Monetary Expansion during the COVID-19 Pandemic

The outbreak of the COVID-19 pandemic and its unprecedented impact on economies and financial markets forced central banks around the world to adopt extraordinary monetary policy measures, including unconventional policies at an unparalleled scale, to mitigate its impact on their economies and financial markets and prevent those economies from precipitating into a pandemic-driven crisis. The Sri Lankan case was no different. The spread of COVID-19 in Sri Lanka led to a nationwide lockdown during March-May 2020 sending tremors across all segments of the economy, followed by partial lockdowns and mobility restrictions with the resurgence of the pandemic in multiple waves thereafter, thus affecting the lives and livelihoods of millions. Restrictions on mobility, the closure of factories, and the halting of domestic production were set to amplify uncertainty and trigger a massive shock on domestic demand. A swift and substantial policy intervention was required to minimise the impact of the shock on the markets and the economy.

Accordingly, the Central Bank of Sri Lanka adopted a series of policy easing measures at the onset of the pandemic. With a view to reducing the cost of borrowing, the Central Bank reduced its key policy interest rates, while reducing specific lending rates through the imposition of caps as well as the introduction of special low interest rate loan schemes. Further, the reduction of the SRR, provision of required financing to the Government through the purchase of Treasury bills, and the implementation of concessional credit schemes such as the Saubagya COVID-19 Renaissance Facility infused liquidity to the domestic financial market, thereby easing strains in the financial markets, while also encouraging lending to the needy sectors of the economy. The Central Bank provided further relief to distressed businesses and individuals affected by the pandemic by implementing several debt moratoria schemes, while also supporting financial institutions through regulatory forbearance. In addition, the Central Bank continued to fulfill the currency requirements to facilitate transactions in the domestic economy and the increased precautionary demand for currency amidst pandemic-related uncertainties.

Reinforced by these stability-focused and growth-supportive measures implemented by the Central Bank, the domestic economy managed to avert a major economic catastrophe, made gradual headway, and recorded a noteworthy recovery in economic activity and sentiments. Moreover, a notable increase in the provision of low cost credit to the needy and more productive sectors of the economy was also observed, thereby further enhancing its growth prospects. The World Economic Outlook of the IMF also suggested that if not for the swift policy support globally, the severity of the global economic downturn could have been at least three times as large, which signifies the importance of policy stimuli and the possible economic loss if not for such policy support.

With economic activity around the globe gradually reaching normalcy supported by policy stimuli and the successful rollout of the COVID-19 vaccination programmes, central banks around the globe have signalled the need to tighten monetary policy, with some already having taken measures to rollback the support extended since the onset of the pandemic. In the same vein, the Central Bank of Sri Lanka, having observed the gradual normalisation of domestic economic activity and the resultant buildup of demand driven inflationary pressures in the future, allowed monetary conditions to tighten since mid 2021 and signalled the end to its easing monetary policy stance in mid August 2021 by raising its key policy rates, while raising the SRR with effect from 01 September 2021. Furthermore, the maximum yield rates for acceptance at primary auctions of government securities were also removed mid September 2021 onwards, allowing yields on government securities to adjust and be market-determined, while also limiting the need for the Central Bank's purchases of Treasury bills at the primary market auctions. In addition, the Central Bank has continued to conduct overnight and term repurchase (repo) auctions amidst deficit liquidity levels in the domestic money market with a view to maintaining the prevailing tight monetary conditions. Lastly, having identified the need to rollback the notable levels of financing extended to the Government during the pandemic, the Central Bank would work towards gradually unwinding such monetary stimulus as enunciated in '*The Six-Month Road Map for Ensuring Macroeconomic and Financial System Stability*', with a view to preserving macroeconomic and financial system stability without affecting the ongoing recovery of the domestic economy.