Chapter 3

MACROECONOMIC OUTLOOK

Summary

The Sri Lankan economy is expected to continue to recover and reach its potential in the coming years, bolstered by the return of greater macroeconomic stability. Assuming the uninterrupted continuation of ongoing ambitious reforms and economic adjustments underpinned by the Extended Fund Facility (EFF) programme of the International Monetary Fund (IMF), stability is envisaged on multiple fronts. Following the swift disinflation process, inflation is expected to remain around the target of 5 per cent on average during 2024, despite intermittent fluctuations caused by supply side shocks amid lower demand conditions. Inflation is expected to stabilise around the target over the medium term, supported by appropriate policy measures. The Central Bank's independence coupled with greater public accountability in monetary policymaking would be instrumental in maintaining domestic price stability over the medium term. Early signs of economic recovery that were observed in the second half of 2023 are expected to translate into a broadbased recovery across all sectors in the ensuing period. Despite a possible widening in the trade deficit driven by the revival of imports along with increased economic activity, the external sector is anticipated to build upon the favourable developments in 2023, with the revived tourism sector, elevated levels of workers' remittances, and expected non-debt creating inflows, while augmenting external buffers. With the waning of vulnerabilities that were profound in 2023, the financial sector is expected to expand its service provision in the period ahead, with improved resilience bolstered by the strengthening of the legislative structure. On the fiscal front, the Government is expected to persevere with its fiscal consolidation efforts, while continuing the much needed reform drive to ensure the transition of the economy towards a sustainable path. Amidst longer term challenges arising from climate change, population ageing and geopolitical tensions, the overall outlook for the Sri Lankan economy in the medium to long term will be conditional on the continuation of the IMF-EFF programme with the successful completion of the debt restructuring process and uninterrupted execution of productivity and efficiency enhancing reforms with broader political and social consensus.

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3.1 Global Economic Environment and Outlook

The global economy showed signs of resilience in 2023 and is expected to recover from a multitude of economic woes including sluggish growth, stubbornly slow disinflation, and risks emanating from geopolitical uncertainties, going forward. According to the World Economic Outlook (WEO) update of the IMF released in January 2024, global growth is estimated to have slowed down from 3.5 per cent in 2022 to 3.1 per cent in 2023. Global growth is projected to remain around 3.1 per cent in 2024 and accelerate to 3.2 per cent in 2025 on account of the stronger rebound in several large economies, including the United States (US), and fiscal stimulus in China. However, the projected global growth rates for 2024-2025 are below the historical average (2000-2019) of 3.8 per cent, reflecting the impact of restrictive monetary policies to curb inflation, fiscal tightening amidst high debt weighing on economic activity, and low underlying productivity growth. Advanced economies are expected to experience a slowdown, with growth dropping from 2.6 per cent in 2022 to 1.6 per cent in 2023 and 1.5 per cent in 2024, before rising to 1.8 per cent in 2025. Although Eurozone economies and the United Kingdom are expected to recover from their low rates of growth in 2024, owing to waning effects of the war in Ukraine, the moderate growth in advanced economies is mainly attributed to the slowdown in the US with lagged effects of monetary policy tightening as well as contractionary fiscal policies. This anticipated growth moderation in advanced economies could have an adverse impact on Sri Lanka's export performance as the US and the European Union are the largest export destinations for Sri Lanka. Also, subdued economic growth in advanced economies may also have a bearing on the much anticipated resurgence of high-spending tourist arrivals to Sri Lanka. Meanwhile, emerging markets and developing economies are expected to maintain a stable growth of 4.1 per cent in 2023 and 2024, the same as in 2022, which is expected to rise to 4.2 per cent in 2025. The resilience in these economies mainly reflects the strong growth rates in India and China. The Indian economy is estimated to have grown by 6.7 per cent in 2023 and projected to remain strong at 6.5 per cent in both 2024 and 2025 reflecting robust domestic demand. Economic growth in China is estimated at 5.2 per cent in 2023 and it is projected at 4.6 per cent and 4.1 per cent in 2024 and 2025, respectively, considering the increased fiscal support to build capacity against natural disasters. Higher anticipated growth rates in China and India are expected to have a favourable impact on the Sri Lankan economy, given the strong economic and geopolitical linkages with these economies, particularly in terms of merchandise trade, tourism, Foreign Direct Investment (FDI) and financial assistance.

Table 3.1 Global Economic Developments and Outlook (a)

	2022 (b)	2023 (c)	2024 (Proj)	2025 (Proj)
World Output	**3.5**	**3.1**	**3.1**	**3.2**
Advanced Economies	2.6	1.6	1.5	1.8
United States	1.9	2.5	2.1	1.7
Euro Area	3.4	0.5	0.9	1.7
United Kingdom	4.3	0.5	0.6	1.6
Japan	1.0	1.9	0.9	0.8
Emerging Market and Developing Economies	4.1	4.1	4.1	4.2
Emerging and Developing Asia	4.5	5.4	5.2	4.8
China	3.0	5.2	4.6	4.1
India	7.2	6.7	6.5	6.5
World Trade Volume (Goods and Services)	**5.2**	**0.4**	**3.3**	**3.6**
Price Movements				
Consumer Prices				
Advanced Economies	7.3	4.6	2.6	2.0
Emerging Market and Developing Economies	9.8	8.4	8.1	6.0
Commodity Prices				
Oil	39.2	-16.0	-2.3	-4.8
Non-fuel	7.9	-6.1	-0.9	-0.4

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

Source: World Economic Outlook (January 2024), IMF

Global headline inflation is falling faster than expected due to monetary policy tightening, softening labour markets and passthrough effects of the relative decline in energy prices, thus creating conducive conditions for the envisaged easing of global monetary conditions. Global inflation is expected to have gradually decelerated from 8.7 per cent in 2022 to 6.8 per cent in 2023 and projected to moderate further to 5.8 per cent in 2024. Although commodity prices, mainly oil prices, are expected to decline over the next two years contributing to faster disinflation, new commodity price spikes resulting from geopolitical shocks, including possible escalation of the conflict in Gaza to the Middle East region as well as continued attacks in the Red Sea, could accelerate global inflation. Higher global energy prices may result in increased import expenditure thereby widening the trade deficit while also weighing on inflation in many countries, including Sri Lanka. Meanwhile, weather related shocks such as floods and droughts together with the El Niño phenomenon could cause food price hikes and jeopardise efforts to restore price stability globally. Additionally, many economies face significant debt distress risks due to escalating debt service costs necessitating fiscal consolidation measures which could hinder growth prospects further.

The global monetary policy stance which was gradually tightened in 2022 in view of rising inflationary pressures, was further tightened to significantly high levels during 2023 as inflation remained excessively stubborn. Supply disruptions due to geopolitical tensions, lagged effects of monetary and fiscal stimulus during the pandemic, high inflation expectations, and wage pressures were key factors that contributed to the persistence in inflation in many advanced and emerging market economies. Despite some early signs of inflation moderating, incoming data and other unfavourable global developments such as the economic decoupling where Western economies have loosened ties with China, and tensions in the Red Sea and its impact on global and regional supply chains, together with downward rigid core inflation levels have led central banks globally to remain cautious in easing their monetary policy stance in 2024. Meanwhile, the US dollar strengthened against other major currencies so far in 2024. This can be attributed to robust economic performance in the US, including higher than expected surge in new job additions to the US economy. Further, the delay in normalisation of interest rates amidst persistent inflationary pressures is also expected to contribute towards a stronger US dollar in the near future.

3.2 Domestic Economic Outlook

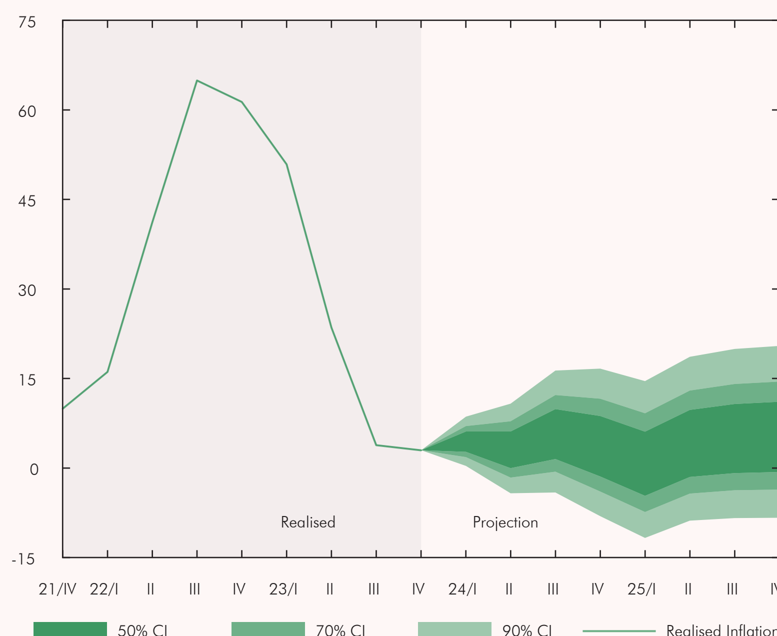
3.2.1 Inflation Outlook

Despite intermittent fluctuations caused by supply side deviations amid lower demand conditions, inflation is expected to stabilise around the targeted level over the medium term, supported by appropriate policy measures. Following the rapid disinflation process, inflation reached lower single digit levels towards end 2023. However, a temporary uptick in inflation was observed during early 2024, mainly driven by the Value Added Tax (VAT) adjustments implemented in January 2024. Nevertheless, the realised data thus far in 2024 indicates that the direct impact of the VAT change on inflation and its second round effects may not be as large as initially envisaged amidst subdued demand. Moreover, the effects of this tax increase are anticipated to be partly offset by the notable downward

revisions to electricity tariffs effective from March 2024 and the moderation in food prices. These effects partially accounted for the considerable reduction of inflation observed in March 2024, and as per the current projections of the Central Bank,[1] they are expected to contribute to inflation remaining below the target of 5 per cent during the second quarter of 2024. The trajectory for headline inflation during the latter half of the year could be somewhat impacted by the next round of revisions to electricity tariffs and cost reflective monthly revisions to fuel and gas prices. However, inflation is expected to remain around the target of 5 per cent, on average, during 2024. As per currently available information, inflation is expected to decline for a short period in early 2025, mainly due to the favourable base effect associated with the increase in inflation due to tax adjustments and notable food inflation in early 2024 in the absence of aggregate demand pressures. Meanwhile, core inflation is projected to rise in the upcoming quarters, largely due to changes in the VAT structure, despite subdued demand conditions. This projected path of core inflation is also contributed by the fact that it may not benefit from the direct impact of reduced electricity tariffs as energy related expenses are not included in the core consumption basket, and the relatively high persistence that is usually observed in core inflation. Similar to headline inflation, core inflation is expected to follow a declining trend in early 2025, partly contributed by the favourable base effect, albeit at a lower

1 The Central Bank uses a Quarterly Projection Model (QPM), which is a semi-structural macroeconomic model, to arrive at medium term macroeconomic projections. Projections are updated during each monetary policy round, using data on the latest economic developments, including, but not limited to, monthly releases of inflation data and quarterly releases of GDP data by the Department of Census and Statistics (DCS) and global macroeconomic forecasts. In addition to data updates, forecast near term movements of key macroeconomic variables together with staff judgements, are taken as key inputs for QPM based medium term projections. The projections discussed in the Annual Economic Review 2023 are based on the March 2024 forecast round.

Figure 3.1 **Headline Inflation Projections CCPI* (quarterly average, year-on-year, %)**



*Realised data up to Q4 2022 shown in the fan chart are based on CCPI (2013=100, seasonally adjusted), while data after this period are based on CCPI (2021=100, seasonally adjusted).

Note: A forecast is neither a promise nor a commitment

The projections reflect the available data, assumptions and judgements made at the forecast round in March 2024.

The fan chart illustrates the uncertainty surrounding the baseline projection path using confidence bands of gradually fading colours. The confidence intervals (CI) shown on the chart indicate the ranges of values within which inflation may fluctuate over the medium term. For example, the thick green shaded area represents the 50 per cent confidence interval, implying that there is a 50 per cent probability that the realised inflation outcome will be within this interval. The confidence bands show the increasing uncertainty in forecasting inflation over a longer horizon.

Source: Central Bank Staff Projections

Table 3.2

Near term Macroeconomic Projections (a)

Indicator	Unit	2022 (b)	2023 (c)	Projections 2024
Real Sector (d)				
Real GDP Growth	%	-7.3 (c)	-2.3	3.0
GDP at Current Market Price	Rs. tn	24.1 (c)	27.6	29.9
Per Capita GDP (e) (f)	USD	3,464 (c)	3,830	4,075
Total Investment	% of GDP	28.6 (c)	25.3	25.8
Domestic Savings	% of GDP	25.0 (c)	23.8	22.4
National Savings	% of GDP	27.2 (c)	27.2	26.3
External Sector (d)				
Trade Balance	% of GDP	-6.7	-5.8	-7.8
Exports	USD bn	13.1	11.9	12.9
Imports	USD bn	18.3	16.8	20.0
Current Account Balance (g)	% of GDP	-1.9	1.8	0.5
External Official Reserves	Months of Imports	1.2	3.1	3.4
Fiscal Sector				
Total Revenue and Grants	% of GDP	8.4 (h)	11.1 (d)	13.0 (i)
Expenditure and Net Lending	% of GDP	18.6 (h)	19.4 (d)	22.3 (i)
Current Account Balance	% of GDP	-6.4 (h)	-6.0 (d)	-3.2 (i)
Primary Account Balance	% of GDP	-3.7 (h)	0.6 (d)	0.8 (i)
Primary Account Balance (With Bank Recapitalisation)	% of GDP	-	-	-1.3 (i)
Overall Budget Deficit	% of GDP	-10.2 (h)	-8.3 (d)	-7.3 (i)
Overall Budget Deficit (With Bank Recapitalisation)	% of GDP	-	-	-9.4 (i)
Central Government Debt	% of GDP	114.2 (h)	103.9 (d)	110.3 (i)
Monetary Sector and Inflation				
Broad Money Growth (M_{2b}) (j)	%	15.4	7.3	15.0
Private Sector Credit Growth (in M_{2b}) (j)	%	6.2	-0.6	8.5
Annual Average Inflation	%	46.4 (k)	17.4 (l)	5.0 (l)

(a) Based on information available up to mid-March 2024
(b) Revised
(c) Provisional
(d) GDP estimates (base year 2015) released in March 2024 by the Department of Census and Statistics have been used
(e) Estimates updated with the latest population figures
(f) Based on quarterly GDP in USD terms calculated using quarterly average exchange rate
(g) Based on accrual basis
(h) Revised based on the latest GDP data published by the Department of Census and Statistics on 15 March 2024
(i) Projections for 2024 are based on 2023 December IMF staff report
(j) Year-on-year growth based on end year values
(k) Based on CCPI (2013=100)
(l) Based on CCPI (2021=100)

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

magnitude than that of headline inflation. However, core inflation is expected to stabilise around mid-single digit levels over the medium term with appropriate policy measures.

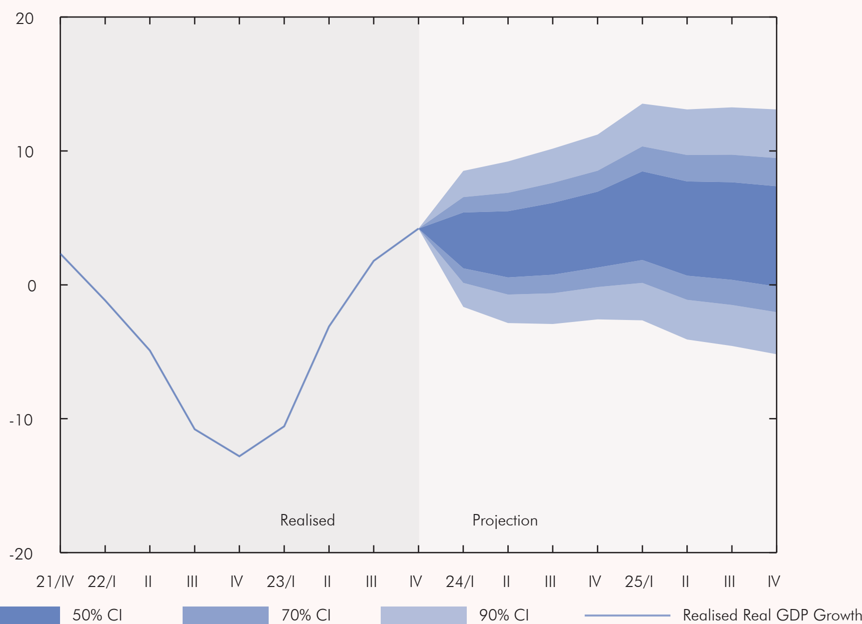
Given the prevailing domestic and global economic uncertainties, adverse weather conditions, and geopolitical tensions, the risks associated with the current projections are higher than in normal times. Current projections are conditional on the forecasts of global energy and food prices, gradual growth recovery of Sri Lanka's major trading partners, the anticipated domestic fiscal path in line with the IMF-EFF projections under the debt restructuring scenario, and global financial conditions implied by the monetary policy stance of the USA. Further, the projections are conditional on the model-consistent interest rate path and resulting macroeconomic responses. Any notable change in these assumptions could lead to the realised inflation path deviating from the projected path. Risks to the projection arise due to the possibility of various factors deviating from the levels already internalised in projections, either explicitly or implicitly, and due to any unforeseen developments. In particular, there are substantial upside risks to inflation projections stemming from factors such as the impact of the possible upward pressures on global food and energy prices amidst uncertainties; the impact of adverse weather on agricultural production and in turn on food prices; the possible upward revision to electricity prices more than initially anticipated, for which

weather anomalies can also be a contributing factor, among others, that could affect the electricity generation mix, requiring the use of costlier sources; and the possible realisation of the demand for higher wages. Meanwhile, downside risks to inflation projections include a faster recovery of supply conditions and the sustained impact of diminished purchasing power of the public. The Central Bank will continue to communicate to the public the possible deviations in the inflation outlook based on upcoming changes to domestic and global economic conditions at each monetary policy round, underpinned by data driven monetary policy formulation under the Flexible Inflation Targeting (FIT) framework.

3.2.2 Growth Prospects

Following six quarters of year-on-year contractions, the economy recorded a positive performance in the second half of 2023 and a sustained recovery is expected in the period ahead. The economy is expected to grow by 3 per cent in 2024 as the benefits of the eased monetary policy stance and low inflation environment continue to be gradually channelled into the economy. The faster than expected recovery of the tourism sector is expected to support the growth momentum in the near term with positive spillover effects on other related sectors. The industry sector is expected to benefit from recent positive developments such as the lifting of import restrictions, declining cost of credit and raw material prices. Leading indicators also show a revival in construction sector activities in light of the aforementioned developments coupled with the resumption of several previously halted infrastructure development projects of the Government. The recently concluded 2023/24 Maha season is expected to have recorded positive yields across major crops highlighting the improved performance of the agriculture sector and based on available information, this positive trend is expected to sustain during the remainder of the year, unless disrupted by

Figure 3.2 Projected Quarterly Real GDP Growth (year-on-year, %)



Note: A forecast is neither a promise nor a commitment

The projections reflect the available data, assumptions and judgements made at the forecast round in March 2024.

The fan chart illustrates the uncertainty surrounding the baseline projection path using confidence bands of gradually fading colours. The confidence intervals (CI) shown on the chart indicate the ranges of values within which real GDP growth may fluctuate over the medium term. For example, the thick blue shaded area represents the 50 per cent confidence interval, implying that there is a 50 per cent probability that the realised real GDP growth will be within this interval. The confidence bands show the increasing uncertainty in forecasting macroeconomic variables over a longer horizon. Given the volatile global environment and the uncertainties in the domestic economy, the baseline forecasts are exposed to various potential upside and downside risks. Any notable change in the underlying assumptions and judgements could lead to the realised growth path deviating from the projection.

Source: Central Bank Staff Projections

adverse weather conditions. The noteworthy rise in remittances also may support in boosting aggregate demand. The near term economic growth trajectory is expected to be supported by the improved fiscal space that is envisaged with the completion of debt restructuring. Expected gradual adjustment in wages would also help improve demand. Notwithstanding the renewed sense of macroeconomic stability, policy certainty and continuity will remain vital to the growth trajectory of the economy during 2024, amid expected elections. External demand for domestic services, particularly through tourism, is expected to remain elevated and some renewed demand for exports may emerge if ongoing initiatives to strengthen exports materialise amid the improved growth prospects of Sri Lanka's key trading partners in the medium term. The economy's positive growth trajectory in the near and medium term continues to hinge on Sri Lanka's continuation of the IMF-EFF programme, timely completion of debt restructuring, and the Government's commitment to forge ahead with the structural reform agenda. Freeing up resources through these reforms, especially in relation to State Owned Business Enterprises (SOBEs) and rechannelling them into productive sectors can help induce the long overdue improvements to productivity and further strengthen the potential of the economy. However, a key fragility in the economic recovery process is the notable continued outflow of human capital, especially highly skilled professionals, amidst adverse demographic developments with ageing. The rapidly materialising impact of climate change may also take a larger than expected toll in the near to medium term through frequent supply shocks, not only on agricultural production but also on other aspects of the economy such as power generation, construction, and tourism, among others. The lack of economic diversification continues to be not only a drag on economic potential but also a source of economic vulnerability, especially considering the rapidly evolving global environment. Further, focused initiatives to improve overall productivity and efficiency across all key economic sectors are imperative at this juncture. At the micro level, ongoing initiatives to strengthen social safety nets, by improving efficiency and adequate budgetary allocations, must be expedited to build near term resilience and enable individuals to seize opportunities for economic empowerment and sustainable development in the period ahead. While expenditure rationalisation is vital for fiscal sustainability, effectiveness of government spending on key social infrastructure, such as health and education, should be enhanced to ensure equitable provision of such services with the aim of sustaining long term growth. Further, timely implementation of identified measures to address governance weaknesses and corruption vulnerabilities are macro-critical for the progress of both the economy and its people.

3.2.3 Monetary Sector Outlook

Given the favourable inflation dynamics and outlook, as reflected by available data, the monetary policy stance of the Central Bank is expected to remain accommodative in the period ahead, which would help stimulate economic activity. Supported by the monetary policy easing measures, improving domestic money market liquidity conditions and the reduction in the risk premia attached to government securities, market interest rates, particularly lending interest rates, are expected to normalise further providing the required relief for businesses and households in terms of reduced financing costs. The expansionary momentum observed in credit extended to the private sector by the banking sector since June 2023 is expected to continue supported by normalising lending interest rates and the

improvements in business sentiments, thereby fuelling the envisaged rebound of domestic economic activity. Meanwhile, the banking sector's exposure to the public sector is expected to be lower than in previous years due to the implementation of decisive fiscal reforms along with the restoration of debt sustainability that would reduce the financing needs of the Government. Further, the resumption of foreign financing from the multilateral development partners and bilateral partners in the period ahead would reduce the Government's excessive reliance on domestic resources for debt financing, thus availing resources for use by productive sectors of the economy. Credit to SOBEs by the banking sector is expected to record a moderate expansion, although the reliance of the key SOBEs on bank funding is likely to be low amidst the implementation of cost-reflective pricing mechanisms. Similarly, going forward, Net Credit to the Government (NCG) by the banking system is expected to remain low, while the Central Bank of Sri Lanka Act No. 16 of 2023 (CBA) prohibits any future monetary financing. Net Foreign Assets (NFA) of the banking system is expected to improve further in the period ahead with the envisaged foreign currency inflows to the country and purchases of foreign exchange by the Central Bank from the domestic foreign exchange market for building official reserves. With the envisaged expansion in domestic credit and the improvement in NFA, year-on-year growth of broad money supply is expected to accelerate to around 15.0 per cent in 2024 and record a moderate growth of around 10.0-11.0 per cent annually over the medium term in line with the envisaged expansion of the domestic economy and medium term inflation target.

The monetary policy stance of the Central Bank will continue to be data-driven and forward-looking. Timely adjustments to the policies and strategies of the Central Bank will be made under the FIT framework, in line with incoming data. With the intention of enhancing transparency, the Central Bank will continue to communicate its policies, the envisaged macroeconomic outcomes and the likely monetary policy actions and the rationale behind them, which will be instrumental in managing the expectations of the public, thus contributing to achieving overall price and macroeconomic stability. As a part of this process, the Central Bank will continue publishing the Monetary Policy Report (MPR) bi-annually to better inform the public on the outlook of the economy, thereby further improving the transparency of the monetary policy actions taken by the Central Bank.

Preserving the independence of the Central Bank is imperative to ensure that the economy and its stakeholders continue to reap the benefits of farsighted policies. The sharp disinflation and the return to a low interest rate environment, achieved within a short period of time, are predominantly attributable to the independent and timely monetary policy interventions by the Central Bank. Therefore, it is in the best interest of the economy and its stakeholders that such enhanced central bank autonomy is preserved and any fiscal dominance of monetary policy is prevented, going forward.

3.2.4 External Sector Outlook

The external sector outlook for 2024 and beyond will be contingent on the successful completion of External Debt Restructuring (EDR) and the perseverance with the reform path set out in the IMF-EFF supported programme. These will be vitally important in eliminating the prevailing uncertainties and sustainably improving global partners' confidence in the country. The merchandise trade deficit is expected to widen in 2024 due to the possible increase in import demand, reflecting the relaxation of import restrictions, improved economic activity, and increased

BOX 7

Making Sri Lanka's External Current Account Outcomes More Sustainable

Sri Lanka recorded a surplus in the current account of the Balance of Payments (BOP) in 2023. This surplus can mainly be attributed to the notable reduction in merchandise imports, significant increase in earnings from tourism and healthy growth in workers' remittances. Over the years, Sri Lanka has been experiencing persistent external current account deficits mainly driven by large deficits in the merchandise trade account. Although the trade in services account and secondary income account recorded surpluses, such surpluses were not sufficient to cushion the impact of merchandise trade and primary income account deficits on the current account (Figure B 7.1).

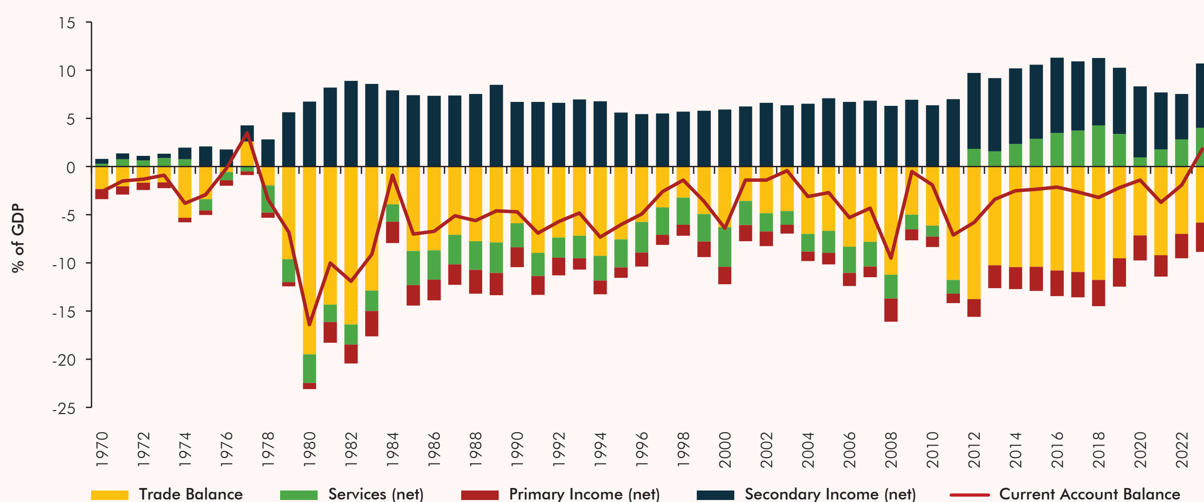
Historically, global experiences show that after a significant economic shock, such as a BOP crisis leading to a debt default, the subsequent adjustment in the exchange rate and corrective policy measures result in an immediate current account surplus. In this context, historical experiences show that some countries were able to sustain a surplus in the current account in the medium to long term following a period of economic distress. At the same time, there were countries that reverted to their historical trend of recording deficits (Figure B 7.2). Generally, countries that have been able to sustain such surpluses in the long run were able to stabilise the exchange rate at an elevated level compared to that of pre-crisis level, supporting export competitiveness, while managing inflation at lower levels. Sustaining these surpluses was supported by policies aimed at gradually accelerating real GDP growth and improving fiscal performance (i.e., improved primary balance and lower budget deficit). In this context, it is important to explore the factors influencing the sustainability of current account surpluses post-economic shocks and economic implications of maintaining persistent current account surpluses or deficits.

The current account balance mirrors the savings-investment gap in the country. A current account surplus reflects a positive savings-investment gap whereas a deficit reflects a negative savings-investment gap. In Sri Lanka, along with the current account surplus, the national savings-investment gap took an upturn to record a positive value in 2023. This surplus can be attributed to the combined effect of reduced domestic investment and a notable increase in net current transfers from the rest of the world, leading to an increase in national savings.

Country Experiences

During the East Asian Financial Crisis of 1997-1998, countries such as Thailand, South Korea, Indonesia, Philippines and Malaysia experienced BOP distress that led to a multitude of macroeconomic shocks, including sharp depreciation of local currencies. In response, these countries implemented structural reforms, including

Figure B 7.1 Composition of the Current Account: 1970 - 2023

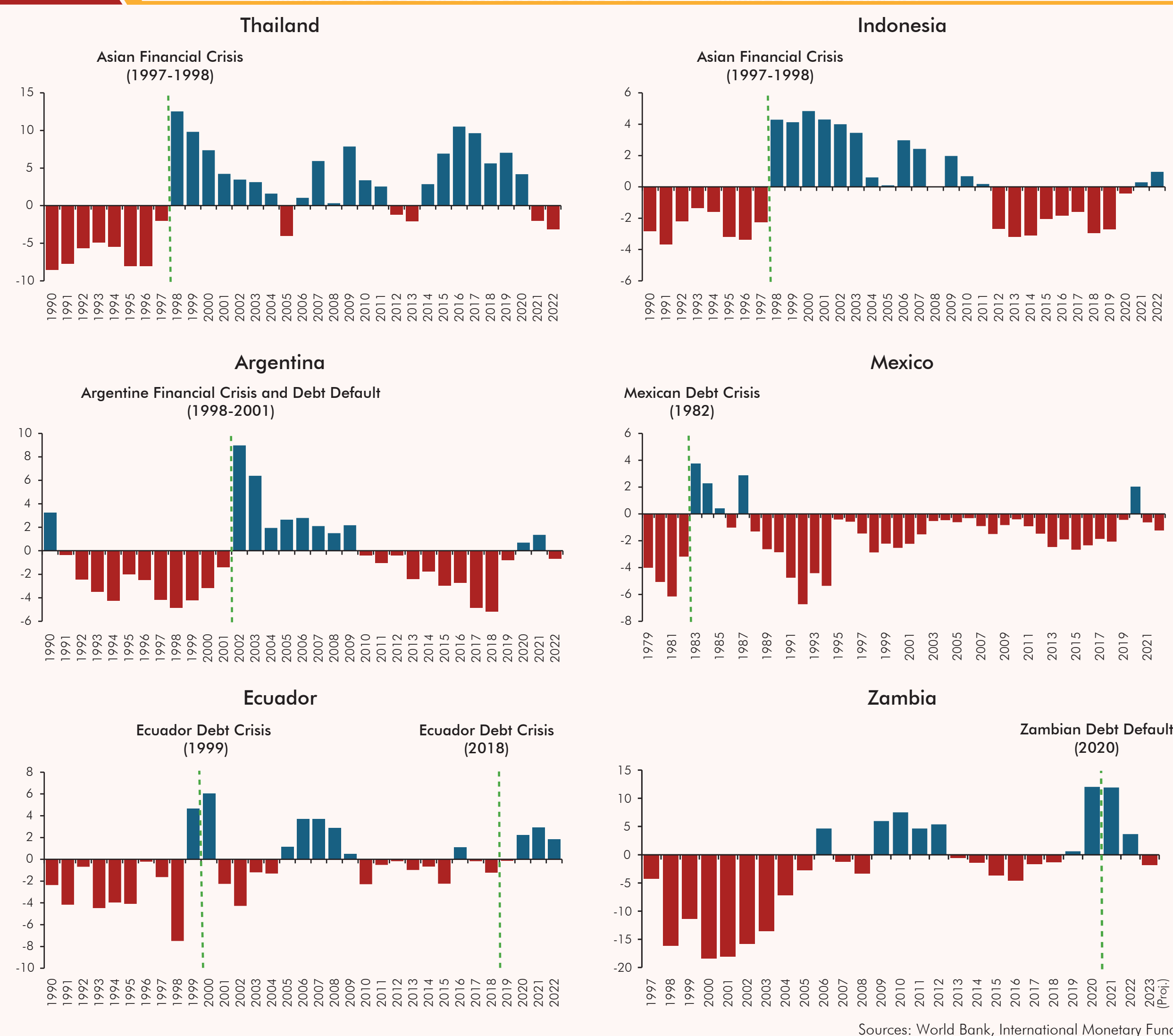


Source: Central Bank of Sri Lanka

fiscal consolidation, strengthening the regulatory framework for the financial sector, adoption of inflation targeting frameworks, implementation of export promotion policies, and reinforcing external buffers by transitioning to flexible exchange rate regimes (Wellisz 2022). As a result, these economies were able to witness V-shaped recoveries characterised by large current account surpluses. However, only some countries were able to sustain these surpluses over the medium to long term. The persistent current account surpluses achieved by these countries could be attributable to export led growth strategies, diversification of export markets, and prudent macroeconomic management executed by these economies. For example, South Korea's export oriented growth policies and diversification of export markets enabled it to maintain current account surpluses, contributing to its economic resilience post-crisis. Thailand transitioned from a fixed exchange rate regime to an independently floating exchange rate regime post-crisis by allowing its currency to float which facilitated an adjustment in its external balances (Sharma 2003). After achieving a current account surplus in the aftermath of the crisis, Thailand was able to maintain a current account surplus for decades by adopting appropriate policy measures including the promotion of services exports, particularly tourism.

Although Indonesia was able to sustain the post-crisis current account surpluses over a decade, the country started to record current account deficits since 2012 due to the sharp fall in commodity prices adversely affecting Indonesia's commodity exports (IMF 2016). Considering elsewhere in the world, Zambia encountered an external debt

Figure B 7.2 Current Account Balance (as a percentage of GDP): Selected Countries



crisis in 2020 resulting in a sharp exchange rate depreciation and BOP challenges. Although Zambia was able to experience temporary current account surpluses in the aftermath of the crisis, the current account is estimated to have reverted to a deficit in 2023 due to a significant contraction in copper exports and imports returning to high levels (IMF 2023). Similar experiences can be observed in the cases of Argentina, Mexico and Ecuador where the current account deficits turned into surpluses in the aftermath of the debt crises followed by debt restructuring. However, these surpluses did not persist. Therefore, it is evident that countries have had mixed experiences with respect to sustaining post-crises current account surpluses, depending on a multitude of factors, including structural reforms, diversification strategies, prudent macroeconomic management as well as the country's ability to withstand external vulnerabilities.

Are current account surpluses always good?

A current account surplus may be considered favourable for the purpose of building up reserves. However, a persistent surplus may lead to significant appreciation of the local currency which would necessitate the Central Bank to intervene in the domestic foreign exchange market to avoid undue appreciation of the currency to ensure maintenance of trade competitiveness. However, adopting such practices for extended time periods may lead to such countries being labelled as stereotypical "currency manipulators" who maintain their currencies undervalued, akin to an export subsidy, to boost their trade surpluses. Moreover, if the current account surplus is achieved as a result of low domestic demand or compressed imports due to restrictive trade policies, it can hinder domestic consumption and investment affecting future economic growth. In order to achieve a sustainable current account balance in the aftermath of an economic crisis, adopting an appropriate policy mix is required while ensuring that there will be no disruptive adjustments. In this regard, adopting a flexible exchange rate policy, where the exchange rate is determined based on demand and supply conditions in the domestic foreign exchange market, maintaining low and stable inflation, and focusing on export promotion and diversification are essential.

Conclusion

There is no agreement among academia or policymakers on an optimal level of current account balance or whether a country should maintain a persistent current account deficit or a surplus (Ghosh and Ramakrishnan 2006; Devadas and Loayza 2018; World Economic Forum 2023). Neither a current account deficit nor a surplus alone could be interpreted as favourable or unfavourable for an economy. A current account is considered to be sustainable if external deficits do not necessitate an immediate change in monetary or fiscal policy or do not result in a BOP crisis leading to a strain on the country's international reserve level or having adverse implications on its ability to service external debt. Although recording a current account surplus is interpreted as favourable for an economy which had recorded persistent deficits historically, a persistent current account surplus may reflect an undervalued currency so that it may subsequently necessitate an appreciation of the country's local currency leading to a loss of trade competitiveness. In conclusion, if Sri Lanka could adopt and maintain an appropriate policy mix with export promotion and diversification, which would result in a stable exchange rate, lower inflation levels and gradual economic growth path, the country would be able to maintain a sustainable current account balance over the medium to long term.

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spending capacity of the public and businesses due to easing monetary conditions, despite the expected moderate growth in export earnings in 2024. Even with the continued growth in import expenditure, the trade deficit is expected to reach manageable levels in the medium term, supported by the expected revival and expansion of earnings from exports. The services account surplus is likely to increase in 2024 and beyond with the projected upswing in earnings from tourism as well as the envisaged improvement in competitiveness of other services exports.

Sri Lanka is likely to benefit from the booming tourism industry in the medium term with the gradual normalisation of the global economy and continued strategic drive to reap the full potential of this sector. However, the expected surge in tourism should also accompany alignment with international standards and sustainable tourism measures while ensuring that estimated revenue is realised fully for the country to reap the benefits. The services account surplus is also expected to strengthen over the medium term with the expected rebound in activities in transport services and high growth in the Information Technology and Business Process Outsourcing (IT/BPO) services subsector. The deficit in the primary income account is expected to narrow in 2024 after the completion of the EDR process and the subsequent scale down of interest payments. The primary income account deficit is expected to widen thereafter over the medium term due to continued interest and dividend payments. Workers' remittances are expected to continue to remain at elevated levels in 2024 and beyond. Consequently, the current account, which recorded a surplus in 2023, is expected to record a surplus in 2024 as well, but at a lower level. During the medium term, the current account deficit is expected to be maintained at sustainable levels following the restoration of debt sustainability and the anticipated adoption of policies in favour of the tradeable sector. The exchange rate will act as a stabiliser in the context of any large trade or current account imbalances.

Inflows to the financial account are expected to be supported by positive investor sentiments owing to the successful continuation of the IMF-EFF programme and debt restructuring process. Also, foreign financing assistance from multilateral agencies such as the IMF, Asian Development Bank (ADB), and the World Bank along with the envisaged resumption of bilateral funding projects are expected to enhance inflows to the financial account while also strengthening gross official reserves in 2024 and beyond. Further, the IMF-EFF supported programme is fully financed with firm commitments of financing for 2024 and strong prospects for financing for the rest of the programme period. Programme financing gaps up to 2027 are expected to be fulfilled through debt restructuring and new financing.

Moreover, non-debt creating foreign inflows to the financial account such as FDI are expected to strengthen over the medium term, particularly to the Colombo Port City and Hambantota Industrial Zone. Proposed improvements to the institutional arrangement for investment promotion and efforts to address longstanding issues on doing business conditions are expected to alleviate any negative perceptions of Sri Lanka among investors. Foreign investments in the government securities market and in the Colombo Stock Exchange (CSE) are also expected to strengthen over the medium term due to the above developments. The Central Bank remains committed to maintaining a market determined and flexible exchange rate and building reserves through net purchases of foreign exchange from the domestic foreign exchange market which are expected to serve as a buffer against external shocks. Moreover, any intervention in the domestic foreign exchange market by the Central Bank would be limited only for the purposes of reserve buildup and curtailing any excessive short term volatility in the exchange rate.

3.2.5 Financial Sector Outlook

The financial sector, which navigated through challenging macro-financial conditions during recent years showed signs of recovery and stabilisation in 2023 and the resilience of the financial

sector is expected to improve further with the dissipation of macroeconomic vulnerabilities in the period ahead. Fragilities and uncertainties in the financial sector that surfaced warranted the Central Bank to take a range of policy measures and initiate structural reforms to maintain and strengthen the resilience of the economy and the financial sector. With the easing of monetary conditions as reflected through downward interest rate movement and dissipating the uncertainty priced in interest rates, credit to the private sector is expected to rebound in 2024 from the contraction it registered in 2023. Banks are expected to rebalance the asset allocation with the normalising yield curves on government securities, which were once inverted, and the correction of the anomaly in the risk-free rates being higher than the lending rates. With the probable restructuring of the Government's foreign currency loans, which may entail an exchange of sovereign loans with sovereign securities, the impending EDR may result in a one-off dip in financial intermediation due to a contraction in the loan book, albeit partially correcting the tilt towards lending to the sovereign. Measures are underway through moral suasion and appropriate regulations to address key elements of sovereign-bank nexus. Reflecting the gradual revival of economic activities, the expected easing of strained borrower capacities and the correction in market interest rates, credit to the private sector is expected to gather momentum. The envisaged credit growth and the gradual easing of trade-related restrictions and improving repayment capacities are expected to improve the credit quality of the banking sector. Liquidity levels of the banks are expected to improve with the envisaged EDR as net foreign currency credit to the sovereign and illiquid foreign currency sovereign instruments are likely to be exchanged with liquid sovereign instruments. The Government endeavours to achieve a smooth EDR operation with minimal macro-financial impact through pre-emptive policy interventions and behavioural responses. The banking sector is formulating comprehensive recapitalisation plans for its top tier domestic Licensed Commercial Banks (LCBs) with the view of strengthening the resilience to enable a smooth sovereign debt restructuring while averting the transmission of negative spillovers across the economy. The credit growth of the Licensed Finance Companies (LFCs) sector is expected to resemble a trajectory similar to that of the banking sector with continued diversification amidst limited growth opportunities for conventional loan products. The credit risk in the LFCs sector is expected to ease with the envisaged recovery in macro-financial conditions and credit rebound.

An array of structural, legal and policy level reforms and innovations will continue to be mobilised to ensure the stability of the financial system. Consolidation endeavours are expected to continue in 2024, enhancing the resilience and efficiency of the LFCs sector. A robust growth in digital transactions is expected in the landscape of payments and settlements due to increased transactions through Instant Payment System facilitated by online banking and mobile payment apps. Awareness campaigns on digital transaction methods will be conducted to increase the uptake of digital payments by customers and merchants. The Central Bank will closely collaborate with financial institutions to support the expansion of safe, efficient and reliable digital payment mechanisms in the country. The Central Bank as the Macroprudential Authority of the country envisages to implement its suite of macroprudential tools when the need arises to contain systemic imbalances with the view of maintaining financial sector resilience and to support the smooth provision of financial services even under adverse economic and financial conditions.

The instigation and timely implementation of well sequenced-consistent policies are expected to ensure the stability of the financial system. The continued advancement along the policy reform agenda envisaged in the IMF-EFF programme is expected to address the shortfalls and weaknesses of the financial sector and to further strengthen the resilience and confidence in the system. Despite all such efforts, if political uncertainties exert significant pressure on the reform agenda going forward, which could lead to departure from the intended policy reform trajectory, it may result in adverse and potentially irreversible impacts on both the financial system and the economy.

3.2.6 Fiscal Sector Outlook

The Government is expected to continue the fiscal consolidation path and its efforts to restore debt sustainability in line with the IMF-EFF supported programme, showcasing the Government's commitment to prudent fiscal management and implementation of long overdue structural reforms. As per the revised Medium Term Macro Fiscal Framework (MTMFF) outlined in the Fiscal Management Report 2024, the Government aims to achieve an ambitious revenue target, surpassing 15 per cent of GDP by 2027. Simultaneously, efforts are directed towards containing the overall budget deficit to below 5 per cent of GDP starting from 2026, while striving to achieve a primary surplus of at least 2.3 per cent of GDP by 2025 and beyond. Aligned with this stance, the Government implemented robust revenue enhancement measures since mid-2022, and the impact of these fiscal policy reforms has been reflected in the Government's finances since 2023, resulting in a significant increase in tax revenue collection. Furthermore, the envisaged introduction of a property tax as well as a gift and inheritance tax, is expected in 2025, further augmenting tax collection if implemented as scheduled. Revenue enhancement in the forthcoming periods is also expected through the strengthening of revenue administration measures. Compulsory registration of individuals for personal income taxes, strengthening of large taxpayers and high wealth taxpayers units, upgrading the Revenue Administration and Management Information System (RAMIS), and the abolishment of the Simplified Value Added Tax (SVAT) system are expected to improve revenue administration efforts of revenue collecting agencies. Recent efforts by the Government mandating information sharing by the financial institutions, CSE, Registrar General's Department, Registrar General of Companies and Department of Motor Traffic with the Inland Revenue Department, is a welcoming move to build interlinkages with government institutions and the revenue authority to improve tax administration and minimise tax evasion. However, any reversal of hard earned fiscal sector achievements prior to or after the upcoming elections will derail the IMF programme and destabilise the economy, thereby triggering a deeper socioeconomic and political crisis than that was observed in 2022. Additionally, the Government aims to manage expenditure within 20 per cent of GDP over the medium term. While streamlining government expenditure, making appropriate allocations to priority areas such as health, education, public transport, and social protection, as outlined in MTMFF, is pivotal for equitable and faster economic recovery. The implementation of the new legislations related to Public Financial Management and Public Procurement is expected to strengthen fiscal discipline through the establishment of a framework of fiscal rules, enhanced transparency, monitoring mechanisms, and stricter discipline on government procurement. In addition, the Government is implementing a stringent project appraisal and prioritisation process with regard to capital projects to align capital expenditure

with development priorities in a cost effective manner. At the same time, the transfer of public debt management to a separate Public Debt Management Office (PDMO) is expected with the implementation of a new debt management law.

Meanwhile, the debt restructuring process continues to progress, guided by quantitative targets established under the IMF Sovereign Risk and Debt Sustainability Framework (SRDSF), while simultaneous efforts are underway to tackle longstanding issues of SOBE reforms and address other corruption and transparency vulnerabilities. In this regard, the Government completed key aspects of the Domestic Debt Optimisation (DDO) operation in 2023 to complement the foreign debt restructuring efforts and meet debt sustainability targets. The completion of the restructuring of the foreign debt portfolio and adherence to the fiscal consolidation path that the Government has committed under the IMF-EFF programme are expected to bring down the debt trajectory to a sustainable level in the medium term. In the meantime, the implementation of cost reflective pricing mechanisms helped alleviate the longstanding financial stresses experienced by SOBEs, limiting the possibility of SOBE losses translating into government debt. Continuation of such policies, along with ongoing SOBE reforms, including the divestment of non-strategic SOBEs, are anticipated to reduce the burden they exert on the Budget. Furthermore, the publication of details regarding procurement contracts, disclosure of certain tax exemption information in the public domain, and the appointment of Commissioners to the Commission to Investigate Allegations of Bribery or Corruption (CIABOC) are commendable steps towards enhancing transparency, increasing accountability, and addressing bribery concerns. The publication of the Government Action Plan, derived from recommendations in the recently concluded Governance Diagnostic Assessment by the IMF, offers transparency and details progress of these recommendations. Successful completion of these recommendations will strengthen public and civil sector confidence in good governance, essential for preventing Sri Lanka from becoming a failed state. Concerted efforts by the Government, supported by domestic and foreign stakeholders, are expected to address the challenges in the fiscal sector and implement broad based economic reforms, thereby restoring fiscal sector sustainability in the medium term.