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Annexure III

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STRICTLY CONFIDENTIAL

PAPER SUBMITTED TO THE MONETARY BOARD
03 MAR 2022
Board Secretariat

27 January 2022

**Hon. Basil Rajapaksa**
**Minister of Finance**
Ministry of Finance
The Secretariat
Colombo 01

My dear Minister,

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

This confidential report is submitted as a follow up to my previous correspondence on the same dated 31 December 2021 under the provisions of the Monetary Law Act to apprise you of the prevailing macroeconomic vulnerabilities that affect the stability of the external sector and the domestic price stability of the Sri Lankan economy. Whilst the details of the subsequent developments are given in Annex I, the following key points are highlighted for the immediate attention of the Hon. Minister.

1. **Signs of recovery in domestic economic activity are observed as reflected by several leading indicators.**
   a. The Sri Lankan economy recorded a growth of 4.4 per cent during the first nine months of 2021 in spite of the contraction recorded in the third quarter. As observed by several leading indicators, the economy is expected to have grown by around 4.0 per cent in 2021 and is expected to grow by around 5.0 per cent in 2022. The rapid rollout of the COVID-19 vaccine and the subsequent easing of mobility restrictions in October 2021 have supported domestic economic recovery.
   b. While new strains of the pandemic are affecting economic activity globally, the Government is expected to take measures and proactively mitigate the risk of the



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spread of the virus, while ensuring that the country continues to operate without lockdowns.

2. **Several measures were taken to address issues in the external sector, but vulnerabilities still remain.**

   a. The external sector vulnerabilities highlighted in previous reports still persist.

   b. The current level of official reserves remains critically low, compared to the foreign currency debt service payments of the Government and the need for financing essential imports to the country.

   c. The liquid reserves have reached a critically low level mainly due to the need for providing foreign exchange liquidity to banks to facilitate urgent payments for essential imports such as oil, gas, coal, essential food items and medicine, to ensure uninterrupted supplies for economic activity and the welfare of the public.

   d. The significant import growth observed towards the latter part of 2021 remains a serious concern.

   e. Maintaining stability in the exchange rate, while supplying foreign exchange to the market to meet the demand for essential imports remains extremely challenging.

   f. If significant and sustainable forex inflows do not materialise in the immediate future, the Government would face severe challenges, particularly in terms of fulfilling debt servicing obligations as well as meeting forex requirement for essential imports despite the proposed new mechanism to share some of the oil financing requirements with private and foreign commercial banks.

   g. Hence, expeditious realisation and attraction of sizeable foreign exchange flows through adopting urgent measures, including the monetisation of identified non-strategic assets, seeking government to government funding facilities, and obtaining financial facilities from the multilateral agencies are essential to help ease the forex shortage and build up gross official reserves.

3. **The significant increase in money and domestic credit supply continues, driven largely by substantial monetary financing, while inflation has accelerated.**

   a. The Government continues to rely on the Central Bank to finance even pre-planned expenditure, including debt service payments raising concerns of the lack of a clear strategy on expenditure and debt management. Therefore, we suggest introducing a tax policy that would generate required inflows from alternative, non-inflationary sources and as a result, the Government would be able to secure funds from market sources without creating new money.

   b. The Government is requested to be wary of the possible severe implications of loose fiscal policy and resultant financing from the Central Bank and the banking sector on domestic price stability as well as financial system stability.

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c. The expected rollback of the Central Bank's holdings of government securities is being challenged with recent developments, particularly with the allocation of large sums of Treasury bills to the Central Bank in January 2022.

d. Inflation has accelerated to double digit levels by end 2021 bringing an end to the single digit inflation era that was maintained since February 2009, requiring the Central Bank to take monetary policy actions to address demand driven inflationary pressures stemming from monetary financing.

4. **The banking sector, particularly the two states banks, is at significant risk with an acute shortage of liquidity in the domestic forex market, along with a significant rupee liquidity shortage.**

   a. While the two state banks have been grappling with the shortage of forex liquidity, the excessive reliance of the Government on bank financing has posed a serious concern causing significant shortages in rupee liquidity.

   b. The stability of the two state banks have been severely hampered by the operations of the State-Owned Business Enterprises (SOBEs), particularly the Ceylon Petroleum Corporation (CPC).

   c. Hence, the rectification of the financial soundness of the SOBEs is required urgently to prevent major disruptions to the macroeconomy and financial institutions, and the entire system.

   d. The lack of a cost reflective pricing mechanism for the products of SOBEs has negatively impacted their financial performance and sustainability.

   e. Hence, given the prevailing shortage in foreign exchange, and the unviable financial position of CPC, an immediate price revision is vital, as the country would not be able to supply petroleum products even to meet essential requirements at current prices, given the already apparent significant rupee liquidity shortage of the CPC.

   f. It is observed that Sri Lanka has the lowest fuel 'pump' prices in the South Asian region and even across the globe for diesel and is among the lowest in petrol, even after the two rounds of upward price revisions in 2021. Therefore, ample leeway for further prices revisions is available, which would help improve the financial position of CPC.

   g. It is also required that SOBEs prepare a credible repayment plan of their outstanding debt to the banking sector, while improving their Treasury operations in line with changing economic dynamics. The Central Bank is in a position to second a senior Chartered Accountant from its cadre to the CPC for a specified period in order to provide the required technical assistance in Treasury operations of the CPC.

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5. While the Central Bank is pursuing every possible avenue to support this endeavour by replenishing the gross official reserves, it strongly believes that the Government should also take expeditious measures and implement required reforms, urgently, to address the underlying issues faced by the economy at present, potentially averting a deeper economic crisis.
6. Therefore, the Government is urged to swiftly implement the remedial measures proposed by the Central Bank herein and in previous correspondences to ensure that the economy successfully traverses through this difficult period.

Yours sincerely,

Ajith Nivard Cabraal

**Ajith Nivard Cabraal**
**Governor and the Chairman of the Monetary Board**
**Central Bank of Sri Lanka**

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

Encl.

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