Presentation by the Governor of the Central Bank Ajith Nivard Cabraal at the All-Parties Conference on 23rd March 2022

Your Excellency the President, Honourable Prime Minister, Party Leaders, Ministers and Members of Parliament

1. The current economic crisis

The whole world is aware of the massive economic crisis we are facing today. We witnessed how economies of many countries were falling into massive crises over the past two years when hit by the COVID-19 pandemic. This was experienced by almost every country.

When COVID-19 pandemic started to escalate gradually into a global crisis, some countries were on a strong economic foundation, but some countries were weak due to various reasons.

Unfortunately Sri Lanka belonged to the latter category as the economic growth rate in Sri Lanka had gradually fallen from 7 percent to 2 percent during 2015-2019. Forex reserves had dropped by USD 1 billion, despite the growth of foreign debt by a significant USD 15 billion. The GDP had grown to only USD 84 billion, from USD 79 billion.

The tourism industry had stalled following the Easter Sunday attack. The total of foreign debt servicing payable per year had increased from about USD 2 billion to nearly USD 6 billion. The Sri Lankan rupee had depreciated to Rs.182 from Rs.131 against the USD.

Therefore, the already weakened Sri Lankan economy was not economically prepared to withstand the shock of the pandemic. Thus, the Government and the Central Bank of Sri Lanka had to face the crisis by implementing various innovative methods and new ways.

As a result of the pandemic and its aftermath, Sri Lanka had to allocate large amounts of money for vaccines: a debt moratorium amounting to over Rs. 4 trillion had to be granted to the pandemic affected individuals and businesses. The loss of economic activities to the country due to the lockdown amounted to more than Rs. 1,000 billion: the drastic decline in government revenue compelled the Central Bank to finance government payments: the annual average foreign exchange inflows from the tourism industry fell from USD 4.5 bn per annum to near-zero levels: there was a severe decline in forex remittances since mid-2021 due to various reasons: a steep increase was experienced in crude oil prices to USD 130 per barrel due to the war between Russia-Ukraine: and inflation all over the world recorded its' highest rates over many decades.

As a result of these effects, it is no secret that prices in Sri Lanka have moved well beyond expectations due to supply side pressures coupled with the pick-up in aggregate demand. At the same time, due to the scarcity of foreign exchange, the scarce forex inflows had to be distributed among various needs, such as debt servicing, financing fuel and other essential imports, and other essential forex outflows. Unfortunately, at the same time, scarce foreign exchange had also been expended on financing non-essential and non-urgent imports that kept pouring into the country.

Meanwhile, the electricity supply had been interrupted from time to time due to the declining water levels in the reservoirs and shortage of fuel for electricity generation. The weakening financial conditions of the relevant state-owned business enterprises due to the continuous maintenance of prices and tariffs below cost, had also emerged as another crisis. Therefore, it was by supplying more than USD 1,800 mn in foreign exchange to the forex market, since August 2021 to date, for the importation of essentials such as food items, medicine, fuel, coal and gas, even amidst severe difficulties, that the Central Bank was able to ease the severity of the situation to a certain extent.

In the circumstances, we will be compelled to state without doubt that the current economic crisis is extremely severe.

2. The primary reasons for this foreign exchange crisis

- **External debt crisis**

One of the main reasons for the present day external debt challenge in Sri Lanka is the steep rise in external indebtedness during the 5 years, from 2015 to 2019. In that regard, we need to acknowledge an increase in external debt is a lot riskier than an increase in domestic debt.

During the 5 years from 2015 to 2019, Sri Lanka's external debt stock increased by a massive 65% from USD 23.4 billion to USD 38.7 billion. Even more seriously, International Sovereign Bonds outstanding, which is a form of commercial debt increased 200%, from USD 5 billion to USD 15 billion, even though the GDP increased only by 5.8%, from USD 79 to 84 billion.

This huge mis-match made it very challenging to meet the payments on account of debt servicing amounting to nearly USD 6 billion from 2019 onwards, although in 2014, it was only about USD 2 billion. If the economy which was at USD 79 billion in 2014, had grown by 65% to around USD 131 billion by 2019, this challenge would not have been serious. However, by 2019, the economy had grown only up to USD

84 billion and therefore, this repayment of foreign debt and debt servicing had become extremely challenging.

Table: Outstanding Foreign Currency Denominated Central Government Debt

(USD. million)

	31 Dec. 2014	31 Dec. 2019	31 Dec. 2020	31 Dec. 2021	28 Feb. 2022
Debt Instruments/ Types of Debt					
Sri Lanka Development Bonds	2,984	3,084	2,639	2,295	2,089
Foreign Currency Banking Unit Loans	150	925	1,220	695	449
Syndicated and Term Loans	-	1,333	1,500	2,223	2,224
Projects Loans	15,309	18,293	19,084	18,943	19,017
International Sovereign Bonds	5,000	15,050	14,050	13,050	12,550
Other		63	55	49	48
Total Foreign Currency Denominated Debt	23,443	38,748	38,548	37,255	36,377
Gross Domestic Production **(***US Dollar. billion)*	79.4	84.0	81.0	n/a	n/a

USD million

	2014	2019	2020	2021	2022
Foreign Currency Denominated Debt Service Payments	2,102	5,560	5,940	6,366	7,024

- **<u>Loss due to the COVID-19 pandemic and the imposition of lockdown measures</u>**

At the same time, the economic growth rate further decreased alongside the imposition of lockdown measures, and the GDP deteriorated significantly to USD 81 billion by the end of 2020, further worsening the situation. Therefore, arresting the continuing recession despite some modest growth in 2021, had become a very difficult proposition for the new government.

In the face of the COVID-19 pandemic, many were of the view that the country should be in a strict lockdown to save the lives of the people. Accordingly, the country was in a lockdown in 2020 and 2021 for very long periods. As a result, industries and businesses were hit hard, while the small and medium-sized enterprises (SMEs) were also severely affected.

As a result, Sri Lanka's economy contracted by 3.5% by 2020, while in 2021, the growth rate is set to record a modest rate of around 4% only . It is true that this loss has led to serious economic downturn in the country, and the consequences were even more severe, since the economy had already been in a major downward spiral by the end of 2019. In fact, the challenge posed was severe, especially to the external sector, for several reasons. The first is that the amount of public debt borrowed in foreign exchange had increased by 65% during the 5-year period from 2015 to 2019. The second is that the regular foreign exchange inflows received by the tourism sector alone in 2020 and 2021 had declined by about USD 9 billion. Third, in 2021, the foreign exchange inflows through workers' remittances had declined by about USD 1.5 billion.

The lesson that could be learnt here is that while the lives of people are to be valued, it is important to value the livelihoods of the people as well. Although some persons may insist that the country should be in a lockdown in times of a pandemic, it should also be understood that the situation and the pressure which a country and the economy would have to face later as a consequence may be also extremely challenging. Therefore, going forward, it should be kept in mind that all persons must adhere to health guidelines while adapting to the new normal, as the country cannot afford any further lockdowns.

3. Solutions to the existing key challenges

The prices of goods and services globally have increased rapidly as of today. Prices of fuel, coal, gas, food, freight charges, airfares, and interest rates have been on a sharp rise, continuously.

Inflation, even in countries like the USA and the UK, are recording its highest values in the past 40 years. As a result, the interest rates of those countries are also on the rise. In this background, such conditions exert significant pressure and, therefore, have a huge bearing on developing economies such as Sri Lanka.

Due to the weak position of the Sri Lankan economy in 2019, the effect of such adverse external conditions on the Sri Lankan economy has been even more severe. Therefore, we have to acknowledge the difficulties encountered by the people due to the domestic shortages of foreign currency gas, fuel and electricity. At the same time, we need to understand the impact of these pressures have been aggravated by the behavior of some groups as well. For example, some exporters have been holding on to their foreign exchange earnings without converting such foreign exchange in the market, thereby contributing towards aggravating the crisis. At the same time, some importers, have been stockpiling imported goods, thereby actively contributing to the exchange rate pressures in the economy. Some others, witnessing the shortage of foreign exchange in the market, spread rumors that trigger panic, with a view to making supernormal profits.

In this background, the country is set to experience significant pressures due to the multitude of challenges it has encountered in the recent past. Not only that, the continued fear-mongering caused by the daily media reports of the ongoing foreign exchange shortage has exacerbated the prevailing conditions further. Unfortunately, it is also observed that certain vested interests take steps to internationalize and sensationalize the shortage of foreign exchange with the malicious intent of pushing Sri Lanka into a deeper crisis.

We all regret the pressure and suffering faced by the people due to the rising prices of commodities and the queues due to sporadic shortages. We are sensitive to these issues. However, when considering the overall state of the country's economy, certain decisions have to be taken by the authorities which are complex, challenging, and tough.

For example, if a country does not pay its foreign debt, the consequences can be severe. At the same time, the outflow of foreign exchange due to debt repayments could also have severe consequences, if the lives of the people are disrupted by such action. In some of these difficult situations, certain sectors or programmes may have to be prioritized, when considering the severity of the medium to long term consequences. Therefore, although some oppressed groups may misunderstand the long-term consequences of the decisions taken by the government and the authorities, the relevant authorities may still have to take such decisions for the long term benefits of the economy.

In recent times, in order to strengthen the external sector and encourage forex inflows, the Central Bank decided to allow greater flexibility in the exchange rate. The adjustment to the exchange rate is expected to encourage exporters, discourage non-essential imports, and also expected to encourage more forex inflows, thereby stabilizing the exchange rate at a lower level than the currently prevailing rate.

Accordingly, once the exchange rate stability is achieved, the Central Bank expects prices to gradually adjust downwards, supported by improvements in the supply of some commodities as well.

It must also be said that if the country had a stronger economic growth or a larger foreign reserve before the COVID-19 pandemic, the country would not have experienced as much of a difficult situation as being experienced at present. However, since such a favourable situation did not exist, some heavy burdens have to be borne by the public, although, such pressures will probably ease as the economy turns into a better shape in the period ahead.

4. "Money printing" and its reversal

One of the key policy decisions that was taken by the present Government at its inception was to reduce tax rates and maintain a low tax regime, considering that the economy was showing signs of slowing down. The rationale behind that move was to allow the private and public sectors to save more and invest their excess funds in efficient and productive economic activities. The policy was expected to support economic growth, strengthen the industry as well as other sectors, and enhance tax revenue, of the Government revenue in the future.

However, with the rise of the COVID-19 pandemic at the beginning of 2020, businesses experienced many difficulties. The Government was compelled to impose mobility restrictions that hampered the envisaged recovery in the economy. In that context, the Central Bank had no option but to provide the necessary funding for the Government (amidst government revenue losses) to ensure the smooth functioning of fiscal operations and day to day activities. The Central Bank also had to pump more liquidity into the banking sector to stimulate challenged companies and people. Concessional loan schemes had to be implemented to support micro and small businesses in the face of the pandemic. Further, considering the pressing need of the time, the Central Bank also reduced interest rates to historically low levels to reduce cost of funds to the private sector while supporting the public sector. If not for these policies, the financial markets and the economy would have been in a deeper recession and the public would have gone through an unbelievably stressful time.

Nevertheless, the Central Bank started to tighten monetary policy since August 2021 with the country gradually recovering from the effects of COVID-19. Policy interest rates were raised to contain the gathering inflationary pressures while measures were taken to gradually reduce the monetary stimulus provided during the pandemic. In that background, the Central Bank now expects to reduce its government securities holdings by Rs. 500 billion during this year.

5. Flexibility of the Sri Lankan Rupee and rising interest rates

On 04 March 2022, the Monetary Board of the Central Bank announced a comprehensive policy package and also announced that it would continue to closely monitor the emerging macroeconomic and financial market developments, both globally and domestically. The Central Bank also stated that it will stand ready to take further measures as appropriate, with the aim of achieving price, external, and financial sector stability.

As part of the new policy package, the Monetary Board decided to allow greater flexibility in the exchange rate with effect from 07 March 2022. Although it was not an easy decision, the Central Bank was of the view that it was required in the face of the challenges the economy was facing at that time.

As a result of this policy change, it is expected that there will be improved inflows to the economy in the form of workers' remittances and export proceeds and as envisaged by many, that the parallel forex markets would be weakened. Meanwhile, it is also expected that the exchange rate would soon stabilise around a reasonable level, and the Central Bank will be able to accumulate gross official reserves, which have now depleted to record low levels.

It must also be stated that, considering the need of the time at the outset of the pandemic, the Central Bank had reduced interest rates to historic low levels to reduce cost of funds to the private sector, while supporting the public sector. Thus, the Central Bank had provided the necessary funding for the Government to ensure the smooth functioning of fiscal operations. However, the prolonged low interest rate structure has led to a rise in aggregate demand and inflationary pressures and, therefore, the Central Bank has now reversed the accommodative monetary policy by raising policy interest rates and the statutory reserve ratio since August 2021. Subsequently, considering the recent economic developments, the Central Bank has raised the policy interest rates twice to ensure price and economic stability.

6. Alternatives for the Government and the Central Bank in the future

Extraordinary challenges need extraordinary solutions. Extraordinary times also create opportunities for some serious adjustments to be done. Such extraordinary situations also compel the introduction and implementation of important and needed reforms. Many economic analysts believe that this is an appropriate time to create strong institutions and to display commitment by all stakeholders, to adjust for a better future.

As the economic and financial adviser to the Government, the Central Bank proposed eight broad measures to be urgently considered by the Government, in early March 2022, to complement the efforts of the Central Bank to overcome the present economic challenges. These are:

i. introducing measures to discourage non-essential and non-urgent imports

ii. increasing fuel prices and electricity tariffs immediately, to reflect the cost

iii. incentivising foreign remittances and investments continuously

iv. implementing energy conservation measures, and accelerating renewable energy projects

v. increasing government revenue through tax increases on a sustained basis

vi. mobilising foreign finance and non-debt forex inflows on an urgent basis

vii. monetising non-strategic and underutilised assets, and

viii. postponing non-essential and non-urgent capital projects.

Despite the difficulties, the Government has already implemented two of the above proposals, namely, the proposals of limiting the imports of non-essential and non-urgent imports and revising fuel prices. We appreciate it.

The aforementioned 8-point plan would undoubtedly assist to overcome the challenging economic circumstances faced by the country and facilitate the gradual exit from the Covid-related policy accommodation.

We are well aware that the implementation of these policies can cause challenges to the daily activities of the people. We also know that prices of goods and services will be subjected to significant increases, as a result. It should also be noted that tight fiscal, monetary and financial policies could lead to some set back in the growth of the economy. At the same time, it must also be said that these policy measures taken by the Government and the Central Bank will help stabilise the economy faster and that is the need of the hour.

7. Expected engagement with the International Monetary Fund (IMF)

Considering the current low level of international reserves, Sri Lanka is constantly facing difficulties of meeting its debt service payment requirements. The liquidity in the domestic foreign exchange market has dried up to some extent amidst high foreign debt service payments, reduction in foreign exchange inflows, settlement of accumulated payments, and need to finance the import of essential commodities which are getting increasingly more expensive. Due to the sovereign rating downgrades by the rating agencies, the access to international capital markets by both the Government and banks has also been severely restricted. Therefore, Sri Lanka's banking sector is facing constraints to allocate sufficient foreign exchange to meet the forex demands for essential imports such as fuel, gas, and other essential commodities.

In this context, there is a need of securing a sizeable amount of foreign financing in the immediate future in order to maintain the macroeconomic and financial system stability. Accordingly, the Government has already announced that it intends to request an IMF engagement. Sri Lanka is a member of the IMF, and many experts, including the Opposition, have expressed confidence that an engagement with the International Monetary Fund will enhance investor confidence and encourage non-debt flows.

Moreover, the IMF has also recently emphasised the urgent need to implement a strategy to restore macroeconomic stability and debt sustainability and while engaging with the IMF, it must be kept in mind that the policies prescribed by the IMF could be tough in relation to various economic matters.

8. Conclusion

Your Excellency the President, Honourable Prime Minister, Party Leaders, Ministers and Members of the Parliament,

The Sri Lankan economy has reached to a very decisive stage at this juncture. The decisions taken as a country in the next few weeks and months will have a profound impact on our future. Therefore, the fullest support by all political leaders and political parties, regardless of their political stances, would help to stabilise the country's economy. Rather than trying to win political advantage in the face of various issues, if all get together to stabilise the economy within a short period of time, it would be a great service to the country and the economy.

It is a great victory for the country to have all these party leaders at one forum to discuss the economic challenges, and if everyone provides their fullest strength and support, Sri Lanka would be able to overcome this economic crises soon, and in a sustainable manner.

I sincerely thank His Excellency, President Gotabhaya Rajapaksa for giving me the opportunity to make a few remarks at this this very important conference today.