INTERNATIONAL MONETARY AND FINANCIAL COMMITTEE

Forty-First Meeting
April 16, 2020

Statement No. 41-19

Statement by Ms. Sitharaman
India

On behalf of
Bangladesh, Bhutan, India, Sri Lanka

Statement by MS. NIRMALA SITHARAMAN, Minister of Finance and Corporate Affairs, India, and Member, International Monetary and Financial Committee (IMFC), representing the Constituency consisting of Bangladesh, Bhutan, India and Sri Lanka, to the 41st Meeting of the IMFC at the Virtual Spring Meetings 2020

April 16, 2020

A Global Covid

1. The Covid-19 led health pandemic is having a disruptive impact on global trade, economic activity and financial systems. The measures needed to halt the spread of this virus - social distancing and lockdown - are also the precise reasons for bringing the world economy to a standstill. The only solace is that we may be past the worst in many parts of the world; given relentless efforts of the world community towards supporting and reforming health systems, we may have arrived at the beginning of the end of this crisis. However, it is important that we keep our monitoring and preparedness high.

2. **Global growth in 2020** is estimated to be -2.9 percent -- much lower than even during the global financial crisis. Lockdowns, quarantines, and social distancing have caused acute disruption to supply chains, production activity, services, and the financial sector. Can this forum assist in evolving mechanisms to mitigate these risks and boost mutually beneficial engagements? To stand firm against this global emergency, we need to join forces as never before. We need to adopt a prolonged accommodative stance across economies, along with macroprudential measures. IMF has an important role in supporting the growth and stability of all members, and especially the poor and low-income economies.

3. Our **top priority** is to contain the spread of the outbreak and to equip healthcare systems with maximum resources. It is heartening to see the global community coming together to successfully combat the health crisis as never before. This health crisis underscores the need to put human beings at the centre of our vision of global prosperity and cooperation. We need to freely and openly share the benefits of medical research and development, and to develop adaptive, responsive and humane health care systems.

4. The disease knows no boundaries, and hence, our region (South Asia) in many ways has to fight the threat together. On March 15th, the **leaders of the SAARC** (South Asian Association for Regional Cooperation) countries interacted with one another through video conference to chart out a common strategy to combat COVID-19 in the region. In the spirit of collaboration, the Prime Minister of India proposed the creation of a **COVID-19 Emergency Fund** based on voluntary contributions from all the countries, with India making an initial offer of **US$ 10 million**. The fund can be used by any of the partner countries to meet the cost of immediate actions.

5. During the 2008 financial crisis, concerted global efforts and coordinated steps were necessary to accelerate the path to recovery. Lessons learnt from that collaborative effort provide a template for overcoming the current crisis. The measures required today, in order to be effective, call for more of the same – and importantly, flexibility and innovation among the countries, policymakers and institutions and with a sight on the exit as well when the pandemic ends.

6. It is heartening to note the swift response of the stakeholders to mitigate the immediate fallout of the crisis. Immediate fiscal support for the needy (food and cash transfers), expansion of healthcare services, and priority support for business, particularly small and medium, has been provided by almost all countries.

India and Covid

7. India has taken proactive and firm measures to contain the spread and limit the damage to people. Apart from the lockdown at a national level, we have taken several measures to create awareness in the population, strengthen testing facilities, and enhance medical logistics, infrastructure and supplies. To alleviate the impact on the people, particularly, the poor and needy, the government has announced a package of well-targeted measures. The key elements of the package are food, cash transfers to lower-income households, insurance coverage for workers in the healthcare sector, and income support to low-wage workers. (*Detailed note on India's multi-pronged response to Covid and its economic impact is at paragraphs 31-36*).

IMF and Covid

8. Multilateral institutions like the IMF are well-equipped to analyze the full effects of the crisis and to co-ordinate and implement an effective global response. Based on the experience of its member countries, the **IMF can develop a spectrum of possible macro-level scenarios and deploy analytical tools** to develop solutions to address country specific solutions. Appropriate policy responses require optimization of available resources, balanced trade-offs and calibrated sequencing of recovery measures.

9. The impact of the crisis varies across regions and countries. The IMF can harness its vast experience and talent pool to innovate and design solutions to address specific needs of different countries. In this context, we welcome the efforts being made to bring forward the timeline for developing an Integrated Policy Framework. IMF is also well-placed to gather, organize and **share up to-date information of the policy developments and action taken around the world**. Its policy-tracker is an effective means to communicate, co-ordinate and assist members to achieve global best practices.

10. It is well recognized that developing economies – especially **low-income countries** – are the most vulnerable. Even though the virus has spread less in these economies, they are economically impacted via lower exports, lower commodity prices, and lower tourism revenues (as a share of their respective GDPs). The various channels of support including **emergency financing** through rapid deployable facilities, and **debt service relief for the poorest and most vulnerable countries** through the Catastrophe Containment and Relief Trust would help alleviate distress to a great extent. In the context of large portfolio outflows from EMEs post Covid, a non-stigmatized **short-term liquidity line** would be a valuable instrument to inject liquidity into member countries that are otherwise strong on economic fundamentals and policies. On the **general allocation of SDR** being envisaged, there are concerns. In the current context of illiquidity and flights to cash, the efficacy of an SDR allocation is not certain, and that in the absence of a global safety net, countries rely on national reserves as the first line of defence against market turmoil and confidence crises. Consequently, extraneous demands for these reserves, not related to domestic monetary and financial stability, would be costly, and hence cannot be supported.

11. Let me turn now to my constituency, where our nations are getting affected, especially as service sectors, including hospitality, tourism and transportation have come to a grinding halt and major commodity exports are on standstill.

DEVELOPMENTS IN THE CONSTITUENCY

A. Bangladesh

12. Bangladesh's progression path of the government's pursuit of an ascending trajectory of sustained inclusive, equitable and environmentally benign economic growth and social development proceeded broadly on track during H1FY20 (July 2019-December 2019). In this period, the pace of economic activity continued its normal trend due to robust domestic demand aided by strong remittance inflows and higher government investment, while decelerated private credit growth and weak external demand suggested some moderation. The growth in the industry sector was moderated as reflected in the large and medium scale manufacturing output growth. The agriculture sector remained vibrant, supported by favorable agricultural commodity prices and timely availability of inputs and finance. Cautiously accommodative monetary and fiscal stances with inclusivity bias have helped stabilize headline (y-o-y annual average) CPI inflation at around 5.5% in February as targeted for FY20. With significant drop in international commodity and energy prices along with domestic bumper production of crop and non-crop agriculture will keep food inflation thereby general inflation well in check in the coming months.

13. Fiscal deficit (including grants) of 5.0 percent of GDP projected for FY2020 remains within its typically moderate lower single digit trend level, with more than half (2.8 percent of GDP) of it to be funded by domestic borrowing. The implementation of the new VAT law, in part helped generate increased volume of tax revenue although it still remained short of the target. The balance of payment witnessed a surplus of USD 132 million during July-Jan 2019-20, contributed by a decline in current account deficit to USD 1,516 million on the back of hefty remittance inflows along with a higher inflow in FDI coupled with somewhat healthy inflows of medium and long-term loans. However, deficit in trade balance widened to USD 9,643 million during this period, amid a decline in exports and imports by 5.3 percent and 4.4 percent, respectively. Exchange rate remains broadly competitive aided by timely intervention of Bangladesh Bank. Capital market during the first half of FY20 experienced a weak performance as reflected in price indices, market capitalization, and turnover.

14. Towards the end of calendar year 2019, the dark shadows of the hitherto wholly unknown new Covid-19 pandemic began to engulf the entire global community very rapidly, bringing in its trail deaths and disruptions on an unprecedented scale, Bangladesh too came under the cloud of the new scourge mainly via individuals from her diaspora abroad visiting home; although the pandemic's pace of expansion in Bangladesh has thus far remained relatively moderate, not going altogether out of hand yet. Like everywhere else, Bangladesh authorities too have had to adopt drastic steps like community wide extensive spells of mandatory quarantines and lockdowns to limit and contain the threat of Covid infection; bringing in its trail disruptions in domestic economic activities on massive scales. Similar disruptions in countries buying Bangladeshi exports or hosting Bangladesh workers have caused drastically adverse effect on the growth in exports and remittance inflows from Bangladeshi diaspora abroad, sapping external sector strength of the economy as well. To overcome these adverse effects, the Bangladesh authorities had no option other than to line up massive support measures to help out affected businesses and weaker population segments facing loss of work opportunities for their livelihood.

15. This abrupt worsening trend of the external sector balances was due to the global Covid-19 pandemic negatively impacting exports (most worrisomely in the key RMG sector from cancellations and deferrals of orders at hand coupled with drying up of fresh orders) and declining remittance inflows caused by widespread job losses of Bangladeshi workers in host countries abroad. Foreign exchange reserve balances are also on eroding trend due to substantial current account deficits and maturing debt service obligations of the public and private sectors. General slowdown in economic activities from these causes has also worsened pressure on government's fiscal balances, with weaker outlook of revenue growth coupled with increased expenses for emergency relief measures for businesses and for poorer population segments losing daily wages during periods under lockdowns enforced to prevent community transmission of corona virus infections.

16. Safeguarding the deficits in the external sector balances and budgetary gaps due to global Covid-19 pandemic would require immediate and adequate external supports in softer terms (particularly from the multilateral global institutions), including, *inter alia*, for attaining some of the key UN SDGs like climate change, risk mitigation and adaptation, and for larger physical infrastructure projects. Bangladesh looks forward to continuing role of the Bretton-Woods Institutions and their subsidiaries in catalyzing such external financing support.

B. Bhutan

17. Successive decline in hydro-electricity production and public investment have slowed down the growth to 3 percent in 2018 from 4.7 percent in 2017. Growth has dipped to its lowest level since 2014. The combined effect of low hydropower production and construction activities (which decreased by 8.0 percent) due to low spending by the government in capital expenditure and slowing hydropower construction activities contributed to the slippage in the growth by almost 2 percentage points in 2018. Moving forward, the projected growth, prior to Covid-19 pandemic effect for 2019 and 2020 was estimated at 5.4 percent and 6.9 percent, respectively. However, due to the effect of Covid-19 on the economy, particularly, the tourism and its allied sectors contribution to GDP is expected to significantly decline, resulting into downward revision of GDP for the consecutive year.

18. The overall CPI inflation (measured by the year-on-year change of the consumer price index) recorded at 2.28 percent in December 2019 compared to 3.10 percent during the same month of the previous year. The fall in the overall inflation during 2019 is largely contributed in moderation in the prices of non-food commodities. The trend in falling non-food prices is anticipated to continue with the fall in oil prices during the recent COVIT-19 crisis.

19. During FY 2018/19, the fiscal deficit remained within the anticipated threshold of 3 percent of GDP. Persistent drop in external grants and lowered capital investment resulted into financing of the deficit through both external and market borrowings. Although, the capital expenditure has reduced by more than 40 percent, the deficit level remained at 2 percent of GDP (Nu. 3.78 billion) at the end of March 2019. The Government Contingency Measures to combat Covid-19 will increase the re-current expenditure and further widening the fiscal gap over the medium term.

20. On the external front, both the trade and current account deficits deteriorated in FY 2018/19. The current account deficit increased from 19.5 percent of GDP in FY 2017/18 to 23.7 percent of GDP in FY 2018/19, mainly on the account of the trade deficit, which has increased to Nu. 29,880.30 million from Nu. 27,958.14 million in the previous year, driven by higher imports and fall in export of goods and services. The gross international reserves were recorded at USD 1,213.58 million as of December 2019 which is sufficient to finance 14 months of merchandise imports. The immediate and after effects of Covid-19 on external sector are yet to be assessed.

21. The broad money (M2) recorded a significant growth at 13.06 percent in December 2019, as compared to the growth of 7.75 percent in previous year. Higher growth in time and savings deposit and currency in circulation helped to drive the broad money supply in 2019. On the other hand, the positive growth trend in both net foreign assets (by 17.22 percent) and credit to private sector (by 17.85 percent) kept up the higher growth momentum in the broad money supply cushioning the economy from spillover impact of Covid-19 on domestic liquidity management.

22. Although, the current macroeconomic situation looks comfortable, the uncertainty in timeliness and amount of resources needed to combat the ongoing Covid-19 pandemic poses a deep concern, which will have strong adverse impact on our growth and employment situation. We are yet to make a clear assessment on the impact at this moment.

23. With the onset of Covid-19 pandemic, the economy remains vulnerable to both direct impact on the domestic economy and also from the spillover impact of Covid-19 originated from the regional economies, particularly related to India. Its impact on country's balance of payment, particularly in terms of managing the foreign exchange reserves becomes challenging for a small economy like Bhutan since a large portion of foreign exchange earnings are generated from tourism and its allied sectors.

24. Financial sector stability continues to be an overarching objective of the RMAB. Since the tourism and allied sector are one of the major players in the financial sector, providing necessary support in the form of conventional monetary policy measures at this point of time becomes imperative. However, if the situation prolongs, the financial institutions will be stressed, posing further challenges for maintaining the financial sector stability.

25. Bhutan has two constitutional requirements (a) meeting all re-current Government expenditure from domestic revenue and (b) foreign exchange reserves to meet 12 months of essential import coverage. With the expected decrease in domestic tax revenue collection, the rising government re-current expenditure to combat Covid-19 crisis along with increasing pressure on essential imports and on foreign exchange reserves will potentially put tremendous pressure in meeting the above Constitutional requirements.

26. Further, with exchange rate peg between Ngultrum and INR, the spillover impact of INR depreciation will have adverse impact on Bhutan's balance of payments particularly, in terms of external debt servicing denominated in foreign currency.

27. As we understand that all the International Financial Institutions (IFIs) are under tremendous pressure at the moment. It is critical to understand the ground realities of each country hit by the Covid-19. The comfort on policy guidance and financial assistance at this hour as well as moving forward provided by the IFIs will be immensely beneficial to the member countries to fight back this unprecedented crisis of the moment and rebuilding our economy on a stronger foundation.

C. India

28. After a subdued **GDP growth** estimated to be 5.0 percent in 2019-20, the outlook of growth in India was looking up but the expectations of a rebound in 2020-21 have been stifled by the Covid-19. The pandemic is **impacting economic activity directly due to lockdowns, and through second round effects operating through global trade and growth**. Due to **restrictions in travel**, disruption in shipments, and also **disruption in supply chain** caused by production lockdown outside, there is wide-ranging impact on economic activity in India. A few critical sectors like **hospitality, tourism and aviation** have already been affected by travel restrictions, and cancellation in ticketing, hotel bookings, event bookings, besides no fresh bookings. Some industrial sectors in the country such as **automobiles, agro-chemicals, electronics and pharmaceuticals** are getting affected on account of shipment difficulties and supply-chain disruptions, which could lead to inventory mismanagement at the company level.

29. Currently, uncertainty is high and eventual outcome will depend on the intensity, speed and duration of the pandemic. India initiated steps and mobilized its population at an early stage to contain the spread and has been largely successful. While these steps slowed down the domestic economic activity, the **external sector has also suffered from the disruption of supply chains**. Conditions worsened with the flight of capital to safe havens, as was also witnessed by most emerging economies.

30. **India's GDP growth** is forecast to be **1.9 percent in 2020-21**, as per IMF's estimates. This is a sharp slowdown due to exogenous shock though among the major economies, this is the fastest projected growth. Depending on the initial conditions, the impact of a generalized global shock varies significantly across geographies. The central government **fiscal deficit** remains moderate and **current account deficits** during previous two years have remained stable at about 2 percent of GDP. We do not see a major deterioration in our external and internal balance, especially as **lower oil prices** is a good offset, but we are not being complacent as external demand will fall and tightening of financial conditions can have domino effects. The upside is that India's reliance on external financing continues to remain limited with its **external debt-GDP ratio reasonable** (by global standards) and **import cover more than adequate** (as per reserve adequacy criteria). After capital infusion, the **capital ratios of Indian banks remain comfortable** and **asset quality and profitability of commercial banks has improved** (after a long period of stress). The provisioning coverage ratio of banks has improved markedly. The **Insolvency and Bankruptcy Code in India has gained traction**, enhancing resolutions. Since India's initial conditions remain strong, and because of a well calibrated domestic response to Covid-19, we expect the Indian economy to steer through the rough waters and is expected to suffer less than its peer economies with weaker initial conditions.

India's response to Covid-19

31. Given the size of our population, India could have become a major Covid hotspot. However, it is noteworthy to mention that even as of April 11th, India had 6,565 active cases and 239 deaths. From the very beginning, the Government has been taking no chances and had **launched massive efforts** to assist the health system respond effectively to the Outbreak. The Government instituted important measures which included **social distancing measures** like travel restrictions, work from and stay at home in both the public and private sectors, and direct health interventions centred on scaled up testing, screening and treatment. The Government has been mobilizing all efforts, including **allocation of resources amounting to INR 150 billion (about US$ 2 billion), for health infrastructure, protection and containment measures (personal protective equipment, ICU, ventilators), medical supplies, strengthening of labs, creation of quarantine facilities, capacity building, etc**.

32. For a country of India's size and population, the comparatively low rate has been made possible by the **leadership's initiative and voluntary participation by people in social distancing and lockdown measures** that has made prevention a relative success. On March 24th, the Prime Minister of India had announced an unprecedented **nation-wide lockdown for 21 days** in India to arrest the spread of the virus. The three-week nationwide lockdown of 1.3 billion people has been particularly helpful in breaking the tide. Tabulation (and documentation) of containment policy measures in an **Oxford University study** shows **India** with the **highest preventive policy stringency index** among all countries as of March 31st, 2020.

33. Country-wide lockdown in India has attracted willing compliance by masses despite fallouts of human hardships. Conscious of this fact, the **Government has taken steps to provide adequate support,** including **home delivery of food** to migrant agricultural labourers, industrial workers, other unorganized sector workers, older people, differently abled people, senior citizens and women during this lockdown period. **Shelter** has also been provided to homeless people for safe habitation to avoid Covid-19 spread. Besides, the Government has taken major steps in the area of **food security, life insurance, employment guarantee and direct cash and income transfers for poor**.

34. In addition to preventive measures, the two other possible policy responses to this historic pandemic are **monetary and fiscal**. **Monetary policy was eased** (policy rate was cut by 75 bps) and supplemented by far reaching **liquidity easing and credit easing measures** that included additional accommodation through **standing facilities, long-term repo**

operations (LTROs), targeted long term repo operations (TLTROs) intended to de-freeze markets for corporate bonds, commercial paper and debentures, a **moratorium on payment of instalments of term loans, deferment of interest on working capital facilities and easing up of working capital financing**. RBI also undertook **INR/USD sell-buy swaps** that stabilized foreign exchange markets. A gist of the key Monetary and Regulatory Measures is as under:

- **Policy repo rate was cut** by 75 basis points to support economic activity. Monetary Policy Committee (MPC) indicated their resolve to maintain an accommodative stance as long as it is necessary to revive growth and mitigate the impact of Covid-19 on the economy while ensuring that inflation remains within the target.
- **Reduction in the cash reserve ratio** (CRR) of all banks by 100 basis points to 3.0 percent of net demand and time liabilities (NDTL).
- Increase in the **accommodation under the marginal standing facility** (MSF) from 2 percent of the statutory liquidity ratio (SLR) to 3 percent. These measures will inject total liquidity of Rs. 3.74 trillion to the system (approximately 1.25% of GDP). As a measure to ease pressure on banks, **regulatory norms were relaxed** *viz*., deferment of Implementation of Net Stable Funding Ratio (NSFR) and of last tranche of Capital Conservation Buffer (CCB). Regulatory measures have been introduced to promote credit flows to MSMEs and the retail sector.
- **Targeted Long-Term Repo Operations** (TLTRO) for an amount up to Rs. 1000 billion to ease cash flow pressures across sectors, with liquidity availed under the scheme by banks to be deployed in investment grade corporate bonds, commercial paper and non-convertible debentures.
- **Moratorium of three months** on payment of instalments on Term Loans was extended by commercial banks (including regional rural banks, small finance banks, and local area banks), co-operative banks, all-India Financial Institutions, and NBFCs (including housing finance companies and micro-finance institutions). Deferment of Interest on Working Capital Facilities extending by lending institutions for three months.

35. Keeping in mind the economic challenges arising from Covid-19, an **Economic Response Task Force** was set up under the Finance Minister on March 24th that take decisions regularly, based on regular interactions and feedback from all stakeholders, and analysis of all situations and dimensions. This Task Force also ensures that all steps taken to reduce the economic difficulties are effectively implemented. On March 24th, the Task Force announced several **decisions in respect of statutory and regulatory compliance matters** related to income tax, GST/ indirect tax, customs, financial services, corporate affairs, commerce and fisheries. This announcement helped alleviate the hardships faced by several sectors in adhering to the year-end compliances for various regulatory matters due to travel restrictions and lockdown.

36. Regarding the conventional policy measures, India, like many other economies, has been extremely proactive, especially with regard to the vulnerable population. On March 26th, the Task Force announced the **Prime Minister's *Garib Kalyan Yojana***, a welfare scheme for the poor, vulnerable and disadvantaged groups amounting to **INR 1,700 billion (about US$ 23 billion)** to provide various support measures. The package, *inter-alia,* includes **free health insurance to health workers; cash transfers to farmers, women and elders, free food and gas distribution for the poor with a view to compensate for the economic loss of this vulnerable population; and social security measures for affected workers in both organized and informal sectors**.

D. Sri Lanka

37. A new government assumed office in November 2019 under the leadership of His Excellency President Gotabaya Rajapaksa. The governments' economic policy strategy is aimed at reinvigorating the economy through a substantial fiscal and credit stimulus to increase aggregate demand and thereby growth. This policy strategy was adopted against the backdrop of subpar economic growth that has been a persistent feature of the Sri Lankan economy for several years and low growth in credit and monetary aggregates.

38. The Sri Lankan economy continued to grow at a sluggish pace in 2019 registering a GDP growth of 2.3 percent in real terms in comparison to 3.3 percent in 2018. Growth was largely led by the services and the industry sectors, while the agriculture sector contributed positively, although at a slower pace. The services sector, which accounts for 58.2 percent of GDP, grew by 2.3 percent in 2019 supported largely by the higher value addition in the wholesale and retail trade, telecommunication, IT, and other personal services sub-sectors. The industry sector accelerated its growth momentum to 2.7 percent in 2019 from 1.2 percent in the previous year, increasing its GDP share to 27.4 percent in 2019. Manufacturing activities, together with a recovery in construction and mining and quarrying, largely accounted for the improved performance in the industry sector. The agriculture sector, accounting for 7.4 percent of GDP, grew marginally by 0.6 percent in 2019 as key agricultural activities such as growing of rice and fishing recorded contractions in value addition.

39. Inflation was maintained within mid- single digit levels during the first nine months of 2019 although some upward pressure was witnessed thereafter due to higher food prices and the low base effect. Headline inflation (y-o-y) as measured by the National Consumer Price Index (NCPI), increased to 6.2 percent in December, 2019 while the Colombo Consumer Price Index (CCPI) registered 4.8 percent. Core inflation, which spiked in January mainly due to house rental revisions, stabilized at higher levels registering 5.2 percent and 4.8 percent (y-o-y) respectively in terms of NCPI and CCPI in December, 2019. However, core inflation currently remains below 3 percent in terms of the CCPI index reflecting subdued demand pressures.

40. Against the backdrop of well anchored inflation expectations, the Central Bank adopted an accommodative monetary policy stance in 2019 in view of the sluggish growth, deceleration in monetary and credit aggregates and the global trend in monetary policy easing. The Central Bank reduced the Statutory Reserve Ratio (SRR) by a total of 2.50 percentage points on two occasions in November, 2018 and March, 2019 to ease liquidity conditions in the domestic money market. In May, 2019, the Central Bank reduced its policy rates, namely the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) by 50 bps to 7.50 percent and 8.50 percent respectively, followed by another 50 bps reduction to 7 percent and 8 percent, respectively in August, 2019 to support economic activity. During the year, interest rate caps were also imposed to improve the monetary policy transmission process. In January 2020, the policy rates were reduced further by 50 bps to 6.50 percent and 7.50 percent for the SDFR and SLFR respectively, while credit support schemes were implemented to encourage domestic economic activity.

41. The fiscal performance deteriorated in 2019 as budgetary operations reflected lower revenue collections amidst a rise in government expenditure, resulting in a higher budget deficit of 6.5 percent of GDP in 2019, as against a target of 4.4 percent of GDP envisaged for the year. Revenue declined both in nominal and GDP terms in comparison to the previous year, registering 12.2 as a percentage of GDP in 2019 in comparison to 13.3 percent of GDP in the previous year. The setback in revenue mobilization was largely due to the slowdown in economic activity, policy measures imposed to curtail imports and the delayed implementation of revenue proposals in the 2019 budget. Meanwhile, government expenditure as a percentage of GDP rose to 18.7 percent of GDP from 18.6 percent in the previous year due to higher recurrent expenses on account of interest payments and subsidies and transfers. Public investment as a percentage of GDP was maintained at 4.1 percent in 2019. The expansion in the budget deficit increased the government’s debt stock in 2019.

42. A series of fiscal policy measures was announced by the new government in November 2019 to re-vitalize the economy. Tax reform measures entailed changes to direct and indirect taxes aimed at reducing the tax burden, simplifying the tax structure and creating a conducive environment for the private sector to generate economic activity, thereby boosting economic growth. A plethora of tax measures were adopted to ease the tax burden including the reduction in the VAT rate, lower income tax rates and the provision of tax incentives for identified sectors, while certain ad-hoc taxes were abolished to simplify the tax structure. Meanwhile, expenditure rationalization measures were aimed at improving public expenditure management, enhancing the financial viability of state enterprises and simplifying administrative systems and procedures to improve governance. Public investments have also been prioritized to high impact projects that have a significant economic and financial benefit to the economy.

43. Despite the occurrence of a severe shock to the economy in April 2019, Sri Lanka's external sector remained stable during the year, aided by policy measures implemented to improve the stability of the sector. Policies were adopted to curtail non-essential imports mainly by increasing tariff and margin requirements, reducing loan-to-value ratios and suspending the use of permits for vehicle imports. These policy measures, aimed at easing the pressure on the exchange rate, resulted in significant reductions in imports of gold, vehicles and non-essential items. Consequently, the trade deficit in 2019 contracted significantly driven by the substantial reduction in imports, and a marginal increase in exports. Meanwhile, the slowdown in tourism earnings and remittances adversely impacted the services account of the BOP. Nevertheless, the substantial contraction in the trade deficit enabled the current account of the BOP to record a notable surplus in 2019. In the financial account, foreign investments in the government securities market as well as the Colombo Stock Exchange (CSE) showed a net outflow in 2019. Gross official reserves stood at US dollars 7.6 billion at end December 2019 which was equivalent to 4.6 months of imports. Mirroring these trends, the Sri Lankan rupee appreciated by 0.6 percent against the US dollar in 2019. However, in March 2020, the COVID-19 outbreak adversely impacted the domestic foreign exchange market with the sharp depreciation of the Sri Lankan rupee due largely to foreign investment outflows from the government securities market.

44. Sri Lanka received the sixth tranche of the Extended Fund Facility (EFF) of the International Monetary Fund (IMF) in May 2019 after completion of the seventh review. However, commitments made under the EFF have not been fulfilled to receive the seventh tranche as the envisaged international reserve targets and fiscal targets have not been achieved.

45. Sri Lanka faces significant challenges stemming from the unfolding of the COVID-19 pandemic. The economic fallout from the pandemic will weaken the country's fiscal and external position while diminishing growth prospects in the near term. Given the high level of trade openness, Sri Lanka will be severely affected by global trade and supply chain disruptions while subdued external demand will also negatively impact the country's merchandise trade. Similarly, lower services exports, particularly tourism, and reduced remittances can exert pressure on the current account of the BOP. Capital outflows of portfolio investments will adversely impact the foreign exchange market requiring policy action by the authorities. These developments, together with tight financial conditions globally, will pressurize the external sector. Given the elevated fiscal gap, higher expenditures and lower revenue mobilization during this period of low economic activity will have adverse implications for macroeconomic stability in terms of inflation and debt sustainability. As domestic financing is limited, additional external funding is urgently needed to deal with the human and economic fallout from the pandemic situation. Against the background of COVID related restrictions on domestic activity as well, economic growth is expected to contract sharply in 2020.

Economic Policy Response to COVID Pandemic

46. In order to combat the economic fallout arising from the COVID-19 pandemic, the government and the Central Bank put in place fiscal, monetary and financial policies. In terms of monetary policy, the accommodative stance was eased further In March, 2020 with a 25 bps reduction in both policy rates - the SDFR was lowered to 6.25 percent and the SLFR reduced to 7.25 percent. Furthermore, the SRR on rupee deposit liabilities of licensed commercial banks was lowered by 1.00 percentage point to 4 percent. In addition to these measures, the Central Bank also introduced several measures to ease the pressure on the exchange rate and prevent financial market panic due to the COVID-19 pandemic. These measures included the suspension of imports of motor vehicles and non-essential goods and the suspension of the purchase of Sri Lanka International Sovereign Bonds by licensed banks in Sri Lanka. In addition, the issuance of foreign currency notes by authorized dealers for travel purposes was reduced to a maximum of USD 5,000 per person. Restrictions on outward remittances in respect of capital transactions were also introduced in April 2020 to preserve the foreign currency reserves of the country. Furthermore, in line with the cabinet decision made to provide relief measures to businesses and individuals affected by the COVID-19 pandemic, the Central Bank of Sri Lanka established a re-financing facility for a wide range of fiscal and financial concessions, including debt moratoriums on capital and interest payments and the provision of working capital loans at concessionary interest rates.

47. The COVID-19 pandemic has put tremendous pressure on Sri Lanka's macroeconomic stability. Sri Lanka has limited fiscal space to launch widespread measures such as large-scale income support schemes to overcome the debilitating economic impact of the COVID crisis. Sri Lanka also carries a high debt burden at present. Moreover, the country is faced with a BOP crisis amidst capital outflows and loss of income from tourism and related exports. Sri Lanka's large fiscal gap and the balance of payments needs necessitate external financing. However, in the current context, emergency financing from an institution such as the IMF requires debt sustainability. This conditionality excludes many countries from access to such funding when it is really needed. The Fund needs to show flexibility in its response to the COVID crisis for countries in this situation. As these are exceptional circumstances which demand exceptional measures, the IMF must find a way to address this issue if all countries are to benefit from emergency financing schemes.

****