BDO

BUDGET HIGHLIGHTS 2022

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12th November 2021

Dear Valued Client,

BUDGET HIGHLIGHTS 2022

BDO Partners take great pleasure in presenting our views on the budget proposals for the year 2022. In this publication, we provide a synopsis of the budget proposals made by Hon. Basil Rajapakse, Minister of Finance, in his budget speech presented in parliament today.

We believe that being proactive in analysing the tax exposure regarding the proposed changes may provide new tax planning opportunities for the taxpayer. The proposed changes may have an impact on the way you do business and manage your affairs. If you need any further clarifications in relation to the proposed changes our team of tax professionals would be pleased to assist you. Please refer the outer back cover for their contact details.

This publication can also be accessed online through our website www.bdo.lk

At BDO nothing matters more to us more than our clients. Our brand stands for exceptional client service, delivered by exceptional people. We hope you find our comments useful and hope you will engage with us to discuss any tax planning opportunities.

Yours faithfully,

BDO Partners

CHARTERED ACCOUNTANTS

Content

Policy Framework

The 76th Budget of the Democratic Socialist Republic of Sri Lanka was presented on the 12th of November 2021 by the Minister of Finance, Hon. Basil Rajapakse. This is his maiden budget and the second budget presented during the presidency of HE, President Gotabaya Rajapakse. It is presented at a time where the world is facing five major catastrophes, namely increasing economic disparity, sustainable development slowing down, increasing environmental issues, limited access to bilateral and unilateral aid and the challenge to adapt to the post-pandemic “new normal” situation which has multitude of effects. This impact on a trade-based economy has been greater than on a manufacturing -based economy. This is a challenging time to combat economic revival and to stabilize employment.

The Minister also highlighted the strengths in which the budget is woven which includes brave leadership and a strong parliament lead by the most senior Politician in Asia, infra structure of international standards, strong international relations, healthy and educated work force, conservationist citizens, policies inculcating integration of development and the environment, focus on national security and vaccination against the pandemic.

Multitude of barriers identified were drug trafficking, illegitimate forms of trade, global crisis such as environmental issues, challenges in the rising cost of living, outdated economic instruments, dependency on revenue from services, challenges in earning foreign currency, increase in government debt, management of foreign reserves, identification of export opportunities, loss making state owned enterprises and many more.

It is also important to understand that some challenges were beyond control while some were manageable. The budget is expected to soothe the economic distress created by the pandemic-hit economy and to enable the small man to rise and thrive.

Overall, it is clear that the envisaged internal growth of the economy was of the utmost importance based on the policies set forth. This budget is expected to control the increasing cost of living as well. A production economy is to be nurtured through structural changes within a framework of market economy. To enhance this outlook the banking and financial sectors would be reformed to ensure availability of credit and financing.

Proposals for Expenditure Management

Social Wellbeing

- For all Ministries, Departments, Corporations and Statutory Bodies to device a mechanism to take into consideration gender, racial and other cultural differences and demographics in preparing budgets.
- To establish a contributory pension scheme for senior citizens who do not currently receive pensions.
- The establishment of an Act on Rights of the “differently-abled” and a programme for the development of their entrepreneurship and skills
- To introduce an inclusive programme to address the issues on children and mental health development having identified the basic issues faced
- Proposed to provide the required lands and tax concessions to encourage investors to establish an international school and a hospital in every district.

Agriculture & Horticulture

- Proposed focus on a production economy, namely for fruits, vegetables, fish-based products, liquid milk and commercial crops
- Encouraging of growth of flowers for export
- To expand the capacity of the organic fertilizer production of special categories of fertilizer for targeted cultivations/crops
- To promote the diversification of agricultural products and value-added agricultural products so as to generate foreign income
- The establishment of hi-tec agro parks in order to produce new agro-entrepreneurs by providing uncultivated lands to women and youth
- To draft a Green Agricultural Development Act that protects the traditional knowledge of the farmers, safeguards their right to own lands and right to the distribution of water and ensures the participation of the farmers in the decision-making process.

Savings & Investments

- To inculcate a savings culture amongst a majority of the country. This is to create a conducive environment that enables all citizens to save as much as they can and thereby expand their investment capacity. To modernize the Samurdhi movement considering the practical social context without restricting the movement solely to a poor relief programme
- To convert Samurdhi banks as one-stop shops that provide all services and facilities including financial facilities and financial advice for the development of micro and small enterprises
- Focus on making the Cooperative movement stronger, through restructuring activities to conduct proper investigations into alleged frauds.

Local Business expansion

- The establishment of a Three-wheeler Regulatory Authority and to standardize their charges and services

Development of SME's and home production

- Propose to promote the local handloom and the Batik production industry with the aim of generating an income of USD 1 billion by 2025 and to produce the raw materials required for the apparel sector.
- To enhance steps taken to publicize Sri Lankan gems

Foreign Employment

- Improve skills of those seeking foreign employment

Education

- The proposal to install a country wide telecommunication network expeditiously covering all 10,155 schools in the country using Fibre Optic technology, supported by the Telecommunication Regulatory Commission.

Construction Industry

- To decentralize the monitoring of all infrastructure development projects of the government to continuously maintain the commitment of the contractors
- To modernize the Procurement Processes including the introduction of a more decentralised process and also the e procurement process.
- Proposal to make it mandatory to obtain recommendations for all constructions from relevant institutions.

Finance & Investment Related Reforms

- Propose to expeditiously look into whether conditions currently imposed to facilitate attraction of FDIs should be relaxed and to identify suitable methods and to formulate a programme for this purpose.
- To submit a Special Finance Bill to ensure the safety of local and foreign exporters, to ensure the safety of transactions of foreign current accounts and to simplify the conditions that are imposed by the Central Bank on exports with regard to foreign currency conversions and transfers.
- To obtain investments through public-private partnerships and local and international sources to implement mixed development projects.
- To obtain green bond financing facilities and to respond to climate change through those projects

Manufacturing

- To facilitate and encourage the private sector to produce medicines of the highest quality in Sri Lanka targeting the international market and to keep the pharmaceutical prices stable.
- To promote investments in the production of rubber-related finished products instead of exporting rubber as a raw material and to restrict importation of rubber related products.
- Encourage the local manufacturing of equipment and appliances required for the generation of renewable energy.

Public Sector Reforms

- To issue quarterly warrants instead of the annual warrant. Accordingly, it is expected to instill financial discipline in the utilisation of the allocations by requiring all government institutions to prepare their plans. Commitment to control in accordance with the desired objectives is also required.
- To improve the business focus and financial discipline of State Owned Enterprises by forming a multi-disciplinary consultative committee to propose a strategic way forward.
- Full utilization of all state owned under utilized assets. To achieve this task it is proposed to include amendments to the Appropriation Bill preventing requests for Supplementary Estimates for 2022 by all Ministries.
- Public sector to promote savings by accepting a reduction in their fuel allowances, telephone expense & electricity expenses of Ministers, Government officials and Government Institutions.
- To have a minimum eligibility criteria of 10 years to be eligible for a pension by Members of the Parliament.
- A “Client Charter” to be prepared by all public entities and for it to be displayed with the aim of transforming the organizations into to customer centric service centers.
- To introduce an appraisal system for the public service based on the satisfaction of clients and Key Performing Indicators (KPI) to enhance efficiency and productivity of the public service.
- To establish a new salary structure for the public service by removing the anomalies in public service salaries with effect from the next financial year.
- To establish an Integrated Results Based Management System to follow up the achievements of anticipated progress as per the plans prepared.

  To extend the retirement age of public service to 65 years in order to strengthen the labour force.
- State Owned Media Institutions are entrusted with the responsibility of substantively reviewing the business focus.

- To expand the business focus of the Sri Lanka Insurance Corporation to move into other sectors.
- To introduce new laws on the usage of lands owned by plantation companies as well as those of both public and private ownership to ensure the maximum utilization of buildings and other assets.

Ayurvedic & wellness

- To promote Sri Lanka as a center for wellness tourism
- Formulation of a new programme for establishing new Ayurveda treatment centres and promoting traditional indigenous medicine and natural treatment methods.

The Five Hubs strategy presented by “Mahinda Chinthana” policy statement in 2010 was re-introduced.

1. **Navel Hub**
   The proposal to introduce necessary legal provisions under a new Finance Act to establish free ports and to simplify rules in place with regard to registration of ships.

2. **Aviation Hub**
   To improve the infra-structure at the Bandaranaike International Airport and to develop the Mattala Airport.

3. **Energy Hub**
   The unutilized Trincomalee Tank Farm and the two new Refineries focused on exports, are planned to be established in Hambanthota and Trincomalee.

4. **Commercial Hub**
   The country to be a trading place for goods and to provide professional services such as Banking, Insurance, Arbitration and legal services together with a developed securities and a financial sector market.

5. **Knowledge Hub**
   To boost a techno-entrepreneurship driven economy three new techno-parks are proposed to commence in Habarana, Nuwaraeliya (Mahagasthota), Kandy (Digana) by 2023.

Development of National Economy

Agriculture sector

- Rs, 4,000 million has been allocated to promote the usage of alternatives to weedicides.

- A grant of Rs. 5,000 per hectare up to a maximum of 2 hectares will be granted to minimize the use of weedicides in the preparation of land for cultivation.

- Every farmer will be provided with startup working capital to produce solid and liquid fertilizers, organic pesticides instead of chemical pesticides, and further financial support will also be provided to support farmers to incur additional expenses to remove weeds without using chemical weedicides. Rs. 35,000 million is allocated for this purpose.

- Allocate Rs.5,000 million to introduce new agro-technologies.

- Address issues faced in the plantation sector including ensuring water supply to increase productivity and to encourage investment to increase exports a sum of Rs. 10,000 million has been allocated.

- Amenities will be expanded to encourage the production of processed fish, dried fish, Maldive-fish, and canned fish.

- To release 196 million fingerlings into the 200,000 hectares of freshwater reservoirs in 2022 which will yield around 125,000 metric tons worth about Rs. 18,000 million and implement numerous programs to develop and construct the fishing anchorages and fishing harbors which are already underway. Rs. 1,000 million has been allocated for this purpose.

- An investment of Rs. 1,000 million is to be made in the livestock sector.

Manufacturing economy and livelihood development

- Rs. 1,000 million has been allocated for promoting and protecting traditional cottage industries including rattan, clay-based products, brass, lacquer, masks, coconut shell, jewellery, stone carving, flax fibre and dumbara patterns. A new ministry will be set up for this purpose.

- Rs. 1,000 million has been allocated for the development of textile industries including handloom and batik.

Investment zones for new products

- To build an export oriented economy for manufacturing products aimed at both local and foreign markets and to re-export products after value addition. For this purpose certain sectors have been identified to increase production.

- Investment zones will be established with land, electricity, water, access roads both internal and external with an investment of Rs. 5,000 million. Specific areas and industries have already been identified.

Small and medium scale enterprises at regional and district levels

- Action is being taken to provide basic facilities such as land, electricity, water, roads and fences outside the Western province to shift small and medium enterprises from cities to villages.

- Government seeks to establish small and medium scale industries at divisional and district level to open direct and indirect employment opportunities. A sum of Rs. 5,000 million has been allocated for this purpose.

Basic infrastructure development

- In 2022, to provide pipe-borne water connections to approximately 200,000 households while expanding the community water projects and developing reservoirs while conserving water sources.

- To provide 3,314,500 new water supply connections around the country through the completion of already initiated water supply schemes including Attanagalle, Minuwangoda, Kurunegala, Kandy, Anuradhapura North, Jaffna and Kilinochchi. To allocate Rs.15,000 million additionally for the above purposes

- Under “Vari Saubhagya” programme, 5,000 small tanks and anicuts are planned to be renovated. Out of those, 1,050 small tanks and anicuts have been rehabilitated and a further 2,000 will be completed. Rs.20,000 million will be additionally allocated for this project.

- Under the 100,000km of roads project, 18,000 km of roads will be completed by the end of this year. In addition, 25,000 km of roads per year will be constructed starting from 2022.

- Under the rural bridges programme which has been designed to provide access to remote villages, 200 bridges have already been completed and allocations will be provided to complete the balance bridges.

- Colombo Port Access Elevated Expressway, New Kelani Bridge - Athurugiriya Elevated Expressway, Central Expressway, Kurunegala – Dambulla Expressway, Ruwanpura Expressway, Colombo – Moratuwa Marine Drive and the Fly Overs in the city of Colombo will be completed within the medium term of 2022-2024.

- Rs.20,000 million will be allocated additionally for the above road development projects.

Development of renewable energy

- Additional Rs.500 million has been allocated for the facilitation of encouraging private investment in Renewable Energy sector. It is expected to add approximately 2,000 Mw to the National Grid within the next three (03) years.

- Encourage the Local government agencies to move into the provision of street lighting through renewable energy sources in a bid to reduce the use of fossil fuels in the country.

Housing and Urban Development

- Rs.500 million is allocated within the next three (03) years to develop housing in the estate sector.

Providing relief for those affected by Covid 19 pandemic

- Allocate an additional Rs.5,000 million to provide relief to micro, small and medium scale businessmen representing all sectors that were directly affected by the actions resorted to by the government to control the Covid 19 pandemic.

- To allocate Rs.400 million to provide relief to school van and bus owners.

- To allocate Rs.600 million to provide relief to the Three Wheel owners who lost their income

- To allocate Rs.1,500 million to provide relief to the private bus owners who lost their income

- Income sectors that relied on Arts and Entertainment and Weddings and Event Management came to a complete halt due to the Covid pandemic. To allocate Rs.500 million to facilitate and motivate this sector.

Public services and rural infrastructure facilities

- To accelerate the education related programmes and for other developments in the education sector an allocation of Rs.5,300 million has been made additionally.

- Rs. 5,000 million to be additionally allocated for the development of agencies that continue Children's and maternal clinics, rural hospitals, dispensaries, offices of Medical Officers of health, ayurvedic dispensaries, yoga and clinics for mental health.

Judicial Reforms and provision of infrastructure

- To allocate Rs. 5,000 million to make the judicial functions efficient through digitalization of human resources required for reforms in laws related to criminal, civil and commercial laws and to ensure the continuity of the programme to develop Court infrastructure facilities

- To establish a community police service that works closely with the people to curb drugs and crimes. To recruit police officers and to provide facilities for the community police service an additional amount of Rs.500 million has been allocated

- Rs. 200 million has been allocated for the improvement of sanitary facilities of all prison inmates

Securing the Home Economy

- A Home Economy Security Program which includes three-components will be introduced. To allocate Rs. 31,000 million to provide relief to people under this Home Economy Security Program.

- An allocation of around Rs. 15,000 million will be made to implement a program identifying economically poor families at the GN Division level and provide them with a relief basket to alleviate the pressure of the cost of living hike.

- Allocate around Rs. 15,000 million to this program to establish a mini supermarket network at the Grama Niladhari Division level.

Public Service

- Rs. 500 million will be allocated additionally to increase the productivity and efficiency of the public service, making it client-centric, and to digitize the public service

- To provide motorcycles aiming to increase efficiency of public services offered by the field officers. To allocate Rs. 500 million for the activities necessary for this.

- The government through the Cabinet decision dated 30 August 2021 has agreed as a matter of policy to eliminate the Teacher –Principal salary anomalies, thereby ending the trade union activities. Therefore, for the expeditious implementation of such policy, an additional Rs. 30,000 million will be allocated for salary payments.

- Government has focused on creating an appropriate mechanism to correct the pension anomalies. Accordingly, Rs. 500 million will be allocated to undertake the initial action required.

One-time tax

A One-time tax will be charged from all individuals and companies that report more than Rs. 2 billion as Taxable Income for the Year of assessment 2020/21. This will be levied as a tax surcharge of 25% on such individuals and companies.

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It is assumed that 25% will be charged on the taxable income reported by such taxpayer for the year of assessment 2020/21.

This is a tax that will be charged retrospectively on the profits reported for the financial year ending 31^{st} March 2021. The chargeability of this tax is based on the taxable income of the individual or company. The final tax payment due for the year of assessment 2020/21 was already made on 30^{th} September 2021. Therefore, the due date for payment of this additional tax surcharge should be specified. Further, it is not specified if the tax can be paid in installments.

Social Security Contribution

In order to recover from the severe impact of Covid on the Sri Lankan economy a Social Security Contribution will be charged at the rate of 2.5% from persons having turnover of more than Rs. 120 million per annum. This will be effective from 01^{st} April 2022.

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This is a tax that will be charged on the turnover of the taxpayer. It is not clear whether this tax can be passed on to the customer or should be borne by the taxpayer. It will have to be introduced by a new tax legislation which sets out the chargeability. It is assumed that it will apply to both goods and services as it is imposed on turnover.

Special Goods and Services Tax

The budget proposals for 2021 mentioned that a Special Goods and Services Tax will be introduced on alcohol, cigarette, vehicles, telecommunication, betting and gaming to streamline the multiple taxes that are applicable on these products. This tax will be implemented from January 2022 onwards.

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Charging a composite tax would simplify the tax structure and ease payments. The tax rate and the tax base on which this tax will be charged has not been specified.

Motor Vehicles related levies and Charges

Vehicles that meet with an accident

It has been proposed to impose a charge on motorists meeting with an accident. This amount can be indemnified by the insurer of such motor vehicle. This is to act as a deterrent and to address the large number of motor vehicle accidents that take place in Sri Lanka.

Vehicles subject to modification, alteration or refurbishment

A fee will be charged on any vehicle subject to modification, alteration or refurbishment. It is not clear how these charges will be levied and the rates which will be charged.

Legalising of all unauthorized roadworthy motor vehicles and motor cycles

Motor Vehicles that are not registered will be allowed to register within an amnesty period, after making a penalty payment.

Motor Vehicles stationed at the Sri Lanka Customs

Subject to the payment of a tax and fine, all motor vehicles that are parked in the Customs premises will be released.

Leisure License Fee

A special license will be issued under goods and service tax for areas that have been developed as special zones for leisure activities.

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The special areas that are developed under this license will have to be identified and authorised by the respective government institution. The fee for issuing the license has not been specified.

License issued by Telecommunication Regulatory Commission

The licenses issued for telecommunication services, including fixed phone operations, mobile phone operations, internet service providers, and satellite broadcasting operation will be done by way of an auction to ensure transparency. The 5G frequencies will also be sold by auction to ensure fair play.

Value Added Tax

Exemptions

The following items will be exempt from VAT;

on importation or supply of medical equipment, machinery, apparatus, accessories and parts thereof hospital furniture, drugs and chemicals donated to a government hospital or the Ministry of Health for the provision of health services to address any pandemic or public health emergency approved by the Minister of Finance on the recommendation of the Secretary to the Ministry of the Minister assigned with the subject of Health.

Value Added Tax on Financial Services

Value Added Tax on the supply of financial services is on Licensed Commercial Banks, Finance Companies and/or Licensed Specialized Banks providing financial services and any person providing “financial services”.

The tax rate of 15% currently charged as Value Added Tax on Financial Services has been increased to 18% for a limited period between 1st January 2022 to 31st December 2022 and to be paid monthly. The proposals specify that this additional tax burden should not be charged to the customers but should be borne by the respective banks and other financial institutions specified above.

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The additional VAT on financial services will have to be borne by the taxpayer, which will impact their profitability. A further tax of 2.5% charged as Social Security Contribution and the tax surcharge of 25% on taxable income (if applicable) will also further thin the margins enjoyed by such institutions. This will be restrictive in a low interest, high inflationary economic environment.

Simplifying new business registration process

The Finance Act will be amended to simplify the process for new business registrations. Currently, there are mutually exclusive processes adopted by the Board of Investment, Department of Foreign Exchange and Export Development Board and each of these institutions have independent fee structures. These complexities will be removed by consolidating all such processes and fees through an amendment to the Finance Act.

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This is a welcome move as most foreign investors find it difficult to navigate through the various processes involved in starting a business in Sri Lanka. This will help attract FDIs into Sri Lanka and improve the Doing Business index of the country. Currently non-residents enjoy income tax exemptions from any interest or dividend paid to such non resident from Sri Lanka. These measures will further aid towards boosting investments into Sri Lanka.

Establish free ports in Sri Lanka

The Finance Act will facilitate setting up freeports in Sri Lanka. This is with a view to make Sri Lanka a naval hub, taking advantage of the strategic location of the island nation which is central to shipping routes connecting East Asia and West Asia.

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Sri Lanka needs to attract more foreign currency income and establishing freeports with tax and other concessions will facilitate this.

Business registration fee removed

In order to encourage entrepreneurship and facilitate new business ventures, the business registration fee has been removed for the year 2022.

Excise Duty

Excise duty is imposed on tobacco, liquor and other excisable articles.

The budget proposals have made revisions to the following;

- Excise Duty (Special Provisions) on Cigarettes
- Excise Duty on Liquor under Excise Ordinance

The revised tax rates will be notified by gazette.

Tax Administration

It has been identified that a large amount of tax revenue is being lost due to inherent deficiencies in the tax administration. Therefore, it has been proposed to introduce measures to improve the tax administration. Further legal provisions will be introduced to facilitate technological processes to tax administration.

Large Taxpayers

The majority of the tax revenue of the Government is earned through a small number of taxpayers. Therefore, it was proposed to strengthen the Consolidated Large Taxpayers Unit of the Inland Revenue Department to integrate the administration of all the units that deal with such large taxpayers. More focus has been given to the Large Taxpayers Unit (LTU) and Upper Corporate Unit (UCU) to improve tax collection.

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There is emphasis on the Large Taxpayers in the Budget proposals this year. A new One off tax has been introduced for this category of taxpayers. This proposal alone is expecting to bring in LKR 100 Bn, which accounts for 30.3% of the new revenue proposals. In addition to this the Social Security Contribution will also have to be borne by such taxpayers.

Digital Revenue Collection Systems

The following digital revenue collection systems will be improved;

- Revenue Administration Management Information System (RAMIS) of the Department of Inland Revenue
- Single Window System of the Sri Lanka Customs

Specific measures to improve the RAMIS system will be;

- Fully implement the system expeditiously
- Integrate the online tax payment platform of the Department of Inland Revenue with all banks and financial institutions through Lanka Clear
- Mechanism to examine the accuracy of tax documents
- Allow to present digital invoices and documents as valid documents where possible
- Introduce statutory provisions to use digital identification numbers and other legal requirements

Digital Revenue systems will be implemented for the Excise Department and measures will be taken to improve efficiency by simplifying the Excise licensing process (i.e. liquor license)

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In the current context, most corporates have switched to work remotely due to the pandemic. Significant investments have been made in digital systems and processes. This paradigm shift can be facilitated by the revenue collection authorities in improving efficiency and accessibility to these systems by the taxpayers. This will improve efficiency in revenue collection and tax administration.

Money earned by Perpetual Treasuries Ltd

It has been proposed that Rs. 8.5 billion earned by Perpetual Treasuries Limited in violation of the Code of Conduct of the Central Bank of Sri Lanka be transferred to the Treasury. This is to be done, without causing any impediment to legal action taken by the Hon. Attorney General.

Economic Analysis

Introduction

Global economic outlook

A global economic recovery is expected in 2022 despite significant disparities created by the pandemic across countries. As per IMF, the global economy is projected to grow by 5.9 per cent in 2021 and 4.9 per cent in 2022. Economic prospects remain divergent across countries, mainly due to disparities in access to COVID-19 vaccines and policy support. Consumer price inflation in most countries increased significantly, reflecting the impact of pandemic related supply-demand mismatches and the surge in commodity prices.

According to World Bank, per capita income losses in 2021 will not be fully unwound by 2022 in about two-thirds of Emerging Market and Developing Economies (EMDE). The global outlook remains subject to significant downside risks, including the possibility of additional COVID-19 waves and financial stress amid high debt levels in EMDEs. Policy makers will need to balance the need to support the recovery while safeguarding price stability and fiscal sustainability and to continue efforts toward promoting growth-enhancing reforms.

Sri Lankan economic outlook

From an economic point of view 2021 has been a very challenging year. The pandemic situation continued from 2020 eased out through the first quarter of 2021 but raised its head to peak in the third quarter to reach almost uncontrollable levels. This resulted in another lock down spanning over six weeks but the situation was brought under control with the comprehensive vaccination program deployed by the government.

Real GDP grew by 8% YoY, in the first half of 2021 from a low base with significant contributions from manufacturing, trade, financial services, and real estate activity. The subsequent up-tick of COVID-19 infections likely weakened the pace of recovery in the second half of 2021. Consequently, the growth in 2021 is expected to be 3.3% according to the latest IMF projections.

However, the medium-term outlook is clouded by pre-existing macroeconomic weaknesses and the adverse economic impact from the COVID-19 pandemic. With jobs and earnings lost, poverty is projected to remain above pre-pandemic levels in 2021.

Apart from having to incur over LKR 200bn in direct costs of combating Covid-19, the government also supported the business sector through extended moratorium schemes and easing of monetary policy. In the meantime during 2021 the economy faced many a challenges: depletion of foreign exchange reserves, depreciation of LKR, weakening of fiscal revenue and foreign remittances and increase in NPL and impairment provisions in the banking sector, to name a few.

Extension of the Covid-19 related concessions

The Central Bank of Sri Lanka was requested to consider extending the concessions granted previously (until 31.08.2021) to borrowers affected by COVID-19 up to 31.12.2021, considering the subsequent developments in the pandemic and the resultant difficulties to the borrowers.

The concessions granted for COVID-19 affected borrowers were mainly deferment of loan repayment until end December 2021. This is for performing credit facilities as of 01.09.2021, to defer recovery of capital, interest, or both, on a case-by-case basis, considering the financial difficulties of the eligible borrowers, including loss of job, loss or reduction of income/salaries or sales, reduction or impairment of business operations or closure of business, etc. Accordingly, the borrowers obtaining these concessions shall start repaying them from 01.01.2022.

Inflation

The YoY CCPI touched 6% in August ’21 which returned back to 5.7% in September ’21 with certain price control measures introduced by the government. It was 10% for the food group and 3.8% for the non-food group with transport and health being the main contributors.

Considering that the main contributors to inflation being essential items the government invoked emergency regulations to curb speculative practices of traders amid high food prices and shortages of some essential commodities. To curb rising inflationary pressures, the CBSL introduced monetary policy revisions increasing the interest rates.

However, with the increase in shortages in the market, of essential commodities such as LPG, milk powder, rice, sugar and dhal; and of raw material inputs such as cables and cement; in the market, the government was subsequently compelled to withdraw many price controls either fully or partially. The impact of these measures on inflation is yet to be seen.

Monetary Policy

In 2020 during the early part of pandemic, the CBSL reduced the Statutory Reserve Ratio applicable on LKR deposits to 2% by a total of 300 basis points with a view to provide liquidity to the banks to meet the demand of Covid-19 related concessions extended by the government. The CBSL further reduced the SDFR and SLFR to 4.5% and 5.5% respectively which reduced the interest rates and eased the pressure of finance cost of the borrowers.

At the Monetary Board meeting held on 18 August 2021, SDFR and the SLFR of the CBSL were increased by 50 basis points each, to 5% and 6% per cent, respectively. In addition, the Statutory Reserve Ratio on all rupee deposit liabilities of licensed commercial banks by 200 basis points to 4% per cent, with effect from 01 September 2021. These measures were taken with a view to addressing the imbalances on the external sector of the economy and to preempt the build-up of any excessive inflationary pressures over the medium term, amidst improved growth prospects.

The Monetary Board of the CBSL, at its meeting held on 13 October 2021, decided to maintain the above rates after carefully considering the macroeconomic conditions and expected developments on the domestic and global fronts. The Board reiterated its commitment to maintaining inflation at the targeted levels over the medium term with appropriate measures, while supporting the economy to reach its potential in the period ahead.

Financial Markets

Credit growth

Reflecting the increased demand for credit amidst the low interest rate environment, credit extended to the private sector expanded as envisaged during the eight months ending August 2021. With this expansion private sector credit edged closer to a LKR Trillion representing a growth of more than 15% YoY.

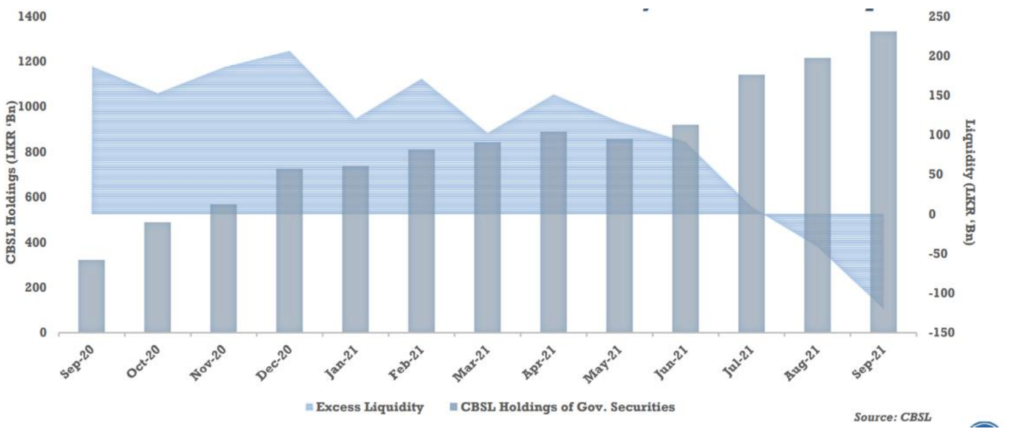
The momentum of credit expansion is expected to continue during the remainder of the year, with the recovery in economic activity and continued efforts to channel credit flows to productive and needy sectors of the economy. Meanwhile, credit obtained by the public sector from the banking system, particularly net credit to the Government, also increased notably during the eight months ending August 2021. With increased domestic credit, the growth of broad money (M2b) continued to remain elevated.

Market Liquidity

Market liquidity witnessed significant volatilities during Sep 2021. With SRR down at 2% the market liquidity remained high till August 2021 which experienced a significant contraction in September in response to the increase in SRR to 4%. Overnight liquidity in the market has remained negative since then, but negativity declined.

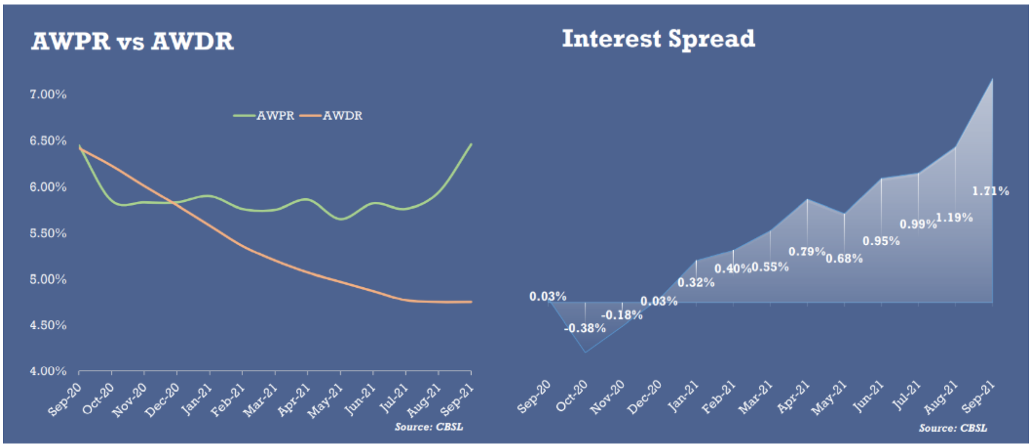
At the beginning, liquidity saw a significant contraction due to the implementation of increased SRR requirement on Deposits. However, towards the end, negativity of liquidity declined due to increased holdings of bonds by CBSL.

Market Liquidity



Interest Rates

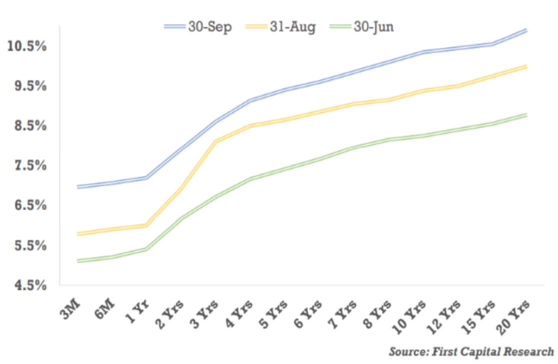
In response to the tightening of monetary policy in August 2021, most market deposit and lending rates have adjusted upwards. Further, yields on government securities witnessed a sharp upward adjustment with the removal of maximum yield rates for acceptance at primary auctions. Following these upward adjustments, greater stability is expected in market interest rates in the period ahead.



Since January 2021, the interest spread started widening with a sharp decline in the deposit rates. Since August the spread has widened due to an upward movement in lending rate resulting from the monetary policy changes in August.

Government Securities

During the month of September, the secondary bond market yield curve steered significantly upwards across the board amidst the mounting pressure on yields quoted by market participants although volumes remained low. With the dried-up liquidity in the system and growing uncertainty, yields of 1Yr, 5Yr and 10Yr peaked at a 14-month high for the first time on 08th Sep 2021.



Equity Market

Boosted by the low interest rates the CSE has performed well with ASPI surpassing 10,000 mark gaining over 70% in 2021 YTD primarily driven by the local investors. Foreigners have gradually withdrawn from investing in Equity as a result of unwarranted fear of default triggered by rating downgrades despite Sri Lanka's unblemished track record of debt repayment. Fear of depreciation in the LKR has also been a factor leading to withdrawal of foreigners.

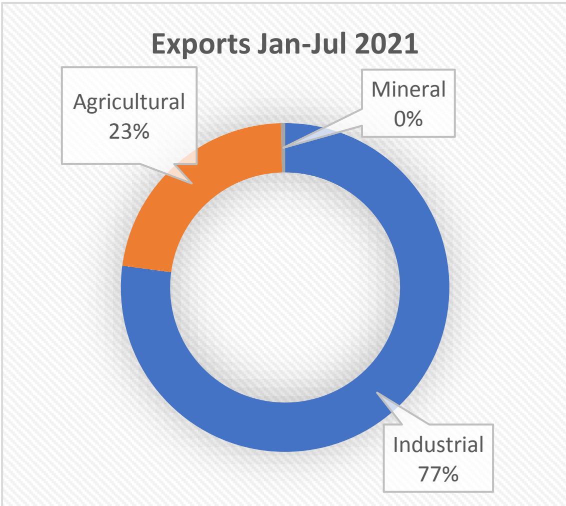
Economic Analysis

External Sector

External vulnerabilities further elevated thus far in 2021. The government introduced many restrictions on non-essential goods to curb the situation. Despite these efforts the trade deficit widened as rising import bills driven by intermediate and investment goods, offset the increase in earnings from exports.

Exports

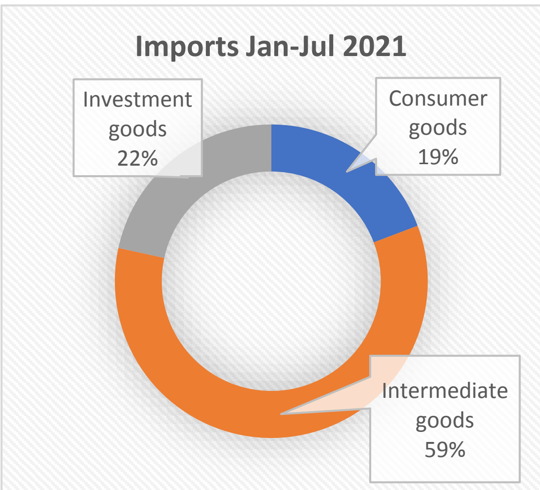
Exports for the period Jan-Jul 2021 recorded USD 6.8Bn, an increase of 23.7% YoY. The growth was led by the increase in industrial and agricultural exports. Earnings from the export of industrial goods recorded USD 5.2Bn an increase of 25.4% led by petroleum products, machinery and mechanical appliances and rubber products. Earnings from the export of petroleum products improved because of the increase in prices and quantities of bunker fuel supplied, as well as the prices of aviation fuel supplied. Earnings from the export of agricultural goods in same period recorded USD 1.5Bn an increase of 17.4% YoY mainly due to the increase in export of seafood and spices.



A concern has been that a wide gap exists between the goods flow and financial flow of exports. Due to an undue speculation on exchange rate movements, there has been a reluctance to convert export earnings, thereby limiting inflows to the domestic foreign exchange market. During the 7-month period there has been a financial flow of only USD 4.5Bn (66%) leaving one-third of exports not contributing to the system.

Imports

Despite the continuation of the import restriction measures, import expenditure reached, during the period of Jan-Jul 2021, USD 11.7Bn an increase of 30.7% YoY. Consumer goods accounted for only 19% of the total imports and the increase which was restricted to 8.8% was not sufficient enough to restrict the total imports increasing by 30.7% which was primarily led by imports of intermediate and investment goods.



Expenditure on the importation of intermediate goods, during the period, increased by 41.4% YoY with increases in most of the main categories including base metals (iron and steel) and fuel (refined petroleum and crude oil).

Value of investment goods increased by 27.5% YoY with substantial increases in all three types of investment goods, namely, machinery and equipment, building material and transport equipment.

Worker Remittances and Tourism

Worker remittances for the period Jan-Jul 2021 stood at USD 3.8Bn which showed a marginal improvement of 2.6% YoY. However there has been a declining trend MoM since January 2021 that could lead to an overall decline for 2021 YoY.

Earnings from tourism in 2021 thus far has been negligible. With the declining trend in the pandemic tourist arrivals have shown a notable improvement in September with a total number of tourist arrivals of 13,547. The largest source markets recorded for the month of Sep were India, Pakistan and Germany, followed by the United Kingdom and Russia.

The government is formulating strategies to rebound the tourism industry which is expected to be back on track through 2022.

Balance of Trade and Balance of Payment

Despite the severe import control measures the balance of trade (BOT) for 2021 reached USD 5.5Bn by end of August compared to the total deficit of USD 5.9Bn in the whole year of 2020.

Complemented by the collapse of tourism and declining remittances coupled with lack of FDI, Sri Lanka has reached a balance of payments (BOP) deficit of USD 2.8Bn up to July 2021. In 2020 Sri Lanka ran a balance of payments deficit of USD 2.4Bn which has been surpassed in the first seven months in 2021.

Foreign Exchange

Official reserves declined to USD 2.6Bn (equivalent to less than 2 months of imports, estimated as of September), in September from USD 7.4Bn in Aug 2020 as the government continued to use reserves for debt servicing.

In Sep 2021 foreign reserves declined to USD 2.6Bn relative to USD 3.6Bn in Aug 2021, following the high debt repayment and inadequate inflow of foreign currency im the month of September.

The LKR has depreciated by 7% against the USD since the beginning of 2021 according to the official exchange rate. However, the parallel market premia had been rising but has been controlled by the government. The government has further introduced various measures to encourage the exporters to liquidate their earnings with a view to enhancing the foreign reserves and pull down the pressure on the exchange rate.

Future Outlook

Since March 2020, the COVID-19 pandemic has significantly slowed down the progress of activities which finally resulted in the economy contracting by 3.6% in 2020 and expecting to see through 2021 with around 4% growth. Amidst this challenging situation Sri Lanka managed to repay a billion dollar bond in foreign currency debt, maintain its unblemished debt servicing record thus far. Despite meeting the debt obligations Moody's has downgraded the credit rating of the country to Caa2 whereas S&P reclassified its rating from positive to negative in early July.

While addressing the domestic issues such as inflation, interest rates, exchange rate, fiscal deficits, unemployment etc., the next challenge faced by the government is to meet the next obligation of debt repayment amounting to USD 1.5Bn in 2022. The repayment in July was financed through foreign exchange reserves which caused depletion of foreign reserves. The government has been pursuing to secure financial assistance via foreign exchange swaps with China, South Korea, Bangladesh, and India to bolster its reserves and finance imports.

Amidst this backdrop the government has identified three critical issues: (1) Debt and foreign exchange concerns; (2) Financial sector concerns; and (3) Macroeconomic stability. The CBSL has developed a comprehensive road map for ensuring macroeconomic and financial systems ability by addressing these issues and engaging a wider group of stakeholders.

The strategies concerning debt and foreign exchange have been framed with the aim of promoting value added exports, attracting non-debt foreign exchange inflows through FDI and tax amnesty, encouraging import alternatives, encouraging exporters to convert export proceeds, attracting foreign investment into government securities, diversification of the SLDB investor base and expansion of service exports.

The strategies concerning the financial sector have been framed with the aim of expediting non-banking sector consolidation, reducing government dependence on the banking sector and improving capital and liquidity buffers of the banking sector.

The strategies concerning the macroeconomic stability have been framed with the aim of maintaining inflation within the target band of 4-6%, green financing initiatives, regional and SME strengthening and maintaining interest rates at reasonable levels.

The Port City project is expected to boost the economy in the long term and the government is formulating strategies to achieve the desired objectives of the project.

Measures to support the above initiatives are anticipated to be included in the 2022 budget. With appropriate planning and goal driven strategies supported by an inclusive budget would drive the country through the current challenges faced by the economy.

Summary of the Budget (2021- 2022)

Rs. Billion

Item	2021 Revised Estimate	2022 Budget
Total Revenue and Grants	**1,561**	**2,284**
Total Revenue	**1,556**	**2,274**
Tax Revenue	**1,325**	**1,987**
Income Tax	295	496
Taxes on Goods and Services	650	1,031
Taxes on External Trade	380	460
Non Tax Revenue	**170**	**226**
Provincial Council Tax Sharing and Devolved	**61**	**61**
Grants	**5**	**10**
Total Expenditure	**3,387**	**3,912**
Recurrent	**2,817**	**2,996**
Salaries and Wages including Provincial Councils	887	1,015
Other Goods and Services including Provincial Councils	198	203
Interest	1,055	1,115
Subsidies and Transfers	677	663
Public Investment	**582**	**931**
Other	**(12)**	**(15)**
Revenue Surplus (+)/Deficit(-)	**(1,261)**	**(722)**
Primary Surplus (+)/Deficit(-)	**(771)**	**(513)**
Budget Surplus (+)/Deficit(-)	**(1,826)**	**(1,628)**
Total Financing	**1,826**	**1,628**
Total Foreign Financing	**(48)**	**(179)**
Foreign Borrowings-Gross	489	508
Project and Programme Loans	332	358
Foreign Commercial	157	150
Debt Repayment	(536)	(687)
Total Domestic Financing	**1,874**	**1,807**
Non - Bank Borrowings	1,569	1,397
Sri Lanka Development Bond	(64)	(91)
Bank Borrowings and Other	368	501
Revenue and Grants/GDP (%)	**9.5**	**12.3**
Total Revenue/GDP (%)	**9.4**	**12.3**
Tax Revenue/GDP	8.0	10.7
Non Tax Revenue/GDP (%)	1.0	1.2
PC Tax Sharing and Devolved Revenue/GDP (%)	0.4	0.3
Grants/GDP (%)	**0.03**	**0.05**
Total Expenditure/GDP (%)	**20.6**	**21.1**
Recurrent Expenditure/GDP (%)	17.1	16.2
Non Interest including Provincial Council/ GDP (%)	10.7	10.2
Interest/ GDP (%)	6.4	6.0
Public Investment/ GDP (%)	3.5	5.0
Revenue Surplus (+)/Deficit (-) GDP (%)	(7.7)	(3.9)
Primary Surplus (+)/Deficit (-) GDP (%)	(4.7)	(2.8)
Budget Surplus (+)/Deficit (-) GDP (%)	**(11.1)**	**(8.8)**

Compiled by Department of Fiscal Policy

Revenue Proposals - 2022

No.	Proposal	Rs. Mn
1	Surcharge Tax	100,000
2	Social Security Contribution	140,000
3	Value Added Tax (VAT) and other charges	14,000
4	Special Goods and Services Tax	50,000
5	Proposals relating to Motor Vehicles	4,000
6	Licence fees, auctions and other non-tax revenue	25,000

Compiled by Department of Fiscal Policy

Gross Borrowings Requirement – 2022
(Provisioning for Accounting Transactions)

Item	Rs. Billion
Total Receipts other than Government Borrowings	2,261
Total Payments Including Debt Repayments	5,245
Provision for Advanced Accounts	6
Adjustments for book/cash Value of Government Securities	150
Risk Provision	60
Total Gross Borrowing Requirement to be recorded in Government Accounts	3,200
O/W Total Debt Repayments	1,531

Compiled by the Department of Fiscal Policy, Department of National Budget and Department of Treasury Operations

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