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ECONOMIC, PRICE AND FINANCIAL SYSTEM STABILITY, OUTLOOK AND POLICIES

1.1 Overview

Real economic growth in Sri Lanka in 2015 registered 4.8 per cent, compared with 4.9 per cent in 2014. A slowdown in the growth of demand in Sri Lanka's traditional export markets impacted the growth of the export sector while a strengthening US economy prompted short term capital outflows. The impact of these developments was offset to some extent by lower international commodity prices. Nevertheless, domestic consumption rebounded as incomes grew, particularly among public sector workers. Agriculture and services related activities grew by 5.5 per cent and 5.3 per cent, respectively, while industry related activities grew by 3.0 per cent during 2015. Inflation, as measured by the year-on-year change in the Colombo Consumers' Price Index (CCPI), was in negative territory during July-September 2015, mainly due to subdued commodity prices. This was the first time that inflation turned negative since March 1995. However, by end 2015, year-on-year headline inflation was recorded at 2.8 per cent, compared to 2.1 per cent at the end of 2014. Correspondingly, core inflation, which switches out energy and selected food items from the CCPI basket, grew from 0.8 per cent, on a year-on-year basis in February 2015, to reach 4.5 per cent at the end of the year. This was driven primarily by the enhanced growth of bank credit as well as higher wages afforded to government workers and employees in other sectors of the economy. Meanwhile, despite substantial gains from the lower oil prices and continued positive trends in the tourism sector, slowing down of net foreign exchange inflows, including worker remittances, and capital outflows, generated an overall deficit in the balance of payments (BOP). Efforts to reverse the downward trend in government tax and non-tax revenues were moderately successful, but overruns on the expenditure side of the government budget meant that the budget deficit grew to 7.4 per cent of Gross Domestic Product (GDP), as against the targeted deficit of 4.4 per cent. Central government debt grew to 76.0 per cent of GDP by the end of 2015. The new coalition government formed after the Presidential election in January 2015 focused on implementing the 100-day programme before the general election that was held in August 2015. The policy responses to volatile global economic conditions took time to evolve after the general

Table 1.1 Macroeconomic Performance (2011-2015)

Indicator	Unit	2011	2012	2013	2014 (a)	2015 (b)
Real Sector and Inflation						
Real GDP Growth (c)	%	8.4	9.1	3.4	4.9(b)	4.8
GDP at Market Price (c)	Rs.bn	7,219	8,732	9,592	10,448(b)	11,183
Per Capita GDP (c)	US$	3,129	3,351	3,610	3,853(b)	3,924
Annual Average Inflation (d)	%	6.7	7.6	6.9	3.3	0.9
External Sector						
Trade Balance (c)	% of GDP	-14.9	-13.8	-10.2	-10.4	-10.2
Current Account Balance (c)	% of GDP	-7.1	-5.8	-3.4	-2.5	-2.4
Overall Balance	US$ mn	-1,059	151	985	1,369	-1,489
External Official Reserves	US$ mn	6,749	7,106	7,495	8,208	7,304
Fiscal Sector (c)						
Current Account Balance	% of GDP	-0.8	-0.9	-0.7	-1.2	-2.2
Overall Balance	% of GDP	-6.2	-5.6	-5.4	-5.7	-7.4
Central Government Debt	% of GDP	71.1	68.7	70.8	70.7	76.0
Monetary Sector (e)						
Broad Money Growth (M_{2b})	%	19.1	17.6	16.7	13.4	17.8
Growth in Credit to the Private Sector (in M_{2b})	%	34.5	17.6	7.5	8.8	25.1

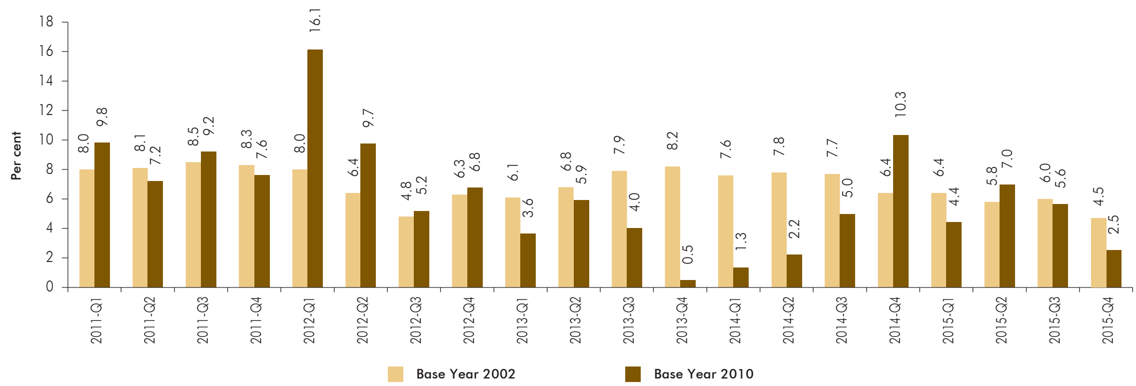
(a) Revised
(b) Provisional
(c) The data is based on the base year 2010 GDP estimates of the Department of Census and Statistics.
(d) Based on CCPI (2006/07=100)
(e) Year-on-year growth based on end year values.

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

election held in August 2015. In order to address the adverse implications of growing demand pressures on price and financial stability and help cushion pressure on the BOP, the Central Bank took early corrective action by imparting greater flexibility in the management of the exchange rate, enforcing the new macroprudential regulation of loan to value (LTV) ratio as a selective demand management instrument and tightening monetary policy through an upward adjustment of the Statutory Reserve Requirement (SRR) and also later increasing the Central Bank's policy interest rates. A renewed focus on export led economic growth and the buttressing of collection of government revenue to contain the overhang of government debt are the key drivers of the government's medium term economic strategy, and structural reforms proposed by the government towards this end are expected to be endorsed by the International Monetary Fund (IMF) as well.

It is expected that, with appropriate policies, the economy will return to a high growth path in the medium term. Addressing the already identified constraints faced by the economy, including low government revenue to GDP ratios and excessive government expenditure, falling exports to GDP ratios and insufficient inflows of foreign direct investments (FDI) remain key ingredients to achieve sustained economic growth in the medium term. In addition, other structural and emerging challenges that require the attention of the government include, putting in place more efficient systems to ensure the development of required skills to support the growing demand for high quality human capital; improving public transport to curb the economic loss caused by road traffic congestion; strengthening the national policy on renewable energy development and ensuring energy security; introducing robust market based pricing formulae for energy and public utilities; addressing issues in the agriculture sector, including low productivity, lack of diversification, food insecurity, and inefficiencies in water management; creating enabling socioeconomic infrastructure and lucrative livelihood opportunities amidst constraints on public resources; ensuring the sustainability of the public sector pension scheme while introducing market oriented pension and superannuation schemes that ensure

Chart 1.1 Quarterly Real GDP Growth (Year-on-Year)



the full coverage of the labour force; facilitating financial deepening through raising the efficiency of financial intermediation, introducing a diverse range of financial products and services, and improving access to formal finance as well as building external and domestic policy buffers to sustain a robust growth trajectory over the medium to long term.

1.2 Macroeconomic Developments, Stability and Policy Responses in 2015

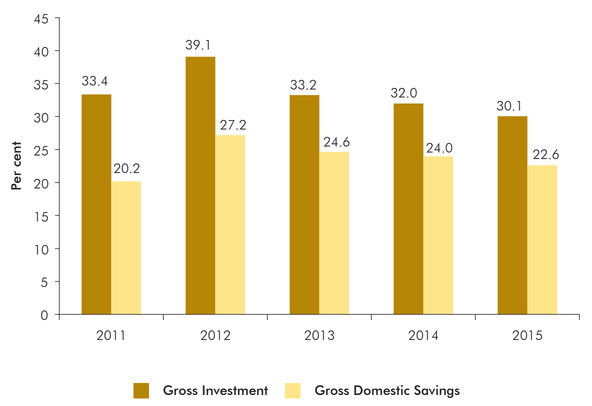
Real Sector Developments and Inflation

According to provisional estimates released by the Department of Census and Statistics (DCS), the economy grew by 4.8 per cent during 2015 in real terms, compared to 4.9 per cent in 2014.[1] Services activities, which account for 56.6 per cent of GDP, grew by 5.3 per cent, buttressed by the growth in financial services (15.8 per cent), real estate activities (9.6 per cent), transport activities (5.5 per cent) and wholesale and retail trade (4.7 per cent). Despite the minor slowdown in construction (-0.9 per cent) and mining and quarrying (-0.9 per cent) activities, industry activities, which account for 26.2 per cent of GDP, grew by 3.0 per cent, mainly supported by the growth in manufacturing activities (4.7 per cent). Agriculture activities, which account for 7.9 per cent of GDP, expanded by 5.5 per cent, mainly due to the significant growth in growing of rice (23.3 per cent) and vegetables (24.9 per cent), amidst the contraction in fishing (-2.7 per cent), growing of rubber (-10.1 per cent) and growing of tea (-2.6 per cent).

As per the expenditure approach, the growth in real GDP in 2015 was largely driven by an increase in consumption demand, while investment activities made a modest contribution. Public sector consumption expenditure grew at a high rate, mainly reflecting the increase in salaries and wages of public sector employees in 2015. Private consumption expenditure also grew during the year, mainly due to the low interest rate environment and increased real wages. However, investment activities, as measured by gross capital formation, decelerated during 2015. Meanwhile, as a combined outcome of the increased demand for imports, mainly consumption goods, and weak demand from Sri Lanka's major export destinations, net external demand deteriorated, in real terms, during the year.

1 In July 2015, DCS changed the base year for national accounts statistics to 2010 from 2002, while adopting the United Nation's System of National Accounts (SNA) 2008 standard. The improved compilation procedure captures the changes in the economic structure of Sri Lanka over the past decade and introduces new economic activities to the national accounts system. The rebased GDP estimates had varying effects on macroeconomic indicators. The analysis of the state of the Sri Lankan economy in 2015 provided in this report is based on new GDP estimates, which are provisional.

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



Domestic savings declined to 22.6 per cent of GDP in 2015, from 24.0 per cent of GDP in 2014. An increase in government dissavings, amidst lower than expected government revenue coupled with an overrun in recurrent expenditure, resulted in the deterioration of domestic savings during the year, as private savings remained broadly unchanged. This, together with the deterioration of net primary income from the rest of the world, along with a reduction in earnings on investment and increased outflows, dampened national savings in 2015, although remittances increased marginally, in rupee terms. Accordingly, national savings declined to 27.8 per cent of GDP in 2015 from 29.5 per cent of GDP in the previous year. Meanwhile, as the decline in investments as a percentage of GDP was higher than the decline in national savings as a percentage of GDP, the savings-investment gap narrowed during 2015.

The Agriculture sector accelerated its growth momentum, increasing its GDP share marginally to 7.9 per cent in 2015. The value addition from Agriculture, Forestry and Fishing activities grew by 5.5 per cent in 2015, in comparison to the growth of 4.9 per cent in the previous year. This was largely driven by the expansion in growing of rice, which recorded a high growth of 23.3 per cent. Paddy production, which was severely affected by extreme weather conditions in 2014, increased significantly during both 2014/2015 Maha and 2015 Yala seasons, supported by favourable weather conditions and the increased purchase price of paddy. The value addition from several other key sub sectors,

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

Item	Rs. billion		Growth (%)		As a percentage of GDP	
	2014	2015	2014	2015	2014	2015
1. Domestic Demand	**11,285.0**	**12,013.7**	**8.3**	**6.5**	**108.0**	**107.4**
1.1 Consumption	7,943.8	8,652.2	9.9	8.9	76.0	77.4
Private	7,074.7	7,666.4	9.1	8.4	67.7	68.6
Public	869.1	985.8	16.6	13.4	8.3	8.8
1.2 Investment (Gross Domestic Capital Formation)	3,341.2	3,361.5	4.8	0.6	32.0	30.1
2. Net External Demand	**-836.5**	**-830.5**	**-1.2**	**0.7**	**-8.0**	**-7.4**
Export of Goods and Services	2,185.0	2,295.4	12.1	5.1	20.9	20.5
Import of Goods and Services	3,021.5	3,125.9	8.9	3.5	28.9	28.0
3. Total Demand (GDP) (1+2)	**10,448.5**	**11,183.2**	**8.9**	**7.0**	**100.0**	**100.0**
4. Domestic Savings (3-1.1)	**2,504.7**	**2,531.0**	**6.0**	**1.1**	**24.0**	**22.6**
Private	2,632.4	2,777.8	8.3	5.5	25.2	24.8
Public	-127.7	-246.8	-88.5	-93.3	-1.2	-2.2
5. Net Primary Income from Rest of the World (c)	**-236.7**	**-251.3**	**-4.7**	**-6.2**	**-2.3**	**-2.2**
6. Net Current Transfers from Rest of the World (c)	**813.1**	**833.5**	**11.6**	**2.5**	**7.8**	**7.5**
7. National Savings (4+5+6)	**3,081.1**	**3,113.2**	**7.5**	**1.0**	**29.5**	**27.8**
8. Savings Investment Gap						
Domestic Savings - Investment (4-1.2)	-836.5	-830.5			-8.0	-7.4
National Savings - Investment (7-1.2)	-260.0	-248.3			-2.5	-2.2
9. External Current Account Balance (2 + 5 + 6) (c)	**-260.0**	**-248.3**			**-2.5**	**-2.2**

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

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

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

Economic Activity	Value (Rs. million)		As a Share of GDP (%)		Rate of Change (%)		Contribution to Change (%)	
	2014 (c)	2015	2014 (c)	2015	2014 (c)	2015	2014 (c)	2015
Agriculture, Forestry & Fishing	**641,493**	**676,899**	**7.8**	**7.9**	**4.9**	**5.5**	**7.8**	**9.0**
Agriculture and Forestry	520,835	559,445	6.3	6.5	5.1	7.4	6.7	9.8
Fishing	120,658	117,453	1.5	1.4	3.7	-2.7	1.1	-0.8
Industries	**2,194,167**	**2,259,223**	**26.7**	**26.2**	**3.5**	**3.0**	**19.6**	**16.5**
Mining and Quarrying	202,905	201,036	2.5	2.3	2.2	-0.9	1.2	-0.5
Manufacturing	1,292,994	1,354,083	15.7	15.7	2.3	4.7	7.6	15.5
Electricity, Gas, Water and Waste Treatment	108,157	119,105	1.3	1.4	4.7	10.1	1.3	2.8
Construction	590,111	584,999	7.2	6.8	6.6	-0.9	9.6	-1.3
Services	**4,634,805**	**4,881,273**	**56.3**	**56.6**	**5.2**	**5.3**	**59.9**	**62.6**
Wholesale and Retail Trade, Transportation and Storage, and Accommodation and Food Service Activities	1,914,236	2,002,655	23.3	23.2	4.0	4.6	19.3	22.5
Information and Communication	44,102	49,613	0.5	0.6	11.6	12.5	1.2	1.4
Financial, Insurance and Real Estate Activities including Ownership of Dwellings	945,090	1,061,757	11.5	12.3	8.1	12.3	18.6	29.6
Professional Services and Other Personal Service Activities	1,007,434	1,020,397	12.2	11.8	4.3	1.3	11.0	3.3
Public Administration, Defence, Education, Human Health and Social Work Activities	723,943	746,852	8.8	8.7	5.5	3.2	9.8	5.8
Gross Value Added at Basic Price	**7,470,465**	**7,817,394**	**90.8**	**90.7**	**4.7**	**4.6**	**87.3**	**88.1**
Taxes less Subsidies on Products	758,521	805,431	9.2	9.3	6.9	6.2	12.7	11.9
Gross Domestic Product at Market Price	**8,228,986**	**8,622,825**	**100.0**	**100.0**	**4.9**	**4.8**	**100.0**	**100.0**
Net Primary Income from Rest of the World	-189,495	-196,496			-2.9	-3.7		
Gross National Income at Market Price	**8,039,492**	**8,426,330**			**4.9**	**4.8**		

(a) The data is based on the base year 2010 GDP estimates of the Department of Census and Statistics.
(b) Provisional
(c) Revised

Source: Department of Census and Statistics

including coconut (a growth of 5.1 per cent), fruits (a growth of 16.5 per cent), and vegetables (a growth of 24.9 per cent), also increased in 2015, compared to the previous year, due to favourable weather conditions. However, the growing of tea contracted for the second consecutive year, registering a 2.6 per cent decline, due to supply side factors as well as in response to demand conditions, including lower demand from major export destinations. Growing of rubber also declined by 10.1 per cent, partly due to the slowdown of tapping operations of smallholders in response to declining global prices of rubber. In contrast, animal production activities grew in 2015, with the increase in milk production, owing to favourable producer prices for raw milk and increased capacity of milk factories. However, value addition from the fisheries sector contracted with lower production from inland fishing as well as marine fishing.

In 2015, the government introduced several measures which contributed to the increase in output of the Agriculture sector. The increase in the purchase prices of paddy and raw milk contributed towards the increased production in these sectors. Subsidy programmes to promote replanting and new planting in the tea, rubber and coconut sectors aimed at improving productivity in these sectors. The Sri Lanka Tea Board continued the "B Leaf 60" programme to upgrade the average best leaf standard of tea and introduced a subsidy scheme in March 2015 for small holders who provide quality green leaf. Further, in order to overcome the financial difficulties faced by tea factory owners, a short term working capital loan scheme was implemented by the government, with the Central Bank providing an interest rate subsidy of 2 per cent for this scheme. Efforts were taken to fulfill the conditions laid down by the European Union (EU), in order to get the ban lifted on fish exports from Sri Lanka to the EU, which affected Sri Lanka's overall fisheries exports in 2015. Agrarian policies proposed in the Budget for 2016 also aim to make the country self-sufficient in essential food commodities, through crop diversification and productivity improvements, while envisaging a move from subsistence agriculture into an agri-business based economy with access to export markets. Accordingly, the Budget proposed several policy measures, including setting up granaries with state of the art technology for paddy, maize, gingelly, pepper, black gram, etc. and cold rooms for vegetables and fruits, developing local fishery harbours, creating an Agro Livestock and Fish Processing Park as well as the removal of import duties pertaining to agriculture machinery and equipment. Initiatives have been taken to provide a cash grant in place of the existing fertiliser subsidy allowing greater flexibility for farmers in selecting farming inputs. In the meantime, with a view to preventing the use of highly toxic agrochemicals in the farming sector, a three year national programme was launched in early March 2016 under the theme "A Wholesome Agriculture - A Healthy Populace - A Toxin Free Nation." Further, it has been proposed to establish 23 Agricultural Development Mega Zones in order to make Sri Lanka's agricultural products globally competitive. As part of the Western Region Megapolis Master Plan, 13 planning areas have been proposed, including a Plantation City and a Forest City.

The growth in the Industry sector slowed down to 3.0 per cent in 2015, marginally reducing the share of industry in GDP to 26.2 per cent. The contraction in construction, and mining and quarrying activities largely contributed to the slower growth in the industry sector. However, the major component of the Industry sector, manufacturing activities, supported the growth in the sector with an expansion of 4.7 per cent, largely driven by the manufacturing of food, beverages and tobacco products. In addition, the manufacture of machinery and equipment, metals and metal products, and furniture also supported the growth momentum in manufacturing activities. Meanwhile, electricity, water and waste treatment activities also contributed positively to the overall growth in Industry activities. The value addition in the manufacture of textiles, wearing apparel and leather related products recorded no growth during 2015.

Government incentives towards industrial development continued with fiscal concessions, technical assistance and upgrading of infrastructure facilities to promote regional industry development initiatives. The National Policy Framework for the development of small and medium scale enterprises (SMEs) has been formulated by the Ministry of Industry and Commerce (MIC) and an action plan developed for its implementation in 20 districts. Initiatives were taken to encourage commercial banks to enhance lending to SMEs. The development and upgrading of Industrial Estates (IE) continued under the Regional Industrial Development Programme of the MIC, with an emphasis on lagging areas, especially the North and the East. Accordingly, the development of several other industrial cities, as specialised economic zones spanning across several districts, is also planned. Keeping in line with the broad objectives of the government, the development of a Science and Technology City enabling the transformation of the country into a knowledge-based innovation-driven economy is proposed under the Western Region Megapolis Master Plan. Fiscal incentives were aimed at enhancing value addition, private sector participation, promoting environmentally sustainable products and knowledge-based sectors such as Business Process Outsourcing (BPO) and Information and Communication Technology (ICT) as well as encouraging the expansion of micro institutions and SMEs in the medium term.

The Services sector, which accounts for 56.6 per cent of GDP, grew by 5.3 per cent in value added terms in 2015, in comparison to a growth of 5.2 per cent in 2014. The robust growth of 15.8 per cent in financial service activities, which benefitted from the relaxed monetary policy stance, largely contributed to the Services sector growth. Meanwhile, wholesale and retail trade, and transport activities, the two major Services components grew by 4.7 per cent and 5.5 per cent, respectively. Moreover, IT programming, telecommunication, real estate activities, including the ownership of dwellings and insurance services notably grew during 2015, supporting the momentum in Services activities. However, the setback observed in education services, professional services, postal and courier activities, and accommodation, food and beverage services affected the overall growth in Services activities.

The unemployment rate increased to 4.6 per cent during 2015, compared to 4.3 per cent recorded in 2014, amidst a marginal increase in labour force participation, particularly by females. The female unemployment rate increased from 6.5 per cent to 7.6 per cent, while the male unemployment rate declined from 3.1 per cent to 3.0 per cent in 2015, compared to 2014. The increase in unemployment among youth and those with GCE A/L and higher qualifications was notable. The labour force participation rate increased to 53.8 per cent in 2015, from 53.3 per cent in 2014, with increased participation of rural sector females in the labour force. Labour productivity increased during 2015, with positive contributions from all three sectors of the economy. Meanwhile, a sharp decline of 12.4 per cent was observed in the total number of departures for foreign employment, which could partly be attributed to escalated geo-political tensions and the slowdown of economic activity in the Middle East. This had an impact on the unemployment rate as well as the labour force participation rate.

Inflation, based on CCPI (2006/07=100), remained below mid-single digit levels, supported by the downward adjustment of prices of several key consumer items, favourable supply side developments in the domestic and international markets, and well contained inflation expectations. Headline inflation, as measured by the year-on-year change of CCPI, declined sharply from 3.2 per cent in January 2015 to 0.6 per cent in February 2015, with the price revisions introduced in the Interim Budget for 2015. Year-on-year Inflation remained below 1 per cent thereafter until September 2015, while recording negative inflation during July-September 2015. Inflation picked up in the fourth quarter of 2015, and recorded 2.8 per cent by end 2015. Annual average headline inflation declined from 3.3 per cent in 2014 to 0.9 per cent in 2015. Signalling the gradual buildup of demand pressures in the economy, CCPI based year-on-year core inflation increased to 4.5 per cent by end 2015 from 3.2 per cent at end 2014, although core inflation in terms of the annual average declined from 3.5 per cent in 2014 to 3.1 per cent in 2015. Meanwhile, in

Chart 1.3 Annual Unemployment Rate

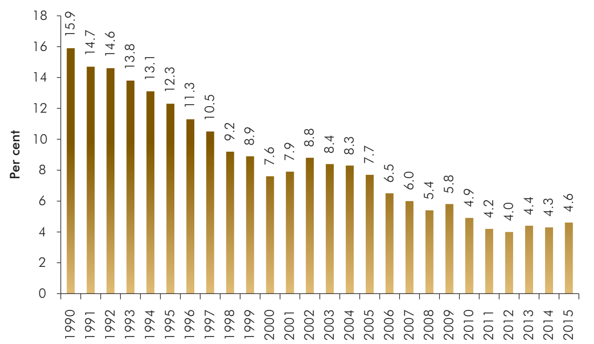
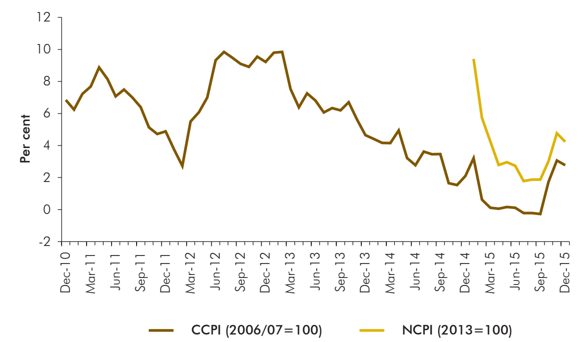


Chart 1.4 Year-on-Year Headline Inflation



2015, the DCS introduced the National Consumer Price Index (NCPI, 2013=100), which captures price movements of all provinces and changes in consumption patterns based on the findings of the Household Income and Expenditure Survey (HIES, 2012/13). Inflation based on NCPI was at 4.2 per cent on a year-on-year basis and 3.8 per cent on an annual average basis by end 2015. Wage inflation was particularly high in the public sector, as reflected by the change in the public sector wage rate indices, which registered 31.7 per cent in nominal terms and 27.0 per cent in real terms in 2015.

External Sector Developments

The performance of Sri Lanka's external sector reflected the impact of the changing global economic environment as well as a number of developments in the domestic economy. In spite of the benefit of lower expenditure on fuel imports, the merchandise trade deficit widened marginally by 1.7 per cent over the previous year, due to the increase in non-oil imports and the slowdown in export earnings. Continued increase in tourist arrivals and higher spending by tourists resulted in a growth in earnings from tourism, which contributed substantially to the improved performance of the services account during the year. The deficit in the primary income account continued to widen in 2015. However, the surpluses in the secondary income and services accounts helped abate a large deficit in the external current account. In absolute terms, the current account deficit expanded marginally in 2015, although as a percentage of GDP, the current account deficit reduced marginally to 2.4 per cent in 2015 from 2.5 per cent in 2014. The modest performance of the current account, together with the decline in inflows to the financial account, in the form of FDI and loans to the government, banking and private sectors and the withdrawal of foreign investments from the government securities market, resulted in the balance of payments (BOP) recording a deficit of US dollars 1,489 million. Along with the deterioration of the BOP, the country's gross official reserves declined to US dollars 7.3 billion by end 2015 from US dollars 8.2 billion at end 2014. Meanwhile, the rupee, which remained broadly stable during the first eight months of the year, depreciated at a faster pace from early September with the Central Bank's decision to allow greater flexibility in the determination of the exchange rate, based on market forces. Accordingly, as of end 2015, the rupee had recorded a depreciation of 9.03 per cent against the US dollar.

The deficit in the trade account expanded by 1.7 per cent in 2015 in nominal terms, although as a percentage of GDP, it declined marginally. Despite the slowdown in expenditure on imports, the greater decline in exports resulted in the expansion of the trade deficit in 2015. Accordingly, the trade deficit expanded to US dollars 8,430 million in 2015 from US dollars 8,287 million recorded in 2014. Nevertheless, as a percentage of GDP, the deficit in the trade balance declined marginally to 10.2 per cent in 2015 from 10.4 per cent in 2014.

Earnings from exports, which grew at a healthy rate in 2014, contracted by 5.6 per cent in 2015 reflecting the decline across all major export categories. The decline in international commodity prices, the slower pace of growth in advanced economies, geopolitical uncertainties in many of Sri Lanka's key export destinations, and restrictions by the European Union (EU) on fish imports from Sri Lanka contributed to the substantial reduction in export earnings. Despite the significant improvement recorded in earnings from the export of spices (42.7 per cent) and transport equipment (60.5 per cent), the decline in earnings from tea (17.7 per cent), rubber products (14.5 per cent), textiles and garments (2.2 per cent), and seafood (35.5 per cent) contributed to the overall decline in export earnings. Reflecting global developments, exports to the EU and Middle East contracted by 13.4 per cent and 11.8 per cent, respectively, while exports to the USA increased by 2.9 per cent, on a year-on-year basis. However, on average, export volumes increased by 4.6 per cent in 2015, while export prices, in US dollar terms, recorded a decline of 9.8 per cent.

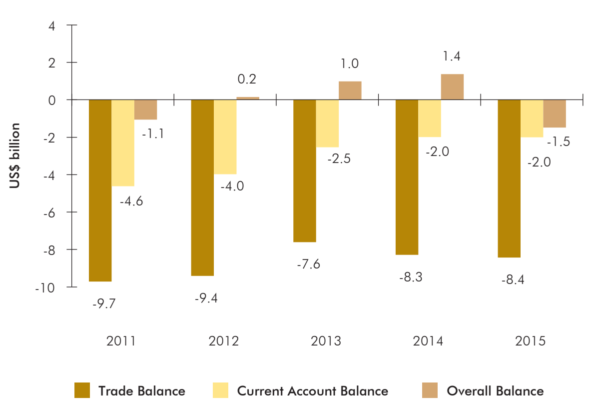
Although expenditure on non-fuel imports increased significantly by 9.6 per cent during 2015, overall expenditure on imports declined by 2.5 per cent. During the year, the fuel import bill declined by US dollars 1.9 billion to US dollars 2.7 billion, due to the significant reduction in international oil prices and the lower import volume due to less reliance on oil based thermal power. However, the higher expenditure on the importation of personal motor vehicles and other consumer durables contributed largely to the increase in expenditure on non-fuel imports. The provision of concessionary motor vehicle permits for government employees, reduced taxes on the importation of motor vehicles with engine capacity of less than 1,000cc, the depreciation of the Japanese Yen, the availability of import credit facilities at lower interest rates and the increase in salaries of government employees can be cited as reasons for the higher outlays on motor vehicle imports. However, policy measures taken by the Central Bank and the government towards the end of the year resulted in a slowdown of import expenditure on consumer goods, particularly motor vehicles. On average, import volumes increased by 10.6 per cent in 2015, while import prices declined by 11.8 per cent in US dollar terms.

Despite the widening of the deficit in the merchandise trade balance and the primary income account, the external current account deficit in 2015 was largely unchanged from 2014, as a result of the surpluses in the services and secondary income accounts. The buoyancy of the travel and tourism sub sector and the satisfactory performance in transportation, telecommunication, computer and information services sub sectors contributed to the improvement of the services account during the year. The increase in tourist arrivals and the average period of stay and spending, resulted in a 22.6 per cent growth in earnings from tourism during the year. The continued expansion of the Business Process Outsourcing (BPO) and Knowledge Process Outsourcing (KPO) industries contributed to the improved performance of the telecommunication, computer and information services sub sector. Meanwhile, during the year, the deficit in the primary income account widened further as a result of the reduction in earnings from the investment of reserve assets, increased interest payments and outflows in the form of dividends and re-invested earnings. The slowdown in workers' remittances and government transfers led to a lower surplus in the secondary income account. Workers' remittances, which had been a traditional source of foreign exchange, declined by 0.5 per cent in 2015 compared to the growth of 9.5 per cent observed in 2014. This decline can be largely attributed to the fall in incomes of oil exporting countries in the Middle East due to the low level of international oil prices, and the decline in migration under the semi-skilled and unskilled categories, including housemaids. With these developments in the trade, services, primary and secondary income accounts, the current account recorded a deficit of US dollars 2,009 million in 2015 compared to the deficit of US dollars 1,988 million in 2014. However, as a percentage of GDP, the current account deficit narrowed marginally to 2.4 per cent in 2015 from 2.5 per cent a year earlier.

Both net incurrence of liabilities and net acquisition of assets in the financial account of the BOP were comparatively lower in 2015. Major inflows to the financial account during the year comprised proceeds from the issuance of two International Sovereign Bonds (ISBs) totaling US dollars 2,150 million, and the proceeds of the international swap arrangement entered into with the Reserve Bank of India (RBI), amounting to US dollars 1,500 million. The inflows of FDI, portfolio investment and loan inflows to the government, banking and private sectors offered little support to the financial account. This was partly due to unfavourable developments in the global economic environment and cautious investor sentiment on the domestic front in the wake of two major national elections. Meanwhile, the anticipation of, and the subsequent increase of interest rates by the US Federal Reserve prompted foreign investors to withdraw their investments from emerging markets. Accordingly, during the year, there was a net outflow of US dollars 1,093 million from the government securities market. Additionally, scheduled debt service payments and the settlement of a matured ISB weighed negatively on the financial account.

The BOP, which recorded an overall surplus in 2014, registered a deficit in 2015 largely due to lower than expected inflows to the financial account. In 2015, the BOP recorded an overall deficit of US dollars 1,489 million in comparison to the surplus of US dollars 1,369 million in 2014. Consequently, Sri Lanka's gross official reserves declined to US dollars 7.3

Chart 1.5 Balance of Payments



billion at end 2015 from US dollars 8.2 billion at end 2014. Gross official reserves reduced mainly due to scheduled foreign currency debt service payments, settlement of the matured ISB, payments to the IMF on account of the Stand-By Arrangement (SBA) and the supply of liquidity to the domestic foreign exchange market. The level of gross official reserves at end 2015 was equivalent to 4.6 months of imports of goods and 3.8 months of imports of goods and services. Meanwhile, total foreign assets declined from US dollars 9.9 billion at end 2014 to US dollars 9.3 billion at end 2015, equivalent to 5.9 months of imports of goods and 4.9 months of imports of goods and services. The gross official reserve asset position covered 60 per cent of the country's short term debt and liabilities as at end 2015.

The country's total external debt, which comprises external debt of the public and private sectors, increased in 2015. The increase in the total external debt of the country in nominal terms was the combined outcome of a moderate level of inflows on account of foreign loans, and considerable outflows on account of debt service payments throughout the year. The total external debt stock of the country was US dollars 44.8 billion at end 2015 compared to US dollars 42.9 billion at end 2014. Further, as a percentage of GDP, total external debt increased to 54.4 per cent at the end of 2015, from 53.6 per cent at end 2014. Meanwhile, debt service payments on Sri Lanka's external debt obligations increased significantly from US dollars 3,479 million in 2014 to US dollars 4,683 million, as a result of increases in both capital and interest payments. The increased level of debt service payments and the decline in exports of goods led to debt service payments as a percentage of exports of goods and services increasing significantly to 27.7 per cent in 2015 from 20.8 per cent in 2014.

In early September 2015, the Central Bank decided to allow greater flexibility in the determination of the exchange rate. Lower than expected inflows to the current and financial accounts, high volume of foreign exchange outflows on account of increased imports, debt service payments and the reversal of foreign investments from the government securities market exerted a substantial pressure on the domestic foreign exchange market. In this context, the Central Bank supplied US dollars 1.9 billion, on a net basis, to the domestic foreign exchange market during the first eight months of the year to curb excessive volatilities in the exchange rate. Consequently, the rupee depreciated marginally by 2.57 per cent until the policy decision of the Central Bank, on 03 September 2015, to accommodate greater flexibility in the determination of the exchange rate. Subsequent to this decision and till the end of the year, the rupee recorded a depreciation of 6.64 per cent against the US dollar, resulting in an overall depreciation of 9.03 per cent against the US dollar during the year. In line with the nominal depreciation of the Sri Lankan rupee against the US dollar, and relatively low levels of domestic inflation compared to most trading partners, both the 5-currency and 24-currency Real Effective Exchange Rate (REER) indices depreciated by 3.07 per cent and 2.26 per cent, respectively, by end 2015.

Fiscal Sector Developments

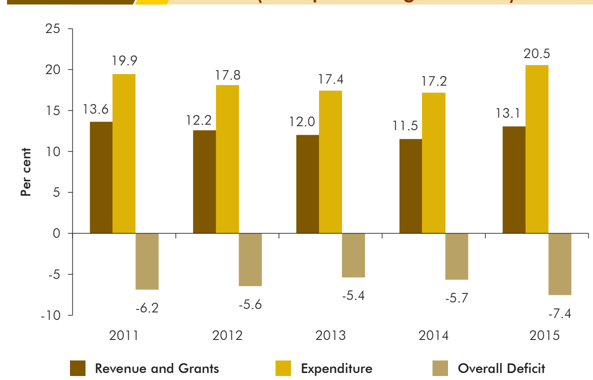
Although the Interim Budget for 2015 expected a sharp reduction in the budget deficit during the year, a number of developments challenged fiscal management, hindering the envisaged fiscal consolidation path. The Interim Budget, which was presented following the Presidential election in January 2015, introduced several fiscal reforms aimed at realising the expected outcomes of the fiscal consolidation process. The government expected to reduce the budget deficit to 4.4 per cent of GDP in 2015 from 5.7 per cent recorded in 2014, while maintaining the central government debt to GDP ratio at 72.0 per cent in 2015, as per the targets outlined in the Medium Term Macro Fiscal Framework 2014-2017 of the Fiscal Management Report for 2015. Nevertheless, the fiscal sector performance deteriorated in 2015, resulting in deviations from the budgetary targets stipulated in the Interim Budget for 2015. The lower than expected collection of government revenue, high level of recurrent expenditure, particularly on salaries and wages, welfare expenditure, and higher than estimated outlay on interest payments, exerted a significant pressure on the overall budget deficit in 2015. Accordingly, the budget deficit increased from 5.7 per cent of GDP in 2014 to 7.4 per cent of GDP in 2015, significantly overshooting the government's original target of 4.4 per cent of GDP. The current account deficit, which reflects government dissavings, increased to 2.2 per cent of GDP in 2015 from 1.2 per cent in the previous year, while the primary deficit, which excludes interest payments from the overall deficit, increased to 2.9 per cent of GDP from 1.5 per cent in 2014. The budget deficit was largely financed by domestic sources, given the slowdown in foreign financing during the year. The central government debt to GDP ratio increased to 76.0 per cent in 2015 from 70.7 per cent in 2014, highlighting the need for strong fiscal reforms to reduce the budget deficit and accumulation of debt.

The government revenue to GDP ratio showed an improvement in 2015, mainly benefitting from several one off taxes and the significant expansion in revenue from excise duties on increased motor vehicle imports. Although total government revenue as a percentage of GDP increased to 13.0 per cent in 2015 from 11.4 per cent in 2014, it remained below the annual target of 13.3 per cent of GDP stipulated in the Interim Budget for 2015. While non tax revenue as a percentage of GDP declined to 0.9 per cent in 2015 from 1.4 per cent in 2014, tax revenue as a percentage of GDP increased to 12.1 per cent in 2015 from 10.1 per cent in 2014. Despite the increase in revenue from excise duty, corporate and non corporate income tax, import duties, Cess levy, Special Commodity Levy (SCL) and Telecommunication Levy, the revenue collection from Value Added Tax (VAT) on both domestic activities and imports, Ports and Airports Development Levy (PAL) and withholding tax recorded a decline. The increase in tax revenue could also be attributed to several policy measures introduced during the year to streamline the tax system and expand the tax base. The key measures introduced during the year include, the streamlining of personal income tax by applying a lower tax rate for all employment categories, introduction of several new taxes including few one off taxes, and strengthening of tax administration in revenue agencies, while taking measures to improve tax compliance.

In nominal terms, total revenue increased by 21.7 per cent to Rs. 1,454.9 billion in 2015 from Rs. 1,195.2 billion in 2014 mainly due to the increase in revenue collection from excise duties, income tax and import duties. Revenue from excise duties became the highest single contributor to total tax revenue in 2015, reflecting the impact of the imposition of composite higher excise tax rates on motor vehicles, liquor and cigarettes. Accordingly, excise duties contributed 36.7 per cent to total tax revenue, accounting for 34.2 per cent of total revenue during the year. Meanwhile, revenue collection from one-off taxes introduced during the year, such as the Super Gain tax, which generated Rs. 50.0 billion, also made a significant contribution to the increase in tax revenue. Although revenue from fees and charges increased during the year, non tax revenue at Rs. 99.1 billion, recorded a decline of 31.6 per cent, largely due to lower profit and dividend transfers from SOBEs and the decrease in revenue from interest and rent.

Total expenditure and net lending as a percentage of GDP increased to 20.5 per cent in 2015 from 17.2 per cent in 2014, reflecting a significant increase in both recurrent expenditure and public investment. During the year, recurrent expenditure as a percentage of GDP increased to 15.2 per cent from 12.7 per cent in 2014, due to the increased expenditure on salaries and wages, interest payments, current transfers and subsidies. In nominal terms, recurrent expenditure increased by 28.6 per cent to Rs. 1,701.7 billion in 2015 from Rs. 1,322.9 billion in 2014, exceeding the budgetary target of Rs. 1,552.0 billion. Salaries and wages of central government employees increased, in nominal terms, by 27.4 per cent to Rs. 561.7 billion in 2015, exerting a significant upward pressure on government expenditure. Interest expenditure also increased, in nominal terms, by 16.8 per cent to Rs. 509.7 billion in 2015, on account of higher borrowings and the depreciation of the rupee vis-a-vis other foreign currencies. Meanwhile, capital expenditure and net lending as a percentage of GDP increased to 5.3 per cent in 2015 from 4.5 per cent in 2014. Accordingly, in nominal terms, it increased by 24.5 per cent to Rs. 588.7 billion during the year, in comparison to Rs. 473.0 billion recorded in the previous year. Reflecting this trend, public investment also increased to 5.4 per

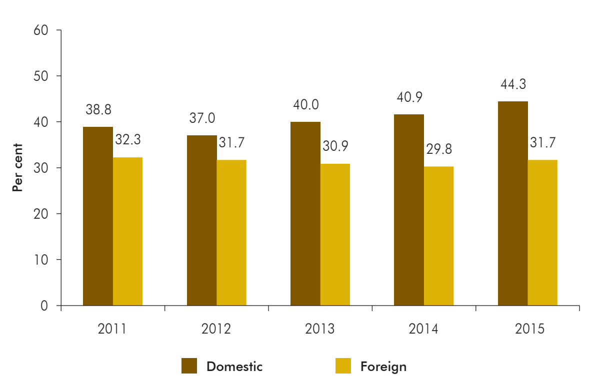
Chart 1.6 Revenue, Expenditure and Overall Fiscal Deficit (as a percentage of GDP)



cent of GDP in 2015 from 4.7 per cent of GDP in 2014, while in nominal terms, public investment increased by 23.9 per cent to Rs. 602.8 billion in 2015 in comparison to Rs. 486.6 billion in 2014.

The government mainly relied on domestic sources of financing, particularly the non bank sector, to fund the budget deficit of 7.4 per cent of GDP in 2015. Net domestic financing increased from Rs. 378.7 billion in 2014 to Rs. 592.7 billion in 2015, recording a significant deviation from the annual estimate of Rs. 208.0 billion. Of the total net domestic financing, 50.8 per cent, amounting to Rs. 300.9 billion, was raised from the non bank sector. Meanwhile, government borrowings from the banking sector also increased from Rs. 126.9 billion in 2014 to Rs. 291.8 billion during the year, which was also significantly higher than the annual estimate of Rs. 70.0 billion envisaged in the Budget for 2015. Although borrowings from commercial banks through Treasury bonds recorded a net repayment during the year, borrowings in the form of Treasury bills and Sri Lanka Development Bonds (SLDBs) increased. Net borrowings from the Central Bank also increased, mainly through Treasury bills. Despite significant outflows in foreign holdings of rupee denominated Treasury bills and Treasury bonds, net financing from foreign sources also increased to Rs. 236.8 billion in 2015 from Rs. 212.5 billion in 2014 with the issuance of two ISBs in 2015.

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



The total government debt to GDP ratio increased to 76.0 per cent at end 2015 from 70.7 per cent at end 2014, reflecting the weak performance of the fiscal sector and relatively low nominal GDP growth during the year. In nominal terms, total outstanding government debt increased to Rs. 8,503.2 billion at end 2015, from Rs. 7,390.9 billion at end 2014. The increased level of required borrowing, as a result of the below par revenue collection, and the significant depreciation of the rupee against major foreign currencies largely contributed to this substantial increase in government debt.

Fiscal performance in the recent past reflects serious structural weaknesses in the government budget. The complex tax system, relatively low revenue base, weak tax compliance as well as the need for improving tax administration adversely affect revenue generation. As reflected in the significant increase in the deficit in the revenue account (current account) of the budget, the country's revenue is not sufficient to even finance the maintenance expenditure of the government. This has forced the government to recourse to borrowings even for its day-to-day operations. This structural weakness limits the ability of the government to channel adequate funds for development needs. The pressing resource needs, which tend to increase spending through borrowing, lead to a deviation of fiscal targets from the desired levels. This leads to a vicious cycle of revenue shortfalls, expenditure overruns, high budget deficits, increase in government debt and debt service payments, thereby lowering the expenditure on public investment and the ability to enhance other essential expenditures while making fiscal consolidation a difficult task. Hence, it is essential to address each point of this vicious cycle by implementing necessary reforms to revamp budgetary operations.

BOX 01 Fiscal Space for Stability and Resilience

Introduction

Generating fiscal space, to support macroeconomic stability and improve the resilience of the economy to face shocks, has gained the attention of fiscal authorities across the globe, especially since the financial crisis. Constrained fiscal environments in both advanced and emerging market economies have spurred interest in creating fiscal space in the government budget, as pressures emerging from uncertain global developments, rising debt service obligations and demographic transitions continue to challenge the sustainability of fiscal operations. Budgetary processes in emerging middle income countries, such as Sri Lanka, have come under pressure in the light of the need for rapid development without undue risk to the government's future fiscal position. This provokes a question as regards to the maintenance of sufficient fiscal space in Sri Lanka.

Heller (2005) defines fiscal space as "budgetary room that allows a government to provide resources for a desired purpose, without jeopardising the sustainability of its financial position or the stability of the economy".[1] In other words, fiscal space refers to the availability of additional resources to provide flexibility to the government in order to decide on its spending, revenue or borrowing choices, without adversely impacting macroeconomic stability. Key determinants of fiscal space include the composition and trend of public expenditure, the propensity to tax, the propensity to borrow and economic growth. Therefore, fiscal space can be created by increasing revenue, curtailing expenditure or borrowing resources from domestic or external sources and accelerating growth. The creation of fiscal space should in no way compromise fiscal sustainability. The government must ensure that it has the capacity, in the short term and the long term, to finance its expenditure programmes and service its debt.

Structure of Sri Lanka's Government Budget

Competing expenditure claims in an environment of tightening resource constraints have characterised Sri Lankan budgetary operations in the recent past. Pressing needs for expenditure, given the low revenue mobilisation and tightening financial conditions, have resulted in successive governments reporting high budget deficits. Sri Lanka's budget deficit for the 2010 - 2015 period averaged to around 6 per cent of GDP. An examination of the structure of government revenue and expenditure brings forth some concerns that have challenged fiscal authorities. Public expenditure has been maintained on average at around 18.8 per cent of GDP during the period 2010 – 2015. Although the current outlays of the government hovered at around 13.7 per cent of GDP during this period, interest payments, the "non-discretionary" spending component of the budget, and the expenditure on salaries and wages have remained static in terms of current expenditure shares, accounting for over two-thirds of recurrent expenditure. Salaries and wages, and interest payments have averaged 4.4 per cent and 4.7 per cent of GDP, respectively, during 2010 – 2015. Moreover, transfer payments and welfare expenditure of the budget, which includes transfers to households, a key component of poverty alleviation, have also averaged around 3.0 per cent of GDP during this period.

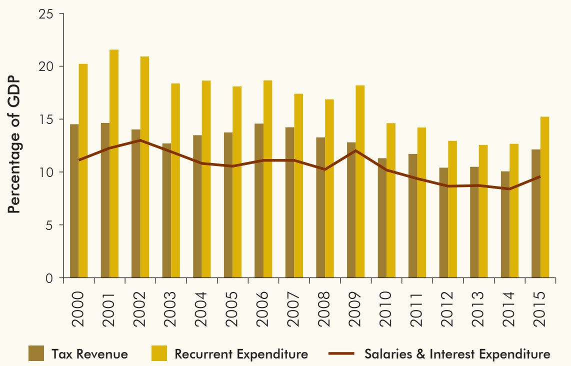
In the above context, the leeway available in the budget to accommodate other pressing needs remains limited. The dilemma fiscal authorities face in this context can be clearly seen when observing the expenditure incurred by the government on priority sectors such as education and health. An examination of expenditure outlays on a functional basis shows that education and health sectors receive only an average of 16 per cent of the total funds channeled through the budget and, on average, accounted for 1.7 per cent and 1.3 per cent of GDP, respectively, during the period from 2010 to 2015, although there was an improvement in 2015. An argument can be made to increase health and education outlays, as such expenditures will generate benefits over the long term, by way of higher returns to human capital. However, given the present expenditure structure of the budget, which has limited manoeuvrability, it is necessary for the government to create the enabling fiscal space for this purpose.

On the revenue front, the government's revenue collection has been well below the total expenditure, and not even sufficient to cover recurrent expenditure. Revenue as a percentage of GDP averaged at around 12.4 percent during the period 2010 – 2015. The low revenue collection is largely attributable to the weak tax collection in the country. The tax revenue/ GDP ratio has also declined to 10.1 per cent in 2014 before picking up to 12.1 per cent in 2015, partly due to the imposition of several one off taxes during

1 Heller, P. (2005) 'Understanding Fiscal Space', Policy Discussion Paper PDP/05/4, Washington, DC: Fiscal Affairs Department, IMF

that year. Sri Lanka's tax performance remained weak in comparison to its regional peers. Low elasticity of the tax system, due to numerous exemptions, tax avoidance and weak tax administration are some reasons for the poor revenue performance.

Chart B 1.1 Revenue and Expenditure Performance



Low revenue mobilisation, together with high expenditure levels, and the associated high budget deficits have resulted in high government debt levels. Government debt, as a percentage of GDP, has increased to 76 per cent in 2015. This has necessitated increased debt service payments, which in turn have pressurised fiscal operations. Debt service payments at present absorb about 90 per cent of the revenue generated by the government through tax and non-tax sources. While there is not much leeway to borrow domestically from non-inflationary sources, high levels of external debt increase the vulnerability of the country to external shocks. The lack of fiscal space reflects the inability of the government to resort to increase borrowings to accommodate the growing resource needs of the economy.

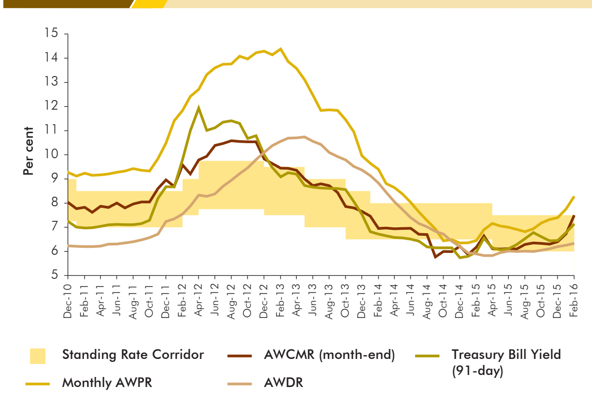
Way Forward

The lack of room to manoeuvre fiscal operations makes the accommodation of new demands from various sectors of society, into the government budget, an extremely difficult task. Given the inability of the government to resort to additional borrowings, fiscal space must be created through reforms of the tax and expenditure structures. The creation of fiscal space entails a comprehensive revamp of the present budgetary structure. Fiscal policy should aim at increasing the tax/GDP ratio at least in line with that of Sri Lanka's regional peers, by improving the revenue mobilisation effort. Tax reforms should be undertaken with a view to expanding the tax base and increasing compliance. On the expenditure front, consideration of fiscal space will have to be made in the context of a medium term expenditure framework, that has a comprehensive perspective on the government's expenditure priorities. At the same time, the efficiency of expenditure management has to be improved to obtain value for money in respect of expenses incurred by the country. In this context, each expenditure item will have to be carefully reviewed in terms of economic, political, social and other considerations of the government. Moreover, ad-hoc spending decisions made outside the regular budget should be limited as these curtail fiscal space. The government should also improve the performance of state owned enterprises (SOEs) by improving the financial viability of these entities and reducing their dependence on the budget. Labour market reforms should be undertaken to improve productivity and increase growth. The possible resistance to essential reforms will have to be mitigated with proper engagement of the government with all stakeholders, including labour associations and the general public, through awareness programmes.

Monetary Sector Developments

The Central Bank continued to maintain an accommodative monetary policy stance during the year in an environment of persistently low inflation, but initiated a gradual tightening of monetary policy from end 2015 with a view to preempting excessive demand pressures on inflation, emanating from high credit and money expansion. Considering the sustained increase in credit flows to the private sector encouraged by the low interest rate environment that was maintained during the past few years, in March 2015, the Central Bank removed the restrictions placed on the access to its Standing Deposit Facility (SDF) under open market operations (OMO) that was in effect since September 2014. Consequent to this measure, to address the excessive volatility of short term interest rates, the Central Bank lowered its key policy interest rates, namely the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR), by 50 basis points to 6.00 per cent and 7.50 per cent, respectively, in April 2015. Nevertheless, as credit and monetary aggregates continued to expand at a faster pace than projected, the Central Bank commenced tightening monetary policy gradually towards end 2015. Accordingly, the SRR applicable on all rupee deposit liabilities of commercial banks was raised by 1.50 percentage points to 7.50 per cent to be effective from the reserve period commencing 16 January 2016, signalling the end of the relaxation cycle of monetary policy. Even prior to the commencement of monetary tightening, several policy measures were introduced in the last quarter of 2015 to contain excessive credit flows to selected sectors. Accordingly, a minimum cash margin requirement was imposed on Letters of Credit (LCs) opened for the importation of motor vehicles, which was replaced later on by a maximum Loan to Value (LTV) ratio, a macro prudential measure, on loans and advances granted for the purpose of purchase or utilisation of motor vehicles. These measures, along with greater flexibility allowed in the determination of the exchange rate and the changes to the tax structure made by the government, were expected to contain excessive growth of personal loans and advances, while strengthening macroeconomic and financial system stability. Nevertheless, considering the possible aggravation of demand driven inflationary pressures due to continued high monetary expansion, as a preemptive policy measure, the Central Bank raised its SDFR and the SLFR by 50 basis points each, to 6.50 per cent and 8.00 per cent, respectively, effective from the close of business on 19 February 2016.

Chart 1.8 Standing Rate Corridor and Selected Market Interest Rates

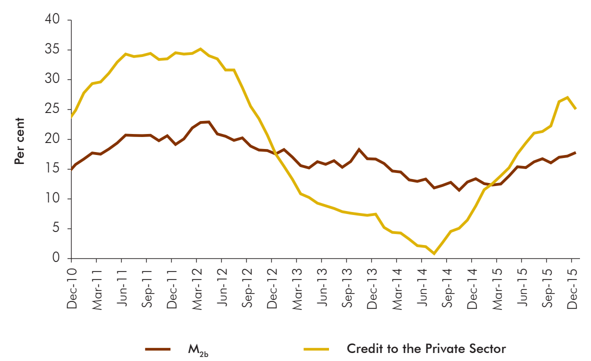


Rupee liquidity in the domestic money market, although lower than the levels observed in 2014, continued to be in excess throughout 2015. Excess liquidity remained high at the beginning of the year due to Treasury bill purchases and provisional advances to the government by the Central Bank. However, excess liquidity declined gradually until August 2015, reflecting the continued supply of foreign exchange to the domestic foreign exchange market, foreign loan repayments, early retirements and outright sales of Treasury bills held by the Central Bank as well as high volumes of currency issuances, particularly during the general election. The Central Bank managed excess liquidity in the domestic money market on overnight, short term and long term bases, with a view to maintaining the stability in short term interest rates. Nevertheless, since September 2015, excess liquidity in the money market increased due to the purchase of proceeds of the Sri Lanka Development Bonds (SLDBs) by the Central Bank, increased purchases of Treasury bills by the Central Bank in the primary market, and the purchase of a part of the proceeds of the International Sovereign Bond (ISB) by the Central Bank. During 2015, overnight excess liquidity ranged from Rs. 3.3 billion to Rs. 149.6 billion, and averaged Rs. 76.6 billion, while total excess liquidity stood at Rs. 105.3 billion by end 2015.

During the year, the Central Bank conducted monetary policy within an enhanced monetary policy framework with features of both monetary targeting and flexible inflation targeting (FIT). Under this enhanced monetary policy framework, the Central Bank attempts to stabilise inflation in mid-single digits over the medium term, while supporting the growth momentum of the economy. In terms of operational aspects of this framework, the Central Bank uses its policy instruments to guide short term interest rates, particularly the average weighted call money rate (AWCMR), which is the operating target of the framework, along the desired path. Reserve money is not considered an operating target any more, although broad money supply (M_{2b}) remains a key indicative intermediate variable to guide monetary policy, and plays a key role in the annual monetary programme of the Central Bank, which is prepared considering the envisaged inflation target and the growth of real GDP. However, during the year, the actual broad money growth was substantially higher than the projected levels.

Broad money (M_{2b}) growth accelerated during 2015 due to the expansion in credit to both public and private sectors. M_{2b} increased by 17.8 per cent, year-on-year, by end 2015 compared to a growth of 13.4 per cent at end 2014, while the average broad money growth was 15.2 per cent during the year. As net foreign assets (NFA) of the banking system recorded a contraction during the year, the expansion in broad money was entirely due to the increase in net domestic assets (NDA) in 2015 underpinned by domestic credit expansion. NFA of the banking system contracted substantially by Rs. 413.6 billion in the first ten months of 2015 and the contraction was moderated in the last two months of the year with the receipt of proceeds from the ISB by the Central Bank. Accordingly, the contraction of NFA by end 2015 amounted to Rs. 313.3 billion. During the year, NFA of the Central Bank declined by Rs.111.8 billion along with the increased supply of foreign exchange by the Central Bank to the domestic foreign exchange market. Meanwhile, NFA of commercial banks declined by Rs. 201.5 billion in 2015, with increased short term foreign borrowings by commercial banks as well as an increase of balances in non resident foreign currency accounts (NRFC) and resident non national foreign currency accounts (RNNFC). NDA expanded by 26.0 per cent, or by Rs. 1,003.3 billion in absolute terms, in 2015, driven by increased credit flows to both public and private sectors. Within NDA, net credit to the government (NCG) extended by the banking system increased substantially by Rs. 323.6 billion, exceeding the levels envisaged in the government budget. The considerable increase in NCG is attributable to the government's increased reliance on domestic financing amidst delays in the receipt of foreign financial flows, the continued shortfall in revenue collection as well as expenditure overruns. NCG by the Central Bank increased by Rs. 80.3 billion during 2015 with increased placements of Treasury bills with the Central Bank, while NCG by commercial banks increased by Rs. 243.3 billion, due to increased investments in Treasury bills and SLDBs by commercial banks. However, investments in Treasury bonds by commercial banks recorded a decline of Rs. 52.2 billion (net of repurchase agreements) during the year, reflecting lesser appetite of commercial banks for long term securities. The outstanding overdraft balance of the government with state banks also increased by Rs. 10.5 billion to Rs. 125.1 billion at end 2015 compared to Rs. 114.6 billion that was recorded at end 2014. Meanwhile, the expansion in credit obtained by public corporations from the banking sector moderated marginally to Rs. 76.9 billion in 2015 in comparison to the increase of Rs. 80.9 billion observed in 2014. The increase in credit granted to Sri Lankan Airlines (SLA), Ceylon

Chart 1.9 Year-on-Year Growth of Broad Money (M_{2b}) and Private Sector Credit



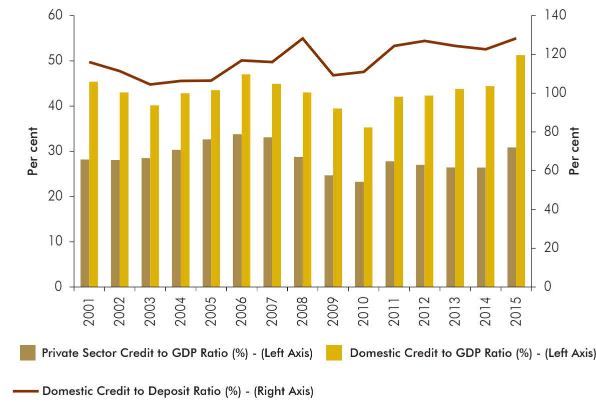
ECONOMIC, PRICE AND FINANCIAL SYSTEM STABILITY, OUTLOOK AND POLICIES

1

Petroleum Corporation (CPC), Road Development Authority (RDA) and Paddy Marketing Board (PMB) mainly contributed to the expansion in credit to public corporations during the year, while Ceylon Electricity Board, Ceylon Fertiliser Corporation and Colombo Commercial Fertiliser repaid a part of their outstanding liabilities to the banking sector.

In response to the continued relaxed monetary policy stance, credit extended to the private sector by the banking system expanded at a high rate. By end 2015, credit to the private sector increased by 25.1 per cent on a year on year basis, compared to the 8.8 per cent growth recorded at end 2014. In absolute terms, credit to the private sector increased by Rs. 691.4 billion during the year compared to the increase of Rs. 223.9 billion in 2014. The acceleration of credit extended to the private sector was driven by persistently low market lending rates as well as the aggressive marketing campaigns by lending institutions to attract borrowers. In addition to the regular expansion in private sector credit, this included an additional sum of Rs. 83.0 billion of loans and advances that was added to the overall expansion in credit to the private sector in M_{2b}, as a result of the merger of DFCC Vardhana Bank and DFCC PLC in October 2015 to formulate one licensed commercial bank. Meanwhile, as per the Security-wise Analysis of Advances, credit in terms of leasing and hire purchase agreements increased considerably by Rs. 65.6 billion in 2015 compared to the increase of Rs.16.4 billion in the previous year, indicating high import demand for motor vehicles. The contraction in pawning advances was limited to Rs. 38.2 billion in 2015 compared to the significant decline of Rs.140.0 billion recorded in 2014. Moreover, as per the Quarterly Survey of Commercial Banks' Loans and Advances to the Private Sector, credit to the Services sector and the Industry sector expanded significantly by 34.1 per cent and 25.0 per cent, respectively, indicating the continued flow of credit to major sectors of the economy during the year.

Chart 1.10 Credit as a Ratio of GDP and Deposits



Market interest rates remained low during 2015 although some upward movement was observed during the latter part of the year. AWCMR, which had remained below the SDFR since September 2014, due to the restrictions placed on SDF, moved upward in March 2015 consequent to the removal of the restrictions. Although AWCMR declined with the reduction in policy interest rates in April 2015 and remained close to the lower bound of the policy rate corridor until August 2015, it displayed some upward trend thereafter. This movement in AWCMR was mainly a reflection of the decline in excess liquidity in the domestic money market. Accordingly, AWCMR was at 6.40 per cent by end 2015 in comparison to 6.21 per cent at end 2014. Meanwhile, yields on government securities also increased substantially during 2015. Although the issuances of SLDBs and ISB helped ease the pressure on interest rates on domestic debt instruments to some extent, market anticipation of a high domestic funding requirement of the government amidst delays in foreign financial inflows and the Central Bank's decision to issue government securities only through public auctions increased pressure on the yields on government securities. Meanwhile, interest rates offered on deposits by commercial banks remained low during 2015, although a gradual increase was observed since the middle of the year. By end 2015, the average weighted deposit rate (AWDR) stood at 6.20 per cent, having returned to the same level that prevailed at end 2014. The average weighted fixed deposit rate (AWFDR) increased by 24 basis points to 7.57 per cent by end 2015 from 7.33 per cent at end 2014. The average weighted lending rate (AWLR), which captures lending rates on all advances weighted by outstanding loan balances, declined by 91 basis points to 11.00 per cent by end 2015 from 11.91 per cent at end 2014. Nevertheless, reflecting the gradual rise in short term lending rates towards the latter part of the year, the weekly average weighted prime lending rate (AWPR) increased by 127 basis points to 7.53 per cent by end 2015 from 6.26 per cent at end 2014. The increasing trend in interest rates continued into the first quarter of 2016, mainly reflecting the monetary policy tightening measures adopted by the Central Bank, reduced levels of excess liquidity in the money market, and the continued high financing requirement of the government.

Financial Sector Developments

In 2015, the financial sector demonstrated its resilience to volatile market conditions emanating from domestic and global uncertainties. Business operations of the banking sector expanded, supported by increased credit demand against the backdrop of the low interest rate regime, increased profits and internal capital generation, which augmented the cushion available in the sector for absorbing risks arising from any adverse shocks. Asset quality of the banking sector improved during the year. The finance and leasing companies sector also recorded improved performance as reflected in its increased relative share in terms of total assets of the domestic financial system. The Central Bank continued to take regulatory measures in 2015 to protect depositors' and investors' interest in a few liquidity threatened finance companies. The Primary Dealers of government securities showed moderate operating results in spite of rapid business expansion, while the liquidity issues faced by one primary dealer necessitated regulatory intervention to maintain investor confidence and facilitate smooth operations in the government securities market. Contractual savings institutions secured a return close to levels in previous years in spite of low market interest rates. Other non-banking financial institutions also recorded business growth, but with mixed operating performances given their business models and financial market conditions. During the year, domestic financial markets operated with relatively high volatility consequent to monetary and BOP conditions that emanated partly from global developments. Meanwhile, large and retail value national payments systems of the country operated smoothly without any major disruption and stability concerns, while facilitating the growing and changing payment needs of the financial sector and the general public, with improved efficiency and safety.

Introducing regulatory measures to strengthen liquidity risk management of banks and credit risk management of banks and non-banking financial institutions, and taking action to curb unauthorised finance businesses were the key developments in the licensed bank and non-bank financial sector with regard to new prudential regulations. Further, with a view to promoting electronic payments among the general public, limits were imposed on transaction fees charged by banks from their customers on large value and retail electronic fund transfers. The implementation of several regulations for the insurance industry in areas of settling insurance claims within a stipulated time period to protect claimants, imposing a minimum net capital level for insurance brokers to enhance soundness, streamlining business canvassed by insurance agents for customer protection, and the requirement for all insurance companies to adhere to risk based solvency margin (risk based capital) to enhance risk management systems of insurance companies, were seen in 2015. The formulation of a capital market development master plan covering statutory gaps, risk management, and public awareness, and the adoption of the Global Industry Classification Standard (GICS) to classify companies listed in the Colombo Stock Exchange (CSE) were other major policies to develop listed debt and equity capital and unit trust markets.

1.3 Global Economic Environment and Outlook

According to the World Economic Outlook of the International Monetary Fund (IMF), global economic activity remained subdued in 2015, with the decline in growth in emerging market and developing economies, amidst the modest recovery in advanced economies. The performance of a number of advanced economies and their emerging market counterparts diverged as output gaps narrowed in certain advanced economies while emerging markets encountered new challenges during the year. These were mainly a result of rebalancing of economic activities in key emerging markets and low levels of commodity prices. The persistent decline in oil prices helped maintain inflation at subdued levels in most economies although oil exporting countries experienced shrinking fiscal and external spaces. Weak growth prospects, worsening terms of trade and spillover effects of the monetary policy tightening by the Federal Reserve of the United States (US) led to several currencies facing depreciation pressures during the year.

Global growth is expected to remain dampened, weighed down by the performance of large emerging market economies. Accordingly, global growth is estimated at 3.2 per cent in 2016 and 3.5 per cent in 2017. Despite challenges posed by the global environment, the Federal Reserve expects the US economy to continue expanding at a moderate pace as a result of the increase in household spending and strengthening of the labour market. The robust economic recovery of the United Kingdom (UK) has been driven by the accommodative monetary policy of the Bank of England and the resultant expansion of private domestic demand, helping to offset the contractionary impact of fiscal consolidation. However, there are concerns that the positive outlook of the UK economy may be impacted by the uncertainty surrounding the referendum on EU membership scheduled for mid-2016. The growth prospects of advanced economies are weighed down by the downgraded economic outlook for Japan where inflation expectations remained weak. In addition, lower than expected levels of inflation could weigh negatively on the performance of the euro zone in 2016. While recent reductions in key interest rates and expansion of bond purchases by the European Central Bank may help tackle the deteriorating inflation outlook, political developments, such as volatilities associated with terrorism, and the surge of refugees from the Middle East and Africa, may cap the growth outlook for the region. Among emerging market economies, rebalancing of China's growth strategy, from one driven by investment to one driven by domestic consumption, is expected to have far reaching implications. In the short run, this transformation is expected to generate spillover effects through trade and financial channels. Meanwhile, a low inflation environment, substantial FDI flows and preemptive supply side measures are expected to help India sustain its growth in the coming years, complemented by strong domestic demand and a boost in private investment.

The decline in commodity prices throughout 2015 presented several challenges to the pace of recovery of the global economy. The recent fall in international commodity prices extended across all commodity sectors, including energy, metals and minerals, and agriculture. In general, net commodity exporting economies experienced lower economic growth prospects, currency depreciation, decline in export revenues and a deterioration of the current account. These economies responded to currency depreciation and capital outflows through tighter monetary policies and increased intervention in foreign exchange markets. While it may be expected that net commodity importers would have benefited from the low commodity prices, linkages between net exporters and net importers caused savings from price declines to be negated by lower inflows in terms of remittances, tourism earnings, capital flows and even foreign aid.

Table 1.4 Global Economic Developments and Outlook (a)

Item	2014	2015	2016 (Proj)	2017 (Proj)
World Output	**3.4**	**3.1**	**3.2**	**3.5**
Advanced Economies	1.8	1.9	1.9	2.0
United States	2.4	2.4	2.4	2.5
Euro Area	0.9	1.6	1.5	1.6
United Kingdom	2.9	2.2	1.9	2.2
Japan	0.0	0.5	0.5	-0.1
Emerging and Developing Economies	4.6	4.0	4.1	4.6
Developing Asia	6.8	6.6	6.4	6.3
China	7.3	6.9	6.5	6.2
India	7.3	7.3	7.5	7.5
World Trade Volume (Goods and Services)	**3.4**	**2.8**	**3.1**	**3.8**
Imports				
Advanced Economies	3.4	4.3	3.4	4.1
Emerging and Developing Economies	3.7	0.5	3.0	3.7
Exports				
Advanced Economies	3.4	3.4	2.5	3.5
Emerging and Developing Economies	2.9	1.7	3.8	3.9
Price Movements				
Consumer Prices				
Advanced Economies	1.4	0.3	0.7	1.5
Emerging and Developing Economies	5.1	4.7	4.5	4.2
Commodity Prices (US$)				
Oil	-7.5	-47.2	-31.6	17.9
Non-Fuel	-4.0	-17.5	-9.4	-0.7
Six-month London Interbank Offered Rate (LIBOR) on US$ Deposits (per cent)	**0.3**	**0.5**	**0.9**	**1.5**

(a) Annual percentage change unless otherwise indicated.

Source: World Economic Outlook (April 2016), IMF

The volatility of the global economic environment posed several challenges to Sri Lanka during 2015 and these are expected to persist in 2016. With the continued decline in global oil prices, the stagnating growth in Middle Eastern countries negatively affected workers' remittances and tea exports, which are key sources of foreign exchange. This trend is expected to continue to impact remittances and future job prospects of Sri Lankan migrant workers. Further, the stagnating growth momentum of economies, which have been Sri Lanka's traditional sources of tourism, e.g. Europe, Russia and China, may cause a decline in tourist earnings in the coming year, despite the significant growth observed in 2015. During the year, as observed across all emerging markets, there was a significant unwinding of investments from the domestic government securities market, on expectations of the monetary policy normalisation of the US Federal Reserve. Subsequent to the interest rate hike in December 2015 by the Federal Reserve and on expectations of further hikes in 2016, it is expected that this trend will continue. In addition, Sri Lanka may have to incur higher levels of interest payments on foreign loans that had been obtained on a variable rate basis by the government, state owned enterprises (SOEs) and the private sector. Global uncertainties caused by factors such as the weakened pace of global economic growth and geopolitical developments may affect FDIs to the country, both directly and through spillover effects, particularly from China and its major commodity trading partner countries, and from the Middle East.

1.4 Medium Term Macroeconomic Outlook

Sri Lanka's economy is projected to expand at a rate of 5.8 per cent in 2016, and strengthen over the medium term to achieve a higher growth trajectory of around 7 per cent. The envisaged growth path is expected to be attained with the improvement in investor sentiments. Further, the new policy initiatives of the government to spur growth across all major sectors of the economy and increase private sector participation through the creation of an investor friendly environment, are also expected to contribute to the growth trajectory of the economy over the medium term. The implementation of policy measures to encourage small and large scale entrepreneurs to participate in the global economy and the resultant positioning of Sri Lanka in the global value chain, are expected to bolster the contribution of the Industry, Agriculture and Service sectors to this growth momentum. Accordingly, the growth potential of the economy is expected to be enhanced through the adoption of advanced technology and the subsequent digitisation of the economy, attraction of new investment initiatives, including those of global tech giants, and the effective utilisation of socioeconomic infrastructure facilities. It is also expected that the gradual recovery of the global economy will provide the required impetus to maintain Sri Lanka's external demand at favourable levels. However, the rise in income levels, expected from this improved external demand, will support Sri Lanka's graduation to the upper middle income status, bringing forth new challenges, as characterised by the 'middle income trap.' Appropriate monetary and fiscal policy measures are expected to create an environment conducive for investment. Accordingly, inflation is estimated to be at a low level of around 4.0 per cent. Meanwhile, fiscal policy will continue to focus on strengthening the fiscal consolidation process.

Positive developments in the domestic and global economies, coupled with recent policy initiatives, are expected to result in a favorable outlook for the external sector over the medium term. The decline in the current account deficit is expected to be largely driven by the improvement in trade in merchandise goods and services. Although import expenditure is expected to decline in 2016, as a result of the low level of international oil prices and the decline in motor vehicle imports as a result of the greater flexibility in the determination of exchange rates, it is expected to rise thereafter with the anticipated increase of crude oil prices in international markets and the growth in imports of investment goods required to facilitate the new growth trajectory. Exports, which recorded a decline in 2015, are expected to regain their upward momentum over the medium term with the expected recovery of global demand and the improvement in external competitiveness, induced by productivity improvements. Meanwhile, earnings from trade in services are expected to record a gradual improvement with the realisation of the outcomes of policy initiatives to position Sri Lanka in the global value chain. However, workers' remittances are expected to slow down due to the decline in migration for foreign employment as a result of economic and geopolitical uncertainties in traditional destinations, such as the Middle East and Europe, the increased availability of domestic employment opportunities, and the implementation of policy measures to discourage migration in semi-skilled and unskilled categories. The overall BOP position is also expected to improve over the medium term, with the expected rise in inflows to the financial account. Several policy measures adopted by the government, including the establishment of a 'one-stop-shop' by the Board of Investment to create a hassle-free environment for investors, are expected to attract a substantial level of FDIs. The envisaged improvements in the BOP are expected to thereby strengthen external reserves, enabling the country to improve its resilience to external shocks.

The medium term fiscal strategy of the government will focus on strengthening the fiscal consolidation process, by maintaining the budget deficit and public debt at a sustainable level, conducive to the broad based development objective of enhancing the living standards of the people. The policy measures proposed by the government to enhance revenue and rationalise expenditure are expected to facilitate the fiscal consolidation process in the medium term. As stipulated in the Fiscal Management (Responsibility) Act No. 3 of 2003, as amended, and the announcement made by the government in November 2015, the budget deficit is expected to be reduced to 3.5 per cent of GDP by 2020, while the debt to GDP ratio is to be reduced to 60.0 per cent over this period. On the revenue front, a simplified tax regime, broadened tax base, enhanced tax compliance and improvements in the tax administration are expected to increase revenue mobilisation. Meanwhile, the implementation of the Revenue Administration Management Information System (RAMIS) at the Inland Revenue Department (IRD), the 'Single Window' at the Sri Lanka Customs (SLC) and the Integrated Treasury Management Information System (ITMIS) at the General Treasury is expected to result in substantial improvements in the revenue administration process. In order to complement the ongoing fiscal consolidation process, certain measures, including the establishment of a Budget Implementation and Monitoring Unit (BIMU) in the Department of National Budget in the Ministry of Finance, were introduced for the rationalisation of public expenditure and the maintenance of public investment at a sustainable level. On the expenditure front, the government's commitment towards the rationalisation of government expenditure and the curtailment of unproductive expenditure, are expected to limit recurrent expenditure to below 15.0 per cent of GDP over the medium term. Accordingly, the current account balance, which reflects the savings position of the government, is expected to gradually improve over the medium term on a sustainable path.

Table 1.5 Medium Term Macroeconomic Framework (a)

Indicator	Unit	2014 (b)	2015 (c)	Projections			
				2016	2017	2018	2019
Real Sector							
Real GDP Growth (d)	%	4.9 (c)	4.8	5.8	6.3	7.0	7.0
GDP at Market Price (d)	Rs. bn	10,448 (c)	11,183	12,307	13,614	15,155	16,863
Annual Average Inflation	%	3.3 (c)	0.9	4.0	4.0	4.0	4.0
Per Capita GDP (d)	US$	3,853 (c)	3,924	4,008	4,298	4,704	5,181
Total Investment (d)	% of GDP	32.0 (c)	30.1	30.3	30.9	31.0	32.0
Domestic Savings (d)	% of GDP	24.0 (c)	22.6	23.8	24.6	25.3	26.7
National Savings (d)	% of GDP	29.5 (c)	27.8	28.1	29.1	29.5	30.6
External Sector							
Trade Gap (d)	% of GDP	-10.4	-10.2	-9.5	-9.7	-9.7	-9.6
Exports	US$ mn	11,130	10,505	10,853	11,542	12,057	12,589
Imports	US$ mn	19,417	18,935	18,920	20,500	21,940	23,387
Current Account Balance (d)	% of GDP	-2.5	-2.4	-2.1	-1.8	-1.5	-1.4
External Official Reserves	Months of Imports	5.1	4.6	4.0	4.2	4.5	4.6
Fiscal Sector (e)							
Total Revenue and Grants	% of GDP	11.5	13.1	12.7	13.5	13.9	14.9
Expenditure and Net Lending	% of GDP	17.2	20.5	18.0	18.5	18.4	18.9
Current Account Balance	% of GDP	-1.2	-2.2	-1.4	-0.7	0.0	0.6
Overall Budget Deficit	% of GDP	-5.7	-7.4	-5.4	-5.0	-4.5	-4.0
Central Government Debt	% of GDP	70.7	76.0	74.0	70.0	66.0	63.0
Monetary Sector (f)							
Broad Money Growth (M_{2b})	%	13.4	17.8	9.0	10.5	11.5	11.5
Growth in Credit to the Private Sector	%	8.8	25.1	12.0	11.0	11.5	12.0

(a) Based on information available by mid March 2016.
(b) Revised
(c) Provisional
(d) The data is based on the base year 2010 GDP estimates of the Department of Census and Statistics.
(e) Medium term fiscal indicators are based on the revised numbers for 2016 by the Ministry of Finance.
(f) Year-on-year growth based on end year values.

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

The conduct of monetary policy in the medium term will focus on maintaining inflation in mid-single digit levels while facilitating the economy to realise its potential. In this pursuit, the Central Bank would conduct its monetary policy within an enhanced monetary policy framework, aligned towards a flexible inflation targeting (FIT) framework, which focuses on both price stability and economic stability. The AWCMR would be the operating target under this enhanced monetary policy framework, and greater emphasis would be placed on market based instruments, particularly policy interest rates and OMO, to guide the AWCMR along the desired path to maintain inflation within the targeted levels. Broad money supply would continue to be a key indicative intermediate variable to guide monetary policy. Accordingly, the annual monetary programme of the Central Bank, which takes into account the growth in broad money supply, would be prepared in line with the anticipated growth of nominal GDP. Meanwhile, the robust growth in credit and monetary aggregates that was observed in 2015 is expected to moderate in the medium term supported by appropriate policy measures, thus ensuring that inflation remains at the envisaged mid-single digit levels. While focusing on the achievement of inflation objectives, the Central Bank would ensure sufficient availability of credit in the economy to facilitate the economy's transition towards a high growth trajectory. Credit extended to the government by the banking sector is expected to decline in line with government's efforts to strengthen the fiscal consolidation process, thereby releasing additional resources for more productive private investments. Foreign assets of the banking system are also expected to improve in the medium term, with the realisation of expected higher inflows to the financial account of the BOP.

1.5 Issues and Policies

Improving fiscal performance through essential reforms is key to achieving the envisaged medium term fiscal consolidation path, reducing public debt, and strengthening prospects for a brighter macroeconomic outlook. This should encompass enhancing government revenue, improving the management of government expenditure and implementing other reforms, particularly in state owned enterprises (SOEs), while improving public financial management. Despite efforts made by successive governments towards fiscal consolidation, government revenue, particularly tax revenue as a percentage of GDP, has declined over the past several years, although it increased in 2015 mainly due to the introduction of one-off taxes and increased revenue from excise duties on motor vehicle imports. This was largely due to tax evasion and avoidance, excessive tax concessions and exemptions, ad hoc revenue measures taken from time to time and weaknesses in revenue administration. Therefore, in order to reverse the declining trend in the revenue to GDP ratio on a sustainable basis, and to improve the elasticity of the tax system, the tax structure of the country needs further rationalisation. Towards this end, the government needs to focus on simplifying the tax structure, broadening the tax base, increasing tax compliance, minimising tax exemptions and concessions, making the tax system equitable, while strengthening tax administration. In particular, income tax collection needs to be further strengthened as the government policy is aimed at improving the ratio of direct to indirect taxes. At the same time, a critical assessment on various aspects of tax laws is also necessary to identify their weaknesses as well as complexities, to bring about necessary improvements to the legal framework to complement the ongoing process of redrafting tax laws. The relative overreliance on import related taxes has made the country's fiscal system vulnerable to the external sector performance, which needs to be taken into account in efforts on designing the country's tax policy. Such restructuring must also facilitate protecting the country's external competitiveness. While the government's initiatives to implement an automated tax administration system, including the Revenue Administration Management Information System (RAMIS) of the Department of Inland Revenue is commendable, more efforts are required to improve the tax compliance of both corporate and non-corporate sectors. The simplification of the tax system as well as expediting dispute resolution mechanisms would also improve the Doing Business ranking of Sri Lanka, in addition to their positive effect on revenue generation. On the expenditure front, the government needs to improve the quality of its spending programmes by curtailing unproductive expenditure, while also assessing the sustainability of existing subsidy schemes to provide necessary support for the needy segments of the population. Overruns in recurrent expenditure could limit the availability of resources for public investment, thereby affecting the growth prospects of the country. Further, in an environment of high government debt, a large part of financial resources has to be allocated for debt repayment and interest payments, significantly reducing the country's fiscal space for growth promoting activities and sustenance of essential welfare services. High budget deficit crowds out private sector investments, while expansionary financing poses challenges for monetary management and maintaining exchange rate stability. Therefore, urgent steps are needed to strengthen fiscal consolidation efforts.

An equally important issue is the unavoidable reforms in SOEs, which should be undertaken based on a carefully thought strategy and implemented within the country's socio-economic and political context, while adequately explaining and educating the stakeholders and the general public on the rationale and potential medium to long-term consequences in the absence of such reforms. Over the years, many SOEs have continued to make losses due to a number of reasons, including absence of cost-reflective pricing mechanisms, weak financial management, lack of good governance, weaknesses in human resource management, lack of internal controls, structural deficiencies, and political interference. The significant amount of accumulated losses of SOEs are particularly of serious concern as they continue to be a major drag on the economic prospects of the country. Proper identification of the issues and causes for these losses, careful reviewing of the available options to revive the respective entities, identification of needs, including cost reflective pricing strategies, management and marketing expertise, proper controls, recapitalisation, etc., following a pragmatic strategy are important to improve the financial viability of SOEs.

Maintaining the resilience of the external sector against various shocks will require a concerted effort to overcome the challenge of attracting more non-debt creating foreign investment flows such as FDI and growth promoting long term financial flows. Despite the improvements marked in recent years, Sri Lanka has persistently maintained a deficit in the external current account, thus necessitating the use of debt creating financial flows or the use of foreign exchange reserves to finance the deficit. As Sri Lanka is undergoing a demographic transition with a rise in the elderly dependency ratio, public expenditure on this category of the population will rise, thereby weighing negatively on public sector savings. In addition, private sector savings could remain depressed unless the productivity of the existing labour force and corporate savings are raised. Hence, the savings-investment gap, which is identical to the current account deficit, will further deteriorate and the gap will have to be financed through foreign sources. Economic and geo-political developments around the world have proven that the country cannot entirely rely on workers' remittances and external borrowings to finance the current account deficit, as these are susceptible to economic and political volatilities in source countries, as was evident from the sharp moderation in remittance flows in 2015 in the wake of low oil prices and prevailing unrest in the Middle Eastern region. Although Sri Lanka had been successful in drawing loans from multilateral agencies on concessional terms, access to concessional funding will diminish in Sri Lanka's transition towards a higher middle-income country. Further, the ongoing monetary policy normalisation in advanced economies will translate into increased cost of new borrowing. Therefore, priority should be given to the implementation of policies to attract FDI and other long term private sector flows over the coming years, through efficient business facilitation, investment promotional activities in key potential markets overseas and prompt availability of information on investment opportunities. While the relaxation of exchange control regulations, strengthened macroeconomic environment as well as greater political stability in the country will make investment environment more attractive, further steps need to be taken to encourage foreign investments. Executing the required reforms to improve the Doing Business ranking is necessary to boost the investment climate and realise the full growth potential of the economy. In addition to healthy economic indicators such as high growth and low and stable inflation, good governance and guarantee of property rights, including land ownership, 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, inconsistent and regressive tax policies, and weak rule of law and enforcement mechanisms that could discourage foreign investments.

Strengthening the external sector resilience would largely depend on the performance of external trade both in goods and services, backed by enhanced competitiveness. Sri Lanka has been continuously burdened with a significantly high trade deficit due to low growth in exports, compared to the growth in imports. Despite the increase in Sri Lanka's merchandise exports in nominal terms, as a percentage of GDP, exports declined from 33.3 per cent in 2000 to 12.8 per cent in 2015, while the share in global exports also contracted in a similar manner, indicating that the country's exports are becoming less competitive compared to the other competing countries. Hence, improving the country's external competitiveness is imperative for narrowing the external trade deficit. As a country with a limited resource base, small domestic market and investment capacity, Sri Lanka should focus on export-led strategies. Insufficient investment in research and development, non-existence of financing especially for exports, insufficient market promotion, low quantum of assistance for SMEs for trade fair participation and market development programmes, lower productivity due to the dearth of skilled labour and high cost of energy are the common issues that erode the competitiveness of Sri Lankan products in international markets. Additionally, the concentration of export products and market destinations is another concern as it can lead to instability in export earnings. Apart from maintaining a competitive exchange rate, a public and private sector combined multi-faceted approach is essential for moving export industries up the value chain. In this respect, the possibility of integrating industries with high export potential that enjoy a comparative advantage into global value chains should be explored and encouraged while promoting FDIs and other investors in those sectors. Therefore, Sri Lanka should promote competitive industries while attracting foreign investors who would not only bring in capital but also modern technology, management skills, technical expertise and assured markets.

For enhanced market access and product diversification, existing trade agreements and arrangements for trade facilitation must be optimally utilised. Sri Lanka is mostly dependent on European and USA markets, which account for around two third of total exports and the continued reliance on traditional export markets makes Sri Lanka vulnerable to external shocks. In recent years, regional trade agreements (RTA) have become prominent in the global trade to reinforce and enhance international trade, mainly through mutual reduction in trade barriers. Sri Lanka is also a signatory to bilateral & multilateral trade agreements, mostly with a regional focus. However, it has lagged behind with only four preferential trade agreements (PTAs) in force. In order to exploit large economies as potential export markets, a free-trade agreement (FTA) with China is being explored, which, however, needs careful drafting so as to effectively enhance export trade with China, thereby reducing the trade gap with China. Studies have revealed that the success of South Asian RTAs is limited as a result of low level of tariff concessions, negative lists, non-tariff barriers (NTB), phase-down approach, similarities in production structure and consumption pattern, and illegal trade. NTBs varying from port restrictions, rules of origin related issues, quota restrictions, import licensing requirements, labelling requirements, and costs and delays related to technical compliance have created impediments to reap the potential benefits offered by the India-Sri Lanka Free Trade Agreement (ISFTA) as well. Such problems have made the exporters lose confidence in FTAs. However, given its size and the growing Indian market, with huge untapped potential for Sri Lankan exporters, appropriate measures should be taken to resolve some of the NTBs. In this regard, it will be beneficial to consider the Mutual Recognition Agreement (MRA) on Conformity Assessment Procedures (CAPs) to minimise barriers faced at the Indian ports, while taking measures to build capacity to ensure exporters meet international/importing country standards, cost effectively. At the same time, bilateral negotiations with India should be continued, particularly on easing NTBs, while effectively disseminating information to the involved stakeholders. It is also envisaged that Sri Lanka will benefit from multilateral free trade agreements (MFTAs) that would increase its participation in global production value chains. In this respect, entering into economic partnerships or FTAs with some of the main players in the Asian supply chain, such as South Korea, Japan, Singapore, Malaysia, would be fruitful, while such agreements with the main export destinations outside Asia too need to be pursued to enhance trade. Also, it would be worthwhile to evaluate the impact of being a signatory to the WTO Information Technology Agreement (ITA) in the wake of Sri Lanka's pursuit of increasing exports of IT products. Further, the absence of PTAs with some of Sri Lanka's potential markets, where Sri Lanka's competitors have access under preferential tariff schemes, is another concern. This has resulted in our exporters having to compete without a level playing field in the international market, which has put Sri Lanka in a disadvantageous position. Initiation and capitalisation on FTAs and PTAs in order to increase market access would yield Sri Lanka a competitive advantage amongst competitors, while integrating into the international markets. Meanwhile, efforts to regain the Generalised System of Preference plus (GSP+) concession and to get the ban on fish exports to the EU lifted need to be expedited.

Despite continued public investment in socioeconomic infrastructure, development challenges arising from the country's transition into a middle income economy have to be tackled through proactive policies, which are properly targeted and centred on creating an inclusive growth. When compared to its peers in the region and other lower middle income economies, Sri Lanka had been a forerunner in the fulfilment of many of the goals set out in the Millennium Development Goals (MDGs), some of which had been achieved well before the target year of 2015. Nevertheless, studies show that certain regions of the country and pockets of the

BOX 02 The Socioeconomic Challenges of Poverty, Income Inequality and Child Under-nutrition in Sri Lanka

Since independence, Sri Lanka has gradually evolved from a low income, predominantly agricultural economy, to a more diversified, service oriented, lower middle income economy by now. This economic transformation has been complemented by many notable developments, especially in the area of social development, such as education and health. Although Sri Lanka has been a success story in development policy circles, the ongoing socioeconomic transformation has given rise to concerns with respect to the sustenance of such developments, especially in the areas of poverty, income inequality and child under-nutrition. While various challenges persist across all spheres of the economy, studies show that the issues of poverty, income inequality, and child under-nutrition can severely undermine economic growth and result in social unrest. Therefore, addressing challenges in these three particular areas is necessary to improve the living standards of the people and achieve sustainable economic growth and development.

Poverty

> *"Don't ask me what poverty is because you have met it outside my house. Look at the house and count the number of holes. Look at my utensils and the clothes that I am wearing. Look at everything and write what you see. What you see is poverty".*
>
> - A poor man, Kenya 1997 [1]

Poverty is generally defined as whether households or individuals have enough resources or abilities to meet their needs. The multidimensional nature of deprivation associated with poverty and the notion of the existence of poverty amid plenty has resulted in poverty reduction consistently being at the forefront of the global development agenda.

Sri Lanka has made notable strides in reducing poverty, enabling the country to achieve the target set out in the Millennium Development Goals (MDGs) of halving poverty at the national level seven years before the deadline of 2015. Under the commonly used measure, the Poverty Headcount Ratio (PHCR), which presents the total number of persons living below the poverty line[2] as a percentage of the total population, Sri Lanka's poverty declined to 6.7 per cent in 2012/13, from 8.9 per cent in 2009/10 and 28.8 per cent in 1995/96. In terms of the PHCR, in 2012/13, approximately 1.3 million individuals were in poverty, in comparison to 1.8 million in 2009/10. According to a World Bank report, which uses an extreme poverty line of US dollars 1.25 per person per day (in 2005 purchasing power parity (PPP) terms) for comparison purposes, Sri Lanka's poverty is low by international standards.[3] Under this definition, extreme poverty in Sri Lanka fell from 13 per cent in 2002 to around 3 per cent in 2012/13.

This significant decline in poverty is the outcome of various programmes implemented by successive governments, to raise the income levels of vulnerable sections of the population, especially those living below the poverty line. These include direct financial assistance, livelihood support programmes, empowerment programmes to encourage village and community centric economic activities, subsidy programmes generally directed towards low income people, food assistance programmes and general welfare public expenditure programmes, such as the provision of free education and health.

Being able to reduce poverty gradually over the years and having achieved the MDG of halving poverty between 2000-2015, Sri Lanka now faces the new challenge of ending poverty in all its forms, everywhere, under the Sustainable Development Goals (SDGs), which are expected to be met by 2030. In the Sri Lankan context, this highlights the need to implement policies that will reach the extreme poor, especially in peripheral districts.

The poverty map prepared by the Department of Census and Statistics (DCS) and the Poverty Global Practice of World Bank Group, based on data from Sri Lanka's 2012 Census of Population and Housing (CPH) and the 2012/13 Household Income and Expenditure Survey (HIES), highlights the presence of significant geographical disparities among poverty rates at the Divisional Secretariat (DS) level.[4] For instance, the PHCR in DSs in the Batticaloa district vary extensively, from 5.3 per cent to 45.1 per cent. Notably, all DS divisions in the Moneragala district remain severely poor. While the presence of poverty in certain districts is low, on an overall basis, some DSs possess pockets of poverty, such as Akurana DS in the Kandy district and Kinniya DS in the Trincomalee district. The most significant geographical inequality is observed in the gap between the PHCR of 0.6 per cent recorded in the least poor DS of the country, Dehiwala in the Colombo district, and the PHCR of 45.1 per cent recorded in Manmunai-West in the

1 "Can Anyone Hear Us? Voices From 47 Countries", Deepa Narayan with Raj Patel, Kai Schafft, Anne Rademacher and Sarah Koch-Schulte, Poverty Group, PREM, World Bank, December 1999, p.26.

2 Sri Lanka's official national poverty line defines a person as being poor in the 2012/13 Household Income and Expenditure Survey (HIES) if his or her real per capita consumption expenditure is less than Rs. 3,624 per month, which is equivalent to about US dollars 1.50 in 2005 purchasing power parity terms. Data from the HIES, conducted by Department of Census and Statistics (DCS), once in three years, is used to calculate poverty using the Cost of Basic Needs (CBN) method. The latest HIES is for 2012/13.

3 Poverty and Welfare in Sri Lanka: Recent Progress and Remaining Challenges, World Bank, 2016, p.9.

4 The Spatial Distribution of Poverty in Sri Lanka, Department of Census and Statistics - Sri Lanka and Poverty Global Practice, World Bank Group, August 2015.

Batticaloa district. The spatial distribution of poverty also shows that high PHCR does not always indicate that an equally high proportion of the population is poor. This is reflected by the PHCR in Mullaitivu and Mannar districts of 28.8 and 20.1 per cent, respectively, accounting for only 3.4 per cent of the poor population of the country, whereas Kurunegala accounts for 7.6 per cent of the country's poor, with a PHCR of 6.5 per cent.

These regional disparities undermine the country's achievements so far in terms of overall poverty reduction, and therefore, focused policy efforts are essential to address the remaining facets of overlooked and acute poverty in the country. It is vital for policies to focus on the multidimensional nature of poverty, as studies show that poverty spans over several aspects, inclusive of, but not limited to income. This includes, poor educational attainment, lower access to basic amenities (such as safe water, sanitation, healthcare, and nutrition), weak labour market linkages and an overall lack of access to productive economic assets. As there is a legitimate right for the poor to have access to the socioeconomic infrastructure of the country, the government has the responsibility of addressing their issues on a systematic basis. In addition to increasing the coverage of government welfare assistance programmes to address the needs of the bottom quintile of the poor, it is important to ensure proper targeting to improve the effectiveness of such programmes. Other macro-level initiatives encompassing the creation of employment opportunities for unemployed youth, enhanced public investment in infrastructure, improved provision of public goods in rural areas and designing social protection strategies targeting the ageing population are also essential.

Table B 2.1 Poverty Head Count Ratio by Districts: 2009/10 and 2012/13

District	Survey Period	
	2009/10*	2012/13
Colombo	3.6	1.4
Gampaha	3.9	2.1
Kalutara	6.0	3.1
Kandy	10.3	6.2
Matale	11.5	7.8
Nuwara Eliya	7.6	6.6
Galle	10.3	9.9
Matara	11.2	7.1
Hambantota	6.9	4.9
Jaffna	16.1	8.3
Mannar	-	20.1
Vavuniya	2.3	3.4
Mullaitivu	-	28.8
Kilinochchi	-	12.7
Batticaloa	20.3	19.4
Ampara	11.8	5.4
Trincomalee	11.7	9.0
Kurunegala	11.7	6.5
Puttalam	10.5	5.1
Anuradhapura	5.7	7.6
Polonnaruwa	5.8	6.7
Badulla	13.3	12.3
Moneragala	14.5	20.8
Rathnapura	10.5	10.4
Kegalle	10.8	6.7
Sri Lanka	**8.9**	**6.7**

Source: *Department of Census and Statistics*

* Excluding Mannar, Mullaithivu and Kilinochchi districts

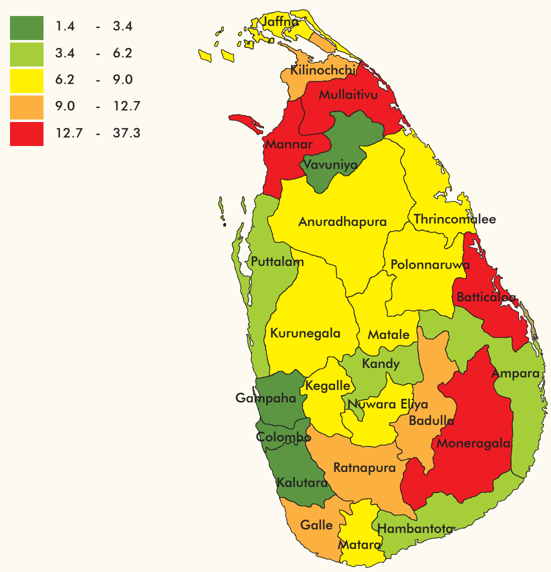
Income Inequality

"So distribution should undo excess, and each man have enough"

- William Shakespeare, English Playwright (1564-1616)

Chart B.2.1 Spatial Distribution of Poverty in Sri Lanka - 2012/13

Poverty Head Count Ratio



Source: Department of Census and Statistics

Inequality in the distribution of income, consumption or other attributes across the population is another important aspect that needs attention. According to Oxfam, in 2014, the richest 1 per cent of people in the world owned 48 per cent of global wealth, leaving just 52 per cent to be shared between the other 99 per cent of adults on the planet.[5] While inequalities between countries have fallen slightly due to the growth in emerging countries, it is inequality within countries that matters most to people. In countries around the world, a wealthy minority are taking an ever-increasing share of their nation's income. Given the implications of this trend, the reduction of inequality within and among countries has been identified as one of the key goals under the SDGs.

5 Oxfam Issue Briefing, Wealth: Having it All and Wanting More, January 2015

Despite the improvement in Sri Lanka's annual per capita income from US dollars 981 in 2003 to US dollars 3,924 in 2015, significant income inequalities continue to persist. According to the latest 2012/13 HIES of DCS, the mean and median monthly household incomes were Rs. 45,878 and Rs. 30,814, respectively. Considering district-level figures, the Colombo district recorded the highest monthly mean household income (Rs. 77,723) while the Mullaitivu district recorded the lowest (Rs. 23,687). Accordingly, in terms of deciles, the highest decile held 38 per cent of the household income in the country and the highest 20 per cent held 53 per cent of household income. In contrast, 50 per cent of the households accounted for only 20 per cent of total household income, reflecting a significant inequality in income distribution across the country.

Table B 2.2 Decile Groups and Share of Income

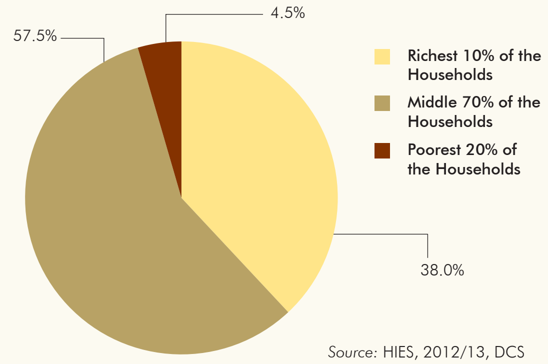
Decile Group: All Groups	Decile Group: Cumulative (%)	Income Group (Rs.per month)	Share of Income (%)	Share of Income (%) (Cumulative)
1	10	Less than 10,836	1.5	1.5
2	20	10,836 - 16,531	3.0	4.5
3	30	16,532 - 21,286	4.1	8.6
4	40	21,287 - 25,903	5.1	13.7
5	50	25,904 - 30,814	6.2	19.9
6	60	30,815 - 36,758	7.3	27.2
7	70	36,759 - 45,000	8.9	36.1
8	80	45,001 - 57,495	10.9	47.0
9	90	57,496 - 83,815	14.9	61.9
10	100	More than 83,815	38.0	100.0

Source: *HIES, 2012/13, DCS*

According to HIES in 2012/13, the Gini coefficient[6] of the household income in Sri Lanka, which measures the extent to which the distribution of income among individuals or households within an economy deviates from a perfectly equal distribution, stood at 0.48. Although it reflects a marginal improvement of income distribution in comparison to 0.49 in the previous HIES in 2009/10, there exists a strong need to implement appropriate policies to improve income equality.

6 The Gini index measures the extent to which the distribution of income (or, in some cases, consumption expenditure) among individuals or households within an economy deviates from a perfectly equal distribution. A Lorenz curve plots the cumulative percentages of total income received against the cumulative number of recipients, starting with the poorest individual or household. The Gini index measures the area between the Lorenz curve and a hypothetical line of absolute equality, expressed as a percentage of the maximum area under the line. Thus a Gini index of 0 represents perfect equality, while an index of 1 implies perfect inequality (The World Bank, http://data.worldbank.org/indicator/SI.POV.GINI).

Chart B 2.2 Income Inequality-Share of Income



Source: HIES, 2012/13, DCS

Child Under-nutrition[7]

"Hunger and malnutrition have devastating consequences for children and have been linked to low birth weight and birth defects, obesity, mental and physical health problems, and poorer educational outcomes"

- Marian Wright Edelman, Founder/President of the Children's Defence Fund (CDF), USA[8]

The presence of hunger and under-nutrition in a world of plentiful food denotes that extreme poverty is an underlying cause of undernourishment. However, under-nutrition, especially micronutrient deficiencies are key causes of poverty as they affect the ability of individuals to escape poverty. The impairment of children's ability to develop physically and mentally can severely inhibit school attendance and performance, thus undermining the effectiveness of investments in education and subsequently reducing productive potential as they enter the labour force. Such individuals are then caught in a trap of hunger, low productivity and chronic poverty.

Sri Lanka faces a substantial burden of child under-nutrition, with 13 per cent of all children under 5 years reported as stunted and 24 per cent as underweight in 2012. Across a range of standard indicators – rates of anaemia, low birth weight (LBW), stunting, underweight and wasting – Sri Lanka's performance is more comparable to countries with worse health outcomes than those with which it normally ranks in health achievement. Despite the steady pace of economic growth and rising standards of living, improvements in this area in the past decade have been slow and marginal.

7 Based on "The Challenge of Child Under-nutrition in Sri Lanka" (Unpublished), Dr. Renuka Jayatissa, Consultant Medical Nutritionist, Ministry of Health, Colombo, Sri Lanka.

8 "Preventable Hunger in Our Land of Plenty", Children's Defence Fund, USA

The United Nations Children's Fund (UNICEF) has also made the following important observations on child nutrition in Sri Lanka:[9]

- Under-nutrition remains a key concern in Sri Lanka.
- While stunting rates (13 per cent of all children under 5 years) are lower than other countries in the region, including Afghanistan and Pakistan, they are higher than other middle-income Asian countries such as China, Thailand and Malaysia.
- The prevalence of both childhood wasting and underweight have increased since 2009 and trends indicate that wasting is a serious concern (more than 15 per cent of all children under 5 years) in 24 out of 25 districts.
- About half of stunted children and 27 per cent of wasted children are younger than age two.
- About 2.3 per cent of under-5 children (40,000) suffer from Severe Acute Malnutrition (SAM), while more than four million Sri Lankans, particularly women and children, are anemic.
- Significant disparities exist in the prevalence of such conditions, across regions and income quintiles.

The problem of child under-nutrition in Sri Lanka is concentrated in poorer families, the central hill country and estates, and parts of the dry zone, specifically North-Central Province, Kilinochchi and Moneragala. The prevalence of LBW and child under-nutrition is three times higher in the poorest families than in the richest, and in the estates than in the rest of the country.

The leading causes of the poor performance of Sri Lanka in nutrition indicators, are poverty, food insecurity and the resultant poor health of mothers. Of these, the single most important modifiable cause in Sri Lanka is poverty and the food insecurity that results from poverty, which in combination contributes to more than two-thirds of the incidence of LBW, child stunting and underweight. Food insecurity is reflected not only in inadequate food consumption, but also in the inability to obtain a healthy diverse diet.

Analyses of all national surveys between 1993 and 2012 consistently find that household income is the leading modifiable determinant of LBW and stunting in Sri Lanka, with the rise of incidence of stunting and LBW in line with levels of poverty. Food availability in most poor households is too low to ensure that everyone achieves the minimally acceptable energy intake. Accordingly, energy deficits are closely correlated with income. The poorest households have energy intakes equivalent to only two-thirds of those in the richest households, thereby facing energy deficits of 2,000-3,500 calories per family per day. Considering that poor families spend almost all of their income on food, they are not able to close this gap themselves. Furthermore, it is biologically implausible – even with the best medical care – to expect that children in poor families can achieve normal growth standards, or that calorie-starved mothers can expect to deliver children of normal weight.

The modest improvement in under-nutrition indicators contrasts with the 5–6 per cent annual growth in per capita incomes that has been observed in Sri Lanka since the 1990s. This is partly attributable to the unequal sharing of economic growth. Much of the benefits derived from this high growth trajectory has benefitted the non-poor, with a poor trickle-down to the poor. This has resulted in the lagging of the living standards of the poor. Growing inequalities have caused a reduction in the share of income received by the poorest 40 per cent of Sri Lankans, from 15.3 per cent in 1996/97 to 13.7 per cent in 2012/13. This, coupled with the weak targeting of government assistance, has weighed negatively on the food security of the poorest Sri Lankans.

Given the socioeconomic significance of the issues underlying the prevalence of under-nutrition in the country, in addition to the ongoing efforts by the government, a multisectoral approach is required to promote improved nutrition outcomes among the poor. Furthermore, an effective national strategy must consist of core interventions that provide effective and adequate food supplementation to families at risk, agricultural policies to enhance diversification and local production and other micro-level interventions that support, inform and supplement such core interventions. Moreover, non-health interventions, such as the provision of adequate funding for the capacity building of health workers in the field of nutrition are also essential to address this problem. Moreover, the rising issue of over-nutrition amongst children, which indicates a widening of inequality in nutrition levels, also requires urgent attention, in order to prevent an escalation of conditions such as diabetes and heart diseases amongst the population in future.

Way Forward

The high growth trajectory that Sri Lanka is expected to achieve and sustain over the medium-term will present several opportunities to uplift the standards of living of the population. However, the structural transition of the economy has made it impossible for policymakers to entirely rely on the "trickling down" of the benefits of economic growth to uplift the vulnerable sections of the population out of poverty. Therefore, it is imperative for the government to consolidate and continue its efforts to create a growth process wherein the entire populace can not only contribute to but can also benefit from the growth process, i.e., sharing prosperity through inclusive growth.

9 Nutrition, UNICEF, http://www.unicef.org/srilanka/Nutrition(1).pdf

population remain vulnerable as a result of poor educational attainment, low performance in health and nutrition indicators and lack of access to basic infrastructure such as safe drinking water, sanitation, and electricity as well as lack of financial literacy and access to finance. The World Bank noted in a Report published in 2015, that despite the drastic reduction in poverty between 2002 and 2012/13, 1 in 4 people are nearly poor, defined as those living above the official poverty line but below US dollars 2.50 per day in 2005 PPP terms. This depicts the high level of vulnerability among a substantial share of the population, especially during periods of economic shocks and natural disasters. Notable poverty disparities between provinces also highlight that certain provinces continue to remain outside the ambit of the mainstream growth process, unable to contribute to and benefit from the high growth trajectory of the country, despite the rapid development of physical infrastructure, in the post-conflict era. This is further corroborated by the inequalities in provincial contribution to GDP, thereby highlighting the need to reorient policies to create a growth process which is of an inclusive nature. Such policies should address challenges that arise from regional gaps that prevail in the delivery of public services such as education and health, infrastructure and connectivity, access to labour markets and the availability of job opportunities. The efficacy of such interventions will depend greatly on identifying the individual needs of lagging provinces and developing multi-sector interventions that would cater to their specific challenges. Proper targeting of these interventions will not only ensure the rapid achievement of the desired outcomes but also ensure financial efficiency.

Effective measures are required to meet the growing demand for high quality human capital needs. With the structural transformation the country has gone through in the past, from a highly agriculture based economy towards an industry and service sector oriented economy, enhancing the manufacturing and service value-added is important to reach these goals. It is generally observed that an advanced industrial sector is imperative to reach great heights in economic and social development, apart from a high performing services sector. In spite of the low share of the agriculture sector in GDP, it still remains the primary employer, accounting for a share in employment of about 28.2 per cent. In addition, the public sector accounts for about 15 per cent of total employment. This gives rise to relatively low productivity gains while creating labour shortages in other sectors. A decline in agriculture sector employment is observed, which is expected to continue but problems of direct employability of these workers in industries and services related activities remain, raising concerns of labour mobility. It is observed that there is a shortage of skilled labour of expected standards necessary to embark on a higher growth trajectory, which is a persistent issue faced by many industry and service sectors. In this backdrop, human capital development, as a means of increasing industrial production and boosting competitiveness through high value, high technology products and services is a prerequisite in the attempt to avoid the middle income trap. It will be worthwhile considering the setting up of vocational training or technical colleges following examples such as Technical and Further Education Institutions (TAFEs) in Australia or community colleges in the US, to provide necessary knowledge and training in the highly sought after skill categories, especially targeting the export sector. In addition, revisiting the existing technical colleges to expand and upgrade them to meet the current needs, possibly with foreign collaboration, too would be beneficial in meeting the skill gaps, while creating opportunities for non-entrants to local universities. Moreover, the rapid advancement in technology that is taking place in the global economy has implications for local industries as well. These developments will bring in a host of new challenges apart from the world of opportunities, including the possibility of introducing flexible work options. With rising wages and relatively high manufacturing costs in comparison to some other competing Asian countries, the need for increased automation of industries is on the rise, to enhance export competitiveness. There are a few companies in Sri Lanka that have already opted for increased automation and the use of robotics in their plants. In this context, it is essential that the Sri Lankan workforce is well equipped and dynamic to meet the higher level skill requirements demanded by these technology-driven developments. In addition, steps should be taken to encourage Sri Lankan expatriates with relevant expertise and industry knowledge, while further encouraging those who have already returned after gaining academic, technical and professional qualifications and experience from abroad, to impart their know-how and help inculcate attitudes and best work practices in the local industries.

The evolution of the current education system into a demand driven one is essential for Sri Lanka to capitalise on the substantial investment that it has made in the education sector even prior to independence and to sustain its achievements. The commitment of successive governments to the provision of universal access to education has helped the country achieve near universal coverage of primary and secondary education. Although Sri Lanka possesses a highly literate population, the country lags behind higher income economies in language and numeracy skills. The education provided by the system should hone the competencies of students, helping them gain life skills while encouraging independent thinking, rather than strictly following a content based, examination oriented curriculum. This can facilitate the development of market oriented skills, e.g., language fluency, ICT knowledge, and soft skills such as communication, leadership, creativity and problem solving. At the tertiary level, 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 other higher education institutes has failed to reach the expected level to deliver the envisaged advantages from higher education in Sri Lanka towards achieving a competitive edge in global trade and services. This would require stronger innovation oriented institutional linkages between the industry and academia, which could also help transform the university structure into a self-sustaining model. Further, Sri Lanka lags behind its middle income counterparts in terms of enrolment in higher education. This may be largely attributed to the limited capacity of the public education system, while issues such as availability and affordability limit the number of opportunities available from the private education sector. Considering the constraints on fiscal space, increased private sector participation will help provide the investment required to improve the productivity and quality of output from the education system thereby helping to improve the skill sets of school leavers and graduates.

Chronic Kidney Disease of unknown etiology (CKDu) has been a serious health issue in Sri Lanka over the past two decades. CKDu was first detected in the early 1990s from the North Central Province and now poses a greater challenge due to its rapid spread across around 10 districts in adjacent provinces. In addition to Sri Lanka, CKDu is seen in India, El-Salvador and Nicaragua. In Sri Lanka, CKDu is attributed to several possible causal factors, including high use of agrochemicals, hard water, which include high levels of Calcium and Fluoride, dehydration due to inadequate drinking of water and heat, and presence or absence of certain chemical compounds such as high levels of Arsenic and Cadmium and low levels of Selenium. Although a growing number of women and children have been affected by CKDu, the majority of those affected are male paddy farmers and agricultural workers, who are the breadwinners of families. The resultant loss of income due to the illness adversely impacts the socio economic condition of the entire family. Since Sri Lanka lacks a comprehensive formal social support system, the loss of productivity from the illness and the costs of care in terms of consultation, drugs, dialysis and transplantation could push families and communities to economically unstable positions. High risk population screening for early identification of the CKDu was started in 2008 by the Ministry of Health. Early identification improves the longevity of the patients through controlling their comorbidities such as Hypertension and Diabetes, which are also chronic conditions that will continue to increase the government's expenditure on health. Meanwhile, as a preventive measure, the government banned the importation of three pesticides, namely Chlopyrifos, Propanil and Vabarly from April 2014 as some researchers found that CKDu is caused by agrochemicals. The government also introduced reforms to the existing fertiliser subsidy scheme to discourage excessive use of fertiliser and to encourage organic fertiliser. Additionally, the government continues to support CKDu patients through treatment modalities including haemodialysis, kidney transplant programmes and medication. Further, the government has taken steps to provide Rs. 3,000 as a monthly allowance for the diagnosed and economically unprivileged CKDu patients. The National Water Supply and Drainage Board (NWS&DB) provides water through RO (Reverse Osmosis techniques) plants to the places where pipe borne water is not available as a temporary measure to provide clean water, but there is a strong need of water supply projects to provide safe drinking water for all the residents, particularly areas exposed to the threat of CKDu, not only as a counter activity against CKDu but also for the drive that all residents in the country have access to clean drinking water. Further, it would be vital to improve water quality testing and lab facilities, safe drinking water supply for schools and hospitals, hand pump rehabilitation and existing rural water supply schemes in affected areas with a view to controlling the epidemic.

Immediate improvements to public transport are needed to curb the economic loss caused by road traffic congestion. The transport network of a country must be able to support economic growth, growing population in cities and increased movements between urban, suburban and rural sectors. The inefficiency of the public passenger transport system has resulted in increasing numbers of private vehicles on the roads transporting fewer numbers of passengers per vehicle leading to heavy traffic congestion, causing increased fuel costs to households and the economy and a substantial loss of productive labour hours, which weighs down the growth potential of the country. The associated economic losses of congestion are expected to increase further with the anticipated trend growth in vehicle ownership caused by rising income levels. Although the government has invested heavily in transportation infrastructure development, such as the building of roads and adding fleets of buses, the issue of congestion persists due to the lack of good quality and reliable mass transport options. Hence, it is important to take appropriate measures to improve the existing road and rail transportation systems, especially in urban areas. Promoting alternative modes of transport, such as establishing safe and clearly demarcated cycle routes and promoting the effective use of the canal network for public transportation, could reduce congestion to some extent. In the medium term, it is also important for policymakers to adopt Transport Demand Management (TDM) processes to apply strategies and policies to promote efficient public transportation modes and reduce travel demand from single occupancy private vehicles, or to redistribute this demand over space or time.

Ongoing changes in weather patterns and volatilities associated with fuel prices reiterate the need for strengthening the national policy on renewable energy development, while undertaking initiatives to overcome barriers to increase the sustainability of low cost energy

generation in Sri Lanka. Although Sri Lanka has exploited the energy production potential of all major hydro resources, there are several other hydro resources, including irrigation networks, capable of making an invaluable contribution to the energy mix, which remain untapped. It has also been identified that there is considerable wind power potential in the country, particularly in Mannar, Puttalam and Jaffna as well as hill-country areas. Further, readily available biomass resources, agricultural waste and municipal solid waste also possess immense potential to generate a sizeable amount of power. Solar power is also another readily available source of electricity that Sri Lanka is not adequately harnessing, despite its high level of scalability, high level of accessibility and contribution to greener energy. It is necessary to bring together the industry experts and policymakers to assess the potential of such renewable energy sources and investigate innovative means of overcoming the technological, financial and economic constraints in the use of such resources. Such policies should focus on the attraction of private sector participants for micro level projects, long-term unsubsidised economic cost analysis of competing resources, dynamic prioritising mechanism, and the availability of long term and low cost financing, which will enable the country to reap benefits offered by renewable energy. In the meantime, continued efforts are necessary to encourage practices of energy saving, both in residential and business sectors.

Having a robust pricing formula for domestic petroleum products is essential to ensure the commercial viability of the CPC, while passing the effects of global oil price variations transparently to domestic users. World crude oil prices are constantly exposed to global supply and demand shocks and expectations, and maintaining domestic prices of petroleum products at a particular level for long periods will create a burden either on domestic oil suppliers or consumers. A pricing formula that takes into account the Free On Board (FOB) price, freight and insurance costs, exchange rate, port charges, taxes and duties, levels of locally refined and refined import volumes and sales and administration costs, could minimise these externalities. The pricing formula could be strengthened with a rule that determines the frequency, a trigger level for revision and the quantum of change to be imposed on the current retail price, probably as a percentage of the total cost. Therefore, the current efforts of the government to introduce a pricing formula for domestic petroleum products must be encouraged as a step in the right direction. In the meantime, adopting cost reflective pricing mechanisms in relation to other key public utilities is also necessary to minimise losses of SOEs.

The agriculture sector is saddled with major issues such as low productivity, lack of diversification, food insecurity and inefficiency in water management as well as the natural challenge of climate change. Therefore, the necessity for the revitalisation of this sector with large investment in the areas of agricultural research, development of water resources and infrastructure facilities is often highlighted. It is also necessary to facilitate the shift from traditional low value to modern high value agriculture, accompanied by improved diversification, productivity and competitiveness, while making an attempt to reform current agriculture policies to drive the sector into a higher growth trajectory and thereby increase food security. Further, encouraging scientific farming, promoting agro-based industries and initiating commercial agriculture with the participation of both farmer organisations and the private sector are essential for equity based development and to improve yields. At the same time, diversifying into high value added agricultural products would be a significant factor to enhance agricultural growth, particularly in rain-fed areas. In this regard, measures should be taken to expand agro processing and link producers with urban centres and export markets. Attention should also be paid towards strengthening agricultural research and extension services, which had suffered over the years owing to underfunding of infrastructure and limited access to state-of-the-art technologies, for the expansion of the sector. Meanwhile, increased competition for water by many stakeholders, including industry, domestic and agriculture sectors, emphasises the necessity of improving water resource management, more efficient delivery mechanisms and irrigation systems to enhance the efficiency of irrigation.

Increasing cost of production, outdated machinery, low yields, old age of crops, low value addition and inadequate diversification remain key issues in the plantation sector. These issues highlight the need for replanting, cultivation of better crop varieties, effective usage of fertiliser, pest management practices, diversification, improved manufacturing and value addition and the establishment of effective marketing channels. Meanwhile, the decline in commodity prices, along with the escalated cost of production, remain key challenges that impede the growth of both rubber and tea industries. It is noted that although a large number of crops cultivated in Sri Lanka have considerable potential to be developed in various agro-processing industries, most of the crops are exported as a primary commodity, without much value addition. Hence, greater efforts are necessary from all stakeholders to make the plantation sector more profitable and sustainable.

In order to create an enabling socioeconomic infrastructure and lucrative livelihood opportunities amidst constraints on public resources, the government will have to actively consider innovative mechanisms, such as Public Private Partnerships (PPPs), to meet the rising funding gap. Sustained public investment in essential infrastructure, such as education, health, electricity, roads and highways, contributed to Sri Lanka's rapid transition into a middle-income country. However, the country has immense potential to benefit from alternative financing models that will help leverage private sector capital and expertise across all sectors of the economy. While private sector financing can help ease public sector debt and expenditure burdens, private sector financing in PPPs can induce crowding in of private sector investment, as successful PPPs help in the development of robust institutional arrangements and instil confidence that will stimulate activity across other sectors. The involvement of the private sector can also lead to more effective and efficient service provisioning due to their competitive nature. However, the onus of the success of attracting private sector participation and reaping the benefits of such strategic partnerships lies in the government's ability to set and enforce standards that will ensure appropriate safety, service quality and pricing. Therefore, the public sector will have to uphold good governance in its role as regulator, facilitator and the ultimate policy maker. The government may also actively encourage the financial sector to contribute to these initiatives through the development of the domestic bond market and through policy initiatives to create infrastructure debt funds, both of which can facilitate the issuance of infrastructure bonds. The success of attracting private sector participation and reaping the benefits of PPPs will largely depend on the government's policy consistency and commitment, and the creation of a conducive legal and macroeconomic environment.

With the acceleration of population ageing, there is a need to ensure the sustainability of the public sector pension scheme, while introducing market oriented pension and superannuation schemes that ensure a wider coverage of the labour force. The rise in the number of pensioners and pension allowances, is a significant recurrent expenditure in the government budget. The associated financial burden is not expected to subside over the medium term as a result of the gradually ageing population and increasing life expectancy. This demographic transition underscores the need for the development of savings and pension products to cater to the requirements of this rising share of the population that is reaching retirement age. The urgency to develop these products is intensified by the comparatively low level of interest rates prevailing in the market and the dependence of many retirees on interest income. While a few financial institutions have already introduced some products, there is a need for further development of alternative savings and pension products, such as annuities, superannuation schemes and pension plans, to cater to the needs of long term savers. The introduction of such products while providing a cushion for retirees would also facilitate the development of the financial sector and be a source of long term funding for projects with long gestation periods. Meanwhile, a contributory pension scheme has been proposed in the Budget for 2016, for new recruits to the government sector, to ensure the sustainability of the public sector pension scheme.

Financial deepening through the raising of efficiency of financial intermediation, introduction of a diverse range of financial products and services, and improving access to formal finance would be pivotal to the sustenance of the high growth momentum of the economy. Financial development increases the resilience of the economy, while boosting economic growth through the mobilisation of savings, promotion of information sharing, improvement in resource allocation, and facilitation of the diversification and management of risk. Financial development can also promote financial stability as deep and liquid financial systems with diverse instruments can dampen the impact of shocks. Accordingly, while the banking sector continues to be the key provider of financing for the corporate and SME sectors, there is a need to introduce and promote alternative market based financing methods to ensure adequate availability of long term financing, catering to the diverse needs of the economy. This is essential for the effective implementation of policy measures targeted at boosting private sector investment activity. Accordingly, more focus should be placed on the development of deep and liquid corporate debt markets over the medium term, while undertaking initiatives to improve the depth of the equity markets through increased market participation of both local and foreign investors. As the country aspires to emerge as a regional financial center, the gradual development of proficient and liquid currency, derivatives and commodities markets to accommodate complex financial instruments, and the development of a dynamic and globalised regulatory regime is also important. Meanwhile, the lack of a well-developed private equity and venture capital industry continues to remain a concern, as the presence of such industries can help catalyse the economy's transition towards a knowledge driven one as has been seen in the spurt of venture capital flows to emerging markets such as Malaysia, Vietnam, Philippines and Indonesia. The development of the financial sector can also cater to several unmet needs of the economy such as improving access to finance in economically backward regions, development of alternative savings and pension products to cater to the needs of long term savers, and the financing of innovative initiatives such as those related to renewable and alternative energy.

The strategic position of the island of Sri Lanka in the Indian Ocean in the middle of the maritime silk route from China to Europe must be exploited to harness the potential of the country. In addition to locational advantage, Sri Lanka's strengths, including its educated workforce, improved physical infrastructure, relatively easy doing business environment in the region, relatively low tax regime, political consensus on broad policy direction on macroeconomic issues as well as the rapid growth in the region, can be used to promote the country as a key investor destination in the region. Although Sri Lanka is identified as a part of the South Asia block, the country shows more differences than similarities in comparison to the other countries in the region in terms of socio-economic development. This enables the country to exploit opportunities in the region and provides a unique opportunity to connect both with the East Asian economic giants as well as the advanced economies in the West. Sri Lanka could also leverage competencies and advantages in logistical services as Sri Lanka is potentially an integral part of the global value chain. In this regard, concerted efforts are necessary to enhance investor confidence and brand Sri Lanka as the most open, globalised and competitive economy in South Asia in the medium term and regain its position as the Indian Ocean hub for trade and investment.

The year 2015 highlighted the structural vulnerabilities of the economy that had built up over time, and decisive steps are necessary to correct these vulnerabilities to ensure the country's progress along a high growth – low inflation path. Short term fiscal and monetary stimuli are inadequate to support economic growth continuously, and tightening policy spaces and resource constraints point to the fact that such short term stimuli are no longer affordable. Therefore, it is necessary for the country to adopt a proper blend of structural reforms, including fiscal reforms on revenue and expenditure fronts as well as with regard to SOEs, ensure policy consistency and improve the ease of doing business in order to attract non debt creating capital flows. These reforms must aim at harnessing and synergising the country's strengths, including its human capital, with greater participation of the private sector.