Crisis as an Opportunity for a Paradigm Shift

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01. Introduction

Sri Lanka, once considered a promising emerging and developing economy of Asia, has to tread through rough waters over the past several years resulting in poor macroeconomic performance, particularly in terms of subpar growth and rising external and fiscal sector vulnerabilities. In the year 2022, Sri Lanka experienced its worst-ever economic crisis, a crisis that was in the making for many years, triggered by policy errors and exacerbated by other exogenous factors. Failure to build fiscal and external buffers over time made the nation vulnerable to domestic and external shocks, and the COVID-19 pandemic and the related shocks unearthed the vulnerabilities in the Sri Lankan economy, bringing about the worst economic crisis in Sri Lanka's history. The resultant economic hardship led to both public anxiety and political upheaval. The absence of national economic policies, delayed implementation of the required structural reforms and the inability to build sufficient policy spaces are considered as the key impediments that hampered the progression of Sri Lanka, leading the country towards an unimaginable economic crisis.

1.1. Root Causes of the Crisis

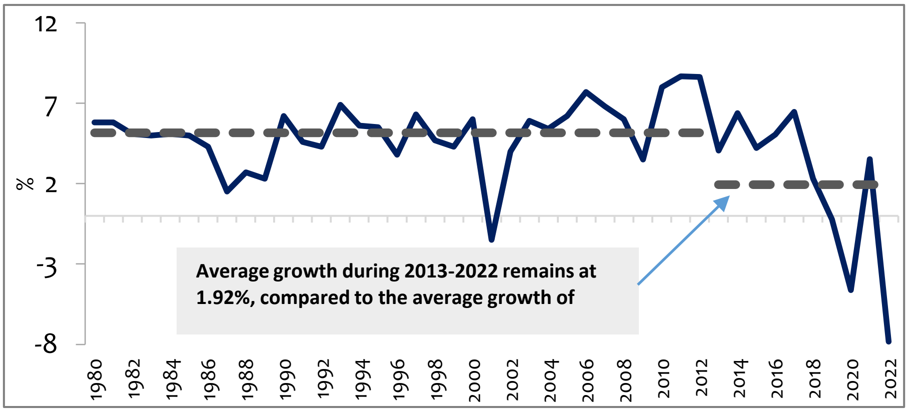

Figure 1: Annual GDP Growth Rate of Sri Lanka

Source: Department of Census and Statistics

Subsequent governments that came to power since independence in 1948 adopted numerous policies aiming to stimulate growth and enhance welfare. Apart from policy swings, the internal conflict and youth uprisings caused severe damage to the economy, including loss of human capital and resources, while curtailing the fiscal space on investing in development

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projects, and preventing the economy from reaping expected benefits of various types of policy reforms introduced from time to time. With the end of the internal conflict in 2009, the economy started to unleash its potential along with large infrastructure development, recording above 8 per cent growth on average in the three years that followed, accompanied by rebounding investor confidence. Sri Lanka was progressing well towards graduating into an upper middle-income country, but the progress slowed amidst subdued economic growth over the subsequent years due to various reasons.

Sri Lanka has been grappling with several structural issues that persisted over decades. The country has been living beyond its means, resulting in persistent fiscal and external current account deficits. Moreover, fiscal sector issues remain the root cause of most of the problems the country faced. Popular tax policies of successive governments and rigid expenditures, especially of recurrent nature, created budget deficits every year since 1948, except in 1954 and 1955. In addition, Sri Lanka's export income continued to decline, performing poorly compared to its regional peers, while imports remained relatively high, resulting in large trade deficits.

Budget Deficit and External Current Account Deficit

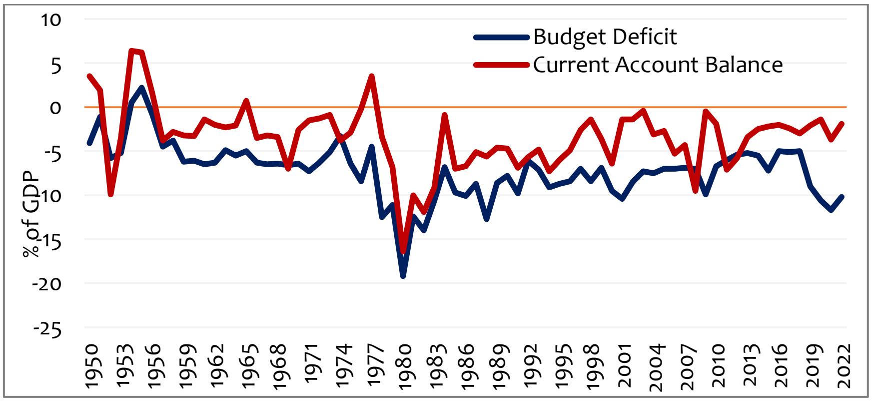

Figure 2: The Tale of Twin Deficits

Source: Ministry of Finance, Economic Stabilisation and National Policies

Having run an unsustainable macroeconomic model in tandem with the longstanding deficits in the budget balance and the external current account, the economy had fully exhausted its buffers by early 2022 as it was straddled by a myriad of vulnerabilities that emanated from both global and domestic sources. Several inherent weaknesses of the economy, further exacerbated by policy lapses, steered the country towards a multifaceted disaster. Ill-timed tax reductions, an ill-equipped attempt to swiftly adopt organic agriculture, the depletion of the country's official reserves amidst futile attempts to maintain an untarnished debt servicing record, the delay in the exchange rate adjustment, and the failure to pay heed to several early warning signals caused tremendous shockwaves across the economy.

1.2. Macroeconomic impact of the Crisis

Sri Lanka's economic growth has been volatile over the past and has remained subpar in recent years. The momentum in economic growth observed towards the end of 2021 dissipated and the economy fell into a contraction in 2022. Accordingly, the Sri Lankan economy witnessed a broad-based contraction in 2022, reversing the post-pandemic recovery in 2021. The real GDP contracted by 7.8 per cent in 2022, compared to the growth of 3.5 per cent in 2021. Although Sri Lanka managed to have single-digit inflation for over 12 years since 2009, inflation rose to historically high levels in 2022 stemming from global oil and other commodity price hikes, adjustments to domestic administrative prices, domestic supply disruptions, the substantial depreciation of the Sri Lanka rupee against the US dollar and the lagged effects of relaxed monetary policy amidst large monetary financing during the COVID-19 pandemic. Contrary to the co-movement in inflation and economic growth in regular business cycles, Sri Lanka witnessed inflation and economic growth moving in opposite directions, as supply as well as demand-driven inflation accelerated overall inflation while economic growth stalled.

Moreover, the economy was battered by excessive balance of payments (BOP) pressures with acute shortage of foreign exchange liquidity and pressured exchange rate, spiralling inflation and dampened economic activity amidst mass loss of livelihoods, large fiscal imbalances, public debt reaching unsustainable levels with extraordinarily high risk premia, devastating sovereign rating downgrades that constrained access to external finance, unprecedented heightening of socio-economic and socio-political tensions, and rapidly deteriorating business confidence, among others. Businesses and the general public were in severe distress amidst shortages and rationing of essentials, ballooning cost of living and cost of production, and the loss of welfare and livelihoods. Consequently, the rapid unfolding of social unrest resulted in political instability, warranting an urgent need for redefining policy priorities to steer the economy away from further turmoil.

1.3. Measures taken to overcome the Crisis

The unprecedented crisis warranted immediate and coordinated policy initiatives by the Government and the Central Bank to preempt a further escalation of the situation. Although the corrective measures were associated with near term costs, they were necessary to safeguard the economy and economic agents from potentially devastating consequences of unrestrained economic instability, such as hyperinflation, collapse of economic activity to a much deeper level, and a complete disconnect of the country from the rest of the world, with far worse consequences to the people and businesses.

1.4. Measures taken by the Central Bank

Several policy measures have been taken by the Central Bank to stabilise the economy and tighten monetary and credit conditions. With a view to countering rising inflationary pressures and anchoring inflation expectations, the Central Bank tightened monetary policy significantly since August 2021, with a significant increase in policy interest rates happening in April 2022. Monetary policy had to be conducted with an unprecedented level of deliberations, as the country entered a phase of high inflation and economic stagnation and tightening of monetary conditions will not only result in a reduction in inflation, but also economic growth.

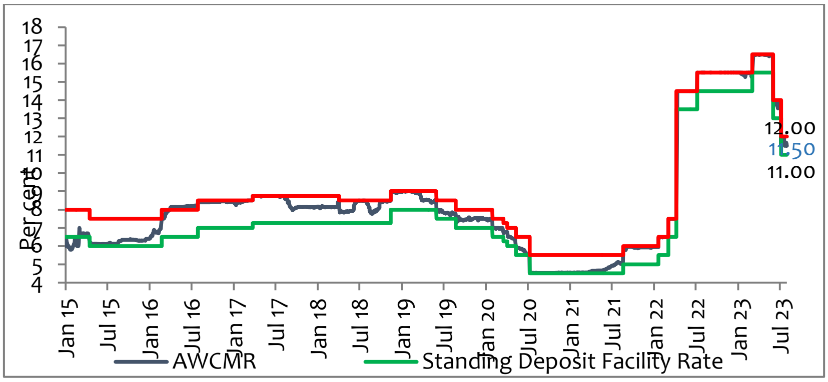

Figure 3: Key Policy Interest Rates and Average Weighted Call Money Rate (AWCMR)

Source: Central Bank of Sri Lanka

Further, the Central Bank implemented a series of policy measures aimed at maintaining external sector stability and reducing import demand. Amidst mounting BOP pressures, the exchange rate was allowed a measured adjustment in early March 2022. However, the subsequent floating of the exchange rate resulted in an overshooting, fuelled by speculative activity. As such, the Central Bank adopted appropriate measures to stabilise the exchange rate amidst exhausted levels of useable reserves by April 2022. This includes daily guidance on the exchange rate determination to curtail undue intraday volatilities in the interbank markets. Meanwhile, the Central Bank provided foreign exchange to the market to meet the demand for essential imports to the greatest extent possible amidst a dearth of foreign exchange inflows and significantly low levels of official reserves. Moreover, the Central Bank initiated measures to prioritise essential imports and restrict capital outflows through appropriate control measures, while continuing the requirement for the mandatory sale of foreign exchange to the Central Bank by licensed banks, based on the conversion of repatriated foreign exchange. Moreover, the Central Bank's continuous financial sector oversight and adoption of appropriate regulatory measures along with effective communication ensured financial system stability amidst severe socio-economic distress.

1.5. Measures taken by the Government

At a time when the economy was entrenched in a severe economic crisis of this nature, it was obvious that this rescue operation could not be conducted singlehandedly by the Central Bank through monetary policy. Hence, the Government embarked on a difficult, yet essential, economic stabilization and reform programme. In early 2022, the Government initiated measures to seek assistance from the International Monetary Fund (IMF) after months of indecisiveness. Further, the Government announced a debt standstill in mid-April 2022, when it reached a critical point of inability to service debt payments, thereby suspending the servicing of external debt, mainly bilateral and commercial debt, as an interim measure, while soliciting support from official and private creditors to restructure outstanding debt.

Simultaneously, several initiatives were made by the Government to enhance government revenue, curtail expenditure, introduce reforms to major State Owned Business Enterprises (SOBEs), implement import controls, and ration energy supply, while exploring bridging finance from bilateral and multilateral partners for essential expenditures as well as supporting the most vulnerable segments.

The outcomes of these efforts have eventuated since late 2022. The country managed to transition to a workable equilibrium in the near term, focused on restoring socio-economic stability, while the envisaged assistance from the international financial institutions begins to materialise. Inflation returned to an impressive disinflation path following a historic peak in September 2022, and the exchange rate remained stable and registered an appreciation in early 2023, having depreciated sharply during the first half of 2022. Further, the external current account deficit remained modest alongside the gradual accumulation of official reserves, thereby enabling the reinstatement of exchange rate flexibility from early March 2023.

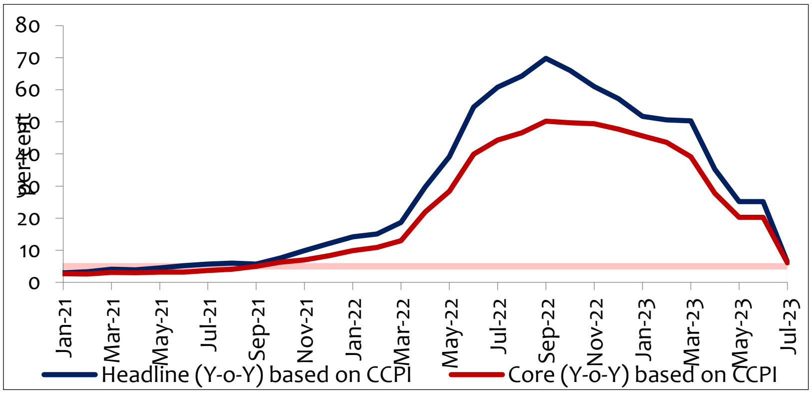

Figure 4: Movements in Headline and Core Inflation (CCPI based, y-o-y)

Source: Department of Census and Statistics

In the efforts to emerge from the current crisis, consistent and well-coordinated policies, including those outlined in the IMF-EFF supported programme, should be executed in a timely manner to avert another crisis in the period ahead. Given this, it is important to identify the longstanding, pressing structural issues in the Sri Lankan economy and measures that are being taken as well as measures that have to be taken to address those issues.

02. Sustaining the Economic Recovery by Addressing the Long-Standing Structural Issues

2.1. Real Sector

Although the agriculture sector accounts for one fourth of the total employed population, productivity in the sector remain notably low. Low levels of productivity in the agriculture sector translates into lower income levels, hampering the economic progress of those working in this sector. Imperfections in land policy and regulations, slow pace of technological adoption such as mechanisation and smart farming, inadequate R&D, high labour intensity, lack of integration in supply chains are some of major factors affecting lower productivity in the agriculture sector. Adoption of precision and smart farming technologies, improving storage and warehousing for agricultural to minimise post-harvest losses, enhancing the farmers' access to credit are some measures to improve agriculture sector productivity.

Long-standing financial woes of key SOBEs continue to remain a significant burden on the fiscal front and hinder the progress of overall economic activity. Although SOBEs perform key roles in numerous strategic economic sectors, such as electricity, petroleum, water, banking, transportation, and aviation, a significant share of these entities continues to grapple with an array of issues, including operational inefficiencies, poor governance and mismanagement, lack of accountability and transparency, weak market orientation, continuing political interference through high level appointments and excessive workforce, which weaken their financial performance. Meanwhile, the financial inefficiencies of energy sector SOBEs led to an energy crisis in 2022. Recognizing the urgent need for implementing long overdue structural reforms in the SOBE sector, regular cost reflective pricing mechanisms have been introduced to major utilities, including electricity and fuel prices, while measures have been taken to restructuring of balance sheets of selected SOBEs. Further, SOBE reform policy has been formulated based on nine strategic principles along with institutional arrangement for reforms which includes the establishment of SOBE holding company and inter-ministerial SOBE policy committee. With the proposed reforms, the Government will divest investments in SOBEs, except in the cases related to national security or there is no or limited potential for private sector participation. In addition, actions have been taken to liberalise domestic petroleum market, by allowing foreign suppliers to participate in the market, with a view to ensure continuous supply of fuel, without burdening the country's external reserves.

Despite the continuous efforts towards eradication poverty in Sri Lanka by successive Governments, poverty levels and inequality in the population remain high, partly reflecting the poor targeting and inefficiencies in such poverty eradication measures. Also, the impact of the unprecedented economic fallout and its associate impacts on livelihoods and income of the people have been significant, heightening the risk of increasing poverty levels in the country. In this context, the Government has introduced several reforms in relation to Social Safety Nets (SSN) under the IMF-EFF arrangement, including operationalising of the Welfare Benefit Board, development of a social registry and eligibility criteria for SSN as well as the introduction of new welfare benefit payment scheme of 'Aswesuma' to support vulnerable people from the impact of the economic crisis and recent policy adjustments. However, these measures should be equipped with proper monitoring mechanisms to ensure proper targeting of such programmes. In addition, livelihood development programmes and exit mechanisms also should be introduced for the SSNs beneficiaries to reduce their perpetual reliance on SSNs.

Rigid labour market conditions also remain as one of the major bottleneck for efficient allocation of labour resources. Persistent rigidities in the labour market, such as absence of flexible working hours and compressed work hours, gender barriers, lack of performance-based remuneration packages, skill gaps in the labour force, etc., have largely impacted employability and labour productivity in the country during the past several decades. Also, significant pension benefits offered by the public sector discourage mobility of labour towards productive employment opportunities in the private sector. Therefore, urgent action is needed to modernise and liberalise labour market laws and regulations in line with international labour standards, in order to facilitate the revival of the Sri Lankan economy. Accordingly, measures should be implemented allowing more flexibility in the labour market such as, reducing the cost of severance and making job termination/switching easier, enhancing temporary employment, providing flexibility in minimum and statutory retirement ages, aligning the retirement age with life expectancy, and increasing the employability of females. In addition to that, to improve female employment in the productive sectors of the economy, policy makers should consider on the areas of flexible working hours, day care/childcare options. The Government Budget for 2023 proposed a unified labour law in a manner to benefit both employee-employer segment and the economy. Accordingly, proposed labour reforms include, abolishing wage boards, social security and unemployment insurance, maternity benefits, digitalization and monitoring of labour market data as well as formalizing of informal sector.

2.2. Inflation and Price Stability

Following a decade of single-digit inflation, Sri Lanka has experienced a high inflation episode, primarily due to supply-side disruptions stemming from both domestic and global factors, currency depreciation, as well as aggregate demand pressures caused by the lagged effect of monetary accommodation during recent years. And also, the government's continuous borrowing from the banking sector to cover its expenditure owing to fiscal imbalances led to an increase in the money supply contributing to inflationary pressures. High external debt burden exerted pressure on balance of payments affecting exchange rate and import costs. At the same time, Sri Lanka has endured several structural vulnerabilities that contribute to the volatility and persistence of inflation. The volatility of food prices stemming from supply-side factors, as well as legacy issues such as post-harvest supply chain issues, limited storage, and lack of value addition and preservation methodologies contribute to soaring food prices. Moreover, the supply of several key food items is dominated by a few players, resulting in colluding behaviours, which limits the efficiency and transparency of pricing. Given that the consumption basket comprises a large share of food items, this uncertainty in food prices passes through to overall inflation. Recent food price hikes have been driven by inefficiencies in the domestic production and distribution processes as well as agriculture sector. During times when high food prices are slow to normalise, they feed into demand pressures in the economy, resulting in persistent inflation episodes. Further, it has been observed that prices of items which are heavily influenced by fuel and gas prices as well as other imported goods have drastically risen during the period of high inflation due to faster and more than complete passthrough of global commodity prices along with the depreciation of the rupee. However, during times of global price decreases as well as domestic currency appreciation, these adjustments have not been not fully reflected in the domestic price levels, resulting in downward price stickiness. This is also related to an overall impediment of the Sri Lankan economy, where even goods and services that could be produced withing the country at a higher quality being imported due to deteriorated doing-business environment and consumers preferring imported substitutes due to lack of adherence to quality standards. Barriers to switching to substitutes in certain goods and services (e.g., gas) also limit competitive pricing, thereby leading to sticky price movements. Therefore, appropriate structural reforms are needed to address these concerns. Although Sri Lanka has addressed some of these legacy issues to some extent, there still are considerable improvements to be made in order to manage food price volatilities, as well as to ensure food security. Supporting the agriculture sector through access to credit, and improved technology can lead to increased agricultural output, including new varieties of crops. Enhancing supply chain management and logistics by creating economic centers throughout the country can reduce transportation and distribution costs, making goods more affordable for consumers.

2.3. Monetary and Financial Sector

The enactment of the new Central Banking Act will be a key element of the economic stabilisation and economic management reforms as it ensures the independence of the Central Bank, while also strengthening its accountability. The new Central Banking Act would not only set the platform for the Central Bank to strengthen and pursue its flexible inflation targeting framework (FIT) regime in restoring price stability, but it would also help greater fiscal consolidation indirectly by way of phasing out of monetary financing to cease fiscal dominance and promoting greater fiscal discipline, that would be imperative for sustained macroeconomic stability. An improved level of fiscal-monetary coordination would be a necessary condition to steer the economy from the current crisis and ensure non-occurrence of the same in the period ahead.

A stable, resilient and dynamic financial sector is imperative to facilitate the transition of the economy to a high and sustainable growth trajectory. For this purpose, the financial system should possess sufficient depth, capital buffers, an effective level of credit expansion and risk mitigation capacity. The current fragmented nature of the financial sector makes the system vulnerable to external shocks and prevents cost effective provision of financial services to productive sectors. This must be addressed through the consolidation of the financial sector by merging relatively small financial institutions to create a sector comprising strong and dynamic institutions, which cater to all sectors of the economy and exhibit resilience to domestic and external shocks.

The new Banking (Special Provisions) Act is expected to provide the required legal framework to ensure that the banks are adequately capitalised, and upgrade their resolution framework, safeguard the interests of depositors, while strengthening the regulatory powers of the Central Bank. Consolidation of financial institutions in both the banking and non-banking financial sectors will be facilitated to improve capital with the benefit of economies of scale, synergy, and efficiency, while enhancing the financial strength, resilience and overall stability of those entities and their ability to cater to the growing demands of the business community in the period ahead. Meanwhile, amendments to the Finance Business Act No. 42 of 2011 and the Finance Leasing Act No. 56 of 2000 in line with the market developments will be introduced aiming at ensuring stability of the non-bank financial sector.

2.4. External Sector

Sri Lanka has been experiencing persistent external current account deficits mainly driven by large deficits in the merchandise trade account and primary income account over the past few years. Although the trade in services account and secondary income account, which comprise workers' remittances, recorded surpluses, these surpluses were not large enough to cushion the impact of merchandise trade and primary income account deficits on the current account. Lackluster performance in export earnings and increasing import expenditure led to a widening deficit in merchandise trade over the years. Sri Lanka has not been able to attract non debt creating foreign financial flows, such as Foreign Direct Investments (FDI) up to the expected levels, even during the post war period, due to structural and policy issues related to FDI. Over the past decade, annual FDI inflows remained around US dollars 1.3 billion, on average, and around 1-2 per cent of GDP. The prevailing weak investment climate in Sri Lanka can be attributed to a range of factors including policy uncertainty, restrictive labour regulations, lack of progress in ease of doing business, inconsistencies in protection of property rights, weaknesses in maintenance of law and order, and so forth. In addition, institutional weaknesses, such as corruption, weak regulations, red tape and faltering infrastructure have resulted in Sri Lanka attracting significantly lower inflows of FDI than its peer economies. During the last decade, the mounting external debt and growing debt service payments were the major contributors to the external sector imbalances. With Sri Lanka accessing international financial markets to raise funds by issuing International Sovereign Bonds (ISBs) since 2007, the country's external debt has been accumulating at a steady pace. However, this increased the overall cost of funding of the debt portfolio as ISBs were often priced at relatively high interest rates compared to the development assistance finances Sri Lanka used to receive at concessional rates. Moreover, the expansion in government fiscal deficit due to the financing of large infrastructure projects with the post war economic resurgence also contributed towards this increase. Following the trend in debt accumulation, the external debt as a percentage of GDP has also gradually been on the rise over the past decade. Increasing external debt stock as well as the compositional change in Sri Lanka's foreign debt profile from concessional borrowings to costlier non-concessional and commercial borrowings have resulted in increased foreign debt service payments. The high cost of external borrowings has expanded the deficit in the primary income account, exerting further pressure on the current account of the BOP. The gross official reserve position of the country deteriorated to critically low levels by end 2022 due to higher foreign currency debt service payments amidst inadequate foreign exchange inflows. The low level of foreign exchange inflows in terms of export earnings repatriation, workers' remittances and foreign capital flows resulted in a shortage of liquidity in the domestic foreign exchange market. The external sector imbalances are largely reflected by the dried up liquidity conditions in the domestic foreign exchange market, series of sovereign rating downgrades along with the precarious level of international reserves that have exerted significant depreciation pressures on the exchange rate.

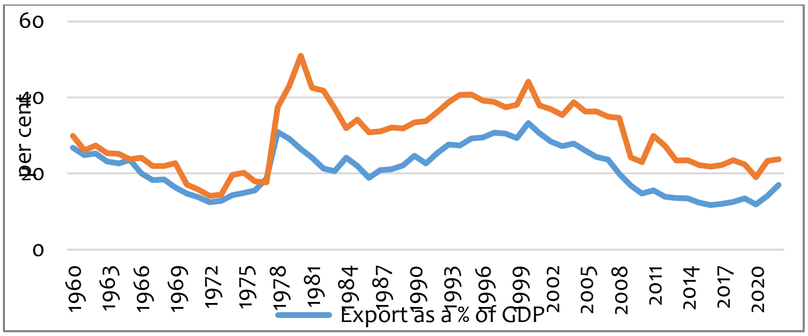

Figure 5: Exports and Imports (% of GDP)

Source: Sri Lanka Customs

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Sri Lanka's external sector met with severe BOP stresses in 2022 amidst constrained foreign financial inflows, depleted gross official reserves, and overshooting of the exchange rate, necessitating a myriad of policy measures to avoid further aggravation of the situation and restore external balance. The Government sought assistance from the IMF for a funding arrangement and announced a debt standstill as an interim measure, pending negotiations on debt restructuring with bilateral and commercial creditors during early 2022. As a result of the measures taken to limit foreign exchange outflows by the Government and the Central Bank import demand was reduced notably, reflecting the impact of significantly tightened monetary policy and subdued demand conditions. Measures included the temporary suspensions and imposition of licensing and margin deposit requirements on selected imports, restrictions on selected import payment methods and limitations on certain foreign exchange outflows of capital nature were also continued. Further, workers' remittances through official channels were encouraged through cash based and non-cash based targeted incentives for migrant workers. The large depreciation of the exchange rate, restrictions on imports under certain payment terms, such as open account terms, and subdued demand for imports led to a correction in the large spread between the official exchange rate and rates offered in the informal market. The Government obtained a number of emergency credit facilities for the importation of essential goods, including fuel, medicine and fertiliser, from regional countries in the form of bilateral loans, resulting in significant foreign loan disbursements during 2022. The Central Bank played a major role in managing foreign exchange to ensure the supply of essential goods and services under extremely challenging circumstances during 2022 by supplying forex to meet foreign exchange required for importing essential commodities. From mid-May 2022, with the aim of curbing any significant intraday volatility due to excessive speculation, the Central Bank commenced offering market guidance by publishing a middle rate and a variation margin applicable to the interbank weighted average spot exchange rate. This measure was effective in stabilising the exchange rate since then, helping to mitigate the adverse macroeconomic implications of excessive depreciation and volatility of the currency. With the revoking of the mandatory sales requirement to the Central Bank and the announcement of the withdrawal of variation margin with effect from 07 March 2023, the rupee has recorded a significant appreciation so far during 2023. In addition, the Government is also following a policy of gradually relaxing of import restrictions, considering the improved forex liquidity conditions in the domestic forex market in recent periods.

With respect to external trade, Sri Lanka's exports in the last few decades have seen no major growth drive or boom due to legacy issues, such as limited diversification, low value addition, lower integration to global value chains, lower connectivity with less FTAs, high production costs, and the lack of sophistication required to remain competitive amidst the overvalued exchange rate, anti-export bias, and inadequate investments in the tradable sector. Expenditure on all categories of imports have increased at a faster pace leading to widening trade deficits, especially since 2011, mainly financed through external sector borrowings. Measures already taken to address those issues includes the continuation of the implementation of the National Export Strategy (NES) 2018-2022 and the provisioning of institutional support helped the export sector to remain resilient, while the depreciation of the exchange rate largely benefitted the export sector. Measures were taken to resume negotiations of free trade agreements in an expeditious manner, while initiating measures to improve on terms of existing trade agreements. The Government announced several trade supportive policies in the Budget 2023, such as establishing an International Trade Office to deal with all trade negotiations and an Agency for External Trade and Investment to coordinate with institutions engaged in external trade and reintroducing a Trade Adjustment Programme.

Measures proposed to address external sector issues include any effort in addressing the external current account deficit should be focused on strategies to reduce the trade deficit by simultaneous measures to increase the earnings from merchandise exports while increasing the surplus in the services account. Demand management measures through rationalisation of imports and efforts on import substitution may be introduced only on a temporary basis to preserve economic stability, as long term adaptation of such measures might undermine the competitiveness of the economy. Priority should be given to alleviate supply side constraints, such as high production costs, while strengthening the export orientation, supported by Research and Development (R&D) led innovation to harness potential global value chains and product networks through component manufacturing, vertical and horizontal integration, improving value addition, rationalising the institutional framework, removing bureaucratic bottlenecks, reducing over reliance on traditional markets as export destinations by way of exploring new markets and creating a trade and investor friendly environment.

Moreover, the export sector would have to be supported by conducive macroeconomic policies, particularly by maintaining a flexible exchange rate, consistent tax and investment policies, price stability and a thereby less volatile interest rate structure, and essential infrastructure facilities. Policy measures aimed at promoting domestic industries that supply intermediate goods required for key exports should be implemented promptly to enhance the domestic value addition in the export sector, while effectively substituting imports through integration. A level playing field created through free trade agreements would be an added advantage. Further, initiatives focused on moving towards renewable energy sources would also reduce the country's reliance on fossil fuels in the medium to long term thereby helping to minimise the pressure on the current account stemming from fuel imports.

2.5. Fiscal Sector

The government revenue collection in Sri Lanka has been well below the average revenue collection of peer economies. This was further aggravated with the low tax regime instituted since late 2019 which caused government revenue to record historically lowest tax to GDP ratio in 2021 and 2022. Considering the mounting financing pressure on fiscal front, the Government embarked on a major reform drive in 2022 aimed at strengthening revenue based fiscal consolidation measures. Accordingly, the Government introduced numerous revenue enhancement measures, including upward revision of personal and corporate income tax rates, increase in value added tax (VAT) rates and excise duties on petroleum, liquor and cigarettes, expansion in income tax and VAT base, revision of betting and gaming levy and introduction of new social security contribution levy. Several other taxes, such as property tax and inheritance tax will be introduced to improve government revenue collection within the next couple of years. In addition, Simplified VAT (SVAT) system and most tax exemptions will be removed in the period ahead to minimise tax losses to the Government. At the same time, institutional reforms are being undertaken at the Inland Revenue Department to improve tax administration. In addition, databases of revenue collection agencies, financial institutions, and other property registration institutions should be linked to identify tax evaders. Introduction of a real time invoicing system to prevent frauds related to value added and turnover taxes and the introduction of blockchains, integrated customs management systems, cargo scanners and trackers to minimise cross-border tax evasion could help in improving revenue administration. Moreover, the introduction of an efficient appeal process and an expeditious judicial process to resolve tax disputes could drastically cut down tax losses to the Government.

Borrowings from both domestic and foreign markets to finance perpetually large budget deficits has resulted in escalation of government debt levels to an unsustainable level. Subsequent to the debt standstill announced in April 2022, the Government initiated a debt restructuring process for the foreign debt portfolio with the aim of restoring debt sustainability. Negotiations are underway with the bilateral and commercial foreign creditors to restructure selected foreign debt. In addition, the Government has announced the Domestic Debt Optimisation strategy to complement foreign debt restructuring to facilitate the achievement of debt sustainability targets stipulated under the IMF-EFF supported programme. Going forward, the Government is committed to achieve a primary surplus from 2024 onwards through fiscal consolidation measures, which will reduce further accumulation of debt. Further, an independent debt management authority will be established with the objective of prudential, transparent and sustainable debt management. In addition, enhancing the transparency and accountability of state-owned business enterprises, implementation of cost-reflective pricing mechanisms for SOBEs engaged in supplying utilities, institutional reforms for SOBEs and divestment of non-strategic SOBEs would minimise the realisation of contingent liabilities of the Government in the period ahead.

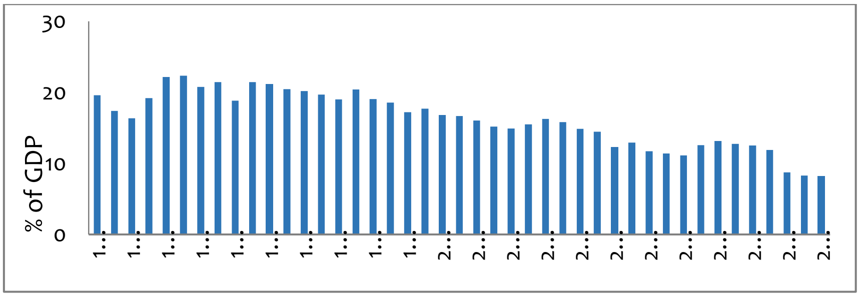

Figure 6: Government Revenue (as a % of GDP)

Source: Ministry of Finance, Economic Stabilisation and National Policies

Ineffective budgeting and poor public financial management have been main reasons for fiscal sector imbalances in the past. In most years, actual revenue collection was below the budget, whereas government expenditure was on or above the target, resulting in wider than expected budget deficits. Under the IMF-EFF supported programme, a new legislation will be introduced in relation to public financial management with the aim of improving the budgeting process and ensuring accountability and transparency for prudent public finance management. In addition, Anti-Corruption legislation has been enacted to minimise losses to the Government through possible corruption. Although Fiscal Management (Responsibility) Act was in place since 2003, actual public finance management in the country was not in line with the fiscal rules set out in the Act due to lack of accountability and weak enforcement. Therefore, strict enforcement of the aforementioned new legislations is warranted to attain the envisaged efficient public finance management.

03. Medium Term Outlook

The macroeconomic conditions have established to a greater extent at present, compared to the devastating conditions in 2022. Going forward, the country demands urgent and corrective actions aimed at fostering stabilization and ensuring a sustainable recovery over the medium term, with pointed actions towards securing long term economic growth. In resolving the long standing structural impediments of the economy, the country needs a multifaceted reform agenda. Major reforms areas, among others, would include factor market reforms (land, labour and capital market including inward investment regime), reforming the regulatory system to ensure competition in all markets including in non–tradable sector, revamping the existing inefficient social protection with targeted and clearly defined segments of protection, institutional and legal reforms, divestiture of SOEs, which perform poorly despite large government support contributing to the fiscal deficit and non-competitiveness of the present. These reforms would help transform the present economy into an export oriented, highly competitive social market economy, with higher and sustainable GDP growth, reduced poverty, and improved income distribution. In what follows a brief assessment on the sectoral outlook of the economy, subject to the assumption that the identified reforms would be implemented efficiently.

3.1. Real Sector

Sri Lankan economy is expected to record a contraction in the near term, and to gather some pace in recovery towards the latter part of 2023, supported by the eased monetary conditions, relaxation of import controls, particularly related to raw materials, moderation of inflation as well as gradual strengthening of investor confidence along with the envisaged macroeconomic stability.

As per the high frequency indicators, the real economy is envisaged to have contracted further during the second quarter of 2023, albeit at a slower pace than the contraction recorded in the first quarter of 2023. Services sector Purchasing Managers' Index (PMI) continued to remain in growth territory in June 2023 for the second consecutive month, following the marginal drop observed in the month of April, while manufacturing PMI continued to display subdued performance during the second quarter of 2023. However, a year-on-year contraction in manufacturing sector is expected in the second quarter of 2023 as reflected in the Index of Industrial Production (IIP), though cement availability registered some expansion during the same period, showing some demand recovery in the domestic construction sector. The agriculture sector is expected to report a growth during the second quarter of 2023 owing to the expected recovery in the growing of rice and cereals sectors, supported by an adequate supply of required fertilisers and agrochemicals for cultivation.

Going forward, the economy is expected to gradually recover during the second half of 2023 and reach the desired growth path over the medium term. With the envisaged macroeconomic stability in the aftermath of the debt restructuring process and the implementation of long overdue structural reforms as agreed under the IMF-EFF arrangements, the economy will be poised for faster economic growth in the medium term. The gradual normalisation of foreign inflows including foreign direct investments, easing of monetary conditions in the domestic market and improved investor confidence would boost the economic growth, enabling the economy to reach its full growth potential in the medium to long-run.

3.2. Inflation

According to the projections of the Central Bank, the declining trend of inflation is expected to continue. In the near term, headline inflation is expected to experience a temporary decline, falling below mid-single-digit level. Over the medium term, inflation is expected to stabilise at the targeted level with the anticipated developments in domestic and global fronts. Nevertheless, this projection is subject to considerable uncertainty, given the prevailing domestic and global economic uncertainties and geopolitical tensions.

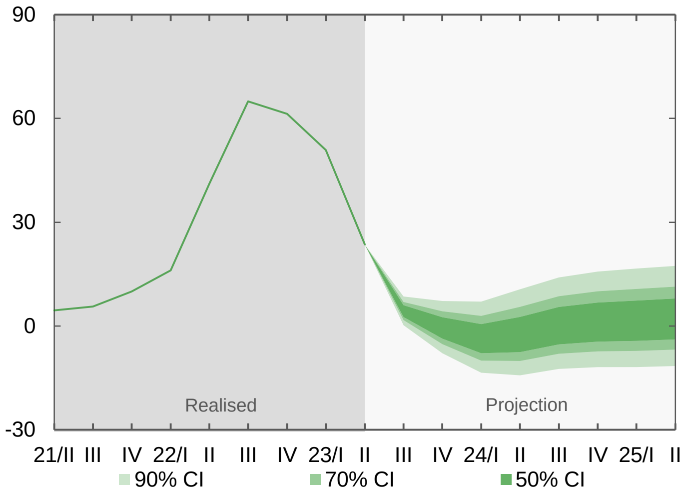

Figure 7: Projected Headline Inflation

(Quarterly, Colombo Consumer Price Index (CCPI), year-on-year, %)

Source: Central Bank Staff Projections

3.3. Monetary Sector

A downward adjustment in market interest rates, particularly lending interest rates, is expected in the period ahead, stabilising the interest rate structure at levels that enable sustainable credit flows to productive sectors of the economy. In terms of domestic credit by the banking system, credit to the private sector is expected to gradually recover in the second half of 2023 supported by relaxed monetary conditions, expected decline in market interest rates and the gradual relaxation of import restrictions. However, due to the significant contraction observed in private sector credit thus far during the year, the growth of private sector credit is expected to remain subdued on a year-on-year basis by the end of 2023. The credit to the public sector is likely to expand during the year mainly due to the expansion in net credit to the government (NCG) by the banking system. However, NCG is expected to

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expand at a lower scale compared to the previous year, as the Central Bank's NCG is envisaged to decline in line with the targets set by the IMF-EFF supported program to reduce monetary financing. Meantime, NCG by licensed commercial banks (LCBs) is projected to remain high throughout the year, leading to an overall expansion of NCG in 2023. On the other hand, credit to SOBEs is expected to decline in 2023, attributed to their improved financial positions due to cost-reflective pricing mechanisms and the transfer of outstanding liabilities from the banking system to the Government. The net foreign assets (NFA) of the banking system are expected to improve with the envisaged economic recovery, driven by the expected foreign currency inflows to the country. Accordingly, considering all these developments, broad money (M_{2b}) is expected to experience moderate growth compared to the previous year.

3.4. External Sector

The external sector outlook for 2023 and beyond will largely depend on the progress of debt restructuring, continuation of the IMF-EFF supported programme, and global economic and financial outlook. The trade deficit is likely to widen in 2023 with a projected increase in merchandise imports triggered by the gradual normalisation of economic activity and the relaxation of trade restrictions. The services account surplus is likely to increase in 2023 with the projected increase in earnings from tourism as well as the envisaged improvement in competitiveness of other services exports with the gradual normalisation of domestic economic activity. The primary income account deficit is likely to widen marginally in 2023 due to the possible rise in borrowing costs caused by monetary policy tightening in advanced economies. The secondary income account surplus is expected to widen in 2023 due to the persistently high departures for foreign employment and the expected rise in workers' remittances. The possible expansion in the trade deficit and primary income account deficit would be cushioned by the envisaged improvements in the services and secondary income accounts, resulting in the current account deficit to likely remain at a modest level in 2023. Inflows to the financial account are expected to strengthen in 2023 with the recommencement of certain infrastructure projects, envisaged FDIs, and foreign portfolio investment in the CSE and government securities markets along with other foreign financing flows from multilateral and bilateral partners. These inflows are expected to strengthen confidence among foreign investors in the prospects of economic engagement with the Sri Lankan economy in the period ahead.

Moreover, the external sector is expected to revert to a sustainable path over the medium term, supported by the envisaged successful progress of the debt restructuring as well as the economic adjustment programme under the IMF-EFF arrangement. The trade deficit is expected to narrow down over the medium term as the growth in exports is expected to outpace the increase in imports. Meanwhile, with the gradual normalisation of the global economy as well as increased mobility of people across the globe, Sri Lanka is likely to benefit from the prospects of its booming tourism industry reaching its potential in the period ahead. This, together with the expected rebound in activities in transport services and high growth in the IT/BPO services subsector, is envisaged to strengthen the surplus in the services account over the medium term. The primary income account deficit is expected to moderate in the period ahead with the expected reduction in interest payments due to the debt restructuring programme. Further, workers' remittances are expected to improve steadily over the medium term. Consequently, the external current account deficit is expected to decline gradually to a sustainable low level over the medium term. Moreover, financial flows are expected to strengthen over the medium term with the envisaged non debt creating inflows to the Colombo Port City, Colombo West Container Terminals, and the development of industrial zones, such as the Hambantota Industrial Zone. Inflows to the financial account are expected to be supported by enhanced investor confidence following the successful finalisation of debt restructuring and the economic adjustment programme supported by the IMF-EFF arrangement. Consequently, the gross official reserves are envisaged to strengthen over the medium term.

3.5. Fiscal Sector

With the completion of foreign debt restructuring and domestic debt optimisation processes, the Government is expected to receive a substantial relief on future debt service obligations. Furthermore, as uncertainties in the markets settle down, the risk premia expected by investors are anticipated to narrow down, reducing the interest costs to the Government. Reduced debt service payments, alongside the fiscal consolidation and revenue administration measures, will ease the pressure on the government finances, ensuring that the fiscal sector outlook remains in line with the recovery path envisaged under the IMF-EFF supported programme. Debt restructuring and improved fiscal performance would enable the Government to maintain the debt levels on a declining and sustainable path.

3.6. Legal Reforms

With the passage of the new Central Bank of Sri Lanka Act, the autonomy of the Central Bank is respected at all times, enabling independent policymaking by the Central Bank to achieve the mandated objectives of maintaining domestic price stability and securing financial system stability. Furthermore, it endorses more accountability and transparency of the Central Bank making it answerable to the legislature and the public. Moreover, the new Central Bank of Sri Lanka Act is expected to protect the country from disruptive effects of high and volatile inflation, and associated sharp movements in interest rates, thus fostering sustainable long term economic growth. The new Banking (Special Provisions) Act, as a supplement to the Banking Act, No. 30 of 1988, will provide the required legal framework to improve the resilience of the banking and financial sector, while also enhancing liquidity levels and related financial sector safety nets and resolution framework to preserve financial system stability. Strengthening Sri Lanka’s governance and anti-corruption framework is crucial to restore and sustain economic stability. Towards this end, the Anti-Corruption Bill was passed in the Parliament as part of a comprehensive anti-corruption reform agenda of the Government. Moreover, legislative reforms aiming at good governance, such as the Public Financial Management Bill and the Anti-corruption Act, are expected to ensure fiscal prudence and transparency in the period ahead. In addition, legal reforms are being introduced to liberalise the energy markets in Sri Lanka. Under this, the new Petroleum Products Act allows foreign suppliers to participate in the domestic petroleum market, with a view to ensuring continuous supply of fuel. Furthermore, reforms to revamp the electricity sector of the country are ongoing with a Cabinet-Appointed Committee on Power Sector Reform. Recommendations have already been made for unbundling of the provisioning of electricity, with the establishment of separate entities for generation, transmission, distribution, and sale of electricity. Meanwhile, efforts are needed to modernise and liberalise labour market laws and regulations in line with international labour standards, to facilitate the revival of the economy, as rigid labour market conditions remain one of the major bottlenecks for sustained economic growth.

04. Conclusion

The Sri Lankan economy is poised to recover gradually from its deepest economic contraction witnessed in 2022. This recovery would be buoyed by the macroeconomic adjustment programme under the IMF-EFF arrangement, which is aimed at restoring macroeconomic stability, debt sustainability, safeguarding financial system stability, strengthening governance and unlocking the growth potentials of the economy, while also alleviating the adverse impact of the economic crisis on the poor and vulnerable segments of the population.

The medium term outlook of the Sri Lankan economy depends heavily on the timely and effective fulfilment of performance criteria and structural benchmarks and reforms envisaged in the macroeconomic adjustment programme outlined in the IMF-EFF arrangement. Effective implementation of reforms in a timely and consistent manner would be essential to create a conducive business environment in the period ahead.

Although tightened monetary and fiscal policies and the BOP constraints could slow the pace of recovery in 2023, the improved sentiments following the approval of the IMF-EFF supported arrangement in March 2023 and the ongoing debt restructuring efforts, and the resultant stabilisation of macroeconomic conditions, are expected to support the recovery in momentum from late 2023.

Nonetheless, the economy is likely to face global headwinds, stemming from broad-based slowdown in global economic growth in 2023 and burgeoning financial market distress, which could impede the country's trade potential and discourage prospective foreign exchange inflows and foreign investment. Moreover, lower than expected external demand and the continuation of global supply chain issues could pose a risk of delayed normalisation of economic activities in Sri Lanka.

Headwinds due to consecutive economic shocks in recent years have severely affected Sri Lanka's economic activity in 2022, inflicting unimaginable hardships to individuals and businesses. The Government and the Central Bank were compelled to implement painful, but unavoidable policy measures aimed at restoring macroeconomic stability. The near-term economic stabilisation measures implemented thus far are unprecedented and we have started seeing the positive outcomes of such policies. Inflation is expected to follow a faster than expected disinflation path throughout 2023. External sector performance improved and the previous overshooting in the exchange rate is getting corrected. The IMF programme is progressing well despite several challenges. The stability of the financial sector has been preserved amidst numerous challenges, while the liquidity position of the banks has improved. Against this backdrop, we can use this crisis as an opportunity to introduce the necessary reforms to reorient our nation as a competitive and highly productive country in the region, All the participants in this conference, have the ability to contribute towards this, enabling our country to navigate through the crisis swiftly and effectively, thereby creating a prosperous nation for all of us.