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ECONOMIC, PRICE AND FINANCIAL SYSTEM STABILITY, OUTLOOK AND POLICIES

1.1 Overview

The vulnerability of the Sri Lankan economy to global and domestic disturbances became increasingly visible in 2018, with a modest expansion in real economic activity amidst a low inflation environment during the year. Real GDP growth was recorded at 3.2 per cent in 2018, compared to 3.4 per cent in the previous year. This growth was largely supported by services activities that expanded by 4.7 per cent and the recovery in agriculture activities, which recorded a growth of 4.8 per cent. Industry activities slowed down significantly to 0.9 per cent during the year, mainly as a result of the contraction in construction. According to the expenditure approach, both consumption and investment expenditure supported growth. Investment as a percentage of GDP stood at 28.6 per cent in 2018 compared to 28.8 per cent in the previous year, while the savings-investment gap widened during the year indicating increased dependence on external resources to fill the shortfall. The total size of the Sri Lankan economy was estimated at US dollars 88.9 billion, while the per capita GDP was recorded at US dollars 4,102 in 2018, which was marginally lower than in the previous year. Amidst the moderate growth in economic activity, a marginal increase in the unemployment rate and a decline in the labour force participation rate were observed during the year.

The external sector of the economy was volatile during the year due to both global and domestic factors. Globally, monetary policy normalisation, particularly in the United States of America (USA), resulted in global financial conditions tightening, thus causing capital outflows from emerging market economies and increased pressure on exchange rates of twin deficit economies, in particular. Sri Lanka also experienced these headwinds, particularly from mid-April 2018, which were exacerbated following the political uncertainties and the downgrade of the country's Sovereign rating in the fourth quarter of the year. Domestically, the trade deficit surpassed US dollars 10 billion for the first time in history with higher growth in import expenditure outpacing the growth in export earnings, which were at a record level in nominal terms. Although services exports are estimated to have grown substantially, the deficit in the merchandise trade balance, stagnant workers' remittances and rising foreign interest payments resulted in a widened current account

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deficit of 3.2 per cent of GDP during the year. The financial account benefitted from increased foreign direct investment (FDI) inflows which recorded its historically highest level in 2018, as well as borrowing from abroad, particularly through the issuance of International Sovereign Bonds (ISBs). The combined result of these developments was a deficit in the overall balance in the balance of payments (BOP). In 2018, the Central Bank followed a market based exchange rate policy and allowed a sharper depreciation of the rupee, but intervened in the domestic foreign exchange market, particularly at times when large capital outflows and undue speculation caused excessive volatility in the market. In order to address the widening trade deficit, the Central Bank and the government implemented a series of measures to curb non-essential imports by increasing tariffs, imposing margin requirements, tightening loan-to-value ratios on selected types of lending, and suspending the issuance of letters of credit (LCs) on concessionary permits for vehicle imports. In response to these measures and the global financial markets becoming less unfavourable, the pressure on the BOP and the exchange rate subsided during late 2018 and early 2019, and the Sri Lankan rupee appreciated against major currencies during the first quarter of 2019, thus correcting the overshooting of the exchange rate observed in the previous year to some extent. The resumption of discussions and the achievement of staff level agreement with the International Monetary Fund (IMF) on the programme under the Extended Fund Facility (EFF) arrangement in February 2019 also helped improve investment sentiments.

In spite of the sharp depreciation of the rupee and the introduction of the pricing formula for domestic petroleum price adjustments, headline and core inflation remained well anchored in low single digit levels during the year, supported by proactive monetary policy measures, improved domestic supply conditions, and also due to subdued aggregate demand conditions. Headline inflation fluctuated largely in line with the price movements of the food category, where food prices declined mostly during 2018 owing to favourable weather conditions that prevailed during the year. Inflation is expected to remain well within mid single digit levels in the medium term, particularly under the envisaged flexible inflation targeting (FIT) regime.

Subdued inflation and inflation expectations and lower than potential growth in real economic activity prompted the Central Bank to signal an end to the monetary tightening cycle in April 2018 by reducing the Standing Lending Facility Rate (SLFR) by 25 basis points. Thereafter, the Central Bank maintained a neutral monetary policy stance throughout the year, in view of the continued pressure on the external sector amidst the subpar performance in the domestic economy. Nevertheless, the large and persistent liquidity deficit in the domestic money market, particularly since September 2018, compelled the Central Bank to inject liquidity on a permanent basis in November 2018, by way of reducing the Statutory Reserve Ratio (SRR) applicable on all rupee deposit liabilities of commercial banks by 1.50 percentage points. However, at the same time, to neutralise the impact of the SRR reduction and maintain its neutral policy stance, the Central Bank increased the Standing Deposit Facility Rate (SDFR) by 75 basis points and SLFR by 50 basis points, further narrowing the policy rate corridor to 100 basis points. Accordingly, by end 2018, SDFR and SLFR stood at 8.00 per cent and 9.00 per cent, respectively. As the shortage in rupee liquidity persisted into early 2019, the Central Bank reduced the SRR by a further 1.00 percentage point to 5.00 per cent effective 01 March 2019. Meanwhile, *the year-on-year growth of broad money (M_{2b}) decelerated in 2018 driven by the contraction in net foreign assets (NFA) of the banking sector. However, within broad money growth, the overall expansion of credit granted to the private sector by commercial banks in 2018 was higher than expected, in spite of tight liquidity conditions and high nominal and real market interest rates.*

In the meantime, fiscal operations during 2018 demonstrated some improvements with a higher primary surplus and a lower budget deficit, notwithstanding the decline in revenue mobilisation. The government revenue declined to 13.3 per cent of GDP in 2018 while expenditure and net lending declined, particularly due to lower public investment, which was affected by political tensions that prevailed towards the end of the year resulting in delays in the implementation of budgetary operations. Reduced capital expenditure also contributed to a dampening of economic activity. The current account deficit increased in 2018 as a percentage of GDP reflecting dissavings of the government. The primary balance, which mirrors the difference between the government revenue and non-interest expenditure, registered a surplus of 0.6 per cent of GDP in 2018 compared to the surplus of 0.02 per cent of GDP in 2017. The budget deficit declined to 5.3 per cent of GDP in 2018 from 5.5 per cent of GDP in 2017 as a result of the substantial reduction in capital expenditure, but a deviation from the target level of 4.8 per cent of GDP envisaged in the Budget 2018 was also observed. The outstanding central government debt increased to 82.9 per cent of GDP at end 2018 from 76.9 per cent at end 2017, which is attributed to the depreciation of the rupee that affected the rupee value of foreign debt, relatively low nominal GDP and higher net borrowings during the period. Rollover risks can be contained through the implementation of the provisions of the Active Liability Management Act (ALMA) and the introduction of the Medium Term Debt Management Strategy (MTDS), which would help manage the government's debt obligations in the period ahead, with the support of continued commitment towards revenue based fiscal consolidation.

The financial sector continued to expand in 2018, supported by the moderate but stable growth of the banking sector. However, the profitability of the banking sector declined during the year mainly due to some deterioration in the asset quality, a rise in operating costs and higher taxes. The Central Bank strengthened the prudential policy measures, including the implementation of Basel III requirements and the adoption of Sri Lanka Accounting Standard - SLFRS 9 during the year. Meanwhile, the Licensed Finance Companies (LFCs) and Specialised Leasing Companies (SLCs) sector also recorded moderate growth amidst a challenging environment, and the Central Bank took measures to resolve distressed finance companies and to address the lingering concerns in the sector. The Colombo Stock Exchange (CSE) recorded yet another year of poor performance due to adverse developments on domestic and global fronts, which affected investor sentiments.

While Sri Lanka has made significant progress in maintaining price stability in the past decade, progress in terms of real economic performance has fallen below expectations in recent years impacted by the continued delays in the implementation of the required structural reforms and inconsistent and unpredictable policies introduced from time to time. These irregularities have crippled the growth momentum of the economy, thus preventing the country from progressing into a higher income economy. In this background, it is vital that all stakeholders make concerted efforts to expedite the reform agenda that is already in place, which includes the National Export Strategy (NES) and

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Table 1.1
Macroeconomic Performance (2014-2018)

Indicator	Unit	2014	2015	2016	2017 (a)	2018 (b)
Real Sector (c)						
Real GDP Growth	%	5.0	5.0	4.5 (a)	3.4 (b)	3.2
GDP at Current Market Price	Rs. bn	10,361	10,951	11,996 (a)	13,418 (b)	14,450
Per Capita GDP (d)	US$	3,819	3,842	3,886 (a)	4,104 (b)	4,102
External Sector						
Trade Balance (c)	% of GDP	-10.4	-10.4	-10.8 (a)	-10.9	-11.6
Current Account Balance (c)	% of GDP	-2.5	-2.3	-2.1	-2.6	-3.2
Overall Balance	US$ mn	1,369	-1,489	-500	2,068	-1,103
External Official Reserves	US$ mn	8,208	7,304	6,019	7,959	6,919
Fiscal Sector (c)(e)						
Current Account Balance	% of GDP	-1.2	-2.3	-0.6	-0.7	-1.2
Primary Balance	% of GDP	-1.5	-2.9	-0.2	0.02	0.6
Overall Balance	% of GDP	-5.7	-7.6	-5.3	-5.5	-5.3
Central Government Debt	% of GDP	71.3	77.7	78.3	76.9	82.9
Monetary Sector and Inflation						
Broad Money Growth (M_{2b}) (f)	%	13.4	17.8	18.4	16.7	13.0
Private Sector Credit Growth (in M_{2b}) (a)(f)	%	8.6	25.0	21.6	14.7	15.9
Annual Average Inflation (g)	%	3.3	2.2	4.0	6.6	4.3

(a) Revised
(b) Provisional
(c) Based on the GDP estimates (base year 2010) of the Department of Census and Statistics.
(d) Estimates updated with the latest population figures
(e) Based on revised GDP estimates for 2016 and 2017 made available on 19 March 2019 by the Department of Census and Statistics
(f) Year-on-year growth based on end year values
(g) Data for 2014 is based on CCPI (2006/07=100) while data from 2015 onwards is based on CCPI (2013=100).

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

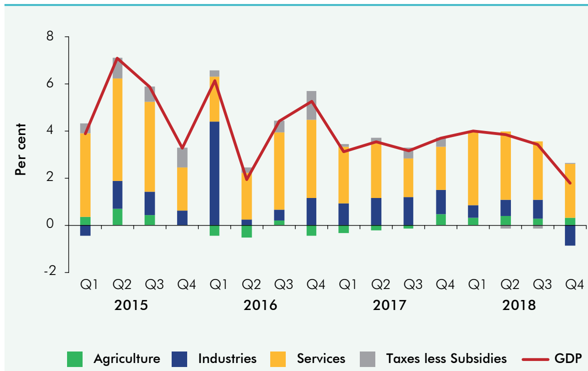
New Trade Policy (NTP) to improve earnings from merchandise and service exports, the fiscal consolidation programme to improve fiscal discipline and debt sustainability, and the Central Bank's move towards adopting FIT by 2020 to ensure sustained price stability. The timely implementation of these reforms will not only improve Sri Lanka's economic outlook and its prospects as a highly sought after destination for investments given the country's strategic location in the Indian Ocean, but also would be essential to uplift the overall standard of living and quality of life of its people.

1.2 Macroeconomic Developments, Stability and Policy Responses in 2018

Real Sector Developments and Inflation

As per the provisional estimates of Gross Domestic Product (GDP) released by the Department of Census and Statistics (DCS), the Sri Lankan economy continued to record a modest growth of 3.2 per cent in 2018 in real terms, compared to the growth of 3.4 per cent in 2017. Agriculture activities grew by 4.8 per cent in 2018, indicating a recovery from the effect of extreme weather conditions experienced in the previous year. Accordingly, growing of rice recorded a notable growth while other cereals and vegetables also supported growth in 2018. The improved growth recorded in the agriculture

Figure 1.1
Activity-wise Contribution to GDP Growth



Source: Department of Census and Statistics

BOX 1

The Impact of Frequent Large Revisions to National Accounts Estimates on Macroeconomic Indicators and Macroeconomic Policymaking

National accounts estimates are a key gauge used by macroeconomic policymakers, investors and other stakeholders to measure the direction of an economy with a view to making various decisions. Therefore, it is of paramount importance that accurate national accounts estimates, which are regularly updated to capture the evolving structure of the economy, are made available on a timely basis by a country's national statistical agency.

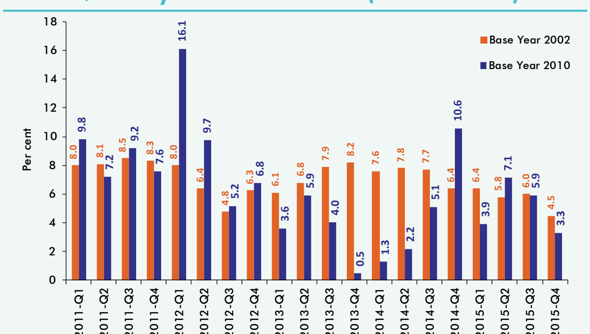
In 2015, with a landmark revision to the method of compiling national accounts, Sri Lanka's national statistical agency, the Department of Census and Statistics (DCS), moved the base year of GDP from 2002 to 2010 with the objectives of enhancing the accuracy of GDP estimates and representing the true structure of the economy. In the rebasing process, DCS made several improvements such as the adoption of international classifications and the adoption of the United Nations System of National Accounts – 2008 (SNA – 2008) compilation methodologies. Accordingly, from the first quarter of 2015, Sri Lanka's national accounts are compiled with 2010 as the base year, and it is expected that DCS will rebase national accounts from time to time in order to capture new economic activities taking place in the country, particularly through improved survey coverage.[1]

Along with this change in the base year, DCS also introduced a revision policy of national accounts estimates from 2015. According to the revision policy, "provisional estimates" are prepared and published around 75 days after the respective quarter, broadly following an advance release calendar. When annual estimates are published, revised estimates for the first three quarters of the same year and for the two previous years are also published as "revised provisional estimates". When final data becomes available, "final quarterly and annual national accounts estimates" are released.

Although the concepts of base year revisions and the revision of provisional national accounts estimates as per the revision policy of DCS are in line with international best practices,[2] frequent revisions have made data-driven evidence-based decision making challenging for policymakers as well as investors. Such challenges are common to many economies,[3] but large revisions that cannot be explained using established macroeconomic linkages are not desirable, especially when the first provisional estimate of national accounts is released around 2½ to 3 months after the end of each quarter.

Figure B 1.1 shows the effect of the latest rebasing of national accounts on quarterly real GDP growth rates, as discussed in the Central Bank Annual Report 2015. For example, real GDP growth rate in 2012-Q1, which was estimated at 8.0 per cent under the base year 2002, was recorded at 16.1 per cent under the base year 2010, while real GDP growth rate in 2013-Q4, which was estimated at 8.2 per cent under the base year 2002, was estimated at 0.5 per cent under the base year 2010.

Figure B 1.1
Quarterly Real GDP Growth (Year-on-Year)



Source: Department of Census and Statistics

Table B 1.1 shows the impact of recent revisions on national accounts (2010 base) based on the expenditure approach, by comparing national accounts released in July 2018 and March 2019, i.e., within a space of eight months. Accordingly, both consumption and investment (gross capital formation) shares of GDP have been substantially revised for the period after 2016. Consumption as a share of GDP, which was estimated at 72.4 per cent for 2016 and 70.5 per cent for 2017, has been sharply revised upwards to 79.4 per cent for 2016 and 78.3 per cent for 2017, while it has been estimated at 78.8 per cent for 2018. On the other hand, investment as a share of GDP, which was estimated at 35.0 per cent for 2016 and 36.7 per cent for 2017, has been sharply revised downwards to 27.9 percent for 2016 and 28.8 per cent for 2017. It is estimated at 28.6 per cent for 2018. Although the revised shares of investment in GDP for 2016-2018 appear to be more aligned with the recent growth path of the economy, the sharp drop in investment to GDP share from 39.1 per cent in 2012, to 31.2 per cent in 2015 and further to 28.6 per cent in 2018 remains unexplained, and questions the accuracy and credibility of national accounts.

1. It is observed that the growth estimates of DCS for recent years have been considerably below the growth projections of several domestic and international agencies engaged in economic analysis, and at times, not in line with the movement of other macroeconomic indicators. It is expected that DCS will address the deficiencies in data coverage and quality in GDP compilation, at the upcoming revisions as well as future releases of GDP estimates. Nevertheless, the purpose of this Box Article is not to discuss such deficiencies, but to highlight the challenges faced by the economy due to frequent large revisions to national accounts estimates.

2. See Berry, F.; Iommi, M.; Stanger, M. and Venter, L. "The Status of GDP Compilation Practices in 189 Economies and the Relevance for Policy Analysis." IMF Working Papers, 2018, WP/18/37.

3. See, for instance, Orphanides, A. "Monetary Policy Evaluation with Noisy Information." Journal of Monetary Economics, 2003, 50(3), pp. 605-31; Orphanides, A. and van Norden, S. "The Unreliability of Output-Gap Estimates in Real Time." The Review of Economics and Statistics, 2002, 84(4), pp. 569-83; and Giannone, D.; Reichlin, L. and Sala, L. "Monetary Policy in Real Time." NBER Macroeconomics Annual, 2004, 19, pp. 161-200.

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Table B 1.1
Expenditure of GDP, Shares at current prices

Per cent

Component		2010	2011	2012	2013	2014	2015	2016	2017	2018
Final consumption expenditure	**Data released in March 2019**	**76.9**	**79.8**	**72.8**	**75.4**	**75.8**	**76.4**	**79.4**	**78.3**	**78.8**
	Data released in July 2018	***76.9***	***79.8***	***72.8***	***75.4***	***75.8***	***76.4***	***72.4***	***70.5***	
Gross capital formation	**Data released in March 2019**	**30.4**	**33.4**	**39.1**	**33.2**	**32.3**	**31.2**	**27.9**	**28.8**	**28.6**
	Data released in July 2018	***30.4***	***33.4***	***39.1***	***33.2***	***32.3***	***31.2***	***35.0***	***36.7***	
Gross fixed capital formation	Data released in March 2019	23.7	26.3	29.0	29.3	27.7	25.7	26.8	26.5	25.7
	Data released in July 2018	*23.7*	*26.3*	*29.0*	*29.3*	*27.7*	*25.7*	*26.7*	*26.3*	
Changes in inventories	Data released in March 2019	5.9	5.1	9.2	3.2	4.1	5.1	0.4	1.3	2.2
	Data released in July 2018	*5.9*	*5.1*	*9.2*	*3.2*	*4.1*	*5.1*	*7.6*	*9.3*	
External balance of goods and services	**Data released in March 2019**	**-7.3**	**-13.2**	**-11.9**	**-8.6**	**-8.1**	**-7.5**	**-7.3**	**-7.2**	**-7.3**
	Data released in July 2018	***-7.3***	***-13.2***	***-11.9***	***-8.6***	***-8.1***	***-7.5***	***-7.3***	***-7.2***	
Gross domestic product (GDP/GDE) at market prices	**Data released in March 2019**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**
	Data released in July 2018	***100***	***100***	***100***	***100***	***100***	***100***	***100***	***100***	

Source: Department of Census and Statistics

Economic decisions are made, based on the statistics available at the time of decision making, and most often, policy decisions cannot be reversed even when there is a large subsequent revision to already published data. For instance, one key input for the monetary policy decision making process is the output gap, which is the difference between actual output and the potential output of the economy. Frequent large revisions to national accounts estimates invalidate estimates of potential output as well as the output gap, and a real time decision to tighten or relax monetary policy could have a harmful impact on the economy, which cannot be remedied when revised national accounts estimates become available later. With regard to fiscal indicators, revenue, expenditure, key fiscal balances, and debt levels are generally expressed as ratios of GDP, and fiscal policy decisions made on currently available indicators will also have a real effect on the economy, irrespective of subsequent revisions to national accounts estimates. Investors also closely watch GDP data releases, as they are the most crucial indicator for economic activity, and it is not helpful to realise that the economy has performed exceptionally well, or otherwise, years after the initial data release, as investors would have made real time investment decisions by then.

Therefore, the macroeconomic cost of the non-availability of accurate data on time is high, and this is a key factor that needs to be taken into consideration in making future revisions more transparent and when designing rebasing exercises and advance release calendars.

sector also reflected the base effect of the drought affected growth in 2017. Meanwhile, the growth momentum in industry activities moderated considerably during the year to 0.9 per cent from 4.1 per cent in the previous year. The slowdown in industry related activities was particularly due to the contraction in construction, and mining and quarrying activities during the year. However, the performance of manufacturing, and electricity, water and waste treatment activities contributed towards the expansion in industry activities. Services sector, which is the largest production sector within GDP, grew by 4.7 per cent in 2018 compared to the expansion of 3.6 per cent in the previous year. Within services activities, financial services continued to be the main contributor to economic expansion followed by wholesale and retail trade activities.

As per the GDP estimates based on the expenditure approach, the expansion in consumption as well as investment expenditure supported nominal economic growth in 2018. However, consumption expenditure, which accounted for a share of 78.8 per cent of GDP, recorded a slowdown from a growth rate of 10.3 per cent in 2017 to an

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

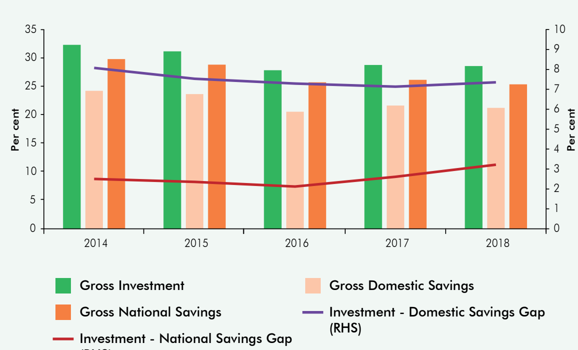
Item	Rs. billion		Growth (%)		As a percentage of GDP (%)	
	2017 (c)	2018	2017 (c)	2018	2017 (c)	2018
1. Domestic Demand	**14,381.1**	**15,511.8**	**11.7**	**7.9**	**107.2**	**107.3**
1.1 Consumption	10,513.1	11,381.4	10.3	8.3	78.3	78.8
Private	9,382.5	10,081.2	10.2	7.4	69.9	69.8
Public	1,130.7	1,300.2	11.4	15.0	8.4	9.0
1.2 Investment (Gross Domestic Capital Formation)	3,867.9	4,130.4	15.8	6.8	28.8	28.6
2. Net External Demand	**-962.8**	**-1,061.9**	**-10.1**	**-10.3**	**-7.2**	**-7.3**
Exports of Goods and Services	2,909.7	3,292.4	14.6	13.2	21.7	22.8
Imports of Goods and Services	3,872.5	4,354.3	13.4	12.4	28.9	30.1
3. Total Demand (GDP) (1+2)	**13,418.3**	**14,449.9**	**11.9**	**7.7**	**100.0**	**100.0**
4. Domestic Savings (3-1.1)	**2,905.1**	**3,068.5**	**17.8**	**5.6**	**21.7**	**21.2**
Private	3,001.3	3,238.3	18.2	7.9	22.4	22.4
Public	-96.2	-169.7	-34.1	-76.5	-0.7	-1.2
5. Net Primary Income from Rest of the World (d)	**-352.9**	**-391.9**	**-10.4**	**-11.1**	**-2.6**	**-2.7**
6. Net Current Transfers from Rest of the World	**964.3**	**999.5**	**2.6**	**3.6**	**7.2**	**6.9**
7. National Savings (4+5+6)	**3,516.6**	**3,676.1**	**13.9**	**4.5**	**26.2**	**25.4**
8. Savings-Investment Gap						
Domestic Savings-Investment (4-1.2)	-962.8	-1,061.9			-7.2	-7.3
National Savings-Investment (7-1.2)	-351.3	-454.3			-2.6	-3.1
9. External Current Account Balance (2+5+6) (d)	**-351.3**	**-454.3**			**-2.6**	**-3.1**

(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

expansion of 8.3 per cent in 2018. This slowdown in consumption expenditure was due to the moderation in the growth of private consumption expenditure while public consumption expenditure grew at a higher rate compared to the previous year. Meanwhile, investment expenditure, which recorded an expansion of 15.8 per cent in 2017, grew by 6.8 per cent amidst a modest nominal growth in construction activities during the

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

year. With these developments, investment as a percentage of GDP fell marginally to 28.6 per cent in 2018 from 28.8 per cent in the previous year. Accordingly, domestic demand grew by 7.9 per cent while net external demand deteriorated by 10.3 per cent in 2018. Meanwhile, domestic savings as a percentage of GDP fell marginally to 21.2 per cent in 2018 from 21.7 per cent in the previous year. Moreover, national savings also declined as a percentage of GDP to 25.4 per cent in 2018 compared to 26.2 per cent in 2017. This was a result of the marginal decline in domestic savings and continued deterioration of net primary income from rest of the world amidst the modest expansion in net current transfers. Accordingly, both the domestic savings-investment gap and national savings-investment gap widened marginally to 7.3 per cent and 3.1 per cent, respectively, during 2018.

Underpinned by favourable weather conditions, agriculture activities recovered in 2018 and registered a growth of 4.8 per cent,

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compared to the contraction of 0.4 per cent observed in the previous year. Production in several agriculture crops, including paddy, coconut, fruits, livestock, vegetables and other field crops increased during 2018, while tea, rubber, fisheries and sugar production recorded a decline. Paddy production, which was affected by adverse weather conditions in 2017, recovered with an increase of 64.9 per cent, resulting in a production of 3.9 million metric tons during 2018. The significant improvement in paddy production in both seasons were supported by conducive weather conditions and sufficient availability of water for paddy cultivation. In response to increased availability of domestic paddy stocks, rice imports witnessed a considerable decline of 66.7 per cent in 2018 compared to the previous year. Although the domestic supply of rice improved considerably, the average price of selected rice varieties remained at elevated levels during 2018. Unfavourable weather conditions in tea growing areas, particularly during the second quarter of 2018, and wage related trade union action in the plantation sector affected tea production during 2018, amidst lower average prices of tea. Rubber production also declined during the year due to continued rainfall during tapping days in rubber plantation areas and high cost of production. Meanwhile, supported by sufficient rain, coconut production recorded an expansion during 2018. Production of other field crops increased although the Fall Armyworm infestation during the last quarter of the year in certain parts of the country severely damaged maize and finger millet (kurakkan) production. Meanwhile, the production of vegetables, fruits and milk recorded an expansion in 2018 while sugar production contracted for the second consecutive year. Egg production contracted during 2018, while meat production recorded a modest growth. The fisheries sector witnessed a marginal setback in 2018 following the marginal expansion recorded in 2017.

During 2018, industry related activities experienced a slowdown, particularly with the decline in construction, and mining and quarrying activities. Construction activities, which accounted for 6.8 per cent of GDP, contracted by 2.1 per cent during 2018 compared to the expansion of 4.3 per cent recorded in the previous year. In tandem with the decline in construction activities, mining and quarrying activities also contracted during the year. Meanwhile, manufacturing activities, which accounted for 15.5 per cent of GDP, registered a modest growth of 3.0 per cent in 2018, supported by increased production of sectors such as food products, beverages, wearing apparel, rubber and plastic products, coke and refined petroleum products and textiles. However, production in the subsectors of paper and paper products, chemicals and chemical products, electrical equipment and furniture products contracted during the period under review. Meanwhile, electricity, water and waste treatment activities also contributed to economic growth with an expansion of 4.7 per cent during 2018. The government took several policy measures aimed at promoting the industry sector focusing on enhancing the industrial production capacity of the country to cater to both domestic and global markets through increased private sector participation.

Services related activities expanded by 4.7 per cent in 2018 compared to the growth of 3.6 per cent recorded in the previous year. The growth of the services sector was particularly supported by the expansion in financial services activities (11.8 per cent) during 2018. Meanwhile, wholesale and retail trade activities that accounted for 10.8 per cent of GDP, grew by 5.0 per cent while transportation activities, which accounted for a similar share, recorded an expansion of 2.8 per cent in 2018. In addition, other personal services and real estate activities grew by 4.8 per cent and

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

Economic Activity	Rs. million		As a Percentage of GDP (%)		Growth (%)		Contribution to Change (%)	
	2017 (c)	2018	2017 (c)	2018	2017 (c)	2018	2017 (c)	2018
Agriculture, Forestry & Fishing	**642,366**	**672,923**	**6.9**	**7.0**	**-0.4**	**4.8**	**-0.7**	**10.2**
Agriculture and Forestry	524,121	555,679	5.6	5.8	-0.3	6.0	-0.5	10.5
Fishing	118,245	117,244	1.3	1.2	-0.5	-0.8	-0.2	-0.3
Industries	**2,495,721**	**2,518,964**	**26.7**	**26.1**	**4.1**	**0.9**	**32.0**	**7.8**
Mining and Quarrying	237,381	225,321	2.5	2.3	9.1	-5.1	6.4	-4.0
Manufacturing	1,448,383	1,491,654	15.5	15.5	3.3	3.0	14.9	14.4
Electricity, Gas, Water and Waste Treatment	135,932	142,303	1.5	1.5	3.9	4.7	1.6	2.1
Construction	674,025	659,687	7.2	6.8	4.3	-2.1	9.1	-4.8
Services	**5,311,107**	**5,560,849**	**56.8**	**57.7**	**3.6**	**4.7**	**59.4**	**83.3**
Wholesale and Retail Trade, Transportation and Storage, and Accommodation and Food Service Activities	2,158,118	2,244,056	23.1	23.3	3.6	4.0	24.1	28.7
Information and Communication	57,870	63,021	0.6	0.7	9.5	8.9	1.6	1.7
Financial, Insurance and Real Estate Activities including Ownership of Dwellings	1,245,274	1,346,781	13.3	14.0	6.7	8.2	25.4	33.8
Professional Services and Other Personal Service Activities	1,072,328	1,122,590	11.5	11.6	3.3	4.7	11.2	16.8
Public Administration, Defence, Education, Human Health and Social Work Activities	777,518	784,401	8.3	8.1	-1.2	0.9	-3.0	2.3
Gross Value Added at Basic Price	**8,449,194**	**8,752,736**	**90.4**	**90.8**	**3.4**	**3.6**	**90.6**	**101.2**
Taxes less Subsidies on products	895,645	891,993	9.6	9.2	3.3	-0.4	9.4	-1.2
Gross Domestic Product at Market Price	**9,344,839**	**9,644,728**	**100.0**	**100.0**	**3.4**	**3.2**	**100.0**	**100.0**
Net Primary Income from Rest of the World	-249,616	-266,091			-3.6	-6.6		
Gross National Income at Market Price	**9,095,223**	**9,378,637**			**3.4**	**3.1**		

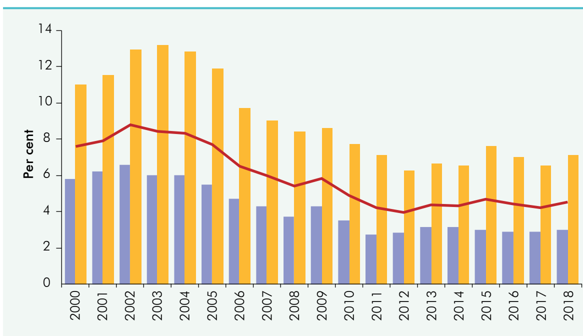
(a) Based on the GDP estimates (base year 2010)
(b) Provisional
(c) Revised

Source: Department of Census and Statistics

3.8 per cent, respectively, during the year. The marginal contraction of 0.6 per cent witnessed in public administration and defence activities dampened the growth in services activities to some extent in 2018.

The unemployment rate increased marginally to 4.4 per cent in 2018 compared to 4.2 per cent recorded during 2017. Both male and female unemployment rates increased during the year to 3.0 per cent and 7.1 per cent, respectively, from 2.9 per cent and 6.5 per cent, respectively, in the previous year. Meanwhile, unemployment among youth aged 20-24 years and 25-29 years remained high at 20.1 per cent and 10.4 per cent, respectively, during the year. Unemployment among females with higher education attainment, i.e., GCE A/L and above, was notably higher at 13.2 per cent in 2018, compared to 11.3 per cent recorded during 2017. The labour force participation rate (LFPR) fell considerably in 2018 to 51.8 per cent from 54.1 per cent during the previous year. LFPR among both males and females declined in 2018 to 73.0 per cent and 33.6 per cent, respectively. With the decline in LFPR amidst the marginal increase in the unemployment rate, the employed population declined by 2.4 per cent to 8.015 million during 2018. Meanwhile, the agriculture sector accounted for 25.5 per cent of the employed population while the industry and services sector shares were 27.9 per cent and 46.6 per cent, respectively, during the year. In 2018, the total number of departures

Figure 1.3
Unemployment Rate



Source: Department of Census and Statistics

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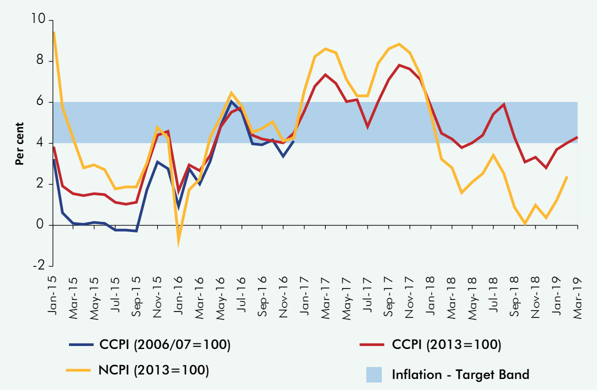
for foreign employment continued to decline with a fall in male departures while female departures increased.

Despite the sharp depreciation of the rupee against major currencies and transitory price pressures due to upward revisions to prices of domestic petroleum products and other administratively determined prices, both headline and core inflation remained subdued in 2018 as a result of well anchored inflation expectations under the enhanced monetary policy framework. Headline inflation, as measured by the year-on-year change in the Colombo Consumer Price Index (CCPI, 2013=100), was broadly on a downward path in 2018. The short-lived pickup in headline inflation during mid 2018 was mainly due to cost push factors arising from upward adjustments in domestic petroleum prices and volatile food prices. Inflation decelerated significantly during the latter part of the year and reached levels even lower than the desired mid single digit levels, primarily due to low food prices, downward adjustment of selected administratively determined prices as well as the reduction of the Special Commodity Levy and Telecommunication Levy. Accordingly, year-on-year headline inflation based on CCPI declined to 2.8 per cent by end 2018 from 7.1 per cent at end 2017. Headline inflation, as measured by the year-on-year change in the National Consumer Price Index (NCPI, 2013=100), followed the same trend as CCPI, peaking in July 2018 and remaining at low single digit levels thereafter. Year-on-year headline inflation based on NCPI declined sharply to 0.4 per cent by December 2018 from 7.3 per cent at end 2017. Headline inflation, as measured by the year-on-year change in both CCPI and NCPI, showed some acceleration in the first quarter of 2019 mainly due to higher non-food inflation driven by increased expenditure on certain items such as

Figure 1.4
Headline Inflation (Year-on-Year)



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

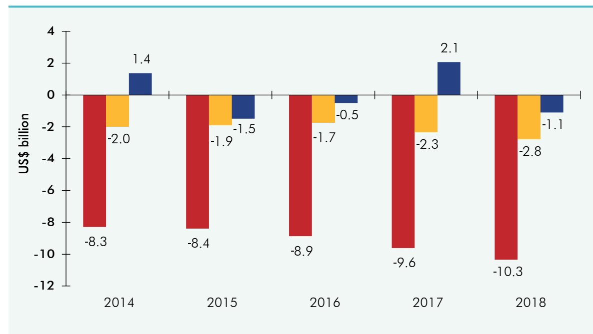
house rentals and education. Accordingly, year-on-year headline inflation, as measured by CCPI, increased to 4.3 per cent by March 2019, while NCPI based headline inflation rose to 2.4 per cent by February 2019. Core inflation remained at low single digit levels throughout 2018, reflecting the lagged impact of the relatively tight monetary policy stance maintained in the past. Year-on-year core inflation based on CCPI decelerated to 3.1 per cent by end 2018 from 4.3 per cent recorded at end 2017, reflecting subdued demand pressures in the economy. NCPI based core inflation accelerated marginally to 3.1 per cent (year-on-year) by end 2018 in comparison to 2.7 per cent at end 2017. Price adjustments in the housing and education sectors in January 2019 contributed to an increase in underlying inflation, resulting in CCPI based year-on-year core inflation accelerating to 5.6 per cent by March 2019 and NCPI based year-on-year core inflation accelerating to 5.5 per cent by February 2019.

External Sector Developments

Sri Lanka's external sector experienced a setback during 2018, with increased foreign exchange outflows, particularly due to higher import expenditure and capital outflows.

The trade deficit expanded during 2018, as the growth of import expenditure, driven by a significant increase in the imports of vehicles and fuel (as well as gold during early 2018), outpaced the growth of export earnings. The deficit in the primary income account widened with an increase in interest payments on foreign loans by the government and dividend payments by direct investment enterprises (DIEs). Trade in services recorded a notable surplus during the year, driven mainly by earnings from tourism, transportation and computer services sectors. Meanwhile, workers' remittances, which grew during the first nine months of the year moderated in the latter part of 2018 impacted by the prevailing geopolitical uncertainties in the Middle Eastern region, variations in oil prices as well as the drop in overall labour migration. Consequently, the current account deficit widened to 3.2 per cent of GDP in 2018 from 2.6 per cent of GDP in 2017. The financial account recorded notable inflows, mainly on account of the issuance of International Sovereign Bonds (ISBs), the receipt of the fifth tranche of the IMF-Extended Fund Facility (IMF-EFF), the foreign currency term financing facility (FCTFF) and FDI inflows including proceeds from the long-lease of the Hambantota Port. However, foreign investment in the government securities market and the Colombo Stock Exchange (CSE) recorded net outflows since the second quarter of 2018, exerting pressure on the external sector. Further, the banking sector also recorded a sizeable amount of international bond maturities during the year. Gross official reserves, which reached its historically highest level in the first half of the year, declined by end 2018 with an increased trade deficit, higher foreign debt service payments, capital outflows and the sale of foreign exchange by the Central Bank in the domestic foreign exchange market to counter undue fluctuations in the exchange rate. Consequently, the overall balance of the balance of payments (BOP) recorded a deficit of US dollars 1.1 billion by end 2018. The broad-based strengthening of the US dollar, political uncertainty that prevailed in the latter part of 2018 and tight liquidity conditions in the domestic foreign exchange market exerted pressure on the Sri Lankan rupee. The Central Bank allowed greater flexibility in the determination of the exchange rate and pursued a market based exchange rate policy with a cautious approach in intervening in the domestic foreign exchange market, which took into consideration the significant volatility in the exchange rate and the level of gross official reserves. Consequently, the Sri Lankan rupee depreciated by 16.4 per cent against the US dollar in 2018, while the Central Bank supplied US dollars 1,120 million to the domestic foreign exchange market on a net basis. While the depreciation pressure was partly addressed by the Central Bank's intervention in the foreign exchange market, further policy measures were taken by the Central Bank and the government to restrain foreign exchange outflows owing to rising import demand for gold, motor vehicles and certain non-essential consumer goods during the year. Meanwhile, the Real Effective Exchange Rate (REER) index remained below the base

Figure 1.5
Balance of Payments



Source: Central Bank of Sri Lanka

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year level throughout 2018, reflecting continued competitiveness of Sri Lanka's external sector in terms of currency movements.

The deficit in the trade account expanded in 2018. The trade deficit widened significantly during the first half of the year owing to high import expenditure incurred on gold, fuel and personal motor vehicles along with modest export performance. However, the trade deficit improved towards the latter part of the year as a result of the policy measures adopted by the Central Bank and the government to curtail import expenditure as well as the substantial depreciation of the Sri Lankan rupee. The overall trade deficit widened to US dollars 10,343 million in 2018 from US dollars 9,619 million in 2017. The trade deficit as a percentage of GDP widened to 11.6 per cent in 2018 from 10.9 per cent in 2017.

Earnings from merchandise exports, which rebounded strongly in 2017 continued to grow in 2018. Accordingly, earnings from exports grew by 4.7 per cent to US dollars 11,890 million in 2018 from US dollars 11,360 million in 2017. The restoration of the European Union - Generalised System of Preferences Plus (EU-GSP+) facility, conducive external trade policies together with strong institutional support and the flexible exchange rate policy maintained by the Central Bank buttressed the performance of export earnings. Earnings from industrial exports contributed to the expansion in export earnings in 2018, while earnings from agricultural and mineral exports declined. Industrial exports, which accounted for around 78 per cent of total exports, increased by 8.4 per cent, year-on-year, to US dollars 9,258 million in 2018. The increase in export earnings from textiles and garments (5.7 per cent), petroleum products (43.2 per cent), food, beverages and tobacco (17.7 per cent), machinery and mechanical appliances (17.3 per cent) and rubber products (4.8 per cent) mainly contributed to the improved performance in industrial exports. However, contractions were recorded in earnings from transport equipment (-25.9 per cent), leather, travel goods and footwear (-6.8 per cent) and printing industry products (-35.2 per cent) during the year when compared to the previous year. Earnings from agricultural exports, which accounted for about 22 per cent of total exports, declined by 6.8 per cent, year-on-year, to US dollars 2,579 million in 2018 due to poor performance in most subcategories, particularly tea (-6.6 per cent), spices (-11.3 per cent) and coconut (-10.6 per cent). However, earnings from seafood exports rose by 10.5 per cent with higher exports to the EU market. Meanwhile, earnings from mineral exports declined by 0.4 per cent, year-on-year, due to lower earnings from earths and stones, and precious metals. The US remained the major export destination accounting for 25.9 per cent of Sri Lanka's exports, followed by the UK (8.2 per cent), India (6.5 per cent), Germany (5.2 per cent) and Italy (4.8 per cent). Meanwhile, the export volume index increased marginally by 0.5 per cent in 2018 while the export unit value index increased by 4.2 per cent, implying that, on a cumulative basis, the growth in exports was driven mainly by higher prices rather than volumes in 2018.

Import expenditure, which recorded a substantial growth during the first half of 2018, gradually decelerated thereafter, as a result of the policy measures adopted by the Central Bank and the government as well as the sharp depreciation of the Sri Lankan rupee. Accordingly, import expenditure, which grew by 10.4 per cent, year-on-year, in the first nine months of 2018, recorded a contraction of 5.9 per cent in the last quarter of the year. Overall, expenditure on imports grew by 6.0 per cent to US dollars 22,233 million in 2018, in comparison to US dollars 20,980 million in 2017. Within this increase, expenditure on non-fuel imports increased by 3.0 per cent to US dollars 18,081 million during the year. Expenditure on intermediate goods imports, which accounted for more than half of the total imports, increased by 9.2 per cent to US dollars 12,488 million mainly led by higher expenditure incurred on fuel (21.1 per cent), textiles and textile articles (4.9 per cent) and fertiliser (154.4 per cent). Expenditure on gold imports also contributed significantly to higher import growth during the first four months of the year. Considering the possible illicit arbitrage resulting from the tariff differential between India and Sri Lanka on gold imports, the government re-imposed a 15 per cent customs duty on the importation of gold since April 2018. As a result, import expenditure on gold declined considerably since May 2018, with a marginal value of around US dollars 1 million being recorded during the remaining eight months of the year. Further, import expenditure on rubber and articles thereof (-6.6 per cent) and mineral products (-14.0 per cent) decreased in 2018. Meanwhile, consumer goods imports increased by 10.6 per cent to US dollars 4,980 million, mainly due to higher expenditure incurred on non-food consumer goods, despite a considerable reduction recorded in expenditure on food and beverages driven by reduced importation of rice. Expenditure on the importation of personal motor vehicles contributed mainly to the increase in expenditure on non-food consumer goods imports in 2018, registering a 103.6 per cent growth. Expenditure on personal motor vehicle imports increased noticeably during the first eight months of the year mainly due to the increase in importation of vehicles with small engine capacity, hybrid and electric vehicles as a result of the revision to tax structure for vehicles in the Budget 2018. Considering the pressure on the external sector and mainly on the exchange rate from increased vehicle imports, several policy measures were adopted from August 2018 to curtail such imports. As a result, expenditure on vehicle imports declined in November and December 2018. Further, as a result of the policy measures by the Central Bank to discourage non-essential consumer goods imports, such as refrigerators, washing machines, perfumes, mobile phones, etc., import expenditure on many of these categories declined in 2018. Meanwhile, expenditure on investment goods also declined in 2018. India continued to remain the largest source of imports registering its share at 19.0 per cent of total imports followed by China (18.5 per cent), United Arab Emirates (8.3 per cent), Japan (7.1 per cent) and Singapore (6.2 per cent). Meanwhile, the import volume index and the import unit value index increased by 1.8 per cent and 4.1 per cent, respectively, in 2018 indicating that the growth of imports was driven mainly by the price impact rather than the volume impact during the year.

The current account deficit widened significantly with increased trade and primary income account deficits, despite healthy flows to the services and secondary income accounts during 2018. The trade deficit expanded significantly during 2018 as import expenditure outpaced the growth of export earnings. This development, along with a higher deficit in the primary income account, led to the widening of the current account deficit. Improvements in earnings of services exports, mainly on account of higher earnings from tourism, as well as inflows of workers' remittances partially offset the widened current account deficit. Tourist arrivals grew by 10.3 per cent during 2018, while earnings from tourism grew by 11.6 per cent to US dollars 4,381 million in 2018 in comparison to US dollars 3,925 million in 2017. Workers' remittances declined by 2.1 per cent to US dollars 7,015 million in 2018, following the decline of 1.1 per cent observed in the previous year. Consequently, the current account deficit is estimated to have widened to US dollars 2.8 billion in 2018.

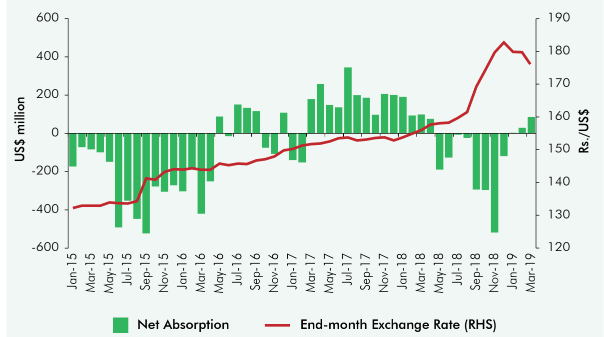
The financial account recorded higher inflows, despite significant outflows from the government securities market and the CSE as well as debt servicing requirements during 2018. Proceeds from the issuance of ISBs, receipt of the FCTFF, receipt of the fifth tranche of the IMF-EFF and FDI inflows including proceeds from the long-lease of the Hambantota Port supported the financial account during the year. However, net outflows of foreign investment from the government securities market and the secondary market of the CSE exerted pressure on the BOP, especially since the second quarter of 2018. These developments, together with higher foreign currency debt service payments, resulted in the overall balance recording a deficit of US dollars 1,103 million by end 2018. Meanwhile, the financial account recorded notable inflows in the first quarter of 2019 owing to inflows to the government securities market and issuance of ISBs amounting to US dollars 2.4 billion in March 2019, which contributed to improve investor sentiment, in addition to the repayment of the maturing ISB of US dollars 1.0 billion in January 2019.

Gross official reserves, which reached the historically highest level of US dollars 9.9 billion at end April 2018, moderated thereafter with foreign debt service payments and Central Bank intervention in the domestic foreign exchange market. During the first four months of the year, relatively stable domestic foreign exchange market conditions enabled the Central Bank to build up international reserves through the absorption of foreign exchange from the market together with the receipt of ISB proceeds and the second tranche of the Hambantota Port long-lease. However, tightening global financial conditions weighed on the foreign exchange inflows in the BOP leading to capital outflows. Moreover, on the domestic front, the increased demand for foreign currency from importers and the lack of foreign exchange conversions by exporters necessitated the Central Bank to intervene in the domestic market by supplying foreign exchange, particularly from May 2018 onwards, to curtail the undue depreciation pressure on the Sri Lankan rupee. Consequently, by end 2018, gross official reserves declined to US dollars 6.9 billion, which was sufficient to finance 3.7 months of imports. Thereafter, gross official reserves are estimated to have improved substantially with the receipt of the proceeds from the issuance of ISBs in March 2019.

Sri Lanka's outstanding external debt increased, mainly due to the increase in external debt of the general government and direct investment enterprises (DIEs) in 2018. The government's external borrowings were mainly financed by the issuance of ISBs totalling US dollars 2.5 billion, project loan inflows of US dollars 1.2 billion and FCTFF of US dollars 1.0 billion during the year. The outstanding liabilities of the Central Bank increased with the receipt of the fifth tranche of the IMF-EFF while the outstanding liabilities with the Asian Clearing Union (ACU) decreased compared to the beginning of 2018. A notable decline in outstanding external debt of deposit taking corporations was observed with the maturing of international bonds issued by Bank of Ceylon, National Savings Bank and DFCC Bank totalling US dollars 1.35 billion during 2018. Further, outstanding external debt of intercompany borrowing of DIEs recorded an increase while outstanding foreign loans of state owned business enterprises (SOBEs) declined during 2018.

The Central Bank pursued a market based exchange rate policy with greater flexibility in the exchange rate. The exchange rate, which remained relatively stable in the first four months of 2018, came under significant pressure thereafter due to both domestic and external factors. The Central Bank allowed greater flexibility in the determination of the exchange rate while intervening only to curb unwarranted excessive volatility. During the year, Central Bank intervention in the domestic foreign exchange market amounted to a net supply of US dollars 1,120 million, while the Sri Lankan rupee depreciated by 16.4 per cent against the US dollar in 2018, reflecting the degree of pressure created by the tight liquidity conditions in the domestic foreign exchange market as well as changing global financial market conditions. With the nominal depreciation of the Sri Lankan rupee against some major currencies, together with the movements in cross currency exchange rates, both 5-currency and 24-currency Nominal Effective Exchange Rate (NEER) indices declined during 2018. Further, the Real Effective Exchange Rate (REER) index remained below 100 index point level throughout the year, indicating Sri Lanka's continued external competitiveness. Meanwhile, reflecting greater stability of the external sector in early 2019, the Sri Lankan rupee appreciated against the US dollar and most other major currencies in the first quarter of 2019.

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



Source: Central Bank of Sri Lanka

Assisted by the policy measures to curtail non-essential imports and greater political stability, the resilience of the external sector improved somewhat towards the end of 2018 and the first quarter of 2019. The possible delay in further rate hikes by the US Federal Reserve, positive investor sentiment brought about by the repayment of maturing ISB of US dollars 1 billion in January 2019, the extension of the IMF-EFF and the successful issuance of ISBs amounting to US dollars 2.4 billion helped improve the external sector outlook. These developments were complemented by a further reduction in the trade deficit in January 2019, which also contributed to the appreciation of the Sri Lankan rupee in the first quarter of 2019.

Fiscal Sector Developments

The fiscal strategy of the government in 2018 was aimed at continuing the fiscal consolidation measures to reduce the budget

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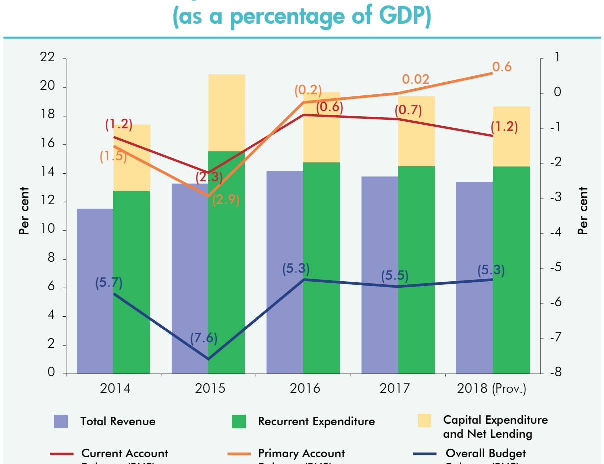
deficit and outstanding debt, while generating a sizable surplus in the primary balance. The overall budget deficit improved to 5.3 per cent of GDP in 2018 from 5.5 per cent of GDP in the previous year, mainly due to lower capital expenditure despite the decline in government revenue collection. Consequently, the primary balance, which excludes interest payments from the overall balance, recorded a surplus of 0.6 per cent of GDP (Rs. 91.4 billion) in 2018 thereby supporting the fiscal consolidation efforts of the government and improving the debt dynamics. The current account deficit, which reflects government dissaving, widened marginally to 1.2 per cent of GDP in 2018, indicating lower than expected revenue collection and overrun in recurrent expenditure largely due to higher expenditure on interest payments. Meanwhile, central government debt as a percentage of GDP increased to 82.9 per cent by end 2018 from 76.9 per cent at end 2017, mainly due to the impact of the depreciation of the rupee, relatively low nominal GDP and net financing of the budget deficit.

Government revenue as a percentage of GDP declined to 13.3 per cent in 2018 from 13.6 per cent recorded in 2017. The decline in

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



Source: Ministry of Finance

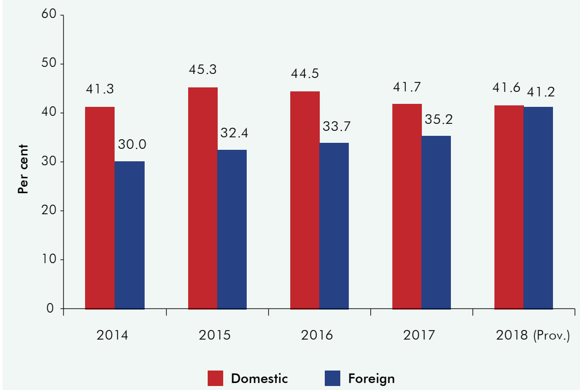
tax revenue from import duties, Value Added Tax (VAT), excise duty on petroleum products and liquor, withholding tax and Cess levy led to the underperformance in revenue collection. Total revenue in nominal terms increased by only 4.8 per cent to Rs. 1,920.0 billion in 2018 from Rs. 1,831.5 billion recorded in the previous year, supported by the nominal increase in the revenue from income taxes, tobacco and cigarettes, VAT and Ports and Airports Development Levy (PAL). The revenue collection from import duties, excise duty on petroleum products, withholding tax and Cess levy declined by 28.9 per cent, 10.4 per cent, 13.0 per cent and 10.4 per cent, respectively, in 2018 compared to 2017. Non tax revenue as a percentage of GDP increased to 1.4 per cent in 2018 from 1.2 per cent in 2017 owing to profit transfers by the Central Bank and the increase in revenue from fees and charges.

Total expenditure and net lending during 2018 declined to 18.6 per cent of GDP from 19.2 per cent in 2017, due to the decline in capital expenditure and net lending. Recurrent expenditure as a percentage of GDP increased marginally to 14.5 per cent in 2018, from 14.4 per cent in 2017, and recorded a nominal increase of 8.4 per cent to Rs. 2,089.7 billion in 2018, from Rs. 1,927.7 billion in 2017. Total interest expenditure, in nominal terms, increased by 15.9 per cent to Rs. 852.2 billion in 2018, from Rs. 735.6 billion in 2017, while expenditure on foreign interest payments increased by 29.0 per cent to Rs. 212.7 billion in 2018, reflecting the effects of exchange rate variations and the rise in global interest rates. Capital expenditure and net lending declined by 6.5 per cent in nominal terms to Rs. 603.5 billion during the year in comparison to Rs. 645.4 billion in 2017. Accordingly, capital expenditure and net lending as a percentage of GDP also declined to 4.2 per cent in 2018 from 4.8 per cent in 2017. As a result, public investment declined to 4.3 per cent of GDP (Rs. 625.0 billion) in 2018 from 4.9 per cent of GDP (Rs. 657.4 billion) in the previous year.

More than half of the budget deficit for 2018 was financed through domestic sources. In total financing of the budget deficit, 57.5 per cent was sourced domestically, while the balance was met from foreign sources in 2018. The government relied mainly on domestic non bank sources in 2018, accounting for 75.0 per cent (Rs. 327.8 billion) of total net domestic financing compared to 36.2 per cent (Rs. 106.5 billion) in 2017. As a result, borrowings from the banking sector declined significantly to Rs. 109.5 billion (25.0 per cent) in 2018, from Rs. 187.7 billion (63.8 per cent) in 2017. During 2018, financing from commercial banks recorded a net repayment of Rs. 136.6 billion compared to borrowings of Rs. 375.7 billion in 2017, owing to higher net repayments of Sri Lanka Development Bonds (SLDBs) and Treasury bonds. However, borrowings from the Central Bank increased notably to Rs. 246.1 billion in 2018, from a net repayment of Rs. 187.9 billion in 2017 due to increased purchases of Treasury bills by the Central Bank mainly as a result of the tight liquidity conditions in the domestic money market. Foreign financing of the budget deficit declined to Rs. 323.5 billion in 2018, in comparison to Rs. 439.2 billion in 2017, partly reflecting the impact of significant outflows from the foreign holdings of rupee denominated Treasury bonds and Treasury bills, which amounted to Rs. 141.1 billion during the year. Net borrowings through ISBs amounted to Rs. 390.4 billion (US dollars 2.5 billion) in 2018. Meanwhile, net borrowings through the FCTFF and foreign project loans amounted to Rs. 66.6 billion and Rs. 7.7 billion, respectively, in 2018.

Central government debt as a percentage of GDP increased to 82.9 per cent by end 2018 from 76.9 per cent at end 2017. The increase

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



Sources: Ministry of Finance
Central Bank of Sri Lanka

in the debt to GDP ratio in 2018 was a combined outcome of the impact of the depreciation of the rupee against major foreign currencies, relatively low nominal GDP and net borrowings to finance the budget deficit. In nominal terms, central government debt increased to Rs. 11,977.5 billion by end 2018 from Rs. 10,313.0 billion at end 2017. Of this, total outstanding domestic debt increased by 7.6 per cent to Rs. 6,018.0 billion, while the rupee value of total outstanding foreign debt increased substantially by 26.3 per cent to Rs. 5,959.5 billion by end 2018. Although the depreciation of the Sri Lankan rupee is reflected as an increase in the government foreign currency debt stock in rupee terms, the debt stock denominated in foreign currency would remain unchanged in terms of foreign currency. As the debt denominated in foreign currency would be serviced using foreign currency inflows to the government, the impact of such a nominal increase in the outstanding balance due to the depreciation of the rupee would not matter for debt servicing, provided the confidence of foreign creditors and investors is maintained to attract sufficient inflows. Since the average interest rate on foreign currency debt is much lower than that on rupee denominated debt, this interest rate differential would largely

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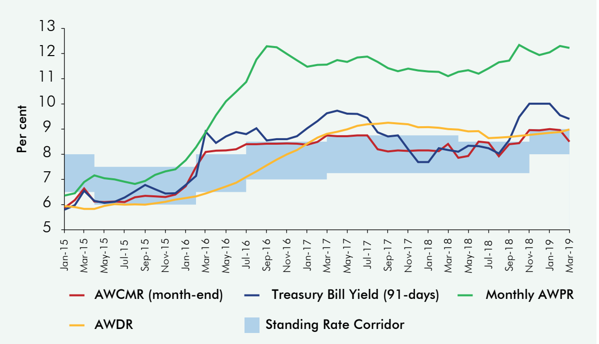
compensate for the depreciated value of interest payments in rupee terms over the maturity periods of such foreign currency loans.

Monetary Sector Developments

With the realisation of the objective of the tight monetary policy stance that was in place since end 2015, the Central Bank signalled an end to the monetary tightening cycle in April 2018 and maintained a neutral monetary policy stance thereafter. Favourable developments in inflation, inflation outlook as well as subpar performance in the real economy encouraged the Central Bank to reduce its policy rates in April 2018. Accordingly, the Central Bank reduced the Standing Lending Facility Rate (SLFR) by 25 basis points to 8.50 per cent in April 2018, thus narrowing the policy rate corridor to 125 basis points. In view of the developments in the global economy amidst measures by the US Federal Reserve to continue its stance on monetary policy normalisation and its impact on the stability of the external sector of the domestic economy, the Central Bank maintained a neutral monetary policy stance since April 2018. The large and persistent liquidity deficit in the domestic money market, particularly since September 2018, required policy intervention by the Central Bank. Accordingly, in order to inject liquidity on a permanent basis, the Statutory Reserve Ratio (SRR) applicable on all rupee deposit liabilities of commercial banks was reduced by 1.50 percentage points to 6.00 per cent in mid-November 2018. Nevertheless, to neutralise the impact of this SRR reduction, the Standing Deposit Facility Rate (SDFR) was increased by 75 basis points and SLFR was increased by 50 basis points further narrowing the policy rate corridor. Despite the liquidity injection in November 2018, the liquidity deficit in the domestic money market continued to persist at high levels. Accordingly, the SRR was reduced by a further 1.00 percentage point to 5.00 per cent with effect from 01 March 2019, while maintaining SDFR and SLFR unchanged at 8.00 per cent and 9.00 per cent, respectively.

Figure 1.9
Standing Rate Corridor and Selected Market Interest Rates



Source: Central Bank of Sri Lanka

Amidst tight liquidity conditions and the tight monetary policy stance that was maintained until April 2018, most market lending and deposit interest rates of commercial banks remained high in both nominal and real terms during 2018. While some deposit rates declined with the policy rate adjustment in April 2018, most deposit and lending rates of commercial banks increased in 2018. Accordingly, the Average Weighted Deposit Rate (AWDR), which captures the movements in interest rates of all outstanding interest bearing rupee deposits held with commercial banks, decreased to 8.81 per cent by end 2018 from 9.07 per cent recorded at end 2017. Tight liquidity conditions amidst continued high demand for credit caused lending rates of commercial banks to remain high in 2018. Accordingly, the Average Weighted Lending Rate (AWLR), which is based on interest rates of all outstanding loans and advances extended by commercial banks, increased to 14.40 per cent by end 2018 from 13.88 at end 2017. Meanwhile, yields on government securities, which showed mixed movements during the first nine months of

2018, increased notably during the last quarter of 2018, reflecting changes in market sentiments as well as the funding requirement of the government amidst tight liquidity conditions. Accordingly, in 2018, primary market yields on the 91-day, 182-day and 364-day Treasury bills increased by 232, 169 and 230 basis points, respectively. Moreover, yields on Treasury bonds in the primary market also displayed mixed movements during 2018. The secondary market yield curve for government securities shifted upwards during 2018. Despite some moderation, interest rates applicable on corporate debt securities remained high during the year. In the meantime, interest rates applicable on foreign currency deposits maintained with commercial banks showed mixed movements amidst increasing interest rates in global markets. Meanwhile, as a result of improved sentiments and in response to the Central Bank's action to ease the liquidity shortage in the domestic money market, along with the issuance of ISBs in March 2019, some downward shift in the secondary market yield curve of government securities as well as a decline in primary market yields were observed in early 2019. Bank lending and deposit rates are yet to respond to monetary policy adjustments and the declining yields on benchmark government securities.

Reserve money recorded a moderate growth during 2018, particularly in the latter part of the year, with the downward adjustment in the SRR in November 2018. In absolute terms, reserve money increased by only Rs. 21.3 billion to Rs. 961.1 billion during 2018, compared to the expansion of Rs. 83.6 billion in 2017. In terms of liabilities, the increase in currency in circulation contributed entirely to the expansion of reserve money while commercial banks' reserve balances with the Central Bank declined during 2018 as the SRR was reduced in November 2018. From the assets side, the expansion of reserve money during 2018 was driven entirely by the increase in net domestic assets (NDA) of the Central Bank. The expansion in NDA of the Central Bank was the result of a significant expansion in credit extended to the government on a net basis (NCG) by the Central Bank, reflecting an increase in the Treasury bill holdings of the Central Bank. Treasury bill holdings of the Central Bank (net of repurchase transactions), which contracted by Rs. 304.5 billion to Rs. 25.6 billion by end 2017, increased notably by Rs. 247.4 billion to Rs. 273.0 billion by end 2018. This was mainly due to term and outright purchases of government securities by the Central Bank from the market in order to inject liquidity to the domestic money market. However, in contrast to the increase in NDA, net foreign assets (NFA) of the Central Bank declined by Rs. 95.6 billion in 2018, compared to the sharp increase of Rs. 287.5 billion in the previous year. The decline in NFA was a result of the increase in foreign liabilities, particularly with international organisations and the supply of foreign exchange to the domestic market by the Central Bank during the year.

Broad money (M_{2b}) growth, which gradually moderated since late 2017, maintained its decelerating trend throughout the year, largely on account of the contraction in NFA of the banking system. M_{2b} growth decelerated to 13.0 per cent, year-on-year, by end 2018, from 16.7 per cent at end 2017. Broad money growth during 2018 was entirely due to the expansion in NDA of the banking system, as NFA of the banking system contracted during the year. NFA of the banking system declined by Rs. 188.5 billion during 2018 as a result of the decline in foreign reserves of the Central Bank and the foreign currency financial position of commercial banks, amidst capital outflows and rising pressures on the exchange rate. Meanwhile, NDA of the banking

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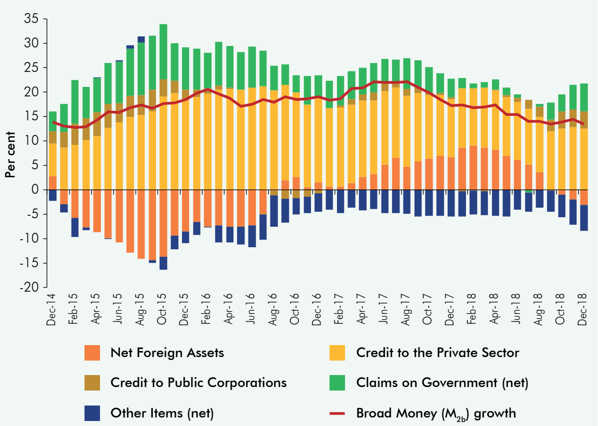
Figure 1.10
Broad Money Growth and Contribution

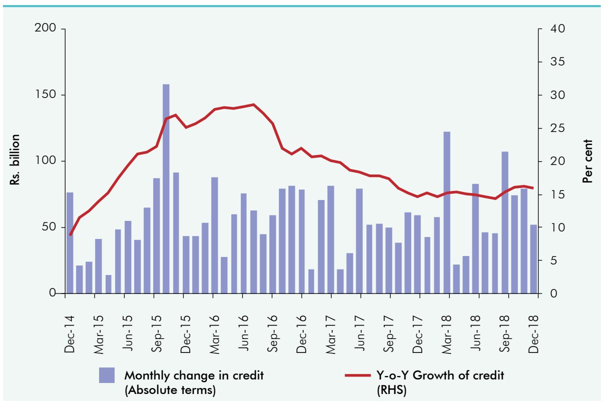


Source: Central Bank of Sri Lanka

sector expanded significantly by Rs. 1,008.8 billion in 2018, which was mainly attributed to the considerable increase in credit flows to the private sector, as well as the surge in credit to the government and SOBEs during the year. Within NDA, NCG increased significantly by Rs. 346.7 billion in 2018, compared to Rs. 196.4 billion in the previous year driven by the expansion in credit from the Central Bank and commercial banks during the period under review. Accordingly, NCG from the Central Bank increased by Rs. 246.3 billion during 2018, in comparison to a significant contraction of Rs. 187.9 billion in 2017, while NCG from commercial banks increased by Rs. 100.5 billion during 2018, in comparison to the significant increase of Rs. 384.3 billion in 2017. Meanwhile, credit obtained by public corporations from the banking system expanded by Rs. 218.4 billion in 2018, in comparison to the increase of Rs. 23.2 billion in 2017.

Credit to the private sector by commercial banks grew at a slower pace during the first eight months of 2018 while some acceleration was witnessed during the last four months of 2018. The year-on-year growth of private sector credit moderated to 14.3 per cent by end August 2018 from 14.7 per cent at end 2017. However, private sector credit growth subsequently accelerated to 15.9 per cent by end 2018 with private sector borrowings increasing in anticipation of government and Central Bank policies to curtail imports as well as the rising import costs with currency depreciation. In absolute terms, credit to the private sector expanded by Rs. 762.1 billion during 2018, compared to the increase of Rs. 613.4 billion in 2017. While credit extended to the Services sector and Personal Loans and Advances expanded during 2018, some moderation was observed in the growth of credit extended to the Industry sector and the Agriculture and Fishing sectors. Accordingly, the year-on-year growth of credit to the Industry sector moderated to 15.3 per cent by end 2018 from 19.6 per cent at end 2017, largely due to the slowdown in credit to the construction sector. Meanwhile, credit to the Agriculture and Fishing, and Services sectors grew by 14.0 per cent and 17.8 per cent, respectively, by end 2018 in comparison to the growth of 14.1 per cent and 8.3 per cent, respectively, recorded at end 2017. Personal Loans and Advances also grew by 20.3 per cent, year-on-year, by end 2018 in comparison to the year-on-year growth of 18.5 per cent at end 2017 on account of the expansion

Figure 1.11
Credit Granted by Commercial Banks to the Private Sector



Source: Central Bank of Sri Lanka

in credit in terms of pawning advances, credit cards as well as credit disbursed to purchase consumer durables during the year.

Financial Sector Developments

The financial sector recorded a moderate expansion in 2018 amidst challenging market conditions, both globally and domestically. The banking sector that dominates the financial sector recorded a moderate growth in total assets and maintained its capital and liquidity levels well above the minimum statutory requirement. The growth of assets was driven mainly by the expansion in the loan portfolio, which increased significantly during the second half of 2018 partly due to the depreciation of the Sri Lankan rupee. The increase in loans accounted for 84.1 per cent of the asset growth of the banking sector during 2018. Deposits continued to be the main source of funding representing 72.0 per cent of total liabilities of the banking sector. The quality of the banking sector assets deteriorated due to challenging global and domestic market conditions, as reflected by the increase in Non-Performing Loan (NPL) ratios. Gross NPL ratio, which recorded a historical low figure of 2.5 per cent at end 2017, increased to 3.4 per cent by end 2018. Profitability of the banking sector moderated in 2018, due to the deterioration in asset quality, rise in operating costs and increase in taxes. Lower profits of the sector, during 2018, were reflected by the decline in Return on Assets (ROA) and Return on Equity (ROE). The Central Bank continued to introduce prudential policy measures and regulations to strengthen the safety and soundness of the banking sector.

The growth of the Licensed Finance Companies (LFCs) and Specialised Leasing Companies (SLCs) sector slowed in 2018, with the decline in credit growth and profitability during the year. Lending activities of the sector decelerated mainly due to recent fiscal and macroprudential policy measures, which were taken to curtail the imports of motor vehicles and credit facilities for purchasing vehicles. The profitability of the sector declined during the year mainly due to increased funding cost and higher loan loss provisions made against NPLs. Signs of stress towards the sector's profitability during the year were reflected by the decrease in ROA and ROE. The Central Bank continued to strengthen the supervisory and regulatory framework of LFCs and SLCs and took action to revive or close down weak LFCs. Other sectors of the financial system, including superannuation funds, insurance and primary dealers expanded moderately during 2018. Nevertheless, a deterioration in the performance of the Unit Trust sector was recorded during the year.

Rupee liquidity in the domestic money market, which displayed mixed movements until mid-September 2018, turned into persistent deficit levels thereafter mainly due to foreign exchange related transactions carried out by the Central Bank. The imposition of the margin requirement on Letters of Credit (LCs) on the importation of motor vehicles and the statutory requirement that such deposits be maintained with the Central Bank also contributed to the liquidity deficit to some extent. Although the pressure on domestic money market eased considerably with the injection of liquidity by way of the SRR reduction in November 2018, liquidity in the domestic money market continued to remain at deficit levels by end 2018 partly due to foreign exchange sales by the Central Bank. In the domestic foreign exchange market, the Central Bank intervened to ease the continued pressure on the exchange rate and curb the excess volatility arising from substantial capital outflows and increased import demand, particularly from May 2018. Meanwhile, the CSE recorded a dismal performance in 2018, impacted by significant

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foreign outflows driven by increased pressure on the exchange rate, political uncertainty and the shift in investor sentiments due to domestic and global developments. The negative developments were reflected by the decline in most indicators including share prices, turnover, market capitalisation and Price to Earnings (PE) ratios throughout the year. Meanwhile, the Central Bank further broadened the regulatory and supervisory activities relating to payment and settlement systems during the year with the objective of ensuring safe and efficient payment and settlement infrastructure required for households and the corporate sector to facilitate economic activities.

1.3 Global Economic Environment and Outlook

As per the January 2019 update of the World Economic Outlook (WEO) of the IMF, a moderation in the expansion of global economic activity was observed in 2018, on account of mounting economic and political headwinds internationally. Compared to 2017, global growth was increasingly unsynchronised during 2018, as most economies, apart from the US, experienced a slowdown in economic activity. In spite of the notable growth in economic activity in the US, growth among advanced economies grew modestly during 2018, with a larger than expected moderation in economic activity in the UK, Euro area and Japan. Meanwhile, emerging market and developing economies continued to grow strongly, albeit at a slower pace than in the previous year, underpinned by improved domestic demand and higher oil prices favouring oil-exporting economies, amidst a challenging global macroeconomic environment driven by rising trade tensions and tighter financial conditions. Further, the uncertainty surrounding the Brexit and mounting tensions from the Sino-American trade war led to a moderation

Table 1.4
Global Economic Developments and Outlook (a)

Item	2017	2018	2019 (Proj)	2020 (Proj)
World Output	**3.8**	**3.7**	**3.5**	**3.6**
Advanced Economies	2.4	2.3	2.0	1.7
United States	2.2	2.9	2.5	1.8
Euro Area	2.4	1.8	1.6	1.7
United Kingdom	1.8	1.4	1.5	1.6
Japan	1.9	0.9	1.1	0.5
Emerging Market and Developing Economies	4.7	4.6	4.5	4.9
Emerging and Developing Asia	6.5	6.5	6.3	6.4
China	6.9	6.6	6.2	6.2
India	6.7	7.3	7.5	7.7
World Trade Volume (Goods and Services)	**5.3**	**4.0**	**4.0**	**4.0**
Price Movements				
Consumer Prices				
Advanced Economies	1.7	2.0	1.7	2.0
Emerging Market and Developing Economies	4.3	4.9	5.1	4.6
Commodity Prices (US$)				
Oil	23.3	29.9	-14.1	-0.4
Non Fuel	6.4	1.9	-2.7	1.2
Six-month London Interbank Offered Rate (LIBOR) on US$ Deposits (per cent)	**1.5**	**2.5**	**3.2**	**3.8**

(a) Annual percentage change unless otherwise indicated.

Source: World Economic Outlook (January 2019), IMF

in global trade during 2018. Meanwhile, oil prices, which were on an increasing trend during the first nine months of 2018, caused some acceleration in inflation in both advanced economies and emerging market and developing economies during the year.

Amidst mounting uncertainties in the global economic environment, a gradual approach of monetary policy normalisation was undertaken by most advanced economies during 2018, citing favourable developments in domestic market conditions, necessitating emerging market economies to respond with the view of containing the adverse spillover effects of such normalisation. The US Federal Reserve, which commenced tightening monetary policy in late 2015, tightened its stance further by increasing the Federal Funds target rate in four instances during 2018, responding to improved domestic demand and strengthening labour markets. However, considering the signals that the US economy is slowing down while inflationary pressures remain subdued, the

Federal Reserve adopted a more cautious approach from January 2019. Meanwhile, the Bank of England (BOE) increased its policy rates in August 2018, with domestic economic activity gathering momentum and inflation hovering above the targeted levels. However, the intensification of tensions surrounding Brexit along with subdued domestic and global growth caused the BOE to remain increasingly dovish. With inflation gaining momentum and risks to the growth outlook remaining broadly balanced, the European Central Bank (ECB) announced the gradual winding down of quantitative easing (QE). Accordingly, by end 2018, the net asset purchases concluded, although Brexit woes and rising global risks resulting from escalating trade tensions led the ECB to continue its accommodative stance on monetary policy. Having little success on the achievement of the inflation target, the Bank of Japan (BOJ) continued with its accommodative monetary policy stance during 2018. Meanwhile, emerging market economies were impacted by monetary policy normalisation measures in key advanced economies and the ensuing capital outflows as well as rising trade tensions. In response to these economic headwinds, a number of central banks in emerging market economies raised interest rates. The Reserve Bank of India (RBI) raised its interest rates twice during 2018, which was later reversed with a policy rate cut in early 2019. The lacklustre growth and investor confidence, and rising risks to financial stability required China to ease fiscal and monetary policies during 2018. As a result of global economic and financial market developments and domestic vulnerabilities, currencies of several emerging market economies depreciated considerably against the US dollar during 2018.

The balance of risks to global growth, as highlighted in the January 2019 update of WEO, is tilted to the downside indicating the possibility of some slowdown in the global economy going forward. Central banks in most advanced, and emerging market and developing economies have taken measures to tighten monetary policy during 2018 in view of containing undue inflationary pressures arising from the favourable economic outlook, stronger labour markets and subsequent firming up of demand. However, with increased uncertainty surrounding global and domestic macroeconomic developments and inflationary pressures remaining somewhat muted, the policy stance of major central banks turned more accommodative commencing early 2019. Nonetheless, several risks remain that could weigh down on global growth prospects. The continuation of the US-China trade tensions could bring in greater policy uncertainties among economies and could restrain global trade, thereby weakening global growth prospects. Also, a further slowdown in the Chinese economy will require continued fiscal and monetary stimulus, failing which the economy could be increasingly vulnerable to a prolonged downturn. This could wane demand for commodities leading to a drop in prices, severely affecting commodity-exporting economies and global growth at large. The ongoing uncertainties surrounding Brexit would impede growth prospects in the UK, Eurozone as well as in other partner economies. In the meantime, oil prices are expected to remain subdued, particularly with a possible supply glut due to US shale production and lack of cooperation among OPEC economies. Although moderate oil prices are expected to reduce global inflationary pressures, oil exporting economies are expected to be negatively impacted while oil producing corporates are likely to experience a thinning of their margins.

Mounting uncertainties in the global political and economic environment pose significant challenges to Sri Lanka, necessitating the implementation of timely and prudent policy

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measures to support domestic growth initiatives while maintaining stability. The weaker economic outlook reflecting subdued global demand could impact Sri Lanka's trade during 2019. Moreover, escalating trade tensions between the US and China, as well as the UK and the Eurozone could exacerbate this impact affecting the country's BOP. However, this impact could ease somewhat with key economies increasingly adopting accommodative monetary policies to stimulate domestic demand. Nevertheless, any rise in global market interest rates could increase debt servicing costs of the government and corporates, leading to greater financial fragility and weaker risk profile of the country. Therefore, prudent accumulation of foreign exchange reserves and careful management of external debt are essential in the period ahead. As global oil prices are expected to remain at current subdued levels, its impact on domestic inflation is expected to remain minimal during 2019.

1.4 Medium Term Macroeconomic Outlook

The growth momentum of the economy that has been subdued in recent years is expected to gradually improve over the medium term. Real GDP growth, which remained modest at around 3.2 per cent in 2018, as per the estimates of the DCS, is projected to gradually improve to around 5.0 per cent by 2023.[1] The achievement of the envisaged growth path would depend on the successful implementation of the growth framework laid out in public policy documents along with higher participation of the private sector. The implementation of consistent policy measures without frequent revisions is expected to attract investment from both local and foreign sources into more productive sectors in the economy. With these investments, the output in the manufacturing sector that has remained modest, is expected to gradually shift towards higher value added products that are capable of meeting the demand of the domestic market as well as accessing international markets through the effective exploitation of trade agreements. Meanwhile, the value added contribution from the services sector is envisaged to rise with the expansion in knowledge based services. The efforts towards developing a commercially viable agriculture sector would also support the productive allocation of resources in the economy. Moreover, continued investment in economic infrastructure would provide impetus to growth during the medium term. This would include numerous projects in energy, public transport, and road development sectors aimed at supporting the production capacity of the country. In addition, the successful completion of development activities taking place in relation to the Colombo Port City project and the Western Region Megapolis Master Plan is also expected to boost economic growth. In tandem with these developments, education standards in the country are expected to be enhanced to meet the demands for a more skilled labour force from emerging sectors. Moreover, strengthening the higher education sector to enhance research and innovation is also expected to contribute towards sustaining a higher growth path. Implementation of measures aimed at increasing female labour force participation would also support the growth drive.[2] These developments together with policies aimed at maintaining a stable macroeconomic environment are expected to improve Sri Lanka's per capita GDP to over US dollars 5,000 by 2023.

1 The medium term growth path is projected based on national accounts compiled by DCS with the base year 2010. Any revisions to past growth rates and to the base year will require a revision to the medium term projections as well.

2 The ageing of the population leading to the end of the demographic dividend means that growth can no longer be driven by labour augmentation derived from a rising population. It would need to be supported by higher productivity and increased female labour force participation, which is currently at around 34 per cent.

Table 1.5
Medium Term Macroeconomic Framework (a)

Indicator	Unit	2017 (b)	2018 (c)	Projections				
				2019	2020	2021	2022	2023
Real Sector (d)								
Real GDP Growth	%	3.4 (c)	3.2	4.0	4.5	5.0	5.0	5.0
GDP at Current Market Price	Rs. bn	13,418 (c)	14,450	15,855	17,389	19,170	21,131	23,297
Per Capita GDP	US$	4,104 (c)(e)	4,102	4,001	4,262	4,530	4,816	5,122
Total Investment	% of GDP	28.8 (c)(f)	28.6	29.1	29.6	30.1	30.6	31.1
Domestic Savings	% of GDP	21.7 (c)(f)	21.2	22.9	23.9	25.1	26.7	28.4
National Savings	% of GDP	26.2 (c)(f)	25.4	26.8	27.5	28.1	28.8	30.1
External Sector								
Trade Gap (d)	% of GDP	-10.9	-11.6	-11.6	-11.5	-11.2	-10.6	-9.9
Exports	US$ mn	11,360	11,890	12,935	14,075	15,390	16,875	18,557
Imports	US$ mn	20,980	22,233	23,070	24,825	26,620	28,250	29,891
Current Account Balance (d)	% of GDP	-2.6	-3.2	-2.3	-2.1	-2.0	-1.8	-1.0
External Official Reserves	Months of Imports	4.6	3.7	4.1	4.3	4.5	4.7	4.8
Fiscal Sector (d)(g)								
Total Revenue and Grants	% of GDP	13.7 (h)	13.4	15.1	16.1	16.8	17.0	17.5
Expenditure and Net Lending	% of GDP	19.2 (h)	18.6	19.5	19.6	20.3	20.5	20.7
Current Account Balance	% of GDP	-0.7 (h)	-1.2	0.2	1.1	1.7	1.8	2.2
Primary Balance	% of GDP	0.02 (h)	0.6	1.5	2.4	2.5	2.5	2.8
Overall Budget Deficit	% of GDP	-5.5 (h)	-5.3	-4.4	-3.5	-3.5	-3.5	-3.2
Central Government Debt	% of GDP	76.9 (h)	82.9	82.6	81.0	75.0	72.0	70.0
Monetary Sector and Inflation								
Broad Money Growth (M_{2b}) (i)	%	16.7	13.0	12.0	12.5	12.5	12.5	12.5
Private Sector Credit Growth (in M_{2b}) (i)	%	14.7	15.9	13.5	13.3	13.7	13.6	13.5
Annual Average Inflation (j)	%	6.6	4.3	4.8	5.0	5.0	5.0	5.0

(a) Based on information available up to end March 2019.
(b) Revised
(c) Provisional
(d) Based on the GDP estimates (base year 2010) of the Department of Census and Statistics.
(e) Estimates updated with latest population figures.
(f) Total investment, domestic savings and national savings as a % of GDP in 2017 were revised by the Department of Census and Statistics from 36.5%, 29.3% and 33.9%, respectively.
(g) The Medium Term Fiscal Framework will be revised during the third quarter of 2019.
(h) For 2017, revised GDP estimates were used, as released by the Department of Census and Statistics on 19 March 2019
(i) Year-on-year growth based on end year values
(j) Based on CCPI (2013=100)

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

The outlook for the external sector, which improved since the latter part of 2018, is expected to remain resilient despite potential downside risks over the medium term. Exports are projected to improve with the support of a flexible and competitive exchange rate, envisaged economic growth in Sri Lanka’s export destinations, the establishment of bilateral trade agreements and the implementation of the National Export Strategy (NES). Imports are also projected to increase moderately over the medium term with higher imports of intermediate and investment goods supporting the medium term growth trajectory. Meanwhile, the surplus in the services account is expected to improve with higher inflows, particularly on account of tourism, Information Technology (IT), Business Process Outsourcing (BPO) and transport services. Tourist earnings are expected to increase over the medium term with the projected increase in arrivals, the development of new star class hotels and aggressive promotional campaigns. The IT related exports are expected to continue their robust growth while earnings from transportation are expected to rise with the enhanced external trade, accelerated development in the Hambantota port and further growth in activities in the Colombo port. Workers’ remittances are expected to remain at current levels over the medium term due to the possible slowdown in labour migration given the improved domestic employment opportunities,

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and initiatives aimed at discouraging semi-skilled and unskilled migration together with unfavourable geopolitical developments in the Middle East. Meanwhile, the deficit in the primary income account is expected to widen over the medium term with higher interest payments amidst rising global interest rates. However, the combined effect of these developments is expected to result in an improvement in the external current account deficit over the medium term to a sustainable level. Meanwhile, the financial account of the BOP is expected to improve with higher FDI inflows, particularly with the long term development projects in the Colombo Port City and Hambantota industrial zone as well as FDI expected through Private Public Partnership (PPP) initiatives of the government. Further, foreign investments to the CSE and the government securities market are also expected to stabilise with the perceived delay in interest rate hikes in international markets. In addition, the extension of the IMF-EFF programme is expected to contribute towards improving the external sector outlook, thereby bolstering investor sentiment. Amidst the expected adjustment in the current account deficit and the gradual reduction in the reliance on debt related inflows, a flexible and competitive exchange rate is expected to be maintained within the envisaged flexible inflation targeting regime. This would also contribute to reinforce international reserves while reserve adequacy is expected to remain at satisfactory levels over the medium term. Further, the successful implementation of the provisions in the Active Liability Management Act No. 08 of 2018 (ALMA) and the Medium Term Debt Management Strategy (MTDS) of the government is expected to address potential vulnerabilities associated with refinancing requirements arising from bunching of foreign currency debt service payments, including the future maturities of ISBs. Meanwhile, the financial position of commercial banks is also expected to strengthen with the expected gradual improvement of liquidity in the domestic foreign exchange market.

The priority of the government's fiscal strategy is to reduce the budget deficit and thereby the outstanding debt to a sustainable level over the medium term with the continuation of the revenue based fiscal consolidation measures. Government revenue is expected to increase to around 17 per cent of GDP by 2023, supported by policy measures to broaden the tax base, simplify the tax legislation and improve the tax administration. Further, the government intends to rationalise the expenditure by imposing ceilings and improving efficiency in public financial management over the medium term. The continuation of social safety nets with improved targeting through the Welfare Benefits Board, implementation of contingent budgeting and strengthening the insurance scheme for managing fiscal costs on natural disasters together with the ongoing progress of the rationalisation of recurrent expenditure would support the envisaged expenditure management, while maintaining the total expenditure at around 20 per cent of GDP in the medium term. Consequently, the budget deficit is expected to record a deficit of 3.5 per cent of GDP in 2020 and 3.2 per cent of GDP by 2023. The government's fiscal strategy would strengthen the primary balance in the medium term assisted by improved government revenue and expenditure management. Thus, the primary balance of the government is expected to record a surplus of 2.8 per cent of GDP by 2023. In addition, the current account is also envisaged to record a surplus in 2019 and remain in surplus thereafter. With the anticipated improvement in the budget deficit and the primary balance, the outstanding central government debt to GDP ratio is expected to decline to around 70 per cent of GDP by 2023. The achievement of the above medium term targets would be a challenging task, and the successful implementation requires a strong commitment and dedication by all stakeholders of the government. Meanwhile, the successful implementation of the provisions in the ALMA and the MTDS are expected to further improve and strengthen the debt management strategy over the medium term. Building on the envisaged fiscal consolidation over the medium term, the government is expected to elevate public investment to 5.5 per cent of GDP, thereby supporting the medium term growth prospects of the economy. Further, proper implementation of fiscal rules, with necessary amendments to the Fiscal Management (Responsibility) Act, No. 3 of 2003, would ensure the achievement of the expected improvements in the fiscal sector with improved fiscal discipline.

Inflation expectations are likely to be anchored more firmly at mid single digit levels in the medium term under the envisaged flexible inflation targeting regime. Monetary policy decisions made in an increasingly forward looking and data driven framework are expected to maintain aggregate demand conditions at appropriate levels, in spite of the risks to inflation arising from global and domestic macroeconomic developments. On the global front, supply disruptions, particularly in relation to energy prices, could exert pressure on inflation periodically, while volatility in domestic food supplies could threaten the achievement of inflation targets unless domestic supply conditions are improved and short term fiscal adjustments are made proactively to address such concerns. In the meantime, adhering to the envisaged fiscal consolidation path is required in order to sustain inflation at desired levels. While monetary policy decisions are expected to be responsive to demand driven inflation and the output gap, the flexible exchange rate policy will allow the exchange rate to be determined by market fundamentals and act as the first line of defense to dampen the impact of external shocks. Further, the Central Bank would ensure sufficient money and credit flows to support the expected growth of economic activity, and accordingly, broad money supply (M_{2b}) and credit to the private sector are projected to grow annually by around 12.5 per cent and 13.5 per cent, respectively, over the medium term.

1.5 Issues and Policies

Amidst efforts to maintain the country's macroeconomic stability over the past several years, the postponement of much needed structural reforms has moved the Sri Lankan economy to a modest growth path. Sri Lanka's graduation to the middle income status almost a decade ago required far reaching policy reforms to move towards higher income status by avoiding the so-called middle income trap. However, delays in addressing barriers to growth and introducing growth enhancing reforms in the areas of export promotion, attracting FDI, reducing budget deficits and debt levels, reforming factor markets, strengthening public administration, and ensuring the rule of law have largely contributed to Sri Lanka's economic stagnation, while peer economies have progressed rapidly as a result of growth supporting reforms. Therefore, for Sri Lanka to succeed as a higher income economy and improve the wellbeing of its people, it is essential that the root causes for the continued low economic growth are addressed by expediting the required structural reforms with a focus on improving productivity and efficiency of the economy. The end of the demographic dividend reinforces the need for this.

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Sri Lanka is endowed with plenty of natural resources with potential to support a high economic growth path, if utilised efficiently. As an island nation in the Indian Ocean, Sri Lanka has numerous ocean resources. However, local consumers still consume imported canned fish and this reflects the strong need for supporting the fisheries sector. Common salt extracted from sea water is used to produce a number of industrial raw materials, including Caustic Soda, Chlorine, Hydrochloric acid, Sodium Carbonate, Sodium Bicarbonate, Bleaching Powder, Poly Vinyl Chloride (PVC), etc. Sri Lanka, however, spends a substantial amount of foreign exchange in importing these raw materials at present. Sri Lanka, compared to its size, has many minerals that are essential for state-of-the-art technologies. Although the presence of mineral sands in Sri Lanka was discovered in 1904 and the industry dates back to the 1950s, there has been no significant value addition to commercially viable minerals such as ilmenite, rutile and zircon during the past six decades. Further, the phosphate deposit in Eppawela, which can be used in the manufacturing of fertiliser as well as other industrial inputs is clearly underutilised. Hence, implementing an integrated national policy to facilitate value addition of minerals is a priority that would contribute to enhancing export earnings while creating new job opportunities. In addition, the ongoing efforts to exploit the potential to produce graphene, which is used in the production of solar cells, LEDs, touch panels and batteries, etc. using Sri Lankan graphite should be fast-tracked. Moreover, petroleum exploration in Sri Lanka began in the late 1960s and, in the recent past, several leading international petroleum companies have shown interest to explore oil and gas in Sri Lankan waters. Against the backdrop of Sri Lanka's total dependence on imported petroleum and the government plans to shift Sri Lanka's power plants towards natural gas, it is essential to continue the efforts on oil and gas exploration as the benefits of finding commercially viable petroleum deposits could be much larger than the associated costs. Moreover, Sri Lanka is historically gifted with a hydraulic civilisation driven by a rich irrigation tradition. In fact, the Sri Lankan agrarian system, the "ellanga gammana" or Cascaded Tank-Village system in the dry zone, was designated as a Globally Important Agricultural Heritage System by the Food and Agriculture Organization of the United Nations (FAO) in 2018. In spite of this rich heritage, inadequate water resource management policies and delays in the enforcement of existing regulations have resulted in complex issues, including the depletion and degradation of water resources due to contamination with domestic sewage, industrial waste and agricultural residuals, biological contamination of ground water as well as over-utilisation of water, particularly through tube wells. In spite of numerous government initiatives, little or no progress has been made towards the effective management of natural resources in the country over the past several decades, and accordingly, more focused, proactive, policy initiatives which could also harness the support of the private sector are crucial to tap the full potential of Sri Lanka's natural resources in a sustainable manner.

In spite of some progress in relation to a few products in recent times, Sri Lanka's merchandise exports sector requires greater efforts to address the rapid decline in its share in the domestic economy as well as within global trade. The growth of merchandise exports has slowed down substantially over the past two decades, although services exports showed a notable growth during this period. The slowdown in merchandise exports has widened the current account deficit, requiring the country to increasingly rely on foreign borrowings to finance this deficit. Poor performance in merchandise exports could be attributed to several structural issues in the economy such as

BOX 2
The National Export Strategy (NES) 2018-2022

The Need for a National Strategy for Exports

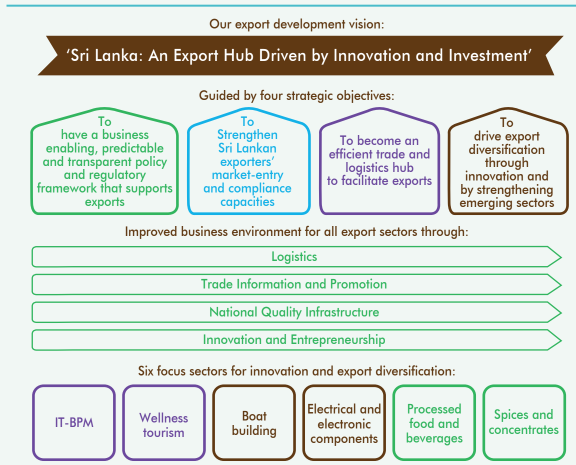
Exports play an important role in an economy affecting the balance of payments, including the capacity to service external debt, economic growth and employment. Sri Lanka adopted an export led growth strategy when economic liberalisation policies were introduced in 1977. However, the country has been unable to maintain a sustained growth in exports despite measures taken by successive governments for export promotion. Sri Lanka's exports as a share of GDP have declined drastically from 33.3 per cent in 2000 to 13.4 per cent in 2018. In fact, Sri Lanka's annual average export growth has declined to 5.6 per cent during the period 2000-2018 from 10.7 per cent during 1977-2000. In line with this, Sri Lanka's exports as a share of world exports declined from 0.086 per cent in 2000 to 0.064 per cent in 2017. Although earnings from exports have recovered slightly since 2017, Sri Lanka has lagged behind in terms of its export performance in comparison to the rest of the world, particularly regional peers such as Vietnam, Cambodia, India, and Bangladesh who have recorded average export growth rates of 18.1 per cent, 14.7 per cent, 13.7 per cent and 11.4 per cent, respectively, during the period 2000-2017. The lack of coordinated export promotion policies and strategies has been a key reason for the dismal export performance. An attempt was made in 2004 to produce a National Export Strategy (NES) for Sri Lanka (NES 2004-2008), but its ineffective implementation failed to deliver the intended outcomes. It was evident that for the export sector to emerge as a key driver of economic growth, formulating a strategic plan to drive the export sector within the overall development strategy of the government is important. Accordingly, export sector stakeholders have highlighted the need for a National Export Strategy, which would be implemented over a sustained period in order to achieve the export targets identified in the strategy. The Central Bank of Sri Lanka (CBSL), in its Annual Report for 2016 also underscored the importance of a NES for Sri Lanka *(Box 07: National Strategy towards Export Promotion)*.

Against this backdrop, the government, under the initiative of the Ministry of Development Strategies and International Trade (MODSIT) and the Export Development Board (EDB), crafted and launched the NES 2018 – 2022, in July 2018, following a thorough stakeholder consultation process. The technical support in designing the NES 2018 - 2022 was obtained from the International Trade Centre (ITC) within the framework of the EU - Sri Lanka Trade Related Assistance Project funded by the European Union.

The NES 2018 - 2022 at a Glance

The NES is a blueprint intended to be executed within a 5-year horizon from 2018 - 2022 to fast track Sri Lanka's export growth, harnessing the capabilities and resources of the country to achieve the targets envisaged in the government's Vision 2025 policy document and the New Trade Policy (NTP). The NES 2018 - 2022 was designed with a view to transforming Sri Lanka into an export hub driven by innovation and investment, based on four strategic objectives as illustrated in Figure B 2.1. In addition, it aims to improve the business environment for all export sectors based on four cross-cutting Trade Support Functions (TSFs). These TSFs include logistics, trade information and promotion, national quality infrastructure and innovation and entrepreneurship. The development of the identified TSFs would help overcome main challenges in the provision of quality and affordable support services to Sri Lankan exporters. Meanwhile, the NES 2018 - 2022 highlights six focus sectors for innovation and export diversification, namely; information technology and business process management (IT-BPM), wellness tourism, boat building, electrical and electronic components, processed food and beverages, and spices and concentrates, while supporting the growth of traditional export industries.

Figure B 2.1
The Structure of the NES (2018 - 2022)



Source: Export Development Board

The six focus sectors were identified based on quantitative and qualitative parameters derived from export potential assessments conducted by the EDB and the Board of Investments (BOI) under the guidance of Harvard University, in collaboration with the Commonwealth Secretariat, McKinsey Consultants, the World Bank and the ITC. Focus sectors cover all major economic sectors, namely, agriculture, industry and services and are at different stages of growth where their growth trends have been classified as mature, emerging and visionary (Table B 2.1). Sectors such as IT-BPM and spices and concentrates are considered as mature sectors that have a high potential for increased export revenue. For instance, in 2018, about 80,000 professionals were employed in the IT-BPM sector, contributing 10.1 per cent to total services exports of Sri Lanka. Sri Lanka is also well known for its spices and extracts or concentrates due to their unique qualities, yet the sector contributed only 3 per cent, in 2018, to total merchandise exports in spite of Sri Lanka being the largest global supplier of cinnamon with a market share of 30 per cent in global cinnamon exports. Wellness tourism and processed foods and beverages were identified as emerging focus sectors where growing ayurvedic health services and unique food and beverage blends with Sri Lankan spices would create a large potential for export earning opportunities for Sri Lanka. The boating industry and the electrical and electronic component sectors were considered as visionary focus sectors, which could benefit from Sri Lanka's strategic location while enhancing the country's potential for participation in product sharing networks. All six focus sectors feature a competitive advantage for Sri Lanka through its unique location, the skilled workforce, the long history and rich culture and the tropical climate that feeds biodiversity and the agricultural base.

Table B 2.1
The Focus Sectors of the NES (2018-2022)

Focus Sector	Type of Industry	Growth Trend	Contribution in 2018
1. **IT-BPM**	Services	Mature	US$ 848 mn (10.1% of services exports)
2. **Wellness Tourism**	Services	Emerging	11,902 tourists (0.5% of total arrivals)
3. **Spices and Concentrates**	Agriculture	Mature	US$ 360 mn (3.0% of merchandise exports)
4. **Processed Foods and Beverages**	Agriculture	Emerging	US$ 462 mn (3.9% of merchandise exports)
5. **Boating Industry**	Manufacturing	Visionary	US$ 27 mn (0.2% of merchandise exports)
6. **Electrical and Electronic Components**	Manufacturing	Visionary	US$279 mn (2.3% of merchandise exports)

Sources: Export Development Board
Sri Lanka Customs
Sri Lanka Tourism Development Authority
Central Bank of Sri Lanka

The Plan of Actions and Effective Monitoring of NES Implementation

The NES contains a comprehensive Plan of Actions (PoAs) which translates priorities into actions to be implemented during the period 2018-2022. The responsibility of implementing PoAs has been assigned to national institutions identified as leading and supporting institutions, where the former would coordinate the implementation of the PoAs with the help of the latter. The effective implementation of the PoAs is key to the success of the NES 2018-2022, given the experience of the previous NES. Therefore, the success of the NES 2018-2022 would depend on the commitment, willingness and capacity of all stakeholders to contribute, collaborate, own and drive PoAs towards a common national objective. A management and coordination mechanism has been inbuilt in the NES 2018-2022 under the MODSIT, consisting of several advisory committees with private and public sector representatives and a management unit empowered with the authority to oversee and coordinate with various entities to carry out PoAs. Accordingly, 16 new advisory committees have been established, covering all major sectors under the purview of the NES 2018-2022, and a review of the progress of implementation of the PoAs has commenced.

Expectations of the NES 2018 - 2022

The NES is expected to create steady and sustainable growth in exports for the benefit of all Sri Lankans. The NES would unlock nascent export sectors to create new job opportunities, while facilitating value addition through increased participation in global value chains and product sharing networks. TSFs are expected to ease barriers for start-ups to enter into the export sector, especially for SMEs, while attracting new investments by streamlining legal and administrative procedures. Overall, the NES would support export led growth on a sustained basis over the medium term. A transformation in export performance is also essential to service the onerous debt servicing burden, while supporting the country's import requirements and maintaining a level of external reserves which provides sufficient confidence to foreign investors and creditors.

In conclusion, the NES 2018-2022 is a comprehensive national strategy designed in line with international best practices to address the needs of the Sri Lanka's lagging export sector with a view to uplifting its competitiveness in a sustainable manner. The success of the strategy depends on the effective implementation of the proposed actions within the specified time period. Therefore, a coordinated effort is required for the successful implementation of this nationally important strategy to reap the intended benefits for the betterment of the country.

Reference

National Export Strategy of Sri Lanka 2018 - 2022 (2018), Ministry of Development Strategies and International Trade, Colombo

limited product and market diversification, lack of competitiveness, misaligned exchange rate at times, para-tariffs which impede access to global and regional supply chains, absence of sufficient innovation and research and development (R&D) and inability to gain economies of scale. In this backdrop, export promotion strategies should be focused on the overall economy while encouraging selected sectors with identified potential. Regional peers, such as South Korea and Vietnam, have achieved a significant boost in exports by following a holistic approach towards export promotion. In this regard, several policy measures have already been taken by the government to address some of the identified issues in the export sector. New Trade Policy (NTP) and NES, which urge overall economic reforms, were the most recently introduced landmark measures. NTP aims at improving competitiveness of both goods and services sectors through domestic policy reforms, including rationalisation of tariffs and para-tariffs, non-tariff barriers and liberalising the services sector, while establishing appropriate legal mechanisms, standards, regulations and safeguards. NES focuses on trade promotion, export finance and streamlining the institutional and regulatory framework. The generation of higher export revenues will serve as a buffer against rising foreign liabilities, help stabilise the exchange rate and support building up of international reserves to improve the country's economic resilience while supporting economic growth. Growth in exports also entails several other benefits such as inflow of FDI and new technology, higher value employment opportunities, greater economies of scale, and increased overall productivity and competitiveness of the country.

The potential of the tourism industry to become the highest foreign exchange earner in Sri Lanka must be supported by addressing barriers to its further growth. Sri Lanka has positioned itself as one of the best tourist destinations in the region with an annual average growth of tourist arrivals of over 20 per cent during the post conflict era compared to the low growth of around one per cent during 2000-2009. Further, during the post conflict period, the average daily spending by tourists has increased substantially while average duration of stay has also increased. Despite these recent developments, Sri Lanka has not reached its potential, compared to the other countries in the region, such as Thailand, Singapore and Malaysia. The government has introduced a comprehensive Tourism Strategic Plan (TSP) 2017-2020 identifying issues and policy reforms towards achieving a medium term target of US dollars 7 billion tourist earnings by 2020. However, in order to increase the sustainability of the tourism sector and improve earnings, further enhancements are required. Sri Lanka has many diverse attractions spread all over the island, but there is no balanced or smooth flow of visitors to them, which disturbs the attractions as well as tourists. Therefore, a coordinated effort is needed among tourist service providers and related organisations to spread out tourist visits over the attractions and time periods. Providing facilities for advance online ticket booking with peak and off peak pricing, online information on crowd pressure, weather conditions and public transport systems would be able to ease the pressure on currently overcrowded attractions, such as Sigiriya, and national parks, such as Horton plains, Yala and Udawalawe. Further, improving public amenities at attractions, increasing accessible time and enabling night time visits, would support the tourism industry. To prevent disturbances to animals as well as tourists and to be more environmental friendly, possibilities could be explored to occupy electric powered vehicles for safaris instead of individual fuel powered noisy safari jeeps. Further, Sri Lanka lacks tourist facilities and attractions that can handle a large number of tourists, such as cable car systems, theme parks, cruises, scenic train rides and coordinated tourism zones. GPS enabled self-guiding multi-lingual mobile devices can be provided at key tourist attractions such as Anuradhapura, Polonnaruwa and Sigiriya, as well as for Colombo city tours. In addition, as the Port City Project develops, a surge in business and MICE (Meetings, Incentives, Conventions, Exhibitions) visitors, who generally have short travel plans, could be expected, and the specific needs of such tourists must be met through advanced planning. Further, Sri Lanka needs to increase its capacity and the quality of airports as tourists form their first impression of the country at the entry point. At the same time, development of seaports is essential to cater to cruise liners. Further, stopover packages can be designed to attract transit passengers at air and seaports to spend a short stay in Sri Lanka. Improving Sri Lanka's greenery, air quality and biodiversity would attract more tourists. Government farms, which are scattered around the country, can be utilised for agro tourism as Sri Lanka is blessed with unique agro techniques and a wide variety of crops. In order to implement plans to promote tourism, private sector participation can be encouraged through PPP, allowing Sri Lanka to achieve the untapped potential of the tourism industry.

While measures are taken to attract increased FDI inflows, it is necessary to ensure that such inflows are routed to productive sectors that can support sustained economic growth. During recent years, although FDI inflows have been on the rise, these inflows have contributed little towards enhancing export competitiveness and stimulating economic growth as a result of such investments being largely concentrated in non-tradable sectors. Sri Lanka still lags behind its regional counterparts in attracting FDI, particularly to sectors that enable manufacturers to integrate into high value added global production networks, which could also bring along technological know-how related to the high-tech manufacturing industry. In contrast, other emerging market economies in the Asian region, such as Vietnam, have been extremely successful in attracting impressive levels of FDI over the years, with such investments being mainly received by processing and manufacturing industries that account for half the value of industrial production in Vietnam. Moreover, Vietnam's FDI strategy focuses on increased foreign investment in high-tech industries, rather than labour-intensive sectors. Vietnam's success can be mainly attributed to the country's sociopolitical stability, the government's commitment to create a fair and attractive business environment for foreign investors while constantly improving its legal framework and institutions related to business and investment. Reforms introduced by the Vietnamese government to improve the investment climate have led Vietnam to be placed 69th in the "Ease of Doing Business Ranking - 2019" published by the World Bank, whereas Sri Lanka, although recording an improvement from the previous year, was ranked in the 100th position among 190 countries, mainly due to cumbersome business regulatory structures related to business start-up, enforcement of contracts, property registration, paying taxes and obtaining credit. Moreover, a weak institutional environment, rigid labour markets and less developed infrastructure have been identified as deterrents that have caused Sri Lanka to slip in the ranking by 4 notches over the preceding year to the 85th place among 140 countries in the "Global Competitiveness Index 2018" published by the World Economic Forum. Therefore, robust policy initiatives must be implemented urgently to overcome these concerns that undermine an investor friendly environment. Furthermore, Sri Lanka needs to develop a well-articulated and coherent investment policy clarifying how the country can use FDI to achieve the development goals of the country while focusing on how to better attract efficiency seeking FDI as well as enhance market seeking investment in export oriented industries in which Sri Lanka possesses a higher competitive advantage. A targeted approach is required to attract foreign investors who would not only bring in capital but also support the country to integrate with global value chains through their established networks while facilitating the domestic manufacturing sector by utilising the country's natural resources and pool of skilled labour. Moreover, measures should be taken to eradicate corruption, enhance institutional alignment and regulatory coherence by forging linkages between government institutions, and improve logistics for trade facilitation and expedite labour market reforms in order to foster investor confidence. Most importantly, financing the current account deficit through increased non debt creating flows in the form of FDI is essential as a sustainable solution in addressing Sri Lanka's weak external sector and enhancing resilience against external vulnerabilities.

While taking measures to strengthen the external sector resilience by attracting non-debt creating foreign exchange inflows, the medium term challenge of overcoming the bunching of foreign debt service payments must be met in order to prevent major disruptions to the macroeconomic balance. During the last decade, a major contributor to the country's external sector imbalances has been the mounting external debt and external debt service payments. With annual external debt repayment commitments of over US dollars 5 billion on average, Sri Lanka faces heightened refinancing risks. The situation is further exacerbated by the limited availability of concessional foreign financing, following Sri Lanka's transition to a middle income economy. This has resulted in an increase in the country's dependence on market based foreign borrowings and such borrowings have increased the country's exposure and vulnerability to tightening global financial conditions. Moreover, Sri Lanka, being a twin deficit country with persistently high budget and external current account deficits, has been relying on domestic and foreign borrowings to finance these deficits over the years. Large fiscal deficits have resulted in a mounting external debt stock of Sri Lanka. In addition, the widening current account deficits have also led to an increased reliance on unsustainable levels of foreign borrowings to finance such deficits. These borrowings will increase associated interest payments, thereby contributing to widen the deficit in the current account in a vicious cycle. On the other hand, the increased foreign debt service payments will drain the country's international reserves, which serves as a buffer for external shocks. Even with an effective liability management framework and continued fiscal consolidation, the solution to addressing persistent issues in the external sector lies in resolving the current account deficit through encouraging the production economy and export of merchandise goods and services, while creating an investor friendly environment to attract higher FDI inflows.

Although notable progress is made in the process of fiscal consolidation and in implementing fiscal reforms, further efforts are necessary to address the lingering concerns in public finance. Lower than expected revenue mobilisation is a chronic issue in the fiscal operations in Sri Lanka. Although the enactment of the Inland Revenue Act and the introduction of electronic systems for revenue management are likely to help enhance revenue, the delays in implementing revenue enhancement measures and leakages due to tax evasion and tax avoidance need to be addressed if the envisaged fiscal targets are to be achieved. Despite the substantial increase in the number of tax files in the Inland Revenue Department (IRD) in the recent past, such an increase has not been fully translated into a rise in income tax collection and therefore the direct to indirect tax ratio still remains weak. Proper implementation of tax revenue enhancement measures, close and efficient monitoring of compliance, further simplification and streamlining of the tax structure, improving public awareness on tax obligations and tax payment procedures are among the actions that need to be taken without delay in this regard. Meanwhile, in response to the constrained fiscal space and the need to persist with the fiscal consolidation path, a reduction in capital expenditure, relating predominantly to economic and social infrastructure, was also observed in recent years. This is counter-productive and will dampen economic growth over the medium to long term. Curtailing and delaying much needed public capital expenditure to offset overruns in recurrent expenditure is undesirable, especially in an environment where a lack of confidence continues to constrain private capital investment. Moreover, it is important to avoid expansionary fiscal operations, particularly those of a recurrent nature, amidst rising debt levels and debt servicing requirements, as this would escalate macroeconomic imbalances. Against this backdrop, implementation of legally binding fiscal rules and commitment to a fiscal consolidation programme that allows the maintenance of a level of capital expenditure aligned with absorptive capacity are, therefore, imperative to reinforce fiscal sustainability in Sri Lanka.

The energy infrastructure of the country needs to progress in tandem with the envisaged growth path in order to prevent undue bottlenecks to growth. The country's energy requirement would grow rapidly in an environment of urbanisation, increasing economic activity, and in view of the planned mega projects, such as the Port City, industrial zones and the Western Region Megapolis project. This is evidenced by an over 50 per cent increase in electricity generation to meet the rising demand during the past decade, while achieving over 99 per cent electrification in the country. However, amidst the rising demand, cost of energy has risen in the backdrop of increased reliance on external sources as reflected through a burgeoning annual petroleum bill. Moreover, losses made by the major SOBEs that provide these utilities are also a serious cause for concern. While such losses need to be addressed by the adoption of cost reflective pricing mechanisms, the rising energy cost that weighs on the competitiveness of the domestic tradable sector and increases cost of living must be proactively addressed by improving the power sector to meet the growing demand for electricity. In the meantime, efficient utilisation of the existing generation capacity must be encouraged while promoting the avenues to make use of the abundant renewable energy sources in the country, such as solar and wind power. Many countries around the globe have made remarkable inroads into exploiting renewable energy sources. Countries like China are in the process of curbing their dependence on polluting energy sources and transitioning towards cleaner energy initiatives. Some countries have announced bans on fossil fuel powered vehicles within the next 10-20 year time horizon paving way for greener energy usage. Although Sri Lanka has moved towards promoting greener electricity sources as laid out in the Long-Term Generation Expansion Plan of the country, the envisaged levels are below the levels that are necessary to meet the relevant United Nations Sustainable Development Goals (SDGs), indicating the need for heightening these efforts. Hence, Sri Lanka should further encourage private sector institutions and households to invest in renewable energy sources, thereby lessening the burden on the public sector as well. Moreover, taking measures to install a high quality efficient public transportation system, while establishing an electric vehicle charging network would promote the drive towards greener and cost effective energy sources leading to sustainable development in the country. These measures would contribute towards meeting the energy needs of a rapidly developing economy at lower costs thereby contributing to increase the overall efficiency and competitiveness of the country.

The overdependence of the agriculture sector on the government for subsidies and other forms of protection needs to be rationalised in view of their long term economic costs. The agriculture sector receives a substantial portion of government subsidies directly and indirectly, given its importance for food security and in consideration of the large number of the population dependent on the sector. However, such subsidies and price support schemes reduce the efficiency of resource allocation and encourage less productive farming practices. While around two million people or a quarter of the labour force are employed in the agriculture sector, its contribution towards GDP stands at around 7-8 per cent. The continued use of traditional, labour-oriented techniques of farming in the context of rapid fragmentation of agricultural lands, have led to low productivity of the agriculture sector, and low incomes for the farming community. Excessive protection extended to the sector also discourages the potential movement of the labour force to more productive sectors, such as manufacturing and the leisure sector that experience continued labour shortages. As Sri Lanka aspires to transform itself to an efficiency driven economy, timely measures are required to address the prevailing issues in the agriculture sector. Agriculture or farming units need to be transformed to profit-seeking business units by way of upskilling, mechanising and inculcating an entrepreneurial culture, which would help generate higher income in the sector. In the same vein, barriers to amalgamate these individual, profit-seeking business units to form larger farming organisations should be eliminated. Initiatives must be encouraged to intensify competitiveness through increased productivity, intensified R&D, diversifying by cultivating more profitable agricultural products and overcoming challenges arising from climate change while reaping benefits from Good Agriculture Practices (GAP), instead of depending on excessive protection from the government at a high social and economic cost. Such initiatives to make the agriculture sector independent, productive and competitive will help ensure its positive contribution towards the country's growth momentum, going forward.

The untapped potential of Sri Lanka's industry sector must be exploited by strengthening the manufacturing sector through diversification as well as investment in research and development (R&D). The industry sector of Sri Lanka, is the second largest sector of the economy after services, and within industry, the manufacturing sector, contributed about 15.5 per cent of GDP in 2018. However, Sri Lanka's manufacturing sector is relatively small compared to its regional counterparts such as China (around 29 per cent), Thailand (around 27 per cent), Malaysia (around 22 per cent), and Bangladesh (around 17 per cent). Similarly, as a percentage of GDP, the share of medium and high-tech industrial production within the manufacturing sector has been notably low at around 7 per cent in Sri Lanka compared to Singapore (80 per cent), Philippines (46 per cent), Malaysia (43 per cent), China (41 per cent), Thailand (41 per cent), Vietnam (40 per

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cent), India (38 per cent), Pakistan (25 per cent) and Bangladesh (9 per cent) in 2015 as per World Bank sources. This shows that Sri Lanka is lagging behind its regional peers in the manufacturing of medium and high-tech industry products. Another major issue in the manufacturing sector is the low spending on R&D, which reduces innovation and thereby competitiveness. Sri Lanka's investment in R&D is the lowest in the region at 0.1 per cent of GDP in 2014 while that of Singapore (2.2 per cent), China (2.1 per cent), Malaysia (1.3 per cent), India (0.6 per cent), Thailand (0.6 per cent) and Vietnam (0.4 per cent) are higher as per the most recent data available in the World Bank sources. Sri Lanka also has only 100 people per million engaging in R&D activities while peers in the region employ a significantly higher number of people in R&D, ranging from 294 people per million in Pakistan to 6,730 people per million in Singapore. Therefore, Sri Lanka needs to increasingly focus on enhancing R&D, particularly in the form of technology transfer and applied industrial research, to improve the industry sector performance over the long term. Meanwhile, the surveys to capture investment and employment in R&D must be strengthened to obtain a more accurate picture of public and private sector engagement in such activities.

Sri Lankan entrepreneurs must be supported to graduate from small scale production aimed at narrow markets to larger scale operations in order to benefit from economies of scale. In Sri Lanka, most economic activities are operated by micro or small scale operators. Although there may be merit in such small scale operations at times, the benefit of economies of scale does not accrue to the country. Accordingly, high cost of production and low quality products and services are key issues faced by most local producers and consumers in Sri Lanka. Higher local production costs lead to elevated domestic prices compared to low imported prices, thereby forcing the government to impose and adjust taxes frequently to protect local producers. Although the government receives revenue in the form of taxes, this practice would distort market activity leading to higher market prices, which would inconvenience end consumers. Moreover, most export oriented emerging markets capitalise on economies of scale, which enable them to make substantial profits. However, in Sri Lanka, for instance in the paddy sector, the yield per hectare is low in districts with a high percentage of small sized paddy fields while a higher average yield is recorded in those districts with comparatively large paddy fields, thereby clearly indicating the prevalence of economies of scale. Moreover, the usage of machinery would also be more productive when the land extent is larger. A possible solution would be to encourage the pooling of lands into agriculture societies, allow them to use more machinery and enhance productivity, empower them to take decisions and share profits based on the extent pooled. Further, such societies would also benefit from enhanced bargaining power. Similarly, the small scale of business units is a common issue in the services sector as well. For example, a privately operated bus or a taxi, is a single business unit that is operated individually without a goal other than maximising individual profits. Due to such operations, benefits of agglomeration arising from resource pooling and associated synergies are lost, often resulting in a reduction in individual profits as well. This situation could be improved by forming entities, empowered with decision making abilities on transport operations of a region, where both government and privately owned vehicles could be used. This entity would be responsible for the management of the fleet, efficient maintenance, preparation of a comprehensive timetable, balancing low profit time periods and low profit routes. Such a system will increase the efficiency and the quality of service provided, while also making public transport increasingly attractive. Therefore, the policy focus should be to support the transformation of small scale, fragmented entities to large scale business ventures, enabling such operations to benefit from economies of scale and contribute towards the growth objectives of the economy, while also enhancing the overall welfare of the society. In the case of industries, such transformation will help realise the country's untapped export potential as well.

While the country's unemployment rate has remained low during the past several years, reforms are required to improve and sustain the contribution of labour resources towards economic growth going forward. Upskilling the labour force is imperative to support Sri Lanka's efforts to progress as an upper middle income economy. Over the last several years, Sri Lanka has observed low rates of unemployment, which highlight the need for the implementation of well-thought-out labour market reforms to encourage the productive use of labour resources and also boost the overall growth potential of the economy. A primary concern in the labour market is the dismal rate of female labour force participation. Although university enrolment among females has increased noticeably over the years, issues such as lack of child and elderly care facilities, discrimination at the workplace leading to widening gender pay gaps, inflexible working hours and tight labour laws, and the lack of safe transport have led to the poor female participation in the labour market. Moreover, a noticeable mismatch exists between the required and available skills in the labour market. A concern highlighted by the private sector, particularly foreign companies, is the weak English language and Information and Communication Technology (ICT) skills of Sri Lankan workers, which have challenged their employability, whilst also making the country a less attractive investment destination. As per the EF English Proficiency Index 2018, Sri Lanka has been designated as a country with low English proficiency compared to its regional counterparts such as Singapore, Philippines, Malaysia, India and Vietnam that display high or medium proficiency, while Sri Lanka's computer literacy remained at a strikingly low level of 27.5 per cent during the first half of 2018 as per the Department of Census and Statistics. The shortage of low-to medium-skilled labour in the manufacturing sector and export agriculture has also led to an increase in the cost of labour, thereby affecting the competitiveness of exportable products. While these issues form structural impediments to the overall growth of the economy, several policy initiatives have been proposed by the government with a view to encouraging greater female labour force participation and enhancing human capital by upskilling the labour force through the provision of better university and vocational training opportunities. Measures are also expected to be taken to provide reliable and affordable childcare facilities by establishing nurseries and crèches, thereby enabling mothers to return to their jobs. Also, awareness campaigns and strict regulations promoting zero tolerance should be introduced to prevent sexual harassment of women both at work and on public transport, while opportunities to work part-time and flexible hours should be introduced to attract the educated, but largely underutilised female workforce. Sri Lanka's education system should also be aligned with the evolving needs of the labour market, and the quality of education should be improved by regularly updating the school and university curricula, while graduate training should better prepare students that match the requirements of the labour market, particularly the private sector. Greater emphasis should also be placed on improving English and ICT skills as well as other soft skills, such as working in teams

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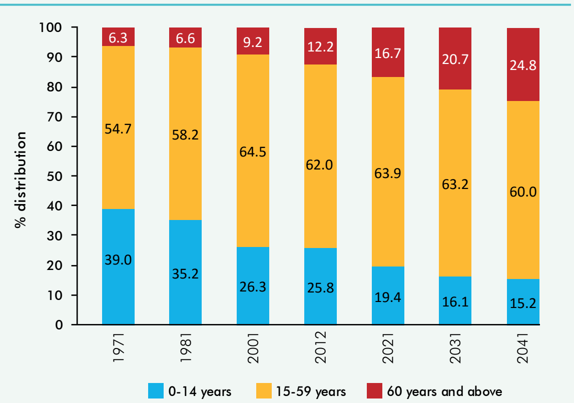
BOX 3

Need for a Nationwide Contributory Pension Scheme amidst a Rapidly Ageing Population

Changing Demographic Structure

Sri Lanka's post-independence progress in terms of social indicators has been more satisfactory relative to the advancement of its economic indicators. This was one of the reasons for Sri Lanka's demographic and epidemiological transition coming close to being on par with developed economies. The country's population pyramid has changed notably during the past four decades owing to declining fertility and mortality rates together with increasing life expectancy and migration.[1] Consequently, as one of the first developing economies to record below replacement level fertility, Sri Lanka's population structure is expected to rapidly shift towards a higher concentration of the elderly, in the not-too-distant future. The share of the elderly population in Sri Lanka is projected to rise to 16.7 per cent by 2021 and further to 24.8 per cent by 2041 (De Silva, 2015). This indicates that approximately one in every four persons will be 60 years or above within the next two decades.

Figure B 3.1
Percentage Distribution of the Population by Age Group: 1971 – 2041



Sources: De Silva (2015), Department of Census and Statistics

Although the longevity of the population highlights the benefits of investments the country has made on social infrastructure during the post-independence era (Osmani, 1993), population ageing brings about an array of challenges. In this backdrop, it is essential to analyse such socio-economic challenges and identify possible solutions, drawing from global experiences. This will help facilitate the implementation of national policies to enable a supportive environment for the elderly population within the broader development strategy to ensure the well-being of all, while reducing the fiscal burden of population ageing.

1 See Box Article 07: Economic Implications of the Age Structure Transition of the Population of the Central Bank Annual Report 2012 and Box Article 09: Population Ageing: Challenges and the Way Forward of the Central Bank Annual Report 2015.

Social, Healthcare and Economic Implications of Ageing

Although evolving, the Sri Lankan culture attaches significance to family values, which include taking care of the elderly. Accordingly, the responsibility of caring for the elderly in the family is considered a primary responsibility of the younger generation. The Census of Population and Housing - 2012 reveals that 99.0 per cent of the elderly live in household units while the remaining 1.0 per cent live in homes for the elderly. Nevertheless, rapidly changing lifestyles, urbanisation and demographic transition have put pressure on this traditional social protection system. More specifically, the decreasing family size, the diminishing role of the extended family due to internal migration from rural to urban areas or outward migration in search of better economic prospects, as well as the changing perceptions regarding supporting and caring for the elderly have largely contributed to this phenomenon. However, elderly care facilities and other social protection schemes, including retirement benefits have not expanded sufficiently to accommodate this change. Therefore the elderly population continues to rely on family members, who are also ageing. This social challenge is likely to become aggravated further with rising dependency ratios highlighting the need for an elderly care system that would support and supplement the traditional family based care system.

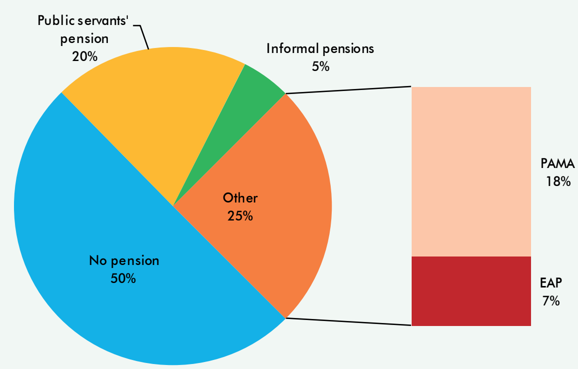
In addition to the demographic transition that is taking place in the country, the health profile of the elderly population has changed. While the prevalence of communicable or infectious diseases has reduced, the occurrence of non-communicable diseases (NCDs) affecting principally the elderly has increased with rising standards of living, nutrition and sanitation. In Sri Lanka, a considerable number of elderly persons have NCDs such as cardiovascular diseases, cancer, diabetes, arthritis, depression, dementia and Alzheimer's disease. Managing these diseases would improve the wellbeing and quality of life of the ageing population. However, providing access to good quality healthcare services for the elderly population is a challenging task. The healthcare system still has considerable shortages in addressing the medical needs of the ageing population. For a majority of the population, treatment for inpatient care for cancer and emergency care for heart diseases are publicly financed to a great extent, whereas care for a substantial portion of NCDs is self-financed drawing on the services provided by the private sector. This shows the need to expand public and private healthcare services to suit the requirements of the ageing population and also highlights the increasing fiscal burden associated with the provision of public healthcare services.

Furthermore, the impact of ageing on the size and composition of the labour force will have major implications for economic growth. Due to low and decreasing fertility rates, Sri Lanka will face a slower increase or a decline in the labour force. A decrease in the labour force could have a negative impact on economic growth unless the country encourages higher labour force participation and/or opens up for foreign labour. Fulfilling the needs of an increasing elderly population, who would be dependent on a shrinking labour force, will be more challenging when economic growth is low, thus burdening the government further. As the labour force is growing older while shrinking in size, it may have an impact on the overall efficiency of the economy. Besides the changes in the labour market, population ageing will also affect economic activity and growth performance through other channels such as consumption, investment and savings. When income levels decline with age, consumption levels may also decline and economic growth could be negatively affected by lower domestic demand. Similarly, the saving capacity could also decline with age, which could impact on the levels of savings and this, in turn, will have implications on investment.

Social Protection for the Elderly in Sri Lanka

The increase in the elderly population in Sri Lanka highlights the need for secure social security schemes where the quality of life and dignity of the elderly can be upheld. Social protection schemes available for formal sector workers in Sri Lanka can be broadly categorised based on the type of employment. The Public Sector Pension Scheme (PSPS) is available for government employees along with the armed forces pension scheme, widows, widowers and orphans pension (W & OP) scheme, and public servants' provident fund. The PSPS is a non-contributory scheme where the public sector employees are assured a monthly income from the government during their lifetime. However, the W & OP scheme is contributory and provides for the spouse and dependent children below 18 years of age or any handicapped children irrespective of age after the death of the employee. Formal private sector employees are entitled to benefits under the Employees' Provident Fund (EPF) and Employees' Trust Fund (ETF) at the time of their retirement. EPF is a scheme contributed by both the employee and employer, while the employer contributes towards ETF. The employee is eligible to obtain the entire amount available in these funds at retirement, and in most cases, such funds are invested after retirement as time deposits in order to earn a monthly interest as living expenses. The government has also introduced pension schemes for farmers, fishermen and self-employed persons of the informal sector, but the popularity of these schemes is low. Meanwhile, a public assistance monthly allowance (PAMA) and an elderly assistance programme (EAP) are available for the low income elderly population of Sri Lanka. In 2017, the government approved granting of a monthly allowance of Rs. 5,000 for citizens over 100 years of age, with a view to ensuring security and welfare of such individuals. As the labour force participation rate in Sri Lanka is around 50 per cent *(52.2 per cent in 2018 Q4 as per the Quarterly Report of the Sri Lanka Labour Force Survey)*, a considerable number of the population are excluded from the retirement benefits mentioned above. In addition, around 60 per cent of the labour force belong to the informal sector *(58.0 per cent in 2017 as per the Quarterly Report of the Sri Lanka Labour Force Survey)*, with limited access to old age benefits. Therefore, a majority of the elderly population are not covered by any of these schemes, while the benefits received are inadequate to ensure a decent standard of living.

Figure B 3.2
Pension Coverage of the Population aged 60 and above in Sri Lanka (2012)



Source: Arunatilake (2015)

Moreover, the current pension framework is a considerable burden on already limited fiscal resources as it is a non-contributory scheme. Government expenditure on pensions has been on the rise and in 2018 Rs. 194.5 billion was incurred as pension payments accounting for 9.3 per cent of recurrent expenditure. By February 2019, there were 623,417 pensioners, i.e., 2.9 per cent of the total population. Hence, about 10 per cent of the government's recurrent expenditure is spent directly on less than 3 per cent of the total population, which is not a sustainable model given the rapidly ageing population. According to the Census of Public and Semi Government Sector Employment conducted in 2016, 84,084 public and semi government sector employees, excluding armed forces (7.6 per cent of the total employed) were over 56 years of age and 854,300 (77.4 per cent) were between 30 – 55 years of age. This implies that the government will have to bear the cost of pensions of over 80,000 additional pensioners by 2020 and over 800,000 additional pensioners in the forthcoming 30 years. The current arrangements are an inter-generational time-bomb as future generations will have to bear the rapidly increasing fiscal burden. Since the PSPS is a non-contributory scheme with defined benefits, the burden on government expenditure will escalate in the coming years. In view of the unfunded nature of the PSPS, frequent upward revisions to pensions in the form of rectifying pension anomalies would not only result in the ballooning of government expenditure

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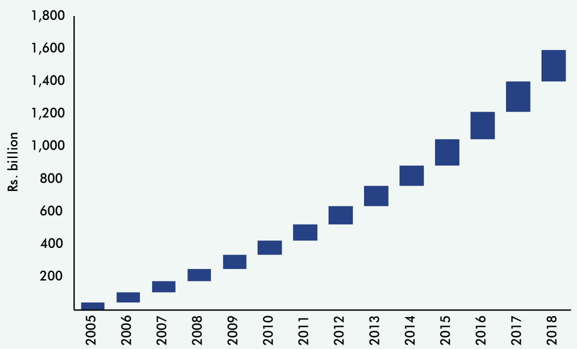
on pensions but also increase the wedge between the pensioners and non-pensioners in the society in terms of their standard of living at the expense of current and future tax payers. Given the tight fiscal envelope, it is essential that viable policies and strategies are adopted to ensure social security of the elderly population, not only those who retire from the public service, but also those in the formal and informal private sector as well.

Figure B 3.3
Government Expenditure on Pension



Source: Ministry of Finance

The existence of the Public Service Pension Scheme has also created unfavourable incentives among the working age population by creating a wedge between "good jobs" and "bad jobs", as many prefer public sector employment rather than the private sector. This has led to inefficiencies in the labour market and disincentivised the labour force from moving from one sector to another, due to the inability to carry forward the accumulated pension benefits when switching employment from the public sector to the private sector and vice versa.

These concerns highlight the need to introduce a contributory pension scheme, which will be operated across the country covering the public, private and informal sectors. The contribution by the employee towards such a pension scheme would help to neutralise undue incentives attached to public sector employment. Such a scheme would ensure that the working population has some form of social security in their retirement, irrespective of the nature of employment an individual is engaged in, be it the public, private or informal sector. Once such a mechanism is in place, it will ease the fiscal burden by replacing the social benefit schemes currently in operation with a nationwide contributory pension scheme, which could also help contain the required expansion of government spending on healthcare as well.

Way Forward

Addressing issues related to changing population dynamics and rising fiscal burden lie partly with the implementation of a contributory nationwide pension scheme, covering both the public and the private sector. Such a contributory pension scheme would be successful if it brings the employee and employer as well as the government together to share the responsibility of paying for retirement, where the employer and employee would contribute defined percentages based on earnings per month, and the government could contribute a defined amount indexed with inflation. These contributions could be invested in financial markets including government securities. When the employees reach the retirement age, their benefit could be returned in the form of an annuitised pension. Lessons can be drawn from peers in the region as well as developed economies, which operate such contributory pension schemes and transfer the benefits to employees on their retirement in the form of an annuitised pension. However, the implementation of such a nationwide contributory pension scheme would require consultation with all stakeholders, while avoiding policy swings from one government to another. A nationwide pension scheme with effective regulation would also help address issues with the fragmented pension schemes that are in operation at present in terms of their sustainability and would facilitate labour mobility between sectors as well. Moreover, it will ease the prevailing and projected expenditure burden on the government. Along with this nationwide contributory pension scheme, a choice of options need to be made available where affordable healthcare is provided for the elderly population who are unable to pay for their medical treatment, while maintaining more targeted and streamlined poverty alleviation programmes such as Samurdhi/Divineguma as they are essential to uplift the consumption levels of the poor in the short term and to increase their income generating capacity for them to graduate from poverty.

The government, having identified the growing challenge that Sri Lanka has to face with an ageing population, has proposed the introduction of a National Pension Plan with a sustainable financing structure in its Budget for 2019. As similar proposals have been made by previous governments, it is heartening to note that the need for such a scheme is accepted across the political divide. Given its increasing importance with rapid population ageing, it is essential that such a nationwide contributory pension scheme is formulated and implemented without delay.

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and being accountable, that are highly sought by employers in the present day. Measures could also be taken to allow foreign talent in Sri Lanka's labour market by way of attracting recognised experts as well as mid-career professionals in a transparent manner, which would enhance knowledge-sharing whilst also increasing the competition in the labour market leading to better productivity. Moreover, improving access to finance of those in lagging regions would promote entrepreneurship prospects. Overall, in the backdrop of an ageing population, these policy initiatives will not only attract more workers to the job market, but would also enhance the contribution of the labour force to the country's growth process through improved labour productivity. These initiatives would ultimately improve the livelihood and living standards of workers and their dependents, while also enhancing equality and reducing overall poverty in the economy.

Appropriate reforms to general education and higher education are essential to increase the growth potential of the economy. With the waning of the demographic dividend and the comparative advantage of a low wage regime, the next stage of economic growth needs to be derived by uplifting the quality of human capital of the country through education. Although numerous policy measures implemented in the education sector have enabled Sri Lanka to attain commendable achievements in primary and secondary education in terms of student enrolment and gender equality, the education system has failed to replicate the achievements of its regional peers, particularly in terms of learning outcomes. The lack of student engagement in STEM (Science, Technology, Engineering and Mathematics) and vocational subject streams has resulted in the labour demand for entrants with technical skills not being met. In this regard, there are attempts to improve the quality of education through initiatives such as the '13 years of guaranteed education' programme, the 'closest school is the best school' initiative and the introduction of STEM education in schools, which is expected to be extended to cover Arts subjects as well (STEM+A). However, lack of resources, particularly in terms of qualified teachers and facilities, has limited student engagement in STEM subjects inhibiting entrants into these streams. Measures to strengthen the education of technical and vocational subjects within the school curricula should be effectively implemented as delays in investments on reshaping the education system to meet the rising demands of the labour market would further erode Sri Lanka's competitiveness. Moreover, although around 160,000 students were eligible for university entrance during 2018, only around a fifth were absorbed into the government university system. In addition to the lack of opportunities for students to engage in higher studies, a significant share also face issues in finding suitable job placements on graduation, suggesting a skills mismatch. Further, capacity of the government tertiary education sector should be enhanced both in terms of quantity and quality with greater orientation towards awarding professional qualifications. This needs to be supplemented through the establishment of a proper quality assurance framework for education services, while encouraging further private sector participation in providing such services.

The rising trend in non-communicable diseases (NCDs) threatens the sustainability of achievements in the health sector. Health statistics show that a large share of early deaths in Sri Lanka are due to NCDs such as high blood pressure, high blood cholesterol, diabetes, chronic kidney disease and cancer. Addiction to tobacco and alcohol, unhealthy dietary habits, physical inactivity and air pollution have been identified as key risk factors that drive NCDs. It has been observed that cancer is one of the rising threats among NCDs, with adolescents and youth gradually becoming victims primarily due to unhealthy lifestyles. The economic burden of NCDs is larger compared to that of communicable diseases due to their permanent nature. Costs of NCDs include direct medical costs for treatment, such as investigations and drugs, and indirect costs to the economy, including loss of income due to illness and absenteeism and lower productivity as a result of deprived health conditions. Meanwhile, Sri Lanka is facing a demographic transition with an ageing population, who are more vulnerable to chronic illnesses. This phenomenon is likely to further increase the fiscal burden on medical and welfare expenditure. Further, vulnerable households are susceptible to catastrophic health expenditure creating the potential to spiral into 'medical poverty', if they seek care for NCDs from the private health sector due to the inability of public health facilities to cater to rising demands for health services in a timely manner. In this backdrop, implementation of urgent policy measures is essential to confront this issue arising from NCDs that is threatening the sustainability of achievements in the health sector. Such measures could include awareness among the public on NCD preventive lifestyles and improved nutritional literacy, while making available the required medicinal drugs and facilities at affordable rates with the support of the private sector. In particular, it is also important to take proactive measures to lower the incidence of preventable cancers, while controlling and combating determinants of cancers, by ensuring early detection and providing holistic and accessible cancer care. Moreover, in addition to the individual based approaches, attention should be paid to encouraging innovative community-based approaches in preventing NCDs.

Despite excessive growth in public sector employment over time, public sector service delivery has stagnated due to inefficiencies and non-optimal allocation of resources, thus highlighting the urgent need for policy reforms in the public sector, including the increased use of modern technology. The number of people served by a public official has decreased significantly over the years demonstrating the high growth of public sector employment compared to population growth. However, the public sector output is far below expectations, thus impacting negatively on the economic and social wellbeing of the general public. Inefficiency of the public service arises from many fronts. Lack of independence from political interference and inadequate protection to perform duties properly are key deficiencies. Issues in relation to recruitment procedures, promotional procedures and performance appraisal also reduce the efficiency of the public service and encourage the most efficient employees to seek employment elsewhere. As a result, the public service faces constraints in attracting and retaining good quality workers. Further, the general negative attitude of public servants towards the people who require their services, and the fact that most public servants consider their rights more than responsibilities toward the society are also key issues that need to be remedied. Temporary and external appointment procedures to fill the crucial positions at the helm of public administration have also contributed to the subpar performance of the public sector as many such appointees are not held responsible for their actions later on. While many of these issues need to be addressed through well thought out public sector reform, it is essential that short term solutions to increase the efficiency of public sector services delivery are introduced using technological advancements. Although some vital systems have been automated, many more systems in the public domain require urgent automation to improve efficiency. Expediting the establishment of a centralised system for personal identification and revenue collection, which could be expanded to cover agencies handling law and order, health and education, and income redistribution is essential.

With Sri Lanka aspiring to maintain inflation at mid single digit levels with the envisaged adoption of the flexible inflation targeting (FIT) framework by 2020, stakeholders of the economy need to get accustomed to low nominal rates of interest on financial products in the future with reasonable real returns. Sri Lanka has experienced large swings in market interest rates both in nominal and real terms in the past, and with the implementation of FIT that targets inflation at mid single digit levels, a gradual decline in nominal interest rates from their current high levels is expected. Although savers will be protected as positive real returns are envisaged even after this transition, there may be an impact on some savers, particularly senior citizens who depend on interest income. This highlights the need to introduce alternative financial products or schemes that are safe and provide attractive returns to savers including senior citizens. In this regard, financial service providers could also assess the possibility of bundling deposits with other products such as medical insurance, which would enhance overall benefits received by depositors. Moreover, value added services such as offering services of specialised financial gerontologists to provide advice on savings best practices and how the senior citizens could plan their financial flows during retirement could be easily made available to enhance the overall banking experience of the elderly. As a long term solution, the government, with the assistance of the private sector, could introduce contributory pension schemes and annuity schemes, while highlighting the growing importance of such schemes in an era of low interest rates, to prevent the sole dependence on interest income during retirement. Further, there is a need to increase awareness regarding the benefits of alternative financial products, such as mutual funds and unit trusts, to promote investments in such instruments, which provide a higher return when compared to plain vanilla deposits. The timely introduction of such financial products or schemes would support the livelihoods of fixed income earning senior citizens in the low inflation - low interest rate environment expected in the period ahead.

While allowing the realisation of benefits of technological advancement in payments systems that were dominated by cash in the past, the challenges arising from such developments need to be addressed proactively. Although there are notable improvements in the country's national payments system, cash is still the most popular means of retail payment in Sri Lanka. The habit of carrying cash is encouraged as only a limited number of stores accept card payments or e-money due to the costs involved, such as annual fees and commissions, lack of required infrastructure as well as to avoid the tax net. However, the cost of handling cash is becoming increasingly challenging, for the users of cash as well as the financial institutions and the Central Bank. Therefore, this practice needs to be gradually replaced with a more secure cashless payment medium, thereby encouraging and inculcating a tradition of cashless transactions as in many other emerging market as well as advanced economies. The increased use of cashless modes of transactions will not only improve the transparency of financial flows, but would also reduce illegal and informal economic activity. Meanwhile, the increased use of mobile electronic devices such as smartphones by the public has created an enabling platform, thereby widening the avenues available for cashless transactions, including e-banking and e-wallets. Although mobile phone penetration in Sri Lanka was around 150 per cent in 2018, mobile based payments as a percentage of total retail payments was minute relative to other countries. Nevertheless, digital payments are expected to replace traditional cash transactions in the near future and in such a transformational phase, blockchain technology will be a key payment platform going forward. In this context, timely acquisition of the required technological expertise would be imperative for all stakeholders, particularly banks, merchants and end users, so as to keep up with the advances in payment technologies. While such developments are expected to reshape the financial landscape of the country, it would also enhance the efficiency and overall stability of the financial system of Sri Lanka. The Central Bank and other financial institutions are expected to strengthen precautionary measures to enhance cybersecurity by providing the required infrastructure and increasing consumer awareness about such technologies.

The national policy agenda needs to be constantly reviewed to ensure that the country's progress is aligned with the framework of the United Nations' Sustainable Development Goals (SDG) enabling the country to achieve sustained prosperity. SDGs emphasise the importance of addressing a country's economic, social and environmental issues in a holistic manner. The SDG agenda is essentially an action plan to end poverty, protect the planet and ensure prosperity for all. Although poverty levels in Sri Lanka have declined, extreme poverty pockets and income disparities still exist within the country. This highlights the need for proper targeting of poverty alleviation programmes with special focus on vulnerable groups such as economically deprived social groups, elderly and disabled people. Further, social safety nets also need to be strengthened to support those who are living just above the poverty line and are more susceptible to fall back to poverty during adverse economic conditions. In addition, the livelihoods of poor people can be uplifted through financial inclusion, provision of infrastructure facilities as well as education and skills development. Enhancing financial literacy and access to financial markets are imperative to promote the livelihoods of the poor in order to reduce their reliance on government transfers in the long run. Education and skills development also help improve the standards of living of the population through improved employability, thereby alleviating poverty and income inequality. In the meantime, despite the substantial investments made in physical infrastructure in recent years, it is important for policymakers to also focus on the environmental impact of such investments in order to ensure long run socioeconomic sustainability in line with SDGs. In this regard, the promotion of green financing initiatives is key to driving environmentally sustainable infrastructure development. Essentially, a strong collective effort by all stakeholders led by the government, is required if Sri Lanka is to achieve the SDGs by 2030. In addition, policies adopted by the government must ensure consistency with the SDG agenda.

Sri Lanka's disaster risk management policies and strategies could be strengthened further with timely information dissemination, appropriate use of modern technology and supporting economic partnerships. Sri Lanka has been affected by a series of natural disasters in the recent past, which have had an adverse impact on the economy and the society as a whole. Although disasters cannot be avoided completely, the disaster risks and their consequences could be mitigated to a great extent by identifying and using technological advancements, especially in the fields of data collection and emergency responses. Disaster prone countries, such as Japan, are increasingly relying on modern technological developments including drones, satellite imagery through Geographical Information Systems (GIS) and real-time disaster modelling, in order to enhance the level of responsiveness and improve the efficiency of disaster risk management policies. Further, real time data generated by modern sophisticated equipment would also allow disaster management institutions to develop more targeted response plans which allow better emergency preparedness and monitoring strategies. With the advent of smartphone technology, disaster management strategies have also been reshaped in the world in which real time information on disasters or weather related dynamics is alerted by individuals. Social media has also taken a technological leap in terms of emergency responsiveness during a disaster period, which allows emergency response crews to connect with survivors within a short period of time. Considering the above, Sri Lanka needs to capitalise on these modern technological developments with proper coordination between policymaking institutions and data generating agencies relevant to disaster risk management, with the support of the private sector where necessary.

The recent weak performance of the Sri Lankan economy and the limited policy spaces highlight the challenges that the country is now facing due to delaying growth supportive, yet unpopular, structural reforms. Although successive governments have expressed their intention to reform the economy through a number of policy documents, the key stumbling block has been the implementation of such proposals effectively while ensuring policy consistency and coordination amongst all stakeholders, in a manner that would improve delivery of public services as well as strengthen 'Doing Business' conditions to support private sector led economic growth. However, the country can no longer afford to postpone such reforms, if Sri Lanka is to progress along a high and sustainable growth trajectory over the medium term and catch up with countries that were behind Sri Lanka several decades ago.