

The State of the Sri Lankan Economy, Challenges and Outlook

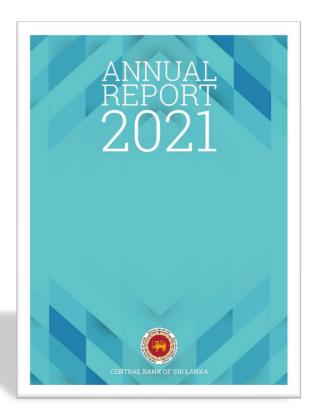
As Reflected in the Annual Report 2021

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23 May 2022

The Statutory Requirement...



This is the 72nd Annual Report of the **Monetary Board of the Central bank for** the Year 2021

Section 35 of the Monetary Law Act:

... Within four months after the end of each financial year, the Monetary Board shall submit to the Minister in charge of the subject of Finance and shall publish an annual report on the condition of the Central Bank and a review of the policies and measures adopted by the Monetary Board during the financial year and an analysis of the economic and financial circumstances which prompted those policies and measures...



Content of the Annual Report...

Volume I	Part I	-	State of the economy, its performance, policies and issues Statistical Appendix Special Statistical Appendix
Volume II	Part II	-	Accounts and Operations of the Central Bank
	Part III	-	Administrative measures adopted by the Government and the Monetary Board during the year relating to the functions and operations of the Central Bank and banking institutions in Sri Lanka
	Part IV	-	Major legislative enactments of 2021 relating to the functions and operations of the Central Bank and banking institutions in Sri Lanka

Part I - State of the Economy, Its Performance, Policies and Issues...

- 1. Economic, Price and Financial System Stability, Outlook and Policies
- 2. National Output, Expenditure, Income and Employment
- 3. Economic and Social Infrastructure
- 4. Prices and Wages
- 5. External Sector Developments and Policies
- 6. Fiscal Policy and Government Finance
- 7. Monetary Policy, Interest Rates, Money and Credit
- 8. Financial Sector Performance and System Stability

The Sri Lankan economy is currently undergoing a distressed situation, in a level never experienced in its history...















Critically low official reserves

External debt payment standstill

Accelerated Inflation

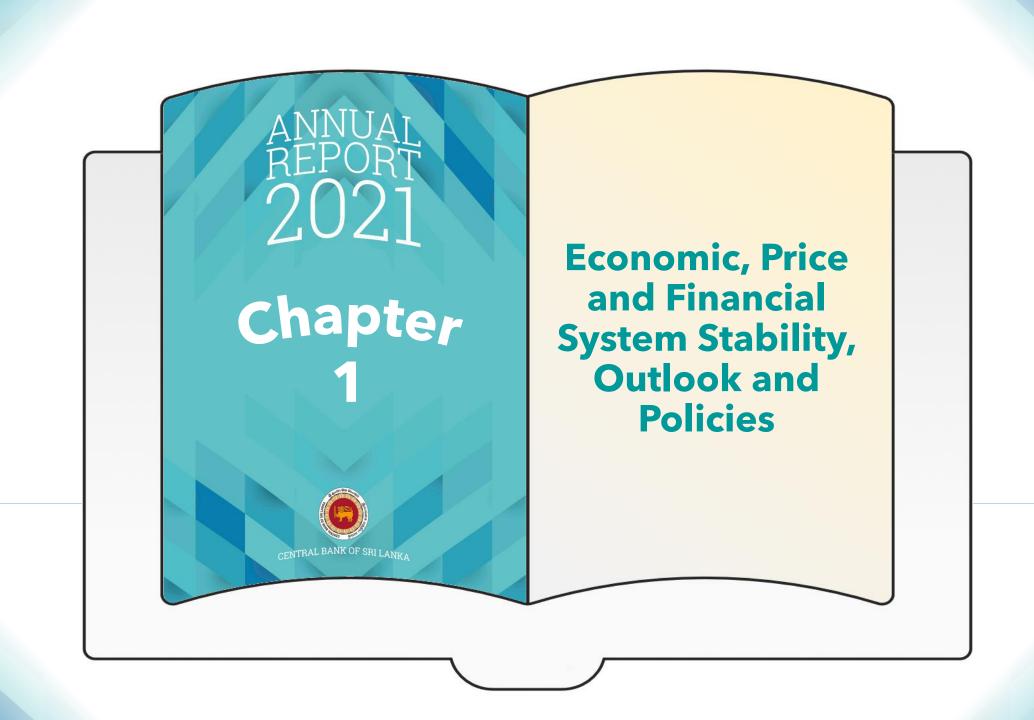
Overshot Exchange rate

Extremely Low fiscal space

Power crises, hindering activity

Social and political unrest

The Central Bank Annual Report 2021 mainly covers the performance in 2021, as required by the statute...



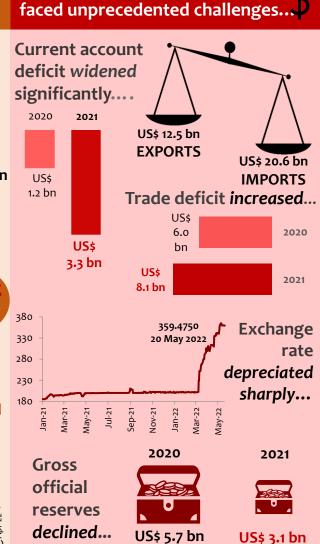
SNAPSHOT OF THE SRI LANKAN ECONOMY IN 2021 AND EARLY 2022...

EXTERNAL sector

Ultra Easy Macroeconomic Policy Package of the Central Bank and the Government supported the post pandemic economic recovery in 2021...



REAL economy rebounded in



FISCAL performance deteriorated significantly...

Outstanding

Central Government

Debt

(as a % of GDP)

86.9%

2019

Government debt stock...

Government revenue slippages and

worsen the budget deficit escalating

government expenditure overruns led to



104.6%

2021

Sovereign ratings

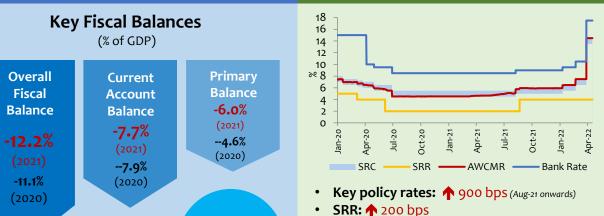
were downgraded..

100.6%

2020

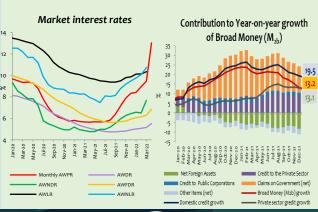
MONETARY policy tightening commenced in August 2021...





 Ceilings on selected lending products relaxed/ removed

Market interest rates which declined to historically low levels, have gradually adjusted upwards



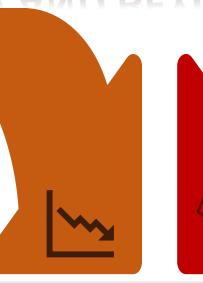


Sector

Real

WAY FORWARD: 2022 AND BEYOND

- A macroeconomic stabilisation package is needed to put the growth trajectory back on track
- Strengthening of well targeted social safety net schemes





- Seeking Bridging Finance
- Ensure the exchange rate remains flexible, without excessive volatility
- Improving non-debt creating foreign exchange inflows

Coordinated macroeconomic policies are needed to come out of the current crisis

- Fiscal Consolidation through revenue enhancement measures and expenditure rationalisation and prioritisation
- Achieving public debt sustainability
- Structural reforms in SOBEs





- Appropriate monetary policy measures to restore price stability
- Gradual reduction of monetary financing
- Strengthening the Central Bank balance sheet
- Maintenance of financial system stability

Monetary and Financial Sector

ANNUAL REPORT 2021

Chapters 2,3 & 4



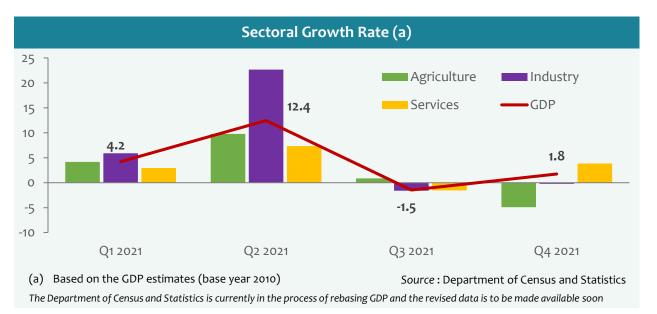
National Output, Expenditure and Income,

Economic and Social Infrastructure

&

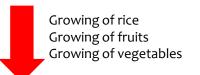
Prices and Wages

The Sri Lankan economy expanded in 2021, recovering from the depth of pandemic-induced contraction in 2020...



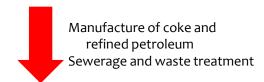
Agriculture Sector:

Growing of oleaginous fruits
Animal production
Growing of tea
Growing of spices
Forestry and logging



Industry Sector:

Manufacture of textiles and apparel
Manufacture of food and beverages
Manufacture of rubber and plastic products
Construction

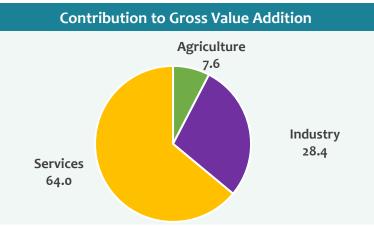


Services Sector:

Financial services and auxiliary financial services
Wholesale and retail trade
Real estate activities
Human health activities

Economic Activity	Annual Growth Rate %			
Economic Activity	2020	2021		
Agriculture, Forestry and Fishing	-2.2	2.0		
Industries	-6.9	5.3		
Services	-1.6	3.0		
Taxes less subsidies on products	-8.1	4.9		
GDP	-3.6	3.7		

Source: Department of Census and Statistics



 All three major economic activities namely,
 Agriculture, Industry and Services activities expanded during 2021

Investment and consumption expenditure grew in 2021, while net external demand weakened...

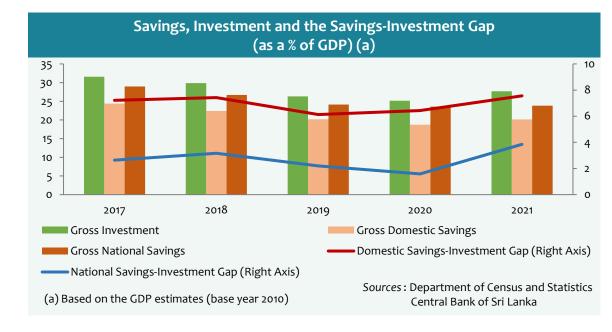
- As per the expenditure approach of GDP at current market prices
 - Gross capital formation (27.7% of GDP), which registered a contraction of 4.2% in 2020, expanded by 23.2% in 2021
 - Net external demand for goods and services contracted by 31.6%, reflecting the higher growth for import of goods and services than exports

- However, consumption expenditure (79.9% of GDP) recorded a significant increase of 9.9% in 2021

compared to the growth of 2.0% in 2020

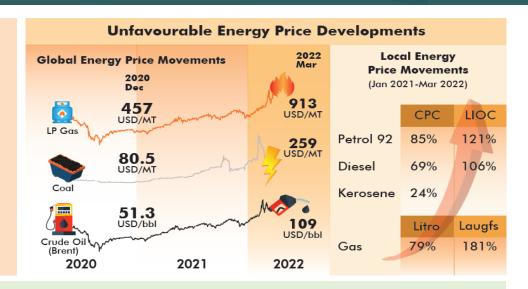
 Domestic savings as a percentage of GDP increased to 20.1% in 2021 from 18.7% in 2020

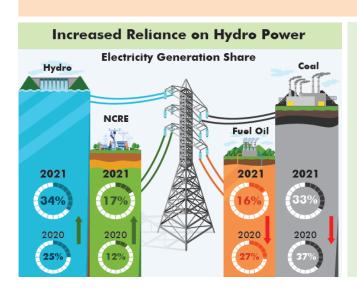
- National savings as a percentage of GDP increased marginally to 23.8% in 2021 from 23.6% in 2020
 - The national savings-investment gap widened to -3.9% of GDP in 2021, from -1.6% of GDP in 2020, due to the comparatively lower growth in national savings than the growth in investment



Performance of key SOBEs in the energy sector continued to remain disconcerting...

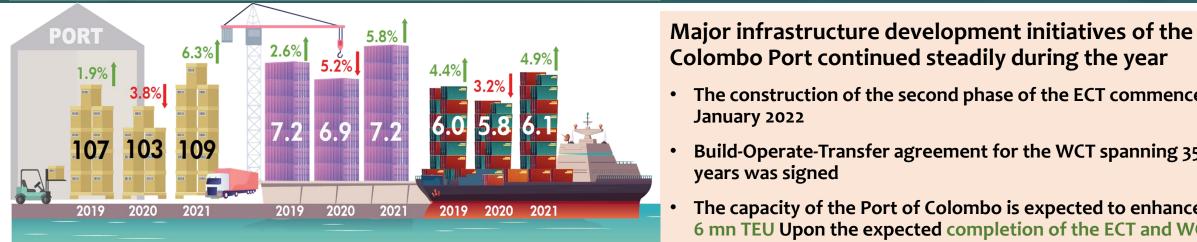
- The average crude oil price (Brent) increased by 63.3% to USD 70.80 per barrel in 2021 compared to USD 43.35 per barrel in the previous year. The highest Brent crude oil price since 2008 was recorded in March 2022
- The continuous escalation of global crude oil prices warranted the Government to increase the domestic retail prices of key petroleum products in 2021 after a hiatus of over one and half years
- During the year, sales volumes of petroleum products in the domestic market contracted by 7.7%





- Electricity demand continued to expand in line with the recovery in economic activity in 2021
- Total electricity generation increased by 6.4% to 16,716 GWh in 2021
- The reliance on low-cost hydropower generation increased during the year, while the share of expensive fuel oil-based generation remained low
- High share of hydropower generation has helped buoy the CEB's financial performance during 2021, however, this was insufficient to offset losses incurred during the year as well as those from the past

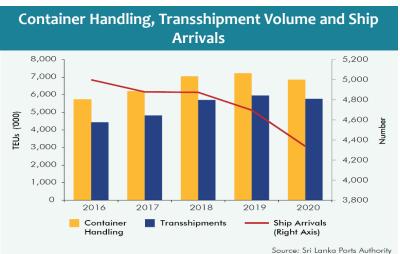
The overall performance of the port activities rebounded sharply in 2021 with operations exceeding pre-pandemic levels...



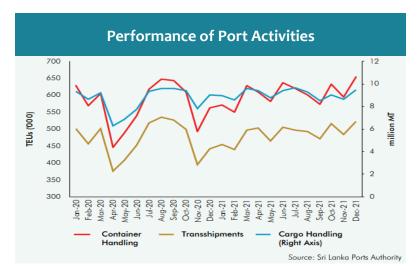
Colombo Port continued steadily during the year The construction of the second phase of the ECT commenced in

- January 2022
- Build-Operate-Transfer agreement for the WCT spanning 35 years was signed
- The capacity of the Port of Colombo is expected to enhance by 6 mn TEU Upon the expected completion of the ECT and WCT by 2025 and 2026

Cargo handling Container handling Mn TEUs Mn mt



Transshipment Mn TEUs

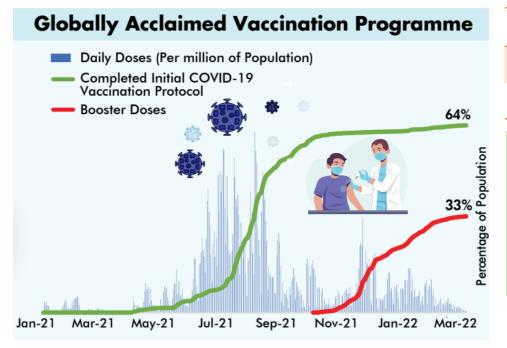


The Colombo Port continued to be ranked high on international rankings

- **Container Port Performance** Index – 17th position
- **Port Liner Shipping Connectivity** Index – 17th position



The health sector has been at the helm of containing the spread of COVID-19, while the education sector adopted the 'new normal' of online education systems...



Intermittent closures of schools warranted the adoption of various novel methods to conduct education activities to overcome the challenges of the COVID-19 pandemic

Sri Lankan status of COVID-19 vaccination drive (as of 20.05.2022)

1 Dose (out of over 12) 2 Doses (out of over 12) Booster (out of fully vaccinated)
97% 82% 55%

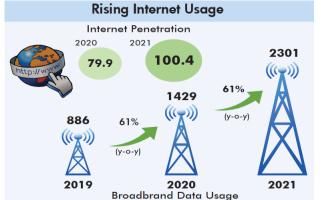
- The Government cautiously adopted appropriate and timely mobility restrictions to curb the spread of the virus, while facilitating the continuity of economic activity in order to ensure overall socioeconomic wellbeing
- Despite the several outbreaks of COVID-19 variants during 2021, the globally acclaimed vaccination drive had enabled Sri Lanka to minimise the caseload







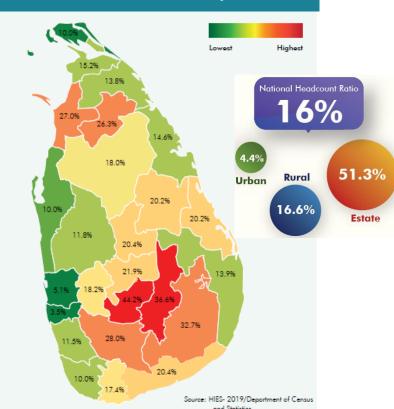




Progress in poverty alleviation is likely to have been affected by the pandemic, along with a widening of already prevalent inequalities...

The latest poverty data of the DCS reveal that approximately one in six Sri Lankans is multidimensionally poor and experiences deprivations across 42% of the weighted indicators, with substantial disparity among Districts...

Multidimensional Poverty Headcount Index District-wise Data-2019



The Government initiated several social protection measures targeting vulnerable groups of the population, while continuing all existing safety net programmes...

Government provided an allowance of Rs. 5,000 per vulnerable household in two rounds

Rs. 22.3 bn

An allowance of Rs. 2,000 per household was also provided

(targeting groups who were not covered under any govt. assistance programme)

Rs. 11.8 bn

V	Divineguma / Samu	rdhi Subsidy Programme	Nutrition Allowand	Dry Ration Programme	
Year	Families (No.) (b)	Value (Rs. million) (c)	Beneficiaries (No.) (b)	Value (Rs. million)	Value (Rs. million)
2017	1,388,242	39,707	372,407	5,408	84
2018	1,384,021	39,239	329,047	5,490	58
2019	1,800,182	44,660	300,246	5,279	105
2020	1,770,086	52,434	238,034	4,761	n.a.
2021	1,760,485	55,400	250,848	5,248	n.a.

- (a) For pregnant and lactating mothers
- (b) As at year end
- (c) Including the kerosene subsidy

Sources: Department of Samurdhi Development

State Ministry of Women and Child Development, Pre-Schools & Primary Education, School Infrastructure & Education Services Ministry of Finance

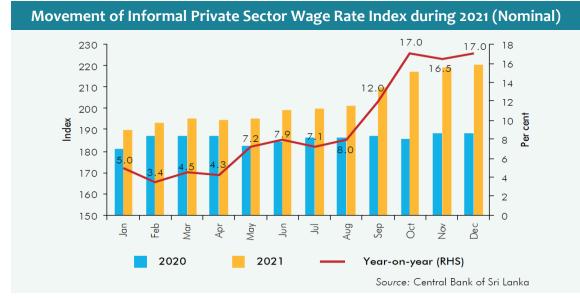


The general price level followed an overall increasing trend during 2021 with a notable rise towards the latter part of the year...

- Global commodity price hikes of both food and non-food items, higher freight charges, domestic supply side bottlenecks, direct and indirect impacts from various price revisions and demand pressures instigated with successful control of the COVID-19 pandemic made a considerable impact on domestic prices
- Within the Food category, a major contribution to the increase in the general price level was from the prices of items in the Volatile Food category
- Prices of items in the Volatile Food category increased noticeably in the latter part of 2021
- Prices of food items excluding Volatile Food increased continuously during 2021
- Prices of items in the Non-Food category increased continuously during the period with a higher pace towards the end of the year

Real wages of the employees in the formal and informal private sectors showed an increase while the real wages of the public sector employees showed an erosion in 2021...

- Nominal wages of informal private sector employees, as measured by the informal private sector wage rate index (2012=100), followed an overall increasing trend during 2021
- Nominal wages of employees in the formal private sector, as measured by the minimum wage rate index (1978 December=100) of employees, whose wages are governed by wage boards, increased significantly by 74.4% in 2021 compared to 2020
- Nominal wages of public sector employees, as measured by the public sector wage rate index (2016=100), remained unchanged during 2021 compared to the previous year





(c) Change of nominal and real wages indicated refers to the percentage change between average of 2021 and 2020 (d) Wages of the formal private sector employees, whose wages are governed by the wage boards



Several labour market indicators improved during 2021, compared to 2020, yet the labour market has not reached the pre-pandemic levels...

- The labour force increased to 8.553 mn in 2021 from 8.467 mn recorded in 2020.
- Labour Force Participation Rate (LFPR) decreased to 49.9% in 2021 from 50.6% in 2020

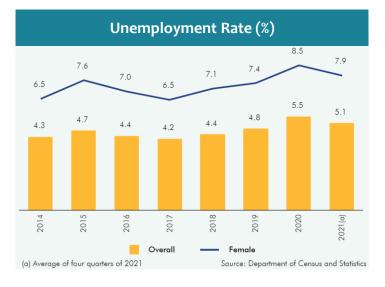
Male LFPR : 71.9% → 71.0%

Female LFPR : 32.0% → 31.8%

• The employed population increased to 8.114 mn in 2021 from 7.999 mn in 2020. The increase in employment was due to the increase in employment in agriculture and services activities

Share of employment	2020	<u>2021</u>
Agriculture	27.1%	27.3%
Industry	26.9%	26.0%
Services	46.0%	46.7%

• The unemployment rate declined to 5.1% in 2021 from 5.5% recorded in 2020



Labour Market Indicators



Labour Force

8.467 mn (2020) 8.553 mn (2021)



Economically Inactive Population

8.273 mn (2020) 8.581 mn (2021)



Labour Force Participation Rate

50.6% (2020) **49.9%** (2021)



Employed Population

7.999 mn (2020) 8.114 mn (2021)



Unemployment Rate

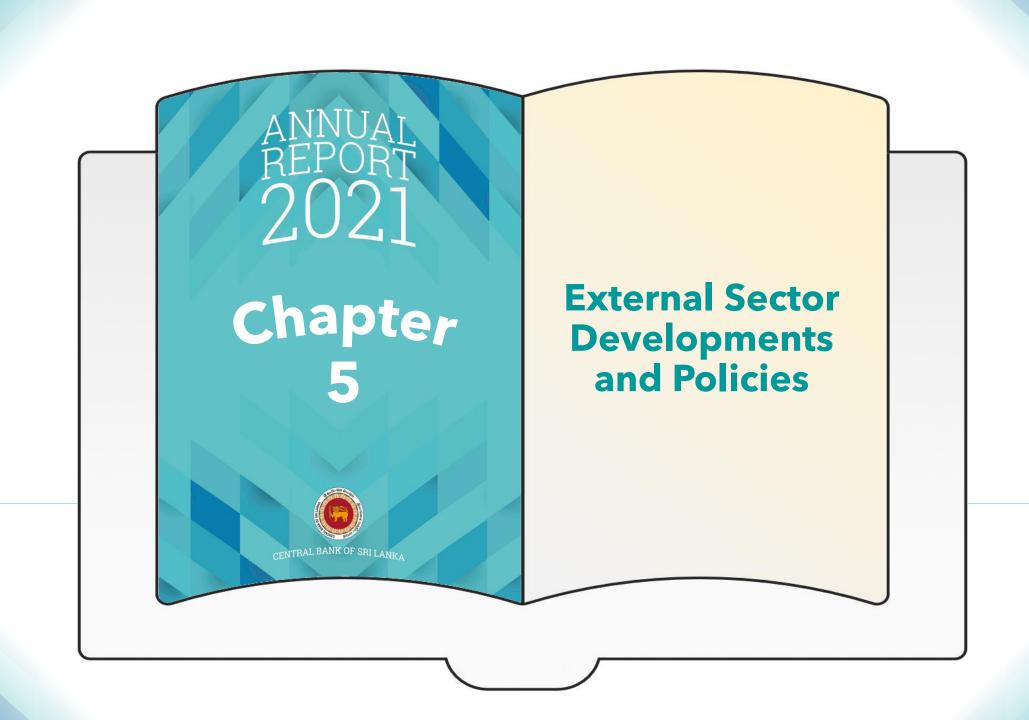
5.5% (2020) **5.1%** (2021)



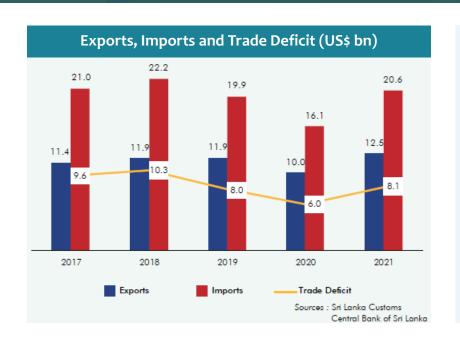
Departures for Foreign Employment

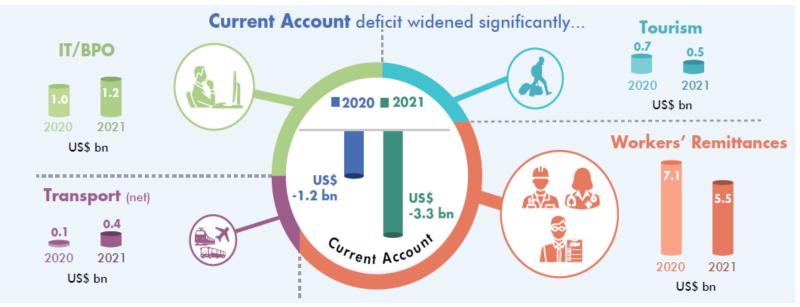
53,711 (2020) **121,795** (2021)





External current account deficit widened significantly in 2021, mainly reflecting the expansion in the trade deficit and the reduction in workers' remittances...

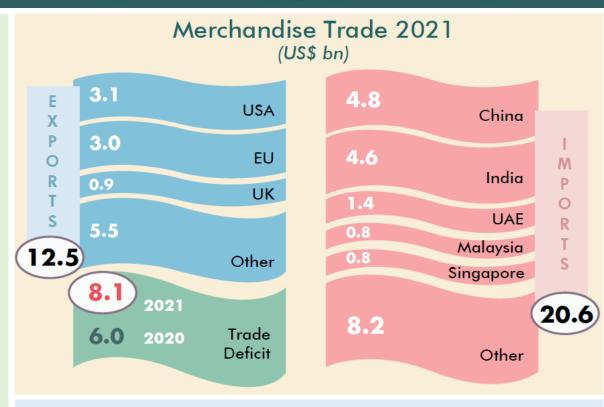




- Major inflows to the financial account included the foreign currency term financing facilities of USD 810 mn from CDB, SDR allocation of around USD 787 mn from the IMF in August 2021 and inflows on account of FDI (including loans) of USD 784 mn.
- Major outflows included the outflows of foreign investments from the rupee denominated government securities and the settlement of the maturing ISB of USD 1 bn in July 2021.

The trade deficit expanded due to the significant increase in imports, which outpaced the growth of exports...

- Earnings from exports improved by 24.4% to a record high of USD 12,499 mn:
 - Earnings from all major exports categories increased
- Increase in exports was driven by:
 - Textiles and garments(22.9%)
- Rubber products (33.6%)
- Declines were recorded in:
 - Plastics and articles due to PPE products (-55.4%)
- The increase in export volumes significantly contributed to the increase in export earnings.



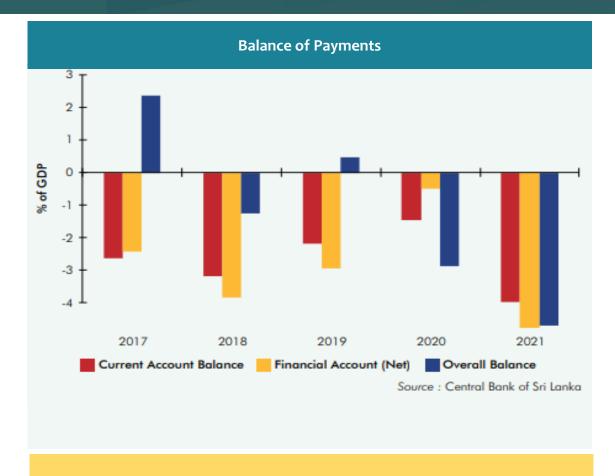
The trade deficit widened notably in 2021 led by:

- high commodity prices
- normalisation of economic activity
- pharmaceutical items such as vaccines
- the relaxation of some of the restrictions

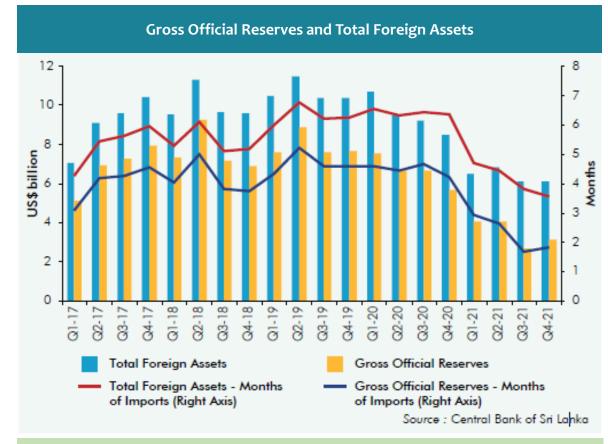
- Expenditure of imports increased by 28.5% to USD 20,637 mn:
 - Expenditure of all major imports categories increased
- Increase in imports was driven by:
 - Fuel (47.2%)
 - Textiles and articles (31.3%)
- Declines were recorded in:
 - Fertiliser (-38.9%)
 - Medical and pharmaceuticals (48.2%)
- The increase in import expenditure was influenced by both volume and price increases



Gross official reserves declined, amidst foreign debt service payments and limited foreign exchange inflows...



The overall balance recorded a deficit in 2021 as well as in 2020



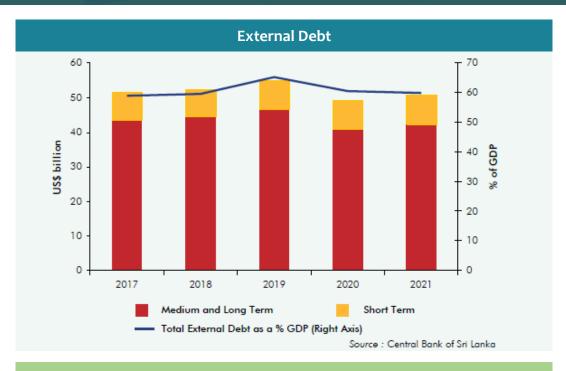
Gross Official Reserves

2021: USD 3.1 bn (1.8 months of imports)

2020: USD 5.7 bn (4.2 months of imports)



Sri Lanka's total external debt rose by end of 2021...



Total External Debt Stock

at end 2021: USD 50.7 bn (60.0% of GDP)

at end 2020: USD 49.0 bn (60.5% of GDP)

External Debt Service Payments

2021: USD 4.5 bn 2020: USD 4.6 bn

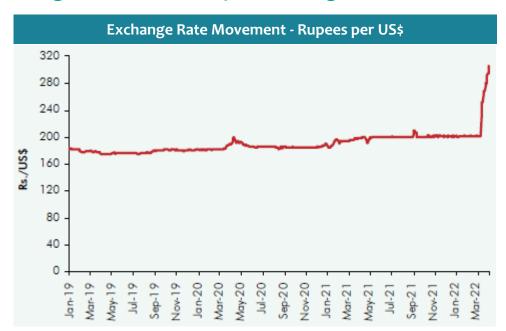
Sri Lanka's total external debt position rose in 2021 mainly due to

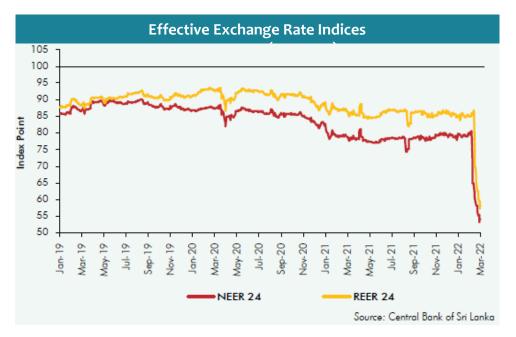
- receipt of two foreign currency term financing facilities obtained from China Development Bank
- engage with new bilateral currency swap arrangements with the Bangladesh Bank and the PBOC
- Increase in intercompany borrowing of DIEs, as a number of DIEs received intercompany loans and shareholder advances during the year
- Increase in the outstanding external debt of deposit taking corporations, owing to the significant increase in currency and deposits

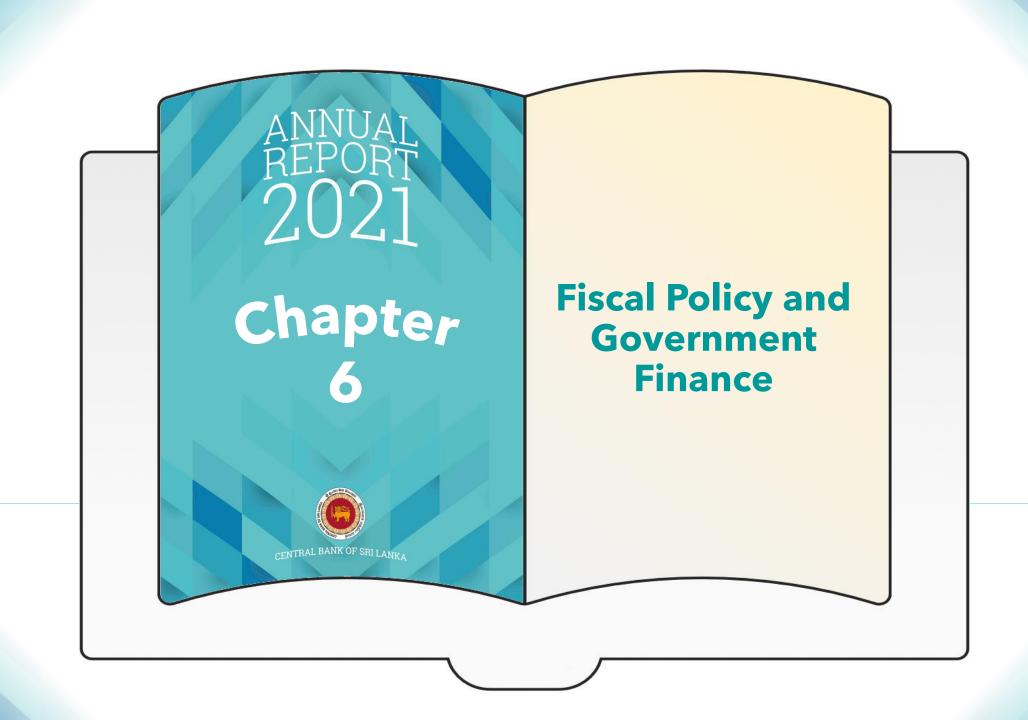


The Central Bank allowed a measured adjustment in the exchange rate since early March 2022, from the level that was maintained through 2021...

- The rupee exhibited some volatility with a pressure to depreciate, particularly during the first four months of 2021 due to limited foreign currency liquidity in the domestic foreign exchange market
- Overall, the Central Bank intervened in the domestic foreign exchange market by way of supplying USD 747 mn on a net basis in 2021
- The Real Effective Exchange Rate (REER) indices remained below the base year level (2017=100) in 2021, indicating the continued competitiveness of the Sri Lanka rupee
- The notable pressures witnessed in the domestic foreign exchange market caused a large overshooting, subsequent to the allowing of more flexibility in exchange rate determination

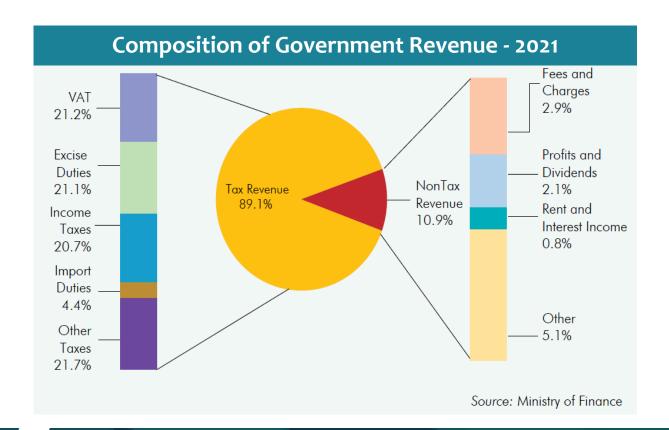






Government revenue as a percentage of GDP declined to a historic low level...

 Although government revenue, in nominal terms, grew by 6.5%, y-o-y, as a percentage of GDP, it declined to 8.7% in 2021 from 9.1% in 2020



Both the government revenue and tax revenue as a percentage of GDP declined due to

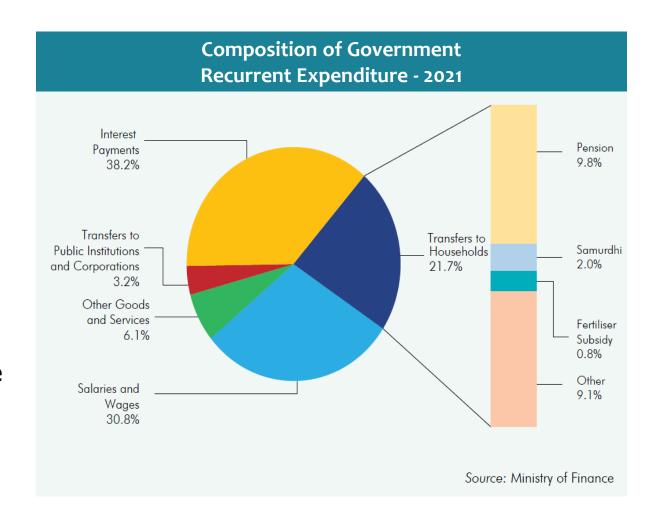
- continuation of the low tax regime
- import restrictions imposed to ease external sector pressure
- modest pickup of the economy

Summary of Government Revenue

ltem	2020 (a)	2021 (b)	
F	Rs. million		
Tax Revenue	1,216,542	1,298,019	
Income Taxes	268,249	302,113	
VAT	233,786	308,213	
Excise Taxes	321,932	306,86	
Import Duties	114,183	64,339	
Other Taxes	278,392	316,490	
Non Tax Revenue	151,417	159,052	
Total Revenue	1,367,960	1,457,07	
As a Perd	entage of GDP (c)		
Tax Revenue	8.1	7.7	
Income Taxes	1.8	1.8	
VAT	1.6	1.8	
Excise Taxes	2.1	1.8	
Import Duties	0.8	0.4	
Other Taxes	1.9	1.9	
Non Tax Revenue	1.0	0.9	
Total Revenue	9.1	8.7	

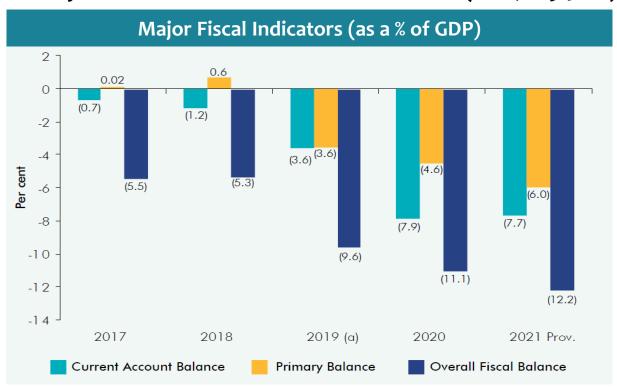
Total expenditure and net lending as a percentage of GDP increased to 21.0% in 2021 from 20.2% recorded in 2020...

- Total expenditure and net lending increased significantly by Rs. 480.7 bn to Rs. 3,521.7 bn in 2021 compared to Rs. 3,041.0 bn recorded in 2020
- Recurrent expenditure increased to Rs. 2,747.5 bn in 2021 over Rs. 2,548.4 bn recorded in 2020, reflecting higher expenses on account of salaries and wages, and interest payments
- As a percentage of GDP, recurrent expenditure moderated to 16.3% in 2021 from 17% in 2020, while capital expenditure and net lending increased to 4.6% in 2021 over 3.3% registered in 2020



The key fiscal balances weakened in 2021 and financing of the budget deficit was met through domestic sources...

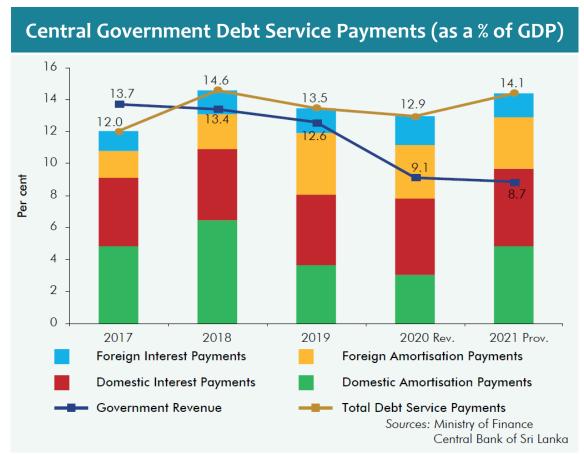
- The overall budget deficit to GDP increased to 12.2% (Rs. 2,057.9 bn) in 2021 from 11.1% (Rs. 1,667.7 bn) in 2020
- Current account deficit remained high at 7.7% of GDP (Rs. 1,290.4 bn) in 2021 broadly unchanged from 7.9% of GDP (Rs. 1,180.4 bn) recorded in 2020
- Primary deficit also weakened to 6.0% of GDP (Rs. 1,009.5 bn) compared to 4.6% of GDP (Rs. 687.4 bn) in 2020

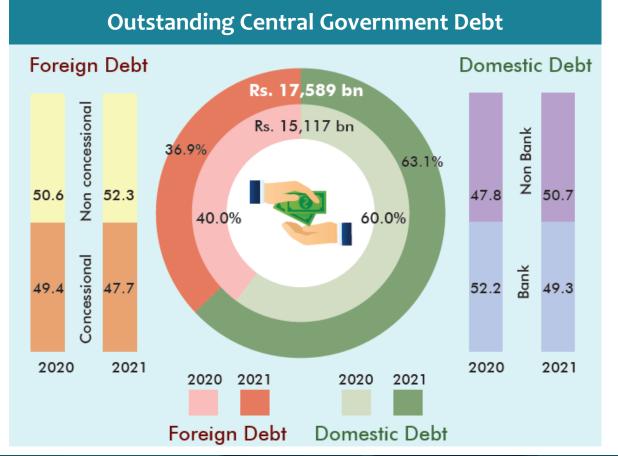


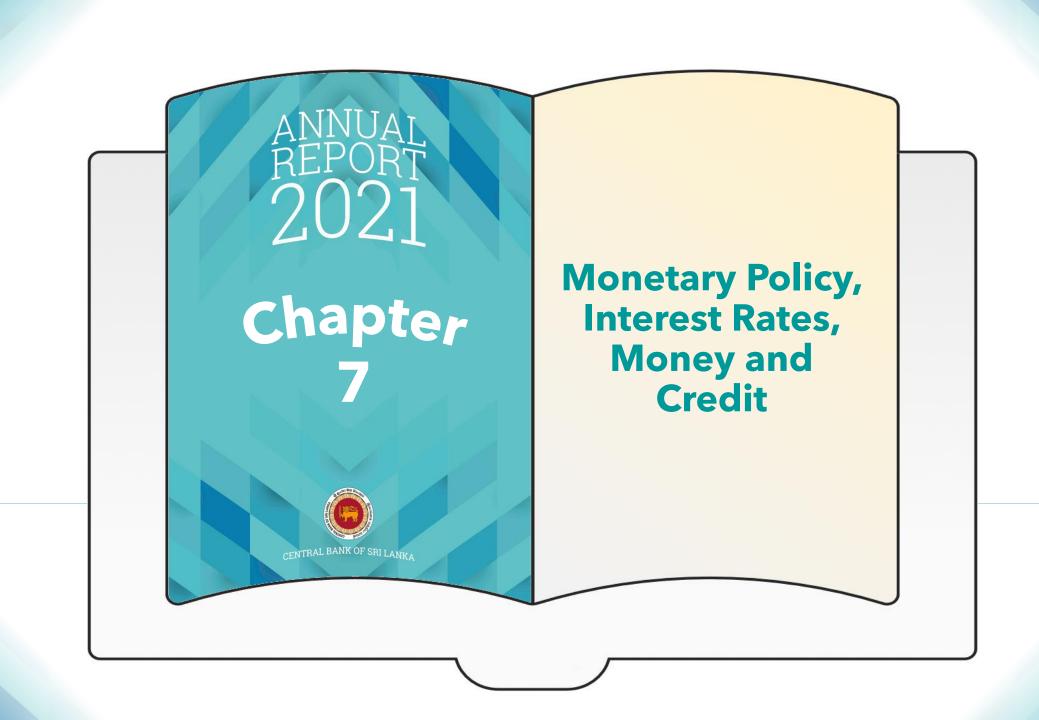


Outstanding central government debt increased to a disconcerting level in 2021...

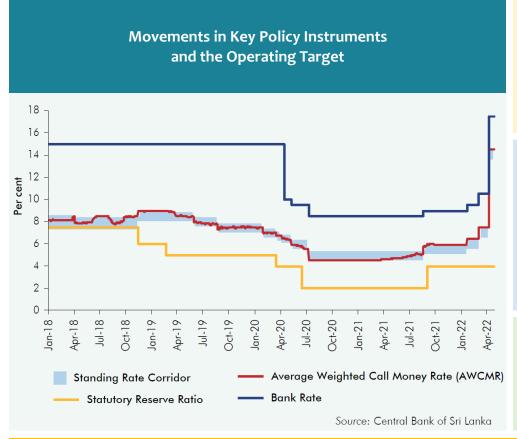
- Total debt service payments increased by 22.4% in nominal terms to Rs. 2,375.6 bn in 2021 with the rise in both debt amortisation and interest payments
- The outstanding central government debt increased to 104.6% of GDP by end 2021 from 100.6% of GDP at end 2020







The Central Bank commenced tightening its monetary policy stance since August 2021...

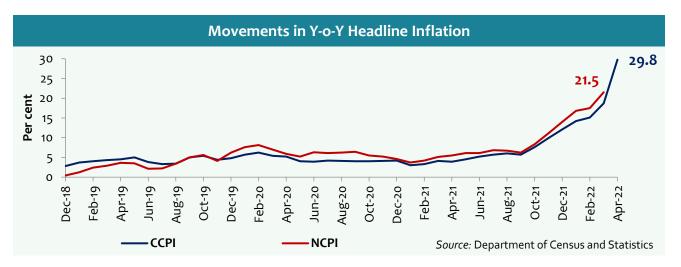


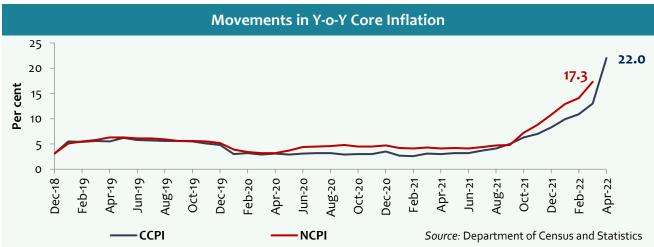
- The continuation of the extraordinary monetary policy accommodation during the first half of 2021 was required amidst multiple waves of COVID-19
- The Central Bank provided financial support to the Government by way of purchasing a significant amount of Treasury bills
- As some signs of imbalances in the economy were witnessed, particularly the build-up of demand pressures and the pressure in the external sector and financial markets
- Policy interest rates of the Central Bank were raised by 50 bps each in mid-August 2021. The SRR was also increased by 2pps to 4.0% effective September 2021
- With inflation continuing to accelerate beyond desired levels amidst sustained pressures in the external sector along with the accommodative fiscal policy stance, the monetary policy measures adopted in August 2021 turned more hawkish in 2022

Having identified the need to counter the effects of such inflationary pressures and to pre-empt escalation of adverse inflationary expectations, policy interest rates of the Central Bank were increased by 850 bps, in aggregate, during the period from January to April 2022



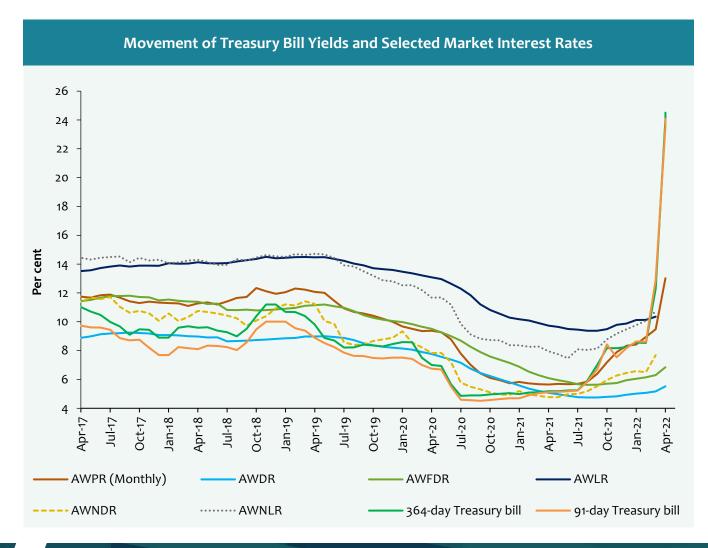
Inflation accelerated in 2021 driven by both supply side and demand side factors...





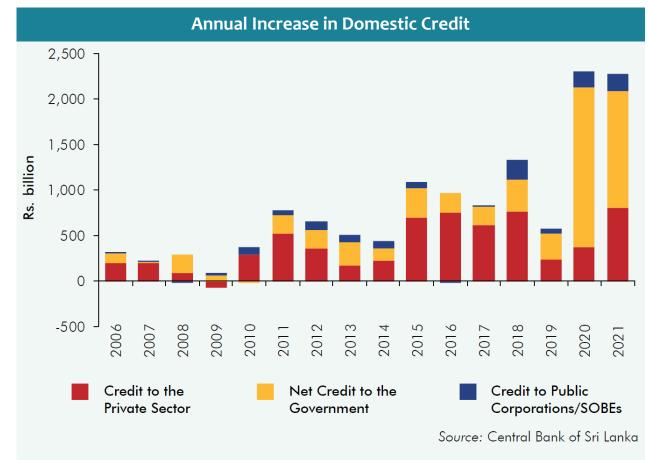
- Headline inflation (y-o-y) based on the CCPI accelerated to 12.1% by end 2021 and to 29.8% in April 2022
- Reflecting the lagged effect of significant monetary accommodation, core inflation also followed an upward trend in the second half of 2021
- Inflation expectations, gauged by the Inflation Expectations Survey of the Central Bank, remained elevated during 2021 induced by the movements in actual inflation

Market interest rates are increasing in response to tight monetary and liquidity conditions...



Interest Rate	End 2020	As of 18 August 2021	End 2021	As at 20 May 2022	From end 2020 to End 2021	From 18 August 2021 to so far	From end 2021 to so far
	%	%	%	%	bps Change	bps Change	bps Change
AWCMR	4.55	5.09	5-95	14.50	140	941	855
91-day T-bill	4.69	5.33	8.16	24.07	347	1,874	1,591
182-day T-bill	4.80	5-34	8.33	24.69	353	1,935	1,636
364-day T-bill	5.05	5.32	8.24	24.50	319	1,918	1,626
Weekly AWPR	5.81	5.71	8.61	20.32	280	1,461	1,171
Monthly AWPR	5.74	5.70	8.33	13.02	259	732	469
AWLR	10.29	9.45	9.87	10.35	-42	90	48
AWNLR	8.38	8.09	9.48	10.73	110	264	125
AWDR	5.80	4.77	4.94	5.52	-86	75	58
AWFDR	7.14	5.67	5-94	6.84	-120	117	90
AWNDR	4.93	4.99	6.45	7.68	152	269	123
AWNFDR	5.08	5.15	6.67	8.06	159	291	139

Credit extended to the private sector expanded during 2021, while lending to the Government from the domestic banking system also rose notably in 2021...



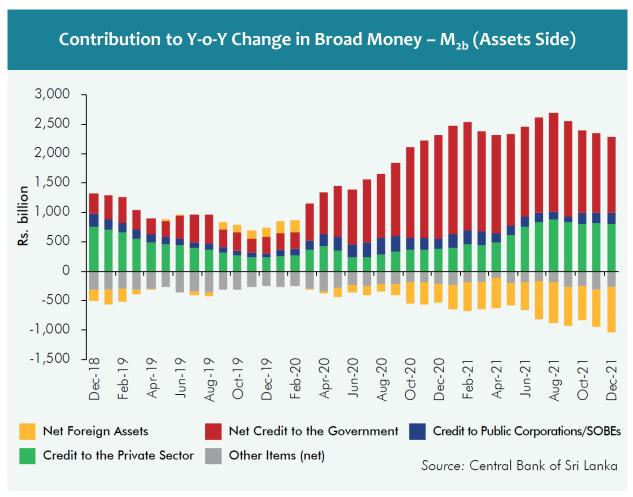
 Credit extended to the private sector by LCBs increased by Rs. 810.5 bn during 2021 Net Credit to the Credit to Government SOBEs

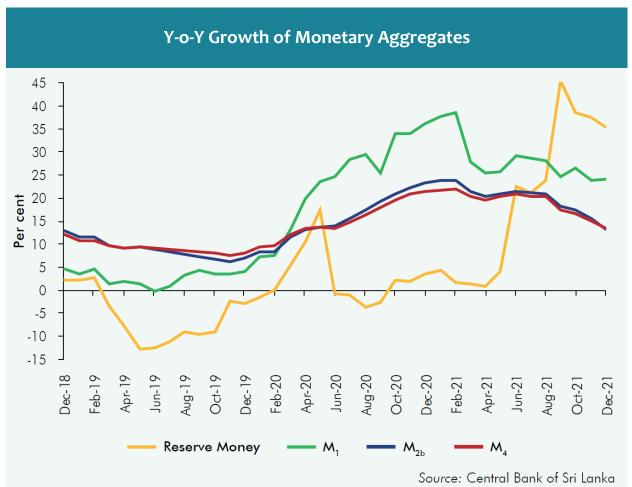
Annual Change (Rs. bn)

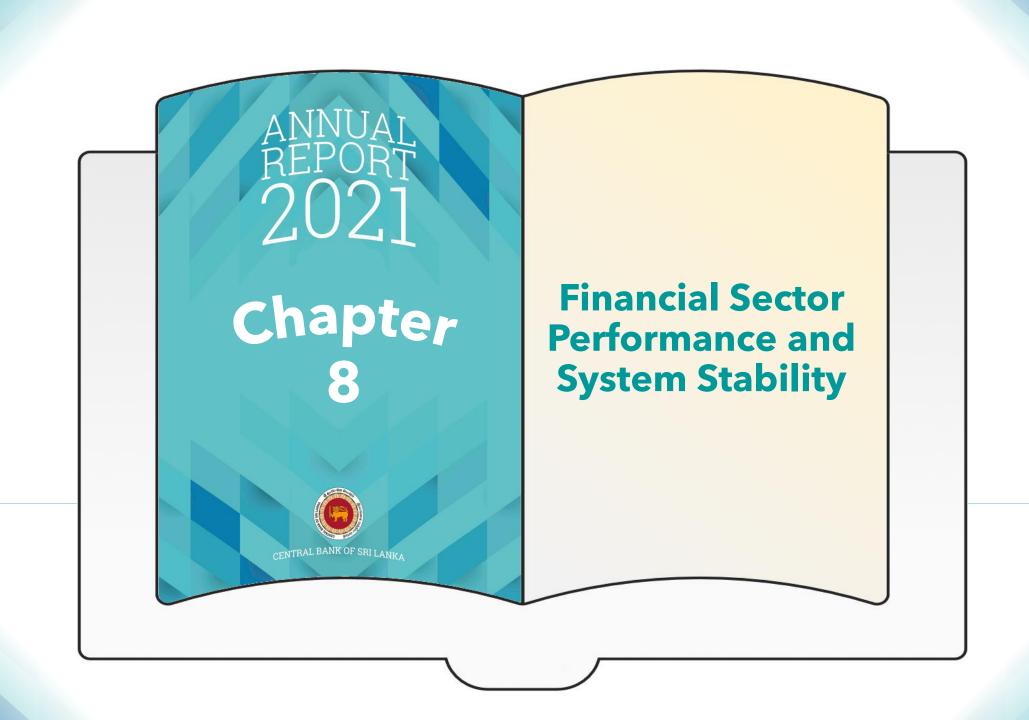
1,284 2021 186

- NCG from the Central Bank increased by Rs. 1,225.2 bn during 2021
- Credit obtained by SOBEs from the banking system continued to expand in 2021, reflecting their weak financial positions and legacy issues

The growth of M_{2b} moderated towards the latter part of 2021 due to the contraction in NFA of the banking system...

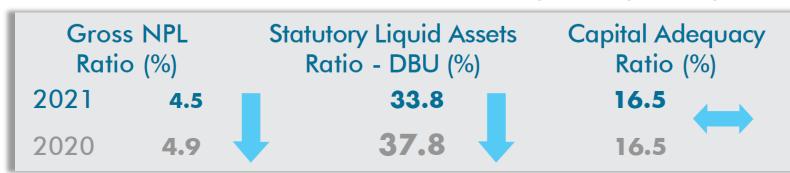


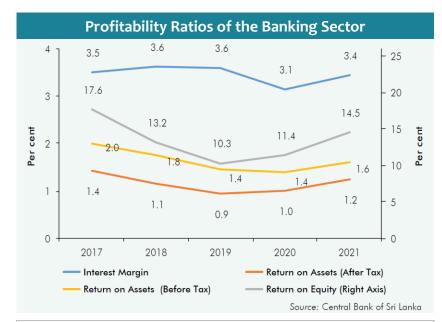


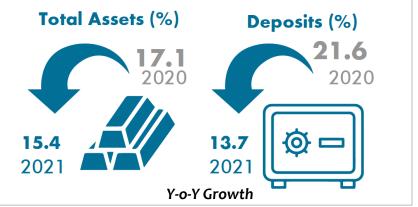


The banking sector expanded at a moderate pace during 2021...

- Profitability of the banking sector improved, compared to the previous year, due to increase in interest income, non-interest income and decline in interest expenses
- The asset base of the banking sector expanded mainly due to the growth in the loans and advances and investments
- The gross NPL ratio declined, owing to comparatively higher increase in loans and advances during 2021
- The domestic foreign exchange market liquidity was severely affected due to slow recovery of tourism, subdued levels of workers' remittances, slow conversion of export proceeds, increased import expenditure, and sovereign rating downgrades



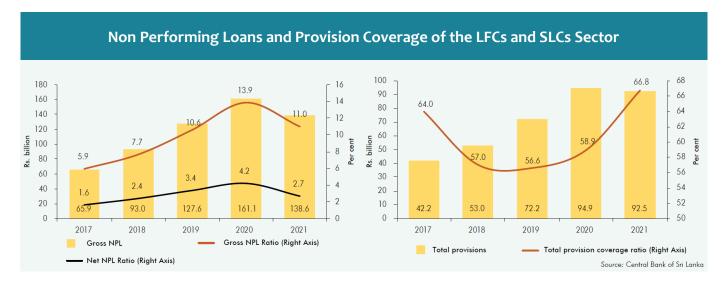




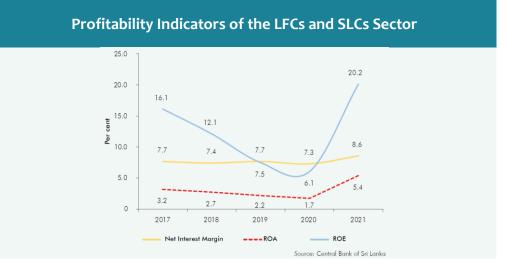


Performance of the LFCs and SLCs sector improved during 2021...

- In terms of credit growth and profitability, the LFCs and SLCs sector recorded a considerable improvement
- Profitability of LFCs and SLCs increased owing to the decline in interest expenses and increase in non-interest income
- Although the gross NPL ratio declined compared to the previous year, the NPL ratio of the sector remained high
- The sector as a whole remained stable, with capital and liquidity maintained at healthy levels above the minimum regulatory requirements









Over several decades, the **Sri Lankan economy Outpaced** its peers with the economic and social changes that have taken place,

though the country's **economic prospects** have been overshadowed by **persistent structural impediments** that need to be addressed with a sense of urgency to

ensure sustained macroeconomic stability and inclusive growth...



Achieving a **sustainable external current account balance** by enhancing net inflows from goods and services exports as well as through promoting workers' remittances is imperative to overcome the **heightened vulnerabilities** stemming from external sector imbalances.

Attracting non debt creating foreign financial inflows to strengthen the external sector resilience has become the pressing need going forward in order to ensure stability in the external sector, amidst higher foreign currency debt servicing requirements and the lack of fiscal space for debt repayment.

Measures need to be taken expeditiously to accelerate the expected FDI inflows into the Colombo Port City in order to optimise its potential benefits to the economy.

- 04
- **Persistently low revenue mobilisation** over the years remains the key underlying reason for the continued vulnerabilities in the fiscal sector and the macroeconomic imbalances, warranting the need for adopting **sustainable revenue generation** measures.

- 05
- Achievement of **medium term fiscal targets** of the Government is highly conditional on consistent, **well-coordinated and evidence based** policymaking.
- The **sharp rise in central government debt** driven by weakened fiscal sector performance over the past several decades continues to remain a key issue in the fiscal front, raising concerns for investors, creditors, and rating agencies.
- 07
- As the country grapples with the setbacks caused by the COVID-19 pandemic, the need for improving the **public sector service delivery**, in terms of quality and efficiency, has become more crucial than ever before in the process of economic recovery.

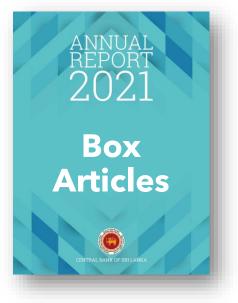
- The **overreliance of the public sector on the banking system**, including the Central Bank to source financial resources, needs to be scaled down by exploring alternative sources of financing and implementing long due structural reforms enabling the improvements in financial strength of the banking system.
- The frequent volatility and persistence of general price levels driven by **food inflation**, which weakens the Central Bank's efforts to **maintain inflation within the targeted** range and anchor inflation expectations, needs to be controlled by the Government intervention on a timely and sustainable basis.
- There is a pressing need for all stakeholders of the **energy sector** to work together to devise a **holistic plan for the energy sector** that will guarantee **energy security** of the economy, while also ensuring the **energy related SOBEs serve as growth drivers** of the economy that create positive externalities.
- Having recovered to pre-pandemic levels, **export industries** needs to build **capacity and resilience** to withstand risks from global issues and commodity price shifts and strategies to grow and diversify.

- Adoption of **stronger industrial policies and strategies** are necessary in the face of the greater need to ensure availability of essential goods in the country, develop import substitution industries and increase export earnings.
- Export sectors should be developed beyond relying heavily on free/preferential trade agreements.
- The increased **departure of students for higher education** and the significantly high foreign exchange outlay that it entails highlight the need to urgently address issues pertaining to the dearth of **domestic higher education opportunities**.
 - Despite the transformation of the agriculture sector since independence, Sri Lanka continues to **grapple with creating a sustainable agriculture sector** that is capable of generating healthy income levels to sectoral workers while ensuring food security and efficient ecosystem management that will enhance **overall productivity of the sector**.

- Despite being a key driver of economic growth and having more potential for further growth, **Micro,**Small and Medium scale Enterprises (MSMEs) in Sri Lanka face numerous hindrances, thus necessitating policy priorities at the national level.
- Despite several policy initiatives, Sri Lanka continues to struggle with waste management issues that have been further amplified by the COVID-19 pandemic.
- Focusing on 'green' development remains a critical contemporary need to ensure that Sri Lanka's natural resources are better conserved and also restored so that the economy can reap up to the full potential of its ecosystem.
 - Despite the country's efforts to achieve its target of **alleviating all forms of malnutrition** by 2030, as declared under the Sustainable Development Goals (SDGs), developments pertaining to **COVID-19** and other supply side shocks observed recently in relation to agricultural commodities **may** threaten the outcomes achieved thus far while posing hindrances to long term development.

The largely stagnant levels of female labour force participation observed in Sri Lanka for the past three decades highlight that a significant portion of the labour force remains outside the ambit of the economy's growth and development processes warranting urgent attention as the economy tries to rapidly recover from the effects of the COVID-19 pandemic and progress onto a higher growth trajectory.

Against this backdrop, committed efforts of the government and all stakeholders in defying the looming dire economic consequences and keeping the economy floating with a sense of urgency while addressing the structural issues remain to be the immediate priority to revive the external and fiscal sector outlook and preserve the macroeconomic stability going forward...



- 1. The Importance of the International Monetary Fund (IMF) Programmes
- 2. Achieving Sri Lanka's External Sector Stability in the Medium to Long Term
- 3. Fiscal Consolidation: Path to Macro Fiscal Stability
- 4. Catalysing Micro, Small and Medium Sized Enterprises (MSMEs) as a Growth Driver and Challenges
- 5. The Role of Tourism during Post-Pandemic Recovery in Sri Lanka
- 6. The Impact of Informal Money Transfers on Financial Markets and the Economy
- 7. Re-strategising State-Owned Enterprises as Growth Facilitators
- 8. A Review of Recent Global Inflation Episodes
- 9. COVID-19 Concessions and Moratoria: Challenges and Way Forward
- 10. National Financial Inclusion Strategy of Sri Lanka: "Better Quality Inclusion for Better Lives"
- 11. The FinTech Invasion: Way forward for Banking Supervisors
- 12. Major Economic Policy Measures

Thank You



The Importance of the International Monetary Fund (IMF) Programmes

- IMF provides loans under its programmes to member countries that experience BOP problems, to support rebuilding international reserves, stabilising currencies, ensuring continuity in payments for imports, and restoring economic growth, while correcting underlying problems
- Objectives, policies and conditionality in an IMF programme depend on a country's specific economic circumstances
- Policy commitments agreed with country authorities include, Prior Actions, Quantitative Performance Criteria, Indicative Targets and Structural Benchmarks

History of Sri Lanka's Relationship with the IMF

- Sri Lanka has engaged in 16 IMF programmes since obtaining IMF's membership in 1950.
- Most successful programme was the SBA in 2009 where full allocation of funds were disbursed.
- Previous IMF programmes concentrated primarily on improving foreign reserves and conduct of monetary policy.
- Vital structural reforms were also undertaken that included introduction of a fuel price formula, improving Central Bank's independence, flexible exchange rate policy and revenue based fiscal consolidation.
- In the EFF in 2016, Sri Lanka was unable to meet fiscal targets due to the significant revenue shortfalls after the Easter attacks but made significant progress on structural reforms.
- In IMF SBA in 2009, Sri Lanka fulfilled the NIR, net domestic financing and reserve money indicative targets and all structural benchmarks except one.
- IMF has also extended many technical assistance opportunities to Sri Lanka.
- Despite being part of many programmes only a few have been successfully implemented by authorities.
- This has been mainly due to the lack of commitment in meeting the conditionalities, especially those related to structural reforms.

Implications of a Future IMF Programme on Sri Lanka

- In the current context, an IMF programme will be important to overcome the challenging economic conditions.
- With the current low level of international reserves, servicing significantly high debt repayments will be extremely challenging.
- Entering into an IMF programme would provide access to additional financing and enhance investor confidence.
- Implementation of a macroeconomic policy package is expected to stabilise the overall macroeconomy which will promote non debt creating financial inflows.
- Some of the main measures that could be expected in a potential IMF programme include fiscal consolidation, appropriate monetary policy stance, exchange rate flexibility, phasing out of monetary financing, reforms of SOBEs, etc.
- Macroeconomic stabilisation measures could result in a painful adjustment in the economy, but it has become imperative considering the current economic crisis.
- Sri Lanka should ensure management of external debt sustainably through appropriate measures.
- Government has already announced suspension of external debt servicing for an interim period pending an orderly and consensual restructuring of debt obligations.
- Political and social stability is needed to successfully negotiate and implement an IMF programme.

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

- With the economic headwinds caused by the pandemic and the adverse developments in the global economy, the external sector has been facing unprecedented challenges during the last couple of years
- Implementing policies aimed at long term stability in the external sector, characterised by a sustainable external debt position and a manageable current account deficit is important

External Sector: Current Position and Issues

- 1. Persistently High Current Account Deficits
- Adverse Implications on the Current
 Account with Easter Sunday Attacks and
 COVID-19 Pandemic
- Meagre performance in the Financial Account
- 4. Mounting External Debt
- 5. Foreign Debt Service Payments
- 6. Declining Gross Official Reserves
- 7. Significant Pressure on the Exchange Rate

Short Term Measures to Restore Stability

Medium Term Measures

Long Term Measures

- The Central Bank and the Government took numerous measures
 - a. to improve liquidity conditions in the domestic foreign exchange market and build up of reserves
 - b. to increase workers' remittances
 - c. to secure foreign financial assistance
- Initiating comprehensive macroeconomic reforms consistent with an economic adjustment programme supported by the IMF
- 2. The need for ensuring "External Debt Sustainability"
- 3. Maintaining healthy levels of gross official reserves
- 4. Strengthening regional cooperation
- 1. Strengthening non-debt creating foreign exchange inflows
 - a. Promoting merchandise and services exports sectors
 - b. Enhancing workers' remittances
 - c. Attracting foreign direct investments



Fiscal Consolidation: Path to Macro Fiscal Stability

Although the pandemic has severely affected Sri Lankas' fiscal sector, current weaker fiscal position and the resultant macroeconomic issues are not entirely due to the pandemic situation, but rather a reflection of longstanding and unresolved issues in the fiscal sector



Given the serious macroeconomic imbalances emanating from weak fiscal conditions, well-planned fiscal consolidation measures are more likely to be beneficial for the Sri Lankan economy, to ensure macroeconomic stability and growth in the medium to long term

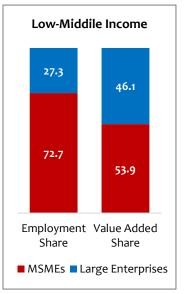
Way Forward

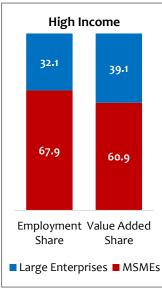
- Designing fiscal consolidation packages in a 'growth-friendly' manner by using fiscal instruments that have low fiscal multipliers
- Widening the VAT base, increasing APIT/ personal income tax rates and implementing administration and enforcement reforms.
- Better targeting of subsidy programmes while being cautious in new government recruitments and salary revisions
- Achieving sizable capital expenditure cuts through 'value for money' strategies, instead of across the board expense cuts
- Growth-promoting investments and long overdue structural reforms → Reforms related to SOBEs such as cost-reflective pricing mechanisms, institutional restructuring for efficiency gains, and market-oriented product and service delivery
- Legislative and administrative reforms to monitor the progress of fiscal consolidation

Catalysing Micro, Small and Medium Sized Enterprises (MSMEs) as a Growth Driver and Challenges

- MSMEs play an important role by acting as a breeding ground for large organisations, which in turn would promote the businesses of MSMEs by expanding supply chains
- MSMEs, provide employment opportunities for the majority of the population, in turn increasing the spending power of the general public, which drives up consumption and boosts overall economic growth
- MSMEs span across all forms of social clusters, and appear to heavily contribute to increasing the income levels of low income families, and thereby contribute to reducing disparities in the income distribution
- MSMEs can increase competition in their respective business environments, and can encourage innovative ideas
- MSMEs play an important role in achieving the SDGs, thereby playing an indirect role to support economies by improving investor sentiments as well
- MSMEs can improve the resilience of an economy up to a certain extent

Median Shares of MSMEs and Large Enterprises (%)







- Limited access to finance
- Limited business skills and inability to retain human resources
- Regulatory barriers and incoherent policy
- Low market share and limited access to markets
- Lack of information and data on MSMEs
- Impact of the pandemic and other developments
- **Gender-wise disparities**

- **Addressing financing difficulties**
 - Credit guarantee schemes
 Development banks

 - Policy driven lending Alternative financing
- **Supporting winners**
- Clustering and improving linkages
- Targeted support
 - Prioritisation
 - **Promoting IT usage**





The Role of Tourism during Post-Pandemic Recovery in Sri Lanka

- Tourism is as an important source of net foreign currency earnings since outflows for inputs is minimal. Tourism also contributes to economic growth, employment, and reduction in regional income disparity
- Tourism was the 3rd largest source of foreign currency earnings between 2014 and 2019 and steadily grew until 2018
- In 2018, tourism earned more than exports from garments net of textile imports, tea, rubber products etc. Worker remittances were greater but has declined
- Due to current external sector pressures from persistent trade deficits and large foreign currency debt burden, the tourism industry has a key role to play in maintaining the economy's resilience
- Global tourism has been steadily growing till 2019
- Tourism will pick up to 2019 level in 2024
- High yearning to travel and pent-up savings
- Small countries with macroeconomic issues are highly dependent on tourism – IMF

Tourism in the New Normal

- Importance of health and sanitary measures
- Socially-distanced tourism replacing high-density tourism.
- Most travellers are Generation X & Y (younger).
- Length of stay and spending have increased
- Last minute bookings and cancellations
- Digital nomading and staycations
- Interest in personal wellness and mental health
- Higher concern for natural environment

Way Forward

Tourism policy awaits Cabinet approval. Strategic action plan 2022-2025 is available. Further emphasis needed on,

- Exploring new drivers of tourism educational, wellness, philanthropical
- Preserving nature constructions in scenic sites and protected areas, noise pollution, animal welfare etc.
- Focus on the individual tourist's journey and concerns
- Greater use of digital technology for information provision, directing tourists to lesser visited places, contactless payment options etc.
- Improving information network –Tourism Satellite Accounting and market research capabilities of authorities
- Managing the effect of tourism industry on financial institutions
- Reducing informality within the sector
- Encourage diversity among tourists
- Diversify exports and reduce reliance on tourism gradually



The Impact of Informal Money Transfers on Financial Markets and the Economy

- The informal money transfer channels consist of service providers of unregulated markets such as Hawala, Hundi or Undiyal who have not been licensed to perform money remittance services in different countries.
- Hawala/Undiyal are highly vulnerable to misuse by money launderers and terrorist financiers due to the absence of a regulatory framework, lack of attention to the source and use of funds and difficulty to initiate legal proceedings.
- Hence these channels could be detrimental to the smooth functioning of the financial systems and economic activities of a country. Some of the impacts discussed in the box article are as follows:

Impact of Hawala/Undiyal on the Economy

- Lower Tax Income
- Understated Balance of Payment
- Reduced Foreign Reserves
- Instability of Demand for Money

- Inefficient Monetary Policy
- Constrained Availability of Banking Resources
- Threat to National Security
- The following steps have been taken by the Central Bank considering the expansion of such activities in the Sri Lankan market during the recent past and their possible impact to the economy
 - Conducting public awareness sessions (discussion, public notices, advertisements, articles) through different media such as Newspapers, TV, etc.,
 - Seizing funds arising from Hawala/Undiyal transactions till Law Enforcement Authorities investigate the source of funds for such activities
 - Introducing financial incentives to encourage foreign workers to remit their earnings through formal channels
- As per international experience; restrictions on engaging in these activities without licensing, imposing requirements for registration and monitoring activities through the legal enactments in compliance with international AML/CFT requirements and expansion of formal banking channels specially into regional areas are the steps taken to control the harmful effect of Hawala type informal money transfer channels to the economy
- The need to introduce an appropriate legal framework to formalize Hawala type systems has been identified in Sri Lanka and authorities are working towards this requirement

Re-strategising State-Owned Enterprises as Growth Facilitators

Over the last three decades

successive governments have alternated between attempts at privatisation and nationalisation.

Over 400 SOEs operating

in several key sectors including power, energy, finance and insurance, water, aviation, health and education, among others.

SOEs have become a heavy fiscal burden with significant macroeconomic implications.





Cost Reflective Pricing Policies



Improvement of Strategic Direction



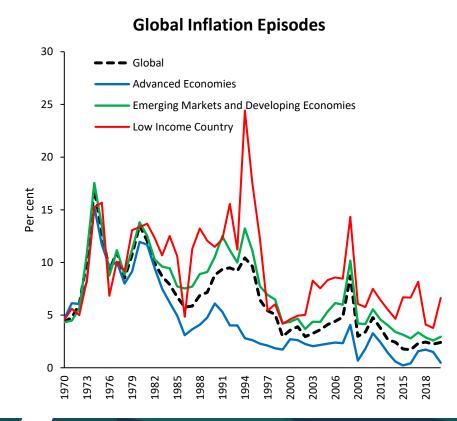
Enhancement of Financial Transparency & Accountability

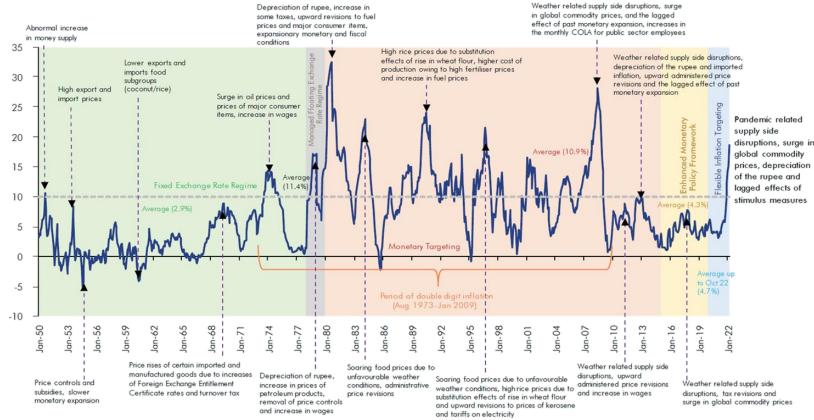


Strengthening of Corporate Governance

A Review of Recent Global Inflation Episodes

- There have been frequent high inflation episodes globally as well as domestically due to numerous reasons, however, inflation in general has been on a downward trend
- Among the reasons for global high inflation episodes are increased commodity prices, mainly oil and food, elimination of price controls domestically, supply shortages and pent-up demand, policy mistakes, and disruptions to supply chains as in COVID 19
- High inflation in developing and emerging markets persisted longer than that of developed countries due to populist political culture, high budget deficits and financing deficits by the central bank, high government expenditure, high military expenditure, low productivity, frequent weather shocks, high persistent inflation expectations by the economic agents, excess money supply and unstable exchange rates
- Among the policy responses to address high inflationary episodes are, monetary policy tightening with appropriate fiscal policies by the governments, price controls and subsidies, transparent and independent central banking, safety net interventions such as cash transfers. active use of countercyclical policies including the fiscal rules





COVID-19 Concessions and Moratoria: Challenges and Way Forward

<u>-</u>		
1	2	3
Introduction	Concessions provided by Central Banks including CBSL	Challenges for FIs
 COVID-19 challenges and hardships faced by Sri Lanka and economies worldwide 	 Relief packages introduced by CBSL Relief beyond moratoria Relief packages introduced by other Central Banks Why interest? Couldn't we have introduced debt relief with zero interest? 	 Rising NPLs and the impact on other KPIs Managing liquidity and honour their debt repayment obligations Managing with limited resources and providing essential services Changes to business plans, strategic direction and rearranging priorities
4	(5)	6
		Way forward
Unwinding Moratoria	What's beyond moratoria?	Expectations for an inclusive, sustainable revival
_		and growth
 Why unwinding moratoria too early or too late is bad for the economy How to strike a balance and manage expectations of all stakeholders concerned, when unwinding relief packages 	 Restructuring loans based on the new normal cashflows and business potentials Encourage firms (borrowers) and banks (FIs) to rethink of their business models – new business opportunities, increase efficiency, recapitalisation, alternative/low-cost funding methods Equity financing for the revival of viable businesses 	 Reflect on the lessons learned from the pandemic and use the pandemic as an opportunity to introduce long overdue reforms to make businesses greener. Make the financial sector and borrowers ready and resilient to face man-made and natural catastrophes. Support local, community-led, women-led, green and social enterprises for a post-pandemic inclusive recovery.

National Financial Inclusion Strategy of Sri Lanka: "Better Quality Inclusion for Better Lives"

• Bringing together all key stakeholders for the first time to carry out a long-term, comprehensive, and coordinated strategy for achieving financial inclusion in Sri Lanka, the National Financial Inclusion Strategy (NFIS) was launched in March 2021 by the CBSL, to ensure all individuals and enterprises in Sri Lanka have well-informed, fair, and equitable access to a range of high-quality, appropriate, secure, and affordable financial products and services that they can use to contribute to economic growth and improve their standard of living.

Key Policy Areas

Digital Finance and Payments

MSME Finance

Consumer Protection

Financial Literacy and Capacity Building

Objectives

Existence of a well-established digital finance and payments system in the country

Eliminate obstacles faced by MSMEs in accessing appropriate and affordable financial products and services

Well-designed regulatory frameworks and measures to secure financial consumer protection the uptake and usage of financial products and services

High level of financial literacy among individuals and MSMEs to increase the uptake and usage of financial products and services

Expected Impact

More conducive regulatory environment and necessary digital infrastructure to facilitate cost efficiencies and viable delivery of digital financial services

Increase access to financial products and services for MSMEs to be more productive towards generating income and creating more formal employment opportunities

Strengthened market conduct of all types of financial service providers to promote well-being of customers

Broader the right financial knowledge, skills, and behavior of consumers empowering future Sri Lankans in meeting their basic financial needs effectively

The Fintech Invasion: Way Forward for Banking Supervisors

1

2

Introduction

- Rise of FinTech as a challenger to traditional banking allowing more competition, increased efficiency, and reduced intermediation cost
- Potential for emergence of risks on technology, data governance, and market conduct; and need for banking supervisors to adopt latest technologies

Fintech innovations that will impact traditional banking

- open banking (extending banking through 3rd party platforms), virtual banking (branchless banking), and digital currencies
- The need to adopt an open yet cautious regulatory approach and the need for supervisors to use SupTech

3



SupTech capabilities for banking supervisors

 Supervisory information systems, advanced data analytics based early warning signals, surveillance capabilities to detect misconduct and financial crimes, and use of artificial intelligence (AI) to generate supervisory insights from public and non-public unstructured data

Initiatives already taken by CBSL

 Regulatory framework on technology risk management and resilience, Regulatory sandbox, and Proof of concept (POC) on KYC data sharing

