THE ROLE OF POLICY REFORMS IN ACHIEVING A SUSTAINABLE ECONOMIC BOUNCE-BACK

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What is your overview of the current state of the Sri Lankan economy?

The economy is experiencing its largest economic contraction in the post-independence period, resulting from heightened macroeconomic instabilities, particularly on the fiscal and external fronts, which culminated in an economic crisis. Although the economy was on a recovery path after the COVID-19-induced contraction, with the onset of an unprecedented economic crisis owing to fuel shortages, power outages, widespread scarcity of key imported raw materials and other essentials, and the soaring cost of production, the economy contracted by 7.1 percent during the first nine months of 2022, compared to a growth of 3.8 percent in the corresponding period of 2021. The combined effect of shortages in raw materials amidst tight foreign exchange liquidity, volatility in commodity prices, vulnerabilities

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in power and energy sectors, as well as the tightening of both monetary and fiscal policies are expected to weigh down the economic performance during 2022. However, concerted policy measures implemented by the Central Bank and the Government along with demand management strategies have supported in smoothening the supply of essentials, including fuel, pharmaceuticals, and fertilizers, and curtailed the economic and social issues to a great extent, resulting in some improvement in overall economic activity, while inflation also has been following a disinflation path since October 2022. Meanwhile, economic activity is expected to remain subdued in the first half of 2023 owing to lingering effects of ongoing macroeconomic vulnerabilities in the economy, notable upward adjustments to domestic tax structure, and a possible slowdown in the global economy due to monetary policy tightening by major central banks around the world to arrest inflationary pressures as well as geopolitical fragmentations. Considering the envisaged progress that has been made thus far in relation to the Extended Fund Facility (EFF) arrangement from the International Monetary Fund (IMF) and debt restructuring negotiations along with the policy priorities to address structural issues in the country would expect to support the transition of the economy to a sustainable recovery path in the period ahead.

As far as you think, what are the main factors contributing to the current crisis and the resultant hardships?

The current economic crisis is a culmination of several deeply entrenched structural problems, particularly the twin deficit in the Government budget and external current account. Persistently limited fiscal space, which was further constrained by the changes introduced to the tax structure in late 2019 resulted in the downgrading of sovereign credit rating and thus restricted access to international capital markets. Most of the State-Owned Enterprises (SOE) in the country tend to be straddled by low productivity while distorting competition and being afflicted by corruption. This has resulted in them being a significant burden on the budget and the government, while also burdening the financial system. Low levels of liquidity in the domestic foreign exchange market owing to a delayed recovery in tourism earnings, slow conversion of export proceeds, increase in import expenditure as well as unfavorable market conditions led by several sovereign downgrades led to a foreign exchange crisis thereby resulting in many hardships to the public. The sudden disastrous switch to organic farming in 2021 led to serious impacts on the country's economy and food security. Further, external factors have compounded the catastrophe, including the COVID-19 pandemic. Mobility restrictions and other containment measures imposed locally and internationally, intending to prevent the spread of COVID-19, hampered real economic activity across all sectors. Further, escalation in global commodity prices, including food and energy mainly due to geopolitical tensions in the Eastern Europe region also affected the Sri Lankan economy to a greater extent.

"THE CURRENT ECONOMIC CRISIS IS A CULMINATION OF SEVERAL DEEPLY ENTRENCHED STRUCTURAL PROBLEMS, PARTICULARLY THE TWIN DEFICIT IN THE GOVERNMENT BUDGET AND EXTERNAL CURRENT ACCOUNT. PERSISTENTLY LIMITED FISCAL SPACE, WHICH WAS FURTHER CONSTRAINED BY THE CHANGES INTRODUCED TO THE TAX STRUCTURE IN LATE 2019 RESULTED IN THE DOWNGRADING OF SOVEREIGN CREDIT RATING AND THUS RESTRICTED ACCESS TO INTERNATIONAL CAPITAL MARKETS. MOST OF THE STATE-OWNED ENTERPRISES (SOE) IN THE COUNTRY TEND TO BE STRADDLED BY LOW PRODUCTIVITY WHILE DISTORTING COMPETITION AND BEING AFFLICTED BY CORRUPTION"

What is the role of the Central Bank of Sri Lanka during the economic and business normalcy in Sri Lanka?

The Central Bank's mandate is to maintain economic and price stability and maintaining financial system stability, to encourage and promote economic development. Price stability or stable prices means maintaining low and stable inflation levels over the period. With stable prices, both the consumers and producers can make decisions with confidence and hence the economy can perform well. Such an

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environment allows an economy to achieve its growth potential and fosters high employment. In other words, Central Bank mainly focuses on maintaining price stability that promotes sustainable long-term economic growth and employment.

Financial system stability means the effective functioning of financial institutions and financial markets and the absence of banking, currency, and balance of payments crisis. A stable financial system creates a favorable environment for both depositors and investors, encourages efficient financial intermediation and the effective functioning of markets, and hence, promotes investment and economic growth. In order to have a stable financial system, a stable macroeconomic environment, an effective regulatory and supervisory framework, well-organized financial markets, sound financial institutions, and safe and robust payments infrastructure are imperative.

In the context of the prevailing high inflationary environment, to counter rising inflationary pressures and anchor inflation expectations, the Central Bank has taken necessary and preemptive measures. In 2022, the Central Bank tightened monetary and liquidity conditions to an unprecedented level. Such a strong monetary policy response was necessitated to provide a signal to the economy that the Central Bank is committed to curtailing inflation, which is extremely necessary to anchor inflation expectations. Since the inception of monetary tightening measures in August 2021, the Central Bank's key policy interest rates, have been raised by 10 percentage points, while the Statutory Reserve Ratio (SRR) applicable on all rupee deposit liabilities of Licensed Commercial Banks (LCBs) was also raised by 2 percentage points in September 2021. The increase in policy interest rates and the subsequent passthrough to market interest rates along with other measures, including the impact on disposable income due to the proposed tax revisions and the restrictions on non-urgent imports have already caused demand pressures to ease as reflected by the easing of inflationary pressures. We have already seen that inflation is now on a steady disinflation path as the Colombo Consumer Price Index (CCPI, 2013=100) based headline inflation (year-on-year), which peaked in September 2022, recording an unprecedentedly high level of 69.8 percent, moderated to 66.0 percent in October 2022 and 61.0 percent in November 2022.

The financial sector has also encountered notable challenges in

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the face of the current economic environment with the contraction in economic output, sovereign debt restructuring, high-interest rate environment, tax revisions, and high exposure of the banking sector to the Government and state-owned business enterprises (SOBEs). The Central Bank rigorously monitors and implements required measures to ensure the continued stability of the banking sector as well as the non-bank financial sector. To spearhead the economic recovery process with the Government, the Central Bank contributes to the negotiations with the IMF for an EFF arrangement with the intention to restore macroeconomic stability and debt sustainability.

What are the required policy reforms to rebuild the country from your point of view?

Correcting fiscal imbalances while making public debt sustainable is a priority to rebuild the economy. Fiscal consolidation, i.e., the policies undertaken by the Government to reduce the budget deficit and the accumulation of debt, would make the public debt more sustainable, thus providing the country with much-needed space to engage in productive economic activity. Domestic production, which is the main driver of economic growth, should be encouraged with appropriate policy reforms. Further, export-led growth strategies should also be introduced to suppress the pressures on the external sector, while contributing to overall growth. In this regard, means of building external buffers, improving technology, improving market access, and encouraging foreign investments should be explored. Many of the State-Owned Business Enterprises (SOBEs) in Sri Lanka are experiencing inefficiencies that lead to huge financial losses. The poor performance of SOBEs has put pressure on government expenditure, which eventually gets transmitted to an economic cost. Accordingly, policy reforms focusing on financial independence, autonomy, cost-reflective pricing structures, the institutionalization of good governance, accountability mechanisms, and notable productivity enhancement are needed to ease the burden on government expenditure, thereby improving value creation for the economy.

The required legislative changes to labor market laws and business regulatory reforms are important to promote and expand businesses contributing to the economic recovery process. Further, it is necessary to strengthen the legal framework to ensure public accountability of state institutions, while ensuring policy coherence. In

> A CONTINUOUS INCREASE IN PRICES COULD ERODE THE REAL VALUE OF PEOPLE'S INCOMES AND SAVINGS, THUS REDUCING THEIR PURCHASING POWER. THEREFORE, FIGHTING INFLATION HAS BEEN AT THE FOREFRONT OF THE POLICY OBJECTIVES OF THE CENTRAL BANK, AND MONETARY POLICY FORMULATION IN THE RECENT PAST HAS BEEN DONE WITH A VIEW TO ACHIEVING THIS OBJECTIVE

terms of legislative changes, the Cabinet of Ministers recently approved the new Central Bank Act, which would improve the independence, transparency, and autonomy of the Central Bank and its operations. International solidarity, corporation, and global partnerships are important to the development of a country. Such cooperation with the international community, which eliminates structural barriers, would create a conducive setting for cross-border interactions aimed at sustainable global development. Maintaining financial system stability facilitates efficient financial intermediation while building confidence among the business community and the investors. Thus, policy reforms aiming at strengthening the financial system stability would create a conducive environment for investors that in turn stimulates investments and economic growth. Uncertain policies, and inefficiencies in institutions and administration, including corruption, malpractices, and coordination issues, continue to prevent Sri Lanka from having a business environment that is favorable for investments. Accordingly, policy reforms should focus on correcting such long-term impediments, thus improving investor confidence on a sustainable basis. The cost of failing to protect the poor and vulnerable would be far greater to society in the medium to long run. Hence, policy reforms should also look at the most vulnerable and poor population in the country, especially in the current economic condition. A strong social safety net system would protect the poor and vulnerable in their time of need, thereby allowing them to participate in economic activity, once the growth-oriented policy reforms are operational.

What are the measures you have been implementing so far, to ease the burden of the current economic hardships on the people?

From the general public's perspective, inflation is 'public

enemy number one'. A continuous increase in prices could erode the real value of people's incomes and savings, thus reducing their purchasing power. Therefore, fighting inflation has been at the forefront of the policy objectives of the Central Bank, and monetary policy formulation in the recent past has been done with a view to achieving this objective. Accordingly, the Central Bank has been maintaining an unprecedentedly tight monetary policy stance to contain the buildup of demand-driven inflationary pressures in the economy, while anchoring inflation expectations. A tight monetary policy stance coupled with the anticipated improvements in supply conditions are expected to play a key role in bringing down inflation to low and stable levels over the medium term, thereby helping ease the burden of high inflation on the public. The Central Bank is aware of the impact of tighter monetary conditions on overall economic activity, including the hardships on micro, small, and medium-scale businesses. Therefore, intending to address concerns raised by parties affected by the current financial hardships, the Central Bank requested licensed banks to grant concessions to the affected borrowers by devising suitable repayment arrangements for outstanding loans.

Further, the Central Bank noted a disproportional increase in market interest rates, particularly deposit interest rates and short-term lending interest rates, which could adversely affect businesses and individuals. Therefore, the Central Bank communicated to the banks that it expects a moderation of excessive market interest rates, consistent with the prevailing policy interest rates, supported by the current macroeconomic developments. Such a reduction in excessive market interest rates would help ease the burden of high financing costs. Meanwhile, the Central Bank has facilitated the importation of essential goods, by bridging the liquidity shortfall in the domestic foreign exchange market, thereby ensuring the continued availability of fuel, LP gas, coal, medicine, fertilizer, and other supplies to the public. Moreover, arrangements are in place to secure an uninterrupted supply of such essential commodities in the period ahead as well. The exchange rate remained broadly stable, supported by the market guidance offered by the Central Bank since mid-May 2022, and measures are taken to improve the availability of liquidity in the domestic forex market. The stabilization of the exchange rate has minimized a further escalation of imported inflation due to the passthrough of further depreciation of the exchange rate. Further, exchange rate stability has re-established some level of market confidence, thereby eliminating certain uncertainties surrounding the business and economic outlook.

In the meantime, the Central Bank has been providing financial support to the government amid a shortfall in government revenue and limited access to foreign financing sources. Such monetary financing helped ease pressures on government cashflow operations to some extent and enabled the Government to settle payment obligations, including recurrent expenditures, such as salaries of public servants, pensions, etc. However, the envisaged revenue-based fiscal consolidation program, along with the rationalization of government expenditure, is expected to lower the monetary financing requirement in the period

In your opinion, what are the different mechanisms that can be implemented to attract FDIs?

Sri Lanka has not been able to attract FDIs up to the expected levels as well as compared to regional peers, even during the post-war period, due to structural and policy issues. FDI including foreign loans to Direct Investment Enterprises amounted to US dollars 404 million in the first half of 2022. On a sector-wise basis, major FDIs were received by projects related to telecommunications, property development, rubber products, chemicals, textiles, and hotel sectors. In the Budget for 2023, it has been proposed to set up a single agency enabling the creation of a conducive environment for promoting investment and external trade. Accordingly, a new agency is to be set up in place of the Board of Investment, Export Development Board, Sri Lanka Export Credit Insurance Corporation, National Enterprise Development Authority, etc., with the enactment of a new law. Increased FDIs are expected in the period ahead supported by enhanced investor confidence once the Executive Board of the IMF approves the EFF arrangement. To sustain a healthy momentum of FDI over the medium term, there is a dire need to maintain policy consistency, improve doing business conditions, strengthen institutions, uphold the rule of law, and establish institutions for effectively expediting the approval and implementation processes to facilitate FDI. Modifying labor and land laws to be more flexible, and establishing a well-structured and competitive legal, tax, regulatory, and dispute resolution mechanism would also facilitate attracting FDIs.

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. It is

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imperative to expeditiously implement the legal and operational framework outlined in the Colombo Port City Economic Commission Act to attract FDIs to this project. Other areas that need improvement in attracting FDIs include strengthening coordination and monitoring mechanisms to facilitate and promote investments, while identifying key areas on investments in production, export, and energy sectors, and promoting such investment options among prospective investors.

In your opinion, what are the measures that can be taken to improve foreign earnings?

Sri Lanka reached a staff-level agreement in early September 2022 with the IMF for an economic adjustment program under the EFF of about US dollars 2.9 billion. The staff-level agreement is subject to the approval by the Executive Board of IMF in the period ahead, contingent on the implementation by the authorities of prior actions, and on receiving financing assurances from Sri Lanka's official creditors. Therefore, all efforts need to be in place to complete this process at the earliest, as it would provide the much-needed confidence for investors and forex earners to remit funds to Sri Lanka. The Central Bank imposed mandatory conversion requirements on export proceeds and directed banks to sell a part of the converted export proceeds and workers' remittances to the Central Bank. The Central Bank and the Government also implemented several measures to encourage workers' remittances during the year. At the same time, taking into consideration the dearth of foreign exchange liquidity in the market, the Central Bank provided financing support facilitating the importation of essential imports, including that of fuel and coal, through the foreign exchange mobilized through the mandatory sale of workers' remittances and export proceeds by LCBs in 2021 and 2022.

Further, the Central Bank has established a fuel-sinking fund that will be funded by foreign exchange absorbed from the banking system to further facilitate the importation of fuel and coal to help energy security. The government and the Central Bank have appealed to the international community and diaspora for humanitarian assistance and to finance essential imports through a fund. It is imperative to explore bridging finance options to seek bilateral and multilateral assistance or negotiate credit lines for the procurement of essentials. Discussions with the World Bank, the Asian Development Bank, the Asian Infrastructure Investment Bank, and the Government to Government (G-to-G) bilateral negotiations are currently underway. In relation to long-standing structural issues, 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 decades. Although the trade-in services account and secondary income account, which comprises workers' remittances, recorded surpluses, these surpluses were not adequate to cushion the impact of merchandise trade and primary income account deficits on the external current account. Therefore, any effort in addressing the current account deficit should be focused on strategies in reducing the trade deficit while increasing services exports.

"SRI LANKA REACHED A STAFF-LEVEL AGREEMENT IN EARLY SEPTEMBER 2022 WITH THE IMF FOR AN ECONOMIC ADJUSTMENT PROGRAM UNDER THE EFF OF ABOUT US DOLLARS 2.9 BILLION. THE STAFF-LEVEL AGREEMENT IS SUBJECT TO THE APPROVAL BY THE EXECUTIVE BOARD OF IMF IN THE PERIOD AHEAD, CONTINGENT ON THE IMPLEMENTATION BY THE AUTHORITIES OF PRIOR ACTIONS, AND ON RECEIVING FINANCING ASSURANCES FROM SRI LANKA'S OFFICIAL CREDITORS. THEREFORE, ALL EFFORTS NEED TO BE IN PLACE TO COMPLETE THIS PROCESS AT THE EARLIEST, AS IT WOULD PROVIDE THE MUCH-NEEDED CONFIDENCE FOR INVESTORS AND FOREX EARNERS TO REMIT FUNDS TO SRI LANKA"

Therefore, measures should be taken to increase the earnings from merchandise exports, while continuing with measures of curtailing non-essential imports. Product diversification through vertical and horizontal integration, participation in product sharing networks and global value chains through component manufacturing as well as reducing the over-reliance on a few advanced markets as export destinations by exploring new markets could be considered as initiatives to enhance export earnings over the medium term.

In addition, Sri Lanka has not been able to attract non-debt-creating foreign financial flows, such as FDI up to the expected levels as well as compared to regional peers, even during the post-war period, due to structural and policy issues related to FDI. The prevailing weak investment climate in Sri Lanka can be attributed to a range of factors including policy uncertainty, restrictive labor regulations, lack of progress in ease of doing business, inconsistencies in the protection of property rights, further room for strengthening law and order, bureaucratic delays and inefficiencies, and so forth. It is imperative to address these issues expeditiously to attract substantial levels of FDI in productive and tradable sectors over the medium term.

According to your point of view, who are the key stakeholders who should come forward to play a major part in this rebuilding stage?

In the near-term economic stabilization stage, support from the multilateral development banks (MDBs) is part and parcel. Once the stabilization is ensured, all efforts need to be driven toward rebuilding the economy on a sustainable footing. Rebuilding the economy through overcoming current economic woes and distresses requires substantial and concerted efforts from all stakeholders of the economy including the Government and policymakers, regulatory bodies, government authorities, financial institutions, corporates, industrialists, small and medium-scale enterprises, and as well as the general public. Policymakers' unwavering commitment to implementing consistent policy reforms in a timely, holistic, and efficacious manner is imperative to ensure recovery from the economic slowdown. Further, to address the rooted structural issues, offer essential support to the general public, and move toward sustained stability, the cooperation of the government institutions during the arduous transition process will also be required.

The commitment of the industrialists to move towards high-value-added products and targeting their products on the export market to enable transform transformation of the economy into an export-oriented manufacturing economy focusing on the use of local raw materials will be vital for the recovery of the external sector and to strengthen and improve the resilience of the economy.

Further, active engagement, participation, awareness, and forbearance of the general public as well as all other economic stakeholders, micro and macro alike, are imperative to undertake long overdue reforms, which will be critical to ensure that the country not only recovers from the ongoing crisis but also to prevent any similar crises in the period ahead and progress towards growth in the medium to long term. The crisis, however, is an opportunity to implement long-outstanding structural reforms. Some of the difficult reforms, such as tax reforms and SOE reforms, have already been initiated in the past several months. It is important to continue these initiatives with the support from all stakeholders having a continuous dialogue among them to ensure the sustainability of such actions.

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