the repayment of an ISB, although the outstanding foreign loans of the Government recorded an increase during the year. Further, the outstanding external liabilities of the Central Bank increased significantly due to the net impact of international currency swap arrangements. Consequently, Sri Lanka's total external debt increased to US dollars 50.7 billion by end 2021 from US dollars 49.0 billion as of end 2020. Sri Lanka settled the ISB of US dollars 1 billion that matured in July 2021 and the ISB of US dollars 500 million that matured in January 2022. The Sri Lanka rupee was maintained broadly at stable levels during 2021 and in early 2022, partially aided by moral suasion to keep the currency stable around Rs. 200 levels. However, considering the severity of the external shocks and further adverse developments in the global and domestic fronts, the Central Bank allowed flexibility in the exchange rate, yet intending to keep the rate of depreciation at a certain level, since early March 2022 as a part of the comprehensive policy package announced to alleviate the difficult situation in the external sector. However, the large pressures witnessed in the domestic foreign exchange market caused a large overshoot in the Sri Lanka rupee. Consequently, the Sri Lanka rupee, which depreciated by 7.0 per cent in 2021,

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



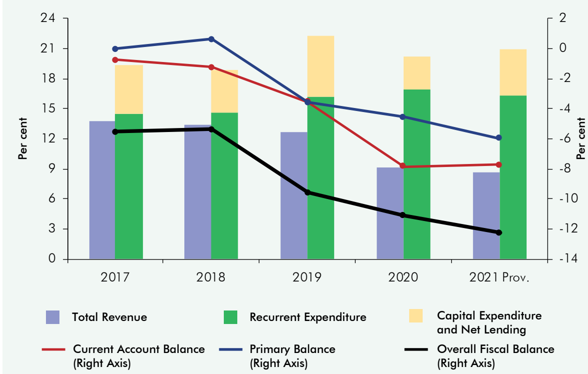
Source: Central Bank of Sri Lanka

depreciated significantly by 33.0 per cent by end March 2022. The Government and the Central Bank have identified the need for implementing urgent measures to address external sector vulnerabilities and for such measures to complement broader economic reforms aimed at resolving persistent and long-standing issues in the economy. While many regional countries and institutions have assisted the country with numerous credit lines, international swap facilities, syndicated loans and substantial current and capital grants, the country is seeking an effective engagement with the IMF and other external stakeholders in order to ensure the sustainability of the country's external debt for restoring macroeconomic stability.

Fiscal Sector Developments

Fiscal sector performance, which suffers from chronically high structural budget deficits caused by government expenditure overruns and government revenue slippages over the years, has deteriorated in 2021, further escalating the government debt stock. The fiscal strategy outlined in the Budget 2021 was aimed at ensuring macroeconomic stability while enhancing economic revival and poverty alleviation, although the envisaged fiscal outcomes were off the mark during 2021 as a result of overly optimistic fiscal targets, prominently in relation to government revenue, which was not adequately supported by felicitous fiscal policies. Government revenue declined to a historic low level of 8.7 per cent of GDP in 2021 as against 9.1 per cent of GDP in 2020. Actual revenue collection significantly deviated from the original budget estimate of 11.1 per cent of GDP, owing to the loss of revenue flows which was a result of the tax relaxations implemented in late 2019 and early 2020, slower than expected economic revival, as well as the

Figure 1.7
Summary of Fiscal Sector Performance (as a percentage of GDP)



Source: Ministry of Finance

continuation of some import restrictions. However, in nominal terms, government revenue recorded a moderate growth of 6.5 per cent, year-on-year. Income taxes, Value Added Tax (VAT), Ports and Airports Development Levy (PAL) and CESS levy contributed to the nominal growth in government revenue, although the revenue mobilised through import duty, excise duty and Special Commodity Levy (SCL) declined primarily due to import restrictions. The rate of growth in government revenue failed to keep pace with the rate of growth in national income in 2021, as in the past, mainly due to the continuation of a plethora of tax incentives introduced since late 2019 and additional direct and indirect concessionary tax reforms introduced since the onset of the pandemic and under the Budget 2021. On the other hand, government expenditure, in nominal terms, increased by 15.8 per cent, year-on-year, to Rs. 3,521.7 billion in 2021. Accordingly, government expenditure as a percentage of GDP increased to 21.0 per cent in 2021 from 20.2 per cent in 2020. Higher expenditure on salaries and wages and interest expenses, which stood at 11.3 per cent of GDP in 2021 and 130.0 per cent of government revenue, drove the growth in recurrent expenditure. Moreover, capital expenditure and net lending increased by 57.2 per

BOX 1
The Importance of International Monetary Fund Programmes

Background

The International Monetary Fund (IMF) is an organisation established in 1944 to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world. The IMF usually provides loans under its programmes to member countries that experience Balance of Payments (BOP) problems to support rebuilding international reserves, stabilising currencies, ensuring continuity in payments for imports, and restoring economic growth, while correcting underlying problems. All IMF members are eligible to access IMF's resources in the General Resources Account (GRA) on non concessional terms, and the IMF also provides concessional financial support through the Poverty Reduction and Growth Trust (PRGT), which is tailored to the diversity and needs of low-income countries. For emerging and advanced market economies in crises, IMF assistance is provided through Stand-By Arrangements (SBAs) to address short term or potential BOP problems. The Stand-By Credit Facility (SCF) serves a similar purpose for low-income countries. The Extended Fund Facility (EFF) and the corresponding Extended Credit Facility (ECF) for low-income countries are the main facilities aimed at providing medium term support to countries facing protracted BOP problems. To help prevent or mitigate crises and boost market confidence, members with already strong policies can use the Flexible Credit Line (FCL) or the Precautionary and Liquidity Line (PLL). The Rapid Financing Instrument (RFI) and the corresponding Rapid Credit Facility (RCF) for low-income countries provide rapid assistance to countries with urgent BOP needs, including difficulties posed by commodity price shocks, natural disasters, and domestic fragilities. Objectives, policies and conditionality under an IMF funding arrangement depend on a country's specific economic circumstances.

The prime concern often raised with regard to approaching the IMF for a programme is the conditionalities attached to it. Conditionalities in IMF programmes in general cover key macroeconomic and structural policy adjustments. Even though these conditionalities were largely focused on macroeconomic policies until the early 1980s, the complexity and scope of structural conditions increased subsequently, reflecting the IMF's growing involvement in low-income and transitional countries. These conditionalities are intended to help countries resolve BOP problems, while avoiding recurring instances of such problems. Further, the remedial measures are intended to ensure that the country's BOP will be strong enough to meet payments for imports and to service external debt in a sustained manner.

The policy commitments agreed with country authorities generally include:

Prior Actions (PA): These are the steps a country agrees to take before the IMF approves financing under a programme. Such actions are set out to ensure that a country has the required foundation to achieve programme goals successfully. PA may generally include the elimination of price controls (if any), formulation of the government budget in consistence with the medium term fiscal framework, and taking measures to achieve debt sustainability.

Quantitative Performance Criteria (QPC): These are specific, measurable conditions relating to macroeconomic variables under the control of the authorities, such as monetary and credit aggregates, international reserves, fiscal balances, and external borrowing. QPC may generally include a minimum level of government primary balance, a ceiling on government borrowing, and a minimum level of international reserves.

Indicative Targets (IT): IT may be set for quantitative indicators to assess progress in meeting programme objectives. IT are sometimes set instead of QPC because of uncertainty about economic trends. As uncertainty is reduced, these targets may become QPC, with appropriate modifications. IT may generally include a minimum level of the government primary balance, a minimum level of domestic revenue collection, and a minimum level of social assistance spending.

Structural Benchmarks (SB): These are reform measures that often are non quantifiable but are critical for achieving programme goals. SB may generally include improvements in financial sector operations, building up social safety nets, and strengthening public financial management.

The Success of IMF Programmes in Terms of Fulfilling Conditions

The IMF periodically reviews the performance of its programmes. An IMF programme is designed in such a way that disbursements of funds are conditional on meeting QPC, IT, etc. To improve the programme's success and reduce risks, the IMF recommends measures to improve the practicality of projections, sharpen debt sustainability analysis, enhance the quality of fiscal consolidation, and improve the tailoring of structural conditions. For the RCF and the RFI facilities provided by the IMF, there is no ex-post programme based conditionality or reviews except for limited overall conditionality. If a country fails to meet QPC, the IMF Executive Board may approve a waiver if it is satisfied that the programme will still succeed, provided that the deviation is minor/temporary or national authorities are taking corrective actions. Missed structural benchmarks and indicative targets do not require waivers but are assessed in the context of overall programme performance.

History of Sri Lanka's Relationship with the IMF

Sri Lanka has engaged in sixteen IMF programmes since obtaining membership of the IMF in 1950. Sri Lanka's first IMF programme was in 1965 and the last was in 2016. The most successful IMF programme was the SBA which commenced in 2009, in which the IMF disbursed the full allocation of funds to Sri Lanka. The previous IMF programmes concentrated primarily on improving foreign reserves and the conduct of monetary policy. In addition, there was emphasis on undertaking vital structural reforms that included the introduction of a fuel price formula, improving the Central Bank's independence, a flexible exchange rate policy, and revenue based fiscal consolidation. In the Sri Lankan context, for official dealings with the IMF, the Hon. Minister of Finance holds the capacity of the Governor of the IMF, and the Governor of the Central Bank of Sri Lanka (CBSL) holds the capacity of the Alternate Governor of the IMF.

In addition, the IMF has extended many technical assistance opportunities to the CBSL and to the Government, including the Forecasting and Policy Analysis System (FPAS) model that was aimed at improving the technical capacity of the CBSL in its transition to the flexible inflation targeting framework.

The Overall Success of IMF Programmes in Sri Lanka

Despite being part of many programmes since the first in 1965, only a few IMF programmes in Sri Lanka have been successfully implemented by authorities. This has been mainly due to the lack of commitment in meeting the conditionalities attached to such programmes, especially those related to structural reforms, which required painful macroeconomic adjustments and unpopular policies that were aimed at long term productivity improvements in the economy. Notably, the need to seek external assistance is a result of the failure to take initiative as a country to introduce structural reforms, which are often included in IMF programmes as well. Most reforms identified in the previous IMF programmes have not been completed fully or abandoned abruptly after drawing some disbursements under the financing facilities, while meeting only short term objectives. This has led to a cycle of being in and out of IMF programmes frequently as shown in Table B 1.1. In contrast, India, which obtained seven programmes from the IMF during 1951 to 1993, has not approached the IMF since the conclusion of its last programme in 1993. If an IMF programme is completed successfully, the economy would be able to reap the long term benefits, especially through structural adjustments, and the need to approach the IMF on future occasions of short term economic stresses would have been minimal. A summary of the success of the latest IMF programmes extended in 2009 and 2016 to Sri Lanka in terms of fulfilling the conditionalities is as follows.

IMF-SBA Programme in 2009

As per the IMF staff report for the eighth and final review under the SBA, Sri Lanka fulfilled the net international reserve targets, net domestic financing and reserve money indicative targets related to the programme. Sri Lanka also implemented all structural benchmarks, except the proposed reforms to the regulatory framework for private pension funds prior to the expiration of the programme.

IMF-EFF Programme in 2016

As per the IMF staff report for the sixth review under the EFF, Sri Lanka was unable to meet fiscal targets due to the significant revenue shortfalls after

Table B 1.1
History of IMF Programmes Obtained by Sri Lanka

000' SDRs

Facility	Date of Arrangement	Expiration Date	Amount Agreed	Amount Drawn	Amount Outstanding
EFF	Jun 03, 2016	Jun 02, 2020	1,070,780	952,230	892,283
SBA	Jul 24, 2009	Jul 23, 2012	1,653,600	1,653,600	0
ECF	Apr 18, 2003	Apr 17, 2006	269,000	38,390	0
EFF	Apr 18, 2003	Apr 17, 2006	144,400	20,670	0
SBA	Apr 20, 2001	Sep 19, 2002	200,000	200,000	0
ECF	Sep 13, 1991	Jul 31, 1995	336,000	280,000	0
SAFC	Mar 09, 1988	Mar 08, 1991	156,170	156,170	0
SBA	Sep 14, 1983	Jul 31, 1984	100,000	50,000	0
EFF	Jan 01, 1979	Dec 31, 1981	260,300	260,300	0
SBA	Dec 02, 1977	Dec 01, 1978	93,000	93,000	0
SBA	Apr 30, 1974	Apr 29, 1975	24,500	7,000	0
SBA	Mar 18, 1971	Mar 17, 1972	24,500	24,500	0
SBA	Aug 12, 1969	Aug 11, 1970	19,500	19,500	0
SBA	May 06, 1968	May 05, 1969	19,500	19,500	0
SBA	Jun 15, 1966	Jun 14, 1967	25,000	25,000	0
SBA	Jun 15, 1965	Jun 14, 1966	30,000	22,500	0

Source: Sri Lanka Country Page (IMF Website)

EFF – Extended Fund Facility, SBA – Stand-By Arrangement, ECF – Extended Credit Facility, SAFC – Structural Adjustment Facility Commitment

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the Easter Sunday attacks in April 2019. The net international reserve targets were met, and the CBSL was committed to rebuilding reserves, while allowing greater exchange rate flexibility. Sri Lanka also made significant progress on the structural reforms agenda under the programme by implementing key structural benchmarks, including developing a roadmap for flexible inflation targeting and flexible exchange rate regime, submitting the 2018 budget to the Parliament in line with the programme targets including a tax expenditure statement, a plan to rationalise tax expenditures in 2018, and the estimated fiscal cost of non-commercial obligations (including subsidies) for State Owned Business Enterprises (SOBEs), preparation of an effective strategic plan and operating business model by the Board of SriLankan Airlines, obtaining approval of the Cabinet of Ministers for a strategy to rationalise para-tariffs over the medium term together with new revenue sources to offset revenue losses, and the rolling out of the Integrated Treasury Management Information System (ITMIS), among others.

Programmes of Regional Countries with the IMF

Other countries in the region have also engaged in IMF programmes from time to time based on the economic conditions. The number of countries requesting an IMF programme has increased notably with the economic fallout from the COVID-19 pandemic. A list of the latest IMF programmes obtained by regional countries is given in Table B 1.2.

Table B 1.2
Latest IMF Programmes Obtained by Selected Regional Countries

000' SDRs

Facility	Date of Arrangement	Expiration Date	Amount Agreed	Amount Drawn	Amount Outstanding
Pakistan					
EFF	Jul 03, 2019	Oct 02, 2022	4,268,000	2,144,000	2,144,000
RFI	Apr 16, 2020	Apr 20, 2020	1,015,500	1,015,500	1,015,500
EFF	Sep 04, 2013	Sep 30, 2016	4,393,000	4,393,000	2,244,750
SBA	Nov 24, 2008	Sep 30, 2011	7,235,900	4,936,035	0
ECF	Dec 06, 2001	Dec 05, 2004	1,033,700	861,420	0
India					
SBA	Oct 31, 1991	Jun 30, 1993	1,656,000	1,656,000	0
SBA	Jan 18, 1991	Apr 17, 1991	551,925	551,925	0
EFF	Nov 09, 1981	May 01, 1984	5,000,000	3,900,000	0
SBA	Mar 22, 1965	Mar 21, 1966	200,000	200,000	0
SBA	Jul 09, 1963	Jul 08, 1964	100,000	0	0
Bangladesh					
RCF	May 29, 2020	Jun 02, 2020	177,770	177,770	177,770
RFI	May 29, 2020	Jun 02, 2020	355,530	355,530	355,530
ECF	Apr 11, 2012	Oct 29, 2015	639,960	639,960	283,411
ECF	Jun 20, 2003	Jun 19, 2007	400,330	316,730	0
ECF	Aug 10, 1990	Sep 13, 1993	345,000	330,000	0
Nepal					
ECF	Jan 12, 2022	Mar 11, 2025	282,420	78,500	78,500
RCF	May 06, 2020	May 08, 2020	156,900	156,900	156,900
RCF	Jul 31, 2015	Aug 10, 2015	35,650	35,650	24,955
ECF	Nov 19, 2003	Nov 18, 2007	49,900	49,900	0
ECF	Oct 05, 1992	Oct 04, 1995	33,570	16,785	0
Maldives					
RCF	Apr 22, 2020	Apr 24, 2020	21,200	21,200	21,200
SBA	Dec 04, 2009	Dec 03, 2012	49,200	8,200	0
ESF	Dec 04, 2009	Dec 03, 2011	8,200	2,050	0
Afghanistan					
ECF	Nov 06, 2020	May 05, 2024	259,040	184,566	184,566
RCF	Apr 29, 2020	Jun 23, 2020	161,900	161,900	161,900
ECF	Jul 20, 2016	Dec 31, 2019	32,380	32,380	31,930
ECF	Nov 14, 2011	Nov 13, 2014	85,000	24,000	1,200
ECF	Jun 26, 2006	Sep 25, 2010	81,000	75,350	0

Sources: Pakistan, India, Bangladesh, Nepal, Maldives and Afghanistan Country Pages (IMF Website)

EFF – Extended Fund Facility, RFI – Rapid Financing Instrument, SBA – Stand-By Arrangement, ECF – Extended Credit Facility, RCF – Rapid Credit Facility, ESF – Exogenous Shock Facility

Implications of a Future IMF Programme on Sri Lanka

As previously mentioned, Sri Lanka has entered into IMF programmes from time to time to support the BOP position and the Government's reforms agenda. However, unlike in previous occasions, in the current context, an IMF programme will be an important part of strategies to overcome prevailing challenging economic conditions in the country. Considering the current low level of international reserves, servicing the significantly high debt repayments due in the near term will be extremely challenging. Liquidity in the domestic foreign exchange market has dried up amidst high foreign debt service payments and the reduction in foreign exchange inflows, resulting in significant depletion of gross official reserves and inadequate foreign exchange to meet the forex demands for essential imports, such as fuel, gas, coal, medicine, and essential food items. In this context, there is a need for securing a sizeable amount of foreign financing in the immediate future. Entering into an IMF programme would not only provide access to additional financing but would also enhance the confidence of potential foreign investors, including multilateral and bilateral counterparts. This, coupled with the implementation of a macroeconomic policy package, is expected to stabilise the overall macroeconomy which will further promote non debt creating financial inflows.

Major areas that could be expected to be considered in the discussion of a potential IMF programme could include fiscal consolidation, appropriate monetary policy stance, exchange rate flexibility, phasing out of monetary financing, reforms of SOBEs, the gradual unwinding of capital flow management measures, the introduction of market based pricing formulae for utilities and strengthening social safety nets, among others. Some of the aforementioned measures have been already implemented by the CBSL and the Government. The monetary policy has been significantly tightened, the exchange rate is increasingly being determined by market forces, and adjustments to prices of domestic petroleum and LP gas have been allowed to reflect costs. These macroeconomic stabilisation measures could result in a painful adjustment to the economy in the adjustment stage, but it has become imperative considering the current economic crisis. However, in order to successfully implement an IMF programme, the country should ensure the management of external debt sustainably through appropriate measures. Towards this end, the Government has already announced the suspension of external debt servicing for an interim period pending an orderly and consensual restructuring of debt obligations in a manner consistent with an economic adjustment programme supported by the IMF. Further, political and social stability needs to be achieved through an agreement between all relevant stakeholders to successfully negotiate and implement an IMF programme. The success of this will also rest on the extent to which the long neglected structural reforms are implemented in a way that ensures sustainable macroeconomic stability.

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cent, year-on-year, due to the base effect, although public investment declined by 2.7 per cent in 2021. The expenditure rationalisation plan was derailed with rigid recurrent spending and additional expenditure requirements of public health services and direct and indirect financial support provided to pandemic affected households and businesses. The overall fiscal deficit, as a percentage of GDP, worsened to 12.2 per cent (Rs. 2,057.9 billion) in 2021 from 11.1 per cent (Rs. 1,667.7 billion) recorded in the preceding year. Meanwhile, the primary deficit in 2021 increased from Rs. 687.4 billion (4.6 per cent of the GDP) in 2020 to Rs. 1,009.5 billion (6.0 per cent of the GDP) in 2021, highlighting the inadequacy of government revenue to meet at least non interest expenditure of the year. The current account deficit, which reflects the dissavings of the Government, also widened in nominal terms from Rs. 1,180.4 billion in 2020 to Rs. 1,290.4 billion in 2021, while declining marginally to 7.7 per cent in 2021 from 7.9 per cent in the previous year, as a percentage of the GDP. With these developments, the primary deficit, current account deficit, and overall budget deficit, as percentages of GDP, notably deviated from the respective estimates of 4.0 per cent, 2.9 per cent, and 8.9 per cent, set out in the Budget 2021. Amidst limited access to foreign

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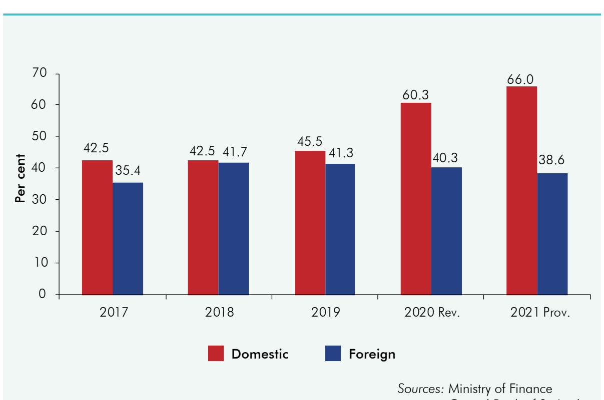
financial markets resulting from the adverse global developments and sovereign rating downgrades, the Government relied heavily on domestic sources, especially the banking sector, to finance the budget deficit. Accordingly, during 2021, net financing through domestic sources amounted to Rs. 2,071.8 billion, whereas a net repayment of Rs. 13.9 billion was registered in relation to foreign sources. The Government relied on financing from the banking sector on a large scale, especially from the Central Bank, to meet the rising expenditure requirements and debt servicing obligations in 2021. As a result, the Central Bank accounted for Rs. 1,225.2 billion of domestic bank borrowings of the Government in 2021. The wider fiscal deficit, increased market interest rates, as well as parity losses caused by the depreciation of the Sri Lanka rupee, resulted in an increase in outstanding central government debt from Rs. 15,117.2 billion recorded at end 2020 to Rs. 17,589.4 billion by end 2021. Accordingly, outstanding central government debt, as a percentage of GDP, increased to 104.6 per cent by end 2021 from 100.6 per cent registered at the end of the preceding year. In nominal terms, domestic debt and foreign debt increased by 22.4 per cent and 7.3 per cent, respectively, by end 2021 over 2020. The increased domestic borrowings

Figure 1.8
Outstanding Central Government Debt
(as a percentage of GDP)

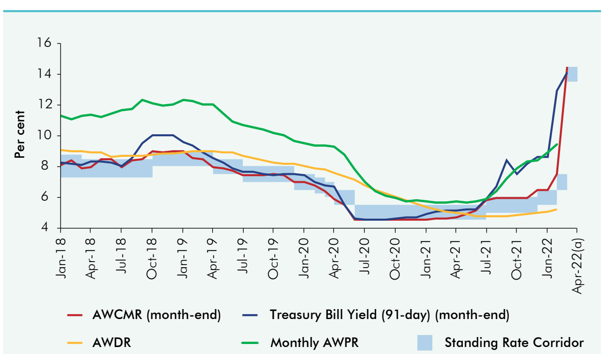


from Treasury bills and Treasury bonds resulted in the share of domestic debt in the government debt portfolio to rise from 60.0 per cent in 2020 to 63.1 per cent in 2021. The total debt service payments increased from Rs. 1,941.4 billion in 2020 to Rs. 2,375.6 billion in 2021. Accordingly, debt service payments increased to 14.1 per cent of GDP in 2021 from 12.9 per cent of GDP in the preceding year. In 2021, interest payments and capital payments amounted to 6.2 per cent and 7.9 per cent of GDP, respectively. A series of sovereign rating downgrades for Sri Lanka was exercised by rating agencies during 2021, in consideration of its worsened external liquidity position, weakening fiscal outlook and forthcoming substantial debt service payments. The significantly high debt level of the Government and bunching of foreign debt obligations in the near to medium term raised serious concerns about external debt sustainability of the country. Against this backdrop, the already announced efforts of the Government to restructure the debt portfolio, along with a strong commitment towards fiscal consolidation efforts and prudent liability management strategies are expected to restore public debt sustainability in the period ahead.

Monetary Sector Developments

Considering the possible build-up of excessive inflationary pressures and the imbalances that emerged in the external sector and financial markets, the Central Bank, which deployed unprecedented monetary stimulus measures since 2020, commenced monetary tightening measures in mid-August 2021. The extremely accommodative monetary policy stance, which was maintained by the Central Bank from the onset of the pandemic in early 2020 through mid-August 2021, helped reduce market interest rates to historically low levels and provide adequate liquidity to the domestic money market, thereby helping individuals and businesses affected by the pandemic, while facilitating economic recovery. The Central Bank continued to provide extraordinary financial support to the Government by way of purchasing Treasury bills from the primary market, as well as direct allocations to the Central Bank to meet the emergency funding needs of the Government amidst disruptions to its cashflows resulting from low revenue mobilisation and high expenditure during the pandemic. However, to preempt the build-up of excessive inflationary pressures over the medium term and to address imbalances in the external sector and financial markets, measures were taken to commence tightening the monetary policy stance from August 2021 onwards. Accordingly, the key policy interest rates, i.e., the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) were raised by 50 basis points to 5.00 per cent and 6.00 per cent, respectively, in mid-August 2021, and the Statutory Reserve Ratio (SRR) applicable on all rupee deposit liabilities of Licensed Commercial Banks (LCBs) was raised by 2 percentage points to 4.00 per cent, effective from September 2021. Several other regulatory measures were also taken by the Central Bank to better reflect market conditions. The Central Bank imposed a ceiling on

Figure 1.9
Standing Rate Corridor and Selected Market Interest Rates



(a) As of 8 April 2022

Source: Central Bank of Sri Lanka

interest rates offered for foreign currency deposit products of LCBs and National Savings Bank (NSB) in August 2021 to address the anomalies between interest rates of rupee and foreign currency deposits in the market. The interest rate applicable on the special mortgage-backed housing loan scheme for salaried employees was revised and linked to a variable interest rate in December 2021. With continued challenges emanating from the external sector and inflation fronts, the Central Bank tightened its monetary policy stance further in January and March 2022 by raising the SDFR and the SLFR by 150 basis points each, in total. In March 2022, the maximum interest rate imposed on foreign currency deposits of LCBs and NSB was also removed, while the maximum interest rates imposed on interest rates of domestic lending products i.e., credit cards, pre-arranged temporary overdrafts and pawning facilities were revised upwards. With the tightening of the monetary policy stance and rupee liquidity concerns encountered by certain banks, liquidity in the domestic money market, which remained at considerable surplus levels during the first half of 2021, declined notably into large deficit levels. Market interest rates, which declined to historic low levels, started to adjust upwards gradually. Yields on government securities were also allowed to increase with the removal of the maximum yield rates for acceptance at primary auctions of government securities. In early April 2022, noting the considerable inflationary pressures driven by substantial exchange rate depreciation, the build-up of aggregate demand pressures, the elevated prices of commodities globally, and domestic supply disruptions, the Central Bank raised policy interest rates significantly by 700 basis points, the highest single day adjustment in recent history, to arrest the build-up of excessive demand driven inflationary pressures and preempt the escalation of adverse inflationary expectations, to provide the required impetus to stabilise the exchange rate and also to

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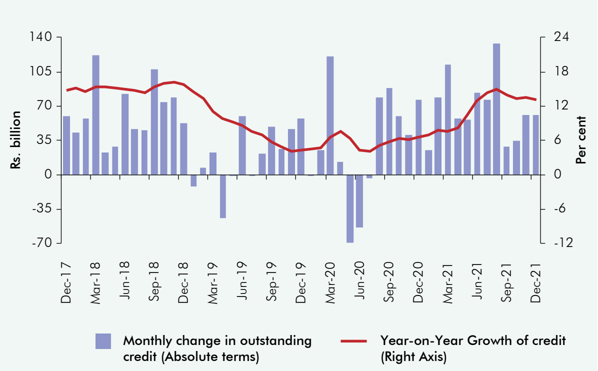
correct anomalies observed in the market interest rate structure. Accordingly, the SDFR and SLFR were increased to 13.50 per cent and 14.50 per cent, respectively, effective from the close of business on 08 April 2022. The interest caps imposed on selected domestic lending products were also removed.

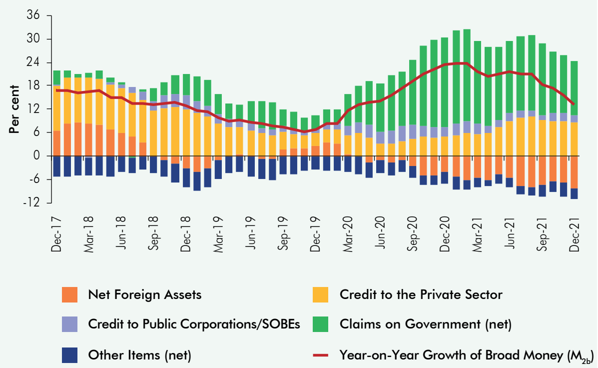
Domestic credit extended by the banking system expanded significantly during the year driven mainly by the notable increase in net credit to the Government (NCG) by the Central Bank, while net foreign assets (NFA) of the banking system contracted resulting in a moderation of broad money supply (M_{2b}). Amidst the decline in government revenue and limited access to foreign financing, the Government's increased funding requirement was met largely through the domestic banking system. Thus, NCG by the banking system increased notably by around Rs. 1,284.4 billion in 2021, of which, about 95 per cent was funded by the Central Bank. Credit obtained by the SOBEs from the banking system also expanded notably by Rs. 185.9 billion in 2021, reflecting their weak financial positions. Supported by the low cost of funds, credit extended to the private sector also expanded notably by Rs. 810.5 billion in 2021. However, with the contraction in NFA of the banking system, particularly NFA of the Central Bank, due to foreign currency debt service payments by

Figure 1.10
Credit Granted by Commercial Banks to the Private Sector



Source: Central Bank of Sri Lanka

Figure 1.11
Broad Money Growth and Contribution



Source: Central Bank of Sri Lanka

the Central Bank on behalf of the Government, the growth of M_{2b} moderated towards the latter part of 2021, recording a year-on-year growth of 13.2 per cent by end 2021, compared to the growth of 23.4 per cent recorded at end 2020.

Financial Sector Developments

Despite severe challenges faced by the economy, the stability of Sri Lanka's financial systems was preserved during the year 2021. Financial intermediation by the banking sector was satisfactory, while the profitability of the sector improved considerably during 2021, compared to the previous year, due to notable increases in both net interest income and non-interest income. However, banks faced a severe foreign currency liquidity shortage due to the lack of foreign inflows to the country. Licensed Finance Companies (LFCs) and Specialised Leasing Companies (SLCs) sector also showed a notable overall improvement in terms of credit growth and profitability against the backdrop of the progressing Financial Sector Consolidation Masterplan. The Central Bank continued to assist financial institutions to adapt to the new normal and provided certain regulatory forbearances with a view to supporting the pandemic disrupted economy. The insurance sector also recorded an expansion. Liquidity in the money market turned to deficit levels followed by foreign debt repayments and a reversal of the accommodative monetary policy stance since August 2021. Liquidity in the domestic foreign exchange market was at significantly low levels owing to a delayed recovery in tourism earnings, slow conversion of export proceeds, increase in import expenditure as well as unfavourable market conditions led by several sovereign downgrades during the year. The Colombo Stock Exchange (CSE) recorded an improvement in 2021, despite negligible contribution by foreign investors. The country's payment and settlement system was operated smoothly by the Central Bank during the period under review. Meanwhile, the Central Bank continued to introduce reforms to major legislations to provide a stronger legal foundation for the regulatory and supervisory framework.

Table 1.4
Global Economic Developments and Outlook (a)

Item	2020 (b)	2021 (c)	2022 (Proj)	2023 (Proj)
World Output	**-3.1**	**6.1**	**3.6**	**3.6**
Advanced Economies	-4.5	5.2	3.3	2.4
United States	-3.4	5.7	3.7	2.3
Euro Area	-6.4	5.3	2.8	2.3
United Kingdom	-9.3	7.4	3.7	1.2
Japan	-4.5	1.6	2.4	2.3
Emerging Market and Developing Economies	-2.0	6.8	3.8	4.4
Emerging and Developing Asia	-0.8	7.3	5.4	5.6
China	2.2	8.1	4.4	5.1
India	-6.6	8.9	8.2	6.9
World Trade Volume (Goods and Services)	**-7.9**	**10.1**	**5.0**	**4.4**
Price Movements				
Consumer Prices				
Advanced Economies	0.7	3.1	5.7	2.5
Emerging Market and Developing Economies	5.2	5.9	8.7	6.5
Commodity Prices (US$)				
Oil	-32.7	67.3	54.7	-13.3
Non Fuel	6.8	26.8	11.4	-2.5

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

Source: World Economic Outlook (April 2022), IMF

1.3 Global Economic Environment and Outlook

As the global economy begins to recover from the effects of the COVID-19 pandemic in 2022, the progress is being severely disrupted by the repercussions of the Russia-Ukraine conflict. According to the World Economic Outlook (WEO) of the International Monetary Fund (IMF) released in April 2022, global economic growth is estimated at 6.1 per cent in 2021, compared to a contraction of 3.1 per cent in 2020. During 2021, advanced economies were estimated to have recorded a growth of 5.2 per cent, while the growth estimation for emerging market and developing economies stood at 6.8 per cent. The IMF projects global economic growth to slow down to 3.6 per cent in 2022, largely reflecting the spillover effects of Russia’s invasion of Ukraine and associated sanctions imposed on Russia, on the global economy. In addition to the war, the IMF predicts that disruptions to global supply chains due to frequent and large-scale lockdowns in China, persistent inflationary pressures leading to tightening of monetary policies of many countries and withdrawal of fiscal policy support previously provided across the world to cushion the impact of the pandemic could also affect the global growth prospects adversely. Accordingly, economic growth rates of 3.3 per cent and 3.8 per cent are projected in 2022 for advanced economies and emerging market and developing economies, respectively. Further, the global growth projection for 2023 has been revised downwards by the IMF to 3.6 per cent, 0.2 percentage points lower than the January 2022 WEO.

There is consensus that in addition to the loss of lives and human suffering, the ongoing Russia-Ukraine conflict poses significant economic risks beyond these two countries creating an economic toll felt worldwide. The war is resulting in a tragic loss of lives and human suffering and significant damages to the Ukrainian infrastructure and consequently, the Ukrainian economy is set to experience a deep recession in 2022. According to the IMF, the Ukrainian economy is expected to contract by 35 per cent in 2022. The tight trade and financial sanctions being imposed on Russia, including oil and gas embargoes by some large economies, freezing of assets of the Central Bank of Russia by Western countries and suspension from using services of the Bank for International Settlements are expected to result in a sharp contraction of the Russian economy in 2022 with its GDP falling by about 8.5 per cent, while having a substantial impact on the global economy and financial markets. The neighbouring countries of these two nations are particularly affected by interruptions to trade and remittances and by the influx of refugees. According to the IMF, the spillover effects of the war are being transmitted to the rest of the world through five key channels. The first and the most impactful channel is the surge in commodity prices including energy and other commodities such as wheat, corn, metals and inputs for fertilisers. This has added on to the already high inflationary pressures caused by supply chain disruptions and the revival from the COVID-19 pandemic. Accordingly, inflation is projected to remain elevated at 5.7 per cent in advanced economies and 8.7 per cent in emerging market and developing economies for 2022. Secondly, countries with direct and substantial trade and remittances linkages with Russia and Ukraine would also be negatively affected. Moreover, the tourist earnings of the countries which heavily rely on Russian and Ukrainian tourists would be affected by lower tourist arrivals due to economic disruptions and the withdrawal of international payment services from Russia. Thirdly, as the integration of Russia and Ukraine into global value chains extends beyond typical commodity linkages, disruptions to component manufacturing processes stemming from raw material shortages could propagate across the globe through cross border production networks. The fourth channel is business confidence and financial conditions which have already been tightening with the commodity price pressures and sanctions. In the Asian region, higher global food and energy prices, tighter global financial conditions and reduced tourism earnings would hold back growth for some oil importing economies while oil exporters would gain from higher fossil fuel prices. Agriculture industries in some South and Southeast Asian nations that rely on Russia and Ukraine for fertiliser and grain, on the other hand, would also be negatively affected. Capital outflows may be triggered from the Asian region with risk aversion in financial markets. Developments in the Chinese economy are expected to dominate the outlook for Asia, with a projected economic growth of 4.4 per cent in 2022. Overall, the rising global energy and commodity prices, leading to high domestic inflation and widening trade deficits, weakening global demand, volatile capital flows, exchange rate instabilities, rising borrowing costs, and tightening global financial conditions as a result of monetary tightening in advanced economies, could make developing countries more vulnerable, resulting in recession, insolvency, and halting development processes in some cases.

Prices of energy and food commodities were on a rising trend throughout 2021 on the back of global demand recovery with the easing of COVID-19 concerns and are expected to continue to remain elevated with the ongoing geopolitical tensions in Europe. Although crude oil prices fell sharply with the outbreak of COVID-19 in 2020, prices were steadily rising from April 2020 onwards and reached pre-pandemic levels by March 2021 before reaching seven-year highs in October 2021. The recent emergence of geopolitical tensions between Russia and Ukraine led crude oil prices to remain above US dollars 100 per barrel due to concerns of further tightening of global crude oil supplies as buyers remained apprehensive of purchasing from Russia. As per the April 2022 WEO, the average crude oil price for 2022 is forecast at US dollars 106.83 per barrel, thereby signalling the strong likelihood that crude oil prices will remain elevated throughout the year despite some downward pressures stemming from outbreaks of COVID-19 and related mobility restrictions, as those that are being seen in China and the expectation of release of additional supplies of oil from countries' strategic reserves. In relation to food prices, during 2021, the Food and Agriculture Organisation's (FAO) Food Price Index depicted an overall growth of 28.1 per cent above the prices observed in 2020. Global food prices were on an upward trend amid high cost of inputs, unfavourable climate conditions and hesitation to increase production amid COVID-19 related uncertainties. These concerns continued to linger and will continue to be aggravated by the geopolitical tensions between Russia and Ukraine, both of whom are key agricultural exporters. This led to the index continuing to escalate during the first three months of 2022.

Most central banks around the world adopted substantial monetary easing measures during 2020 and in early 2021 leading to policy interest rates of many economies reaching historically low levels. Contributed by multiple policy support, including that of monetary policy, and successful vaccination programmes, the world economy started showing signs of recovery during 2021. In particular, demand conditions in many countries started to normalise faster than supply conditions, thereby creating price pressures across multiple sectors. As a result, several countries, especially developed economies, began to unwind the large monetary policy easing measures undertaken thus far and to tighten monetary conditions in view of rising inflationary pressures and unfavourable inflation expectations. Further, the recent global political uncertainty and supply disruptions, driven by the Russia-Ukraine war, have also created added pressures on price levels in most economies, forcing many governments to undertake policy measures to address inflation rates that are substantially higher than the levels projected and experienced in the recent past. The Federal Reserve of the United States, which had kept the federal funds target rate range at 0.00 per cent to 0.25 per cent for the last two years, increased it by 25 basis points in March 2022, in view of rising inflationary pressures, as US inflation had increased to a 40-year high in early 2022. In addition to this policy rate increase, the Federal Reserve also signalled further tightening of monetary policy with policy rate hikes and shrinking of its balance sheet over the near term. The Bank of England (BoE), which adopted an accommodative policy stance from early 2020 onwards to support the pandemic hit economy, commenced tightening the monetary policy stance from late 2021. By end March 2022, BoE had raised its Bank Rate by 65 basis points in three steps compared to the rate that prevailed during the pandemic. Since the refinance rate of the European Central Bank (ECB) had already reached the zero level, policy accommodation during the pandemic in the euro area was primarily conducted with asset purchase programmes. However, net asset purchases are expected to be gradually reduced, while any adjustments to policy rates are expected to take place sometime after the end of net asset purchases. The ECB has also affirmed the provisioning of forward guidance on the interest rate path. Meanwhile, several Asian economies, including China, continued to adopt accommodative policies to further support economic growth. The People's Bank of China (PBoC) continued to relax monetary policy in early 2022 as well, amidst modest levels of inflation and growth concerns due to issues in the property sector and resurgence of the COVID-19 pandemic in some areas. The Reserve Bank of India (RBI) continued to maintain the relaxed

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monetary policy stance while focusing on withdrawal of monetary stimuli to ensure that inflation remains within the target in the period ahead. Bank Negara Malaysia (BNM), which brought down its overnight policy rate to 1.75 per cent in several steps in mid-2020, continued the relaxed monetary policy stance by maintaining the policy rate unchanged from 2021 into early 2022. Since demand driven inflationary pressures remained subdued and medium-term inflation projections were expected to return to target levels with the stabilisation of energy and food prices, Bank of Thailand (BoT) continued to maintain the emphasis on supporting the recovery of the economy by maintaining its dovish policy stance. Similarly, Bangko Sentral ng Pilipinas (BSP) also continued to maintain the accommodative policy stance during 2021, and had not deviated from it by March 2022 to support growth momentum, but emphasised its readiness to address inflationary pressures that could de-anchor inflation expectations. The policy behaviour of Indonesia was also similar to the other South East Asian economies discussed above, where Bank Indonesia (BI) maintained its policy rate stable since early 2021 onwards. At the same time, BI continued to normalise liquidity conditions by incrementally raising reserve requirements. In contrast to the almost synchronous policy accommodations by most central banks across the world in response to the COVID-19 pandemic during 2020, the winding up of such accommodative policy measures seem to be divergent across countries, due to varying levels of inflationary pressures, underlying causes of such pressures, and concerns about growth outlook. Some economies seem to have managed inflationary pressures better than others, particularly with supply side adjustments, while most countries have attempted to strike a balance between price stability and post pandemic growth recovery. However, by March 2022, the developments regarding the Russia-Ukraine war had led to substantial uncertainty over global economic outlook. The April 2022 WEO states that the appropriate monetary response across countries may vary considerably as the transmission of the effects of the war could be diverse across various economies, and highlights the importance of clear communication and data driven forward guidance in order to maintain policy credibility over the period ahead.

1.4 Macroeconomic Outlook

Sri Lanka's economy is envisaged to grow modestly in the near term as the economy is to reset with a debt restructuring programme and long overdue structural reforms alongside an economic adjustment programme to be supported by the IMF, which is expected to facilitate the economy to gather momentum over the medium term. The build-up of macroeconomic instability in the economy, stemming from the heightened vulnerabilities on both the external and fiscal fronts, rising social unrest and political instability, effects of the pandemic, the domestic energy crisis, and elevated commodity prices both globally and domestically are expected to significantly dampen the growth prospects in 2022 and have lingering effects in the immediate future leading to a slowdown in growth. Also, economic activity is likely to further slowdown amidst the announcement of a suspension of external debt servicing by the Government for an interim period and commitment to a debt restructuring programme. However, the commissioning of prudent macroeconomic policies aimed at stabilisation of the domestic economy coupled with an IMF engagement, improved monetary and fiscal policy coordination and envisaged SOBE reforms is expected to restore the pace of growth over the medium term. The aggressive tightening of monetary policy is expected to contain excessive inflationary pressures in the economy, thereby anchoring inflation expectations, which is pivotal in establishing a conducive environment for investment. However, in the short run, a notable rise in the interest rates would discourage lending, and in turn hamper economic growth, but would address interest rate anomalies and pressures on the exchange rate to a certain extent, thereby attracting productive investment in the medium to long run. The tightened monetary policy would be instrumental in stabilising the external value of the domestic currency favourably, facilitating the influx of foreign exchange. While the expansion of credit to the private sector as well as broad money supply are expected to remain somewhat subdued in 2023 due to the lagged effects of tight monetary policy, growth of broad money and private sector credit is expected to normalise and improve from 2024 onwards over to the medium term amidst a moderation in the expansion of NCG, as the envisaged fiscal consolidation efforts would materialise. Earnings from exports are expected to moderate during 2022 before strengthening in the period ahead with the envisaged recovery in global demand, favourable exchange rates, and the policies to improve the tradable sector. Demand for imports is expected to dampen due to tight monetary policy and difficulties in financing imports in 2022 and in the period ahead, whilst higher global commodity prices including fuel are likely to keep imports relatively at elevated levels. The envisaged improvement in earnings from exports is expected to result in a contraction of the trade deficit in the medium term. Meanwhile, with the gradual normalisation of the world economy as well as the people mobility across the globe, Sri Lanka is likely to benefit from the tourism industry in the period ahead, once the socioeconomic unrest witnessed at

Table 1.5

Near Term Macroeconomic Projections (a)

Indicator	Unit	2020 (b)	2021 (c)	2022 (Projections)
Real Sector (d)				
Real GDP Growth	%	-3.6 (c)	3.7	1.0
GDP at Current Market Price	Rs. tn	15.0 (c)	16.8	20.7
Per Capita GDP	US$	3,695 (c)(e)	3,815	3,041
Total Investment	% of GDP	25.1 (c)(f)	27.7	28.0
Domestic Savings	% of GDP	18.7 (c)(f)	20.1	19.5
National Savings	% of GDP	23.6 (c)(f)	23.8	25.4
External Sector				
Trade Gap (d)	% of GDP	-7.4	-9.6	-12.4
Exports	US$ bn	10.0	12.5	13.0
Imports	US$ bn	16.1	20.6	21.4
Current Account Balance (d)	% of GDP	-1.5	-4.0	-2.6
External Official Reserves	Months of Imports	4.2	1.8	1.5
Fiscal Sector (d)(g)(h)				
Overall Fiscal Balance	% of GDP	-11.1 (i)	-12.2	-10.2
Central Government Debt	% of GDP	100.6	104.6	108.2
Monetary Sector and Inflation				
Broad Money Growth (M_{2b}) (j)	%	23.4	13.2	12.7
Private Sector Credit Growth (in M_{2b}) (j)	%	6.5	13.1	10.0
Annual Average Inflation (k)	%	4.6	6.0	22.0

(a) Based on information available up to mid April 2022.
(b) Revised
(c) Provisional
(d) Based on the GDP estimates (base year 2010) of the Department of Census and Statistics
(e) Estimates are updated with the latest population figures.
(f) Total investment, domestic savings and national savings as a percentage of GDP in 2020 were revised by the Department of Census and Statistics from 25.2%, 18.9% and 23.9%, respectively.
(g) Fiscal sector estimates are based on CBSL projections.
(h) Based on the revised GDP estimates for 2020 released on 29 March 2022 by the Department of Census and Statistics
(i) According to the Ministry of Finance, fiscal sector statistics of 2020 have been adjusted as announced in the Budget Speech for 2020.
(j) Year-on-year growth based on end year values
(k) Based on CCPI (2013=100)

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

1

present eases away. This, together with the expected rebound of activities in transport services and high growth in the IT/BPO services subsector is envisaged to strengthen the surplus in the services account over the medium term. The primary income account deficit is expected to moderate in the period ahead with the expected savings on interest payments on account of external debt due to the suspension of external debt servicing for an interim period, and the envisaged commencement of the debt restructuring programme. Further, workers' remittances are expected to improve steadily over the medium term with the gradual improvement in departures for foreign employment, the improvement of global travel, increased demand for migrant labour and expected recovery in the flow of remittances through official channels. Consequently, the external current account deficit is expected to decline gradually to a sustainable level. Moreover, financial flows are expected to strengthen over the medium term with the envisaged non debt creating inflows to the Colombo Port City and the development of industrial zones, such as the Hambantota Industrial Zone. Inflows to the financial account are expected to be supported by the enhanced investor confidence expected from the debt restructuring programme and the envisaged engagement with an economic adjustment programme supported by the IMF. Meanwhile, the Government's commitment towards fiscal consolidation, along with measures to improve revenue mobilisation with an appropriate tax structure as well as efforts to mobilise non debt creating foreign flows are essential to support the growth drive of the economy. Accordingly, the Sri Lankan economy is expected to accelerate gradually from 2023 onwards to reach its growth potential in the medium term, supported by prudent macroeconomic policies aimed at economic stabilisation, thereby expanding the productive potential of the economy while addressing long lasting structural issues.

Projections of the Medium Term Macroeconomic Framework require adequate information on the impact of recently announced policy changes (in early April 2022), including the commencement of negotiations for an IMF programme, forthcoming restructuring of external debt obligations, efforts towards strengthening fiscal consolidation, along with the introduction of various structural reforms. As most of these policy announcements are currently at the initial stage, the Medium Term Macroeconomic Framework published regularly in the Annual Report of the Central Bank is not available; instead, only the projections for major macroeconomic variables for 2022 are provided. Once informed projections for major macroeconomic variables become available the Medium Term Macroeconomic Framework will be made available in forthcoming publications of the Central Bank.

1.5 Issues and Policies

Over several decades, the Sri Lankan economy outpaced its peers as reflected by the economic and social changes that had taken place, particularly in terms of reasonable economic growth and development indicators along with the consistent investment in social infrastructure, although the country's economic prospects have been overshadowed by persistent structural impediments that need to be addressed with a sense of urgency to ensure sustained macroeconomic stability and inclusive growth. At the time of independence, Sri Lanka was well poised for rapid economic growth and development and appeared to be one of Asia's most promising nations. The country's unique strategic geographical location and identity as a leading maritime and commercial hub in the main sea route and being a classical model of the gradual evolution towards independence,[1] coupled with several other positives, including non-aligned diplomacy, well established democracy, continuous investment in human capital and social infrastructure in terms of free education resulting in high levels of literacy and free health yielding increased life expectancy, investments in the capital stock yielding the improvements in physical infrastructure, as well as progressive economic policies towards market orientation and trade openness implemented ahead of many other emerging economies, provided a conducive environment for a smooth transformation of the economy to become a prosperous nation in Asia. In spite of such achievements, the country's long term economic progress has been significantly below its potential, thereby delaying the path towards prosperity. The Sri Lankan economy was able to transition from a low income country to a lower middle income status only during the new millennium, but even such progress was not sustained to reach higher economic status for the benefit of the people. As such, the progress of the economy to become a high income country was nipped by a myriad of challenges. During the last seven decades since the independence, the economic performance was withered by a host of factors such as the internal conflicts, calamitous natural and manmade disasters, diseases, intermittent external shocks, weak institutions, issues in relation to accountability, transparency, and governance, including corruption, waste, nepotism, and certain episodes of political instability, and above all, weaknesses in effective economic management. As a result, the economy is persistently saddled with volatility in growth, high inflationary episodes, fiscal imbalances, particularly in terms of persistently large fiscal deficits and debt burden, and the spillover effects of fiscal imbalances on the external and monetary sector stability. The twin deficit challenge, namely the budget deficit and the external current account deficit, emanating from the imbalances due to excessive spending over and above the country's capacity and reflecting the imbalances in the fiscal and external sectors, remains the major structural impediment and the key source of economic vulnerability in Sri Lanka. The country is one of the classic examples to prove that prolonged fiscal expansions contribute to current account imbalances thus yielding several macroeconomic ailments. In this context, the commitment towards fiscal prudence of successive governments to address such prolonged fiscal imbalances has been short-lived as reflected in the expanding budget deficits, and in turn, the rising public debt and the associated interest costs to disconcerting levels. On the other hand, the external sector has been plagued by meagre export performance amidst high import expenditure, high external debt challenge, and the misaligned exchange rate, posing risks to macroeconomic stability. Inconsistent fiscal policies driven by the socially and politically populist short term motives, instead of adopting consistent national policies with a focus on long term economic progress, have caused a sequence of detrimental consequences towards achieving the country's macroeconomic objectives as well as the overall welfare of the citizens. Against this backdrop, Sri Lanka has often failed to harness the strength of its economic endowment and reach full economic potential by drawing lessons from the success stories of its peers, who have surpassed Sri Lanka in terms of both social and economic development. Moreover, the outbreak of the pandemic and related uncertainties have severely undermined the past achievements of the Sri Lankan economy, while intensifying its macroeconomic fragilities. Amidst the disruptions of the pandemic, several longstanding unresolved

1 Lee Kuan Yew. 2000. From Third World To First: The Singapore Story: 1965–2000, Singapore: Singapore Press Holdings

structural impediments, which have been left unaddressed and postponed repeatedly, have now resurfaced impeding the economic recovery, despite unprecedented monetary and fiscal stimuli offered by the monetary and fiscal authorities, respectively. This underscores the need for having a credible macroeconomic plan and a national policy agenda to address persistent and severe macroeconomic imbalances. Therefore, ambitious and consolidated efforts with appropriate and consistent policy directives are required to be implemented expeditiously by way of charting a strong macroeconomic management framework to address long due structural issues and new challenges surfaced by the pandemic. Such efforts would pave the way for the country to move towards the envisaged higher growth trajectory over the medium term, while ensuring stable economic conditions, which will ultimately yield improved living standards for the people.

In the above context, several structural issues and policies are discussed with the view to highlighting key areas in the economy that needs special and urgent attention.

Achieving a sustainable current account balance by enhancing net inflows from goods and services exports as well as by promoting workers' remittances is imperative to overcome the heightened vulnerabilities stemming from external sector imbalances. The persistent external current account deficit remains one of the key and largely unaddressed vulnerabilities in Sri Lanka's macroeconomic landscape. This is mainly driven by continuously widening deficits in the trade and primary income accounts that are too large to be offset by the surpluses in the services and secondary income accounts. Sri Lanka's exports in the last few decades have seen no major growth drive or boom due to longstanding issues such as limited diversification, low value addition, slower integration to global value chains and the lack of sophistication required to remain competitive, amidst inadequate investments in the tradable sector. In the meantime, expenditure on imports, including non essential and non urgent imports, have increased at a faster pace leading to substantial trade deficits. Sri Lanka was ahead of its regional peers in liberalising the economy in 1977 and the adoption of liberal economic policies, such as private sector driven development, export led growth, and promoting FDI, that led to the immediate realisation of notable improvements in foreign trade. However, during the last few decades, Sri Lanka's international trade performance has been lacklustre and regressing continuously, ultimately contributing to the widening of the external current account deficit, which has been mainly financed through external sector borrowings, amidst limited FDI. These borrowings to bridge the external current account deficit and to finance the budget deficit not only increased the external debt stock of the state, but also increased the quantum of interest payments, thereby contributing to the widening of the deficit in the primary income account. In order to reduce the debt repayment burden, it is important to ensure that foreign borrowings are utilised effectively for income generating and productivity enhancing ventures, especially in the tradable sector that generates foreign exchange earnings. At the same time, any effort in addressing the external current account deficit should be focused on strategies to reduce the trade deficit by increasing the earnings from merchandise exports, while increasing the surplus in the services account. Further, product diversification, vertical and horizontal integration, participation in production sharing networks and linking with the global value chains through component manufacturing as well as reducing the over reliance on certain markets as export destinations by way of exploring new markets could be considered as vital initiatives to maximise the return from integrating with the rest of the world, while minimising the risk of adverse global spillovers. Despite the changes in the political regimes, speedy and uninterrupted implementation of the actions outlined in the National Export Strategy is essential in the national interest to achieve the intended outcomes. Policy measures aiming at promoting domestic industries that supply intermediate goods required for key exports should be implemented promptly to enhance the domestic value addition in the export sector. Further, initiatives on moving towards renewable energy sources would also reduce the country's reliance on fossil fuels thereby helping to minimise the pressure on the current account stemming from fuel imports. Moreover, services exports are vital in cushioning the deficit in the external current account, and hence it is imperative to exploit their full potential. Certain services exports, especially in the IT/BPO sector, have the potential to become the forerunner in bringing foreign exchange inflows to the country. Capitalising on the high potential, the aim should be to transform the IT/BPO sector from the current levels of around US dollars 1 billion per year to a US dollars 5 billion export industry in the medium term with the necessary assistance of the Government. Growth opportunities in the IT/BPO sectors have expanded with the increased digitalisation of economies worldwide which is also supported by the novel working arrangements introduced with the outbreak of the COVID-19 pandemic. Therefore, Sri Lanka should capitalise on the availability of a skilled labour force and the state-of-the-art IT infrastructure to promote Sri Lanka as a digital nation thereby encouraging higher foreign exchange inflows. Also, the IT education policy needs to be aligned to complement the development of human capital required to keep up with the expansion in this sector. Moreover, the tourism sector is showing signs of revival after the pandemic with the gradual relaxation of travel restrictions and the success of the vaccine drive although some new risks have emerged due to global geopolitical tensions. Hence, to reap the maximum benefits of the recovery in the tourism industry, it is imperative to diversify the tourism sector to focus on niche offerings that would attract high spending tourists, thereby enabling access to non traditional markets and tourists that travel for different purposes. Meanwhile, Sri Lanka has been heavily relying on workers' remittances from Middle Eastern economies to cushion the impact of the trade deficit on the external current account. This also increases Sri Lanka's exposure to any geopolitical conflicts and the growth slowdowns in the Middle Eastern region due to oil price volatilities. Therefore, workers' remittances from the Middle East can no longer be considered a sustainable source to finance the current account deficit. Thus, there is a need to find alternative destinations by exploring new labour markets, especially in advanced economies such as South Korea, Singapore, Japan and European countries. In addition, enhancing the skills of migrant employees is beneficial to secure employment opportunities with higher and stable earnings. More importantly, rerouting remittances that are partly channelled through informal means at present to the formal banking channel through targeted policy measures along with the support of all stakeholders is the need of the hour to bridge the trade gap. In addition to the targeted measures to address broader current account deficits, it is also necessary to supplement them by attracting more non debt creating inflows in the form of FDI and also portfolio investments into the financial account of the BOP in order to ensure greater external sector stability and improved macroeconomic stability.

Attracting non debt creating foreign financial inflows to strengthen the external sector resilience has become a pressing need going forward in order to ensure stability in the external sector, amidst higher foreign currency debt servicing requirements and lack of fiscal space for debt repayment. Being a twin deficit country, Sri Lanka has been resorting to foreign and domestic debt to finance deficits in both the external current account and the government budget. As a result, a disproportionate increase in external debt in relation to GDP and surging debt service payments have been largely contributing towards the external sector imbalances over the recent past. Moreover, with limited access to concessional funding in line with the transition towards a middle income country, financing requirements have to be fulfilled through commercial loans and sovereign debt issuances. Such efforts are constrained by heightened uncertainties in the global financial markets and successive sovereign rating downgrades. Accordingly, Sri Lanka could not raise an adequate quantum of funds in the international capital markets during the last two years. Amidst weak FDI inflows, foreign investments in the stock market and the government securities market have been considerably low over the past two years due to weak investor sentiment owing to the pandemic although there have been some temporary pickups in the markets. Therefore, in the absence of significant foreign financial inflows, the liquidity in the domestic foreign exchange market dried up notably and foreign debt service payments have been met at the cost of depleting foreign reserves. Against this backdrop, it is vital to focus on attracting non debt creating foreign financial flows such as FDI, which are long term capital flows and are not susceptible to immediate withdrawals like portfolio investments rather than just resorting to more and repeated foreign borrowings. Beyond supporting the financing of the current account deficit and augmenting domestic investment, FDI fosters economic growth by generating technology spillovers, supporting human capital development, assisting business expansion and enhancing international trade linkages through improved access to foreign markets. Although FDI flows plunged globally in 2020 and 2021 owing to the pandemic, Sri Lanka's FDI remained acutely low compared to its regional peers over the past decades due to several legal, structural and institutional deficiencies such as rigid labour market regulations, difficulties in obtaining utilities, complex and inconsistent tax structures and laborious regulatory structures, particularly related to contract enforcement, export import documentation, business startups, obtaining funds and property acquisition, and the lack of well developed infrastructure facilities. Apart from these factors, policy uncertainty, institutional and governance weaknesses such as corruption and coordination failures continue to pose impediments to creating a conducive investment climate in Sri Lanka. Therefore, in order to foster investor confidence, Sri Lanka needs to establish a transparent and effective policy environment by articulating a comprehensive investment policy and build the required human competencies and institutional capacities to implement policy actions. Harmonisation of investment policy with other government development policies and strategies, such as trade and industrial policies, as well as inter agency coordination in implementing these policies remain equally important. While efforts have already been taken to rectify these concerns by relevant authorities, it is imperative to expedite the implementation process before global FDI flows resume to pre-pandemic levels. Furthermore, creating a conducive regulatory environment through labour and land market reforms as well as tax reforms that would simplify the tax regulations will also complement this endeavour. Establishing and respecting rule of law, strengthening efforts to eradicate corruption, and ensuring transparency, are also crucial to making Sri Lanka an attractive investment destination. A renewed focus on expediting policy reforms aimed at reducing administrative deficiencies and bureaucratic constraints will also be instrumental in attracting and retaining a high level of FDI. Developing the Colombo Port City and promoting the Colombo and Hambantota ports as commodity trading hubs could attract considerable foreign investments to the country in the period ahead. While taking measures to enhance FDI flows, it is essential to gradually reduce the ISB exposure with a view to reducing the external debt burden. Further, monetisation of underutilised non strategic assets would also help bring in much needed foreign exchange to the country. Most importantly, immediate attention should be drawn to restoring investor confidence weakened by unwarranted fears triggered by credit rating actions and numerous media coverage including social media creating negative perceptions about the country. In this regard, engaging in a continued dialogue with existing and potential investors, capitalising on trade and diplomatic relations to entice investment opportunities, liaising with regional counterparts to tap niche markets and exploring investment opportunities to make use of green financing options would be beneficial. A key issue identified by many of the Green and Sustainable Finance initiatives is the need to develop standard definitions, i.e., a taxonomy. The Central Bank is in the process of developing a green finance taxonomy that will provide the framework for investment analysis for the banking sector when funding green projects.

There is a pressing need for all stakeholders of the energy sector to work together to devise a holistic plan for the energy sector that will guarantee energy security of the economy, while also ensuring that energy related SOBEs serve as growth drivers of the economy that create positive externalities. The energy sector of Sri Lanka saw a rapid transformation in the post-conflict era with electrification levels reaching 99 per cent and a significant progress in augmenting the power generation infrastructure base of the country. The Government's recent thrust to expand the renewable energy sector to cater to 70 per cent of the country's energy requirement by 2030 is a welcome initiative as it would help substantially improve the resilience of the energy sector, especially in the wake of weather related volatilities that affect hydro power generation and rising energy commodity prices that could hinder thermal power generation. Over the last many months, economic activity has been significantly hampered by long and continuous power cuts, also leading to extreme social unrest and even political turmoil. Such adverse developments in the form of an energy crisis would be a significant setback to the recovery process of the economy and its sustainability. While several small and medium enterprises are extremely vulnerable to such long episodes of power cuts, several exporters, including those in the apparel and services sector, are also likely to lose their competitiveness, potentially resulting in orders migrating to other competitor countries. Even with the sharp decline in crude oil prices in 2020 followed by favourable weather conditions throughout 2021 that enabled higher hydropower generation, the country was not able to derive the benefits of such price declines. At the same time, the ongoing energy sector crisis is partly a culmination of the persistently weak financial positions of the key SOBEs. Their poor financial situation is further aggravated by the upward price trends of energy commodities and the overall scarcity of foreign currency liquidity amidst a steady increase in demand for energy. These developments reiterate the importance of cost-reflective pricing for both petroleum products and electricity tariffs, in addition to forward looking planning and management of such SOBEs, to create a long term energy plan focused on assessing the growing demand for energy and identifying sustainable means of fulfilling such demand. The implementation of cost reflective pricing mechanisms is essential not only to strengthen and ensure the financial viability of SOBEs, but also to ensure the stability of the banking sector and the macroeconomy. Implementation of such a mechanism can improve efficiency, transparency and predictability, thereby enhancing the general public's acceptance of both upward and downward price revisions. Hence, such a market based mechanism can ensure that the interests of both SOBEs and consumers are

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BOX 2

Achieving Sri Lanka's External Sector Stability in the Medium to Long Term

Introduction

In an open economy, stability in the external sector is vital as external imbalances could cause widespread spillover effects across all sectors of the economy, thereby threatening the overall macroeconomic stability. The external sector in Sri Lanka has been facing unprecedented challenges in recent years, amidst headwinds caused by the COVID-19 pandemic and adverse developments in the global economy. In this context, long term stability in the external sector, characterised by a sustainable external debt position and a manageable external current account deficit, has been identified as an important near to medium term priority in macroeconomic policymaking. Sri Lanka needs sustainable solutions to ensure long term stability in the external sector vis-a-vis short term measures.

Evolution of External Sector Related Economic Policies in Sri Lanka

At the time of gaining independence from the British, Sri Lanka was an agriculture based open economy characterised by a plantation sector and a subsistence agriculture sector with a fixed exchange rate regime. Exports were based on three main plantation crops; tea, rubber and coconut, which accounted for around 90 per cent of total exports.

External Sector Policies in the Post-Independence Era

Free Trade Policy in Early 1950s

Sri Lanka maintained a free trade policy regime in the early period of independence and the country was one of the most liberalised economies in Asia. Until the late 1950s, Sri Lanka was able to sustain the open trade policy regime with large trade surpluses supported by two commodity booms, which had led to significant build-up of foreign reserves. However, substantial trade deficits were recorded since 1957 owing to the rapid growth of import expenditure and deterioration of terms of trade.

Import Controls from Mid 1950s to Mid 1960s

Large trade deficits exerted pressure on the balance of payments (BOP) resulting in a sharp depletion of gross official reserves after 1956. In response, by establishing a Foreign Exchange Budget Committee, the Government imposed rigorous import control measures including imposition of quotas, licenses and tariffs on imports except food, petroleum and pharmaceutical imports. The development strategy of the Government was based on encouraging import substitution and domestic agricultural expansion to reduce import expenditure and achieve self sufficiency in essential commodities. By the mid 1960s, the economy was heavily regulated with protectionist measures and an overvalued fixed exchange rate was maintained. Meanwhile, export promotion strategies were also adopted to arrest the BOP issues.

Partial Liberalisation of the Economy from Late 1960s to 1970

Partial liberalisation of international trade was allowed since 1966 with partial relaxation of import restrictions accompanied by a devaluation of the currency by 20 per cent in 1967 and the introduction of the dual exchange rate system under the Foreign Exchange Entitlement Certificate mechanism in 1968. Although foreign financing assistance was received from multilateral institutions, such as the International Monetary Fund (IMF) during the period, the external sector performance weakened considerably in 1960s.

Reimposition of Import Controls from 1970 to 1977

Sri Lanka experienced the most stringent trade and exchange restrictions during this period with the socialist oriented policies introduced by the new Government that came to power in 1970. All imports were brought under licensing requirements and incentives were provided to promote non-traditional exports. During this period, the economy faced global headwinds from an oil crisis, the Vietnam War and structural deficiencies in the US economy, which led the Bretton Woods System of exchange rates to collapse. With changing the value of rupee against the US dollar subsequent to the collapse of the Bretton Woods System and BOP pressures, exchange restrictions on both current and capital transactions were tightened and these rigid controls were in place until 1977.

Introduction of Open Economic Policies in 1977

The Sri Lankan economy marked a significant milestone in 1977 with the introduction of liberal economic policies with enhanced private sector participation in production and investment. As an integral part of the liberal policy regime, the dual exchange rate system was abolished by establishing a unified exchange rate. The transition from a fixed exchange rate regime to a managed float exchange rate regime, which determined the exchange rate based on market demand and supply conditions, was a radical shift in Sri Lanka's exchange rate policy. A plethora of exchange control relaxation measures were also implemented. These policy measures included removal of restrictions on current transactions, lifting of quantitative import restrictions, rationalisation and simplification of import tariff structure, and removal of price controls and licensing requirements. Simultaneously, in view of reducing the adverse implications stemming from fiscal sector imbalances, many fiscal reforms, such as restructuring of food subsidies, privatising government enterprises and promoting private sector led growth, were introduced. Incentives were provided to encourage foreign direct investment (FDI) to export industries and export processing zones. Foreign financial flows gradually started to increase after 1977, with the relaxation of exchange restrictions. Subsequently, with the economy changing its course from being primarily an agricultural economy to one driven by the services and industrial sectors, Sri Lanka entered into a number of preferential trade agreements to strengthen trade and investment linkages with its regional peers.

External Sector: Current Position and Issues

Persistently High Current Account Deficits

Sri Lanka has been experiencing persistent external current account deficits mainly driven by large deficits in the merchandise trade account and primary income account over the past few years. Although the trade in services account and secondary income account, which comprise workers' remittances, recorded surpluses, these surpluses were not large enough to cushion the impact of merchandise trade and primary income account deficits on the current account. Lackluster performance in export earnings and increasing import expenditure led to a widening deficit in merchandise trade over the years. Although Sri Lanka was one of the first countries in the region to adopt liberal economic policies in 1977, its trade openness remains low. Trade openness, which is the total value of exports and imports in relation to the country's GDP, was 36.4 per cent in 1977 and it nearly doubled to 72.2 per cent by 1979. However, Sri Lanka's international trade performance has not been impressive in terms of trade openness, declining to levels that were seen during the pre-liberalisation era by 2019, where Sri Lanka's trade openness was 38.0 per cent. Workers' remittances have also shown a declining trend since mid 2021, contributing to widening current account deficits.

Adverse Implications of the Easter Sunday Attacks and the COVID-19 Pandemic on the Current Account

Although the current account deficit narrowed significantly in 2019 and 2020 due to the notable contraction in the trade deficit driven by reduced import expenditure, the surplus in the services account was affected severely in both years by the loss of earnings from tourism due to the Easter Sunday attacks and travel restrictions imposed with the outbreak of the COVID-19 pandemic. Despite a notable recovery since end 2020, the tourism sector has not yet reached pre pandemic levels thus far. Workers' remittances, which declined initially during the pandemic period, started to increase rapidly since mid 2020. However, workers' remittances received through formal channels started to decline since mid 2021, mainly due to the differences in the exchange rate prevailing between the grey market and official channels. The trade deficit that contracted during the last two years widened significantly in 2021, particularly during the second half of the year owing to a sharp increase in import expenditure, even amidst continuing import restrictions on selected imports, negating the impact of notable increase in export earnings. These adverse developments in the post pandemic period, particularly related to trade deficit, inflows to the services account and workers' remittances, have aggravated the vulnerabilities in the already fragile external sector.

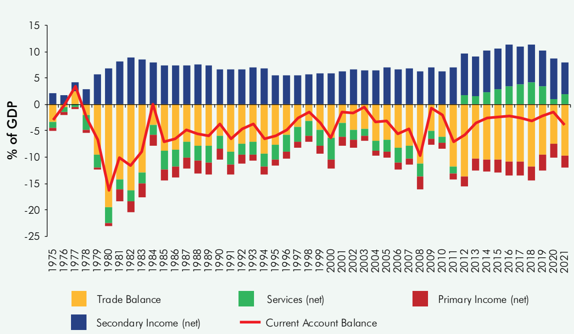
Meagre Performance in the Financial Account

Sri Lanka has not been able to attract non debt creating foreign financial flows, such as FDI up to the expected levels, even during the post war period, due to structural and policy issues related to FDI. Over the past decade, annual FDI inflows remained around US dollars 1.3 billion, on average, and around 1-2 per cent of GDP. The prevailing weak investment climate in Sri Lanka can be attributed to a range of factors including policy uncertainty, restrictive labour regulations, lack of progress in ease of doing business, inconsistencies in protection of property rights, weaknesses in maintenance of law and order, and so forth. In addition, institutional weaknesses, such as corruption, weak regulations, red tape and faltering infrastructure have resulted in Sri Lanka attracting significantly lower inflows of FDI than its peer economies.

Mounting External Debt

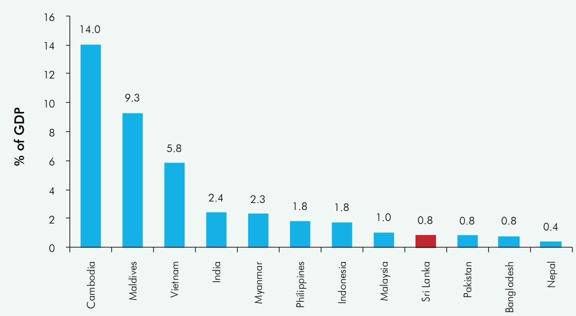
During the last decade, the mounting external debt and growing debt service payments were the major contributors to the external sector imbalances. With Sri Lanka accessing international financial markets to raise funds by issuing International Sovereign Bonds (ISBs) since 2007, the country's external debt has been accumulating at a steady pace. However, this increased the overall cost of funding of the debt portfolio as

Figure B 2.1
Composition of the Current Account: 1975-2021



Source: Central Bank of Sri Lanka

Figure B 2.2
Foreign Direct Investment Inflows: Sri Lanka and Selected Regional Peers - 2020



Sources: World Bank
United Nations Conference on Trade and Development (UNCTAD)
Central Bank of Sri Lanka

ISBs were often priced at relatively high interest rates compared to the development assistance finances Sri Lanka used to receive at concessional rates. Moreover, the expansion in government fiscal deficit due to the financing of large infrastructure projects with the post war economic resurgence also contributed towards this increase. Following the trend in debt accumulation, the external debt as a percentage of GDP has also gradually been on the rise over the past decade and remains around 60 per cent of GDP, on average. When comparing the external debt as a percentage of GDP with its regional peers, Sri Lanka has recorded the highest ratio after Bhutan, Maldives and Cambodia. Except for these four countries, the external debt to GDP ratio of other peer Asian countries lies well below 50 per cent of their respective GDP.

Foreign Debt Service Payments

Increasing external debt stock as well as the compositional change in Sri Lanka's foreign debt profile from concessional borrowings to costlier non-concessional and commercial borrowings have resulted in increased foreign debt service payments. The high cost of external borrowings has expanded the deficit in the primary income account, exerting further pressure on the current account of the BOP. Total external debt service payments as a percentage of export of goods and services has increased from 13.2 per cent in 2011 to 30.0 per cent in 2021 indicating that nearly one third of Sri Lanka's annual export earnings are consumed for debt servicing. Further, government debt servicing accounts for more than 80 per cent of the foreign debt service payments indicating that the external sector financing issues are mainly stemming from fiscal imbalances.

Declining Gross Official Reserves

The gross official reserve position of the country deteriorated to critically low levels by end 2021 due to higher foreign currency debt service payments amidst inadequate foreign exchange inflows. The low level of foreign exchange inflows in terms of export earnings repatriation, workers' remittances and foreign capital

Figure B 2.3
Outstanding External Debt: Sri Lanka and Selected Regional Peers - 2020

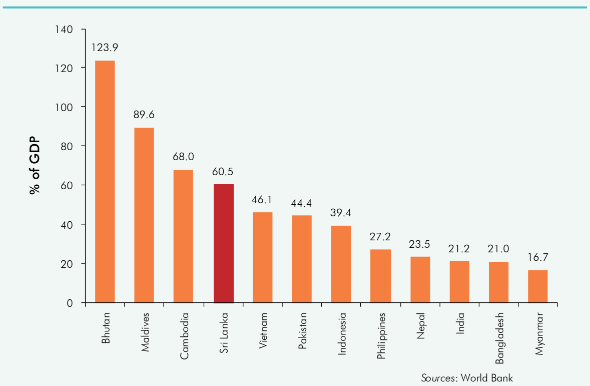
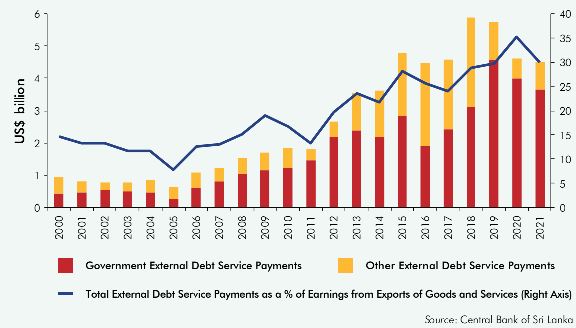


Figure B 2.4
External Debt Service Payments of Sri Lanka: 2000-2021



flows resulted in a shortage of liquidity in the domestic foreign exchange market necessitating the Central Bank to supply foreign exchange to finance essential imports, which further depleted the reserve levels.

Significant Pressure on the Exchange Rate

The external sector imbalances are largely reflected by the dried up liquidity conditions in the domestic foreign exchange market, series of sovereign rating downgrades along with the precarious level of international reserves that have exerted significant depreciation pressures on the exchange rate. While the exchange rate was maintained at around Rs. 200 – 203 per US dollar during most of 2021 and until early March 2022, mainly through moral suasion by the Central Bank, a notable development of parallel markets for foreign exchange was observed. However, following the adjustment in the exchange rate in early March 2022 and subsequent market pressure, the Sri Lanka rupee depreciated sharply by 33.0 per cent against the US dollar by end March 2022. However, some stability in the exchange rate is expected with the significant tightening of the monetary policy stance in early April 2022 along with other corrective measures currently being considered to be implemented with immediate effect, which mainly include, initiating discussions with the IMF for an economic adjustment programme, suspension of external debt servicing for an interim period leading to an orderly and consensual debt restructuring process, and fiscal consolidation, along with the negotiations to obtain bridging financing.

Medium to Long Term Policies to Achieve External Sector Stability

The Central Bank took a number of short term measures in the recent past to address the external sector issues. The Central Bank issued new rules pertaining to mandatory repatriation and conversion of proceeds of exports of goods and services to Sri Lanka rupees that helped improve the liquidity conditions in the domestic foreign exchange market. Further, with the aim of building up of gross official reserves through non borrowed sources, the Central Bank instructed the licensed banks to sell to the Central Bank a portion of foreign exchange so converted. Although this measure impacted the liquidity in the domestic forex market to a certain extent, it enabled the Central Bank to supply much needed foreign exchange to the market to partly finance the demand for essential goods imports. Initiatives were taken to encourage transferring of workers' remittances through formal channels including the provision of incentives above the normal exchange rate for the foreign exchange remittances converted at licensed banks, reimbursement of transaction costs incurred on account of workers' remittances, and the launch of a National Remittance Mobile Application branded as "Lanka Remit". Further, rules were issued requiring hotel service providers registered with the Sri Lanka Tourism Development Authority to accept payments in respect of services rendered to non residents only in foreign exchange. Moreover, the Central Bank has also been able to secure foreign financial assistance from regional central banks by way of bilateral currency swaps. Although the short term policy measures have been effective in reviving the external sector to a certain extent, policies spanning over medium to long term are required to enhance the resilience and maintain continuous stability in the external sector. Such policies should be focused on the following key areas:

Medium Term Measures

Initiating Comprehensive Macroeconomic Reforms Consistent with an Economic Adjustment Programme Supported by the IMF

Considering the spiraling economic issues faced by the country, the Government has decided to begin negotiations with the IMF that may lead to a possible IMF funded programme aiming at macroeconomic stability. This IMF funding arrangement could be complemented with a comprehensive reform agenda in major areas, such as fiscal consolidation, strengthening financial performance of State Owned Business Enterprises (SOBEs), phasing out monetary financing, and improving efficiency in social safety net programmes, among others.

The Need for Ensuring External Debt Sustainability

The current focus of the Government and the Central Bank is on ensuring the sustainability of the country's external debt in the long term to build resilience in the economy. In this context, the Government has already published Request for Proposals from interested parties for appointing Financial Advisors and Legal Consultants for managing its external debt in a sustainable manner. Such debt management process may involve a comprehensive debt restructuring plan, which would be conditional upon an agreement to an economic reform programme with the IMF. In parallel, the Government announced on 12 April 2022 that it would temporarily suspend external debt servicing for an interim period pending consensual external debt restructuring. These measures are expected to reduce high exposure to external debt and thus helping to ensure external debt sustainability.

Maintaining Healthy Levels of Gross Official Reserves

In order to maintain external sector stability, it is crucial to maintain a healthy level of gross official reserves, which is an indicator of the country's ability to withstand external shocks as well as its ability to honour external debt service payments. Hence, increasing the country's gross official reserves remain the most important medium term objective of the external sector. The country envisages to enhance gross official reserves to cover a minimum of 4 months of merchandise imports. While these targets remain significantly challenging, the ongoing efforts towards debt restructuring and envisaged foreign currency inflows are expected to increase gradually over the medium to long term, enabling the gradual build-up of gross official reserves. While the medium term objective of the Central Bank is to gradually increase the quantity of reserves, the composition is also expected to be improved by organic build-up of reserves through non-borrowed sources.

Strengthening Regional Cooperation

It is essential to maintain international cooperation with regional stakeholders, including regional central banks, governments, business communities, investors and multilateral agencies to build up stakeholder confidence leading to sustained external sector stability over the medium term. In this regard, the Central Bank continues to hold discussions on future collaborations with counterparts in several regional countries.

Long Term Measures to Strengthen Non-debt Creating Foreign Exchange Inflows

Promoting Merchandise and Services Exports Sectors

The National Export Strategy (NES) is instrumental in supporting both goods and services export industries to achieve higher foreign exchange earnings. The existing NES was designed and implemented with a view to transforming Sri Lanka into an export hub driven by innovation and was expected to be implemented within a 5-year horizon from 2018 - 2022. It will be important to revive the NES with some modifications to suit the more recent developments in international trade and provide much needed policy support to the exports sector and such policies should continue without interruption under any political regime. Implementation of a broad based and consistent NES is expected to create steady and sustainable growth in exports while unlocking potential export sectors to create new job opportunities and facilitating value addition through increased participation in global value chains and product sharing networks. Along with these, measures should be introduced and monitored in attracting investment to the tradable sector, especially for industries producing intermediate goods for the export sector and industries oriented mainly towards global trade.

Equal attention should be given to promoting services sector exports that have high potential and domestic value addition than traditional merchandise exports. Earnings from tourism have been the major contributor to the surplus in the services account in the recent years although being severely affected by the Easter Sunday attacks and the COVID-19 pandemic. Continuous promotion of tourism to reach its potential should be

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prioritised. Other services sectors, such as IT/ BPO, transportation and port services sectors, also have to be integrated into the national plan to strengthen export earnings from goods and services.

Enhancing Workers' Remittances

With the gradual dissipation of the adverse effects of the COVID-19 pandemic and the implementation of targeted policy measures, workers' remittances have shown signs of improvement. The departures for foreign employment are rising as reflected by the increase in migrant workers registering with the Sri Lanka Bureau of Foreign Employment (SLBFE). Further, narrowing of the gap between the official exchange rate and the grey market rate is also expected to help attract higher foreign remittances formally. Active stakeholder engagement to promote foreign employment, diversifying foreign employment market and upskilling of migrant employees are expected to secure more foreign employment opportunities with higher earnings, thereby increasing the contribution of workers' remittances to cushion the impact of the widening trade deficit.

Attracting FDI

To sustain a healthy momentum of non debt creating foreign financial flows, such as FDI over the medium term, there is a dire need to maintain policy consistency, improve doing business conditions, strengthening institutions, and expediting the approval and the implementation processes to facilitate FDI. Development of the Colombo Port City, promoting the Colombo and Hambantota ports as commodity trading hubs and establishing modern investment zones for local and foreign private investors, are expected to attract considerable foreign investment to the country in the period ahead. A close coordination and monitoring mechanism to facilitate and promote such investment is necessary to build long term macroeconomic resilience.

Conclusion

The corrective measures taken by the Government and the Central Bank, including initiating negotiations with the IMF for an economic adjustment programme, commencement of an external debt restructuring process, commitment towards fiscal consolidation, alongside significant monetary policy tightening and more market based exchange rate determination, are expected to help restore confidence of stakeholders in the economy in the period ahead. It is imperative that the long neglected structural reforms are introduced in the immediate future to reduce the external current account deficit and the fiscal deficit, which remained the root cause of the recurring external sector instability for decades. Managing the twin deficits at sustainable levels is crucial to ensure long term sustainability in country's external debt, while maintaining healthy levels of reserves to withstand economic headwinds, thereby ensuring long term stability of the external sector.

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safeguarded at all times with a quick pass through of the costs of any price rises and the benefits of any associated price declines. In this regard, strong collaborative efforts are also required not only between the Ceylon Petroleum Corporation (CPC) and the Ceylon Electricity Board (CEB) but also with other stakeholders such as the Public Utilities Commission of Sri Lanka, Sustainable Energy Authority, Independent Power Producers and other private and public stakeholders to devise not only a suitable pricing mechanism but also sustainable long term strategies with due consideration to all aspects of the energy sector. Going forward, with the growing demand for energy stemming from the development of the Colombo Port City, industrial zones, and other infrastructure projects, it is essential that appropriate plans are devised to ensure the provision of reliable, adequate, and affordable energy utilities to improve the country's productivity and competitiveness.

Measures need to be taken expeditiously to accelerate the expected FDI inflows into the Colombo Port City in order to optimise its potential benefits to the economy. The Colombo Port City Economic Commission, which was established recently via a Parliamentary Act, enables the facilitation of FDI inflows to the country through the issuance or granting of registrations, licenses, and authorisations to engage in business, facilitating and exercising overall regulatory supervision, and leasing of Government's marketable land situated within the area of the Colombo Port City. Further, it was established as the single window investment facilitator, being the sole point of contact to investors and is empowered to improve the ease of doing business through expeditious approvals, enter into agreements with international financial and business centres and enable expeditious resolution of any commercial dispute. With a massive investment already channelled into the initial stages, the contribution of the Colombo Port City to the domestic economy as the main conduit of integration to the global economy is vital, given the shortfall in major growth drivers at present. Nevertheless, FDI to the Colombo Port City remain modest as the timing of the completion of the initial stages of the project was not perfect due to the prevailing international investor sentiments, driven by the concerns amidst the COVID-19 pandemic and uncertainties caused by the geopolitical tensions along with heightened domestic economic hardship. However, as the Colombo Port City has the proximity advantage to major cities in South Asia and South East Asia, it is expected to facilitate enhancing FDI into the country over the medium term, provided that aggressive investor facilitation and promotions are initiated immediately. Further, easing of the long rooted structural bottlenecks for investments and businesses is also vital to entice investors' preference towards Sri Lanka, though the Colombo Port City is governed by specific legislation and regulatory arrangements. Also, a robust and customised strategy to approach potential investors to promote investments would have to be considered. Moreover, as a Financial City is proposed to be established within the Colombo Port City as the financial services hub, it is important to capture these economic activities into the country's GDP to fully reflect the contribution of the Colombo Port City to the economy. The development of the Colombo Port City as a financial centre is expected to enhance inflows to the services account through exports of financial services, IT/BPO services, etc. Also, as the Colombo Port City is strategically located in a geopolitically important position that draws strategic interest from global investors in a competitive environment, any foreign interest needs to be dealt with in line with Sri Lanka's non aligned foreign policy, with a view to strengthening foreign relationships with regional and global counterparts. Also, as the legislative structure under which the Colombo Port City is governed provides a highly conducive business environment for foreign investors, policies would have to be carefully formulated to ensure that it would not disintegrate from the main economy. Given the massive initial investment made in the Colombo Port City and the considerable tax benefits that were extended to newly established enterprises during the gestation period, the success of the whole project will depend on the amount of revenue collected from the ventures in terms of taxes and other means and using the same for the benefit of the economy. The skill premium required by the more advanced enterprises to be established in the Colombo Port City would be reflected in the wage premium offered by such enterprises, triggering a migration of skilled labour to the Colombo Port City from the rest of Sri Lanka. Two major effects could be expected when a modern sector is carved out within an economy. Firstly, there would be an acceleration of structural transformation, as the wage premium on offer could encourage the acquisition of skills in high demand, leading to an overall improvement in labour productivity. Secondly, it could lead to deviations in income distribution due to the attractive wage premiums on offer in the modern sector. Nevertheless, the wage premium gap would be an incentive for workers to develop specialised skills to match the modern technology and requirements in a dynamic labour market. At the same time, the education system would have to be transformed to cater to the demand for skilled workers in the Colombo Port City and efforts to produce more graduates in STEM (science, technology, engineering and maths) subjects must be reinforced. This project is also expected to boost the tourism industry and it would require exploring ways to attract affluent tourists given the potential to promote the Colombo Port City as a luxury destination. The activities and accommodation available in the Colombo Port City need to target a niche market of tourists and

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carry a premium price. Further, a resident guest visa programme and the newly proposed Golden Paradise residential visa programme could be promoted overseas targeting to attract residential visa holders for the Colombo Port City. The income from services and inflows of FDI to the Colombo Port City are expected to provide much needed non debt creating financial flows to the BOP over the medium term and thereby bolster the policy efforts aimed at the recovery of Sri Lanka's external sector.

Persistently low revenue mobilisation over the years remains the key underlying reason for the continued vulnerabilities in the fiscal sector and the macroeconomic imbalances, warranting the need for adopting sustainable revenue generation measures. Although government expenditure in Sri Lanka remains at a moderate level compared to the regional peers, government revenue collection has been well below the average revenue collection of peer economies and has been continuously declining over the past two decades. In 2021, government revenue as a percentage of GDP was only 8.7 per cent in Sri Lanka, whereas the same for emerging and middle income countries stood at 26 per cent of GDP. The low tax regime introduced in late 2019 coupled with the economic downturn caused by the COVID-19 pandemic resulted in a sharp reduction in government revenue in the past two years. Moreover, tax elasticity and tax buoyancy of Sri Lanka are estimated to be less than unity indicating that the expansion in tax revenue mobilisation is weaker than the expansion in economic activity.[2] In addition, Sri Lanka's tax system has turned out to be a regressive system with over 75 per cent of tax revenue being collected by means of indirect taxes, posing a disproportionately high tax burden on low income households. The multitude of tax exemptions and tax holidays which have not necessarily translated into higher economic activity, ad hoc tax rate reductions and upward revisions in tax free thresholds and tax brackets, slow expansion in the tax base, lack of progressive taxes, low tax compliance, tax evasion and tax avoidance as well as weak tax administration are the major factors that have led to low tax revenue mobilisation in Sri Lanka. Frequent tax changes have also negatively impacted tax compliance, hindering the consistency of the tax system, while increasing the cost of tax administration. Persistently low revenue mobilisation has posed serious repercussions on the macroeconomy, with elevated budget deficits and higher financing requirements from both foreign and domestic sources, thereby resulting in burgeoning public debt, vulnerabilities in the domestic financial system, inflationary pressures, BOP issues and depreciation pressures on the exchange rate. Low revenue mobilisation also impedes long term economic growth by restricting the Government's capacity to make public investments in both physical and social infrastructure. These deep-rooted issues emphasise the importance of expediting the implementation of consistent and persistent revenue based fiscal consolidation that would eventually render long run macroeconomic stability and sustainable growth. In this regard, raising tax rates for both direct and indirect taxes, broadening the tax base by lowering tax free thresholds, reducing tax exemptions and eliminating long tax holidays could enhance government revenue in the short term. Any tax concessions should be granted by giving due consideration to the effectiveness of such policies in improving fiscal balances in the long term through the achievement of economic growth and overall macroeconomic objectives. Such concessions should be short time bound and linked to measurable performance outcomes in the specific industry with a view to gradually supporting the envisaged development. Further, making realistic revenue forecasting and revenue targets based

2 Tax elasticity indicates the inherent responsiveness of tax revenue to GDP assuming no change in tax structure. Tax buoyancy reflects the total response of tax revenue to changes in GDP, which includes the impact of discretionary policy adjustments such as increase in tax rates and expansion in the tax base.

on past experiences and economic conditions is extremely important to correct recurring deviations in revenue targets and expenditure overruns resulting in continuous expansion in the budget deficit. In addition, maintaining a consistent and simple tax structure is imperative to encourage tax compliance and thereby improve revenue collection. Meanwhile, strengthening tax administration is also critical in enhancing government revenue, as the sustainability of enhanced tax collection usually coincides with reforms in tax administration. Given the interlinked tax administration activities, a holistic approach pursuing multiple reform strategies at numerous tax administrative layers could improve the capacity and efficiency of the tax administration, while reducing tax evasion. Thus, strict enforcement of rules related to registration and filing, strengthening audits and verification measures through better coordination with financial institutions, upgrading information technology systems for greater institutional coordination, and simplifying the procedures for tax filing, tax payments and reporting are vital for improving tax administration. Moreover, attention should also be paid towards improving the management, governance, and human resources of tax administration agencies by enriching the technical skills of the staff, monitoring the performance of such agencies, implementing prudent strategic plans, and empowering revenue collecting entities by strengthening tax legislation. Since large taxpayers make a higher contribution to government tax revenue collection, scaling up of tax administration efforts targeted at large taxpayers is also vital to ensure timely filing and payment of taxes. Moreover, a high level of political will and commitment with a strong and deep social dialogue is also key to enhancing the effectiveness of these reforms. Efficacy and efficiency of government spending and transparency of government finances are also necessary to encourage tax payments, in order to promote a culture of higher tax compliance.

Achievement of medium term fiscal targets of the Government is highly conditional on consistent, well-coordinated and evidence based policymaking. Historical evidence pinpoints to notable deviations in successive governments' fiscal operations in comparison to budgetary estimates and medium term fiscal rules, with revenue mobilisation often falling short of the targets and government expenditure exceeding the estimates in consecutive years. Implementation of ad hoc policy measures that are inconsistent with the overall fiscal and macroeconomic objectives remains one of the key reasons for such undue deviations. Most of these unplanned policies have direct or indirect fiscal implications on revenue and expenditure fronts, and the means of deficit financing. Consequently, ad hoc government policies driven by socially and politically populist short term motives could have intertemporal effects on the budget, creating long term spending commitments for the Government that could be detrimental towards achieving fiscal objectives and the overall welfare of the citizens. For instance, managing and rationalising recurrent expenditure is a challenging task amidst large scale recruitments to the public sector, without considering the cadre requirements and not linking wage increments to productivity improvements, as well as the provision of allowances/ subsidies that are difficult to be withdrawn in future without causing social unrest. Extemporary policymaking also leads to fiscal indiscipline, lack of transparency and accountability, thus resulting in an uncertain business environment. In addition, the imposition of ad hoc retrospective taxes to meet short term revenue shortfalls of the Government could create inconsistency in the tax system, uncertainties for businesses, and erode both local and foreign investor confidence, along with the increased cost of taxation being ultimately passed onto consumers causing hardship for the public. Further, government policies implemented for the betterment of one sector may have spillover effects on the other sectors and in turn, have indirect budgetary implications. Hence, evidence based and well coordinated policymaking with a holistic view is of paramount importance to minimise unforeseen implications on fiscal performance and discipline. Moreover, it is crucial to educate the general public that short term untargeted handouts and fiscal indiscipline often result in long term fiscal imbalances eventually affecting macroeconomic stability and sustainable growth while creating a higher tax burden on future generations. Creating such awareness is vital to transforming the mindset of the general public to assess the performance of the governments based on their effectiveness in achieving long term macroeconomic objectives. Such a transformation in the mindset of the public would encourage the authorities to refocus their priorities towards long run development objectives and welfare maximising policies instead of implementing myopic and populist policies in an ad hoc manner.

The sharp rise in central government debt driven by weakened fiscal sector performance over the past several decades continues to remain a key issue on the fiscal front, raising concerns for investors, creditors, and rating agencies. Persistent structural budget deficits, expenditure overruns, continued government revenue slippages, rising gross financing needs and excessive borrowings by consecutive Governments have culminated in substantially high public debt levels. Moreover, sluggish economic growth recorded in recent years and the unprecedented economic setback during the pandemic have further aggravated the country's debt issue, while deteriorating the key fiscal ratios. Posing many macroeconomic challenges, the debt stock increased by two folds every five to six years in nominal terms in the past, reaching the second historically highest debt to GDP ratio of 104.6 per cent by end 2021. A high level of public debt exacerbates the economy's vulnerability to macroeconomic shocks. Growing public debt also restrains room for adopting countercyclical fiscal policy measures, creates spillover effects on the private sector through increased risk premia and cost of borrowings, which are linked to lower sovereign credit rating. This could severely limit economic recovery and may result in further economic contraction. Thus, aggressive fiscal consolidation is needed to reduce the debt burden and stabilise the debt at manageable levels even amidst periods of subpar economic growth. In addition, the high debt burden could adversely affect the country's long run economic growth, especially by crowding out private investment and reducing the capacity for public investment towards needy sectors, such as health, education, and infrastructure, to enhance productivity over the long term. At the same time, higher debt servicing costs associated with high debt levels often pose challenges to the effectiveness of monetary policy, especially when the fiscal deficit is excessively monetised by the monetary authority. Further, high debt levels increase the possibility of future distortionary taxes and uncertainties and create financial system instabilities. The public debt burden in Sri Lanka has amplified the external sector vulnerabilities, especially due to the higher share of foreign debt and unfavourable maturity structure, with the bunching of maturing foreign debt service obligations. This high public debt trajectory of Sri Lanka was led by the weak adherence to fiscal consolidation targets amidst the formation of over-optimistic revenue targets and poor revenue mobilisation, recurring primary deficits, lower than expected economic growth, non-availability of concessional inflows, and foreign borrowings which have not been matched with productive projects that generate foreign currency earnings. Gradual improvement in government finances is essential to phaseout additional borrowings to meet interest obligations, both in terms of domestic and foreign debt, to ease debt accumulation. Therefore, expeditious actions are crucial to preserve debt sustainability, particularly through committed fiscal discipline and rigorous fiscal consolidation efforts to generate a substantial surplus in the primary balance. Credible commitment to adhere to fiscal rules, i.e., the long lasting constraints imposed on fiscal policy by imposing numerical limits on budgetary aggregates, that are specified in the Fiscal Management (Responsibility) Act No. 3 of 2003 is imperative to ensure sustainable fiscal consolidation, and thereby curbing the pressures for overspending, and ensuring fiscal transparency and accountability. Fiscal discipline can be further strengthened by implementing binding fiscal rules, instead of voluntary and non binding fiscal rules. Also, efforts to replenish reserves and build reserves through foreign currency receipts or outflow management need to be pursued, irrespective of short term difficulties to be faced in relation to real economic activity. The implementation of overdue economic reforms with regard to SOBEs such as the introduction of the cost reflective pricing mechanisms and establishment of an efficient governance structure is also essential as persistent losses of such inefficient institutions are more likely to be eventually converted into the state's contingent liabilities. In addition, the promotion of long term economic growth is also vital to essentially reduce the debt-to-GDP ratio, while structural reforms are crucial to eliminating obstacles to sustainable economic growth. Considering the limited fiscal space, the Government should streamline the foreign funded projects that are in the pipeline taking economic priorities into account, while devoting much attention to high economic rates of return ensuring transparent and efficient use of funds, which reduces the future accumulation of debt stock of the Central Government. Further, seeking concessional financing could also help the Government to meet its debt sustainability targets and strengthen macroeconomic fundamentals. For example, resorting to green/ blue financing options for implementing sustainable infrastructure projects could involve more favourable conditions for borrowing, such as relatively low interest rates and longer repayment periods.

As the country grapples with the setbacks caused by the COVID-19 pandemic, the need for improving public sector service delivery, in terms of quality and efficiency, has become more crucial than ever before in the process of economic recovery. The public sector has been an integral part of Sri Lanka's development path by delivering much needed public goods and services, ensuring inclusive and equitable access to infrastructure, and creating a conducive business environment with the aim of fostering private sector investments and growth. The role played by certain subsectors in the public sector in combating the spread of COVID-19 and mitigating socioeconomic hardships has reinstated its eminence, particularly in the recent past. Since the economy is gradually adjusting to a 'new normal' amidst the pandemic and regaining growth momentum, efficient resource allocation in the public sector and minimising bureaucratic red tapes related to public administration and business facilitation are vital to assist pandemic affected individuals as well as the business fraternity, including local and foreign investors. However, growing inefficiencies in the public sector and the resultant fiscal burden remain longstanding concerns in policy circles, since the public sector is utilising a considerable fraction of financial and labour resources, which otherwise could have been available for efficient use by the private sector. Meanwhile, the pandemic has further exposed the existing weaknesses and rigidities in the public sector service delivery, creating new challenges and opportunities to improve government services. Although 'work from home' arrangements were widely adopted during the pandemic, the performance of the public sector under these new arrangements was not comparable with that of the private sector that successfully institutionalised these new norms. Limitations in the physical infrastructure and automated systems as well as limited adaptability of the public sector labour force, weak monitoring mechanism and stringent working arrangements

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BOX 3
Fiscal Consolidation: Path to Macro Fiscal Stability

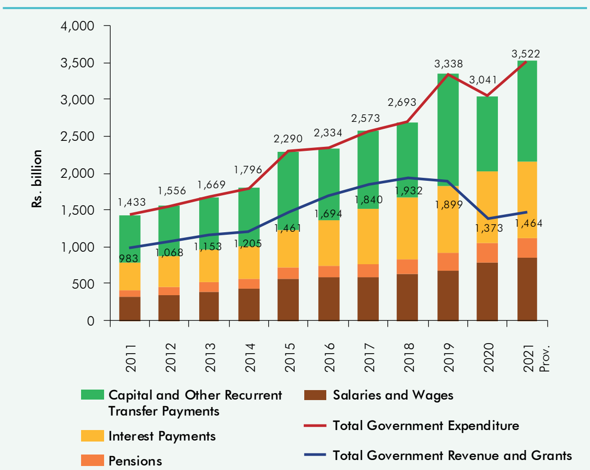
Fiscal Policies during the Pandemic

Fiscal policy responses to the COVID-19 pandemic curbed the scarring effects on economies across the world facilitating post pandemic recovery, albeit with a notable bearing on public finances, and in turn resulting in fiscal stress in these countries. The swift fiscal measures deployed in response to the unanticipated and unprecedented economic headwinds were disparate in scale, type, and coverage and were dependent on the specific structural, inherent and fiscal leeway of each economy. Advance markets and large emerging markets were in relatively better positions with ample fiscal space to accommodate such fiscal stimuli, compared to small emerging markets and developing economies. Direct budgetary measures such as increased spending on health, provision of unemployment benefits and other reliefs, tax concessions and tax deferments, liquidity support, equity injections, and indirect actions including provision of guarantees for deferred debt repayments were among common fiscal policy measures implemented by numerous countries. The steady stream of fiscal stimuli via deficit spending, and lingering effects of the pandemic together with the slowdown in economic growth have put pressure on fiscal operations of most economies, thereby threatening macroeconomic stability in respective countries.

The outbreak of the pandemic and related uncertainties have severely affected Sri Lanka, prominently the fiscal sector, as reported in many other lower middle-income and market access countries. Despite insufficient fiscal space to undertake hefty fiscal intervention, the Sri Lankan Government also committed to providing a number of fiscal stimuli to address pressing priorities since the onset of the pandemic. With increased expenses for healthcare and pandemic control measures as well as financial and in-kind transfers to vulnerable groups, the Government spent at least Rs. 117.5 billion and Rs. 165.6 billion as pandemic related expenses for 2020 and 2021, respectively. The Government instituted a low tax regime to boost the sluggish economic activity since the latter part of 2019 and this low tax environment was upheld during the pandemic period. Several tax reliefs for certain essential imports such as medicines were also granted during this period. Consequently, government revenue dwindled sharply during the pandemic period owing to modest tax rates, and diminished tax base due to the increases in tax free thresholds as well as subpar economic growth. Accordingly, fiscal deficit in 2020 and 2021 increased to 11.1 per cent and 12.2 per cent of the GDP, respectively. Meanwhile, as per the Fiscal Monitor Database of Fiscal Policy Responses to COVID-19 Pandemic – October 2021, the cumulative value of additional spending and foregone revenue by the Sri Lankan Government in relation to the pandemic was around 1.1 per cent of the GDP, which is low in comparison to several regional peers, such as India (4.1 per cent), Pakistan (2.0 per cent), Bangladesh (2.3 per cent), and Maldives (8.0 per cent). In addition, with limited fiscal space to manoeuvre, pandemic affected individuals and businesses in Sri Lanka were mainly supported by accommodative monetary policy. Moreover, reduced foreign inflows amidst the pandemic and substantial debt service payments added further stress on the fiscal and external sectors. With limited avenues for new foreign financing sources, liquidity constraints in the international capital markets as well as sovereign rating downgrades of Sri Lanka, the Government was compelled to resort to higher domestic borrowings, especially through the Central Bank and the banking sector, to meet the government financing gaps. Such fiscal imbalances led to the government debt reaching 100.6 per cent and 104.6 per cent of GDP by end 2020 and end 2021, respectively.

Nevertheless, the current weak fiscal position and the resultant macroeconomic issues in Sri Lanka are not entirely due to the pandemic situation, but rather a reflection of longstanding and unresolved issues in the fiscal sector. For several decades, Sri Lanka has been plagued by persistent fiscal deficits, compelling the Government to continually borrow from both domestic and foreign markets and accumulate public debt. As a result, a large fraction of government revenue and foreign currency inflows to the country are required to be channelled for debt service payments, permitting little leeway for productive investments. Since 1994, revenue and grants have not been sufficient to meet at least recurrent expenditure of the Government, necessitating government borrowings to cover recurrent expenses that generally do not contribute to future growth and

Figure B 3.1
Government Expenditure and Government Revenue



Source: Ministry of Finance

the country's debt repayment potential. Moreover, as depicted in Figure B 3.1, revenue and grants in 2020 and 2021 were well below the rigid expenses that include salaries, pension, and interest payments, amplifying the severity of the issue. The unprecedented large tax reductions announced in end 2019 aggravated the issue of low revenue mobilisation of the Government, compelling monetary financing of the budget deficit during 2020 and 2021.

The Medium Term Macro-Fiscal Framework which is unveiled along with the Budget Speech outlining the Government's targets to reduce the overall budget deficit and debt levels to a sustainable level over the past several years has never materialised, as reflected in the historical trend of actual data. Over ambitious targets for government revenue in the Budget and planning of annual expenditure in line with the overestimated revenue have always resulted in a wider than expected budget deficit. Meanwhile, the Fiscal Management (Responsibility) Act, No. 3 of 2003 (FMRA) was enacted to ensure responsible fiscal management, prudent debt management and public scrutiny over fiscal affairs via implementing 'fiscal rules' that are, however, not binding rules. These fiscal rules pertaining to fiscal deficit, public debt and contingent liabilities of the Government as stipulated in the FMRA have been subsequently amended as given in Table B 3.1. Successive Governments constantly have not met the fiscal deficit rule, while fiscal rules in relation to public debt reduction and limiting of contingent liabilities have not been attained at specified milestones. Instead, the FMRA has been amended several times, extending the time targets along with several approvals for supplementary budgets. A strong commitment to ensure prudent fiscal management has not been evident as against the proposed path of fiscal consolidation.

Figure B 3.2
Government Revenue – Budget Estimates vs. Actual

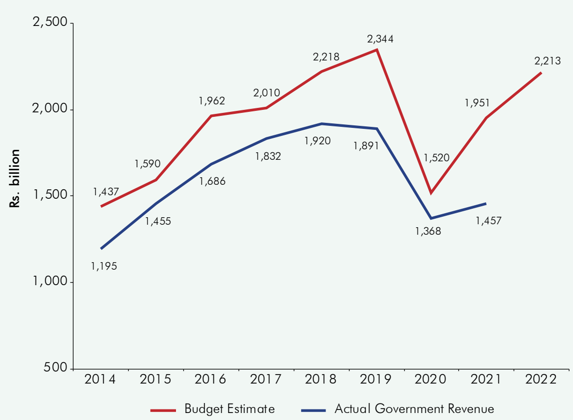
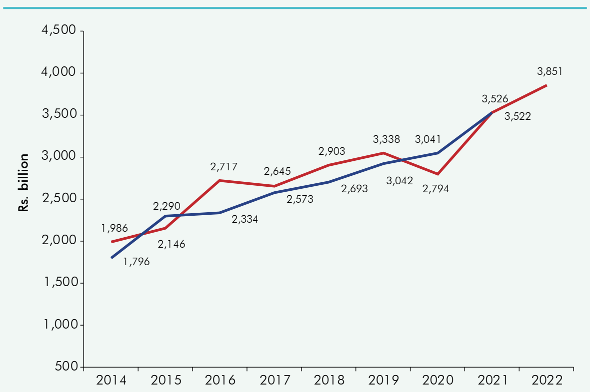


Figure B 3.3
Government Expenditure – Budget Estimates vs. Actual



Source: Ministry of Finance

Table B 3.1
Fiscal Rules Framework of Sri Lanka

Fiscal Rule	FMRA 2003	Amendment 2013	Amendment 2016	Amendment 2021
Fiscal deficit	Less than 5 per cent by 2006 and beyond	Unchanged	Unchanged	Unchanged
Public debt (share of GDP)	Less than 85 per cent by 2006 and less than 60 per cent by end 2013	Less than 80 per cent by 2013 and less than 60 per cent by end 2020	Unchanged	Less than 60 per cent by end 2030
Treasury Guarantees (share of GDP)	Less than 4.5 per cent based on 3-year moving average GDP	7.5 per cent of GDP	10 per cent of GDP	15 per cent of GDP

Source: Fiscal Management (Responsibility) Act, No. 3 of 2003 and subsequent amendments

The Impact of Weak Fiscal Performance on Price Stability and Financial System Stability

According to Sargent and Wallace (1981), amidst fiscal dominance, the central banks are compelled to generate seigniorage revenues to ensure the solvency of governments, when fiscal operations are fixed to a given higher fiscal deficit path. Blanchard (2004) also asserts that inflation targeting only through monetary policy may not be successful in a high debt environment. The monetary authority's attempt to raise the real interest rate with the aim of maintaining inflation at a targeted rate may aggravate debt levels through increased borrowing costs, if the fiscal authority is disinclined for fiscal consolidation. Moreover, rising debt levels could intensify sovereign default risk and exert exchange rate depreciation pressure, and thereby result in higher inflation instead of lower inflation. Therefore, Blanchard (2004) emphasises that in a high debt environment, inflation should be managed through fiscal policy by attempting to reduce fiscal deficits, and thereby government debt levels, instead of only using monetary policy to combat inflation. Meanwhile, some academics have argued that inflation and financial repression[1]

1 Financial repression is used to lower the cost of borrowing for the Government by way of explicit or implicit caps on interest rates, direct lending to the Government by captive domestic sources such as pension and provident funds, regulation of cross-border capital movements, and a strong connection between the Government and banks.

are possible solutions to cope with a surge in public debt (Reinhart & Sbrancia, 2011). However, long term financial repression could be detrimental to financial system stability as it creates tight liquidity conditions for banks and deteriorates banks' balance sheets, especially when the Government is on a borrowing spree from domestic banks. On the other hand, allowing inflation to rise in the economy to increase nominal GDP and thereby improving the budget balance and debt to GDP ratio could be counterproductive, especially when market participants internalise higher inflation expectations in government securities yield rates, which in turn raise borrowing costs for the Government.

At present, the Central Bank of Sri Lanka conducts monetary policy under the Flexible Inflation Targeting (FIT) framework with the aim of maintaining inflation at low and stable levels in line with the Bank's mandate for economic and price stability. Persistent fiscal deficit, high government debt levels, and the heavy reliance of the Government on the Central Bank for deficit financing in the recent times, however, have undermined the effective conduct of monetary policy while threatening the financial system stability. Although supply-side disruptions have stemmed from the acceleration in inflation during the latter part of 2021, breaching the upper bound of the county's inflation target, demand fuelled mainly by increased credit to the Government by the banking sector has also been seen as a cause for the uptick in inflation. The economic history of Sri Lanka suggests that high inflation episodes in the country coincide with fiscal imbalances. Hence, in order to ensure long term price stability, fiscal consolidation remains to be a key condition.

Fiscal Consolidation Amidst an Economic Downturn

Drawing lessons from the rest of the world, alongside a tightened monetary policy stance, fiscal consolidation should be carefully designed and implemented without depressing the demand too much to circumvent scarring effects on the economy due to its fragile state. The standard Keynesian proposition suggests that fiscal consolidation, also called fiscal austerity, has a contractionary effect on economic activity in the short run. Accordingly, as a result of attempts for fiscal consolidation, a country's fiscal performance may even deteriorate further due to lower revenue collection and lower nominal GDP following the slowdown in economic growth. Hence, as the economic growth of the country has already been affected by the COVID-19 pandemic, fiscal consolidation during the pandemic period itself may be a greater concern for policymakers. However, persistent weak fiscal conditions have instigated a myriad of macroeconomic imbalances in the Sri Lankan economy, such as high inflation, weak currency and tight liquidity conditions of the banking sector, creating greater uncertainties, reducing investor confidence, and aggravating vulnerabilities in the financial system, thereby hindering high and sustained economic growth. Therefore, at this critical juncture, the objective of attaining macroeconomic stability by resolving the macroeconomic imbalances supersedes the objective of achieving near term higher growth. Contrary to the traditional Keynesian view, recent studies have also indicated the possibility of offsetting contractionary effects of fiscal consolidation, when the fiscal consolidation is large and perceived to be credible by the public, especially when public debt levels are high (Giavazzi & Pagano, 1990). On one hand, private consumption could increase if households perceive there is a permanent reduction in the government borrowing requirement when the Government is committed to achieving fiscal consolidation. Such a reduction in government borrowings implies lower taxes in future and thus, a higher lifetime income for the households, encouraging them to increase their consumption from the current period. On the other hand, a reduction in government borrowing requirements will reduce inflation risk premia and default risk premia associated with public debt issuances due to lower inflation expectations and fewer economic uncertainties. This will lead to a fall in real interest rates and promote more productive private investment. As such, given the serious macroeconomic imbalances emanating from weak fiscal conditions, well-planned fiscal consolidation measures are more likely to be beneficial for the Sri Lankan economy, particularly to ensure macroeconomic stability and growth in the medium to long term. However, it is crucial that Sri Lanka implements the optimal combination of consolidation strategies to minimise possible contractionary effects in the short term and thereby avert fiscal austerity being a 'self-defeating' strategy.

At the same time, fiscal consolidation may have disproportionate effects on different economic segments resulting in widening inequalities. Fiscal austerity could worsen the prevailing inequalities that have been aggravated by the COVID-19. Therefore, consolidation strategies should be implemented with due consideration of not only output effects but also of possible consequences of austerity measures on social divide.

Way Forward

Fiscal conditions in Sri Lanka left much to be desired even prior to the onset of the pandemic, and the pandemic has compounded the pre-existing maladies of the fiscal sector. Hence, fiscal consolidation remains the utmost priority to ensure stability and long term sustainable growth. Whilst economic recovery is underway, fiscal consolidation packages should be designed in a 'growth-friendly' manner by using

Table B 3.2
Income Taxes in Sri Lanka vs. Regional Peers

Sri Lanka		India		Pakistan		Singapore		Thailand	
Taxable Income slabs (LKR mn)	Tax Rate (%)	Taxable Income slabs (INR mn)	Tax Rate (%)	Taxable Income slabs (PKR mn)	Tax Rate (%)	Taxable Income slabs (SGD mn)	Tax Rate (%)	Taxable Income slabs (THB mn)	Tax Rate (%)
0-3	0	0-0.25	0	0-0.6	0	0.005-0.02	1	0-0.15	0
3 -6	6	0.25-0.5	5	0.6-1.2	5	0.02-0.035	3	0.15-0.3	5
6-18	12	0.5-0.75	10	1.2-1.8	10	0.035-0.05	8	0.3-0.5	10
18 above	18	0.75-1	15	1.8-2.5	15	0.05-0.07	13	0.5-0.75	15
		1-1.25	20	2.5-3.5	17.5	0.07-0.1	21	0.75-1	20
		1.25-1.5	25	3.5-5	20	0.1-0.25	24	1-2	25
		1.5 above	30	5-8	22.5	0.25-0.4	24.5	2-5	30
				8-12	25	0.4-0.6	25	5 above	35
				12-30	27.5	0.6-1	26		
				30-50	30	1-2	28		
				50-75	32.5	2 above	30		
				75 above	35				

Source: PricewaterhouseCoopers – World Tax Summaries

fiscal instruments that have small fiscal multipliers[2] in order to ensure that the policy package is generating required fiscal effects with the lowest economic costs. To this end, a clear understanding of the fiscal policy transmission mechanism and the size of multipliers of different fiscal instruments, such as the disaggregated level fiscal multipliers related to different revenue and expenditure components, are required to design a consolidation package that has benign effects on output and inequalities.

Empirical evidence related to other countries suggest that expenditure based fiscal consolidation is less likely to be contractionary, as opposed to revenue based consolidation (Alesina, Favero, & Giavazzi, 2019). However, given the low tax revenue to GDP ratio, Sri Lanka still has space for manoeuvring fiscal consolidation through revenue policies with minimal disruptions on output. Successful revenue based fiscal consolidation measures in other countries, such as in Brazil, Canada, Finland, New Zealand, and South Africa, have focused on broadening the tax base and introducing reforms to simplify tax administration (Okwuokei, 2014). Since raising indirect tax rates such as Value Added Tax (VAT) could disproportionately affect consumption of low income households during these hard times, widening the VAT base (increasing the number of VAT paying businesses) would be the appropriate option to augment government revenue while minimising output and distributional effects. In this regard, the VAT free threshold could be revised downwards to the levels that prevailed prior to the last VAT threshold adjustment.[3] Meanwhile, considering the modest impact on economic growth, taxes on capital income could be raised at the personal level.

2 Fiscal multipliers measure the effect of increases in fiscal spending or taxes on GDP.

3 In December 2019, the VAT free threshold was revised upward from Rs.12 million turnover per annum to Rs. 300 million turnover per annum.

Given the relatively sticky wage structures and rigid employment contracts in Sri Lanka, Advance Personal Income Tax (APIT)/ personal income tax rates could be raised to a level comparable to the country's regional peers while adjusting tax free thresholds and tax brackets to the levels that prevailed prior to the last income tax revision, without causing notable impact on firms' costs and labour input. More importantly, a range of administration and enforcement reforms is key to enhancing government revenue in the medium to long term by curbing tax evasion and corruption.

Past experiences of other countries suggest that fiscal austerity through expenditure reduction is more successful since expenditure cuts reflect greater commitment of the Government and efficiency gains (Price, 2010). Although a reduction in wages and transfers are proven to be more effective in fiscal consolidation in other countries, such a move will not be an easy feat in the Sri Lankan context given the associated political cost and stringent labour market conditions. Hence, at least, new government recruitments and major public wage revisions should be considered with caution along with better targeting of subsidies. On the other hand, the reduction in capital expenditure and expenditure on health and education could create more contractionary effects both in the short and long term, especially due to the country's deficiencies in physical and soft infrastructure. Therefore, fiscal consolidation through sizeable capital expenditure cuts should be achieved through 'value for money' strategies, instead of across the board expense cuts. In this regard, the Central Government as well as local government authorities should streamline capital expenditure by selecting infrastructure projects that generate the highest economic value and future growth potential. Moreover, streamlining and digitalising

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work processes, and trimming unproductive recurrent expenses are essential for efficiency gains and reducing the pressure on government expenditure.

Fiscal consolidation coupled with growth-promoting investments and long overdue structural reforms would be a welcome move in this dire economic situation to address the challenges and capitalise the opportunities presented by the pandemic. Since the debt burden of inefficient, loss-making State Owned Business Enterprises (SOBEs) translates into contingent liabilities of the Government, reforms related to SOBEs should be expeditiously implemented in tandem with fiscal austerity. Cost-reflective pricing mechanisms, institutional restructuring for efficiency gains, and market-oriented product and service delivery are several overdue reforms related to SOBEs. In addition, legislative and administrative reforms are required to monitor the progress of fiscal consolidation, strengthen public scrutiny over the consolidation process, and ensure accountability of the policymakers and government officials for meeting austerity targets. It may be noted that the continuous reliance of major SOBEs on the two state banks, and eventually on central bank financing, has created numerous challenges to price stability. Hence, SOBEs should be held accountable for their operations and such entities should not pass their debt burden on commercial banks and the Central Bank.

The Sri Lankan economy has reached a critical juncture where fiscal consolidation is imperative and any further delay in implementing the same effectively would be economically and politically very costly. However, the Government's strong commitment to adhere to fiscal rules and the fiscal consolidation path is paramount for the actual realisation of desired outcome. Major impediments such as the lack of broad political consensus, lacklustre approach of authorities and resultant 'stop-go', short term and ad hoc policies should be wiped out to contain the derailment of the fiscal consolidation process. At the same time, as success and continuation of fiscal consolidation hinges on the support of the general public, creating awareness among the general public on the repercussions of the 'subsidy mindset' is of high significance to transform the voter-base to be more fiscally prudent, and in turn deter policymakers pursuing fiscal profligacy.

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and procedures remain hindrances to uninterrupted operations and smooth service delivery since the onset of the pandemic, causing severe hardships to the public. According to the Census of Public and Semi Government Sector Employment - 2016 report of the Department of Census and Statistics, 33.2 per cent of the public sector employees are unable to use a computer, while 30.4 per cent were not using a computer for official purposes, indicating the skill gap of the public sector labour force deterring the shift towards a technology intensive working environment. However, experiences gained during the pandemic also reveal that most government services can be efficiently delivered using a fraction of the existing labour force by reskilling and upskilling them, and by introducing simple and people friendly automated systems and virtual platforms. Going forward, the public sector of Sri Lanka needs to embrace new technologies to cater to the dynamic needs and expectations of the population by building better customer relations, improved institutional coordination and data management, and advanced evidence based policymaking. Legislative and procedural amendments and flexible working arrangements should also be implemented in tandem with digitalisation to ensure uninterrupted service delivery during the pandemic or any other disruptions such as natural disasters. The effectiveness of the service delivery depends not only on technological enhancements, but also on human capital, regulations, and enforcement policies. Sri Lanka, which ranked at the 51st percentile in the Government Effectiveness Index – 2020, could derive policy prescriptions on the public sector effectiveness from countries like Singapore, which was ranked at the top of the same index. The emphasis on meritocracy in recruitments and career advancements, competitive market salaries, and continuous training have equipped the Singapore bureaucracy with highly competent personnel for efficacious policy implementation. In addition, a strong legislative framework against corruption coupled with adequate personnel and funding for the strict enforcement of anti-corruption measures have enabled Singapore to successfully combat corruption and maintain a high level of efficiency in the public sector. Moreover, public sector recruitments that are in line with the administrative and macroeconomic requirements, target oriented approaches in budgeting, resource reallocation from excessive sectors to needy sectors, planned and targeted reskilling and upskilling of labour, and creating administrative flexibility for the workers to move across different sectors within the public sector are essential to ensure productive efficiency in the Sri Lankan public sector.

The overreliance of the public sector on the banking system, including the Central Bank to source financial resources, needs to be scaled down by exploring alternative sources of financing and implementing long due structural reforms enabling improvements to the financial strength of the banking system. Apart from the revenue earned by the public sector, bank financing has been one of the key sources of financing for both the Government and SOBEs. In recent years, particularly since the onset of the pandemic, the public sector, predominantly the Government, has been increasingly relying on the banking system to meet its financing requirements, thereby exerting tremendous pressure on the banking sector, especially the state banks, and domestic price stability. The loss of access to international capital markets amidst the rise in debt and sovereign credit rating downgrades has aggravated the funding constraints of the Government, while SOBEs have been compelled to borrow from the banking sector due to the inadequate adjustment of administratively determined prices and tariffs of their products, forcing them to continuously borrow for working capital purposes. Such excessive reliance of the public sector on bank financing has put pressure on the domestic banking sector and the overall domestic financial market, raising financial system stability concerns as well. Further, continued financing of the public sector without a commensurate improvement in productivity and efficiency, could in turn pose even higher inflationary pressures, while increasingly becoming a burden on the Government and taxpayers. Also, this would lead to the crowding out of productivity bound private sector investment, which could have adverse implications on the long term growth potential of the economy. The Government's cashflows have been severely affected by tax relaxations and exemptions as well as limitations associated with tax collection. Similarly, large overdue payments to some SOBEs, particularly from other government entities and other SOBEs, have also impacted cashflows forcing them to obtain loans and overdrafts at high interest rates, thereby affecting levels of profitability. This highlights the need for the Government to actively explore avenues to raise finance from non bank sources. With regard to SOBEs, measures should be taken to revise retail selling prices to reflect costs, while also enhancing productivity, improving infrastructure, reducing associated wastage to bring down the overall cost of production and upgrade them as autonomous entities, enabling them to operate on their own without assistance from the government budget. Further, immediate attention should be given to improving the financial viability of SOBEs by strengthening tariff collection, thereby enhancing cashflow management, while also exploring alternative low cost and long term financing options. The implementation of the proposed reforms would enhance public sector performance, thereby limiting the need for banks' support to meet the financing needs of the public sector, facilitating near to medium term economic stability and sustainable growth in the long term.

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The frequent volatility and persistence of general price levels driven by food inflation, which weakens the Central Bank's efforts to maintain inflation within the targeted range and anchor inflation expectations, needs to be controlled by government interventions on a timely and sustainable basis. Since a large portion of the consumer price basket of goods and services consists of food items in Sri Lanka, frequent and sizeable changes to the food prices cause volatility in inflation. High, frequent and persistent deviations of inflation from the inflation target mainly driven by food inflation could derail inflation expectations, thereby undermining the objectives of Flexible Inflation Targeting (FIT). While supply side factors largely trigger food price hikes in a country, demand side factors could also complement such price hikes. In Sri Lanka, supply driven factors, including the pandemic and weather related supply disruptions, as well as external factors such as large swings in global food and commodity prices, were the main causes of recent food inflation. Further, productivity losses during the transition period to organic agriculture practices and the legacy issues, such as post harvest supply chain issues, limited storage, value addition and preservation methodologies can also be attributed to the acceleration in food prices. Food prices driven inflation hikes are more regressive, as they disproportionately affect less affluent sectors of the society and deteriorate the living conditions of the poor. Attempts to contain such supply driven inflation mainly through monetary policy measures could be counterproductive or ineffective. Hence, implementing short to long term, well planned supply side policies by the Government is imperative to ensure the smooth functioning of domestic food supply chains and to minimise the impact of upward global price movements. These policies should comprise improving domestic production, off season cultivation, food storage infrastructure, adopting preservation methodologies, minimising cost of transportation, enhancing the technology used in production and promoting cost effective import substitution industries. Countries like India have been able to soften their high food inflation through implementing short term supply side measures such as imposing stock limits, easing import restrictions, reducing basic import duties, etc., in parallel with successfully implementing the inflation targeting framework. Although Sri Lanka has also taken such short term policies within the limited fiscal space available to address supply concerns, especially related to transitory food price hikes, further measures are required to maintain a robust and resilient food supply chain in the country. During the pandemic period, the Government took several short term measures, such as removing travel restrictions for those who are involved in the food supply chain to continue their services. In the long run, appropriate policies and infrastructure need to be in place to invest in improving productivity in agriculture and focus on food security issues. It will also be important to obtain support from the private sector in implementing these policies. The Government has already initiated implementing infrastructure and livelihood development programmes such as "Vari Saubhagya" to ensure food safety through the improvement of food production, while attempting to promote the production of agricultural and industrial goods that can be identified as import substitutes. Further, it is important to have proper storage systems with controlled environments in place to reduce post harvest losses as well as for off season storage. While the investments from the international and domestic private sector would expand storage and goods transportation facilities within the country, the establishment of food banks will aid to make use of regional food reserves in emergency situations. Among other measures, it would be worthwhile to have a specialised preparedness team consisting of both government and private sectors to detect possible developments leading to supply shortage of essential food items early and make proactive policy recommendations to the Government to help prepare the economy to face likely shocks to food supply. Moreover, it is vital to have a robust regulatory framework on the functioning of food supply chains from the agriculture sector to the retail sector to avoid monopolies, undue dumping of stocks and subsequent price hikes, thereby reducing volatilities in food prices. Less volatility in food inflation in shaping inflation dynamics, by way of anchoring inflation expectations will help achieve and maintain price stability.

Export industries need to build the capacity and resilience to withstand risks posed by the pandemic, and global issues that affect global markets and commodity prices, while forming strategies to grow and diversify. Export industries, which were significantly affected when the pandemic initially broke out in 2020, recovered within a short time span and recorded a notable growth to historically highest ever export earnings in 2021. As the pandemic intensified and continued, the main concerns for the exports were the changes to demand patterns, international maritime disturbances that resulted in a surge in costs along with lack of vessels and containers, mobility restrictions that disrupted production and transport, the difficulty in sourcing certain inputs, and the notable increase in the cost of raw materials. Nevertheless, some export categories performed well starting from the latter part of 2020 (mainly agricultural exports), while other export categories have only partly recovered thus far. However, uncertainties still linger in the international economy arising from the continuation of the pandemic, monetary policy normalisation in major economies, high commodity prices, energy market issues and the recent geopolitical tensions. Notwithstanding these difficulties, Sri Lanka needs to identify that developing the export sector during the 'new normal' as a policy priority to increase non debt inflows and would accelerate growth through the allocation of resources to the productive tradeable sector in the economy. External sector policies should not only focus on the need for diversifying export markets but also on the improved sophistication of export products to more technologically advanced, high quality and high value goods and services. Diversifying into new export sectors with potential for higher domestic value addition such as Information and IT/BPO, electricals and electronics, processed food, beverages, spices and concentrates, boatbuilding and after sales services and pharmaceuticals, need to be explored and supported through policies. The exports sector would have to be supported by conducive macroeconomic policies of the country, particularly through maintaining a flexible exchange rate, consistent tax and investment policies and essential infrastructure facilities.

Adoption of stronger industrial policies and strategies is necessary to ensure the availability of essential goods in the country, develop import substitution industries and to increase export earnings. Even though Sri Lanka has been a trade dependent economy for the past several decades, the pandemic, the consequent global supply chain issues and the current geopolitical tensions have shown that it would be difficult for a country that suffers from macroeconomic vulnerabilities to rely heavily on other countries to secure an uninterrupted supply of food and essential goods through international trade, particularly during times of crisis. The need for import substitution, at least for selected essential goods that could be produced domestically was felt strongly in the midst of difficulties to import and shortages of goods in domestic markets. Such essential goods include food, pharmaceuticals, inputs that are necessary for industries, construction material and machinery. The Government's efforts to develop the agricultural sector by discouraging imports, forming plans to establish a pharmaceuticals manufacturing zone, a textile manufacturing park, etc., are commendable efforts in this regard.

Policies to promote backward integration of value chains of major export sectors also support this. On the other hand, carefully designed and strategised substitution policies could save foreign exchange for the country. Against this background, there is a new wave of import substitution like policies adopted by many other countries, especially after the global pandemic. It was observed that large economies such as China, India, the USA and several African countries attempted to promote domestic production recently by discouraging imports. Further, attracting FDI not only for export oriented manufacturing, but also for identified backward integration sectors may also support higher control over the value chains, while effectively substituting imports. However, pursuing strong and continuous efforts focusing on industrialisation under a comprehensive and long lasting industrial policy, which is also linked to agricultural policies, remains vital and urgent.

The export sectors development should not rely heavily on free/preferential trade agreements. Sri Lanka has preferential export access to several foreign markets through eleven Generalised System of Preferences (GSP) schemes (including the EU GSP+). Meanwhile, Sri Lanka has entered into seven multilateral and bilateral trade agreements, which allow preferential access to foreign markets under concessions. At the same time, efforts are underway to negotiate and enter into free/ preferential trade agreements with some trading partners with high future potential such as China, Japan, Indonesia, Singapore, and Bangladesh. Although trade agreements generally focus on tariffs and quotas, their scope has recently expanded to include services exports, intellectual property rights and patent rules, health and safety regulations, labour and environmental standards, investments, and banking. In the case of GSP schemes, countries implementing them provide non reciprocal preferential market access to selected counterparty countries and Sri Lanka is a beneficiary of such schemes. The beneficiary status of some GSP schemes depends on criteria such as low GDP per capita and conditions stipulated by the granting country such as good governance requirements, labour standards, and environmental factors. As the GDP per capita of Sri Lanka increases, Sri Lanka stands to lose eligibility for some of these schemes. Trade agreements and GSP schemes also encompass rigorous Rules of Origin requirements and hence should have high value addition within Sri Lanka. Therefore, a number of exports that utilise these trade agreements are limited to agricultural exports and industrial goods that depend on local inputs, such as rubber products. It is difficult for exports, which use imported inputs to a great extent, to meet stringent Rules of Origin criteria. Hence, even for apparel, which is Sri Lanka's main export, the utilisation rate of schemes such as the EU GSP+ is not high, compared to goods such as rubber products, toys, and agricultural exports. It is evident that when Sri Lanka lost the EU GSP+ status between August 2010 and May 2017, exports to the EU did not decline considerably. Despite these concerns, some exports enjoy significant benefits through low tariffs under these schemes/agreements. As a result, out of total export earnings in 2021, about 43 per cent were earned through exports under the preferential trade agreements, including GSP schemes. However, the fact that a large share of export earnings to Sri Lanka have been earned under trade agreements does not necessarily mean that such agreements were the single main reason for the reported increase in exports. Such exports may be incentivised by other factors pertaining to the exporting entity, domestic economic factors, and global market factors. Meanwhile, the trade agreements of other countries such as the Regional Comprehensive Economic Partnership ("RCEP" entered into by 30 countries in East Asia, Southeast Asia and Oceania), also raise questions about Sri Lanka's future competitiveness. Although the benefits of trade agreements and GSP schemes on Sri Lanka's exports have been significant, it would be prudent to reduce the dependency on such trade agreements or schemes, while considering successful integration with global value chains and diversification of exported goods, while broadening the export market. However, free/preferential trade agreements must be entered into only if the potential increase in exports or cost saving from imports can be identified and justified. Nevertheless, rather than relying too much on duty concessions, export promotion policies need to focus on exporting improved quality goods with high value addition at lower costs of production, achieved through research and development led innovation, over the medium to long term.

The increased demand for higher education abroad and the significantly high foreign exchange outlay highlight the need for urgently addressing issues pertaining to higher education opportunities available domestically. Despite the commitment of successive governments to the provision of free education and upgrading of infrastructure related to the provision of higher education, a large number of qualified students remain outside the ambit of the public education system at the graduate and postgraduate levels. In 2020, although approximately 63 per cent of those who sat for GCE Advanced Level examination were eligible to enter the public tertiary education system, only 22 per cent of the qualified students were admitted into the system, in spite of the recent increases in intakes. Accordingly, the limited number of opportunities available in the domestic public and private higher education systems has translated into students steadily departing for higher education abroad. A key issue in this regard is the substantial outflow of foreign exchange, which could also add pressure to the prevailing imbalances in the external sector. Moreover, as the economy integrates more into the global economy, it is expected that the domestic labour force would have to transform to cater to the dynamic demands of a modern work environment. Especially, when the IT/BPO sector is expected to expand into a US dollars 5 billion industry and as Sri Lanka continues to strive to attract FDI, the availability of a pool of skilled labour with internationally recognised qualifications will be essential. Similarly, new employment opportunities that will be created in the Colombo Port City and International Financial City would also require such a pool of skilled people. Accordingly, improving the opportunities for domestic education at the international standard will help to improve the required skills of the workforce while enabling to retain the talent within the country to some extent, along with further expansion in the services sector. Therefore, focused policy initiatives to improve the standards of local universities, alongside capacity improvements, are essential not only to retain domestic students but also to attract international students from foreign shores. Further, it is also important for private higher education institutions to focus on building 'university-class' infrastructure comprising accommodation facilities, social activities, specialised research and laboratory facilities, among others. Such initiatives will not only contribute to improving standards of learning delivery, but also to the overall learning experience which is also a key point of attraction for students who are currently emigrating for higher education. The Government may consider facilitating an expansion in the private higher education sector with increased collaborations with the world class universities along with international accreditation. Further, facilitating foreign based universities to establish branch universities in Sri Lanka would be a welcome move to attract international students to its shores as a study abroad destination, while accommodating local students to study from renowned foreign institutions while being on shores. It is also required to attract world class faculty members under a residential visa scheme to enrich the quality of education provision by

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internationally accredited educational institutions. Such an arrangement would enhance FDI flows and bring in technical and technological know-how. Such initiatives can facilitate the country's ongoing efforts to emerge as a leading provider of IT/BPO solutions as it would enable elevating the quantity and quality of labour produced to cater to this industry and serve to attract international students who can later continue here as 'digital nomads'. This can pave the way for an overall improvement in access to higher education without the Government having to bear the entire burden of such expansion, while also enabling the higher education sector to emerge as a key foreign exchange earning sector in the future.

Despite the transformation of the agriculture sector since independence, Sri Lanka continues to grapple with the creation of a sustainable agriculture sector that is capable of generating healthy income levels while ensuring food security and efficient ecosystem management to enhance the overall productivity of the sector. The agriculture drive in the 1960s to develop the agriculture sector to fulfil the growing demands of the economy entailed the rapid introduction of high yielding crop varieties alongside increased usage of chemical fertilisers as well as other agro-chemical inputs under a fertiliser subsidy scheme. In subsequent periods, Sri Lanka continued to provide fertiliser concessions to farmers by way of cash grants or issuance of fertiliser free of charge or at a rate below market value with the view to ensuring sustained increases in production. In turn, the continuation of such concessions to farmers alongside poor extension services, and lack of farmer awareness have led to excessive use of chemical or inorganic materials in the agriculture production process, thus creating long term negative effects on human wellbeing, health and ecosystems, in addition to the associated expenditure burden on the fiscal front. Also, the abundance of low cost chemical fertiliser at below market prices in the country has prevented farmers from using organic manure as well as other organic and sustainable agriculture practices in cultivation given the labour and time intensity of such practices. The use of organic fertiliser can always generate multiple benefits to growers, consumers as well as the environment. It supports nutrient and water retention, and thereby soil fertility, while maintaining soil biodiversity. However, excessive usage of chemical fertiliser and non-usage of organic fertiliser and soil conservation practices in the agriculture systems in Sri Lanka have resulted in the weakening of the natural environment through soil degradation, pollution of ground and surface water, eutrophication, and disruption of aquatic ecosystems. Meanwhile, the excessive usage of agrochemicals is also expected to cause significant negative impacts on biodiversity, while also creating direct and indirect health hazards. Accordingly, there is an urgent need for devising a long term policy framework targeted at promoting sustainable agriculture, which will ensure economic profitability, social and economic equity as well as environmental health. While recognising the Government's efforts to promote organic fertiliser with a view to limiting the excessive use of synthetic manure in agriculture, it must be noted that only a holistic strategy that encompasses all the elements related to sustainable agriculture could ensure the fulfilment of the needs of the present generation without compromising the needs of future generations. This is also essential considering the fact that almost one-third of Sri Lanka's labour force is engaged in the agriculture sector and many of their livelihoods are consistently vulnerable owing to the sector's lack of resilience to the shocks. In this regard, the Government must facilitate the creation of a sustainable agriculture base that will enable farmers to capitalise on these sustainable and climate smart agricultural practices. Accordingly, urgent measures focusing on establishing a precision agriculture system that would encourage the optimal use of inputs in agriculture are needed. Under such approach, the promotion of organic fertiliser, while encouraging efficient and optimal use of chemical fertiliser remains of utmost importance. Given the frequent drought spells experienced by the country in recent times, efficient management of water should also be promoted through reduced volume irrigation systems such as drip irrigation and the introduction of drought tolerant crop species. Also, major emphasis should be given to soil conservation strategies to ensure long term soil productivity in agricultural lands and to minimise landslide hazards. At the same time, addressing the issues of growing food demand, climate change as well as limited arable land, it is vital to promote innovative ways of farming, including vertical farming and urban farming, while mechanising agriculture activities in the traditional agriculture sector. Meanwhile, the promotion of domestic production of fertiliser, agrochemicals as well as seeds is essential in achieving sustainability in agriculture since the country is highly reliant on imported seeds, fertilisers, and agrochemicals. Towards the endeavour of building a sustainable agriculture sector, creating awareness of sustainable, climate smart and good agriculture practices among all the stakeholders would enable a faster transition. Moreover, a well developed and a coherent mechanism with a suitable transition period is essential to transform the present agriculture system of Sri Lanka into a sustainable system, while ensuring that the full benefits of such a transition are passed on to all those engaged in the agricultural supply chains.

Despite being a key driver of economic growth and having more potential for further growth, Micro, Small and Medium sized Enterprises (MSMEs) in Sri Lanka face numerous hindrances, thus necessitating policy priorities at the national level. More than 99 per cent of establishments in the non agricultural sector in Sri Lanka are found to be MSMEs, contributing to about 75 per cent of employment within the non agriculture sector.[3] Different studies report the contribution of MSMEs to economic activity in Sri Lanka to be more than 50 per cent. However, this appears to be relatively low when compared to developed nations and even some developing economies. These observations suggest that despite the existence of a large number of MSMEs in Sri Lanka, their economic contribution may not have reached its potential yet. Over several decades, MSMEs in Sri Lanka endured difficult circumstances due to various reasons including natural disasters, terrorist activities, health crises, etc. In order to support MSMEs during such periods, for example, during the pandemic, the Government and the Central Bank provided a substantial package of financial and non-financial reliefs similar to many other countries. Nevertheless, a considerable number of businesses and individuals in this sector may not have recovered or even explored the potential of such support schemes. It has been identified that several issues have hindered the progress of the MSME sector, including insufficient access to finance as well as poor financial literacy. Many MSMEs do not possess the required financial literacy to prepare project proposals with sufficient information required by financial institutions, while financial reporting remains relatively weak among these entrepreneurs, thereby forcing financial institutions to rely on collateral based selection, which restricts the ability of MSMEs to obtain loans due to their inherently small asset base, in turn driving them to utilise the services of informal lenders as well. Considering the difficulties encountered by MSMEs when securing finance for their projects amidst a lack of sufficiently acceptable collateral, the Government in consultation with several stakeholders embarked on an initiative to set up a Credit Guarantee Institution (CGI), which was a long overdue requirement. With the implementation of the CGI, the funding concerns

3 As reported in the Economic Census 2013/2014, conducted by the Department of Census and Statistics.

of MSMEs are expected to ease, to some extent, and enhance their prospects as well as their contribution to overall economic activity, going forward. The expeditious operationalisation of the CGI would immensely support the MSME sector to thrive. Meanwhile, the establishment of a well functioning development bank is also a necessity to support small businesses in the country, and this has been highlighted for several years. Further, the possibility of adopting and popularising alternative funding avenues for MSMEs that have been successful in various countries, such as crowdfunding, venture capital investments, pitch competitions, etc. also needs to be explored. At the same time, MSMEs can benefit from improving awareness of equity finance opportunities, such as those facilitated by the CSE via its Empower Board. Other impediments that limit MSMEs from reaching their true potential include, low levels of managerial skills, use of outdated technology and the resulting low quality of output, limited market knowledge, information asymmetry, and certain cultural perceptions that are less conducive to entrepreneurial development. A close look at some of these factors highlights that these are interconnected issues which reinforce each other, requiring collective effort to overcome them successfully. Although the multitude of initiatives undertaken by the Government and other agencies have helped many individuals and businesses to overcome some of these issues, MSMEs operating in Sri Lanka still have substantial space for improvement. It is important to continue the efforts undertaken to strengthen managerial and entrepreneurial skills and to improve financial literacy among Sri Lankan MSMEs. The provision of business consultancy and credit advisory services by both Government and non government agencies need to be enhanced, while such services could be offered and popularised via special units in financial institutions as well, ultimately leading to financial arrangements. Further, developing marketing opportunities, both domestically and internationally, is vital for the success of MSMEs, while enabling supply chain integrations with large businesses will help improve the resilience of the sector. At the same time, a holistic effort is needed from all stakeholders to improve the use of new technology by MSMEs, so that the quality of their output is improved and their access to markets is enhanced. It is also important to improve coordination among various arms of the Government and non government agencies, which provide support to MSMEs to improve their effectiveness. Improving awareness of these various support elements is essential so that businesses and individuals can easily reach them when needed. At the same time, the entire MSME sector would benefit from a well coordinated grievance handling mechanism operating at a district or divisional secretariat level, which would contribute to easing operating difficulties faced by them and could serve as a conduit for the escalation of any major issues to higher levels to be addressed through appropriate policies. Further, efforts to minimise long standing impediments in the doing business environment of the country would undoubtedly help the MSME sector as well, while facilitating improvements across all business activities in the economy.

Despite several policy initiatives, Sri Lanka continues to struggle with waste management issues that have been further amplified by the COVID-19 pandemic. In recent years, Sri Lanka has been in the spotlight regarding its waste management practices, especially with the garbage landslide disaster in Meethotamulla in 2017 and more recent incidents of wildlife being affected by open waste dumps. Despite there being several national and micro level initiatives and goals regarding the improvement of waste management practices, there has been a consistent lag in the effective implementation of such initiatives. Further, the outbreak of the COVID-19 pandemic and the resultant increase in healthcare waste such as masks, Personal Protective Equipment (PPE), gloves, handkerchiefs, tissues, sanitary pads, diapers, and other materials contaminated by body fluids of patients, disposed from healthcare institutions, quarantine centres and households has become a serious concern as such 'single-use' items are unlikely to reduce in the periods ahead. The National Audit Report on Healthcare Waste Management - 2019 highlights that approximately 70 per cent of the audited hospitals were not complying with healthcare waste management standards during the pre-pandemic period. This poses significant contemporary risks as nonadherence to healthcare waste management standards and inappropriate disposal of hazardous and infectious waste create serious threats to the environment, public health, and biodiversity. In addition to the substantial increase in clinical waste from designated COVID-19 hospitals and treatment centres, there has been an increase in the open burning of clinical waste during the pandemic period. Despite the Government's initiatives to address these concerns through the issuance of guidelines for healthcare facilities and increased resources for clinical waste handling, healthcare facilities still face significant resource and technical limitations such as limited waste storage, transportation and incineration facilities. In addition to the expeditious completion of the Metro Colombo Solid Waste Management Project, it will also be essential to focus on establishing waste to energy power plants, one of which was commenced in early 2021 with a generation capacity of 10 MW. The construction of such power plants has been delayed due to high levels of capital outlay associated with such projects. However, the timely establishment of these projects can be a cornerstone solution not only to the country's solid waste management problems but also to the country's electricity needs. Global trends highlight that there is immense potential to attract FDI and even multilateral funding to waste management and recycling projects as investors and donor agencies are looking for opportunities for returns while also contributing to global sustainability initiatives through such greenfield projects. Proper implementation of an efficient waste collection mechanism, upgrading of existing disposal practices as well as the provision of adequate mechanical and biological treatment facilities, are imperative to address the country's growing waste management issue. Accordingly, there is a dire need for continued commitment to multi sectoral initiatives focused not only on recycling and composting waste, but also on reducing waste and encouraging reuse thereby paving the way for the creation of both sustainable development in the short term and transitioning to a circular economy over the long term.

Focusing on 'green' development remains a critical contemporary need to ensure that Sri Lanka's natural resources are better conserved and restored so that the economy can reap the full potential of its ecosystem. There is widespread consensus on the need for striking a balance between economic growth derived through resource consumption and conservation of the environment to preserve the existing natural resources, thereby addressing the issue of climate change. In recent years, there have been significant concerns about the impact of climate change with the frequent occurrences of natural disasters such as flooding and landslides, and drought conditions, among others. A recent study by the World Bank highlights that the temperature rise in Sri Lanka is projected to be only marginally lower than the global average indicating that periods of extreme heat will increase and stay persistent in the future. Such temperature increases can pose a threat to the well-being of the people, especially those in dry areas, and have direct implications on the economy, especially in relation to agricultural productivity, labour productivity and energy security. The study also highlights Sri Lanka's vulnerability to potential increases in the frequency and intensity of extreme precipitation events, such as the torrential rains, which could render significant risks to lives, livelihoods and infrastructure due to the resultant floods and landslides that may occur. The largest

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impact of such volatilities stemming from the natural environment will be on the poorest and marginalised communities, particularly the large segment of the population engaged in agriculture. Amid such concerns, several other issues continue to affect the quality of natural environments in the country such as the decades long human elephant conflicts, incidents of sand mining, the release of hazardous waste to water bodies by industries, forest destruction and the recent X-Press Pearl Maritime disaster. All these environmental concerns will have lasting, persistent, and potentially recurring negative socioeconomic implications. This emphasises the urgent need for committing to forward-looking and holistic policy initiatives that will pave way for sustainable natural resource management. Continuous monitoring of the status of natural resources is an essential aspect, which needs to be strengthened through a stringent regulatory and legal framework that ensures the prevention of environmental and natural resource crimes such as illegal logging, poaching and even Illegal, Unreported and Unregulated (IUU) fishing, which are rarely prosecuted. The Government and the Central Bank should also work together to promote sustainable finance practices in Sri Lanka that will be instrumental in routing credit towards environmentally friendly businesses.

Despite the country's efforts to achieve its target of alleviating all forms of malnutrition by 2030, as declared under the Sustainable Development Goals (SDGs), developments pertaining to COVID-19 and other supply side shocks observed recently in relation to agricultural commodities may threaten the outcomes achieved thus far, while posing hindrances to long term development. Although Sri Lanka made remarkable progress in achieving many of the national level targets under the Millennium Development Goals (MDGs) to uplift the socioeconomic wellbeing of the community by 2015, performance across the targets set for nutrition continued to remain unachievable reflecting the prevalence of nutrition related anomalies across geographical regions and economic sectors. As per the Demographic and Health Survey – 2016 of the DCS, some malnutrition related indicators such as stunting (height for age), wasting (weight for height), prevalence of obesity (weight for age) as well as low birth weight continued to remain unachieved compared to the national targets set for improving maternal, infant and child nutrition, with the estate sector showing the poorest nutritional outcomes. Such disparities and concerns are likely to have been aggravated by the COVID-19 pandemic. In 2021, Sri Lanka's Child Multidimensional Poverty Indicator (CMPI) indicated that about 42.2 per cent of children aged between 0-4 years old were multidimensionally poor with 33.4 per cent experiencing deprivations in relation to nutrition. Further, the recent supply side shocks observed regarding the availability and affordability of food, stemming from both global and domestic developments, raises concerns about long term impacts on nutritional outcomes of the population, especially children and women. The high levels of food inflation that occur occasionally may have scarring impacts on the future productivity of the population, if allowed to persist. It must be noted that the Government's provision of cash transfers and food distribution programmes targeting households below the poverty line is expected to have cushioned the negative impact on the nutrition status of such households to some extent. This reiterates the importance of the adoption of a holistic policy approach comprising near to long term strategies to ensure food security. Such policy initiatives should not only focus on availability through improved productivity in the agriculture sector but also post harvest marketing and distribution. As part of initiatives that are underway to improve domestic production, there is a need to strengthen databases relating to both national demand and domestic supply, especially for essential food commodities. Realistic and timely forward looking assessments on the part of relevant institutions in the agricultural sector are essential for proactive planning and timely implementation of remedial measures to safeguard the food security status and overall wellbeing of the population. It is to be noted that in the past, Sri Lanka received the assistance of multilateral donor agencies to strengthen the agriculture sector and food security status of the country. Despite Sri Lanka's progression into the middle income status, multilateral assistance in this regard, such as through the UN's World Food Programme, the World Bank and the Asian Development Bank is widely available. Tapping into such sources, both for funding and to improve technical capacity in relation to data collection, analysis, and monitoring, may not only contribute to improving the nutritional status of the population but also improve the resilience of the agriculture sector and augment the food security status of the country in the long term.

The largely stagnant levels of female labour force participation observed in Sri Lanka for the past three decades highlight that a significant portion of the labour force remains outside the ambit of the economy's growth and development processes, warranting urgent attention as the economy attempts to rapidly recover from the effects of the COVID-19 pandemic and progress onto a higher growth trajectory. Sri Lanka took almost four decades to double its female labour force participation rate from about 19 per cent in 1953 to 36 per cent in 1990. Since then, the female labour force participation rate has averaged just 33 per cent and has been on a declining trend in recent years. Although, Sri Lanka is ahead of the South Asian average of 24 per cent, the country's female labour force participation remains much lower than the 'upper middle income' country average of 55 per cent. The continued stagnation of the female labour force participation is a key policy issue to be addressed as the economy struggles with a rapidly ageing population, labour productivity issues and increasing migration, especially of skilled and semi skilled workers. With due consideration for considerable investments that consecutive governments have made in the education and health sector over the last seven decades, it is noted that bringing women into the labour force and thereby creating an expansion of the labour force can have significant positive impacts on the growth process of the country, while also ensuring the efficacy of such investments, amid limited fiscal space. Initiatives in this regard should also focus on ensuring that women avail of 'decent work',[4] as outlined in the SDGs. The need to engage women in 'decent work' is underscored by the developments arising due to the COVID-19 pandemic, which has caused a rise in the socioeconomic vulnerability of women as they tend to be employed in vulnerable jobs in the services or agriculture sectors and are more likely to be underpaid or engaged under less favourable working terms. Since long, there has been a broad consensus that policies focused on alleviating the 'triple burden' of women and thereby enhancing female labour force participation are lacking in Sri Lanka. This is evident from the dearth in the availability of affordable and regulated childcare or elderly care facilities, the absence of flexible working arrangements and the lack of reliable and safe modes of public transportation – international experiences highlight these as essential to improve the female labour force participation. Developing such infrastructure can lead to better absorption of females into the labour force thereby paving way for an increase in overall welfare through the increase in the productive resource base of the economy. Over the medium term, the higher levels of household incomes can translate into improved education and nutritional outcomes for future generations, thereby contributing to consistent improvements in the productivity of the labour force. Accordingly, it is vital to devise a targeted, holistic and multi sectoral policy initiative that supports stronger diversity and inclusion in a gender sensitive manner.

4 The International Labour Organization (ILO) defines decent work as 'productive work for women and men in conditions of freedom, equity, security and human dignity'.

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Against this backdrop, committed efforts of the Government and all stakeholders in defying the looming dire economic consequences and keeping the economy floating with a sense of urgency, while addressing the structural issues remain the immediate priority to achieve sustainable growth and to preserve macroeconomic stability going forward. While the COVID-19 pandemic has uncovered unprecedented opportunities to implement bold and better coordinated policy reforms, with the support of an external engagement, such as an economic adjustment programme supported by the IMF, exploring undiscovered new challenges, and addressing such challenges without delays through concerted efforts remain extremely vital at this juncture in order to reap tangible and broad-based benefits to the economy for robust macroeconomic stability and growth outlook, which will also ensure fulfilling the expectations of the general public at large.