

SOE Reforms; the Impetus for Post Pandemic Economic Revival

Key Takeaways

- Many State-Owned Business Enterprises (SOBEs) in Sri Lanka are showing sub-optimal performance in terms of its efficiency and profitability with 83% of SOBE profits being generated by 6 entities while 97% of losses being generated by 5 entities during 2020.
- SOEs have been one of the significant contributors to government's stimulus programmes. Therefore, owing to poor performance and badly run balance sheets of SOEs at the start of the pandemic, it has further aggravated the economic and fiscal costs of COVID-19 for the country.
- In the year 2020, total credit directed to the 52 SOBEs by Banks was close to LKR 920 billion¹ and Treasury support given to SOBEs was at LKR 75 billion. While, total turnover of SOBEs amounted to LKR 1,804 billion, which was about 1.5 times the total government revenue in 2020. Therefore, focusing on improving efficiency and profitability will help ease government's revenue concerns and, financing requirements of SOEs from Banks and the Treasury.
- There is an array of SOE reforms that can be implemented ranging from performance management, improving composition of SOE boards, strengthening regulatory authorities, listing on the capital market and establishing a holding company for SOEs.

What are SOEs?

State-Owned Enterprises (SOEs) have many definitions to it, often entailing a definition of a legal entity engaged in a commercial activity that has majority control or ownership by the country's Government through direct or indirect means. However, because of the complex and diverse landscape of SOEs around the world, there is no longer a uniform definition of SOEs.

Globally, SOEs are present in key economic sectors accounting for 20% of investment, 5% of employment, and up to 40% of domestic output as estimated by the International Finance Corporation (IFC) in 2018. Over the last two decades, SOE's share among the world's 2000 largest firms has doubled to 20%², making them a significant player in the world ecosystem.

¹ According to the MoF Annual report 2020

² According to International Monetary Fund (IMF) calculations

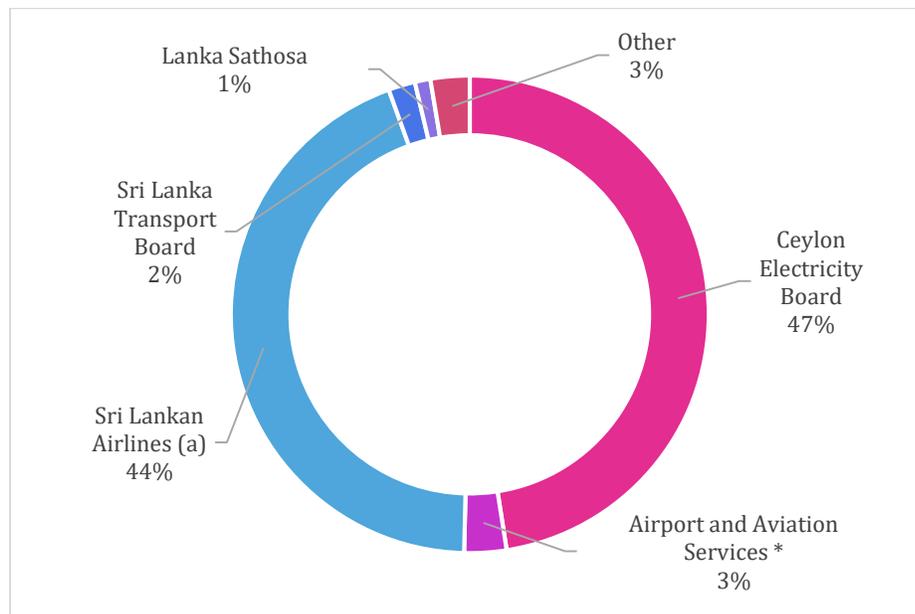
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In Sri Lanka, SOEs are governed by the "Administer Part II" of the Finance Act No 38 of 1971 and the Companies Act No 07 of 2007³. Currently, there are 52 strategic SOEs termed as State-Owned Business Enterprises (SOBEs)⁴ monitored by the Ministry of Finance (MoF), 87 SOEs with strong commercial aspect monitored by the Department of Public Enterprises and 117 SOEs with non-commercial aspects monitored by the National Budget Department⁵. SOEs represent a key element of the Sri Lankan economy with being prevalent in strategic sectors such as energy, water, ports, banking, insurance, transportation, aviation and construction.

The 52 strategic SOBEs, represent nearly 10% of the public sector employees in 2019 and their asset base has expanded by 16.6% in 2020 on a Year-on-Year (YoY) basis according to MoF. However, the continuous losses recorded by some SOBEs and the reliance on Treasury support remain a key cause of concern.

The Fiscal Management Report 2020-21 issued by the MoF, highlighted that during the first 8 months of 2020, the 52 SOBEs recorded a net loss of LKR 10 billion. However, as at end 2020, this was translated into a net profit of LKR 34 billion with measures introduced by MoF to improve the liquidity positions of these SOBEs and the decrease in fuel bill that was effected in 2020. On close examination of the profits and losses contributed by the SOBEs, it was observed that 97% of losses were contributed by 5 SOBEs and 83% of profits were contributed by 6 SOBEs. Below provides a breakdown of the largest contributors to the profits and losses during 2020.

Figure 01: Breakdown of the Major Contributors to SOBE Losses during 2020

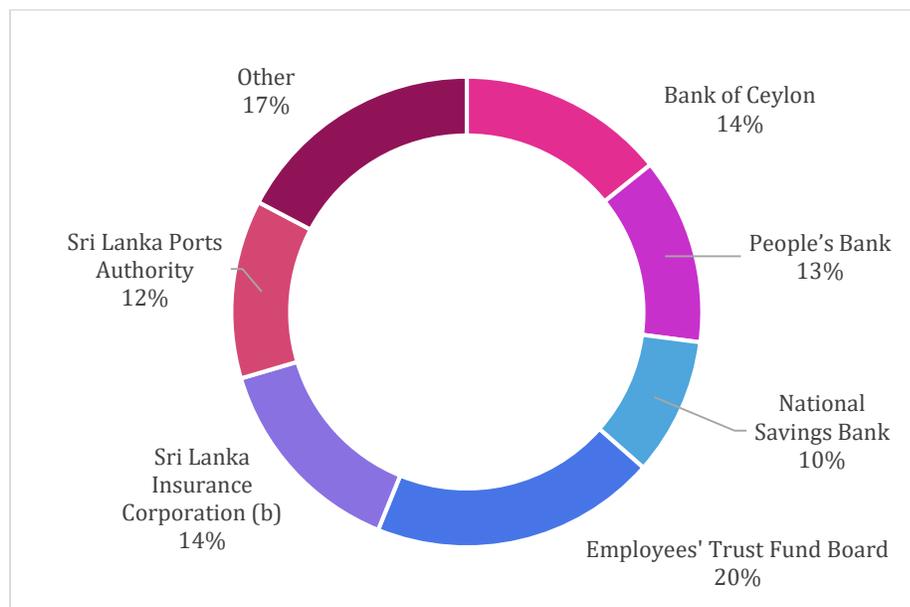


³ According to the Department of Public Enterprise and as given in MoF Annual report of 2018

⁴ Treasury identifies State Owned Business Enterprises (SOBEs) as the SOEs engaged in business activities and generate revenue by way of sale of goods or services.

⁵ <https://www.youtube.com/watch?v=-fbK1taTBwc>

Figure 02: Breakdown of the Major Contributors to SOBE Profits during 2020



Source: MoF, Annual Report 2020

(a) Financial Year End 31st March, for 2020/21 only 11 months were included

(b) Return of both shareholders and policy holders

*Observing data for the past 5 years, Airport and Aviation services has been generating profits barring 2020

Role of SOEs during the Pandemic in 2020

SOEs around the world have been one of the significant contributors to Governments' stimulus programmes. The advantage of having state presence in sectors is that an immediate shift in products or services can be allocated to meet emergency needs and relief measures unlike in a free market. Drawing from countries' experiences during the pandemic, the public utilities of most countries have expanded their services without raising prices or at zero cost to consumers. Similarly, governments in Brazil, Canada, Germany, and India have directed their public banks to assist in alleviating the impact of the pandemic. In countries such as Indonesia and China, the governments have also taken drastic steps in converting their SOEs into producers of emergency supplies such as ventilators and face masks.

This, however, can be a source of distortion with the lack of competitive pressures to improve efficiency and can have knock-on effects on the whole economy. Based on a survey carried out by the World Bank with a sample of 482 COVID-19 related aid packages approved across five continents (as at July 2020), the total approved state aid amounted to around USD 7 trillion. Out of this, 4.6% targeted support was allocated to SOEs in order to continue their operations. Therefore, if a SOE had poor performance and badly run balance sheets at the start of the pandemic then it would have acted as a burden rather than as a buffer for economies during the pandemic.

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SOEs in Sri Lanka too played a significant role in rolling out government's stimulus programmes. This was particularly seen in sectors such as utilities, pharmaceuticals, banking and aviation where SOEs have continued their services without raising prices, and/or providing moratoriums on due payments. This may have further aggravated the economic and fiscal costs of COVID-19 for the country. Hence, managing the performance of SOEs becomes a critical factor when recovering from the COVID-19 crisis and lingering debt crisis.

In 2020, net profit generated by SOBEs increased by LKR 30 billion when compared to 2019, together with treasury support for SOBEs growing over 50% to LKR 75 billion. This increase in treasury support offsets the profits generated by the SOBEs with a net negative impact of LKR 41 billion on the treasury. Levy and dividend transfers from major SOEs that go into the Government coffers, too declined significantly by 35% and 43% respectively during 2020. This was owing to the treasury refraining from enforcing excessive levies, in order to infuse more liquidity into SOEs.

The State-Owned Banks played a vital role in implementing moratoriums and the credit relief scheme introduced by the Central Bank of Sri Lanka (CBSL), to support the businesses that were affected by the pandemic. This has resulted in a drag on the Banks' profitability. SOEs such as Sri Lankan Airlines (SLA), Airport and Aviation Services and Sri Lanka Transport Board (SLTB) who continued their services amidst COVID-19 too have seen a decline in their profitability. Therefore, the financial viability of SOEs remain crucial in order to continue their services without being a drain on the treasury and further intensifying costs of the pandemic to the country. Below table 01, provides an overview of the profitability of key SOBEs, which played an integral role during the pandemic together with the financial support provided by the treasury to these entities.

However, it should be noted that SOBEs such as Ceylon Electricity Board (CEB) and Ceylon Petroleum Corporation (CPC)⁶ have benefitted from the low crude oil prices seen globally during 2020. The average crude oil price seen in 2020 was at USD 41 per barrel, which was a 33% decrease YoY when compared to the average price seen in 2019. SOEs such as Lanka Sathosa has also benefited from the sales growth in essential goods during the COVID-19 pandemic.

Table 01: Overview of selected SOBE's Profitability and Treasury Support during 2020.

| No | SOBE | 2019 (LKR Million) | 2020 (LKR Million) | YoY | Treasury Support (LKR Million) |
|----|----------------|--------------------------|--------------------------|------|-----------------------------------|
| 1 | Bank of Ceylon | 29,685 | 23,552 | -21% | - |

⁶ Fuel Price Stabilisation Fund (FPSF) was established on 23 March 2020, to collect revenue from the surcharge on petrol and diesel imports rather than revising domestic fuel prices. The FPSF was partly utilised to settle the dues of the Ceylon Electricity Board (CEB) to the Ceylon Petroleum Corporation (CPC) during 2020, and the fund recorded a balance of LKR 379.1 million at the end of 2020 according to CBSL annual report 2020.

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|----|---|----------|----------|-------|---------|
| 2 | People's Bank | 19,666 | 21,227 | 8% | - |
| 3 | Ceylon Electricity Board | (85,411) | (62,561) | 27% | 20,536 |
| 4 | Ceylon Petroleum Corporation | (11,835) | 2,371 | 120% | - |
| 5 | Sri Lanka Ports Authority | 16,155 | 20,327 | 26% | - |
| 6 | National Water Supply and Drainage Board | (1,111) | 663 | 160% | 3,067 |
| 7 | Airport and Aviation Services (Sri Lanka | 15,223 | (3,748) | -125% | - |
| 8 | Sri Lankan Airlines Ltd | (47,198) | (58,066) | -23% | 27,735 |
| 9 | Sri Lanka Transport Board | 1,890 | (2,383) | -226% | 13,192 |
| 10 | State Pharmaceuticals and Manufacturing Corporation | 592 | 1,164 | 97% | - |
| 11 | State Pharmaceuticals Corporation | 2,176 | 2,546 | 17% | - |
| 12 | Lanka Sathosa Ltd (LSL) | (2,982) | (1,381) | 54% | 11,470* |
| 13 | STC General Trading Company | (27) | (120) | -344% | - |
| 14 | Ceylon Fishery Harbour Corporation | (71) | (109) | -54% | 652 |

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| | | | | | |
|----|---|-----|-----|------|---------|
| 15 | Colombo Commercial Fertilizer Company Ltd | 306 | 241 | -21% | 6,781** |
|----|---|-----|-----|------|---------|

Source: MoF, Annual Report 2020

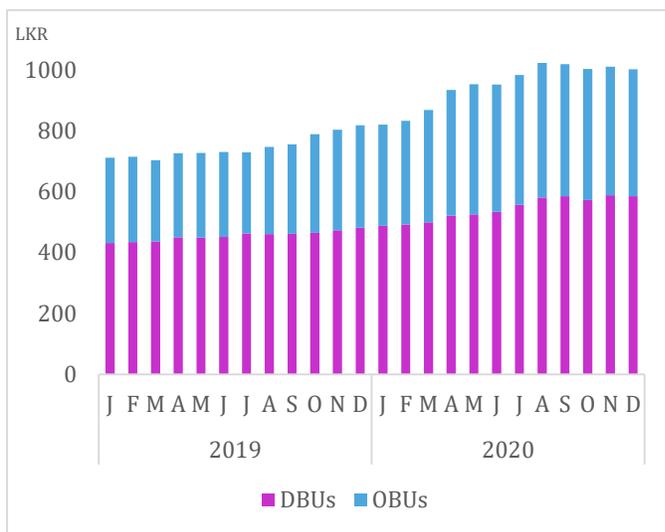
* In 2020, as a part of restructuring LSL, Treasury undertook debt servicing obligations on behalf of LSL for LKR 11.47 Billion. This figure is not included in the total figure of treasury support.

** To continue with the state fertilizer subsidy program, Treasury granted LKR 6.8 Billion in 2020. This figure is not included in the total figure of treasury support.

(a) Financial Year End 31st March (i.e. 2020 - 2020/21), only 11 months were included

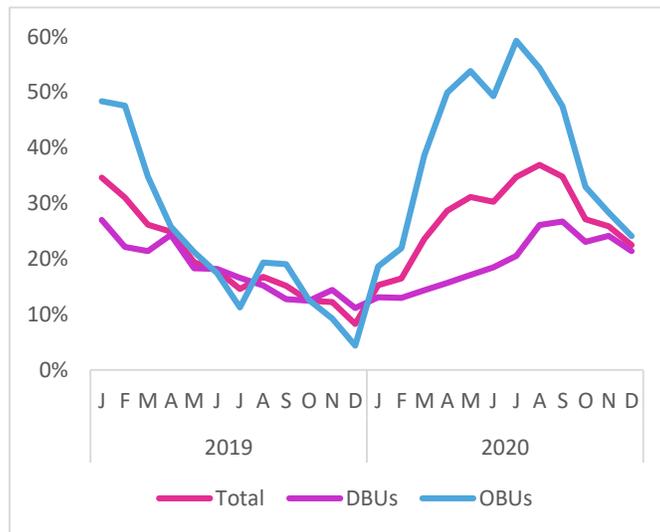
The increase in cost for SOEs during the pandemic can be further explained by the escalation of borrowings by SOEs from Banks. The total credit that was directed to SOEs as at end 2020 rose by 23% YoY to LKR 1002 billion⁷ with a notable growth in foreign currency borrowings (24%)⁸. The CBSL annual report (2020) attributes this credit growth, to SOEs such as Road Development Authority⁹, National Water Supply & Drainage Board, Paddy Marketing Board, CPC¹⁰, SLA, SPC and CEB. Therefore, given the country’s current position in terms of its debt obligations, it would not be sustainable for SOEs to be contributing to public sector debt and instead will need to be looking at avenues to enhance its position to improve government finances.

Figure 03: Absolute Credit to Public Corporations 2019 and 2020



Source: Central Bank of Sri Lanka
 DBUs – Domestic Banking Units
 OBUs – Offshore Banking Units

Figure 04: YoY Growth in Credit to Public Corporations 2019 and 2020



⁷ According to CBSL statistics. This figure looks at SOEs such as Road Development Authority and Paddy Market Board also, which are outside the 52 SOBEs monitored by MoF. The total credit extended to the 52 SOBEs by the banking sector was close to LKR 920 Billion according to MoF annual report 2020.

⁸ YoY growth of 50% or over, was seen in OBUs during months of April to August 2020

⁹ RDA borrowings from banks increased by LKR 53.6 billion during 2020

¹⁰ CPC borrowings from banks in foreign currency increased by around LKR 74 billion. However, CPC maintained a large rupee deposit balance with the banking system in 2020

Importance of SOE Reform and Tools Available

SOEs worldwide have a growing global reach with assets valued at USD 45 trillion in 2018, which accounts for about half of global Gross Domestic Product (GDP) when compared to USD 13 trillion in 2000 according to International Monetary Fund (IMF) staff calculations. This outreach of SOEs can either exacerbate economic challenges or create significant value creations for countries. Therefore, SOEs around the world face strong pressures to improve their performance.

Similarly, for Sri Lanka, the presence of SOEs in strategic sectors of the country is proof of the significant value creation it can generate through spillover effects. The societal returns too are greater as it links to our day-to-day activities such as the water we drink, the electricity we use, or even the bus or train we ride.

The total revenue of the 20 largest SOBEs, was identified by MoF to be almost 60% greater than the revenue recorded by the entities under the S&P SL 20 Index of the CSE. The total turnover of the 52 SOBEs recorded in 2020 too was significant, amounting to LKR 1804 Billion¹¹ which was about 1.5 times the total government revenue collected in 2020. However, in 2019 (pre-COVID), 88% of the total profits generated by SOBEs were by 7 entities only while 93% of losses were by 3 entities¹², indicating that there is room for improvement in terms of its efficiency and profitability. Hence, focusing on improving efficiency and profitability can increase government revenue and ease revenue collection for the government. The IMF too has estimated that globally, better utilisation of public assets can add additional public revenue equal to 3% of GDP.

Therefore, optimizing the performance of SOEs can be the best course of action the Government can follow to enhance Government revenue and improve value creations for both the society and economy, especially given the COVID-19 context.

Absence of coherent pricing policy, lack of competitiveness, inadequate level of capital infusion, and incompetent or less empowered boards have been identified by the MoF as the critical factors that lead to sub-optimal performance of SOEs. An array of options is available for the Government to take on board in order to improve the performance and effective product or service delivery of SOEs to catalyse the country in the post pandemic era. Below provides a brief overview of these possible solutions and its current state.

A. Performance Management

Performance management is a tool that ensures a set of individual activities that are aligned to an organization's goals are achieved in an effective and efficient manner through periodic monitoring and evaluation.

A fundamental challenge SOEs face is that they have both commercial and social objectives to achieve. The social goals often times carry financial costs, making it difficult to evaluate their financial performance, creating a tradeoff. SOEs also often operate behind a curtain with a severe lag in

¹¹ A reduction of 15% when compared to 2019

¹² In 2020, 83% of the profits generated by SOBEs were by 6 entities while 97% of losses were generated by 5 entities

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releasing their mandated information. These information asymmetries can provide less visibility onto the performance of SOEs, in real time. Therefore, a sound performance monitoring framework addressing these inherent challenges should be in place. These include identifying the core financial and non-financial objectives of each SOE that are aligned with the government's priorities and, sound transparency and disclosure mechanisms to enhance SOE reporting.

As identified by the World Bank, below factors are crucial when developing a sound performance monitoring framework incorporating the principles of accountability, transparency and governance:

- Obtaining baseline information to develop a performance monitoring system. This will provide the necessary building blocks to build the framework.
- Setting mandates, strategies, and objectives for each SOE that are aligned with the overall policy goals of the government.
- Structuring and developing performance agreements to facilitate periodic monitoring of SOE performance.
- Identifying and developing Key Performance Indicators (KPIs) to measure and evaluate results.
- Installing a mechanism to ensure periodic reporting with disclosures on financial and nonfinancial information.

Sound performance monitoring frameworks are observed in countries such as Sweden, Korea and New Zealand with very detailed performance agreements for SOEs in terms of their design and execution. This comprises a performance evaluation system (KPIs for both commercial and non-commercial objectives, targets aligning with industry standards, and assigned weights that enable to calculate a single composite score), and a system that links performance information to evaluation and performance incentives thereof. This is followed by a public reporting of financial returns and societal returns in a timely manner for all stakeholders.

In Sri Lanka, the Government requested SOEs to submit strategic business plans during 2020 to develop their KPIs from it. The government is also in the process of establishing a regulatory framework for SOEs in order to provide the required commercial freedom with a high level of accountability¹³. Therefore, the government can look to enhance this regulatory framework by developing it into a sound performance monitoring framework as mentioned above.

B. Improving Composition of SOE Boards

A Board bears the ultimate responsibility for stewardship and performance of SOEs, hence, its composition and functioning have a significant impact on the SOE's operational and financial performance. A Board should be of the right size, comprise the right mix and should include competent individuals through a robust selection process. Maintaining continuity of Boards is also imperative so that the Boards' objectives and goals would not change time-to-time from complete changes in Board composition.

¹³ As given in MoF Annual Report 2020

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SOE Boards across the world especially in State-Owned financial institutions, are also adding a risk management function to the Boards in order to avert any risks associated with global pandemics such as COVID-19. This is usually overseen by a Chief Risk Officer who reports to a dedicated risk management committee of the Board. The function of the Board is then to understand potential risks, set the limit of the SOE's risk appetite, ensure risks are taken into account before arriving at decisions and, checking if internal controls and action plans are in place to handle potential risks. Sri Lanka's state Banks such as Bank of Ceylon and People's Bank have had integrated risk management committees in their Boards even prior to the pandemic. This is a reflection of the good Board practices carried out by state Banks in the country and could be extended to other SOEs as well.

In order to improve the Board composition of SOEs in Sri Lanka, the government called for Request for Proposals (RFPs) and CVs from interested parties to serve on the boards at the start of 2020. This resulted in many SOEs appointing qualified professionals to their Boards based on the individuals' merits and competency¹⁴. However, the success of this will remain in the continuous appointment of capable individuals to the Boards of SOEs through a robust and transparent process.

C. Strengthening Regulatory Authorities

A regulatory authority is a body responsible for exercising regulatory and monitory measures on entities to ensure prevention of market failures, restriction or removal of anti-competitive practices, and promotion of public interest. It is used as a tool to achieve competitive neutrality i.e. both government and non-government entities are under the same umbrella of regulation. Establishing a strong regulatory authority on SOEs will also separate the state's operational activities, from its policy making and regulatory functions to avoid or limit potential conflicts of interest and political interference.

According to sector experts, Sri Lanka has a strong SOE presence in 33 sectors with SOE dominance in 16 of these sectors. Therefore, strong regulatory bodies are essential to avoid a monopoly situation as well as to ensure effective and efficient product or service delivery of SOEs. However, in Sri Lanka, regulatory authorities are sometimes classified as SOEs themselves¹⁵ and hence the distinction between SOEs and regulatory authorities is critical to ensure optimization of SOE performance. This coupled with empowered regulatory authorities will ensure regulation in sectors.

Globally, countries have also implemented separate competition authorities where they are responsible to prevent and redress anti-competitive practices in order to promote a conducive business environment and protect consumers. This is an area Sri Lanka too can look at, in order to improve competition and enhance the efficiency of SOEs. However, it must be ensured that the competition authority and sector regulator does not have overlapping jurisdiction on competition. Countries such as Australia, South Africa and Malaysia have signed Memoranda of Understanding (MoUs) and Memoranda of Agreements (MoAs) between the sector regulator and competition authority to avoid ambiguity and conflicts when their functions overlap.

¹⁴ As given in the Fiscal Management report 2020-21

¹⁵ In accordance with the list published by the Department of Public Enterprises

Strategic Insights - Volume 08**D. Listing on Capital Markets**

Divesting SOE ownership by listing on the capital market leads to improved accountability and transparency of SOEs. This is owing to the corporate governance requirements that listed entities have to comply with, such as periodic reporting and dissemination of externally audited financial reports. Listing will also be an opportunity for the Government to tap into public funds while maintaining Government control.

The Organisation for Economic Co-operation and Development (OECD) conducted a study considering firm level insights from the air transport and automotive sectors as these were among the sectors that were most adversely affected during lockdown in OECD countries¹⁶. This study was carried out, to understand the performance of SOEs relative to private sector firms under weak and strong SOE governance. It showed that on average, SOEs tend to have significantly lower returns on equity than private sector firms under weak SOE governance. However, in countries where SOEs were subject to good governance practices, SOEs perform, as good as private sector firms¹⁷.

The above relays international evidence to support listing of SOEs. Since by listing, SOEs can, not only raise capital but also improve their financial performance while practicing good governance mechanisms. This will also provide the necessary income for SOEs to carry out accountability and good governance measures. Since, often times these are not put into action but merely identified as good principles owing to the significant amount of institutional capacity and resources required.

However, in order to list SOEs in Sri Lanka, a change in the structure of listing would be required such as lifting the cap on the non-voting shares. Securities and Exchange Commission (SEC) is considering these amendments, similar to how the rules were amended to enable debentures issued by SOEs to fall under a different framework to that of corporate debentures. This has enabled Ceylon Electricity Board (CEB) for the first time to raise debt capital from investors in the CSE. The oversubscription of this issue is an indication of the confidence placed by investors and makes it opportune for the Government to raise funds.

E. Holding Company Model

This refers to a holding company for SOEs that act as a central coordinating agency charged with monitoring performance and ensuring governance practices across the SOEs. This section uses the Malaysian holding company - Khazanah Nasional Berhad – as a case study to identify the role and key factors for the successful implementation of a holding company model. Khazanah Nasional Berhad is the central agency that manages state assets (including investment decisions) in strategic sectors on behalf of the Malaysian government. Khazanah also acted as the secretariat of Government Linked Company (GLC) Transformation Programme¹⁸ that drove major corporate restructurings and

¹⁶<https://www.oecd.org/coronavirus/policy-responses/evaluating-the-initial-impact-of-covid-19-containment-measures-on-economic-activity/>

¹⁷ For more details on the study, it can be accessed at- <https://www.oecd.org/coronavirus/policy-responses/the-covid-19-crisis-and-state-ownership-in-the-economy-issues-and-policy-considerations-ce417c46/>

¹⁸ Government Linked Company (GLC) Transformation Programme was a 10-year (2005-2015) programme headed by the then incumbent Prime Ministers' of Malaysia that looked to drive growth of State enterprises and thereby the economy. <https://www.youtube.com/watch?v=GJqI48ag0Zw>

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institutional reforms of state enterprises. Key success factors for Khazanah as identified by sector experts were;

1. Clear objectives that align with national goals
2. Sound communication, transparency and public accountability measures
3. Competent and empowered holding company with the right leadership
4. Carefully designed programme together with an actionable implementation plan
5. Targeting key critical areas for improvement in corporate restructurings
6. Making changes to the policy mix, ownership, financing and controls based on identified strategic sectors and, its commercial and social goals.

A similar approach too can be adopted by Sri Lanka to reform its SOEs after reviewing all its enterprises and, identifying if it is still necessary and whether it delivers the desired services. A holding company could also act as a buffer against future pandemics and assist the Government in its relief measures. This was observed in Malaysia where Khazanah contributed RM 20 million to the Malaysian Government to support relief efforts in response to the COVID-19 pandemic.

Currently, the Sri Lankan Government has introduced two holding companies namely; Selendiva and Sahasya. Selendiva Investments has been created to oversee and list key real estate ventures of the country. Sahasya Investments is set up to own and operate expressways, and other ancillary assets such as quarries in the country and is in the process of structuring its operations¹⁹. President's manifesto – Vistas of Prosperity and Splendour – too suggests a holding company termed as 'National Enterprises Authority' for managing SOEs. Therefore, the holding company model is not a new concept for the government and can be easily implemented.

As the foregoing suggests, there is evidence that the above-mentioned tools would provide the necessary restructuring for SOEs to enhance its financial viability and effective product or service delivery. Sri Lanka has undertaken certain reform measures to improve SOEs' performance as cited above. This is a good first step in this regard but building on it is vital as SOEs can be significant social and economic value creators, since, most Sri Lankan's encounter these on a daily basis. SOEs can also aid the government to reduce its debt burden and improve its fiscal performance. Improvements in all these areas will ultimately lead to higher economic growth while also achieving the country's development goals in the post pandemic era. However, the success of SOE reform will rely on the SOE's ability to be agile and respond rapidly to changes in the environment without losing its vision, similar, to the agility we saw during the outbreak of COVID-19 where the immediate shift of SOE resources were observed to meet emergency demand and relief measures.

¹⁹ According to MoF, Annual Report 2020

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