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ECONOMIC, PRICE AND FINANCIAL SYSTEM STABILITY, OUTLOOK AND POLICIES

1.1 Overview

The stabilisation policy measures taken by the Central Bank and the government in the past two years resulted in a number of notable improvements, although real economic growth faltered and recorded a multi year low during 2017. The monetary policy stance of the Central Bank that was gradually tightened since end 2015, was tightened further in March 2017 by raising the key policy interest rates of the Central Bank by 25 basis points. Increasing market interest rates were allowed to stabilise at high levels. Nevertheless, the improvements in relation to the government securities market, which corrected some distortions that prevailed in 2015 and 2016, resulted in a significant decline in yields on government securities, thus exerting a downward effect on some market interest rates towards the end of the year. The high nominal and real interest rates, together with supportive macroprudential measures, prompted a gradual deceleration in the growth of monetary aggregates in 2017. This deceleration was effected via more active open market operations (OMOs) through which the Central Bank maintained appropriate levels of liquidity in the domestic money market by reducing the Central Bank holdings of government securities substantially in order to offset the impact of the rapid buildup of net foreign assets (NFA) of the banking system due to net purchases of foreign exchange inflows by the Central Bank. While active OMOs helped the Central Bank to maintain short term interest rates, particularly the interbank call market rate, at desirable levels, the enhanced monetary policy communication strategy helped anchor inflation expectations, despite higher than expected headline inflation driven by supply side disturbances.

Several measures were introduced to deepen and develop the domestic foreign exchange market further during the year. Such measures helped the Central Bank to purchase a significant amount of foreign exchange from the domestic market without creating excess volatility in the exchange rate, while facilitating a market based exchange rate aligned with macroeconomic fundamentals. Consequently, gross official reserves increased to US dollars 8.0 billion by end 2017 with an accompanying qualitative improvement. The overall balance of the balance of payments (BOP) recorded a surplus of US dollars 2.1 billion in 2017 after two years of deficits, as a result of significant inflows to the financial account.

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Substantial inflows were observed in the form of debt capital, while foreign direct investment (FDI) recorded the highest ever inflows in 2017 supported by improving investor sentiments. In the external current account, although earnings from exports increased to the highest levels recorded, the increase in imports, mainly arising from drought related imports of petroleum and rice as well as increased importation of gold, caused a wider trade deficit. Although inflows on account of services exports including tourism, and workers' remittances continued to cushion the impact of the widened trade deficit to some extent, the current account recorded a deficit of 2.6 per cent of GDP during the year. The Sri Lankan rupee depreciated against the US dollar by 2.0 per cent during the year, while the real effective exchange rate indices also depreciated, raising the competitiveness of the currency. Such a fairly-valued currency in real terms, is expected to enable a gradual adjustment of the current account deficit of the BOP in the period ahead.

In relation to public finance, the revenue based fiscal consolidation programme continued, resulting in increased tax revenue as a percentage of GDP as well as a surplus in the primary account, which reflects the difference between revenue and non-interest expenditure, for the first time since 1992 and only the second time since 1955. Nevertheless, revenue collection was lower than expected, while government spending was affected by the need to provide relief to the people affected by inclement weather conditions, and also by the rising interest payments. This resulted in an expansion in the overall budget deficit to 5.5 per cent of GDP. While the surplus in the primary account helped reduce the central government debt as a percentage of GDP to a certain extent, relatively high real interest rates in the government securities market compared with real GDP growth contained further favourable adjustment in public debt dynamics. The continued generation of higher primary surpluses, together with increased real GDP growth and moderate real interest rates, is expected to generate favourable public debt dynamics at a faster pace in the future.

Adverse weather conditions and their spillover effects continued to affect real economic activity, and the economy surprised to the downside by recording a growth of 3.1 per cent in real terms. This was significantly below projections of the Sri Lankan authorities as well as international agencies. In spite of the low real GDP growth, the economy created sufficient employment opportunities that induced a further reduction in the unemployment rate to 4.2 per cent during the year. In terms of expenditure, growth was supported by the expansion of both consumption and investment expenditure in 2017, while net external demand continued to weigh on growth negatively. Both services and industry related activities, which together account for 92.4 per cent of gross value added, recorded growth rates of below 4 per cent. The agriculture related activities recorded a negative growth for the second consecutive year, although estimates for Quarter 4, 2017 indicated a recovery in the sector.

Headline inflation displayed twin peaks during the year, with the first peak in March 2017 and the second in October 2017, and remained above the desired mid single digit levels in most months due to double digit food inflation. However, core inflation moderated gradually during the year, as monetary policy measures to contain inflation took effect. With the moderation of food inflation, headline inflation decelerated considerably by the first quarter of 2018, and the favourable inflation and inflation outlook as well as the weak real GDP growth prompted the Central Bank to signal an end to the tightening cycle of monetary policy, by lowering the upper bound of the policy interest rate corridor by 25 basis points in April 2018.

Meanwhile, with the exception of a few small non-bank financial institutions, the financial sector performed well amidst measures taken by the authorities to ensure the stability of the financial sector and to strengthen financial markets and related infrastructure. Several initiatives were taken to address possible forbearance in regulation and supervision, particularly in relation to non-bank financial institutions and primary dealers in government securities. Stronger enforcement mechanisms were introduced to take prompt action against any non-compliance of regulations. The rule based and transparent auction mechanism for government securities helped reduce the volatility in interest rates and helped the smoothing out of bunching up domestic debt maturities. The new Active Liability Management Act (ALMA) is expected to provide greater flexibility in managing future bunching of both domestic and external debt.

Furthermore, the Extended Fund Facility programme with the International Monetary Fund (IMF-EFF) progressed, with the economy achieving the end year targets in relation to net international reserves, the government's primary balance, and inflation.

Going forward, addressing the weak growth performance of the economy through the implementation of required growth supporting reforms will remain a priority. Sri Lanka has advanced gradually to reach a per capita GDP of US dollars 4,065 by 2017, establishing itself as a middle income economy. However, the country can progress further only if policymaking remains rational with a long term focus on greater public good, while minimising policy swings motivated by short term political gains. Therefore, it is essential that the envisaged reforms are institutionalised to ensure their sustainability, enabling the country's unhindered progression under increasingly challenging global and domestic conditions. In this regard, notable progress has already been achieved in terms of implementing the Inland Revenue Act (IRA), enacting the ALMA and the Foreign Exchange Act, and reaching a consensus with regard to improving the independence of the Central Bank and facilitating the move towards flexible inflation targeting (FIT) by 2020. Much remains to be done in relation to strengthening public financial management and ensuring fiscal sustainability through the adoption of binding fiscal rules, and also with regard to the implementation of a trade and investment facilitation framework that could enhance the country's overall productivity and effectively link the Sri Lankan economy to global production networks. The formulation and implementation of policies must also take into consideration the effect of such policies on the vulnerable segments of the population as it is the poorest of the society who suffer most from failed policy experiments.

1.2 Macroeconomic Developments, Stability and Policy Responses in 2017

Real Sector Developments and Inflation

As per official data released by the Department of Census and Statistics (DCS), Sri Lanka's real GDP growth decelerated further during 2017 to 3.1 per cent, from the growth of 4.5 per cent recorded in 2016.[1] Agriculture related activities recorded a contraction of 0.8 per cent against the backdrop of adverse

1 The GDP analysis in the Central Bank Annual Report is based on official data released by the DCS. In this regard, it is observed that the provisional growth estimates of the DCS for 2017 was considerably below the growth projections of the Central Bank, IMF, World Bank, Asian Development Bank and several other agencies engaged in economic analysis. Inconsistencies were also observed between this provisional growth estimate and leading indicators of economic activity for 2017. It is expected that the DCS will continue to improve data coverage and quality in GDP compilation, at the upcoming revisions as well as future releases of GDP estimates.

Table 1.1
Macroeconomic Performance (2013-2017)

Indicator	Unit	2013	2014	2015	2016 (a)	2017 (b)
Real Sector (c)						
Real GDP Growth	%	3.4	5.0	5.0(a)	4.5(b)	3.1
GDP at Current Market Price	Rs. bn	9,592	10,361	10,951(a)	11,907(b)	13,289
Per Capita GDP (d)	US$	3,609	3,821	3,842(a)	3,857(b)	4,065
External Sector						
Trade Balance (c)	% of GDP	-10.2	-10.4	-10.4	-10.9	-11.0
Current Account Balance (c)	% of GDP	-3.4	-2.5	-2.3	-2.1	-2.6
Overall Balance	US$ mn	985	1,369	-1,489	-500	2,068
External Official Reserves	US$ mn	7,495	8,208	7,304	6,019	7,959
Fiscal Sector (c)(e)						
Current Account Balance	% of GDP	-0.7	-1.2	-2.3	-0.6	-0.7
Primary Balance	% of GDP	-0.8	-1.5	-2.9	-0.2	0.0
Overall Balance	% of GDP	-5.4	-5.7	-7.6	-5.4	-5.5
Central Government Debt	% of GDP	70.8	71.3	77.7	78.8	77.6
Monetary Sector and Inflation						
Broad Money Growth (M_{2b}) (f)	%	16.7	13.4	17.8	18.4	16.7
Private Sector Credit Growth (in M_{2b}) (f)	%	7.5	8.8	25.1	21.9	14.7
Annual Average Inflation (g)	%	6.9	3.3	2.2	4.0	6.6

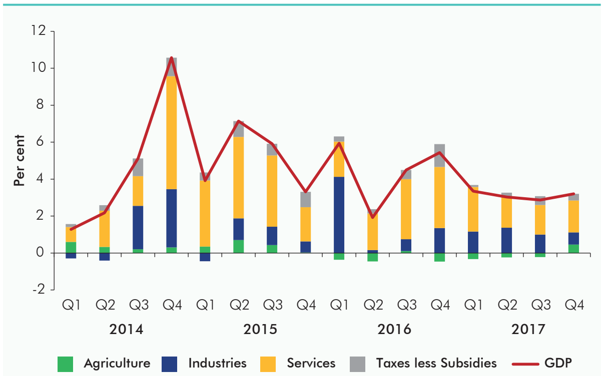
(a) Revised
(b) Provisional
(c) The data is based on the base year 2010 GDP estimates of the Department of Census and Statistics.
(d) Estimates updated with the latest population figures
(e) Based on revised GDP estimates for 2015 and 2016 made available on 20 March 2018 by the Department of Census and Statistics
(f) Year-on-year growth based on end year values
(g) Data up to 2014 is based on CCPI (2006/07=100) while data from 2015 onwards is based on CCPI (2013=100).

Sources: Department of Census and Statistics
Ministry of Finance and Mass Media
Ministry of National Policies and Economic Affairs
Central Bank of Sri Lanka

weather conditions that continued from 2016, while a slowdown in economic activity in both services and industrial sectors was observed. Amongst the sub activities of agriculture, growing of oleaginous fruits, vegetables and rice reported negative growth rates. However, the growth of forestry and logging, fruits and tea helped contain the contraction in agriculture activities to some extent. Industry related activities, accounting for 26.8 per cent of real GDP, grew by 3.9 per cent in 2017. The growth in industrial activities was primarily supported by manufacturing activities, construction activities, and mining and quarrying. However, the growth of construction activities that supported overall economic growth throughout the post conflict period, with the exception of 2015, decelerated notably during 2017. Services activities, which accounted for 56.8 per cent of real GDP, grew by 3.2 per cent in 2017, on a year-on-year basis, driven by the expansion in financial service activities, wholesale and retail trade, and other personal service activities. On the other hand, public administration and defence activities recorded a contraction, dampening the services sector growth, while the slowdown in transportation activities also contributed towards the moderation in overall economic growth during the year.

According to the expenditure approach of GDP estimates, economic growth in nominal terms was supported by the expansion of both

Chart 1.1
Activity-wise Contribution to GDP Growth



Source: Department of Census and Statistics

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

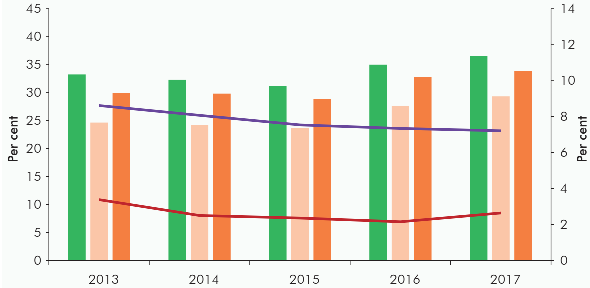
Item	Rs. billion		Growth (%)		As a percentage of GDP	
	2016 (c)	2017	2016 (c)	2017	2016 (c)	2017
1. Domestic Demand	**12,781.0**	**14,247.7**	**8.5**	**11.5**	**107.3**	**107.2**
1.1 Consumption	8,616.2	9,393.5	3.1	9.0	72.4	70.7
Private	7,601.4	8,262.8	3.1	8.7	63.8	62.2
Public	1,014.7	1,130.7	3.0	11.4	8.5	8.5
1.2 Investment (Gross Domestic Capital Formation)	4,164.9	4,854.2	22.0	16.6	35.0	36.5
2. Net External Demand	**-874.3**	**-958.2**	**-6.0**	**-9.6**	**-7.3**	**-7.2**
Exports of Goods and Services	2,540.0	2,914.3	10.4	14.7	21.3	21.9
Imports of Goods and Services	3,414.3	3,872.5	9.2	13.4	28.7	29.1
3. Total Demand (GDP) (1+2)	**11,906.8**	**13,289.5**	**8.7**	**11.6**	**100.0**	**100.0**
4. Domestic Savings (3-1.1)	**3,290.6**	**3,896.0**	**27.1**	**18.4**	**27.6**	**29.3**
Private	3,362.3	3,992.1	18.5	18.7	28.2	30.0
Public	-71.7	-96.2	70.9	-34.1	-0.6	-0.7
5. Net Primary Income from Rest of the World (d)	**-321.3**	**-356.3**	**-16.9**	**-10.9**	**-2.7**	**-2.7**
6. Net Current Transfers from Rest of the World	**939.8**	**963.0(d)**	**11.6**	**2.5**	**7.9**	**7.2**
7. National Savings (4+5+6)	**3,909.1**	**4,502.7**	**23.8**	**15.2**	**32.8**	**33.9**
8. Savings-Investment Gap						
Domestic Savings-Investment (4-1.2)	-874.3	-958.2			-7.3	-7.2
National Savings-Investment (7-1.2)	-255.8	-351.5			-2.1	-2.6
9. External Current Account Balance (2+5+6) (d)	**-255.8**	**-351.5**			**-2.1**	**-2.6**

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

consumption and investment expenditure in 2017. Consumption expenditure, which accounts for the largest share of total expenditure of the economy, recorded a growth of 9.0 per cent in nominal terms during 2017, compared to the modest growth of 3.1 per cent in 2016. Higher growth of consumption expenditure was a result of the expansion in both public and private expenditure. Meanwhile, investment expenditure continued to support growth, with an expansion of 16.6 per cent in nominal terms. However, the slowdown in the growth of construction activities during 2017 contributed towards lowering the growth momentum in investment expenditure, compared to 2016. Nevertheless, in nominal terms, investment as a percentage of GDP rose to 36.5 per cent in 2017, compared to 35.0 per cent in 2016.[2] Economic growth in 2017 was supported by domestic demand, which grew by 11.5 per cent (6.8 per cent in real terms), amidst the deterioration of net external demand by 9.6 per cent (35.6 per cent in real terms). Driven by private savings, domestic savings as a percentage of GDP increased to 29.3 per cent in 2017 from 27.6 per cent in 2016. National savings as a percentage of GDP also increased during the year to 33.9 per cent from 32.8 per cent in 2016, although net current transfers from the rest of the world decreased to 7.2 per cent of

Chart 1.2
Savings, Investment and the Savings-Investment Gap (as a percentage of GDP)



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

2 Sharp revisions to 2016 GDP estimates based on the expenditure approach by the DCS are also observed. Accordingly, at the latest round of revisions, consumption (final consumption expenditure) as a percentage of nominal GDP for 2016 has been revised from 76.2 per cent to 72.4 per cent, while investment (gross capital formation) as a percentage of nominal GDP for 2016 has been revised from 31.5 per cent to 35.0 per cent.

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GDP in 2017 from 7.9 per cent in the previous year. Accordingly, the domestic savings-investment gap and the national savings-investment gap stood at 7.2 per cent and 2.6 per cent, respectively, during 2017, reflecting the dependence of the economy on the external sector.

The value added growth in the agriculture, forestry and fishing activities declined due to the impact of adverse weather conditions during 2017, as in the previous year. The output of major agricultural crops such as paddy, vegetables, other food crops and coconut declined considerably, mainly due to the drought that prevailed during the year. Paddy production during the two seasons, 2016/17 Maha and 2017 Yala, fell significantly, resulting in a decline in the total paddy production by 46.1 per cent to 2,383 million kg, recording the lowest production during the last decade. Consequently, rice production in 2017 was sufficient to meet only eight months of domestic demand. This drove up retail prices of rice, prompting the government to reduce levies on the importation of rice. Accordingly, rice imports increased during the year to meet the shortfall in domestic production and arrest escalating price pressures. Coconut production was also affected by dry weather conditions that continued from the previous year. Amidst the decline in production by 18.7 per cent to 2,450 million nuts, the average retail price of a fresh coconut increased by 47.1 per cent to Rs. 67.40 during the year. Production of both vegetables and other food crops was also hampered by adverse weather, with vegetable production declining during the 2016/17 Maha season as well as the 2017 Yala season. Meanwhile, encouraged by elevated prices, tea production, which has been falling in recent years, improved during 2017 with favourable agro climatic conditions in major tea planting areas, particularly during the second half of the year, and factories operating at increased capacity. The livestock sector also recorded a positive performance with increased output in milk, eggs and most types of meat. However, fish production remained almost unchanged compared to the previous year as a result of the decline in marine fish production that offset the increase in inland fish production. Considering the importance of the agriculture sector for the overall wellbeing of the population, the government provided enhanced support for the sector.

The growth in industry related activities slowed during 2017 with the deceleration in the growth of construction, and mining and quarrying activities. The construction sector, which supported the overall growth of the economy considerably during the post-war era, slowed down to record a growth of 3.1 per cent compared to an expansion of 8.3 per cent in 2016. Meanwhile, mining and quarrying activities also witnessed a slowdown in growth to 5.9 per cent in 2017 from the expansion of 14.4 per cent recorded in the previous year. Value added contribution from electricity, water and waste treatment activities also slowed down considerably during the year to 3.9 per cent from 10.1 per cent in 2016. Meanwhile, manufacturing activities, which accounted for 15.7 per cent of real GDP in 2017, grew at a sluggish rate of 3.9 per cent in 2017, having grown at 3.2 per cent in 2016. The favourable developments in export oriented industries such as wearing apparel, rubber and plastic products, as well as industries with a high domestic market orientation, such as food and other non-metallic mineral products supported the growth in the manufacturing sector. Measures taken by the government to promote the industrial sector during 2017 focused on enhancing the industrial production capacity of the country through increased private sector participation.

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 (%)	
	2016 (c)	2017	2016 (c)	2017	2016 (c)	2017	2016 (c)	2017
Agriculture, Forestry & Fishing	**644,262**	**639,273**	**7.1**	**6.9**	**-3.8**	**-0.8**	**-6.6**	**-1.8**
Agriculture and Forestry	525,433	521,030	5.8	5.6	-5.0	-0.8	-7.1	-1.6
Fishing	118,829	118,243	1.3	1.3	1.6	-0.5	0.5	-0.2
Industries	**2,399,285**	**2,492,286**	**26.6**	**26.8**	**5.8**	**3.9**	**34.0**	**33.1**
Mining and Quarrying	218,587	231,516	2.4	2.5	14.4	5.9	7.1	4.6
Manufacturing	1,403,905	1,459,071	15.5	15.7	3.2	3.9	11.1	19.6
Electricity, Gas, Water and Waste Treatment	130,861	135,952	1.4	1.5	10.1	3.9	3.1	1.8
Construction	645,933	665,747	7.1	7.1	8.3	3.1	12.7	7.0
Services	**5,124,016**	**5,289,227**	**56.7**	**56.8**	**4.7**	**3.2**	**59.3**	**58.8**
Wholesale and Retail Trade, Transportation and Storage, and Accommodation and Food Service Activities	2,083,262	2,135,987	23.1	22.9	4.0	2.5	20.8	18.8
Information and Communication	52,827	58,203	0.6	0.6	8.0	10.2	1.0	1.9
Financial, Insurance and Real Estate Activities including Ownership of Dwellings	1,163,600	1,245,261	12.9	13.4	9.2	7.0	25.5	29.0
Professional Services and Other Personal Service Activities	1,037,514	1,072,260	11.5	11.5	0.9	3.3	2.5	12.4
Public Administration, Defence, Education, Human Health and Social Work Activities	786,812	777,516	8.7	8.3	4.9	-1.2	9.5	-3.3
Gross Value Added at Basic Price	**8,167,563**	**8,420,786**	**90.4**	**90.4**	**4.3**	**3.1**	**86.8**	**90.1**
Taxes less Subsidies on products	866,727	894,702	9.6	9.6	6.3	3.2	13.2	9.9
Gross Domestic Product at Market Price	**9,034,290**	**9,315,488**	**100.0**	**100.0**	**4.5**	**3.1**	**100.0**	**100.0**
Net Primary Income from Rest of the World	-239,263	-252,040			-11.4	-5.3		
Gross National Income at Market Price	**8,795,027**	**9,063,448**			**4.3**	**3.1**		

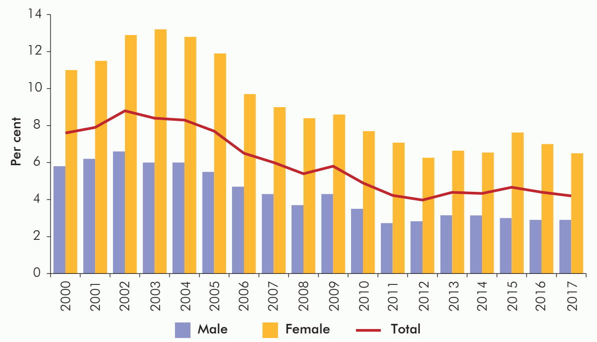
(a) The data is based on the base year 2010 GDP estimates of the Department of Census and Statistics.
(b) Provisional
(c) Revised

Source: Department of Census and Statistics

The growth rate of services related activities, which accounted for over 56 per cent of real GDP, also moderated during 2017. The growth of services activities, which was recorded at 4.7 per cent in 2016, decelerated to 3.2 per cent in 2017, particularly due to the contraction in public administration and defence activities, and the slowdown in transportation activities. Accordingly, transportation activities that contributed to over 10 per cent of GDP in 2017, grew marginally by 0.9 per cent. However, the growth in services activities was supported by the notable growth of 9.4 per cent in financial services during 2017. Furthermore, wholesale and retail trade, and other personal service activities, which grew at 3.8 per cent and 3.2 per cent, respectively, also contributed positively towards the growth of the services sector.

During 2017, the unemployment rate declined to 4.2 per cent from 4.4 per cent in the preceding year. In spite of the low overall unemployment rate, high unemployment among youth, educated groups and females has been a longstanding issue in the country. Nevertheless, there was a decline in the female and youth unemployment rates during 2017. The female unemployment rate declined from 7.0 per cent in 2016 to 6.5 per cent in 2017, while the male unemployment rate remained unchanged at a lower level of 2.9 per cent. Further, unemployment among youth aged 15 to 24 years declined to 18.6 per cent

Chart 1.3
Unemployment Rate



Source: Department of Census and Statistics

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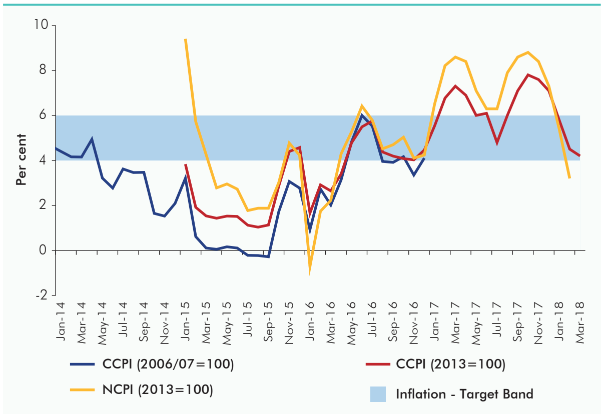
in 2017, from 21.6 per cent in the preceding year. The decline in the unemployment rate occurred amidst an increase in the labour force participation rate (LFPR), especially among females. The LFPR amongst females increased from 35.9 per cent in 2016 to 36.6 per cent in 2017. However, the male LFPR declined marginally to 74.5 per cent in 2017 from 75.1 per cent in the previous year. Meanwhile, the number of employed persons increased by 3.3 per cent in 2017 in comparison to the previous year, mainly due to increased employment in industry and services sectors. The increase in employment despite the size of the public service remaining broadly unchanged indicates a shift from past trends in employment generation and constitutes a more sustainable path for job creation in a highly constrained fiscal environment. However, the number of employed persons engaged in the agriculture sector declined to 26.1 per cent in 2017 due to the subdued performance in agriculture activities. With respect to migrant labour, departures for foreign employment declined by 12.6 per cent in 2017, owing to the policy actions taken by the government to reduce unskilled female migration considering its negative social impact, and lower demand for labour due to geopolitical uncertainties in the Middle Eastern economies. Overall, labour productivity during the first three quarters of the year decreased marginally, and the productivity level in the agriculture sector remained significantly low in comparison to other sectors.

Poverty levels continued to decline while the income disparity of the economy also showed a marginal improvement. Based on the results of the Household Income and Expenditure Survey (HIES) – 2016 of the DCS, the Poverty Head Count Ratio (PHCR) declined to 4.1 per cent from 6.7 per cent during the previous survey period of 2012/13. An improvement in poverty levels was witnessed across all sectors, with the PHCR improving to 1.9 per cent, 4.3 per cent and 8.8 per cent in the urban, rural and estate sectors, respectively. Although poverty levels have declined steadily, a considerable portion of the population still remains just above the poverty threshold, signalling their vulnerability in the face of unexpected events such as natural disasters and illness. Hence, continued efforts towards uplifting the livelihoods of relatively low income families through empowerment and effective social safety nets are vital. Meanwhile, based on the Gini coefficient, household income inequality improved marginally to 0.45 during the HIES – 2016 from 0.48 in the HIES – 2012/13.

Headline inflation remained broadly above the target during 2017, while core inflation stabilised at desired levels during the latter part of the year. Despite the tight monetary policy stance maintained by the Central Bank, the sharp acceleration in food inflation caused by weather related supply disruptions resulted in unanticipated upward movements in headline inflation. Revisions to Value Added Tax (VAT) and Nation Building Tax (NBT), and higher commodity prices in the global market also contributed to high levels of inflation. Accordingly, headline inflation, as measured by the year-on-year change in both the National Consumer Price Index (NCPI, 2013=100) and the

Chart 1.4
Headline Inflation (Year-on-Year)



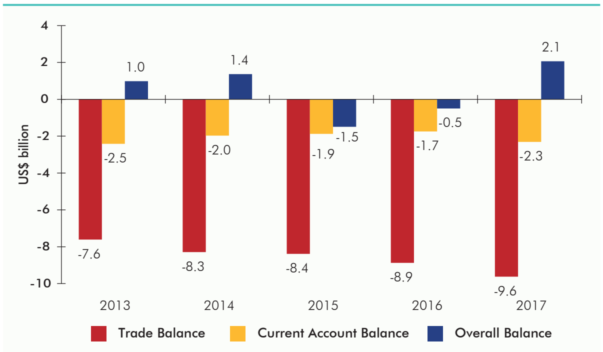
Sources: Department of Census and Statistics
Central Bank of Sri Lanka

Colombo Consumer Price Index (CCPI, 2013=100) experienced twin peaks, initially in the first quarter of 2017 and then in the last quarter. However, the deceleration in food inflation, partly supported by the government's initiatives to address price escalations, helped inflation to decelerate towards the end of the year. Year-on-year headline inflation based on the NCPI, which was at 8.6 per cent in March 2017 gradually slowed thereafter, before reaching a peak of 8.8 per cent in October 2017 and moderating to 7.3 per cent by end 2017. Following a similar trend, year-on-year headline inflation based on the CCPI also rose to 7.3 per cent in March 2017 and peaked at 7.8 per cent in October 2017, before declining to 7.1 per cent by end 2017. On an annual average basis, NCPI based headline inflation accelerated to 7.7 per cent by end 2017, compared to 4.0 per cent recorded at end 2016, while CCPI based annual average inflation accelerated to 6.6 per cent by end 2017, compared to 4.0 per cent at end 2016. However, year-on-year headline inflation continued its moderation during the first quarter of 2018, benefiting from a sharp decline in food inflation. Accordingly, year-on-year headline inflation based on the NCPI decelerated to 3.2 per cent in February 2018, while headline inflation based on the CCPI receded to 4.2 per cent in March 2018. Meanwhile, core inflation remained subdued in the second half of 2017, reflecting the containment of demand pressures through the tight monetary policy stance of the Central Bank. Accordingly, NCPI based core inflation declined to 2.7 per cent, year-on-year, by end 2017 from 6.7 per cent at end 2016. Year-on-year core inflation based on the CCPI declined to 4.3 per cent by end 2017, compared to 5.8 per cent at end 2016. A further slowdown in core inflation was observed in early 2018, with year-on-year core inflation based on the NCPI recording 2.0 per cent in February 2018, while CCPI based year-on-year core inflation decelerated to 3.4 per cent by March 2018.

External Sector Developments

Despite the setback in the current account, Sri Lanka's external sector improved gradually in 2017 with higher foreign exchange inflows to the financial account. Earnings from the export of merchandise goods recorded a notable double digit growth in 2017, partly supported by the reinstatement of the European Union's Generalised System of Preferences plus (EU GSP+) facility, and strong institutional and policy support. However, higher than expected expenditure on imports, particularly on fuel and rice imports, to manage the impact of disruptive weather conditions, as well as imports of gold, caused an expansion in the trade deficit during the year. The deficit in the primary income account also widened during the year, mainly with the increase in interest payments and reinvested earnings by direct investment enterprises (DIEs). Although the healthy growth in transportation and computer services contributed towards the increase in earnings from exports of services, the moderation in earnings from tourism due to the partial closure of the Bandaranaike International Airport (BIA) for resurfacing of the runway and the breakout of the Dengue epidemic weighed down on the expected expansion in inflows to the services account. Workers'

Chart 1.5
Balance of Payments



Source: Central Bank of Sri Lanka

remittances also declined in 2017, partly due to the sluggish growth in the Middle Eastern economies following geopolitical uncertainties and relatively low petroleum prices that prevailed during most months of 2017. The combined effect of the developments in trade, services and primary and secondary income accounts was a widening of the external current account deficit to 2.6 per cent of GDP in 2017 from 2.1 per cent of GDP in 2016. In contrast, the financial account of the BOP improved substantially, especially during the last three quarters of the year, with the highest ever annual inflow of FDI, foreign investment in the government securities market and in the Colombo Stock Exchange (CSE), the receipt of the proceeds of the eleventh International Sovereign Bond (ISB), the foreign currency term financing facility, two tranches of the IMF-EFF programme and other foreign currency inflows to the government and the private sector. Reflecting these developments, the overall balance of the BOP recorded a surplus of US dollars 2.1 billion in 2017. The gross official reserve position improved, both in terms of quantity and quality, reaching a healthy level of US dollars 8.0 billion by end 2017, from US dollars 6.0 billion at end 2016, while short-term liabilities in the form of swaps with banks were reduced from US dollars 2.5 billion at end 2016 to US dollars 1.5 billion by end 2017. Improved external sector performance, along with measures to deepen and develop the foreign exchange market further during the year, facilitated the Central Bank to follow a more market based exchange rate policy. Accordingly, even with the absorption of US dollars 1.7 billion from the domestic foreign exchange market on a net basis, the external value of the Sri Lankan rupee remained relatively stable, depreciating only by 2.0 per cent against the US dollar in 2017.

During the year, the trade deficit widened as a result of the increased expenditure on imports beyond expected levels, which outpaced the considerable increase in earnings from exports. The trade deficit expanded to US dollars 9,619 million in 2017, compared to US dollars 8,873 million recorded in 2016. As a percentage of GDP, the trade deficit was at 11.0 per cent in 2017, compared to 10.9 per cent in the previous year.

Exports rebounded during 2017 to record the historically highest value in terms of earnings, thus reversing the lacklustre performance in exports, which has seen them declining from 33.3 per cent of GDP in 2000 to 12.6 per cent in 2016. Accordingly, earnings from exports increased by 10.2 per cent to US dollars 11,360 million in 2017. The increase in exports was supported by the restoration of the EU GSP+ facility, recovery in external demand, expansion in investment in export related industries, increased commodity prices in the international market, conducive external trade policies together with strong institutional support and the favourable impact of the flexible exchange rate policy maintained by the Central Bank. Increase in earnings from exports of tea (20.5 per cent), textiles and garments (3.0 per cent), petroleum products (51.4 per cent) and spices (28.1 per cent), mainly contributed to the improved export performance during the year. Earnings from textiles and garments exports, which accounted for around 44 per cent of total exports, surpassed US dollars 5 billion for the first time in history. However, in spite of the notable performance in some sectors, export earnings from coconuts (-4.9 per cent), gems, diamonds and jewellery (-6.0 per cent) and leather, travel goods and footwear (-4.4 per cent) declined during 2017. The USA remained the single largest buyer of Sri Lanka's exports in 2017, accounting for 25.6 per cent of total exports, followed by the UK (9.1 per cent), India (6.1 per cent), Germany (4.8

per cent) and Italy (4.6 per cent). In line with the increase in earnings from exports, the overall export volume index increased by 7.6 per cent, while the export price index, in US dollar terms, increased by 2.4 per cent.

Expenditure on imports increased considerably in 2017, mainly due to higher imports related to inclement weather conditions and the firming of international commodity prices. Accordingly, imports increased by 9.4 per cent to US dollars 20,980 million during 2017, within which expenditure on non-fuel imports increased by 5.1 per cent to US dollars 17,552 million. Expenditure on imports of fuel increased by 38.2 per cent to US dollars 3,428 million during the year owing to the increase in import volumes of fuel led by higher demand from the domestic power generation sector as a result of dry weather in catchment areas as well as high oil prices in the international market. Expenditure on rice imports increased significantly to US dollars 301 million in 2017 compared to US dollars 13 million recorded in 2016 reflecting the impact of the reduction of duty on rice imports to meet the shortage in the domestic market caused by adverse weather conditions. In addition, import expenditure on diamonds, precious stones and metals (50.1 per cent), base metals (37.8 per cent) and wheat and maize (43.1 per cent) also increased considerably during the year. A sharp increase was recorded in gold imports driven by arbitrage facilitated by tariff differentials between Sri Lanka and India. However, import expenditure on machinery and equipment (-4.4 per cent), sugar (-25.2 per cent), spices (-29.7 per cent) and fertiliser (-24.9 per cent) declined during the year. Imports from India accounted for 21.6 per cent of total import expenditure, enabling India to regain its position as Sri Lanka's main import source, followed by China (18.9 per cent), the UAE (8.1 per cent), Singapore (6.4 per cent) and Japan (4.9 per cent). The overall import volume index increased by 8.1 per cent while the import price index, in US dollar terms, increased by 1.2 per cent.

The expansion in the trade deficit, moderation in earnings from tourism, decline in workers' remittances and higher interest payments and reinvested earnings by DIEs led the external current account deficit to widen in 2017. Despite the slowdown in the growth of tourist earnings, the services account continued to record a surplus with the healthy growth in transportation and computer services subsectors. Accordingly, the services account of the BOP recorded a surplus of US dollars 3,338 million in 2017 compared to a surplus of US dollars 2,879 million in 2016. Earnings from tourism recorded a growth of 11.6 per cent to US dollars 3,925 million in 2017 with increased average spending and duration of stay. The deficit in the primary income account expanded in 2017 to US dollars 2,355 million from US dollars 2,202 million recorded in the previous year, primarily due to increased outflows by way of interest payments and reinvested earnings by DIEs. The secondary income account remained subdued during 2017 with workers' remittances declining by 1.1 per cent to US dollars 7,164 million in 2017 in contrast to the growth of 3.7 per cent witnessed in 2016. Reflecting these developments, the current account deficit widened to US dollars 2,309 million, which is equivalent to 2.6 per cent of GDP in 2017 from 2.1 per cent of GDP in 2016.

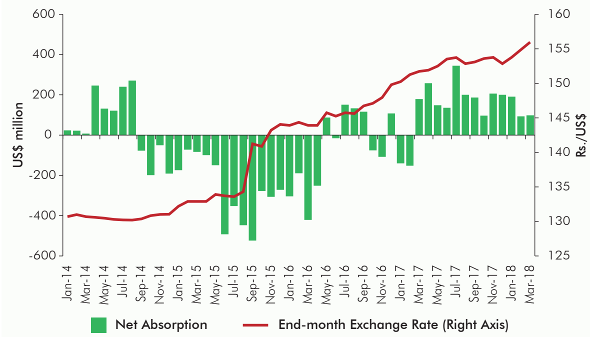
Both net incurrence of liabilities and net acquisition of assets in the financial account increased significantly in 2017 compared to the previous year. On a net basis, the incurrence of liabilities amounted to US dollars 5,128 million in 2017, compared to US dollars 2,213 million in 2016, while the net acquisition of financial assets in 2017 amounted to US dollars 2,944 million compared to US dollars 31 million in 2016. Inflows to the financial account increased significantly with a notable increase in foreign investment in government securities from the second quarter of 2017, reflecting increased investor confidence with improving overall macroeconomic stability. The financial account was further strengthened by FDI, which recorded the highest ever annual inflows during 2017 with large inflows to the Hambantota Port Project and the Colombo Port City Project. The proceeds of the ISB amounting to US dollars 1.5 billion, the receipt of US dollars 1 billion from the proceeds of a foreign currency term financing facility and the receipt of the third and fourth tranches of the IMF-EFF amounting to US dollars 419 million were the other major inflows to the financial account. Portfolio investment in the form of equity recorded a net inflow of US dollars 359 million during 2017. The main outflows from the financial account included the maturity of a five-year international bond issued by Bank of Ceylon (BOC) of US dollars 500 million, maturing of the remaining segment of the international swap arrangement with the Reserve Bank of India (RBI) amounting to US dollars 400 million, and foreign loan repayments by the government amounting to US dollars 1,320 million. Meanwhile, the Central Bank completed the repayment of the IMF Stand-By Arrangement (SBA) facility obtained in 2009 by June 2017.

Reflecting the improvements in the external sector, the BOP recorded an overall surplus in 2017, after recording overall deficits for two consecutive years. The surplus in the BOP amounted to US dollars 2,068 million in 2017 against a deficit of US dollars 500 million recorded in 2016. This improvement in the overall balance was reflected in the significant increase in gross official reserves to a healthy level of US dollars 8.0 billion, which is equivalent to 4.6 months of imports, by end 2017 from US dollars 6.0 billion at end 2016. A notable improvement in the quality of reserves was also witnessed during the year with an improvement in organic reserves in the form of purchases of foreign exchange from the domestic foreign exchange market amounting to US dollars 1,664 million, on a net basis, and retiring of domestic swaps by around US dollars 1 billion during the year. Apart from direct market purchases, proceeds from the issuance of the ISB, foreign currency term financing facilities, two tranches of the IMF-EFF programme, and the first tranche of the investment proceeds on account of handing over of operations of the Hambantota Port to China Merchant Port Holdings Company Ltd., helped augment the gross official reserve position during the year. Meanwhile, Sri Lanka's total foreign assets also increased to US dollars 10.4 billion by end 2017, equivalent to 6.0 months of imports, from US dollars 8.4 billion at end 2016.

Sri Lanka's total external debt increased in 2017 primarily due to the increase in the outstanding debt stock of the government. The total outstanding external debt of the country increased to US dollars 51,824 million by end 2017 (59.5 per cent of GDP) from US dollars 46,418 million (56.8 per cent of GDP) by end 2016. External borrowings of the government increased mainly due to the issuance of an ISB, foreign currency term financing facility and project and programme loans. Despite the receipts under the IMF-EFF during the year, the outstanding external debt of the Central Bank declined to US dollars 1,924 million by end 2017 due to the repayment of US dollars 235 million under the IMF-SBA facility and the settlement of the international foreign currency swap arrangement with the RBI. Outstanding external debt of deposit taking corporations declined marginally, mainly due to the decline in the holding of debt securities by commercial banks. The outstanding stock of external debt of private sector corporations and intercompany lending of direct investment enterprises increased in 2017 while outstanding debt of State Owned Business Enterprises (SOBEs) remained broadly unchanged compared to end 2016. Meanwhile, debt service payments, which consist of capital repayments and interest payments on Sri Lanka's external debt, increased in 2017. Capital repayments decreased to US dollars 3,156 million in 2017 from US dollars 3,243 million in 2016, of which general government accounted for US dollars 1,354 million. The repayment of long term loans obtained for financing projects mainly contributed to the increased amortisation payments of the government. However, external debt service payments of the Central Bank declined noticeably to US dollars 635 million in 2017, which included the settlement of the international currency swap arrangement with the RBI and the settlement of the IMF-SBA facility. Repayments by the private sector and deposit taking corporations increased due to the settlement of an international bond issued by BOC amounting to US dollars 500 million and increased repayments of foreign loans by the private sector. Interest payments increased during the year to US dollars 1,405 million from US dollars 1,219 million in 2016. The decline in interest payments by the private sector and deposit taking corporations was outweighed by the increase in interest and coupon payments on outstanding general government foreign loans and ISBs.

The external value of the Sri Lankan rupee remained relatively stable in 2017 under a more market based exchange rate policy implemented by the Central Bank during the year. The depreciation pressure on the rupee, which prevailed particularly during the first two months of 2017, moderated thereafter with increased foreign investment to the government securities market and the CSE, and the increase in the conversion

Chart 1.6
Central Bank Intervention in the Domestic Foreign Exchange Market and the Exchange Rate



Source: Central Bank of Sri Lanka

of export proceeds. The depreciation pressure on the rupee further eased from May onwards with the receipt of the proceeds from the ISB, the foreign currency term financing facility and disbursements of two tranches of the IMF-EFF programme, which helped improve investor confidence. With these developments and measures taken to develop the foreign exchange market, the rupee remained broadly stable, depreciating by 2.0 per cent against the US dollar during the year. However, reflecting the movements in the cross currency exchange rates against the US dollar, the rupee depreciated markedly against all other major currencies in 2017. Reflecting the nominal depreciation of the Sri Lankan rupee against the US dollar and other major currencies, the Nominal Effective Exchange Rate (NEER) indices depreciated. The 5-currency NEER index depreciated by 8.68 per cent, while the 24-currency index depreciated by 7.75 per cent in 2017. Meanwhile, the Real Effective Exchange Rate (REER) based on 5-currency and 24-currency REER indices also depreciated by 4.83 per cent and 4.85 per cent, respectively, moving close to the 100 index point mark by the end of the year. This correction in REER indices will help augment the country's competitiveness, which in turn, is expected to lead to a gradual adjustment of the current account deficit of the BOP over time.

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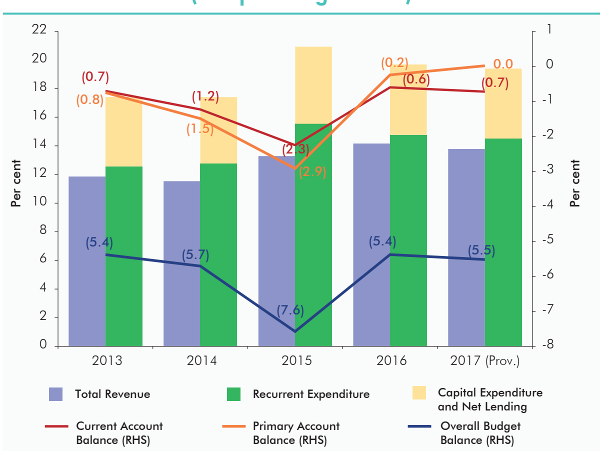
Fiscal Sector Developments

Fiscal policy during 2017 was aimed at continuing the fiscal consolidation programme, with the objective of reducing the budget deficit and lowering the debt burden of the government. The government's primary account, which excludes interest payments from the overall balance, recorded a surplus of Rs. 2.1 billion in 2017 for the first time since 1992 and only the second time since 1955. However, the current account deficit, which reflects government dissaving, increased marginally to 0.7 per cent of GDP in 2017 compared to 0.6 per cent of GDP in the previous year. Further, the overall budget deficit deviated markedly from the envisaged target of 4.6 per cent of GDP and increased to 5.5 per cent of GDP in 2017 compared to 5.4 per cent of GDP in the previous year due to slippages in the revenue collection and unanticipated expenditure on drought and flood relief. During the year, central government debt as a percentage of GDP declined to 77.6 per cent in 2017 from 78.8 per cent in 2016 due to the deceleration of growth of debt accumulation and the increase in nominal GDP growth.

Chart 1.7
Summary of Fiscal Sector Performance
(as a percentage of GDP)



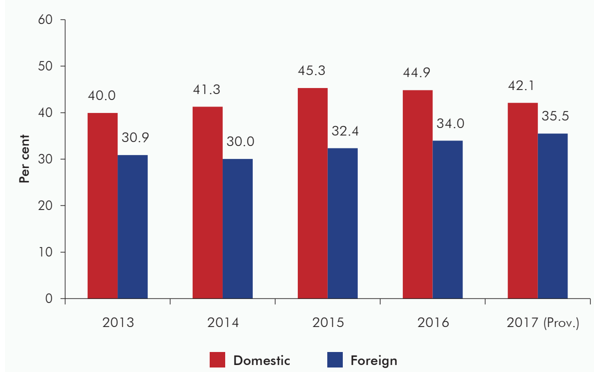
Source: Ministry of Finance and Mass Media

Government revenue as a percentage of GDP declined to 13.8 per cent in 2017 from 14.2 per cent in 2016 due to the decline in revenue from non-tax revenue sources. However, tax revenue increased in nominal terms and also as a percentage of GDP, primarily due to amendments made to the VAT Act, including the increase of VAT to 15 per cent from 11 per cent during the latter part of 2016 and other reforms introduced to the Economic Service Charge (ESC) and NBT in 2017 to enhance the collection of tax revenue. Accordingly, in nominal terms, tax revenue increased to Rs. 1,670.2 billion by 14.1 per cent in 2017, from Rs. 1,463.7 billion in 2016, while as a percentage of GDP, tax revenue increased to 12.6 per cent in 2017 from 12.3 per cent in the previous year. In contrast, non-tax revenue declined in 2017 mainly due to weakened financial performance of major SOBEs. As a percentage of GDP, non-tax revenue declined to 1.2 per cent in 2017 from 1.9 per cent in 2016, while in nominal terms it declined by 27.4 per cent to Rs. 161.4 billion in 2017. The combined effect of the performance of tax and non-tax revenue resulted in an increase in total government revenue by 8.6 per cent to Rs. 1,831.5 billion in 2017 from Rs. 1,686.1 billion in 2016. However, as a percentage of GDP, total revenue decreased to 13.8 per cent in 2017 from 14.2 per cent in the previous year. The share of tax revenue in total revenue accounted for 91.2 per cent in 2017 while indirect taxes continued to be the key constituent of government tax revenue, accounting for 83.6 per cent of tax revenue.

Total expenditure and net lending as a percentage of GDP declined to 19.4 per cent in 2017 from 19.6 per cent in 2016, reflecting the efforts taken to rationalise government expenditure. Accordingly, recurrent expenditure as a percentage of GDP declined to 14.5 per cent in 2017 from 14.8 per cent in 2016. However, in nominal terms, recurrent expenditure increased by 9.7 per cent to Rs. 1,927.7 billion in 2017 from Rs. 1,757.8 billion in 2016, mainly due to the increase in interest payments and expenditure incurred on disaster relief. The increase in the outstanding stock of debt, especially the outstanding foreign commercial loans obtained in the recent past, caused a rise in interest expenditure during the year. The total interest expenditure, in nominal terms, grew by 20.4 per cent to Rs. 735.6 billion in 2017 from Rs. 610.9 billion in 2016, while expenditure on foreign interest payments increased by 30.2 per cent to Rs. 164.9 billion in 2017 compared to the previous year. Meanwhile, with the prioritisation of public investment progammes in line with the fiscal consolidation process, capital expenditure and net lending as a percentage of GDP remained at 4.9 per cent in 2017 compared to 4.8 per cent in the preceding year. However, in nominal terms, capital expenditure and net lending increased by 12.0 per cent to Rs. 645.4 billion during the year in comparison to Rs. 576.1 billion in 2016. Public investment declined marginally to 4.9 per cent of GDP in 2017 from 5.0 per cent of GDP in 2016. However, in nominal terms, public investment increased by 10.7 per cent to Rs. 657.4 billion in 2017 in comparison to Rs. 594.0 billion in 2016.

The overall budget deficit was largely financed through foreign sources during 2017, for the second consecutive year. Accordingly, 59.9 per cent of the total financing need was covered by foreign financing in 2017 compared to 61.2 per cent in the previous year. Financing from foreign sources increased during 2017, mainly due to the issuance of ISBs and obtaining Foreign Currency Term Financing Facilities (FCTFFs). Net foreign financing consisted of Rs. 228.5 billion (US dollars 1,500 million) of ISBs, Rs. 152.7 billion (US dollars 1,000 million) of FCTFFs, net foreign investment of Rs 57.3 billion in Treasury bills and Treasury bonds, and Rs. 779.4 million of net borrowings related to foreign project loans. Government financing through domestic sources accounted for 40.1 per cent of total financing in 2017, which amounted to Rs. 294.3 billion in nominal terms. This was mainly through provisional advances of Rs. 116.5 billion and Treasury bonds of Rs. 109.1 billion, while a net repayment of Rs. 81.7 billion was recorded in Treasury bills. The government financing from the banking sector accounted for 63.8 per cent (Rs. 187.7 billion) of net domestic financing in 2017 compared to 56.3 per cent (Rs. 140.0 billion) in 2016, which was largely due to the significant increase of financing through commercial banks amounting to Rs. 375.7 billion in 2017 in comparison to a net repayment of Rs. 43.1 billion in 2016. The impact of borrowings from commercial banks was partly offset by the net repayment of Rs. 187.9 billion to the Central Bank.

Chart 1.8
Central Government Debt
(as a percentage of GDP)



Sources: Ministry of Finance and Mass Media
Ministry of National Policies and Economic Affairs
Central Bank of Sri Lanka

As a percentage of GDP, central government debt declined to 77.6 per cent by end 2017 from 78.8 per cent recorded at end 2016.[3] The reduction in the debt to GDP ratio in 2017 was mainly attributed to the deceleration in the growth of debt accumulation and the increase in the

3 Hambantota Port related debt continued to be classified under debt liabilities of major public non-financial corporations in 2017.

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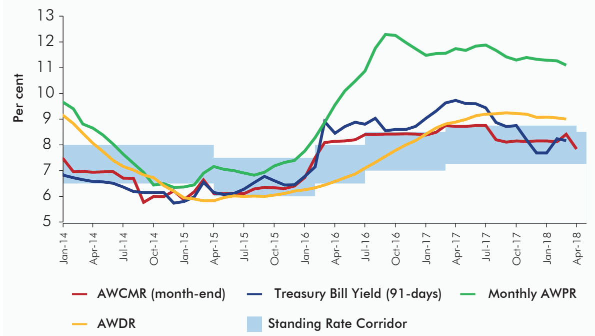
nominal GDP growth. Central government debt, in nominal terms, increased to Rs. 10,313.0 billion by end 2017 from Rs. 9,387.3 billion at end 2016. Of this, total outstanding domestic debt increased to Rs. 5,594.4 billion by 4.7 per cent, while total outstanding foreign debt increased substantially to Rs. 4,718.6 billion by 16.6 per cent.

Monetary Sector Developments

The Central Bank continued to maintain its tight monetary policy stance in 2017 to curtail adverse inflation expectations and the possible acceleration of demand driven inflationary pressures due to excessive monetary and credit expansion. Following the increase in inflation during early 2017, which could have led to the buildup of adverse inflation expectations amidst high money and credit expansion, the policy interest rates of the Central Bank, the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) were increased by 25 basis points in March 2017 to 7.25 per cent and 8.75 per cent, respectively, in addition to the 100 basis point increase in policy interest rates and the 1.50 percentage point increase in the Statutory Reserve Ratio (SRR) in 2016. Macroprudential measures to contain credit to selected categories of the private sector also complemented the conduct of monetary policy during 2017. Despite such contractionary measures, headline inflation continued to remain above the Central Bank's targeted range mainly due to the disturbances to domestic food supply caused by prolonged adverse weather conditions along with the implementation of changes to the government tax structure. Nevertheless, underlying inflation, as measured by the movements in core inflation, gradually moderated with the transmission of the tight monetary policy stance maintained over the past two years. Headline inflation also reverted to mid single digit levels in the first quarter of

Chart 1.9
Standing Rate Corridor and Selected Market Interest Rates



Source: Central Bank of Sri Lanka

2018 with the decline in volatile food prices. The moderation in inflation in the first quarter of 2018 and the favourable inflation outlook as well as the continued negative output gap compelled the Central Bank to end its policy tightening bias and reduce the SLFR by 25 basis points on 4 April 2018. Effective liquidity management by the Central Bank helped steer the Average Weighted Call Money Rate (AWCMR), which is the operating target of the current monetary policy framework, along the desired path. Accordingly, until mid July 2017, AWCMR increased and hovered around the upper bound of the policy interest rate corridor, reflecting tight liquidity conditions in the domestic money market. Along with surplus liquidity levels since mid July 2017, and active OMOs of the Central Bank, AWCMR stabilised at around 8.15 per cent. High real and nominal interest rates, resulting from tight monetary policy measures adopted by the Central Bank, caused a moderation in the growth of broad money supply and the growth of credit extended to the private sector by commercial banks, as expected. With the reduction in SLFR on 4 April 2018 and appropriate OMOs, AWCMR declined gradually to around 8.00 per cent by mid-April 2018.

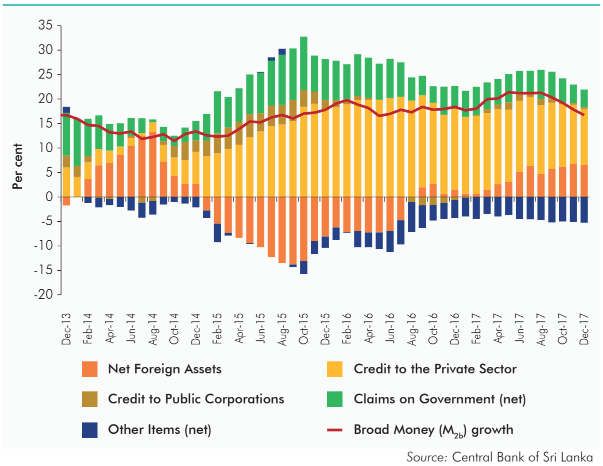
In view of the tight monetary conditions in the economy, market interest rates continued to increase further during 2017, although some

market interest rates started to stabilise or adjust downwards towards the end of the year reflecting the improved liquidity conditions in the market. Deposit and lending interest rates of commercial banks continued to increase during most of 2017 raising the cost of funds in the economy. However, some moderation in deposit rates was observed towards the end of the year, while lending rates stabilised at elevated levels. Yields on Treasury bills in the primary market showed upward movements during the first four months of 2017 reflecting the increased borrowing requirements of the government in a purely auction based system for issuing government securities and the tight monetary conditions. However, yields on Treasury bills in the primary market adjusted downwards thereafter, supported by improved liquidity conditions in the domestic money market and the favourable market sentiments with the availability of foreign financing to the government. Accordingly, by end 2017, yields on 91-day, 182-day and 364-day Treasury bills declined by 103 basis points, 133 basis points and 127 basis points, respectively, from end 2016. Yields on Treasury bonds in the primary market also followed a similar pattern, and the improved auction system contributed largely to the moderation of yields and corrected some distortions that prevailed in 2015 and 2016. The issuance of foreign currency denominated debt securities, such as Sri Lanka Development Bonds (SLDBs) and ISBs, also helped ease the pressure on yields of domestic debt instruments, particularly in the second half of 2017, to some extent. The secondary market yield curve for government securities shifted downwards and remained relatively flat in 2017, particularly at the long end, facilitated by the improvements in investor sentiment as well as anchored inflation expectations. Meanwhile, interest rates applicable on corporate debt securities remained high during 2017. Moreover, reflecting the gradual rise in key interest rates in the international markets, interest rates applicable on foreign currency denominated deposits maintained with commercial banks increased marginally during 2017.

Reserve money growth moderated to 9.8 per cent, year-on-year, by end 2017, compared to the high growth of 27.1 per cent recorded at end 2016, mainly due to the impact of the high base observed in 2016 on account of the upward adjustment to SRR in January 2016. In absolute terms, reserve money expanded only by Rs. 83.6 billion during the year to reach Rs. 939.8 billion by end 2017, compared to the notable expansion of Rs. 182.7 billion reported in 2016. From the liability side, both currency in circulation and the commercial banks' reserve balances with the Central Bank contributed to the moderate increase in reserve money during 2017. From the assets side, reserve money expansion during 2017 was driven entirely by the increase in NFA of the Central Bank along with the increase in reserve assets of the Central Bank, reflecting the accumulation of the foreign reserves and a decline in foreign financial liabilities of the Central Bank during the year. In contrast to the increase in NFA, net domestic assets (NDA) of the Central Bank declined considerably by Rs. 203.9 billion to Rs. 93.6 billion during 2017, compared to the increase of Rs. 200.3 billion in 2016. The sharp decline in NDA reflected the contraction in net credit to the government (NCG) by the Central Bank, with the Central Bank unwinding its holdings of Treasury bills to offset the rapid buildup of NFA resulting from the net purchases of foreign exchange inflows by the Central Bank. Accordingly, NCG by the Central Bank declined significantly by Rs. 187.9 billion to Rs. 225.1 billion during 2017, compared to the increase of Rs. 183.1 billion in the previous year.

Broad money (M_{2b}) growth, which remained at elevated levels during most of 2017, decelerated towards the desired levels during the latter

Chart 1.10
Broad Money Growth and Contribution

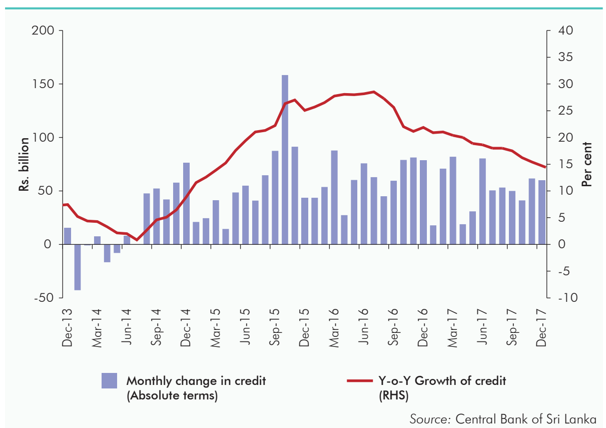


Source: Central Bank of Sri Lanka

part of the year, driven by the moderation in domestic credit. M_{2b} growth decelerated to 16.7 per cent, year-on-year, by end 2017 compared to a growth of 18.4 per cent at end 2016. Both NFA and NDA of the banking system contributed to the expansion in monetary growth during the year. NFA of the banking system increased substantially by Rs. 352.8 billion in 2017 in comparison to the moderate increase of Rs. 66.9 billion recorded in 2016. In addition to the considerable expansion in the Central Bank's NFA, NFA of commercial banks also expanded by Rs. 65.2 billion in 2017 resulting from a decline in foreign borrowings of commercial banks during the period under review. The expansion in NDA moderated to Rs. 549.7 billion, in absolute terms, during the year, compared to the expansion of Rs. 772.8 billion in 2016, driven by the slowdown in domestic credit observed during the second half of the year. Within NDA, NCG by the banking system increased by Rs. 196.4 billion in 2017, entirely due to the expansion in NCG from commercial banks, amounting to Rs. 384.3 billion during the year, mainly with increased investment in government domestic debt instruments in spite of the decline in NCG from the Central Bank in 2017. Credit obtained by public corporations from the banking sector increased by Rs. 19.2 billion in 2017 in comparison to the decline of Rs. 27.9 billion observed in 2016.

In response to the continued tight monetary policy stance, credit extended to the private sector by the banking system decelerated to desired levels by end 2017. Growth of credit to the private sector decelerated to 14.7 per cent by end 2017 on a year on year basis, compared to the growth of 21.9 per cent recorded at end 2016. In absolute terms, the expansion in credit to the private sector amounted to Rs. 617.4 billion during the year compared to an increase of Rs. 754.9 billion in 2016. The deceleration of credit extended to the private sector was caused by high market interest rates along with tight monetary conditions in the economy as well as the supportive macroprudential and fiscal policy measures. Moreover, with the exception of the acceleration observed in Personal Loans and Advances, the growth of credit extended to all major sectors decelerated during 2017. Accordingly, credit to the Services and Industry sectors expanded by 8.3 per cent and 19.6 per cent, respectively, in 2017, compared to the growth of 35.4 per cent and 22.2 per cent, respectively, in 2016. Growth of credit to the Agriculture and Fishing sector also

Chart 1.11
Credit Granted by Commercial Banks to the Private Sector



Source: Central Bank of Sri Lanka

moderated to 14.1 per cent by end 2017, compared to the growth of 17.0 per cent recorded in 2016. Credit under the Personal Loans and Advances category increased by 18.6 per cent by end 2017 compared to 15.2 per cent recorded at end 2016.

Financial Sector Developments

The performance of the financial sector improved, while the stability of the system was maintained in 2017 amidst the challenging economic environment. The improved performance of the financial sector was driven mainly by banks, other deposit taking financial institutions and contractual savings institutions. Banking sector credit, which reported a steady growth during the first half of the year, moderated gradually during the second half of the year in response to the tight monetary policy measures. The banking sector asset base surpassed Rs. 10 trillion recording an annual growth of 13.8 per cent, with the increase in loans and advances that accounted for 62.5 per cent of the total assets by end 2017. Meanwhile, the non performing loan (NPL) ratio declined marginally during the year reflecting the improvement in asset quality of the banking sector. Profitability of the banking sector, as measured by Return on Assets (ROA) and Return on Equity (ROE), improved noticeably with net interest income growing by 12.3 per cent during 2017. Capital adequacy ratios of banks were also maintained at comfortable levels under Basel III in order to absorb any adverse shocks, while the Statutory Liquid Assets Ratio (SLAR) of the domestic banking sector continued to be higher than the minimum statutory requirement of 20 per cent.

The Licensed Finance Company (LFC) and the Specialised Leasing Company (SLC) sector recorded a moderate growth during the year with low credit growth, declining profitability and increasing NPLs. The deceleration in credit growth in the sector can be mainly attributed to the restrictive macroprudential measures taken with respect to lending for motor vehicles and the modest growth witnessed in the economy during the year. Exhibiting a shift in the funding mix, the growth of assets of the sector was mainly funded through deposits while borrowings of the sector declined compared to the high growth recorded in 2016. The sector maintained its overall capital and liquidity levels well above the minimum requirement during the year in spite of the weak financial position of a few LFCs. A gradual moderation was observed in activities of the Primary Dealer (PD) sector in 2017. The asset base of PDs showed a considerable expansion during the year, although profitability of the industry declined marginally. The Employees' Provident Fund (EPF) and the Employees' Trust Fund (ETF), the leading institutions in the contractual savings sector, witnessed a healthy growth in their assets in 2017, while securing reasonable returns to their members. The asset base of the insurance sector also expanded during the year underpinned by the significant growth recorded by the life insurance sector.

Domestic financial markets witnessed some volatility during 2017. The domestic money market operated with excess liquidity, particularly during the second half of the year consequent to net purchases of foreign exchange by the Central Bank in the domestic foreign exchange market. Volatility in domestic money market was closely managed through active OMOs to avoid any undue pressure on short term interest rates. The rule based and transparent auction mechanism for government securities also helped to reduce the volatility in interest rates. Although the Sri Lankan rupee depreciated against the US dollar due to outflows of foreign investment from the government securities and the equity markets on expectations of tightening of financial conditions by advanced economies during the first half of the year, improving investor sentiments, particularly with the continuation of the IMF-EFF programme, attracted foreign inflows that helped ease the pressure on the rupee. The payments and settlement systems saw continued improvements and functioned without major disruptions.

The supervisory and regulatory framework governing the financial sector continued to strengthen during the year to enhance the safety and resilience of the financial sector. Prudential measures taken by the Central Bank were mainly focused on licensed banks, LFCs and SLCs with a view to enhancing their transparency, capital requirements, liquidity and risk management frameworks. Addressing possible regulatory forbearance, particularly in relation to non-bank financial institutions and primary dealers, was prioritised during the year. Several measures were taken to terminate or limit finance business operations of weak financial institutions to safeguard depositors and the long term stability of the sector. With regard to the capital market, the Securities and Exchange Commission (SEC) issued directions with respect to capital adequacy, disclosures and regulatory compliance of stock brokering companies with a view to enhancing the transparency and resilience of the sector, while the Demutualisation Bill approved by the Cabinet in 2017 is yet to be implemented.

1.3 Global Economic Environment and Outlook

According to the World Economic Outlook (WEO) of the IMF, the global economy continued to gain momentum in 2017 with a substantial majority of economies registering a pickup in growth. Two thirds of the world economies, comprising emerging and developing economies

Table 1.4
Global Economic Developments and Outlook (a)

Item	2016	2017	2018 (Proj)	2019 (Proj)
World Output	**3.2**	**3.8**	**3.9**	**3.9**
Advanced Economies	1.7	2.3	2.5	2.2
United States	1.5	2.3	2.9	2.7
Euro Area	1.8	2.3	2.4	2.0
United Kingdom	1.9	1.8	1.6	1.5
Japan	0.9	1.7	1.2	0.9
Emerging Market and Developing Economies	4.4	4.8	4.9	5.1
Emerging and Developing Asia	6.5	6.5	6.5	6.6
China	6.7	6.9	6.6	6.4
India	7.1	6.7	7.4	7.8
World Trade Volume (Goods and Services)	**2.3**	**4.9**	**5.1**	**4.7**
Price Movements				
Consumer Prices				
Advanced Economies	0.8	1.7	2.0	1.9
Emerging Market and Developing Economies	4.3	4.0	4.6	4.3
Commodity Prices (US$)				
Oil	-15.7	23.3	18.0	-6.5
Non Fuel	-1.5	6.8	5.6	0.5
Six-month London Interbank Offered Rate (LIBOR) on US$ Deposits (per cent)	**1.1**	**1.5**	**2.4**	**3.4**

(a) Annual percentage change unless otherwise indicated.

Source: World Economic Outlook (April 2018), IMF

as well as advanced economies, registered higher growth rates in 2017, compared to 2016. For the first time since the Global Financial Crisis, there is synchronised growth in the US, UK, EU and Japan. Growth in the advanced economies and China was triggered mainly by the increase in expenditure on fixed capital formation and accommodative monetary policy, while an increase in private consumption contributed to increased growth in most emerging market economies. Global trade recovered strongly and recorded substantially higher levels in 2017 compared to the past two years, despite the beginning of a series of successive retaliatory trade restrictions imposed on each other by the US and China. During the year, oil prices escalated as a result of the strengthening global growth momentum, supply side disruptions in the US, a unanimous Organisation of the Petroleum Exporting Countries Plus (OPEC+) agreement to curb oil production and geopolitical tensions in the Middle East. Despite the rapid rise in crude oil prices in late 2017, prices are expected to decline in the medium term with US production reaching record levels on the back of increased shale oil supplies. The increase in oil prices partly contributed to the increase in headline inflation in most economies. Prices of most types of commodities, including petroleum, Liquefied Natural Gas (LNG), metals and agricultural products, increased considerably in 2017, compared to the previous year.

Despite the overall strengthening of global growth in 2017, low levels of inflation called for the continuance of an accommodative monetary policy in most advanced economies. The US economy continued to show signs of a strengthening labour market and rising economic activity, despite brief episodes of volatilities resulting from natural disasters. In light of this, the US Federal Reserve proceeded to increase the Federal Funds target rate in March, June and December 2017, and again in March 2018. US tax reforms are expected to stimulate near term activity, but this is not expected to negatively impact inflation as the Federal Reserve is expected to undertake further policy rate hikes during the course of the year. Economic activity of the UK, however, was negatively impacted by its decision to leave the EU and due to the effect of the referendum-related depreciation in the sterling pound. Japan and several euro area economies, including Germany, experienced a strong momentum in domestic demand as well as external demand during the year. Although China continued to progress on the 'Supply Side Structural Reform' programme, the lack of resolution of several structural problems are expected to cause some moderation of growth in 2017. With the dissipation of the negative effects of the demonetisation and the teething problems of the Goods and Services Tax (GST), prospects for the Indian economy improved. The US dollar remained lacklustre during the year amidst the strengthening of other major currencies and due to policy uncertainties. However, a largely synchronised expansion across the euro area stemming from improving labour markets and an accommodative monetary policy helped buoy the euro in 2017. The strength of the yen has been supported by the recovery of the Japanese economy and the currency's safe haven status. In spite of increased global market volatility, financial flows and portfolio flows to emerging market economies remained robust during the year.

The global growth momentum is expected to improve further in 2018 and 2019 with better prospects for both advanced and emerging economies in terms of investment, production and trade, though possibly in the face of tightening financial market conditions and disruptions arising from trade wars between key global economies. The cyclical upturn registered in the last two years, which was synchronised across a broad cross section of advanced, and emerging and developing economies, is expected to augment further to record higher growth rates in the next two years and begin to moderate thereafter with growth in advanced economies returning to potential levels. Global growth in the next two years will mainly be driven by the pickup in domestic and external demand of the US, Europe and advanced Asian economies, as well as the effects of tax policy changes in the US that involved corporate tax reductions. In the US, fiscal adjustments to offset the deficit created through the tax reduction are expected in the medium term. Meanwhile, emerging and developing Asia is projected to grow at 6.5 per cent and 6.6 per cent, respectively, in the next two years. The effects of enhanced growth and business sentiment in the advanced nations are expected to spill over to the emerging market economies mainly through trade channels. The main risk factors affecting the aforementioned improvement in the growth momentum in the world are: the possible tightening in financial markets, if the inflation in the US shows signs of being higher than anticipated, triggering faster policy rate tightening by the Federal Reserve System; and the escalation of the trade war between the US and China. Risks are present also in the realm of the financial sector. With low interest rates and low volatility in asset prices that persisted in the last few years, more finances have flowed into financial assets with higher risks and less creditworthy borrowers. Meanwhile, the major trade agreements, involving the US and the UK, that are being renegotiated, as well as the progress of the 'One Belt One Road' initiative, will have a significant bearing on production, trade and investment across the globe in the next few years. Non-economic factors such as climate change, natural disasters and increase in political risks in some regions of the world would also pose considerable risks for global economic outcomes.

In this global context, Sri Lanka needs to make a firm commitment to expeditiously carry out the implementation of growth focused policy measures in order to tap into the enhanced production and trade levels in the world, while strictly managing sovereign and corporate exposure to international financial markets. Sri Lanka's economic growth has been well below the average growth rates of emerging market economies, and declined below the global growth estimate in 2017. Therefore, Sri Lanka needs to urgently make a firmer commitment to carry out well focused strategies to make use of the increase in demand in the advanced nations and to manage volatile capital flows. The continued geopolitical tensions in the Middle Eastern region further highlights the need to rely less on workers' remittances and promote export focused industries instead. The escalation of the trade war between the US and China could have some bearing on Sri Lanka's trade not only with these two economies, but also with other trading partners through value chains. On the fiscal and monetary fronts, the possibility of increases in interest rates in the global financial markets could increase the cost of sovereign and corporate debt issued at flexible rates, while making new issues of debt instruments costlier. Therefore, managing external debt at prudent levels, while closely monitoring the exposure of financial institutions in Sri Lanka to global markets, will be crucial in the medium term.

1.4 Medium Term Macroeconomic Outlook

The growth trajectory of the economy is projected to gradually improve over the medium term, especially with higher private sector participation supported by conducive macroeconomic policies. Although the growth performance of the Sri Lankan economy, in 2017, remained subpar as per the estimates of the DCS, the annual real GDP growth is expected to gradually improve to around 6.0 per cent by 2022. The growth strategy of Sri Lanka is based on developing the country to transform itself into a hub in the region with a knowledge based, highly competitive social market economy. To this end, numerous key initiatives, including the Port City development project, the Megapolis project, and the economic corridor projects, are being carried out. The Port City development project would support the drive towards making the country a hub in the Indian Ocean by developing a world class enclave that would include a financial district in addition to other features such as luxury living spaces and office complexes that would also attract FDI. Moreover, developments within the ports sector that would exploit Sri Lanka's geographical position would also support this drive towards establishing the country

Table 1.5
Medium Term Macroeconomic Framework (a)

Indicator	Unit	2016 (b)	2017 (c)	Projections 2018	2019	2020	2021	2022
Real Sector (d)								
Real GDP Growth	%	4.5 (c)	3.1	5.0	5.5	6.0	6.0	6.0
GDP at Current Market Price	Rs. bn	11,907 (c)	13,289	14,515	16,015	17,817	19,819	22,053
Per Capita GDP	US$	3,857 (c)(e)	4,065	4,340	4,665	5,075	5,547	6,095
Total Investment	% of GDP	35.0 (c)(f)	36.5	32.5	33.0	33.5	34.0	34.5
Domestic Savings	% of GDP	27.6 (c)(f)	29.3	26.1	27.3	28.6	29.6	30.9
National Savings	% of GDP	32.8 (c)(f)	33.9	30.3	31.0	31.7	32.4	33.2
External Sector								
Trade Gap (d)	% of GDP	-10.9	-11.0	-11.3	-10.9	-10.3	-9.6	-8.7
Exports	US$ mn	10,310	11,360	12,614	14,070	15,743	17,692	19,961
Imports	US$ mn	19,183	20,980	23,149	25,119	27,234	29,436	31,800
Current Account Balance (d)	% of GDP	-2.1 (g)	-2.6	-2.2	-2.0	-1.8	-1.6	-1.3
External Official Reserves	Months of Imports	3.8	4.6	4.8	4.5	4.4	4.6	4.7
Fiscal Sector (d)								
Total Revenue and Grants	% of GDP	14.2 (h)	13.8	15.7	15.9	16.4	17.0	17.4
Expenditure and Net Lending	% of GDP	19.6 (h)	19.4	20.4	19.8	20.0	20.5	20.9
Current Account Balance	% of GDP	-0.6 (h)	-0.7	0.5	0.9	1.4	1.9	2.3
Primary Balance	% of GDP	-0.2 (h)	0.0	1.0	2.0	2.4	2.4	2.6
Overall Budget Deficit	% of GDP	-5.4 (h)	-5.5	-4.8	-3.9	-3.5	-3.5	-3.5
Central Government Debt	% of GDP	78.8 (h)	77.6	77.4	74.8	71.7	69.0	69.0
Monetary Sector and Inflation								
Broad Money Growth (M_{2b}) (i)	%	18.4	16.7	15.1	13.5	13.5	12.5	12.5
Private Sector Credit Growth (in M_{2b}) (i)	%	21.9	14.7	13.5	15.0	15.0	15.0	15.0
Annual Average Inflation (j)	%	4.0	6.6	4.0	5.0	5.0	5.0	5.0

(a) Based on information available up to mid-April 2018.
(b) Revised
(c) Provisional
(d) The data is based on the base year 2010 GDP estimates of the Department of Census and Statistics.
(e) Estimates updated with the latest population figures.
(f) Total investment, domestic savings and national savings as a % of GDP in 2016 were revised by the Department of Census and Statistics from 31.5%, 23.8% and 28.9%, respectively.
(g) The difference between the BOP estimate and the GDP estimate is due to the time lag in compilation.
(h) Based on revised GDP estimates for 2016 made available on 20 March 2018 by the Department of Census and Statistics.
(i) Year-on-year growth based on end year values.
(j) Based on CCPI (2013=100)

Sources: Department of Census and Statistics
Ministry of Finance and Mass Media
Ministry of National Policies and Economic Affairs
Central Bank of Sri Lanka

as an economic hub in the region. In addition, the Megapolis Master Plan would transform the Western Province into a smart, vibrant and liveable area, while addressing issues pertaining to urbanisation. The development initiatives in the Plan, which include housing, transportation, waste management, disaster mitigation and development of industrial townships and technological hubs, would also support the overall growth strategy of the economy. Moreover, continued digitalisation of the economy; mechanisation of agriculture and industrial activities; skills development of the workforce to be in line with the economic strategy and the expectations of the labour force; diversification of the economy both in terms of domestic production as well as the export basket; together with continued improvement in economic and social infrastructure would also be crucial components of attaining a sustainable growth path for the country. Furthermore, the development initiatives of the country should be implemented in a manner that would uplift the wellbeing of the citizens while giving due consideration to environmental and social implications. Higher value employment is the most effective measure of transmitting the benefits. These expected developments, underpinned by stable macroeconomic conditions, including maintaining inflation at a low and stable level, would result in a gradual improvement in income levels with per capita GDP surpassing US dollars 6,000 by 2022. Achieving a growth path above the cautious path mapped in the Medium Term

Macroeconomic Framework, could be possible with the efficacious implementation of the planned development projects, which would stimulate both foreign and domestic private sector economic activity in the country.

The external sector is projected to improve over the medium term with appropriate policy measures and positive developments on the external front, including the gradual recovery of export markets. The deficit in the external current account is expected to be tapered over the medium term with the expected improvements in the trade account, inflows to the services account and workers' remittances. Exports are projected to grow at a higher rate than imports, narrowing the trade deficit as a percentage of GDP from 11.0 per cent in 2017 to 8.7 per cent by 2022. The acceleration in exports is expected to be aided by the increased volume and complexity of the export basket, improved competitiveness of the economy in the export markets due to the flexible exchange rate policy, the reinstatement of the EU GSP+ and enhanced market access through improved trade linkages through the existing and new trade agreements. Imports are also projected to increase over the medium term with higher imports of intermediary and investment goods. Meanwhile, the surplus in the services account is expected to improve over the medium term supported by higher inflows, particularly on account of tourism, Information and Technology (IT) and transportation services. Tourist earnings are expected to increase at a higher rate due to the addition of new star class hotels and more effective marketing campaigns. Proceeds from IT related exports are expected to continue their rapid growth trajectory. Earnings from transportation will rise with the anticipated acceleration in port and airport related activities due to enhanced external trade. A moderate growth in workers' remittances, which have historically proven to be a resilient flow of foreign exchange to cushion the current account deficit, is expected over the medium term. Meanwhile, the financial account of the BOP is expected to improve with both debt and non-debt creating inflows. Reflecting the gradual rise in the reliance on non-debt creating inflows, FDI as a percentage of GDP is expected to increase. Proceeds from ISBs, and other concessional and non-concessional loans are also expected to assist the financial account, while the government securities market and the CSE are expected to be augmented with foreign inflows. With the envisaged developments in the BOP, the country's gross official reserves are projected to improve to a healthy level, thus reducing the country's vulnerability to external shocks.

The government is expected to continue its focus on the revenue based fiscal consolidation process in the medium term. Accordingly, the budget deficit is estimated to decline to 3.5 per cent of GDP by 2020, while recording surpluses in the current account as well as the primary account. The government revenue to GDP ratio is expected to increase to around 17 per cent by 2021, with the expected increase in revenue collection following the implementation of the IRA, which simplifies the tax structure and broaden the base, and the continuation of the automation process of revenue collecting agencies. Further, on the expenditure front, the continuation of the automation of Treasury operations through the Integrated Treasury Management Information System (ITMIS), the presentation of quarterly expenditure reports and income outcome reports to the Parliament, the rationalisation of unproductive public expenditure, the establishment of an integrated system for all welfare programmes under the Welfare Benefits Board (WBB), the effective implementation of Statements of Corporate Intent (SCIs), the introduction of automatic pricing mechanisms for fuel and electricity and divesture of non-strategic enterprises are expected to be given priority. Accordingly, over the medium term, government expenditure is expected to be maintained at around 20-21 per cent of GDP and public investment is expected to remain at the current level of around 5 per cent of GDP. Further, the government aims at promoting and executing projects based on Public Private Partnerships (PPPs) amidst the limited fiscal space available for public investment. Meanwhile, since both domestic and foreign debt service obligations have become a serious challenge, in the medium term, liability management activities are expected to be carried out to smooth out the maturity profile of the central government debt portfolio with the recent enactment of the ALMA. Further, a medium term debt strategy is being developed jointly by the Ministry of Finance (MOF) and the Central Bank for better management of the government debt. With these developments and the continued generation of higher primary surpluses, the central government debt to GDP ratio is expected to decline to below 70 per cent after 2020. In addition, the Fiscal Management (Responsibility) Act, No. 3 of 2003 is expected to be amended to incorporate binding fiscal rules, clearly defined escape clauses and correction mechanisms in case of a breach of fiscal targets to improve fiscal discipline.

Initiatives by the Central Bank to successfully adopt flexible inflation targeting (FIT) as the monetary policy framework in Sri Lanka are expected to ensure price stability over the medium term. In early 2017, the Central Bank officially announced its intention to move towards a FIT framework by 2020. Several measures were taken since the official announcement to facilitate the smooth transition towards adopting FIT. This included the formulation of a Road Map for the adoption of FIT, highlighting the required legislative, institutional, operational and policy reforms. The approval of the Cabinet of Ministers has been obtained to introduce comprehensive amendments to the Monetary Law Act (MLA) to strengthen Central Bank independence and facilitate the adoption of FIT as the monetary policy framework, in addition to other amendments to improve governance of the Central Bank, strengthen financial sector oversight and boost fiscal-monetary coordination. Other ongoing reforms related to institutional and operational arrangements will also continue to ensure the successful transition towards the adoption of FIT. The efforts to strengthen the modelling and forecasting capacity at the Central Bank with technical assistance from the IMF would continue during this transition. Also, the Central Bank would gradually narrow the existing policy interest rate corridor in order to improve the efficiency of monetary policy signals. Meanwhile, the Central Bank will continue to improve monetary policy communication. In spite of the transition to FIT, monitoring of the behaviour of monetary and credit aggregates will continue to ensure the availability of sufficient liquidity for the smooth functioning of the economy. Overall, the conduct of monetary policy will be aimed at maintaining inflation at mid single digit levels in the medium term, forming the platform for the economy to achieve its growth potential. The increasing resilience of the financial sector along with the envisioned improvements in associated policies, infrastructure and reforms would complement the price stability initiatives of the Central Bank by way of enhancing the efficacy of the transmission of monetary policy through a deep and liquid financial market.

1.5 Issues and Policies

Although Sri Lanka made progress towards greater macroeconomic stability through the adoption of appropriate policy measures, its

growth performance was not at desired levels, highlighting the urgent need to implement structural reforms to address deterrents to growth. While recognising the fact that numerous measures are being implemented to strengthen the growth framework, the ensuing section highlights key issues and required policies with the view of re-emphasising the need to address such issues, if the country is to move to a higher growth path in the medium term and beyond.

The agriculture policy focus needs to gradually shift towards empowering farmers to engage in commercially viable activities. Recognising the vital role played by the agriculture sector in supporting the overall wellbeing of the country's population through ensuring food security and employing over a quarter of the labour force, successive governments have implemented numerous measures to promote this sector. These measures have helped in increasing the agriculture output of the country with Sri Lanka recording near self sufficiency in rice. One such measure that has been adopted to improve the agriculture sector is the fertiliser subsidy scheme. This scheme was first introduced in 1962 and continued thereafter, with the exception of a short period in early 1990s, in various forms including the cash grant offered to paddy farmers from the 2016 Yala season. However, the existence of the subsidy scheme has increased the reliance on fertiliser resulting in overusage and contamination of soil and water resources. Despite the heavy use of inorganic agro inputs, productivity levels have remained very low, resulting in a majority of those working in the agriculture sector earning low incomes while end consumers continued to face high and volatile prices. Therefore, the policy focus should gradually shift from subsidy dependent, subsistence agriculture activities towards empowering the farming community to engage in commercially viable agriculture. While the subsidy scheme may need to continue in a more targeted manner to assist specific sectors, emphasis is required to promote farmer groups to increase economies of scale, while improving access to finance to promote mechanisation in the sector and improving the agricultural logistics network to increase market access both domestically and internationally. Moreover, measures should be taken to reduce post harvest losses through better storage, transportation techniques and adopting best practices in post harvest food handling, as well as other productivity enhancing mechanisms such as crop rotation, water management, and crop-livestock integration. In addition, enhanced focus in ensuring that agriculture supply is compatible with market demand would also support better income levels to farmers. Developing derivative products for agricultural goods must also be considered to reduce price uncertainties faced by farmers. The shift towards commercial agriculture will help strengthen the financial condition of farmers and generate higher productivity levels in the sector.

Addressing the host of challenges faced by the plantation industry would enable the sector to improve productivity and to remain competitive, thereby enabling the attainment of its economic potential. The prolonged drought, floods and the erratic rainfall, which prevailed throughout 2016 and 2017 caused production levels to decline across the agriculture sector. However, an array of other factors, including the drawbacks in the structural organisation of the plantation industry, as well as poor agro management practices at the enterprise level, contributed to aggravating the ill effects of the adverse weather conditions and threatened the viability of the industry even under normal environmental conditions. Issues common across the agriculture sector together with crop specific challenges have contributed towards current low productivity levels witnessed in the plantation industry. Lack of replanting, high labour costs, low quality of the output, pest attacks, low quality imported seeds, improper application of fertiliser and the fragmented nature of institutional support are some of the issues that plague most of the plantation industries. These problems have been compounded by the glyphosate ban. In the context of Sri Lanka's tea industry, it has been steadily losing its share in the global market due to its low adaptability to innovations and poor productivity as a result of lack of reforms. Meanwhile, a significant increase in the quality of rubber produced is required if the industry is to compete with synthetic rubber. In the coconut sector, a major challenge is that plantations are increasingly being diverted for real estate purposes, both legally and illegally. In addressing the issues related to the plantation industry, measures need to be in place to avoid haphazard interventions, while the planning process must consider the long term needs of the industry. On major plantation crops, Sri Lanka competes with countries that have substantial cost and technological advantages. Therefore, Sri Lanka should explore avenues to diversify into niche areas, such as planting medicinal crops via intercropping or as plantation crops. In the meantime, strong policy measures are needed to strengthen plant quarantine services in Sri Lanka. Improving seed production and curtailing the import of low quality seed, which have sometimes been found to contain alien pests, via supporting the seed industry and the seed certification service will also be important. Since the main factor affecting poor replantation in most industries is the high risks and high volatility in incomes perceived by planters, an enabling macroeconomic environment with predictable prices and productivity linked wage structures, sound crop insurance schemes and market based hedging instruments to support prices, would help sustain the plantation industry.

Heavy investment in infrastructure has not been able to stimulate the industry sector to spur growth, highlighting the need to align the objectives of infrastructure development with those of industrialisation. Sri Lanka, along with many other middle income and developing economies, invested heavily in mega infrastructure projects in the past decade. Although such investment helped to increase gross value added in the economy in the short term, the contribution of certain investments to enhance the productive potential of the tradable sector over the longer time horizon has been limited. Overall, the rates of return have been disappointing. This was primarily due to the underutilisation of such infrastructure by industries and the inability of the infrastructure facilities to attract complementary investment by the private sector. Moreover, during the past several years, FDIs were channeled to infrastructure development, non-tradable services and other inward focused industries, rather than export oriented industries. Investment into manufacturing industries, agribusiness or tradable services has been very low compared to other comparable economies in Asia, implying that the availability of infrastructure is not a sufficient condition to attract investment. Meanwhile, scrutiny of the industrial infrastructure reveals that there is a significant disconnect between development of logistical and industrial infrastructure in the country. While the coordination between the government agencies engaged in investment promotion and industrial development needs to be improved for the success of economic zones, proliferation of small industrial groups in random areas of the country poses significant impediments to gaining agglomeration economies through industrial clustering. The experience of other countries shows that infrastructure led economic growth models yield positive results only when such infrastructure is used to support industries. A few large industrial zones, with appropriate logistical facilities that help achieve economies of agglomeration, promoted rapid industrialisation in countries like Japan, China, South Korea and Vietnam. Therefore, while ensuring that strict needs assessments and feasibility studies are carried out prior to infrastructure development projects, emphasis is also required on developing industries in the surrounding areas simultaneously.

Despite low levels of unemployment, there are policy concerns surrounding the contribution of labour markets to the growth process, especially in light of the country's attempts to progress as a middle income economy in the medium term. The commitment of successive governments towards universal healthcare and education has enabled Sri Lanka to create a resourceful pool of labour, many of whom are engaged in some form of employment, as reflected by the low levels of unemployment in the recent past. However, the lack of translation of the prevailing low levels of unemployment into substantial gains in economic growth highlights that merely increasing the quantity of jobs will no longer suffice. While the share of the employed in the agriculture sector had been steadily falling, 26.1 per cent of the employed continued to be engaged in the sector, contributing only 6.9 per cent of GDP in 2017. This raises concerns regarding labour productivity and underemployment in this sector. This condition is a more serious concern in the Sabaragamuwa, North Central and Uva provinces, where the share of employment in the Agriculture sector is four times as high as the sector's share of GDP. Further, the issue of the current and future labour force being inadequately equipped with an education and skills set that is relevant to the needs of modernising a more complex economy continues to remain unresolved, despite this being highlighted by several stakeholders over the years. While initiatives taken by the government in recent years to ensure formal and relevant education over a longer period of time and encompassing vocational education opportunities are commendable, the availability of higher or tertiary education opportunities remains largely insufficient to fulfill the skill and knowledge gaps in the economy. Sri Lanka's low levels of tertiary enrolment rates, which are below the averages for lower middle income and upper middle income countries, has also negatively weighed on the country's Global Competitiveness Index (GCI) Ranking in Higher Education and Training. Although several policy initiatives are underway to remodel Sri Lanka as an export oriented economy and thereby position it in the export value chain, policy efforts to improve the quality of the labour force lack sufficiency, coordination and commitment. Policy initiatives pertaining to quality, relevance, equity and capacity of the education sector, specifically pertaining to higher education, need to be urgently prioritised as high quality human resources are essential for the transformation of the economy. At present, growth in Sri Lanka is driven by the Industry and Services sectors, both of which would be subject to rapid technological change in the upcoming decade. The World Bank estimates that 69 per cent of jobs in India and 77 per cent of jobs in China are under threat from automation. While surveys conducted on labour demand by the Tertiary and Vocational Education Commission (TVEC) and the DCS show that there is a high demand for several categories of semi-skilled and unskilled labour, such occupations are likely to be automated in the very near future, rendering them redundant and resulting in a loss of employment opportunities. It is vital for policymakers to engage with stakeholders to assess the impact of such technological change and adopt proactive policy measures, which will enhance the skills sets of those who are currently engaged in such tasks so that they possess some degree of mobility across occupations in the wake of any 'waves' of automation. In addition, almost 60.2 per cent of employment is in the informal sector. According to the DCS, 73 per cent of enterprises in the industrial sector surveyed in 2015, employed between 5 to 25 people. This highlights several policy concerns, especially with regard to productivity, innovation, and growth and at a micro level in terms of the rights of workers, availability of social security and decent working conditions. The economy is in dire need of not simply employment creation but policy initiatives that focus on the improvement of labour productivity and access to better paid jobs, both of which can ensure efficiency driven growth, effective utilisation of resources and a growth process that will also reduce poverty and inequality.

The quality assurance and accreditation of private education services need to be further strengthened to support the healthy growth of this sector. Given the tight fiscal space, private sector engagement in the provision of education is imperative to meet the country's socioeconomic challenges such as dynamic labour market requirements, increasing demand for world class education from higher income households and limited opportunities at the state sector schools and universities. In this regard, the private sector has gradually increased its presence in education during the past few decades, both in general and tertiary education. The demand for private sector school education is rising in the country, especially due to the overcrowding in government schools. Although government approved private schools are monitored and evaluated on a regular basis by the Ministry of Education and provincial and zonal authorities, there is no such regulatory mechanism for international schools at present. With no regulatory or monitoring mechanism in place, the facilities, qualifications of the staff, and the quality of education provided by international schools can be highly uneven. As there is no transparent rating and standardisation process, parents are unable to make an informed decision regarding their choice of school. Since state sector schools are unable to provide equitable access to high quality education to all students, higher income households opt for international schools. International schools generally differ from each other and from government and government approved private schools in terms of their methods of teaching, medium of instruction, curriculum, co-curricular activities, examinations and evaluation procedures, discipline, their affiliations and accreditations, standards, etc. Therefore, a regulatory framework and a quality assurance mechanism that takes into consideration the aforementioned differences should be established, while ensuring that these regulations do not hinder the well functioning high quality international schools. Bringing all international schools under the purview of a regulatory body can facilitate the introduction of minimum quality standards for international schools. Meanwhile, the government is in the process of establishing an independent Quality Assurance and Accreditation Authority (QAAA) with a view to introducing a regulatory framework for both state and non-state universities, encompassing prerequisites for entry, a uniform credit and qualification framework, teaching and training standards, and evaluation methods. It is essential that the proposed QAAA is set up expeditiously to introduce quality standards across all disciplines to avoid recurrence of issues similar to those experienced in relation to institutes providing private medical education in the past, and create an environment conducive for private sector engagement in the provisioning of high quality tertiary education that meets global standards.

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BOX 1
Petroleum Price Reforms

Introduction

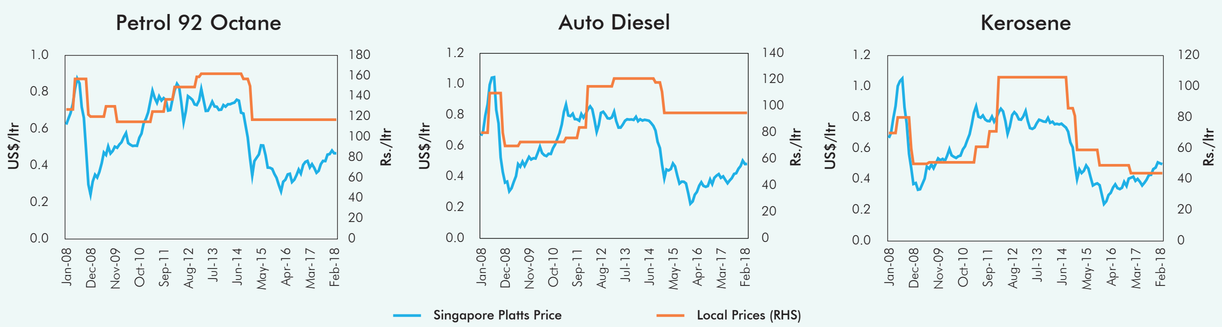
Price reforms for petroleum products have been a long-standing policy issue in Sri Lanka due to its direct impact on the cost of living and the cost of production as well as on the overall macroeconomic stability. The petroleum sector of Sri Lanka is dominated by the Ceylon Petroleum Corporation (CPC), a strategically important state-owned business enterprise, which accounts for approximately 86 per cent of the retail market share. Sri Lanka depends heavily on imported petroleum products to meet the primary and secondary energy requirement of the country. Moreover, as a small net-oil importing country, Sri Lanka is a price taker in the global market. Due to the high impact of petroleum prices on the cost of production, and thereby the cost of living, setting of petroleum prices has always been a politically sensitive issue in the country. However, non-adjustment of retail fuel prices to reflect their costs has seriously challenged the financial viability of the CPC on numerous occasions while creating macroeconomic imbalances and in fact lowering consumer welfare. Non-cost reflective administered prices have resulted in high fiscal costs associated with fuel subsidies, large contingent liabilities of the government, excessively high import bills and balance of payments issues, weakening of state-banks' balance sheets through heavy borrowings by the CPC as well as sub-optimal resource allocation and inefficient subsidy targeting. With the view of ensuring the financial viability of the CPC and reducing fiscal costs of fuel subsidies, in January 2002, the government implemented a cost-reflective pricing formula, which was in effect during 2002 and 2003. In 2004, the pricing formula was revised to align it with the changed market conditions, but this was not used to set prices thereafter. Consequently, since 2004, successive governments have opted for administered retail fuel prices, which have been revised by the government from time to time.

Passthrough of Petroleum Prices in Sri Lanka

Fuel prices have shown large fluctuations in global markets in the past decade, although the administered prices for petroleum products were not adjusted in the domestic market to reflect the movements in the global market. If the domestic prices reflect the total cost of the product, i.e., volume-weighted average cost of the imported and locally refined product including taxes, the passthrough of prices is said to be complete. The cost of petroleum products comprises Cost, Insurance and Freight (CIF) price, terminal charges for storage and bulk distribution, transport costs, exchange rate variation cost, short-term financing costs and personnel and overhead costs of the CPC. However, passthrough of global oil price fluctuations into the domestic market has been incomplete in the past, and any gains or losses of this incomplete passthrough were allowed to reflect in the CPC's balance sheet.

During 2011 to 2014, petroleum prices were exorbitantly high in the global markets. However, the government did not allow a full passthrough of oil prices during this period, resulting in a deterioration of the financial performance and an accumulation of heavy losses by the CPC. Conversely, Sri Lankan consumers did not benefit from declining global prices due to the non-adjustment of domestic prices to reflect global oil price movements. For example, during the mid-2008 to mid-2009 period and September 2014 to end-2015 period, global petrol prices declined by 44 per cent and 51 per cent, respectively, although domestic petrol prices were adjusted downwards only by 24 per cent and 25 per cent, respectively, during these periods. Moreover, during the same periods, global diesel prices declined by 54 per cent and 58 per cent, respectively, but local diesel prices were reduced only by 36 per cent and 19 per cent, respectively. Due to heavy accumulated losses of the CPC in periods of high global petroleum prices, the government was unable to allow a full passthrough

Chart B 1.1
Passthrough of International Prices into Local Retail Prices

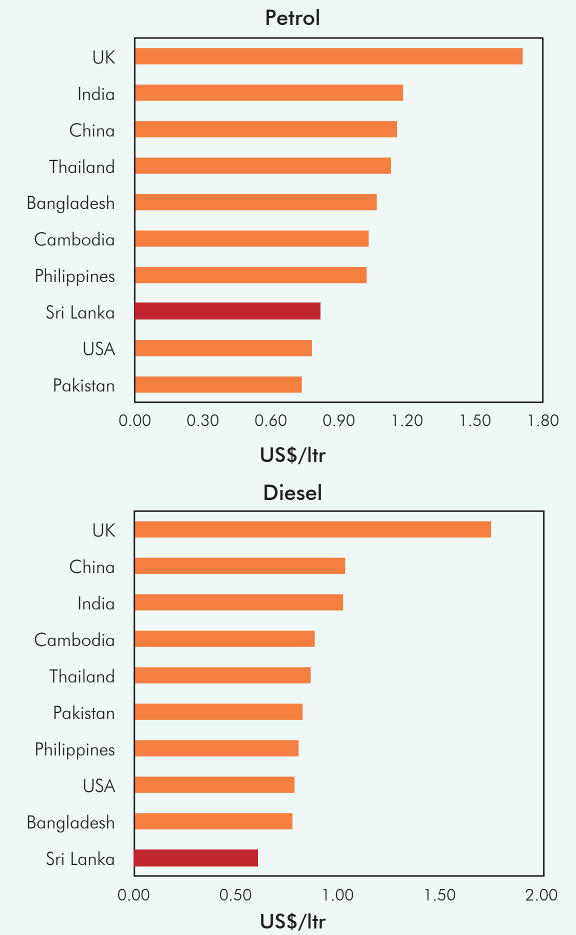


Sources: Ceylon Petroleum Corporation
Reuters
Central Bank of Sri Lanka

of prices when global oil prices were declining. By end 2017, the accumulated losses of the CPC amounted to Rs.217.3 billion.

Global oil prices have been on a rising trend since February 2016 due to OPEC and non-OPEC oil producing countries limiting oil production. However, domestic retail oil prices of the CPC remained unchanged since 2015, except for the reduction in kerosene prices in early 2017. Due to this non-adjustment of domestic petroleum prices, despite the gradual increase in global oil prices local retail petroleum prices remain significantly lower compared to most countries.

Chart B 1.2
Global Retail Price Comparison – As at 09 April 2018



Source: globalpetrolprices.com

Economic Implications of Administered Fuel Prices

Consumer subsidies are generally determined as the differential of the full passthrough price and the administered price.[1] The full passthrough price, which consists of the sum of supply cost, transportation cost, profit margins and taxation, is the total cost of the product. In the absence of any pricing formula, the difference between sales revenue and the total cost provides the basis for estimating fuel subsidies in Sri Lanka.

Table B 1.1
Estimated Subsidies for Petroleum Products during 2017

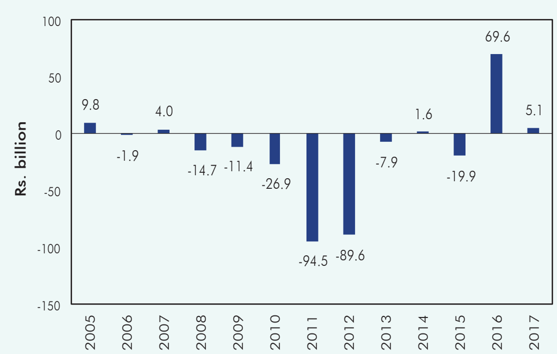
Product	Sales Revenue [a] (Rs. per litre)	Total Cost [b] (Rs. per litre)	Subsidy [c] (Rs. per litre)	Quantity (mn litres)	Total subsidy (Rs. mn)
Petrol 92 Octane	113.00	126.41	13.41	1,210.2	16,234
Petrol 95 Octane	123.72	136.97	13.25	178.6	2,366
Auto Diesel	92.46	96.71	4.25	1,871.8	7,961
Super Diesel	106.75	104.23	-2.52	88.4	-223
Auto Diesel for Electricity	95.00	94.79	-0.21	397.3	-82
Kerosene	42.85	70.38	27.53	198.1	5,454

[a] Sale revenue excluding dealer margin
[b] Include government taxes
[c] '-' denotes negative subsidy

Source: Ceylon Petroleum Corporation

Notably, aforementioned petroleum products, except super diesel and auto diesel for electricity, are sold at subsidised prices. Kerosene has the largest subsidy cost per litre, followed by petrol and diesel. However, given the large volume sold, petrol contributed the most to the burden of subsidy during 2017. Further, the fiscal cost arising due to the incomplete passthrough of fuel prices would crowd out high priority public spending with an adverse impact on growth and poverty reduction (Coady, et al., 2012). Moreover, fuel oil used by the electricity generation sector are not subject to administered prices and are sold by the CPC at a price above the cost recovery level. During 2017, profit earned by the CPC from the power generation sector amounted to Rs. 19.2 billion which indicates that part of the fuel subsidy is cross-subsidised by the electricity generation sector, raising the cost of electricity generation. Higher electricity prices have a negative impact on the competitiveness of the economy.

Chart B 1.3
Profit/Loss before Taxes of the CPC



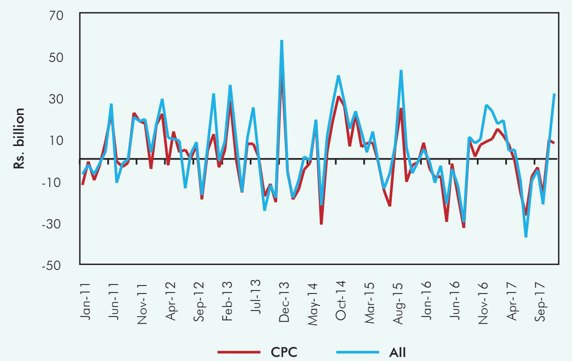
Source: Ceylon Petroleum Corporation

There are no formal budgetary provisions for financing petroleum subsidies resulting from administered prices being below cost-recovery levels, and accordingly, the CPC tends to bear part of the subsidy costs by reporting heavy financial losses over the years. Consequently, the CPC has to rely on bank borrowing to cover losses and meet liquidity requirements. Heavy borrowing by the

1 There are no pre-tax subsidies in Sri Lanka and accordingly, consumer subsidies are a measurement of the post-tax subsidy.

CPC affects the balance sheets of the state-banks and drive credit growth, and thereby complicates monetary policy operations of the Central Bank. At the same time, the government has to provide guarantees to support the CPC's borrowings raising the contingent liabilities of the government.

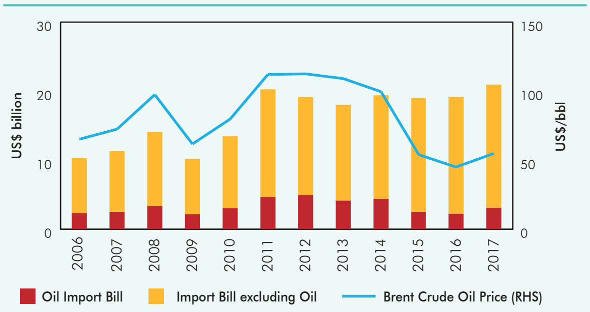
Chart B1.4
Monthly Change in Commercial Bank Credit to CPC vs. All Public Corporations



Source: Central Bank of Sri Lanka

Prices that do not reflect the true cost of production will lead to sub-optimal decisions related to production and demand. If the domestic prices do not reflect the rising global prices, demand for petroleum products will not adjust accordingly, leading to excessive increase in the import bill, creating external imbalances. During 2011, 2012 and 2013, petroleum imports accounted for more than 23 per cent of the total import cost of Sri Lanka highlighting the external vulnerability of the economy to rising oil prices.

Chart B1.5
Brent Crude Oil Price and Import Bill



Sources: Ceylon Petroleum Corporation
Lanka IOC PLC
Sri Lanka Customs
Bloomberg
Central Bank of Sri Lanka

2 Passthrough describes the extent to which shocks to costs change prices. Hence, passthrough rates play an important role in determining tax incidence, as it describes means by which the party that physically pays a tax can transmit the effects of that tax to others (Ganapati, Shapiro, & Walker, 2016).

3 Three most important environmental factors to be considered in energy prices as per Coady, Parry & Shang (2017), are CO2 emissions, premature deaths from local air pollution, and broader externalities, such as congestion associated with petroleum powered motor vehicles.

There are many emerging market economies that do not fully passthrough[2] changes in international petroleum prices to domestic retail prices. This non-adjustment of retail prices leads to adverse consequences on petroleum tax revenues and tax volatility (Coady, et al., 2012). Fuel taxes are often an efficient and equitable source of tax revenues that avoid possible higher distortionary taxes elsewhere in the economy. In addition, in countries like Sri Lanka where direct tax revenue collection is low, fuel taxes could be deemed as an effective source of revenue to be used for road infrastructure developments by the government. In addition, excessive use of non-renewable energy sources, particularly fossil fuels, causes a diversity of high cost environmental effects.[3] Economic analysis and empirical evidence reveal that pricing policies are noticeably more effective than regulatory approaches in addressing such issues (Parry, Evans, & Oates, 2014).

Way Forward

The administered pricing mechanism for petroleum products, which has been implemented with a discretionary approach, has weakened the financial viability of the CPC while creating numerous macroeconomic issues. Hence, the re-introduction of a cost-reflective pricing mechanism and supporting the continuance of such mechanism are imperative to curtail inefficiencies in the current petroleum pricing system. The implementation of an automatic price adjustment mechanism will facilitate a better passthrough of changes in international fuel prices to domestic retail prices, avoiding inefficient price subsidies, stabilising of fuel tax revenues, and reducing the adverse effect on the environment.

However, there are numerous aspects to consider in implementing a pricing formula for petroleum products. Fedrico et al. (2001) argue that full passthrough of international price changes may be suboptimal, in the face of shocks of large magnitude, in particular. If the government is concerned about excessive price volatility or if the market is imperfect, an automatic pricing mechanism that adjusts prices periodically to reflect international prices is more appropriate (Coady, et al., 2010). Accordingly, the government can implement a partial passthrough of prices in the short term while ensuring full passthrough in the medium to long term. This can be achieved through various price smoothing rules: moving averages (setting retail prices based on the moving average of past spot prices); trigger rules (retail prices are updated only if spot prices change by more than a predetermined trigger amount); and max-min rule (this rule places a ceiling and a floor on the level of petroleum prices) (Fedrico, Daniel, & Bingham, 2001). However, Fedrico et al. (2001) elaborate on the fact that governments in developing countries would not be well prepared to address the associated short-term fiscal risks emanating from price smoothing activities. In this regard, the government has the option of using self-insurance mechanisms such as the establishment of an oil price stabilisation fund to reduce the short-run fiscal risk associated with price smoothing. Nevertheless, international experiences suggest that a well-planned and comprehensive reform strategy is key to ensure the success of the policy, and accordingly, the International Monetary Fund (2017) identifies five broad lessons learnt from different country experiences to make the reform a success: formulate an integrated reform strategy, protect the most vulnerable, build broad public support, refrain from ad hoc adjustments that do not address the root of the problem, and move gradually when feasible. These are key lessons to be followed in Sri Lanka as well, in the inevitable implementation of a cost reflective pricing formula for domestic fuel prices. Implementation of a cost reflective pricing mechanism also needs to be extended to other utilities as well, to ensure the financial viability of the relevant state-owned business enterprises.

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Moving towards more cost reflective pricing strategies for energy not only ensures the financial viability of SOBEs, but also promotes the efficient use of energy in production and consumption. Currently, administered pricing strategies are implemented in petroleum and electricity sectors, where domestic petroleum prices and electricity tariffs often do not reflect the true economic cost of the provision of these utilities, leading to suboptimal resource allocation decisions in the economy. If the administered prices of petroleum are not raised during the periods of oil price escalation in global markets, the Ceylon Petroleum Corporation (CPC) tends to make substantial losses while consumer demand does not adjust to reflect the true cost of petroleum products. With regard to electricity generation, losses of the Ceylon Electricity Board (CEB) escalate if domestic electricity tariffs are not adjusted to reflect the cost of generation during times of increased reliance on thermal power. Deteriorating financial performance of CPC and CEB has repercussions on the banking sector through heavy bank borrowing, which also undermines the Central Bank's policy measures to curb credit growth to manage inflation when needed. Higher demand for energy arising from inappropriate pricing also results in increased pressure on the BOP, and thereby on the exchange rate. On the other hand, administered prices and tariffs that do not reflect the actual cost may not pass on benefits to users during periods of low energy prices in global markets or periods with lower power generation costs. This could affect the country's competitiveness while the cost of living could remain artificially high, worsening the living standards. Further, uncertainty arising from sudden and sharp revisions to administered prices of energy also affects consumer and producer decisions adversely. Therefore, it is essential that urgent steps are taken to implement cost reflective pricing strategies for the energy sector with fixed time intervals for domestic price revisions, in order to ensure the financial viability of SOBEs and promote optimal resource allocation in the economy. At the same time, it is crucial to ensure the losses that arise due to operational inefficiencies of these SOBEs are addressed without passing such losses to consumers through prices and tariffs. Moreover, it is important to actively promote the variable electricity tariff scheme based on the time of usage that is currently available for household consumers to better manage electricity demand.

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Expeditious implementation of effective and affordable traffic management solutions is vital to curb numerous negative externalities arising from traffic congestion. In response to the increasing number of vehicles in main cities, the government has continued to expand and upgrade the existing road and highway network. However, the increase in traffic, most of which are low occupancy vehicles, has been rapid, and has resulted in heavy traffic congestion, wasting time and financial resources of the country, while increasing pollution levels. While buses, as a mode of public transportation, are slow, congested, uncomfortable and unpredictable, three wheelers and taxis are relatively expensive, prone to accidents and unavailable at peak times. Meanwhile, the structure of the private bus industry has led to an unhealthy competition, with little improvement in the quality of services provided. Also, there are other factors that contribute to high traffic congestion, such as the extremely high levels of traffic rule violations, lack of discipline in driving and disruptive construction work on the roads during daytime. Therefore, while implementing the light rail transit (LRT) system, as envisaged in the Megapolis Development plan, other solutions that are targeted directly at the root causes of the current increase in traffic congestion, and are relatively faster and cheaper to be implemented must also be explored by the government. These include rigorous educational campaigns to discourage the culture of driving in which violations of road rules are the accepted norm, implementation of a wide network of CCTV cameras for monitoring and enforcement without discrimination, incorporating modules on road discipline at primary and secondary school levels, regulating the three wheeler industry, as well as restructuring the bus network in the Capital of Colombo into a Bus Rapid Transit (BRT) System as mooted by industry experts.

The expansion of exports through diversification is of utmost importance to ensure external sector stability. Sri Lanka has been continuously experiencing a deficit in the external current account from 1978, which has been financed mostly through external borrowing. Imbalances in the external sector has also led the country to depend on external assistance of agencies, such as the IMF, in addressing this issue with a short to medium term focus. While debt creating foreign inflows can serve to finance the current account deficit in the short term, this is clearly unsustainable. Developing an export oriented manufacturing sector, supported by services exports, would present the long term solution. Development policies should be aimed at promoting new industries through streamlining regulations related to business activities, encouraging private sector initiatives related to export oriented manufacturing activities, encouraging research and development, exploiting opportunities to tap regional and global value chains (GVC) and ensuring stable macroeconomic conditions. Since the country has the potential to grow as a knowledge- and services-based economic hub in the Indian Ocean, a new trade policy framework for Sri Lanka has been prepared to improve domestic production capacity and trade performance, while formulating a new national export strategy for Sri Lanka. This has identified six focus sectors and four trade support functions to develop exports. Meanwhile, focus on industrial zones would also be a key ingredient in developing exports together with productivity enhancements across the economy. However, international market access should also grow in tandem with the envisaged expansion in exportable output. Accordingly, Sri Lanka is in the process of entering into new trade agreements to improve international market access. In 2017, Sri Lanka entered into a comprehensive free trade agreement with Singapore and is in discussions with India and China on similar agreements. Upon finalising these agreements, Sri Lanka will be among the handful of countries that have free trade agreements with both India and China. No country has bilateral access to both these large and fast growing markets, together with access to Europe under the GSP+ facility. However, continuous dialogue with domestic stakeholders is also a key element in ensuring the success of these strategies by identifying concerns of the business community and maintaining transparency in the negotiation process. Trade adjustment packages to mitigate adverse impacts, if any, resulting from structural changes in the economy owing to new trade agreements are also important. Moreover, Sri Lanka has also enacted antidumping legislation, which would provide local producers protection against unfair trading practices, if implemented properly. Safeguard provisions have also been put in place to guard against import surges. Hence, going forward, local producers should be educated on the opportunities and measures available for them to exploit these agreements for the benefit of the country, leading to a favourable long term outcome in the external sector.

While Sri Lanka succeeded in attracting FDI inflows of over US dollars 1.9 billion in 2017, the country's FDI inflows remain significantly low in comparison to its regional peers. In 2017, Sri Lanka achieved the historically highest FDI inflows to the country mainly due to the improving macroeconomic environment and positive investor sentiments. However, Sri Lanka, being a twin deficit country with persistently high budget and external current account deficits, has been relying on domestic and foreign borrowings to finance these deficits over the years. Meanwhile, the bunching of future foreign debt repayments and limited access to concessional funding with Sri Lanka's transition towards an upper middle income country raise concerns regarding financing the BOP with foreign debt continuously. Additionally, amidst rising global interest rates, Sri Lanka is vulnerable to possible reversal of capital flows particularly from the government securities market and the CSE. In this context, it is imperative to attract further non-debt creating foreign inflows in the form of FDI, as these financial flows are a long term source of funds, thereby supporting the resilience of the external sector. In addition, FDI not only fills the savings-investment gap, but is also a significant driver of economic development with associated flows of technology, management practices and access to international markets. Therefore, the country needs to strengthen its investment policy framework further while harmonising investment policy with other government development policies and strategies, particularly trade and industry. Inter-agency coordination in implementing these policies are equally important to ensure policy consistency, which is a key prerequisite to attract foreign investment.

Over-reliance on workers' remittances from the Middle East to finance the current account deficit needs to be redressed. The Middle Eastern region remains the primary market for Sri Lankan migrant workers, accounting for over 90 per cent of annual departures for foreign employment from the country and more than half of the total remittance receipts. However, a notable decline in labour migration to the Middle Eastern countries has been observed in the wake of low oil prices and increasing unrest in the region in the recent years, dampening the earnings from inward remittances. Several regional economies including India, Pakistan and Bangladesh, have also witnessed declines in workers' remittances similar to the moderation experienced by Sri Lanka during the past few years. Hence, Sri Lanka cannot expect a continuous growth in workers' remittances if the primary source of remittances continues to be repatriations from unskilled workers and

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housemaids from the Middle East. With the decline in remittances from the Middle Eastern region, there is a growing necessity to transform Sri Lankan migrant workers from unskilled and housemaid categories to semi skilled and skilled levels. In addition, there is a need to find alternative destinations by exploring new labour markets and entering into bilateral agreements with other advanced Asian and European economies. This will reduce the vulnerability created by the exposure of Sri Lankan foreign remittances being sourced largely from a single region. As a remedy to the mismatch between the international demand for jobs and Sri Lanka's supply capabilities, investment in competency development for progressive up-skilling of migrant workers through language and vocational training on par with international standards would be beneficial in securing employment opportunities with higher earnings. However, it is also observed that migration of skilled workers and professionals is often associated with tied migration where the family accompanies the migrant worker leading to permanent settlement in destination countries. Resultant weaker links with Sri Lanka would limit foreign exchange remittances, whilst also creating brain drain. Meanwhile, the number of foreign workers in Sri Lanka also appears to be rising, signaling that there will also be increased foreign exchange outflows in terms of remittances in the near future, and thus reducing the surplus in the secondary income account in the BOP. In this backdrop, while taking appropriate measures to maximise inward workers' remittances, it should be noted that Sri Lanka will no longer be able to depend solely on remittances as a major foreign exchange earner to finance the external current account deficit. Hence, priority should be given to attract non-debt creating inflows, such as FDI, and route those funds to export oriented enterprises with the view of generating more sustainable foreign exchange flows in the long run. Such enterprises can also absorb labour made available domestically, if there is any reduction in temporary migration to the Middle East, in higher value employment.

While the commitment to increase government revenue through tax reforms has yielded results, there is further space to enhance direct tax revenue by strengthening tax administration through Information and Communication Technology (ICT) to bring in tax evaders into the tax net. Tax evasion by individuals and corporates has been one of the primary reasons for the decline in direct tax revenue as a percentage of GDP. Tax evaders deliberately understate or avoid reporting the true state of their net worth and income to the tax authorities to reduce tax liability. An effective method to address tax evasion is by the close monitoring of high end consumption driven transactions. This requires reconciling income declarations with data retrieved from high end transactions such as luxury car sales and property sales. Although, the Inland Revenue Department (IRD) carries out such examinations and follows up with semi automated systems, a sophisticated electronic system linking up relevant institutions with the tax system is essential to efficiently confront tax evasion. Such an automation process has already commenced with various tax reforms initiated to improve tax administration recently, including the introduction of the Revenue Administration Management Information System (RAMIS). The full implementation of the RAMIS is expected to connect the system with over 20 other external institutions including the Central Bank, licensed banks, Sri Lanka Customs, Registrar of Motor Vehicles, Condominium Management Authority, CSE and the Land Registry, for effective tax reconciliation. Addressing the remaining infrastructure and human resource bottlenecks to implement this much needed system would enable authorities to tackle tax evasion efficiently and address the obvious disconnect between the growth of high end economic activity and the declining direct tax revenue to GDP ratio.

The speedy implementation of liability management activities is imperative to manage risks associated with maturing foreign currency debt. With the country's graduation to middle income level in the late 2000s, the availability of foreign grants and concessional loans declined, requiring the government to mobilise commercial debt such as ISBs continuously from the global capital market to finance its external current account and budget deficits. While the government's present commitment to implementing revenue based fiscal consolidation would contribute to containing debt at a sustainable level in the medium to long term, addressing near term bunching of debt repayments and mitigating refinancing risks of the debt portfolio remain crucial. The recently introduced ALMA provides the necessary legal framework to implement liability management exercises on the central government debt portfolio with a view to smoothening out future debt servicing payments by restructuring the existing debt stock through mechanisms such as buyback options, switching and prefunding arrangements. The successful implementation of the liability management framework will help reduce the country's external vulnerability in the period ahead. Priority must, therefore, be attached to developing a comprehensive liability management strategy to reduce rollover risk associated with the bunching of external debt in 2019-2023.

The commitment of the government to fiscal discipline through strict adherence to the proposed fiscal consolidation path is of paramount importance to the success and sustainability of the proposed FIT framework. Over several decades, Sri Lanka has been straddled with high fiscal deficits and onerous government debt levels. As high levels of fiscal deficits and government debt can impede the Central Bank's ability to control inflation, it is essential that consolidation continues until fiscal sustainability is achieved. An expansionary fiscal policy inevitably fuels inflationary pressures. This exerts pressure on both interest rates and the currency. In addition, heavy reliance of the government on domestic markets for deficit financing can also be a concern as this may lead to "crowding out" of productive and efficient private sector investment. This can weigh negatively on economic growth over the medium to long term. Despite the strong commitment of the monetary authority to fight inflation aggressively, particularly under an inflation targeting regime, macroeconomic stability and sustained growth cannot be achieved unless there is commitment of, and coordination between, both monetary and fiscal authorities. Therefore, ensuring fiscal sustainability will be of paramount importance to not only successfully transition to the new monetary policy regime but also to achieve economic progress over the medium to long term.

Although Sri Lanka's financial sector has significantly progressed over time, its shallowness in terms of product coverage remains an impediment to the country's overall economic development. Continued expansion in the financial sector, as reflected by the growth of total assets of the sector, has been considerable, particularly since the end of the internal conflict. During this period, total assets of the financial sector increased by more than three-fold and its outreach in terms of the network of branches and automated teller machines (ATMs) has been impressive, thus enhancing financial inclusion. Although financial institutions continued to bring innovation and new technology into their day-to-day products and services, their progress in deepening the financial market through the introduction of new financial

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products has been noticeably slow. Financial derivatives and derivative related instruments as a means to hedge risk are available as products only in a handful of banks. Insurance products, particularly pension schemes, have been slow in taking off, as such schemes are often deemed too rigid and less personalised. The equity market in Sri Lanka mainly features traditional instruments, whilst the possibility of trading equity derivatives has been left largely unexplored. The corporate debt market also remains miniscule in spite of the many measures to revive this segment of the financial market. However, notable developments observed in technology and payments and settlements infrastructure could be used by providers of financial services as catalysts to deepen the financial market and bring forth greater financial inclusion and stability as well as economic development. In the meantime, from a user perspective, the lack of awareness and confidence about existing financial products, let alone new ones, continues to be a major setback for the deepening of the financial market. Programmes to enhance awareness and financial literacy would generate demand for new financial products, thereby encouraging financial institutions to introduce novel instruments or schemes. Tailor made insurance and pension schemes will create greater public interest in such products, thereby enhancing savings and investment of the country as well. Equity market activities could be boosted through popularising margin trading, which has been used sparingly by market participants due to the cost and restrictions involved, while short selling could be facilitated with proper monitoring and regulations in place. Overall, financial deepening achieved through the development of appropriate financial products and markets would not only enhance liquidity, transparency and reach, but would also increase the resilience of the economy to shocks. Moreover, promoting healthy competition among financial institutions would also generate cost effective and innovative products, effectively deepening the financial market, which in turn would improve the effectiveness and speed of monetary policy transmission as well.

A myriad of opportunities presented by the expanding digital economy needs to be enhanced while addressing associated challenges through strengthening the current regulatory and legislative framework. With growing volumes of online transactions across the globe, there is notable progress in the role of emerging market economies in the form of both buyers and sellers of goods and services on online platforms. There is a range of proven and potential benefits to be gained by business-to-business (B2B) and business-to-consumer (B2C) e-commerce, such as enhanced participation in international value chains, greater market access and reach, and improved internal and market efficiency, as well as lower transaction costs. Research shows that there are significant productivity gains associated with selling over the Internet and that micro, small and medium scale enterprises (MSMEs) and those in services industries stand to gain more. Although there has been a rapid expansion in the Sri Lankan e-commerce industry, largely attributed to the strong growth in mobile penetration, e-commerce sales are comparatively low when compared to regional peers. Moreover, while this industry opens new avenues that can translate into improved job creation and productivity gains, it also entails legislative and regulatory concerns. Strengthening legislation pertaining to e-transactions, consumer protection, privacy and data protection, and cybercrime is essential to safeguard all stakeholders of the ‘digital economy’, but such strengthening must take into account the dynamic nature of e-commerce. In the wake of the growing incidence of cybercrime and Sri Lanka’s rapid integration with the global digital economy, concerted efforts are required in the area of law enforcement and to continuously strengthen the technical capacity of emergency response teams. On the other hand, the internet also presents several opportunities for timely and relevant evidence based policymaking using “big data”. Such data science can help provide invaluable insights into consumer behaviour while enabling meticulous surveillance of risks and even enhanced regulatory and fiscal compliance. Sri Lanka is also yet to entirely familiarise itself with advanced digital financial assets such as crypto assets. While crypto assets and related transactions are yet to make a strong entry into the Sri Lankan economy, in an increasingly globalised environment, the country remains vulnerable to the risks associated with such assets, especially in terms of the anonymity that they offer and how they may serve as a vehicle for money laundering and terrorist financing. There needs to be concerted policy efforts to assess these novel and dynamic challenges and identify appropriate regulatory and supervisory technologies that will augment the opportunities presented by the digital economy while safeguarding stakeholders of both the digital and traditional economies.

Avoiding frequent reversals of policy decisions is essential to reinforce trust in public policymaking and strengthen stability in social and economic spheres. In recent times, Sri Lanka has witnessed an array of examples of inconsistent policies and policy reversals, spanning economic, social and political spheres. Some examples are policies with regard to investment approvals, land holding by foreigners, use of asbestos, use of polythene, use of weedicides, provision of fertiliser subsidy, long term power generation planning, provision of private medical education, and women’s rights on alcohol purchase and related work. In democratic politics, public policymaking is inherently a process of striving towards an equilibrium of competing objectives, competing interests, competing stakeholders and competing strategies to allocate scarce resources amongst numerous competing needs. Therefore, there can seldom be one solution to an issue that satisfies all stakeholders, even after strenuous public consultation. However, frequently changing decisions once taken, will only lead to more public dissatisfaction and tarnish government credibility, while inviting more disruptive lobbying for continuous changes. Furthermore, as expectations play a central role in economic progress, uncertainty about the durability of policy decisions taken would affect the economic decisions of the private sector, which could have lasting effects on the economy. Therefore, the formation of a culture of policy uncertainty must be avoided by encouraging evidence based decision making and ensuring consensus amongst decision makers before a policy is adopted, while sufficient time for a policy to operate must be allowed before a revision is considered.

As highlighted above and also in numerous occasions in the past, several existing and emerging challenges need to be addressed for the country to achieve high economic growth and sustainable economic development over the medium term and beyond. Whilst the commitment of the government is essential to implement the envisaged reforms, increased private sector participation in productive economic activity is also vital in the country’s progress as a middle income economy. Proactive policy measures implemented in a timely manner with increased consistency and focus will enable effective and sustainable utilisation of resources resulting in an efficiency driven growth process, which would facilitate improved welfare of the general public in the country.