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Sri Lanka's Economic Policy Response to the Covid-19 Shock

Abstract

Covid-19 pandemic has hit Sri Lanka severely in mid-2020, which led to various containment measures taken by the Government including travel restrictions. The pandemic also exacerbated the already underperformed economic growth since 2013. Even before the pandemic, the country's external sector was facing challenges. The pandemic shock caused a contraction of real GDP in 2020, which was also associated with moderate consumption, sharply declined investment, drop of merchandise exports, and deteriorating labour market. Sri Lanka used both monetary and fiscal policy measures to address the economic shock, including reducing key policy interest rates, introducing fiscal stimulus-nevertheless relatively small due to the limited fiscal space. Sri Lanka is recovering from the health crisis, but still facing some economic challenges, notably the balance of payment issue due to low reserves, unsustainable external debt levels, losing access to international capital market, and high budget deficit, etc.

Key words: Sri Lanka, Covid-19, monetary policy, fiscal policy

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1. Introduction

The COVID-19 outbreak rapidly spread across the globe in 2020. To date, the pandemic has left an unprecedented trail of both humanitarian and economic damage in all countries. With over 255 million people infected and more than 5 million deaths by end-November 2021, the economic repercussions of the pandemic are expected to dwarf the Global Financial Crisis of 2007-08. The pandemic has also created new challenges in meeting the 2030 Agenda and the Sustainable Development Goals (SDGs) as developing countries have suffered disproportionately more from the pandemic due to lack of resources and capacity to deal with pandemic related issues.

The outbreak has led to many adverse social and economic implications particularly for developing countries necessitating these countries to introduce new strategies and economic measures to overcome the ensuing adverse situation. Responses to the pandemic have been different across countries depending on country circumstances as well as the resources and policy spaces available for countries to manage adverse impacts. Therefore, it is important to study the impact of the pandemic under certain circumstances and how such countries have responded by way of various measures in managing such an external shock. In this regard, this paper examines the measures, actions, and impacts of Sri Lanka's policy responses to Covid-19 shock. The first three sections of the paper explain global economic impact briefly and health measures introduced by the Sri Lankan authorities to contain the spread of virus and some comparison of such measures with regional peers. The balance part of the paper analyses economic measures, impacts of such measures, current state of the economy and lessons learnt from Sri Lankan experience.

2. Economic impact on global economy

The pandemic has created the worst crisis in the global economy, since the Great Depression, and it is more complex with interlinked shocks to the health of people and economies that have brought normal life to an almost complete stop. There have been more uncertainties as there has been no previous experience on how to treat the novel virus, make containment effective, and restart economic activity. Global economic activity has already declined more than during any of the previous global economic crises since the Great Depression.

Economic shocks due to pandemic comes through several channels. First, there has been a medical shock when a significant part of work force has been sick and they have been unable to make contributions to GDP. Secondly, public and private containment measures like school and factory closures, travel restrictions, and quarantines has severely reduced economic activity. Thirdly, demand disruptions due to a drop in aggregate demand due to recessions and uncertainty makes consumers and investors adopt a wait-and-see attitude to purchases and delay their consumption and investment decisions.

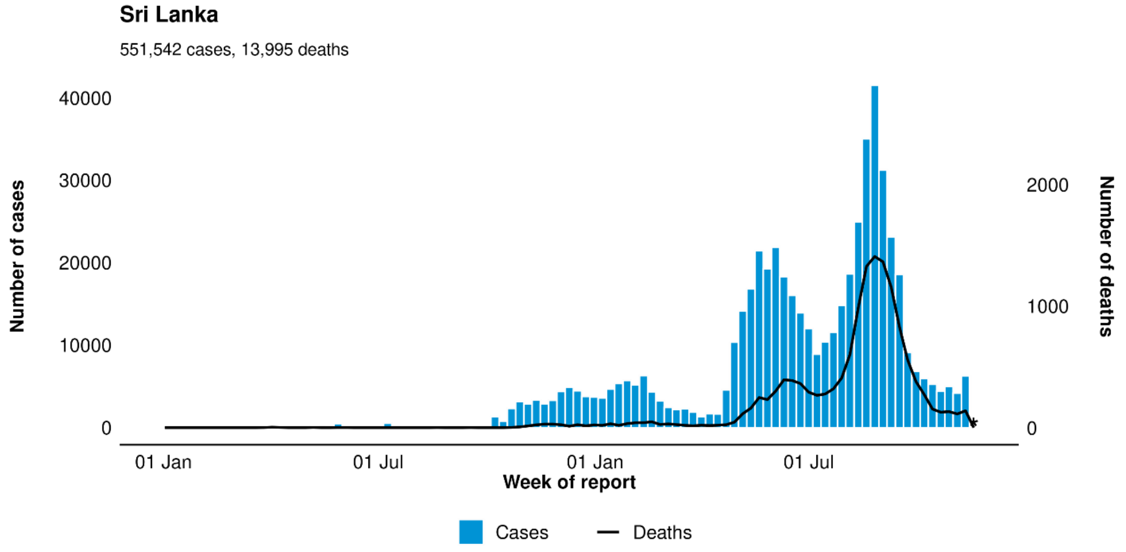
Sector wise, the tourism and leisure sector has had the first adverse impact due to travel restrictions. Secondly, the manufacturing sector has been affected adversely through three channels: 1. Direct supply disruptions have hindered production, since the disease has focused on the world's manufacturing heartland in Asia and has spread fast in the other industrial giants. 2. Supply-chain contagion has amplified the direct supply shocks as manufacturing sectors in less-affected nations have found it harder and/or more expensive to acquire the necessary imported industrial inputs from the hard-hit nations, and subsequently from each other. For example, amidst the slowing down of the Chinese economy with interruptions to production, the functioning of global supply chains has been disrupted. Companies across the world, irrespective of size, that are dependent upon inputs from China have started experiencing contractions in production. Transport being limited and even restricted among countries has further slowed global economic activities. Freight rates have increased very sharply and there have been long delays in the major ports.

Two versions of World Economic Outlook (WEO), published by the International Monetary Fund in April 2021 and October 2021, estimate the global economic impact of the pandemic. The performance of emerging market and developing economies are expected to suffer larger medium-term damages compared to advanced economies on average, as discussed in Chapter 2 of the April 2021 WEO. WEO projects that activity is generally expected to remain below its pre-pandemic path through 2023 across emerging and developing country groups and output in the advanced economy group is projected to return to pre-pandemic trends by 2022 and rise slightly above it thereafter, mainly because of the anticipated additional policy support in the United States. The other income groups, however, are projected to remain below their pre-pandemic paths throughout the forecast horizon. Moreover, negative output gaps—indicative of slack—are projected across many economies over the next three years. Chapter 2 of the April 2021 WEO also predicts that the pattern of medium-term damages across economy groups is different from what was observed after the 2008–09 global financial crisis when advanced economies were hit hard and emerging market and developing economies fared better. The reverse is predicted due to the pandemic, consistent with the greater protection against further COVID-19 shocks from more widespread vaccinations in many advanced economies and sizable policy support. Despite higher-than-usual growth as the global economy recovers from the COVID-19 shock, in the IMF's latest projections, world output is estimated to be about 3 percent lower, in 2024, than pre-pandemic projections suggested.

3. Spread of virus in Sri Lanka and Containment Measures

In Sri Lanka, infections were limited to a single person until 11 March 2020, but the number escalated rapidly to 50 and then to over 300 confirmed cases, with 7 casualties by mid-April 2020. Despite introducing awareness measures that had prevented any outbreak till early March, the continued arrival of tourists, the return of Sri Lankans from countries that were most affected by the virus, and the lack of adherence to the containment measures that were imposed from mid-March 2020 fueled the outbreak.

Figure 1. Spread of Virus in Sri Lanka



Source: World Health Organization

Figure 1 shows the spread of Corona virus in Sri Lanka. Although the virus started to spread in Sri Lanka from March 2020 health authorities were able to contain its spread during the first phase through imposing severe restrictions and country-wide lockdowns until the second half of 2020. Sri Lanka got its well-trained military forces involved in containing the virus. As of 23 March 2020, forty-five quarantine centres had been built in the country by the Sri Lanka Army as a preventative measure in an attempt to stop the spread of the pandemic. Nearly 3,500 people were placed under quarantine in 45 quarantine centres, including 31 foreigners from 14 countries. As of 25 March 2020, Sri Lankan authorities tracked down over 14,000 people who had come into contact with identified patients, and ordered those people to self-quarantine.

The government banned the arrival of travelers from several European countries, including Spain, Norway, Switzerland, Belgium, Sweden, Germany, France, Austria, and the Netherlands, extending the ban to the United Kingdom on 15 March. The travel ban was also imposed on foreign travelers from India, South Korea, and Iran. Sri Lankan Airlines, the national airline, cancelled several scheduled flights from a number of countries, including India amid coronavirus fears. As of 17 March 2020, the Sri Lankan government ordered travel restrictions to Canada, Bahrain, and Qatar. On 22 March, the government banned the arrival of all passenger ships and planes. Restrictions were reinforced on 21 December after a highly transmissible SARS-Cov-2 strain was found in the UK and some other countries.

Since severe travel restrictions and lockdowns were no longer feasible and affordable, the authorities had to ease some restrictions from the third quarter of 2020. Although Sri Lanka was successful in handling the first wave of the pandemic, the government's failure to handle the second and the third waves of the pandemic caused a spike in COVID-19 deaths in November 2020. Subsequently, the highly contagious Delta Variant was responsible for the considerably higher fatality rate in the country since August 2021. As of August 2021, Sri Lanka became the country with the fourth-largest number of daily deaths in the world by population just behind Georgia, Tunisia, and Malaysia.

On 20 August 2021, government imposed a ten-day lockdown island-wide to curb the spread of COVID-19 cases. Some businesses imposed a voluntary lockdown for a period of 10 to 14 days during the early parts of August when the government refused to impose a lockdown despite the worsening situation in the economy. The decision to lockdown the country came following the immense pressure from the health authorities and civil society who demanded a complete lockdown after Sri Lanka surpassed 1,000 deaths over the course of eight days.

3.1 Regional Comparison

Table 1 shows comparative data of the spread of virus and rate of vaccination among South Asian countries.

Table 1. Comparison among South Asian countries

	Cases per million at the peak	Deaths per million at the peak	Vaccination per 100 pop
Sri Lanka	200	9	137.4
Bangladesh	100	2	49.2
India	200	3	79.4
Pakistan	25	1	49.7
Nepal	2000	40	55.5
Maldives	3000	10	139.6
Bhutan	40	0.5	148.8
Afghanistan	45	3	15.0

Source*:* World Health Organization.

Maldives recorded the highest number of cases per million and the highest number of deaths per million at the peak period of virus spread. However, the Maldivian population is only about half a million compared to Sri Lanka's population of 21 million. Maldives also had a sharp and short single wave of the spread compared to three waves of the spread in Sri Lanka. Sri Lanka is the second worst performer among other South Asian counterparts in terms of cases and deaths per million at the peak of virus. Nepal is the worst performer on both counts. Although India had a similar rate of cases per million, India's death per million is much lower than that of Sri Lanka.

Vaccination was started much later in Sri Lanka than among regional peers but the vaccination drive was implemented faster and more efficiently in Sri Lanka which contained the spread of the virus more effectively. In terms of vaccination rates, Bhutan, Maldives and Sri Lanka are much ahead of other South Asian countries. Although it commenced relatively later than other countries, Sri Lanka's vaccination program was much more successful and effective. It should also be noted that it is easier to implement vaccination programs in countries with smaller populations such as Maldives and Bhutan.

Sri Lanka rolled-out its vaccination program in three phases. In the first phase, the government began vaccination of health and front line workers, in February 2021, under the Covax facility when the first batch of Oxford–AstraZeneca vaccines arrived in Sri Lanka on 28 January 2021 from the Serum Institute of India.

In the second phase, the government began vaccination of persons above the age of 30, in late-February 2021 in the Western Province. This was rolled back in early-March 2021 and limited to persons above the age of 60. By April, vaccination of persons above the age of 30 had started and extended beyond the Western Province.

In the third phase, with vaccination of persons above 30 years reaching completion, vaccination of those between 18 and 30 years, who did not fall under special categories, were started in early -September 2021.

Sri Lanka was able to achieve relatively good progress in the vaccination drive thanks to its robust public health system and the effective involvement of military forces in delivering vaccines to general public.

4. Economic impact of the pandemic on Sri Lanka

In order to assess the impact of the pandemic on the Sri Lankan economy, it is important to understand economic performance during the previous decade as the Sri Lankan economy was growing well below its potential economic growth for several years since 2013. In 2019, the economy suffered another setback because of a series of bomb attacks on the Easter Sunday, in April 2019, which crippled the booming tourism industry. While the economy was gradually recovering, in early- 2020, from impacts of the Easter Sunday bomb attack the pandemic hit the economy from March 2020 resulting in a sharp deterioration in economic performance during

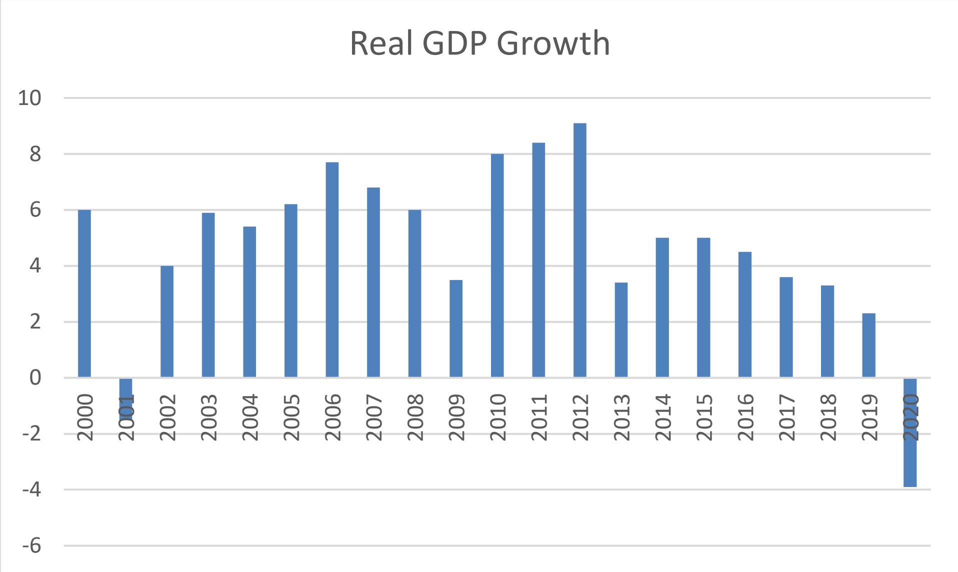
2020 in terms of real economic growth and worsening macroeconomic imbalances. In the context of such developments, the following section analyses economic performance prior to the pandemic.

4.1 Impact of the Easter Sunday Attack on the Economy in 2019

The attacks affected the tourism industry tremendously, while causing negative spillover effects on several other sectors, such as air transportation services, domestic transportation, wholesale and retail trade and accommodation, food and beverage service activities, leisure and entertainment, manufacturing of food and beverages and agriculture. The exchange rate also experienced some pressure in the immediate aftermath of the attacks, with withdrawals of foreign investment from the government securities market. The Colombo Stock Exchange also experienced a setback with a fall in price indices and market capitalization. However, the exact economic impact of the terrorist attacks cannot be quantified, as other major events, such as global economic and financial market developments, adverse weather conditions that prevailed throughout the second half of 2019 and the uncertainty that prevailed until the conclusion of the presidential election in the latter part of the year, also impacted the economic slowdown in the aftermath of the Easter Sunday attacks. Nevertheless, there is strong evidence that the attacks amplified the already sluggish economic growth, and largely contributed to the slow real GDP growth of 2.3 per cent recorded in 2019.

There is clear evidence that the tourism industry was adversely affected by the attacks. According to the estimates of the Sri Lanka Tourism Development Authority (SLTDA), direct and indirect employment in the tourism sector is 4.6 per cent of the total labor force in Sri Lanka. Moreover, tourism earnings, as a share of the country's GDP, is approximately 4-5 per cent. Following the terrorist attacks, 37 countries, including the top-most sources of inbound tourists, issued travel advisories at various levels of risks. However, most of the advisories were lifted in subsequent months with the improvement of the security conditions in the country. Tourist arrivals per day, which averaged around 7,600 during 2019 prior to the attacks, dropped significantly to around 1,700 during the two-month period after the attacks. However, Sri Lanka's tourism industry witnessed a speedy recovery during the second half of the year with average arrivals per day increasing to around 6,900 during the last two months of the year.

Figure 3. Trends in growth in real GDP



***Source**:* Annual Reports. Central Bank of Sri Lanka

Even before the pandemic adversely affected growth in real GDP, the Sri Lankan economy has been growing at a much lower annual average rate of 2.9 per cent during 2013 to 2020 compared with 5.8 per cent recorded during the years 2000-2012. As shown in Figure 3 growth in real GDP has been on a steady declining trend since 2013 even before the pandemic providing evidence of the vulnerability of the Sri Lankan economy to external shocks.

Table 2 compares actual values of key macroeconomic variables for 2019 with projections made for the same variables just before the Easter Sunday attack. The differences between actuals and projections can be attributed to the impact of unexpected economic shocks such as the Easter Sunday attack on key macroeconomic variables. For example, growth in real GDP was lower by 1.7 percentage points compared to projections published by Central Bank of Sri Lanka prior to the attack. As a result, per capita GDP was lower by US dollar 149 compared with the projections. Even in comparison with 2018 levels, per capita GDP declined by USD 250 in 2019.

Table 2. Comparison of Actuals and Projections for 2019

	Unit	2018 Actual (1)	2019 Actual (2)	Projections for 2019 made in early 2019	Difference (2) – (1)
Real GDP Growth	per cent	3.2	2.3	4.0	1.7
Per Capita GDP	USD	4102	3852.0	4001.0	149.0
Merchandise Exports	USD billion	11.89	11.9	12.9	1.0
External Current Account Balance	per cent of GDP	-3.2	-2.2	-2.3	-0.1
Overall Fiscal Balance	per cent of GDP	-5.3	-6.8	-4.4	2.4
Central Government Debt	per cent of GDP	83.7	86.8	82.6	-4.2
Growth in Broad Money	per cent	13.0	7.0	12.0	5.0
Annual Average Inflation	per cent	4.3	4.3	4.8	0.5

***Source**:* Annual Reports. Central Bank of Sri Lanka

4.2 Pre-pandemic external balance of payments issues

Even before the pandemic, Sri Lanka's external sector was facing some challenges mainly due to relatively large forthcoming external debt service obligations compared to levels of gross official reserves available to service future foreign currency debt obligations. For example, the government's annual foreign currency debt obligations had risen to an average of US dollar 6 billion in the forthcoming years compared to official external reserves of US dollar 7.6 billion available as at end 2019. In order to meet future debt service obligations, it was imperative to secure a continuous net inflow of foreign exchange by from international capital markets and official lenders as well as healthy non-debt creating FDI, portfolio and remittance inflows. In addition to debt service obligations, Sri Lanka was already running large trade deficit of 9.5 per cent of GDP and a current account deficit of around 2.2 per cent of GDP. In order to contain rising trade deficits, the authorities had already imposed restrictions on importation of motor vehicles and gold even before the pandemic. As a result of import restrictions, the deficit in the current account had decreased to 2.2 per cent of GDP by end- 2019 despite the decline in tourist earnings due to Easter Sunday attack and balance of payments recorded a surplus of US dollar 377 million mainly due to issuance of two International Sovereign bonds worth of US dollars 4.4

billion during the year. Since the balance of payment position was relatively stable by end-2019, the value of Sri Lankan Rupee also appreciated marginally during 2019 first time since 2010. However, since the eruption of the pandemic together with worsening macroeconomic conditions from early 2020, receipt of sufficient amounts of foreign exchange inflows to finance the external financing gap became extremely challenging.

4.3 Pre-pandemic fiscal performance

The fiscal deficit also deteriorated significantly, in 2019, from the projected deficit of 4.4 per cent of GDP to 6.8 per cent even before the pandemic affected fiscal balances further in 2020. Additional expenditure related to the Easter Sunday attack, lower than expected tax revenue as a result of slower economic activity and higher expenditure relating to the presidential election in November 2019 were the main causes for the deterioration of the fiscal deficit in 2019. As a result of the higher fiscal deficit, the central government debt position increased to 86.8 per cent of GDP against the projected level of 83.7 per cent. Therefore, there was very little fiscal space to stimulate the economy even before the pandemic hit the economy in early-2020. Despite such a tight fiscal position at end-2019, the new government reduced taxes further soon after the Presidential election with a view to boost economic growth. The reduction in taxes tightened the fiscal position further even before the pandemic. Sri Lanka’s debt and deficit dynamics left very little space for the government to use counter-cyclical fiscal policy during the pandemic.

4.4 Pre-pandemic monetary Policy stance

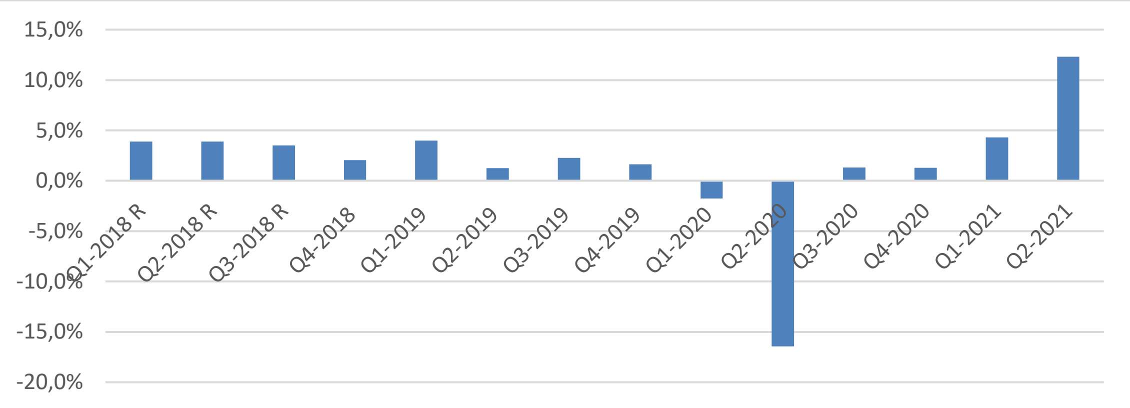
As inflation and monetary expansion remained around the projected level, there was some space to use monetary stimulus to minimize the impact of the pandemic in subsequent years. For example, inflation remained within the projected level, in 2019, while monetary expansion in terms of growth in broad money increased only to 13 per cent from the projected 12 per cent. Therefore, monetary policy was the only effective tool available for the authorities to use in an economic downturn without creating further macroeconomic imbalances, at the beginning of the pandemic.

5. Impact of the pandemic on the economy

5.1 Real GDP

As the pandemic started spreading in Sri Lanka, government imposed severe mobility and other restrictions from mid March 2020 during the first half of 2020. Growth in real GDP during the first quarter of 2020 recorded a contraction of by 1.5 per cent compared to the same quarter in 2019, even though restrictions due to the Corona virus were imposed only from mid-March 2020. This confirms the fact that the economy was already contracting before the pandemic due to other reasons. During the second quarter of 2020, the authorities imposed further restrictions and countrywide lockdowns to prevent the spreading of the virus. Although such measures were successful in containing the virus, imposing these severe restrictions had an adverse impact on economic activity. As a result, real GDP growth, during the second quarter, recorded a contraction of 16 per cent compared to the same quarter in the previous year, as shown in Figure 4. In addition, such restrictions became a heavy burden to the fiscal authorities as the government had to give cash handouts to a large segment of low-income families whose livelihood was affected due to lockdowns. In addition, tax revenue came down significantly due to restricted economic activity and the drastic reduction in tax rates introduced by the government from January 2020, soon after the presidential election. Since the fiscal authorities had no space to provide a meaningful fiscal stimulus, the Central Bank provided a significant monetary stimulus by pumping large amounts of liquidity and compelling the financial sector to provide debt moratoria and credit at concessional rates. Although such monetary stimulus was helpful for businesses to survive and retain employment to a certain extent during lockdowns, without significant fiscal stimulus the economy was not able to prevent a sharp contraction as shown in Figure 4.

Figure 4. Trends in Quarterly GDP growth



***Source**:* Department of Census and Statistics

In order to quantify the impact of pandemic on the economy, this section uses a similar methodology which was used to assess the impact of the Easter Sunday attack in the previous section. The assessment is based on comparing projections made in early-2019 by the Central Bank for the year 2020 and the actual outcome of the same macroeconomic variables. The difference between the projections and actuals reflects the impact of shocks unknown at the time of the projections. At the time of making projections in early-2019, the Easter Sunday attack and the pandemic were not known. Therefore, differences in projections may reflect mainly the impacts of both shocks. To separate out the impact of pandemic, the difference between actuals and projections needs to be adjusted by some margin for the impact of the Easter Sunday attack.

Table 3. Comparison of Actuals and Projections for 2020

	Unit	2019 Actual	2020 Actual (1)	Projections for 2020 made in early 2019 (2)	Difference (2) – (1)
Real GDP Growth	per cent	2.3	-3.6	4.5	8.1
Per Capita GDP	USD	3852.0	3682.0	4262.0	580.0
Merchandise Exports	USD billion	11.9	10.0	14.1	4.1
External Current Account Balance	per cent of GDP	-2.2	-1.3	-2.1	-0.8
Overall Fiscal Balance	per cent of GDP	-6.8	-11.1	-3.5	7.6
Central Government Debt	per cent of GDP	86.8	101.0	81.0	-20.0
Growth in Broad Money	per cent	7.0	23.4	12.5	-10.9
Annual Average Inflation	per cent	4.3	4.6	5.0	0.4

Source*:* Annual Reports. Central Bank of Sri Lanka

As shown in Table 2, in early 2019 real GDP was projected to grow by 4.5 per cent in 2020 but ended up recording a contraction of 3.6 per cent. The projected growth declined by 8.1 percentage points mainly due to the impact of the pandemic in 2020. Spillover effect of the Easter Sunday attack happened in 2019 may also have contributed to the decline in growth in 2020 to some extent but not as much as its impact on growth in 2019. In 2019, as measured in the previous section, Easter Sunday attack reduced real GDP growth by 1.7 percentage points. However, there is evidence that the economy was recovering from the impact of Easter Sunday attack in early 2020. Therefore, if there is any residual impact of the Easter Sunday attack in 2020, it could be a maximum of 50 per cent of the impact in 2019. Even if 50 per cent of the 1.7 percentage points economic contraction attributed to the Easter Sunday attack is apportioned to 2020, the impact of the pandemic on growth in 2020 can be estimated as a reduction of 7.25 (8.1-0.85) percentage points.

As shown in Table 2, per capita GDP also decreased by USD 580 compared with the projected level for 2020. This reduction is equivalent to USD 12.7 billion or about 15 per cent of nominal GDP. Of this reduction, USD 149 can be attributed to the decline in per capita GDP, in 2019, due to Easter Sunday attack. Therefore, the net impact of the pandemic can be estimated as the decline of per capita GDP by USD 431 or loss of GDP by USD 9.5 billion (11.7 per cent of GDP) during 2020.

The Central Bank recently estimated that the annual loss of nominal GDP due to the pandemic, in 2021, would be around Rupees 2.5 trillion, which is equivalent to USD 12.5 billion or 15 per cent of GDP. This estimate is based on the difference between the projected GDP for 2020, made in early 2019, and the projected GDP for 2021 made in November 2021. However, this difference could include the impact of Easter Sunday attack which happened after projections were made in early-2019. The decline in exports by USD 4 billion, in 2020, against the projected level can also be attributed to the impact of the pandemic due to lower global demand and supply disturbances to export processing industries in Sri Lanka, particularly the Covid outbreaks in garment factories in 2020.

5.2 Consumption and Investment

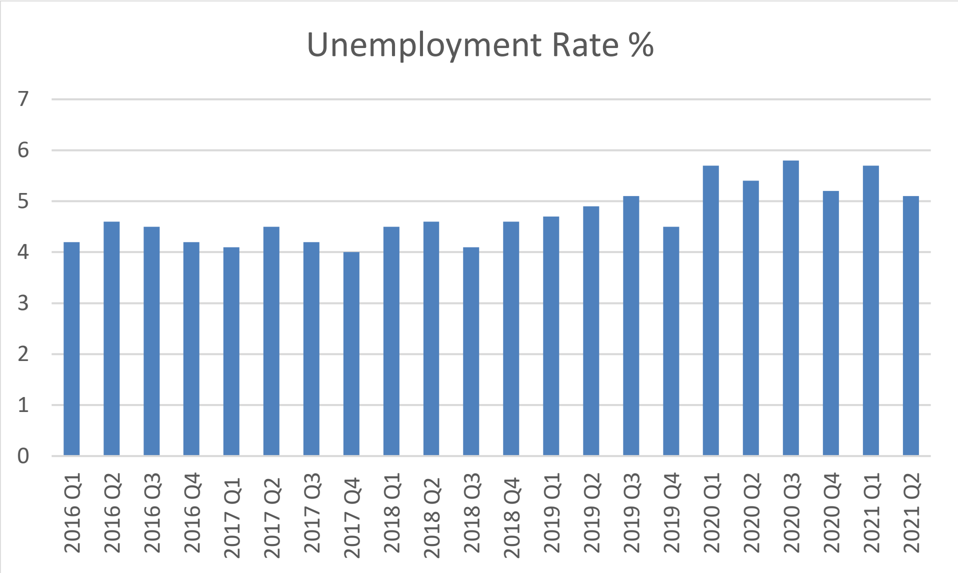
Contraction of the economy in 2020 also reflected in both consumption and investments levels. Consumption expenditure, which accounted for 81.1 per cent of the aggregate expenditure of the economy at current prices in 2020, grew at a moderate pace of 2.1 per cent during the year compared to the growth of 7.4 per cent in 2019, hampered by the lockdowns and the cautious consumer spending due to income uncertainty. This moderation is mainly attributable to the considerable slowdown in private consumption expenditure (PCE), which is the main consumption expenditure category, while prices of most of the consumer goods categories remained high during the year. In the meantime, government consumption expenditure (GCE) grew at a higher rate of 9.8 per cent in 2020 due to higher fiscal expenditure compared to the previous year. Reflecting the negative impact on consumer behavior from the COVID-19 pandemic, PCE at current prices grew only marginally by 1.0 per cent in 2020 compared to the growth of 7.3 per cent in 2019. The pandemic formed adverse conditions in many consumer markets during the year led by restrictions on mobility, working-from-home arrangements and other health related precautions which made consumers stay away from the markets, contracting most PCE categories such as transport, restaurants and hotels, and clothing and footwear. However, being essential goods and services, PCE on food and non-alcoholic beverages, housing, water, electricity, gas and other fuels, health and communication categories expanded during the year even amidst a pandemic

Investment as a percent of GDP declined to 25.2 per cent which is the lowest ratio recorded since 2003. Investment expenditure at current prices contracted by 6.2 per cent in 2020 compared with 2019, mainly affected by the uncertainty on the recovery timeline of the pandemic, locally as well as globally. This decline was driven by the noticeable contraction in gross fixed capital formation by 6.4 per cent in 2020 compared to the growth of 8.1 per cent in the previous year. Accordingly, the major categories of gross fixed capital formation, such as construction, transport equipment, and machinery and equipment, contracted in 2020 against the positive contributions recorded in 2019. Construction activities, the largest contributor to investment, experienced a setback due to pandemic-related disturbances severely affecting investment growth. However, investment expenditure on categories such as information and communication technology equipment and intellectual property products recorded a growth compared to the previous year.

5.3 Unemployment

As shown in Figure 5, the quarterly unemployment rate exceeded 5 per cent in the third quarter of 2019 mainly due to the impact of the Easter Sunday attack. The rate recovered to some extent in the fourth quarter of 2019 as the economy was recovering from the attack. However, since the pandemic, the quarterly unemployment rate has remained above 5 per cent throughout 2020 and so far in 2021. Sri Lanka's unemployment rate remained below 5 per cent during the postwar period from 2009 until the third quarter of 2019.

Figure 5. Unemployment Rate



Source: Department of Census and Statistics

5.4 Poverty

Sri Lanka had made significant progress in poverty reduction during the decade prior to the pandemic mainly due to average economic growth of above 5 per cent since end of the civil war in 2009. Above average growth rates during early post war period mainly contributed to this poverty reduction. According to World Bank (2021), growth over that period had been inclusive and poverty reduction strong, with the poverty rate at $3.20 per day (in 2011 purchasing power parity) declining from 16.2 percent in 2012/13 to 11.0 percent in 2016.

However, the pandemic appears to have reversed past progress in poverty reduction with the economy contracting by 3.2 per cent in 2020 and rising unemployment since the pandemic. Although official statistics are not available yet on latest poverty data, World Bank (2021) has used a microsimulation model to simulate the impact of macroeconomic indicators on the employment status and earnings of individuals. The simulation results suggest that the $3.20

poverty rate increased from 9.2 percent in 2019 to 11.7 percent in 2020 because of the pandemic reversing the progress made since 2016.

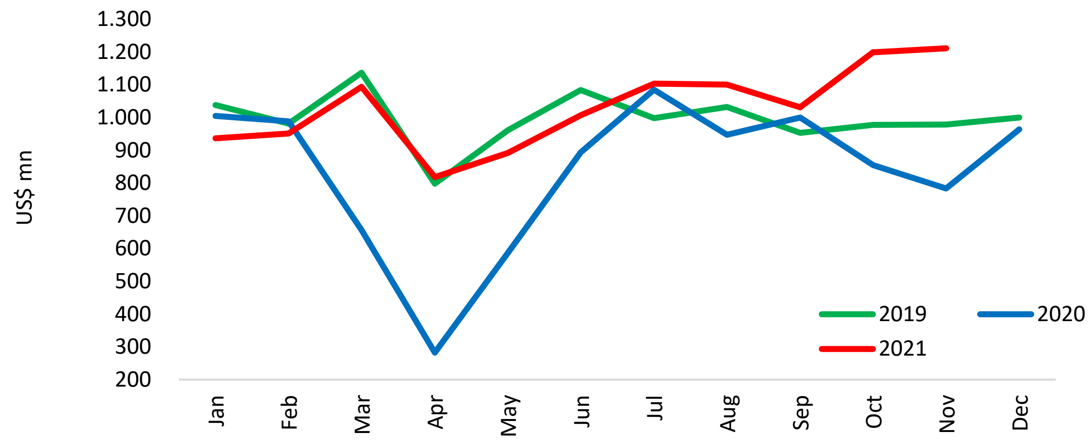
According to World Bank, deteriorations in labor market outcomes are the main channels through which the COVID-19 pandemic has increased poverty. Just as improvements in the labor market drove poverty reduction pre-COVID, widespread job and earning losses are the main drivers behind rising poverty since the onset of the pandemic. Sectors such as construction, transport, manufacturing, food, and accommodation created most new jobs in recent years but have been particularly hard hit.

5.5 International Trade

Export earnings from merchandise exports in 2020 were severely impacted during the months in which containment measures were more intense with the spread of the COVID-19 pandemic but recovered towards the pre-pandemic levels during the latter part of 2020. Lockdowns and other public health restrictions enforced to combat the spread of COVID-19 negatively affected the production of exportable goods particularly during the months when some garment factories were operating with severe restrictions due to a Covid cluster spreading in factories. Meanwhile, subdued external demand, disruptions to shipping and supply chains, issues in importing necessary inputs due to lockdown measures in foreign countries and adverse price movements also affected the overall export performance during the year. As a result, earnings from exports fell to US dollars 10,047 million in 2020, a 15.9 per cent decline compared to 2019.

As shown in Figure 6, the largest year-on-year declines in exports were recorded in the months of March, April and May 2020, while considerable reductions were also recorded in June, October and November 2020 when COVID-19 related health restrictions were more intense. In July and September, export earnings were higher than the corresponding months in the previous year with a notable increase in the export of personal protective equipment (PPE). Compared to 2019, most of the industrial goods registered a decline in exports, while agricultural exports showed a mixed performance with notable increases in some products. Industrial exports registered a broad-based decline in earnings, with an overall reduction of 18.6 per cent in 2020 compared to 2019. The export of textiles and garments, the single largest export of Sri Lanka, registered a decline in earnings of 21.0 per cent in 2020.

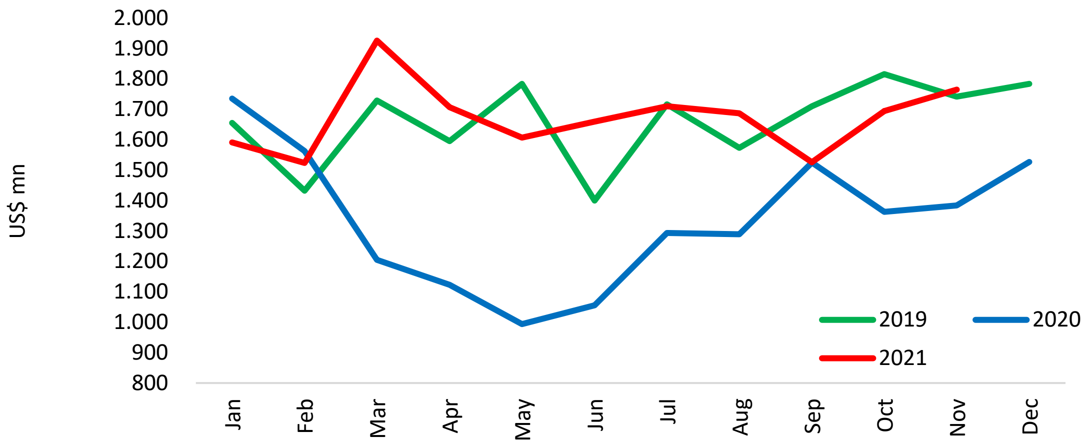
Figure 6. Export of Merchandise Goods (Monthly)



Recovery in merchandise exports to pre pandemic levels continued so far in 2021 as export earnings during the first 10 months recorded USD 10 billion which is a growth of 22 per cent compared to the first 10 months of 2020. Export oriented manufacturing facilities were permitted to operate with some measures to prevent spreading the virus even during lockdowns periods in second and third waves of the virus. Such measures helped recover export of merchandise goods faster than expected.

As shown in Figure 7, expenditure on imports also declined by 19.5 per cent to US dollars 16,055 million in 2020 compared to 2019, with declines in imports of intermediate goods, investment goods and non-food consumer goods. The overall decline in import expenditure was a result of restrictions imposed by the government on the importation of non-essential goods due to declining external reserves, low oil prices in the global market, and the reduction in the importation of intermediate goods due to subdued economic activity in the country and disruptions to global supply chains.

Figure 7. Import of Merchandise Goods (Monthly)



Expenditure on intermediate goods declined by 20.2 per cent in 2020. Expenditure on crude and refined petroleum, the largest import item among intermediate goods, declined to US dollars 2,325 million in 2020 from US dollars 3,677 million in 2019, mainly due to the decline in prices. Expenditure on investment goods declined by 22.6 per cent in 2020. Declines in import expenditure in all three main categories of investment goods, i.e., machinery and equipment, building material and transport equipment, were observed in 2020 compared to 2019. Import restrictions as well as other effects of the pandemic on the global and local economy resulted in this outcome.

Imports of non-food consumer goods declined by 27.0 per cent in 2020 compared to the previous year, with the largest contribution to the decline arising from motor vehicles for personal use. Import restrictions imposed by the Government on non-essential imports also contributed to this decline.

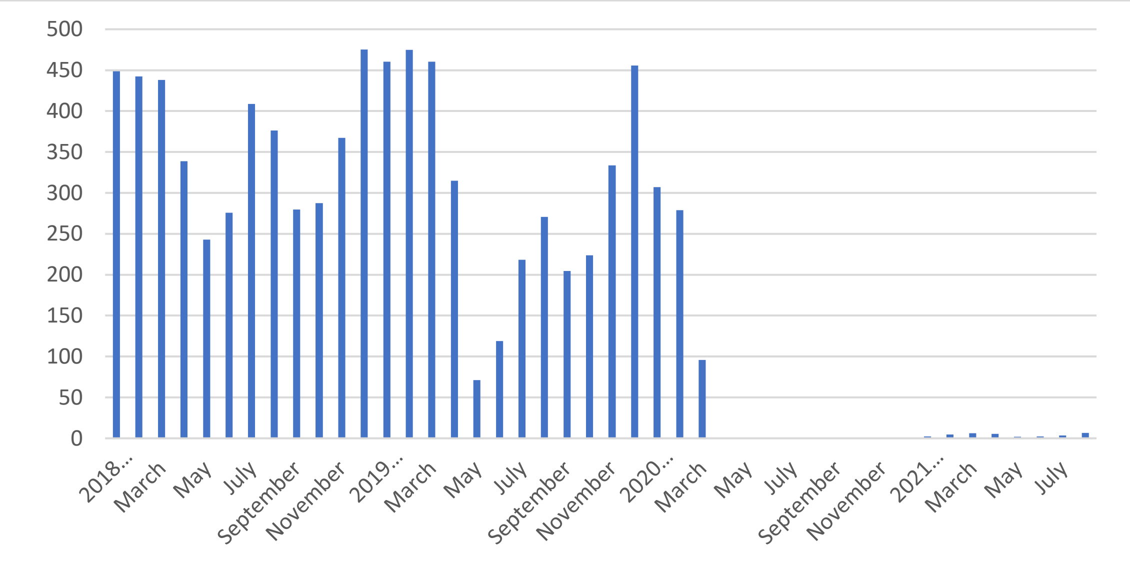
During first 10 months of 2021 merchandise imports recovered to pre-pandemic levels and grew by 26.6 per cent to US dollars 16.6 billion despite some restrictions on non-essential imports and shortages in foreign exchange available for importers due to declining external reserves. Higher petroleum and other essential commodity prices mainly contributed to higher expenditure on imports during 2021.

The combined effect of the gradual recovery in earnings from merchandise exports and the continuous decline in expenditure on merchandise imports resulted in the trade deficit to contract notably to record 7.4 per cent of GDP in 2020 compared to 9.5 per cent of GDP recorded in 2019. However, the cumulative deficit widened during January to October 2021 to US dollars 6,498 million from US dollars 4,846 million in the corresponding period of 2020.

5.6 Tourist Earnings

Foreign exchange earnings from tourism industry had become a major source of income from export of services in Sri Lanka by 2018. In 2018, tourist earnings had increased to US dollars 4.3 billion (4.8 per cent of GDP). After the Easter Sunday attack in April 2019, tourism industry was recovering to earlier levels by early 2020. However, the recovery in the tourism sector was short lived as the pandemic emerged in early 2020.

Figure 8. Tourist Earnings in USD



***Source**: Central Bank of Sri Lanka*

As shown in Figure 8, tourist earnings dropped significantly after the Easter Sunday attack, in April 2019, but the sector recovered almost to the pre-Easter Sunday attack by January 2020. However, with the beginning of the spread of Corona virus globally from February 2020, tourist earnings disappeared fast and have not recovered yet. Trends in tourist earnings indicate the fact that the impact of the Easter Sunday attack on the economy was short-lived and recovered fast but the impact of the pandemic appears to be much more significant and long-lasting.

6. Economic policy Measures taken in response to Covid

Sri Lanka has mainly used two types of policies to address the economic effects of the pandemic: a) monetary and financial sector measures; and b) fiscal measures.

6.1 monetary and financial sector measures

In relation to monetary measures, the Central Bank of Sri Lanka has reduced the key policy interest rates, namely the Standing Deposit Facility Rate (SDFR) and Standing Lending Facility Rate (SLFR), several times since January 2020. By July 2020, policy rates were reduced by 250 basis points and the rates were maintained at this historically very low level until August 2021. This was the sharpest reduction of policy rates within a short time period and the lowest level ever rate maintained by the Central Bank of Sri Lanka. In addition, the Statutory Reserve Ratio (SRR) on all rupee deposit liabilities of licensed commercial banks (LCBs) was reduced by 3.00 percentage points during the same period thereby injecting permanent liquidity of around Rs. 200 billion to the domestic money market. The Central Bank also ensured maintenance of large liquidity surpluses in the domestic money market through open market operations (OMOs) of various types and maturities, to avail sufficient liquidity for financial institutions. This has enabled them to facilitate the urgent financial requirements of the economy. The Central Bank was able to implement such a huge monetary stimulus as inflation was maintained between the targeted level of 4-6 per cent for a long period until very recently.

The Central Bank also monetized a major part of the rising fiscal deficit in an unprecedented manner at suppressed interest rates, as the government was not willing to pay market interest rates to finance the budget deficit. At the weekly Treasury bill auctions, the Treasury imposed a cap on maximum interest rates which the government was willing to accept. Since such interest rates were below market rates, T-bill auctions were partly or fully unsubscribed forcing the Central Bank to purchase the unsubscribed amounts at suppressed rates. In this manner, the Central Bank has provided Rs 2002 billion (13.4 per cent of GDP) to monetize fiscal deficits during 2020 and up to September 2021. This is by far the highest ever amount of deficit financing by the Central Bank within such a short period. According to CBSL estimates announced in its Road Map (2021) for six months, the Treasury has saved Rs 313 billion (2.1 per cent of GDP) in interest payments by monetizing fiscal deficits at lower interest rates than market rates through financial repression.

The lagged impact of such excessive monetary expansion is now being felt with a time lag in terms of inflation already exceeding the targeted levels announced by the Central Bank. Inflation is likely to increase further with relaxation of covid restrictions which will boost aggregate demand back to normal levels. In addition, such excessive monetary expansion has created demand for more imports thereby contributing to widening the trade deficit despite selective import controls. This is exerting pressure on the currency to depreciate or deplete external reserves further from current very low levels. Therefore, the burden of excessive monetary expansion is now being borne by the public by way of the rising cost of living caused by higher-than-expected inflation and sharper depreciation of the currency. Despite the Central Bank propping up the exchange rate through moral suasion, a significant share of imports is being priced at parallel market exchange rates which are being passed through to prices.

Monetary policy was the only available macroeconomic instrument available to support the economy during the pandemic as there was no fiscal space to do so due to already very high fiscal deficits with government debt moving towards unsustainable levels even before the pandemic. Deterioration of fiscal imbalances is due less to the pandemic and far more to successive governments running unsustainable fiscal deficits over a long period. This is the root cause of the macroeconomic imbalances, as highlighted in Weerasinghe (2021).

In addition to monetary stimulus, several measures were undertaken across the financial sector to ease the burden on businesses and individuals arising from the outbreak and containment measures. A wide-ranging debt moratorium has been announced for the tourism, plantation, IT and apparel sectors, related logistics providers as well as small and medium scale enterprises. Debt moratoria offered not only postponing payment of capital and interest payments but also offered some concessional interest rates when interest payments are collected by commercial banks and non-bank financial institutions. Value of debt extended under the moratoria, as at end-September 2021, was Rs 780 billion which is around 5 per cent of GDP. These moratoria have now been extended further as businesses have still not recovered from the pandemic. This has posed a significant risk to financial system stability as a significant portion of these loans are likely to be in the default category. This will erode the capital of some financial institutions, particularly ones which are already below prudential levels of capital requirement. With the government having no resources for a bail-out, the collapse of some of them could lead to contagion that threatens financial system stability.

Although concessions on interest rates were offered by regulations, the cost of such concessions were not financed by the Treasury or Central Bank and therefore financial institutions had to bear and manage the cost of concessions. In such situations, financial institutions recover the cost of the subsidy from depositors in terms of lower interest rates offered for deposits. As per Central Bank estimates announced in its Road Map (2021) for six months, the value of this subsidy amounted to Rs 365 billion (2.4 per cent of GDP) by end-September. This implies that depositors of financial institutions have paid Rs 365 billion out of their interest income to provide interest subsidy to businesses affected by the pandemic. The fact that commercial banks have reported same or higher levels of profits even during the pandemic confirms that the cost of subsidy has been passed to depositors by reducing interest rates on deposits. Ideally, this cost should have been borne by the government through taxpayers' money rather than funded by savers, the majority of whom are living off their interest income, in Sri Lanka, as there is no social safety net for retired private sector workers and senior citizens. Only employees in the public sector receive a lifetime pension from taxpayers' money. Since the government had no fiscal space even before the pandemic, savers were compelled to bear the burden of providing interest subsidies to businesses in addition to the adverse impact on their livelihoods due to the pandemic. This may have widened income inequality further and more people would have fallen below the poverty line. Poverty levels estimated in World Bank (2021) confirms increasing poverty after the pandemic.

Commercial banks have been able to manage the impact of debt moratoria on capital and liquidity as they had created capital and liquidity buffers well above regulatory requirements before the pandemic. Further, to facilitate the provision of these concessions, lower capital conservation buffer requirements and a relaxation of loan classification rules have been announced by the regulator, the Central Bank of Sri Lanka, in addition to the availability of liquidity at reduced interest rates. However, there are several non-bank financial institutions, which were already running with low capital and liquidity ratios that are facing the risk of further deterioration in their capital and liquidity positions thereby posing a risk to financial system stability.

In addition to debt moratoria, the Central Bank introduced a concessionary loan scheme for working capital requirements for businesses affected by the pandemic without any funding from the government for the interest subsidy. This measure provided additional monetary stimulus as the Central Bank had to pump new funds to the banking system at concessional interest rates even below the policy interest rates under which financial institutions have access to short-term liquidity for their lending. Such concessions would reduce the Central Bank's future profits and hence government's future non-tax revenue. The value of this concessional refinance scheme funded by the Central Bank was Rs 165.5 billion (1.1 per cent of GDP) as at September 2021.

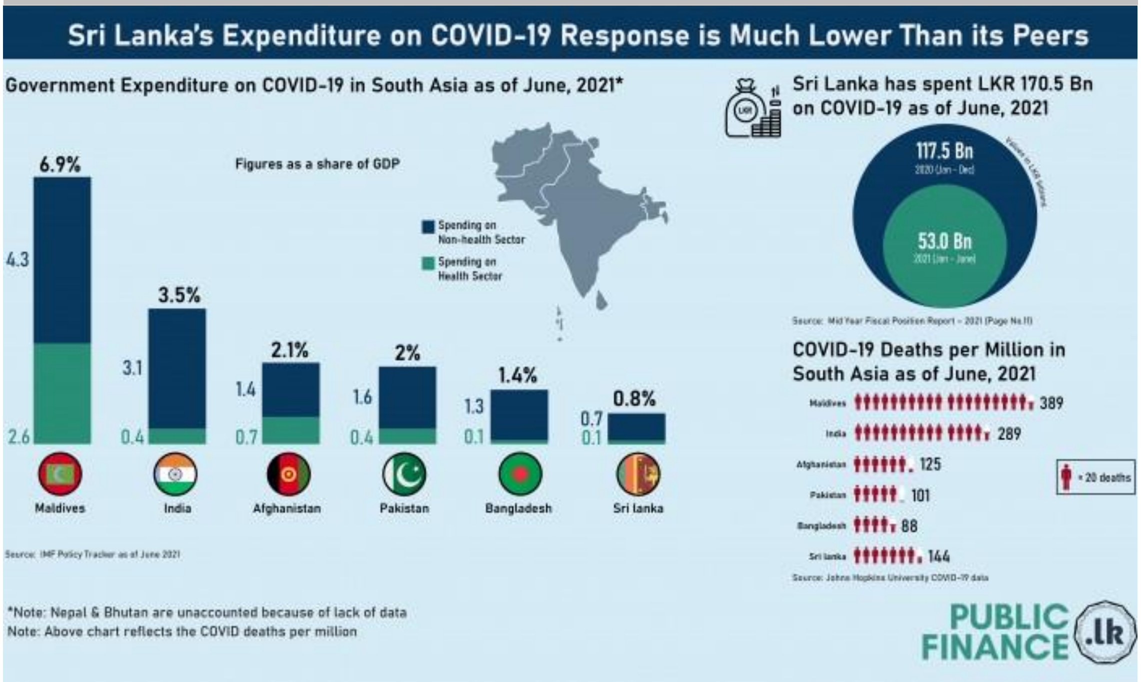
6.2 Fiscal policy measures

On fiscal policy, the overall deficit in fiscal accounts and government debt increased substantially during 2020 against projected levels. A small portion of the higher fiscal deficit can be attributed to higher pandemic related expenditure and lower tax revenues due to lower- than-expected GDP growth. However, a significant portion of the reduction in revenue can be accounted for by the reduction in taxes by the government soon after presidential election before pandemic hit the economy. The reduction in government revenue due to lower taxes has been estimated to be around Rs 500 billion (3.3 per cent of GDP).

Due to severe fiscal constraints, the Government was able to spend a relatively small amount for Covid related expenditure. During 2020 and up to 07 September 2021, Government was able to spend only 1.4 per cent of GDP (Rs 209 billion). This amount was spent mainly on the vaccination programme, financial assistance to low-income families during lockdowns, tax exemptions for medical equipment, PCR and rapid antigen tests, provision of healthcare facilities and community awareness programmes.

PublicFinance.lk makes a comparison on Covid related government expenditure across a sample of South Asian countries using information available in the IMF Policy Tracker, as at end-June 2021. Figure 9 shows this comparison. Accordingly, the Sri Lankan fiscal authorities spent the lowest amount as a percent of GDP on Covid related expenditure, despite Sri Lanka's deaths per millions being higher than that of Afghanistan, Pakistan and Bangladesh. It is also noteworthy that Sri Lanka's per capita GDP is higher than all countries in the sample except for Maldives. Despite Sri Lanka's relatively higher income levels the fiscal authorities have failed to mobilize domestic resources to support the economy facing a severe economic shock. This reinforces vividly the importance of maintaining adequate fiscal buffers.

Figure 9. Regional Comparison on Covid-19 Response



As highlighted in Weerasinghe (2021) the root cause of the current macroeconomic crisis, in Sri Lanka, is the failure to manage public finances by the fiscal authorities over a long period even before the pandemic. Unsustainable fiscal deficits have led to high current account deficits resulting in regular balance of payment crises. The unprecedented shock from the pandemic has led to the already fragile economy facing the worst ever economic crisis now.

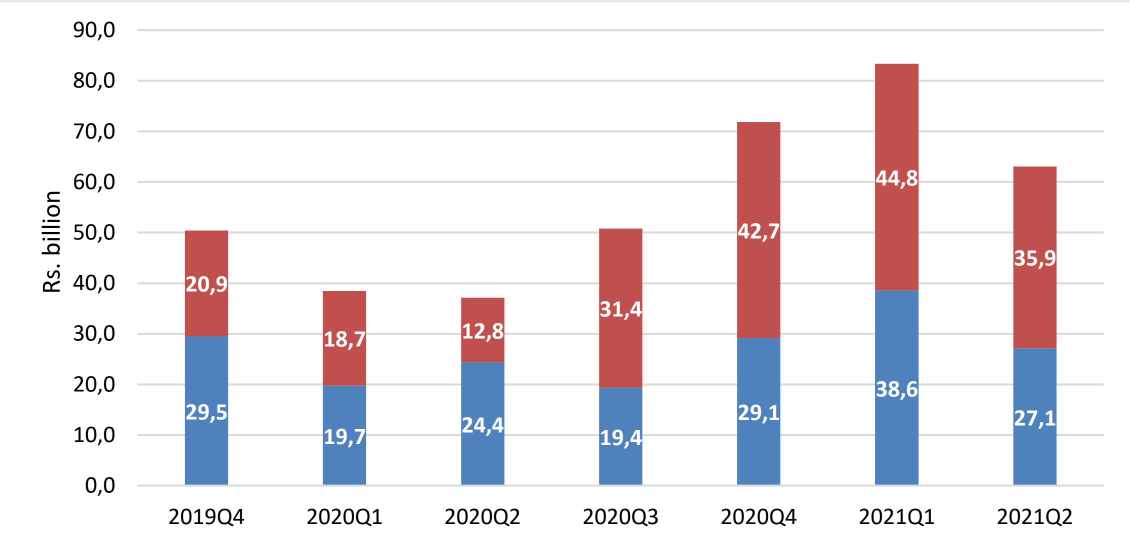
Table 3. Breakdown of support packages and costs borne by different stakeholders

	Rs Billions	per cent of GDP
Total value of monetary stimulus	2167.5	14.5
Total value of fiscal stimulus	209	1.4
Total value of debt moratoria	780	5.2
Cost borne by Depositors in Financial Institutions	365	2.4
Costs borne by investors in Government Securities	313	2.1
Cost borne by taxpayers	209	1.4

***Source**: Road Map, Central Bank of Sri Lanka*

Table 3 provides a summary of total values of support packages provided by the Central Bank and government. Accordingly, the total value of the monetary stimulus and debt moratoria is equivalent to almost 20 per cent of GDP, while the value of support provided by the fiscal authorities out of taxpayers' money is equivalent to only 1.4 per cent of GDP. Depositors of financial institutions have funded subsidies provided to businesses by way of concessional interest rates while investors in government securities have funded the interest subsidy provided to the Treasury by way of financing budget deficits at interest rates below market rates. In fact, the value of the interest subsidy (Rs 313 billion) to the Treasury is higher than the amount (Rs 209 billion) it has spent on covid related measures. Therefore, the entire burden of the covid support package has fallen on depositors of financial institutions and investors in government securities. The largest investor in government securities is the Employees Provident Fund which is the superannuation fund of all private sector employees. A significant portion of the return on their savings has been used to finance the interest subsidy for the Treasury by way of suppressed interest rates. On a net basis, taxpayers' money has not been utilized at all to provide support for covid related measures by the authorities. Ideally, taxpayers should have carried a major share of the burden to distribute it fairly, thereby reducing income equality. However, in Sri Lanka burden-sharing of covid related expenditure appears to have widened income inequality further. This is also confirmed by the fact that majority of companies listed in the Colombo Stock Exchange have reported more profits during the pandemic compared with pre-pandemic profits as shown in Figure 10. Two major sources of such profits are: 1) lower cost of finance through monetary policy easing and subsidized credit facilities offered during the pandemic; and 2) much lower tax liabilities as the government reduced taxes drastically just before the pandemic.

Figure 10. Profits of public listed Financial and Non-Financial Companies in Sri Lanka



***Source**: Compiled by the author using data published by Colombo Stock Exchange*

7. Current Economic Policy Challenges

Sri Lanka is now recovering from the health crisis mainly due to the successful vaccination drive. Number of patients per day, number of deaths per day are much lower compared to the past three waves of the pandemic. Travel restrictions within the country have been removed. Border restrictions have also been relaxed to a greater extent by Sri Lanka and also for Sri Lankans who faced travel restrictions by other countries. Although economic activity is gradually recovering back to pre-pandemic conditions, economic challenges have greatly worsened. The country's official foreign exchange reserves are dwindling fast and have decreased below US dollars 2 billion dollars by end November 2021 which is less than one and a half months of import expenditure. In comparison to annual external debt service payments of around US dollars 4.5 billion in the next few years, current levels of official reserves are sufficient to meet debt service payments only for few months unless a significant net foreign exchange inflow is realized soon. Since all three rating agencies have downgraded Sri Lanka to CCC levels just a couple of notches above default category, Sri Lanka has no access to international capital markets to raise any external financing. The government and Central Bank are making attempts to arrange short-term foreign currency facilities from regional central banks by way of currency swaps to bridge short-term external financing gaps expecting that tourism and worker remittances will bounce back in 2022 to ease the severe shortage in foreign exchange inflows to the country. In addition, trade and current account deficits are rising due to higher petroleum and other essential commodity prices, while worker remittances coming through the banking sector are declining at a faster rate due to a very lucrative black market for foreign exchange where the parallel market premium is around 20 per cent of the official exchange rate. Such a high parallel market premium has not existed since moving towards a market-oriented economy in 1977. There are severe shortages in the availability of foreign exchange at the official exchange rate even to import essential items such as petroleum, gas, sugar, rice and other essential food items. The Government has banned or restricted import of almost all non-essential items, such as motor vehicles, gold, electronic and electrical items. Since there is an acute shortage of foreign exchange to import essential items, there are shortages and long queues to purchase cooking gas, sugar and some essential items. Due to shortages, prices of such items have risen sharply in the market. The Government made several attempts to control prices by imposing caps on prices. Such caps led to hoarding and eventually the government was compelled to remove price controls through regulations. Inflation has risen above the Central Banks's target range of 4-6 per cent since October 2021 and risen to double digit levels by end 2021.

In addition to issues in the balance of payments in terms of low reserves, shortage in foreign exchange, unsustainable external debt levels, the fiscal position has worsened further compared to pre-pandemic levels. Due to the significant reduction in tax rates and exemptions introduced soon after the Presidential election, in November 2019, tax revenue has plummeted to historically low levels in 2020 and so far in 2021. Expenditure on interest payments has become 80 per cent of total government revenue. Government expenditure remained at the same levels of which the expenditure portion on public investments has reduced further while increasing the share of recurrent expenditure. The overall budget deficit was recorded 11.1 per cent of GDP, the highest level since 1988 and public debt has risen to 101 per cent of GDP which is the highest level since 2004. A larger part of the deficit was financed by the Central Bank and commercial banks. Such monetization of budget deficits by the Central Bank has adversely affected prudent implementation of monetary policy. The recent budget has made an attempt to address the worst fiscal position Sri Lanka has experienced for some time through introduction some ad hoc tax measures, including a one-off tax increase on very high corporate taxpayers. However, such measures are not adequate to bring the fiscal position to a sustainable level even in 2022. Monetization of the budget deficit by the Central Bank is most likely to continue in 2022 as well at a similar scale further threatening monetary stability and leading to further distress in the balance of payments.

The main causes of the current unstable macroeconomic conditions are mainly due to the authorities' inability to implement necessary structural reforms and a prudent fiscal policy. The pandemic has worsened the situation, but the pandemic is not the underlying reason for the current macroeconomic challenges. Situation will get worse with economic activity moving back to pre-pandemic levels. This will boost aggregate demand further through higher domestic demand for investment and consumption exerting more pressure on the balance of payments and inflation as global demand for export of goods and services will be slower to recover than domestic demand. Without a credible plan to finance the widening external financing gap, there is a significant risk for the economy to go through a currency crisis. Such a crisis will threaten financial system stability as several large financial institutions have large foreign currency exposures by way of foreign currency lending to the government and state-owned enterprises.

8. Lessons and Conclusions

In containing the virus, although strict lockdowns are effective in containing it, the economic and social cost of such restrictions are not affordable for countries like Sri Lanka where governments do not have sufficient resources and policy buffers to support a large segment of affected businesses to retain employment and the informal work force whose daily livelihoods are lost due to lockdowns. In Sri Lanka, there is no social safety-net available for the large informal work force who lose daily incomes. Even the safety-net available for low-income families is barely sufficient to meet essential basic needs. Since strict lockdowns for long periods are not feasible, the government has imposed soft lockdowns so that people can engage in daily livelihood activities without travelling long distances. However, such lockdowns cannot contain the spread of a highly contagious version of the virus. Vaccination of a larger segment of population has proved to be most effective way of containing the virus, while allowing economic activity to continue. Sri Lanka has had to face three waves of the virus mainly due to delay in commencing the vaccination drive. The effective vaccination drive that is being implemented currently can prevent further spread and creation of more waves in Sri Lanka.

In mitigating the impact of the pandemic induced adverse economic shock, many countries, particularly advanced countries, introduced unprecedented macroeconomic policy responses by way of large-scale fiscal and monetary stimulus packages. In Sri Lanka, even before the pandemic there were already large macroeconomic imbalances in terms of fiscal deficits, government debt, current account deficits and low external reserves. There were no attempts to introduce structural reforms to address such imbalances and in fact some policies such as drastic tax cuts even before the pandemic widened not only macroeconomic imbalances to unsustainable levels, but also drastically reduced the capacity of the government to provide any fiscal stimulus to mitigate the impact. Monetary policy and financial sector policies were the only available tools to mitigate the impact to a certain extent. However, the way such measures were implemented have widened income inequality further and more people have fallen below the poverty line. A key lesson Sri Lanka has learnt is the necessity of maintaining sufficient macroeconomic policy buffers to be used to mitigate the adverse impact of such unprecedented exogenous shocks. In absence of such policy buffers, the economy is compelled to experience painful adjustments lowering living standards of the people. Such deterioration of economic conditions is already visible with declining per capita GDP, rising inflation, sharp depreciation of the currency, dangerously low levels of external reserves which are sufficient to finance less than four weeks of imports or servicing a couple of months of debt service obligations, severe restrictions in foreign exchange to import even essential items and resultant shortages of such items and a wide gap between official and large parallel market exchange rates etc. Central Bank Road Map (2021) for six months introduced some measures to address short-term issues in end-October 2021 but but no progress has been made so far. The Government presented the Budget for the year 2022 in Parliament, in November 2021. Proposals in the Budget hardly contained tangible measures or policies to address immediate issues faced by the economy. Sri Lanka's macroeconomic imbalances are far wider than the adverse economic impact of the pandemic. With economic activity gradually returning to normal, the situation will get worse unless a strong policy package with structural reforms is introduced. The circumstances are such that there is a case for the authorities to consider an approach to the IMF and a preemptive rescheduling to address the urgent external financing challenge. The authorities have expressed their reluctance to seek assistance from the IMF for bail out and sought some assistance from regional countries and their central banks for short-term financial support to meet short-term debt service obligations. Such attempts have not shown any tangible results so far.

The Sri Lankan experience provides opportunities to learn important lessons in addressing the root causes of such macroeconomic imbalances in order to mitigate adverse impacts of external shocks such as the pandemic.

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