BOX 2
Achieving Sri Lanka's External Sector Stability in the Medium to Long Term

Introduction

In an open economy, stability in the external sector is vital as external imbalances could cause widespread spillover effects across all sectors of the economy, thereby threatening the overall macroeconomic stability. The external sector in Sri Lanka has been facing unprecedented challenges in recent years, amidst headwinds caused by the COVID-19 pandemic and adverse developments in the global economy. In this context, long term stability in the external sector, characterised by a sustainable external debt position and a manageable external current account deficit, has been identified as an important near to medium term priority in macroeconomic policymaking. Sri Lanka needs sustainable solutions to ensure long term stability in the external sector vis-a-vis short term measures.

Evolution of External Sector Related Economic Policies in Sri Lanka

At the time of gaining independence from the British, Sri Lanka was an agriculture based open economy characterised by a plantation sector and a subsistence agriculture sector with a fixed exchange rate regime. Exports were based on three main plantation crops; tea, rubber and coconut, which accounted for around 90 per cent of total exports.

External Sector Policies in the Post-Independence Era

Free Trade Policy in Early 1950s

Sri Lanka maintained a free trade policy regime in the early period of independence and the country was one of the most liberalised economies in Asia. Until the late 1950s, Sri Lanka was able to sustain the open trade policy regime with large trade surpluses supported by two commodity booms, which had led to significant build-up of foreign reserves. However, substantial trade deficits were recorded since 1957 owing to the rapid growth of import expenditure and deterioration of terms of trade.

Import Controls from Mid 1950s to Mid 1960s

Large trade deficits exerted pressure on the balance of payments (BOP) resulting in a sharp depletion of gross official reserves after 1956. In response, by establishing a Foreign Exchange Budget Committee, the Government imposed rigorous import control measures including imposition of quotas, licenses and tariffs on imports except food, petroleum and pharmaceutical imports. The development strategy of the Government was based on encouraging import substitution and domestic agricultural expansion to reduce import expenditure and achieve self sufficiency in essential commodities. By the mid 1960s, the economy was heavily regulated with protectionist measures and an overvalued fixed exchange rate was maintained. Meanwhile, export promotion strategies were also adopted to arrest the BOP issues.

Partial Liberalisation of the Economy from Late 1960s to 1970

Partial liberalisation of international trade was allowed since 1966 with partial relaxation of import restrictions accompanied by a devaluation of the currency by 20 per cent in 1967 and the introduction of the dual exchange rate system under the Foreign Exchange Entitlement Certificate mechanism in 1968. Although foreign financing assistance was received from multilateral institutions, such as the International Monetary Fund (IMF) during the period, the external sector performance weakened considerably in 1960s.

Reimposition of Import Controls from 1970 to 1977

Sri Lanka experienced the most stringent trade and exchange restrictions during this period with the socialist oriented policies introduced by the new Government that came to power in 1970. All imports were brought under licensing requirements and incentives were provided to promote non-traditional exports. During this period, the economy faced global headwinds from an oil crisis, the Vietnam War and structural deficiencies in the US economy, which led the Bretton Woods System of exchange rates to collapse. With changing the value of rupee against the US dollar subsequent to the collapse of the Bretton Woods System and BOP pressures, exchange restrictions on both current and capital transactions were tightened and these rigid controls were in place until 1977.

Introduction of Open Economic Policies in 1977

The Sri Lankan economy marked a significant milestone in 1977 with the introduction of liberal economic policies with enhanced private sector participation in production and investment. As an integral part of the liberal policy regime, the dual exchange rate system was abolished by establishing a unified exchange rate. The transition from a fixed exchange rate regime to a managed float exchange rate regime, which determined the exchange rate based on market demand and supply conditions, was a radical shift in Sri Lanka's exchange rate policy. A plethora of exchange control relaxation measures were also implemented. These policy measures included removal of restrictions on current transactions, lifting of quantitative import restrictions, rationalisation and simplification of import tariff structure, and removal of price controls and licensing requirements. Simultaneously, in view of reducing the adverse implications stemming from fiscal sector imbalances, many fiscal reforms, such as restructuring of food subsidies, privatising government enterprises and promoting private sector led growth, were introduced. Incentives were provided to encourage foreign direct investment (FDI) to export industries and export processing zones. Foreign financial flows gradually started to increase after 1977, with the relaxation of exchange restrictions. Subsequently, with the economy

changing its course from being primarily an agricultural economy to one driven by the services and industrial sectors, Sri Lanka entered into a number of preferential trade agreements to strengthen trade and investment linkages with its regional peers.

External Sector: Current Position and Issues

Persistently High Current Account Deficits

Sri Lanka has been experiencing persistent external current account deficits mainly driven by large deficits in the merchandise trade account and primary income account over the past few years. Although the trade in services account and secondary income account, which comprise workers' remittances, recorded surpluses, these surpluses were not large enough to cushion the impact of merchandise trade and primary income account deficits on the current account. Lackluster performance in export earnings and increasing import expenditure led to a widening deficit in merchandise trade over the years. Although Sri Lanka was one of the first countries in the region to adopt liberal economic policies in 1977, its trade openness remains low. Trade openness, which is the total value of exports and imports in relation to the country's GDP, was 36.4 per cent in 1977 and it nearly doubled to 72.2 per cent by 1979. However, Sri Lanka's international trade performance has not been impressive in terms of trade openness, declining to levels that were seen during the pre-liberalisation era by 2019, where Sri Lanka's trade openness was 38.0 per cent. Workers' remittances have also shown a declining trend since mid 2021, contributing to widening current account deficits.

Adverse Implications of the Easter Sunday Attacks and the COVID-19 Pandemic on the Current Account

Although the current account deficit narrowed significantly in 2019 and 2020 due to the notable contraction in the trade deficit driven by reduced import expenditure, the surplus in the services account was affected severely in both years by the loss of earnings from tourism due to the Easter Sunday attacks and travel restrictions imposed with the outbreak of the COVID-19 pandemic. Despite a notable recovery since end 2020, the tourism sector has not yet reached pre pandemic levels thus far. Workers' remittances, which declined initially during the pandemic period, started to increase rapidly since mid 2020. However, workers' remittances received through formal channels started to decline since mid 2021, mainly due to the differences in the exchange rate prevailing between the grey market and official channels. The trade deficit that contracted during the last two years widened significantly in 2021, particularly during the second half of the year owing to a sharp increase in import expenditure, even amidst continuing import restrictions on selected imports, negating the impact of notable increase in export earnings. These adverse developments in the post pandemic period, particularly related to trade deficit, inflows to the services account and workers' remittances, have aggravated the vulnerabilities in the already fragile external sector.

Meagre Performance in the Financial Account

Sri Lanka has not been able to attract non debt creating foreign financial flows, such as FDI up to the expected levels, even during the post war period, due to structural and policy issues related to FDI. Over the past decade, annual FDI inflows remained around US dollars 1.3 billion, on average, and around 1-2 per cent of GDP. The prevailing weak investment climate in Sri Lanka can be attributed to a range of factors including policy uncertainty, restrictive labour regulations, lack of progress in ease of doing business, inconsistencies in protection of property rights, weaknesses in maintenance of law and order, and so forth. In addition, institutional weaknesses, such as corruption, weak regulations, red tape and faltering infrastructure have resulted in Sri Lanka attracting significantly lower inflows of FDI than its peer economies.

Mounting External Debt

During the last decade, the mounting external debt and growing debt service payments were the major contributors to the external sector imbalances. With Sri Lanka accessing international financial markets to raise funds by issuing International Sovereign Bonds (ISBs) since 2007, the country's external debt has been accumulating at a steady pace. However, this increased the overall cost of funding of the debt portfolio as

Figure B 2.1
Composition of the Current Account: 1975-2021

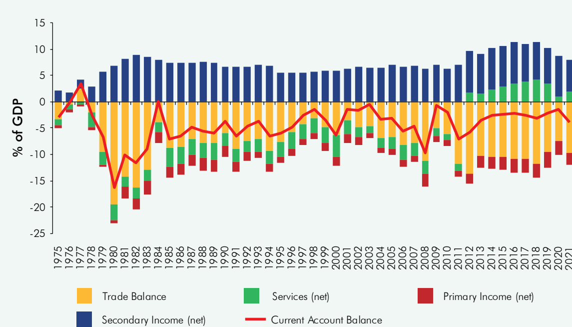
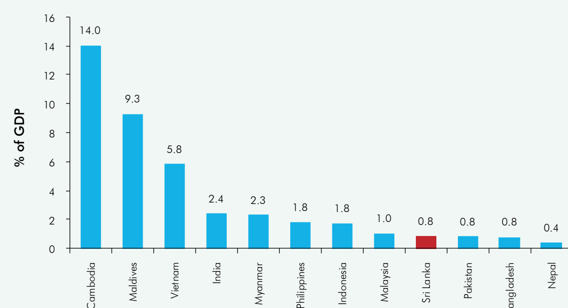


Figure B 2.2
Foreign Direct Investment Inflows: Sri Lanka and Selected Regional Peers - 2020



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ISBs were often priced at relatively high interest rates compared to the development assistance finances Sri Lanka used to receive at concessional rates. Moreover, the expansion in government fiscal deficit due to the financing of large infrastructure projects with the post war economic resurgence also contributed towards this increase. Following the trend in debt accumulation, the external debt as a percentage of GDP has also gradually been on the rise over the past decade and remains around 60 per cent of GDP, on average. When comparing the external debt as a percentage of GDP with its regional peers, Sri Lanka has recorded the highest ratio after Bhutan, Maldives and Cambodia. Except for these four countries, the external debt to GDP ratio of other peer Asian countries lies well below 50 per cent of their respective GDP.

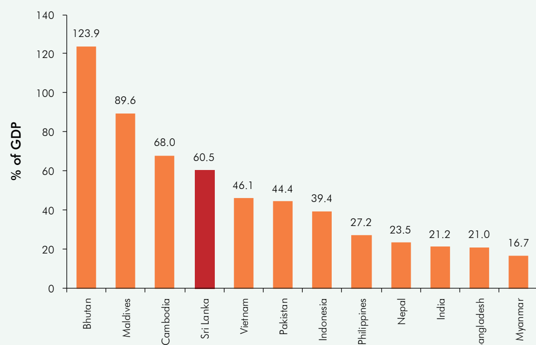
Foreign Debt Service Payments

Increasing external debt stock as well as the compositional change in Sri Lanka's foreign debt profile from concessional borrowings to costlier non-concessional and commercial borrowings have resulted in increased foreign debt service payments. The high cost of external borrowings has expanded the deficit in the primary income account, exerting further pressure on the current account of the BOP. Total external debt service payments as a percentage of export of goods and services has increased from 13.2 per cent in 2011 to 30.0 per cent in 2021 indicating that nearly one third of Sri Lanka's annual export earnings are consumed for debt servicing. Further, government debt servicing accounts for more than 80 per cent of the foreign debt service payments indicating that the external sector financing issues are mainly stemming from fiscal imbalances.

Declining Gross Official Reserves

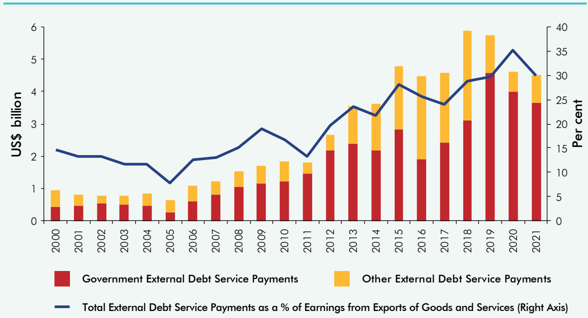
The gross official reserve position of the country deteriorated to critically low levels by end 2021 due to higher foreign currency debt service payments amidst inadequate foreign exchange inflows. The low level of foreign exchange inflows in terms of export earnings repatriation, workers' remittances and foreign capital

Figure B 2.3
Outstanding External Debt: Sri Lanka and Selected Regional Peers - 2020



Sources: World Bank
Central Bank of Sri Lanka

Figure B 2.4
External Debt Service Payments of Sri Lanka: 2000-2021



Source: Central Bank of Sri Lanka

flows resulted in a shortage of liquidity in the domestic foreign exchange market necessitating the Central Bank to supply foreign exchange to finance essential imports, which further depleted the reserve levels.

Significant Pressure on the Exchange Rate

The external sector imbalances are largely reflected by the dried up liquidity conditions in the domestic foreign exchange market, series of sovereign rating downgrades along with the precarious level of international reserves that have exerted significant depreciation pressures on the exchange rate. While the exchange rate was maintained at around Rs. 200 – 203 per US dollar during most of 2021 and until early March 2022, mainly through moral suasion by the Central Bank, a notable development of parallel markets for foreign exchange was observed. However, following the adjustment in the exchange rate in early March 2022 and subsequent market pressure, the Sri Lanka rupee depreciated sharply by 33.0 per cent against the US dollar by end March 2022. However, some stability in the exchange rate is expected with the significant tightening of the monetary policy stance in early April 2022 along with other corrective measures currently being considered to be implemented with immediate effect, which mainly include, initiating discussions with the IMF for an economic adjustment programme, suspension of external debt servicing for an interim period leading to an orderly and consensual debt restructuring process, and fiscal consolidation, along with the negotiations to obtain bridging financing.

Medium to Long Term Policies to Achieve External Sector Stability

The Central Bank took a number of short term measures in the recent past to address the external sector issues. The Central Bank issued new rules pertaining to mandatory repatriation and conversion of proceeds of exports of goods and services to Sri Lanka rupees that helped improve the liquidity conditions in the domestic foreign exchange market. Further, with the aim of building up of gross official reserves through non borrowed sources, the Central Bank instructed the licensed banks to sell to the Central Bank a portion of

foreign exchange so converted. Although this measure impacted the liquidity in the domestic forex market to a certain extent, it enabled the Central Bank to supply much needed foreign exchange to the market to partly finance the demand for essential goods imports. Initiatives were taken to encourage transferring of workers' remittances through formal channels including the provision of incentives above the normal exchange rate for the foreign exchange remittances converted at licensed banks, reimbursement of transaction costs incurred on account of workers' remittances, and the launch of a National Remittance Mobile Application branded as "Lanka Remit". Further, rules were issued requiring hotel service providers registered with the Sri Lanka Tourism Development Authority to accept payments in respect of services rendered to non residents only in foreign exchange. Moreover, the Central Bank has also been able to secure foreign financial assistance from regional central banks by way of bilateral currency swaps. Although the short term policy measures have been effective in reviving the external sector to a certain extent, policies spanning over medium to long term are required to enhance the resilience and maintain continuous stability in the external sector. Such policies should be focused on the following key areas:

Medium Term Measures

Initiating Comprehensive Macroeconomic Reforms Consistent with an Economic Adjustment Programme Supported by the IMF

Considering the spiraling economic issues faced by the country, the Government has decided to begin negotiations with the IMF that may lead to a possible IMF funded programme aiming at macroeconomic stability. This IMF funding arrangement could be complemented with a comprehensive reform agenda in major areas, such as fiscal consolidation, strengthening financial performance of State Owned Business Enterprises (SOBEs), phasing out monetary financing, and improving efficiency in social safety net programmes, among others.

The Need for Ensuring External Debt Sustainability

The current focus of the Government and the Central Bank is on ensuring the sustainability of the country's external debt in the long term to build resilience in the economy. In this context, the Government has already published Request for Proposals from interested parties for appointing Financial Advisors and Legal Consultants for managing its external debt in a sustainable manner. Such debt management process may involve a comprehensive debt restructuring plan, which would be conditional upon an agreement to an economic reform programme with the IMF. In parallel, the Government announced on 12 April 2022 that it would temporarily suspend external debt servicing for an interim period pending consensual external debt restructuring. These measures are expected to reduce high exposure to external debt and thus helping to ensure external debt sustainability.

Maintaining Healthy Levels of Gross Official Reserves

In order to maintain external sector stability, it is crucial to maintain a healthy level of gross official reserves, which is an indicator of the country's ability to withstand external shocks as well as its ability to honour external debt service payments. Hence, increasing the country's gross official reserves remain the most important medium term objective of the external sector. The country envisages to enhance gross official reserves to cover a minimum of 4 months of merchandise imports. While these targets remain significantly challenging, the ongoing efforts towards debt restructuring and envisaged foreign currency inflows are expected to increase gradually over the medium to long term, enabling the gradual build-up of gross official reserves. While the medium term objective of the Central Bank is to gradually increase the quantity of reserves, the composition is also expected to be improved by organic build-up of reserves through non-borrowed sources.

Strengthening Regional Cooperation

It is essential to maintain international cooperation with regional stakeholders, including regional central banks, governments, business communities, investors and multilateral agencies to build up stakeholder confidence leading to sustained external sector stability over the medium term. In this regard, the Central Bank continues to hold discussions on future collaborations with counterparts in several regional countries.

Long Term Measures to Strengthen Non-debt Creating Foreign Exchange Inflows

Promoting Merchandise and Services Exports Sectors

The National Export Strategy (NES) is instrumental in supporting both goods and services export industries to achieve higher foreign exchange earnings. The existing NES was designed and implemented with a view to transforming Sri Lanka into an export hub driven by innovation and was expected to be implemented within a 5-year horizon from 2018 - 2022. It will be important to revive the NES with some modifications to suit the more recent developments in international trade and provide much needed policy support to the exports sector and such policies should continue without interruption under any political regime. Implementation of a broad based and consistent NES is expected to create steady and sustainable growth in exports while unlocking potential export sectors to create new job opportunities and facilitating value addition through increased participation in global value chains and product sharing networks. Along with these, measures should be introduced and monitored in attracting investment to the tradable sector, especially for industries producing intermediate goods for the export sector and industries oriented mainly towards global trade.

Equal attention should be given to promoting services sector exports that have high potential and domestic value addition than traditional merchandise exports. Earnings from tourism have been the major contributor to the surplus in the services account in the recent years although being severely affected by the Easter Sunday attacks and the COVID-19 pandemic. Continuous promotion of tourism to reach its potential should be

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prioritised. Other services sectors, such as IT/ BPO, transportation and port services sectors, also have to be integrated into the national plan to strengthen export earnings from goods and services.

Enhancing Workers' Remittances

With the gradual dissipation of the adverse effects of the COVID-19 pandemic and the implementation of targeted policy measures, workers' remittances have shown signs of improvement. The departures for foreign employment are rising as reflected by the increase in migrant workers registering with the Sri Lanka Bureau of Foreign Employment (SLBFE). Further, narrowing of the gap between the official exchange rate and the grey market rate is also expected to help attract higher foreign remittances formally. Active stakeholder engagement to promote foreign employment, diversifying foreign employment market and upskilling of migrant employees are expected to secure more foreign employment opportunities with higher earnings, thereby increasing the contribution of workers' remittances to cushion the impact of the widening trade deficit.

Attracting FDI

To sustain a healthy momentum of non debt creating foreign financial flows, such as FDI over the medium term, there is a dire need to maintain policy consistency, improve doing business conditions, strengthening institutions, and expediting the approval and the implementation processes to facilitate FDI. Development of the Colombo Port City, promoting the Colombo and Hambantota ports as commodity trading hubs and establishing modern investment zones for local and foreign private investors, are expected to attract considerable foreign investment to the country in the period ahead. A close coordination and monitoring mechanism to facilitate and promote such investment is necessary to build long term macroeconomic resilience.

Conclusion

The corrective measures taken by the Government and the Central Bank, including initiating negotiations with the IMF for an economic adjustment programme, commencement of an external debt restructuring process, commitment towards fiscal consolidation, alongside significant monetary policy tightening and more market based exchange rate determination, are expected to help restore confidence of stakeholders in the economy in the period ahead. It is imperative that the long neglected structural reforms are introduced in the immediate future to reduce the external current account deficit and the fiscal deficit, which remained the root cause of the recurring external sector instability for decades. Managing the twin deficits at sustainable levels is crucial to ensure long term sustainability in country's external debt, while maintaining healthy levels of reserves to withstand economic headwinds, thereby ensuring long term stability of the external sector.

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