

## BOX 04

## Monetary and Fiscal Policy Coordination in Sri Lanka

Effective coordination between monetary and fiscal policies plays an important role in maintaining macroeconomic stability and supporting sustainable economic growth. Monetary policy encompasses actions undertaken by the central bank to maintain price stability, while fiscal policy involves government decisions on taxation, public expenditure, and debt management. Monetary policy and fiscal policy may have either complimentary or competing objectives and different time horizons to achieve such objectives. For example, as observed during the 2022 economic crisis, both monetary policy and fiscal policy had to be focused on regaining economic stability. However, at times, the objectives of these policies may differ. Monetary policy needs to prioritise price stability by raising interest rates when there is a looming threat of inflation, which may contradict with the fiscal policy objectives that prioritise economic growth and employment creation in the immediate future. There may also be instances where excessive aggregate demand created by loose fiscal policy may require tightening of monetary policy in order to curtail price pressures in the economy. In spite of such divergences, effective monetary-fiscal coordination with due regard to each other's objectives, independence, and accountability, serves a nation well in its journey towards long term stability and growth.

In Sri Lanka, monetary-fiscal coordination has evolved considerably over time. Under the Monetary Law Act, No. 58 of 1949 (MLA), coordination between monetary and fiscal policy was closely integrated, however, for most of this period, fiscal dominance prevailed, limiting monetary autonomy and often requiring the Central Bank to accommodate deficit financing needs. This framework has since transitioned to a more robust and clearly delineated institutional arrangement under the Central Bank of Sri Lanka Act, No. 16 of 2023 (CBA). The new legal framework strengthens central bank independence, enhances accountability and transparency, clearly defines policy mandates, and facilitates effective monetary-fiscal coordination, while safeguarding macroeconomic and financial stability.

### Monetary and Fiscal Policy Coordination Prior to the CBA

Since the enactment of the MLA, monetary-fiscal coordination has been embedded within the country's institutional framework. The MLA established the Central Bank as the authority responsible for the administration, supervision, and regulation of Sri Lanka's monetary, financial, and payments system. It also provided a structured framework within which monetary policy operates in alignment with the government's fiscal policy. The Secretary to the Ministry of Finance was included in the Monetary Board of the Central Bank and the Central Bank was designated as the fiscal agent, banker, and financial adviser to the Government. The MLA also permitted the Central Bank to facilitate monetary financing to the government in the form of provisional advances and other forms of credit. From 1950s onward, fiscal authorities and the Central Bank operated in coordination, seeking to promote economic growth, price stability and employment, while addressing macroeconomic challenges. However, when fiscal deficits became persistent and large in the Sri Lankan economy, greater reliance on monetary financing contributed to inflationary pressures and external imbalances, particularly when fiscal expansion exceeded the economy's absorptive capacity. This situation also illustrates the concept of "Unpleasant Monetarist Arithmetic" (Sargent & Wallace, 1981),<sup>1</sup> whereby tight monetary policy aimed at controlling inflation can be rendered ineffective if fiscal authorities continue to run unsustainable deficits, forcing the central bank to eventually accommodate fiscal deficits through monetary expansion, thereby undermining future price stability. Although the MLA provided a formal framework that facilitated policy coordination, it also permitted a high degree of fiscal reliance on monetary financing, giving rise to fiscal dominance. The unprecedented socio-economic crisis experienced in 2022 can be partly traced to this structural weakness, as monetary policy was insufficiently insulated from fiscal pressures, thereby undermining the Central Bank's ability to operate with effective independence.

<sup>1</sup> Sargent, T. J., & Wallace, N. (1981). Some unpleasant monetarist arithmetic. In *Monetarism in the United Kingdom* (pp. 15-41). London: Palgrave Macmillan UK.

### Recent Structural Reforms in Strengthening Central Bank Independence

Recognising the shortcomings of the former legal and monetary policy framework and observing international best practices, the CBA was introduced in September 2023 by repealing the MLA. The CBA significantly restricts avenues for fiscal dominance, thereby strengthening the Central Bank's operational independence and enhancing the effectiveness of monetary policy. A notable reform under the CBA is the exclusion of the Secretary to the Treasury (ST) from the Central Bank's Governing Board and Monetary Policy Board, a change that structurally removes direct fiscal representation and strengthens the independence of monetary policy. While the CBA restricts direct monetary financing, it permits limited provisional advances to the Government to manage short-term cash flow needs. However, with improved fiscal discipline and performance, the Government has not invoked this provision since the CBA's enactment in 2023. In addition to the above, provisions exist to enable monetary financing under exceptional circumstances, such as a global health emergency, subject to the approval of Parliament. Meanwhile, in accordance with the provisions of the Public Debt Management Act, No. 33 of 2024 (PDMA), the transfer of public debt management responsibilities from the Central Bank to Public Debt Management Office (PDMO) further enhances the Central Bank's institutional independence in conducting monetary policy. Alongside the CBA, the enactment of the Public Financial Management Act, No. 44 of 2024 (PFMA), has significantly strengthened the fiscal discipline, thereby reinforcing the effectiveness of monetary-fiscal policy coordination. Enacted in August 2024, the PFMA serves as the cornerstone of fiscal governance reforms by establishing a clear legal framework for the budget process, strengthening accountability and enhancing transparency in fiscal operations.

### Current Monetary-Fiscal Policy Coordination in Sri Lanka

With the clear separation of fiscal and monetary policy frameworks under the recent legislative amendments, the CBA has made special provisions to institutionalise monetary-

fiscal policy coordination by establishing the Council for the Coordination of Fiscal, Monetary and Financial System Stability Policies. The Coordination Council serves as the formal platform for information sharing and dialogue between the Ministry of Finance, Planning and Economic Development (MoF) and the Central Bank on macroeconomic developments, outlook, and risks. With the Governor of the Central Bank and the ST as members, the Coordination Council brings together senior officials from both the fiscal authority and the Central Bank. Convening quarterly, it facilitates the exchange of relevant monetary and fiscal information, thereby supporting more informed and coherent policy decision-making. Since of late, in line with the Coordination Council meetings, technical-level meetings are also held among relevant officials of the monetary and fiscal authorities to facilitate the proceedings of the Coordination Council meetings and further strengthen analytical engagement and operational coordination between the Central Bank and MoF.

In addition to the Coordination Council, the CBA provides effective inter-agency coordination to safeguard financial system stability through the Financial System Oversight Committee (FSOC). Chaired by the Governor of the Central Bank of Sri Lanka, the FSOC brings together senior officials from the Central Bank, a Deputy Secretary to the Treasury (DST) nominated by the ST, and other regulatory institutions. This cross-institutional composition facilitates timely information exchange, informed policy dialogue, and coordinated assessments of systemic risks within a macroprudential framework, thereby supporting coherent and well-aligned policy responses to strengthen overall financial system stability. Additionally, to strengthen policy coordination between the Central Bank and the MoF and enhance crisis preparedness, and to minimise spillover effects of the recent economic crisis on the financial sector, the Financial Sector Crisis Management Committee (FCCMC) was established under the Banking (Special Provisions) Act, No. 17 of 2023. The Committee enabled effective coordination among relevant authorities in addressing evolving risks.

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Meanwhile, a Public Debt Coordinating Committee (PDCC) has been established under the PDMA. Chaired by a DST, the PDCC comprises nine members, including two representatives appointed from the Central Bank. The PDCC is tasked with ensuring that the public debt management strategy is aligned with overall macroeconomic policies, evaluating borrowing plans, and assessing conditions in domestic and international markets. The Central Bank's representation on the PDCC facilitates ongoing coordination between monetary and fiscal authorities in support of public debt management, without granting the Central Bank direct influence over government debt management decisions.

Effective monetary and fiscal policy coordination is further reinforced by close and continuous engagement between the Governor of the Central Bank and the ST on matters of macroeconomic significance. On key economic policy issues, both institutions maintain regular communication and coordination to ensure consistency and coherence in decision-making. In addition, the Central Bank engages constructively with other line ministries and public sector institutions on matters requiring coordination, reflecting a holistic approach to economic policy. Importantly, during periods of heightened domestic or global uncertainty, such as US tariff policy changes, extreme weather-related disruptions caused by *Cyclone Ditwah*, and evolving geopolitical tensions in the Middle East, well-coordinated policy engagement between the Government and the Central Bank helped assess risks and implement timely policy responses, thereby safeguarding macroeconomic stability and supporting economic resilience.

Moreover, as per the provisions of CBA, under the Flexible Inflation Targeting (FIT) framework, the inflation target is determined jointly by the Government and the Central Bank following a thorough assessment, with a high degree of coordination between the authorities.

Sri Lanka's earlier-than-expected recovery from the 2022 economic crisis emphasises the critical importance of effective coordination between monetary and fiscal policies in restoring macroeconomic stability. Supported by the IMF's Extended Fund Facility (EFF), the implementation of disciplined fiscal measures, prudent monetary policy as well as structural reforms enabled the country to stabilise inflation, strengthen public finances, and gradually revive economic activity. This coordinated policy approach played a vital role in navigating a period of severe economic distress and placing the economy back on a path towards economic stability.

### Conclusion

Recent legislative reforms introduced in the aftermath of the socio-economic crisis in 2022 have established a clearer delineation and strengthened the monetary and fiscal policy frameworks, underpinned by enhanced accountability and transparency. At the same time, these reforms preserve robust mechanisms for monetary-fiscal policy coordination, supporting macroeconomic stability and sustainable economic growth. Going forward, sustained and constructive coordination between monetary and fiscal authorities will remain essential to achieving improved economic outcomes for the country.

