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Hon. Mahinda Rajapaksa
Prime Minister and Minister of Finance
Ministry of Finance
The Secretariat
Colombo 01

Honourable Prime Minister,

Report to the Hon. Minister of Finance as required under Sections 64 and 68 of the Monetary Law Act

Copy issued to
Prof. W. D. Lakshman

As the Honourable Prime Minister is aware, and as detailed in my previous reports under Sections 64 and 68, the Sri Lankan economy is undergoing a challenging period, with a need to support the rebound of economic growth on the one hand, and a need to maintain macroeconomic stability on the other. This challenge has been further exacerbated by the effects of the third wave of the COVID-19 pandemic, currently impacting Sri Lanka.

Complementing the Government's stimulus measures introduced to help the people and businesses, the Central Bank of Sri Lanka maintained an unprecedented scale of monetary accommodation to ensure adequate liquidity in the domestic money market at an affordable cost, thereby supporting a faster recovery of economic activity. This resulted in an inevitable expansion in the money supply from July 2020 onwards.

Further, the pandemic situation exacerbated the vulnerabilities in the external sector, with the loss of earnings from tourism as well as certain other exports of goods and services and the slowdown of investment inflows. The access to international financial markets has also been restricted consequent to the sovereign credit rating downgrades. Despite the downgrades, Sri Lanka has continued to maintain its unblemished record of

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foreign debt servicing. There was a significant decline in gross official reserves (GOR), but not to the full extent of the debt repayments.

We are pleased to note that the Government was able to enact the Colombo Port City Commission Bill with an overwhelming majority. The effective implementation of the Port City project would help immensely to strengthen investor confidence to attract foreign investments, and increase economic activity and generate employment opportunities.

Given this background, this report apprises the Honourable Prime Minister of the evolving challenges to monetary stability and the possible decline in international reserves to critical levels, while highlighting the remedial actions that have been taken, and the need for further action to strengthen the stability of the Sri Lankan economy. By so doing, this report aims to fulfill the statutory requirement under Sections 64 and 68 of the Monetary Law Act.

External Sector Conditions, Challenges and Remedial Measures

With respect to the external sector, many vulnerabilities that were highlighted to the Honourable Prime Minister in my previous correspondence still remain, mainly due to limited foreign exchange inflows to the country. Earnings from tourism have declined to negligible levels compared to the annual average of around US dollars 3.7 billion in the five-year period from 2015 to 2019. Further, since the outbreak of the pandemic in March 2020, net outflows of foreign investment from the government securities market and the secondary market of the Colombo Stock Exchange for the period from March 2020 to May 2021 have been around US dollars 467 million and US dollars 383 million, respectively. Further, despite the access to international capital markets being shut down with global developments and Sri Lanka's sovereign rating downgrades, Sri Lanka has continued to service all its foreign debt service obligations on time. The Government and the Central Bank repaid around US dollars 6.7 billion of foreign currency denominated external and domestic debt (including domestic SWAPs) in 2020. So far in 2021, the Government and the Central Bank have repaid around US dollars 3.9 billion of foreign currency debt obligations. Primarily as a result of these foreign currency debt service obligations, the GOR level has come down to US dollars 5.7 billion at end 2020, declining further to an estimated US dollars 4.0 billion at end May 2021. This level is equivalent to 2.7 months of imports compared to the international standard of a minimum of 3.0 months of imports.

In the above context, since the onset of the local outbreak of the COVID-19 pandemic, several measures were taken by the Government and the Central Bank to stabilise the external sector, as outlined below.

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a. Imposing restrictions on the importation of non-essential goods helped ease the pressure on the exchange rate and the balance of payments (BOP) to a great extent. The reduction in expenditure on items subject to import restrictions accounted for about 35 per cent (approximately US dollars 1.3 billion) of the decline in overall import expenditure during the period from April 2020 to March 2021 when compared with the corresponding period of 2019/2020.

b. Further, a number of measures, including the reimposition of suspension of purchase of Sri Lanka ISBs by licensed banks (LBs) and removal of short term foreign currency borrowing limits of the LBs were executed recently under the Banking Act. The Central Bank also directed all LBs to refrain from entering into forward market contracts other than interbank forward market transactions in the domestic foreign exchange market. Moreover, the Central Bank is considering the extension of restrictions on certain identified capital transactions, such as reduction in the maximum limit on migrant transfers, under the Foreign Exchange Act.

c. Following the Government's initiative to pay additional Rs. 2 per US dollar for workers' remittances converted at LBs, the Central Bank instructed all LBs to sell 10 per cent of such remittances converted to Sri Lankan rupees, to the Central Bank with effect from 27 January 2021. Further, the Central Bank imposed a rule on 18 February 2021 that all exporters of goods shall receive the export proceeds in Sri Lanka within 180 days from the date of shipment and convert 25 per cent of such export proceeds to Sri Lankan rupees (which was reduced to 10 per cent on 16 April 2021), of which 50 per cent is to be sold by LBs to the Central Bank. However, these two requirements, which required the LBs to sell foreign exchange to the Central Bank with respect to conversions of workers' remittances and exports proceeds, were temporarily suspended with effect from 17 March 2021, in order to ease the liquidity pressure experienced by the banks. Considering the prevailing liquidity conditions in the domestic foreign exchange market, on 28 May 2021, the Central Bank reverted to the conversion percentage of export proceeds to 25 per cent and directed the LBs to sell 10 per cent of converted exports proceeds to the Central Bank. Also, the Central Bank reimposed the requirement to sell 10 per cent of converted remittances to Sri Lankan rupees at LBs, to the Central Bank.

d. Furthermore, given the Government's stance not to approach the International Monetary Fund (IMF) for emergency financing and in recognition of the long overdue need to strengthen the real sector of the economy, the Central Bank has been actively working with the Government to facilitate enhancing non-debt sources of foreign exchange inflows. For this purpose, several committees have been established with the participation of public and private stakeholders in the broad merchandise exports sector, apparel sector, tea, rubber, and coconut

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sectors, gem and jewellery sector, fisheries, spices and minor exports crop sectors, tourism sector, IT sector, and also with stakeholders involved in foreign employment and remittances as well as direct and portfolio investment.

e. A number of further policy proposals on the external sector were also proposed by the Central Bank from time to time for the consideration of Honourable Prime Minister and the Government. These proposals include, further rationalisation of import expenditure to discourage non-essential imports through direct controls and increased taxes as well as imposing cash margin requirements on Letters of Credit (LC).

Several positive developments have also occurred in the external sector. These include entering into the SWAP agreement with the People's Bank of China, the receipt of foreign loan proceeds of US dollars 500 million from China Development Bank (CDB) and a further approval for the receipt of yuan denominated foreign loan equivalent to around US dollars 300 million from CDB. These developments have prevented gross official reserves from diminishing below US dollars 4 billion so far in 2021. Further, the Central Bank has been able to secure the agreement for an international SWAP arrangement of US dollars 250 million with the Bangladesh Bank. This is currently being finalised and will be available soon. In addition, the enactment of the Colombo Port City Act would help strengthen investor confidence while creating positive sentiments in terms of foreign direct investments. Moreover, further measures are being pursued to improve investor confidence, including opportunities opened up for the private sector.

However, despite the above measures implemented to revive the external sector, several key risks still remain.

a. The GOR level has declined significantly over the past five months in 2021 and is likely to decline below the critical levels to around US dollars 2.5 - 3.0 billion by end July 2021, with the scheduled repayment of the International Sovereign Bonds (ISBs) of US dollars 1 billion among other debt service requirements, if the current plans to secure foreign funding fall to materialise.
b. The third wave of the pandemic and the spread of COVID-19 in source countries are expected to result in a further delay of the revival in the tourism sector.
c. The gradual withdrawal of foreign investments from the government securities market and the Colombo Stock Exchange (CSE) since the first wave of the pandemic is continuing, albeit at moderate levels. As a result, outstanding foreign investments in government securities currently remain at a negligible level. However, Port City related developments are likely to reverse this trend by attracting sizeable foreign currency inflows into the country going forward.
d. Prior to the third wave of the pandemic, there were signs of increasing import expenditure, particularly in the months of March and April 2021. Import

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expenditure amounted to US dollars 1,926 million in March 2021, compared to US dollars 1,524 million in February 2021 and US dollars 1,205 million in March 2020. Further, based on provisional customs data, import expenditure in April and May 2021 amounted to US dollars 1,707 million and US dollars 1,477 million, respectively. Import expenditure could rise in coming months with the containment of the third wave of the pandemic as well as increased global crude oil prices.

e. Earnings from merchandise exports have not recorded a notable growth in the first few months of 2021. Based on provisional customs data, merchandise exports amounted to US dollars 818 million in April 2021 and US dollars 884 million in May 2021. The export level of US dollars 1,094 million in March 2021 was not matched in subsequent months. Further, Sri Lanka's access to the Generalised System of Preferences (GSP+) facility from the European Union could be at risk with the recent resolution adopted by the European Parliament, calling for a temporary suspension of the facility. If this happens, Sri Lanka's export performance could be further weaken at least in the near term.

f. Despite the continuation of the pandemic in the Asian sub-continent, economic activity in the United States, Europe as well as in China is expected to recover with the successful vaccination programmes in these countries. Hence, it is likely that the global oil prices will increase in the short to medium term. This is likely to increase import expenditure on petroleum. Hopes of improving trade deficit in 2021 do not appear promising with these developments.

g. The exchange rate remained relatively stable particularly after the receipt of the loan proceeds from CDB largely due to heavy moral suasion by the Central Bank, but remains under depreciation pressure due to the lack of foreign exchange liquidity in the domestic foreign exchange market. Further, supply of foreign exchange to the domestic foreign exchange market by the Central Bank may be required to curb any undue volatility in the exchange rate. This is not viable given the current low level of reserves.

h. The major concern related to the external sector is the sizable foreign currency debt service obligations of the Government, including capital and interest payments of US dollars 6.3 billion during 2021 (including Sri Lanka Development Bonds (SLDBs) and Offshore Banking Unit (OBU) loans of US dollars 2.2 billion). Out of this, further US dollars 3.7 billion is to be paid in the remainder of the year, with the major debt servicing of US dollars 1 billion in July 2021 for the maturing ISB. However, out of the maturing ISBs in July 2021, around US dollars 300 million is held by domestic banks, of which a substantial portion is expected to be invested in SLDBs. In addition, the foreign currency debt service obligations of the Central Bank, which include domestic SWAPs and

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payments to the IMF, are projected at US dollars 1.9 billion in 2021, of which around US dollars 600 million is to be paid during the remainder of 2021.

i. Even with the expected receipt of an IMF SDR allocation, international SWAPs with the Reserve Bank of India and the Bangladesh Bank and the remainder of the foreign loan from CDB, the reserves are projected to remain at the critically low level of around US dollars 3.7 billion by end 2021. However, if the ongoing negotiations with Bank of China to secure a SWAP facility would be successful, conditional on the progress of Sri Lanka's trade with China in Chinese yuan, end 2021 reserve level could increase to above US dollars 4 billion.

j. By way of an advance warning, it is the duty of the Monetary Board to keep the Honourable Prime Minister informed of debt service obligations falling due in 2022. There are Government foreign currency debt service obligations of around US dollars 6.6 billion (also including OBU loans and SLDB maturities) in 2022. Of the total, US dollars 3.0 billion (including SLDBs and OBUs payments) are falling due in the first quarter of 2022, including an ISB repayment of US dollars 500 million in January, regular foreign loan repayments of US dollars 585 million, interest payments of US dollars 435 million, SLDB maturities of US dollars 942 million and capital repayments of OBU loans of US dollars 550 million. Significant foreign exchange inflows have to be secured, to maintain reserves in 2022.

Considering these developments, further significant policy measures are needed to address the current vulnerabilities in the external sector, which have also been discussed with the Honourable Prime Minister recently. These suggestions can be summarised as below:

a. Maintaining the restrictions imposed on imports is needed as an urgent short-term solution for at least some selected items as highlighted previously to mitigate the pressure on the exchange rate and the BOP, and prevent financial market panic. So far Sri Lanka has achieved these objectives to some extent and these restrictions may need to be continued so long as Sri Lanka suffers from severe BOP difficulties and the uncertainty of the third wave of the pandemic.

b. Measures to discourage non-essential imports including increasing taxes on imports and introducing appropriate LC margins.

c. Further, it is requested from the Government to take urgent action to secure at least US dollars 1 billion through high level government intervention at the earliest, which would support the ongoing efforts to prevent the decline in reserves. The recent improvement in secondary market yields of Sri Lankan ISBs as well as the interest shown by the Middle Eastern and Chinese financial institutions need to be utilised by the Government to raise foreign resources, thus reducing the severe pressure on the external sector of the economy as well as the monetary sector. Moreover, expediting efforts to obtain foreign investment to the Port City project would support enhancing non borrowed resources.

Monetary Conditions, Challenges and Remedial Measures

With the outbreak of the COVID-19 pandemic and its rapid spread denting the entire economy, including a significant drop in government revenue and a sharp increase of current expenditure to help affected businesses and people, the Central Bank was compelled to take unprecedented measures to ease monetary conditions to support individuals, businesses and the Government. Such intervention forestalled the economy from running into a full blown economic and financial crisis, as well as a social upheaval. This process has ultimately led to the unavoidable expansion of money supply since mid-2020 through April 2021, at a rate exceeding fifteen per cent, year-on-year.

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The latest available data reveal that the expansion of broad money supply (M_{2b}) continued to remain high, recording a growth of 20.4 per cent, year-on-year, by end April 2021, despite the moderation observed during the month compared to the growth of 21.5 per cent, year-on-year, recorded in March 2021. Contributing to such expansion of broad money supply was the rapid expansion of credit to the public sector as well as the private sector, extended with the view of supporting the economy impacted by the pandemic. The increased reliance by the Government on bank funding to meet its funding requirements led to the substantial increase in net credit to the Government (NCG) from the banking system during the period from January to April 2021. Accordingly, NCG increased by Rs. 417.0 billion during this period, in addition to the substantial increase of Rs. 1,752.1 billion recorded in 2020. The increase in NCG thus far during the year remains above the Government's expected borrowing from the banking system of Rs. 319 billion for 2021, as estimated in the Budget 2021. The expansion of credit obtained by state-owned business enterprises (SOBEs) from the banking system remained high at Rs. 91.2 billion during the first four months of the year. In addition, the pace of expansion of credit extended to the private sector continued in April, with a cumulative expansion of Rs. 275.0 billion during January-April 2021, compared to the increase of Rs. 374.1 billion during 2020. This indicates that the appetite for credit for the private sector is picking up with improving economic conditions. In this context, a gradual reduction in bank borrowing by the public sector is desirable.

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Due to the continued subdued market participation at government securities' auctions at the published maximum yield rates for acceptance, the Central Bank was compelled to continue purchasing sizable amounts of Treasury bills from the primary market during the months of April and May 2021 as well, with a view to fulfilling the Government's financing needs. Therefore, the Central Bank's holding of government securities, which remained at Rs. 725.2 billion at end 2020 and Rs. 74.7 billion at end 2019, increased to Rs. 888.7 billion (on face value basis) by end April 2021, before coming down to Rs. 856.6 billion by end May 2021 due to the maturity of government securities held by the Central Bank. Accordingly, the share of Central Bank's holding remained high at 45.2 per cent of the outstanding stock of Treasury bills issued by the Government, compared to that of 8.3 per cent at end 2019. Such intervention has resulted in an unprecedented increase in domestic assets of the Central Bank while the transfer of distributable profits of the Central Bank in its entirety to the Government in March 2021 has caused a reduction in equity (which includes reserves). This could give rise to severe macroeconomic imbalances if continued unrelentingly while weakening the financial strength of the Central Bank thereby limiting its capacity to intervene in the future, should the need arise. While the provision of monetary financing to the Government in order to meet essential expenditure, such as pandemic related emergency spending, may be unavoidable, and in fact necessary, the use of monetary financing for other non-urgent expenditure could lead to serious repercussions on monetary stability in the period ahead. As an initial measure to address this concern, the Monetary Board noted that the efforts may be required to limit fresh borrowing by the Government to rollover only the capital component of government securities at maturity while utilising the cashflow to repay the interest component. Such an arrangement is essential to prevent the continued buildup of the country's debt burden.

The Central Bank has continued to maintain its accommodative monetary policy stance with a view to providing the required support towards the faster recovery of the economy. However, the increased Government borrowing requirement and the resultant borrowing from the banking system have led to the buildup of upward pressure on yields on government securities. Moreover, excessive government borrowings from state banks have led them to increasingly borrow from the interbank market, creating upward pressure on short term market interest rates. Going against the relaxed monetary policy stance of the Central Bank, these developments are likely to dilute the effectiveness and the potential benefits that the economy could have obtained from such accommodative monetary policy. Raising of external financing for the Government, at least to a limited extent, could ease the pressure on the domestic financial resources and interest rates as well. There is also a necessity to entice

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institutional investors, mainly public sector institutions and funds managed by the public sector with large financial resources, such as the Employees' Provident Fund, Employees' Trust Fund, Sri Lanka Insurance Corporation, and state banks to increase their subscription at primary market auctions for government securities, enabling an easing of pressure on yields on government securities.

Despite the elevated levels of monetary expansion, subdued aggregate demand conditions and well-anchored inflation expectations have led to the consumer price inflation being maintained at mid-single digits levels thus far during the year, although some acceleration was observed recently largely driven by food inflation. Accordingly, Colombo Consumer Price Index (CCPI, 2013=100) based headline inflation accelerated to 4.5 per cent, year-on-year, in May 2021, compared to 3.9 per cent, year-on-year, in April 2021. Moreover, National Consumer Price Index (NCPI, 2013=100) based headline inflation also accelerated to 5.5 per cent, year-on-year, in April 2021, compared to 5.1 per cent, year-on-year, in March 2021. Subdued core inflation based on both indices thus far during the year was indicative of muted demand pressures, primarily resulting from the economy continuing to operate below its potential.

Inflation in the near term is expected to remain low at the desired levels with muted demand pressures and possible supply side improvements supported by the Government's drive towards promoting domestic value adding activities. However, the continued expansion of money supply triggered by the large and sustained monetary financing of the government budget deficit, the depreciation of the Sri Lankan rupee against the US dollar, and the possible increase in domestic petroleum and other commodity prices in line with global developments, could exert a threat on the maintenance of domestic price stability sooner than expected. The Monetary Board is of the view that these developments, which could inadvertently lead to the buildup of inflationary pressures, necessitate the proactive intervention by the Central Bank. Although there may be merit in allowing some moderate inflation at early stages of an economic pickup, a continued rise in inflation could threaten price stability by destabilising inflation expectations and generating a price-wage spiral. In the meantime, as the Honourable Prime Minister is aware, food inflation is a key concern of the general public, which must be addressed through timely, appropriate and well-thought-out Government policies, in order to ease the burden on consumers as well as producers of food products amidst pandemic conditions.

Concluding Remarks

In the context of the extremely challenging economic conditions, the Monetary Board is of the view that recent regulatory and policy measures to stabilise the external sector have helped to arrest the situation to some extent. However, significant policy measures as proposed above aiming at strengthening the external sector of the economy are required to be implemented urgently to reduce foreign exchange outflows and increase foreign exchange inflows, avoiding the sharp depletion of gross official reserves of the country which is extremely likely in the near term, in the absence of counteracting developments.

The Central Bank took unprecedented measures to ease monetary conditions to support individuals, businesses and the Government with the outbreak of the pandemic, leading to the unavoidable expansion of money supply since mid-2020 through April 2021, at a rate exceeding fifteen per cent, year-on-year. In this context, the Government's increased reliance on borrowings from the banking system, if continued, could create several macroeconomic imbalances, including further pressure on the BOP, which necessitates concerted efforts to improve government revenue, while further rationalising non-priority expenditure.

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The Monetary Board will continue to monitor developments in the balance of payments, exchange rate, and official reserves, and, working with the Government, take necessary steps to maintain stability in these variables to the maximum possible extent and apprise the Government of further actions necessary. Further, the Monetary Board will continue to monitor developments in money and credit aggregates and would take appropriate monetary policy measures as required to maintain inflation at the desired target range of 4-6 per cent over the medium term, while continuing to support the recovery of the pandemic-stricken economy with its accommodative monetary policy stance.

Yours sincerley,

Deshamanya Professor W D Lakshman
Governor and the Chairman of the Monetary Board
Central Bank of Sri Lanka

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Copy to: Mr. S R Attygalle, Secretary to the Treasury

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