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Stability in the Midst of Uncertainty

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During the past 60 year period, Sri Lanka faced numerous internal and external shocks. Some were positive shocks, most of which were short-lived, while the majority were negative, originating from both external and internal factors, and sent waves of destabilisation through the entire economy. These adverse shocks affected many macroeconomic variables of the country, including economic growth, inflation, exchange rate, balance of payments (BOP), budget deficit as well as the stability of the financial system and created periods of economic uncertainty, particularly among economic agents in taking various decisions and undertaking various activities.

The economy faced two key positive shocks in terms of export commodity price increases during the 1950s. While the Korean War significantly raised international rubber prices during 1950-52, the tea prices in the international market increased significantly during the 1954-55 period, thereby improving export earnings, creating a surplus in the BOP and leading to a surplus in the budget due to the increased revenue from exports related taxes. Another significant positive shock was seen in the 1976-77 period with the increase of tea prices in the international market. The adverse external shocks were in many areas, including the decline in export prices, increase in import prices of commodities, including the price of crude oil, and financial market related developments. The internal shocks were mainly in the form of an internal conflict, political uncertainties and natural disasters. In those circumstances, policy makers and authorities also faced uncertainty in their courses of action. In order to deal with these types of adverse shocks, policy makers and authorities, including the Central Bank of Sri Lanka (CBSL), introduced various policies and measures to address uncertainties and maintain stability considering pros and cons of the possible responses. The remainder of this article attempts to summarise the highlights of such adverse events during the past 60 years.

BOP Crisis in mid-1960s

Since 1957, Sri Lanka's external position continued to worsen and needed corrective measures. The government and the CBSL introduced various measures to stabilise the external position, including the introduction of stringent import and exchange restrictions. However, there was a BOP crisis in mid 1960s, triggered mainly by low export prices and a high volume of imports. In order to maintain export competitiveness and induce an adjustment to BOP, Sri Lanka devalued the rupee on 22 November 1967, and a dual exchange rate system was introduced involving a Foreign Exchange Entitlement Certificate System (FEECS) with a partial liberalisation of imports.

First Oil Price Shock during 1973-74

The increase in international oil prices led the country to implement various measures during this period. Given the rapid increase in oil prices, import controls were further tightened to keep the external payments situation under control. The impact of the price increase was passed on to the domestic consumers. Consequently, the consumption of all petroleum based products decreased, and the increase in export proceeds of petroleum based products were partially used to subsidise domestic consumption. Sri Lanka received the support from the International Monetary Fund (IMF) under the Scheme for Compensatory Financing for Export Fluctuations while the suppliers' credit facilities were also obtained to face the situation. The gradual recovery of the tourism industry, which was interrupted by the state of civil unrest in 1971, too helped bring in foreign exchange to the country. Meanwhile, inflation increased considerably, which was mainly addressed through government subsidies and price controls.

Second Oil Price Shock during 1979-80

The significant rise of international oil prices resulted in an increase in the import bill on intermediate goods in the 1979-80 period. As a result, the trade deficit increased significantly and the current account recorded huge deficits. The BOP in 1980 turned negative after a period of continuous surpluses since 1975. Given the deteriorated external situation, the IMF, in January 1979, approved an Extended Fund Facility (EFF) for a three year period from 1979 to 1981 to support Sri Lanka's BOP position.

Internal Conflict during 1983-2009

The internal conflict, which prevailed for more than 26 years since 1983, is one of the most severe shocks experienced by Sri Lanka, which led to uncertainties in every corner of the country. The conflict resulted in severe losses in terms of invaluable human lives, human suffering and displacements. The infrastructure and the economy in the North and the East were severely destroyed and investment and other economic activities in the entire country were adversely affected, decelerating economic growth significantly. The government had to incur a significant cost in terms of defence expenditure, creating pressure on all macroeconomic variables. Although successive governments made various efforts to end the conflict, it was only in May 2009, the government was able to end the conflict comprehensively. The successful conclusion of the conflict is a result of a well planned and focused attempt with strong and unwavering commitment on the part of the government.

Gulf Crisis in 1990

The economic performance of Sri Lanka was affected by the Gulf crisis in 1990, although the period of high oil prices it caused was relatively short. Increased oil prices adversely impacted the oil import bill and the BOP. In particular, the expenditure on petroleum imports in 1990 rose by about 46 per cent over the previous year. The domestic prices of petroleum products were increased on two occasions in August and November 1990, and were subsequently revised downwards with the stabilisation of international oil prices. The inflation rate, which was relatively high in 1989, accelerated sharply in 1990 mainly reflecting the impact of higher oil prices.

Asian Financial Crisis in 1997-98

The Asian financial crisis, while having a significant impact on the global economy and created uncertainties in the international markets, had no significant impact on the Sri Lankan economy. The 1997 Annual Report of the CBSL reported that "…The recent improvement in Sri Lanka's macroeconomic conditions, the maintenance of some capital controls, the low exposure to short-term foreign debt, enhanced surveillance of financial market activity and a rise in short-term interest rates towards the end of the year helped to maintain a reasonable degree of stability in the domestic financial market in a highly volatile and uncertain external environment and to avoid a contagion effect of the East Asian crisis…". In 1997, the economy grew by 6.4 per cent while it was a moderate rate of 4.7 per cent in 1998. The inflation rate remained at a moderate level of 9 per cent, the budget deficit declined to 7 per cent of GDP in 1998 and the BOP recorded surpluses with current account recording lower deficits. The 1998 Annual Report of the CBSL reported that "…Survival in a sea of turbulence became an achievement and the Sri Lanka economy could be deemed to have fared reasonably well during the biggest crisis it faced since 1930s".

Multiple Shocks in 2001

The economic performance in 2001 was significantly affected by various shocks and uncertainties. The 2001 Annual Report of the CBSL reported that "... An unfavourable global economic environment, exacerbated by domestic uncertainties, made 2001 a very difficult year for the Sri Lankan economy". The shocks included: (i) the slowdown in the global economy reducing the demand for Sri Lankan exports causing a deterioration of external trade activities, which was deepened following the September 11 terrorist attack in the USA; (ii) the prolonged draught, that declined agriculture output, increased domestic food prices and reduced hydro power generation resulting in power cuts; (iii) the terrorist attack on the Katunayake International Airport, which disturbed economic activity, weakened investor confidence and led to the imposition of a war risk premium; and (iv) political uncertainty that postponed reform. As a combined outcome of these major factors, the economy recorded a widespread negative growth of 1.5 per cent, the first time in the post independence period. Inflation increased to double digit level, budget deficit increased to above 10 per cent of GDP and the external position weakened. A BOP crisis was imminent, and the depletion of official foreign exchange reserves and the severe pressure on the exchange rate to depreciate, displayed the inability of a central bank to pursue multiple objectives simultaneously. Monetary policy was tightened and prudential measures were imposed to ensure financial market and financial system stability.

However, as a result of the measures taken by the government, the CBSL and various stakeholders coupled with other positive developments, the economy recovered since 2002. Accordingly, economic growth rebounded into the positive territory, inflation declined, external position recovered and the budget deficit declined. In particular, the country made progress in exchange rate management by graduating into an independently floating exchange rate regime in January 2001 towards further market orientation of the exchange rate.

Tsunami Disaster in 2004

Sri Lanka was severely affected by the Indian Ocean Tsunami disaster in December 2004. The 2004 Annual Report of the CBSL reported that … "Tsunami caused extensive damage along more than two thirds or over 1,000 km of the coastline…. About 31,000 human lives have been lost, over 4,000 persons are reported missing and nearly 550,000 were left homeless. Coastal infrastructure and public and private property in the affected areas were damaged while economic activities, mainly fishing, tourism, trading and small scale industries, have been damaged. The total damage is estimated to be around US dollars 1 billion (4.9 per cent of GDP)…". The CBSL ensured that the market remained liquid and stood ready to deal with any interruption to the payment system. The recovery from this huge natural disaster needed a strong and coordinated effort. Financing needs for reconstruction were estimated at US dollars 1.5-1.6 billion and included upgrades in the power, water, and transportation sectors. It was expected that the reconstruction efforts would exert pressure on the BOP and the fiscal situation. Economic growth was initially to be lower than the original projections. The significant financial and material support received in various ways by bilateral and multilateral donors, private institutions and general public helped overcome the situation, while the CBSL took steps to avoid excessive appreciation of the rupee. Inflation remained subdued through prudent monetary policy measures and by the favourable developments in aggregate supply. The stability of the financial system was strengthened through improved supervision and regulations. Meanwhile, economic growth was better than initially expected.

End of the Multi-fibre Agreement (MFA) in 2005

From the beginning of 2005, the MFA, which governed the international trade in textile and apparel through a system of quota, was abolished. The increased international competition in the quota-free market environment resulted in some major firms taking measures to increase their competitiveness through enhancing productivity, focusing on high value products and upgrading human capital, design and marketing skills. Many players were well prepared to deal with the situation, although small and medium enterprises displayed increased vulnerability.

Commodity Price Increases during 2006-08

The rising petroleum and commodity prices in international market threatened the achievement of price stability during the 2007-08 period. The adverse impact of these price increases negated the favourable impact that arose from the demand management policies implemented by the CBSL to a considerable extent. The 2007 Annual Report of the CBSL reported that "… It was disappointing for the monetary authority to observe the negation of the demand management efforts by external price shocks and supply side shocks, despite tighter and more disciplined monetary policy stance maintained by the Central Bank".

The external price shocks particularly came from the international petroleum prices, which rose to unprecedented levels by end 2007. The discontinuation of the fuel subsidy given to oil distributing companies by the government since July 2006 to reduce the fiscal cost of subsidies helped the government to reduce the impact of high oil prices on its fiscal operations. The removal of the subsidy had a one off impact on headline inflation which would dissipate over time but the long-term impact would be positive with the removal of financing needs of the government. However, the CBSL was concerned on the potential second round effect of the prices which would lead to lasting inflation, hence a further tightening of monetary policy took place.

The world food prices, especially the prices of staple foods, increased sharply in 2007 and a considerable part in 2008 after showing initial signs from late 2006. The Global Food Price Index (2002-2004=100), compiled by the Food and Agricultural Organisation (FAO), reached the peak of 214 by June 2008, recording an year-on-year increase of 44 per cent. Reflecting the severity of the impact of commodity prices increase, including oil, the point-to-point inflation increased to 28.2 per cent in June 2008.

The government dealt with the world food crisis in many fronts, including the use of tax policy to provide concessions, continuation of the fertiliser subsidy, and introduction of policy stimulus to promote agriculture, while reinforcing the government's national programme "Api Wawamu – Rata Nagamu" (Let us grow – Let us develop) to improve domestic agriculture. Due to the tight monetary policy stance of the CBSL, coupled with the healthy domestic supply side conditions and the sharp decline in international commodity prices from around mid 2008, inflation decelerated to 14.4 per cent by end 2008.

Twin Crises during 2008-10

The most challenging shock that created a significant uncertainty in the country's recent history was the global financial crisis and the subsequent global economic recession. Since September 2008, the global economy passed through its deepest financial and economic crisis since the Great Depression in 1930s. The primary impact of the global financial crisis on Sri Lanka was minimal as the country's capital account was not fully liberalised and many local banks did not trade in collateralised debt instruments. Also, Sri Lankan financial institutions had only a small relationship with those foreign institutions that were severely affected during the financial crisis. The prudential regulations helped limit foreign exposure of banks and this limited exposure shielded the domestic financial institutions from the primary impact of the global financial crisis.

However, Sri Lanka experienced a second round economic impact due to the global economic slowdown and liquidity crunch in the global capital market. The impact of the financial crisis led to a large scale flight of capital due to withdrawals of foreign investments in Treasury bills and bonds by the foreign investors since last quarter of 2008 at a time of great uncertainty, which continued until March 2009. The 2009 Annual Report of the CBSL reported that "… On the external front, Sri Lanka continued to be impacted by the spill-over effects of the global financial and economic crises… The sudden withdrawal of capital by foreign investors resulting from adverse global conditions placed an enormous strain on the country's foreign reserves and the management of liquidity."

As a result of the declining global demand, foreign trade of the country was affected adversely. The decline in foreign inflows forced the government to rely on domestic financing, particularly for infrastructure development projects already commenced. Tourist arrivals declined significantly, reflecting the impact of the crisis on many tourism generating countries. However, as the price of commodities, such as oil, declined, the narrowed trade deficit had a favourable impact on the BOP though the country registered its highest level of trade deficit in 2008. Total inward remittances in 2008 were lower than expected. The external current account recorded a significant deficit of 9.3 per cent of GDP while the BOP turned into a deficit of US dollars 1.2 billion in 2008 after 3 continuous years of surpluses. The country's reserve position declined to US dollars 1.8 billion by end 2008. The continuation of the outflow however, resulted in a significant decline in foreign reserves to US dollars 1.2 billion by March 2009. The unemployment rate, which declined to a minimum level in 2008, increased again during the first half of 2009 due to the closure and/or the downsizing of some firms as a result of the global recession.

Economic growth decelerated gradually reflecting the significant decline in international trade and decelerated domestic economic activity. There was a notable decline in the real output to 1.5 per cent in the first quarter of 2009. Despite the low interest rate environment, the growth in credit to the private sector declined significantly in 2009, mainly due to the lack of demand for loans as a result of the slowdown in economic activity and the cautious approach to lending adopted by banks amidst the uncertain environment. FDI indicated a decline as against the continuous increase recorded in recent years. Meanwhile, the fiscal sector suffered seriously with a significantly declined revenue due to the decline in imports as the country's tax base significantly depended on imports. This resulted in a higher budget deficit increasing the borrowing requirement.

This situation created uncertainties about the sustainability of the country's economy and hence, the authorities and policy makers had to respond by taking decisions with calculated risks. Accordingly, the CBSL and the government implemented coordinated and timely actions to deal with this situation.

Measures adopted by Sri Lanka

The policies that Sri Lanka pursued even before the eruption of the financial crisis and the fact that Sri Lanka's financial institutions did not trade in collateralised debt instruments, helped to minimise the direct impact of the financial crisis, particularly on the domestic financial system. Sri Lanka has been introducing prudential policies from time to time, drawing from industry best practices worldwide. Many of these policies were in line with the Basel I and subsequently the Basel II Accord, which Sri Lanka adopted to strengthen financial sector stability.

Policies that were implemented before the global financial crisis include the imposition of single borrower limits, necessity for obtaining entity rating for commercial banks from an approved credit rating agency, imposing general provision on performing loans and advances, making credit ratings mandatory for issues of all varieties of debt instruments, which exceed a certain limit, limiting commercial banks' foreign borrowings, taking measures to formalise bank supervision activities and to educate banks on the management of risks, stringent enforcement of corporate governance directions, restricting foreign ownership of Treasury bills and bonds, re-capitalisation of state banks by the government to build up public confidence in state banks, gradually building up official reserves and investing external reserves with highly rated international instruments and secure institutions.

When foreign investors were liquidating their investment in government securities, the CBSL considered that it was prudent to provide foreign exchange to the market to meet the demand and maintain exchange rate stability. In order to face such situations, the CBSL had built up its reserves when the exchange rate was floating, and adopted a number of prudential measures to ease the pressure on the exchange rate to depreciate. Accordingly, all licensed commercial banks were directed not to effect any pre-payments of import bills and obtain a 100 per cent margin on the import value for any letters of credit (LCs) opened for selected categories of imported items, while raising the existing margin deposit requirement for the importation of motor vehicles to 200 per cent. Further, forward contracts for the sale and/or purchase of foreign exchange was limited only for a period up to 180 days, and several prudential measures to limit the demand for credit for certain non-essential categories of imports were introduced with a view to preventing excessive volatility in the domestic foreign exchange market. Meanwhile, the CBSL continued to provide US dollar liquidity with a view to mitigating excessive volatility in the domestic foreign exchange market, which resulted in a shortfall in rupee liquidity. The rupee liquidity concern was addressed by reducing SRR, purchasing Treasury bills and continuously providing liquidity through Reverse Repos, which was facilitated greatly by the declining trend observed in inflation.

When the foreign reserve position became a difficult issue, particularly in early 2009, the uncertainty about the country's external position increased and many predicted a significant BOP crisis and the collapse in the entire economy. Nevertheless, identifying the importance of addressing uncertainties and achieving stability, the CBSL took a number of initiatives to strengthen the external position. These included the arrangement of swap facilities with central banks in the region to build up the reserves, execution of promotional programme on Treasury bills and bonds among the Sri Lankan Diaspora and migrant workers to encourage them to invest in Sri Lankan government securities, payment of a bonus interest on interest earned on NRFC and RFC deposits to encourage repatriation of foreign exchange earnings by Sri Lankans abroad and passing of an amendment to the Inland Revenue Act by Parliament to provide tax concessions on foreign income and profits earned through providing services to non-residents. In order to build up reserves to comfortable levels as those that prevailed in mid 2008 and build up investor confidence, a Stand-by Arrangement (SBA) facility with exceptional access was requested from the IMF. Subsequently, the IMF on 24 July 2009, approved a 20-month SBA facility of US dollars 2.6 billion, which is equivalent to 400 per cent of the country's current quota, to strengthen Sri Lanka's reserve position.

The government also introduced a Rs. 16 billion stimulus package to help the industrial sector to withstand the deteriorating external environment. Sri Lanka had taken the decision of passing-through the oil prices early. Meanwhile, the absorption of foreign exchange to strengthen foreign reserves continued.

In order to strengthen the financial sector, a number of measures were introduced, which included resolving the distress situation of a commercial bank that threatened financial system stability, safeguarding registered finance companies and restoring public confidence in the entire financial system with the timely intervention of the CBSL, and containing the emerging bubble in local financial markets by taking pre-emptive measures.

The communications policy of the CBSL was also influential in restoring confidence against uncertainties. As 2008 and 2009 were extremely challenging years, the CBSL gave high priority to the communication of its policy actions with a view to aligning the expectations of market participants with the policy stance of the CBSL and improving the efficiency of the monetary policy transmission mechanism. Hence, the communication activities of the CBSL played a pivotal role in managing expectations and speculations of different stakeholders. In particular, the communication activities were intensified to arrest the possible crisis situation while maintaining high standards and accuracy.

Summary of Major Adverse External and Internal Shocks Faced by Sri Lanka

Period	Type of Shock	Remarks
Mid 1960s	BOP crisis	The BOP crisis was triggered by low export prices and a high volume of imports. In order to maintain export competitiveness, Sri Lanka devalued the rupee on 22 November 1967. A Foreign Exchange Entitlement Certificate system was introduced in 1968 in an attempt to ease the pressure on BOP.
1973-74	First oil price shock	The BOP was adversely impacted and exchange control restrictions were tightened further. Inflation increased sharply.
1979-80	Second oil price shock	BOP and domestic prices were impacted adversely.
1983-2009	Internal conflict	The country had huge losses in terms of human lives, human suffering and economic benefits that could have been achieved during the 26 year conflict period.
1990	Gulf crisis	Sri Lanka was affected by the Gulf crisis in 1990, although it caused relatively a short period of high oil prices.
1997	Asian financial crisis	As the country's capital account was not fully liberalised, there was no significant contagion effect due to this crisis.
2001	Multiple shocks including prolonged drought, attack on Bandaranaike International Airport, September 11 attack in the USA and other issues	Sri Lanka moved to an independently floating exchange rate regime in January 2001. The economy recorded a negative growth for the first time in the post independence history.
2004	Tsunami disaster	The impact in terms of the loss of human lives, and damage to infrastructure and livelihoods was huge and the reconstruction and rehabilitation needed significant effort.
2005	End of Multi-fibre Agreement (MFA)	Larger firms were able to shape their industry with global trends. However, small and medium entreprises became vulnerable.
2007/2008	International commodity price increase	The commodity prices, including oil and food, increased to unprecedented levels causing point-to-point inflation to increase to 28.2 per cent in June 2008.
2008/2009	Global financial crisis	The investors in government securities wanted to withdraw their investments and the government made the due payments in full, without any default. Foreign exchange reserves depleted to a minimum level.
2009/2010	Global economic recession	As a consequence to the deceleration in domestic economic activities and international trade related activities, economic growth in 2009 slowed down. However, with the end to the internal conflict in May 2009, the economy recovered strongly since the latter part of 2009, which is still continuing.

Chart 3.1

Foreign Investments and Withdrawals of the Government Securities

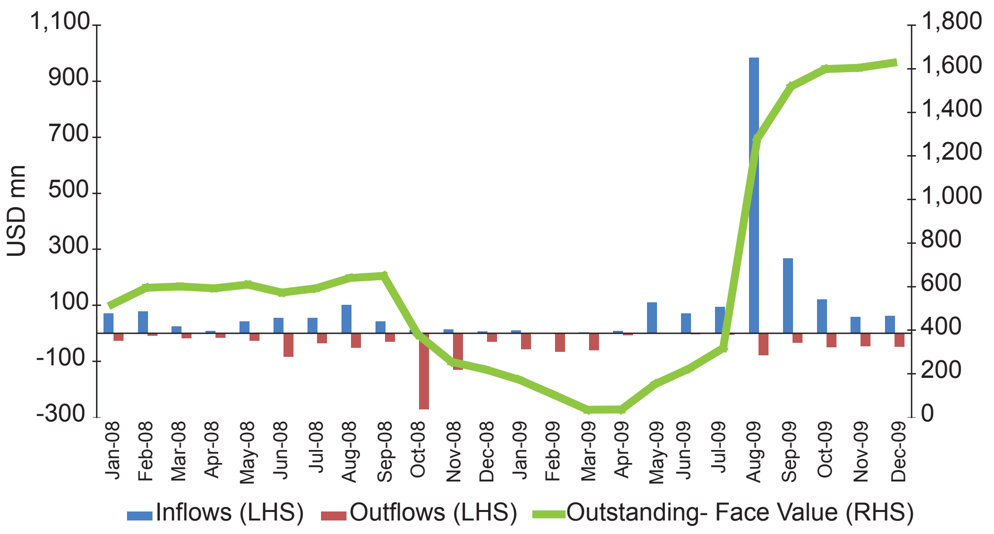
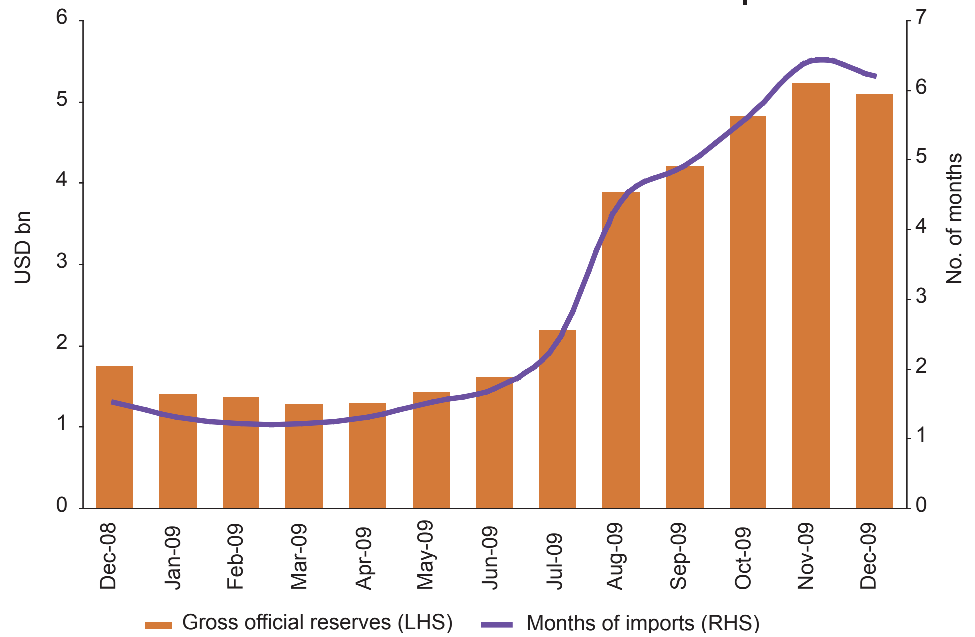


Chart 3.2

Gross Official Resrves and Months of Imports



The end to the prolonged internal conflict in May 2009 resulted in a significant turnaround of many uncertainties that prevailed in the economy. The new post-conflict environment, which had been established in the country with peace, is characterised by lower uncertainties and improved confidence about the future of the country. This has been complemented by the appropriate monetary and fiscal policies, aimed at further strengthening the newly gained improvements. The peaceful environment has been instrumental in improving investor confidence and particularly instrumental in improving the country's external position.

Conclusion

Sri Lanka has been able to maintain stability in the midst of uncertainties caused by adverse shocks that it had to face from time to time during the last 60 year period. The country has been able to achieve an average growth rate of 4-5 per cent during the last 6 decades while improving living standards of the people considerably. Among the many shocks, the most critical and challenging was the twin crises during the 2008-2010 period. When taking measures to avoid uncertainties and stay strong, the way Sri Lanka responded, particularly to the global financial crisis, reveals a number of lessons for small economies like Sri Lanka. The strengthening of the economy in good times and creating space for future flexibility, developing ability to move quickly and decisively, reading early signs of vulnerabilities in major economies, practising "Long Termism" instead of "Short Termism", using several policy initiatives and implementing them simultaneously, central banks working closely with the political authorities, and being conscious of the law of unintended consequences are among them. These would be important lessons to follow in the future as well when dealing with uncertainties to achieve stability.

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