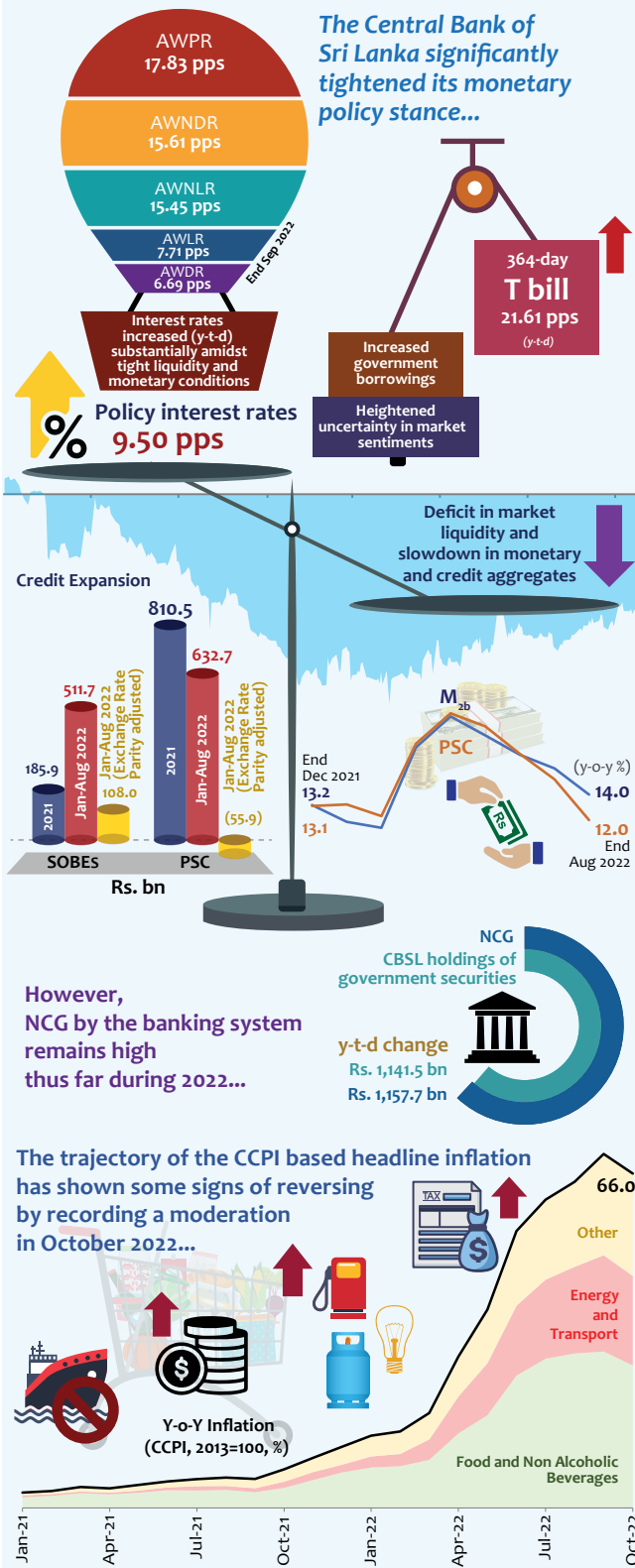


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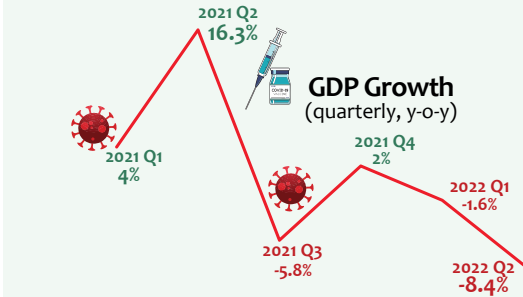
Economic Performance and Outlook

The Sri Lankan economy, which faced extreme headwinds and heightened uncertainties during the first half of 2022, has shown signs of stability in the second half of the year thus far, helped by the myriad of multifaceted policy interventions undertaken to steer the economy to transition towards a path of stable and sustainable growth over the medium term. Although the economy was on a recovery path subsequent to the abating of the COVID-19 pandemic, its progress was muted by the culmination of the entrenched twin deficits in the government budget and external current account. Hence, the growth momentum observed towards the end of 2021 dissipated rapidly and the real economy fell into a contraction during the first half of 2022, driven by the spillover effects of the unprecedented economic crisis felt across several sectors, owing to fuel shortages, power outages, widespread scarcity of key imported raw materials and other essentials, and the soaring cost of production, among other factors. The steady rise in inflation to historically high levels since the beginning of the year has hollowed out household purchasing power. This anomalous rise in inflation stemmed from domestic and global supply side disruptions, the undertaking of long overdue adjustments in administrative prices, the sharp depreciation of the Sri Lanka rupee against the USD, and the release of pent-up demand pressures emanating from the lagged impact of monetary accommodation in the recent past. Moreover, the expansionary fiscal policy with the low tax regime introduced in late 2019 fuelled inflation, not only by directly enhancing aggregate demand but also by necessitating monetary financing to bridge the expanding budget deficit amidst the lack of access to international capital markets following the rating downgrades. The monetary tightening efforts, which commenced in August 2021, accelerated thus far in 2022 to avoid possible de-anchoring of inflationary expectations and arrest lingering demand driven pressures. Supported by these measures and the easing of supply side pressures, inflation commenced moderating along the envisaged disinflation path in October 2022. Meanwhile, the passthrough of monetary tightening measures coupled with persistently tight money market liquidity conditions led to sharp upward adjustments in market interest rates resulting in a substantial decline in private sector credit. Nevertheless, net credit to the Government by the banking system expanded notably amidst low government revenue and limited

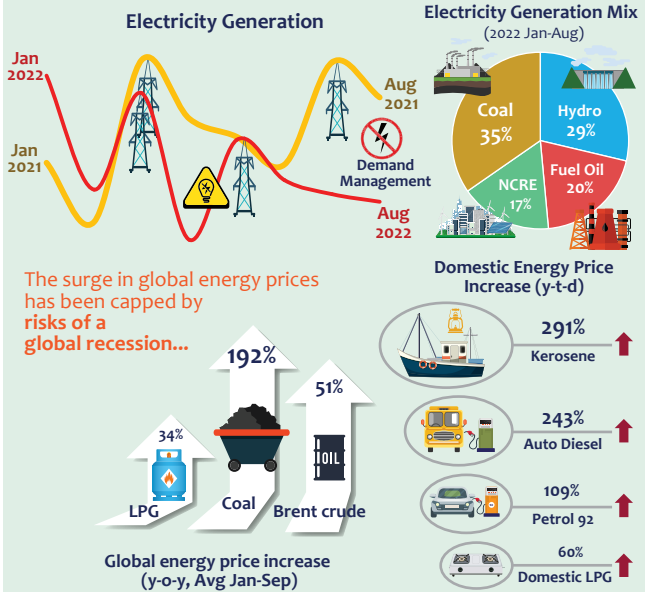
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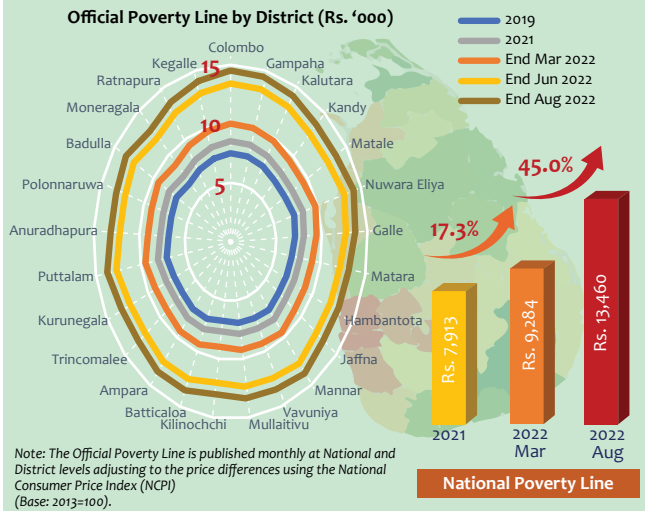
Sri Lankan economy continues to battle through the worst economic crisis on record...



Economic activity dampened by the prolonged supply side constraints...



Ongoing crisis could have disproportionate impact on households' welfare status...



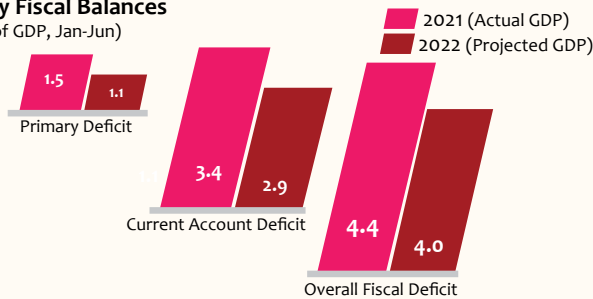
Banking Sector	Total Assets (Rs. tn)	Total Capital Adequacy Ratio (%)	Stage 3 Loans to Total Loans (%)	Return on Assets (Before Tax) (%)	Statutory Liquid Assets Ratio (DBU) (%)	Gross Stage 3 Loan Ratio (%)	Total Risk Weighted Capital Adequacy Ratio (RWCAR) (%)	Return on Assets (%)
End Aug 2021	16	19	5.0	1.3	36.1	10.8	16.6	4.5
End Aug 2022	19	16.3	10.6	1.1	27.3	18.0	21.8	2.4
End Jun 2021	15.2	15.2	5.0	1.3	36.1	10.8	16.6	4.5
End Jun 2022	15.2	15.2	10.6	1.1	27.3	18.0	21.8	2.4
End Aug 2021	5.0	15.2	10.6	1.3	36.1	10.8	16.6	4.5
End Aug 2022	5.0	16.3	10.6	1.1	27.3	18.0	21.8	2.4
End Dec 2021	5.0	15.2	10.6	1.3	36.1	10.8	16.6	4.5
End Aug 2022	5.0	16.3	10.6	1.1	27.3	18.0	21.8	2.4

SRI LANKAN ECONOMY

The beneficial impact of fiscal policy measures introduced thus far during 2022, aimed at improving revenue while curtailing expenditure, is yet to be fully reflected in fiscal sector performance...

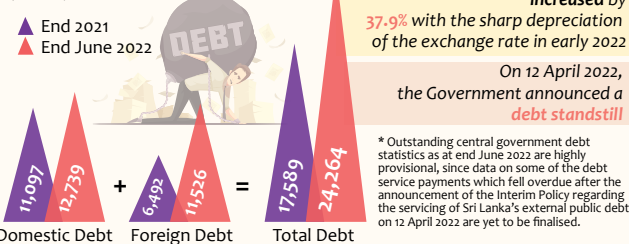
Key Fiscal Balances

(% of GDP, Jan-Jun)

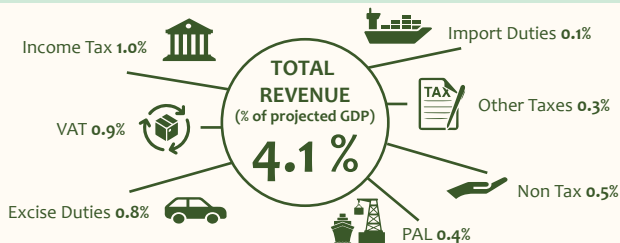


Central Government Debt

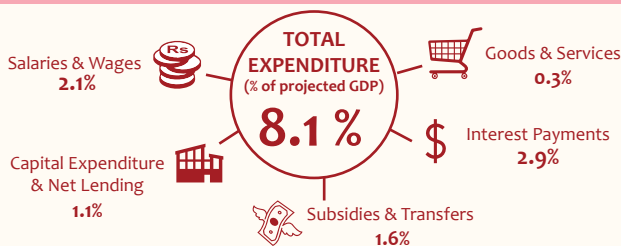
(Rs. bn)



Tax revenue improved due to Surcharge Tax, increased Value Added Tax (VAT) rates and Telecommunication Levy, and high inflation during the first half of 2022



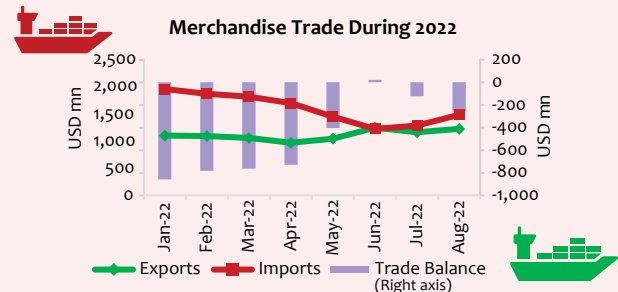
Despite the expenditure rationalisation attempts in the latter part of the period under review, government spending was on a rising trend, in nominal terms, in the first half of 2022



Fiscal Consolidation Measures

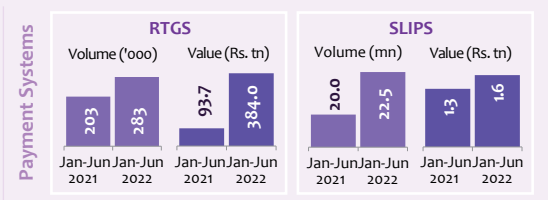
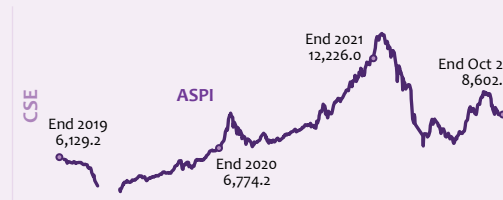
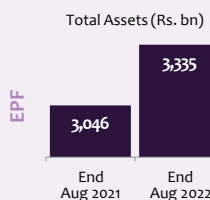
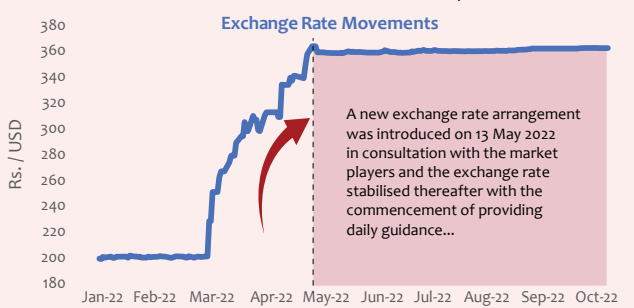
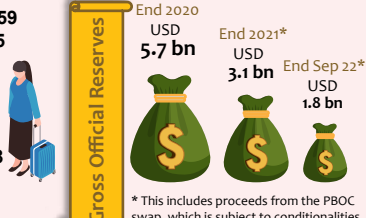
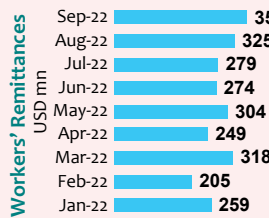
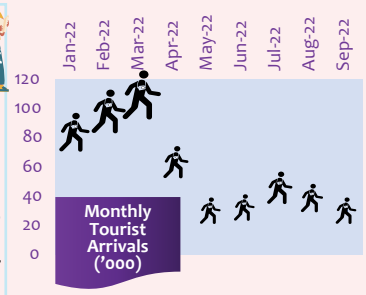
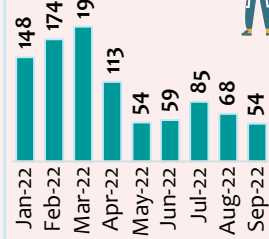
- Revenue enhancement measures
 - Increase in VAT rates
 - Imposition of Surcharge Tax
 - Increase in Telecommunication Levy
 - Imposition of Social Security Contribution Levy
- Expenditure rationalisation measures
 - Guidelines were issued to the public sector to minimise the usage of electricity and fuel while restricting unproductive/non-essential expenses
- Cost reflective pricing

The external sector in Sri Lanka has been facing unprecedented challenges in recent years, amidst headwinds caused by the COVID-19 pandemic, dearth in forex liquidity and adverse developments on the global front...



Earnings from Tourism

(USD mn)



access to foreign financing sources. The growth of broad money supply (M_{2b}), once adjusted for the impact of the depreciation of the rupee, has registered a deceleration from its peak in April 2022 driven mainly by the contraction in private sector credit and the decline in net foreign assets of the banking system. During the year, servicing of external debt became increasingly challenging, given the lack of access to international markets due to consecutive sovereign downgrades and the bunching of large foreign debt service payments amidst lacklustre foreign exchange inflows. With due consideration to these challenging circumstances, the Government announced a standstill on external debt servicing on account of bilateral and commercial loans for an interim period commencing from 12 April 2022. In the period thereafter, with the intention of helping the economy to transit to a stable and more sustainable footing, the Government embarked on a reform programme through the introduction of a slew of measures to increase both tax and non-tax revenue, while continuing its drive to further rationalise expenditure through the curtailment of non-urgent capital expenditure and recurrent expenditure. Further the Government opted to seek financial assistance from the IMF by way of an EFF arrangement. However, the overstretched fiscal position, which is already weighed down by soaring levels of debt, offered little fiscal leeway to undertake measures that could catalyse the economic recovery process. The external sector also continued to grapple with heightened challenges amidst the dearth of liquidity in the domestic foreign exchange market. Despite the subduing of import demand and the announcement of the debt standstill, modest inflows to the current and financial accounts were insufficient to tame pressures on the exchange rate. The external current account deficit widened in the first half of 2022, compared to the same period in 2021. The trade deficit narrowed due to the moderation in imports driven mainly by import control measures, lack of availability of foreign exchange in the market, depreciation of the exchange rate, tighter monetary conditions and the robust export performance. Tourism earnings recorded some turnaround, while workers' remittances remained subdued despite recording some revival in recent months. The heightened pressures on the exchange rate necessitated a measured adjustment, which was allowed on 07 March 2022. However, the sparse liquidity conditions in the domestic foreign exchange market and adverse market perceptions caused a sharper than expected depreciation of the exchange rate. With a view to curtailing excessive and speculative volatilities in the intraday exchange rate, the Central Bank commenced providing guidance to the market by announcing a middle rate and a variation margin of the interbank weighted average spot exchange rate from 13 May 2022. This enabled restoring stability in the exchange rate to a greater extent and minimising the gap between official and grey market exchange rates. The engagement with the IMF on a macroeconomic adjustment programme progressed on many fronts, with a staff level agreement for an EFF being reached in early September 2022. The debt restructuring process has also reached an advanced stage.

The economic issues in Sri Lanka are encapsulated in deeply entrenched structural weaknesses that are a culmination of the lack of policymakers' commitment to undertaking holistic and efficacious reforms over the long run. The IMF-EFF programme will provide an opportunity to embark on much needed and long neglected structural adjustments in a more structured and timely manner, which will be instrumental in shaping the economy to progress on a trajectory of greater stability and sustained growth. Nevertheless, the expected near term recovery of the economy is fraught with many challenges due to the unprecedented scale of the crisis that the economy is facing and uncertainties on several fronts which may require swift policy actions as circumstances evolve. In the midst of significant economic challenges on the domestic front, the economy will also have to grapple with global uncertainties emanating from monetary policy tightening measures adopted by major central banks in response to surging inflation, the spillover effects of geopolitical tensions and thereby a looming global recession, which will make the external environment less conducive for economic recovery.

Considering the progress that has been made thus far in relation to the IMF-EFF programme and debt restructuring negotiations, and the reforms that have already been undertaken and those that are to be implemented in the period ahead, the economy is expected to transition onto the path to recovery from the latter part of 2023. Nevertheless, this will hinge on policymakers' unwavering commitment to implementing policy reforms in a timely, holistic, and efficacious manner while ensuring that such commitment remains unhampered by political and election cycles. This is imperative to prevent any oscillations of national policies in the crucial period ahead in order to strengthen the economy's resilience to external shocks, thereby ensuring its unwavering progress over the medium term.

1.1 Sectoral Developments

Real Sector and Inflation

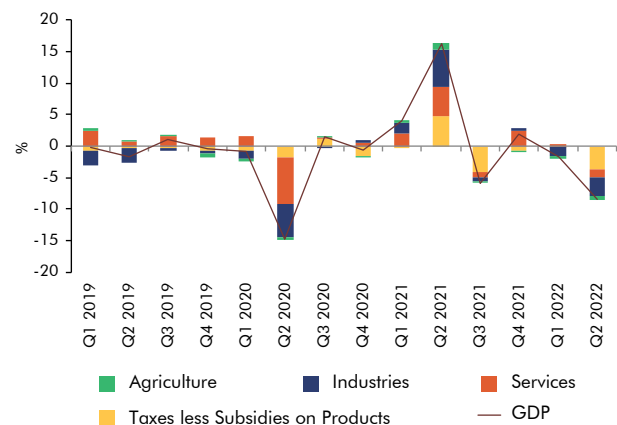
As per the provisional estimates of the Department of Census and Statistics, the Sri Lankan economy witnessed a y-o-y contraction of 4.8% during the first half of 2022, compared to the growth of 9.3% in the corresponding period of 2021. The gradual recovery in economic activity, which was observed with the abating of the COVID-19 pandemic, reversed since the beginning of 2022, with the deepening of the economic crisis and heightened uncertainties caused by the dearth of foreign exchange liquidity, resulting in a contraction of the real economy during the first half of 2022. Frequent power outages, prolonged fuel shortage that hampered supply channels, scarcity of raw materials, and the soaring cost of production, amidst price escalations in both domestic and global markets, significantly dampened economic activity across all sectors of the economy. The Agriculture sector recorded a y-o-y contraction of 7.6% during the period under review, owing to shortages in agricultural inputs, particularly fertiliser and agrochemicals, increased cost of inputs as well as fuel shortages. Activities relating to the growing of rice, tea, rubber, and vegetables were a key driver of the overall contraction in the agriculture sector, while activities relating to the growing of oleaginous fruits recorded a growth during the first half of 2022. The y-o-y contraction of 7.1% recorded by the Industry sector was driven by the subdued performance of construction and manufacturing activities, stemming from the scarcity of raw materials, soaring input costs, fuel shortages, and prolonged power outages. On a y-o-y basis, the construction and mining and quarrying subsectors contracted by 8.9% and 13.1%, respectively, while the manufacture of coke and refined petroleum products and manufacture of food, beverages, and tobacco products registered notable contractions of 56.6% and 9.9%, respectively. Meanwhile, the Services sector witnessed a marginal contraction of 0.6% in the first half of 2022, supported by expansions in certain service activities, such as those relating to accommodation, food and beverages. The strong rebound observed in this category helped greatly offset the significant contractions observed in relation to the transportation of goods and passengers, other personal service activities, and financial services.



The Sri Lankan economy recorded a contraction of 4.8% during the first half of 2022, y-o-y...

In nominal terms, the Sri Lankan economy expanded by 24.8% in the first half of 2022, compared to the corresponding period of 2021. As per the expenditure approach, economic growth in the first half of 2022 was mainly driven by the expansion in consumption expenditure, reflecting the impact of elevated price levels. Consumption expenditure, which accounted for 74.1% of the GDP, recorded a notable growth of 25.7% in the first half of 2022, compared to the expansion of 14.5% in the corresponding period of the preceding year. Contributing to this expansion, household expenditure grew at a higher rate of 26.8% in the first half of 2022. Further, government consumption expenditure also recorded a y-o-y growth of 18.3% in the first half of 2022, while the y-o-y growth in investment expenditure was limited to 10.9% during the first half of 2022, reflecting the downturn in investment amidst heightened economic uncertainties. Investment, as a percentage of nominal GDP, remained at 31.0% in the first half of 2022. Net external demand for goods and services at current prices improved notably in the first half of 2022, reflecting the significant y-o-y expansion of exports by 76.7%, which offset the y-o-y increase of 40.4% registered by imports. Accordingly, the net nominal external balance of goods and services, as a percentage of GDP, improved from -8.5% in the first half of 2021 to -5.1% in the same period in 2022.

Figure 1.1
Contribution to Quarterly Real GDP Growth (y-o-y)
(Base year 2015=100)



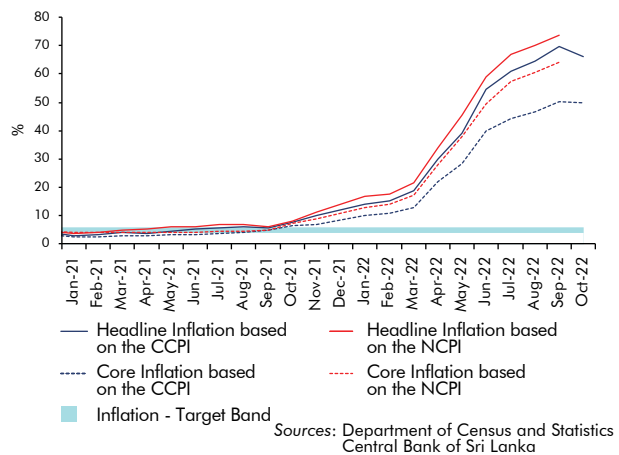
Source: Department of Census and Statistics

The gradual recovery in the labour market observed in the first quarter of 2022 was outweighed by the deepening economic crisis in the country. With the dissipation of the COVID-19 pandemic and the gradual easing of pandemic-related restrictions, labour market indicators showed improvements during the first quarter of 2022. The LFPR increased to 51.2% in the first quarter of 2022 from 49.5% and 50.9% recorded in the fourth quarter of 2021 and the first quarter of 2021, respectively. However, with the dampening of economic activity from the latter part of the first quarter onwards, the LFPR declined to 50.1% during the second quarter of the year. Although the unemployment rate declined to 4.3% in the first quarter of 2022, which was the lowest level in the last eight consecutive quarters, the unemployment rate rose to 4.6% in the second quarter of 2022. Accordingly, the unemployment rate for the first half of 2022 stood at 4.5%.

The onset of the economic crisis led unemployment to rise to 4.5% during the first half of 2022...

During the year, inflation accelerated at a notable pace, reaching historically high levels owing to supply side disruptions both locally and globally, administrative price adjustments, sharp depreciation of the Sri Lanka rupee, and the pent-up demand on the back of the lagged impact of large monetary accommodation amidst the COVID-19 pandemic. Accordingly, headline inflation, as measured by the CCPI (2013=100), accelerated to 69.8%, y-o-y, in September 2022, recording a substantial deviation from the desired range of inflation. However, the trajectory of CCPI based headline inflation has subsequently shown some signs of reversing by moderating to 66.0%, y-o-y, in October 2022. Meanwhile, headline inflation, as measured by the NCPI (2013=100), also accelerated to 73.7%, y-o-y, in September 2022. Both food and non-food inflation accelerated significantly. The contribution of the energy and transport sector in non-food category to the recent acceleration of inflation has been sizeable due to the several upward revisions to the prices of domestic fuel and gas and the revision to electricity tariffs, followed by their spillover effects across production chains. Imported inflation also accelerated reflecting the impact of higher global commodity prices and the notable passthrough of the sizeable depreciation of the rupee that occurred in

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



March 2022. Although recent inflation trends have been largely supply driven, these developments are also to be partly attributed to demand driven pressures that have been underpinned by the substantial monetary accommodation that was provided in the wake of the COVID-19 pandemic and thereafter. As indicated by the Inflation Expectations Survey of the Central Bank, both corporate and household sectors' inflation expectations have increased thus far during 2022, albeit with some moderation observed in recent months.

External Sector

Sri Lanka's external sector vulnerabilities worsened in 2022 amidst headwinds on the global and local fronts, leading to an unprecedented BOP crisis. The expenditure on merchandise imports in the first quarter of 2022, substantially increased that of 2021, thereby necessitating the introduction of policy measures to curb import expenditure to improve foreign exchange liquidity required for essential imports. Since March 2022, import expenditure declined notably, mainly due to the policy measures introduced to compress imports and the foreign exchange liquidity shortage in the banking system, while export earnings continued to remain robust throughout the year. Consequently, the deficit in the merchandise trade account narrowed during the period spanning from January to August 2022.

Earnings from tourism showed a notable improvement so far during the year, while workers' remittances, which were modest during the first half of 2022, recorded a considerable rebound in

recent months. Reflecting the impact of the modest performance of workers' remittances and the increase in the primary income account deficit, the current account deficit widened in the first half of 2022 despite the moderation in the trade deficit and improvement in the surplus in the services account. Despite foreign investment in the CSE, including primary market purchases, and the government securities market recording net inflows, inflows to the financial account were modest due to the decline in foreign inflows to the Government, and to the private sector in the form of direct investments. In line with these developments, the gross official reserves declined to USD 1.8 bn by end September 2022 in comparison to USD 3.1 bn recorded at end 2021.

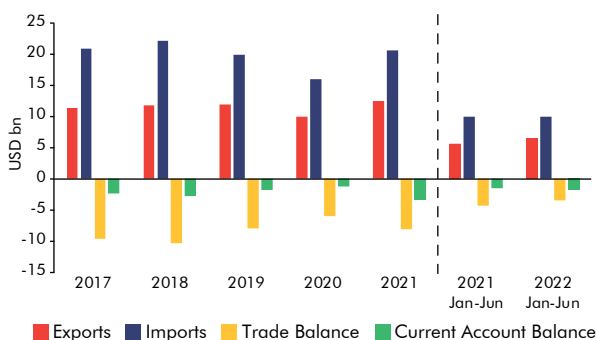
Accordingly, the Sri Lanka rupee depreciated substantially by 41.4% against the USD by end April 2022. Considering the undue excessive and speculation driven volatilities in the exchange rate, the Central Bank commenced the provision of market guidance on the daily exchange rate with an allowable margin from mid-May 2022. This has enabled the Sri Lanka rupee to remain relatively stable against the USD since then. Accordingly, the overall depreciation of the Sri Lanka rupee against the USD stood at 44.8% during the year up to end October 2022. The NEER and REER indices, which assess the external competitiveness of the Sri Lanka rupee by measuring the movement of the Sri Lanka rupee against a basket of currencies, declined during the ten months ending October 2022. Meanwhile, in an attempt to alleviate the shortages of essentials in the economy caused by the acute deficit in foreign exchange liquidity in the banking system, the Central Bank continued to provide foreign exchange financing support for the importation of essential goods.

The unprecedented BOP crisis currently being encountered amidst headwinds on the global and local fronts is expected to see some reprieve with the envisaged progress of the IMF-EFF arrangement and the debt restructuring process, along with the policy priorities to address structural impediments...

The significant shortage in liquidity in the domestic foreign exchange market continued to exert pressures on the exchange rate, necessitating a measured adjustment of the exchange rate that was allowed in early March 2022, which was followed by a significant overshooting as induced by unwarranted speculation.

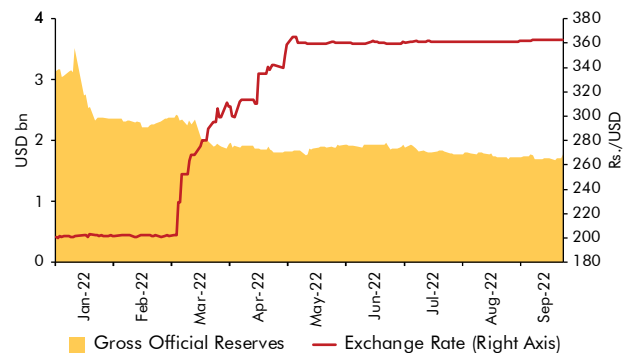
In April 2022, the Government announced a temporary suspension of external debt servicing which led to a 'pre-emptive default', following which Sri Lanka initiated negotiations with the IMF for an economic adjustment programme in April 2022 while initiating a debt restructuring process. By early September 2022, a staff level agreement was reached with the IMF for the economic adjustment programme pertaining to the EFF, which is expected to support the transition of the economy to a sustainable recovery path in the medium term. There has also been significant progress in the debt restructuring process, and negotiations to obtain financing assurances from the official creditors are underway.

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

Fiscal Sector

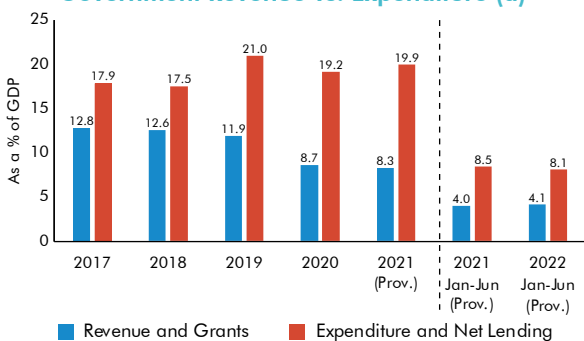
With due consideration to mounting financing pressures on the fiscal front, the Government introduced several fiscal consolidation measures during 2022, and the benefits of these measures are yet to be fully reflected in fiscal indicators. Accordingly, the Government introduced significant tax reforms during the first half of 2022, including the imposition of a Surcharge Levy and increased VAT rate on financial services, while also raising the general VAT rate and Telecommunication Levy with effect from 01 June 2022. Given the limited fiscal leeway, several expenditure rationalisation measures were also introduced in April 2022. These included the curtailment of non-urgent capital expenditure and recurrent expenditure on overtime and new recruitments, among others. During the first half of 2022, government revenue and grants stood at Rs. 919.5 bn (4.1% of projected GDP), compared to the moderate revenue and grants of Rs. 715.3 bn (4.0% of GDP) that was mobilised in the corresponding period of 2021. Revenue policy measures implemented in the period under review together with the spillover effects of increased domestic and global inflation and exchange rate depreciation led to the growth in government revenue. Despite the expenditure rationalisation attempts, government spending continued to rise mainly due to the escalation of additional expenditure on relief measures to alleviate the ripple effects of the pandemic on poor and vulnerable segments of the population, unfavourable market developments emanating from increased domestic interest rates, and escalating cost of goods and services owing to high inflation and large depreciation of the

exchange rate, among others. In nominal terms, total expenditure and net lending during the first half of 2022 recorded an increase of 21.8% to Rs. 1,822.1 bn (8.1% of projected GDP) from Rs. 1,495.5 bn (8.5% of GDP) registered for the corresponding period of 2021.

As the full impact of fiscal consolidation measures is yet to be realised, the rise in government expenditure offset the nominal increase in government revenue during the first half of 2022, resulting in the overall fiscal balance and current account balance deteriorating in nominal terms during the first half of 2022, albeit some improvements were observed when assessing key fiscal indicators as a percentage of projected GDP. Accordingly, in nominal terms, the budget deficit widened to Rs. 902.7 bn (4.0% of the projected GDP) from Rs. 780.2 bn (4.4% of GDP) recorded in the corresponding period in 2021. Nevertheless, the primary deficit declined to Rs. 244.8 bn (1.1% of projected GDP) during the period under review from Rs. 273.2 bn (1.5% of GDP) reported in the first half of 2021. However, any settlement in the near term payments of the Government that were in arrears over the past two years and thus far in 2022 could result in further deterioration of fiscal balances unless a substantial flow of government revenue is realised in the period ahead.

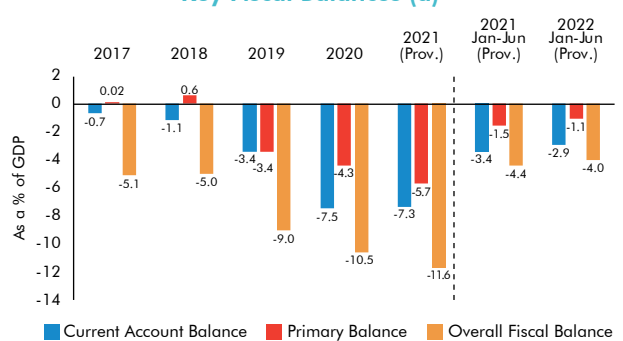
Given the limited fiscal leeway, the Government introduced significant tax reforms and expenditure rationalisation measures in 2022...

Figure 1.5
Government Revenue vs. Expenditure (a)



(a) Rebased GDP estimates (base year 2015) of the Department of Census and statistics have been used for 2018-2021 and GDP projection of the Central Bank of Sri Lanka has been used for 2022. Sources: Ministry of Finance, Economic Stabilisation and National Policies Central Bank of Sri Lanka

Figure 1.6
Key Fiscal Balances (a)



(a) Rebased GDP estimates (base year 2015) of the Department of Census and statistics have been used for 2018-2021 and GDP projection of the Central Bank of Sri Lanka has been used for 2022. Sources: Ministry of Finance, Economic Stabilisation and National Policies Central Bank of Sri Lanka

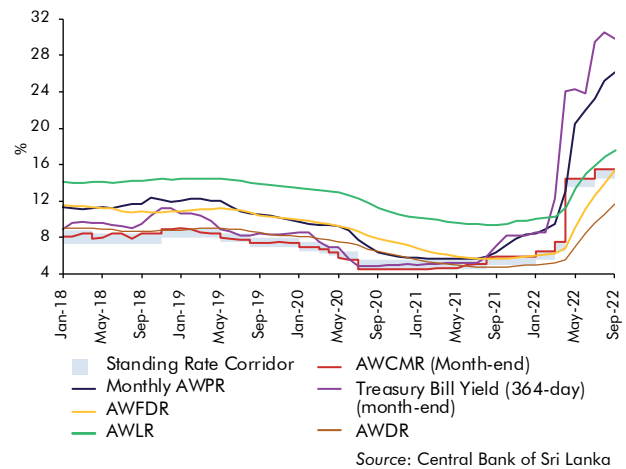
In financing the budget deficit, the Government relied entirely on domestic sources on a net basis as a result of the limited access to global financial markets amidst Sri Lanka’s sovereign credit rating downgrades and the debt standstill. During the period from January to June 2022, net domestic financing amounted to Rs. 947.1 bn, compared to Rs. 759.0 bn during the corresponding period of 2021, while net foreign financing amounted to a repayment of Rs. 44.4 bn, compared to a net foreign financing of Rs. 21.2 bn recorded in the corresponding period of 2021. Despite the decrease in borrowings from the banking system to finance the budget deficit resulting from repayments to commercial banks, net financing from the Central Bank increased markedly to Rs. 1,000.0 bn in the first half of 2022, compared to Rs. 310.0 bn recorded in the same period of 2021. Meanwhile, the sharp depreciation of the Sri Lanka rupee, along with the increased budget deficit resulted in a notable increase of around 37.9% in central government debt by the end of June 2022 from end 2021. The central government debt stock is estimated to have reached Rs. 24,264.4 bn by the end June 2022, pending the finalisation of several debt service payments that fell due after the announcement of the Interim Policy regarding the servicing of Sri Lanka’s external public debt on 12 April 2022. At end June 2022, the total domestic debt witnessed an increase of Rs. 1,641.3 bn to Rs. 12,738.5 bn, while foreign debt increased by Rs. 5,033.7 bn to Rs. 11,525.9 bn from the levels recorded at end 2021.

The sharp depreciation of the Sri Lanka rupee against the USD, along with the increased budget deficit resulted in a notable increase in central government debt by end of June 2022...

Monetary Sector

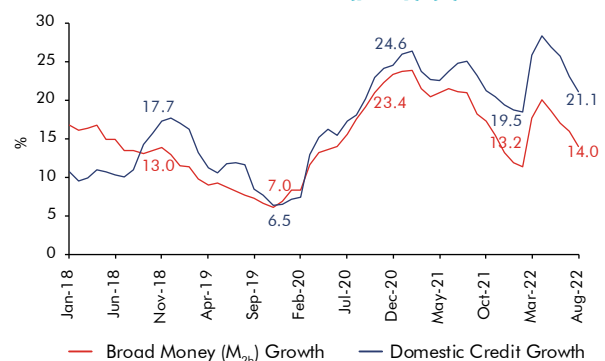
As inflationary pressures continued to surge, exacerbated by the rupee depreciation, global oil and other commodity price hikes, adjustments to domestic administrative prices and domestic supply disruptions, the Central Bank continued to maintain a tight monetary policy stance throughout 2022 to rein in inflationary pressures, while arresting possible

Figure 1.7
Standing Rate Corridor and Selected Market Interest Rates



de-anchoring of inflation expectations. Accordingly, commencing August 2021, the key policy interest rates, i.e., SDFR and SLFR, were increased by 10 pps in total to 14.50% and 15.50%, respectively, by end October 2022. This includes the unprecedented upward adjustment of policy interest rates by 7 pps in April 2022 with the intention of arresting any further buildup of demand driven inflationary pressures, preempting the escalation of adverse inflationary expectations, supporting the stabilisation process of the exchange rate, and correcting anomalies observed in the market interest rate structure. Meanwhile, liquidity levels in the domestic money market continued to remain at relatively high deficit levels, following the increase in SRR by 2 pps in September 2021, along with several other developments thus far during 2022, such as the use of gross official reserves to honour foreign currency debt service obligations of the Government, net currency

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



(a) The sharp depreciation of the Sri Lanka rupee during March to May 2022 remains the key reason for the augmentation of monetary and credit aggregates during that period.

Source: Central Bank of Sri Lanka

Table 1.1
Recent Monetary Policy Measures

Date	Measure
19-Aug-2021	SDFR and SLFR increased by 50 basis points to 5.00% and 6.00%, respectively, and Bank Rate commensurately adjusted to 9.00%
19-Aug-2021	SRR increased by 2.00 percentage points to 4.00% to be effective from the reserve period commencing 01 Sep 2021
20-Jan-2022	SDFR and SLFR increased by 50 basis points to 5.50% and 6.50%, respectively, and Bank Rate commensurately adjusted to 9.50%
04-Mar-2022	SDFR and SLFR increased by 100 basis points to 6.50% and 7.50%, respectively, and Bank Rate commensurately adjusted to 10.50%
07-Mar-2022	Allowed an adjustment in the exchange rate
08-Apr-2022	SDFR and SLFR increased by 700 basis points to 13.50% and 14.50%, respectively, to be effective from the close of business on 08 Apr 2022 and Bank Rate commensurately adjusted to 17.50%
07-Jul-2022	SDFR and SLFR increased by 100 basis points to 14.50% and 15.50%, respectively, and Bank Rate commensurately adjusted to 18.50%

Source: Central Bank of Sri Lanka

Note: The Central Bank imposed/revised caps on interest rates as follows:

- 24.08.2021: Imposed caps on interest rates to be paid in respect of foreign currency deposit products of LCBs and NSB
- 30.12.2021: Revised caps on interest rates (linked to 364-day Treasury bill yield) to be paid in respect of foreign currency deposit products of LCBs and NSB
- 31.12.2021: Revised caps on interest rates (linked to AWPR) of mortgage-backed housing loans of licensed banks
- 04.03.2022: Revised caps on interest rates (relaxed) of selected lending products of licensed banks
- 11.03.2022: Removed caps on interest rates to be paid in respect of foreign currency deposit products of LCBs and NSB
- 21.04.2022: Removed caps on interest rates of selected lending products of licensed banks

withdrawals, net foreign exchange sales by the Central Bank for continued financing of essential imports, foreign exchange sell-buy swaps (net of maturities) by the Central Bank and outright sales of Treasury bills by the Central Bank. The faster passthrough of the sharp increase in policy interest rates and tight liquidity conditions in the domestic banking system led to a notable increase in market interest rates which reached their highest levels in recent history. Subsequent to the sharp increase in key policy interest rates amidst the increased borrowing requirement of the Government and heightened uncertainty in market conditions amidst debt restructuring concerns, yields on government securities also recorded a considerable upward movement, disproportionate to adjustments in other interest rates. With monetary conditions turning tighter, credit to the private sector by the banking system started moderating, albeit recording an expansion during the months of March-

May 2022 due to the sharp depreciation of the Sri Lanka rupee, followed by contractions in outstanding credit, in absolute terms, consecutively since June 2022. Accordingly, by end August 2022, the y-o-y growth of credit extended to the private sector decelerated to 12.0%, with the same estimated to have decelerated to around 1.9%, y-o-y, after adjusting for the depreciation of the rupee. Nevertheless, reflecting the continued reliance of the Government on domestic financing, particularly on the Central Bank, NCG by the banking system expanded notably amidst low government revenue and limited access to foreign financing sources. Credit obtained by the SOBEs from the banking system also expanded substantially, reflecting their weak financial performance and the revaluation effects of foreign currency denominated debt. Meanwhile, NFA of the banking system continued to decline driven by a deterioration in NFA of the Central Bank. Despite the substantial expansion in credit to the public sector and the revaluation effects of foreign currency denominated debt, the growth of broad money supply (M_{2b}) decelerated from April 2022, driven by the contraction in private sector credit and a decline in NFA of the banking system. By end August 2022, the y-o-y growth of M_{2b} moderated to 14.0% from its peak of 20.0% in April 2022. Once adjusted for the impact of the rupee depreciation, the y-o-y growth of M_{2b} is estimated to have decelerated notably to around 5.8% by end August 2022.

Reflecting a faster passthrough of unprecedented monetary policy actions and tight liquidity conditions, market interest rates rose notably, resulting in a marked deceleration in the growth of credit to the private sector...

Financial Sector

The stability of the financial sector was challenged amidst the crisis conditions that have prevailed in the economy during thus far in 2022. Although the banking sector recorded growth in terms of assets, the foreign exchange crisis and contractionary monetary policy posed challenges for the sector, particularly in terms of foreign currency liquidity and credit quality. The performance of the LFCs and SLCs

sector improved during the eight months ending August 2022 while a considerable increase in gross Stage 3 loans was observed indicating a potential deterioration in the credit quality of the sector. Primary Dealer Companies, Licensed Microfinance Companies, Insurance Companies, Superannuation Funds and other subsectors demonstrated a mixed performance during the period mainly owing to contemporary economic uncertainties. In terms of financial markets, the domestic money market persistently remained in a deficit in 2022 due to scheduled foreign loan repayments, currency withdrawals as well as maturities of foreign currency swaps, while the domestic foreign exchange market continued its declining trend in terms of trading volumes. The government securities market depicted an upswing in the primary market yield rates as a consequence of the significant requirement for financing by the fiscal sector, rise in policy interest rates and market uncertainties. Moreover, the equity market witnessed a steep decline since early February 2022 which moderated from April 2022 onwards. Despite the challenging conditions that prevailed in the financial markets, the financial infrastructure ensured the smooth functioning of the sector during the year. Meanwhile, the legal and regulatory framework of the financial sector is also being strengthened by way of several measures to be implemented, including the new Banking Act.

The stability of the financial sector was challenged amidst the crisis conditions that prevailed across the economy during the period thus far in 2022...

1.2 International Economic Environment

The global economy is being straddled by several significant challenges, such as higher inflation, tightening financial conditions, adverse spillover effects of geopolitical tensions, the persistent effects of the COVID-19 pandemic, and emerging concerns about a possible global recession and food insecurity, among others. According to the WEO of the IMF released in October 2022, global growth is anticipated to decline from 6.0% in 2021 to 3.2% in 2022 and 2.7% in 2023. Notably, apart from the global financial crisis in 2007/08 and the peak of the COVID-19 pandemic, this

is the weakest growth forecast released by the IMF. Accordingly, the poor global growth performance is expected to be driven by major economic downturns in the world's largest economies including the United States, the Euro area and China. So far, about one-third of the world economies have experienced two consecutive quarters of negative growth, which technically points to a 'recession'. Considering these developments, the WEO forecasts that the growth in advanced economies will slow down from 5.2% in 2021 to 2.4% and 1.1% in 2022 and 2023, respectively. The growth in the United States is projected to decline from 5.7% in 2021 to 1.6% and 1.0% in 2022 and 2023, respectively, mainly due to declining real disposable income and high spending on residential investments. In the Euro area, growth projections have been revised downwards from 5.2% in 2021 to 3.1% in 2022 and 0.5% in 2023. Growth in emerging market and developing economies is also expected to slow down from 6.6% in 2021 to 3.7% in 2022 and remain at similar levels in 2023, reflecting lesser contraction in emerging markets compared to developed nations. Growth in emerging and developing Asia, which stood at 7.2% in 2021, is projected to be 4.4% in 2022 and 4.9% in 2023, reflecting the prospects of a slowdown in China due to COVID-19 lockdowns and deteriorating property market prices; the Chinese economy is expected to slow down from 8.1% in 2021 to 3.2% and 4.4% in 2022 and 2023, respectively. Growth prospects for India have also been revised to 6.8% and 6.1% in 2022 and 2023, respectively, compared to the growth of 8.7% in 2021.

The global economy faces prospects of a recession stemming from persisting geopolitical tensions and its spillover effects on commodity prices, rising inflationary pressures and an overall tightening of monetary policy by major central banks...

Global inflation is at the highest level seen in the past two decades, necessitating the adoption of rapid monetary policy tightening. Inflation has increased faster and steadier than expected since 2021, while in 2022, inflation in advanced economies reached the highest levels recorded since 1982. As per the WEO

Table 1.2
Changes in Policy Interest Rates of Selected Central Banks

Country	Key Policy Rate	End 2019	End 2020	End 2021	End Oct 2022
Sri Lanka	SDFR	7.00	4.50	5.00	14.50
	SLFR	8.00	5.50	6.00	15.50
Emerging Market Economies					
India	Repo Rate	5.15	4.00	4.00	5.90
Malaysia	Overnight Policy Rate	3.00	1.75	1.75	2.50
Thailand	1-day Bilateral Repo Rate	1.25	0.50	0.50	1.00
China	1-year Loan Prime Rate	4.15	3.85	3.80	3.65
Indonesia	7-day Reverse Repo Rate	5.00	3.75	3.50	4.75
Philippines	Overnight Reverse Repo Rate	4.00	2.00	2.00	4.25
Advanced Economies					
USA	Federal Funds Rate	1.50 - 1.75	0.00-0.25	0.00-0.25	3.00-3.25
UK	Bank Rate	0.75	0.10	0.25	2.25
ECB	Refinance Rate	0.00	0.00	0.00	2.00
Japan	Overnight Call Rate	-0.10	-0.10	-0.10	-0.10
Canada	Overnight Rate	1.75	0.25	0.25	3.75
Australia	Cash Rate	0.75	0.10	0.10	2.60
Sweden	Repo Rate	-0.25	0.00	0.00	1.75

Source: Websites of respective central banks

forecast, the inflation rate in advanced economies, which was at 3.1% in 2021, is expected to accelerate to 7.2% in 2022 before moderating thereafter to 4.4% in 2023. In emerging markets and developing economies, inflation which stood at 5.9% in 2021 is expected to accelerate to 9.9% in 2022 and decelerate slightly to 8.1% in 2023. Although the impact of these high inflationary levels is felt worldwide by all economic stakeholders, these price developments will have a severe impact on low income countries, where half of household consumption is spent on food. This is expected to severely affect socio-economic well-being and living standards, particularly for a sizeable section of the population living below the poverty line in these economies. Further, many emerging market and developing economies are already facing significant external challenges stemming from the substantial appreciation in the value of the USD which has exacerbated local pricing pressures, resulting in increased cost of living in many nations. The WEO highlights that these growing pricing pressures will squeeze/suppress real earnings and weaken macroeconomic stability further in the near future. Although central banks across the world are currently focusing on rebuilding price stability, the pace at which policy tightening will occur remains a major point of contention, with some policymakers already softening their policy tightening to some extent, with due consideration of the balance between recessionary effects and the benefits of a faster policy tightening.

1.3 Expected Developments

The Sri Lankan economy is expected to regain stability in the near term from the notable slowdown and worsened economic vulnerabilities associated with the historically high inflation levels coupled with the lowest growth levels recorded since post-independence. The successful implementation of stabilisation measures introduced by the Government and the Central Bank remains essential, despite warranting painful socio-economic adjustments by all economic stakeholders. Undoubtedly, the recently introduced fiscal and monetary policy measures are expected to dampen consumer demand, while helping to rein in inflation and anchor inflation expectations, although at the cost of subdued economic growth in the near term. However, such measures are expected to help the economy to restore stability and progress towards a more sustainable growth trajectory over the medium term by addressing deep rooted structural issues in a holistic and efficacious manner. Accordingly, following a stringent economic stabilisation framework that is broadly aligned with the planned economic adjustments and structural reforms under the IMF-EFF arrangement is imperative to the economy's progress, alongside the successful and timely completion of the debt restructuring process.

The successful implementation of stabilisation measures introduced by the Government and the Central Bank remains imperative to restore economic stability, despite warranting painful socio-economic adjustments in the near term...

In 2022, the economy is projected to contract sharply by about 8.0%, registering the largest economic contraction in Sri Lanka on record. The combined effect of shortages in raw materials amidst tight foreign exchange liquidity conditions, elevated levels of global commodity prices, vulnerabilities in the power and energy sector, as well as the tightening of both monetary and fiscal policies, are expected to weigh negatively on overall economic performance in 2022. The recovery in economic activity is expected to remain moderate in 2023 owing to lingering effects of ongoing macroeconomic vulnerabilities in the economy, notable

upward adjustments to domestic tax structure, and a possible slowdown in the global economy due to monetary policy tightening by major central banks around the world to arrest inflationary pressures as well as the spillover effects of geopolitical tensions on commodity prices. Nevertheless, with the envisaged macroeconomic adjustment programme, growth is expected to gather pace from 2024 onwards leading to a conducive environment for the economy to grow. The unwavering commitment of the Government and other policymakers to implementing structural reforms will be essential to restore confidence in the economy and harness its potential at this critical juncture. Policy transitions and measures that are underway will contribute to improving the resilience of the economy over the medium term. A key initiative in this regard is the Government's efforts towards the increased adoption of renewable energy sources to improve the energy security of the economy in a cost-effective and sustainable manner. Also, recent drives to strengthen the legal framework pertaining to the Colombo Port City and the Colombo International Financial Centre are expected to help attract FDIs in the period ahead considering the uniqueness and attractiveness of the project within the South Asian region. In addition, several of the reforms that have been planned by the Government and proposed by the IMF will also help to improve the productive potential of the economy by helping to harness the potential of the existing human capital and natural resource base.

The economy is likely to continue to experience external headwinds in the near term as the possible worsening of global economic conditions will put potential international lenders and investors on a weaker footing. Nevertheless, with the envisaged IMF-EFF arrangement, the economy is expected to receive substantial bridging finances from various parties, including several multilateral agencies. Moreover, greater flexibility in determining the exchange rate based on market forces that will accompany a successful economic revival programme is also expected to result in a positive impact on foreign exchange inflows. These developments will be a cornerstone in ensuring growth impetus from the country's longstanding key drivers in the external sector, including merchandise and service exports, tourism, workers' remittances, and FDIs, among others.

On the fiscal front, implementation of economic and policy reforms stipulated under the IMF economic adjustment programme with a strong commitment, in tandem with the debt sustainability efforts, would enable

improvement of fiscal sector performance in the near to medium term to achieve fiscal sustainability of Sri Lanka. In this regard, several actions have been undertaken while several more are underway. Such measures include reforms targeted at strategising SOBEs together with the adoption of cost recovery pricing formulas for major utility providers as well as several reforms to the tax structure. Although several tax reforms that were introduced thus far in 2022 are envisaged to yield higher revenue generation, the fullest benefits from these policy adjustments are to be realised next year onwards, where the government revenue is expected to reach about 11% of GDP leading to an improvement in the primary balance. The government debt restructuring initiative, which is currently underway, would reduce the debt burden of the Government to a manageable level with the expected support from all creditors. However, strong fiscal discipline, rigorous revenue enhancement measures, including improved tax administration, and reforms to SOEs to induce efficiency gains remain imperative to minimise further debt accumulation and achieve fiscal sustainability in the post-debt-restructuring period. Achieving fiscal and debt sustainability in the medium term through expeditious completion of debt restructuring activities and ensuring fiscal prudence is critical to rebuild investor confidence and reopen foreign financing avenues for the country. In turn, these can ease the liquidity pressures in the domestic financial markets and curtail monetary financing. However, any holdout issues by major creditors could derail the debt restructuring process, thereby affecting the economic recovery process. Nevertheless, the unprecedented fiscal consolidation efforts could affect the disposable income of households, alongside the spillover effects of the recent high levels of inflation and slowdown in economic activity, thereby exacerbating income inequalities that existed even prior to COVID-19. Unless addressed through well-targeted and sufficient social safety measures, such developments could trigger cyclical effects of income inequality resulting in the deterioration of the productive capacity of households, thereby worsening such inequality and leaving them in a protracted status of worsening living standards. It is expected that the financial assistance extended by multilateral agencies and those that are awaited from other lending sources in the near future would help mitigate any such poverty cycles.

Reflecting tight monetary and liquidity conditions, market interest rates are expected to remain elevated in the near term, before moderating as economic conditions improve reflecting the impact of stabilisation measures.

Competitive high deposit interest rates are expected to attract currency in circulation back into the banking system, while higher market lending interest rates are expected to reduce the appetite for credit leading to a contraction in the overall stock of credit extended to the private sector. Meanwhile, the envisaged fiscal reforms as well as reforms to the lossmaking SOBEs, along with the introduction of cost-reflective pricing formulae, are expected to gradually reduce the burden on the Government’s budget and its subsequent heightened reliance on bank financing, especially financing by the Central Bank, in the period ahead. Accordingly, the expansion in NDA of the banking system is expected to be benign in the period ahead. With LCBs phasing out some of their foreign liabilities, amidst parallel efforts by the Central Bank to gradually rebuild its external reserves, the NFA position of the banking system is expected to improve in the forthcoming period.

improved domestic supply conditions in relation to agriculture and subdued aggregate demand pressures resulting from tight monetary and fiscal conditions, and the favourable statistical base effect. Although recently announced tax adjustments could pose upside risks to the near term inflation outlook, the medium to long term impact of such policies is expected to be favourable in achieving the price stability objective of the Central Bank.

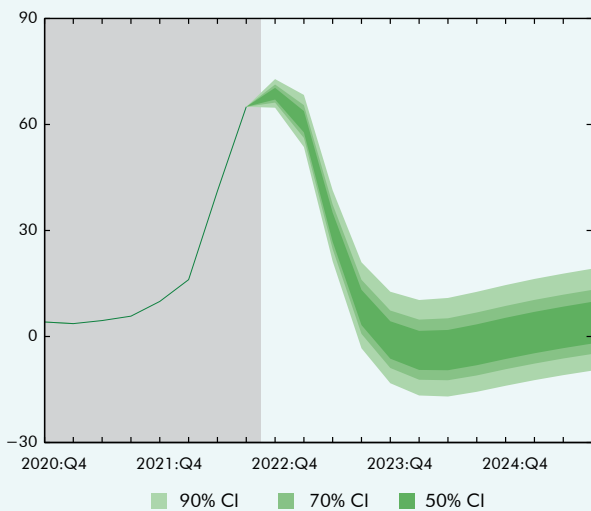
Market interest rates are expected to remain elevated in the near term before moderating, as economic conditions improve reflecting the impact of stabilisation measures...

Headline inflation is expected to follow a faster disinflation path from early 2023 onwards, supported by appropriate policy measures and expected easing of food and other commodity prices...

Headline inflation is expected to moderate in the period ahead with the potential softening of domestic commodity prices in the wake of downward revisions to administratively determined prices of certain commodities in line with global developments,

The Central Bank will continue to engage in well-coordinated, effective, and transparent communication of current economic conditions with all the stakeholders of the economy as managing inflation expectations is vital to expedite the disinflationary process. Nevertheless, price pressures could persist unless domestic prices are not adjusted in line with downward trending global commodity price trends. This will also result in delays in the disinflation process. Therefore, transparent and market based price adjustments, primarily of administratively determined energy prices, remain vital to both anchoring inflation expectations and also to improve the efficiency of SOBEs.

Figure 1.9
Quarterly Average Headline Inflation Projections Based on the CCPI (y-o-y, %)



Source: Central Bank Staff Projections

Note: A forecast is neither a promise nor a commitment.

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

The projection reflects the available data, and assumptions and judgements made in the October 2022 forecast round. The projections are conditional on current forecasts of global fuel and food prices that are anticipated to ease gradually, which in turn are expected to be reflected in domestic prices; below potential level growth in Sri Lanka’s major trading partners; and tightening global financial conditions implied by the current and anticipated monetary policy stance of the USA. Further, the projections are conditional on the model-consistent interest rate path and the achievement of medium-term fiscal targets. Moreover, domestic food supply conditions are assumed to ease in 2023. Given the prevailing domestic and global economic uncertainties and geopolitical tensions, the risks associated with the current projections are much higher than in normal times. Any notable change in these assumptions could lead to the realised inflation path deviating from the above. The Central Bank remains committed to communicating anticipated changes in inflation outlook to the public on a regular basis, to enable them to make informed decisions.

The financial sector is likely to encounter significant challenges in the face of the current economic environment with the contraction in economic output, sovereign debt restructuring, high interest rate environment, tax revisions and high exposure of the banking sector to SOBEs. At present, an increasing trend in impaired loans is observed due to the present adverse macroeconomic circumstances and is expected to further increase in view of contemporary weak economic conditions despite the concessions granted to borrowers by the industry to confront the challenges. Meanwhile, capital levels of banks remained above the minimum statutory requirements during the eight months ending August 2022. The deadline to achieve enhanced minimum capital levels was deferred for licensed banks, which are yet to meet the minimum capital requirement of end 2022, until end 2023. However, banking sector stability may be threatened by rising challenges in maintaining its capital ratios above regulatory minimum levels and a substantial deterioration in capital buffers due to the impact of adverse macroeconomic conditions. Although the liquidity positions of banks remained above the minimum regulatory requirements during the eight months ending August 2022, the prevailing extraordinary developments including the debt standstill have affected the liquidity position of banks. While rigorously monitoring the liquidity risk profiles of the banks, the Central Bank is in the process of reviewing the currently applicable regulations on liquidity requirements to ensure continued resilience and stability of the banking sector. The legal and regulatory framework of licensed banks will be further strengthened through the new Banking Act. With the view of further strengthening the resolution framework for the LFC/SLCs sector, the Finance Business Act and Finance Leasing Act are being amended, which will revise the existing directions in line with the current market developments and align the regulatory framework with that of the licensed banks. The proposed Microfinance and Credit Regulatory Authority Act is also expected to be enacted in the recent future, which will streamline the microfinance sector to be brought under the purview of a dedicated authority. The NBFIs as a whole are expected to be stabilised with the successful implementation of the Masterplan for Consolidation, which will support the resilience of the sector as well as the entire financial system.

The financial sector is likely to encounter significant challenges in the face of the current economic environment with the contraction in economic output, sovereign debt restructuring, high interest rate environment, tax revisions and high exposure of the banking sector to SOBEs...

The consistent implementation of envisaged reforms and major policy initiatives already undertaken is expected to result in the expansion of productive employment opportunities and income generation avenues in a robust manner. Amidst domestic and global headwinds, the economic stabilisation programme of the Government is expected to attract funding assistance from multilateral and bilateral partners while also luring investors. The expeditious finalisation of the debt restructuring process and achievement of sustainability in debt are instrumental to securing further funding that is vital for the smooth transition of the economy towards greater stability in the period ahead. Policy commitment towards equipping the economy to transform into one that is driven by export oriented manufacturing and high tech services exports will be vital for the recovery of the external sector and to strengthen and improve the resilience of the economy over the long run. Despite the positive outcomes of the broad policy response thus far rolled out by the Government and the Central Bank to address the challenges faced by the economy, the upcoming arduous adjustment process requires concerted efforts and strong, consistent and unwavering commitment by the authorities which are independent of any upcoming election cycles. Active engagement, participation, awareness and forbearance of all stakeholders, micro and macro alike, are imperative to undertake long overdue reforms, which will be critical to ensure that the country not only recovers from the ongoing crisis but also to prevent any similar crises in the period ahead, by addressing long rooted structural problems and therefore progressing towards sustained stability, growth, and prosperity in the medium to long term.

Abbreviations and Acronyms

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