A publication of

Professionals for a Better Future

THE FREEFALL

The rapid deterioration of the
Sri Lankan Economy since January 2015

"The present state of affairs in the country can be described only as a national calamity"

Professor Siri Hettige, University of Colombo - Daily Mirror, 18th May 2016

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PROFESSIONALS FOR A BETTER FUTURE

சிறந்த எதிர்காலத்திற்கான நிபுணந்நுவர்வர்கன்

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PREFACE

By the end of 2014, the Sri Lankan economy was internationally recognized as a well-managed and successful economy. The country was on a progressive path. The mood was optimistic and growth was plainly visible. However, following the change of government in January 2015, ground conditions have changed materially within a short period of time, and just one and half years later, the Sri Lankan economy has plunged into deep turmoil, and is today begging for external support from IMF, China, India and many others.

A number of scholars, intellectuals and professionals have been repeatedly highlighting the grave dangers the country is facing due to the poor management of the economy. These revelations have been made through newspaper articles, TV and radio discussions, and public seminars as well as through social media. However, neither the politicians nor the general public have fully understood these concerns due to the scattered nature of such revelations.

"Professionals for a Better Future", have therefore embarked on this effort to compile a single document based on the information that is already available in the public domain in order to help all stakeholders to understand the current status of the economy which is on a rapid and uncontrolled **"freefall"**. The statistics and information quoted in this document have been primarily obtained from the annual reports of the Central Bank and the Ministry of Finance, although learned observations made by various writers and experts including Dr Nimal Sanderatne, Dr. W.A. Wijewardane, Professor Siri Hettige, Dr Saman Kelegama, Dr. Dushni Weerakoon, Chandra Jayaratne, Subashini Abeysinghe, Dinesh Weerakkody etc, who have regularly expressed their concerns about the serious issues facing the economy, have also been referred to. Reference is also made to the observations, concerns and findings of several international agencies such as the IMF, ADB, UNDP, Fitch, Moody's, S & P, etc.

As Dr. W. A. Wijewardena has said in his recent article in the Daily FT of 24th May 2016, **"Time is running out for Sri Lanka"**. Hence, the professionals in this country cannot continue to shy away from reality. They have a deep responsibility to understand what is going on, and to educate the rest of the population. Accordingly, we have taken this initiative and hope that this publication will be useful to take the corrective action in order to arrest the present **"freefall"** of our economy.

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31st May 2016

I) THE STATE OF THE ECONOMY BY THE END OF 2014

The summary of the economy as at 31st December 2014 as set out on the Road Map 2015 of the Central Bank portrayed a reasonably healthy economy demonstrating continuous expansion. The Gross Domestic Product (GDP) per capita had already doubled within the previous 5 years and it was expected to comfortably exceed USD 4,000 by 2015. The country was receiving a steady flow of Foreign Direct Investment (FDIs). Unemployment was down to 4.2%. Inflation was at single digit levels for 6 years continuously. The Growth rate had reached a high trajectory, and growth projections for the next 3 years were at over 7% per annum. Capital markets were thriving with the Colombo Stock Exchange returning gains of 23.4% in 2014 at a market capitalization of Rs 3.1 trillion. These achievements were results of decade long planning and implementation of progressive economic policies. The following table compares the changes in the key economic indicators between 2004 and 2014.

Table : Comparison of key economic indicators 2004-2014

Indicator	2004	2014 (Revised)
GDP	USD 20.7 billion	USD 80.0 billion
GDP per capita	USD 1,062	USD 3,853
Average Inflation	9%	3.3%
Foreign Reserves	USD 2.3 billion	USD 8.3 billion
Debt/GDP ratio	102.3%	70.7%
Public Investment	USD 0.98 billion	USD 3.7 billion
FDIs	USD 0.24 billion	USD 1.6 billion
All Share Price Index	1506	7299
Unemployment	8.3%	4.3%
Poverty head count	15%	6%
Fiscal Deficit/GDP	7.5%	5.7%
Electricity for households	73%	98%
Safe drinking water	72%	90%
Telephone penetration	37%	120%
Computer Literacy	0.5%	26%
University Admissions	14%	18%

Source: Annual Report 2014 of the Ministry of Finance and CBSL Report 2015

The favourable status in 2014 was confirmed by several multi-lateral institutions and rating agencies, as reflected in their comments which are reproduced below:

- *"Sri Lanka's economic growth has been one of the fastest among Asia's developing economies in recent years" - IMF, 29th July 2014*
- *"Sri Lanka's stable government is focused on a high-growth strategy, with public investments as a key driver"* - Standards & Poor's, August 2014
- *"Inflation has markedly decelerated"* - Moody's, July 2014
- *"Sri Lanka's social indicators are among the best in South Asia"* - Asian Development Bank
- *"Big public infrastructure projects are part of a larger development strategy, and lead to roads and ports that compare well with regional infrastructure"* – Fitch, may 2014
- *"Fiscal consolidation has continued, with the overall fiscal deficit falling"* – IMF July 2014
- *"Sri Lanka has made significant progress in poverty reduction"* – Millennium Development Goal, UNDP
- *"Sri Lanka's economic strength is higher than most peers because of its higher per capita income and global competitive score"* – Moody's, July 2014
- *"The Colombo Stock Exchange (CSE) is the most sustainable growth exchange in Asia"* - Capital Finance International (CFI) of UK, December 2014
- *"Colombo is amongst the top 10 fastest growing cities in the world"* - Annual Travel Study of MasterCard in 2014

B**ased on the above background, some of the key national targets, (as set in December 2014), from 2015 to 2020 by the Sri Lankan authorities seemed to be reasonable and achievable.**

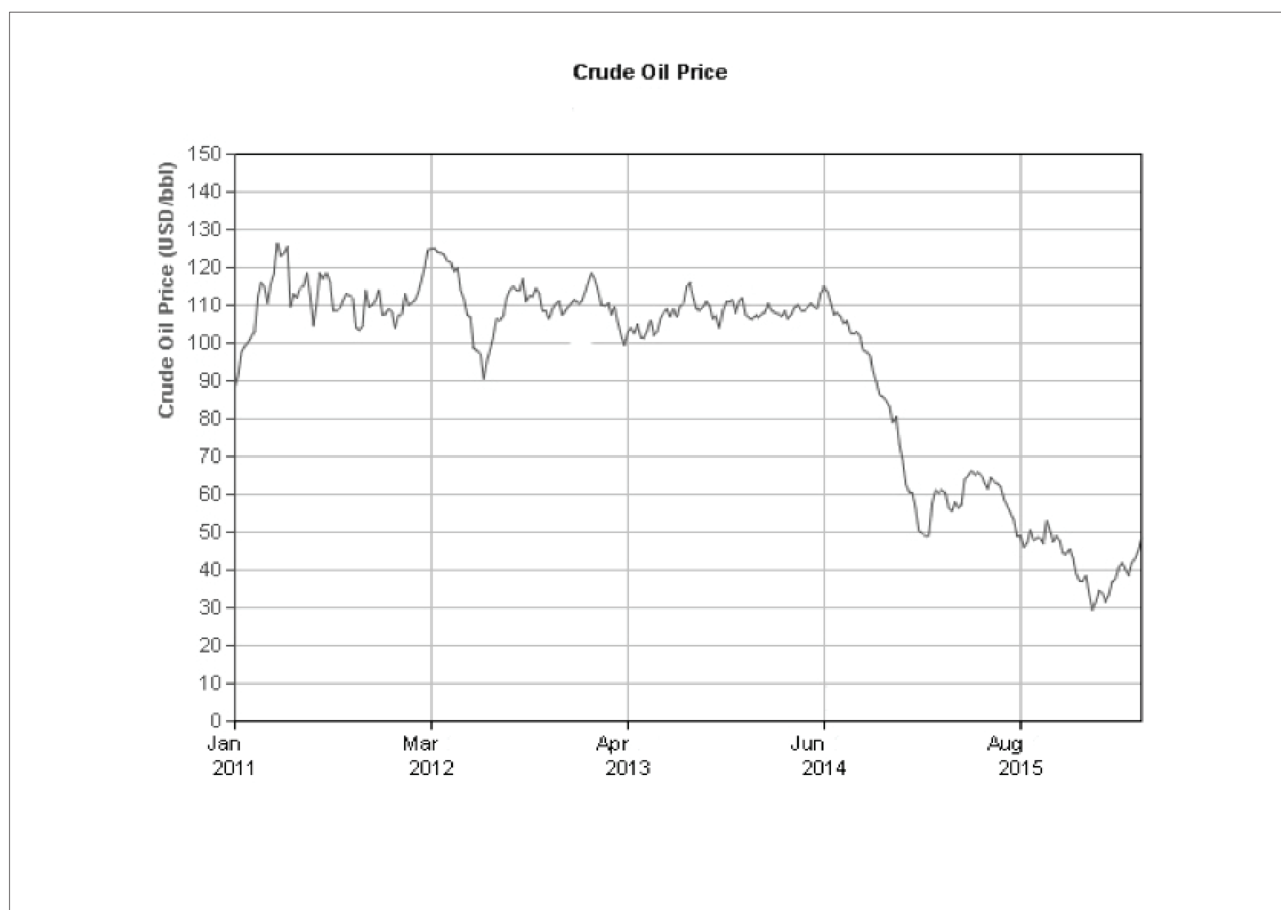
- GDP to exceed USD 150 billion by 2020
- GDP per capita to reach USD 7,500 by 2020
- Average growth rate of 7%
- Debt to GDP to be brought down to below 65%
- Budget deficit/GDP to be brought down to 3%
- Stock market capitalization to reach USD 100 billion
- Unemployment to be contained at 3%
- Poverty to be brought down to 0%

The expectation of all those who voted for a change at the 8th January Presidential election was that the country would progress even faster with the fresh thinking of a new government.

The new government also benefited from the rapidly falling global oil prices. The global oil prices were all time high during the 2011-2014 periods, (see Graph), but the oil prices fell globally by almost 60% during early part of 2015, immediately after the change of government in Sri Lanka.

In 2014, oil imports cost USD 4.6 billion accounting for 24% of Sri Lanka's total imports bill. However, due to the reduced world oil prices, the new government saved USD 1.9 billion in 2015, which meant that the cost of oil was down to 14% of the total import bill.

Graph: Global crude oil prices



Source: www.infomine.com

However, contrary to the common expectation that the new government would fare better than the previous regime on the economic front, the economy started slowing down and deteriorating, and the new administration has not been able to sustain the favourable economic trends that existed in the country prior to the election. The recently published Annual Report 2015 of the Central Bank is a useful and authoritative source to assess how the economy has been mismanaged during the first year of the new political and economic leadership.

To understand this better one could compare the 2015 results with that of 2014. While doing so, it would also be important to be conscious that the Department of Census and Statistics had made many changes to its reporting of information during 2015 and had also revised the originally published data of 2014.

Therefore, the table below has been compiled to show both the originally published 2014 data as well as the revised data of 2014, which are then compared against that of 2015.

All these figures have been extracted from the annual reports of the Central Bank which are available in the public domain.

Table: Comparison of key economic indicators 2014 vs 2015

Indicator	Unit	2014 (Original)	2014 (Revised)	2015
GDP Growth for year		7.4	4.9	4.8
GDP	US$ mn	75,561	80,000	82,300
GDP Per Capita	US$	3,654	3,853	3,924
Unemployment	%	4.2	4.3	4.6
Inflation (Annual Average	%	3.3	3.3	0.9
Current Account Deficit	% of GDP	3.1	2.5	2.4
BOP Balance	US$ mn	1,369	1,369	(1,489)
Tourist Arrivals	'000	1,593	1,527	1,798
Remittances	US$ mn	7,000	7,018	6,980
FDI Inflows	US$ bn	1,900	1,635	1,161
Gross Official Reserves	US$ mn	8,200	8,208	7,304
	Months of Imports	5.0	5.1	4.6
Exchange Rate (End)	Rs./US$	131.05	131.05	144.06
Exchange Rate (Av)	Rs./US$		130.56	135.94
Fiscal Deficit	% of GDP	5.2	5.7	7.4
Total Public Debt	Rs. bn	7,391.0	7,391.0	8,503.0
Public Debt to GDP	% of GDP	75.0	70.7	76.0
Broad Money Growth	%	13.0	13.4	17.8
All Share Price Index	(1985=100)	7299	7299	6894
Stock Market Cap.	Rs. bn	3,105	3,105	2,938

Source: Annual Reports 2014 and 2015 of the Central Bank of Sri Lanka

The bubbling sense of optimism that had prevailed in 2014 has now been relegated to the past. The prevailing somber feeling is hardly surprising, considering the declining trends in the macro-economy.

In the Real economy, growth has been affected considerably with many projects being curtailed. The private sector management is demoralized as a result of the retrospective taxes and the subtle intimidation of some top businesses, which seem to have been targeted as some business enterprises have been perceived by the governmental authorities to be sympathetic to the previous regime.

In relation to the Monetary and Fiscal sectors, the fiscal slippage caused by the politically motivated salary increase in the public sector has placed a massive burden on the government and put the government's borrowing cycle into disarray. To make matters worse, the arbitrary increase in interest rates as a result of the controversial Treasury Bond issue in late February 2015 caused a further unnecessary increase in the interest burden in all government local debt instruments.

The effect of that blow affected the entire interest rates structure for nearly 10 months, until policy interest rates were officially increased on 31st December 2015, which fortunately signaled that the loose monetary policy practiced by the Monetary Board throughout 2015 had finally been discontinued. Needless to say, these strains placed significant loads on an already stressed budget, and the impact of that stress is still being experienced by the battered economy.

In the External sector, the economy experienced a significant exodus of investments by foreign investors, from the government securities market and the stock exchange. This prompted the Central Bank to intervene heavily in the forex market to prop-up the SL Rupee, particularly up to August 2015 in order to maintain the Rupee at stable levels in the run-up to the Parliamentary elections. Those massive interventions have now taken its toll and the resulting erosion of foreign reserves has led to a serious self-inflicted vulnerability in the foreign reserves position of the country.

In the Financial front, the retrospective taxes imposed on the large banks and other top companies led to the exit of many investors in banking and other top stocks from the bourse, leading to significant falls in those stocks. At the same time, certain restrictions on banking activities, as introduced in the budget 2016, also served to erode confidence in the financial sector further. Fortunately, the safety cushions that almost all banks had painstakingly built-up in their balance sheets up to 2014, which is one of the main strengths of the economy that appears to be still intact, enabled the banks to yet remain reasonably strong and stable.

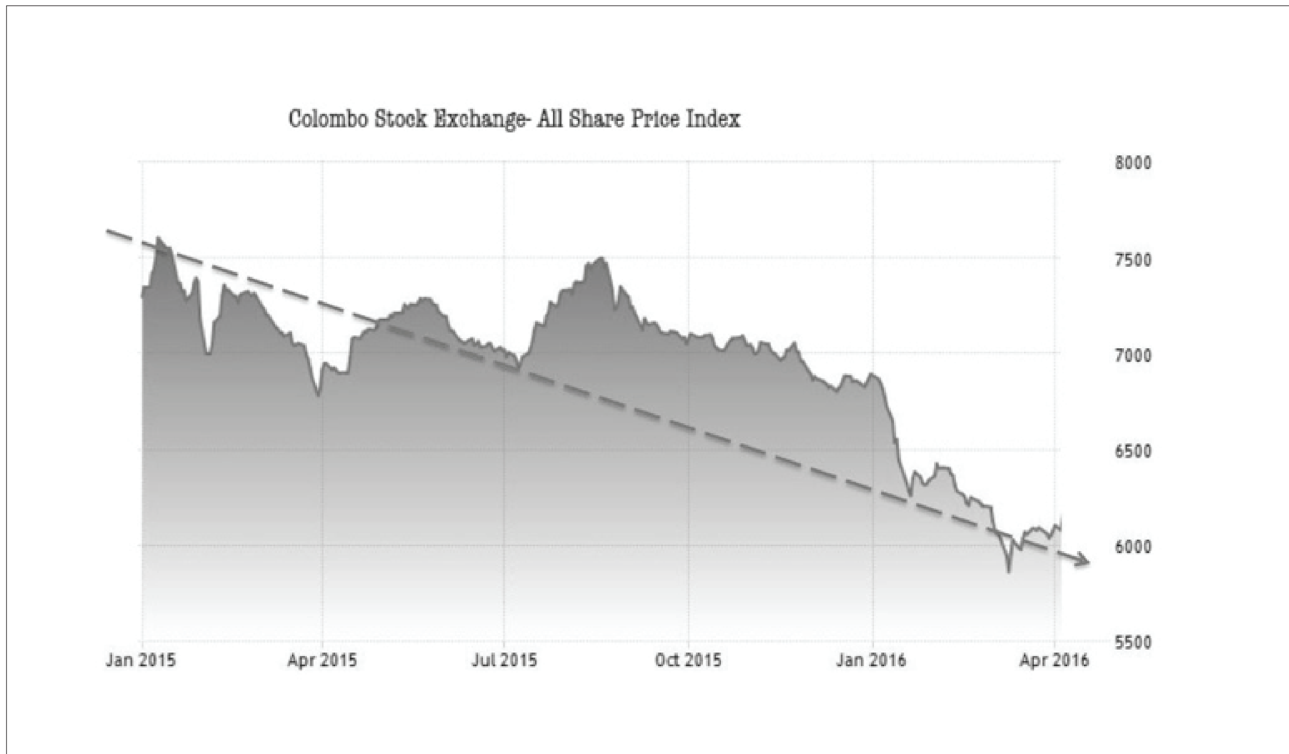
The falling sentiment of the investment community has been quite evident from the poor performance of the Colombo Stock Exchange (CSE) during 2015, after being rated the most sustainable stock exchange just one year earlier. Since the end of the war in 2009, the CSE had performed remarkably well with 115.6% returns over the 5-year period. The All Share Price Index (ASPI) had reached 7299 points by December 2014 and average daily turnover was in the range of Rs 1.4 billion. The annual returns of 2014 was 23.4%, and the general expectation was that growth would be sustained and the ASPI would reach the 8000 mark by mid-2015.

However, what happened to the Stock Market during 2015 is a clear reflection of the poor economic management of the new government. After all, the Stock Market is considered the barometer of economic health of a country. During the last three years leading to the presidential election in January 2015, the CSE was growing at a healthy pace, but unfortunately, it could not sustain the momentum during the year 2015, with the CSE entering a prolonged phase of market downturn, losing Rs. 600 billion in value within just 15 months!

All in all, a rather dismal and deteriorating report card for 2015, which has unfortunately aggravated the challenges faced by the economy in 2016 as well.

This impending disaster seems to have been well captured by Dr. Nimal Sanderatne in his column on 1st May 2016, in the Sunday Times, when he wrote: “The workers who march the streets today shouting slogans are perhaps unaware of the dire straits the economy is in”.

Graph: Performance of the Stock Market



Source: http://www.tradingeconomics.com/sri-lanka/stock-market

In this background, the key question that has engaged the attention of many anxious stakeholders has been as to what factors caused the current economic downturn from the healthy starting point in early January 2015.

This is a complex question which has no simple or straight forward response. Nevertheless, this comprehensive analysis attempts to discuss some of the key reasons for the current downturn in the Sri Lankan economy.

II) WHAT CAUSED THIS MASSIVE ECONOMIC DOWNTURN IN JUST OVER 12 MONTHS?

As with all major debacles, the reasons are many. These are also inter-connected, and feed on each other, to form a vicious cycle, which makes it difficult to escape from the inevitable chaos.

There are 12 causes that have been identified and these are discussed below. However, it must be appreciated that the "causes" as set out herein, while being inexhaustive, have not been listed in any order of importance or intensity, but in a logical manner to facilitate understanding. For purpose of clarity and simplicity, it is attempted to document these causes in a logical and professional manner so that an intelligent discussion could take place, hopefully leading to an improvement and a revival of the Sri Lankan economy from the current depths it has plunged into.

1. The election gimmick that backfired

The massive salary increase of Rs. 10,000/- for each of the 1.4 million public servants as well as other increases in the public sector emoluments, promised in the interim budget of the 100-day government had placed a major burden on the fiscal sector. The government promised this increase without identifying any corresponding sustainable funding sources or planning an increase in productivity. As a result, that weight dragged down the other sectors of the economy as well, while seriously damaging the defenses of the economy, thereby significantly contributing to the current economic downturn.

The increase in public sector emoluments as per the interim budget in January 2015, pushed the government recurrent expenditure to Rs.1,702 billion from Rs.1,323 billion in 2014, a massive increase of 25%, compared to the modest 12% increase witnessed in the previous year. While the absolute increase in emoluments in Rupee terms in the year 2014 was only Rs.121 billion, the increase in 2015 was a staggering Rs.379 billion.

Overall, the root cause of the current economic woes could be traced to this embarrassing slippage in the fiscal sector, which is one of the main problems that would need to be fixed, if the economy is to be brought back on track. Disappointingly, the expected tightening of fiscal measures after the elections did not materialize, although there was a legitimate expectation in business circles that fiscal policy would be tightened from 2015 Q4 after the Parliamentary election in August 2015.

At the same time, the budget proposals for 2016 presented in November 2015 and modified many times in December 2015, also did not seem to provide any assurances that a significant attempt at fiscal consolidation has been made by the government.

The projected and highly ambitious fiscal deficit target set at 5.9% of GDP for 2016 (compared to the actual of 6.0% in 2014, and the now-realized deficit of approximately 7.4% for 2015, as against the initial estimate of 4.4% contemplated in January 2015), has also not been convincing. In fact, economist Dr. Nimal Sanderatne, in his weekly column in the Sunday Times, two days after the budget was announced, lamented that the budget *"was seeking political popularity rather than facing up to the serious fiscal situation the country is in."*

Another regular columnist, former Deputy Governor of the Central Bank, W. A. Wijewardena argued that the 2016 Budget varied significantly from the Prime Minister's Economic Policy Statement (EPS) and stated that the "Budget 2016 has made both the indirect taxes and the direct taxes regressive, which the EPS had sought to avoid". Wijewardena further observed in the Financial Times of Sri Lanka that, "the budget deficit which the EPS is planning to reduce to 3.5% of GDP by 2020, has been raised to 6% in Budget 2016."

It is now obvious that if an IMF bail-out package is to be accessed by the government shortly, the IMF would probably insist that the government stays on course with a tight set of fiscal measures even if there are political difficulties arising, when doing so. However, as to whether the coalition "unity" government would have the required political ability to do so, remains to be seen.

In that regard, many political analysts suspect that the greater likelihood is that the government would not be able to handle the political fall-out of the proposed economic reforms, and hence, it would fall foul of the global lender, or the people, or both!

2. Compromising of fiscal policy

Sri Lanka's first serious and sustained fiscal consolidation exercise seemed to be on track from 2010 to 2014, and that disciplined path was having a favourable impact on the entire economy.

Table : Fiscal Deficit as a % of GDP

Year	%
2010	7.0
2011	6.2
2012	5.6
2013	5.4
2014	5.7

Source: Central Bank Annual Report 2015

However, the sudden, deliberate and politically-motivated increase in government expenditure in 2015, led to the disastrous effort to generate quick inflows towards government revenue, by any means. The attitude of taxing, whatever the consequences, without considering the ramifications of that policy action, compromised and destabilized overall fiscal policy, and caused serious damage to the economy.

A key case in point is that, in order to fund the unproductive increase in government expenditure, an ill-advised Super Gains Tax (SGT), which was one of the main measures adopted in 2015 to boost

government revenue, was imposed amidst many protests from the private sector. Although finally the SGT raked in revenues of around Rs.60 billion, this draconian measure had many drawbacks, which also contributed to the current economic downturn. The shock of the retrospective tax imposed by an administration considered to be "business friendly" clearly affected investor sentiment, as witnessed by the plummeting of the stock market immediately after the interim budget proposals were announced in January 2015. Sadly, the market has still not recovered from that shock.

Table : The performance of CSE since January 2015

	2014	Jan 2015 – March 2016
ASPI	7,299	6,061
Market Growth	23.4%	(25.4%) Negative return
Av. Daily Turnover	Rs.1.4 billion	Rs.300 Million
Market Cap.	Rs 3.1 trillion	Rs.2.5 trillion (Drop Rs.600 billion)
Foreign Flows	Rs 22 billion inflow	Rs.5.5 billion outflow

Source : www.cse.lk

Since the imposition of the SGT was announced as a temporary measure applicable for 2015 only, uncertainty was created as to how the lost revenue (in the absence of SGT) would be recovered in 2016, and thereafter. Investors and corporates were naturally wary that additional taxes would be imposed upon them in 2016, and therefore adopted a "wait and see" attitude in relation to their investment decisions throughout 2015.

The SGT shock impacted on the balance sheets of corporates, in that the tax had the unintended consequence of depressing future direct private sector investments, possibly to a value of around Rs.150 billion (nearly 2% of GDP), since many corporates had ear-marked the funds paid as SGT, for long term investments with corresponding bank leverage of at least twice their own investment. This situation caused a significant reduction in investment in 2015, and that outcome has not only affected economic activities and employment opportunities in the year 2015, but also in the medium term covering 2016– 2020.

Through all this, the major downside has been that the fiscal deficit for 2015 had shot up to reach a staggering 7.4%, which indicated a major reversal from the benign trend that had been established over a period of 5 years by the previous administration. In a weekly column in the Sunday Times titled *"Populist measures lead to Economic Crisis"*, Dr. Nimal Sanderatne roundly criticizes the Sri Lankan authorities about the economic mismanagement by stating: *"… the present government did not take the necessary policy measures to mitigate the impending crisis. It aggravated it by its fiscal and monetary policies in its quest for popularity to win the general elections in August".*

Sanderatne went on to say: "The fiscal discipline that was expected especially after the Prime Minister's Economic Policy Statement prior to the budget was not implemented in the Budget of 2016. The guiding principles of the PM's statement on taxation and fiscal consolidation were not adhered to. The fiscal deficit target of 5.9 per cent of GDP in the budget was disappointing. Moreover the fiscal measures were not expected to achieve it and the amendments increased the deficit further".

In his column, Sanderatne also discussed the government's political actions which compromised the economy in the following manner: *"…the savings from petroleum imports was spent on consumption. This was mainly due to the expenditure of the present government to fulfil election promises made at the Presidential election and granting of further benefits to woo the electorate at the general election".*

Thereafter, Sanderatne is particularly harsh on the authorities and castigates the mismanagement in a more direct manner: *"The new government of 2015 continued to mismanage fiscal policies as it increased public expenditures to fulfil election promises and gain political support for the general elections. It worsened the fiscal balance and the 2015 fiscal deficit is expected to be over 7 per cent of GDP. Inappropriate fiscal and monetary policies aggravated the trade deficit. Capital outflows owing to global developments and weakening of the country's economic fundamentals eroded the foreign reserves":* a strong indictment from an economist who is generally known to be favourable to the present government. These comments indicates the deep disappointment of many persons who expected a lot more from this administration.

3. Good Dollars thrown after bad

Sri Lanka ended the year 2014, with an impressive Capital and Finance Account as could be seen from the following information and data as contained in the CBSL Road Map 2015.

- FDIs: US$ 1,635 million
- Net Inflow to CSE: US$ 184 million
- Project Loans to the Government: US$ 1,439 million
- International Sovereign Bond Issuance: US$ 1,500 million
- Foreign Borrowing by Deposit-taking corporations: US$ 1,358 million
- Corporate and SOBE Sector Inflows: US$ 777 million

As a result, the BOP for 2014 had recorded a comfortable surplus, on the back of healthy surpluses during the previous 2 years as well.

However, it is now well known that a massive quantum of the country's foreign reserves was applied by the Monetary Board to maintain the value of the LKR in the first eight months of 2015, up to the General Election of August 2015. This short-sighted and reckless attitude has been another significant cause for the current economic downturn leading to a serious external vulnerability of the economy.

As a result, the BOP surplus of USD1,369 million in 2014, turned into a BOP deficit of USD 1,489 million in 2015!

The origin of this catastrophic condition could perhaps be traced to a seemingly unconnected source, namely, the unexpected relaxation of monetary policy in April 2015, via the reduction in policy interest rates by 50 bps. At that time, prior to April 2015, treasury yields were on a rising trend for several reasons including the effects of the controversial bond scam, and an increase of about 100 bps had been witnessed from the rates that prevailed in December 2015.

In that background, the Monetary Board's lowering of policy rates resulted in the decline in the yields by around 50 bps, till around July 2015. The effect of this controversial policy action was that it led to several outcomes, which should have been foreseen at the time, and which are discussed below.

First, the timing of the monetary policy relaxation. It will be noted that domestic interest rates were lowered at the same time that vehicle import taxes were sharply reduced, fuel prices were slashed, and government servants' salaries were generously increased. In that background, it should have been anticipated by the Monetary Board that an imports and credit growth spike will follow. Anticipated or not, the expected imports and credit growth spike took place in 2015 H2, with the cumulative credit growth in 2015 H2 increasing to Rs.612 billion compared to Rs.480 billion in 2015 H1. This increase naturally served to overheat the economy, which led to a corresponding spike in interest rates, with a lag, in 2016, (adding further risks to the already vulnerable economy). It also fuelled a credit-driven import demand, which adversely affected the balance of payments.

Second, it should have been anticipated by the Monetary Board that the artificially low interest rates would have discouraged the already-anxious foreign holders of treasury securities. Anticipated or not, as a result of the cut in policy rates, the foreign holdings which were stable at around Rs.455 billion at the beginning of 2015, started to plummet from around May 2015 onwards, and the holdings quickly reduced to about Rs.400 billion by the end of July 2015, and to around Rs.300 billion by the end of October 2015. The holdings have now dwindled to a mere Rs.220 billion by end March 2016.

Third, it should have been anticipated by the Monetary Board that if and when foreign holdings in government securities decline rapidly with the exit of investors, pressure would build on the Rupee to depreciate. Anticipated or not, that outcome too materialized and as a result, the Monetary Board ill-advisedly started to defend the Rupee stoutly, seemingly without a proper plan or an understanding of the consequences of continuously doing so. As a result, the net sales/supply of USD by the Central Bank to the forex market reached almost USD 2,000 million from May to September in 2015, compared to around USD 430 million from January to April 2016.

The year 2015 finally ended with total sales/supply of USD to the forex market by the Central Bank reaching a massive and untenable USD 3,250 million, which was, by far, the highest-ever intervention in the entire history of the Central Bank!

4. Recklessly defending the Rupee

Sri Lanka started the year 2015 with a healthy level of foreign reserves, which provided a useful and comfortable buffer to meet any external contingency.

However, as is now well known, depreciation-pressure mounted on the SL Rupee, from the second quarter of 2015 onwards. This pressure was triggered by the local factors of political uncertainty, policy inconsistency, reckless fiscal measures, relaxed monetary policy and loose talk, and the international factor of the global trend of "flight to safety" from the so-called "risky" assets in frontier/emerging markets.

These factors, which perhaps caused some panic with the political authorities and the Monetary Board, probably led the Monetary Board to make a huge miscalculation in defending the SL Rupee via the almost indefinite application of its carefully accumulated foreign reserves.

As a direct consequence, the country's reserves which were at a healthy level of USD 8,208 million as at 31st December 2014 and acting as a vital "buffer" to meet any external challenge, commenced a rapid downward spiral, with critical levels being reached today, with no saviour in sight other than the tough IMF white knight.

Ironically, in this desperate situation, the government has also now to eat humble pie and reach out for support from the China, which country was publicly branded as the "Economic Hit-man" of the world via the Daily Financial Times of 28th January 2012, by the current Deputy Minister of Foreign Affairs, Dr. Harsha de Silva, when in the opposition.

According to emerging information, the net USD supply/sales by Central Bank reached a staggering USD 1,800 million from June to September 2015, which sales have now been identified by many analysts as the 'economic cost' to the country through the current regime's politically-motivated attempt to maintain the value of the SL Rupee in the run-up to the General Election in August 2015!

Thereafter, even after the General Election, albeit at a slower pace, the Monetary Board's regular sales of USD to the forex market continued, and as a result, the total net USD forex sales to the market in 2015, has been now disclosed as an incredible USD 3,250 million, or about 40% of the total forex reserve as at 30th December 2014, or nearly USD 9 million (Rs 1.25 billion) per day! To put in perspective, US$ 3,250 million is higher than the entire foreign investment in Treasury Bills and Bonds as at 1st January 2015 of US$ 2,966 million; a fact that would be viewed with serious concern by all foreign investors.

In this context, it would also be noted that in 2015, significant forex flows took place, although not retained due to the imprudent and reckless policies of the government and the Central Bank. Two International Sovereign bond issues realized USD 2,150 million; several issues of SLDB's contributed a net inflow of over USD 1,650 million; around USD 1,900 million was saved due to the reduction in the oil import bill as a result of the low global oil prices; and a SWAP by the Central Bank with the Reserve Bank of India generated a further inflow of USD 1,500.

On that basis, a high percentage of the inflows of over USD 7,200 million could have been comfortably added to the forex reserves of the country as at 31st December 2014, if prudent policies had been followed, and the reserve level should have easily exceeded USD 10,000 million, even if USD 2,800 was retained in the reserves. In contrast however, the foreign reserves declined from a healthy USD 8,208 million at the beginning of 2015, to a disappointing USD 7,304 million by the end of 2015: a depletion nearly a billion dollars!

The exchange rate, which was artificially propped up throughout the year by the Monetary Board by supplying massive amounts of forex into the market without a proper plan or focus, depreciated marginally from Rs.131.56 per USD at the beginning of 2015 to about Rs.133 per USD by August, 2015. However, in September 2015, after the General Election, the intervention by the Monetary

Board eased to some extent, and as a result, the SL Rupee depreciated more freely, with the SL Rupee selling rate reaching Rs.150 in March 2016.

Accordingly, during the year, the SL Rupee depreciated by over 9% or Rs. 13.01, and such depreciation could be considered significantly high, since the SL Rupee had depreciated by only 29.9% or Rs 30.06 across 9 years from 2006 to 2014, or an average Year-on-Year depreciation of a more modest 2.9% per annum for 9 years!

The SL Rupee depreciation during the year 2015 is the highest percentage depreciation of the SL Rupee in an year in its recent history, and the fact that such depreciation has taken place at a period when a barrel of oil had fallen to around a mere USD 50, (or about 50% less than the average price prevailing during the previous year), is alarming. A further cause for alarm is that this SL Rupee depreciation had occurred, even in the face of the highest-ever levels of intervention by the Monetary Board in the forex market, in its entire history!

It is now patently clear that, had the Monetary Board tightened monetary policy in mid-2015, credit growth would have tapered off towards the end of 2015, and the economy would have avoided an overheating situation.

At the same time, it is likely that the increase in interest rates from those prevailing at the end of 2014, would have been only around 100 to 200 bps, instead of the massive increase of about 400 to 500 bps, which is the increase that is being experienced currently, as seen in the Table below:

Table: Interest rates of Treasury Bills and Bonds

Tenor	Interest Rates as at 31.12.14	Interest Rates as at 31.12.15	Interest Rates as at 31.03.16	Increase in 15 months 01.01.15 to 31.03.16	% Increase
3 months	5.72	6.37	8.82	3.10	54.2
6 months	5.86	6.64	9.63	3.77	64.3
12 months	6.04	7.09	10.24	4.20	69.5
< 2 Years	6.22	7.63	10.40	4.18	67.2
< 5Years	7.26	9.63	12.56	5.30	73.0
< 6 Years	7.57	9.77	12.58	5.01	66.2
< 8 Years	7.91	10.15	12.83	4.92	62.2
< 10 Years	7.99	10.40	12.93	4.94	61.8
< 15 Years	8.58	10.60	12.92	4.34	50.6
< 20 Years	9.15	10.88	13.03	3.88	42.4
< 30 Years	9.27	11.34	13.20	3.93	42.4

Source: Central Bank

It is clear that a tightening of monetary policy in mid-2015, together with a stable and rational fiscal policy, would have given confidence to all stakeholders. In such circumstances, it is very likely that the SL Rupee would not have depreciated beyond Rs.136 per USD, and that too with minimal intervention by the Monetary Board. Such a course of action would have allowed the Central Bank to further accumulate reserves from the oil savings, the issue of sovereign bonds and short term

SLDB's, and in such circumstances, the politically-charged Reserve Bank of India (RBI) SWAP would not have even been needed!

It is also likely that, in such circumstances, the net foreign outflows from the government securities market would have been materially less, although of course, the fiscal, governance and political uncertainties as well as the global concerns as explained in this analysis could have still resulted in a certain quantum of net foreign outflows, although such foreign outflows would have been significantly lower.

Dr. Saman Kelegama, the Executive Director of the Institute of Policy Studies, more or less confirmed the above position in his comments in the Daily Mirror of 9th May 2016: *"Due to loose Fiscal and Monetary Policy adopted since early 2015, Sri Lanka's rupee took a dive from around 132/dollar to 146/dollar after hitting a record low on 150/dollar in late March 2016 as cheaper credit and higher disposable income fuelled imports, and lower interest rates prompted the foreigners to sell their government securities holdings"*. Dr. Kelegama further added: *"such a freefall of the rupee could have be averted had the floating of the rupee in September 2015 (been) complemented by an increase in interest rates which did not happen at that time"*. He explained further: *"the government has allowed the bulk of the economic adjustment to be borne by the exchange rate as seen from the beating the Lankan Rupee has taken in recent times".*

In that background, it is now clear that the Central Bank would have been able to comfortably increase its foreign reserves to well over USD 10,000 million by the end of 2015, thereby ensuring that Sri Lanka is not in any way vulnerable to the external shocks in the post "Fed-hike" world. Unfortunately however, a massive amount of foreign reserves were dissipated in the above mentioned controversial, reckless and unprecedented manner to fulfil narrow political objectives at the expense of the well-being of the economy. Consequently, the country is today facing a grave economic crisis in almost all sectors; Real, Fiscal, Monetary, External and Financial, as a result.

5. Borrowing short-term in foreign currency

The debt dynamics of Sri Lanka had improved considerably during the 10 year period, 2005 to 2014, as reflected in almost all debt related indices, as shown in the Central Bank's Road Map 2015. At the same time, when the GDP was re-based in June 2015 by the present regime, the Debt to GDP ratio in 2014 was expressed at a reasonably respectable value of 70.7%, down substantially from the value of 91% in 2005.

By 31st December 2014, the debt servicing cost in terms of the GDP of the debt portfolio had also reduced to its lowest level in the past 15 years to record a value of 4.2% only, a considerable improvement from the value of 7.4% in 2002!

Equally significantly, the Average Time to Maturity (ATM) of the debt portfolio had more than doubled thereby reducing the "roll-over risk" materially with the ATM lengthening from a risky 2.38 years in 2005, to a comfortable 5.84 years by the end of 2014.

However, this improving trend was completely reversed from 2015 onwards. The outstanding government debt which recorded Rs 7,391 billion at the end of 2014, reached a staggering Rs 8,503 billion by the end of 2015; an increase of Rs. 1,112 billion,

the highest increase in Sri Lanka's history. This increase was therefore much higher than the annual increases of Rs 793 billion and Rs 598 billion in 2013 and 2014, respectively.

Further, almost USD 3,100 million of Sri Lanka Development Bonds (SLDBs) were borrowed since March 2015, compared to only USD 1,500 million borrowed in the four years, 2011 – 2014, prior to 2015.

In addition, the issue of international sovereign bonds enabled the borrowing of a further USD 2,150 million in 2015.

The above debt issues clearly indicate that the quantum of foreign and domestic borrowings by the government, had increased substantially since January 2015.

Another alarming feature of these rampant borrowings was that most of the foreign debt taken in 2015, was mainly of a short-term nature. In fact, a large portion of the SLDBs issued from about the middle of 2015 onwards, had tenors of just 13 months, and those loans had to be repaid, or rolled-over in 2016. In contrast in the past, SLDBs usually had a maturity profiles of 3 to 5 years.

Worse still, since a substantial portion of the forex raised via SLDBs seems to have been consumed to defend the Rupee. As a result, such forex is now no longer available with the Central Bank, to pay back when repayments fall due, which then makes the roll-over imperative. This dangerous situation seems to be continuing into the year 2016 as well, with a substantial portion of the SLDBs still being issued for durations of even less than 6 months!

In addition, the currency SWAP's entered into by the Central Bank with the RBI have also been of a very short tenor and the roll-over at the RBI's option, and, as per currently circulation information, these SWAPs too, have to be settled in 2016.

These short term borrowing practices, which suggest recklessness or desperation or both, have substantially increased the local currency and forex debt repayment pressure in the near term, and investors are presently naturally demanding a higher risk premium for almost all Sri Lankan instruments, as a result.

In that background, there is now no doubt (as the interest rates are expected to be on a rising trend following a tightening of monetary policy in the USA as well), these short term forex debts would have to be rolled over at a substantially higher cost, which adds further costs and risks to the beleaguered Sri Lankan economy.

6. Stopping major infrastructure projects killed the growth momentum

The arbitrary stoppage of the USD 1,400 million, Chinese-funded Port City project that was inaugurated jointly by the Chinese President Xi Ping and the Sri Lankan President Mahinda Rajapaksa in 2014, as well as several other infrastructure projects including the Integrated Resort project mooted by Australian tycoon, James Packer, seriously damaged the growth momentum of the real economy.

In this regard, it is now well-known that these projects were stopped at the insistence of certain regional powers, who used various NGOs to agitate against these projects during and after the Presidential elections in January 2015. This position is confirmed by the highly vociferous criticisms of the Port City project by the well-funded NGO, “Friday Forum”, convened by “Good Governance Activist”, Chandra Jayaratne, which, *inter alia*, issued a Media Release on 15th April 2015 as follows: *“The Friday Forum calls upon the government to immediately place in the public domain the details of all agreements, assessments and regulatory determinations related to the Colombo Port City development project. The government’s review of project must also be conducted with complete transparency, inclusive of a mechanism for public submissions to this review process. Given the significant financial interests at stake with this project and the considerable scope for corruption, there is a need for on-going public disclosure of all aspects of the project, as well as timely investigation of allegations of impropriety or irregularities to date. The ‘exclusive’ nature of the proposed development project also calls for a public debate of whether its benefits and costs will be shared equitably (through taxation for example) amongst the citizens of this country, especially those living below average income levels within and beyond Colombo. It is the responsibility of the government to ensure that the long-term interests of all the Sri Lankan people override any other considerations”.*

Notwithstanding the lofty concerns expressed before the parliamentary elections, the Friday Forum has been maintaining a deafening silence after the elections in August 2015, and now seems to be quite comfortable and content with the likely resumption and progress of the Port City project.

The government’s actions, post-January 2015, together with that of various NGOs, during the year 2015, seriously disturbed business sentiment, leading to the discouragement of future private sector investment as well. The foreign inflows on account of these committed FDIs that were expected in 2015, did not materialize in 2015, while the scant disregard for the sovereign commitments given by a previous regime, seriously undermined the credibility of the country. In fact, FDIs, which were in a rapidly increasing trend up to 2014, and were expected to record around US$ 3,000 in 2015, started to decline in 2015, with FDIs in 2015 being a dismal USD 1,161 million, almost 30% lower than the FDIs for 2014 which recorded a healthy USD 1,635 million.

It is now estimated that the unilateral suspension of the Port City Project would have resulted in about USD 700 million that was scheduled to flow into the economy as Sri Lanka’s anchor FDI project for 2015, being lost to the economy in that year. This politically-motivated action also caused substantial short term job and growth losses, and dealt a major blow to the long term credibility of Sri Lanka’s investment regime.

In addition, the stoppage of the Port City infrastructure project also reportedly prompted a massive damages claim by the Chinese company in the value of USD 125 million, which claim is even

well above the losses incurred on the highly publicized "hedging" debacle during the Rajapaksa administration, or the "Centre-point" damages fiasco during the Kumaranatunge administration.

The abrupt cancellation of Australian tycoon James Packer's Crown Integrated Entertainment Complex Project, leading to its quick, controversial and summary exit from Sri Lanka, would have also meant that a USD 200 million investment was lost to the Sri Lankan economy in 2015, and a further USD 300 million being lost over the next couple of years. Another FDI exit was that of the Indian oil-exploring firm, Cairn Lanka which voluntarily discontinued its oil exploration and mining activities in Sri Lanka's Mannar Basin. That exit too, would have resulted in the probable investment inflow of about USD 100 million in 2015 and many more millions in future years, being lost to the Sri Lankan economy. All in all, the significant list of "exits" during the year 2015, cost the real economy dearly.

In addition to the "exits" of the committed existing FDIs, as a probable consequence of the arbitrary and arrogant attitude of the government, the FDI inflow pipe-line, which had been robust up to 2014, also dried up in 2015 and so far in 2016. To add to the woes, foreign investors also exit from the equity market at a value of Rs 6.6 billion since January 2015, and from the government securities market as well, with the foreign equity funds balances dropping from US$ 1,869 million in 2014 to US$ 1,536 by 2015.

It is only after a period of over one year that realization seems to have dawned on the leaders of the present regime that FDIs would have to be taken seriously, and foreign investors would have to be treated with respect. Accordingly, in early 2016, in an abrupt reversal of policy, government approval was granted for the recommencement of the Port City project, ostensibly *"after considering the new Environmental Impact Assessment report"*. However, by that time, the damage had already been done, and as is now known, the Chinese firm has demanded compensation of approximately USD 125 million based on a loss of USD 380,000 per day, citing the unilateral stoppage of their work by the government for more than an year.

It is also reported that in the event the government is not in a position to pay the demanded compensation, the government may have to permit the Chinese firm to reclaim and enjoy even a greater extent of land from the ocean than what was agreed earlier, in order to compensate them for the loss inflicted by the government. It was also reported that the Prime Minister has held discussions with regard to the matter of compensation with the relevant authorities during his visit to China in early April 2016. Hopefully, the painful truth has now probably dawned upon the administration that resuming projects is tough, and can even lead to eating humble pie!

The Island newspaper 7th May 2016 reported the views of a senior minister of the Unity government as follows: *"Fisheries and Aquatic Resources Development Minister Mahinda Amaraweera yesterday said they would not stop the Port City Project under any circumstances as the country could not bear the huge compensation which had to be paid in case of its unilateral halt by Sri Lanka".*

The Island newspaper further quoted Amaraweera as saying: *"An amount equal to the construction costs of the Mattala International Airport would have to be borne by the government in settling the relevant compensations. Therefore, the projects needs to be relaunched as soon as possible and should not be terminated under any circumstances."*

“They are going back because they’ve woken up to the realities of geopolitics” said economist, Dushni Weerakoon of the Institute of Policy Studies who is quoted in an article by Wade Shapard on 9th May 2016 in “The Diplomat”. Weerakoon has also gone on to say: “Because the Americans or the Indians … don’t have that kind of financing to offer… the sources of capital are from China.”
It is now an acknowledged fact that the arbitrary stopping of the Port City infrastructure project and other projects not only opened out the government to a series of highly damaging and expensive litigation and possible damages, as described above, but also had a highly adverse impact on the entire industry sector. The industry sector, which, of late, had contributed significantly to the economy’s growth, plunged to less than 4% in 2015, from the double digit growth that was recorded in recent years. Unemployment too, increased by nearly 10% from 4.2% in 2014 to 4.6% by 2015 signalling the advent of another worrisome social upheaval. These outcomes were mainly due to the slowdown in the construction segment, and that downturn had a further ripple effect on the businesses of SMEs, suppliers, transporters, service providers, etc.

As a result, the GDP growth for 2015 recorded its lowest level since 2009: a dismal 4.8%. It may also be recalled that 2009 was the year of the Global Financial Crisis, the end of the conflict, and the massive rehabilitation and construction programme. In fact, it may be recalled that and even with such mega challenges, Sri Lanka grew by 3.5% in 2009, as compared to the (revised) growth of just 4.8% in 2015. In fact, even on the suspiciously revised basis, Sri Lanka’s average GDP growth for the five years 2010 to 2014 was a remarkable average of 6.8% per annum. Hence, the growth of 2015 seems to be a nearly 30% drop from that trend line.

7. Losing credibility amongst foreign investors

The new government’s politically-motivated claims (post-election in January 2015), mainly for the local audiences, that the country’s figures and statistics are false and erroneous and cannot be relied upon, had the unintended effect of seriously undermining foreign investor confidence levels.

In addition, the regular and incredulous statements by those in authority about fresh inflows of massive amounts of external funds also seriously damaged the business confidence levels. That damage affected foreign investment in particular, and could be set out as another key reason for the current economic downturn.

In fact, the Finance Ministry and the Central Bank seem to have unleashed a credibility crisis in the economic environment, and unfortunately, the reasons for that situation appears to be of their own making. This credibility crisis has arisen due to the amateurish communication strategies of the two key economic agencies, where certain communications of these two agencies seem to have been blatantly and unprofessionally “doctored”, thereby casting serious suspicions upon the credibility and professionalism of these two institutions.

According to media reports, in the early days of the new government after it assumed office in January 2015, several key Ministers claimed that Sri Lanka’s economic data and information was false and cannot be relied upon. Further, around June 2016, when the SL Rupee had depreciated to around Rs.135 to the USD, the Finance Minister “authoritatively” announced that within two weeks, the SL Rupee would strengthen to around Rs.131 to the USD! Another exercise was carried out by

the government around July 2015, which aroused suspicious was when “revised” growth and GDP figures were announced by a Deputy Minister in respect of 2014, even after such figures had been released by the Central Bank and the Department of Census and Statistics (DCS) just two months earlier. Immediately upon the revised figures being announced by the politician, it was clear that such “revised” figures had been “adjusted” to show incredibly high growth and GDP figures for 2010, 2011 and 2012, while depressing the growth and GDP figures for 2013 and 2014, obviously to gain some local political mileage.

Needless to say, many overseas investors would have naturally been disturbed by this “statistics tinkering exercise” where the growth for 2014 was quite casually slashed by about one-third, from the 7.4% announced by the Central Bank and the Department of Census and Statistics in April 2015, to a lowly 4.9% just two months later.

In the meantime, on a more political front, certain “responsible” government spokesmen and Ministers continued to publicly claim in the media that the country’s debt figures announced previously had been false and that those statistics cannot be relied upon.

It was further claimed by them that there are massive “hidden” debts of more than Rs 1 trillion which have been unaccounted for in the past, and that those had to be now paid by the new administration.

Some government ministers also claimed that, before the issuance of the allegedly corrupt Treasury Bond in February 2015, that there had been issuances of Treasury bonds of more that Rs 2 trillion via corrupt practices, by the previous administration of the Central Bank, as well. Although it was obvious that these persons, were making these damaging statements about the Central Bank procedures to cover up and distract from the controversial bond of February 2015 engineered and covered up by the new administration, the statements also had the effect of undermining the time-tested public debt issuance processes of the Central Bank, resulting in many investors beginning to worry about their investments in the Sri Lankan government securities.

At the same time, another supposedly “responsible” Minister claimed that the former President had spirited away USD 18,000 million, and that the new government is now taking steps to recover such amounts from the former President. Such statement too, had the unintended consequence of conveying to the outside world, that the country’s administrative and financial processes are extremely corrupt, fraudulent and unreliable, which would have naturally discouraged foreign investors from investing in the Sri Lankan economy.

It is now clear that, these irresponsible statements by government Ministers would have caused panic among many foreign investors, and that anxiety too, would have contributed to the accelerated exodus of substantially large foreign holdings of Treasury Bills and Bonds. These types of statements would have also contributed to the increase in the interest rates, since many investors would have factored a heavy risk premium to cover the anxiety that had been created in their minds by the Sri Lankan authorities though their utterances.

As explained above, some of these “horror” stories by the authorities would have prompted at least a partial exit of some foreign investments in Treasury Bills and Bonds, and the impact of such exodus would have impacted upon the massive BOP deficit and the rapid depreciation of the Sri Lankan Rupee.

Perhaps, as a knee-jerk reaction to this outflow and depreciation threat, certain members of the government then resorted to another unprofessional media campaign, where they claimed at regular intervals, that massive foreign currency deposits and investments were flowing into Sri Lanka, or that such forex inflows were imminent. These so-called “massive investments” ranged from investments from Saudi Arabia, to deposits from unnamed investors from whom “no questions” were asked, to a particular investment of USD 1 billion from a mysterious “Belgian” investor and his associate in Sri Lanka!

In March 2016, another claim via the media that could have disastrous consequences was the government statement that Sri Lankan Airlines is unable to pay its dues. This statement was confirmed by several ministers, and it is likely that this statement would have sent the creditors of Sri Lankan Airlines, including those holding international bonds, racing to their legal teams to help secure and safeguard the loans and advances they have provided to the airline.

Although at first glance, this statement may appear as being damaging to the airline and the economy, another theory that is being floated by various parties is that this self-inflicted down-grade of this key national asset could have another motive as well. That is, this statement could actually be a part of a sinister and deliberate campaign to depress the demand for the Airline, so that the carrier could be “privatized” to a selected crony of the government at a discounted value, since there is now a government plan to privatize the institution.

As a result of all these incredulous claims, immense damage has been caused to the credibility of the economy and the administration, and it would probably take a long time as well as a change of faces at the top level of the country’s economic authorities before investors would take statements emanating from the Sri Lankan Economic authorities, seriously.

8. The bond scam of February 2015; and the follow up in March 2016

The terrible scandal of the allegedly fraudulent 30-year Treasury bond issue of February 2015, and the high-level determined cover-up that followed, sent shock waves across all investors. The effect of the scam not only resulted in serious damage being caused to the integrity of the Central Bank(CB) and the government, but also contributed to the downturn within the economy.

W. A. Wijewardena a former Deputy Governor of the Central Bank had this to say about the scam: *“The Central Bank had to face two disasters in the recent past. One was the ‘bomb explosion’ in front of the Central Bank building in early 1996. The other was the ‘bond explosion’ within the Central Bank building in early 2015.The damage done by the bond explosion is not visible to the naked eye as was in the first disaster. But it is far worse than the bomb explosion since it has taken the reputation away from the bank in a single stroke.” Wijewardena also added: “The Central Bank, over its 65 years of existence, had not been black-marked in public by such a serious scandal”.* By the government accepting bonds at a deliberately bumped-up yield which was significantly higher than the yields prevailing in the secondary market at that time, massive direct losses were incurred by the government. In addition, the artificially enhanced interest rate on the controversial 30-year Treasury Bond had an effect on all subsequent bond issues of all tenors, across the board. The magnitude of the direct loss arising from the bond scam has been assessed by various analysts and

the latest computations suggest that the loss to the government due to the higher interest burden arising from the unnecessary, unwarranted and deliberate increase in interest rates, when assessed over the next 30 years, could well exceed a staggering LKR 125 billion!

On a technical basis, prior to this infamous bond issue, the Issue of Treasury Bills and Bonds were by auction and direct placement, after the weighted average rates were decided as per the auction cut-off results. In that background, whenever rates quoted by investors were higher than those considered reasonable by the CB, the CB accepted only what was considered reasonable, and established the weighted average. That auction-determined rate was thereafter applied as the rate for direct placements until the total amount required by the CB was raised. On that basis, primary dealers were not able to connive and manipulate the debt market.

However, on the day of the infamous bond-scam, acceptances of Treasury Bills and Bonds through direct placement was abruptly abandoned (on the Prime Minister's instructions, as per the Governor of the Central Bank, in his evidence before the Parliamentary Committee on Public Enterprises), and the procedure was replaced with a "fully auction based system" only.

As a result of the Central Bank abruptly changing the method of issuing Treasury Bills and Bonds from the time tested method of "auction and direct placement" to "auction only" at the time of the notorious bond scam, the new practice has resulted in the government being compelled to borrow at unfavourable rates, with possible opportunities being created for new scams as well.

There are also suspicions raised that certain high officials are also involved in this scam which are alleged to have been practiced in the year 2016 as well. In this regard, many market watchers have levelled a series of allegations although the government and the Central Bank have been very reluctant to act on any of these allegations. In fact, as per the Daily Mirror of 20th April 2016, "Good governance activist" Chandra Jayaratne has even requested the Monetary Board for detailed information pertaining to the Treasury Bond issues carried out by the Central Bank. However, many do not expect the Central Bank or the Ministry of National Policy and Economic Affairs to respond positively to these demands for information since many believe that the government and the Central Bank have a deep desire and an over-riding need to "cover-up" these suspicious transactions which are alleged to have yielded billions of Rupees to those who have been involved these massive scams!

Another terrible downside of these corrupted practices is that those have resulted in steep and unnecessary increases in the Treasury Bill and Bond interest rates, resulting in mega losses being incurred by the government in debt servicing, and the general public having to suffer higher rates of interest in all their transactions.

In fact, as per the CBSL Annual Report 2015, the Government's own debt servicing payments have increased from Rs.1,076 billion in 2014 to Rs.1,318 billion by 2015, an increase of 22.4%. As per the CBSL Annual Report, the government also suffered an increase in interest payments of Rs. 66.4 billion to Rs. 393.3 billion during the year 2015, owing to the increased interest on Treasury bills and bonds and SLDBs.

It would also be noted that in every economy, the government securities' interest rates set the risk-free benchmark rate for all other market instruments, while also providing guidance for the pricing

of the entire range of financial instruments from over-night bank deposit rates to 10-year prime corporate rates to even 20-year housing loan facility rates to ordinary citizens! In that context, as a result of the bond scam, every borrower also has had to suffer a premium on the interest payable, since the interest rate equilibrium that prevailed prior to that fateful day, was greatly disturbed, leading to higher costs and greater risk, both to the individual and the business community.

Former Deputy Governor of the Central Bank, W. A. Wijewardena also points out in his article as follows: *"In the recent bond explosion fiasco, it does not appear that the Central Bank has followed a clear communication policy. When the rumour that an insider dealing has taken place in the 30 year bond issue started to spread in the market, the Central Bank had become strangely silent. Its silence then fuelled new rumours that dented the Bank's reputation effectively. All opposition forces rallied round the rumour and it soon became hot news for the media. While the local market became agitated, the international markets became extremely nervous".*

Wijewardena further added: *"..the biggest victim of the bond explosion was the long honoured concept of good governance which became a mockery after the inaction of both the Central Bank and the government to listen to the pulses of the people. With the passage of each day, more and more civil society organisations including major political parties are demanding that the Governor of the Bank should take responsibility for the whole fiasco and step down from his position".*

9. The dreaded FCID that dampened business sentiments

The regular parade of top businessmen and government officials to the Financial Crimes Investigation Department (FCID), to face humiliation under the bright lights of the media cameras, has sent shivers and shockwaves down the spines of the investing community, while paralyzing government officials.

Further, the almost permanent suspension of long-term investment by several top-level local investors as a result of the fear that has been instilled in the minds of many through a highly publicized, politically motivated crack-down on alleged manipulations in the stock market and other alleged financial misdeeds, have added to the prevailing negative sentiment, further fuelling the economic downturn. All these sentiments too, have also not helped to boost investment and confidence.

The immense damage caused by these repressive operations has left serious scars in the Sri Lankan investor sentiment, and in that context, it would be too much to expect a turn-around of investor sentiment in 2016.

At the same time, the yet-unsolved scandals of the present government, although not taken up by the FCID and other law enforcement agencies, have not served to enhance investor confidence levels. These scandals of mega proportions, including customs duty waivers, mega bond scams, excessive rent scams, unauthorized purchase of very expensive items of clothing by top officials, etc. are today being discussed by the business community in particular and the society in general, in whispers and via viber and whatsapp connections, so as to avoid the wrath of the powers that be!

10. The Budget 2016 that became a laughing stock

In an article in the Financial Times of 2nd January 2016, titled, *“Sweeteners on offer, but political mood is sour”, the columnist wrote: “Bickering and in-fighting, not only in the Government but within the cabinet, have turned the much promised ‘clean’ administration into a laughing stock”.*

The wisdom of those words rings a strident bell since the Budget for 2016, introduced with much fanfare in November 2015, although passed in Parliament by the required majority and more, seemed to have been striving to achieve too much, too soon, and had failed miserably. **Many proposals ended up being too complicated to implement, too controversial to win governmental approval, or too drastic to win public acceptance, and the final result has been that it had been reduced to a sad joke.**

In this connection, many analysts have also pointed out that:

a) In the face of the obvious need to boost revenue, certain proposals that were introduced to reduce corporate and income taxes, were clearly unnecessary.

b) There seemed to be too much reliance on the raising of “non tax revenue” which was estimated at a massive Rs 378 billion in 2016, from just Rs 126 billion in 2015. Such increased estimate is probably an indication of an aggressive privatisation plan for State Owned Enterprises (SOEs) to generate government revenues, which would not be easy to implement.

c) There seemed to be an attempt towards fiscal consolidation through the sharp curtailment of long-standing and popular subsidies such as the fertiliser subsidy granted to farmers, which obviously would not be easy to implement, politically.

As a result of a series of difficulties, even after the elapse of 4 months of the current year, the government had still not been able to implement most of its budget proposals for 2016, with revenues being seriously impaired, as of now.
In fact, at present, regular farmer protests are taking place demanding the return to the earlier fertilizer subsidy, while many trade unions in SOEs are vociferously displaying their displeasure to possible restructuring/privatisation of SOEs, almost daily. The escalation of these people-based agitations, combined with the inherent weak nature of any Coalition Government, suggest that most budget proposals for 2016 may have to be permanently shelved, or at least strategically postponed until after the Local Government elections due later in 2016, adding further fuel to the disastrous fiscal fire!

A classic case in point which confirms the above dilemma facing the government is the recent proposal to increase the Value Added Tax (VAT) from the existing 8% and 11% to 15%, and the re-introduction of a Capital Gains Tax after almost 30 years. However, as is now well known, in the face of public protests, the implementation date of these proposals were postponed, first until the Sinhala and Tamil New Year in mid-April 2016, and second, until after the May day celebrations.

In summary, it could be said that the irrational and unwise expansion of government expenditure had resulted in a series of ad-hoc taxation policies which have exerted serious pressure on the government’s ability to successfully manage the economy. As a result, many proposals had to be reversed many times, thereby creating severe uncertainty among investors and the economy at large.

Dr. Nimal Sanderatne in an article titled *"Populist measure Leeds to Economic Crisis"*, sums up this situation in polite language: *"The 2016 budget disclosed ineptness in fiscal management. Never in the country's budgetary history has a budget been amended, changed and fresh proposals, so different from those in the original budget, been proposed by the government. Such revisions have created considerable uncertainty in economic policies, eroded confidence in the capacity of the government to manage the economy and are dissuading much needed investment".*

11. The growing political uncertainty

The political platform in the aftermath of the Presidential and General elections has remained unclear and uncertain, although a period of over one year has elapsed since the formation of the "Yahapalana" government. In the meantime, the country is once again preparing for the Municipal and Urban Council Elections scheduled to be held in 2016.

In that regard, two key political factions have emerged:

a) The Sri Lanka Freedom Party (SLFP) led by the President Maithripala Sirisena; and the United National Party (UNP) led by Prime Minister Ranil Wickremesinghe. These two parties are in a coalition as the current government, and

b) A substantial faction of the SLFP and the United Peoples Freedom Alliance (UPFA) constituent parties led by former President Mahinda Rajapaksa;

At the same time, it is an open secret that the ruling group have serious disagreements within the ranks, and the fact that, in the past, coalition governments have not been successful in Sri Lanka, may be a vital factor that may loom large in the minds of all economic stakeholders in times of this nature.

It is now apparent that the policy uncertainty stems to a great extent, from this coalition nature of government, and that the significant changes effected in the budget for 2016 is a manifestation of the differing agendas within the components of government, who are obviously united only to be in power. Accordingly, decisions which may be unpopular among the masses but are essential for the longterm growth of the country seem to be getting effectively curbed, while economically harmful measures which could be popular among different sections of the masses, seem to be implemented more freely.

Subashini Abeysinghe, Economist of the Colombo based, but foreign funded think tank Verite Research, said, as per the Daily Mirror of 28th December 2015: *"Policy uncertainty will be the biggest challenge. The Budget was rather messy and didn't provide clarity. The economic statement made some clarity but the Budget didn't show how to go ahead with those policies. This is because we have a unity government with the UNP and SLFP, which have different policy ideologies".* Abeysinghe further stated: *"People feel lost. Who is calling the shots? Is it the UNP or the SLFP? The unity government has also lost some credibility, because of the appointment of some ministers who didn't have good track records. The Budget was a bit of a disappointment. So there's credibility lost in both political and economic fronts".*

The Sri Lanka Economic Association is also quoted in the Daily Mirror on 28th December 2015 as pointing out that the Interim Budget was weak in policy direction due to such ideological differences of the government.

In the same newspaper article, W. A. Wijewardena warned that: *"a political upheaval, which would bring further uncertainty to the country's economy, is likely to take place if the government does not radically change its means of communicating economic situations to the public".*

As the Local Government elections are due shortly, it is obvious that both the Executive President and the Prime Minister (who are expected to lead the two main parties) would not wish to be on the losing side. Therefore, Sri Lanka would perhaps continue to witness a further period where longterm economic policies would be delayed at the expense of political popularity. In this context, it would also be appreciated that politics and economics are intricately connected, and politics cannot be ignored when taking economic decisions.

An objective assessment of the economic decisions taken by the government in 2015 and 2016, indicates that the authorities' sensitivity to the political and economic fallout of their proposed reforms have been inadequate and weak. It also appears that on many occasions, they have overestimated their own political or economic strength, perhaps not giving sufficient attention to the fact that they are a coalition government. That weakness seems to lead to their embarking on shortsighted decisions, and sadly such decisions have already led to disastrous economic results, which have affected all the people of Sri Lanka and its many investors, local and foreign. That is why a fresh look needs to be taken by the government at some of their proposals, with serious consideration being given to their ability to effectively implement such proposals. It is only by doing so, that they could restore the badly shaken investor confidence that the country is currently suffering from.

12. The global economic slowdown

The global conditions have also not been helpful, with the expected increase in Federal Funds rate in USA. The December 2015 Fed move signalled a mega shift in global macroeconomic fundamentals, and further rate increases by the Fed are expected in 2016. As a consequence, emerging markets are likely to face pressure on interest rates and currencies as the USD strengthens due to the Fed Reserve action, and there is a shift to safety. In this environment, Sri Lanka must expect to experience further pressure on the SL Rupee triggered by foreign capital outflows, and, as a consequence, treasury yields may regularly adjust upwards. Confidence levels would also need to be raised in order to be competitive and thereby stem any outflow, which could cause even greater stress on the fiscal and external situation.

Fortunately for the economy, on a positive note, since the Presidential election in January 2015, Sri Lanka has improved its relationship with the Western nations and there is an increasing optimism that the GSP+ trade concessions would be regained in 2016 or 2017. That would hopefully boost exports to Europe. Although economically, this concession would be helpful, it remains to be seen as to whether the political terms that the Sri Lankan authorities would have to comply with, in order to qualify for the concession, could be managed politically by the coalition government, without a popular fall-out. On another positive note, the steep decline in global crude oil price has drastically reduced the fuel import bill, thereby alleviating BOP pressures to some extent. However, the plummeting of global crude oil price has adversely affected the oil producing economies in the Middle East, and it is likely that the downturn in those economics could affect the worker remittances into Sri Lanka, which would in turn, add to Sri Lanka's economic worries. At the same time, the bearrun experienced by global commodities have also affected global tea and rubber prices, which are key export items from Sri Lanka. As a result, these plantation industries are experiencing severe

hardships currently and if these trends continue, the present crisis in these sectors could turn disastrous with unimaginable consequences on the well-being of a large segment of the Sri Lankan people.

On 10th May 2016, in an article in the Daily Mirror, a key strategist who is closely associated with the UNP and the Yahapalanaya government, Dinesh Weerakkody says: *"Given the many risks involve the world economy ranging from politics to protectionism to oil slumps and cyber-attacks, there is a very good chance of another prolonged down turn in the global economy that can certainly have a negative impact on small economies like Sri Lanka".*

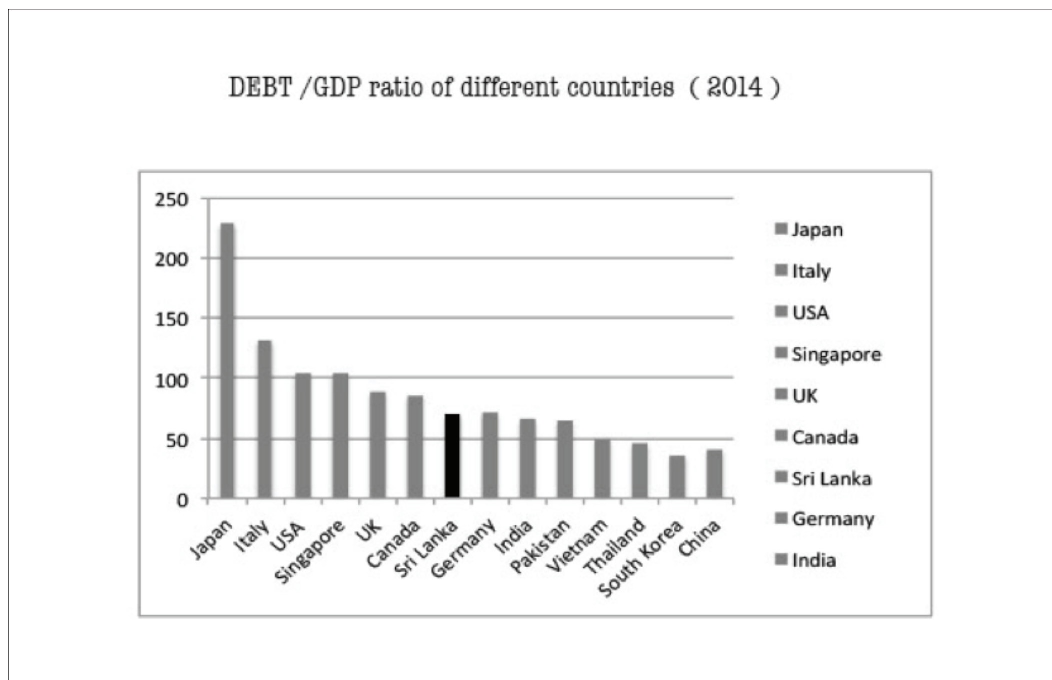
III) IS THERE A REAL DEBT TRAP OR IS IT THE IMCOMPETENCE OF THE ADMINISTRATION ?

One of the main arguments of the present government to cover up the economic mismanagement is that they inherited a debt-ridden country.

How true is this statement? There is no country in the world, or for that matter a large business entity, which does not borrow. In that background, it is not the absolute debt value that matters, but the country's or the institution's ability to repay the debt. Such ability is measured by the "Debt/GDP ratio", in the case of countries, and by the "Gearing ratio" in the case of businesses.

In this context, it would be seen that most of the developed countries have Debt/GDP ratios of over 100%.

Graph: Comparison of Debt/GDP across the World



Source : www.tradingeconomics.com

Why do countries borrow? It could be for a variety of reasons. The bulk of the borrowings of Sri Lanka during the last decade was to support the war efforts. But once the war was over, the government focused its attention towards infrastructure development, rehabilitation and rebuilding, and the government needed debt financing to support these massive development activities.

In 2009 when the war ended the total outstanding government debt was Rs.4,161 billion, and by 2014, the total accumulated public debt had reached Rs.7,391 billion. Accordingly, during the 2009-2014 period, the national debt had increased by Rs.3,230 billion.

However, during this period, it is clear and visible that there has been a massive corresponding development programme which had taken place in the country, with the construction of new Airports, Ports, Power Plants, Irrigation Projects, Roads, Highways, Hospitals, Schools, and Government buildings. In fact, the road development work alone had been done at a cost of over Rs.750 billion. All these investments are tangible assets in the country's balance sheet today.

In contrast, the current government has broken records of all previous governments when it comes to borrowing. Since January 2015, the present government has been borrowing heavily from every local and foreign source possible, and according the published data of the Central Bank, the total outstanding government debt as at end 2015 had reached a staggering Rs.8,503 billion.

Accordingly, the increase in debt by the present government in 2015 has been the highest-ever debt increase in the history of the country in a sum of Rs.1,112 billion, which is about one third of the net loans taken by the previous administration in the post war period of 6 years! Worse still, is that although such a massive amount has been added to the public debt, there are no major infrastructure additions or governmental services additions visible to the public!

"Sri Lanka's debt to GDP which was gradually falling from over 100% ten years ago hit a low of 71% in 2014, but rose to 76% a year after," says the international rating agency, Moody's as quoted in the Daily Mirror of 9th May 2016. "At 76% of GDP, government debt was high compared with similarly rated sovereigns" Moody's added. Moody's also forecast that the ratio would touch slightly below 80% by the end of 2016.

Moody's Investor Service further cautioned: *"Despite the International Monetary Fund (IMF) funding set to ease immediate liquidity pressures, the continuing fiscal consolidation challenges would further increase Sri Lanka's debt burdens and the debt to GDP ratio would continue its upward path during the next two years".* The global rating agency also expressed it doubts over the government's ability to bring about such fiscal reforms as some of them look a tall order to implement.

As pointed out by Moody's, the Government's Debt to GDP ratio, which had a declining trend had a unexpected and undesirable reversal in 2015, with the ratio jumping from 70.7% in 2014 to 76.0% in 2015, with the average for the five years being 70.6%.

Table : Debt to GDP ratio

Year	%
2010	71.6
2011	71.1
2012	68.7
2013	70.8
2014	70.7

Source : Moody's Investors Service

The above computation shows that this ratio has deteriorated significantly during 2015, and is the highest in the past 5 years. Therefore, the sudden increase in this ratio by a significant 7.5% indicates an unacceptably high degree of fiscal indiscipline, and downright economic mismanagement.

IV) THE FREEFALL FROM THE EYES OF THE CENTRAL BANK

In order to make this research analysis even more objective, the following analysis has been carried out by a professional research team, based on the information, tables, graphs and ratios as contained in the CBSL Annual Report 2015.

The Remarks column provides a brief explanation regarding the figures as expressed in the CBSL Annual Report, and it is likely that this analysis would serve as a useful tool to understand the nature of the Sri Lankan economy, come to grips with the issues facing the economy, and to assess the claims and counter-claims made by the government and various other interests.

NATIONAL OUTPUT, EXPENDITURE AND INCOME

INDICATOR	2014	2015	REMARKS
Real Economic Growth	4.9%	4.8%	The continuous low inflation environment supported the outcome of a reasonable growth. The industries sector activity moderated due to the slowdown in large scale infrastructure construction, while favourable weather helped agriculture. As per the CBSL Annual Report 2014, growth was recorded at 7.4%. Subsequently however, it was revised downwards in a somewhat suspicious manner, according to many analysts. Even in that dubious scenario of revised growth where the growth for 2014 was adjusted downwards by about one-third from 7.4% to 4.9%, the average growth for the 5 years, 2010 to 2014, reflects a fairly high rate of 6.8%. On that basis, the slowdown in growth during the year 2015, as against the average growth from 2010 to 2014 is a significant 30%.
Real GDP	Rs. billion 8,229	Rs. billion 8,623	
GDP at current market prices	US$ billion 80.0	US$ billion 82.3	
GDP per capita in US$	US$ 3,853	US$ 3,924	This modest increase in GDP per capita is the 2nd lowest in the past 10 years. It is also worrisome that the GDP per capita was projected at US$ 4122 as per the previous base for the year 2015, and hence the corresponding figure on the new revised basis should have been around US$ 4,400. On that basis, the mere US$ 71 increase in GDP per capita to US$ 3,924 is a disappointment.
Domestic Savings growth	6.0%	1.1%	As a result of this significant deceleration, the savings/ investment gap declined to 2.2% of GDP in 2015, from 2.5% of GDP in 2014

Total FDI	US$ million 1,635	US$ million 1,161	The main reason for the decline in FDIs has been the decreased inflows to infrastructure projects by 33.6%, services by 49.6% and manufacturing by 23.0% Further reasons attributed for the decline: a) Two national level elections, prompting a "wait and see" attitude by investors; b) Possible Fed rate increases; c) Suspension of Colombo Port City Project According to projections made in late 2014, FDIs in 2015 were expected to increase to around US$ 3,000 million. Hence, the present outcome of just US$ 1,161 million is very disappointing. The significant reduction of 29% in FDI reflects the growing uncertainty and the lower confidence of foreign investors.

ECONOMIC AND SOCIAL INFRASTRUCTURE

INDICATOR	2014	2015	REMARKS
Government Investment in Infrastructure	Rs. billion 442	Rs. billion 553	According to these figures, the investment in infrastructure seems to have increased substantially by 25%. However, concerns now arise since very little development work has been visible at the ground level, compared to previous years, where the development was plainly visible.
Telephone Penetration growth	6.9%	7.7%	Growth has been maintained at reasonable levels.
Internet Penetration growth	67.5%	19.3%	Much slower growth in Internet penetration in 2015 compared to 2014. This is possibly a reflection of the slower growth in GDP per capita and rising unemployment among youth.
Ceylon Petroleum Corporation (CPC) Profit/(Loss)	Profit of Rs. billion 1.5	Loss of Rs. billion 18.4	CPC's financing position has weakened seriously in spite of international oil prices falling by 46.1%, from an average of US$ 99.60 in 2014 to an average of US$ 53.75 in 2015. In that background, it is clear that a wonderful opportunity to strengthen CPC's financial status was squandered by the politically motivated massive decrease of the 'pump' prices. Consequently, CPC's balance sheet has become quite vulnerable. In this "low-oil price" scenario, it is unacceptable that CPC's loss of Rs. 18.4 billion is more than the combined loss of SL Railways (Rs. 7.7 billion) and SL Airlines (Rs. 10.6 billion)
CPC's gross liabilities to Banking Sector	Rs. billion 246	Rs. billion 264	CPC's liabilities to banks increased by LKR 18 billion due to LKR depreciation. If prudent policies were followed and the fuel "pump" prices were not slashed to very low levels to gain a political advantage, CPC's liabilities could have been reduced by about Rs. 200 billion during the year, thereby creating a useful safety cushion for CPC.

Ceylon Electricity Board (CEB) Profit/ (Loss)	Loss of Rs. billion 14.6	Profit of Rs. billion 20.1	CEB benefited immensely by increased hydro and coal power availability and lower cost of fuel. The low fuel prices environment provided the opportunity to strengthen the CEB, thus enabling the utility to face any tough challenge in the future.
Expenditure on Roads by Road Development Authority (RDA)	Rs. billion 120.9	Rs. billion 144.6	A massive increase of expenditure on roads is recorded. However, critics point out that not much visible activity has been observed at the ground level, and hence questions surface as to whether any corrupt practices have taken place in this sector.
Registrations of Motor Vehicles	430,000	669,000	The increase in vehicle registrations in 2015 was 55.7%, while the increase in 2014 was a more manageable 31.5%. This massive influx of vehicles has been one of the major causes for the adverse trade balance while it has also led to major road congestion during 2015.
SL Railways	Loss of Rs. billion 11.0	Loss of Rs. billion 7.7	Some improvements have been recorded in the finances of SLR during 2015, and losses have been reduced. However, improvements seems to be mainly due to lower fuel prices, while wages have risen substantially.
SriLankan Airlines	Loss of Rs. billion 29.0	Loss of Rs. billion 10.6	The reduced losses of SLAirlines and the bigger profits of Mihin Lanka in 2015, seem to be mainly due to the lower global fuel prices. At the same time, SLA's total gross liabilities to the banking sector have increased by Rs. 24.0 billion to Rs. 33.0 billion during 2015, thereby establishing that the SLA's liability to the banking sector was only Rs. 9 billion by the end of 2014. In the meantime, the table of outstanding External Debt shows clearly that the entire external debt of all State Owned Business Enterprises (SOBE's) and Public Corporations amounts to only US$ 2.7 billion, up from US$ 2.5 billion in 2014. Hence, it is clear from these figures, that the debt position of SLAirlines and Mihin Lanka is completely different to the news reports that quoted the government as claiming at a media conference on 26th April 2016, that SLA's liabilities are US$ 3.2 billion!
Mihin Lanka Airlines	Profit of Rs. billion 0.7	Profit of Rs. billion 1.3	
SL Ports Authority	Profit of Rs. billion 7.3	Profit of Rs. billion 6.0	Although total revenues of the SLPA had increased by 8.8%, a decrease in profit has been recorded, as a result of operating expenditure increasing by 15.3%.
Water Board	Profit of Rs. billion 2.5	Profit of Rs. billion 0.1	Although total revenue of the Water Board had increased by 5.4%, a decrease in profit has been recorded, as a result of operational and maintenance costs increasing by 21%.

PRICES, WAGES, EMPLOYMENT AND PRODUCTIVITY

INDICATOR	2014	2015	REMARKS
Average Inflation as per CCPI	3.3%	0.9%	The seven year record of average mid-single digit inflation was maintained in 2015 as well. However, with the CCPI declining well below the 2015 projected levels of 3% mainly due to the administrative reduction in fuel prices, the risk of future inflation increasing has escalated considerably.
Public sector Wages Increase	10.5%	31.7%	This year's increase was the highest increase in recent times. It has been estimated that an additional LKR 160 billion would have been incurred by the government due to this salary increase. The fact that the increase is nearly 32% at a time when inflation has moderated to less than 1% clearly demonstrates the recklessness and absurdity of this increase.
Formal Private Sector Wages Increase	0.4%	1.9%	This increase seem marginal although higher than the previous year. It also seems to be in line with the rate of inflation.
Informal Private Sector Wages Increase	7.6%	7.3%	This increase is more modest, when compared to the previous year. In 2014, inflation was 3.3% and hence the increase seems to be more realistic.
Unemployment Rate	4.3%	4.6%	The number unemployed increased by a considerable 10% during the year. The unemployed among those with GCE A/L and above and belonging to the qualified categories, increased to 9.2% in 2015. The benign trend of the systematically reducing unemployment rate has been reversed in 2015. In fact, the average unemployment rate during the period 2010 to 2014 was 4.3%. Further, the rate for 2015 of 4.6% is the highest in 5 years since 2010.
Strikes in Private Sector	38	51	Strike actions seems to have increased considerably in 2015, and the number of man days lost is the highest since 2006. The reversal of this trend is worrisome, particularly in the light of the impending escalation of prices with the imposition of new taxes in 2016, which is likely to result in a clamour for higher wages in the formal and informal private sectors.
Man-days lost	37,000	82,000	
Foreign Employment Departures	301,000	263,000	A 12% reduction was recorded in departures. This reduction is possibly due to slow down in the Mid-east economies, and this situation could worsen in the coming years. The economic impact of this reduction on employment and on the external sector, could be quite disturbing in 2016.

EXTERNAL SECTOR DEVELOPMENTS AND POLICIES

INDICATOR	2014	2015	REMARKS
Balance of Payments (BOP)	Surplus US$ million 1,369	Deficit US$ million 1,489	This deficit is the largest-ever BOP deficit in SL's history. Even more worrisome is the fact that it has occurred on the back of a comfortable surplus and in an environment where the country's fuel bill reduced by a significant US$ 1,900 million.
Trade Deficit	US$ million 8,287	US$ million 8,430	The increase in the deficit was mainly due to a large decline in exports, and substantial imports of motor vehicles as a result of a significant reduction of duty.
Earnings from Exports	US$ million 11,130	US$ million 10,505	Exports contracted by 5.6%, to even below the 2011 level, thus reflecting a serious decline across all major export categories.
Expenditure on Imports	US$ million 19,417	US$ million 18,935	Imports declined by 2.5%, mainly due to the reduction in oil prices. However, the possible benefit was not realised appropriately due to certain other policies of the government which prompted the increase of imports of vehicles.
Workers' Remittances	US$ million 7,018	US$ million 6,980	Remittances declined by 0.5%, compared to growth of 9.5% in 2014. This decline suggests that the slow down in the ME economies could pose serious concerns to the external sector of the SL economy.
Tourist Arrivals	1,527,000	1,798,000	Increase in arrivals, average spend per day, and longer stays resulted in a 22.6% growth in earnings from Tourism in 2015.
Earnings from Tourism	US$ million 2,431	US$ million 2,981	Tourist arrivals more than doubled from 855,975 in 2011 to 1,798,380 by 2015, while direct employment in the Tourism sector increased from 57,786 to 135,930 over the same period. Indirect employment also increased from 80,899 to 183,506.
Issues of International Sovereign Bonds (ISBs)	i) US$ 1,000 million @ 6.0% pa ii) US$ 500 million @ 5.125 % pa	i) US$ 1,500 million @ 6.85% ii) US$ 650 million @ 6.125 % pa	After 2010, SL attracted funds at gradually decreasing rates, notwithstanding adverse global developments. Hence, the higher rates of interest had to be paid by the government in 2015 mainly due to the deteriorating economic conditions.
Foreign Investment in T/Bills and Bonds (Flows)	Outflow of US$ million 38	Outflow of US$ million 903	Suggests a major exodus of funds from SL by overseas investors who have hitherto been quite supportive investors in SL T/Bills and Bonds, even at the time of the QE 1 and QE 2.
Foreign Investment in T/Bills and Bonds (Balances)	US$ million 2,996	US$ million 1,844	The decrease of 38%, and the trend to "exit" from the LKR T/Bills and Bonds seems to be very clear, and this situation exacerbates the growing vulnerabilities.

Govt. Project Loans Inflows	US$ million 1,439	US$ million 1,268 of which, China 488 ADB 288 India 73	It is interesting that, even in 2015, China has accounted for 38% of the government projects, while India has accounted for 6% only. It is in that background that the government may have decided to woo Chinese investment once again.
Foreign Equity Funds Balances	US$ million 1,869	US$ million 1,536	A decrease of nearly 18% reflects a general tendency to exit from the SL equity market.
Gross Official Reserves	US$ million 8,208	US$ million 7,304	Reserves have dropped to nearly the 2012 levels, and the months of imports cover is the second lowest in the past 5 years. Worse still, the declining trend has continued into the year 2016 as well, and according to currently available information, the Gross Official Reserves have dropped to US$ 6.2 billion by 31st March 2016.
	No. of months 5.1	No. of months 4.6	
Total Foreign Assets	US$ billion 9.9	US$ billion 9.3	A significant 6% reduction has taken place in the Total Foreign Assets which comprise of gross official reserves and foreign assets of deposit-taking corporations. An even larger decline was probably avoided by the increase of foreign assets by the deposit-taking institutions
Central Bank Intervention in Forex Market	Net Absorption US$ million 545	Net Supply US$ million 3,250	This intervention works out to nearly 40% of the Reserves at 31.12.2014. This is the highest-ever intervention in forex markets in the history of the Central Bank. It is worrisome that even with such intervention, the Rupee depreciated by over 9%.
Depreciation of the Rupee against US$	0.2%	9.03%	From 2006 to 2014, the Rupee depreciated by Rs. 30.06 only, which is 29.9% for the 9 year period, or 2.9% per annum on a cumulative basis.
SL Rupee to the US$ **Average Year-end**	130.56 131.05	135.94 144.06	The Rupee recorded a massive deprecation of 9% YOY.
International Credit Ratings	Moody's - B1 (Stable) Fitch - BB- (Stable) S & P - B+ (Stable)	B1 (Stable) B+ (Negative) B+ (Negative)	The downgrades of SL's credit rating and/or changes in outlook by 2 Rating Agencies reflect the vulnerabilities as perceived by the International Rating Agencies and Investors.

FISCAL POLICY AND GOVERNMENT FINANCE

INDICATOR	2014	2015	REMARKS: CBSL Comments and Analysts' Views
Fiscal Deficit	Rs. billion 591	Rs. billion 829	This massive increase portrays an even larger fiscal leakage when compared to the proposed fiscal deficit for 2015 of Rs. 499 billion. The reasons attributed are lower government revenue, high recurrent expenditure due to high wages and higher-than-estimated outlay in interest. It may be pertinent to point out that all above reasons are within the control of the government, and that suggests an unacceptable degree of fiscal indiscipline which is likely to be frowned upon by all stakeholders.
Fiscal Deficit (% of GDP)	5.7%	7.4%	
Government Debt to GDP Ratio	70.7%	76.0%	Reflects the weak fiscal sector and low GDP growth. This ratio has deteriorated significantly during 2015, and is the highest in the past 5 years, on the revised basis: 2010 – 71.6 2011 – 71.1 2012 – 68.7 2013 – 70.8 2014 – 70.7 The average for the above five years works out to 70.6%.
Total Outstanding Government Debt	Rs. billion 7,391	Rs. billion 8,503	The reasons attributed for the increase are low revenue collections, and significant depreciation of the Rupee. The increase of Rs. 1,112 billion in a single year, is the highest ever increase in history, and that unprecedented accumulation of debt once again suggests economic mismanagement.
Domestic Debt	Rs. billion 4,278	Rs. billion 4,959	The massive increase of Rs. 681 billion is the highest ever increase of domestic debt in a single year.
Foreign Currency Debt	Rs. billion 3,113	Rs. billion 3,544	
Debt Service Payments	Rs. billion 1,076	Rs. billion 1,318	Debt service payments increased by 22.4%, reflecting relatively higher domestic borrowings.
Foreign Currency Denominated Domestic Debt	US$ million 3,134	US$ million 4,790	This massive and unprecedented increase of 53% is mainly due to significant increase in short term SLDB's. This situation is likely to pose serious challenges to the external sector over the next 5 years, indicating the present administration's callous disregard for prudent policies in the management of the external sector.
Government Foreign Debt to GDP	29.8%	31.7%	The government's increasing exposure to external debt, particularly in a period where the Rupee is depreciating and reserves are falling, is a major concern. The increase in the Government Foreign Debt/GDP ratio also reflects the increase of the external vulnerability of the economy, as well as government finances, and the fact that a large part of the SLDB borrowings in 2015 were of a very short term, and have to be repaid in 2016, has added to the vulnerability.

Average Interest Cost as a % of GDP	4.2%	4.6%	This increase is due to the higher borrowings and depreciation of the Rupee. It is unfortunate that the gains of the past several years, where this percentage had been gradually and systematically reduced from 7.4% in 2002 to 4.4% in 2014, has now been reversed.
Share of SLDBs in Debt composition	11.7%	16.5%	The external risk has increased considerably due to the SLDB's being of a short-term nature. Further, the forex received from the issue of the SLDBs have been dissipated, with the Central Bank using the forex proceeds to defend the currency, without retaining the forex in its reserves to repay the short term liabilities.
Total Govt. Revenue as a % of GDP	11.4%	13.0%	An improvement has been recorded, although it has still remained below target, even after benefiting from the massive one-off super gain tax.
Total Expenditure and net lending as a % of GDP	17.2%	20.5%	This percentage has increased due to a significant increase in recurrent expenditure and public investment.
Recurrent Expenditure	Rs. billion 1,323	Rs. billion 1,702	Recurrent expenditure has exceeded the budgetary targets by a wide margin of Rs. 150 billion, while the increase from that of 2014 being 28.6%, in nominal terms.
Recurrent Expenditure as a % of GDP	12.7%	15.2%	This increase reflected the increases in all major recurrent expenditure items. The percentage increase of 2.5 % has nullified the much-spoken-of revenue increase 1.6%, thus rendering useless, the effect the increase in taxes.
Interest Cost	Rs. billion 436	Rs. billion 510	The interest cost amounting to 30% of total recurrent expenditure, increased by a significant 16.8% due to higher borrowings and depreciation of currency. In a recent advertisement of the Ministry of National Policy and Economic Affairs, the Ministry has claimed that the interest of Rs. 510 billion has been incurred because of the "unprecedented and senseless borrowing of the previous regime". However, it is seen that a massive Rs. 1,112 billion has been added during the year 2015 under the present regime. Hence, it would be grossly inaccurate to state that the burden for the future generations has been created by the previous administration.
Salaries and Wages of Government employees	Rs. billion 441	Rs. billion 562	The government servants' salaries increased by a massive 27.4%. This expenditure increased to 5% of GDP from 4.2% in 2014.
Govt. borrowing from the Banking Sector	Rs. billion 127	Rs. billion 292	Significantly higher than the original estimate of Rs. 70 billion. This also suggests that the borrowing must be at higher rates, which has added further pressures to the budget.

Net Domestic Financing	Rs. billion 379	Rs. billion 593	A significant deviation from the original estimate of Rs. 208 billion.
Increase in Debt stock due to depreciation of LKR		Rs. billion 285	This figure shows the massive impact that the depreciation of the currency has on the foreign debt stock. It also underscores the need to implement prudent policies in all aspects of economic management in order to deliver benign outcomes in an economy.
Public Investment	Rs. billion 486	Rs. billion 603	Public investment increased by a massive 23.9%. However, there is no appreciable reflection of such investment at ground level in the form of improvements to infrastructure or government services.

V) THE TRUTH BEHIND THE MASK

The inability of the present leadership to manage the country effectively is quite clear. The economy, as shown above, is in serious turmoil. Within 1½ years, the Prime Minister has announced three different policy statements in parliament, and the public are wondering which one is valid. The budget 2016, which was presented in November 2015, has been the biggest joke in the Sri Lankan parliamentary history as almost every item in that budget has been subsequently changed. The cost of living is on the rise and ordinary people are heavily burdened with new taxes. Unemployment has increased by 10% since the new government came to power. However, while all these problems are escalating, the government is busy, complaining about the previous regime and pointing fingers at everyone other than themselves, even after 1 ½ years in office. This is a clear sign of incompetence.

Through all this drama, the present ruling junta disguising itself as a “good governance” government has of course shown its effectiveness and competence in lying blatantly, taking revenge and in practicing political victimization. Even in the past, under various governments, political victimization was not uncommon. But the current regime has taken this concept to a completely new level, by focusing most of its energy on this aspect, and this aspect alone. People vote governments to lead and to rule the country. But, the current leadership of the government has no time to rule the country. They are so vicious that their priority is to only make sure that their political opponents are destroyed through lies, deception, public humiliation, misinformation, innuendo, fear and intimidation. They also seem to go to any length to achieve this objective, and their efforts have, on many instances, focused on the relatives and kith and kin of the persons they have targeted, as well.

The sad end to this tragic story is that while the new leadership of the country is spending time on harassing the opposition and engaging in dubious deals, the economy is in freefall and hurtling towards doom!

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