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Economic Performance and Outlook

The Sri Lankan economy rebounded strongly from the COVID-19 pandemic induced contraction in 2020. The real economy grew by 8.0%, y-o-y, in the first half of 2021, registering a broadbased recovery of the major sectors of the economy. This recovery was underpinned by the extraordinary policy stimuli provided by the Government and the Central Bank across a wide spectrum of businesses and individuals, phasing out of the selective mobility restrictions in tandem with the nationwide vaccination programme, and normalising global activity. The Government continued the fiscal stimulus measures announced in late 2019 by way of the low tax regime, among other direct financial support. The large scale debt moratoria provided to businesses and individuals were further extended during 2021, thereby smoothing the effects of cashflow disruptions faced by stakeholders amidst multiple waves of the pandemic. Due to the unprecedented monetary policy support provided by the Central Bank during 2020 and the maintenance of the same through January to mid August 2021, market interest rates declined to historically low levels, thereby facilitating credit to businesses and individuals, and supplementing investment needed to revive the economy. The low interest rate environment benefitted fiscal operations amidst restricted access to global financial markets. Further, the Central Bank provided a large amount of funds to the Government by way of purchasing Treasury bills in bridging the widened financing gap in the midst of the pandemic. However, the Central Bank implemented monetary tightening measures in mid August 2021 by raising policy interest rates and the SRR (effective September 2021) in order to preempt the buildup of excessive inflationary pressures over the medium term, while also addressing imbalances in the external sector. Merchandise exports reached pre-pandemic levels, while import expenditure also rose, reflecting the normalisation of activity as well as the escalation of prices of

all key commodities in the global market. Amidst limited foreign exchange inflows under pandemic conditions, speculative activity exerted further pressure on the domestic foreign exchange market, warranting intervention by the Central Bank to impose a mandatory conversion requirement on export proceeds, provide exchange rate guidance, and ultimately provide liquidity support for essential imports. Meanwhile, the performance of trade in services remained dwarfed by the prolonged setback in the tourism industry, which is expected to rebound fast as global travel activity resumes and vaccination against COVID-19 gathers pace. Workers' remittances, which remained resilient amidst the pandemic, moderated in recent months, mainly reflecting the resumption of cross border travel, modest departures for foreign employment, and the search for exchange gains outside the banking system. Heightened near term vulnerabilities in the external sector and pressures observed in the financial system owing to the moderation of foreign inflows are being addressed by the Government and the Central Bank through coordinated efforts. Concerted measures are being taken to promote foreign exchange earnings of the country, in terms of merchandise and services exports and workers' remittances. The external current account balance is expected to improve over the medium term, supported by these efforts. FDI to large scale projects, and monetisation of non strategic assets, among others, are expected to attract sizeable non debt creating foreign inflows to the Government in the period ahead, thereby facilitating foreign currency debt servicing, along with several bridging finance facilities that are under discussion. Gross official reserves are expected to be enhanced to adequate levels in the period ahead, despite near term volatilities. The exchange rate continues to remain competitive as reflected by the real effective exchange rate indices. The Government honoured all its foreign currency liabilities, in spite of speculation by various parties, including international sovereign rating agencies, about Sri Lanka's ability to meet foreign debt service obligations. Meanwhile, the expansion of the Government budget deficit amidst the pandemic is expected to be curtailed along with the normalisation of activity and planned expenditure rationalisation measures by the Government over the medium term. Headline inflation, in the meantime, exceeded the upper bound of the target range of 4-6%, mainly due to continued high food prices, upward revisions to several administratively determined prices, and relaxation of price controls on selected imported commodities in tandem with the rising global commodity prices. Core inflation also recorded an uptick recently, indicating the strengthening of demand conditions of the economy. While headline inflation could remain above the targeted levels in the near term, the Central Bank remains committed to maintaining headline inflation at the target range over the medium term under the flexible inflation targeting framework with appropriate preemptive measures as and when required, while ensuring the support needed for the economy to reach its potential growth trajectory. Amidst measures to stabilise the economy from the effects of the pandemic, efforts of the Government towards creating an export oriented production economy and diversifying economic activities with the support of domestic and foreign investors are expected to help sustain the growth momentum of the Sri Lankan economy over the medium term and enhance its resilience.

1.1 Sectoral Developments

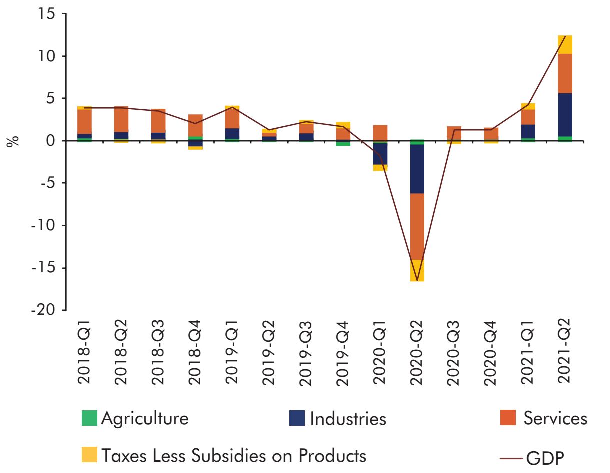
Real Sector and Inflation

The Sri Lankan economy showed a robust recovery during the first half of 2021, over the notable pandemic induced contraction recorded in the same period last year. As per the provisional estimates of the DCS, the economy grew in real terms by 8.0%, y-o-y, in the first half of 2021, compared to the contraction of 9.1%, y-o-y, recorded during the corresponding period of 2020.

> ***The unprecedented policy support from the Government and the Central Bank helped a faster recovery of activity, alongside the expeditious containment of the pandemic through the rapid rollout of the COVID-19 vaccination programme...***

All major sectors of the economy recorded an impressive growth during the first half of 2021, compared to the same period last year. Agriculture, forestry, and fishing activities reported a substantial expansion of 7.1%, y-o-y, particularly tea, oleaginous fruits, rubber, and fruits growing activities expanded, owing to the favourable weather conditions experienced during the period. The value addition in the industry related activities grew notably by 12.1%, y-o-y, during the first half of 2021, compared to the 14.6% contraction recorded in the corresponding period of the preceding year. Growth in all sub-activities of the industry sector remained positive, except the manufacturing of coke and refined petroleum products, and sewerage, waste treatment, and disposal activities. Construction and mining and quarrying subsectors grew by 9.9%, y-o-y, in the first half of 2021, supported by the easing of mobility restrictions. Further, manufacturing activities registered a growth of 14.0%, y-o-y, in the first half of 2021, supported mainly by the manufacturing of textiles, wearing apparel and leather related products, food, beverages and tobacco products, rubber and plastic products, furniture and other non-metallic mineral products subsectors. The services activities recorded a healthy recovery with a real growth of 5.1%, y-o-y, in the first half of 2021, compared to a 5.2% contraction in the first half of 2020. The growth of the

Figure 1.1
Contribution to Quarterly Real GDP Growth (y-o-y)



Source: Department of Census and Statistics

services sector was mainly driven by financial services and auxiliary financial services activities, transport of goods and passengers, including warehousing activities, wholesale and retail trade, real estate activities, including ownership of dwelling, other personal services activities, and telecommunication services. However, accommodation, food and beverage services activities recorded a decline of 13.4%, y-o-y, in the first half of 2021, owing to dampened tourism activities amidst the mobility restrictions.

In nominal terms, the Sri Lankan economy expanded by 13.8% in the first half of 2021, compared to a year earlier. According to the expenditure approach of GDP estimates, economic growth in the first half of 2021 was mainly driven by the expansion in consumption expenditure. Consumption expenditure, which accounted for 84.9% of the GDP, recorded a growth of 16.5% in the first half of 2021, compared to the contraction of 2.9% in the corresponding period of the preceding year. This expansion was mainly observed in household expenditure, which grew by 17.9% in the first half of 2021, compared to the 4.3% contraction recorded in the same period of the previous year. Government consumption grew by 6.7% in the first half of 2021 over the growth of 6.9% recorded in the first half of 2020. Investment expenditure, which recorded a y-o-y contraction of 11.4% in the first half of 2020, expanded by 16.7%, y-o-y, in the same period of 2021, owing to the notable growth of fixed capital formation by 17.3%. Investment, as a percentage of nominal GDP, increased to 24.5% in the first half of 2021, compared to 23.9% of nominal GDP in the corresponding period of the previous year. Net external demand on account

Economic Effect of Lockdowns

Unlike previous episodes of epidemics, such as SARS, H1N1 or Ebola, the rapid evolution of the COVID-19 outbreak into a pandemic within a short period required countries across the globe to introduce lockdowns and other types of mobility restrictions in an unprecedented manner. The effect of such restrictions is reflected in the global economic contraction of 3.1% in 2020 as per the estimates of the IMF.

In Sri Lanka also, the socio-economic effects of the pandemic and the associated lockdowns and mobility restrictions have been substantial. The first wave of the pandemic during March-May 2020 was addressed by a strict nationwide lockdown, which was relaxed in a phased manner thereafter. The nationwide lockdown resulted in the Sri Lankan economy contracting by 16.4%, y-o-y, during the second quarter of 2020. The second wave during October-November 2020 was addressed by selective lockdowns and mobility restrictions, which reduced the economic fallout to some extent. Yet, the recovery process was disrupted, and the economy recorded a growth of only 1.3%, y-o-y, in the fourth quarter. Accordingly, these resulted in Sri Lanka recording its highest economic contraction of 3.6% in 2020, in contrast to the initial expectation of a real GDP growth rate of around 5%. The third wave of the pandemic since April 2021 has been, by far, its largest wave. Mobility restrictions during the third wave were also selective.

While lockdowns and mobility restrictions were necessary to prevent the spread of the pandemic, their impact in terms of macroeconomic performance was severe. According to projections made by the Central Bank in April 2019, Sri Lanka's nominal GDP was expected at Rs. 17.39 tn in 2020 and Rs. 19.17 tn in 2021. However, with the pandemic, the economy recorded a nominal GDP of only Rs. 14.97 tn in 2020 and is likely to record a nominal GDP of about Rs. 16.5 tn in 2021. This indicates a staggering annual loss of GDP in nominal terms of about Rs. 2.5 tn.

While the COVID-19 pandemic has not spared any key economic sector, it must be mentioned that key foreign exchange earning sectors pertaining to trade and tourism related activities have been hard-hit by the pandemic. In turn, this has been reflected in the decline in the foreign exchange flows to the country, thereby negatively weighing on the stability of the exchange rate and having negative spillover effects on investor confidence. On the fiscal front, the slowdown in economic activity contributed to the reduction in government revenue amidst rising expenditure, thereby exerting significant pressures on the fiscal sector and warranting additional borrowing.

The impact of the lockdowns and mobility restrictions may also be assessed from a labour market perspective. According to the Labour Force Survey Quarterly report for the fourth quarter of 2020 published by the DCS, out of the 8.03 mn of the employed population, own account workers and contributing family workers and those employed in the private sector accounted for 82% of total employment. Further, according to the Labour Force Survey Annual Report for 2019, informal sector employment accounted for 57.4% of total employed. This highlights that even among those engaged in employment, the majority are vulnerable in the wake of such disruptions. Furthermore, Sri Lanka has recorded unemployment rates above 5% since the onset of the pandemic, compared to the average unemployment rate of 4.4% since the end of the conflict. In this regard, such loss of livelihoods results in increased vulnerability and increased poverty, especially in relation to those who are just above the poverty line and those who are outside the ambit of social safety nets.

The recovery observed during the first half of 2021 has been on the back of the extraordinary support provided by the Central Bank to all stakeholders of the economy, via various channels since the onset of the pandemic in March 2020. This includes support to the private sector, the banking sector and the Government. The financial sector has also extended broadbased support to borrowers, including businesses and individuals, to smoothen the negative effects of COVID-19 related disruptions. The Central Bank also took steps to protect affected businesses and individuals from undue penalties and forced acquisitions. However, such stimulus cannot be continued indefinitely without adverse macroeconomic repercussions and financial system stability concerns. At the same time, going forward, it is necessary in future credit evaluation to recognise the pandemic effects on relationships between financial institutions and their clientele.

The above highlights that the COVID-19 pandemic and the lockdowns that it entail create a vicious cycle that can have a scarring impact on businesses and households in the near term and thereby the overall growth trajectory and potential of the Sri Lankan economy in the medium term. Going forward, it is imperative that the Government continues to proactively and holistically strike a balance between minimising the human toll of the pandemic while also minimising the economic toll of these circumstances on the Sri Lankan economy which had already been struggling to recover from a long period of sub-par growth. The cornerstone of maintaining this balance is the ongoing COVID-19 vaccination drive spearheaded by the Government. The much-acclaimed progress that has been observed especially since July 2021 is expected to minimise any disruptions stemming from COVID-19 in the period ahead. However, the public's close adherence to prescribed health guidelines will also be vital to the recovery of the economy. Only then can a virtuous cycle of macroeconomic stability, improved economic growth and enhanced resilience be established to pave way for the creation of an inclusive and sustainable growth trajectory for the Sri Lankan economy.

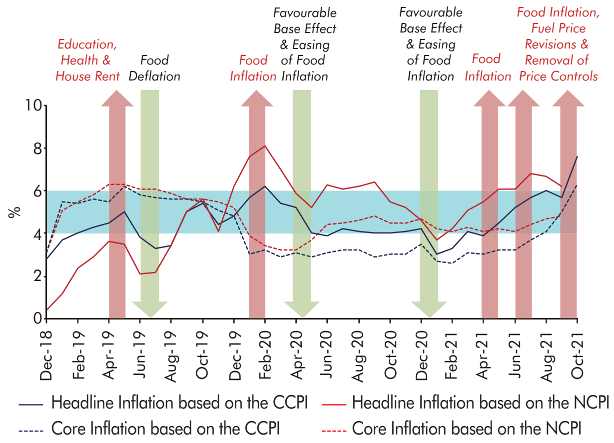
of goods and services deteriorated in the first half of 2021, from a year earlier. Despite the notable growth of exports of goods and services by 19.1%, y-o-y, import expenditure expanded at a faster pace of 29.4%, y-o-y, at current prices. Consequently, net external balance of goods and services, as a percentage of nominal GDP, declined from -6.9% in the first half of 2020 to -9.4% in the same period of 2021.

Reflecting the effects of the pandemic, continued disruptions to the labour market were observed, resulting in relatively low LFPR and higher unemployment rates. The LFPR marginally increased to 50.9% in the first quarter of 2021 from 50.1% in the fourth quarter of 2020. However, with the emergence of the third wave of the pandemic, the LFPR declined to 49.8% in the second quarter of 2021. Meanwhile, the unemployment rate remained above 5% for six consecutive quarters since the onset of the pandemic, registering unemployment rates of 5.7% and 5.1% in the first quarter and the second quarter of 2021, respectively. Accordingly, the unemployment rate during the first half of 2021 stood at 5.4%.

> ***Supply side disruptions during the third wave of the COVID-19 outbreak and adverse weather conditions caused high food inflation...***

Inflation, which remained subdued during early 2021, accelerated thereafter, driven mainly by high food inflation. Administratively determined prices of several commodities, including that of fuel, were revised upward in line with elevated global prices, and price controls on selected imported commodities were also removed. Accordingly, headline inflation as measured by the CCPI (2013=100), accelerated during recent months and exceeded the upper bound of the desired 4-6% range of inflation in October 2021. Headline inflation as measured by the NCPI (2013=100), also accelerated and remained at relatively high levels due to its higher weight on food items. Core inflation, which measures demand driven inflationary pressures, also accelerated moderately in recent months, indicating the buildup of demand pressures in the economy, with the gradual normalisation of economic activity.

Figure 1.2
Movements of Headline and Core Inflation (y-o-y)



Source: Department of Census and Statistics

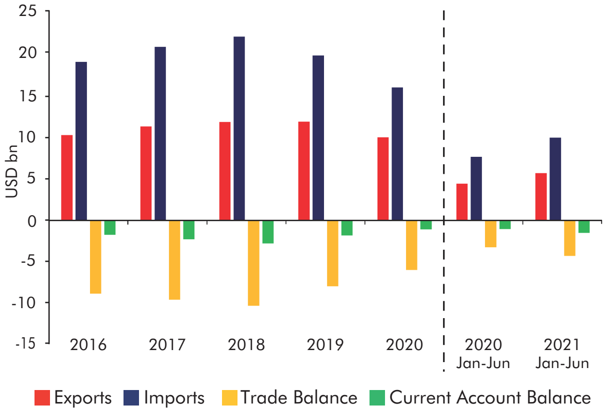
External Sector

The challenges posed by the COVID-19 pandemic heightened vulnerabilities in the external sector, while the timely measures adopted by the Government and the Central Bank helped the external sector to remain resilient thus far in 2021. The trade deficit widened in the eight months ending August 2021 due to the substantial increase in expenditure on imports, despite the recovery in earnings from merchandise exports. The trade deficit in the eight months ending August 2021 widened to USD 5.5 bn, compared to USD 3.8 bn in the comparable period in 2020. Export performance recorded a faster than expected recovery in almost all subsectors, including industrial, agricultural, and mineral exports, recording a healthy growth.

> ***Trade deficit widened so far in 2021 as the increase in imports offset the notable growth in exports...***

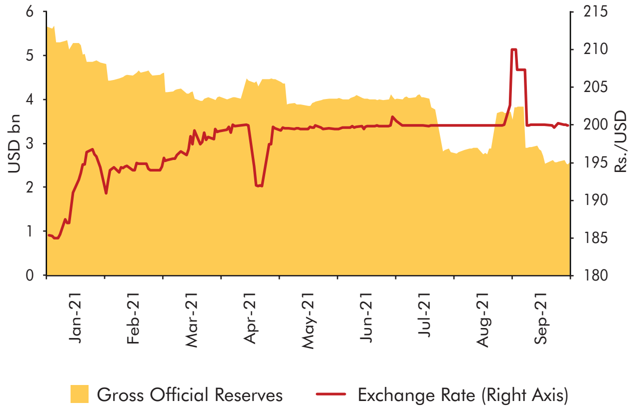
Despite the maintenance of some restrictions, import expenditure also grew as a result of increased domestic activity as well as increased global prices. The growth momentum of workers' remittances moderated with the decline in departures for foreign employment, the resumption of global travel activity, and a possible shift towards informal channels to remit money. However, an increase in migrant registration for foreign employment was observed in recent months, with the gradual opening up of migrant source countries.

Figure 1.3
Trade Balance and Current Account Balance



Source: Central Bank of Sri Lanka

Figure 1.4
Gross Official Reserves and Exchange Rate



Source: Central Bank of Sri Lanka

The deficit in the primary income account moderated during the first half of 2021 as dividend payments by DIEs as well as interest payments on government foreign loans were relatively low, compared to the first half of 2020. The tourism industry, which remained severely affected by the pandemic, recorded only a modest number of arrivals. However, the IT/BPO sector contributed to the services sector with a healthy growth. Earnings from the transportation sector also grew in the first half of 2021, supported by increased transshipment and cargo handling activities amidst the recovery of global and domestic economic activity. The current account recorded a deficit of USD 1.5 bn in the first half of 2021, compared to the deficit of USD 1.1 bn recorded in the first half of 2020. Inflows to the financial account remained limited during the first half of 2021. FDI, including foreign loans to DIEs, remained modest in the first half of 2021. The relatively low FDI inflows reflect the uncertainty caused by the intermittent COVID-19 outbreaks, globally and domestically. The main inflow to the financial account during the first half of the year was the receipt of a syndicated loan facility from CDB in April 2021. Further to these inflows, notable inflows to financial account were the SDR allocation from the IMF, the international swap facility with the Bangladesh Bank and the balance of the syndicated loan from the CDB in August 2021. In addition, the Central Bank secured an international currency swap facility with the PBOC, equivalent to approximately USD 1.5 bn, of which the proceeds are yet to be drawn. Outflows from the financial account remained significantly high due to large external debt service payments so far in 2021, including the maturity of an ISB of USD 1.0 bn in July 2021. Gradual foreign investment outflows were recorded in both the government securities market and the CSE. Consequently, the overall balance of the BOP recorded a notable deficit during the nine months ending September 2021. With limited foreign exchange inflows to the Government amidst the pandemic, and continued external debt service payments, the gross official reserves declined to USD 2.7 bn by end September 2021. Meanwhile, total foreign assets, which consist of gross official reserves and foreign assets of the banking sector, amounted to USD 6.1 bn at end September 2021. Sri Lanka's total outstanding external debt, based on the market value, increased by end June 2021, compared to the beginning of the year, mainly due to the changes stemming from an increase in market prices of Sri Lanka's outstanding ISBs.

> ***Despite limited foreign exchange inflows, Sri Lanka continued to honour all external debt obligations...***

The Sri Lanka rupee depreciated during January-April 2021 due to inadequate inflows to the domestic foreign exchange market amidst large outflows. The exchange rate reached to Rs. 199.54 per USD at end April 2021 from Rs. 186.41 per USD at end December 2020. Subsequently, the weighted average spot exchange rate in the interbank market was maintained at around Rs. 200 per USD with a high degree of moral suasion. The Central Bank intervened significantly in the domestic foreign exchange market recently by way of providing liquidity in order to meet payments for essential imports, as announced in the '*Six-Month Road Map for Ensuring Macroeconomic and Financial System Stability*' on 01 October 2021. Such intervention helped stabilise the exchange rate at current levels of around Rs. 200 per USD. The rupee depreciated against the USD by 7.7% from the beginning of the year to end October 2021. Reflecting cross currency exchange rate movements, the Sri Lanka rupee also depreciated against the pound sterling, the euro and the Indian rupee, while appreciating against the Japanese yen by end October 2021. The NEER and REER indices, which measure the movement of the Sri Lanka rupee against a basket of currencies, declined during the ten months ending October 2021. The REER indices remained below the base year level (2017=100), signalling that the exchange rate remains sufficiently competitive.

Fiscal Sector

Fiscal operations continued to face significant challenges during the seven months ending July 2021, mainly reflecting the adverse effects of the pandemic. Government expenditure increased by 10.8%, y-o-y, to Rs. 1,814.4 bn during the seven months ending July 2021, while government revenue and grants increased only by 4.5%, y-o-y, to Rs. 799.8 bn during the same period. The resultant expansion of the budget deficit elevated the outstanding debt of central government. Access to foreign financing, particularly from commercial sources, remained restricted, thereby exerting pressures on foreign currency debt servicing of the Government. Nevertheless, the Government duly repaid all maturing central government debt with the assistance of the Central Bank.

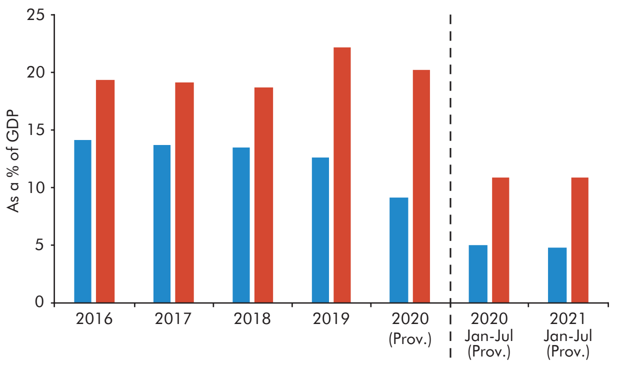
> ***Despite the limited fiscal space, extraordinary fiscal stimulus measures were implemented by the Government…***

Despite these challenges, the Government continued with the low tax regime and social welfare schemes, while providing direct financial support to individuals amidst the pandemic, thereby providing extraordinary fiscal stimuli, which helped to minimise the impact of the pandemic on the economy. Moreover, the Government successfully rolled out COVID-19 vaccines nationwide, thereby containing the pandemic to a great extent, while ensuring a faster recovery of the economy.

Government revenue mobilisation for the period from January to July 2021 increased to Rs. 798.9 bn (4.9% of estimated GDP) from Rs. 763.2 bn (5.1% of GDP) in the corresponding period of 2020. The increase in government revenue during the seven months ending July 2021 was benefited by the high revenue collection from PAL, VAT and CESS levy, reflecting the recovery of economic activity, compared to the same period in the preceding year. However, the current level of government revenue remains substantially below pre-pandemic levels.

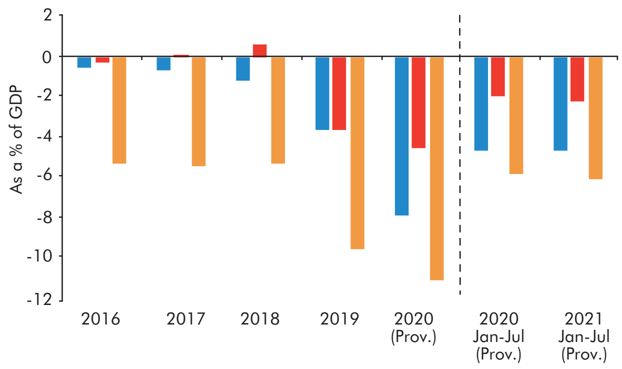
Meanwhile, expenditure and net lending rose to Rs. 1,814.4 bn (11.0% of estimated GDP) during the seven months ending July 2021 from Rs. 1,637.9 bn (10.9% of GDP) in the corresponding period of 2020. This increase

Figure 1.5
Government Revenue vs Expenditure (a)



(a) 2021 figures are based on GDP projections of the Central Bank.
Sources: Ministry of Finance
Central Bank of Sri Lanka

Figure 1.6
Key Fiscal Balances (a)



(a) 2021 figures are based on GDP projections of the Central Bank.
Sources: Ministry of Finance
Central Bank of Sri Lanka

reflects the escalated recurrent expenditure mainly due to the pandemic, as well as the rise in interest payments, and salaries and wages. Public investment increased to Rs. 242.7 bn (1.5% of estimated GDP) during the seven months ending July 2021 from Rs. 192.3 bn (1.3% of GDP) in the corresponding period of 2020. The increase in government expenditure offset the nominal increase in government revenue, causing the budget deficit to expand to Rs. 1,014.5 bn (6.2% of estimated GDP) during the period from January to July 2021 from Rs. 872.6 bn (5.8% of GDP) in the corresponding period of 2020. The current account deficit, which reflects the dissavings of the Government, increased to Rs. 779.1 bn (4.7% of estimated GDP) during the seven months ending July 2021 from Rs. 694.5 bn (4.6% of GDP) recorded in the same period of 2020. The primary balance, recorded a higher deficit of Rs. 377.2 bn (2.3% of estimated GDP) during January-July 2021 in comparison to the deficit of Rs. 288.9 bn (1.9% of GDP) during the corresponding period of 2020.

The relative share of outstanding foreign debt of central government declined further by end July 2021, from the levels observed at end 2020...

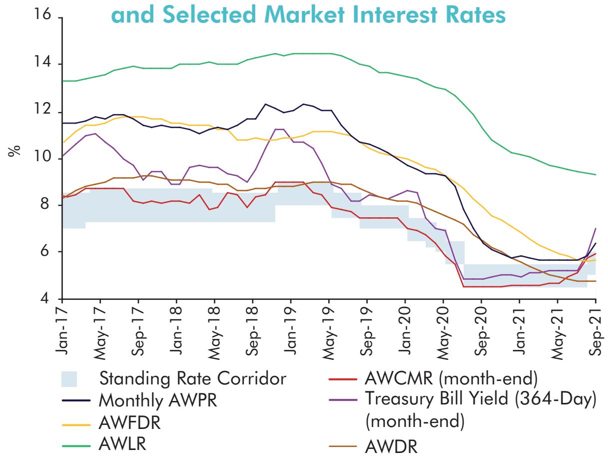
In financing the budget deficit, the Government relied entirely on domestic sources, reflecting the expectation of the Government to reduce exposure to foreign liabilities over the medium term, while the access to conventional global markets remained limited amidst rating downgrades by sovereign rating agencies. Net domestic financing amounted to Rs. 1,204.6 bn during the seven months ending July 2021, compared to Rs. 1,067.0 bn during the corresponding period of 2020, while foreign financing recorded a net repayment of Rs. 190.1 bn during the period under review, compared to a net foreign repayment of Rs. 194.5 bn recorded in the corresponding period of 2020. The Central Bank's contribution to net domestic financing rose to 45.6% in the seven months ending July 2021, compared to 17.5% in the same period last year. The Central Bank supported the Government in terms of providing financing in an unprecedented scale to meet the rising expenditure and debt servicing requirement. The central government debt, which stood at Rs. 15,117.2 bn at end 2020, increased to Rs. 16,751.7 bn at end July 2021. However, foreign exposure of central government debt declined with maturing ISBs, among other net repayments of foreign debt. By end July 2021, the relative share of outstanding foreign debt of the Central Government decreased to 38.4% of total central government debt, compared to 40.0% at end 2020.

Monetary Sector

The Central Bank continued the unprecedented monetary stimulus measures, which were deployed since early 2020 through a major part of 2021, in order to support the businesses and individuals affected by the pandemic, while facilitating the economic recovery. Low interest rates and surplus liquidity levels in the domestic money market resulted in a significant expansion in credit to the private sector. Further, the Central Bank introduced priority sector lending targets for licensed banks on lending to MSMEs in April 2021, with a view to providing further impetus to the needy and productive sectors of the economy. Accordingly, credit extended to the private sector expanded notably by 15.1%, y-o-y, by end August 2021, which, along with the rapid expansion in credit to the public sector, resulted

Supported by the low lending rates and reflecting the increased demand for credit, credit extended to the private sector expanded notably during January-August 2021...

Figure 1.7
Standing Rate Corridor and Selected Market Interest Rates



Source: Central Bank of Sri Lanka

Monetary Expansion during the COVID-19 Pandemic

The outbreak of the COVID-19 pandemic and its unprecedented impact on economies and financial markets forced central banks around the world to adopt extraordinary monetary policy measures, including unconventional policies at an unparalleled scale, to mitigate its impact on their economies and financial markets and prevent those economies from precipitating into a pandemic-driven crisis. The Sri Lankan case was no different. The spread of COVID-19 in Sri Lanka led to a nationwide lockdown during March-May 2020 sending tremors across all segments of the economy, followed by partial lockdowns and mobility restrictions with the resurgence of the pandemic in multiple waves thereafter, thus affecting the lives and livelihoods of millions. Restrictions on mobility, the closure of factories, and the halting of domestic production were set to amplify uncertainty and trigger a massive shock on domestic demand. A swift and substantial policy intervention was required to minimise the impact of the shock on the markets and the economy.

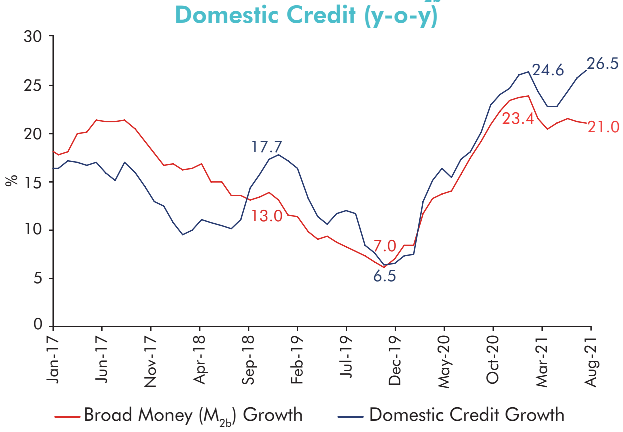
Accordingly, the Central Bank of Sri Lanka adopted a series of policy easing measures at the onset of the pandemic. With a view to reducing the cost of borrowing, the Central Bank reduced its key policy interest rates, while reducing specific lending rates through the imposition of caps as well as the introduction of special low interest rate loan schemes. Further, the reduction of the SRR, provision of required financing to the Government through the purchase of Treasury bills, and the implementation of concessional credit schemes such as the Saubagya COVID-19 Renaissance Facility infused liquidity to the domestic financial market, thereby easing strains in the financial markets, while also encouraging lending to the needy sectors of the economy. The Central Bank provided further relief to distressed businesses and individuals affected by the pandemic by implementing several debt moratoria schemes, while also supporting financial institutions through regulatory forbearance. In addition, the Central Bank continued to fulfill the currency requirements to facilitate transactions in the domestic economy and the increased precautionary demand for currency amidst pandemic-related uncertainties.

Reinforced by these stability-focused and growth-supportive measures implemented by the Central Bank, the domestic economy managed to avert a major economic catastrophe, made gradual headway, and recorded a noteworthy recovery in economic activity and sentiments. Moreover, a notable increase in the provision of low cost credit to the needy and more productive sectors of the economy was also observed, thereby further enhancing its growth prospects. The World Economic Outlook of the IMF also suggested that if not for the swift policy support globally, the severity of the global economic downturn could have been at least three times as large, which signifies the importance of policy stimuli and the possible economic loss if not for such policy support.

With economic activity around the globe gradually reaching normalcy supported by policy stimuli and the successful rollout of the COVID-19 vaccination programmes, central banks around the globe have signalled the need to tighten monetary policy, with some already having taken measures to rollback the support extended since the onset of the pandemic. In the same vein, the Central Bank of Sri Lanka, having observed the gradual normalisation of domestic economic activity and the resultant buildup of demand driven inflationary pressures in the future, allowed monetary conditions to tighten since mid 2021 and signalled the end to its easing monetary policy stance in mid August 2021 by raising its key policy rates, while raising the SRR with effect from 01 September 2021. Furthermore, the maximum yield rates for acceptance at primary auctions of government securities were also removed mid September 2021 onwards, allowing yields on government securities to adjust and be market-determined, while also limiting the need for the Central Bank's purchases of Treasury bills at the primary market auctions. In addition, the Central Bank has continued to conduct overnight and term repurchase (repo) auctions amidst deficit liquidity levels in the domestic money market with a view to maintaining the prevailing tight monetary conditions. Lastly, having identified the need to rollback the notable levels of financing extended to the Government during the pandemic, the Central Bank would work towards gradually unwinding such monetary stimulus as enunciated in '*The Six-Month Road Map for Ensuring Macroeconomic and Financial System Stability*', with a view to preserving macroeconomic and financial system stability without affecting the ongoing recovery of the domestic economy.

in broad money supply (M_{2b}) to grow by 21.0%, y-o-y, by end August 2021. However, the Central Bank implemented monetary tightening measures in mid August 2021, due to the imbalances that emerged in the domestic financial markets and the external sector, while also considering the possible buildup of inflationary pressures resulting from the lagged effects of large fiscal and monetary stimuli already provided to the economy. Accordingly, the key policy interest rates, i.e., SDFR and SLFR, were raised by 50 bps to 5.00% and 6.00%, respectively, and SRR was raised by 2 pps to 4.00%, effective from September 2021. Market interest rates, which declined notably since early 2020 reflecting the passthrough of extraordinary monetary easing measures, commenced responding to monetary and liquidity tightening measures of the Central Bank.

Figure 1.8
Growth of Broad Money (M_{2b}) and Domestic Credit (y-o-y)



Source: Central Bank of Sri Lanka

Table 1.1
Recent Monetary Policy Measures

Date	Measure
30 Jan 2020	SDFR and SLFR reduced by 50 bps to 6.50% and 7.50%, respectively.
17 Mar 2020	SDFR and SLFR reduced by 25 bps to 6.25% and 7.25%, respectively.
17 Mar 2020	SRR reduced by 1.00 pp to 4.00% to be effective from the reserve period commencing 16 Mar 2020.
27 Mar 2020	Introduced a concessional loan scheme, the Saubagya COVID-19 Renaissance Facility (Phase I - Refinance Scheme), up to a cumulative value of Rs. 50 bn at an interest rate of 4.00% to support the businesses affected by COVID-19.
03 Apr 2020	SDFR and SLFR reduced by 25 bps to 6.00% and 7.00%, respectively, to be effective from the close of business on 03 Apr 2020.
16 Apr 2020	Bank rate reduced by 500 bps to 10.00% and allowed to automatically adjust in line with the SLFR, with a margin of +300 bps.
06 May 2020	SDFR and SLFR reduced by 50 bps to 5.50% and 6.50%, respectively, to be effective from the close of business on 06 May 2020. Bank Rate automatically reduced to 9.50%.
16 Jun 2020	SRR reduced by 2.00 pps to 2.00% to be effective from the reserve period commencing 16 Jun 2020.
16 Jun 2020	Extended the concessional loan scheme introduced on 27 Mar 2020 up to Rs. 150 bn at an interest rate of 4.00% to support the businesses affected by COVID-19 (the Saubagya COVID-19 Renaissance Facility - Phase II)
09 Jul 2020	SDFR and SLFR reduced by 100 bps to 4.50% and 5.50%, respectively. Bank Rate automatically reduced to 8.50%.
19 Aug 2021	SDFR and SLFR increased by 50 bps to 5.00% and 6.00%, respectively. Bank Rate automatically increased to 9.00%.
19 Aug 2021	SRR increased by 2.00 pps to 4.00% to be effective from the reserve period commencing 01 Sep 2021.

Source: Central Bank of Sri Lanka

Note: The Central Bank imposed caps on interest rates and lending targets as follows:
- 27 Apr 2020 : Imposed interest rate caps on pawning advances of licensed banks
- 24 Aug 2020 : Tightened interest rate caps on selected lending products
- 26 Nov 2020 : Introduced maximum interest rates on mortgage-backed housing loans
- 21 Apr 2021 : Introduced priority sector lending targets for licensed banks on MSMEs

Financial Sector

Amidst challenging global and domestic macroeconomic conditions stemming from the pandemic, the financial sector remained resilient during the period under review. Assets of the banking sector grew together with increasing profitability. However, the banking sector faced challenges due to declining foreign currency liquidity and deteriorating credit quality. Meanwhile, the LFCs and SLCs sector recorded a marginal increase in the asset base. Despite some LFCs and SLCs making losses, profitability of the sector as a whole increased, although the rise in NPLs remained a concern. Nevertheless, licensed banks and LFCs and SLCs reported adequate provisioning, capital and liquidity buffers, thereby ensuring their soundness. The Central Bank renewed the Master Plan for Consolidation of the financial sector to overcome the longstanding issues in the sector. The consolidation process is in progress, aimed at encouraging mergers and acquisitions, and new capital infusion to the sector. Other subsectors in the financial sector, such as insurance, stockbrokers, unit trusts, and provident funds, recorded a mixed performance during the period under consideration. With regard to financial markets, liquidity in the domestic money market declined considerably in July 2021 and turned negative by August 2021, reflecting mainly the effects of monetary policy and operations, while the domestic foreign exchange market encountered pressures due to large outflows amidst subdued inflows. However, the equity market recorded a remarkable performance, despite some volatilities and foreign investment outflows. The financial infrastructure ensured a smooth functioning of the financial sector, despite heightened uncertainties due to the COVID-19 pandemic.

1.2 International Economic Environment

The global economy recorded a gradual recovery from the effects of the pandemic, despite notable disparities across economies. According to the WEO of the IMF released in October 2021, the global economy, which contracted by 3.1% in 2020, is projected to grow by 5.9% in 2021 and 4.9% in 2022. Large disparities in access to vaccines and policy support remain major concerns due to their impact on economic prospects. Aggregate output for advanced economies is expected to rebound to its pre-pandemic growth path in 2022 and exceed it by 2024, while the projected growth of emerging market and developing economies (excluding China) is expected to remain below the pre-pandemic forecast in 2024. Accordingly, advanced economies are projected to grow by 5.2% and 4.5% in 2021 and 2022, respectively. The United States is projected to grow by 6.0% in 2021 and 5.2% in 2022, compared to a contraction of 3.4% in 2020. Economic activity in the euro area is projected to pick up markedly from a contraction of 6.3% in 2020 to a growth of 5.0% in 2021 and 4.3% in 2022. Emerging market and developing economies, which contracted by 2.1% in 2020, are expected to grow by 6.4% in 2021, followed by 5.1% in 2022. Strong growth of 7.2% and 6.3% projected for 2021 and 2022, respectively, for emerging and developing Asia, is mainly based on the expected high growth in China and India. Despite the reduction in public investment, the Chinese economy is expected to grow by 8.0% in 2021 before slowing to 5.6% in 2022. Growth prospects for India remain robust where the economy is projected to grow by 9.5% in 2021 and 8.5% in 2022.

Inflation rates have increased rapidly across economies so far in 2021, partly fuelled by the strengthening of economic activity as well as global supply chain disruptions amidst the pandemic. Consumer prices in some advanced economies and emerging market and developing economies have increased at a faster pace, reflecting the combined effect of pandemic induced supply-demand mismatches, rising commodity prices, and policy related developments, such as the expiration of temporary tax cuts introduced last year in some countries.

Uncertainties about global inflation remain high, as some major central banks predict that the pressures on global commodity prices could last longer than previously anticipated. Price pressures in emerging market and developing economies are also expected to persist due to high food prices, lagged effects of high energy prices, and currency depreciation, among others. Accordingly, consumer price inflation in advanced economies is projected at 2.8% in 2021, while that of emerging market and developing economies is expected to be 5.5% in 2021. With the expected economic recovery in advanced economies, oil prices are expected to increase by almost 60% in 2021. Non-oil commodity prices are expected to rise by nearly 30% above 2020 levels, particularly reflecting the recent spike in metal and consumer food prices. However, the price pressures are projected to ease to some extent over the medium term, supported by preemptive actions by central banks, as well as the expected improvement in global supply chains.

Table 1.2
Changes in Policy Interest Rates of Selected Central Banks

%

Country	Key Policy Rate	End 2018	End 2019	End 2020	15 Oct 2021
Sri Lanka	SDFR	8.00	7.00	4.50	5.00
	SLFR	9.00	8.00	5.50	6.00
Emerging Market Economies					
India	Repo Rate	6.50	5.15	4.00	4.00
Malaysia	Overnight Policy Rate	3.25	3.00	1.75	1.75
Thailand	1-day Bilateral Repo Rate	1.75	1.25	0.50	0.50
China	1-year Loan Prime Rate	4.35	4.15	3.85	3.85
Indonesia	7-day Reverse Repo Rate	6.00	5.00	3.75	3.50
Philippines	Overnight Reverse Repo Rate	4.75	4.00	2.00	2.00
Advanced Economies					
USA	Federal Funds Rate	2.25-2.50	1.50-1.75	0.00-0.25	0.00-0.25
UK	Bank Rate	0.75	0.75	0.10	0.10
ECB	Refinance Rate	0.00	0.00	0.00	0.00
Japan	Overnight Call Rate	-0.10	-0.10	-0.10	-0.10
Canada	Overnight Rate	1.75	1.75	0.25	0.25
Australia	Cash Rate	1.50	0.75	0.10	0.10
Sweden	Repo Rate	-0.50	-0.25	0.00	0.00

Source: Websites of respective central banks

Significant uncertainties associated with the evolution of the pandemic, the inflation outlook and shifts in global financial conditions would continue to affect the resilience of the global economic recovery. Further, persistent supply-demand mismatches and resultant inflationary pressures leading to faster than anticipated monetary policy normalisation in advanced economies could tighten the global financial conditions. In addition, volatilities in financial markets, social unrest in some countries, adverse climate shocks, cyber attacks, and intensification of trade and technology tensions, etc., could weigh on the global economic recovery. Nevertheless, expediting the vaccination drive and the acceleration of productivity growth driven by technology would help strengthen the global economic recovery in the period ahead.

1.3 Expected Developments

Proactive measures aimed at the expeditious containment of the pandemic, rapid progress of the vaccination drive and continued policy commitment to creating an export oriented production economy are expected to help the economy to rebound during 2021 and to maintain a high growth trajectory thereafter. In 2021, the economy is expected to grow by about 5.0%, which is a downward revision over the initial projection of 6.0%, due to the moderation in economic activity, particularly during the period from April to September 2021, owing to the imposition of mobility restrictions to contain the spread of the pandemic. However, the mobility restriction measures thus far in 2021 were less stringent, compared to the strict lockdown imposed in the first half of 2020. In addition, the Government's COVID-19 vaccination drive, which is aimed at vaccinating all citizens above the age of 18 years by the end of 2021, will further facilitate the continuation of economic activity. Meanwhile, the '*Six-Month Road Map*', announced by the Central Bank on 01 October 2021, introduced multiple measures to be implemented in collaboration with all stakeholders in the economy, targeting the revival of economic activity in the short run, as well as the medium to long run, thereby complementing the measures being implemented by the Government. These measures will help bolster investor confidence and improve the doing business environment, while fostering macroeconomic and financial system stability.

> ***Implementation of structural reforms remains crucial in strengthening the medium to long term growth trajectory of the economy...***

The medium term growth trajectory centres on the ongoing thrust of the Government towards creating an export oriented production economy, with greater diversification of economic activity. Large scale investments, such as the Colombo Port City project and the development of industrial zones such as the Hambantota Industrial Zone, are expected to attract much needed foreign capital in the period ahead. The Government's regional development initiatives are expected to minimise income disparities in the country and promote inclusive growth. Once near term stabilisation objectives are achieved, the envisaged high growth trajectory in the post-pandemic economy is expected to translate into increased employment opportunities, high living standards, and sustainable growth. Supported by these policy endeavours, economic growth is expected to rebound and steadily progress above 5.0% in the medium term, thereby ensuring the shared benefits of growth in the country. However, effective implementation of the long awaited and growth inducing structural reforms is important for the country to overcome heightened vulnerabilities witnessed amidst the pandemic.

The resilience of the external sector is expected to improve in the period ahead, supported by the measures undertaken for export promotion and attracting non debt creating foreign inflows, alongside the revival of the tourism industry. The rising energy and other commodity prices, driven by the global economic recovery as well as supply chain disruptions, together with the recovery of domestic activity and the gradual relaxation of import compression measures, could raise import expenditure in the period ahead, although the observed rise in import alternative production processes is likely to help reduce import expenditure to some extent. However, the notable growth in merchandise exports, witnessed thus far in 2021, is expected to continue in the period ahead, thereby cushioning the trade deficit to some extent. The emphasis placed by the Government on promoting certain industries is expected to provide the impetus needed to sustain the growth momentum in the export sector in the period ahead. In addition to merchandise trade sectors, the Government is in the process of actively promoting trade in services and inflows on account of workers' remittances. Further, the development of the national trade policy, ongoing infrastructure improvements, establishment of special economic zones, and strengthening economic diplomacy with major trade partnering countries/regions are expected to broaden the potential for Sri Lanka's exports in the medium term.

> ***The external sector resilience is expected to be reinforced in the period ahead with the expected foreign exchange inflows...***

The tourism sector is expected to mark a strong recovery with the successful rollout of the national vaccination drive, and the gradual phasing out of the mobility restrictions, alongside the improved momentum in global travel. Workers' remittances are expected to improve from the levels observed in August and September 2021, as the departures for foreign employment are expected to rise with improving global travel and firming demand for labour as global activity normalises. Further, the stabilisation of the exchange rate in the domestic foreign exchange market, and the narrowing differential of exchange rates between the official and the grey markets would help attract more foreign remittances through formal channels.

Improved competitiveness of the Sri Lanka rupee, as reflected in the REER indices, alongside the efforts of the Government, particularly through the sectoral task forces, to promote merchandise exports and trade in services, the trade balance as well as the external current account balance, as a percentage of GDP, are expected to improve in the medium term.

> ***The recently announced 'Six-Month Road Map' sets out strategies to reinforce the stability of the external sector in the near to medium term, and is also aimed at restoring confidence of all stakeholders in the economy...***

Financial flows are expected to strengthen in the period ahead with the envisaged inflows in the form of international swap arrangements, foreign currency term loans, project loans to the Government, and monetising of non strategic assets. Further, several FDI projects are currently in the pipeline and are being expedited. The expected improvements in the BOP would bolster foreign assets of the country, while improving gross official reserves and strengthening exchange rate stability in the period ahead. Gross official reserves are expected to remain at around USD 3.5 bn at end 2021, and around USD 4.0 bn on average in 2022.

With appropriate adjustments, fiscal sector performance is expected to improve over the medium term, despite the envisaged expansion of the budget deficit in 2021 amidst the cashflow disruptions due to the pandemic. Government revenue mobilisation is expected to improve in the medium term as economic activity normalises. Further, the envisaged expenditure rationalisation efforts would help create much needed fiscal space for productive public investment over the medium term. In line with improved revenue and rationalised expenditure of the Government, the budget deficit is expected to reduce gradually over the medium term, as enunciated in the medium term policy framework of the Government. In line with the reduction of the budget deficit, the current account and primary balances are also expected to improve over the medium term, thereby supporting debt consolidation efforts of the Government. Accordingly, the outstanding central government debt to GDP ratio is expected to decline in the medium term, supported also by improvements in economic growth. The financing strategy of the Government is expected to lower the foreign exposure of government liabilities, thereby helping to reduce vulnerabilities associated with foreign debt service payments. The exposure to ISBs is expected to decline to 16.0% of estimated GDP by end 2021 from 17.9% of GDP recorded at end 2019, and it is projected to reduce further to around 10% of GDP over the medium term.

Reflecting the tight monetary and liquidity conditions since mid August 2021, market interest rates are expected to stabilise at a higher level in the period ahead. However, tightening of the monetary policy stance is not expected to result in a return to the excessively high interest rates that prevailed in the past. The market lending rates are expected to be at competitive levels to support sustainable credit flows to the private sector, while deposit rates are expected to provide real returns to savers. Despite the increase in market lending rates, the momentum in credit expansion is expected to continue in the period ahead, with increasing credit flows to productive and needy sectors of the economy.

The upward adjustments in retail market prices of some commodities, mainly driven by supply side factors and increased global commodity prices, are likely to increase inflationary pressures in the near term, causing a deviation of headline inflation from the targeted levels. Accordingly, inflation is projected to remain high at around 8-9% in the next few months, before gradually reverting to the desired 4-6% level thereafter. Addressing near term transitory supply side pressures require timely measures by the Government, thereby preventing such inflationary pressures from affecting the medium term inflation expectations. Measures taken by the Central Bank will help alleviate the buildup of demand side inflationary pressures, alongside the gradual unwinding of the Central Bank's holding of government securities, and the Central Bank remains committed to maintaining headline inflation in the 4-6% range over the medium term, within the flexible inflation targeting framework by taking preemptive measures, as and when required.

With the economy gradually adjusting towards a new normal from the adverse effects of the pandemic, the banking sector is envisaged to maintain its growth momentum in the period ahead. The scaling back of debt moratoria could affect NPLs, while it will also impact positively on the liquidity levels of the banking system. Pressures on foreign currency liquidity in the banking sector are expected to ease with the implementation of measures to enhance the foreign reserves of the country. Measures implemented to enhance the stability and resilience of the banking sector by way of retention of profits and raising new capital to meet the increased minimum capital requirements by end 2022 will improve capital levels of the banks and provide necessary capital buffers for future growth of the banking sector. In the non-bank financial institutions sector, the Finance Business Act and the Finance Leasing Act are being amended to strengthen the resolution framework and to address the concerns raised on leasing business related laws. Further, regulatory framework will be strengthened to promote good governance and facilitate technology driven financial intermediation through the LFCs sector. Successful implementation of the Master Plan for Consolidation is expected to build 25 strong and stable LFCs, while strengthening the capital levels of the sector in the medium term.

Post-pandemic economic recovery will depend largely on the ability of the economy to adapt fast to the new normal, and this adaptation will require bold measures from all stakeholders of the economy…

The extraordinary fiscal and monetary policy stimulus provided to the economy, the rapid rolling out of the national vaccination programme against COVID-19 and the expected revival in global economic activity are expected to support Sri Lanka's near term growth prospects. However, the envisaged post-pandemic economic recovery and achievement of a high and sustainable growth path while maintaining macroeconomic and financial system stability depend largely on the ability of the economy to adapt fast to the new normal. This adaptation will require bold measures from all stakeholders to enable the economy to swiftly implement evidence based policies aimed at improving efficiency, productivity and resilience of the economy. Although reform policies may entail near term adjustment costs, long term benefits accruing to the wider economy would exceed such costs in the period ahead.

Abbreviations and Acronyms

ASPI	:	All Share Price Index
AWCMR	:	Average Weighted Call Money Rate
AWDR	:	Average Weighted Deposit Rate
AWFDR	:	Average Weighted Fixed Deposit Rate
AWLR	:	Average Weighted Lending Rate
AWPR	:	Average Weighted Prime Lending Rate
bn	:	Billion
BOP	:	Balance of Payments
bps	:	Basis Points
BT	:	Before Tax
CCPI	:	Colombo Consumer Price Index
CDB	:	China Development Bank
CESS	:	Commodity Exports Subsidy Scheme
CSE	:	Colombo Stock Exchange
DBU	:	Domestic Banking Unit
DCS	:	Department of Census and Statistics
DIEs	:	Direct Investment Enterprises
FDI	:	Foreign Direct Investment
GDP	:	Gross Domestic Product
GWP	:	Gross Written Premium
IMF	:	International Monetary Fund
ISB	:	International Sovereign Bond
IT/BPO	:	Information Technology and Business Process Outsourcing
LFC	:	Licensed Finance Companies
LFPR	:	Labour Force Participation Rate
LPG	:	Liquefied Petroleum Gas
M_{2b}	:	Consolidated broad money supply
mn	:	Million
MSMEs	:	Micro, Small, and Medium scale Enterprises
NCG	:	Net Credit to the Government
NCPI	:	National Consumer Price Index
NEER	:	Nominal Effective Exchange Rate
NPL	:	Non Performing Loans
PAL	:	Ports and Airports Development Levy
PBOC	:	People's Bank of China
pps	:	Percentage Points
Prov.	:	Provisional
REER	:	Real Effective Exchange Rate
Rs./LKR	:	Sri Lanka Rupee
SDFR	:	Standing Deposit Facility Rate
SDR	:	Special Drawing Rights
SLC	:	Specialised Leasing Companies
SLFR	:	Standing Lending Facility Rate
SOBEs	:	State Owned Business Enterprises
SRR	:	Statutory Reserve Ratio
T-bill	:	Treasury bill
tn	:	Trillion
USD	:	United States Dollar
VAT	:	Value Added Tax
WEO	:	World Economic Outlook
y-o-y	:	Year-on-Year
y-t-d	:	Year-to-Date