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ECONOMIC, PRICE AND FINANCIAL SYSTEM STABILITY, OUTLOOK AND POLICIES

1.1 Overview

During the year 2019, Sri Lanka's dismal performance continued in terms of real economic growth, although macroeconomic stabilisation measures helped correct the external sector imbalances to some extent, while inflation pressures remained muted on average. The Easter Sunday attacks had a severe impact on the tourism sector, and their adverse spillover effects were felt across the economy, worsening the sluggish growth of the economy and further dampening business confidence. Policy measures aimed at reducing pressures on the balance of payments (BOP) and the exchange rate continued in 2019, which together with steps taken to revive the economy, contributed to notable slippages in the fiscal sector. Subdued demand conditions allowed the continuation of low inflation during the year, although extreme weather conditions and resultant disruptions to domestic food supplies caused some volatility in consumer prices. Growth of credit to the private sector decelerated sharply, driven by subdued economic activity and weak business confidence, affecting the performance of the financial sector. Considering the need to support economic activity amidst muted inflation, well anchored inflation expectations and diminished pressures in the external sector, the Central Bank adopted an accommodative monetary policy stance, and took steps to expedite the transmission of monetary policy measures to the economy through regulatory action aimed at reducing market interest rates.

As domestic economic activity started to show early responses to the policy measures taken to revive the economy and improving business sentiments at the beginning of the year 2020, the outbreak of the COVID-19 pandemic, the containment measures adopted by all countries including Sri Lanka, and the resultant projected contraction in the global economy, triggered further uncertainties regarding the country's economic performance in 2020. In the near term, the economy is likely to be impacted severely in terms of its growth, fiscal, external, and financial sector performance, while causing hardships to all stakeholders of the economy. The monetary policy space in terms of the low inflation environment, and the banking sector space created by the maintenance of capital and liquidity buffers above industry norms, enabled the Central Bank to support the efforts of the government to ease the burden on businesses as well as individuals. Despite the temporary setback posed by the pandemic,

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Table 1.1
Macroeconomic Performance (2015-2019)

Indicator	Unit	2015	2016	2017	2018 (a)	2019 (b)
Real Sector (c)						
Real GDP Growth	%	5.0	4.5	3.6 (a)	3.3 (b)	2.3
GDP at Current Market Price	Rs. bn	10,951	11,996	13,328 (a)	14,366 (b)	15,016
Per Capita GDP (d)	US$	3,842	3,886	4,077 (a)	4,079 (b)	3,852
External Sector						
Trade Balance (c)	% of GDP	-10.4	-10.8	-11.0 (a)	-11.7	-9.5
Current Account Balance (c)	% of GDP	-2.3	-2.1	-2.6	-3.2	-2.2
Overall Balance	US$ mn	-1,489	-500	2,068	-1,103	377
External Official Reserves	US$ mn	7,304	6,019	7,959	6,919	7,642
Fiscal Sector (c)(e)						
Current Account Balance	% of GDP	-2.3	-0.6	-0.7	-1.2	-2.7
Primary Balance	% of GDP	-2.9	-0.2	0.02	0.6	-0.8
Overall Fiscal Balance	% of GDP	-7.6	-5.3	-5.5	-5.3	-6.8
Central Government Debt (f)	% of GDP	78.5	79.0	77.9	83.7	86.8
Monetary Sector and Inflation						
Broad Money Growth (M_{2b}) (g)	%	17.8	18.4	16.7	13.0	7.0
Private Sector Credit Growth (in M_{2b}) (g)	%	25.0	21.6	14.7	15.9	4.3
Annual Average Inflation (h)	%	2.2	4.0	6.6	4.3	4.3

(a) Revised
(b) Provisional
(c) Based on the GDP estimates (base year 2010) of the Department of Census and Statistics
(d) Estimates are updated with the latest population figures.
(e) Based on the revised GDP estimates for 2017 and 2018 released on 31 March 2020 by the Department of Census and Statistics
(f) Includes Treasury bonds of Rs. 4,397 million issued to the Co-operative Wholesale Establishment (CWE) in November 2003 (matured on 14 November 2016) and Rs. 13,125 million issued to capitalise SriLankan Airlines in March 2013 (matured on 01 June 2018) and Rs. 78,441 million issued to the Ceylon Petroleum Corporation (CPC) in January 2012 (of which Rs. 21,778 million matured on 01 January 2017 and the current outstanding is Rs. 56,662 million).
(g) Year-on-year growth based on end year values
(h) Based on CCPI (2013=100)

Sources: Department of Census and Statistics
Ministry of Finance, Economic and Policy Development
Central Bank of Sri Lanka

appropriate growth supportive reforms to address longstanding structural issues and enhance domestic production, improve export orientation, attract foreign direct investment (FDI), facilitate innovation, improve factor productivity and efficiency, and improve policy buffers, if implemented without delay, would enable Sri Lanka to realise the desired outcome of achieving sustained and equitable economic growth and becoming a prosperous nation in the period ahead.

1.2 Macroeconomic Developments in 2019

Real Sector Developments and Inflation

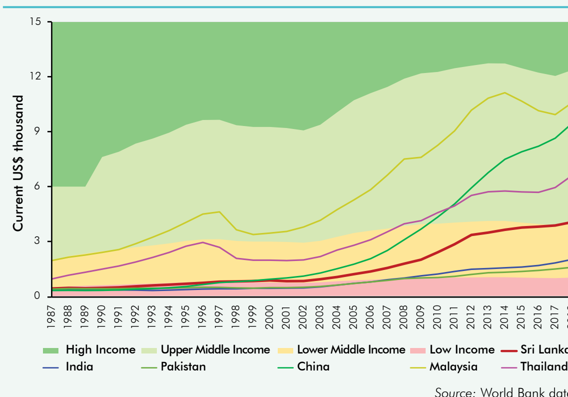
Sri Lanka graduated to the upper middle income country status in terms of per capita Gross National Income (GNI), as per the World Bank's country classification in 2019. The value of the country's Gross Domestic Product (GDP) at current market prices was US dollars 84.0 billion in 2019, compared to US dollars 88.4 billion in 2018. Per capita GDP and per capita GNI at current market prices were estimated at US dollars 3,852 and US dollars 3,741, respectively, in 2019, in comparison to US dollars 4,079 and US dollars 3,968, respectively, in the previous year. Subdued economic growth, coupled with the sharp depreciation of the Sri Lankan rupee towards end 2018, which resulted in a substantially depreciated average exchange rate in 2019, caused the decline in these indicators in 2019 from the levels observed in the previous year.

The Sri Lankan economy recorded a subdued growth of 2.3 per cent in 2019, compared to the growth of 3.3 per cent in 2018, as per the provisional estimates of GDP of the Department of Census and Statistics (DCS). All major sectors of the economy recorded

BOX 1
Sri Lanka's Graduation to the Upper Middle Income Country Status

Sri Lanka graduated to the upper middle income country status as per the World Bank classification of countries published in July 2019. The World Bank classifies countries based on per capita Gross National Income (GNI) into income categories of *low income, lower middle income, upper middle income* and *high income*[1] (Figure B 1.1). As per this classification, Sri Lanka transitioned from the low income country status to the lower middle income country status in 1997. Since then, the country has progressed through challenging periods, including the catastrophic Tsunami disaster in 2004, the escalation of the civil conflict until its end in 2009, periods of extreme weather conditions and related natural disasters, and socio-economic and political changes. Despite the adverse impacts of such disturbances on the macroeconomy, the country recorded above five per cent GDP growth on average since the graduation to a lower middle income country, and reached the upper middle income level. However, Sri Lanka took 21 years to graduate from the lower middle income category to the next level, thereby spending a relatively long period compared to some other emerging market economies. In this context, it is essential that Sri Lanka introduces the necessary structural reforms in a timely manner in order to ensure that a strong growth momentum is sustained in the period ahead, and thereby to avoid possible stagnation in the middle income levels for a longer period, i.e., the *middle income trap*.[2] Table B 1.1 exhibits the time taken by selected countries to move from the upper middle income level to high income level, which ranges between 7 – 40 years.[3] Although there is a lack of consensus as to why countries get trapped in middle income levels, literature points to the slowdown in productivity as the major contributory factor caused by lack of economic diversification, rigid and inefficient labour markets, lack of access to advanced infrastructure, weak institutions, low levels of innovation, etc. For instance, Pruchnik and Zowczak (2017) highlighted seven factors, which are often associated with growth slowdowns, namely, unfavourable demographics, low level of economic diversification, inefficient financial markets, insufficient advanced infrastructure, low levels of innovation, weak institutions and inefficient labour markets. According to the classification of Pruchnik and Zowczak (2017), Sri Lanka remained in the bottom 20 per cent in the level of economic diversification and labour market efficiency. Against this backdrop, measures are required to address the challenges emanating from these areas, while also placing emphasis on addressing issues such as income inequality and poverty alleviation to ensure sustainable growth and shared prosperity in the period ahead.

Figure B 1.1
GNI of Selected Economies and the Evolution of World Bank Income Classification Thresholds



Source: World Bank data

Table B 1.1
Number of Years Selected Economies Required to Graduate from Upper Middle Income to High Income Level

Country	Year of graduation to the Upper Middle Income category	Year of graduation to the High Income Category	No. of years in Upper Middle Income Category
Hong Kong, China	1976	1983	7
Rep. of Korea	1988	1995	7
Japan	1968	1977	9
Singapore	1978	1988	10
France	1960	1971	11
Austria	1964	1976	12
Belgium	1961	1973	12
Germany	1960	1973	13
Chile	1992	2005	13
Norway	1961	1975	14
Sweden	1954	1968	14
Denmark	1953	1968	15
Finland	1964	1979	15
Ireland	1975	1990	15
Italy	1963	1978	15
Netherlands	1955	1970	15
Spain	1973	1990	17
Israel	1969	1986	17
Portugal	1978	1996	18
Greece	1972	2000	28
Argentina	1970	2010	40

Source: Estimates of Felipe, Abdon and Kumar (2012)
Note: Income groups in this study are different from the World Bank classifications

1 For the classifications using data for 2018, the World Bank categorises countries based on their GNI per capita as follows; low income – US dollars 1,025 or less, lower middle income – between US dollars 1,026 and US dollars 3,995, upper middle income – between US dollars 3,996 and US dollars 12,375, high income - US dollars 12,376 or more. These thresholds are updated by the World Bank in the month of July, each year. The World Bank uses the *Atlas method* to convert national currency GNI to US dollars by applying the *Atlas conversion factor*, which is the three year moving average exchange rate, after adjusting for the differences between inflation of the country and international inflation.

2 As per some classifications, Sri Lanka is caught in a so-called *middle income trap*. Economists use this term to represent a scenario where countries that move with speed into middle income levels failing to continue such growth momentum so as to reach high income levels. The definition of middle income trap is not consistent among different studies conducted in this literature, making the number of countries recognised as caught in a middle income trap to differ across different authors. For instance, Pruchnik and Zowczak (2017) compare such different contributions in the middle income trap literature, suggesting that Sri Lanka is caught in the middle income trap as per two studies, thus highlighting the need for measures to avoid such stagnation.

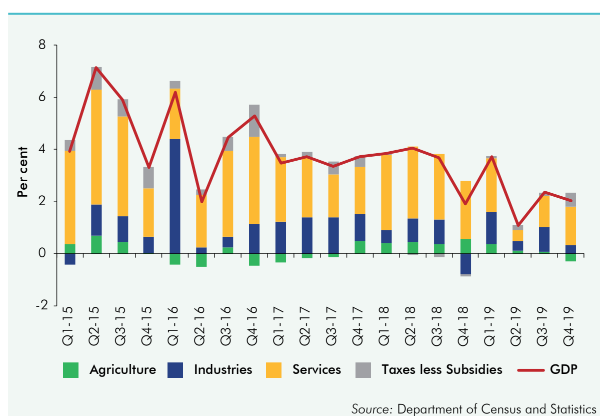
3 Source: Felipe, Abdon and Kumar (2012).

References

1. Felipe, J., Abdon, A. and Kumar, U. (2012). "Tracking the middle-income trap: What is it, who is in it, and why?", *Levy Economics Institute, Working Paper No. 715.*

2. Pruchnik, K. and Zowczak, J. (2017). "Middle-income trap: Review of the conceptual framework", *ADBI Working Paper No. 760.*

Figure 1.1
Activity-wise Contribution to GDP Growth

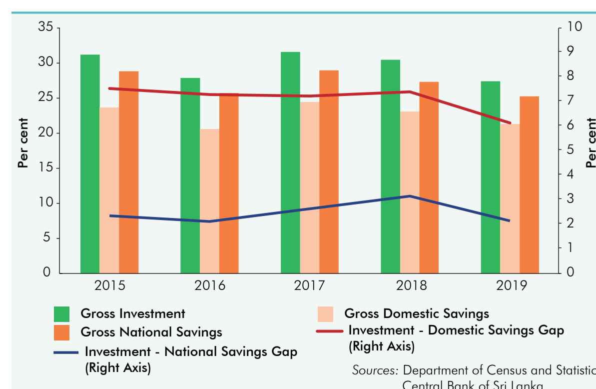


Source: Department of Census and Statistics

positive, but modest growth rates. The agriculture sector recorded a growth of 0.6 per cent in 2019 compared to the growth of 6.5 per cent in 2018. Extreme weather conditions affected the agriculture sector in 2019, with growing of tea, growing of rubber, marine fishing and marine aquaculture subsectors and forestry and logging activities recording notable contractions. On the other hand, growing of oleaginous fruits, growing of vegetables, growing of fruits and animal production mainly supported the growth in value added in the sector. Meanwhile, the industry sector registered a growth of 2.7 per cent in 2019, compared to the growth of 1.2 per cent in the previous year. The growth of the industry sector was mainly supported by the manufacture of textiles, wearing apparel and leather products, the manufacture of food, beverages and tobacco products, and the revival of construction and mining and quarrying activities. Meanwhile, with the impact of the Easter Sunday attacks on tourism related activities, the growth of the services sector decelerated significantly to 2.3 per cent in 2019, compared to the growth of 4.6 per cent in 2018. Activities in accommodation, food and beverage services recorded a contraction during 2019. Activities in wholesale and retail trade mainly contributed to the growth of the services sector, while telecommunication and IT programming consultancy and related activities continued to record a double digit growth.

According to GDP estimates based on the expenditure approach, growth in 2019 was driven by consumption growth and the improvement in the external balance of goods and services. The share of consumption expenditure in GDP at current prices increased to 78.7 per cent in 2019 from 77.0 per cent in the previous year. Consumption expenditure grew by 3.5 per cent in real terms during the year, as a combined outcome of household consumption expenditure and government consumption expenditure growing by 2.9 per cent and 9.6 per cent, respectively. Net external demand for goods and services improved in real terms by 23.2 per cent, and its share in GDP at current prices also improved to -6.1 per cent in 2019, from -7.4 per cent in 2018. Meanwhile, the share of investment in GDP at current prices declined sharply to 27.4 per cent in 2019, compared to 30.4 per cent in the previous year, recording a negative real growth in investment of 9.5 per cent. Domestic savings as a percentage of GDP at current prices declined to 21.3 per cent in 2019 from 23.0 per cent recorded in 2018, while national savings as a percentage of GDP also declined to 25.3 per cent in 2019 from 27.3 per cent in the previous year, as a result of the continued decline in net primary income from the rest of the world. However, due to the higher contraction in investment expenditure, both the domestic

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



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

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

Item	Rs. billion		Growth (%)		As a percentage of GDP (%)	
	2018(c)	2019	2018(c)	2019	2018(c)	2019
1. Domestic Demand	**15,428.0**	**15,935.6**	**8.0**	**3.3**	**107.4**	**106.1**
1.1 Consumption	11,055.6	11,822.9	9.7	6.9	77.0	78.7
Private	9,745.0	10,405.9	9.0	6.8	67.8	69.3
Public	1,310.7	1,417.0	15.2	8.1	9.1	9.4
1.2 Investment (Gross Domestic Capital Formation)	4,372.4	4,112.7	3.8	-5.9	30.4	27.4
2. Net External Demand	**-1,061.9**	**-919.4**	**-10.3**	**13.4**	**-7.4**	**-6.1**
Exports of Goods and Services	3,292.4	3,472.3	13.2	5.5	22.9	23.1
Imports of Goods and Services	4,354.3	4,391.7	12.4	0.9	30.3	29.2
3. Total Demand (GDP) (1+2)	**14,366.1**	**15,016.1**	**7.8**	**4.5**	**100.0**	**100.0**
4. Domestic Savings (3-1.1)	**3,310.5**	**3,193.3**	**1.9**	**-3.5**	**23.0**	**21.3**
Private	3,480.2	3,603.5	4.1	3.5	24.2	24.0
Public	-169.7	-410.3	-76.5	-141.7	-1.2	-2.7
5. Net Primary Income from Rest of the World (d)	**-389.6**	**-432.2**	**-10.4**	**-10.9**	**-2.7**	**-2.9**
6. Net Current Transfers from Rest of the World	**999.5**	**1,030.7**	**3.6**	**3.1**	**7.0**	**6.9**
7. National Savings (4+5+6)	**3,920.4**	**3,791.7**	**1.6**	**-3.3**	**27.3**	**25.3**
8. Savings-Investment Gap						
Domestic Savings-Investment (4-1.2)	-1,061.9	-919.4			-7.4	-6.1
National Savings-Investment (7-1.2)	-452.0	-321.0			-3.1	-2.1
9. External Current Account Balance (2+5+6) (d)	**-452.0**	**-321.0**			**-3.1**	**-2.1**

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

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

savings-investment gap as well as the national savings-investment gap narrowed in 2019 to 6.1 per cent and 2.1 per cent of GDP, respectively, from 7.4 per cent and 3.1 per cent of GDP in 2018.

The agriculture sector recorded a modest growth of 0.6 per cent in 2019, compared to the growth of 6.5 per cent in 2018, reflecting the impact of the extreme weather conditions observed during most months of the year. In 2019, growing of oleaginous fruits, especially coconut production, recorded improved performance with a notable growth of 18.2 per cent, mainly due to the lag effect of the favourable weather conditions that prevailed in the latter part of 2018. Meanwhile, paddy production in 2019 increased to 4.6 million MT, an equivalent of 2.9 million MT of rice, which was estimated to be adequate to meet the domestic demand for rice for approximately 14 months. Consequently, rice imports dropped significantly, in 2019, to 24,193 MT, from 248,901 MT in 2018. However, the production of paddy declined during the 2019 Yala season compared to the previous Yala season due to dry weather conditions. Further, cultivation activities of the 2019/2020 Maha season slowed in comparison to the bumper harvest recorded in the previous Maha season, resulting in a contraction in activities related to growing of paddy in the fourth quarter of 2019. Overall, the contraction in the 2019 Yala season and 2019/2020 Maha season cultivation activities resulted in a negative growth of 0.3 per cent in value added in the growing of rice subsector in 2019. Meanwhile, growing of tea recorded a negative growth of 1.3 per cent in 2019, resulting from the dry weather conditions that prevailed in the first half of the year, disruptions in labour supply amidst wage related trade disputes in the tea sector, and slowing of tea plucking activities due to heavy rains in the latter part of the year. Moreover, rubber production declined to a record low of 74.8 million kilogrammes in 2019, resulting in a contraction of 9.5 per cent in activities related to growing of rubber. Disruptions

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in tapping activities due to the unfavourable weather conditions in the latter part of the year and abandoning of tapping activities due to low prices domestically and globally contributed to the contraction in rubber sector activities in 2019. Further, marine fish production was affected by inclement weather, such as cyclones and heavy rains, during most part of 2019, resulting in a contraction of 5.5 per cent in the marine fishing and marine aquaculture subsector. Further, forestry and logging activities also registered a contraction of 4.8 per cent in 2019.

The industry sector performance somewhat improved in 2019, recording a growth of 2.7 per cent during the year, compared to the growth of 1.2 per cent in 2018. The construction and mining and quarrying subsectors grew by 4.0 per cent and 2.8 per cent, respectively, in 2019, mainly supported by the government infrastructure development projects, compared to contractions of 2.5 per cent and 5.2 per cent, respectively, recorded in 2018. Meanwhile, manufacturing activities, which accounted for 15.6 per cent of GDP, registered a subdued growth of 1.9 per cent in 2019, compared to the growth of 3.6 per cent in the preceding year. In 2019, the manufacturing of textiles, wearing apparel and leather products subsector grew by 3.9 per cent, compared to the growth of 3.4 per cent in 2018, with the gradual recovery in demand for exported goods. Meanwhile, the growth of the manufacture of food, beverages and tobacco subsector decelerated to 3.4 per cent in 2019 from 4.0 per cent in the previous year, reflecting the impact of dampened domestic demand in the aftermath of the Easter Sunday attacks. The manufacture of coke and refined petroleum products subsector grew notably by 23.4 per cent in 2019, compared to the contraction of 8.2 per cent in 2018, amidst the temporary shutdown of the refinery of the Ceylon Petroleum Corporation (CPC) for maintenance purposes.

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

Economic Activity	Rs. million		As a Percentage of GDP (%)		Growth (%)		Contribution to Change (%)	
	2018 (c)	2019	2018 (c)	2019	2018 (c)	2019	2018 (c)	2019
Agriculture, Forestry & Fishing	**683,816**	**687,857**	**7.1**	**7.0**	**6.5**	**0.6**	**13.5**	**1.8**
Agriculture and Forestry	565,337	574,472	5.8	5.8	7.9	1.6	13.4	4.1
Fishing	118,479	113,386	1.2	1.1	0.2	-4.3	0.1	-2.3
Industries	**2,540,315**	**2,608,211**	**26.3**	**26.4**	**1.2**	**2.7**	**10.0**	**30.8**
Mining and Quarrying	225,505	231,893	2.3	2.3	-5.2	2.8	-4.0	2.9
Manufacturing	1,512,800	1,540,969	15.6	15.6	3.6	1.9	16.8	12.8
Electricity, Gas, Water and Waste Treatment	144,940	151,978	1.5	1.5	6.0	4.9	2.7	3.2
Construction	657,070	683,371	6.8	6.9	-2.5	4.0	-5.5	11.9
Services	**5,555,303**	**5,680,757**	**57.5**	**57.4**	**4.6**	**2.3**	**78.2**	**56.8**
Wholesale and Retail Trade, Transportation and Storage, and Accommodation and Food Service Activities	2,234,394	2,273,836	23.1	23.0	3.5	1.8	24.6	17.9
Information and Communication	63,421	73,378	0.7	0.7	9.6	15.7	1.8	4.5
Financial, Insurance and Real Estate Activities including Ownership of Dwellings	1,366,490	1,400,468	14.1	14.2	9.6	2.5	38.6	15.4
Professional Services and Other Personal Service Activities	1,104,097	1,128,115	11.4	11.4	2.9	2.2	10.2	10.9
Public Administration, Defence, Education, Human Health and Social Work Activities	786,902	804,959	8.1	8.1	1.2	2.3	3.0	8.2
Gross Value Added at Basic Price	**8,779,434**	**8,976,825**	**90.8**	**90.8**	**3.7**	**2.2**	**101.6**	**89.4**
Taxes less Subsidies on products	889,166	912,553	9.2	9.2	-0.6	2.6	-1.6	10.6
Gross Domestic Product at Market Price	**9,668,600**	**9,889,379**	**100.0**	**100.0**	**3.3**	**2.3**	**100.0**	**100.0**
Net Primary Income from Rest of the World	-264,507	-281,083			-6.0	-6.3		
Gross National Income at Market Price	**9,404,093**	**9,608,296**			**3.2**	**2.2**		

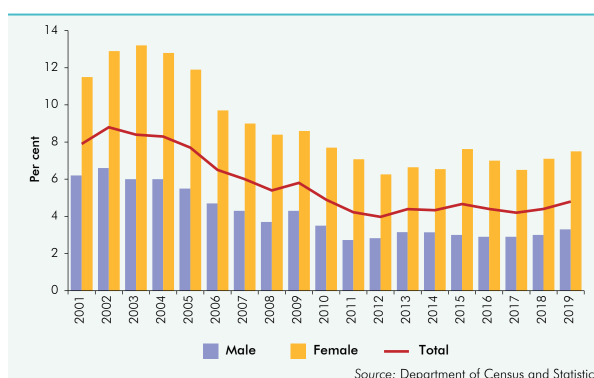
(a) Based on the GDP estimates (base year 2010)
(b) Provisional
(c) Revised

Source: Department of Census and Statistics

Growth of the services sector halved to 2.3 per cent in 2019 compared to 2018, as the impact of the Easter Sunday attacks slowed activities in most of the subsectors. The accommodation, food and beverage activities subsector, which was the most affected subsector, contracted by 4.6 per cent in 2019, compared to the growth of 5.7 per cent in 2018. Reflecting the spillover effects of the Easter Sunday attacks and the general slowdown in economic activity, a deceleration was observed in growth of activities in several other subsectors, including wholesale and retail trade (growth of 3.0 per cent), transportation of goods and passengers, including warehousing (growth of 1.4 per cent), financial service activities and auxiliary financial services (growth of 2.0 per cent), real estate activities, including ownership of dwelling and other personal services (growth of 2.4 per cent) in 2019. Meanwhile, activity in public administration and defence grew by 2.1 per cent in 2019 compared to a contraction of 0.6 per cent in 2018. The telecommunication and information technology subsectors displayed a robust performance, growing at 17.2 per cent and 13.1 per cent, respectively, during 2019.

Reflecting subdued economic activity, the unemployment rate increased to 4.8 per cent in 2019 from 4.4 per cent in 2018. Male and female unemployment rates rose to 3.3 per cent and 7.4 per cent, respectively, during 2019, from 3.0 per cent and 7.1 per cent, respectively, in the previous year. Meanwhile, the Labour Force Participation Rate (LFPR) increased marginally to 52.3 per cent in 2019 from 51.8 per cent in 2018, primarily due to an increase in LFPR of females. Accordingly, LFPR for females increased to 34.5 per cent in 2019 from 33.6 per cent in 2018. However, the male LFPR remained unchanged at 73.0 per cent in 2019. Despite the increase in the unemployment rate, the employed population increased by 2.1 per cent

Figure 1.3
Unemployment Rate



Source: Department of Census and Statistics

to 8.181 million in 2019 along with a higher LFPR. Meanwhile, the services sector, which is the largest sector of the economy, contributed 47.1 per cent of the total employment, followed by the industry and agriculture sectors, contributing 27.6 per cent and 25.3 per cent of the total employment, respectively, in 2019. In terms of employment status, shares of public sector employees, private sector employees, employers, own account workers, and contributing family workers were 14.9 per cent, 43.0 per cent, 2.6 per cent, 32.5 per cent, and 7.0 per cent, respectively, in 2019.

Despite transient supply side disturbances, both headline and core inflation moved broadly in the desired range of 4-6 per cent during 2019, mainly as a result of subdued demand conditions and well anchored inflation expectations. With survey based upward adjustments to house rentals and education fees, headline inflation as measured by the movements in the Colombo Consumer Price Index (CCPI, 2013=100) accelerated at the beginning of 2019. Contributed also by the revisions of administratively determined prices and taxes on certain food and non food items, CCPI based year-on-year headline inflation accelerated from 3.7 per cent in January 2019 to 5.0 per cent in May 2019, before easing during the ensuing three months to record 3.4 per cent in August 2019. However, subsequent adverse weather

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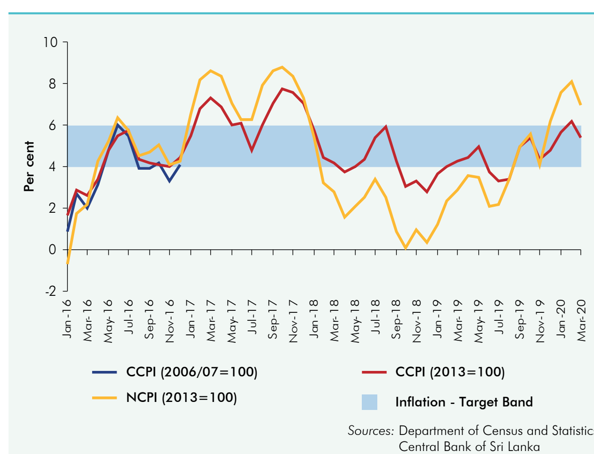
conditions caused high food inflation, resulting in an acceleration of headline inflation to reach 5.4 per cent in October 2019, following which headline inflation remained below 5.0 per cent during the remainder of the year. Accordingly, CCPI based year-on-year headline inflation was recorded at 4.8 per cent in December 2019, in comparison to 2.8 per cent in December 2018. Meanwhile, headline inflation, based on the National Consumer Price Index (NCPI, 2013=100) that attributes a higher weight to food items, followed the trend of CCPI based inflation during the first half of 2019, although remaining notably low. Nevertheless, NCPI based year-on-year headline inflation accelerated during the second half of 2019, reflecting the impact of supply side disruptions, and reached 6.2 per cent in December 2019, compared to 0.4 per cent recorded at end 2018. Meanwhile, year-on-year headline inflation based on both the CCPI and the NCPI accelerated at the beginning of 2020, mainly due to persistently high food inflation. As such, year-on-year headline inflation based on the CCPI reached 6.2 per cent in February 2020, while year-on-year inflation based on the NCPI peaked at 8.1 per cent in February 2020. However, as food inflation eased, year-on-year headline inflation based on the CCPI and the NCPI decelerated to 5.4 per cent and 7.0 per cent, respectively, in March 2020, in spite of the disruptions caused by the spread of the COVID-19 pandemic. Meanwhile, core inflation, which excludes volatile food, energy and transport groups from headline inflation, registered an increase at the beginning of 2019 due to the impact of the revision of house rentals and education fees in the CCPI basket, and remained at elevated levels during the remainder of the year. Accordingly, in December 2019, year-on-year core inflation based on the CCPI and the NCPI remained at 4.8 per cent and 5.2 per cent, respectively, compared to 3.1 per cent recorded by both the indices in December 2018. In the first quarter of 2020, core inflation based on the CCPI and the NCPI decelerated, mostly on account of the base effect, and was recorded at 2.9 per cent and 3.2 per cent, respectively, in March 2020.

Figure 1.4
Headline Inflation (Year-on-Year)



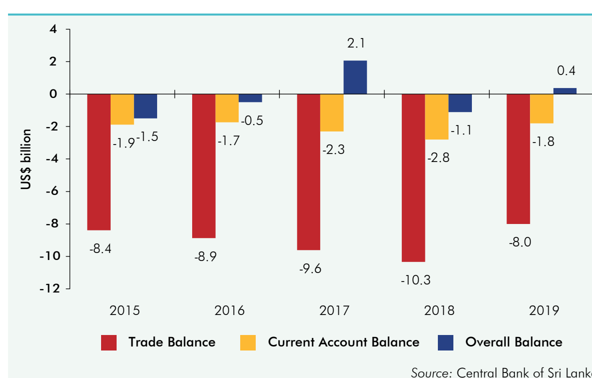
Sources: Department of Census and Statistics
Central Bank of Sri Lanka

External Sector Developments

Policies to curtail import expenditure resulted in a notable improvement in the trade and current account balances, which, along with significant inflows to the financial account, helped strengthen gross official reserves and stabilise the exchange rate. The improvement in the trade balance was mainly due to the reduction in import expenditure amidst the policy induced contraction in merchandise imports, while the modest growth of export earnings also contributed to a lower trade deficit in 2019. The surplus in the services account moderated in 2019, mainly reflecting the adverse impact of the Easter Sunday attacks on tourist earnings and receipts from air passenger services. The deficit in the primary income account widened during the year with an increase in dividend payments and reinvested earnings by direct investment enterprises (DIEs), while interest payments on portfolio investment also rose marginally during 2019. Meanwhile, the

surplus in the secondary income account narrowed further in 2019 reflecting the continued moderating trend in workers' remittances observed over the past few years. Overall, the current account deficit declined in 2019, as the improvement in the merchandise trade balance outweighed the moderation in trade in services and secondary income as well as the widening of the primary income deficit. Meanwhile, the financial account recorded significant inflows in 2019, including proceeds of the International Sovereign Bonds (ISBs) and the receipt of two tranches of the Extended Fund Facility of the International Monetary Fund (IMF-EFF). However, inward foreign direct investment (FDI) moderated, while foreign investment in the government securities market and the Colombo Stock Exchange (CSE) recorded net outflows in 2019. Meanwhile, notable debt repayments were recorded by the government in 2019, including the settlement of two ISBs and the scheduled repayments on syndicated loan facilities. Despite the large foreign currency debt service payments by the government, significant inflows of foreign currency to the government and the Central Bank strengthened gross official reserves. This reflected the surplus in the overall balance of BOP in 2019. Meanwhile, the Sri Lankan rupee recorded a marginal appreciation of 0.6 per cent against the US dollar in 2019, compared to the significant depreciation recorded in 2018. This appreciation of the currency mainly reflected the impact of the notable contraction in the trade deficit, in spite of pressure witnessed in the domestic foreign exchange market in the aftermath of the Easter Sunday attacks and amidst outflows of foreign investment from the government securities market during the second half of 2019. The Central Bank maintained flexibility in the determination of the exchange rate during the year, while intervening only to prevent any excessive volatility of the Sri

Figure 1.5
Balance of Payments



Source: Central Bank of Sri Lanka

Lankan rupee and buildup reserves. Reflecting the nominal appreciation of the Sri Lankan rupee against the currencies of several major trading partners together with the movements in the cross currency exchange rates, both the Nominal Effective Exchange Rate (NEER) and the Real Effective Exchange Rate (REER) indices appreciated in 2019.

Earnings from merchandise exports increased marginally in 2019 compared to 2018, as the growth in export earnings from industrial exports was partly offset by the contraction in earnings from agriculture and mineral exports. Accordingly, earnings from merchandise exports increased by 0.4 per cent to US dollars 11,940 million in 2019 from US dollars 11,890 million in 2018. Earnings from industrial exports, which accounted for about 79 per cent of total export earnings, increased by 1.8 per cent to US dollars 9,426 million in 2019. Earnings from industrial exports were supported by the growth of earnings from textiles and garments (5.2 per cent), gems, diamonds and jewellery (10.0 per cent), transport equipment (21.3 per cent) and base metals and articles (6.7 per cent). However, certain categories of industrial exports recorded a decline in 2019, including petroleum products (16.2 per cent), leather, travel goods and footwear (30.3 per cent)

and machinery and mechanical appliances (8.0 per cent). Earnings from agricultural exports, which accounted for about 21 per cent of total exports, declined by 4.6 per cent to US dollars 2,462 million in 2019, reflecting lower earnings from most sub categories, in particular tea (5.7 per cent) and spices (13.2 per cent). However, earnings from coconut exports increased by 6.0 per cent, as the export of both coconut kernel and non kernel products increased in volume terms. Meanwhile, earnings from mineral exports declined by 1.4 per cent in 2019. The USA remained the major export destination accounting for 26.3 per cent of Sri Lanka's exports, followed by the UK (8.4 per cent), India (6.4 per cent), Germany (5.4 per cent) and Italy (4.4 per cent) in 2019. The export volume index increased by 7.2 per cent, while the unit value index declined by 6.3 per cent, implying that the low growth in export earnings was driven by lower prices in 2019, compared to 2018.

Expenditure on merchandise imports declined notably in 2019, reflecting the impact of policy measures implemented to curtail non essential imports, while lower import prices also contributed to this decline. Accordingly, expenditure on imports declined by 10.3 per cent to US dollars 19,937 million in 2019 from US dollars 22,233 million in 2018. Meanwhile, expenditure on non fuel imports declined by 11.3 per cent to US dollars 16,045 million in 2019. Expenditure on intermediate goods imports, which accounted for 57 per cent of total imports, declined by 9.0 per cent in 2019, led by the decline in expenditure on gold (99.4 per cent), fuel (6.3 per cent), base metals (17.6 per cent) and fertiliser (15.4 per cent). However, an increase was recorded in import expenditure on mineral products (34.0 per cent) and textiles and textile articles (1.8 per cent) in 2019. Expenditure on consumer goods imports, which accounted for about 20 per cent of total imports, declined significantly by 20.5 per cent to US dollars 3,957 million in 2019, reflecting the decline in expenditure on both food and beverages and non food consumer goods. Import expenditure on food and beverages declined by 11.2 per cent, due to lower expenditure on food categories such as rice (88.0 per cent), sugar and confectionery (19.4 per cent) and dairy products (6.1 per cent), while an increase was recorded in expenditure on seafood (8.8 per cent), vegetables (2.0 per cent) and spices (1.3 per cent). Meanwhile, expenditure on the import of non food consumer goods declined by 25.0 per cent in 2019, compared to 2018. This notable reduction was mainly due to the decline in personal vehicle imports by 48.2 per cent to US dollars 816 million in 2019, supported by the policy measures implemented during the latter part of 2018 and the increased tax structure on most categories of personal vehicle imports in the government Budget 2019 presented in March 2019. However, some acceleration of vehicle imports was observed towards the end of 2019, with the resumption of imports under concessionary permits given to public officials. The restrictions imposed in 2018 on the selected non essential consumer goods were also removed in March 2019. Nevertheless, expenditure on most non essential consumer goods continued to decline in 2019, while import expenditure on medical and pharmaceuticals and household and furniture items increased. With sluggish economic growth, expenditure on investment goods, which accounted for about 23 per cent of total import expenditure, declined by 1.9 per cent to US dollars 4,603 million in 2019. In terms of the countrywise distribution of Sri Lanka's import expenditure, China accounted for the largest share of 20.2 per cent, followed by India (19.6 per cent), the United Arab Emirates (8.4 per cent), Singapore (4.8 per cent) and Japan (4.4 per cent).

The import volume index and the unit value index recorded declines by 5.8 per cent and 4.8 per cent, respectively, in 2019, indicating that the decline in import expenditure was due to a combined effect of lower volumes and prices, compared to 2018. Meanwhile, considering the possible impact of the COVID-19 pandemic on the BOP, measures were implemented in March 2020, to suspend the importation of certain categories of motor vehicles and non essential consumer goods for a period of three months.

The trade balance improved significantly in 2019, recording the lowest deficit since 2013. This was driven by the sharp contraction in import expenditure, which was mainly attributed to the reduction in imports of motor vehicles and gold in 2019, responding to the policy measures implemented by the government and the Central Bank in 2018 to curtail such imports amidst external sector pressures. Meanwhile, earnings from exports, which rose notably during the first half of 2019, moderated in the second half of the year, recording only a modest growth in 2019. The trade deficit in 2019 was recorded at US dollars 7,997 million, a decline of US dollars 2,346 million, compared to the deficit of US dollars 10,343 million recorded in 2018. The trade deficit, as a percentage of GDP, declined to 9.5 per cent in 2019 from 11.7 per cent in 2018.

Mainly driven by the contraction in the trade deficit, the current account balance improved significantly in 2019, despite the widening of the primary income deficit and the moderation of services and secondary income balances. The surplus in the services account weakened to US dollars 2,849 million in 2019 from US dollars 3,766 million in 2018, mainly due to modest earnings from tourism reflecting the impact of the Easter Sunday attacks, which resulted in a decline in tourist arrivals to 1.9 million in 2019 from 2.3 million in the previous year. The deficit in the primary income account widened in 2019 to US dollars 2,426 million in 2019, compared to US dollars 2,385 million in the previous year, due to increased dividend payments and re-invested earnings of DIEs, while interest payments also increased marginally in 2019. Meanwhile, workers' remittances continued to moderate in 2019, thus reducing the surplus in the secondary income account to US dollars 5,766 million in 2019 in comparison to US dollars 6,163 million in 2018. Consequently, the current account deficit narrowed notably to US dollars 1,808 million in 2019, which was 2.2 per cent of GDP, compared to 3.2 per cent in 2018.

In 2019, the financial account recorded significant inflows, mainly to the government, amidst outflows of portfolio investment and large debt repayments. The financial account was strengthened by the two ISB issuances in March and June 2019 amounting to US dollars 4.4 billion and the receipt of the sixth and seventh tranches of the IMF-EFF amounting to US dollars 327 million. However, FDI inflows moderated in 2019 compared to the previous year, while foreign investment recorded net outflows from the CSE and the government securities market, driven by the dampened investor sentiment in the aftermath of the Easter Sunday attacks and uncertainties in global markets in the second half of 2019. Financial flows on account of foreign debt service payments increased in 2019 with the maturity of two ISBs amounting to US dollars 1.5 billion, in addition to the scheduled payments of syndicated loans. Financial flows in relation to the banking sector, private sector and state owned business enterprises (SOBEs) recorded net outflows, mainly reflecting the increased debt repayments in 2019. Outflows, particularly

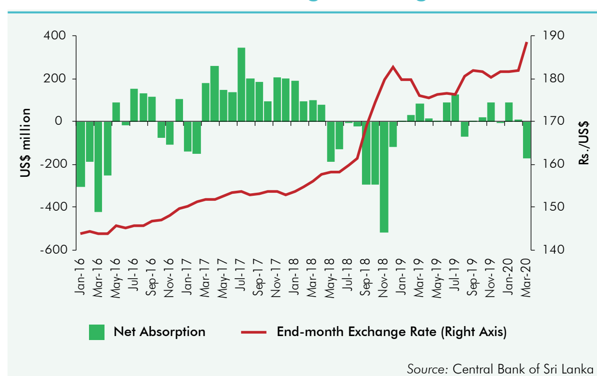
from the government securities market, continued in the first quarter of 2020, amidst heightened uncertainties in global financial markets with the spread of the COVID-19 pandemic.

Gross official reserves improved by end 2019, supported by significant inflows to the government and the Central Bank, despite large foreign currency debt service payments by the government in 2019. Gross official reserves increased to US dollars 7.6 billion by end 2019 from US dollars 6.9 billion at end 2018. The proceeds from the issuances of two ISBs, the receipts of two tranches of the IMF-EFF and the purchase of foreign exchange by the Central Bank from the domestic foreign exchange market, primarily contributed to enhance gross official reserves by end 2019. The country's gross official reserves at end 2019 could cover about 4.6 months of imports and about 57 per cent of its short term liabilities. Furthermore, total international reserves, which consist of gross official reserves and foreign assets of depository corporations, increased to US dollars 10.4 billion by end 2019, equivalent to 6.3 months of imports.

Sri Lanka's external debt increased further by end 2019, mainly due to the rise in external debt of the government. Total external debt of the country increased to US dollars 55.9 billion by end 2019, which was equivalent to 66.6 per cent of GDP, compared to 59.2 per cent of GDP recorded by the end of 2018. The outstanding balance of ISBs, based on market value, increased to US dollars 15.2 billion at end 2019, reflecting the net impact of new ISB issuances and maturities. The outstanding balance of non residents' holding of Treasury bonds declined notably in 2019, while the non residents' holdings of Treasury bills recorded a marginal increase during the year. Meanwhile, the outstanding balance of foreign loans of the government declined marginally due to net repayments in 2019. The outstanding external liabilities of the Central Bank increased with the receipt of the IMF-EFF tranches and the marginal increase in liabilities to the Asian Clearing Union (ACU) by end 2019. However, the external liability position of the banking sector declined due to the maturity of an international bond issued by the National Savings Bank and the decrease in outstanding loan liabilities of Licensed Commercial Banks (LCBs). The intercompany borrowings by DIEs recorded an increase, reflecting the increase in intercompany loans as well as shareholder advances by major companies at end 2019.

The exchange rate remained broadly stable during 2019, supported by a significant improvement in the current account, despite some transient volatility experienced amidst outflows of portfolio investment, responding to domestic and global developments. The exchange rate strengthened during the first four months of 2019, as a result of the significant contraction in the trade deficit and an increase in financial inflows. However, the exchange rate experienced some pressure in the immediate aftermath of the Easter Sunday attacks, and towards the latter part of 2019, reflecting the impact of heightened uncertainties in global markets, which resulted in some unwinding of portfolio investment by foreigners. Nevertheless, favourable liquidity conditions that prevailed in the domestic foreign exchange market during most of 2019 enabled the Central Bank to absorb US dollars 387 million, on a net basis, in 2019. Overall, the Sri Lankan rupee appreciated by 0.6 per cent against the US dollar in 2019, compared to the significant depreciation of 16.4 per cent in 2018. Aligning with the nominal appreciation of the Sri Lankan rupee against the

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



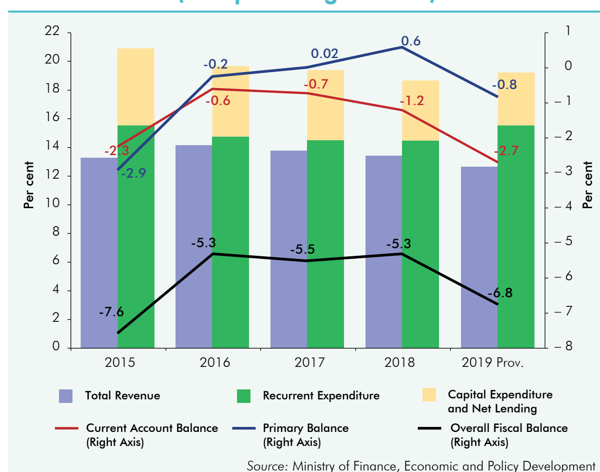
Source: Central Bank of Sri Lanka

currencies of several major trading partners, and together with the movements in the cross currency exchange rates, both the NEER and REER indices appreciated in 2019. However, the REER indices remained below the base year level, reflecting the country's competitiveness in terms of the exchange rate. The Central Bank continued to allow flexibility in the determination of the exchange rate based on market fundamentals, while intervening in the domestic foreign exchange market only to prevent excessive volatility of the Sri Lankan rupee and to build reserves. Meanwhile, the exchange rate, which remained stable up to the second week of March 2020, witnessed significant pressure with the spread of the COVID-19 pandemic, while speculation by market participants and foreign investors also weighed on the stability of the currency. The government and the Central Bank introduced several measures to curb the excessive pressure on the external sector, while allowing the rupee to depreciate in line with currencies of regional peers.

Fiscal Sector Developments

The process of fiscal consolidation faced significant challenges in 2019, amidst the notable decline in government revenue and the rise in government expenditure. Due to the political impasse in the fourth quarter of 2018, the submission of the government Budget 2019 was delayed until March 2019, and fiscal operations were conducted on a Vote on Account from January through early April 2019. The government Budget 2019, which was approved on 5 April 2019, aimed at reducing the budget deficit to 4.4 per cent of GDP in 2019 from 5.3 per cent of GDP in 2018, while targeting surpluses in the current account and the primary balance of 0.2 per cent and 1.5 per cent of GDP, respectively. However, fiscal performance worsened in 2019 due to the notable decline in government revenue caused by the sizeable import compression, particularly of motor vehicles, subpar economic activity exacerbated by the Easter Sunday attacks, as well as the rise in recurrent expenditure mainly on account of subsidies and transfers, and salaries and wages. Further, the delays in implementation of certain revenue measures proposed in the government Budget 2019 also contributed to weak revenue performance in 2019. Consequently, the major fiscal indicators deviated from the envisaged levels in the Budget 2019, and also in comparison to 2018. Accordingly, the budget deficit rose to 6.8 per cent of GDP in 2019, from 5.3 per cent of GDP in 2018. The current account deficit, which reflects the government's dissavings, increased to 2.7 per cent of GDP in 2019, from 1.2 per cent in the previous year, and the primary balance, which excludes interest payments from the overall budget deficit, recorded a deficit of 0.8 per cent of GDP in 2019, compared to a surplus of 0.6 per cent of GDP in 2018. Consequently, central government debt as a percentage of GDP rose to 86.8 per cent by end 2019 from 83.7 per cent at end 2018, reflecting the impact of higher net borrowings to finance the budget deficit and the relatively modest growth in nominal GDP in 2019.

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



Source: Ministry of Finance, Economic and Policy Development

Government revenue as a percentage of GDP declined to 12.6 per cent in 2019 from 13.4 per cent in 2018. The decline in revenue from indirect taxes, mainly excise duty on motor vehicles, Value Added Tax (VAT), Cess levy, Ports and Airports Development Levy (PAL) and import duties, resulted in the lacklustre performance in tax revenue in 2019, in spite of the significant increase observed in the collection of income tax. In nominal terms, government revenue decreased by 1.5 per cent to Rs. 1,890.9 billion in 2019 from Rs. 1,920.0 billion recorded in the previous year, while tax revenue increased marginally by 1.3 per cent to Rs. 1,734.9 billion in 2019, owing to the increase in income tax revenue, particularly from corporate taxes under the new Inland Revenue Act and debt repayment levy. In contrast, non tax revenue declined significantly both in nominal terms and as a percentage of GDP in 2019, with lower revenue from fees and charges, non availability of distributable profits from the Central Bank, and the reduction in profit and dividend transfers from SOBEs.

Total expenditure and net lending increased to 19.4 per cent of GDP in 2019 from 18.7 per cent in 2018, as the increase in recurrent expenditure outweighed the decline in capital expenditure and net lending. Recurrent expenditure as a percentage of GDP increased to 15.3 per cent in 2019 from 14.5 per cent in 2018. In nominal terms, this was an increase of 10.1 per cent to Rs. 2,301.2 billion in 2019 from Rs. 2,089.7 billion in 2018. Total interest expenditure, in nominal terms, increased by 5.8 per cent to Rs. 901.4 billion in 2019 from Rs. 852.2 billion in 2018, while expenditure on foreign interest payments increased by 16.9 per cent to Rs. 248.6 billion in 2019. The increase in outstanding debt, especially on account of Treasury bonds and foreign commercial loans, contributed to the rise in interest expenditure during the year, despite the decline in interest rates domestically and globally. However, capital expenditure and net lending declined to 4.1 per cent of GDP in 2019 from 4.2 per cent of GDP in 2018. In nominal terms, capital expenditure and net lending increased by 1.8 per cent to Rs. 614.1 billion in 2019, in comparison to Rs. 603.5 billion in 2018. Public investment declined to 4.2 per cent of GDP (Rs. 631.2 billion) in 2019 from 4.4 per cent of GDP (Rs. 625.0 billion) in the previous year.

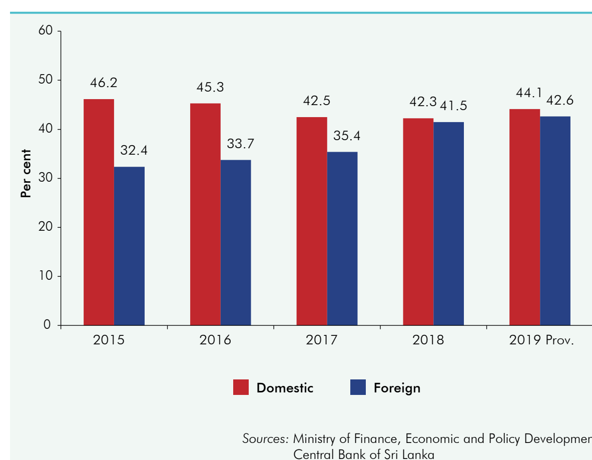
The budget deficit was largely financed through domestic sources during 2019. Accordingly, net domestic financing fulfilled 69.1 per cent of the budget deficit, while the balance was met from foreign sources. In nominal terms, net financing from domestic sources increased by 60.6 per cent to Rs. 702.4 billion in 2019, in comparison to Rs. 437.2 billion in 2018, reflecting an increase in borrowing from both bank and non bank sources. Borrowings from the banking sector increased significantly by 76.4 per cent to Rs. 193.1 billion in 2019, as reflected in net purchases of Treasury bills and Treasury bonds by LCBs amounting to Rs. 312.6 billion in 2019, compared to a net repayment of Rs. 73.1 billion in 2018. Meanwhile,

the net repayment of Rs. 108.1 billion to the Central Bank partly offset the increase in net financing from LCBs amounting to Rs. 301.2 billion in 2019. Net financing through non bank sources increased to Rs. 509.3 billion in 2019 from Rs. 327.8 billion in 2018. However, net financing from foreign sources declined to Rs. 314.1 billion in 2019, in comparison to Rs. 323.5 billion in 2018, mainly due to a repayment on account of Foreign Currency Term Financing Facility (FCTFF) of Rs. 83.5 billion. Net borrowings through ISBs amounted to Rs. 461.4 billion[1] during the year. Meanwhile, foreign project loans recorded a net repayment of Rs. 15.2 billion in 2019.

Central government debt as a percentage of GDP increased to 86.8 per cent at end 2019 from 83.7 per cent at end 2018. This increase was primarily due to higher net borrowings to finance the budget deficit, and the relatively modest growth in nominal GDP in 2019. In nominal terms, central government debt increased to Rs. 13,031.5 billion at end 2019, from Rs. 12,030.5 billion at end 2018. Total outstanding domestic debt increased by 9.2 per cent to Rs. 6,629.1 billion, while the rupee value of total outstanding foreign debt increased by 7.4 per cent to Rs. 6,402.4 billion by end 2019. The nominal increase in the outstanding foreign debt can partly be attributed to the depreciation of the Sri Lankan rupee against some currency denominations in the debt stock. It is noteworthy that the outstanding debt stock denominated in foreign currency remains unchanged in foreign currency terms irrespective of its rupee value due to exchange rate movements, and is typically serviced using foreign currency inflows to the government, thereby rendering exchange rate movements immaterial.

1 This comprised borrowings through ISBs amounting to Rs. 782.5 billion (US dollars 4.4 billion), repayments amounting to Rs. 269.8 billion in 2019, and an unutilised balance of Rs. 51.4 billion at the end of the year.

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



Sources: Ministry of Finance, Economic and Policy Development
Central Bank of Sri Lanka

Following the notable adjustments to the fiscal policy direction to revive the economy after the Presidential Election at end 2019, the government announced several fiscal measures during the first quarter of 2020 amidst the spread of the COVID-19 outbreak. The measures introduced at end 2019 included a series of tax concessions, along with other reforms aimed at increasing the disposable income and encouraging private consumption and investment. As the country was forced into a lockdown with the spread of the COVID-19 pandemic in March 2020, the Cabinet of Ministers approved allocation of funds on an urgent basis for various purposes, including Rs. 5 billion for settling the payments arrears of the small and medium scale contractors, Rs. 10 billion for settling arrears by the government to private institutions on account of purchasing of pharmaceuticals, and Rs. 3 billion for settling fertiliser procurement bills. In addition, the government allocated an additional Rs. 500 million for preventive activities. Measures were initiated to establish a fuel price stabilisation fund, aiming to raise Rs. 200 billion within 6 months by utilising the benefit of low international fuel prices. The government extended the deadline of all payments on VAT and income taxes, and driving license renewal fees until 30 April 2020. The trainee

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allowance of Rs. 20,000 for March 2020 was granted for all graduates selected for government employment in the recent recruitment round. The *Agrahara* Insurance benefits were doubled for employees of the health sector, police, civil defence and all government servants engaged in controlling the spread of the COVID-19. Measures were initiated to exempt Lanka Sathosa and Co-operative shops from VAT and other local taxes and charges. Further, the Samurdhi Authority was instructed to issue entitlement certificates to Samurdhi and low income families immediately, in order to issue nutritional food items to such families on a weekly basis. A COVID-19 Healthcare and Social Security Fund was initiated to facilitate necessary healthcare and relief measures, while taking measures to remove taxes and foreign exchange restrictions in relation to contributions to this Fund. Furthermore, the government pledged US dollars 5 million to the SAARC COVID-19 Emergency Fund established to prevent the spread of the COVID-19 outbreak in the region. The government implemented a cash grant scheme of Rs. 5,000 for low income and vulnerable families and individuals, as a lump sum allowance.

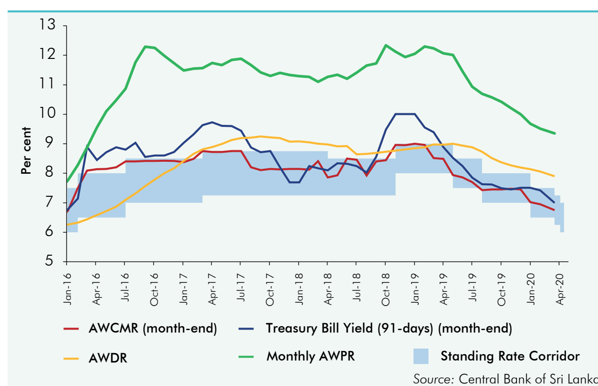
Meanwhile, Sri Lanka's sovereign credit rating was affirmed by major international rating agencies in 2019, despite the downward revision to the outlook for Sri Lanka. Fitch Ratings and S&P Global Ratings affirmed Sri Lanka's rating at "B", while revising the outlook from "Stable" to "Negative" in December 2019 and January 2020, respectively. The revision of the outlook mainly reflected the risks stemming from the possible weakening of the fiscal position of the country. However, Moody's Investors Service (Moody's) maintained its ratings at "B2" with no revision to the "Stable" outlook in 2019.[2]

2 On 17 April 2020, Moody's announced the placing of the Sri Lanka's rating under review for 'downgrade'.

Monetary Sector Developments

In an environment of muted demand driven inflation pressures and well anchored inflation expectations, the Central Bank adopted an accommodative monetary policy stance in 2019 to support the revival of economic activity and address the sluggish growth in credit extended to the private sector. Within a neutral monetary policy stance, the Central Bank reduced the Statutory Reserve Ratio (SRR) applicable on all rupee deposit liabilities of LCBs by a total of 2.50 percentage points in November 2018 and March 2019, thereby addressing the persistent liquidity deficit in the domestic money market. Consequently, market liquidity turned to surplus levels from mid April 2019. However, in spite of the improvement in market liquidity, market interest rates remained downward rigid. Thus, the Central Bank imposed interest rate ceilings on deposit products of licensed banks and non bank financial institutions in April 2019, with a view to expediting the monetary policy transmission through the financial system. Further, with the commencement of the accommodative monetary policy stance, the Central Bank reduced policy interest rates by a total of 100 basis points, in May and August 2019, aimed at lowering the market lending rates and boosting credit flows to the private sector. Responding to these measures, deposit interest rates adjusted downwards notably, while the adjustment of market lending rates remained grossly inadequate. Consequently, the Central Bank imposed ceilings on market lending rates in September 2019, while withdrawing the deposit rate ceilings imposed on licensed banks. This resulted in a continued downward adjustment in market lending rates during the remainder of the year. However, considering the need for a faster reduction in market lending rates to support the slow growth in economic activity, the Central Bank reduced policy interest rates by a further 50 basis

Figure 1.9
Standing Rate Corridor and Selected Market Interest Rates



Source: Central Bank of Sri Lanka

points in January 2020. Moreover, considering the spread of the COVID-19 pandemic in the country and its potential impact on domestic economic activity and financial markets, the Central Bank, in an emergency move, reduced policy rates, in March and April 2020, by a total of 50 basis points, and SRR by 1.00 percentage point to 4.00 per cent in March 2020. Accordingly, effective from the close of business on 3 April 2020, the Standing Deposit Facility Rate (SDFR) and Standing Lending Facility Rate (SLFR) remained at 6.00 per cent and 7.00 per cent, respectively.[3]

Market interest rates declined during 2019, as a result of the monetary policy and regulatory measures of the Central Bank. The Average Weighted Call Money Rate (AWCMR), which remained around the upper bound of the policy rate corridor since September 2018, started to decline gradually from March 2019 with improved liquidity conditions, and hovered around the middle of the policy rate corridor thereafter. A notable decline in deposit interest rates was observed since May 2019, in response to the imposition of caps on deposit interest rates in April 2019, improved liquidity conditions and the reduction in policy interest rates. Accordingly, the Average Weighted Deposit Rate (AWDR) declined by 61 basis points to 8.20 per cent during 2019. Market lending rates, which remained downward rigid despite the accommodative monetary policy measures of the Central Bank, declined notably with the imposition of caps on lending interest rates in September 2019. The weekly Average Weighted Prime Lending Rate (AWPR), which is based on interest rates applicable on short term loans and advances granted by LCBs to their prime customers during a week, declined by 235 basis points to 9.74 per cent during 2019. The Average Weighted Lending Rate (AWLR), which is based on interest rates of all outstanding loans and advances extended by LCBs, declined by 81 basis points to 13.59 per cent during 2019. However, the reduction in market lending rates during 2019 was less than envisaged. Meanwhile, reflecting eased monetary conditions, yields on government securities showed a notable decline during 2019, although a marginal uptick was observed in yields on Treasury bills towards the end of 2019 due to the adverse market speculation on the possible increase in funding requirements of the government. However, yields on primary market Treasury bills decreased by 197-275 basis points across the tenures during 2019. Yields on Treasury bonds in the primary market also declined substantially during 2019, while the government also issued Sri Lanka Development Bonds (SLDBs) at competitive yields. The secondary market yield curve of government securities shifted downwards during 2019 with a larger adjustment in short to medium term yields. Interest rates applicable on corporate debt instruments, which remained elevated during early 2019, declined gradually by end 2019. Despite the decline in global interest rates, interest rates applicable on foreign currency deposits maintained with LCBs remained broadly unchanged during 2019, reflecting domestic investment opportunities

3 Meanwhile, the Bank Rate, the rate at which the Central Bank grants advances to banking institutions as the lender of last resort, was reduced by 500 basis points to 10.00 per cent, with effect from 16 April 2020. The Monetary Board also decided to allow the Bank Rate to adjust automatically with future revisions of the SLFR, with a margin of 300 basis points above the SLFR.

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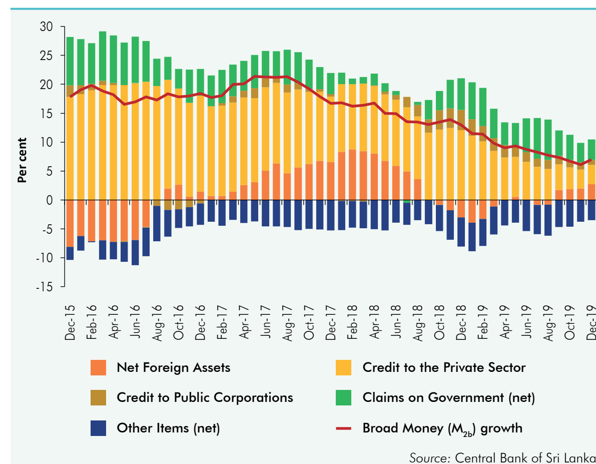
in foreign currency at competitive rates. Meanwhile, with global market volatility arising from the spread of the COVID-19 pandemic, global interest rates declined rapidly in the first quarter of 2020, while the downward movement in domestic interest rates is also expected to accelerate in 2020 to enable a revival of economic activity that has been severely affected by the outbreak.

Reserve money recorded a contraction during 2019, reflecting the impact of the reduction in SRR in March 2019. Accordingly, reserve money contracted by 3.0 per cent, year-on-year, at end 2019 compared to the growth of 2.3 per cent at end 2018. In absolute terms, reserve money contracted by Rs. 28.5 billion to Rs. 932.6 billion by end 2019 compared to an expansion of Rs. 21.3 billion in the previous year. Viewed from the liability side, the decline in LCBs' deposits with the Central Bank due to the reduction in SRR in March 2019 contributed to the contraction of reserve money, while currency in circulation increased moderately during 2019. In terms of assets, the contraction of reserve money during 2019 was mainly reflected in the notable reduction in net domestic assets (NDA) of the Central Bank, which outweighed the expansion in net foreign assets (NFA) of the Central Bank. Accordingly, NDA of the Central Bank contracted by Rs. 173.9 billion to Rs. 36.6 billion by end 2019 in comparison to an increase of Rs. 116.9 billion during 2018, mainly due to the decline in net credit to the government (NCG) by the Central Bank as reflected in the reduction of holdings of government securities by the Central Bank (net of repurchase transactions). Meanwhile, NFA of the Central Bank increased by Rs. 145.5 billion during 2019 compared to the decline of Rs. 95.6 billion in 2018. The expansion in NFA was a result of the increase in foreign assets of the Central Bank due to the conversion of proceeds of ISBs, purchases of foreign exchange from the domestic foreign exchange market and an increase in investment in fixed income securities by the Central Bank, amidst a contraction in foreign liabilities of the Central Bank.

Broad money growth (M_{2b}) continued to decelerate during 2019, with the moderation of the growth of NDA of the banking system. Accordingly, the year-on-year growth of M_{2b} decelerated to 7.0 per cent by end December 2019 compared to the growth of 13.0 per cent at end 2018. The moderation in NDA during 2019 was largely driven by the sluggish growth of credit to the private sector by LCBs, while the growth of credit obtained by the public sector, including the government and SOBEs, also moderated compared to the previous year. In absolute terms, NDA of the banking system increased by Rs. 300.6 billion in 2019 compared to a notable expansion of Rs. 1,008.8 billion in 2018. NCG by the banking system increased by Rs. 250.4 billion in 2019 compared to an increase of Rs. 348.2 billion in 2018. Within NCG, credit from LCBs expanded while NCG by the Central Bank recorded a contraction during the year. Meanwhile, borrowings of SOBEs recorded an increase of

Figure 1.10
Broad Money Growth and Contribution

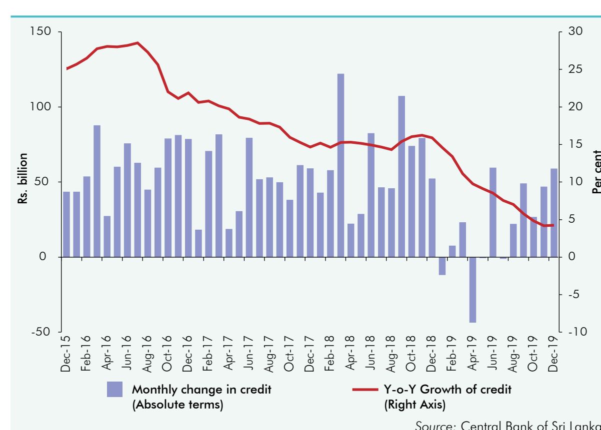


Source: Central Bank of Sri Lanka

Rs. 62.6 billion in 2019 in comparison to the increase of Rs. 218.4 billion in 2018. NFA of the banking system increased by Rs. 195.3 billion in 2019, in comparison to a contraction of Rs. 188.5 billion in 2018, reflecting the rise in NFA of both the Central Bank and LCBs.

Growth of credit to the private sector recorded a sharp deceleration in 2019 amidst high market interest rates, policy uncertainty, dented business confidence especilly after the Easter Sunday attacks, and subdued economic activity during the year, although a recovery was observed in absolute credit disbursements towards the end of the year supported by the measures taken by the Central Bank to ease the monetary conditions. The year-on-year growth of credit to the private sector decelerated to 4.3 per cent by end December 2019 from 15.9 per cent recorded at end 2018. In absolute terms, the expansion of credit to the private sector was Rs. 236.8 billion in 2019, compared to an expansion of Rs. 762.1 billion in 2018. The notable slowdown in growth of credit during the first half of 2019 can be attributed to the high market lending rates, low demand for credit amidst subdued economic activity, which worsened with the Easter Sunday attacks,

Figure 1.11
Credit Granted by Commercial Banks to the Private Sector



Source: Central Bank of Sri Lanka

and rise in non performing advances of the banking sector. Nevertheless, credit flows, in absolute terms, gathered momentum since August 2019 supported by the easing of monetary conditions. In terms of sectoral classification, growth of credit to the Agriculture and Fishing sector decelerated notably and recorded 0.2 per cent, year-on-year, by end 2019, in comparison to the growth of 14.0 per cent at end 2018. Growth of credit to both the Industry and Services sectors slowed to 3.1 per cent by end 2019, from 15.3 per cent and 17.8 per cent, respectively, at end 2018. Personal Loans and Advances, which continued to record a notable growth in the recent past, also moderated to 11.9 per cent by end 2019, compared to the growth of 20.3 per cent at end 2018.

Meanwhile, credit as a percentage of GDP, which is an indicator of financial deepening of the economy, displayed mixed movements in 2019. Having risen continuously from 26.4 per cent in 2013 to 38.7 per cent in 2018, credit to the private sector by LCBs as a percentage of GDP declined marginally to 38.6 per cent in 2019. Credit to the private sector in the monetary aggregate M_4, which covers Licensed Specialised Banks (LSBs) and Licensed Finance Companies (LFCs) in addition to LCBs, also followed a similar trend, declining to 51.9 per cent of GDP in 2019 from 52.2 per cent in the previous year. Reflecting the rise in credit to the public sector during the year, domestic credit as a percentage of GDP in relation to M_{2b} and M_4, continued to increase, recording 62.5 per cent and 80.4 per cent, respectively, at end 2019, compared to 61.5 per cent and 79.1 per cent, respectively, in 2018.

Financial Sector Developments

Sri Lanka's financial system remained stable and resilient amidst challenging domestic and global market conditions in 2019. However, performance of the financial sector moderated in

terms of assets base, credit quality and profitability of financial institutions due to the challenging business environment created by subdued economic growth, policy uncertainty, and the deterioration of investor sentiments stemming from the Easter Sunday attacks. The banking sector, which dominates the financial sector, displayed a moderate expansion during the year, compared to the previous year, reflecting the impact of the low demand for credit and tightened credit screening in an environment of deteriorating credit quality. The moderation of credit flows to the private sector during 2019 caused more funds of banks to shift towards risk free government securities, which in return improved the capital and liquidity levels of the banking sector. The deterioration of credit quality was reflected by the increase in the non performing loans (NPLs) ratio in 2019, compared to the previous year. Deposits, which continued to be the main source of funding, grew in 2019, albeit at a slower pace compared to the previous year, while borrowings contracted in terms of both Sri Lankan rupees and foreign currency. Meanwhile, the profitability of the sector deteriorated in 2019, as reflected by the movements in return on assets (ROA) and return on equity (ROE), mainly due to high operating costs, an increase in loan loss provisions and taxes. Meanwhile, the Financial Action Task Force (FATF) delisted Sri Lanka from its Grey List in October 2019, recognising the significant progress made by Sri Lanka in improving its Anti Money Laundering (AML) and Countering the Financing of Terrorism (CFT) regime.

The performance of Licensed Finance Companies (LFCs) and Specialised Leasing Companies (SLCs) deteriorated during the year, owing to unfavourable market conditions and sector weaknesses. Negative credit growth, declining profitability and an increase in NPLs contributed to the weak performance of the sector during 2019. The Central Bank initiated several stringent regulatory actions and safeguard measures during 2019, in view of ensuring long term sustainability of the sector while seeking to ensure the safety of depositors. The total asset base of the sector expanded marginally during the year, while credit growth of the sector remained negative in 2019. The investment portfolio recorded a significant increase, due to increased investment in government securities, equities, units and other debt instruments, and real estate amidst limited demand for credit and the cautious approach in lending by the sector. The deterioration in asset quality of the sector was reflected by the increase in NPL ratio in 2019. Meanwhile, the sector recorded a substantial decline in profit after tax, compared to the profit recorded in 2018, mainly due to an increase in non interest expenses and high loan loss provisions. Signs of stress on profitability were also reflected by the decline in ROA and ROE during the year. The insurance sector expanded moderately during 2019, recording a growth in its assets base. Contractual savings institutions, dominated by the Employees' Provident Fund (EPF) and the Employees' Trust Fund (ETF), recorded moderate performance while providing reasonable positive real returns to the membership.

Financial markets remained liquid during 2019, and the Central Bank managed liquidity appropriately throughout the year. Liquidity in the domestic money market, which was in deficit levels until mid April 2019, turned into a surplus except for a brief period in August and September during 2019. The downward revision of the SRR in March, conversion of ISB proceeds, and foreign currency purchases by the Central Bank helped maintain surplus liquidity in 2019. The liquidity deficit observed in the market in August 2019 with the maturing of foreign currency swap transactions and Treasury bills held by the Central

BOX 2

COVID-19 and Sri Lanka: Challenges, Policy Responses and Outlook

The COVID-19 outbreak that was first detected in China in late 2019, rapidly spread across the globe prompting the World Health Organization (WHO) to declare it as a pandemic by mid March 2020. To date, the pandemic has left an unprecedented trail of both humanitarian and economic damage in all countries. With 2.5 million people infected and more than 150,000 deaths by mid April, the economic repercussions of the ongoing 'Great Lockdown' are expected to dwarf the Global Financial Crisis of 2007-08. Policymakers around the world are struggling to grapple with this crisis episode amidst numerous uncertainties. While Sri Lanka has been relatively successful in combating the outbreak thus far, as a result of early measures adopted to contain the spread, the interplay of setbacks to domestic economic activity stemming from such containment measures and spillover effects from the global economy are likely to have a notable impact on the Sri Lankan economy during the year.

Spread and Containment of COVID-19 in Sri Lanka

In Sri Lanka, infections were limited to a single person until 11 March 2020, but the number escalated rapidly to 50 and then to over 300 confirmed cases, with 7 casualties by mid April 2020. Despite introducing awareness measures that had prevented any outbreak till early March, the continued arrival of tourists, the return of Sri Lankans from countries that were most affected by the virus, and the lack of adherence to the containment measures that were imposed from mid March 2020 fuelled the outbreak. Nevertheless, efforts to restrict the mobility of people by enforcing police curfew in the country, the closure of airports from 19 March 2020, and actions to quarantine returnees from abroad helped to largely contain the spread – the identified pockets are mainly clustered in a few areas in the Western Province and the Districts of Puttalam and Jaffna. The government established two high level units to combat the spread of the COVID-19 pandemic, while easing the difficulties faced by the public amidst restrictions imposed on mobility. Accordingly, the National Operation Centre for Prevention of the COVID-19 Outbreak coordinates the preventive and management measures of the outbreak, while ensuring the provision of healthcare and other services to the general public. The Presidential Task Force directs, coordinates and monitors the delivery of continuous essential services, paying special attention to low income families and vulnerable persons in the society.

With due consideration to the need to protect the local economy, an exit strategy is being rolled out across the island. Measures include reduction of the timespan of the curfew period, operation of workplaces and businesses with minimal staff, the continuation of teleworking as much as possible and cautious resumption of road and rail transport services. The ban on large gatherings is likely to remain in place for some time.

Economic Impact of the COVID-19 Pandemic on Sri Lanka

While the containment measures adopted have helped curb the outbreak, they have had a substantial negative impact on economic activity on the domestic front. The declaration of holidays, curfew, restricted public services and other measures to contain human movement including the shutdown of airports and seaports for passenger traffic will affect several key economic sectors. The socio-economic impact could also be extensive with the loss of income and livelihoods for a large segment of society. With approximately 60 per cent of those employed being engaged in the informal sector and an estimated 1.9 million being daily wage earners, a large number of households is likely to be in a precarious position. Other vulnerable segments of the population, such as the elderly and the large number of people living just above the poverty threshold, will be disproportionately affected by this episode. Although Sri Lanka has not seen any significant strain on the public healthcare system due to proactive mitigation measures, any unexpected rise of the spread could take a significant toll on the limited capacity of the system.

The global economy is currently seeing its worst downturn since the Great Depression of the 1930s. Several advanced economies such as the United States, the United Kingdom, the Eurozone, and Japan will experience contractions during 2020. Other key trading partners of Sri Lanka, including China and India, are also projected to experience a notable slowdown. Across the globe, the World Trade Organization (WTO) forecasts that global merchandise trade can decline by as much as 32 per cent in 2020. While the poor economic performance of key trading partners will directly impact Sri Lanka's export earnings due to weakened demand, the imposition of various measures domestically and abroad to dampen the spread and the short term economic impact of the outbreak can cause supply chain disruptions, thereby impacting the country's current and future export capacity.

Despite a rapid recovery from the Easter Sunday attacks, the tourism industry is likely to experience the brunt of not only the current pandemic but also its aftermath that may be long lasting and persistent. The overall downturn in the global economy and the economic woes in countries and regions, from which Sri Lanka has been traditionally attracting tourists, including China, India and Europe, will hinder the recovery of the tourism sector. Further, global

health policymakers are consistently raising concerns about possible 'second waves' of the outbreak, thereby emphasising the need to maintain 'physical distancing' for several months after the abatement of the pandemic. Hence, this current standstill of the tourism industry may be protracted if there is any substantial shift in consumer sentiment against travel and leisure.

Another key spillover effect of the contraction of the global economy is the decline in remittances, which have been a vital cushion for Sri Lanka's external sector. In recent years, the leading shares of workers' remittances have been from the Middle East, the European Union, and Far East Asia. While Europe and Far East Asia have been substantially impacted by the COVID-19 outbreak in their respective regions, the Middle East has been impacted by not only the pandemic, but also the sudden decline in international crude oil prices resulting from weakened global demand and the subsequent fallout of the OPEC+ coalition. Although the reduced fuel import bill would ease the burden on the trade deficit, the overall impact on the external current account, arising from the developments in merchandise and services trade and remittances, is likely to be negative in 2020.

Amidst these economic weaknesses, countries have been adopting increasingly accommodative monetary policy stances and undertaking unconventional monetary policies to ensure the provision of ample liquidity to be channeled through the financial sector to households and firms. The resultant low levels of global interest rates can imply a potential easing of costs of refinancing of debt repayments in countries such as Sri Lanka. However, such positive effects have thus far been negated by the capital flow reversals that are being seen across emerging market economies, including Sri Lanka. Although Sri Lanka's exposure to short term capital flows is marginal, this has resulted in the sharp escalation of Sri Lanka's international sovereign bond yields, similar to the experience of other emerging market and developing economies. In addition, across the globe, foreign direct investment flows are likely to be affected by uncertainties caused by the pandemic, which will also impact Sri Lanka's prospects of attracting non debt creating capital flows in the near term.

Hence, through various direct and indirect channels, including the ongoing diversion of additional financial resources to support economic activity, the COVID-19 pandemic will adversely impact the progress of the economy during the year, contrary to previous expectations of a rebound in economic growth. Accordingly, real GDP growth is expected to decelerate to around 1.5 per cent in 2020, before the economy recovers to attain its envisaged potential over the medium term.

Implementation of Revival Measures

Similar to other countries across the globe, Sri Lanka has utilised three types of policies to address the COVID-19 pandemic and its effects: a) border control and health sector policies; b) fiscal measures; and c) monetary and financial sector measures, including capital flow management. Border control and health sector policies attempt to contain the spread of the pandemic, while the other policies adopted by the government and the Central Bank seek to provide relief to businesses and individuals affected by the pandemic and address emerging macroeconomic concerns.

In relation to monetary measures, the Central Bank of Sri Lanka, thus far, has reduced the key policy interest rates, namely the Standing Deposit Facility Rate (SDFR) and Standing Lending Facility Rate (SLFR), by 100 basis points across three cuts, two of which were undertaken during emergency reviews in the months of March and April 2020. The Statutory Reserve Ratio (SRR) on all rupee deposit liabilities of licensed commercial banks (LCBs) was reduced by 1.00 percentage point, thereby injecting permanent liquidity of around Rs. 65 billion to the market. A large surplus has been maintained in the domestic money market through open market operations (OMOs) of various types and maturities, in order to avail sufficient liquidity for financial institutions, enabling them to facilitate urgent financial requirements of the economy. Meanwhile, in April 2020, the Central Bank reduced the Bank Rate, which is an administratively determined rate that could be used in periods of emergency, by 500 basis points from 15 per cent to 10 per cent.

Across the financial sector, several measures have been undertaken to ease the burden on businesses and individuals arising from the outbreak and containment measures. A wide ranging debt moratorium has been announced for the tourism, plantation, IT and apparel sectors, related logistics providers and small and medium scale enterprises. These businesses are also to receive working capital loans and investment purpose loans at concessional rates. Moratoria have also been granted on leasing loans for three wheelers, small value personal banking and leasing loans. In addition, financial institutions have been requested to reschedule non performing loans. To facilitate the provision of these concessions, lower capital conservation buffer requirements and a relaxation of loan classification rules have been announced, in addition to the availability of liquidity at reduced interest rates. Other key initiatives that were undertaken include the introduction of the '*Saubagya* COVID-19 Renaissance Facility', which provides working capital for adversely affected businesses to revive their activities. Sub loans are to be released to farmers through licensed banks under the subsidised 'New Comprehensive Rural Credit Scheme'.

In addition, measures have been introduced to reduce the pressure on the balance of payments (BOP) and the exchange rate. Accordingly, directions were issued to licensed banks to suspend the facilitation of importation of several categories of motor vehicles and other non essential goods. Several measures have also been introduced to restrict capital flows temporarily, through the suspension of outward investment and a prohibition on the purchase of Sri Lankan sovereign bonds by commercial banks. Further, a 'Special Deposit Account' has been introduced with the view of facilitating the inflow of foreign currency deposits from Sri Lankans living abroad and well wishers.

Meanwhile, the government announced several relief measures for businesses and individuals during March 2020, in addition to the previously announced significant tax concessions to businesses and individuals following the Presidential Elections with a view to reviving the subdued level of economic activity. These recent measures include various concessions for businesses engaged in the tourism, apparel, and wholesale and retail trade sectors, the introduction of maximum retail prices for selected essential food items and certain medical items, and a cash grant of Rs. 5,000 as a lump sum payment for low income and vulnerable families and individuals. Further, the *Agrahara* insurance benefits were doubled for all health, police and civil defence employees, and all government servants engaged in controlling the spread of the COVID-19 outbreak. Meanwhile, the government initiated several measures on an urgent basis to ensure the availability of required funds for virus combating efforts, while also ensuring liquidity for businesses affected by long overdue payments. Such measures included allocations for settling payment arrears of small and medium scale contractors and to private institutions on account of purchasing of pharmaceuticals, and for settling procurement bills for fertiliser purchases. Further, the government allocated an additional Rs. 500 million for preventive measures of the pandemic. A COVID-19 Healthcare and Social Security Fund was set up to help the provision of the necessary healthcare and relief measures, and a special bank account was opened by the President's Fund, in which Rs. 100 million was initially deposited to be utilised for tasks related to preventing the spread of the pandemic. The government also established a fuel price stabilisation fund, aimed at raising a sum of about Rs. 200 billion within a period of 6 months, benefiting from the significantly low petroleum prices in the international markets. With due consideration to the burden of Value Added Tax (VAT) on firms, a grace period was granted until April 30 for payment of VAT accruing to February and March 2020. In spite of the limited fiscal space available to the government, the spaces built up in the monetary policy sphere, in terms of maintaining low inflation, and in the financial sector sphere, in terms of maintaining capital and liquidity buffers above industry norms, enabled the Central Bank to support the efforts of the government to implement the relief measures outlined above, while providing direct financing to the government, considering national interest.

Outlook

The nature of the ongoing COVID-19 pandemic is such that its impact on the performance of the Sri Lankan economy hinges on several uncertain factors. These include the further spread of the pandemic, the intensity and efficiency of mitigation measures, the degree of supply disruptions, and the persistence of behavioural changes and other economic patterns, relevant to both the domestic and global economies. Although the recovery of global economic activity is likely to be a slow process, measures to achieve normalcy in domestic economic activities could enable Sri Lanka to record a faster recovery, as domestic demand accounts for a significant portion of aggregate demand in Sri Lanka.

Bank was addressed by injecting liquidity to the domestic money market on a permanent basis through outright purchases of Treasury bonds from the secondary market. In the domestic foreign exchange market, the Sri Lankan rupee appreciated marginally in 2019 supported by major inflows to the financial account including the issuances of ISBs, despite the short lived pressure on the exchange rate following the Easter Sunday attacks and outflows from the government securities market. The CSE recorded a mixed performance during 2019 amidst adverse developments observed in the domestic and global environment. The CSE recorded improvements in terms of market capitalisation, price earnings ratio (PER) and overall share prices, while net foreign outflows from the CSE continued during 2019, albeit at a slower pace compared to 2018. Meanwhile, operations of the payments and settlement systems of the country were maintained orderly during the year without major disruptions and concerns over safety of the payments and settlement infrastructure, and steps were taken to actively promote digital payment means in the country. In consideration

of disruptions to financial market activities arising from the COVID-19 pandemic, the Central Bank took several steps to maintain adequate liquidity in domestic financial markets, while ensuring the availability of currency as well as all other payments and settlement systems. Measures were taken by the government and the Central Bank with the assistance of the financial sector to ease the difficulties faced by businesses and the general public due to the ongoing disruptions to economic activity, and necessary action is also being taken to ensure stability and soundness of the financial system during this challenging period.

1.3 Global Economic Environment and Outlook

Global economic growth slowed in 2019, compared to 2018, reflecting the impact of heightened trade tensions among the major economies, geopolitical tensions and dampened domestic demand in key emerging market economies. According to the World Economic Outlook (WEO) of the IMF, released in April 2020, global economic growth in 2019 was lower at 2.9 per cent, compared to 3.6 per cent in 2018. Growth in advanced economies was estimated at 1.7 per cent in 2019, compared to 2.2 per cent in the previous year, reflecting subdued growth in the United States and the Euro area, despite the improved growth performance in economies such as the United Kingdom and Japan. Meanwhile, growth across emerging market and developing economies moderated to 3.7 per cent in 2019 from 4.5 per cent in 2018, largely due to country specific shocks that weighed on domestic demand. Among key emerging economies, the moderation of growth of China, India, Russia and Brazil was noteworthy in 2019 over the previous year. Reflecting subdued economic activity across the globe, growth of world trade volume of merchandise and trade in services moderated notably in 2019 to 0.9 per cent in comparison to the growth of 3.8 per cent in 2018. As trade and manufacturing slowed significantly, commodity prices showed a significant drop in 2019, as reflected in the decline in petroleum prices by 10.2 per cent in 2019, compared to the acceleration by 29.4 per cent in 2018. Supported by low energy prices and subpar activity, consumer price inflation in advanced economies decelerated to 1.4 per cent in 2019, from 2.0 per cent in 2018. However, consumer price inflation in emerging market and developing economies accelerated marginally to 5.0 per cent in 2019, compared to 4.8 per cent in 2018, reflecting the impact of supply side disruptions, despite the muted demand pressures witnessed across these economies.

The global economy, which had been on an arduous path of recovery amidst gathering economic and political headwinds, showed signs of a far reaching setback with the COVID-19 pandemic. The April 2020 WEO of the IMF forecast the global economy in 2020 to experience its worst recession since the Great Depression, dwarfing the Global Financial Crisis in 2007/08. The period of 'the Great Lockdown' resulting from the COVID-19 pandemic is likely to entail a substantial shrinkage of global growth in 2020, followed by a partial recovery in 2021. Accordingly, global growth is projected to contract by 3.0 per cent in 2020, followed by an expansion of 5.8 per cent in 2021. This reflects a notable departure from the January 2020 WEO update of the IMF, wherein the global economy was projected to grow by 3.3 per cent and 3.4 per cent, respectively, in 2020 and 2021. The growth in Advanced Economies is expected to contract by 6.1 per cent in 2020, led by a contraction in most economies including the United States, Japan, the United Kingdom, Germany, France, Italy, and Spain. The emerging market and developing economies are expected to suffer from the health crisis as well as the severe external

demand shock and tightening of global financial conditions. Accordingly, the growth in emerging market and developing economies is expected to contract by 1.0 per cent in 2020. Notably, Emerging Asia is the only region that is expected to record a positive growth of 1.0 per cent in 2020, despite the downward revision from 5.8 per cent in the January update of the WEO. Economies in this group such as China, India, and Thailand are expected to grow moderately in 2020. Meanwhile, the expectations of improved economic prospects in 2020, prior to the COVID-19 outbreak, drove up commodity prices, including petroleum. However, this trend reversed dramatically in the face of the COVID-19 pandemic, as containment measures caused a sharp decline in global industrial activity.

Table 1.4
Global Economic Developments and Outlook (a)

Item	2018	2019	2020 (Proj)	2021 (Proj)
World Output	**3.6**	**2.9**	**-3.0**	**5.8**
Advanced Economies	2.2	1.7	-6.1	4.5
United States	2.9	2.3	-5.9	4.7
Euro Area	1.9	1.2	-7.5	4.7
United Kingdom	1.3	1.4	-6.5	4.0
Japan	0.3	0.7	-5.2	3.0
Emerging Market and Developing Economies	4.5	3.7	-1.0	6.6
Emerging and Developing Asia	6.3	5.5	1.0	8.5
China	6.7	6.1	1.2	9.2
India	6.1	4.2	1.9	7.4
World Trade Volume (Goods and Services)	**3.8**	**0.9**	**-11.0**	**8.4**
Price Movements				
Consumer Prices				
Advanced Economies	2.0	1.4	0.5	1.5
Emerging Market and Developing Economies	4.8	5.0	4.6	4.5
Commodity Prices (US$)				
Oil	29.4	-10.2	-42.0	6.3
Non Fuel	1.3	0.8	-1.1	-0.6
Six-month London Interbank Offered Rate (LIBOR) on US$ Deposits (per cent)	**2.5**	**2.3**	**0.7**	**0.6**

(a) Annual percentage change unless otherwise indicated

Source: World Economic Outlook (April 2020), IMF

While several key economies had begun to adopt an accommodative monetary policy stance from mid 2019 amidst escalating trade tensions, the spillover effects of the COVID-19 outbreak have warranted a more rapid pace of monetary policy easing alongside increasingly important fiscal stimulus. Having reduced the federal funds rate target range by a half of a percentage point between the scheduled Federal Open Market Committee meetings in early March (the first such emergency move since the Global Financial Crisis in 2007/08), the Federal Reserve of the United States proceeded to a percentage point cut to bring the federal funds rate target range to 0.0 per cent to 0.25 per cent. The Federal Reserve acknowledged that the COVID-19 pandemic brought new risks and challenges to the economic outlook and noted that the rate was to be maintained until it was confident that the economy had weathered the recent events. The Federal Reserve also announced several new measures to support the flow of credit to households and businesses. Meanwhile, the People's Bank of China (PBOC) reduced both its benchmark lending rate, the Loan Prime Rate, and its medium term lending rate by 30 basis points. While announcing specific policy measures to support businesses affected by the outbreak, the PBOC also reduced the reserve requirements for certain banks to enable the flow of credit to micro businesses and other vulnerable sections of the economy while injecting liquidity at lower rates to ensure smooth functioning of the banking system. The European Central Bank (ECB) launched Targeted Longer Term Refinancing Operations (TLTRO-III) to support bank lending to firms and households, and the Pandemic Emergency Purchase Programme (PEPP) to purchase private and public sector securities to counter significant risks to the monetary policy transmission mechanism, and recently adopted a package of temporary collateral easing measures to facilitate participation in liquidity providing operations. The Bank of Japan (BOJ) adopted monetary easing measures to safeguard sentiments and maintain stability in financial markets. Since the onset of the pandemic,

the Reserve Bank of Australia also lowered its benchmark rate in two cuts to a historically low level of 0.25 per cent, directly citing the significant effect of the virus on the economy, which is highly dependent on economic activity in China. In addition to several targeted relief measures, the Bank Negara Malaysia reduced the Overnight Policy Rate by 50 basis points to 2.50 per cent and reduced the statutory reserve requirement ratio by 1 percentage point with due consideration to weakened global economic conditions and disruptions to economic activity within the region. Other regional central banks such as the Reserve Bank of India reduced its policy repo rate by 75 basis points to 4.40 per cent and the reverse repo rate by 115 basis points to 3.75 per cent thus far in 2020, and announced that the accommodative stance was to be maintained for as long as necessary to revive the economy and mitigate the impact of the COVID-19 pandemic. The Bangko Sentral Ng Pilipinas reduced its overnight reverse repo rate by 125 basis points across three cuts to 2.75 per cent so far in 2020, alongside a temporary relaxation of regulations on banks and a reduction of reserve requirement by 2 percentage points. Meanwhile, the Bank of Canada, the Bank of England, the Bank of Japan, the European Central Bank, the US Federal Reserve and the Swiss National Bank announced coordinated action to enhance the provision of liquidity through standing US dollar liquidity swap line arrangements. These are expected to serve as key liquidity backstops to ease strains in global funding markets and thereby to help curb the effects of any such strains on the supply of credit to households and businesses across the world. There is a wide policy consensus that monetary policy will need to remain accommodative to ensure that long term interest rates remain low. While most key economies possess policy space for accommodation, economies with negative interest rates, such as the euro area and Japan, will need to continue undertaking unconventional monetary policy measures to address the challenges of subpar growth and undershooting of inflation. The low interest rate environment can also pave way for active intervention of fiscal policy to strengthen near term demand. Fiscal measures are likely to be more effective in directly addressing short term vulnerabilities faced by households, who may be facing employment related losses, and those of firms who face an abrupt reduction in demand. As several advanced economies have already committed to undertaking some discretionary fiscal easing, additional measures may be adopted without impacting the debt sustainability concerns. Despite fiscal fragilities in emerging market economies, social transfers to low income groups and support for investment will need to continue to prevent negative macroeconomic effects from translating into economic imbalances with political, economic and social implications. Meanwhile, the global community, including multilateral financial institutions, is expected to boost concessionary financing and provide other relief, such as debt moratoria and debt restructuring, for low income economies as well as other vulnerable economies to enable such economies to weather the impact of the pandemic and facilitate meeting growing fiscal needs for medical purposes and strengthening social safety nets.

There are significant downside risks to the global growth momentum. The substantial amount of uncertainty that surrounds the pandemic across several aspects ranging from the intensity of the spread to containment efforts and their repercussions and the likelihood of permanent changes in sentiments and behaviour, make it difficult to ascertain the degree of the economic fallout. Despite the substantial downgrade to global growth, risks to the outlook are also on the downside. Key risks include a more persistent

pandemic and thereby effecting a long lasting impact on economic activity and financial markets. There is also the concern of a 'second wave' of an outbreak as the virus may again spread from residual clusters in the event of a hastened withdrawal of containment measures. It may also stem from imported cases. Hence, the recovery may be hampered due to both the persistent and staggered nature of outbreaks, which could imply persistent disruptions. There is also a concern that despite the slowdown in the spread of the virus, it may have long lasting implications such as persistent uncertainty about the contagion, lack of sufficient and timely restoration of business confidence, structural shifts in the behaviour of households and firms, all of which may culminate in more lasting disruptions to supply chains and denting of aggregate demand. The weak global demand alongside low oil prices are likely to result in a softening of inflation in the near term, although the current undertaking of increased liquidity support, fiscal stimulus and social safety measures could cause inflationary pressures with the abating of the pandemic and a shift recovery in demand. Risks related to oil prices are tilted to the downside in the near term as producers face storage constraints due to the accumulation of stocks in the wake of poor demand. Over the medium term, the risks are balanced with upside risks including faster containment of the pandemic and a strengthening of the OPEC+ deal. However, a key downside risk could be the rapid slowdown in global economic activity alongside a collapse of the OPEC+ coalition. Investor risk aversion in the wake of the rapid spread of the virus caused a capital outflow from emerging market economies, and the magnitude of such outflows is expected to be higher than that observed during the Global Financial Crisis of 2007/08. At times of such heightened global risks, the difficulty in mobilising dollar financing could lead to a self fulfilling prophecy of a decline in capital inflows, followed by a sharp currency depreciation, which could drive further capital flow reversals.

While Sri Lanka has been able to curb a major spread of the COVID-19 outbreak in the country, the interconnected nature of the global economy will result in Sri Lanka experiencing spillover effects of the pandemic. Sri Lanka has had long standing economic linkages with China, where the virus spread began in the latter part of 2019. Hence, the downturn in the Chinese economy is expected to have a significant impact on Sri Lanka across several sectors such as tourism, construction, and apparel in the near term. The reduction in global tourist movements as a result of the widespread nature of the outbreak can negatively affect value chains in the domestic tourism industry, including food, beverages and transport. However, some benefits may also be realised from the weak global demand translating into lower commodity prices, as reflected in recent oil price movements. Further, it is also noteworthy that Sri Lanka may be able to benefit from the increasingly accommodative monetary policy stance globally, which may translate into lower financing costs. In spite of such expectations however, the rise in emerging market sovereign bond yields amidst the flight of capital towards liquidity and quality, will remain a key concern. Despite already implemented proactive policy measures to contain the pandemic while sustaining the economy, policymakers will need to be continuously vigilant of developments and closely monitor incoming data. Targeted and forward looking policy interventions will need to be undertaken with due consideration to both the near term and medium term, in a proactive manner to sustain the growth trajectory of the Sri Lankan economy amidst the current challenging external environment.

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1.4 Medium Term Macroeconomic Outlook

The Sri Lankan economy, which commenced the year 2020 with improved business confidence, is expected to have recorded a pickup in activity in the first two months, until the global and domestic spread of the COVID-19 pandemic severely affected businesses and individuals alike. Although a notable contraction in the global economy is predicted, the magnitude of the near term economic impact of the COVID-19 pandemic remains largely country specific as it would depend on how quickly and effectively governments worldwide take remedial measures to manage the outbreak. Sri Lanka also remains vulnerable to the direct and spillover effects of the COVID-19 outbreak in the near term, as steps taken to ensure social distancing and thereby curbing the spread of the virus, are likely to have significant implications on economic activities. Proactive measures taken by the government from the initial stages of the outbreak showed promising outcomes in terms of containing the spread to a great extent, compared to the experience of many other countries. The relief measures announced by the government and the Central Bank are expected to ease the burden on businesses and individuals affected by this outbreak. Although this is an evolving situation with a high degree of uncertainty on global and domestic economic outcomes and policy responses, a baseline scenario where domestic economic activity gradually picks up from the end of the second quarter of 2020 and global economic activity gathers pace from the fourth quarter of the year is used for the purpose of macroeconomic projections. Accordingly, it is assumed that social distancing measures imposed locally would have been relaxed to a great extent by the end of the second quarter, enabling a mild recovery in domestic economic activity in the third quarter of the year. This would be followed by a return to normalcy in most domestic activities in the fourth quarter of the year, supported by the fiscal and monetary stimulus measures that are already in place, and some recovery in outward oriented industries such as tourism, export oriented manufacturing, etc., as the global economic conditions improve. Accordingly, the near term risks posed by the COVID-19 outbreak are not expected to have a significant impact on the medium term outlook of the economy, with appropriate measures to implement policies to promote sustained growth and improve resilience of the economy.

Based on the assumptions described above, annual real economic growth is projected to decelerate further in 2020, before rebounding thereafter towards the envisaged higher growth path. The envisaged growth path is contingent on the effective implementation of the government's policy agenda, maintaining macroeconomic stability, addressing the structural issues that constrain sustained growth, and a revival in the global economy in the medium term. The direct and indirect tax relief measures introduced in late 2019 and early 2020 are expected to increase the purchasing power of individuals, and encourage domestic investment. Lower nominal and real interest rates will also boost private investment, providing impetus for economic growth. Increased government attention on the agriculture sector is expected to promote value addition in the sector, enhance markets for agriculture commodities, and enable farmers to build entrepreneurial skills, thereby ensuring high levels of income for those engaged in agriculture and related activities. Meanwhile, the industry

Table 1.5
Medium Term Macroeconomic Framework (a)

Indicator	Unit	2018 (b)	2019 (c)	Projections				
				2020	2021	2022	2023	2024
Real Sector (d)								
Real GDP Growth	%	3.3 (c)	2.3	1.5	4.5	6.0	6.2	6.5
GDP at Current Market Price	Rs. bn	14,366 (c)	15,016	15,925	17,466	19,443	21,690	24,245
Per Capita GDP	US$	4,079 (c)(e)	3,852	3,940	4,166	4,473	4,813	5,190
Total Investment	% of GDP	30.4 (c)(f)	27.4	26.8	27.3	27.8	28.1	28.4
Domestic Savings	% of GDP	23.0 (c)(f)	21.3	20.7	21.3	22.5	23.6	24.5
National Savings	% of GDP	27.3 (c)(f)	25.3	23.7	24.7	25.6	26.2	26.8
External Sector								
Trade Gap (d)	% of GDP	-11.7	-9.5	-7.7	-9.8	-9.7	-9.5	-9.2
Exports	US$ mn	11,890	11,940	8,740	11,117	12,421	13,594	15,380
Imports	US$ mn	22,233	19,937	15,415	20,135	22,092	23,815	26,135
Current Account Balance (d)	% of GDP	-3.2	-2.2	-3.1	-2.6	-2.2	-1.9	-1.6
External Official Reserves	Months of Imports	3.7	4.6	5.6	4.6	4.6	4.6	4.6
Fiscal Sector (d)								
Total Revenue and Grants	% of GDP	13.5 (g)	12.6	9.8	11.8	13.5	14.1	14.5
Expenditure and Net Lending	% of GDP	18.7 (g)	19.4	17.7	18.6	19.1	19.2	19.4
Current Account Balance	% of GDP	-1.2 (g)	-2.7	-5.1	-3.6	-2.1	-1.5	-1.0
Primary Balance	% of GDP	0.6 (g)	-0.8	-2.8	-1.0	0.5	0.7	1.1
Overall Fiscal Balance	% of GDP	-5.3 (g)	-6.8	-7.9	-6.8	-5.6	-5.2	-4.9
Central Government Debt	% of GDP	83.7 (g)	86.8	92.4	89.4	84.3	80.5	76.3
Monetary Sector and Inflation								
Broad Money Growth (M_{2b}) (h)	%	13.0	7.0	9.3	12.9	12.7	12.5	12.5
Private Sector Credit Growth (in M_{2b}) (h)	%	15.9	4.3	4.0	10.0	12.2	13.0	13.0
Annual Average Inflation (i)	%	4.3	4.3	4.5	5.0	5.0	5.0	5.0

(a) Based on information available up to end March 2020
(b) Revised
(c) Provisional
(d) Based on the GDP estimates (base year 2010) of the Department of Census and Statistics
(e) Estimates are updated with the latest population figures.
(f) Total investment, domestic savings and national savings as a % of GDP in 2018 were revised by the Department of Census and Statistics from 28.6%, 21.2% and 25.4%, respectively.
(g) Based on the revised GDP estimates for 2018 released on 31 March 2020 by the Department of Census and Statistics
(h) Year-on-year growth based on end year values
(i) Based on CCPI (2013=100)

Sources: Department of Census and Statistics
Ministry of Finance, Economic and Policy Development
Central Bank of Sri Lanka

sector is expected to rebound in the medium term owing to the growth in the manufacturing sector supported by the expected increase in domestic demand and the gradual recovery in the global economy. The government's plans to secure investment for the Port City project and implement the highway development projects could revive investment in the medium term. These infrastructure projects will boost construction activities, enhancing value addition in the industry sector. Meanwhile, the increased purchasing power of households is envisaged to support the services sector, particularly wholesale and retail trade, accommodation, food and beverages, transportation, telecommunication and financial services subsectors. As domestic demand is insufficient to sustain high economic growth, measures are expected to support the expansion of merchandise and services exports in the medium term, in spite of the possible near term setback in these sectors due to sluggish global economic performance with the impact of the COVID-19 pandemic. The stimulus provided by fiscal and monetary policy measures should be accompanied by policy reforms to address the structural issues in the economy, particularly in the energy sector, as well as labour, land and capital markets. It is only with structural reforms that the country will be able to push its production boundaries further and sustain high economic growth without overheating the economy.

The outlook for the external sector is expected to improve over the medium term, despite the near term impact on the BOP from the COVID-19 outbreak. A significant decline in merchandise exports is likely, particularly to Sri Lanka's key export destinations of Europe and the United States. In particular, exports of textiles and garments, other industrial products and commodities including tea and rubber, are likely to experience a decline in the near term. However, with reduced expenditure on crude oil imports, a reduction in investment goods imports, a reduction in export related raw material imports, and the reduction in the imports of motor vehicles and other non essential consumer goods due to the policy measures in place, a significant reduction in expenditure on imports is also expected. These developments are likely to result in a decline in the trade gap in 2020, before expanding thereafter with the normalisation of economic activity. The restoration of normal trade patterns, along with conducive external trade policies, strong institutional support, a flexible and competitive exchange rate and enhancement of trade relations with new trading partners, is expected to support the growth momentum of the export sector over the medium term. Imports are also projected to increase over the medium term with the pickup in imports of intermediate and investment goods, supporting medium term growth prospects. The tourism sector will be impacted significantly in the near term by the COVID-19 outbreak with reduced global travel affecting the industry and its supply chains. This, together with reduced air and freight transportation services, could moderate the surplus in the services account in the near term. Over the medium term however, the improvement of the surplus in the services account is expected to strengthen the current account. Inflows to the services account are expected to augment particularly on account of tourism, Information Technology (IT), Business Process Outsourcing (BPO) and transport services. A notable improvement is expected in earnings from tourism over the medium term with aggressive and coordinated tourism promotion initiatives by the authorities, expected new FDI to the hotel sector as well as the tourism related developments in the Colombo Port City. The deficit in the primary income account is expected to widen, due to the increasing interest payments on account of government borrowings from foreign sources. Workers' remittances are also likely to be impacted with low international oil prices as well as the direct impact of the COVID-19 outbreak on the key sources of workers' remittances to Sri Lanka, such as South Korea and Italy. The growth in workers' remittances is expected to remain subdued over the medium term with improved domestic employment opportunities, geopolitical developments in the Middle East and the government initiatives to discourage semi and unskilled migration. These developments are expected to widen the external current account deficit in the near term, requiring more than envisaged foreign financing at a time when global financial markets are also in a turmoil due to the outbreak. Accordingly, the financial account is likely to be impacted, affecting the international reserves to some extent in the near term, although reserve adequacy is expected to be maintained at satisfactory levels. The external current account deficit would gradually adjust towards sustainable levels and the financial account is expected to receive sizable flows over the medium term. A flexible and competitive exchange rate is expected to be maintained amidst the expected adjustment in the current account deficit. These developments would reinforce international reserves in the medium term. However, Sri Lanka's external debt position, in nominal terms, is projected to increase amidst the large refinancing requirements as well

as future deficits in the external current account and the government budget deficit. However, the expected expansion in the economy over the medium term is likely to ease the country's external debt position.

The medium term fiscal outlook is expected to focus on further strengthening fiscal consolidation, by reducing the budget deficit and public debt to sustainable levels, while supporting the medium term development objectives and enhancing the living standards of the people. The government announced a series of tax concessions aimed at reviving subpar economic activity exacerbated by the impact of Easter Sunday attacks and the COVID-19 outbreak. While such tax concessions could have a negative impact on government revenue collection in the near term, the positive spillovers into aggregate demand resulting from the expected rebound of investment and consumption could raise government revenue over the medium term. Further, the government intends to rationalise expenditure by eliminating unproductive spending, while better targeting public investment, over the medium term. Consequently, the budget deficit is projected to decline below 5.0 per cent of GDP by 2024, supported by a gradual reduction in the current account deficit and an improvement in the primary balance to record a surplus over the medium term. With such improvements in major fiscal balances, the outstanding central government debt to GDP ratio is expected to decline over the medium term. Meanwhile, effective use of active liability management operations would help smoothen debt service obligations over the medium term and prevent debt dynamics falling into unsustainable levels, while the Medium Term Debt Management Strategy (MTDS) would guide the reduction in the central government debt, especially its exposure to foreign debt over the medium term. However, the expected slowdown in activity domestically and globally amidst the COVID-19 outbreak could pose challenges in the short term in achieving the envisaged targets, as the government is likely to incur increased expenditure on strengthening healthcare facilities and providing other relief measures to the economy. Looking beyond these near term challenges, the envisaged fiscal consolidation would depend largely on the government's commitment to adhere to stringent and binding fiscal rules over the medium term.

Inflation is expected to be maintained within the 4-6 per cent range over the medium term with well anchored inflation expectations supported by proactive monetary policy measures taken by the Central Bank under a flexible inflation targeting framework. The fallout of the spread of COVID-19 could adversely affect aggregate demand in the near term, thereby exerting downward pressure on inflation. Further, the decline in commodity prices, especially international oil prices, due to the impact of the pandemic and geopolitical tensions, could lower costs of production, thereby easing inflationary pressures over the medium term. On the other hand, possible supply constraints domestically and globally due to the outbreak of the COVID-19 pandemic could exert pressure on domestic prices in the near term. On balance, inflation is expected to remain within the desired mid single digit range over the medium term with appropriate policy adjustments. Proactive policy measures under flexible inflation targeting are expected for the continued anchoring of private sector inflation expectations at desired levels while exchange rate flexibility is expected to be maintained to increase the economy's resilience to external shocks. Continuation of the fiscal consolidation process is imperative to successfully

manage inflation as well as inflation expectations at desired levels, while the support of the government is also required to minimise transitory volatilities in inflation emanating from supply side factors. The Central Bank would ensure adequate money and credit flows to the economy to support the envisaged growth path over the medium term. Amidst the spread of the COVID-19 outbreak, growth of credit to the private sector is expected to remain low in the near term due to significant disruptions to economic activity. However, as the country recovers from the COVID-19 outbreak, the growth of credit to the private sector is projected to accelerate, supported by low market lending rates, the expected expansion in economic activity buttressed by fiscal and monetary stimulus, the debt moratorium and special credit support schemes offered for businesses, especially small and medium enterprises (SMEs). Meanwhile, the financial sector is expected to remain resilient in the medium term, in spite of the near term challenges due to the unfavourable developments in the domestic and external environment amidst the outbreak of the COVID-19 pandemic.

1.5 Issues and Policies

Similar to all other countries in the world, Sri Lanka, at the time of preparing this report, was in the midst of managing the spread of the COVID-19 pandemic as well as its socio-economic impact. The outbreak has resulted in an unprecedented level of uncertainty on both global and domestic economic fronts. Although the world has experienced similar pandemics in history, for most national and multilateral organisations that are currently in existence, this situation is their first experience in handling a humanitarian and economic crisis of this magnitude. Unlike any other global recessions including the great depression in the 1930s, the projected recession caused by the COVID-19 pandemic has to be tackled in a situation where almost all economies across the globe are in a lockdown and advocate social distancing, with limited domestic and even smaller global trade and other transactions. At present, the priority of national authorities, including in Sri Lanka, is to contain the public health crisis. However, once the situation is condensed to a manageable level, it is essential that measures are taken to revive economies from the sharp downturn that they are experiencing at present. In Sri Lanka, implementing urgent measures to revive the economy is particularly important as it has undergone several years of sluggish economic growth, and the country's capacity to withstand further shocks is diminishing rapidly. While short term measures to support a speedy recovery from the effects of the COVID-19 pandemic are being implemented by the government, the Central Bank, and other policymaking organisations in the country, this section seeks to highlight longstanding structural issues faced by the economy, which need to be addressed to sustain equitable and high economic growth and improve the overall wellbeing of the population.

Increasing foreign debt servicing obligations could pose risks to Sri Lanka's macroeconomic stability in the medium term, requiring urgent measures to enhance the country's foreign exchange earnings continued with measures to discourage excessive expenditure on non essential imports. Following Sri Lanka's graduation to the middle income category as per the IMF classification in 2010, the availability of concessional foreign financing declined rapidly. Moreover, Sri Lanka's recent advancement to the upper middle income country status is likely to restrict access to concessional funding sources further. The composition change in Sri Lanka's foreign debt profile with a shift to costlier commercial

borrowing from concessional borrowing requires prudent management of the debt profile to ensure external debt sustainability. Furthermore, annual external debt repayment commitments falling due in the medium term are projected to be around US dollars 5 to 6 billion, on average. In this context, it is envisaged that Sri Lanka would need to rollover the existing debt by issuing ISBs and syndicated loan facilities from international financial markets. These commercial borrowings are generally characterised by higher interest costs together with relatively short maturities than concessional sources. Rising foreign debt obligations could exert pressure on international reserves, the exchange rate and fiscal operations. In this context, along with the active liability management framework, it is vital that fiscal consolidation efforts are continued through improved revenue mobilisation and prudent spending while adopting sound fiscal rules to ensure overall public debt sustainability as well as external debt sustainability. Further revisions to Sri Lanka's Sovereign rating could result in raising the cost of rolling over the increased commercial debt stock in the period ahead.

Measures to strengthen fiscal consolidation are essential over the medium term following inevitable fiscal slippages in the near term owing to the spread of the COVID-19 pandemic. The fiscal stimulus programme, which included measures announced in the aftermath of the Easter Sunday attacks and following the Presidential Election in November 2019, as well as on the onset of the COVID-19 outbreak, offered significant tax concessions, among others, in view of supporting businesses and individuals affected by the unforeseen events, while also aiming to revive activity through increased private consumption and investment over the near to medium term, thereby raising government revenue in the period ahead. While tax concessions help stimulate sluggish economic activity over the medium term, any adverse impact on tax revenue needs to be offset by appropriate measures. Sri Lanka has grappled with low levels of government revenue for decades despite various reforms introduced from time to time aimed at simplifying the tax structure and strengthening revenue administration systems. Thus, it is important that the intended benefits of fiscal stimulus, which are heavily concentrated on tax concessions, are transmitted efficiently and effectively to intended economic participants to revive activity in the near to medium term. Effective management of government expenditure becomes imperative to curtail the rapid growth of recurrent expenditure while ensuring adequate resources for public investment over the medium term. Government expenditure, particularly of a recurrent nature, could grow sharply in the period ahead amidst fast growing expenses on interest payments, salaries and wages, and subsidies and transfers. While the government plans to increase recruitment to the public sector partly to address issues such as youth unemployment, abject poverty, regional disparity etc., any large scale recruitment to the public sector could eventually result in a lasting impact on government expenditure on account of salaries and wages and pension payments, particularly in the context of the non existence of a contributory pension scheme for the public sector. This also underscores the need for effective deployment of such workforce in order to ensure that the productivity of the public sector improves. Meanwhile, the rising recurrent expenditure coupled with low government revenue could narrow the fiscal space available for much needed investment on health, and education services and physical infrastructure development. Curtailing public investment would result in dampening economic growth over the medium to long term. Thus, further emphasis is needed to enhance public expenditure management in

order to ensure that government spending is cost effective and yields positive growth dividends by strengthening the governance measures of public expenditure to eliminate any inefficient and unproductive spending.

Enhancing domestic production and increasing participation in regional and global value chains (GVCs) are of paramount importance in strengthening the export sector performance of Sri Lanka amidst significant volatility in prices of its exports of primary commodities. Primary commodities continue to be a substantial proportion of exports of many emerging market and developing economies. Sri Lanka is an exporter as well as an importer of primary commodities, where commodities such as agricultural and mineral products, accounted for about 21 per cent of total export earnings and about 15 per cent of import expenditure in 2019. A notable decline in global commodity prices was observed in the recent past, reflecting the impact of lower crude oil prices and the moderation in global trade and overall economic activity exacerbated by the COVID-19 pandemic. As the heightened volatility in prices of primary commodities could impact both export earnings and import expenditure, many emerging market and developing economies increasingly focus on linking up with GVCs to diversify their export products and markets. Meanwhile, trade tensions among major trading nations could trigger a substantial redrawing of supply chains across Asia and the globe, creating challenges as well as opportunities. During the recent past, well before the COVID-19 pandemic, several major economies moved towards protectionist trade policies, partially ignoring the norms of the World Trade Organization (WTO). Any escalation of trade disputes could disrupt cross border production links and redraw production networks and supply chains globally. This could potentially be challenging for countries like Sri Lanka, where a notable share of exports is dependent on imported material. At the same time, this could create opportunities, particularly for countries in Asia, where certain supply chains could relocate to South East Asia and South Asia. Despite the availability of more disaggregated value chains and production sharing networks, Sri Lanka's participation in GVCs remains minimal due to factors such as the high cost of production and low product development due to inadequate public and private sector spending on research and development (R&D). Thus, measures are needed to overcome these inefficiencies and increase value addition and productivity improvements for Sri Lanka to benefit from GVCs. Consistent policies, institutional support, a stable macroeconomic environment, attracting FDI, R&D led innovation, improved ease of doing business, and production oriented financial support schemes are aspects that could help secure successful entry into GVCs. With appropriate measures to overcome the structural issues in the manufacturing sector of the country, merchandise trade can also be improved, thereby supporting the persistent trade deficit for decades. Further, efforts to enhance market access through well negotiated new free trade agreements (FTAs) and enhanced economic cooperation with existing and new trading partners would also complement the already identified reforms and strategies in trade promotion.

Looking beyond the setbacks caused by the Easter Sunday attacks and the COVID-19 pandemic, Sri Lanka's tourism industry needs to embrace new technology to promote and sustain the industry over the medium term. Although the tourism industry has grown notably since the post conflict period from 0.7 million tourist arrivals in 2010 to a peak of 2.3 million arrivals in 2018, its potential remains largely unexplored.

For the tourism industry to reach its full carrying capacity, measures are needed to address issues such as clustered overcrowding, low quality tourism infrastructure, and lack of attractions to serve tourists of all ages. Some of these issues can be addressed by introducing smart technology and standardisation while making use of various social media platforms, and impactful media campaigns to attract and retain tourists. Moreover, smart technology such as focused messaging, an automated visa granting process and border control, wi-fi based tour guiding techniques and real time tourist traffic monitoring are some aspects that could elevate the industry performance. Information services at main tourist attractions and transport hubs need to be improved for proper guiding, increasing safety and, more importantly, to prevent touting. Measures such as standardising taxi services, improving public transport, introducing tourists friendly tour guiding, ticketing and advanced booking systems, and ensuring clean sanitary facilities, could improve the image of Sri Lanka as a safe, tourism friendly destination, which offers good value for money.

The implementation of a comprehensive national industrial policy with emphasis on improving competitiveness and ensuring the continuity of national policies are essential for Sri Lanka to increase its growth potential. With the successful implementation of industrial policy measures at the inception of the development process, countries such as Hong Kong, China, South Korea, and Singapore have rapidly transformed their economies to generate higher gross value addition in the industry sector and moved towards an advanced level of development. However, industrial policy experiments carried out by successive governments in Sri Lanka fell short of producing positive and sustained outcomes, partly due to the abandonment of such efforts before the benefits were realised. Industrial activities in Sri Lanka are dominated by four subsectors: construction, mining and quarrying, manufacture of food beverages and tobacco, and manufacture of textiles, wearing apparel and leather products. However, a large amount of such manufactured goods is intended for the domestic market, except for textiles and garments and a few consumer and intermediate goods. Although some Sri Lankan manufacturers in industries such as tea, rubber and apparels were able to achieve global excellence standards, Sri Lanka still lags behind its Asian peers due to subdued performance in merchandise exports. The low degree of diversification in industrial production and industrial exports highlights the sluggish progress in the manufacturing sector compared to success stories from around the world. Industries such as the capital goods sector largely remains untouched. However, as Sri Lanka tends to gradually lose the low cost labour advantage to its competitors, the country needs to diversify its industrial exports from labour intensive products to more value added and technology driven products, possibly niche product categories, in order to connect with GVCs. These highlight the need to develop a coherent industrial development strategy, coupled with a trade regime that is capable of facilitating businesses and promoting investment opportunities and factor market reforms to cater to the needs of identified industries. Many countries, which own a well developed industry sector, began by identifying priority industries within their industrial policy agenda by considering factors such as high value addition, potential for increasing export revenues, employment generation, and minimising income disparities in the country. The national industrial policy needs to be formulated with due consultation among all stakeholders to ensure consistency and continuity of the industry development agenda, irrespective of changes on the political front, as such policies are likely to have long gestation periods.

The manufacturing sector of Sri Lanka is affected by low productivity, resulting in slow growth in the sector and low competitiveness of Sri Lanka's exports in global markets, emphasising the need for improving the quality of the workforce and increasing productivity through R&D. Sri Lanka's manufacturing sector is dominated by labour intensive, low value added products, which inevitably make it difficult to achieve higher productivity levels. The rising wage levels in the economy have resulted in a deterioration in the low cost labour advantage over competitors. As the space for increasing prices of export goods is limited for Sri Lanka without losing the market share due to competition, productivity improvement in the manufacturing sector is imperative to maintain competitiveness and provide impetus to the economy's take off with resilient and sustainable economic growth. Increasing efficiency of the production processes helps reduce unit labour costs in the manufacturing sector by means of adopting lean manufacturing processes, improved product designs, standardisation, elimination of overscheduling of labour using demand predictive scheduling software and utilising part time labour. Improving the quality of the workforce by introducing necessary reforms at all levels of the education system would help equip workers with required technical skills and enhance productivity. Currently, Sri Lanka's expenditure on R&D activities is negligible, resulting in a low level of innovation in the economy. Hence, technology related R&D activities in the industrial sector should be supported by both government and private sector spending on R&D while strengthening links between R&D institutions, academic institutions, civil society organisations, and the private sector to commercialise inventions. Weak infrastructure and bureaucratic inefficiencies generally result in high costs to firms, reducing profitability and discouraging private investment. Therefore, efforts to improve infrastructure facilities such as the road network and ports must continue while eliminating procedural bottlenecks. Productivity improvements in the manufacturing sector should be accompanied with trade reforms as well as proactive policy measures that attract FDI, in order to expand the market for domestically manufactured goods.

In spite of Sri Lanka's past achievements in the areas of social and human capital development, the graduation of the income status of the economy brings a novel set of challenges, which requires an assessment of whether the labour force is sufficiently equipped to facilitate a high and sustainable growth trajectory. Given the rapid dynamism of the domestic economy and international developments driven by the fourth industrial revolution (4IR), the education system lies at the epicentre of the issues faced by the labour market. Education policy must ensure that curricula are updated and adapted periodically in line with the skill demands of local and global labour markets. In Sri Lanka, a large section of youth possesses neither higher education nor any skill training. In addition, they do not possess other marketable skills such as soft skills, digital literacy and English literacy. These create impediments to their access to high level jobs that are in line with their aspirations. The lack of accessibility to decent work opportunities in the private sector results in the youth depending largely on public sector employment. Graduates who lack marketable skills find it worthwhile to remain unemployed and queue for jobs in the public sector that offer the long term benefits of job security and financial security, in terms of pensions, over the lifetime of the employee and their dependents. This premium associated with public sector jobs will continue to create distortions in the labour market unless addressed through policy reforms. Such policy reforms should ensure that public sector jobs

are not perceived as 'handouts', and pave way for the appropriate recruitment of talented individuals that will ensure the efficiency and productivity of the sector. Further, the redesign of the Public Service Pension Scheme to be contributory while introducing a nationwide contributory pension scheme can also reduce the attractiveness of public sector jobs and allow greater flexibility in the labour market. This will also be essential in light of the increasingly ageing population and the corresponding limited fiscal space. Another shortcoming of the education sector is the poor performance of students in the science, technology, engineering, and mathematics (STEM) subjects and the transcending impact of this on the output of the university system. Equitable access to high quality education, focusing on honing linguistic, mathematical and technological competencies, can not only pave the way for a more productive human capital base but also address provincial disparities. Targeted policy interventions need to be undertaken to level out such irregularities so that backward regions too can engage with and benefit from the digital economy and associated emerging technologies. In light of the low levels of female LFPR, the stress associated with unpaid care work is a critical issue for women. Although the proliferation of the 'platform' and 'gig' economy can contribute to the increase in women's participation in the labour force, the absence of formalised care services will continue to hinder women, particularly those with higher educational qualifications, from being economically active. Further, the high level of informality present in the Sri Lankan economy also negatively weighs on women as a large share of women workers is already engaged as unpaid family labour. The 'gig' economy may aggravate this, thereby excluding them, as well as the entire informal sector workforce, from access to social security and labour protection guarantees. As has been discussed over several years, policymakers need to urgently pursue initiatives and policies that enable flexible work arrangements, improve the availability of jobs in occupations that are preferred by highly skilled women, provide better quality and more affordable child care facilities, and improve public transport services to increase female LFPR.

Inadequate warehousing facilities for agriculture products and the lack of agriculture commodity financing options have resulted in sharp fluctuations in food prices and lower farmgate prices for producers. A substantial portion of the consumption basket considered for inflation estimation consists of food items. Increased volatility in food prices observed in recent years was primarily due to the seasonality of production and disruptions to supplies resulting from unfavourable weather conditions. Limited storage and warehouse facilities available for farmers deprive them of the opportunity to store seasonal harvests and thereby receive a better price for agriculture produce during low supply periods. A common practice among many farmers is to sell their harvest immediately to settle loans obtained to finance expenditure incurred in production and to purchase inputs for the next crop cycle while fulfilling their own household consumption needs. The small and medium scale agriculture producers often grapple with a lack of working capital due to inadequate collateral to obtain loans from the formal financial institutions. Immediate sale of the harvest results in production gluts in the harvest season and shortages in other times, causing disruptions to the food supply in the country and a sharp volatility in food prices. Therefore, there is an urgent need to develop mechanisms to expand affordable, good quality storage and warehousing facilities, especially cold chain logistics, in order to systematically improve the stability and quality of the food supply in the market while improving stability in prices. Along with such efforts, commodity financing options,

including warehouse receipts systems, should be further popularised among farmers as a means to use their produce as collateral to access financial services. Commodity finance schemes are being successfully implemented in various countries, such as India, Indonesia, the Philippines, Kenya, and Zambia, especially for cereals including paddy and corn. Under the warehouse receipt system, warehouse operators will issue receipts certifying that particular commodities of stated quality and quantity are placed at the warehouse by a particular depositor and will hold the stored commodity in safe custody while the depositor uses the receipt as collateral to fulfil short term working capital requirements. Good management practices of warehouse operations must be ensured through efficient supervision by a regulatory agency. Commodity finance, coupled with good storage and warehousing facilities, will ensure the availability of agriculture produce throughout the year, enabling farmers to realise better farmgate prices while minimising sharp fluctuations in retail prices of food items. Meanwhile, financial institutions could also benefit from warehouse receipts because such collateral is highly liquid, providing a high level of protection in relation to credit granted to the agriculture sector.

The progress of many infrastructure development projects in sectors, such as transport, water and electricity, has slowed in recent years, despite their significance in ensuring a faster and inclusive economic growth. Such infrastructure is essential as inputs in the value chains of other productive sectors. Transportation, port and airport facilities and information and communication technologies provide economic and social opportunities to economic agents resulting in positive multiplier effects through better employment opportunities and increased access to markets and finances. Weaknesses in physical infrastructure, such as interruptions in electricity, limited clean water supply, and poor urban development and housing, deteriorate the living conditions of people, thereby affecting the health and education levels and long run productivity of the labour force. Unavailability of efficient and adequate infrastructure acts as an obstacle for industrialisation, erodes the country's competitiveness and hampers FDI. There exists a two way relationship between infrastructure development and economic growth as demand for quality infrastructure tends to rise in tandem with the increasing income levels of households. Hence, strengthening the infrastructure is imperative to boost economic growth, while meeting the rising demand for quality of the same. Since the end of the internal conflict in 2009, the government led infrastructure development drive significantly enhanced transport and logistics facilities, improving connectivity within the country and with the rest of the world. However, this infrastructure development drive has slowed in recent years due to fiscal constraints and rising debt levels, among several other economic and non economic reasons. Considering the lack of fiscal space, private sector engagement in infrastructure development needs to be promoted by creating an investment conducive environment by establishing consistent policies, macroeconomic stability, proper regulatory and quality assurance framework, and minimising bureaucratic inefficiencies. Various funding arrangements can be considered to attract private investment for infrastructure development, such as public private partnerships and investments funds. Such projects generally require a large initial investment and also carry long gestation periods to receive economic benefits, thus limiting the interest of private sector participation, and requiring government intervention. Hence, prioritisation of infrastructure development projects based on their economic and social impact would enable the

government to use the limited public funding more efficiently. Some infrastructure projects tend to have negative externalities such as environmental pollution and overuse of limited resources. Sri Lanka needs to consider such negative externalities of infrastructure projects in the process of project prioritisation while seeking avenues of green financing for environment friendly infrastructure projects by strengthening green financing markets and relevant regulatory frameworks.

Ensuring energy security through a consistent policy on energy generation mix and the timely implementation of the long term generation expansion plan are crucial to reduce the cost of power generation while sustaining economic growth. Uninterrupted electricity supply is one of the major elements that determine productivity, and studies show that the performance of a firm is negatively impacted by weaknesses in electricity infrastructure, particularly due to power outages. Poor electricity infrastructure discourages investors, especially potential foreign investors. As power outages are used to measure the strength of infrastructure in the Ease of Doing Business Index, frequent power disruptions, either planned or unplanned, would result in a lower rank in the Index. Power generation in Sri Lanka is often hampered by frequent and prolonged dry weather conditions, compelling the Ceylon Electricity Board (CEB) to opt for load shedding schedules occasionally. There has been no major addition to the CEB's generation capacity since 2014 due to inconsistencies in policy decisions and drawbacks in the implementation of the Generation Expansion Plan of the CEB. The CEB continued to incur losses in recent years, and such weak financial performance of the CEB was aggravated by regular emergency power purchases from the private sector to cover generation shortfalls at substantially high unit costs. For example, in 2019, the average generation cost per 1 kWh of electricity at the selling point increased by 21.8 per cent compared to the preceding year. The CEB's continuous reliance on emergency power purchases for several consecutive years has resulted in uncompetitive purchasing prices, reflecting weaknesses in the planning and procurement processes of the energy sector. Thus, accurate projections on electricity demand and generation, and proper planning of procurements in a cost effective manner are essential to reduce the financial burden on the CEB, which has ripple effects on the other sectors of the economy, including the financial sector. Meanwhile, the implementation of a national policy on energy generation mix with a long term vision is important, considering the financial aspects, as well as other market and socio-economic and environmental factors, in order to assure sustainability of the energy sector and overall economic growth.

Underperforming SOBEs, which depend largely on financial support from the government, continue to burden the national budget. In the post independence economy of Sri Lanka, SOBEs have performed an important role aiding the socio-economic growth and development, including the growth of the industrial sector and provision of infrastructure facilities. However, due to the changes in policy orientation of successive governments, the lack of adoptability of some SOBEs amidst changing dynamics of the domestic and global economy, managerial issues and other interventions at various levels, hindered the performance of many SOBEs over time, thereby requiring assistance from the government to sustain their operations, contrary to the expectation of becoming an additional source of revenue to the government. Against this backdrop, introducing reforms in relation to such SOBEs has become imperative in order to

ensure unobstructed delivery of public goods and services, while eliminating additional pressure on the government budget. While the recent efforts of the government to appoint professionals to manage SOBEs are commendable, further measures are needed to improve the viability of the financially constrained SOBEs by introducing cost reflective pricing mechanisms in the provision of public utilities on a selective basis, improving corporate governance and rationalising recruitments to improve the productivity of the workforce. Also, except in the areas where the intervention of the government in the market through SOBEs is due to the existence of natural monopolies, enhancing private sector participation in public utility provision must be encouraged in order to improve the overall efficiency of service provision through competition.

Water security has become a serious concern in Sri Lanka amidst erratic weather patterns and increasing demand for water, prompting the need for urgent implementation of improved water management strategies including drip irrigation systems and rain water harvesting techniques. The mean annual average rainfall of the country is around 2,000 mm, which is higher than the average rainfall received by most water stressed countries. However, the average rainfall statistics of the country mask the spatial and temporal water scarcity issues that arise mainly due to the bi-monsoonal rainfall pattern. The country's dry zone, which covers more than 60 per cent of the land area, is prone to water scarcity with a mean annual average rainfall of less than 1,750 mm, with distinct dry periods prevailing from May to September each year. Further, abnormal weather patterns, which can be attributed to the effects of climate change, have resulted in prolonged dry spells in certain areas while intense rainfall has caused floods in some other areas during the same time of the year. Such erratic patterns in rainfall often disrupt the continuous supply of natural water sources, potentially threatening the water security in the country unless addressed promptly, particularly amidst the rising demand for water in the period ahead. Short supply of safe drinking water is not an issue limited to the dry zone, but also an issue in certain wet zone areas given the rapid pace of urbanisation. Agriculture is the largest water consuming activity in the country, while the demand for water for other activities, such as household consumption, industrial activities and hydropower generation, is also on the rise. Meanwhile, the heavy use of agrochemicals and fertiliser has resulted in ground water pollution in certain areas of the country. Under such circumstances, efficient management of water resources becomes vital. As indicated by the mean annual average rainfall statistics, the primary reason for water scarcity is not the limited supply but the suboptimal management of the available water resources. For instance, about one half of the precipitation received by the country flows into the sea without being utilised for any productive activity. Estimates indicate that the relatively large rivers such as Gin, Kelani and Kalu release about 60 to 70 per cent of its water to the sea, while the relatively small rivers such as Kala Oya, Yan Oya, and Malawathu Oya release about 20 per cent of its water to the sea. Therefore, a well coordinated comprehensive water management policy needs to be implemented with the support of all stakeholders to ensure that water resources are better preserved, and water security in the country is safeguarded. Further, priority needs to be extended to the better management of river basins, especially by constructing reservoirs towards the middle of river basins in addition to the upper regions, while measures such as de-silting of existing reservoirs to increase the water retention capacity, promotion of water efficient farming techniques such as drip irrigation

methods, popularisation of good agricultural practices among the farming communities, and introduction of rainwater harvesting practices could also prove useful. Further, the techniques of rainwater harvesting could be promoted not only in water scarce areas such as the dry zone, but also in urban regions, by way of rooftop rainwater harvesting tanks. Such methods, if adopted adequately, will significantly reduce the purified water usage for non drinking purposes, thereby allowing the diversion of excess water into areas where people are deprived of clean drinking water.

Sri Lanka's vulnerability to climate change risks seems to be rising rapidly, causing a significant burden on the government budget. While the increased incidence of natural disasters causes a direct financial burden on the government on reconstruction and rehabilitation, they also create numerous socio-economic issues, including the worsening of poverty levels, necessitating further fiscal intervention. Hence, such consequences associated with climate change risks need to be addressed by introducing reforms, such as environmental tax reforms, which could reap a triple dividend by lowering pollution, raising public social welfare, while generating positive externalities. Meanwhile, financial institutions should actively consider pursuing green finance initiatives that support environment friendly, sustainable business models, while offering products for businesses and individuals to protect themselves from climate risks from a financial perspective.

Price pressures caused by frequent supply side disruptions could weigh on the Central Bank's efforts to maintain low and stable inflation. The Central Bank's flexible inflation targeting based monetary framework aims at stabilising inflation in mid single digit levels over the medium term while supporting economic growth. Although the Central Bank's efforts to anchor inflation expectations and manage demand conditions helped stabilise inflation in single digit levels for a sustained period of over a decade, headline inflation in certain periods exhibited increased volatility reflecting the impact of domestic supply side shocks. As in many emerging market and developing economies, the consumption basket in Sri Lanka contains a large share of food and nonalcoholic beverages. As a result, volatility of food inflation could cause high volatility in headline inflation. In general, supply side pressures, driven by weather related and other disturbances, as well as large swings in global commodity and food prices, contribute to high volatility of food inflation in Sri Lanka. Central banks do not possess instruments to tackle food inflation, and attempting to arrest transitory volatilities in food inflation using monetary policy could have adverse consequences on the economy. However, frequent high food inflation could lead to second round effects on inflation and raise inflation expectations. Therefore, fiscal policy support is required to help stabilise food inflation in an economy. While the government's direct intervention in markets through taxes and tariffs, price ceilings, etc., helps address short term supply side concerns, policy reforms to improve efficiency by enhancing storage, transportation and waste reduction allow long term solutions to mitigate the effects of supply side disruptions in a sustainable manner. In the medium to long term, fiscal policy could encourage the usage of new technologies to increase the resilience to shocks. This often includes the introduction of climate resistant crops, introduction of new storage and food preservation methods, which help minimise wastage of food supplies, increased use of information technology based price discoveries and cultivation information dissemination to control food price fluctuations, while enhancing the efficiency of allocation of inputs and resources.

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Undue delays in the monetary transmission process continue to hinder the efficiency in the passthrough of monetary policy measures to the real economy. The impact of monetary policy action is transmitted to the economy via various channels such as the interest rate, amount of credit, exchange rate, asset price, etc., with a time lag. In Sri Lanka, the interest rate channel acts as the key monetary policy transmission channel, where changes in policy interest rates of the Central Bank passthrough to medium to long term market interest rates via short term money market interest rates. However, undue transmission lags reflect imperfections in the transmission mechanism due to various issues such as the rigidity in the liability side of balance sheets of financial institutions, unhealthy competition in the financial sector, deterioration of credit quality, high taxes in the financial sector and a relatively large share of informal sector in the economy. The rigidity in the liability side of the balance sheets of financial institutions creates delays in the transmission process when a large portion of deposits is priced at fixed interest rates, while unhealthy practices among financial institutions in deposit mobilisation could further delay the passthrough of monetary policy actions. Further, deterioration of credit quality implies relatively high level of NPLs, and the need for increased provisioning could result in rising costs of loanable funds of the financial system, which may be counterproductive to monetary policy measures. Relatively high taxes on financial intermediaries remained a significant concern, impacting the interest margin of financial institutions and cost of funds, thereby hindering the performance of the financial sector. The measures introduced by the government recently to reduce taxes on the financial sector have helped address these concerns to a great extent. Meanwhile, the relatively large share of the informal financial sector could weaken the efficacy of monetary policy and its passthrough to the economy. Additionally, fulfilment of the government's financing requirement largely through the banking sector and banks' preference to invest more in government securities could also hinder the efficiency of the passthrough of monetary policy measures. In addition to these structural issues, subdued economic activity which dampens the demand for credit interactively, could also limit the degree of passthrough of monetary policy measures. These imperfections in the monetary policy transmission mechanism could be costly, particularly when the Central Bank attempts to revive the economy from conditions of persistent subdued levels of activity.

As Sri Lanka transitions to a low interest rate regime, the introduction of new financial products with a reasonable return becomes vital in order to ensure the living standards of savers, particularly senior citizens. Within the flexible inflation targeting framework, inflation is expected to be maintained in mid single digit levels on a sustained basis, implying lower nominal yields on savings in the period ahead, although positive real returns will be preserved. Such developments underscore the need to introduce new financial products such as annuity and pension products and bundling the ordinary deposits with other financial products, for instance, medical insurance, thereby securing a reasonable rate of return. Further, enhancing public awareness on the benefits of alternative financial products such as mutual funds and unit trusts, which usually yield higher returns compared to interest bearing instruments such as bank deposits is vital, while establishing a nationwide contributory pension scheme, particularly in the context of a rapidly ageing population in the country. At the same time, the general public should exercise vigilance and avoid unauthorised establishments or financial products, which claim to offer unusually high returns, as such investments may eventually result in a loss of hard earned savings.

Proactive and timely measures to promote the consolidation of the financial sector are required in order to enhance the resilience and the ability of the financial system to facilitate growth of the economy. The continued subpar growth of the economy has had a severe effect on the financial system as the economy and the financial sector are interdependent. Low levels of credit growth, tightening profitability of financial intermediaries, increased propensity of banks to raise the share of risk free government securities in asset portfolios and a rise in NPLs could lead to rising stress levels in the financial sector. NPLs have been on the rise since 2017 with a noticeable deterioration in credit quality, particularly in the non bank financial institutions sector during 2019. With due consideration to these developments, the imposition of more stringent credit screening conditions by lending institutions could hinder the flow of credit to riskier segments of borrowers, such as small and medium scale enterprises. On the other hand, provision of credit to such borrowers is vital considering their contribution to overall production networks and the productive capacity of the economy. This highlights the need for a stable, resilient and dynamic financial sector to facilitate the transition of the economy to a high and sustainable growth trajectory. For this purpose, the financial system should possess sufficient depth, capital buffers, an effective level of credit expansion and risk mitigation capacity. The current fragmented nature of the financial sector makes the system vulnerable to external shocks and prevents cost effective provision of financial services to productive sectors. This must be addressed through the consolidation of the financial sector by merging relatively small financial institutions to create a sector comprising strong and dynamic institutions, which cater to all sectors of the economy and exhibit resilience to domestic and external shocks. The international experience of financial sector consolidation highlights that mergers and acquisitions could lead to cost savings stemming from economies of scale, economies of scope, and improved allocation of resources. Such robust and dynamic financial institutions will be pivotal for Sri Lanka to harness the opportunities that are expected to accrue from emerging as a financial hub in the region. Among other benefits, the presence of world class financial institutions can pave the way for Sri Lanka to access international capital markets easily, while enabling the generation of other information flows and networks that can help foster the creation of talent and investment required for financial innovation, resulting in positive spillovers to the broader economy.

As Sri Lanka aspires to become a global financial hub with the development of the 'New Colombo', enhancing the efficiency and depth of the financial sector becomes essential. Over the past decade, a notable expansion in Sri Lanka's financial system was observed in terms of asset size, while the outreach and density of financial institutions within Sri Lanka increased noticeably, leading to a gradual increase in financial inclusion. Also, the increased use of new technologies in the provision of financial services deserves commendation. Despite these achievements, the financial sector of Sri Lanka could experience challenges in transforming itself into a state-of-the-art financial service provider within the context of an international financial hub. The lack of variety in existing financial products and the slow introduction of new financial products and services could restrict the deepening of the domestic financial market. Further, the capital market of Sri Lanka is yet to venture beyond the traditional instruments such as stocks and bonds into instruments like derivatives and commodities. Moreover, the lack of access to low cost funds impedes the overall borrowing and affects the sustainability of financial institutions. Furthermore, awareness on tech based financial

products is below average in Sri Lanka. Also, financial institutions in Sri Lanka lack the capacity to serve the funding needs of large scale infrastructure projects and public private partnerships. The way forward for financial institutions would be to collaborate with fintech companies and provide their clients with novel instruments such as investment- and certainty-based financial solutions like education and pension plans, and derivatives as well as tech-based products. The general public is likely to rapidly embrace these new financial solutions once their benefits, as well as associated risks, are highlighted through appropriate awareness programmes. Initiatives by the Central Bank of Sri Lanka such as the setting up of a FinTech Regulatory Sandbox and evaluating the possibility of introducing an Open Banking Framework for Sri Lanka are expected to support the advancement of the domestic financial sector. Meanwhile, equity market activity could be boosted further by promoting equity derivatives and short selling. Also, the use of blockchain technology would make capital markets more efficient by creating encrypted smart contracts that are safe, secure, fast and cost effective. Necessary support from financial sector regulators and the government, along with a strong and stable political and business environment, could set the stage for Sri Lanka to transform itself into a highly sought after international financial hub.

As Sri Lanka is becoming increasingly connected to the rest of the world via movements of people and goods, the implementation of a coherent policy framework for surveillance and quarantine is essential, as evidenced by the rapid contagion of the COVID-19 pandemic. With expanding travel and trade globally, Sri Lanka is exposed to cross border transmission of diseases, which could affect people, animals and plants threatening the health and safety of the ecosystem of the country. Though Sri Lanka has made notable improvements in terms of controlling communicable diseases, increased global mobility of people has raised the possibility of recurrence of controlled communicable diseases. Meanwhile, outbreaks such as COVID-19, SARS, MERS, Ebola, avian flu and swine flu, highlight the need for strong policy frameworks to strengthen the health and safety practices, including surveillance and quarantining. Further, the use of physical and human resources for disease surveillance at entry points to the country needs to be further strengthened in view of the expected increase in tourist arrivals in future. Moreover, the spread of trans-boundary plant pests and diseases has increased significantly in recent years through the importation of plant material from other countries. Most destructive migrant pests, such as the Fall Army worm and fruit flies, cause substantial losses to crop cultivations, endangering the livelihoods of economically vulnerable farmers and the food and nutrition security of the country. Inadequate quarantine regulations in granting clearance for vessels and cargo as well as in warehouses could increase the incidence of pest and disease outbreaks. In addition, there is a wide range of diseases, such as the Bovine Viral Diarrhoea, transmitted through livestock trade, especially through the importation of animal stocks for productivity enhancement and breeding purposes, endangering local breeds. Such diseases can potentially jeopardise the entire livestock production of medium and small scale farmers. Such potential health and safety risks to the ecosystem of the country reflect the need to strengthen its quarantine regulation framework in order to prevent the entry, establishment and spread of diseases, while safeguarding the overall system from health problems. Quarantine policies should be in accordance with the international standards of regulations to prevent cross border transmissions of vectors. Exporters of agricultural products should also follow the global best practices in order to ensure

that goods are free from pests and disease causing organisms, as any presence of such organisms in exported commodities may result in a rejection of the consignment by the importing country as well as any further exports of the product from Sri Lanka, as observed in recent years.

The importance of strengthening disaster management plans and social protection programmes is underscored to tackle the socio-economic effects arising from hazards, such as the spread of the COVID-19 pandemic and other emergencies. Shocks such as floods, landslides, and epidemics have a direct impact on households while having indirect costs on the broader economy including fiscal costs and numerous socio-economic costs. Therefore, the country's disaster management plans need to be strengthened to address these effects, which have a disproportionately high impact on the poor and vulnerable groups, such as the elderly, people with disabilities, women and children. Although the COVID-19 outbreak and physical distancing measures that had to be introduced could be an extreme case of a disaster, it is necessary for disaster management plans to take into account such extreme scenarios as well. These emergencies can instigate spikes in poverty levels within the population as poor and vulnerable groups tend to experience a longer time for recovery, while economic activity gets affected by disruptions to production and consumption. In the current context, low income, daily wage earners, especially informal sector workers, have shown the greatest vulnerability, as income earning opportunities of such workers have been restricted either due to the lockdown or disruptions to supply chains. Further, farming and fishing communities as well as micro, small and medium scale enterprises have been affected significantly due to limited access to markets, disruption to transport and logistics systems, and labour shortages. Low income households generally do not have alternative livelihood opportunities or savings, and may have limited access to social protection. In the face of such situations, some flexibility in expanding social protection becomes an integral part of the disaster management programme in order to cushion direct and indirect economic shocks and combat spiralling poverty levels. For this purpose, the government needs to build up the necessary fiscal space for such contingencies.

The COVID-19 pandemic and the subsequent global response highlight the presence of several fault lines that have necessitated policy responses which are substantially different from those observed in crisis episodes experienced in the past. The acceleration of the COVID-19 spread from an isolated outbreak in China to a global pandemic within three months has resulted in an outpour of unprecedented policy responses. The rapid spread of the virus has been attributed to reduced border controls and thereby the ease of international travel which are key underpinnings of globalisation. The cornerstones of international policy response have been the imposition of barriers to both movement of people and trade, resulting in an increased reliance on the 'nation state'. In turn, this has led to the advocacy of localisation of production and protectionism as economic safeguards in many countries, including Sri Lanka. Rapid innovation, adoption of new technologies and reverse engineering have been employed to produce essential goods, especially personal protective equipment, and ventilators. Other initiatives such as the 'Saubhagya National Programme on Harvesting and Cultivation' that aims to develop 1 million home gardens to achieve self-sufficiency can provide immense benefits over time. Novel service provisioning has been undertaken not only in public health care but also in other essential services such as banking and even retail shopping.

Hence, such crises allow both policymakers and the general public to consider and adopt innovative and efficient strategies that during normalcy may seem unviable or unpopular. However, countries are also adopting 'reverse protectionism' measures – the restriction of exports rather than imports. Such new protectionism could prolong the pandemic as not all economies possess the resources to tackle evolving challenges. It is vital to acknowledge that preventive measures and cures are 'global public goods' and that the widespread availability of these can help curb this crisis as all populations can only benefit from the same without inflicting harm on others. However, shortages in key medical supplies have led countries to ban the export of masks and other protective equipment. While this can cater to the individual needs of the country in the short run, it can also lead to a spiral of retaliation and fear that hurts citizens and businesses as other governments protect themselves or retaliate by also banning exports. Also, in the context of limited resources, productivity and competitive advantage, such forceful prioritisation of home markets can create a situation where countries are worse off as each government will find it more challenging to fight the contagion on their own. In the short term, such policy responses can hinder the much needed global cooperation against the COVID-19 pandemic, thereby leading to several human casualties and potential prolonging of economic disruption. Over the longer term, this can lead to a substantial deterioration of global supply chain networks. While the current breakdown may provide opportunities for economies to focus on domestic production, reentry into sectors which the economy has progressed out of may not create as many benefits. For instance, reentry into low value adding manufacturing industries may not create as many jobs now due to the automation process such industries have undergone in recent years. Such automation is essential to have a competitive advantage. Despite these fault lines, all countries are likely to reembrace globalisation, although in a modified form, as underlying drivers will remain unchanged. These include the need to trade goods and services, and the need to access cheap labour and external capital. In order to foster a strong, sustained and inclusive recovery, global cooperation is necessary. A unanimous and coordinated global response will pave way for a much faster recovery of the 'global village' than sporadic and solitary measures, which seek to solely benefit individual countries at the expense of vulnerable economies. The events such as the outbreak of the COVID-19 pandemic could significantly influence the modus operandi of the way the economies, including Sri Lanka, conduct business domestically as well as globally. Sri Lanka's preparedness to face such events and take appropriate measures to prevent any adverse impact on the economy remains critical in ensuring sustainable development over the medium term. Country's adoptability to changing dynamics would enable its takeoff towards greater heights in the next upturn in the global business cycle.

The preceding discussion attempted to highlight the numerous issues and challenges faced by the Sri Lankan economy that should be addressed if sustained and equitable growth and development are to be achieved as envisaged. These concerns, as well as many others, have been raised in previous Annual Reports of the Central Bank, and are also highlighted at various policy discussions, alongside possible remedies to overcome such issues. Regrettably, this list of issues and challenges continues to lengthen over time. It is hoped that the government makes use of the expected political stability following the General Election to pursue a proactive reform agenda with an emphasis on the implementation of national policies to address such issues and challenges, developed in consultation with all relevant stakeholders, enabling the Sri Lankan economy to takeoff on a sustainable footing, which would allow all Sri Lankans to enjoy prosperity that has eluded them in the past.

BOX 3

Sri Lanka's Economic Takeoff – The Need and The Readiness

Background

Sri Lanka was predominantly an agrarian economy with a somewhat higher per capita income compared to other developing countries, when it became a self governing nation in 1948. Subsequent governments that came to power adopted numerous policies aiming to stimulate growth and enhance welfare. Apart from policy swings, the internal conflict and youth uprisings caused severe damage to the economy, including loss of human capital and resources, while curtailing the fiscal space on investing in development projects, and preventing the economy from reaping expected benefits of various types of policy reforms introduced from time to time. With the end of the internal conflict in 2009, the economy started to unleash its potential along with large infrastructure development, recording above 8 per cent growth on average in the three years that followed, accompanied by rebounding investor confidence. Sri Lanka was progressing well towards graduating into an upper middle income country, but the progress slowed amidst subdued economic growth over the subsequent years (Figure B 3.1) due to various reasons.

While Sri Lanka is now classified as an upper middle income country, it is essential that the country adopts sound economic policies in order to avoid the "Middle Income Trap" and takeoff to become a high income nation with equitable and sustained growth.

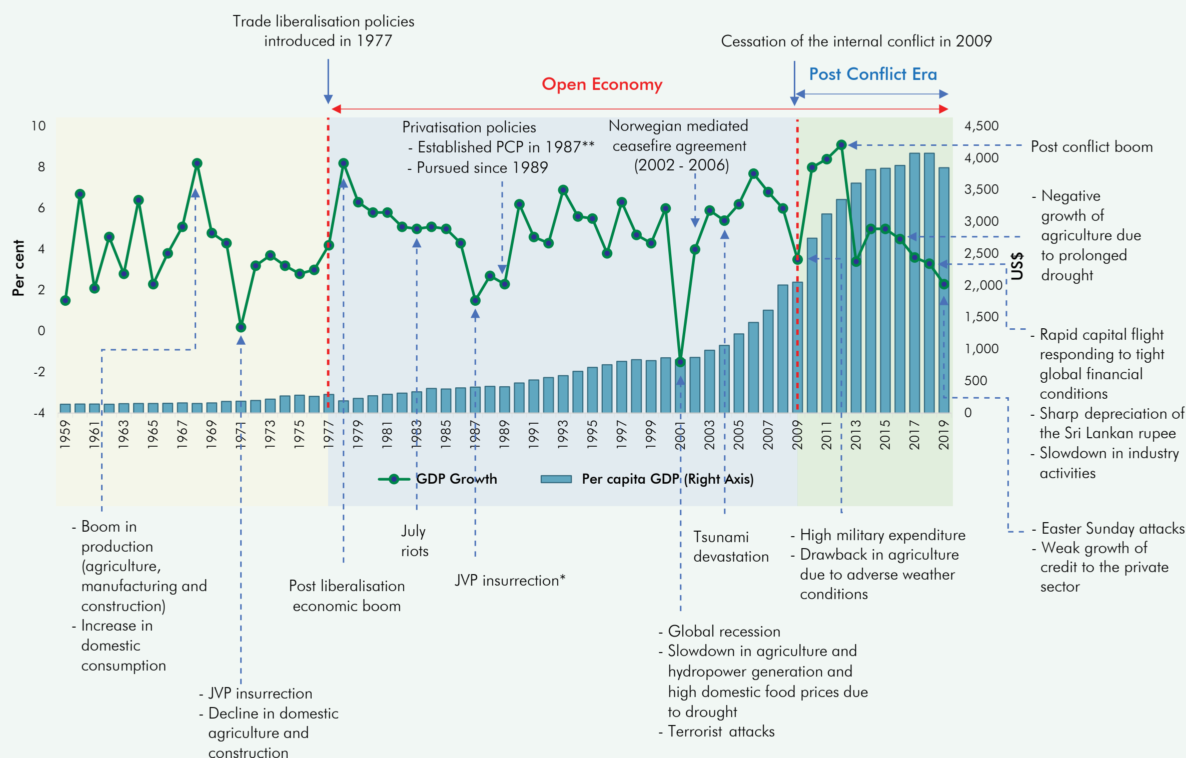
Sri Lanka's Strengths

Sri Lanka stands way ahead of its regional peers in the human development track record, positioning itself among the high human development group, ranking 71 out of 189 countries. In terms of the literacy rates, Sri Lanka surpasses the regional and global averages with a rate of 92.5 per cent.[1] Further, Sri Lanka's social indicators rank among the highest in South Asia, with over 90 per cent households all over the island having access to safe drinking water and with even better records in the health sector backed by free universal healthcare facilities.[2] Extreme poverty is not common, and poverty, as measured by the Poverty Headcount Ratio (PHCR),

1 Based on provisional, Quarterly Labour Force Survey data by the Department of Census and Statistics (DCS) (2018)

2 See more on https://www.worldbank.org/en/country/srilanka/overview

Figure B 3.1
Growth Pattern of Sri Lanka



* Janatha Vimukthi Peramuna - JVP
** Presidential Commission on Privatisation

Sources: Lakshman, 1997
Central Bank of Sri Lanka, Annual Reports

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decreased significantly to reach 4.1 per cent by 2016 from 26.1 per cent recorded in 1996.[3] Further, the physical infrastructure development recorded significant growth in recent years with progress in various fronts, including becoming an almost fully electrified nation, remarkable levels of telecommunication connectivity, continuous additions to the country's expressway network connecting the commercial capital to regional capitals, and the completion of reclamation in relation to Colombo International Financial City. These developments are also reflected in increased ranking in the infrastructure sector of the 2019 Global Competitiveness Index by 4 positions to 61, endorsing Sri Lanka to become the most improved economy in the South Asian region in the overall index.[4] Exemplary diplomatic relationships garnered from the friendly, non aligned foreign policy followed by the nation since independence could be harnessed to attract Foreign Direct Investment (FDI) as well as to foster the country's international trade performance. Further, recent measures taken by the government to improve female participation in the active labour force could support inclusive economic growth.

An island privileged by its strategically important location, Sri Lanka is in the midst of the ancient maritime Silk Route and has been in the spotlight of Eastern and Western merchants throughout history. With growing trade between Asia and the rest of the World, Sri Lanka's geographic location has become even more important today, indicating its potential to evolve as an international maritime and logistics hub. Besides, vibrant aquatic and terrestrial ecosystems influenced by distinct geographic and climatic factors since prehistoric periods as well as inherited cultural values have blessed the nation with a large potential for ecotourism and wellness tourism. Moreover, proper and sustainable sourcing of substantial natural resources, including the mineral resources in the Eastern coast, would aid in boosting the development of the economy.

The Sri Lankan economy has been enjoying single digit inflation consecutively for over a decade as a result of proactive, forward looking monetary policy. Maintaining inflation at low and stable levels is considered to be an essential component to generate overall macroeconomic stability and support growth endeavours by facilitating the country's competitiveness, while helping to protect vulnerable segments of the population and boost employment creating production growth. This significant change in the structure of the Sri Lankan economy, which was once considered an economy with double digit inflation, will remain a catalyst in its efforts towards takeoff in the period ahead.

3 Household Income and Expenditure Survey conducted by the DCS, 2016

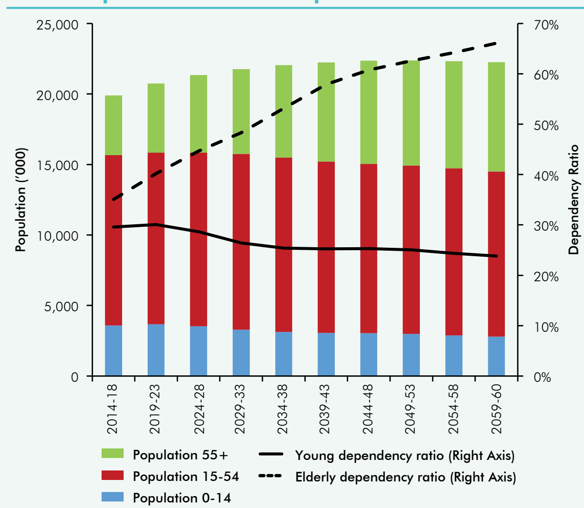
4 Sri Lanka ranks 84 out of 141 economies and has recorded a growth of 1.1 index points reaching a score of 57.1 in 2019 compared to the score of 56 in 2018

Issues and Challenges

Sri Lanka has not been able to maintain high growth over extended periods of time due to numerous reasons including high budget deficits, high trade and current account deficits, issues in land, labour and capital markets, traditional and bureaucratic institutions, cultural factors, weak governance structures, political instability and corruption, in addition to the factors mentioned at the outset.

It is worth noting that exports and FDI have been key drivers of growth in many successful economies in Asia. However, Sri Lanka's progress in terms of exports and FDI has been subpar compared to its regional counterparts. Sri Lanka has not been able to diversify exports and its share in global trade has declined over time, unlike its East Asian neighbours, and its exports structure has not evolved to the next level beyond apparel, tea and rubber products since the early 1990s. Anti export bias, lack of private domestic and foreign investment in the tradable, particularly industry sector, lack of innovation and research and development (R&D) have further deepened the woes of the exports sector. Meanwhile, the volatile economic and political climate together with the bureaucratic and restrictive investment climate have deterred foreign investment inflows to Sri Lanka. These developments have led to the widening of the external current account deficit forcing the country to increasingly rely on foreign borrowings to finance such deficits.

Figure B 3.2
Population Growth Projections in Sri Lanka



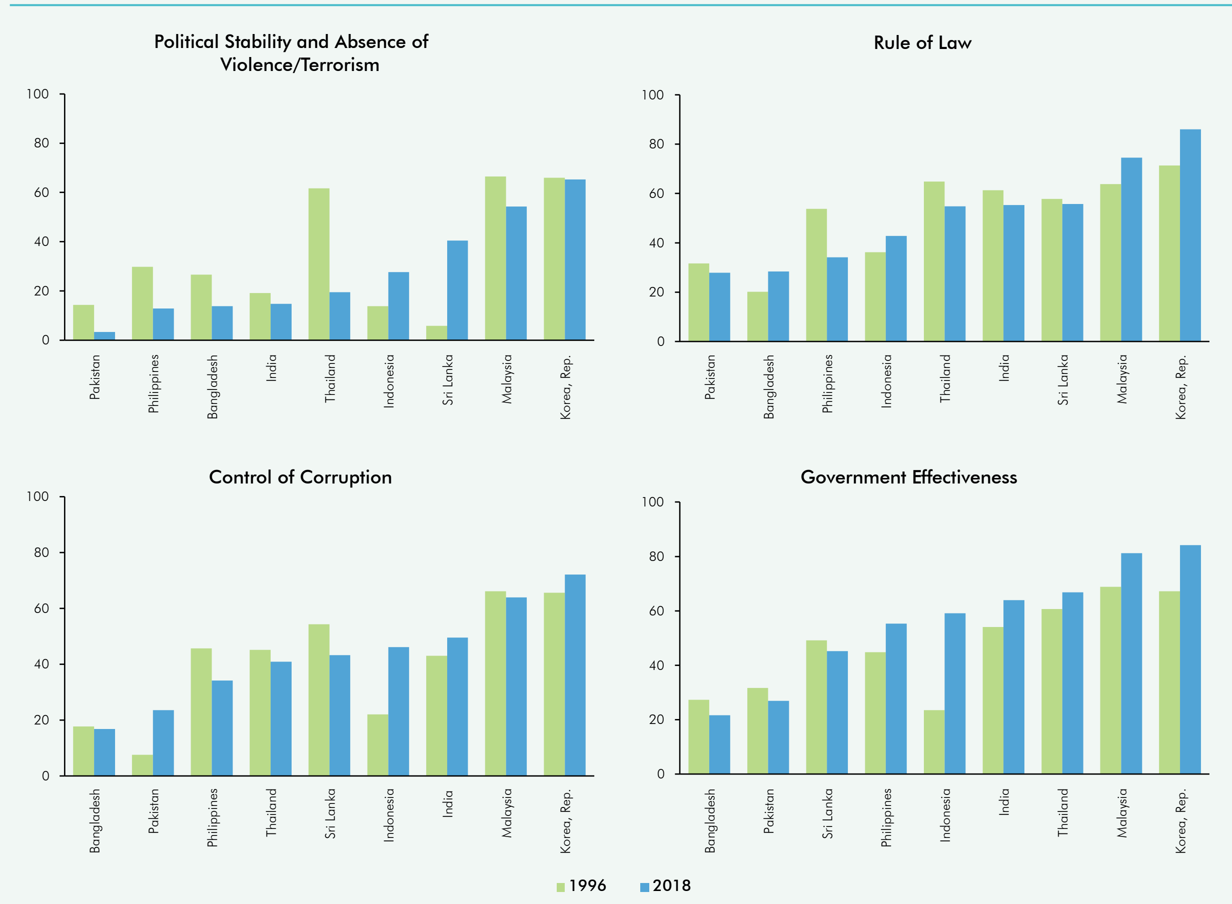
Source: UN population projections, medium fertility scenario (World Bank, 2015)

To achieve sustainable and inclusive growth, the workforce needs to be prepared for the challenges of the 21st century. Although Sri Lanka's performance in terms of human development has been commendable, high levels of educated youth unemployment and low levels of female labour participation have been observed compared to other emerging markets. Female labour force participation in Sri Lanka and in the region, has remained significantly lower than economies like China and those in the ASEAN region, and this is a serious concern for Sri Lanka given its large pool of highly educated females who are neither employed nor looking for work. In addition, inadequate exposure to STEM (Science, Technology, Engineering and Mathematics) education at secondary, higher education and university levels, has created a low skilled workforce that is unfit to serve the needs of present day employers and to create entrepreneurs.

Furthermore, Sri Lanka is undergoing a rapid ageing of its population, and has reached an advanced stage of this demographic transition compared to its peers. According to projections of the UN, between 2015 to 2060, the dependency ratio of the elderly is projected to rise sharply while that of the young would fall. In addition, Sri Lanka's population is projected to peak in the mid 2040s (Figure B 3.2). The share of the elderly is projected to increase to 25.7 per cent of the total population by 2050 compared to 13.4 per cent in 2015. This implies a contraction of the labour force, lower productivity, greater fiscal burden in the form of healthcare and elderly care, and high retirement benefit costs in the future. In fact, according to the World Social Protection Report (2017-2019), less than one third of the Sri Lankan population is covered by at least one social protection benefit scheme and only around 25 per cent of old age citizens are receiving a pension.

A key source of economic instability in Sri Lanka for many years has risen from misaligned fiscal operations. Compared to emerging market peers, Sri Lanka's fiscal deficits have remained high over time amidst declining government revenues and rising recurrent expenditure. Strikingly, the tax revenue to GDP ratio in Sri Lanka is

Figure B 3.3
Worldwide Governance Indicators - Percentile Ranks (a)



(a) Percentile rank indicates the country's rank among all countries covered by the aggregate indicator, with 0 corresponding to the lowest rank, and 100 to the highest rank.

Source: The World Bank

one of the lowest by international standards. Moreover, government expenditure has continued to increase over the years in spite of the steps taken to rationalise expenditure. Reflecting the impact of sustained large budget deficits, debt levels in Sri Lanka have also remained high. Rising levels of external commercial debt have created a further drag on government finances, thus elevating risk and associated premiums, causing an increase in interest costs. Sri Lanka has little fiscal space to drive growth through large and continued fiscal stimulus and to pursue large infrastructure development projects, highlighting the need for intense fiscal reforms if the country is traverse a high growth trajectory.

Political instability and policy uncertainty create significant challenges for sustained economic growth since the associated uncertainties, negatively impact investment decisions and business confidence. Aisen and Veiga (2011) argue that political instability may shorten policy authorities' horizons, leading to sub optimal short term economic policies, and may also cause "a more frequent switch of policies, creating volatility and thus, negatively affecting macroeconomic performance". Political stability, presence of good governance, effectiveness of the government, rule of law, and eradication of corruption contribute positively to the sustained growth of an economy. Although Sri Lanka has remained a vibrant democracy resulting in frequent changes in governments, the absence of an independent civil service and the lack of national policies have led to inconsistent policies and affected Sri Lanka's image as a predictable destination for investment and other long term economic activities.

Strategies to Support Sri Lanka's Economic Takeoff

As discussed above, while several crucial conditions are already in place, there remain numerous hindrances that need to be addressed through policy reforms to support Sri Lanka's economic takeoff. Some examples of such reforms that could help Sri Lanka take the next leap forward towards becoming a high income economy over the next decade are outlined below.

A breakthrough in Sri Lanka's export strategy would serve as a springboard for the country to become a high income economy. Sri Lanka's merchandise export strategy needs to be revolutionised by diversifying to the export of medium to high technology products such as machinery and equipment, electronics, vehicles and pharmaceuticals, and value added mineral products, from the traditional low technology products such as garments and tea. Vietnam, a well known achiever in Asia, diversified its exports from agriculture and natural resources based products to apparel in the early 1990s and then to electronics in the late 2000s, and thus stands among the leading exporters in the global production network today.

Sri Lanka should also look beyond its traditional export markets. Exports to the West have accounted for over half of its total exports, supported by preferential access to some extent. While GSP and GSP+ programmes have supported Sri Lanka in boosting its exports in the past, such benefits are shortlived, and will not be available for an upper middle income economy. Therefore, Sri Lanka should gradually shift its focus towards exporting to emerging Asia and other non traditional markets.

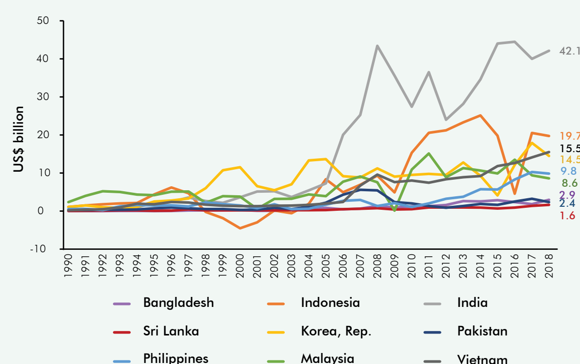
In addition to the diversification of merchandise exports, Sri Lanka needs to focus on further improving services exports. In addition to the already earmarked services sectors such as tourism and IT-BPO, measures should also be taken to improve exports of other important services such as logistics and financial services. The Colombo Commercial and Financial Hub, once ready for operation, would enable Sri Lanka to earn additional foreign exchange through the export of these services.

Sri Lanka needs to form strategic economic partnerships with other nations, particularly the regional countries, to promote its exports and maximise benefits from the movement of capital and human resources. Sri Lanka could, yet again, learn from the experience of Vietnam, which rose to become a leading emerging Asian economy driven by export growth. Since 1995, Vietnam actively signed multiple free trade agreements (FTAs), which resulted in the lowering of tariffs on Vietnamese exports, thereby paving way for the expansion of its exports sector as well as its economy. While taking measures to reap the most from the existing FTAs, measures should be taken to establish new trade pacts with other trading giants while preserving the country's sovereignty and independence. Such trade agreements would assist domestic exporters to integrate into global value chains (GVCs), thereby improving access to markets, while also promoting competition, improving efficiency and supporting innovation.

More crucially, Sri Lanka should also increasingly focus on attracting non debt creating financial flows to support reaching a higher growth trajectory through increased domestic production. Although inflows of FDI to Sri Lanka have gradually risen over the past decade, it remains well below the levels experienced by its regional peers. For instance, Vietnam, with the implementation of investor friendly policies and reforms over the years, has been successful in attracting substantially high FDI to productive and tradable

sectors, and is now home to some of the world's leading electronic brands such as Intel, Samsung, Mitsubishi, GE, LG and Panasonic. Learning from this experience, Sri Lanka should also focus on attracting FDI towards infrastructure development as well as production that could promote the exchange of technology and expertise. Timely introduction of necessary legal, institutional and labour market reforms to address FDI deterrents would improve ranking of ease of doing business and enhance investor confidence in Sri Lanka. With increased FDI, producers would have enhanced access to GVCs, availing them of the opportunity to produce new products, and expand and diversify into new markets, while also leading to job creation, thus supporting the country's overall growth and development agenda. While supporting the stability of the exchange rate, higher FDI would also generate increased foreign revenue in the form of export earnings, thereby reducing the need for debt creating foreign funds to finance external current account deficits and improving government revenues in the long term.

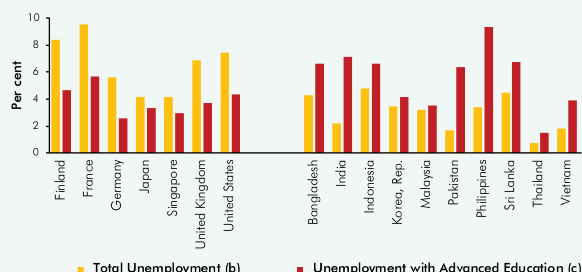
Figure B 3.4
Foreign Direct Investment, Net Inflows (BoP, current US$)



Source: World Development Indicators

As highlighted by authors such as Agénor, Canuto, and Jelenic (2012) and Agénor (2017), the lack of high quality human capital to meet the 21st century's labour market challenges is one of the reasons for the stagnation of countries at middle income levels, since it limits the benefits achievable with borrowed technologies from other countries and also the development of suitable technologies inhouse. Investment in high skilled education and labour market reforms are necessary to face this obstacle. When considering the composition of graduates of Sri Lanka, a majority seems to specialise in humanities and aesthetic studies. However, countries such as Singapore and South Korea, which have transitioned into the high income category from middle income levels, produce a higher proportion of graduates in science and technology related fields, thereby increasing their innovative capabilities. It is equally important to develop and support industries that require high skilled labour, so that the demand for such graduates would also be high. Therefore, in the context of Sri Lanka, the country needs to focus not only on the supply of experts by supporting science and technology related fields of higher education, but also needs to increase the demand for such experts. Experiences of the recent past highlight that many graduates migrate following the completion of their studies, leaving behind a heavy fiscal burden given the free education system in the country. Also, many graduates seem to favour government jobs over private sector employment preferring higher job security, despite the higher wage levels in the private sector, especially in sectors requiring higher skills. This phenomenon suggests an already existing shortage of such experts in the private sector, as highlighted by Nedelkoska, O'Brien and Stock (2018). Therefore, within the government's initiatives to broaden the university intake, further efforts are imperative to widen access to tertiary education to match the demands of the labour market. At the same time, studies including Delalibera and Ferreira (2019) have found evidence suggesting that the quality of early childhood education can contribute to increased levels of labour productivity, and Sri Lanka also needs to improve the quality of the primary and secondary layers of the education system. Improvements to the quality of the labour force achievable through such measures could also be beneficial in facing the country's emerging demographic challenges.

Figure B 3.5
Comparison of Unemployment Rates Among Educated Population – 2009-2016 Average (a)



(a) Data are not available for all countries for all periods. Only available periods are considered for the average in such instances.
(b) Share of the labour force that is without work but available for and seeking employment. Definitions of labour force and unemployment differ by country.
(c) As a percentage of the labour force with advanced education. Advanced education comprises short-cycle tertiary education, a bachelor's degree or equivalent education level, a master's degree or equivalent education level, or doctoral degree or equivalent education level according to the International Standard Classification of Education 2011 (ISCED 2011).

Source: The World Bank

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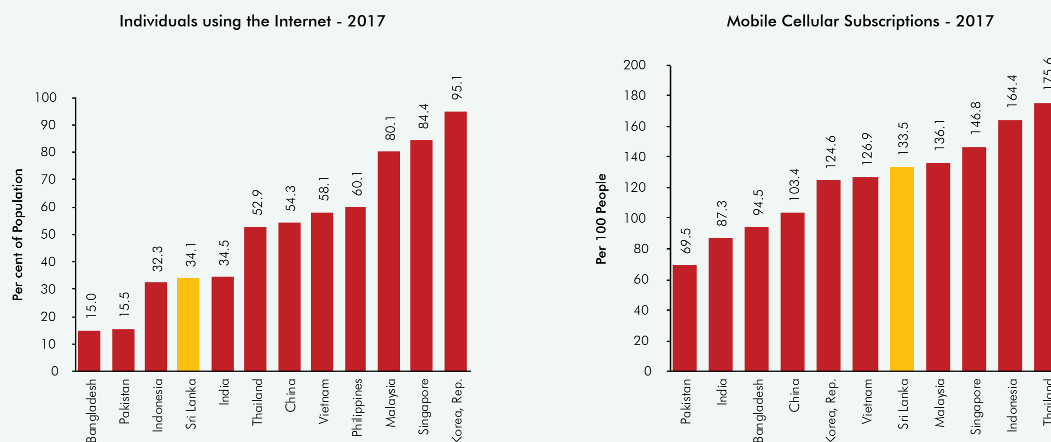
Figure B 3.6
Internet and Mobile Penetration



Source: The World Bank

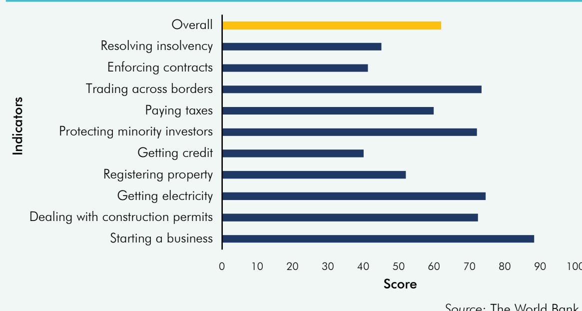
A common argument in literature on the middle income trap is that it occurs due to the inability to innovate. In many developing Asian countries, the importance given to intellectual property rights is low when compared to its Western counterparts. In the case of Sri Lanka, the existing laws and regulations are quite extensive in protecting intellectual property rights established by foreign entities, but attempts to establish intellectual property rights for local innovators and inventions are slow and involve tedious processes, thus discouraging innovation as it is difficult for inventors to obtain economic gains from their efforts. Thus, from a policy perspective, it is important to take measures to improve awareness of intellectual property rights and to ensure enforcement of such rules and regulations, while actively supporting local innovators to establish such rights domestically and abroad.

South East Asian success stories such as Singapore and South Korea suggest that improving access to advanced infrastructure, including telecommunication and broadband has contributed to sustained growth. Despite having made commendable progress in this regard, there is still ample space for improvement in Sri Lanka, as suggested by indicators such as a relatively high effective cost of broadband and a relatively low internet penetration rate (although the mobile phone penetration rate is at comparable levels) when compared with regional peers. With respect to transport infrastructure as well, the country could gain higher economic and social benefits by complementing the improvements to the road network by upgrading public transportation and the railway network.

Enhanced entrepreneurship paves way to generate higher levels of output and productivity of a country, increasing national income and income distribution through improved employment together with higher earnings. A well developed entrepreneurial culture of a country underpinned by a conducive environment to conduct business, enables the economy to move ahead in terms of attracting investments, thereby boosting overall economic activity. As per Doing Business 2020,[5] Sri Lanka holds the 99th position out of 190 economies for ease of doing business, remaining below its regional peers. India managed to raise its ranking through streamlining its reform strategies giving priority to the Doing Business indicators. Countries like Vietnam have upgraded their information technology infrastructure to make it easy to pay taxes. Recently, Sri Lanka too, made a few efforts to upgrade the information technology infrastructure by introducing online systems for filing taxes, processing constructions permits and business registration. With a view to facilitating and attracting foreign investments, the Board of Investment (BOI) has introduced an online application tracking system. The relatively poor score of Sri Lanka on the ease of doing business indicates that there is ample room for further improvement. In Sri Lanka, a lack of improvements can be observed in the areas of getting credit, enforcing contracts, especially in terms of the time and cost spent on resolving a commercial dispute and the quality of the judicial process as well as resolving insolvency considering the recovery rate and reinforcement of the legal framework for insolvency. Further developments can be achieved through government involvement in evolving the country's entrepreneurship by implementing broad minded, long term policies and programmes that offer opportunities for entrepreneurs.

5 Doing Business 2020 is the 17th series of an annual study of The World Bank which presents quantitative indicators on business regulations and the protection of property rights across 190 economies. The data are as of 1 May 2019.

Figure B 3.7
Doing Business Indicators - 2019 for Sri Lanka



Source: The World Bank

For decades, Sri Lanka, as a twin deficit country, has been relying on domestic and foreign borrowings for financing deficits. With a view to strengthening the fiscal position and maintaining government debt at a sustainable level, successive governments have pursued fiscal consolidation strategies, augmenting revenue by expanding the tax base, improving tax administration and compliance, while also rationalising expenditures. Recent tax reform initiatives including those aimed at improving tax administration, are expected to make the country's tax system simpler, while improving business confidence. As government expenditure also remains high, it is crucial for the government to increasingly focus on rationalising expenditure alongside fiscal consolidation measures with a proper monitoring process of government expenditure, without compromising essential public investment. These measures are important in the effort of moving toward becoming a high income country, as unsustainable levels of budget deficits and debt lead to macroeconomic instability, thereby hindering growth. In addition, the government needs to strengthen its efforts on reforming and restructuring State Owned Business Enterprises, thereby enhancing their financial viability and helping to reduce central government expenditure, while inculcating greater discipline in fiscal affairs.

It is widely accepted that political stability is a prerequisite for economic stability. However, consensus across political regimes on long term economic goals is even more important for sustainable growth. Experiences from Finland and Singapore, discussed by Foxley and Sossdorf (2011) and Chua (2011), respectively, suggest that social and political consensus on long term economic priorities can lead to many years of sustained growth. This has historically been a weak area in Sri Lanka as economic priorities have varied frequently when political regimes change. Thus, going forward, it is essential that the people of Sri Lanka demand for a consensus on long term economic goals of the country and persuade political authorities to collectively commit to implement consistent policies to achieve these goals, if the country is to progress towards high income levels with equitable and sustained growth.

Conclusion

Sri Lanka, once considered a promising emerging and developing economy and famously referred to as the "Wonder of Asia" with the dawn of peace in 2009, has to tread through rough waters over the past several years resulting in poor macroeconomic performance, particularly in terms of subpar growth and rising external and fiscal sector vulnerabilities. The absence of national economic policies, delayed implementation of the required structural reforms and the inability to build sufficient policy spaces have led the country to lose its steam as a fast growing economy in the region, amidst domestic political uncertainties, the Easter Sunday attacks, and frequent natural disasters. Moreover, uncertainties in the global front have also posed significant challenges to domestic economic activity. In spite of these drawbacks, Sri Lanka has managed to make steady progress in terms of reducing poverty, upgrading human capital, promoting good governance, fostering healthy international diplomatic and economic relations with key development partners, and maintaining single digit inflation for over a decade, to name a few. It is expected that these factors, together with the country's natural strengths and the implementation of appropriate policy reforms, particularly to address the deficiencies highlighted above, would set the stage for Sri Lanka to takeoff and reemerge as the economic miracle of Asia.

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