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Macroeconomic Impact of COVID-19 and Policy Choices for Sri Lanka

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ABSTRACT

Sri Lanka is a fascinating case study of a middle-income developing country with pre-existing macroeconomic stresses impacted by the COVID-19 pandemic. Despite favourable initial conditions, economic development was held back by external shocks exacerbated by inadequate management of macroeconomic and trade policy. The pandemic shock in 2020 is like no other Sri Lanka has experienced in its history and disrupted implementation of a new government's ambitious agenda. Applying several research methods, this paper analysed the macroeconomic impact of the COVID-19 on the Sri Lankan economy during its first 20 months to August 2021. The pandemic and containment measures caused an unprecedented economic contraction, exports to fall, poverty to rise and women's unemployment to rise. An unconventional policy mix of monetary stimulus, import controls and currency swaps helped to mitigate economic scaring and provide support to the economy. There are signs of a pick-up in growth in 2021 partly reflecting a low base effect, cheap finance and pent up demand. However, prolonging the policy mix beyond the short-term and emerging risks (e.g. unfavourable debt dynamics) could have potential drawbacks for the fragile economy and impede recovery. To support Sri Lanka's nascent recovery in the medium-term, the policy agenda should shift towards complementary reforms for inclusive and sustainable growth. The policy simulations highlighted some economic priorities. A fiscal stimulus targeted towards green investment and gender-sensitive expenditure produces a superior growth outcome than other scenarios. Concluding a deep bilateral FTA with India and a goods BIMSTEC FTA could bring larger export gains to Sri Lanka than a goods FTA China. The Colombo Port City SEZ can be a game changer for modern services development provided Sri Lanka implements a competitive SEZ framework and conducive national policies to attract FDI. If these economic priorities are adopted, Sri Lanka could have reason for optimism.

Key Words: COVID-19, Sri Lankan Economy, Fiscal and Monetary Stimulus, Twin Deficits Hypothesis, Free Trade Agreements, Colombo Port City SEZ, Economic Reforms

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Macroeconomic Impact of COVID-19 and Policy Choices for Sri Lanka

Ganeshan Wignaraja¹

1. INTRODUCTION

In the late 1970s, Sri Lanka had favourable initial conditions by South Asian standards to propel rapid economic development. These include the highest human development indicators in South Asia through significant social spending, early adoption of an outward-oriented development strategy which enticed export-oriented foreign direct investment (FDI), a strategic location in the Indian Ocean which facilitated port development and exceptional tourism assets (Sen, 1988; Kelegama, 2000; Wignaraja, 1998 and 2019). Structural change over several decades had created an economy anchored on a manufacturing sector dominated by labour-intensive garment exports and an expanding service sector. Yet national economic development has disappointed. Sri Lanka was classed as a low middle-income country in 2020 – a status which it attained in the late 1990s.² Growth has slowed and fallen below others in South Asia. The narrow base of industrial and export growth has raised concerns about its sustainability (Wignaraja, 1998; Kelegama, 2009). There are signs of gender gaps in the work force and environmental risks (Gunawardena, 2015; World Bank and ADB, 2020). Sri Lanka's development record can partly be attributed to the economy's vulnerability to external shocks³ compounded by the effects of inadequate management of macroeconomic and trade policy on macroeconomic aggregates (White and Wignaraja, 1992; Stiglitz, 2016; Thenuwara, 2019). The country has suffered from twin fiscal and balance of payments deficits as well as a restrictive trade regime (Pursell and Zialul Ahsan, 2011; World Bank, 2017; Weerakoon, Kumar and Dime, 2019).

Sri Lanka is a fascinating case study of a middle-income developing country with pre-existing macroeconomic stresses impacted by the COVID-19 pandemic. On 27 January 2020, the first case was reported in Sri Lanka and the first death in March 2020.⁴ These numbers sharply rose to 488,482 cases (2.2% of the population) and 11,431 deaths (0.05% of the population) by 14 September 2021.⁵ Rising cases prompted a containment strategy (including contact tracing and quarantine measures, widespread movement restrictions, and periodic national lockdown style curfews), overwhelmed the public health system and precipitated an economic contraction. A delayed vaccination rollout meant that only 49.1% of the population had been double vaccinated by 14 September 2021.⁶ The pandemic external shock is like no other economic crisis that Sri Lanka has experienced in its 73 years of post-independence history. It also disrupted implementation of the ambitious policy agenda of President Gotabaya Rajapaksa's government as it scrambled to mitigate the challenges of a public health

¹ This paper is an output of a research project "Shaping the Macro-Economy in Response to Covid-19: A Responsible Economic Stimulus, a Stable Financial Sector and a Revival in Exports" undertaken by ODI and several think tanks with financial support from International Development Research Centre (IDRC), Ottawa, Canada. Thanks are due to Indrajit Commaraswamy, Arjan de Haan and Dirk Willem te Velde and ODI colleagues for comments; to Max Mendez-Parra for running simulations of FTAs; to Sherilyn Rega for collaborating on estimating fiscal multipliers; to Pabasara Kannangara and Chatuni Pabasara for research assistance; and to Sarah Hettiaratchi for desktop publishing. The views expressed here are solely mine.

² Sri Lanka temporarily attained upper-middle income status in 2019, before slipping back to lower middle-income status in 2020.

³ These include the lingering effects of a prolonged civil conflict (which ended in 2009), aid induced dutch disease, the 2004 Indian Ocean Tsunami, the 2008-2009 global financial crisis and a severe drought in 2016-2017.

⁴ This was of a 44- year-old Chinese woman from Hubei Province in China. The first wave dates to 10 March 2020 with the detection of an infected tour guide and cases rose thereafter.

⁵ <https://hpb.health.gov.lk/covid19-dashboard/>

⁶ https://www.epid.gov.lk/web/images/pdf/corona_vaccination/covid_vaccination_2021-09_14.pdf

emergency and an economic crisis. However, comprehensive analysis of the economic impact of the pandemic on the Sri Lankan economy and ways to build back better is lacking.

This paper assesses the macroeconomic impact of the pandemic on the Sri Lankan economy during the first 20 months or so with a view to exploring public policy choices to engineer economic recovery. It addresses three key questions: (1) how severe was the economic hit of the pandemic? (2) how effective was the Government of Sri Lanka's (GoSL) economic policy response? and (3) what are the effects of complementary policies that can lay the foundations for a better medium-term outlook? A variety of research methods are used.⁷ The first question is addressed by a simple before and after analysis of the economic effects of pandemic which looks at the behaviour of key economic variables during the period immediately preceding the baseline and comparing it with what has happened. The indicators include growth, exports, poverty, gender, climate change, public finance and external sector developments and the trade regime. A standard policy reform perspective is adopted to examine the second question. It critically analyses the measures adopted and forecasters views of the outlook. The third question is addressed using estimates of fiscal multipliers, model-based analysis of free trade agreements (FTAs) and exploration of the impact of FDI-led service sector transformation.

2. MAPPING THE ECONOMIC IMPACT OF COVID-19

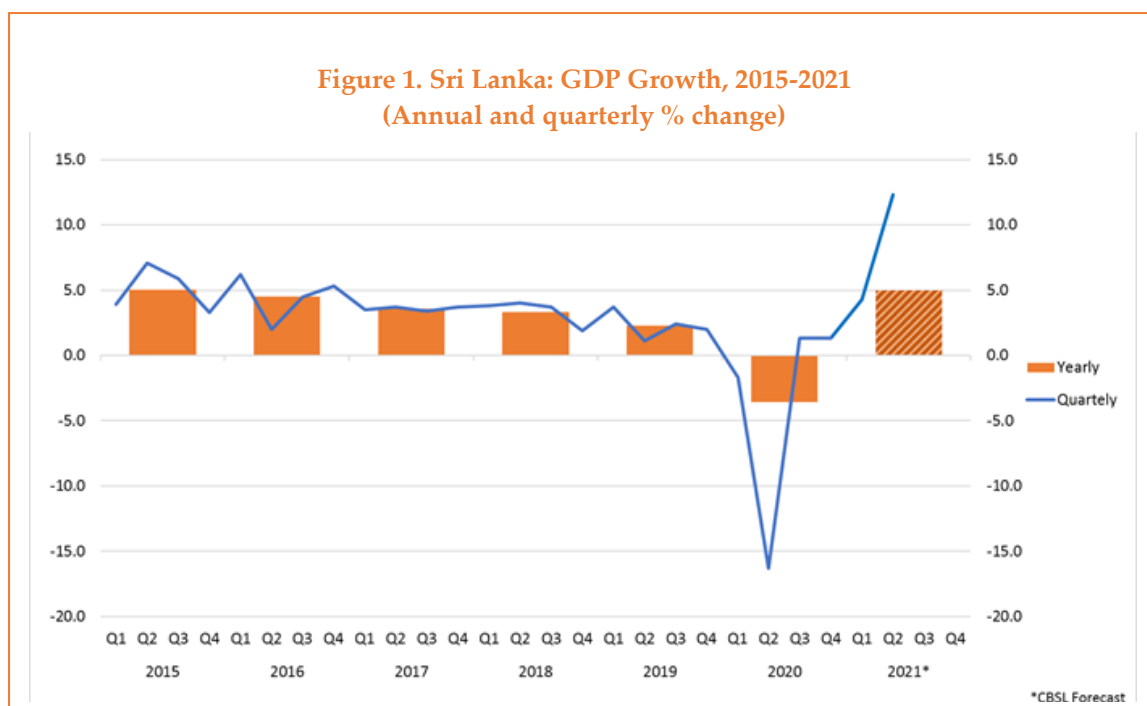
The impact of the pandemic in 2020 (the first full year of transmission) is compared with economic performance since the end of the 30-year civil in 2009. The baseline, representing the economic hit of the pandemic, is represented in seven stylised facts.

2.1 Sudden Contraction of Growth

The end of the conflict brought a so-called 'peace dividend' in the form of a significant pick-up with the economy growing at an average of 8.8% per year between 2010 and 2012 (see Fonseka *et al.* 2012). This was mainly driven by large infrastructure projects financed by foreign borrowing on commercial interest rates⁸, a recovery in the conflict-affected areas and contributions from the non-tradeable sector (e.g. construction, utilities and other services). However, the post-conflict boom was short-lived. Figure 1 shows annual and quarterly data on growth in Sri Lanka from 2015-2021Q2. Annual growth more than halved to 3.7% per year in 2015-2019 as the infrastructure projects moved through their factor-intensive construction phases and external shocks stifled economic activity (see Central Bank of Sri Lanka 2016, 2017, 2018 and 2019). A widespread drought caused negative agriculture growth in 2016 and 2017 and affected the economy. Growth continued to weaken in 2018 as tightening global financial conditions put pressure on the exchange rate, the country's sovereign rating was downgraded and a constitutional crisis affected business sentiment (see Feltman, 2019). Growth softened to 2.3% in 2019 as the Easter Sunday bombings impacted the tourism sector which reverberated throughout the economy and stifled confidence.

⁷ The research draws insights from the methodology paper for this project prepared by ODI with an emphasis on constructing policy scenarios to build back better from the pandemic See Keane *et al.* (2021).

⁸ These projects were mainly financed by China and included the US\$1.5 billion Southern Expressway project, a part of the US\$1.3 billion Norocholai Power Station, the US\$500 million CICT Colombo Port Terminal Project and the US\$190 million Hambantota International Airport. See Wignaraja, *et al.* (2020).



Sources: https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/publications/red/2020/Chapter_1_e.pdf, <https://www.cbsl.gov.lk/en/economic-and-statistical-charts/gdp-growth-chart> http://www.statistics.gov.lk/NationalAccounts/StaticInformation/Reports/press_note_2021q1_en

The pandemic and COVID-19 containment measures caused the worst contraction in the Sri Lanka's post-independence history with annual growth sliding to -3.6% in 2020. But the 2020 figure undershot the projections of some forecasters indicating the high uncertainty surrounding the behaviour of the economy.⁹ Quarterly data provide a granular analysis of the economic hit of the pandemic. Growth fell from 2.0% in 2019Q4 to -1.6% in 2020Q1 driven by weak performance of the construction, garments, tea and mining sectors. In 2020Q2 growth plummeted by -16.3% as a two-month island wide lockdown style curfew choked major economic sectors, the closure of the international airport stopped tourism and global demand remained weak. Thereafter, growth mildly recovered to 1.3% in 2020Q3 and 1.3% in 2020Q4 as the curfews were eased in May 2020, economic activities re-started and pent-up consumer demand was released.

Interestingly, the pandemic induced contraction of the economy appears to be short-lived. Growth picked up to 4.3% in 2021Q1 and accelerated to 12.3% in 2021Q2. This translates into the Sri Lankan economy growing at 8.0% during the first half of 2021. The growth in 2021Q2 was broad based across major sectors, supported by a strong showing in industry (12.1%), following agriculture (7.1%) and services (5.1%). The pick-up in economic activity reflects a strong base effect given the unprecedented contraction, pent up demand, easy credit on low interest rates and signs of increased exports. At the time of writing in September 2021 an issue being debated is whether the uptick represents a blip or a sustained COVID recovery. Macroeconomic forecasts for Sri Lanka from different institutions are assessed below.

2.2 Falling Export Value

Table 1 provides data on the values and shares in Sri Lanka's goods and services exports from 2018 to 2020. Sri Lanka's exports returned to some normalcy after the end of the conflict. The value of merchandise exports increased from US\$8.3 billion to US\$11.9 billion between 2010 and 2018. As a share

⁹ For example, World Bank (2020) projected that Sri Lanka's growth will contract by -6.7% in 2020.

of South Asia's merchandise exports, the increase was from 3.1% to 3.4% over the same period. Data on services exports have only recently become available from the Sri Lanka Export Development Board as services have been below the trade radar in Sri Lanka. Factoring in services exports suggests a value of goods and services exports of US\$15.9 billion in 2018 (up from US\$13.8 billion in 2015).

The export pattern reflects structural change in exports since the adoption of an outward-oriented development strategy in 1977 particularly a shift away from agricultural exports toward exports of labour-intensive manufactures and some services.¹⁰ In 2018, agricultural exports accounted for only about 16.2% of goods and services exports while manufactured exports made up 58.2% and services exports for another 25.3%. There was also a tiny mineral export sector. Goods and services exports have been dominated by the growth of single labour intensive manufacturing activity - textiles and garments (33.4%). Other notable exports include transport and logistics services (15.6%), tea (9.0%), ICT/BPM (6.5%) and rubber (5.5%).

The pandemic dampened exports through a fall in external demand and disruptions on the supply side due to movement restrictions and a shortage of imported inputs. Between 2019 and 2020, the value of goods and services exports fell by as much as 17.4% to US\$13.1 billion, which is less than its value in 2015. This was driven by large falls in the value of manufactured exports (-18.3%) driven by dropping values of textile and garments exports (-21%) and services exports (-22.8%). Meanwhile, the value of agricultural exports recorded a smaller decline (-7.8%) linked to a fall in tea exports while rubber exports increased. In terms of export shares, between 2019 and 2020, agricultural exports increased from 15.6% to 17.9% but manufactured exports fell from 59.6% to 58.9% and services exports declined from 24.6% to 22.9%.

It is worth noting that the fall in external demand for exports reflects a high degree of market concentration of Sri Lankan exports (such as textiles, garments and tea) and the global impact of the pandemic. There were large declines in Sri Lanka's merchandise exports to the EU and US - which together account for over half of Sri Lanka's merchandise exports. Between 2019 and 2020, the value of Sri Lanka's merchandise exports to the US fell by -20.4% (to US\$2.5 billion in 2020) while merchandise exports to the EU fell by -10.6% (to US\$ 3.2 billion). Exports to regional Asian markets also declined. India and BIMSTEC as a grouping (which accounted for 6.4% of 8.8% of Sri Lanka's merchandise exports) saw declines of -21.1% and -22.4%. Meanwhile, exports to China (which only accounted for 2% of Sri Lanka's merchandise exports) fell by -6.3%.

There are early signs of a pick-up in Sri Lanka's merchandise exports from the pandemic. The most recent data from the Central Bank of Sri Lanka indicate that value of merchandise exports increased by 22.6% between January-August 2020 and January-August 2021 to reach US\$ 7.9 billion.¹¹ Although there has been a pick up, the 2021 exports value may not return to the pre-pandemic level of 2019 which was weighed down by the effects of the Easter Sunday bombings (see Table 1). A lack of data on services exports means that it is not possible to compute the value of goods and services exports for January to August 2021.

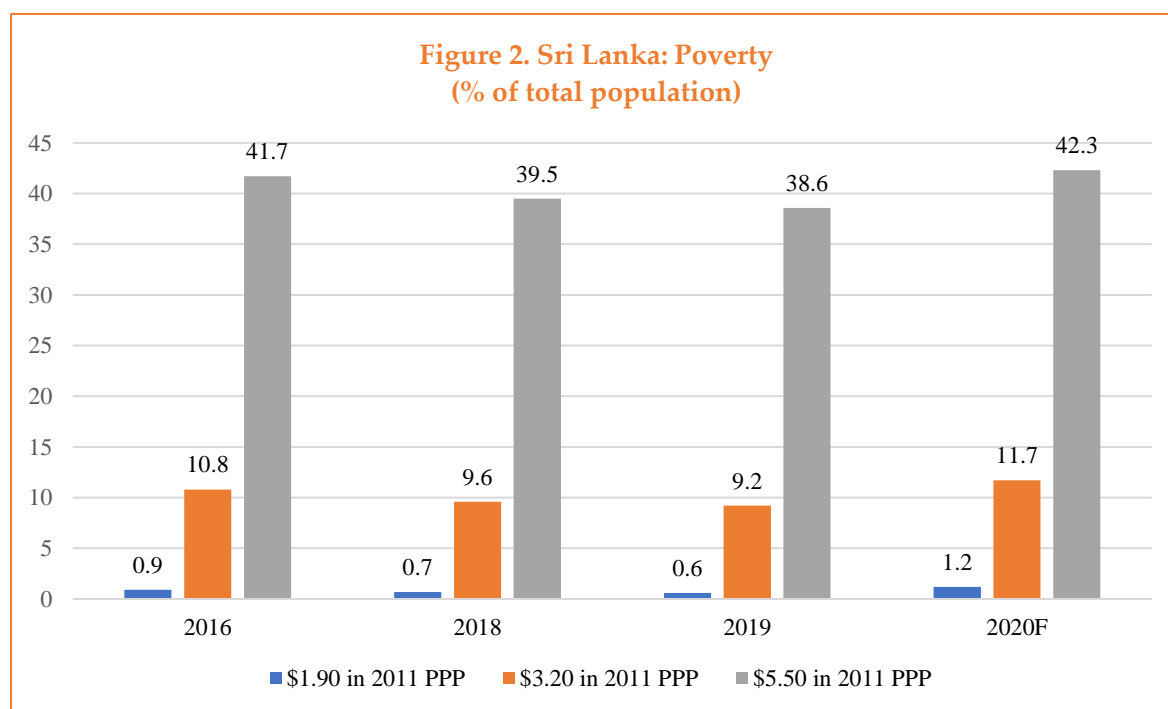
2.3 Rising Poverty

Figure 2 shows income poverty for 2016 and estimates from 2018-2020 under various World Bank's international poverty lines. Growth and various social protection programmes have contributed to reducing poverty in Sri Lanka since the end of the conflict. Extreme poverty was at a historic low of 0.9% in 2016. However, stubborn poverty pockets meant that a significant share of the population remains vulnerable to poverty. Using the US\$3.20 a day poverty line typically found in lower-middle-

¹⁰ For detailed analysis of structural change in Sri Lanka's exports see Wignaraja (1998 and 2008), Dheerasinghe (2009), Kelegama (2009) and Wignaraja and Huttemann (2020).

¹¹https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/press/pr/press_20211019_external_sector_performance_August_2021_e.pdf

income countries, suggests that 10.8% of the population lived in 2016 while the US\$5.50 a day poverty line (representative of upper-middle income countries) suggests that poverty affects as much as 41.7% of the population.



Source: World Bank, <https://data.worldbank.org/indicator/SI.POV.NAHC?locations=LK> (04 February 2021), World Bank, <https://openknowledge.worldbank.org/bitstream/handle/10986/34517/9781464816406.pdf?sequence=7&isAllowed=y> (04 February 2021), <https://www.worldbank.org/en/news/press-release/2021/04/09/sri-lankan-economy-recovers>

National poverty data suggest that a rural-urban divide in Sri Lanka’s poverty profile. The poverty head count index for 2016 (Department of Census and Statistics, 2017) shows that on average poverty was highest in the estate sector, (8.8%), more than double the average for rural areas (4.3%) and more than four times the average for urban areas (1.9%). Moreover, pockets of severe poverty exist in former conflict areas of the North and East provinces as well as isolated areas like Sabaragamuwa province in the South.¹² Meanwhile, the Western province which contains the capital city of Colombo and much of the country’s manufacturing and service activities records the lowest poverty head count index.

Sri Lanka has suffered significant loss of incomes and jobs due to the pandemic (see Hadad-Zervos, 2020). The export-oriented garment sector, which employs about half a million workers, has seen significant layoffs. Tourism, an increasing contributor to growth and employment since the end of the conflict, has been badly affected, just as it was recovering from the Easter bombings in 2019. Although workers in major sectors have been affected, daily-wage earning informal sector workers, who account for nearly three-quarters of the labour force, could be the hardest hit. Looking at the so-called middle-income poverty line (poverty at US\$3.20 a day) World Bank estimates suggest that poverty could increase from 9.2% to 11.7% between 2019 and 2020. Accordingly, an additional half a million people in Sri Lanka, largely in urban areas and the informal sector, could become ‘new poor’ due to the pandemic. Household survey evidence suggests the pandemic could negatively affect family

¹² For a before and after conflict multidimensional poverty analysis of Sri Lanka see Mahadevan and Jayasinghe (2020). They find that geographic pockets of multidimensional poverty exist and efforts to improve regional balance are necessary for sustainable inclusive growth to ensure that no one is left behind.

welfare including income, food consumption and health.¹³ With poverty at US\$5.50 a day also likely to increase to 42.3% and extreme poverty at US\$1.90 a day to 1.2% in 2020, a part of Sri Lanka's past success in reducing poverty could be reversed by the pandemic.

2.4 Gender Gaps in the Workforce

In the late 1970s, Sri Lanka had favourable initial conditions by South Asian standards to propel rapid economic development. These include the highest human development indicators in South Asia through significant social spending, early adoption of an outward-oriented development strategy which enticed export-oriented foreign direct investment (FDI), a strategic location in the Indian Ocean which facilitated port development and exceptional tourism assets (Sen, 1988; Kelegama, 2000; Wignaraja, 1998 and 2019). Structural change over several decades had created an economy anchored on a manufacturing sector dominated by labour-intensive garment exports and an expanding service sector. Yet national economic development has disappointed. Sri Lanka was classed as a low middle-income country in 2020 – a status which it attained in the late 1990s.¹⁴ Growth has slowed and fallen below others in South Asia. The narrow base of industrial and export growth has raised concerns about its sustainability (Wignaraja, 1998; Kelegama, 2009). There are signs of gender gaps in the work force and environmental risks (Gunawardena, 2015; World Bank and ADB, 2020). Sri Lanka's development record can partly be attributed to the economy's vulnerability to external shocks¹⁵ compounded by the effects of inadequate management of macroeconomic and trade policy on macroeconomic aggregates (White and Wignaraja, 1992; Stiglitz, 2016; Thenuwara, 2019). The country has suffered from twin fiscal and balance of payments deficits as well as a restrictive trade regime (Pursell and Zialul Ahsan, 2011; World Bank, 2017; Weerakoon, Kumar and Dime, 2019).

Table 2 provides data on labour force participation rates and unemployment rates for males and females between 2015 and 2020. In line with global trends, female labour force participation rates in Sri Lanka has seen a modest rise since the end of the conflict. The female labour force participation rate reached 35.4% in 2016 and stabilised at 34.5% in 2019. Although such rates are half those of male labour force participation rates (above 70% since 2015), they are above the South Asian average figure of only 23.6%.¹⁶

Modest progress in female labour force participation in Sri Lanka is associated with better educational attainments of females compared to males. Female secondary school enrolment rates (102.6%) are slightly higher than that of males (98.0%) in 2018 but female tertiary enrolment rates (26.0%) are much higher than that for males (16.2%) in 2019.¹⁷ Nonetheless, it is apparent that the impressive rise in female education is not being fully translated into labour market gains.¹⁸ Furthermore, women's employment is typically concentrated in low growth, low productivity sectors and the gender wage gap is sticky. There is also little evidence of progression in the formal private sector where women only make up 8.5% of the board-level positions of companies listed on the Colombo Stock Exchange in 2018 compared with 8.2% in 2017 (IFC, 2019). Gunawardena (2015) investigates the mismatch between high female education and low labour market participation rates in

¹³ A UNICEF/UNDP telephone survey in 2020 reported that 71% of a sample of 2,067 households covering all districts of Sri Lanka had experienced either a total or partial loss in income. Moreover, 30% of the respondents were cutting their food consumption and switching to cheaper less nutritious foods. This could cause serious health problems such as stunting or wasting and hamper child development. See Kidd *et al.* (2020).

¹⁴ Sri Lanka temporarily attained upper-middle income status in 2019, before slipping back to lower middle-income status in 2020.

¹⁵ These include the lingering effects of a prolonged civil conflict (which ended in 2009), aid induced dutch disease, the 2004 Indian Ocean Tsunami, the 2008-2009 global financial crisis and a severe drought in 2016-2017.

¹⁶ <https://www.worldbank.org/en/events/2020/02/18/south-asia-women-in-the-workforce-week#:~:text=Women%20in%20South%20Asia%20continue,%25%20versus%2080%25%20for%20men.>

¹⁷ <https://databank.worldbank.org/source/world-development-indicators>

¹⁸ Sri Lanka's female labour force participation rates lag the 50% average figure achieved by OECD economies with high female education attainments.

Sri Lanka using survey data and highlights the influence of labour market discrimination and cultural issues. She concluded that the labour market treats men and women with the same skills differently and that for women being married and having young children reduces the probability of paid employment significantly.

The pandemic had an adverse impact on women's employment. As Table 2 shows, female labour force participation rates fell from 34.5% to 32.1% between 2019 and 2020 indicating a higher rate of women opting out of the workforce than men and a reversal in previous gains.¹⁹ Several major groups of women have experienced some impact including working mothers, women in senior management and ethnic minorities. A recent survey shows that women have felt heightened pressures during the pandemic from balancing the demands of work-related tasks (often through shift work or teleworking) with household chores and home schooling of children (see IFC, 2020). This caused exhaustion and mental health issues, leading to some women to dropping out of the work force. An added challenge is that women are more at risk of losing their jobs than men with female unemployment rates rising from 7.4% to 8.5% between 2019 and 2020 (see Table 2).

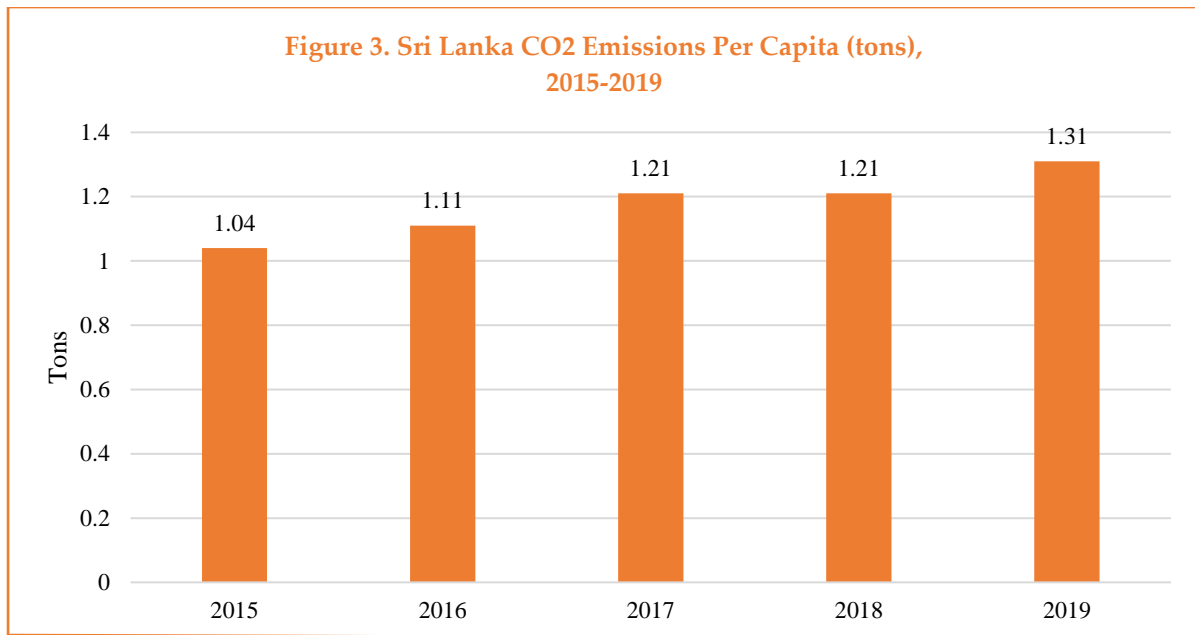
2.5 Climate Risks

There is growing recognition of climate risks facing Sri Lanka. One issue is a unique combination of natural features which have made Sri Lanka vulnerable to the effects of climate change. These include high temperate, a complicated hydrological regime and exposure to extreme climate events. Considering these natural features, recent estimates by World Bank and ADB (2020) indicate that Sri Lanka's temperate could rise by 2.9C to 3.5C by 2090s under a high emissions pathway over a 1986-2005 baseline and by 0.8C to 1.2C under a low emissions pathway (World Bank and ADB, 2020). Although Sri Lanka's temperature rises are marginally less than global figures, the study suggests minimum temperatures could rise faster than average temperatures and Sri Lanka faces the threat of a five-fold increase in the number of days of extreme heat (defined as more than 35 C).

Another issue is that Sri Lanka's greenhouse gases emissions - arising from man-made activities like the burning of fossil fuels and the manufacture of cement - are rising. Figure 3 shows Sri Lanka's energy related CO₂ emissions per capita have nearly doubled from a low base since 2010 to reach an estimated 1.3 metric tonnes in 2019. Nonetheless, Sri Lanka's CO₂ emissions per capita are below the South Asian average of 1.6 metric tonnes per capita and India's figure of 1.8 metric tonnes per capita.²⁰ Although no official data are available, it is likely that the island wide lockdown style curfew and the closure of businesses and schools during the pandemic led to a reduction in Sri Lanka's CO₂ emissions per capita in 2020.

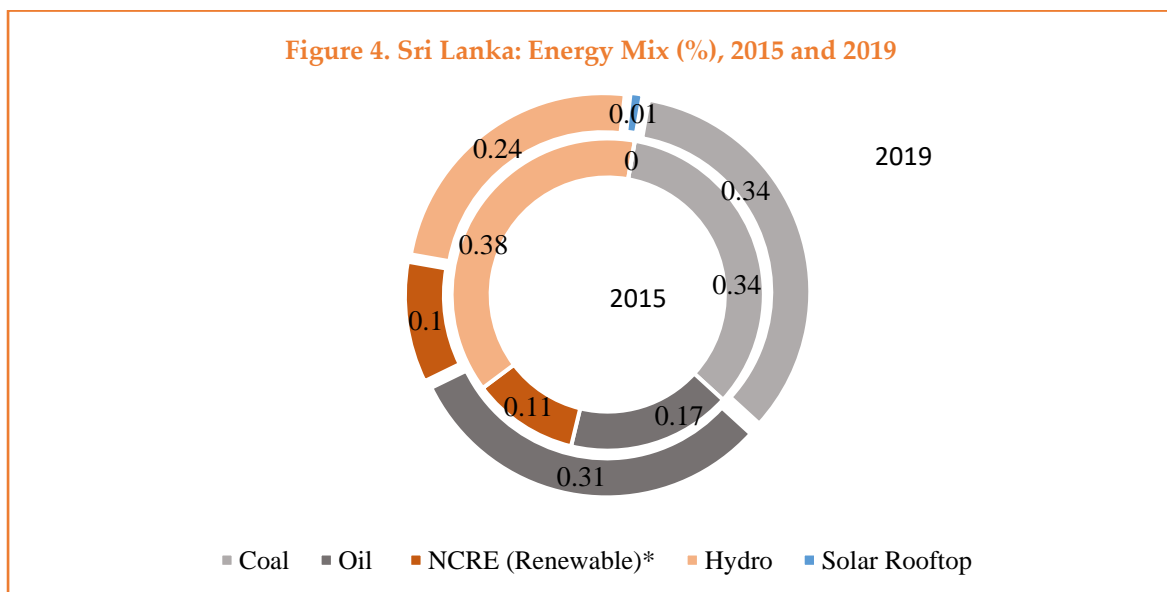
¹⁹ As Table 2 shows male labour force participation rates fell more moderately during the pandemic from 73.0% to 71.9% between 2019 and 2020.

²⁰ <https://data.worldbank.org/indicator/EN.ATM.CO2E.PC?locations=8S>



Sources: <https://knoema.com/atlas/Sri-Lanka/CO2-emissions-per-capita>

Furthermore, Sri Lanka has been relatively slow to shift towards green energy. As Figure 4 shows Sri Lanka has actually increased its reliance on fossil fuels (particularly oil) in its total energy mix from 51% to 65% between 2015 and 2019. Meanwhile, the share of renewables in the total energy mix fell from 49% to 35% over the same period. The sources of non-renewable energy are hydroelectric power (24%), non-conventional renewable energy²¹ (11%) and negligible shares of roof top solar.



Notes: NCRE- Non-Conventional Renewable Energy (Mini-hydro, Solar, Wind and Biomass)

Sources: <https://www.parliament.lk/uploads/documents/paperspresented/performance-report-ministry-of-power-renewable-energy-2015.pdf>

²¹ These include mini hydro, solar, wind and bio mass.

Composite indices show Sri Lanka's positioning on the global spectrum of climate risks. The 2018 ND-GAIN Country Index of the University of Norte Dame's Global Adaptation Initiative ranks Sri Lanka as 103rd out of 181 countries.²² This Index summarises a country's vulnerability to climate change and other global challenges in combination with its readiness to improve resilience. Sri Lanka is the 60th most vulnerable country in the dataset and the 92nd least ready country. Accordingly, Sri Lanka is deemed "being on the road to responding effectively to climate change but the adaptation needs and urgency to act are greater".

2.6 Worsening Macroeconomic Imbalances

Sri Lanka's macroeconomic environment in the post-conflict period has been characterized by notable macroeconomic volatility. Sri Lanka has been referred to a classic twin deficit economy, with strained fiscal positions and fragile trade deficits, which indicate major economic imbalances (see Weerakoon, Kumar and Dime, 2019). The past decade saw a familiar pattern of a boom and bust economic cycle leading to a balance of payments crisis and a recourse to an IMF programme. The previous coalition government sought an IMF programme in June 2016 under the Extended Fund Facility amounting to US\$1.5 billion in a bid to avert a balance of payments crisis. It was subject to the conditionality that Sri Lanka would implement stabilisation measures, including streamlining the tax system and reducing a large fiscal deficit. However, the IMF Programme prematurely ended in November 2019 with the election of a new government.

Summaries of fiscal sector performance are provided in Table 3. The data show Sri Lanka's mixed record of reducing fiscal deficits and improving revenue generation under the IMF programme. Public expenditure (as a % of GDP) fell from a peak of 20.9% to 18.7% between 2015 and 2018. Overextended public expenditure reflects a combination of populist expansionary spending, a legacy of a welfare state, investments in 'white elephant' projects, a large public sector and poor performance of state-owned enterprises (SOEs). However, revenue generation has typically lagged spending. Revenue generation (as a % of GDP) showed a brief uptick from 13.3% to 14.1% between 2015 and 2016, but fell back to 13.5% in 2018. Weaknesses in revenue collection can be attributed to a limited tax base, a proliferation of tax holidays and other fiscal incentives for investors, and poor tax administration.

The pandemic significantly worsened Sri Lanka's public finances. Preliminary estimates indicate that public expenditure is likely to have fallen from 22.2% to 20.3% between 2019 and 2020 as government scrambled to put in place measures to mitigate the effects of the economic collapse. Revenue generation is likely to have fallen from 12.6% to 9.2% due to a reduction in economic activity, job losses and income tax cuts implemented in December 2019. Accordingly, the modest improvement in the overall fiscal balance between 2015 and 2018 (from -7.6% to -5.3%) is likely to have been reversed between 2019 and 2020 (from -9.6% to -11.1%).

Summaries of external sector performance are shown in Table 4. Sri Lanka's balance of payments difficulties in the post-conflict period largely stem from weak balance of trade deficits which widened significantly from -\$8.4 billion to -\$10.3 billion between 2015 and 2018. This indicates a high marginal propensity to import to meet its requirements in both consumption and investment partly reflecting the country's dependence on petroleum imports for its energy supply and a limited industrial base. Lacklustre export expansion is symptomatic of limited diversification in the export structure dominated by a few primary commodities (e.g. tea, rubber and coconut products), garments and services. Non-debt creating financial flows (such as worker remittances, tourism earnings and, to a lesser extent, volatile FDI inflow) were considered means to offset the trade balance deficit. However, the current account deficit increased from -2.3% to -3.2% of GDP between 2015 and 2018 indicating that such flows were insufficient.

²² <https://gain.nd.edu/our-work/country-index/rankings/>

Some aspects of the external sector were hard hit during the pandemic. Merchandise exports were affected by subdued external demand and supply restrictions while tourism earnings collapsed due to halting inbound tourism and the closure of the airport. Remittances held up well linked to workers repatriating their savings before returning home and assisted in maintaining external sector stability. A fall in imports associated with the imposition of import controls and increased remittances have prevented the current account from worsening significantly. The current account deficit actually fell somewhat from -2.2% of GDP to an estimated -1.3% between 2019 and 2020.

However, a particularly worrying development is adverse debt dynamics during the pandemic which could see Sri Lanka positioned as the most indebted country in South Asia. Public debt (as a % of GDP) rose from 85.3% to 92.2% between 2015 and 2018 (see Table 3). Associated with the pandemic shock, this figure is likely to rise sharply from 94.3% to a historic high of 109.7% between 2019 and 2020, thereby exceeding threshold identified in the Reinhart and Rogoff (2010) cross-country findings on the relationship between debt and growth.²³

Sri Lanka faces an increasingly difficult external debt repayment situation linked to the pandemic shock. Gross external debt to GDP ratios increased sharply from 59.2% to 65.3% between 2018 and 2019 before moderating to 60.9% in 2020 (see Table 3). But the external debt ratio in 2020 is not comparable with the earlier data as the Central Bank reclassified domestic holdings of international sovereign bonds (e.g. by banks) as domestic debt while a collapse in secondary market prices of bonds also reduced external debt due to accounting treatment.²⁴ Nonetheless, Fitch (2020) estimates that Sri Lanka has large public external debt obligations of \$23.2 billion between 2021 and 2026 (or about \$4 billion a year). This can be only barely covered by shrinking gross foreign exchange reserves which fell between 2019 to 2020 (see Table 4). Fitch argues that Sri Lanka's sovereign financing and debt service challenges are aggravated by its approach to managing public finances which have caused a high general government interest to revenue ratio averaging 50% from 2016 to 2020.²⁵

2.7 A Restrictive Trade Regime

Sri Lanka was the first economy in South Asia to shift away from inward to outward-oriented trade policies as early as the late-1970s. In 1977 Sri Lanka opened to export-oriented FDI and began a gradual trade liberalization programme which created South Asia's most open economy in the early 1980s (Wignaraja, 1998).²⁶ But trade liberalization efforts waned after facing difficulties in reducing the dispersion of protection among industries (Abeyratne, 1993). Studies argue that reversals in trade liberalization since the mid-2000s produced an anti-export bias in the trade regime as indicated by a halving of the trade to GDP ratio to 48% in 2016 and a lack of export diversification (Pursell and Ahsan, 2011; World Bank, 2017). The introduction of para-tariffs during 2006-2015 significantly increased nominal protection rates making the trade regime more complex and distorted than before. The dispersion of para-tariffs led to prices that distorted production and consumption patterns. The domestic agricultural sector has been afforded particularly high and variable tariffs and fertilizer subsidies to support the expansion of import-competing production. Para-tariffs have also raised trade costs and makes it more difficult for business to access imported inputs which hampers their ability to join global value chains.

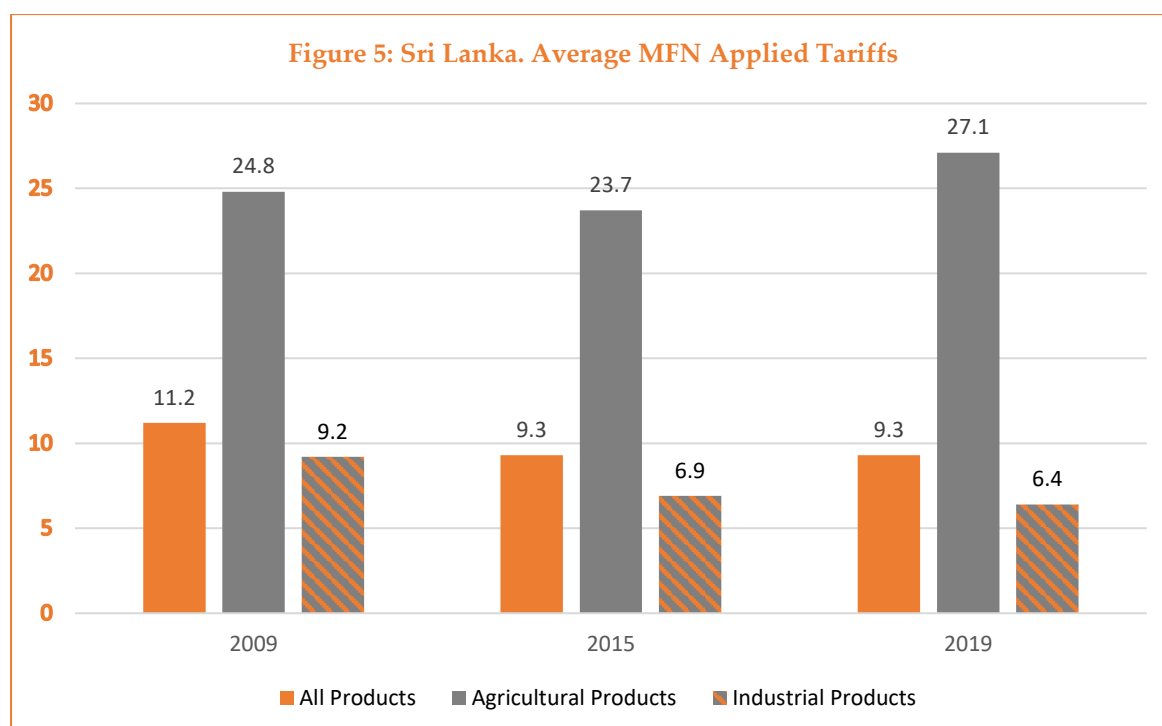
²³ Reinhart and Rogoff (2010) argue that above the threshold debt to GDP ratio of 90%, median growth rates fall by 1%, and average growth falls considerably more. Although this study has been criticised empirically in the literature, it provides a preliminary look at the relationship between debt and growth.

²⁴ <https://economynext.com/sri-lanka-reclassifies-some-sovereign-bonds-as-domestic-debt-81592/>

²⁵ However, period averages can be misleading. Sri Lanka's interest cost to revenue ratio reached an unprecedented level of 71.7% in 2020, one of the highest globally. This reflects the tax cuts in 2019 and the contraction in economic activity. <https://publicfinance.lk/en/topics/Sri-Lanka-Pays-the-Largest-Proportion-of-Its-Revenue-as-Interest-Payment-1630990058>

²⁶ The 1977 reforms included removal of quantitative restrictions and their replacement by a system of tariffs, ending of the public sector import monopoly, and a unified floating exchange rate.

The most recent tariff data broadly support the argument made in Pursell and Ahsan (2011) and World Bank (2017) that Sri Lanka's trade regime remains quite restricted in spite of having been a regional pioneer in trade liberalization. Figure 5 provides simple average unweighted MFN (most-favoured-nation) applied tariffs for Sri Lanka in 2009, 2015 and 2019. Between 2009 and 2015, Sri Lanka's average MFN tariffs for all products fell slightly from 11.2% to 9.3% and remained at 9.3% in 2019. Sri Lanka's average MFN tariffs for all products in 2019 is only slightly lower than the average figure for South Asia (11.0%). Furthermore, sensitive agricultural products enjoy higher tariff protection than industrial products. Average MFN tariffs on agricultural products (27.1%) in Sri Lanka are over four times higher than that for industrial products (6.4%). In addition, the majority of agricultural products (68.3%) seem to enjoy MFN tariffs in excess of 15%.



Sources: WTO World Tariff Profiles,

https://www.wto.org/english/res_e/booksp_e/tariff_profiles10_e.pdf,

https://www.wto.org/english/res_e/booksp_e/tariff_profiles17_e.pdf,

https://www.wto.org/english/res_e/booksp_e/tariff_profiles20_e.pdf

3. ASSESSING THE COVID ECONOMIC POLICY RESPONSE

In an attempt to limit the economic fallout from the pandemic, the GoSL deployed a set of macroeconomic and other policies. Table 5 summarizes key policies and outcomes under: (1) fiscal policies; (2) monetary and macro-financial policies; (3) exchange rates and balance of payments policies; (4) policies for exports, FDI and tourism; and (5) other measures. The discussion below assesses the effectiveness of these policies.

A subdued fiscal policy response. As discussed above, Sri Lanka entered the economic crisis with weak macroeconomic conditions of high fiscal deficits, limited reserve buffers and adverse external debt dynamics. At the policy level, this has translated into a lack of fiscal space to mount an effective fiscal stimulus of the scale visible in other regional economies. Instead, the GoSL adopted a limited fiscal measure with a relatively small resource envelope to deal with the economic effects of the

pandemic. Key measures include small cash payments for vulnerable groups²⁷ amounting to 0.6% of GDP in 2020 and 0.1% from January to June 2021, an allocation of 0.1% of GDP for COVID containment measures, setting up a special fund through private donations for tackling COVID and tax relief measures for affected individuals and SMEs. With fiscal policy not in the equation, the GoSL turned to other policies to support the economy.

Unprecedented monetary policy easing by the Central Bank of Sri Lanka. At the onset of the crisis in Sri Lanka in early 2020, the GoSL directed the Central Bank to relax its monetary policy stance to unparalleled levels in an attempt to revive the economy affected by the pandemic. The radical change in monetary policy was made possible as the Central Bank is a semi-autonomous state body governed by a Monetary Board (whose members are appointed by the President of Sri Lanka) and falls under the administrative purview of the Minister of Finance. The Central Bank reduced its monetary policy rates several times, made liquidity available to the financial system, and relaxed its regulatory forbearance rules thereby enabling banks and non-bank financing institutions²⁸ to do more (e.g. debt moratoriums and guarantees to key sectors, concessional loans for SMEs, ceilings on some interest rates and re-scheduling of non-performing loans). Amidst a muted fiscal stimulus, monetary easing was successful in some downward adjustment of lending rates, increasing liquidity to the banking system and boosting private sector credit.²⁹ For instance, average lending rates on outstanding bank loans fell from 13.6% to 9.4% between the end of 2019 and August 2021. This is equivalent to a reduction in real lending rates from about 9.3% to about 5.1% over the same period.³⁰ The fall in interest rates is likely to support domestic investment, production and consumption in the economy. Bank credit to the private sector also nearly doubled from Rs.131 billion to Rs.257 billion between 2019 Jan-Oct and 2020 Jan-Oct.

However, monetary easing poses two potential drawbacks to the economy. The first is the pick-up in private sector credit could lead to inflationary pressures. Net repayments to the private sector between June to August 2020 enabled the government to borrow. Once private sector recovers to normal levels, inflationary pressures could emerge in the economy. However, inflation (measured by the CPI) was low at 4.3% in both 2018 and 2019 and increased only slightly to 4.6% in 2020 before falling back to 4.3% in August 2021. With inflation is not considered to be a risk in the short-term, the Central Bank is looking to revive economic growth rather than targeting inflation.

Second, risks to financial stability could arise from the relaxation of regulatory forbearance rules on financial institutions (particularly debt moratoriums and guarantees to key sectors and rescheduling of non-performing loans). The ratio of non-performing loans to equity capital and reserves of the banking sector rose from 31.1% to 35.7% between 2019Q1 and 2020Q4. Meanwhile, the ratio of gross non-performing advances to total advances for non-bank financing institutions nearly doubled from 7.7% to 13.9% between March 2019 and December 2020. Although on the rise, the figures appear somewhat low and manageable. However, the full picture of the non-performing loans of banks and non-bank financial institutions will not be known until the debt moratoria on several sectors are ended and the data are available. Even then the picture may remain unclear as moratoriums for tourism and construction have been further extended. In this vein, major banks, with sufficient asset quality and liquidity buffers, are unlikely to face financial difficulties. But, some weaker non-bank financial institutions may face challenges.

²⁷ The GoSL issued an interest free advance of Rs. 10,000 to all low-income households (Samurdhi beneficiaries and Samurdhi card holders) and vulnerable families, registered senior citizens, disabled persons etc during the initial lockdown in March 2020. The GoSL also allocated Rs. 400 Mn to distribute Rs. 5,000 each to those who have lost their incomes due to curfews in particular districts due to the COVID-19 pandemic during the second wave in October 2020.

²⁸ Licensed financing companies and specialised leasing companies.

²⁹ Abeygunawardena, Amarasekara and Tilakaratne (2017) argue that there is a strong transmission of policy rate shocks onto money market rates and government securities in Sri Lanka. But the effect is a smaller and slower effect on banking sector interest rates. They attribute weak transmission to a large informal economy, under-developed financial markets and rigidities in the banking sector.

³⁰ These were estimated using annual CPI inflation rates for 2019 and 2020 from the Central Bank (2021).

Import suspensions were imposed on non-essential goods. In March 2020, the GoSL announced that it was imposing temporary import suspensions on a range of goods deemed ‘non-essential imports’ with immediate effect. The growing list of restrictions over the last year cover a diverse list of imports including motor vehicles, tiles, apparel, cosmetic products, food items, liquor and chemical fertilisers. The original rationale for this temporary measure was to avert a foreign exchange crisis in response a sudden fall in foreign currency earnings in key COVID affected sectors like exports, remittances and tourism. Subsequently, with the measures spilling over into 2021, import controls were justified as a tool to promote an import substituting, production-oriented economy.

As mentioned above, the import suspensions contributed to a fall in the current account deficit between 2019 and 2020. A key aspect was a fall in the balance of trade deficit by about US\$2 billion over the same period due to the decline in imports (see Table 4). Vehicle imports fell by 65.3%, transport equipment by 41.6% and fuel by 34.7% between January to December 2020. With import suspensions helping to ease balance of payments pressures during 2020, the measure may seem partially successful. But such success was short-lived. The monetary stimulus measures increased the supply of cheap credit to business and led to increased imports since mid-2020.³¹ With spending on imports dwarfing the growth in export earnings, the trade deficit continued to widen during Jan.-Aug. 2021 compared with Jan.-Aug. 2020 (see Table 4).

Nonetheless, import suspensions pose two potential drawbacks to the economy.³² The first is prolonged protection could misallocate resources and hinder exporting activities. Anecdotal evidence suggests that the import suspensions did not necessarily conserve foreign exchange as hoped. For instance, the garment industry, Sri Lanka’s dominant manufactured export for decades, is quite well integrated into global supply chains and imports a significant proportion of intermediate inputs partly due to the lack of a domestic textile and accessories industry. The sudden application of import suspensions in March 2020 disrupted supplies of intermediate goods and hurt garment exporting firms. Following intense lobbying by the Joint Apparel Association Forum Sri Lanka (JAAFSL), some import restrictions on intermediate goods imports were relaxed in June 2020. Furthermore, as discussed in the previous section, the economy is characterised by notable and variable tariff protection for reasons unrelated to any apparent economic logic. Excessive protection sheltering domestic producers behind high tariffs, augmented by COVID-induced import suspensions, could have created a cost structure which discourages diversification of manufacturing for export beyond garments to the rest of the world. It is also possible that such protection combined with unprecedented financial loans and guarantees could lead to the establishment of small and inefficient enterprises that only serve the domestic market. It is possible that there are also some upsides to the import suspensions. For instance, suspending food imports may stimulate domestic agricultural production thereby contributing to food security amidst rising COVID-induced income poverty. The debate on the effectiveness of import suspensions is likely to continue for some time. More micro-level evidence needs to be collected to verify the different economic effects of the import suspensions in Sri Lanka.

Second is the risk of violating World Trade Organisation (WTO) rules and inviting retaliation from trading partners. Under WTO rules, members facing balance of payments difficulties are permitted to apply temporary restrictive import measures but these measures must be consistent with the rules of the multilateral trading system. In essence, trade restrictions used for balance of payments reasons have

³¹https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/press/pr/press_20210819_Monetary_Policy_Review_No_6_2021_e_J72sp.pdf Total merchandise imports increased by 30.7% between Jan.-Aug. 2021 compared with Jan.-Aug. 2020.

https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/press/pr/press_20211019_external_sector_performance_August_2021_e.pdf

³² Urwin (2020) reviews the rise and fall of import substitution as a strategy for economic development. Wjesinghe (2021) discusses the costs of the import suspensions in Sri Lanka.

to be temporary, price-based, administered in a transparent manner and avoid sectoral specificity.³³ WTO members are also obliged to immediately follow a process of consultations with the WTO Committee on Balance of Payments Restrictions. In this vein, the GoSL may not have complied with its WTO obligations. For instance, the import suspensions may not be considered temporary as they have been in effect for over a year, they are quantity rather than price based (e.g. imports of all motor vehicles are banned for two years) and they are being administered in an opaque and *ad hoc* manner. In addition, it appears that the WTO Committee on Balance of Payments Restrictions has not been notified of the application of these import restrictions. Major trading partners have expressed public concerns as a possible prelude to retaliation (e.g. through imposing bilateral tariffs or invoking the WTO's Dispute Settlement Mechanism). For instance, the European Union and several European Embassies in a joint statement issued in November 2020 said that 'a prolonged import ban is not in line with World Trade Organisation regulations'.³⁴ Also, during a webinar in March 2021, the Japanese Ambassador opined that the ban on vehicle imports from Japan was not a good move for bilateral relations.³⁵

Reliance on currency swaps and loans for external debt management. Rising debt levels, particularly external debt denominated in US\$, has increased market uncertainty about Sri Lanka's foreign exchange reserve dynamics. With unfavorable credit ratings inhibiting the issuance of international sovereign bonds, the Central Bank of Sri Lanka has used the few other options to obtain foreign currency to boost the country's foreign exchange reserves while making external debt repayments.

One option is bilateral currency swaps with the Central Bank's counterparts in regional economies. The existence of such a line can improve market sentiment even if actual utilization is limited. Market players look favourably on swap agreements because they signify a source of foreign exchange liquidity and support from a major regional central bank. Three swaps were concluded. In July 2020, The Reserve Bank of India extended a currency swap under the SAARC framework amounting to US\$400 million and there are on-going talks for another bilateral currency swap for \$1 billion. In March 2021, a bilateral currency swap was extended by the Peoples Bank of China for CNY10 billion (about \$1.5 billion). In May 2021, the Bangladesh Bank approved a bilateral currency swap of \$200 million.

Another option is foreign borrowing with a two-tranche loan obtained from China Development Bank for \$1 billion of \$500 million in March 2020 and \$500 million in April 2021. In a rare stroke of fortune, a third option of a one-off SDR allocation of US\$780 million from the IMF - under a \$650 billion initiative to boost reserves of all IMF Members and help global recovery – was received in August 2021.

The data suggest, however, that these options had limited success in enhancing Sri Lanka's foreign exchange reserves. Gross official reserves fell from US\$5.7 billion to US\$4.1 billion (i.e., from 4.2 months of import cover to 2.6 months) between December 2020 and June 2021. After an International Sovereign Bond of \$1 billion was paid in late July 2021, reserves declined to US\$2.8 billion (import cover of 1.8 months)³⁶ and rose to US\$3.5 billion at the end of August 2021. The rise reflected the receipt of the IMF's SDR allocation and the initial disbursements under the Bangladesh Bank swap. However, the respite was temporary. Partly linked to rising world prices for petroleum imports, Sri Lanka's reserves fell to a new low of \$2.6 billion at the end of September 2021 (import cover of about 1.6 months).³⁷

³³ The provisions governing the rights and obligations of WTO members using import restrictions for balance of payments purposes are Article XII, XVIII:B and the "Understanding of the Balance-of-Payments Provisions of the GATT 1994". For details see https://www.wto.org/english/tratop_e/bop_e/bop_info_e.htm

³⁴ https://eeas.europa.eu/delegations/sri-lanka_en/88931/Joint%20Statement

³⁵ <http://www.sundaytimes.lk/210321/business-times/ban-on-vehicle-imports-from-japan-not-a-good-move-says-japanese-ambassador-436631.html>

³⁶ https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/press/pr/press_20210819_Monetary_Policy_Review_No_6_2021_e_J72sp.pdf

³⁷ https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/statistics/wei/WEI_20211022_e.pdf

A heavy reliance on bilateral currency swaps could have two potential drawbacks for the economy. The first is that such swaps are a short-term measure and has conditions attached.³⁸ The swap under SAARC framework from the Reserve Bank of India (which was repaid in February 2021) was for three-months and can be renewed only twice each with a three-month tenor, subject to agreement on terms and conditions of the existing SAARC Framework. After renewing twice, a staff-level agreement with the IMF is required for further renewals. While the swap with the Peoples Bank of China is valid for three years, it is in Yuan (rather than US\$) and to be used for promoting bilateral trade and investment. It could be used to source Sri Lanka's imports from China such as refined petroleum and intermediate goods. But, historically Chinese firms have invoiced for imports in US\$ and not in Yuan. With rising US-China rivalries and increasing so-called 'currency nationalism', the situation may change gradually.

Second, geopolitics may affect bilateral currency swaps. As they may involve financial risk to the lending central bank, concluding swap agreements signals trust between governments. Geopolitical considerations can fuel mistrust. Discussions with on the US\$1 billion Reserve Bank of India bilateral swap have been on-going since mid-2020 with little end in sight. This may partly reflect Indian perceptions of the GoSL's foreign policy tilt towards China and concerns about the risk appetite of the Reserve Bank of India in extending a swap line to Sri Lanka with a challenging debt sustainability profile. For similar reasons and that fact that Sri Lanka's foreign currency needs may be too small, a swap involving the US Federal Reserve, the world's leading provider of large bilateral swaps, seems out of the question. The amounts provided and the delays in concluding agreements with the Peoples Bank of China and the China Development Bank suggest that these institutions were concerned about debt sustainability issues in Sri Lanka and the narrative about the country being engulfed by a Chinese debt trap.

A panoply of other measures was announced with uncertain outcomes. These include various measures to promote exports, inward FDI and tourism; a voluntary agreement with employers to keep workers on reduced pay; an export proceeds surrender scheme; and a Presidential Task Force on Economic Revival and Poverty Eradication to coordinate the work of state institutes in response to the pandemic.

One simple and effective way to assess the economic impact of the GoSL's initial COVID response is to look what forecasters make of it. Table 6 provides recent forecasts of key macroeconomic aggregates for Sri Lanka in 2021-2022 from the semi-autonomous Central Bank and three IFIs (the IMF, World Bank and ADB) and a simple average of IFI forecasts.

The forecasters indicate a likely recovery in the Sri Lanka economy in 2021. The outlook hinges on factors such as a significant base effect following the contraction, a rise in private consumption from freeing pent up demand and historically low interest rates, an increase in domestic investment facilitated by easy credit at low borrowing costs, and strengthening global demand conditions. However, the projections of CBSL and the IFI's differ significantly. The CBSL projects a rebound to 5.0% in 2021³⁹ and 5.2% in 2022. This may reflect an upbeat view of the effects of the GoSL's policy mix and upward trending data on leading economic indicators (such as the Purchasing Managers Index). The average IFI growth forecast is lower than the Central Bank's by 1.6 percentage points in 2021 and 2.3 percentage points in 2022. The IFI's appear more cautious emphasizing the balance of external and domestic risks that could weigh in on Sri Lanka's economic outlook and damped business sentiment.

The forecasts for the twin deficits also differ. The Central Bank projects a fall in the overall fiscal balance from -9.4% in 2021 to -7.5% in 2022. This suggests a view that that faster growth could lead to

³⁸ The conditions attached to a swap agreement are intended to protect both parties from currency fluctuations and the risk that a central bank may be refuse or be unable to honor the conditions of the agreement.

³⁹https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/press/pr/press_20211014_Monetary_Policy_Review_No_7_2021_e_E95hq.pdf

more revenue generation alongside some control over government expenditure. Concerned with difficulties in fiscal consolidation particularly on the revenue side, the average IFI projection is for higher fiscal deficits of -10.5% in 2021 and -10.3% in 2022.

On the current account, the Central Bank expects a shift from a small deficit (-0.2%) in 2021 to a small surplus (0.2%) in 2022. This reflects expectations of a revival in tourism earnings alongside stronger export growth, FDI and remittances as global demand recovers. It also suggests higher oil prices and a recovery of domestic demand raising imports but import suspensions continuing for some time thereby containing imports and the current account deficit. The IFIs project a larger current account deficit at -2.7% in 2021 and -2.6% in 2022. This suggests a more muted recovery in exports and tourism from Covid as well as pressures from increasing oil prices on the current account.

While inflation is projected to increase reflecting higher food prices, neither the Central Bank nor the IFI's think that inflation will be especially problematic to the rebound in the short-term. The Central Bank projects inflation of 4.3% in 2021 rising to 5.8% in 2022 while that average inflation projection of the IFI's is 5.1% in 2021 and 5.8% in 2022.

The forecasts, which were released largely in October 2021 may be affected by several downside risks. One risk concerns uncertainty about the duration of the pandemic and the severity of containment measures. At the time of writing in October 2021, the economy was gradually opening from a third wave driven by a highly transmittable Delta variant of the virus which caused a six-week island wide lockdown. The vaccine rollout was also affected by an inability to secure sufficient vaccine doses to cover a critical mass of the population. The month-long lockdown in 2020 caused a significant growth contraction. Another risk is what an expected US recovery and higher interest rates would mean for tighter financial conditions and Sri Lanka's US\$ denominated external debt repayments. Concerns exist that Sri Lanka, already suffering from high external debt repayments and limited fiscal space, could be vulnerable to an interest rate shock and a stronger US\$ emanating from international financial markets. A third risk is inadequate rainfall affecting the agricultural sector which already faces the prospect of a drop-in crop yields due to an unexpected ban on chemical fertilizers in April 2021.

4. ECONOMIC EFFECTS OF COMPLEMENTARY POLICY CHOICES

The early sign of a growth pick-up in 2021 suggests that, to some extent, the government's unconventional policy mix has helped to mitigate economic scaring, and to support the economy at least in the short-term. However, prolonging the unconventional policy mix could introduce economic distortions into the fragile economy and impede the recovery. A study group convened by the Pathfinder Foundation examined the effects of Covid on Sri Lanka and recommended a refined economic strategy to reset the economy and build its resilience in the medium term. The three core priorities in the strategy were to mitigate the hardship of the people through social empowerment and safety nets; to build fiscal and external reserve buffers to increase economic resilience and to de-risk the economy; and to improve the investment climate for the private sector to export and create jobs (see Pathfinder, 2020).

As Kidd et al. (2020) and UN Sri Lanka (2020) have studied the first priority, this paper carries out research on the remaining priorities by exploring the economic effects of the following complementary policies: (1) the impact of a fiscal stimulus on GDP growth, (2) the export effects of FTAs with Asian countries, and (3) attracting FDI for services sector transformation. (1) relates to changes in fiscal policy towards some reallocation of government spending towards environmental and gender-sensitive priorities. Meanwhile, (2) and (3) focus on improving the investment climate for the private sector and non-debt means of generating foreign exchange through expanding exports, FDI and inbound tourism.

4.1 Impact of a Fiscal Stimulus on Growth

As mentioned above, the fiscal policy response was tepid while an extraordinary monetary policy was deployed at the onset of the pandemic in Sri Lanka. But, the tightening of monetary policy in August 2021 in response to imbalances in the external sector and financial markets, has prompted interest in using fiscal policy for sustainable growth in Sri Lanka. Some argue that if significant fiscal actions could somehow be undertaken, growth could be largely determined by fiscal policy at least in the short-term. There are two issues with exploring the implications of this view. First, it is difficult to empirically attribute the direct effects of fiscal actions on GDP because of the two-way relationship between these variables. Second, a dearth of research on fiscal multipliers means that little is known about the historical relationship between fiscal policy variables and growth in Sri Lanka. Applying the so called “bucket method” of Batani et al. (2014) offers an operational way forward to estimate fiscal multipliers for Sri Lanka. This method categorises countries into buckets that are likely to have similar multiplier values based on their structural country characteristics such as public expenditure management and revenue administration, debt level, exchange rate regime, trade openness and labour market rigidity.

A technical background paper for the ODI macro project by Raga and Wignaraja (forthcoming) estimated fiscal multiplier effects for Sri Lanka using the bucket method and existing literature on fiscal multiplier estimates in developing country contexts. The approach and results are outlined here. Sri Lanka proposes to implement a significant fiscal stimulus between 2023 to 2025 (as a % of GDP) amounting to 2.9% in 2023, 3.8% in 2024 and 4.9% in 2025. As limited fiscal space and high public debt levels constrain Sri Lanka’s ability to mount sufficiently large stimulus packages, additional revenue is generated through a combination of higher taxation and external financing. The growth effects of alternative scenarios of an untargeted fiscal expansion and a targeted fiscal expansion (with allocations for investment in renewable energy and gender-responsive expenditure on health and social protection) are compared against a baseline IMF growth forecast. Box 1 contains the detailed assumptions.

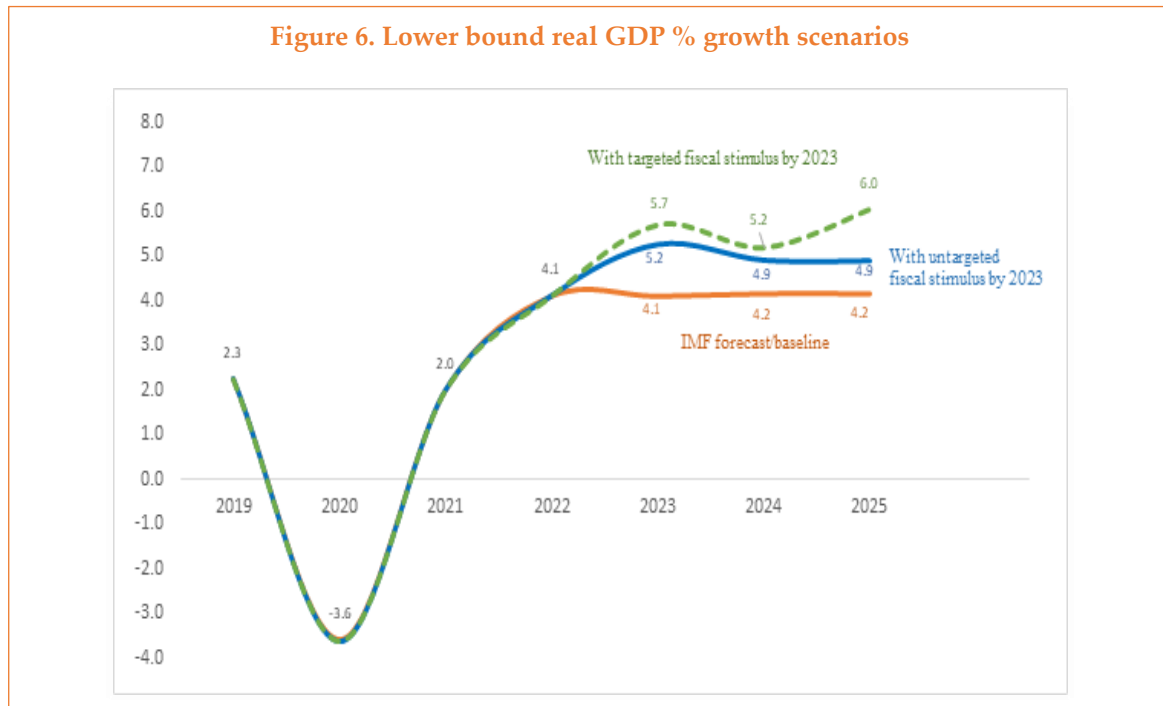
Box 1 Assumptions underlying the estimation of fiscal multipliers for Sri Lanka

- A significant fiscal stimulus between 2023 to 2025 is proposed
 - ✓ The fiscal stimulus (as a % of GDP) amounts to 2.9% in 2023, 3.8% in 2024 and 4.9% in 2025
- The fiscal stimulus is assumed to be generated from:
 - ✓ Annual additional revenues worth 1.3 percentage points above previous year’s revenues (in % of GDP) starting 2023, according to our projections.
 - ✓ Additional external financing worth US\$5 billion from IMF program and commercial borrowing (e.g. loans from China) to be obtained by 2023, and to be delivered in equal nominal tranches from 2023 to 2025. IMF forecasted deflator and exchange rates are utilised.
- On the targeted fiscal stimulus, the following allocations are assumed:
 - ✓ 30% capital expenditure (investment), of which: 20% for green investment and 80% for other capital expenditure
 - ✓ 70% recurrent expenditure (consumption), of which: 30% for care economy (gender) expenditure and 70% for other recurrent expenditure
- The fiscal multipliers estimates from Hayat and Qadeer (2016), Batini, et al (2021) and De Henau, *et al.* (2017) are applied on the targeted and untargeted fiscal stimulus. The nominal equivalent of the fiscal multiplier effect was linearly added to the baseline nominal GDP, utilised the IMF deflator and recomputed the real GDP growth path accordingly.
- IMF growth estimates/forecasts are used as baseline for all years except for the imposed growth rate of 2% in 2021 in view of the dampening economic effects of third wave of Covid-19. IMF forecasts for other years are based on World Economic Outlook as of April 2021 (IMF, 2021).

Source: Raga and Wignaraja (forthcoming).

Figure 6 shows the headline results on growth from the exercise. In essence, a fiscal stimulus – whether untargeted or targeted – produces higher growth than baseline growth over 2023-2025. Furthermore, a targeted fiscal stimulus towards green investment and gender-sensitive spending is more growth enhancing than an untargeted one. In 2023, a fiscal stimulus (worth 2.9% of nominal GDP)

increases growth by at least 1 percentage point higher than the baseline. If fiscal stimulus is targeted, the growth impact is higher by up to 1.6 percentage points from baseline growth. By 2025, a fiscal stimulus (worth 4.9% of nominal GDP) increases growth by 0.7 percentage points from the baseline – indicating a decreasing marginal effect from an untargeted stimulus. However, a targeted fiscal stimulus will increase growth almost 2 percentage points from the baseline – reflecting an increasing marginal effect from earlier investment in earmarked green and gender-sensitive spending.



Source: Raga and Wignaraja (forthcoming).

4.2 Export Effects of FTAs with Asian Countries

Historically Sri Lanka had a passive FTA strategy compared to East Asian countries like Japan, Korea and Singapore which pursued a pro-active FTA strategy. Sri Lanka’s initial focussed involved a couple of regional agreements in the mid-1970s before gradually moving towards bilateral agreements in the 2000s. The outcome today is an imperfect FTA architecture enabling preferential market access to a few developing countries in Asia with which Sri Lanka trades little. Most of these are so-called South-South FTAs with a lower level of ambition in terms of opening up trade in goods and services, investment and regulatory barriers than North-North FTAs. There is an absence of more comprehensive agreements with developed countries outside Asia like the US and the EU, which absorb over half of Sri Lanka’s exports.

Sri Lanka’s first FTA in effect in 1976 was the Asia Pacific Trade Agreement (a regional agreement previously known as the Bangkok Agreement). Forty-five years later, Sri Lanka was involved in 17 FTAs at various stages of progression in August 2021. But, only seven FTAs (41.2%) were in effect which suggest that Sri Lanka has moderate record of converting FTA negotiations into useable agreements by business. The FTAs in effect (with the date of taking effect) include: (a) three regional agreements namely, the Asia Pacific Trade Agreement (1976), the South Asia Preferential Trade Agreement (1995) and its successor, the South Asia Free Trade Area (2006); and (b) four bilateral agreements with India (2000), Iran (2004), Pakistan (2005), and Singapore (2018). After concluding the 2018 Singapore agreement, domestic political uncertainties led to the stalling of Sri Lanka’s FTA strategy.

Sri Lanka's FTA pipeline includes a further four agreements under negotiation and another six FTAs either proposed or under study. Those under negotiation are (with the date of starting negotiations): an upgraded bilateral FTA with India (2016, known as the Economic and Technical Cooperation Agreement or ECTA); bilateral FTAs with China (2014) and Thailand (2018); and the Bay of Bengal Multi-Sectoral Technical and Economic Cooperation (BIMSTEC) FTA (2004).

In August 2020, President Rajapaksa's Government announced an ambitious Asia-Centric foreign policy signalling a possible pivot away from Western-oriented diplomacy. The motivation for the new foreign policy was two-fold. First, it followed the GoSL's populist anti-Western political ideology and the views of majority of its political base. Second, it fitted with the narrative about the shift of the centre of gravity of the global economy to Asia (underpinned by the rise of China, India and ASEAN) that favour a shift eastward, while balancing great power rivalries in the strategic geographical space of the Indian Ocean. A state minister of regional cooperation portfolio was created under the Foreign Ministry to foster trade links with China, India and other Asian countries and strengthen ties with regional groupings like the South Asian Association for Regional Cooperation (SAARC) and BIMSTEC. Two trade committees were also appointed: an expert committee to prepare a national trade policy and a national negotiations committee to oversee talks on pending FTAs. These committees are considering the merits of different agreements in a re-booted FTA strategy seeking to increase trade with Asian countries. However, model-based analysis on the trade potential of different FTAs with Asian countries is lacking.

A preliminary exploration of the potential effects of FTAs with China, India and BIMSTEC on Sri Lanka's exports discussed below. The exercise, with modelling support from ODI, used a static computable general equilibrium model (CGE) model and the GTAP 10 dataset from the Centre for Global Trade Analysis of Purdue University. The FTA scenarios are:

Scenario 1: China-Sri Lanka FTA. This covers removal of all tariffs between both countries. During six rounds of negotiations for the China-Sri Lanka FTA which began in 2014, the complete opening up of bilateral trade in goods was discussed. However, the talks stalled in 2017 due to differences over the extent of trade liberalization under the agreement. Following his meeting with a high-level Chinese delegation in Colombo in October 2020, the Sri Lankan President's office released a statement saying that discussion on the bilateral FTA would be re-started.

Scenario 2: India-Sri Lanka FTA. This covers removal of all tariffs between both countries + elimination of some NTBs + increase of service preferences by 10%. This scenario attempts to resemble the proposed ECTA between India and Sri Lanka. ECTA talks began around mid- 2016 and sought to add liberalising trade in services to the partial trade in the goods only India-Sri Lanka FTA of 2000.

Scenario 3: BIMSTEC FTA. A regional FTA covering removal of all tariffs between the seven BIMSTEC members (Bangladesh, Bhutan, India, Myanmar, Nepal, Sri Lanka, Thailand). This represents a higher level of ambition in trade in goods than the ongoing BIMSTEC FTA talks since 2004 on a partial goods only FTA.

Table 7 provides the export effects for Sri Lanka from the different FTA scenarios. The estimates are reported in percentage change from the baseline in the overall volume of Sri Lanka's merchandise exports. The export effects are 2.71% for the BIMSTEC FTA, 2.34% for the India-Sri Lanka FTA and 1.41% for the China-Sri Lanka FTA. Typically, a large regional FTA involving free trade in goods among BIMSTEC members produces greater export gains for Sri Lanka than a bilateral FTA with China involving free trade in goods or one with India involving free trade in goods and partial services trade. Furthermore, the wider bilateral FTA with India brings more export gains to Sri Lanka than the narrower FTA with China.

The effects on major export sectors in Sri Lanka vary between the agreements. Strikingly, garment exports see limited gains under the China or India FTAs (about 1%) and negligible change under the

BIMSTEC FTA. Rubber and plastics products and other light manufacturing also achieve modest gains under all three FTAs. Meanwhile, textile exports gain significantly under the BIMSTEC FTA (18.57%) and the India FTA (5.19%) but have limited gains under the China FTA (2.50%). Likewise, tea, other beverages and other food products gain significantly under the BIMSTEC FTA (27.31%) and the India FTA (12.82%) but negligible change under the China FTA. Machinery, equipment, electronics and metal work see significant gains under the BIMSTEC FTA and some gains under the China and India FTAs. Adding partial services liberalisation to the India FTA yields gains for some exports particularly transport and logistics (3.08%) as well ICT/BPM (1.82%).

4.3 Attracting FDI for Service Sector Transformation

Establishing export processing zones (EPZs) in the 1980s and 1990s helped to attract manufacturing FDI to Sri Lanka and facilitate economic transformation towards manufacturing and away from commodities which were vulnerable to volatile international prices. FDI stimulated the growth of garment exports by bringing capital, transferring foreign technologies and creating marketing linkages. This brought economic gains such as increased foreign exchange earnings, the entry of small firm subcontractors and jobs mostly for female workers.

The GoSL hoped to repeat this success by using a special economic zone (SEZs) to attract services FDI in an attempt to position Sri Lanka South Asia's 'new Dubai' – a premier services hub rivalling Dubai to the West and Singapore to the East – in a post COVID-19 world economy. In May 2021, Sri Lanka's Parliament passed a law to set up a powerful commission to license and regulate activities at the Colombo Port City (CPC)⁴⁰, which will function as an SEZ for services. Partly in anticipation of the law, Sri Lanka's Board of Investment (BOI) began targeting annual FDI inflows of \$1.5 billion over a three-year period in collaboration with the Foreign Ministry's new economic diplomacy programme.

Projections by the United Nations Conference on Trade and Development (UNCTAD, 2021) expects a partial recovery in global FDI flows in 2021/2022 linked to factors such as a global economic recovery, the availability of COVID vaccines, a large US fiscal stimulus and improved business confidence among multinational corporations (UNCTAD, 2021). Global FDI flows had fallen significantly in 2020 from a year earlier due to the economic fallout from the pandemic on advanced economies and developing economies.

The city of Dubai is widely regarded as a developmental success story in the Middle East and globally. It powered the economic rise of the United Arab Emirates (UAE) to be a high-income economy with a per capita income in excess of US\$, 40,000. Within three decades or so, Dubai has transformed itself into an enviable international hub for FDI particularly in financial services, high-end culture and tourism. It has leveraged a strategic location between Asia and Europe and developed some 30 special economic zones (SEZs). Political stability, excellent branding as an investment destination, a competitive tax regime and world class infrastructure in its SEZs, an open labour market for attracting skilled workers and professionals, and consistent business-friendly economic policies help explain Dubai's success in attracting FDI. Others in the developing world are studying Dubai's experience to learn lessons from its transformation into a regional services hub.

Sri Lanka is blessed with some locational advantages in its quest to emulate Dubai's experience. One major advantage is its strategic geographical location – a few miles off India's southern coast and close to the main Asia-Europe sea route. This, coupled with its relative port efficiency, has contributed to the emergence of the deep-water Colombo Port as a key transshipment hub to India. Maritime logistics, financial services, ICT services and professional services have grown spurred by high levels of human capital and overseas connections. The increasingly high-end garment industry has not only

⁴⁰ The law provides for the creation of a Commission with the powers to grant registrations, licenses, authorizations, and other approvals to carry on businesses in the SEZ to be established within the CPC.

enhanced the country's reputation as a destination for inward investment but also stimulated marketing and design services. Sri Lanka's other locational advantages include exceptional natural and cultural endowments which make it attractive to an expatriate lifestyle.

With the liabilities weighing on Sri Lanka's FDI potential, however, services FDI has been below par, averaging only US\$ 263.8 million a year during 2016-2019 and falling in the aftermath of the pandemic to US\$ 111.0 million in 2020. But this may change. For instance, Browns Investments signed an MoU for a \$1bn mixed development project in CPC in December 2020.

To leverage the country's locational advantages, the government decided to use an SEZ framework as a policy tool to ramp up FDI into the services sector. The CPC SEZ is an ambitious project for two reasons. First, it is considered an engineering marvel being developed on 269 hectares of reclaimed land from the sea by China Harbour Engineering Company Ltd (CHEC), a Chinese state-owned enterprise. The hard infrastructure consists of a multi-purpose office/leisure city built adjacent to the current central business district of Colombo.⁴¹ Second, contrary to popular perceptions, the method of financing the project is unlikely to add to Sri Lanka's debt burden and the narrative of Sri Lanka being engulfed in a so-called 'Chinese debt trap'. Rather than being financed by a high interest rate commercial loan, it is an investment project. CHEC will make an initial foreign investment of US\$1.4 billion in land reclamation and some key infrastructure elements. The expectation is that other foreign and domestic developers would invest another US\$ 13.6 billion in buildings and facilities over the next two decades. Thus, the CPC SEZ could transform the country's services sector by promoting FDI and facilitating clustering of services businesses in a variety of subsectors. Notable spillovers can be gained from sharing resources and costs by locating financial, leisure and related services activities in the CPC.

Table 8 presents our projections of the impacts of an operational CPC on the services sector and the economy which were derived using estimated values from detailed engineering and scenario planning studies prepared by PwC (2020) and LKI (2020). The exercise attempts to capture the CPC's potential contributions to services FDI inflows, foreign exchange earnings from services, value added in services, employment in services, and government revenue. These economic aggregates are calibrated under a low case scenario of a CPC at 30% operational capacity and a high case scenario of a CPC at 85% operational capacity for comparison purposes.

The projections suggest that an operational CPC SEZ can be a game changer for modern services development in Sri Lanka. The CPC could attract annual services FDI inflows of US\$197 million under a low case scenario and US\$623 million under a high case scenario. This could translate into significant impacts on the services sector and the economy. It could add 6% to services sector value added on an annual basis under a low case scenario and 20.5% under the high case scenario. Meanwhile, it could bring an additional 1.5% services sector jobs under the low case scenario and 4.7% services jobs under the high case scenario.

Even under the low case scenario, it could add 3.3% to Sri Lanka's GDP and as much as 11.4% under a high case scenario. Likewise, it could add 0.7% to total employment under the low case and 2.2% under the high case scenario. The impacts on foreign exchange earnings and government revenue are also notable.

The core hardware part of the project is likely to get built given the financial outlay and experience of CHEC. It may take some time to attract other developers to pitch in given global uncertainties in the

⁴¹ When completed, Port City – Colombo is estimated to have 5.7 million square metres of built space including grade-A offices, a hospital, an international school, a marina, shopping malls, and hotels. It is expected to use the latest sustainable city design and smart city concepts to become one of the most modern services hubs in South Asia.

COVID-19 era and decision-making lags by previous governments. In this vein, the under-developed software side of the project has been a major obstacle, particularly the lack of a conducive incentive and regulatory framework for the CPC SEZ. The draft law delegates powers to a powerful commission to oversee activities at the Port City SEZ but this may be a partial solution. In order to fulfill its economic potential, Sri Lanka should rapidly implement a CPC SEZ framework that has several best practice elements including, 1) a transparent and competitive tax regime; 2) a clear arbitration framework for parties to solve commercial disputes; 3) strong anti-money laundering rules; 4) an open international labour market; and 5) modern and cost competitive infrastructure. It also means that like the UAE, Sri Lanka's national economic policies should be transparent and predictable in the medium-term emphasising a market-oriented economy, a neutral foreign policy, a world class education system and movement towards political and social stability. Indeed, putting in place a competitive SEZ framework and conducive national policies will markedly improve the CPC's chances of success and help to position Sri Lanka as South Asia's Dubai after the COVID-19 pandemic.

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5. CONCLUSIONS

This paper examined the macroeconomic impact of the COVID-19 on the Sri Lankan economy during the first 20 months of the pandemic. It examined questions relating to the economic hit from the pandemic, the effectiveness of the policy response and the effects of complementary policies to lay the foundations for a better medium-term outlook.

The COVID external shock and the containment measures caused the Sri Lankan economy to contract during 2020. Already struggling with low growth under the weight of multiple pre-pandemic shocks, the economy contracted. Goods and services exports fell due to a fall in external demand from major Western markets and supply side disruptions. Losses in incomes and jobs resulted in significant new poor particularly in urban areas and the informal sector. Unemployment among women also rose. Heightened work-home life pressures caused some women to drop out of the work force and put others at more of a risk of job losses than men. The pandemic did little to alter Sri Lanka's vulnerability to the long-term challenges of climate change, rising CO2 emissions and slow shifts towards green energy.

Sri Lanka's macroeconomic imbalances worsened during the pandemic with further pressures on stretched fiscal deficits, fragile trade balances and adverse debt dynamics. Public expenditure fell as the government scrambled to put in place measures to mitigate the contraction while revenue generation fell to historic lows due to a reduction in economic activity, job losses and previous income tax cuts. The outcome was a steep rise in the fiscal deficit. While important components of external sector (e.g. exports, FDI and tourism) suffered declines, an artificial fall in imports and steady worker remittances meant that the current account deficit was prevented from worsening significantly. Sri

Lanka's foreign debt situation became more unfavorable with its large external debt obligations only barely covered by shrinking gross foreign exchange reserves at historic lows. A restricted trade regime with an anti-export bias amplified the effects of macroeconomic imbalances.

COVID economic crisis with weak macroeconomic conditions, meant a muted fiscal stimulus compared to others in South Asia. Accordingly, a panoply of policies was attempted to limit the economic fallout from the pandemic. A signature policy was unprecedented monetary policy easing, provision of liquidity and relaxing regulatory forbearance rules. Others included import suspensions which choked off import demand for non-essential goods, thereby conserving foreign exchange and a heavy reliance on currency swaps and loans for external debt management. To some extent, this unconventional policy mix helped to mitigate economic scaring and provide support to the economy. Recent data suggests that the economy is showing signs of a recovery linked to a low base effect, cheap finance and pent up demand. However, prolonging the policy mix beyond the short-term and emerging risks could have potential drawbacks for the fragile economy and impede recovery.

The policy agenda should shift from managing short-term counter cyclical stabilization measures to implementing complementary reforms for medium-term inclusive and sustainable growth. With a tapering of monetary stimulus measures, one important reform is engineering a fiscal stimulus through increased taxation and external financing. The analysis of fiscal multipliers suggests that a fiscal stimulus targeted towards green investment and gender-sensitive expenditure produces a superior growth outcome than an untargeted one or a baseline scenario. Accordingly, Sri Lanka should mainstream environmental sustainability and gender equality into development planning and national budgets so that these issues are fully integrated across the economy.

Recognizing imperative to increase non-debt means of foreign exchange for Sri Lanka, another reform would be to conclude trade agreements with Asian countries. The model-based analysis suggests larger export gains for Sri Lanka from a large BIMSTEC FTA involving free trade in goods than bilaterals with either China or India. Moreover, an upgraded FTA with India opening goods trade while partially opening services brings larger export gains to Sri Lanka than a goods only FTA with China.

Finally, projections suggest that the Colombo Port City SEZ can be a game changer for modern services development and help to position Sri Lanka South Asia's 'new Dubai' in a post-COVID world. The analysis suggests that hardware part of the project is on track but the software side remains underdeveloped. Putting in place a competitive SEZ framework and conducive national policies will markedly improve the CPC's chances of success.

Despite facing difficulties in managing the economic impacts of the pandemic, if Sri Lanka can engineer a fiscal stimulus, increase exports using Asian FTAs and promote modern services through the CPC SEZ, it could have reason for optimism.

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ANNEX: TABLES 1-8

Table 1. Sri Lanka: Export Values and Shares, 2018-2020 (US\$ Millions and %)								
Category	Value (US\$ Million)			% Change in Value (YoY)		Export Shares (%)		
	2018	2019	2020	2018/2019	2019/2020	2018	2019	2020
Agricultural Exports	2,579	2,462	2,336	-4.6%	-5.1%	16.2%	15.6%	17.9%
Tea	1,428	1,346	1,241	-5.7%	-7.8%	9.0%	8.5%	9.5%
Rubber	32	24	30	-23.4%	24.4%	0.2%	0.2%	0.2%
Coconut	311	330	345	6.0%	4.8%	2.0%	2.1%	2.6%
Kernel products	149	161	n/a	7.9%	n/a	0.9%	1.0%	0.0%
Other	162	168	n/a	4.1%	n/a	1.0%	1.1%	0.0%
Spices	360	313	334	-13.2%	6.7%	2.3%	2.0%	2.6%
Vegetables	28	32	37	13.3%	14.4%	0.2%	0.2%	0.3%
Unmanufactured tobacco	36	35	26	-2.4%	-26.6%	0.2%	0.2%	0.2%
Minor agricultural products	118	120	135	1.4%	12.2%	0.7%	0.8%	1.0%
Sea Food	266	262	190	-1.3%	-27.7%	1.7%	1.7%	1.5%
Industrial Exports	9,258	9,426	7,702	1.8%	-18.3%	58.2%	59.6%	58.9%
Food beverages & tobacco	462	447	464	-3.3%	3.8%	2.9%	2.8%	3.5%
Animal fodder	108	129	103	19.7%	-20.2%	0.7%	0.8%	0.8%
Textiles and garments	5,318	5,596	4,423	5.2%	-21.0%	33.4%	35.4%	33.8%
Garments	4,961	5,206	3,939	4.9%	-24.3%	31.2%	32.9%	30.1%
Textiles	260	284	260	9.3%	-8.7%	1.6%	1.8%	2.0%
Other made-up textile articles	97	107	224	10.2%	110.3%	0.6%	0.7%	1.7%
Rubber products	875	866	786	-1.1%	-9.2%	5.5%	5.5%	6.0%
Gems, diamonds and jewellery	278	306	211	10.0%	-30.9%	1.7%	1.9%	1.6%
Machinery and mechanical appliances	435	400	338	-8.0%	-15.6%	2.7%	2.5%	2.6%
Transport equipment	120	146	71	21.3%	-51.1%	0.8%	0.9%	0.5%
Petroleum products	622	521	374	-16.2%	-28.3%	3.9%	3.3%	2.9%
Chemical products	167	176	173	5.7%	-2.0%	1.0%	1.1%	1.3%
Wood and paper products	141	129	99	-7.9%	-23.3%	0.9%	0.8%	0.8%
Printing industry products	32	48	48	52.4%	-0.8%	0.2%	0.3%	0.4%
Leather, travel goods and footwear	148	103	54	-30.3%	-47.6%	0.9%	0.6%	0.4%

Plastics and articles thereof	78	73	176	-5.4%	139.9%	0.5%	0.5%	1.3%
Base metals and articles	165	177	111	6.7%	-37.2%	1.0%	1.1%	0.8%
Ceramic products	31	30	24	-3.9%	-20.1%	0.2%	0.2%	0.2%
Other industrial exports	279	278	247	-0.3%	-11.2%	1.8%	1.8%	1.9%
Mineral exports	34	34	25	-1.4%	-25.9%	0.2%	0.2%	0.2%
Earths and stone	22	18	n/a	-15.8%	n/a	0.1%	0.1%	0.0%
Ores, slag and ash	13	16	n/a	22.7%	n/a	0.1%	0.1%	0.0%
Precious Metals	0	0	n/a	n/a	n/a	0.0%	0.0%	0.0%
Unclassified	18	18	14	0.6%	-21.4%	n/a	n/a	n/a
Merchandise Exports	11,890	11,940	10,077	0.4%	-15.6%	74.7%	75.4%	77.1%
Services (EDB)	4,021	3,888	3,000	-3.3%	-22.8%	25.3%	24.6%	22.9%
ICT/BPM	1,035	1,089	n/a	5.2%	n/a	6.5%	6.9%	0.0%
Construction	65	67	n/a	3.1%	n/a	0.4%	0.4%	0.0%
Financial Services	242	213	n/a	-12.0%	n/a	1.5%	1.3%	0.0%
Transport & Logistics	2,486	2,339	n/a	-5.9%	n/a	15.6%	14.8%	0.0%
Wellness Tourism	193	180	n/a	-6.7%	n/a	1.2%	1.1%	0.0%
Total exports of goods and services	15,911	15,828	13,077	-0.5%	-17.4%	100%	100%	100%

Sources:

https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/press/pr/press_20210311_external_sector_performance_2021_january_e.pdf;

Classification of data on external trade was revised in 2010

Ceylon Petroleum Corporation and Other Exporters of Petroleum

National Gem and Jewellery Authority

Sri Lanka Customs

Central Bank of Sri Lanka

<https://www.srilankabusiness.com/ebooks/export-performance-indicators-of-sri-lanka-2010-2019.pdf>;

<https://www.srilankabusiness.com/news/edb-chief-spells-out-measures-to-aim-for-16b-goods-and-services-exports-in-2021.html#:~:text=%E2%80%9CWe%20are%20forecasting%20a%20performance,3.58%20billion%20from%20services%20exp>orts; https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/statistics/mbt/monthly_bulletin_october_2020.pdf,

<https://www.srilankabusiness.com/news/2020-marks-a-successful-year-for-sri-lanka-exports.html#:~:text=Sri%20Lanka's%20Trade%20Performance%20in,exports%20recorded%20in%20the%20period>

Table 2. Sri Lanka: Labour Force Participation and Unemployment by Gender

	Labour Force Participation Rates		Unemployment Rate	
	M	F	M	F
2015	74.7	35.9	3.0	7.6
2016	75.1	35.9	2.9	7.0
2017	74.5	36.6	2.9	6.5
2018	73.0	33.6	3.0	7.1
2019	73.0	34.5	3.3	7.4
2020	71.9	32.0	4.0	8.5
2020 Q1	72.4	32.5	3.7	9.6
2020 Q2	71.7	31.6	4.1	8.2
2020 Q3	72.5	32.4	4.3	8.6
2020 Q4	70.9	31.7	4.1	7.5

Source: Department of Census and Statistics (various) *Sri Lanka Labour Force Statistics, Quarterly Bulletin 2009Q1, 2020Q1Q2, 2020 Annual*

Table 3. Summary of Fiscal Sector Performance, (% of GDP)

	2015	2016	2017	2018	2019	2020F
Net lending/borrowing (overall balance)	-7.6	-5.3	-5.5	-5.3	-9.6	-11.1
Primary net lending/borrowing (primary balance)	-2.9	-0.2	0.0	0.6	-3.6	-4.6
Revenue	13.3	14.1	13.7	13.5	12.6	9.2
Expenditure	20.9	19.5	19.3	18.7	22.2	20.3
Central Government Debt	77.7	79.0	77.9	84.2	86.8	101.0
Public Debt ¹	85.3	86.1	84.8	92.2	94.3	109.7
Gross External Debt (US\$ mn)	44,839	46,418	51,604	52,412	54,811	49,212
Gross External Debt (%)	55.7	56.8	58.6	59.2	65.3	60.9

Note¹: Outstanding public debt includes central government debt, foreign project loans received by SOBEs, and public guaranteed debt.

Sources: https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/publications/annual_report/2020/en/10_Chapter_06.pdf,

https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/publications/annual_report/2020/en/9_Chapter_05.pdf,

https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/publications/annual_report/2019/en/10_Chapter_06.pdf,

https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/publications/annual_report/2019/en/9_Chapter_05.pdf,

https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/publications/annual_report/2018/en/10_Chapter_06.pdf,

https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/publications/annual_report/2018/en/9_Chapter_05.pdf,

https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/publications/annual_report/2017/en/9_Chapter_05.pdf,

https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/publications/annual_report/2016/en/9_Chapter_05.pdf

Table 4. Summary of External Sector Performance							
	2015	2016	2017	2018	2019	2020	2021 (Jan-Aug)
Trade Balance (US\$ Millions) ³	-8,388	-873	-9,619	-10,343	-7,997	-6,008	-5,509
Merchandise Exports (US\$ Millions)	10,546	10,310	11,360	11,890	11,940	10,047	7,903
Merchandise Imports (US\$ Millions)	18,935	19,183	20,980	22,233	19,937	16,055	13,411
Earnings from Tourism (US\$ Millions)	2,981	3,518	3,925	4,381	3,607	682	33
Workers Remittances (US\$ Millions)	6,980	7,242	7,164	7,015	6,717	7,104	4,224
FDI (US\$ Millions)	680	897	1,373	1,614	743	434	398
Current Account Balance (US\$ Millions) ¹	-1,883	-1,742	-2,309	-2,799	-1,843	-1,083	-2,423
Current Account Balance (% GDP) ²	- 2.3	-2.1	-2.6	- 3.2	-2.2	-1.3	n/a
Gross Official Reserves (US\$ Millions) ⁴	7,304	6,019	7,959	6,919	7,642	5,664	3,500 (a)

Note:
(a) Gross Official Reserves at the end of Aug 2021. At the end of September 2021, reserves were US\$ 2,600 Million.

Sources:
(1) <https://www.cbsl.gov.lk/en/statistics/statistical-tables/real-sector/national-accounts>
(2) <https://thedocs.worldbank.org/en/doc/15b8de0edd4f39cc7a82b7aff8430576-0310062021/original/SriLanka-DevUpd-Apr9.pdf>
(3) <https://www.cbsl.gov.lk/en/statistics/statistical-tables/external-sector>
(2020 data)
https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/press/pr/press_20210311_external_sector_performance_2021_january_e.pdf
https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/statistics/mei/MEI_202001_e_0.pdf
https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/publications/red/2020/Appendix_2_e.pdf
2020 GDP: Figures <https://www.cbsl.gov.lk/en/statistics/statistical-tables/real-sector/national-accounts>
2021 Figures:
https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/press/pr/press_20211019_external_sector_performance_August_2021_e.pdf
https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/statistics/wei/WEI_20211022_e.pdf

**Table 5. Sri Lanka: Key COVID-19 Economic Policies and Outcomes
2020-2021 August 2021**

<i>Key Measure</i>	<i>Outcome (End of period)</i>
Fiscal	
Containment measures	0.1% of GDP allocated
COVID-19 health care and social security fund (donations)	Increased from Rs 822mn (April 2020) to Rs. 1,752mn (end May. 2021)
Cash payments for vulnerable groups	0.6% of GDP disbursed in 2020
Contribution to SAARC COVID-19 Emergency Fund	US\$5 million (0.01% of GDP) allocated
Tax relief measures – extension of due dates for income tax and VAT, partial waiver of income tax arrears for SMEs, more relaxed payment terms, and freezing of legal action against non-payers	
Monetary & Macro-Financial	
CBSL sequential reduction in monetary policy rates by a total of 2.5 percentage points	(1) Av. lending rates on outstanding bank loans ⁴² fell from 13.6% (end-2019) to 10.6% (Nov. 2020). And further from 10.2% (Jan. 2021) to 9.4% (Aug. 2021)
CBSL reduced statutory reserve ratio (SRR) by 3 percentage points and interest rates on CBSL advances to banks lowered by 6.5 percentage points	(2) Share of new lending at <10.6% interest rates rose from 23% (Nov. 2019) to 88% (Nov. 2020)
Debt repayment moratorium on bank loans to key sectors and CBSL concessional credit scheme for SMEs borrowing (1% of GDP allocated)	(3) Overnight liquidity increased from Rs. 37.9bn (end-2019) to Rs. 187bn (Sept 2020)
Government guarantees for construction sector bank loans	(4) Bank credit to the private sector rose from Rs 131bn (2019 Jan-Oct. to Rs 257bn (2020 Jan-Oct.)
CBSL directly purchasing Treasury Bills at several primary auctions	(5) Av. CPI Inflation rose from 4.3% (2019) to 4.6% (2020)
Financial institutions asked to reschedule non-performing loans (NPL)	(1) Gross non-performing loan ratio for the banking sector ⁴³ rose from 31.1% (2019Q1) to 35.7% (2020Q4) (2) Statutory liquid asset ratio ⁴⁴ for domestic banks rose from 31.0% (2019Q1) to 37.3% (2020Q4) while that for foreign banks fell from 47.1% (2019Q1) to 43.2% (2020Q4) (3) Gross non-performing advances to total advances for licensed financing companies and

⁴² Average weighted lending rate (AWLR).

⁴³ Non-performing loans to equity capital and reserves.

⁴⁴ The ratio of liquid assets defined in the Banking Act to total liabilities.

	specialized leasing companies rose from 7.7% (March 2019) to 13.9% (Dec. 2020)
Ceiling on selected interest rates (e.g. housing loans, overdrafts and pawning facilities) to help marginal borrowers	
Banks suspend dividends and share buy backs until end-2020	
Import restrictions on non-essential imports including vehicles	Trade deficit fell from about US\$8bn (2019) to US\$6bn (2020) due to the decline in imports. Vehicles imports fell by 65.3%, transport equipment by 41.6% and fuel by 34.7% (Jan-Dec. 2020)
Restrictions on capital outflows and remittances	(1) Net outflows of Rs denominated securities increased from US\$ 334mn to US\$553Mn (2019 to 2020).
Intervention by CBSL in foreign exchange market	(2) Net outflow of portfolio investment of US\$4Mn became a net outflow US\$217Mn (2019 to 2020).
Banks prohibited from buying foreign currency Sri Lanka International Sovereign Bonds until June 2021	(3) CBSL purchased US\$282.5mn on a net basis in 2020
A scheme to insure investors against foreign exchange rate risk and a special deposit account in foreign currency	(4) The Sri Lankan Rs depreciated against the US\$ by 2.6% and 11.2% against the Euro during 2020. This reverses a mild appreciation against both currencies in 2019. (5) Gross official reserves fell from US\$7.6bn (end-2019) to US\$4.1bn (Mar 2021)
Reserve Bank of India (RBI) currency swap under the SAARC Framework	US\$400mn received (June 2020) and paid back (Feb. 2021)
Request for an RBI bilateral currency swap	US\$500mn received (Mar 2020)
China Development Bank loans to bolster foreign reserves	US\$500mn (April 2021)
Peoples Bank of China (PBOC) currency swap for bilateral trade and investment	10bn Yuan (US\$1.5bn) agreed (Mar. 2021) but not drawn US\$780mn received (Aug 2021)
One-off SDR allocation, which will boost reserves	US\$200mn. Initial disbursement (Aug. 2021) US\$349.6mn committed
Bangladesh Bank bilateral currency swap	
Loans from ADB (for SME financing) and World Bank (for COVID response, health, tele-education and rural poor)	
Exports, FDI and Tourism	

Improved export information and marketing services by the Export Development Board and Sri Lanka's Embassies Establishment of the Export Development Council	Merchandise exports declined 15.6% from US\$11.9bn (2019) to US\$10.1bn (2020)
A new FDI strategy with prioritized sectors from the Board of Investment	FDI fell from US\$758mn (2019) to US\$548mn (2020)
Airport reopened for tourists (Jan 2021)	Earnings from tourism fell from US\$682mn (Jan-Sept 2020) to US\$51 million (Jan-Sept 2021)
Other Measures	
Voluntary agreement with employers to keep workers on reduced pay	Unemployment (U) rose from 4.8% to 5.5% between 2019 and 2020 and fell to 5.1% in 2021Q2. In 2020 female U (8.4%) > than male U (4.0%).
An export proceeds surrender scheme	
Policy Coordination	
Task Force on Economic Revival and Poverty Eradication	Appointed in April 2020
Sources: IMF; CBSL Recent Economic Developments 2020; CBSL Annual Report 2020; CBSL External Sector Performance – March 2021; Daily FT	

Table 6. Economic Outlook for Sri Lanka - CBSL and IFIs

	CBSL ¹ (Oct 2021)			IMF (Oct 2021)		World Bank ³ (Oct 2021)		ADB ⁴ (Sept. 2021)		Simple Av. IFI Forecasts	
	2020	2021	2022	2021	2022	2021	2022	2021	2022	2021	2022
GDP Growth, constant prices (%)	-3.6	5.0	5.2	3.6	3.3	3.3	2.1	3.4	3.4	3.4	2.9
Inflation (%)	4.6	4.3	5.8	5.1	6.2	5.1	6.0	5.1	5.3	5.1	5.8
General Government Net Lending/Borrowing (% of GDP)	-11.1	-9.4	-7.5	-10.5	-10.0	-10.5	-10.1	n/a	n/a	-10.5	-10.3
Current Account Balance (% of GDP)	-1.3	-0.2	0.2	-3.2	-2.9	-2.1	-2.6	-2.8	-2.3	-2.7	-2.6
Sources:											
¹ https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/publications/annual_report/2020/en/5_Chapter_01.pdf , https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/press/pr/press_20211014_Monetary_Policy_Review_No_7_2021_e_E95hq.pdf											
² https://www.imf.org/en/Countries/LKA#countrydata . Accessed October 2021											
³ file:///Users/ganesh/Downloads/9781464817977.pdf . Accessed October 2021											
⁴ https://www.adb.org/countries/sri-lanka/economy . Accessed October 2021											

Table 7 Exports Effects for Sri Lanka from FTA Scenarios (percentage change from baseline)

Export Sector	China-Sri Lanka FTA	India- Sri Lanka FTA	BIMSTEC FTA
Rice and cereals	0.33	2.10	4.44
Vegetables, fruit and nuts.	0.79	1.09	2.53
Crops nec.	1.16	10.94	10.82
Coconut products, other forestry and sugar products	3.54	0.11	0.69
Food products nec.	0.41	0.70	0.83
Cattle, sheep, goats and other animal products	0.55	0.35	12.76
Fish and seafood	0.09	0.37	0.37
Textiles.	2.50	5.19	18.57
Chemical and pharmaceutical products	2.48	2.16	7.71
Garments	0.92	0.86	-0.18
Tea, other beverages, dairy and other food products	0.10	12.82	27.31
Vegetable oils and fats	0.50	2.21	1.34
Coal	0.13	0.61	27.56
Oil	2.22	4.84	1.34
Gas, gas manufacture and distribution.	3.19	10.38	4.12
Petroleum and coal products	2.80	0.35	37.74
Electricity	2.65	5.60	5.15
Rubber and plastic products.	2.35	3.16	3.56
Computer, electronic and optic products	3.55	3.73	7.27
Electrical equipment	7.09	3.48	12.07
Machinery and equipment	6.33	3.34	10.66
Motor vehicles and parts	3.48	2.18	24.61
Boats and misc transport equipment	3.36	3.64	3.31
Leather products; Wood products; Paper products, publishing; Manufactures nec.	4.70	2.12	3.65
Minerals and mineral products	0.71	0.61	1.19
Metals and metal working	7.00	4.14	9.27
ICT/BPM services	1.39	1.82	0.72
Financial services and insurance.	0.34	0.76	-0.53
Real estate activities and misc business services	0.05	1.13	-0.28
Tourism and recreation	0.01	0.92	-0.10
Water; Construction; Trade; Public Administration and defe; Education; Human health and social work a; Dwellings.	0.18	0.71	-0.25
Transport and logistics	1.27	3.08	2.33
Total exports	1.41	2.34	2.71

Notes: China-Sri Lanka FTA = removal of all tariffs between both countries.

India-Sri Lanka FTA = Removal of all tariffs between both countries + elimination of some NTBs + increase of service preferences by 10%.

BIMSTEC FTA = Removal of all tariffs between BIMSTEC members (Bangladesh, Bhutan, India, Myanmar, Nepal, Sri Lanka and Thailand).

1 Volume of merchandise exports.

Source: ODI estimates based on a static GCE Model and the GTAP 10 Database.

Table 8. Estimated Economic Impact of Colombo Port City						
	(1) Estimated Values		(2) Impact on the Services Sector ¹		(3) Impact on the Economy ²	
	Low Case (30%)	High Case (85%)	Low Case (30%)	High Case (85%)	Low Case (30%)	High Case (85%)
Value Added (US\$ mn)	2,888	9,852	6.0	20.5	3.3	11.4
Employment	55,181	177,097	1.5	4.7	0.7	2.2
Foreign Exchange Earnings (US\$ mn)	1,347	4,482	16.6	55.1	5.0	16.7
FDI (US\$ mn)	197	623	70.1	221.6	11.2	35.5
Government Revenue (US\$ mn)	222	684	-	-	1.9	6.0

Note¹: Estimated values divided by 3-year average (2017-2019) of service sector aggregates
Note²: Estimated values divided by 3 year (2017-2019) national economic aggregates
Sources: Author's computations based on estimates in PwC 2020 and LKI 2020. Macroeconomic and sectoral aggregates from Central Bank of Sri Lanka Annual Report 2018-2020, World Development Indicators, <https://www.srilankabusiness.com/ebooks/export-performance-indicators-of-sri-lanka-2010-2019.pdf>, <https://www.treasury.gov.lk/documents/publications/annualReports/2019/Annual%20Report%202019-20200625-rev2-eng.pdf>