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ECONOMIC, PRICE AND FINANCIAL SYSTEM STABILITY, OUTLOOK AND POLICIES

1.1 Overview

In 2014, the Sri Lankan economy showed its resilience in the face of domestic as well as external challenges. Real GDP grew by 7.4 per cent in 2014, in comparison to the growth of 7.2 per cent in 2013. Accordingly, GDP per capita increased to US dollars 3,625 in 2014 from US dollars 3,280 in the previous year. The economy was driven by domestic consumption expenditure that constitutes the largest share of aggregate demand, while investments, particularly on construction, also provided an impetus to the economic expansion during the year. On the production side, the Industry and Services sectors continued to perform well, while adverse weather conditions dampened the performance of the Agriculture sector during the year. Inflation remained at single digit levels for the sixth consecutive year, with year-on-year and annual average inflation declining to 2.1 per cent and 3.3 per cent, respectively, by end 2014, from 4.7 per cent and 6.9 per cent, respectively, at end 2013. Prudent monetary policy as well as the considerable decline in global commodity prices in the second half of the year enabled the deceleration of inflation to low single digit levels during the year. In spite of the relatively relaxed monetary policy stance, the effect of declining pawning advances as a result of lower international gold prices shrouded the pickup of credit obtained by the private sector, particularly in the first seven months of the year. In the absence of demand pressures on inflation, the Central Bank took measures to facilitate further credit disbursements by banks. However, these measures, along with volatile global conditions, caused some portfolio investment outflows and encouraged imports, increasing the pressure on the external sector and the exchange rate towards the latter part of the year. Overall, the trade deficit widened in nominal terms during the year, although inflows from trade in services and workers' remittances supported the reduction of the deficit in the current account. This, together with other financial inflows, helped strengthen the balance of payments (BOP), and hence gross official reserves. The continued inflow of funds from the expatriate workforce in the form of remittances and investments aided an increase in national savings, which helped reduce the savings-investment gap. Meanwhile, in the fiscal sector, despite the government's announced commitment towards fiscal consolidation, the overall fiscal deficit increased to 6.0 per cent of GDP in 2014 from 5.9 per cent of GDP in the previous year, mainly as a result of the continued shortfall in revenue collection. Nevertheless, central government debt as a percentage of GDP declined to 75.5 per cent by end 2014 from 78.3 per cent by end 2013. In the financial sector, the strengthened regulatory and supervisory framework, improved risk management capabilities and adequate buffers to mitigate risks, enabled financial institutions to remain resilient during the year.

Table 1.1 Macroeconomic Performance (2010-2014)

Indicator	Unit	2010	2011	2012	2013(a)	2014(b)
Real Sector and Inflation						
Real GDP Growth	%	8.0	8.2	6.3	7.2	7.4
GDP at Market Prices	Rs.bn	5,604	6,543	7,579	8,674	9,785
Per Capita GDP	US$	2,397	2,836	2,922	3,280	3,625
Annual Average Inflation	%	6.2	6.7	7.6	6.9	3.3
External Sector						
Trade Balance	% of GDP	-9.7	-16.4	-15.9	-11.3	-11.1
Current Account Balance	% of GDP	-2.2	-7.8	-6.7	-3.8	-2.7
Overall Balance	US$ mn	921	-1,059	151	985	1,369
External Official Reserves	US$ mn	7,196	6,749	7,106	7,495	8,208
Fiscal Sector						
Current Account Balance	% of GDP	-2.1	-1.1	-1.0	-0.8	-1.3
Overall Balance	% of GDP	-8.0	-6.9	-6.5	-5.9	-6.0
Central Government Debt	% of GDP	81.9	78.5	79.2	78.3	75.5
Monetary Sector (c)						
Broad Money Growth (M_{2b})	%	15.8	19.1	17.6	16.7	13.4
Growth in Credit to the Private Sector (in M_{2b})	%	24.9	34.5	17.6	7.5	8.8

(a) Revised
(b) Provisional
(c) Year-on-year growth based on end year values

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

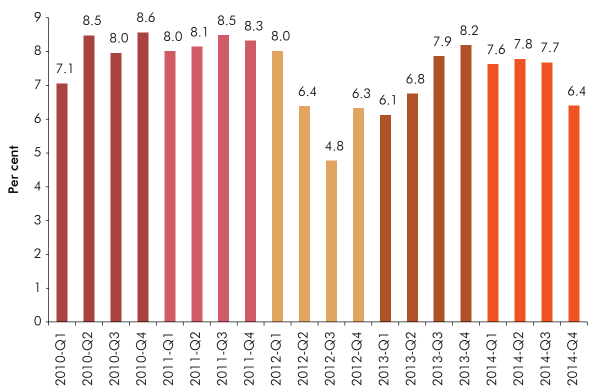
Going forward, the Sri Lankan economy is projected to reach upper middle income levels and sustain the favourable high growth and low inflation nexus in the medium term, supported by appropriate economic policies. The new government is expected to uphold policies of good governance and transparency, which would support a high growth path through an improved investor friendly environment. The government faces the enormous task of articulating a coherent medium term policy framework, which enhances positive effects while addressing possible shortcomings of previously announced policies as well as the challenges ahead. Some of these challenges are, the urgent need to address the continued decline in government revenue as a percentage of GDP in order to achieve a better fiscal balance; increasing productivity of all sectors of the economy, including the public sector; raising resources required for sustained growth through non debt creating sources, in particular, foreign direct investments (FDI); developing appropriate pricing policies for public utilities; better identification of beneficiaries in implementing social safety nets and subsidy programmes; improving the equity and quality of health and education service provision; addressing the issue of public transportation; continuing physical infrastructure development on a sustainable basis; formulating policies to address the challenge of aging population including improving labour productivity and promoting the development of superannuation and insurance products; and, improving the doing business environment and policy predictability. Addressing such challenges would be essential to realise the projected growth path as envisaged, enabling the economy to achieve its full potential while maintaining macroeconomic stability in a more equitable environment.

1.2 Macroeconomic Developments, Stability and Policy Responses in 2014

Real Sector Developments and Inflation

The Sri Lankan economy achieved a real GDP growth of 7.4 per cent in 2014 in comparison to 7.2 per cent in 2013. Amidst diverse developments in the global economy, continued domestic economic activity helped sustain the growth in the Industry and Services sectors. The Services sector, which represents 57.6 per cent of GDP, grew by 6.5 per cent in 2014 compared to the growth of 6.4 per cent in 2013, with significant contribution from Wholesale and retail trade, Transport and communication, and

Chart 1.1 Quarterly Real GDP Growth



Banking, insurance and real estate sub sectors. The share of the Industry sector within GDP increased further to 32.3 per cent, with a sectoral growth of 11.4 per cent in 2014 compared to 9.9 per cent in the previous year. The Construction sub sector recorded the highest contribution to the growth of the Industry sector, while Food, beverages and tobacco and Textile, wearing apparel and leather sub sectors within Factory Industry also made substantial contribution to growth. Meanwhile, affected by adverse weather conditions, the Agriculture sector, which represents 10.1 per cent of GDP, contributed only marginally to real GDP growth. The growth of the Agriculture sector was 0.3 per cent in 2014, compared to 4.7 per cent recorded in the previous year.

The expansion in both investment and consumption activities supported the growth of GDP in 2014. As per the expenditure approach, increased investment expenditure was due to both private and public sector investments. The growth in private consumption expenditure was supported by lower domestic interest rates and higher disposable incomes. As a result, expenditure on imports of consumer goods increased significantly. Higher contribution from the growth in imports relative to exports, however, resulted in a marginal deterioration of net external demand in nominal terms during the year.

Domestic savings improved to 21.1 per cent of GDP in 2014 from 20.0 per cent in the previous year. The improvement in domestic savings during the year was due to the continuous

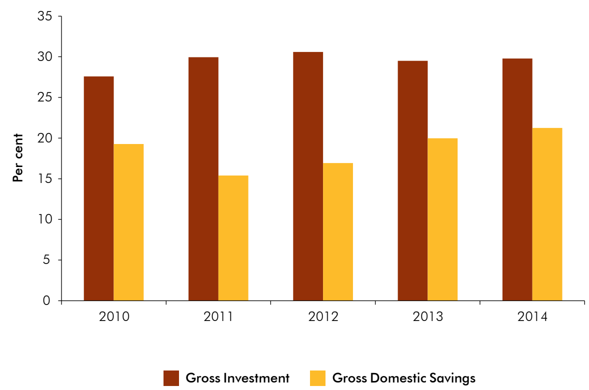
Table 1.2 Aggregate Demand and Savings Investment Gap at Current Market Prices

Item	Rs. billion		Growth (%)		As a percentage of GDP	
	2013 (a)	2014 (b)	2013 (a)	2014 (b)	2013 (a)	2014 (b)
1. Domestic Demand	**9,500.8**	**10,621.2**	**10.3**	**11.8**	**109.5**	**108.5**
1.1 Consumption	6,940.6	7,716.2	10.2	11.2	80.0	78.9
Private	5,803.3	6,398.3	10.0	10.3	66.9	65.4
Public	1,137.3	1,317.8	11.3	15.9	13.1	13.5
1.2 Investment (Gross Domestic Capital Formation)	2,560.2	2,905.0	10.4	13.5	29.5	29.7
Private	1,965.0	2,236.8	9.5	13.8	22.7	22.9
Public	595.2	668.1	13.7	12.3	6.9	6.8
2. Net External Demand	**-826.6**	**-836.5**	**20.2**	**-1.2**	**-9.5**	**-8.5**
Export of Goods and Services	1,949.2	2,185.0	12.6	12.1	22.5	22.3
Import of Goods and Services	2,775.7	3,021.5	0.3	8.9	32.0	30.9
3. Total Demand (GDP) (1+2)	**8,674.2**	**9,784.7**	**14.5**	**12.8**	**100.0**	**100.0**
4. Domestic Savings (3-1.1)	**1,733.7**	**2,068.5**	**35.2**	**19.3**	**20.0**	**21.1**
Private	1,801.4	2,196.2	32.2	21.9	20.8	22.4
Public	-67.7	-127.7	14.9	-88.5	-0.8	-1.3
5. Net Factor Income from Abroad	**-226.1**	**-240.1**	**-46.0**	**-6.2**	**-2.6**	**-2.5**
6. Net Current Transfers from Abroad	**728.7**	**813.1**	**5.8**	**11.6**	**8.4**	**8.3**
7. National Savings (4+5+6)	**2,236.3**	**2,641.6**	**23.1**	**18.1**	**25.8**	**27.0**
8. Savings Investment Gap						
Domestic Savings - Investment (4-1.2)	-826.6	-836.5			-9.5	-8.5
National Savings - Investment (7-1.2)	-324.0	-263.4			-3.7	-2.7
9. External Current Account Balance (2 + 5 + 6)	**-324.0**	**-263.4**			**-3.7**	**-2.7**

(a) Revised
(b) Provisional

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

Chart 1.2 Savings and Investment (as a percentage of GDP)



expansion in private savings amidst an increase in government dissavings. National savings improved to 27.0 per cent of GDP as a combined result of continued inflows in the form of workers' remittances and the deceleration in the negative growth of net factor income from abroad (NFIA) compared to the previous year. These developments contributed to a narrowing of the savings-investment gap to 2.7 per cent of GDP in 2014 from 3.7 per cent of GDP in 2013.

The Agriculture sector grew marginally by 0.3 per cent in 2014 reducing its share in GDP to 10.1 per cent from 10.8 per cent in 2013. Impacted by adverse weather conditions, several key sub sectors including paddy (16.7 per cent), rubber (32.3 per cent) and minor export crops (15.0 per cent) contracted, largely contributing to the deceleration of the growth in the Agriculture sector. The paddy output declined significantly in both Yala and Maha seasons. Rubber production declined for the third consecutive year, affected by weakened international demand for natural rubber as well as adverse weather conditions. However, the contraction in output of several key sub sectors was somewhat offset by the improved performance in the coconut and other food crops sub sectors. The coconut sub sector registered an increase of 7.9 per cent in output in 2014 as against a decline of 16.1 per cent in the previous year. The production of other food crops increased by 7.0 per cent in 2014 compared to the growth of 4.3 per cent in the previous year. The utilisation of paddy lands for the cultivation of other food crops and government policies aimed at protecting local farmers helped increase domestic production. Meanwhile, the tea industry performed well in 2014 backed by increased tea prices although its output declined marginally from the highest ever production levels recorded in 2013.

Table 1.3 Gross National Product by Industrial Origin at Constant (2002) Prices

Sector	Value (Rs. million)		As a Share of GDP (%)		Rate of Change (%)		Contribution to Change (%)	
	2013 (a)	2014 (b)	2013 (a)	2014 (b)	2013 (a)	2014 (b)	2013 (a)	2014 (b)
Agriculture	**352,583**	**353,799**	**10.8**	**10.1**	**4.7**	**0.3**	**7.1**	**0.5**
Agriculture, Livestock and Forestry	309,134	308,403	9.5	8.8	4.5	-0.2	6.0	-0.3
Fishing	43,449	45,397	1.3	1.3	6.2	4.5	1.2	0.8
Industry	**1,016,886**	**1,132,892**	**31.1**	**32.3**	**9.9**	**11.4**	**41.6**	**48.2**
Mining and Quarrying	94,388	104,767	2.9	3.0	11.5	11.0	4.4	4.3
Manufacturing	559,843	604,677	17.1	17.2	7.5	8.0	17.6	18.6
Electricity, Gas and Water	79,913	83,542	2.4	2.4	10.3	4.5	3.4	1.5
Construction	282,742	339,906	8.7	9.7	14.4	20.2	16.1	23.8
Services	**1,896,572**	**2,019,973**	**58.1**	**57.6**	**6.4**	**6.5**	**51.3**	**51.3**
Wholesale and Retail Trade	739,826	798,837	22.7	22.8	5.5	8.0	17.4	24.5
Hotels and Restaurants	25,715	28,676	0.8	0.8	22.3	11.5	2.1	1.2
Transport and Communication	476,721	511,296	14.6	14.6	9.4	7.3	18.5	14.4
Banking, Insurance and Real Estate etc.	285,750	304,478	8.7	8.7	5.9	6.6	7.3	7.8
Ownership of Dwellings	79,175	80,178	2.4	2.3	2.9	1.3	1.0	0.4
Government Services	213,439	216,477	6.5	6.2	2.8	1.4	2.7	1.3
Private Services	75,946	80,030	2.3	2.3	7.3	5.4	2.3	1.7
Gross Domestic Product	**3,266,041**	**3,506,664**	**100.0**	**100.0**	**7.2**	**7.4**	**100.0**	**100.0**
Net Factor Income from Abroad	-85,127	-86,035			-36.8	-1.1		
Gross National Product	**3,180,915**	**3,420,629**			**6.6**	**7.5**		

(a) Revised
(b) Provisional

Source: Department of Census and Statistics

The government undertook several policy measures during 2014 to promote growth and improve productivity in the Agriculture sector. The subsidy programmes to promote replanting and new planting in the tea and rubber sectors were continued during 2014. In the tea sector, factory modernisation continued and steps were taken to popularise mechanisation for tea plucking with a view to improving productivity and good manufacturing practices. Further, the projects under the Livestock Master Plan initiated by several government institutions continued in 2014. Several measures were also implemented to strengthen the national fishing fleet and the construction and upgrading of fishery harbours and anchorages to facilitate deep sea fishing. Meanwhile, policy measures were proposed in the Interim Budget for 2015 including an increase in the purchasing price of paddy under the guaranteed paddy purchasing scheme and increases in the producer prices of potatoes and tea leaves, fresh milk, as well as rubber to promote domestic agriculture. Also, a 50 per cent waiver of loans and advances extended to farmers by commercial banks, which stand past due, was proposed in the Interim Budget, subject to a maximum loan amount of Rs. 100,000.

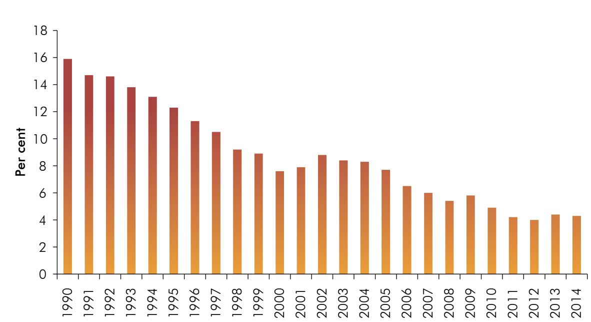
The Industry sector growth, bolstered by manufacturing and construction activity, accelerated to 11.4 per cent, enhancing its share in the national output to 32.3 per cent in 2014. The Manufacturing sub sector, which accounts for 53.4 per cent of the value addition in the Industry sector, grew by 8.0 per cent in 2014. Factory industry, which comprises the largest share of the manufacturing sub sector, grew by 8.5 per cent in 2014 with improved external and domestic demand alongside a conducive domestic macroeconomic environment. Export oriented industries continued to be the primary contributor to the growth in factory industry output. Wearing apparel industry recorded a growth of 13.2 per cent in 2014 benefitting from Sri Lanka's international reputation as a reliable and high quality manufacturer compared to its regional peers. Despite lower domestic production of natural rubber, the Rubber and plastic products sub sector, which increased by 7.1 per cent, maintained its growth momentum facilitated by an increase in raw rubber imports, which were used as an input for the manufacture of rubber product exports during the year. This growth was further supported by external demand for rubber tyres, tubes and other rubber based products. Meanwhile, a persistently low interest rate environment supported by low inflation stimulated domestic demand and boosted the output of domestic market oriented industries in 2014. Accordingly, the Food, beverages and tobacco sub sector grew by 8.1 per cent during the year. This growth was further supported by the increased performance in the leisure industry. Meanwhile, the Construction sub sector continued to play a vibrant role in propelling the economy forward with a growth of 20.2 per cent in 2014, contributing nearly 24 per cent to the growth in 2014. The growth in the Construction sub sector was supported by public investments in infrastructure development activities, housing development projects as well as large scale private construction activities. The Mining and quarrying sub sector also benefitted from the expansion in construction activity.

The government continued to extend incentives for the development of the Industry sector by providing fiscal concessions, technical assistance as well as upgrading infrastructure facilities required to promote regional industrialisation. Fiscal concessions were mainly aimed at encouraging local value addition and in inculcating energy saving and green manufacturing methods. Meanwhile, the establishment of Industrial Estates (IEs), continued to progress under the directives of the Ministry of Industry and Commerce (MIC) while the National Enterprise Development Authority (NEDA) carried out several activities at district and regional levels to provide business development services to Small and Medium Enterprises (SMEs). Further, the government also introduced technological initiatives such as the establishment of the Sri Lanka Gamma Centre to offer sterilization facilities for industrial products such as latex gloves, agriculture products, spices and other export products. National Non-Destructive Testing Centre was also set up in 2014 with well-equipped internationally accepted testing laboratories to provide safety certification for materials used in industries such as construction, heavy machinery and ship building. Meanwhile, to facilitate industry startups the Sri Lanka Institute of Nanotechnology (SLINTEC) commenced the construction of a Technology Incubation Centre during the year. However, to sustain the industrial growth momentum in the long term, the potential of industries with high value addition, such as electrical, electronic and mineral products, needs to be explored further.

The Services sector expanded by 6.5 per cent in 2014 bolstered by the performance in the wholesale and retail trade sub-sector, accounting for a share of 57.6 per cent of value added in GDP. The Wholesale and retail trade sub sector, which accounts for 22.8 per cent of GDP, accelerated its growth rate to 8.0 per cent in 2014 from 5.5 per cent in the previous year. Within wholesale and retail trade, domestic trade activities grew by 8.1 per cent supported by robust consumer demand underpinned by low interest rates, improved supply side conditions such as higher domestic industrial production, and the development of roads and communications networks which facilitated trade activity. Moreover, value added from the Import trade sub sector grew at a healthy rate of 9.4 per cent supported by the continuous growth in consumer goods imports and a recovery in the growth of imports of intermediate goods, while value added from the export trade sub sector expanded at a slower pace of 4.6 per cent. Transport and communications services, accounting for 14.6 per cent of GDP, grew at a slower pace of 7.3 per cent with the deceleration of the growth in passenger and goods transportation sub sector from 9.4 per cent in the previous year to 7.3 per cent in 2014. Meanwhile, the banking, insurance and real estate sub sector grew in line with the domestic economic activity. The hotels and restaurants sub sector, albeit small in terms of GDP percentage share, recorded a noteworthy expansion buttressed by continued high tourist arrivals.

The unemployment rate declined with increased employment opportunities as well as a reduction in the Labour Force Participation Rate (LFPR). The unemployment rate marginally declined to 4.3 per cent in 2014 from 4.4 per cent in the previous year. Both male and female unemployment rates remained broadly unchanged

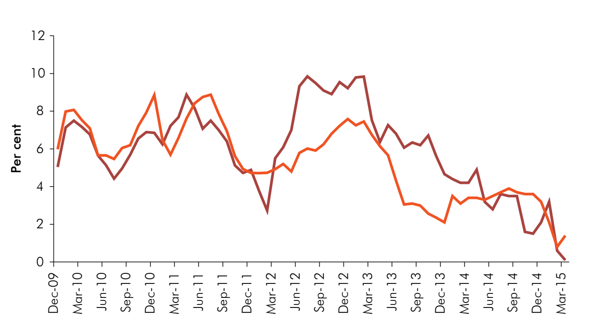
Chart 1.3 Annual Unemployment Rate



at 3.2 per cent and 6.5 per cent, respectively, in 2014. The LFPR declined to 53.3 per cent in 2014 from 53.8 per cent during 2013. The low unemployment rate coupled with decreasing LFPR may be indicative of a labour shortage in the market. In the meantime, labour productivity levels continued to increase, with positive contributions from all three sectors of the economy.

Inflation remained at low single digit levels throughout 2014 reflecting the impact of demand management policies, improved supply conditions, downward revision of administered prices and effectively contained inflation expectations. Headline inflation, as measured by the year-on-year change in the Colombo Consumers' Price Index (CCPI) (2006/07=100), fell further to 2.1 per cent in December 2014 in comparison to 4.7 per cent in 2013. The year-on-year headline inflation remained at single digit levels for the sixth consecutive year. Meanwhile, the annual average rate of headline inflation decelerated to 3.3 per cent in December 2014 from 6.9 per cent in December 2013. The combined impact of prudent monetary management, moderation in international commodity prices, a relatively stable exchange rate, fiscal policy measures taken to address supply side disturbances and well managed inflation expectations contributed to low levels of inflation experienced throughout the year. The downward revision to administered prices of

Chart 1.4 Year-on-Year Inflation



electricity, water, LP Gas and fuel in the latter half of the year resulted in headline inflation declining to 1.5 per cent in November, the lowest recorded for 2014. Core inflation remained at low levels throughout the year although it moved up to 3.2 per cent, year-on-year, in December 2014 compared to 2.1 per cent at end 2013.

External Sector Developments

Sri Lanka's external sector improved its resilience in 2014 with a narrowing of external sector imbalance and a surplus in the overall BOP. The current account deficit narrowed to 2.7 per cent of GDP from 3.8 per cent in the previous year buttressed by higher inflows from remittances and trade in services. The deficit in the trade account, as a percentage of GDP, declined to 11.1 per cent in 2014 from 11.3 per cent in the previous year, although in nominal terms the trade deficit increased with a pickup in imports during the latter part of the year. Meanwhile, inflows to the government, banks and the corporate sector propped the financial account of the BOP helping to record a higher surplus in the BOP and an improvement in gross international reserves of the country, despite some volatility in the government securities and equity markets towards the second half of the year. These developments enabled the rupee to remain relatively stable during the year along with the Central Bank's initiatives to smoothen short term volatility in the exchange rate.

Although the trade deficit declined as a percentage of GDP, a notable increase in the trade deficit in nominal terms was observed in 2014. During the first half of 2014, earnings from exports grew by 17.0 per cent while expenditure on imports declined by 1.2 per cent, resulting in a contraction of the trade deficit by 20.3 per cent over the same period of 2013. However, as imports grew faster and export growth decelerated in the second half of 2014, the overall trade deficit expanded by 8.9 per cent, year-on-year, to a value of US dollars 8,287 million in 2014.

Exports grew at a healthy rate in 2014 supported by improved external demand along with a stable domestic macroeconomic environment. Earnings from exports grew by 7.1 per cent in 2014 compared to the previous year and reached US dollars 11,130 million, reflecting increases in all major categories. The highest contribution to export earnings was from industrial exports, supported by the substantial increase in exports of textiles and garments. Earnings from textiles and garments exports, which accounted for about 44 per cent of total exports, recorded an increase of 9.4 per cent in 2014, reflecting increases in garment exports to both traditional and non-traditional markets. Meanwhile, earnings from agricultural exports registered an increase of 8.2 per cent in value terms due to higher exports of coconut products, tea and certain minor agricultural products. Export earnings from coconut products and tea increased by 74.2 per cent and 5.6 per cent, respectively, mainly due to higher export volumes. However, export earnings from spices, which showed a higher growth of 38.8 per cent during the previous year declined by 25.6 per cent in 2014 mainly due to low harvest of main export crops.

Expenditure on imports registered an increase of 7.9 per cent in 2014 over the previous year, led by imports of intermediate goods and consumer goods, particularly during the second half of the year. The increase in intermediate goods was mainly led by higher imports of petroleum products and textiles and textile articles. Despite the significant decline in fuel prices in the international markets during the latter part of the year, high import volumes due to increased thermal power generation caused the expenditure on import of fuel to increase by 6.7 per cent. In line with the increase in textiles and garments exports, the expenditure on imports of textiles and textile articles increased by 13.8 per cent. Meanwhile, imports of consumer goods increased reflecting the expansion in both food and non-food categories. Higher expenditure on imports of motor vehicles for personal use and increased rice imports mainly contributed to the growth in consumer goods imports. However, during the year, expenditure on investment good imports declined by 2.4 per cent in value terms, largely due to lower imports of machinery and equipment and building material.

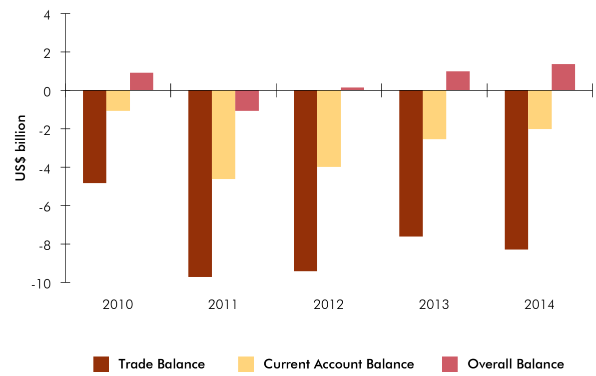
Increased inflows from trade in services as well as higher workers' remittances contributed to reduce the current account deficit during 2014. The surplus of the services account was mainly supported by high inflows into transport, travel and, telecommunication, computer and information services sub sectors. The growth in earnings from tourism was supported by increased average spending of tourists and average period of stay, together with increased tourist arrivals during the year. Meanwhile, increased trade activities and increased earnings from passenger fares due to higher tourist arrivals contributed towards the favourable development in the transport sub sector. The telecommunications, computer and information services sub sectors continued to expand during 2014. Continuous expansion of telecommunication services with new technological innovations and increased earnings from Business Process Outsourcing (BPO) and Knowledge Process Outsourcing (KPO) contributed to the expansion of telecommunications, computer and information services. Meanwhile, the growth in workers' remittances was supported by the expansion in migration under professional and skilled categories. Consequently, the deficit of the current account declined to US dollars 2,018 million (2.7 per cent of GDP) in 2014 from US dollars 2,541 million (3.8 per cent of GDP) in 2013.

Inflows to the financial account increased with the receipts to the private sector as well as to the government. In 2014, the major inflow to the financial account was the US dollars 1.5 billion received from the sixth and the seventh International Sovereign Bonds.

The financial account was supported by FDI related inflows to the banking sector and BOI companies. Meanwhile, the financial account recorded moderate inflows on account of foreign loans to the government, particularly for major infrastructure projects. Inflows to the private sector were supported by an international bond issuance by SriLankan Airlines and other foreign loan inflows. Meanwhile, the international bond issuance of the National Savings Bank (NSB) marked the major inflow to the banking sector during the year. However, foreign investments in the government securities market and the Colombo Stock Exchange (CSE) remained subdued in the backdrop of foreign investment outflows from emerging markets during the latter part of 2014. Nevertheless, the CSE recorded a net inflow during the year.

Higher inflows to the private sector in the form of foreign borrowings, issuances of International Sovereign Bonds and the international debt securities issued by deposit taking corporations resulted in an increase in the external debt position of the country. Accordingly, total external debt stock of the country amounted to US dollars 43.0 billion as of end 2014 recording an increase of 7.7 per cent compared to US dollars 39.9 billion at end 2013. However, total external debt decreased to 57.4 per cent of GDP as at end 2014, from 59.4 per cent as at end 2013, due to the increase in GDP growth at a higher rate compared to the growth of total external debt stock. In the meantime, during 2014, total foreign debt service payments decreased primarily due to the reduction in repayments of Treasury bills and Treasury bonds and decreased capital repayments in relation to long term loans of the government. However, interest payments on outstanding government medium and long term debt recorded an increase during the year. Consequently, debt service payments as a percentage of export of goods and services declined mainly due to decreased capital repayments and increased earnings of exports of goods and services.

Chart 1.5 Balance of Payments



The BOP recorded a surplus with improvements in the current account and net inflows to the financial account during 2014. The BOP surplus improved during the year to US dollars 1,369 million from US dollars 985 million recorded in 2013. With these developments gross official reserves increased to US dollars 8.2 billion at end 2014 compared to US dollars 7.5 billion recorded at end 2013. Gross official reserves by end 2014 were equivalent to 5.1 months of goods imports and 4.3 months of goods and services imports. Meanwhile, total foreign assets, which includes foreign financial assets of deposit taking corporations stood at US dollars 9.9 billion at end 2014 and was equivalent to 6.1 months of goods imports and 5.1 months of goods and services imports. However, with increased demand for foreign exchange, some decline in external reserves was experienced during the first quarter of 2015.

The Sri Lankan rupee remained relatively stable during 2014 supported by regular policy intervention to minimise excessive volatility of the exchange rate and to build up official reserves. The Sri Lankan rupee, which appreciated by 0.29 per cent during the first nine months of the year on the backdrop of increased earnings from exports of goods and services, higher workers' remittances and inflows to the financial account, depreciated by 0.47 per cent during the fourth quarter of 2014. Increased demand for US dollars by importers and some outflow of short term investment were the main reasons that created some pressure and hence the depreciation of the Sri Lankan rupee against the US dollar during the fourth quarter of 2014. Consequently, the Sri Lankan rupee depreciated by 0.23 per cent against the US dollar to Rs. 131.05 at end of 2014, although the rupee appreciated against all other major currencies as a result of cross currency exchange rate movements. Meanwhile, both the Nominal Effective Exchange Rate (NEER) and the Real Effective Exchange Rate (REER) indices based on the 5-currency and 24-currency baskets continued to appreciate during the year. Forward premia for 1-month, 3-months and 6-months on average remained lower than interest rate differentials during 2014 indicating market expectations of further inflows to the foreign exchange market in the short term. However, this trend reversed towards the latter part of the year with the depreciation pressure on the domestic currency.

Fiscal Sector Developments

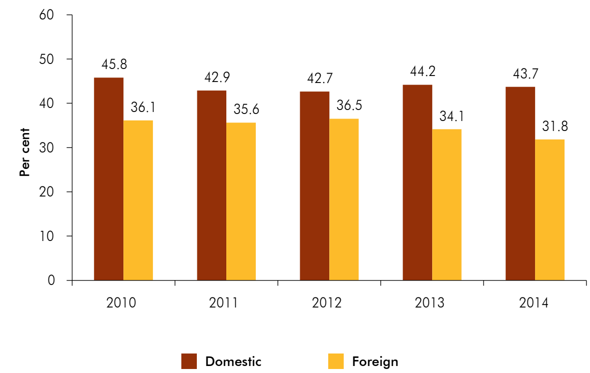
Fiscal sector targets for 2014 were set in line with the Medium Term Macro Fiscal Framework 2014-2017 articulated in the Fiscal Management Report for 2014 with a view to reducing the budget deficit further, while encouraging investment to support a higher economic growth with macroeconomic stability. Accordingly, the budget deficit was targeted to reduce to 5.2 per cent of GDP in 2014 from 5.9 per cent of GDP in 2013. In order to realise this target, total government revenue was expected to increase to 14.5 per cent of GDP in 2014, while recurrent expenditure was to be contained at 13.4 per cent of GDP. Meanwhile, capital expenditure and net lending was expected to be increased to 6.6 per cent of GDP.

Notwithstanding the government's expectations and efforts, a significant deviation from the fiscal targets was observed with the budget deficit in 2014 being recorded at 6.0 per cent of GDP, reversing the declining trend experienced in the past few years. This was an outcome of the decline in government revenue to 12.2 per cent of GDP due to a shortfall in tax revenue below the anticipated levels despite the favourable developments on the expenditure front. Recurrent expenditure as a percentage of GDP declined to 13.5 per cent in 2014 from 13.9 per cent in the previous year, while capital expenditure and net lending declined to 4.8 per cent of GDP from 5.4 per cent in 2013. Meanwhile, the current account deficit, which reflects government dis-savings, also increased to 1.3 per cent of GDP in 2014 from 0.8 per cent of GDP in the previous year and primary deficit increased to 1.6 per cent from 0.8 per cent. Compared to the estimate of 74.3 per cent of GDP, central government debt as a percentage of GDP declined to 75.5 per cent in 2014 from 78.3 per cent in the previous year continuing its declining trend benefiting from the expansion in nominal GDP.

Government revenue as a percentage of GDP declined to 12.2 per cent of GDP in 2014 compared to 13.1 per cent in 2013 despite several measures taken to increase government revenue. As the declining trend in government revenue as a percentage of GDP remained a key concern in the fiscal sector in the recent past, several measures were introduced in 2014 to streamline the tax system, while rationalising tax exemptions and concessions to raise both direct and indirect tax revenue. With regard to direct taxes, corporate and personal income tax structure was further consolidated by introducing a lower tax regime, while improving the tax base. On the indirect tax front, the base of both Value Added

Chart 1.6 Revenue, Expenditure and Overall Fiscal Deficit (as a percentage of GDP)

Chart 1.7 Central Government Debt (as a percentage of GDP)



Tax (VAT) and Nation Building Tax (NBT) was broadened. Furthermore, measures were taken to enhance the efficiency of tax system by simplifying the existing tax structure, particularly transforming multiple taxes on imports to a single tax. In the meantime, emphasis was placed on strengthening tax administration of revenue collection agencies through automation of activities, improved auditing and risk management and the introduction of unique identification numbers for tax payers to link external interfaces. Benefiting from such measures, revenue in nominal terms increased by 5.1 per cent to Rs. 1,195.2 billion in 2014 from Rs. 1,137.4 billion in 2013 mainly due to an increase in indirect tax revenue. Revenue generated in the form of direct taxes, such as corporate and non-corporate income tax, personal income tax, withholding tax and economic service charge (ESC) declined. Meanwhile, non tax revenue in nominal terms increased by 10.1 per cent to Rs. 144.8 billion in 2014 in contrast to the decline of 7.7 per cent in the previous year mainly due to increased profit and dividend transfers from State Owned Business Enterprises.

Reflecting the impact of measures taken to ensure better management of recurrent expenditure and to streamline capital expenditure in view of the shortfall in of government revenue, expenditure and net lending as a percentage of GDP declined to 18.3 per cent in 2014 from 19.2 per cent in 2013. The reduction in total expenditure was the combined outcome of the reduction in recurrent expenditure as well as capital expenditure and net lending. However, in nominal terms, total expenditure and net lending increased by 7.6 per cent to Rs. 1,795.9 billion in 2014 from Rs. 1,669.4 billion in 2013 although it was lower than the expenditure of Rs. 1,985.6 billion envisaged in the budget. During the year, the government introduced several measures for better management of recurrent and capital expenditure. As per the National Budget Circular No.1/2014, all spending agencies were requested to limit their recurrent and capital expenditure to the provisions allocated in the Budget for 2014 with special attention on expenditure on overtime, fuel, electricity, water, transport and foreign travel. Benefiting from such measures, the government was able to maintain recurrent expenditure below the targeted level. As a percentage of GDP, recurrent expenditure declined to 13.5 per cent in 2014 from 13.9 per cent in 2013 mainly as a result of the decline in interest payments. In the meantime, capital expenditure and net lending as a percentage of GDP declined to 4.8 per cent in 2014 from 5.4 per cent in the previous year and was significantly below the annual target of 6.6 per cent of GDP. Accordingly, public investment declined to 5.0 per cent of GDP.

The government mainly utilised domestic sources, especially from the non-bank sector in financing the budget deficit in 2014. The overall fiscal deficit increased to 6.0 per cent of GDP from 5.9 per cent in 2013 and stood at Rs. 591.2 billion in 2014. The government relied mainly on the non bank sector to finance the budget deficit in 2014. Accordingly, net domestic financing amounted to Rs. 378.7 billion in 2014 in comparison to the original estimate of Rs. 229.3 billion and Rs. 392.4 billion in the previous year. Out of the total net domestic financing, Rs. 251.8 billion representing 66.5 per cent was raised from the non banking sector. During 2014, banking sector borrowings declined significantly to Rs. 126.9 billion from Rs. 297 billion in 2013, though it was higher than the budgetary target of Rs. 100 billion. The decline in bank financing to meet the resource gap was mainly due to significant reduction in borrowing from commercial banks from Rs. 461.8 billion in 2013 to Rs. 91.3 billion in 2014 although borrowing from the Central Bank mainly through purchases on Treasury bills and provisional advances increased to Rs. 35.7 billion during 2014 compared to a net repayment of Rs. 164.8 billion in 2013. Meanwhile, net foreign financing at Rs. 212.5 billion was below the original estimate of Rs. 286.8 billion despite having increased from the previous year. Accordingly, domestic financing contributed 64.1 per cent of the total financing requirement in 2014 in comparison to 76 per cent in 2013, while foreign financing contributed 35.9 per cent in 2014 in comparison to 24 per cent in 2013.

The declining trend in the ratio of central government debt to GDP continued in 2014. As at end December 2014, outstanding central government debt declined to 75.5 per cent of GDP from 78.3 per cent recorded at end 2013. However, in nominal terms total debt stock increased by 8.8 per cent to Rs. 7,390.9 billion from Rs. 6,793.2 billion recorded in the previous year.

Further consolidation in the fiscal sector was envisaged in the Budget for 2015. The Budget for 2015 was approved in the Parliament in November 2014 aimed at continuing the fiscal consolidation process. Accordingly, several policy measures were proposed in the Budget to enhance government revenue through simplifying the tax system and broadening the tax base while improving public expenditure management. Also, a high level of public investment was expected to support the realisation of medium term growth prospects. Following the presidential election in January 2015, an Interim Budget for 2015 was presented to the Parliament on 29 January 2015 introducing several measures to reduce the cost of living and income inequality, while announcing the intention to further strengthen fiscal consolidation. The Interim Budget focused on increasing direct tax revenue as a percentage of GDP by broadening the tax base and improving tax administration while rationalising recurrent expenditure further. Public investment was projected at a lower level with the expected increase in private sector involvement in economic activity. Accordingly, under the Interim Budget, the overall fiscal deficit in 2015 is estimated to reduce further to 4.4 per cent of GDP in 2015.

Monetary Sector Developments

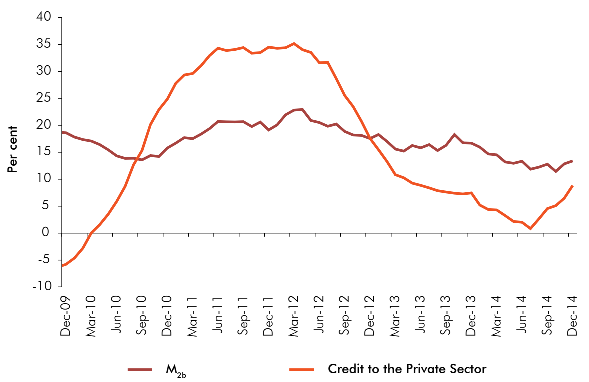
The Central Bank continued to maintain a relatively relaxed monetary policy stance during 2014, given the low inflation environment. In January 2014, the Central Bank renamed its policy interest rates, the Repurchase rate and the Reverse Repurchase rate as the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR), respectively. Meanwhile, in order to ensure the stability of short term interest rates, the SLFR was reduced by 50 basis points to 8.00 per cent in January 2014, while the SDFR remained unchanged at 6.50 per cent, during the year. With this reduction of SLFR, the Standing Rate Corridor (SRC) of the Central Bank was compressed to 150 basis points from 200 basis points. Meanwhile, considering the Central Bank's zero credit risk in rupee transactions, the Standing Deposit Facility (SDF) of the Central Bank was uncollateralised from February 2014, while other transactions under Open Market Operations (OMO) continued to remain collateral based. Given slower growth of private sector credit amidst high excess liquidity in the market, the Central Bank rationalised access to the SDF in September 2014 as a temporary measure to encourage commercial bank lending to the private sector. Accordingly, OMO participants were allowed to access the SDF at the SDFR of 6.50 per cent for a maximum limit of three times per calendar month, with any additional deposits under the SDF being compensated at a special rate of 5.00 per cent. In response to these measures, overnight market interest rates declined notably below the lower bound of the SRC, while other market interest rates also declined to historic lows during 2014. With the revival of the growth in credit to the private sector by commercial banks during the latter part of 2014 and signs of sustained credit growth in 2015, the SDF rationalisation was removed with effect from 02 March 2015. To address concerns over the behaviour of market interest rates inconsistent with falling inflation and investment needs for economic activity, the Central Bank reduced the SDFR and SLFR by 50 basis points each to 6.00 per cent and 7.50 per cent, respectively, with effect from 15 April 2015.

Reflecting accommodative monetary conditions, excess rupee liquidity in the domestic money market remained high during 2014. Net purchases of foreign currency by the Central Bank from the domestic foreign exchange market, Central Bank's foreign currency swap arrangements with commercial banks and purchase of a part of the proceeds of the International Sovereign Bond issued in January 2014, injected a substantial amount of rupee liquidity to the domestic money market during 2014. Overnight excess liquidity ranged from Rs. 0.9 billion to Rs. 107.2 billion averaging Rs. 29.1 billion during 2014, while total market liquidity remained at Rs. 330.9 billion by end 2014 compared to Rs. 71.7 billion recorded at end 2013. The Central Bank actively engaged in absorbing excess liquidity to avoid undue volatility in market interest rates through overnight auctions, short term and long term repurchase transactions as well as outright sales of Treasury bills during the year. In the conduct of OMOs, the Central Bank utilised borrowed securities from the Employees' Provident Fund since the Central Bank's holding of government securities was relatively low compared to the liquidity absorption requirement in the market.

The Central Bank conducted monetary policy through policy rates supported by other policy tools within a framework aimed at maintaining low inflation and high economic growth. As per the initial expectations at the beginning of 2014, broad money (M_{2b}) was expected to grow by 14 per cent, while credit to the private sector was also expected to increase at a similar rate to facilitate the growth momentum of the economy. Nevertheless, with the contraction in private sector credit growth, particularly during the first eight months of 2014, broad money expansion was moderated to some extent. Lower than anticipated credit growth to the private sector during this period necessitated a revision of the Monetary Programme for 2014 although the significant improvement in net foreign assets (NFA) of the banking sector offset the impact of low private sector credit growth on broad money. Accordingly, the projection for average broad money growth was revised downwards to 13.5 per cent for 2014.

Broad money (M_{2b}) expanded as expected in 2014. M_{2b} increased by 13.4 per cent, on a year-on-year basis, during 2014 compared to 16.7 per cent at end 2013, while average growth of broad money was 13.3 per cent during the

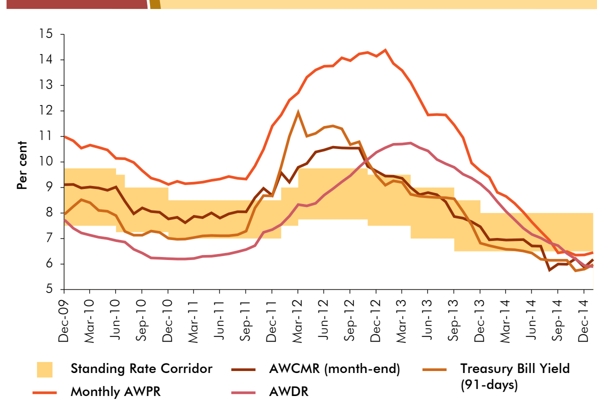
Chart 1.8 Year-on-Year Growth of Money and Credit to the Private Sector



year. The expansion in broad money was mainly due to increases in both NFA and net domestic assets (NDA) of the banking sector by Rs. 91.5 billion and Rs. 366.5 billion, respectively, during the year. In the first eight months of 2014, NFA of the banking sector increased by Rs. 289 billion, contributing entirely to the increase in broad money as NDA declined by Rs. 64.7 billion mainly due to the contraction in credit obtained by the private sector as well as the public corporations. However, during the last quarter of 2014, NFA recorded a contraction of Rs. 134.4 billion mainly due to the sale of foreign exchange by the Central Bank in the domestic foreign exchange market. In the first eight months of 2014, credit granted to the private sector recorded a contraction mainly due to the decline in pawning advances of commercial banks and increased access to alternative financing sources, including external sources as well as the utilisation of internal funds by the corporate sector. However, private sector credit rebounded during the latter part of 2014, supported by historically low interest rates along with the Central Bank's policy measures and the dissipating impact of the contraction in pawning advances. Accordingly, credit to the private sector, on a year-on-year basis, grew by 8.8 per cent recording an overall increase of Rs. 223.9 billion by end 2014. Within domestic credit, net credit to the government (NCG) increased by Rs. 134.6 billion during 2014 exceeding the envisaged levels in the government budget. Meanwhile, credit granted to public corporations increased significantly by Rs. 82.2 billion during the last quarter of 2014, despite a notable contraction during the early part of 2014. With the revival of public and private sector credit during the latter part of 2014, NDA increased by Rs. 300.6 billion during the last quarter of 2014 contributing mainly to the monetary expansion.

Interest rates in most market segments declined to historically low levels during 2014 with the relaxed monetary policy stance of the Central Bank and high excess liquidity in the domestic money market supported by low inflation expectations. The average weighted call money rate (AWCMR), which fluctuated within the policy rate corridor until September 2014, declined below the SDFR following the rationalisation of access to the SDF. As such, at end 2014, AWCMR declined to 6.21 per cent from 7.66 per cent at end 2013, a reduction of 145 basis points. Meanwhile, the yield rates pertaining to government securities also declined to very low levels during the year. Reflecting the transmission of policy rates to market interest rates, commercial banks reduced their deposit and lending rates further during 2014. Accordingly, the average weighted deposit rate

Chart 1.9 Standing Rate Corridor and Selected Market Interest Rates



(AWDR) declined by 317 basis points to 6.20 per cent, while the average weighted fixed deposit rate (AWFDR) declined by 445 basis points to 7.33 per cent at end 2014. Although at a slower pace than deposit rates, the weekly average weighted prime lending rate (AWPR) declined by 387 basis points to a historically low level of 6.26 per cent by end 2014. Further, the average weighted lending rate (AWLR) declined by 327 basis points to 11.91 per cent by end 2014, in line with the continuous declining trend in lending rates.

Financial Sector Developments

The financial sector showed improved performance in 2014 without causing any major macro-prudential concerns or signs, supported by continued expansionary monetary policy and improved macroeconomic performances.

Banking sector continued to expand in 2014 within prudential ratios. Total on-balance sheet assets of the banking sector grew by 17.3 per cent to Rs. 6,972 billion mainly due to rupee lending activities of domestic private banks. Deposits continued to be the major source of funding accounting for 67.2 per cent of the total liabilities of the sector at the end of 2014.The off-balance sheet exposure of the sector increased by 5.2 per cent to Rs. 3,128 billion. Return on Assets (ROA) and Return on Equity (ROE) of the sector improved to 1.4 per cent and 16.5 per cent respectively, in 2014 from 1.3 per cent and 16.0, respectively, in 2013. The level of non performing loans (NPLs) in the sector declined and the NPL ratio decreased to 4.2 per cent from 5.6 per cent in 2013. Risk weighted assets for market risk in the total risk weighted assets continued to be 3 per cent or less. As regards the prudential requirements, the sector operated with excess liquidity consequent to monetary sector condition and the statutory liquid assets ratio (SLAR) of domestic banking units (DBUs) stood above 39 per cent against the 20 per cent of minimum requirement and the total capital adequacy ratio estimated to be about 16.7 per cent at the end of 2014. Implementation of the Standardised Approach for operational risk under Basel II, Regulatory framework for valuation of immovable property, guidelines for information security management and increase of minimum capital requirement from 2016 were among the prudential policy requirements introduced to the banking sector in 2014.

Finance companies and specialised leasing companies sector showed improving performance in 2014 through the business and financial recovery process that started in the recent years. Total assets of the sector grew at a healthy rate of 18.9 per cent in 2014 as a result of low interest rate regime and such growth was funded mainly through low-cost short term deposits. ROA and ROE of the sector improved to 3.0 per cent and 13.1 per cent respectively, in 2014 from 2.1 per cent and 8.2 per cent in 2013. Despite the increase in the volume of NPLs by 19.9 per cent to Rs. 44.3 billion, the NPL ratio increased only marginally to 6.9 per cent from 6.7 per cent in 2013.

The assets and liabilities in the sector underwent a re-pricing process with low interest rate regime causing the net interest margin (NIM) to increase to 8 per cent from 6.6 per cent in 2013. The liquid assets to total assets ratio of the sector increased to 9.6 per cent in 2014 creating a Rs. 29.5 billion surplus against the stipulated minimum liquid assets of Rs. 52.8 billion. Even though the total capital adequacy ratio decreased to 13.5 per cent at the end of 2014 from 14.8 per cent in 2013, owing to growing risk weighted assets, it remained well above the minimum statutory requirement. The financial sector consolidation programme through banks and finance companies and specialised leasing companies regulated by the Central Bank was a major regulatory policy implemented during 2014. Accordingly, the number of finance companies and specialised leasing companies was expected to be reduced to 20 from 58 with regulatory support and tax incentives. As at end 2014, 10 mergers were completed and 22 were in progress. Given several concerns raised on the process, the programme was put on hold pending review by the committee appointed by the new government.

Amidst low interest rates, unit trusts and superannuation funds recorded marked growth in 2014. Total number of unit trusts increased by 10 to 63 while the total assets of the sector more than doubled to Rs. 126.5 billion at the end of 2014. The superannuation funds sector maintained a healthy growth in 2014. The insurance sector, which grew around 13 per cent in 2014, remained resilient. Issuance of a directive to all unit trusts on the minimum number of unit holders for each fund at all times and a minimum number of unit holders at any initial public offering were the major regulatory policies implemented on unit trusts. Increase in minimum regulatory capital and preparation to introduce risk based capital adequacy framework and mandatory public listing by 2016 of insurance companies were the major regulatory policies introduced to the insurance sector.

Domestic financial markets continued to remain liquid and active during 2014. As a result of excessive liquidity condition in the domestic money market, the Central Bank conducted open market operations on a regular basis throughout the year to mop up such excess liquidity for the purpose of stabilising the market interest rates consistent with the policy interest rate corridor. Accordingly, Rs. 4,299 billion worth repo transactions and Rs. 4,340 billion worth standing deposit facilities were granted by the Central Bank in 2014. Benefiting from the low interest rate environment and enhanced investor confidence, the CSE recorded a sustained growth in 2014 with the All Share Price Index (ASPI) reaching 7,548 with market capitalisation of Rs. 3,205 billion in November 2014. At the end of 2014, ASPI stood at 7,299 with a market capitalisation of Rs. 3,105 billion. Furthermore, with the participation by foreign investors, the CSE recorded a net foreign inflow of US dollars 168 million during 2014. The corporate debt primary market recorded relatively low volumes in 2014 in terms of number and the total value of issuances. Accordingly, there were only 46 corporate debt issuances totaling to Rs. 54.2 billion in 2014 compared to 83 listed debt issuances totaling to Rs. 69.1 billion in 2013. The primary market for commercial paper was also relatively less active in 2014 with total such issuances amounting to Rs. 8.2 billion compared to the Rs. 28.3 billion in the previous year. With improved foreign currency inflows through investments and trade, the trading volumes in the domestic foreign exchange market increased by 12.9 per cent to US dollars 15,478 million in 2014 and the pressure on the exchange rate of the Sri Lankan rupee against US dollar was stabilised through normal intervention in the domestic foreign exchange market supported by the foreign reserves.

As regards payment and settlement system, systems facilitated transactions in increased volumes without any major systemic risk. The Lanka Settle System and the Cheque Clearing System continued to account for the largest aggregate transaction value and the volume of payments. In 2014, LankaClear (Pvt.) Limited as the operator and the Central Bank as the regulator collectively completed the preliminary work of the Common Electronic Fund Transfer Switch (CEFTS) being the second phase of the Common Card and Payment Switch

(CCAPS) completed and bank members to the common ATM switch increased to nine with an ATM network of over 2,500.

1.3 Global Economic Environment and Outlook

As per the World Economic Outlook of the IMF, global growth in 2014 was lower than initially expected, with noticeable divergence across major economies and lower growth momentum in emerging economies. Global inflation remained subdued in 2014 with excess capacity prompting substantial output gaps in advanced economies and continuous deflationary price levels assisted by improved global supply of commodities, and weakened demand. Global crude oil prices edged lower in 2014. Currencies of some advanced and emerging economies depreciated against the US dollar during 2014, due to the strong economic outlook in the US economy.

According to the IMF, global growth is expected to remain moderate, weighed down by high debt, high unemployment and low investment, while the anticipated interest rate hike in the US and low inflation in some advanced economies raising additional challenges. Nevertheless, global growth is expected to rise to 3.5 per cent in 2015 and to 3.8 per cent in 2016, supported by gradual recovery in advanced economies, receding domestic headwinds in developing countries and the sharp decline in oil price. Consumer price inflation in advanced economies is expected to remain below 1 per cent in 2015, while subdued commodity prices are expected to increase the threat of deflation in some regions further. Some increase in consumer price inflation in emerging and developing economies is expected due to challenges emanating from spillovers from quantitative easing measures.

Table 1.4 Global Economic Developments and Outlook (a)

Item	2012	2013	2014 (Est.)	2015 (Proj.)
World Output	**3.4**	**3.4**	**3.4**	**3.5**
Advanced Economies	1.2	1.4	1.8	2.4
United States	2.3	2.2	2.4	3.1
Euro Area	-0.7	-0.5	0.9	1.5
United Kingdom	0.3	1.7	2.6	2.7
Japan	1.5	1.6	-0.1	1.0
Emerging and Developing Economies	5.1	5.0	4.6	4.3
Developing Asia	6.7	7.0	6.8	6.6
China	7.7	7.8	7.4	6.8
India	4.7	6.9	7.2	7.5
World Trade Volume (Goods and Services)	**2.9**	**3.5**	**3.4**	**3.7**
Imports				
Advanced Economies	1.2	2.1	3.3	3.3
Emerging and Developing Economies	6.0	5.5	3.7	3.5
Exports				
Advanced Economies	2.0	3.1	3.3	3.2
Emerging and Developing Economies	4.6	4.6	3.4	5.3
Price Movements				
Consumer Prices				
Advanced Economies	2.0	1.4	1.4	0.4
Emerging and Developing Economies	6.1	5.9	5.1	5.4
Commodity Prices (US$)				
Oil	1.0	-0.9	-7.5	-39.6
Non-Fuel	-10.0	-1.2	-4.0	-14.1
Six-month London Interbank Offered Rate (LIBOR) on US$ Deposits (per cent)	**0.7**	**0.4**	**0.3**	**0.7**

(a) Annual percentage change unless otherwise indicated

Source: World Economic Outlook (October 2014 & April 2015), IMF

1.4 Medium Term Macroeconomic Outlook

The Sri Lankan economy is expected to register a sustainable growth path in the medium term, with a real GDP growth of 7.0 per cent in 2015 and an average growth of 7.8 per cent over 2016-2018. The expected moderation of economic growth in 2015 is mainly due to the slowdown in public sector construction activity and conservative sentiment of private investors, particularly in the first quarter of the year. Economic growth is expected to accelerate thereafter with the expected new policy initiatives of the government. The envisaged high growth trajectory over the medium term is expected to benefit from the growth supporting domestic policy framework, improved investor sentiment and improvements anticipated in the global economic activity. All major production sectors, i.e., Agriculture, Industry and Services, are expected to bolster economic growth through improved productivity supported by the adoption of advanced technology, enhanced human resources and new investment initiatives of the private sector. Positive effects that would be brought about by the timely implementation of policy measures to enhance the export of goods and services and financial flows are expected to contribute towards improving Sri Lanka's external sector performance, supported by improved external demand. Prudent monetary and fiscal policies are also expected to support the envisaged growth path in the medium term with the conduct of monetary policy focusing on maintaining inflation at low single digit levels and fiscal policy aiming at further strengthening the fiscal consolidation process by reducing the budget deficit and improving the government debt profile. Meanwhile, annual consumer price inflation is projected at 3.0 per cent in 2015 and around 4.0 per cent thereafter, supported by capacity expansion through new investment initiatives and prudent monetary policy measures.

The external sector outlook is envisaged to improve during the medium term. Earnings from exports are expected to grow at a relatively higher rate in 2015 and beyond, contributing towards strengthening external sector stability. Meanwhile, the growth of imports, which is projected to contract during 2015 due to the impact of relatively low oil prices, would grow at a higher rate in the following year reflecting the expected increase in demand for consumer, intermediate and investment goods imports. However, the trade balance is expected to improve during the medium term with relatively high export earnings. Meanwhile, inflows from services exports would continue to record a healthy growth in the medium term, particularly with the expected improvements in earnings from tourism and telecommunications, computer and information services. Workers' remittances, which contribute significantly to the country's foreign exchange inflows, are also projected to continue its growth, although at a slower pace due to greater employment opportunities domestically.

Table 1.5 Medium Term Macroeconomic Framework (a)

Indicator	Unit	2013 (b)	2014 (c)	Projections 2015	2016	2017	2018
Real Sector							
Real GDP Growth	%	7.2	7.4	7.0	7.5	8.0	8.0
GDP at Market Prices	Rs. bn	8,674	9,785	11,080	12,447	14,044	15,853
Annual Average Inflation	%	6.7	5.1	3.0	4.0	4.0	4.0
Per Capita GDP	US$	3,280	3,625	4,009	4,469	4,997	5,624
Total Investment	% of GDP	29.5	29.7	28.0	30.0	31.0	32.5
Domestic Savings	% of GDP	20.0	21.1	22.3	24.2	25.8	27.7
National Savings	% of GDP	25.8	27.0	27.0	28.6	30.0	31.5
External Sector							
Trade Gap	% of GDP	-11.3	-11.1	-7.8	-8.1	-7.6	-7.1
Exports	US$ mn	10,394	11,130	12,217	13,307	14,331	15,429
Imports	US$ mn	18,003	19,417	18,787	20,958	22,457	24,047
Current Account Balance	% of GDP	-3.8	-2.7	-1.0	-1.4	-1.0	-1.0
External Official Reserves	Months of Imports	5.0	5.1	6.2	5.2	5.0	5.0
Fiscal Sector							
Total Revenue and Grants	% of GDP	13.3	12.3	13.6	14.0	14.7	14.9
Expenditure and Net Lending	% of GDP	19.2	18.3	18.0	18.2	18.7	18.7
Current Account Balance	% of GDP	-0.8	-1.3	-0.4	0.4	1.1	1.3
Overall Budget Deficit	% of GDP	-5.9	-6.0	-4.4	-4.2	-4.0	-3.8
Public Debt	% of GDP	78.3	75.5	72.0	69.0	66.0	63.0
Monetary Sector (d)							
Broad Money Growth (M_{2b})	%	16.7	13.4	12.0	12.5	13.0	13.0
Growth in Credit to the Private Sector	%	7.5	8.8	15.5	15.0	15.0	15.0

(a) Based on information available by mid March 2015
(b) Revised
(c) Provisional
(d) Year-on-year growth based on end year values

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

Sri Lanka's expected graduation to the upper middle income status in terms of per capita GDP would place the country among a new group of peers, strengthening its financing ability. Furthermore, the expected improvement in the investment climate along with developed infrastructure facilities would encourage investments flows to the country. Accordingly, inflows in the form of equity and FDI are projected to increase in the medium term. The banking sector and other corporates are expected to continue to access international debt and capital markets, although the appetite for such funds may be dampened somewhat as the global interest rates are likely to increase in the medium term. Long term external financing of the government is also projected to contribute to inflows to the country.

The conduct of monetary policy in the medium term will be aimed at maintaining inflation in a range of 3-5 per cent on average while facilitating the expansion of economic activity. The framework of monetary policy would be increasingly aligned with a Flexible Inflation Targeting (FIT) regime with a primary focus on key macroeconomic variables of inflation and economic growth, while broad money remaining as the key indicative variable to guide the conduct of monetary policy. In the medium term, inflation is expected to be maintained within the desired range of 3-5 per cent on average, by appropriately adjusting monetary policy instruments, particularly the policy interest rate corridor of the Central Bank and guiding the operating target of overnight interbank interest rate. Being the key driver of broad money, the growth of credit to the private sector by commercial banks is projected at 15.5 per cent in 2015 and is expected to stabilise at around 15.0 per cent thereafter. This will be facilitated by relatively low market interest rates and the expected improvement in the investment climate. The sustained increase in credit to the private sector over the medium term is projected to be supported by measures to improve government revenue collection, rationalisation of government expenditure and cost reflective tariff structures for public corporations that would result in reducing the need for bank financing by the government and public corporations. Meanwhile, as higher foreign inflows are expected in the medium term, appropriate policy measures to sterilise the impact of such inflows would help containing market liquidity and domestic interest rates at levels consistent with the medium term inflation path.

The medium term fiscal strategy of the government has been formulated to further strengthen the fiscal consolidation process by reducing the budget deficit and improving the government debt profile while creating a conducive environment for achieving accelerated regionally balanced economic growth. The fiscal consolidation process was somewhat disrupted in 2014 due to the increase in unplanned expenditure including expenses due to bad weather conditions during the latter part of the year and shortfall in revenue collection. However, the budgetary position of the country is expected to improve with a reduction in the budget deficit to below 4 per cent of GDP in the medium term with new policy initiatives expected to be taken by the government. It is expected that measures would be taken to enhance government revenue to over 15 per cent of GDP by streamlining tax exemptions, improving tax compliance and tax administration to generate a revenue surplus in the medium term. The existing tax system is likely to be restructured to increase the contribution of direct taxes to total tax revenue collection while reducing the contribution of indirect taxes, thereby making the tax system more progressive. In addition, rationalisation of recurrent expenditure is likely to provide further comfort to the government to maintain public investment at

1

ECONOMIC, PRICE AND FINANCIAL SYSTEM STABILITY, OUTLOOK AND POLICIES

BOX 1 Increasing Tax Revenue in Sri Lanka: Challenges and Policies

In spite of the government's attempts at fiscal consolidation that has contained the overall budget deficit as a percentage of GDP to some extent (Chart B 1.1), a mounting threat to fiscal management in Sri Lanka has been the rate of increase in government revenue being slower than the growth of the country's nominal income. Total government revenue, which amounted to 27.4 per cent of GDP in 1978, had gradually declined to 12.2 per cent of GDP in 2014, albeit with some fluctuations. Within this trend, tax revenue, which is considered the main source of revenue to the government,[1] had declined to 10.7 per cent of GDP by 2014 from 24.2 per cent of GDP in 1978 (Chart B 1.2). As a share of total tax revenue, direct taxes in Sri Lanka have historically remained low at around 20 per cent (Chart B 1.3), while non corporate income taxes (including PAYE) accounted for only 15 per cent of the total direct tax collection in 2014. Indirect taxes are at present dominated by the Value Added Tax (VAT), although the annual growth of VAT collection in 2014 was as low as 9.8 per cent. Although Sri Lanka's tax revenue to GDP ratio is not very different to its South Asian peers,[2] this ratio is very low in comparison to around 36 per cent in OECD countries.[3]

Since the introduction of open economic policies, two government Commissions on Taxation, the first in 1989 under the chairmanship of Dr. H.S.Wanasinghe and the second in 2009 with Prof. W.D.Lakshman as chairman, have looked into the issue of declining tax revenues in depth and made recommendations to improve the situation. Based on these recommendations, several reforms have been made to simplify the tax system, broaden the tax base and improve tax compliance from time to time. Nevertheless, the declining trend of the total government revenue to GDP ratio as well as of the tax revenue to GDP ratio has continued. The International Monetary Fund also commented in September 2014 that "the need to arrest and reverse falling tax revenue is well-recognised by staff and the authorities [...]. A durable fiscal consolidation cannot be achieved without significantly boosting tax revenue. Given the need for high and sustained infrastructure spending and a steady reduction in public debt, putting tax revenues back on an upward path is essential and would generate confidence in broader macroeconomic management".[4] Considering the need to improve this situation, reasons for the continued decline in the tax revenue to GDP ratio and possible policy measures that could be adopted are briefly discussed below.

Chart B 1.1 Overall Budget Deficit as a Percentage of GDP

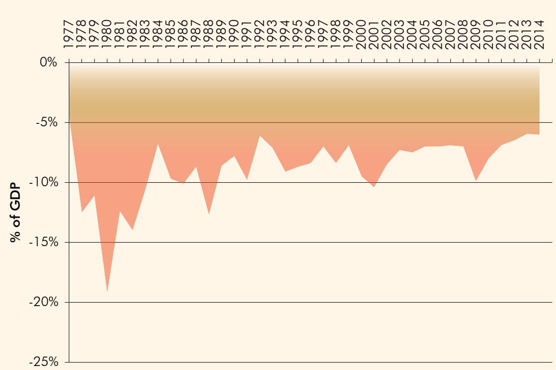


Chart B 1.2 Tax Revenue as a Percentage of GDP

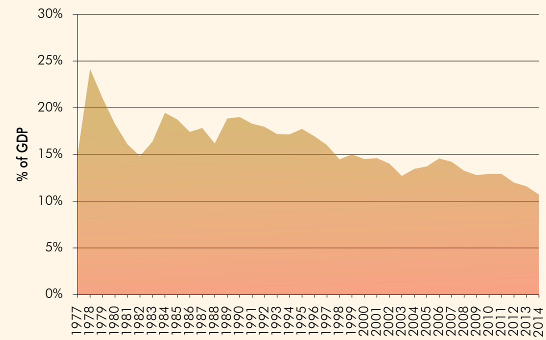
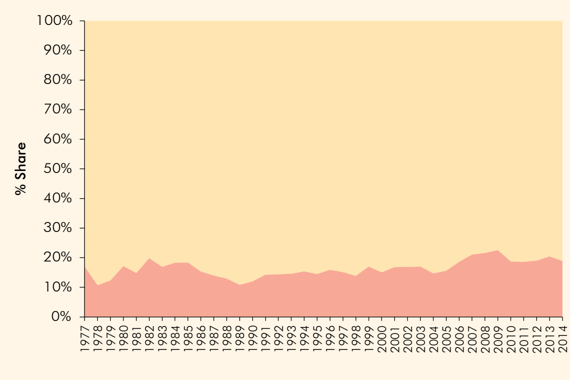


Chart B 1.3 Share of Direct and Indirect Taxes in Total Tax Revenue



1 In addition to the revenue objective, a government would utilise taxation to address income inequality, as a stabiliser of economic activity, to promote economic growth and to guide investment flows. In meeting these varied objectives, a good tax system is also expected to minimise efficiency losses in the economy while ensuring fairness, simplicity and the ease of collection.

2 Revenue Mobilisation in South Asia: Policy Challenges and Recommendations, Global Economic Prospects, World Bank, 2015.

3 Addressing Tax Evasion and Tax Avoidance in Developing Countries, Deutsche Gesellschaft fur Internationale Zusammenarbeit (GIZ), 2010.

4 Sri Lanka: First Post-Program Monitoring Discussion, International Monetary Fund Country Report No. 14/289, 2014.

Why has Sri Lanka's Tax Revenue to GDP Ratio been falling in Recent Times?

The decline in Sri Lanka's tax revenue to GDP ratio during the past few decades could be attributed to the following:

1) Knock-on effects of policies adopted to promote economic activity:

   a. In order to promote exports, trade related taxes have been reduced in the post-liberalisation period. In particular, as signatory to the World Trade Organization (WTO), several tariff barriers have been relaxed. As many emerging market economies including Sri Lanka tended to rely on trade related taxes rather than income taxes, this general trend of tariff reductions has resulted in a decline in overall tax revenue collection in emerging market economies.[5]

   b. Under export-led growth policies (including those to promote service exports in recent times), tax exemptions have been granted to attract much needed foreign direct investments (FDIs). Some exemptions have been granted for long periods and for non-priority sectors. It is known that developing countries are often vulnerable to profit shifting by multinational corporates by misusing tax incentives that are in place to attract FDIs.[6]

   c. In general, as lower taxes are considered conducive for economic growth,[7] the tendency has been to reduce tax rates without expanding the tax base.

2) Adhoc changes to the tax system to meet short term cash flow requirements of the government have affected policy consistency and uncertainty among existing/potential tax payers. This has also complicated the tax system further.

3) The existence of a large informal economy resulting in tax evasion and tax avoidance also contributed to the decline in the tax revenue to GDP ratio. Schneider and Buehn (2009) estimate Sri Lanka's shadow economy to be around 45 per cent of GDP on average during 1999-2006. According to their calculations for 120 advanced and developing economies, the size of the shadow economy varies from 7-8 per cent in advanced economies such as United States and Japan, to about 70 per cent in Bolivia.[8]

4) Administrative inefficiencies have also caused to slowdown in tax collection. These include complex tax laws and the existence of a large number of taxes in spite of attempts towards simplification, as well as cumbersome processes involved in the payment of taxes and arbitration.

5) The inability to change the mindset of the public, including the corporate sector towards paying taxes has also affected tax revenues, in spite of the country progressing towards an upper middle income category.

6) In recent times, the rise of cross-border shopping including online purchases, as highlighted by Emran and Stiglitz (2005), could also have had some impact on tax revenues.[9] However, this impact may still be marginal.

Measures to Increase Tax Revenue in Sri Lanka

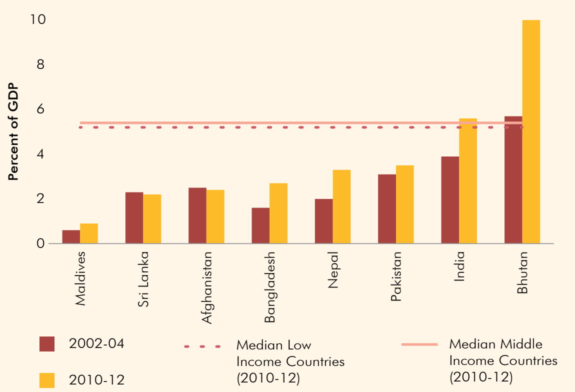
Policies to increase tax revenue in Sri Lanka must address the issues highlighted above while considering the recommendations made by the 2009 Commission on Taxation, the experiences of other countries as well as the basic principles of taxation. Some of these policies are summarised below:

1. **Simplification:** Although several attempts have been made at the simplification of the tax system, the tax structure needs further rationalisation by reducing the number of taxes and levies to at least half of the current level. However, the amalgamation and abolition of taxes should be done carefully without causing a further reduction in the tax revenue.

2. **Direct Taxation vs. Indirect Taxation:** The importance of direct taxation must increase as income levels rise. As Sen Gupta (2007) notes, "countries that depend on taxing goods and services as their primary source of tax revenue, tend to have poorer revenue performance. On the other hand, countries that put greater emphasis on taxing income, profits and capital gains, perform better[10]." This transformation has not taken place in Sri Lanka yet (See Charts B 1.4 and 1.5) and the number of direct tax payers remain below 5 per cent of the population.[11] In addition, tax compliance (within one month from the due date) in the corporate sector is around 70 per cent in the 2012/13 assessment year while it was around 54 per cent in the non-corporate sector. These reflect the need to broaden the tax base and enhance compliance while improving tax assessment methodologies with a view to minimising tax evasion particularly by high

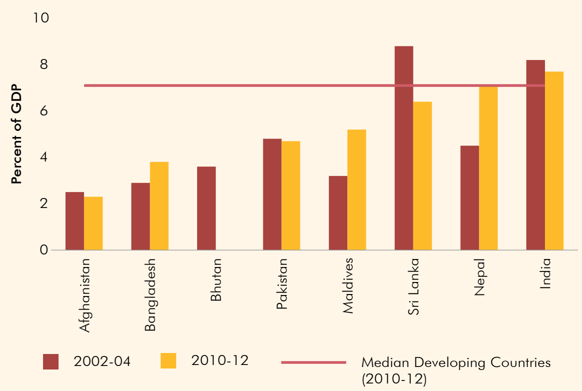
5 Zee, Howell H., Empirics of Crosscountry Tax Revenue Comparisons, World Development, 24(10). Pp. 1659-1671, 1996.
6 Addressing Tax Evasion and Tax Avoidance in Developing Countries, Deutsche Gesellschaft fur Internationale Zusammenarbeit (GIZ), 2010.
7 Using a cross-section data set of 70 countries including Sri Lanka for the period 1970-1997, Lee and Gordon (2005) find that cutting the corporate tax rate by 10 percentage points can increase the annual growth rate by around 1.1 per cent (Lee, Y. and Gordon, R.H., Tax Structure and Economic Growth, Journal of Public Economics, 89, pp. 1027-1043, 2005).
8 Schneider F., and Buehn, A., Shadow Economies and Corruption all over the World: Revised Estimates for 120 Countries, 2009.
9 Emran, M.S., and Stiglitz, J.E., On Selective Indirect Tax Reform in Developing Countries, Journal of Public Economics 89, pp. 599-623, 2005.
10 Sen Gupta, A., Determinants of Tax Revenue Efforts in Developing Countries, International Monetary Fund, WP/07/184, 2007.
11 Revenue Mobilisation in South Asia: Policy Challenges and Recommendations, Glob al Economic Prospects, World Bank, 2015.

Chart B 1.4 Direct Tax Revenues



Source: Revenue Mobilisation in South Asia: Policy Challenges and Recommendations, Global Economic Prospects, World Bank, 2015

Chart B 1.5 Indirect Tax Revenues



Source: Revenue Mobilisation in South Asia: Policy Challenges and Recommendations, Global Economic Prospects, World Bank, 2015

income-earning corporates and individuals and identifying those who are completely outside the tax net. With regard to indirect taxation collection efficiency and leakages through exemptions and frauds must be addressed.

3. **Treatment of Exemptions:** Exemptions granted for various purposes from time to time under different taxes should be revisited to recognise the necessity for such exemptions. Apart from the exemptions, different kinds of concessions granted to promote various sectors also needed to be revisited to identify and reaffirm whether these concessions are in line with current priorities.

4. **Tax Administration:** The administration and assessment processes of tax collection agencies need to be strengthened, particularly through further development of technology and expediting automation and the integration of taxpayer information. Simplification of the tax system including tax legislation, documentation and the tax payment systems as well as expediting the dispute resolution mechanisms would improve revenue collection. This could also support improving Sri Lanka's Doing Business Ranking.[12] Tax administration would also benefit from the removal of nuisance taxes which hinder the usage of formal payment channels such as bank accounts while encouraging cash payments and further expanding informal economy.

12 In Sri Lanka's Doing Business ranking, "Paying Taxes" sub rank was recorded at 158 in 2015. Although it is an improvement compared to the rank of 167 in 2014, such low ranking highlight the need for major reform in this area.

a higher level. With the reduction in the overall fiscal deficit, domestic financing as a percentage of GDP is expected to ease over the medium term, releasing more resources to the private sector and easing pressure on market interest rates further. Reforms introduced to strengthen the balance sheets of State Owned Business Enterprises (SOBEs) in the recent past are expected lessen the burden on the government budget in the medium term. The government's debt management strategy is expected to focus on the utilisation of an appropriate mix of sources of funding, to reduce the cost of funding while minimising the risk. Further, the government debt management strategy would focus on lengthening the average time to maturity of the debt stock while reducing debt servicing cost in the medium term. Accordingly, the government debt as a percentage of GDP is expected to fall below 70 per cent over the medium term.

1.5 Issues and Policies

To enhance industrial growth in the long term, industrial policy should focus more on moving manufacturing up the value chain. Sri Lanka's industrialisation strategy since early 1990s has led to the development of light industrial products in sectors such as textile and garments, ceramic and rubber based products. However, more than two decades later, these products still dominate the country's industry structure accounting for about 70 per cent of the total industrial exports. In contrast, regional competitors have diversified their industry structure to specialise in the manufacturing of more sophisticated products with a share of high-tech product exports in their manufactured exports exceeding 25 per cent compared to Sri Lanka 's share of about 1.5 per cent. Therefore, in order to leap frog the industrial product development process in a highly liberalised global trade regime, it is necessary for Sri Lanka to embark on strengthening the manufacture of hi-tech products. Export of high-tech products lead to much higher profits enabling exporting countries to emerge from a less developed status to a higher income level. For this purpose, adaptation of technology as well as introduction of innovations, backed by proper research and development (R&D) is essential. Even though successive government have taken several measures to encourage R&D at the industry level, more attention should be given to promote the use of nano technology, bio technology, as well as information technology in the field of high value manufacturing industries in order to capture the large export market while expanding manufacturing base into non-traditional areas. This transformation process can be further supported by the government with the adoption of a cluster based industrial development strategy. Industrial clusters, which constitute a geographical concentration of enterprises producing similar or closely related products, have key advantages such as information spillovers, specialisation and division of labour among enterprises, development of skilled labour markets and cost advantages in the form of reductions in transactions costs. At the same time, the concentration of industries at one location will attract FDI that would facilitate inflow of modern technology, technical expertise as well as access to established markets. In addition, the global value chain, which provides opportunities for countries to specialise in different tasks of the production process depending on their relative cost advantage, is also an important area that can be promoted by introducing necessary policies. However, as the industrialisation is a long term process, it is vital to have consistent industrial policies in order to provide a long term vision and strategy to the industrial sector.

A buoyant export performance is imperative for sustaining the growth momentum of the economy. Although Sri Lanka's merchandise exports have increased in nominal terms, exports as a share of GDP have declined from 33.3 per cent in 2000 to 14.7 per cent in 2014. Moreover, as world exports of goods have risen, Sri Lanka's share of global merchandise exports has reduced from 0.09 per cent in 2000 to 0.06 per cent in 2014. Sri Lanka's rank in the World Competitiveness Index has deteriorated from 65 in 2013 to 78 in 2014. Given the size and purchasing power of Sri Lankan domestic market, an export led strategy is a prerequisite for achieving the targets set for growth in the country's medium term trajectory. Several reasons can be cited for the secular decline of exports over the years. The high unit cost of energy in Sri Lanka relative to that of peer economies in the region has increased the cost of production of domestic manufacturers which in turn has reduced the competitiveness of Sri Lankan exports. The appreciation of the real effective exchange rate at various times in history may have dampened the country's competitiveness vis-à-vis its trading partners, and hence export growth. Concentration of products and market destinations in Sri Lanka's exports structure can lead to instability in export earnings. Sri Lanka is dependent on a few export products such as tea, garments, and rubber products, while traditional markets such as Europe and the USA account for about two thirds of total exports. At a time when economic activity is shifting from the West to India and China, the powerhouses of the East, it is imperative for Sri Lanka to rethink its export strategy that is currently biased towards the West. In this regard, the proposed trade agreement with China is a step in the right direction. Export diversification also entails increasing the sophistication of products with more value addition and the use of new technology. It is time now to transform the country's manufacturing base from textiles and garments to more hi-tech products such as electronics as witnessed in the rapid industrialisation process of some Asian Tigers. Moreover, strong participation in global and regional export conventions, strategic marketing and active pursuit of bilateral and multilateral trade treaties with target countries would enable the Sri Lankan export market to increasingly open up to the world. Private sector participation is vital to harness the synergies of entrepreneurship and successful marketing strategies in moving forward the export drive. A combined public and private sector multi-faceted approach in all areas of penetrative marketing, forming strategic alliances, harnessing technological advances and protecting innovation through strong domestic and international intellectual property laws should be encouraged. The recent attempts at regaining entry to the GSP+ scheme that provides preferential access to the EU market is laudable considering the benefits that can be derived to our economy through enhanced exports from increased access to the EU market.

Harnessing the Services sector growth potential would be an integral part of maintaining future economic growth. The importance of the Services sector in the Sri Lankan economy has increased steadily over time, with its share as a percentage of GDP recording 57.6 per cent in 2014. The nature of the service sector has also undergone significant transformation over the years, particularly with the introduction of market liberalisation, from small-scale sundry services to higher skilled and higher value-added activities such as financial services and information technology (IT). The share of the services sector is envisaged to grow even further with the rapid development of infrastructure taking place across the country. The importance of services sector has grown over the last decade with service products becoming tradable and exportable in the global sphere. Therefore, the dimensions of the global trade have moved from competitive advantage in manufacturing to services with exploration of niche markets by the emerging countries. Therefore, there is a need to ascertain proactive measures to transform the existing services structure to a highly tradable service sector to serve the global demand. In this regard, several positive policy initiatives have taken place during last few decades in areas such as port and airport related activities, tourism, IT and IT enabled services. This transformation can be encouraged further through a proper support structure that comprises modern IT platforms, an effective telecommunication services, uninterrupted and consistent supply of inputs such as electricity and high quality human capital. In this regard, heavy investments are needed not only to make avail the latest technology in the world but also to equip the staff with the most up-to-date knowledge. The overall policy should be geared towards facilitating such flexibility in the industry as it directly links with the overall service delivery and quality. Such a facilitating environment would help the country to continue on its envisaged growth path over the medium term.

It is important to focus on promoting market based alternative financing methods than predominantly relying on traditional bank based financing to ensure adequate availability of long term financing, which is an essential element for investment and sustained economic growth. Currently, the domestic banking sector remains the major source of financing for the corporate sector as well as for the SME sector, and raising funds for expansion in economic activity through capital markets is limited only to large corporates. Nevertheless, the traditional model of bank based financing method may not be workable for long term financing due to various problems associated with financial intermediation, particularly high intermediation costs as well as monitoring and transactions costs. Furthermore, since the global financial crisis, the banking sector has undergone a significant deleveraging process thus increasing the gap between supply and demand for long term financing in many economies around the world. In contrast, many country experiences suggest that market based financing methods will reduce inherent inefficiencies associated with bank based traditional financial intermediation, and hence leading to enhanced economic growth. This suggests the importance of promoting deep, liquid and transparent markets for long term financing in the Sri Lankan context, particularly through capital markets, while encouraging the traditional banking system to focus their role as efficient facilitators for financial transactions in the economy and on core banking functions. Hence, in the medium term, the country should focus more on developing deep and broad corporate debt markets, while further deepening the equity markets. In addition, developing the venture capital market further over the medium term by attracting new investors through diversifying investment would also be advantageous to deepen the financial market. Such markets would also attract substantial FDIs, which would bring about innovation, improved management systems, governance practices as well as new market access to local corporates. Recent examples of capital market solutions in developed and emerging markets suggest that market based arrangements have contributed to long term financing for growth in SMEs that typically face financing constraints.

Special attention is required to upgrade the SME sector in line with the overall development strategy of the country. A viable and dynamic SME sector, which encompasses Agriculture, Industry and Services sectors, plays a pivotal role in an economy by creating employment, generating income, alleviating poverty, thereby supporting inclusive growth. However, in Sri Lanka the full potential of the SME sector is yet to be tapped due to the existence of a several constraints in the product as well as factor markets. Lack of access to financing, lack of human resource capabilities and lack of technological capabilities are the underlying constraints to the growth of the SME sector. Although successive governments have identified the access to finance as a vital element for SMEs to succeed in their drive to build productive capacity and introduced several concessional loan and credit guarantee schemes, lack of access to financing still remains a significant and persistent challenge in the sector. In this context, it is vital to introduce remedial measures to ensure availability of funds to this sector. Alongside available credit guarantee schemes, the credit advisory and counselling services are essential to enhance financial know how and financial discipline of SMEs. As Business Development Services (BDS) can play an important role in this regard, it is increasingly vital to enhance the scope, functioning of BDS to facilitate SMEs. Further, to enhance technical capabilities of the SME sector, setting up of industrial clusters can be promoted to gain experience, share expertise and to improve efficiency and productivity thereby enabling them to achieve economies of scale. Moreover, this would facilitate SMEs to build up linkages with large enterprises, which provide opportunity for them to join in larger supply chains. Further, such linkages would facilitate tapping the export potential of SMEs, which currently rely largely on domestic markets.

It is necessary for Sri Lanka to maintain policy consistency in ensuring a favourable doing business environment with the aim of attracting non debt creating foreign investment flows. Although the post conflict period ushered in improvements to macroeconomic fundamentals and infrastructure facilities, Sri Lanka has failed to attract FDI at envisaged high levels. FDI is vital for maintaining a sustainable and high economic growth momentum while financing the savings-investment gap. A negative savings-investment gap has to be financed through external sources, either in the form of borrowings or foreign investments. Financing the savings-investment gap through borrowings and short term investments would be costly while exposing the economy to heightened external vulnerabilities. Therefore, there is a need to increase non debt creating foreign inflows to finance the savings-investment gap. Furthermore, FDI brings in advanced technology, entrepreneurial practices, access to assured international markets and increased employment. Hence, market oriented policies would foster business confidence leading to a surge in investments that would enable higher FDI inflows to the country. In addition to healthy economic indicators such as high growth and low and stable inflation, good governance and guarantee of property rights as well as efficient government services to facilitate private sector businesses, would also enhance investor confidence in the domestic economy. Further, due attention is required in order to avoid policy inconsistencies such as uncertainty in legislation on property rights, regressive tax policies, and enforcement mechanisms that would discourage foreign investments. Meanwhile, Sri Lanka needs to increase its domestic investments on advanced technology and human capital development. Increased commitment and endorsement on the part of the government is very much required to augment reforms in the labour market that would allow for more flexibility in the recruitment and discontinuance of workers, and in turn, improve the doing business ranking and enhance the image of the country as an attractive investment destination.

Recent slippages in the fiscal sector highlight the necessity to intensify efforts to increase tax revenue collection and further consolidate government expenditure. Total government revenue, which amounted to 27.4 per cent of GDP in 1978, had gradually declined to 16.8 per cent of GDP in 2000 and to 12.2 per cent of GDP in 2014. In spite of adopting several measures to simplify the tax system, tax revenue collection as a percentage of GDP has continued to decline over the years. Tax revenue had declined from 24.2 per cent of GDP in 1978 to 14.5 per cent in 2000 and to 10.7 per cent of GDP in 2014. As this is increasingly challenging the performance of the fiscal sector, decisive measures are necessary to address this issue through a medium term framework. Some areas that need attention in this regard are further simplification of the tax system, broadening the tax base by improving direct taxation and minimising tax exemptions, and strengthening tax administration. With regard to government expenditure, government welfare measures such as subsidies provided to several sectors in a blanket manner remain a fiscal burden that should be immediately revisited. Furthermore, it is essential that the targets set by the Fiscal Management Responsibility Act, No. 03 of 2003 (FMRA) as amended, are achieved. In this regard, the intention expressed by the government to curtail excessive overheads, increase transparency and accountability is commendable, and maintaining such practice would send a positive signal to the economy and boost investor confidence. In relation to SOBEs, the implementation of a formula based pricing as envisaged would also minimise the macroeconomic and fiscal impact of future global price fluctuations. These measures would strengthen fiscal consolidation facilitating a further reduction in the government debt to GDP ratio, which although on the decline, is still high compared to peer economies.

In spite of reforms to transform the higher education sector in Sri Lanka, lack of high level research and development (R&D) output necessary to support sustained economic growth remains a challenge. The research exposure of universities and associated higher education institutes has failed to reach the expected level to deliver the envisaged advantage from higher education in Sri Lanka towards achieving a competitive edge in global trade and services. Sri Lankan universities are constantly ranked below other universities in the region. According to World Development Indicators (WDI) 2014 published by the World Bank, patent applications filed by Sri Lankan residents remained a fragment of those filed in peer economies. These are indications that R&D needs to be strengthened through concerted efforts by higher education authorities. This would also require transforming the university structure from the current model to a self-sustaining model where decisions are made by the universities themselves while institutional linkages between the industry and academia are made based on innovation. The resultant technology transfer between the universities and the industry including SMEs could broaden all sectors of the economy. The private sector can play an integral role in this regard through the development of proper linkages with universities, which would ultimately assist the entities to broaden their global market share. Sri Lanka Institute of Nanotechnology (SLINTEC), a joint venture between the National Science Foundation of Sri Lanka and several large corporates, is a classic example of scientific innovation and industrial linkage to fill the much required gap in R&D within the country.

The changing demographic profile of the country has added a new dimension to the existing issues in the labour market requiring forward looking reforms to sustain the high growth momentum. Slow population growth together with the aging population has resulted in a shrinking labour force. Based on International Labour Organization's (ILO) estimates, the average growth of the labour force between 2009-2020 would be around 0.3 per cent per annum, compared to the rate of 1 per cent per annum observed during 1990-2006. Strategies that can be used to address this issue include increasing the labour force participation rate and improving labour productivity. Higher youth and female participation is necessary to increase the labour force. In order to increase youth participation, policies to realign the country's education system to generate an effective work force with necessary skills to cater to the requirements of the market must be strengthened. Youth perceptions of occupation, mostly favouring state sector employment need to be changed. To attract females into the labour market, flexible work hours, improving work conditions, increasing the availability of short-term and part time employment opportunities, and legislative reforms are necessary, while ensuring equal employment opportunities for females. With regard to increasing labour productivity, attention must be paid to the Agriculture sector and the state sector. Investments in physical capital such as irrigation networks, electricity and roads as well as in human capital would facilitate improving labour productivity to some extent. These need to be supported by land and labour market reforms providing flexibility required for efficient resource allocation. Moreover, increases in remuneration need to be linked to productivity, in order to maximise the contribution of the labour force. In addition, although some adjustments have taken place in the foreign employment structure, revisiting foreign employment policies is needed to address the skill, gender and regional concentration. Reviewing the current stipulated age of retirement is also necessary, following the examples of other countries that have experienced the issue of population aging.

The policies of better governance and transparency, as announced by the government, are key catalysts in the process of equitable economic development, and therefore, must be encouraged. Better governance and transparency should foster a conducive environment capable of providing services that would enhance economic activity. This also entails a free, fair and peaceful society, while encouraging public institutions to discharge their responsibilities in a transparent manner, ensuring confidence on the governance system of the country. Such a system would yield positive social dividends including economic benefits of higher and inclusive growth. These policies could have a positive impact on economic performance, particularly in terms of attracting FDI as reflected by the importance attached by investors to global indicators that capture aspects of better governance.