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Monetary and
Financial Sector Policies for
2024 and Beyond

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CENTRAL BANK OF SRI LANKA

Statement on Monetary and Financial Sector Policies for 2024 and Beyond

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Preamble

The challenges that the Sri Lankan economy and its people experienced during the last few years have been the most arduous in the country's post-independence history. Policy measures taken thus far helped restore stability, albeit with some significant socio-economic costs. The recovery of the Sri Lankan economy in the near to medium term hinges on the successful continuation of the reform agenda as underpinned by the Extended Fund Facility (EFF) arrangement obtained from the International Monetary Fund (IMF). This involves credible measures to improve fiscal sector performance and strengthen external sector buffers, while ensuring price stability and financial system stability. Furthermore, improving governance and supporting social welfare remain crucial in ensuring the sustained recovery of the economy. Sri Lanka has made notable progress in carrying out reforms that have helped turnaround the negative effects seen in the wake of the economic crisis. Restoring price stability, rebuilding external buffers, ensuring financial system stability, strengthening fiscal consolidation through revenue enhancement and debt restructuring, extending support to the poor and vulnerable and measures to improve governance are notable achievements thus far. These achievements were made possible through the restoration of confidence and continued reiteration to global multilateral institutions about Sri Lanka's commitment to the implementation of reforms. Hence, sustaining the confidence of the international community requires an unwavering resolve of policymakers to continue the outlined reform agenda. Against this backdrop, the Central Bank would continue to strive to create a conducive macroeconomic environment through its commitment to exercising its mandate as stipulated in the Central Bank of Sri Lanka Act No.16 of 2023, i.e., to achieve and maintain domestic price stability and to secure financial system stability, thus supporting the country to achieve resilient economic growth.

1. Economic Performance in 2023

The Sri Lankan economy started showing signs of gradual recovery during the latter part of 2023. Positive economic growth was recorded by the Sri Lankan economy in the third quarter of 2023, following consecutive contractions since the first quarter of 2022. Leading economic indicators signal the continuation of the strong pace of activity during the last quarter of 2023.

Inflation, which accelerated to unprecedented levels in 2022, was brought down to single-digit levels within a period of one year. Despite the historically high level of inflation in September 2022, the price escalation was quickly reined in and entered an impressive disinflation path thereafter, eventually bringing inflation down to the targeted levels within a period of one year. Sri Lanka's swift disinflationary process was supported by an array of policy measures implemented by both the Central Bank and the Government. Meanwhile, core inflation, which reflects the underlying demand pressures in the economy, also recorded steady disinflation during 2023.

Inflation expectations have been anchored around the targeted levels. Extensive policy measures aimed at restoring confidence and stability in the economy, though painful in the near term, have helped stabilise inflation expectations, which remained largely de-anchored during 2022.

The credible deceleration of inflation and well-anchored inflation expectations within the targeted range allowed the Central Bank to begin its monetary policy easing cycle in mid 2023. The Central Bank commenced the relaxing of its monetary policy stance in June 2023 in view of the deceleration of inflation, benign inflation expectations, stable inflation outlook, and improvements observed in the external sector. As a result of the monetary policy easing measures and administrative measures, market interest rates declined significantly, particularly deposit interest rates. Market lending interest rates also declined, albeit at a slower pace, partly contributed by the rigidity in the yields on government securities amidst the high risk premia.

The enactment of the Central Bank of Sri Lanka Act (CBA) has conferred independence to the Central Bank with improved clarity of policy priorities and enhanced public accountability, in line with international best practices. With the enactment of the CBA, Flexible Inflation Targeting (FIT), which aims at maintaining headline inflation at a prescribed target level over the medium term while supporting the economy to reach its potential, was formally recognised as the monetary policy framework of the Central Bank, complemented by a flexible exchange rate policy. While increasing the autonomy of the Central Bank, the CBA enhanced accountability of the Central Bank in relation to its policy actions. As required by the FIT framework, a Monetary Policy Framework Agreement was signed between the Minister of Finance and the Central Bank to maintain the Colombo Consumer Price Index (CCPI) based quarterly headline inflation at 5 per cent, subject to a tolerance margin of ±2 per cent. Failure to meet the inflation target for over two consecutive quarters requires the Central Bank to submit a report to the Parliament describing reasons for the deviation, remedial actions taken, and the time taken to achieve the inflation target. Such report will also be made available to the general public. The independence afforded to the Central Bank, through the CBA, is primarily through its limitations on monetary financing and the elimination of government representation in decision making bodies. Further, the creation of a separate decision-making body, namely the Monetary Policy Board, in addition to the Governing Board, underscores the importance of independent monetary policymaking for achieving domestic price stability by way of the new legislation. Accordingly, the establishment of such clear legal and institutional frameworks strengthens the monetary policy formulation process, as well as the overall governance of the Central Bank.

The external sector has demonstrated its resilience with stability having been largely restored in 2023 supported by improved foreign exchange inflows. This reinforced the Balance of Payments (BOP) position and facilitated the organic buildup of international reserves, thereby strengthening the Sri Lanka rupee. Gross official reserves (GOR), which declined to a meagre level in April 2022, improved to US dollars 4.4 billion by the end of 2023. Such rapid buildup of GOR was primarily due to sizeable net forex purchases by the Central Bank, receipt of two tranches under the IMF-EFF arrangement and further financing support extended to the Government by the World Bank and the Asian Development Bank (ADB). The external current account is expected to record a surplus in 2023, reflecting the impact of a notable improvement in workers' remittances, the sharp rebound in earnings from tourism and other inflows to the services account, amidst a relatively modest trade deficit due to compressed import activity. The flexible exchange rate policy is recognised by the CBA as complementing the FIT framework. Consequently, following the large depreciation recorded in 2022, the Sri Lanka rupee has shown stability, with the rupee recording appreciation in 2023.

Recognising the persistent fiscal imbalances as the root cause of the economic crisis that emerged in 2022, the Government embarked on a revenue-based fiscal consolidation path alongside the IMF-EFF arrangement with the aim of restoring fiscal sector sustainability. The impact of the fiscal policy reforms has started to reflect in government finances of 2023, with a notable increase in tax revenue collection. The budget deficit is expected to moderate in 2023 and beyond. Implementation of cost-reflective pricing mechanisms has helped improve the financial performance of State-Owned Business Enterprises (SOBEs). As part of the effort to bring down the debt trajectory to a sustainable level, the Government successfully completed the Domestic Debt Optimisation (DDO) operation. Further, an Agreement in Principle (AIP) was reached with the Official Creditors Committee (OCC) and with the EXIM Bank of China for debt restructuring, while good faith negotiations are continuing with other creditors to reach an AIP at the earliest.

The financial sector in Sri Lanka has been navigating through challenging conditions in recent years due to fragilities that stemmed from adverse macro-financial developments. These conditions warranted the Central Bank to take a range of policy actions to maintain and strengthen the resilience of the financial sector. Furthermore, a range of structural reforms was introduced alongside the IMF-EFF supported programme. The financial system was steered through a turbulent period by the Central Bank with careful policy interventions, including the strengthening of crisis preparedness and management frameworks, reiterating the Central Bank's commitment to ensuring the stability and integrity of the financial system. The CBA recognises and empowers the Central Bank as the macroprudential authority of Sri Lanka.

The Central Bank took measures to strengthen the legal framework governing the financial sector of Sri Lanka. The Banking (Special Provisions) Act, No. 17 of 2023 is an important piece of legislation that was introduced for the purpose of defining the resolution authority and resolution powers of the Central Bank. The Act introduced financial safety net mechanisms and new resolution measures to be implemented in consultation with the Government. The Act also facilitated the establishment of a separate department within the Central Bank to exercise its Resolution Authority. Further, the Act grants statutory recognition to the Deposit Insurance Scheme, while setting up a procedure for orderly winding up of licensed banks. The extension of the resolution measures, which are applicable for licensed banks, to Licensed Finance Companies (LFCs), as and when appropriate, is also enabled under the Banking (Special Provisions) Act. Measures were taken to strengthen the financial and institutional capacity of the Sri Lanka Deposit Insurance Scheme (SLDIS) to enhance public confidence in the financial system through the engagement of a concessionary investment project financing mechanism offered by the World Bank through the International Development Association (IDA). Further, initiatives were taken to establish back-stop funding arrangements for SLDIS with the Ministry of Finance. The Central Bank is also engaged in amending the existing Banking Act, No. 30 of 1988 to further strengthen and streamline the provisions and to ensure that the provisions thereof are in line with international standards. The Central Bank is also in the process of amending the Finance Business Act, No. 42 of 2011 and Finance Leasing Act, No. 56 of 2000. In addition, the Microfinance and Credit Regulatory Authority Bill has already been presented to the Parliament. Enactment of this act would help curb unauthorised lending activity.

Efforts to enhance the resilience of the LFCs sector continued. Augmenting the measures undertaken over several years to encourage consolidation of Non-Bank Financial Institutions, and improving their robustness and resilience over the medium term, a Guideline was issued in 2023 on the declaration of dividends or repatriation of profits. This is expected to strengthen their resilience in times of uncertainty and improve their capacity to absorb economic shocks, while continuing to support the credit needs of customers, by maintaining sufficient capital.

2. Monetary Policy Strategy and Policies for 2024 and Beyond

2.1. Monetary Policy Strategy and Stance

In line with the FIT framework, policy actions of the Central Bank would continue to be directed towards achieving its primary objective of maintaining domestic price stability, while facilitating the economy to reach its potential. Monetary policy actions would aim at maintaining CCPI based headline inflation at 5 per cent, as agreed with the Government under the Monetary Policy Framework Agreement.[1]

Currently, the monetary policy stance remains accommodative. Monetary policy was loosened gradually since June 2023 as underlying inflationary pressures subsided. With the latest reduction of policy interest rates in November 2023, further easing entered a pause in the near term. This would allow sufficient space for monetary policy transmission to take full effect and to prevent any undue pressures on the economy. The recent tax and tariff increases would exert supply-side pressures on inflation during the year. However, since this rise in inflation is due to administrative measures, a change in the course of monetary policy action may not be warranted as inflation expectations remain well-anchored. Although underlying demand pressures remain subdued at present, the Central Bank will remain vigilant of any developments that could challenge the inflation outlook, so that monetary policy action can be proactively taken to ensure that domestic price stability is maintained.

The gradual normalisation of market lending interest rates and improving investor and business sentiments are expected to support the expansion of credit to the private sector, thereby allowing the economy to reach its potential. However, the Central Bank is cognisant of possible risks and challenges emanating from both domestic and external environments, which could impede the perceived recovery in economic activity.

The cessation of monetary financing under the CBA, the anchoring of inflation expectations, and the reduction of risk premia on government securities are expected to have a favourable impact over the medium term on the transmission of monetary policy actions by the Central Bank. Meanwhile, the outstanding stock of monetary financing would be gradually unwound in the period ahead through the conduct of monetary policy, as stipulated in the Central Bank Act. While the monetary policy decisions by the Central Bank would continue to be data-driven, proactive measures would be taken to ensure that its core objective of achieving and maintaining domestic price stability is succeeded.

The number of monetary policy reviews during a year has been reduced to six from 2024, facilitating the requirement under the CBA for the Monetary Policy Board to meet at least once in two months. Adhering to the Central Bank's commitment to set out an advance release

[1] The Monetary Policy Framework Agreement between the Minister of Finance and the Central Bank of Sri Lanka was published in the Government Gazette (Extraordinary) No. 2352/20 dated 05 October 2023.

calendar for monetary policy announcements, the following calendar of Monetary Policy Board Meeting dates and policy announcement dates is announced for the year 2024.

Advance Monetary Policy Release Calendar: 2024

NO.	MONETARY POLICY BOARD MEETING	MONETARY POLICY ANNOUNCEMENT
1	22 January	23 January ***Monetary Policy Report – 15 February***
2	25 March	26 March
3	28 May	29 May
4	23 July	24 July ***Monetary Policy Report – 15 August***
5	26 September	27 September
6	26 November	27 November

2.2. Monetary-Fiscal Coordination

As stipulated by the CBA, the '*Coordination Council*' was established in late 2023, and facilitated detailed deliberations of how the policies of the Government and the Central Bank could impact one another. The Coordination Council would meet quarterly to ensure a better coordination of fiscal policy actions of the Government and monetary and financial stability policies of the Central Bank. The Central Bank would share information and exchange views on recent macroeconomic developments, outlook and risks, with an assessment on the impact of economic policies of the Government on inflation, monetary conditions and fiscal operations. Policy coordination is important in a FIT framework, as inflation can be affected by supply side factors and fiscal policy actions, which could be difficult to be addressed by demand management policies of the Central Bank. In such instances, inflation could deviate from the target jointly set by the Government and the Central Bank and thus could lead to the de-anchoring of inflation expectations. Proactive policy coordination helps manage the impact of such episodes. Further, in the absence of government representation in decision making bodies of the Central Bank, this mechanism is expected to enhance macroeconomic policy consistency in the country, through timely sharing of key macroeconomic information and policy discussions.

2.3. Monetary Policy Communication

Efforts would be taken to improve policy communication to all stakeholders in the economy including the general public, which is a cornerstone of the FIT framework. The Central Bank would continue to publish the Monetary Policy Report bi-annually, to better inform the public on the outlook for inflation and real economic growth and the associated risks, thereby further improving the transparency and credibility of monetary policy actions. Meanwhile, views and inputs from external experts and main stakeholders on the Central Bank's policies would continue to be obtained through established mechanisms, such as the Stakeholder Engagement Committee (SEC), and other means. Moreover, efforts would be taken to enhance awareness about monetary policy among the key stakeholders and plans would be devised to further improve public engagement and narrow information and communication gaps. Greater awareness among professional entities and professionals regarding macroeconomic developments, policies and outlook would be a priority, while the spread of misinformation is expected to be minimised with greater public engagement and awareness.

Effective and timely communication is expected to assist the Central Bank in guiding inflation expectations, even during periods of transitory supply-driven inflationary pressures, where the Central Bank may not have direct control and monetary policy actions would be less useful in arresting such inflationary pressures. Policies would be implemented to enhance the visibility of the Central Bank's overall communication. In particular, the content and accessibility of statutory and other publications would be improved, while a wide range of communication platforms would be strategically utilised by sharing regular updates, addressing queries, and engaging with the public to foster efficient and transparent communication by the Central Bank.

2.4. Implementation of Monetary Policy

Monetary policy implementation is inevitably connected with controlling the short-term interest rates, which represent the marginal cost of funding for financial intermediaries. To maintain the Average Weighted Call Money Rate (AWCMR), which is the operating target of the current FIT framework, at appropriate levels, it is expected to strengthen the liquidity forecasting framework in 2024, with a view to supporting effective monetary policy implementation. **More importantly, the Central Bank would consider moving towards a single policy interest rate mechanism, instead of the existing dual policy interest rates, to improve the monetary policy transmission and signalling effect of the monetary policy stance**.

With a view to enhancing the effectiveness of monetary policy implementation as well as catering the current and future developments, a user-friendly system for Open Market Operations (OMOs) would be introduced, with a smooth transition to the new auction system by 2025. **Further, an OMO auction schedule will be introduced in 2024 that helps create certainty on liquidity management among market participants**. The OMO auction schedule is an indicative calendar published in advance to the Participating Institutions (PIs) to provide guidance on the dates on which OMO auctions are to be conducted, typically to manage money market liquidity by the Central Bank.

The Central Bank would review the existing framework of Statutory Reserve Requirement (SRR) in line with international best practices. This would enhance flexibility for Licensed

Commercial Banks (LCBs) in managing reserves and support the payment system, while optimising the usage of SRR as a monetary policy instrument. The proposed policies would involve stakeholder consultation before implementation, with the overarching goal of optimising the SRR framework for the benefit of the broader economy and the financial system.

Overreliance on central bank facilities by the PIs was a challenge for monetary policy implementation, requiring the Central Bank to implement appropriate measures. As the market liquidity conditions indicated a segmentation among PIs, both the surplus and deficit PIs heavily relied on the Central Bank facilities requiring the Central Bank to impose restrictions on the usage of the Standing Facilities by LCBs under the OMOs. Such policies supported reactivating money market activities, while compelling banks with large liquidity shortages to introduce internal corrective measures to improve liquidity levels. The restrictions on the standing facilities have yielded some positive benefits. The Central Bank would consider removing such restrictions gradually without affecting the momentum in the markets. Meanwhile, the Central Bank would explore alternative mechanisms to reduce the over-dependence of Standalone Primary Dealers on the Central Bank, in line with international best practices.

2.5. Further Strengthening of Technical Infrastructure in Monetary Policymaking

A proper forward-looking decision-making process is crucial to conduct monetary policy effectively in the FIT framework. Accordingly, the monetary policy decision-making process would continue to be guided by the Forecasting and Policy Analysis System (FPAS), which has been in operation since around 2017 to facilitate macroeconomic projections and assist monetary policy decision-making at the Central Bank. A suite of models, led by the Quarterly Projections Model (QPM), which is currently in use, would be employed to forecast the macroeconomic outlook. Investigating alternative models, and refining existing models, on a continuous basis, would allow for more accurate forecasting, paving the way for comprehensive macroeconomic analysis and data-driven monetary policy formulation.

Modelling and forecasting capabilities would continue to be improved to better support the monetary policy decision-making process. With improved modelling and forecasting capabilities, the accuracy of projected paths of inflation and other key macroeconomic variables is expected to improve, while the risks associated with such projections would be transparently communicated to the stakeholders in the economy. Moreover, improving policy research and fostering a healthy research culture within the Central Bank and extending collaborative research would also be priority areas, which would help strengthen policy analyses.

2.6. Maintaining External Sector Stability

The completion of external debt restructuring and the successful continuation of the IMF-EFF supported programme would be instrumental in eliminating the prevailing market uncertainties and improving investor confidence on a sustainable basis.

It is imperative that Sri Lanka reduces deficits in the external current account to sustainable levels over the medium term by ensuring the resilience of the export sector to boost merchandise export earnings, amidst the expected gradual recovery of import expenditure. In addition, the external current account is also expected to be supported by an improved surplus in trade in services and workers' remittances. In addition to the efforts to restore macroeconomic stability, concerted efforts are imperative to promote and diversify both merchandise exports and trade in services to resolve recurring balance of payments crises. Moreover, sustaining the momentum in workers' remittances and attracting non-debt obligatory foreign financial inflows would be instrumental in ensuring lasting stability in the external sector.

The Central Bank remains committed to maintaining a market-determined and flexible exchange rate to serve as a buffer against external shocks. The Central Bank's intervention in the market would be limited only for reserve buildup and to curtail any excessive volatility in the exchange rate. Market-determined exchange rates would help correct the anti-export bias that prevailed in the past and the undue buildup of speculative pressure and subsequent volatility of the exchange rate. In this regard, to further enable and support exchange rate flexibility, the Central Bank wishes to foster a deeper and more liquid foreign exchange market and develop adequate systems for managing exchange rate risks. This would be further supported by implementing the FX Global Code in the domestic foreign exchange market, providing a common set of guidance to promote a robust, fair, liquid, open, and appropriately transparent market in which market participants could confidently and effectively transact at competitive prices that reflect available market information.

Rebuilding external buffers is one of the key commitments under the IMF-EFF arrangement. The Central Bank is committed to rebuilding external buffers by purchasing forex from the foreign exchange market. The level of GOR would be further augmented in 2024 to enhance reserve adequacy and build buffers in the period ahead.

The Central Bank successfully launched Phase 1 of the International Transactions Reporting System (ITRS) in 2023 to collect data on cross-border transactions and foreign currency transactions daily from the banking system. **The Central Bank plans to report monthly data pertaining to the external current account, particularly on trade in services, based on ITRS data from 2024 onwards.** Going forward, all banks are urged to continue to support the development of the ITRS system and to ensure the coverage, accuracy and timeliness of data.

3. Financial Sector Policies for 2024 and Beyond

3.1. Banking Sector Outlook and Policies

Following the gradual recovery of the economy and the expectations of ensuring smooth credit flows to the real sector, the Central Bank expects to implement several policy measures in the near and medium term with a view to maintaining the financial and operational resilience of the banking sector.

With the objective of ensuring strong and adequately capitalised licensed banks, the Central Bank has developed a Roadmap for the restructuring and recapitalisation of nine large banks. This seeks to address capital and foreign exchange liquidity shortfalls identified through a diagnostic exercise and forward-looking stress testing based on macro-financial scenarios and sovereign debt restructuring. In line with the Roadmap, the Central Bank will require such banks to submit their board-approved recapitalisation plans in early 2024. The Government has allocated budgetary provisions of Rs. 450 billion in the National Budget of 2024 to cover the potential impacts on capital stemming from the diagnostic exercise and sovereign debt restructuring.

The statutory examinations of licensed banks are to be intensified in line with a risk-based consolidated supervision framework, while reinforcing continuous surveillance through early warning monitoring and reporting.

The legal and regulatory framework of licensed banks is to be further strengthened through the proposed amendments to the Banking Act. The key amendments proposed include strengthening minimum licensing requirements, corporate governance, shareholder suitability, subsidiarisation of foreign banks, as deemed necessary, bank ownership, acquisitions, mergers and consolidation, disposal of non-financial subsidiaries, consolidated supervision, accounts and audit, proportionality, large exposures, and related party transactions. The Banking (Amendment) Bill is expected to be passed in Parliament in early 2024.

Further, the framework on Corporate Governance is to be further strengthened to be in line with international best practices and guidelines issued by global regulators while also factoring in the key recommendations included in the Governance Diagnostic Assessment Report published in September 2023.

The assessment of the fitness and propriety of directors, chief executive officers and key management personnel of licensed banks are to be strengthened through the granting of approval for persons with relevant qualifications and experience, thereby improving the composition and competencies of the Board of Directors. Particularly with respect to state-owned banks, which account for 48 per cent of the banking sector assets, the Central Bank expects to issue guidance to the Ministry of Finance on appointments to the Board of Directors of such banks. Accordingly, a framework is to be developed to strengthen the governance of state banks, requiring their Boards to have a majority of independent members, and nominations for Board and senior management to be made by the banks' nomination committees following open search procedures with clear requirements pertaining to professional experience and ensuring of independence.

In the past, the extensive reliance by the Government and SOBEs on systemically important state-owned banks for funding has posed significant challenges to the stability of the financial system. The Central Bank is in the process of formulating Directions that stipulate prudential limits for large exposures that banks can have vis-à-vis single borrowers and to a group of connected borrowers, including SOBEs. Against this backdrop, SOBEs and large corporations may be required to restructure their balance sheets and diversify their sources of funds.

To facilitate the sustainable revival of businesses affected by the recent challenging macroeconomic circumstances and to ensure the proper handling of the increased levels of impaired assets of licensed banks, the Central Bank is to issue broad guidelines to give effect to the establishment of Business Revival Units in licensed banks to further strengthen their role in the recovery of businesses, especially Small and Medium Enterprises (SMEs) and corporates. Further, a National Credit Guarantee Institution (NCGI) is currently being established by the Government, which would offer credit guarantees to support the SME sector while mitigating potential credit risk in lending to SMEs. These efforts would further encourage financial institutions to facilitate SMEs.

The contribution of licensed banks to promote sustainable finance activities would be continuously monitored while incentive mechanisms would be introduced to licensed banks to promote sustainable and climate finance activities. This is expected to be in line with the Sustainable Finance Roadmap. Further, the capacity building activities of the banking sector in relation to these are also to be supported by the Central Bank.

In the medium term, small and mid-sized banks are expected to seek avenues to consolidate by acquiring or merging with suitable financial institutions to create synergies relating to scale, efficiency, and financial strength, and the Central Bank is to facilitate such market-driven consolidation processes. Existing supervisory capacity is also to be strengthened by introducing SupTech solutions into the regulatory and supervisory processes over the medium term.

The Central Bank would continue to closely engage and collaborate with local and international financial sector regulators and the Ministry of Finance to ensure the soundness and resilience of the banking sector.

3.2. Non-Bank Sector Outlook and Policies

The stability of the non-bank sector is expected to improve further by implementing Phase II of the Masterplan[2] for Consolidation of Non-Bank Financial Institutions (hereinafter referred to as the Masterplan), commencing in 2024, with a view to building stronger and stable Non-

[2] Phase I of the Masterplan is nearing completion with 7 transactions fully completed, and another 2 transactions are progressing.

Bank Financial Institutions (NBFIs). Further amending the existing regulatory framework to align with current market developments, including amendments to the Finance Business Act No.42 of 2011 and Finance Leasing Act No.56 of 2000, the introduction of/revisiting rules and regulations to improve the stability of the non-banking sector while strengthening the supervisory review process are also expected to improve the stability of the sector.

Further, the Central Bank would support the authorities in the establishment and implementation of the regulatory framework under the proposed Microfinance and Credit Regulatory Authority Act. The Act, as proposed by the Central Bank, seeks to improve market conduct and consumer protection and include unregulated moneylenders within the regulatory purview in addition to Licensed Microfinance Companies. The Act is expected to be passed in Parliament soon.

3.3. Payment and Settlement Systems

The Central Bank continued to ensure the smooth operations of the Payment and Settlement Systems of the country during 2023 and expects significant growth in digital transactions in 2024.

With the view of the development of the payment and settlement regulatory framework, the Central Bank aims at revising the Payment and Settlement Systems Act, No. 28 of 2005 (PSSA) and enacting the new PSSA in 2025, to facilitate the rapid expansion of payment innovations. Further, the Central Bank expects to revise regulations to support the expansion of digital payments and to revise the existing regulatory sandbox framework to facilitate more FinTechs entering the Regulatory Sandbox.

In terms of strengthening the retail payment infrastructure, LankaPay (Pvt) Ltd (LPPL), under the guidance of the Central Bank, is developing the Government Digital Payment Platform (GDPP) via the LankaPay Online Payment Platform (LPOPP), to enable government institutions to receive payments digitally from the public. With the aim of facilitating recurring payments digitally, the Central Bank also expects to mandate Licensed Banks to implement the direct debit facility, which enables an approved third-party organisation to automatically collect a payment up to a specified amount from the customer’s bank account on a scheduled date.

To promote digital transactions and remittances via e-money services, the value limits of enhanced e-money accounts and basic e-money accounts were increased with effect from 01 January 2024. Further, LANKAQR would be extended to enable the use through foreign payment apps so that both local customers and foreigners may utilise LANKAQR for payments in Sri Lanka.

One of the key challenges identified by the Central Bank to promote digital transactions among the public is the lack of awareness regarding the availability, methods, and benefits of digital transactions. Therefore, during 2024, the Central Bank expects to continue conducting public awareness sessions on digital payment methods, associated security features and possible threats, such as fraud and scams, to the public. Further, the Central Bank expects to require all Payment Service Providers to send real-time notifications for all debits and credits to the customers.

3.4. Improving Consumer Relationships

The Central Bank seeks to engage in implementing key regulatory measures as outlined in the Financial Consumer Protection Regulations No. 01 of 2023, and market conduct supervision focusing on financial consumer protection activities of regulated financial institutions coming under the purview of the Central Bank.

The initiation of market conduct supervision signifies the Central Bank's proactive approach to creating an environment that prioritises the trust and security of financial consumers. This measure reflects a significant stride towards building a financial ecosystem that is not only resilient but also upholds the highest ethical standards. The implementation of Financial Consumer Protection Regulations is a pivotal endeavour, aimed at strengthening financial consumer protection in line with international best practices and facilitating effective financial inclusion throughout the country.

Building confidence in the financial system via prudent communication strategies is crucial for maintaining stability. In this regard, robust crisis communication protocols are to be developed and regularly updated to ensure that the Central Bank can respond swiftly and effectively during periods of financial turmoil, to restore confidence and ensure the resilience of the financial system. Further, regular risk assessments would be communicated to the public on a priority basis. By proactively sharing insights about potential financial challenges, stakeholders would be better prepared and informed, thereby contributing to a more stable financial environment.

4. Policies to Strengthen the Broader Economy

In addition to core functions, the Central Bank engages in several agency functions to strengthen the broader economy and the financial system. Some key policies to be implemented in the period ahead in these areas are summarised in this section.

4.1. Public Debt Management

The Central Bank plays a significant role in the management of public debt through effective collaboration with the Government to ensure that monetary and fiscal policies are well-coordinated to promote macroeconomic stability and sustainable public finance. Following the completion of the DDO programme in 2023, several initiatives are expected to be carried out in 2024, aimed at enhancing debt management and transparency.

Importantly, facilitating the external debt restructuring process by engaging with the relevant stakeholders would continue to contribute to the restoration of debt sustainability. An early resolution with external private creditors on comparable terms would also contribute to the rapid dissipation of market uncertainties, thereby serving to bring down risk premia associated with government securities leading to the desired downward shift of the yield curve.

Further, the Central Bank would assist the Ministry of Finance in establishing the Public Debt Management Agency (PDMA). The proposed PDMA, which is to be formed under the Ministry of Finance, is expected to be the sole authority responsible for the management of the public debt in the country. In this regard, the Public Debt Management Act is expected to be enacted by March 2024, leading to the establishment of the PDMA, which is expected to be operationalised by December 2024.

4.2. Foreign Exchange Management

In terms of foreign exchange management, the Central Bank will continue to introduce and implement proactive and timely policy measures by way of Regulations, Orders, and Directions under the provisions of the Foreign Exchange Act, No. 12 of 2017 (FEA). These policy measures are expected to further promote foreign exchange inflows to the country, while addressing stakeholder concerns, regulating the domestic foreign exchange market, and strengthening the surveillance of foreign exchange inflows and outflows.

Moreover, to improve compliance with prevailing foreign exchange regulations, active identification of areas, in which key stakeholders (authorised dealers, restricted dealers, and the public) lack awareness, is to be continuously identified and addressed appropriately through digital platforms.

With the observed improvements in the liquidity position of the domestic foreign exchange market, the Central Bank would review the existing restrictions on certain capital foreign exchange outflows on a priority basis with a view to gradually unwinding these restrictions.

The Export Proceeds Monitoring System (EPMS) implemented during 2022 would be further optimised, ensuring improved efficiency and effectiveness of the monitoring mechanism of export proceeds repatriation.

Further, required amendments to the FEA are expected to be finalised and brought in place during early 2024 providing the necessary framework to regulate the functioning of the formal foreign exchange market more efficiently, while empowering the regulatory authorities to take prompt actions against violations of and/or non-compliance with foreign exchange transactions.

4.3. Financial Intelligence

Sri Lanka's 3rd Mutual Evaluation on Anti-Money Laundering and Countering the Financing of Terrorism (AML/CFT) framework, coordinated by the Asia Pacific Group on Money Laundering (APG), is scheduled to commence in March 2025, to assess the country's measures to combat money laundering and terrorist financing. Sri Lanka must ensure that the country is technically compliant with the 40 Recommendations of the Financial Action Task Force (FATF) and Sri Lanka's AML/CFT framework is effective under the FATF 11 Immediate Outcomes. Following the recent conclusion of the 2021/22 National Risk Assessment on Money Laundering and Terrorist Financing, several gaps and deficiencies in Sri Lanka's AML/CFT framework have been identified. In this regard, the Cabinet of Ministers approved the Institution-wise Action Plans outlining actions to rectify the remaining gaps. These actions have already been communicated to respective stakeholders for effective implementation to meet the global recommendations on AML/CFT. An AML/CFT Task Force is to be established in January 2024, with the Financial Intelligence Unit (FIU) serving as the Secretariat of this Task Force. The Task Force is to be empowered with the oversight of these Institution-wise Action Plans and is to operate until the successful completion of the Mutual Evaluation in July 2026.

In addition, steps would be taken to establish an inter-regulatory body under the ambit of the AML/CFT National Coordinating Committee to facilitate effective collaboration and information sharing among various regulatory authorities with a primary focus on AML/CFT efforts.

The FIU is in the process of introducing amendments to the three main pieces of legislation on AML/CFT, i.e., the Prevention of Money Laundering Act, No. 5 of 2006 (PMLA), Financial Transactions Reporting Act, No. 6 of 2006 (FTRA), and Convention on the Suppression of Terrorist Financing Act, No. 25 of 2005 (CSTFA), to further strengthen the legal framework in line with international standards. The AML/CFT National Coordinating Committee would be formalised within the statutory provisions through the amendment to the FTRA. These amendments are expected to be enacted in 2024.

At the request of the FIU, Sri Lanka Police established a specialised unit to investigate diverse scams, prohibited pyramid schemes, and unauthorised deposit taking activities. The FIU would continue to identify various unlawful activities that could come in different forms and alert relevant authorities. Meanwhile, the FIU expects to initiate strategic analysis through the 'goAML' online reporting and analysing system while working towards enhancing the coverage of reporting institutions. To further strengthen the compliance of reporting entities with the legal and regulatory framework relating to AML/CFT, on-site examinations/off-site reviews of Financial Institutions and Designated Non-Finance Businesses and Professions (DNFBPs) are to be conducted with a risk-based approach.

4.4. Regional Development

Following the enactment of the CBA, the primary focus of regional development shifted from providing financial accommodation through intermediaries to promoting financial inclusion in Sri Lanka, reflecting a broader realisation of the necessity of building a more inclusive and sustainable financial system.

The Central Bank discontinued its own funded schemes, as the CBA does not include provisions to continue such initiatives. Instead, the Ministry of Finance would continue the implementation of such schemes going forward, where the Central Bank would support the Ministry in building up its capacity to implement such programmes. Meanwhile, the Central Bank will continue the operation of existing credit and credit supplementary programmes, at affordable rates through licensed banks, supporting income-generating activities of micro, small, and medium-scale entrepreneurs to create new employment opportunities and reduce regional income disparities.

The National Financial Inclusion Strategy (NFIS) Action Plan would be implemented in collaboration with stakeholders through the governance framework. The Phase I of the NFIS would be concluded in 2024 and Phase II would be implemented in 2025. In addition, under the NFIS, a comprehensive Roadmap for financial literacy would be launched in early 2024, thereby consolidating all efforts under a unified policy direction to nurture a financially literate community.

Further, efforts aimed at uplifting the livelihoods of underserved and excluded populations are expected to strengthen the regional presence of the Central Bank and improve financial literacy among people at the regional level across diverse demographic groups.

4.5. Management of the Employees' Provident Fund

As Sri Lanka's largest superannuation fund, with the Central Bank of Sri Lanka being its custodian, the Employees' Provident Fund (EPF) demonstrated robust financial performance during 2023, amidst challenging circumstances, including the economic uncertainties, and the impact of the DDO operation. The Fund successfully carried out the provision and facilitation of refund payments, member-related services, and other services.

Going forward, the EPF is committed to enhancing operational efficiency to deliver efficient and effective services to its stakeholders. Service quality is to be improved through the implementation of a near-paperless operating system with real-time document scanning. Further, the initiatives taken to strengthen the electronic collection procedure by providing multiple payment avenues would continue to provide more flexibility to employers. Furthermore, a comprehensive ICT solution would be implemented at EPF with the view of re-engineering and modernising the existing process. EPF is to seek avenues to diversify its investment portfolio to generate a higher risk-adjusted rate of return while ensuring the safety of the overall fund.

5. Concluding Remarks

Sri Lanka has entered a path of recovery following the worst economic crisis in its post-independence history. The policy measures that were taken by the Government and the Central Bank during 2022 and 2023 helped restore macroeconomic stability. The revival of confidence in the economy, the successful continuation of the IMF-EFF arrangement, and progress on the debt restructuring process would help further strengthening and safeguarding of macroeconomic stability in the period ahead. In the near term, the real economy is expected to record positive growth rates and gain further momentum over the medium term. Such growth is to be underpinned by strong macroeconomic stability, especially price stability, external sector resilience, public debt sustainability as well as structural reforms that are being implemented by the Government to alleviate several vulnerabilities and inefficiencies, especially in relation to corruption.

Several substantial challenges may emerge as the economy progresses on this recovery path. Efforts to improve government revenue via increased taxes and tax administration improvements, though essential, would create price pressures, particularly during 2024. However, such inflationary effects are anticipated to be short-lived, particularly amidst the diminished purchasing power of most of the population. At the same time, efforts to attract non-debt-creating foreign inflows are important to ensure stability in the external sector, while continued commitment to ensuring fiscal sustainability has become a prerequisite for the sustainable recovery of the economy. On the economic growth front, some scarring effects stemming from the economic crisis may have some dampening effects on the growth prospects of the country. Therefore, the continued commitment to addressing long-standing structural impediments of the economy, such as the weak doing-business environment, is imperative for a sustainable recovery of not only the macroeconomic environment but also socio-economic conditions.

Given that the Sri Lankan economy is highly interconnected with the rest of the world, international developments will have a significant impact on Sri Lanka, including its reform efforts. Amidst the prevailing volatile geo-political environment, risks arising from global developments could have an impact on domestic economic activity. Further, on the domestic front, the anticipated elections could create some uncertainty in the decision making of the stakeholders, affecting the recovery process to a certain extent. Moreover, weather anomalies may also continue to create disruptions to economic activity along with worsening climate-related risks. In the meantime, if the balance sheets of the household and the corporate sectors further deteriorate, that could hinder the debt repayment capacities of households and corporates, thereby posing risks to financial system stability.

In this environment, the resolve of the people to support the reform agenda is crucial to the sustained revival of the economy and its ability to deliver, high, sustainable and inclusive growth over the medium term. Any departure from the reform agenda will hurt confidence while significantly endangering the growth prospects of the economy and creating significant pressures on public welfare. This could create irreversible damage to the Sri Lankan economy, especially considering the economy has just exited from a deep economic crisis.

Against this backdrop, the Central Bank would strive to maintain price stability and secure financial system stability, whilst supporting the economy to reach its potential. Economic and market developments would be monitored continuously as the Central Bank remains prepared to undertake timely and proactive measures to address any inflationary pressures and any undue stresses on the financial system. The Central Bank will continue to exercise its mandate under the FIT framework, by maintaining appropriate levels of interest rates, to create an environment that effectively manages the demand conditions in the economy to ensure that inflation remains within the target over the medium term. This, in turn, will serve to create the necessary socio-economic landscape that can promote price stability, financial stability and overall macroeconomic stability that will pave the way for productive investment, inclusive growth, and thereby public welfare.

This policy statement is based on the current and expected economic conditions, and as such, any unexpected developments in economic conditions that could materially change the economic outlook may require appropriate adjustments to the envisaged policies.