IN THE SUPREME COURT OF THE DEMOCRATIC SOCIALIST REPUBLIC OF SRI LANKA

In the matter of an Application under and in terms of Articles 17 and 126 of the Constitution of the Democratic Socialist Republic of Sri Lanka.

Case No: SC FR 212/2022

1. Chandra Jayaratne
   No. 2, Greenland Avenue,
   Colombo 05.

2. Julian Bolling,
   No. 72, 5th Lane,
   Colombo 05.

3. Jehan Canaga Retna
   No. 5, Bullers Lane, Apartment 3B,
   Colombo 07.

4. Transparency International Sri Lanka
   No 366, Nawala Road,
   Nawala, Rajagiriya.

Petitioners

- Vs -

1. Hon. Attorney General
   Attorney General's Department,
   Colombo 12.

2. Hon. Mahinda Rajapakse
   Former Prime Minister, Former Minister of Buddhasasana, Religious and Cultural Affairs, Former Minister of Urban Development & Housing, Former Minister of Economic Policies and Plan Implementation and Former Minister of Finance.
   No 117, Wijerama Mawatha,
   Colombo 07.

3. Hon. Basil Rajapakse,
   Former Minister of Finance
   No 1315, Jayanthipura
   Nelum Mawatha,
   Battaramulla
   No 1316, Jayanthipura Nelum
   Mawatha,
   Battaramulla.

4. Hon. M.U.M. Ali Sabry PC
   Former Minister of Finance
   No. 5, 27th Lane,
   Colombo 03.

5. Hon. Ranil Wickremesinghe,
   Prime Minister,
   Minister of Finance, Economic
   Stability and National Policies.
   No. 117, 5th Lane,
   Colombo 03.

6. **Deshamanya Professor W.D.**
   Lakshman
   Former Governor of the Central Bank
   No. 224, Ihalayagoda,
   Imbulgoda

7. Mr. Ajith Nivard Cabral
   Former Governor of the Central Bank
   of Sri Lanka,
   No 32/7 School Lane,
   Nawala.

8. Dr P. Nandalal Weerasinghe
   Governor of the Central Bank of Sri
   Lanka
   Central Bank of Sri Lanka
   P O Box 590
   Colombo 01,
   Sri Lanka

9. The Monetary Board of the Central
   Bank of Sri Lanka
   Central Bank of SrI Lanka
   P O Box 590
   Colombo 01,Sri Lanka

10. Mr. S.R. Attygala
    Former Secretary to the Treasury/
    Ministry of Finance
    No.23, Madapatha,
    Piliyandala.

11. Mr. K.M. Mahinda Siriwardana
    Secretary to the Treasury/ Ministry
    of Finance
    The Secretariat,
    Colombo 01.

12. Mr. Saliya Kithsiri Mark Peiris, P.C.,
    President of the Bar Association of
    Sri Lanka,
    No. 153, Mihindu Mawatha,
    Colombo 12.

13. Mr. Isuru Balapatabendi, AAL.,
    Secretary of The Bar Association of
    Sri Lanka,
    No. 153, Mihindu Mawatha,
    Colombo 12.

Respondents

TO: HIS LORDSHIP THE CHIEF JUSTICE, AND THEIR LORDSHIPS; THE OTHER HONOURABLE JUDGES OF THE SUPREME COURT OF THE DEMOCRATIC SOCIALIST REPUBLIC OF SRI LANKA.

I, Deshamanya Professor Weligamage Don Lakshman, of 622/14, Kotte Road, Ethul-Kotte being a Buddhist, do hereby solemnly, sincerely affirm hereto and state as follows:

1. I am the affirmant and the 6th Respondent abovenamed.

2. I state that I was appointed Governor of the Central Bank of Sri Lanka [hereinafter referred to as "**CBSL**"] on the 24th December 2019, on the invitation of President Gotabaya Rajapaksa.

3. I resigned from the said post on 14th September 2021.

4. I affirm to the following matters from my personal knowledge and from documents and records available to me during my tenure as Governor of the CBSL and Chairman of the Monetary Board.

5. I state that these limited objections are filed in response to certain averments in the Petition that relate to the afore-mentioned period [24th December 2019 – 14th September 2021] in which I was Governor of CBSL, and ex-officio Chairman of the Monetary Board of Sri Lanka, which is the 9th Respondent above named.

6. I categorically deny the averments contained in the Petition and affidavit of the Petitioners save and except for the specific matters admitted herein below.

7. I reserve my right to file comprehensive objections to this application, in the event Your Lordships' Court were to grant the Petitioners Leave to Proceed with this application.

Preliminary objections to the maintainability of this application

8. By way of Preliminary Objection, I am advised to state that:
   (a) This application is time barred;
   (b) The Petitioners are guilty of suppression and misrepresentation of material facts;
   (c) The Petitioners have failed to add necessary parties to this application;
   (d) The Petition does not disclose an infringement or imminent infringement of the Petitioner's fundamental rights by executive or Administrative action;
   (e) The Petitioners are guilty of Prolixity;
   (f) The reliefs sought in this application are misconceived; and
   (g) Therefore this application should be dismissed in limine.

<u>Without prejudice to the above</u>

<u>Background to the 6th Respondent</u>

9. I state that:

   a. I am an Emeritus Professor of Economics at the University of Colombo and I have held the positions of Head, Department of Economics, Dean, Faculty of Graduate Studies (1992-94) and Vice Chancellor (1994-99) of the University of Colombo.

   b. I obtained a D.Phil in 1973 from the University of Oxford and an Honorary Doctor of Letters (D.Litt.), from the University of Colombo in 2008

   c. I have authored a textbook in Economics titled which has been used extensively by generations of Sri Lankan students, having gone through 12 editions and many reprints.

   d. I have also edited two books on economic development issues in Sri Lanka, one titled *Dilemmas of Development: Fifty Years of Economic Change in Sri Lanka* published by Sri Lanka Association of Economists in 1997 and the other (edited by two, with me as main editor) titled *Sri Lanka's Development since Independence: Socio-Economic Perspectives and Analyses* published by Nova Science Publishers (New York) in 2000.

   e. My edited publication titled *The Distant Neighbours: Fifty Years of Relations between Japan and Sri Lanka*, Colombo: Faculty of Graduate Studies, University of Colombo, 2003 is highly valued as a comprehensive examination of Japan-Sri Lanka relation over the first fifty year of diplomatic relations between the two countries.

   f. In my academic career I have also served (during my sabbatical years) as visiting professor/ invited scholar in several foreign academic institutions - the Institute of Social Studies in the Netherlands, International Development Centre of Japan (IDCJ), Institute of Developing Economies (IDE), Institute for Development Co-operation (JICA) in Tokyo, International Centre for Public Enterprises (ICPE) in Ljubljana Yugoslavia, and Jawaharlal Nehru University in New Delhi, Visiting Professor in Economics at Ryukoku University, Kyoto, and Visiting Professor in Economics at Saga University, Japan.

   g. In Sri Lanka, I have also served as Member, Presidential Commission on Finance and Banking, 1990, Senior Economic Advisor to Ministry of Finance and Planning (2008-09), Member, National Economic Council (2008-10), Chairman, Presidential Commission on Taxation (2009-10), Chairman, Institute of Policy Studies (2010-15), Vice Chancellor, Sanasa University Institute, Kegalle (2014-19) and the Chairman, Committee of Experts appointed by the President to examine Sri Lanka - Singapore Free Trade Agreement in 2018.

h. I have been awarded the National Honours *Deshmanya* by the President of Sri Lanka in 2005 for the services rendered to the progress of education in this country.

i. The Government of Japan has in 2022, conferred on myself and my wife the prestigious award of the *Order of the Rising Sun* in recognition of our distinguished contribution to promoting academic exchanges and mutual understanding between Japan and Sri Lanka. The award ceremony has been scheduled for the second half of August 2022.

j. I am an economist by Profession and an academic scholar and administrator with extensive experience.

k. My specialisation has been in development economics with a focus on macro-economic and international economic issues. I have written extensively and published my research in several globally reputed academic Journals. I have over 90 academic articles published in reputed journals subjects related to development and economics.

l. Among my research papers, there are ones on political economy of taxation, operations of International Monetary Fund and World Bank in Sri Lanka, Foreign Direct Investments in South Asia, Japanese Investments in South Asia and Socio-Economic Impact of Structural Adjustment Policies in Sri Lanka, Poverty in Sri Lanka, performance of public enterprises, and several other topics.

m. After my retirement from University of Colombo, my students and colleagues published two *Festschrifts*, one in English titled *Development Perspectives: Growth and Equity in Sri Lanka: A Festschrift in Honour of Prof. W. D. Lakshman)*, 2008 and the other in Sinhala (- . .), 2008.

n. I am currently in the process of compiling my memoirs and a book based on research about Sri Lanka's development experience using my teaching and professional experience including as Governor of the Central Bank.

Appointment as Governor Central Bank of Sri Lanka and Chairman of the Monetary Board

10. I state that:
    a. On 24th December 2019, I was appointed as the Governor of the CBSL by the President, in terms of Section 12 of the Monetary Law Act [hereinafter referred to as "**the Act**"];
    b. As Governor of the CBSL, I became the Chairman of the Monetary Board in terms of Section 8(2) of the Act.

11. I state that when I assumed office on 24th December 2019, Sri Lanka's economic position, as reflected in the *Central Bank Annual Report*, Volume I for 2019 were as follows:
    a. Real Sector:
        i. GDP (Gross Domestic Product) at current market prices: Rs. Bil. 15,016

Real GDP Growth	2.3%
Rate of Unemployment	4.8%
Rate of inflation (NCPI)	6.2%
(CCPI) (Year on Year % change)	4.8%

ii. External sector

Balance of trade (USD)	- 8.0 billion
Current Account Balance (USD)	- 1.8 billion
Overall balance	+ 0.4billion
Official External Reserves (Gross)	USD 7.6 billion
External Debt	USD 55.9 billion
Exchange rate (USD equivalent)	SLR 179

A true copy of the relevant pages of the Central Bank Annual Report, Volume I for 2019 pages 6-13, marked as ***<u>6R1</u>***.

12. I state that pursuant to the election of President Gotabaya Rajapakse in November 2019, the Government introduced several tax cuts and tax reductions in keeping with the President's election manifesto. I state that these fiscal measures had been introduced prior to my appointment as Governor of the CBSL and Chairman of the Monetary Board.

The COVID-19 Pandemic and its impact on Sri Lanka

13. I state that in less than a month since I assumed office as Governor of the CBSL, the COVID-19 pandemic became globally rampant, with the first case of the COVID-19 virus being detected in Sri Lanka on or about the 27th of January 2020.

14. I state that given the incurable nature of the virus and the fatalities reported globally, the State was compelled to take immediate steps to contain the spread of the virus and also provide all essential requirements to ensure the safety and wellbeing of its citizens.

15. I state that Sri Lanka experienced three waves of the spread of COVID-19 variants from March 2020 to September 2021, each of which necessitated nationwide lockdowns and travel restrictions to save lives.

16. I state that during my tenure as Governor of CBSL and Chairman of the Monetary Board, the entire Sri Lankan economy was adversely affected by the COVID-19 pandemic, causing a drop in domestic production and exports, reduced foreign exchange earnings and increased importation costs especially of food and medicine.

17. I state further that the State also had to incur substantial expenditure to fund hospitals, quarantine centers and intermediate care centers and also provide financial relief to persons affected by loss of employment, closure of businesses and also through the introduction of debt moratoriums, rescheduling of loan repayments, and relief packages for low income families.

Relief measures implemented through the policy of the Monetary Board

18. I state that during my tenure, the Monetary Board introduced a series of extraordinary policy measures to provide liquidity to the economy and regulatory forbearances to enable operational flexibility to licensed banks and non-banking financial institutions (NBFIs) and thereby provide relief to the public.

    *A true copy of a letter dated 23rd March 2020 by the Presidential Secretariat titled "Banking Facility and Credit Support to the Local Economy" is annexed hereto marked as **6R2** and is pleaded as part and parcel hereof.*

19. I state that such policy measures included *inter alia* the following:

    a. Reduction of policy interest rates and Statutory Reserve ratio to the lowest levels in history, in order to provide liquidity to the market at reduced and concessionary rates.

    b. Adequate liquidity support given to the banking system which enabled banks to provide the support required by businesses and individuals to tide over the difficulties faced during the lockdown period.

c. Maintaining the domestic prices of essential imported goods at stable levels by taking measures to ensure the stability of the exchange rate system. However, due to the spread of the COVID-19 virus, export proceeds, workers' remittances and earnings from tourism substantially reduced while substantial capital outflows were observed.

d. CBSL requested financial institutions to provide **a six-month moratorium on capital and interest payments on loans obtained by borrowers affected by the pandemic** and to waive off any accrued and unpaid penal interest charged on such loans. Considering the subsequent waves of the pandemic, this was extended for more than 18 months for customers who were severely affected by the pandemic.

e. Taking steps to enable the provision of **social security payments** for a large share of the population and to make payments in respect of essential health services by providing required financing to the government during this time to overcome fiscal stresses arising from the shortfall in government revenue and increased expenditure.

f. Additionally, **CBSL introduced a Rs. 50 billion refinancing and credit guarantee scheme** to provide low-cost funding for Small and Medium Enterprise (SME) customers, reduced interest rates on targeted lending products, provided liquidity facility to the construction sector and other government suppliers, suspended recovery actions against non-performing loans, and reduced fees and charges on several banking services to provide relief to retail customers. Measures were also put in place to provide liquidity support to any distressed financial institution as and when a need arises.

g. CBSL also ensured **smooth flow of currency required by the economy during the lockdown period.** These measures allowed the general public to fulfill their currency requirements through bank branches and automated teller machines (ATMs) even during the curfew periods. Importantly, uninterrupted operation of payments and settlements systems for both rupee and foreign currency transactions needed by the economy and the financial system was facilitated by the CBSL during the pandemic. Several electronic modes of payments were actively promoted and facilitated, enhancing convenience to the general public to effect transactions.

h. **Amidst the pandemic, Sri Lanka's unblemished record of debt service payments was maintained**. The following external loan repayments (estimated figures) became due and were settled during my tenure:

In Billions of US Dollars

	2020 January to December	2021 January to August
Foreign Loan Repayments	1.5	1.17
Settlement of SLDBs	0.953	1.324
Settlement of OBU loans	0.421	1.122
Syndicated loan repayments	0.335	
Maturity of ISBs	1	1
Total	**4.208**	**4.617**

20. I state that with the onset of the COVID-19 pandemic, the State's objective was focused on saving as many Sri Lankan lives as possible and accordingly the Monetary Board and the Central Bank took every possible measure to support this paramount objective. I state that the total number of deaths in Sri Lanka due to the COVID-19 pandemic stands at over 16,000 with over 665,000 cases being reported since February 2020. I state that the number of fatalities and the number of people who would have been adversely affected would have been much greater if not for the efforts taken by the Government of Sri Lanka assisted by the CBSL to ensure adequate and timely financing.

21. I state that despite the unprecedented burden on the economy during my tenure as Governor of the CBSL and Chairman of the Monetary Board, due to *inter alia* the aforesaid measures taken by the Monetary Board and policies implemented by CBSL, the Sri Lankan economy was stable. In fact:

    a. according to The CCPI (Colombo Consumers Price Index and NCPI (National Consumers Price Index) for 2019-21, the percentage annual increase in general price level was at single digit (i.e. less than 10%) levels.

    b. There was no significant shortage of essentials, goods, commodities, and other essential items including fuel, liquid petroleum gas, medicine and food. When occasional shortages emerged, foreign exchange was made available at the request of the Ministry of Finance for key state sector institutions such as Litro Gas and Ceylon Petroleum Corporation and also importers of food to help them clear cargo from the Port.

*A true copy of the letter dated 12th August 2021 by the Hon. Minister of Finance to the Governor is annexed hereto marked as **6R3** and is pleaded as part and parcel hereof.*

*True copies of the letter dated 21st June 2021 by the Presidential Secretariat titled "Proposals to impose 150 percent deposit margin on Letters of Credit" and the Response letter dated 13th July 2021 are annexed hereto marked as **6R4** and **6R5**and are pleaded as part and parcel hereof.*

FOREIGN RESERVES

c. The gross official International Reserves of the Central Bank: USD 7.6 Billion in 2019; USD 5.7 million in 2020 and USD 3.1 million in 2021.

d. There were several factors which impacted the International Reserves, including but not limited to:

   i. a large volume of debt repayments becoming due in the years 2020 and 2021 amounting to approximately US Dollars Million 4,208 in 2020 and US Dollars Million 4,617 in 2021;
   ii. These debt service requirements becoming onerous due to the COVID-19 pandemic which saw a drop in export earnings and an increase in import costs including costs incurred for the purchase of essential medicines and medical equipment to combat COVID-19;
   iii. Lack of tourism earnings which had in 2018 accounted for over 4 Billion US Dollars in foreign exchange to Sri Lanka;
   iv. Reduction in tax revenue due to tax cuts, which failed to bring in the desired economic benefits to Sri Lanka owing to the economic downturn caused by the COVID-19 pandemic;
   v. The drop in foreign remittances by migrant workers, many of whom lost their employment due to the COVID-19 pandemic.

22. I state that, when I resigned as Governor of the CBSL on 14th September 2021, the key economic indicators as shown in the *Central Bank Annual Report for 2021* were as follows (The statistics below are for entire 2021):

a. Real Sector:

   i. GDP (Gross Domestic Product) at current market prices: Rs. Bil. 16,809

Real GDP Growth	3.7%
Rate of Unemployment	5.1%
Rate of inflation (NCPI)(Year on Year % change)	14.0%

	(CCPI) (Year on Year % change)	12.1%
ii.	External sector	
	Balance of trade (USD)	- 8.1 billion
	Current Account Balance (USD)	- 3.3 billion
	Overall balance	- 4.0billion
	Official External Reserves (Gross)	USD 3.1 billion
	External Debt	USD 50.7 billion
	Average Exchange rate (USD equivalent)	SLR 199

*A true copy of the relevant pages of the Central Bank Annual Report for 2021 pp. 4, 6-8 is annexed hereto, marked **6R6** and is pleaded as part and parcel hereof.*

Role and function of the Central Bank and the Monetary Board

23. I state that in terms of Section 5 of the Act, the Central Bank of Sri Lanka is responsible for the administration, supervision and regulation of the monetary, financial and payments system of Sri Lanka. The Central Bank is also charged with the duty of securing as far as possible the following objectives, namely (a) economic and price stability and (b) financial system stability to encourage and promote the development of the productive resources of Sri Lanka.

24. I state that in terms of Section 8 of the Act, the Monetary Board of the Central Bank shall in addition to determining the policies or measures authorised to be adopted in the Act, is vested with the powers, duties and functions of the Central Bank and generally responsible for the management operations and administration of the Bank.

25. I state that in terms of Section 106 of the Act, the Central Bank shall act as the fiscal agent and banker of the Government and of agencies or institutions acting on behalf of the Government, whether established by any written law or otherwise.

26. I state therefore that neither the Monetary Board or the Central Bank has the power under the Act **to determine fiscal policy**, which is a matter entirely within the purview of the Government and the Parliament of Sri Lanka. The Monetary Board however from time to time provides advice to the Government with regard to fiscal policy so as to ensure macroeconomic stability in the country.

27. I state that in terms of **Section 9(1)** of the Act, The Monetary Board of the Central Bank is a body corporate with perpetual succession and a common seal and may sue or be sued in its corporate name.

28. I state that in terms of **Section 17** of the Act, *inter alia,*

    a. The meetings of the Monetary Board are convened by the Governor of the CBSL,

    b. The quorum for any meetings of the Monetary Board is three members; and

    c. No decision taken at any meeting of the board shall be deemed to be a decision of the board unless it has the concurrence of at least three members, or, in any case where any other provision of this Act requires a unanimous decision, the concurrence of all five members.

29. I state further that in terms of the Monetary Law, the Governor of the CBSL:

    a. does not have a casting vote; and

    b. does not have any power to veto a majority decision of the Monetary Board.

30. I state that during my tenure as Governor of the CBSL;

    a. all decisions of the Monetary Board were taken with consensus;

    b. all members of the Monetary Board were free to express divergent views at the meeting but the decisions were finally approved as decisions of the Monetary Board.

    c. all meetings of the Monetary Board were held with the participation of the Senior Deputy Governor, Deputy Governors and Directors of Departments of the Central Bank who were responsible for the preparation and presentation of papers to the Monetary Board and the recommendations made in the same.

    d. The Monetary Board was guided by economic research findings and data collected and analysed by the Department of Economic Research of the CBSL, in formulating, implementing, and executing policies and measures in the subjects of money and banking and other relevant economic subjects;

    e. All decisions of the Monetary Board were carried out after detailed and well-debated discussions guided by policy and other economic research of the officers of the CBSL.

31. I state that during my tenure as Governor of the CBSL and Chairman of the Monetary Board, the Present Governor of the CBSL, Dr. Nandalal Weerasinghe was Senior Deputy Governor of the CBSL and functioned as such until his retirement in early 2021. He was involved in formulating policy papers and advising the Governor and Monetary Board and was aware of the decisions taken by the Monetary Board from time to time. He participated in meetings with the political authority, generally with and occasionally without, Governor.

32. I state further that during my tenure as Governor of the CBSL and Chairman of the Monetary Board, the present Secretary to the Treasury Mr. K.M.M. Siriwardena also functioned as Deputy Governor and carried out functions as principal officer responsible for several Departments of the Central Bank and, as he participated in Monetary Board meetings, he was aware of the decisions taken by the Monetary Board from time to time. It was I as Governor, who invited him, because of his experience and position, to join in the meetings with the political authority.

33. I state that during my tenure as Governor of the CBSL and Chairman of the Monetary Board, the Monetary Board diligently performed its duties in terms of the Act. I state that:

    a. The Monetary Board had taken appropriate remedial measures where necessary, and periodically sent reports to the Minister of Finance, in terms of the said provisions of the Act.

    b. In the said Reports, I state that I have, on behalf of the Monetary Board, informed the Minister of Finance about the changing conditions in the domestic and external economy and the monetary sector.

    c. In the said letters, the Monetary Board has recommended to the Minister of Finance *inter alia* :

        i. to raise external funding from multilaterals and friendly governments, while doing things to improve non-debt foreign earnings;

        ii. to impose import controls and restrictions if other recommendations were not adopted; and

        iii. to approach the IMF for a facility where necessary, although an IMF programme would be subject to strong conditions.

d. Furthermore, the said Reports also refers to the measures adopted by the Monetary Board from time to time.

*True copies of Reports dated 4th August 2020, 17th December 2020, 6th April 2021, 30th June 2021, 26th July 2021, and 14th September 2021 are annexed herewith marked as **6R7**, **6R8**, **6R9**, **6R10**, **6R11**, and **6R12**respectively and are pleaded as part and parcel hereof.*

Policy of the Monetary Board

34. I state that, guided and assisted by Central Bank officials, I ensured that as Governor of the Central Bank that the core objectives of the Bank, namely economic and price stability and financial system stability were maintained.

35. I state that during my tenure, both the Central Bank and the Monetary Board took effective and meaningful measures to ensure that the core functions of the Central Bank were fulfilled whilst meeting the needs of the Government and ensuring the uninterrupted functioning of the economy.

36. I state that, still, as my aforementioned Monetary Policy Statements as Governor highlighted, the extraordinary impacts of COVID-19 on the economy were addressed with a constant view on the Central Bank's economic and financial stability objectives. During 2020-21 the rate of inflation remained within the range desired maintained by the Central Bank.

Specific responses to the averments in the Petition

37. Without prejudice to the above, I state that I deny all and singular the several averments in the Petition and the corresponding Affidavit thereto. All references to the averments in the Petition should be deemed to be references to the corresponding averments in the affidavits annexed thereto.

38. I state that I am unaware of the averments contained in paragraphs **1, 2, 3, 4, 6, 31, 32, 33, 34, 39, 40, 41, 43, 89, 90, 91, 92, 93, 111 and 117** of the Petition and therefore deny the same.

39. I deny the averments contained in paragraphs **9, 10, 11, 12, 14, 44, 45, 46, 47, 48, 72, 73, 74, 75, 76, 77, 78, 94, 98, 104, 106, 110, 112, 113,114, 115, 116** and **118** of the Petition, and state further that in my role as Governor, CBSL and Chairman, Monetary Board, I have always fulfilled my role and duty under and in terms of the Law,

exercised due diligence and worked in the best interest of Sri Lanka and that the allegations against me are speculative, baseless and misconceived.

40. Answering paragraph **5** of the Petition, I admit only the constitutional provisions referred to therein.

41. Answering paragraph **7** of the Petition, I only state that I was the Governor of the CBSL from 24th December 2019 – 14th September 2021, and I was an ex-officio member of the 9th Respondent Monetary Board of Sri Lanka at the aforesaid time period, and categorically reject any other reference to the 6th Respondent stated therein.

42. I categorically deny the averments contained in paragraph **8** of the Petition and state that the allegations against me are vague, speculative, have no basis, and in any case does not provide a basis to invoke the jurisdiction conferred on Your Lordships' Court in terms of Article 126 of the Constitution in the absence of a specific alleged infringement of the Petitioners' Fundamental Rights.

43. Answering paragraph **13** of the Petition, I state that the broad categorisations referred to in the said paragraphs are not applicable to me for the following reasons;

    a. the tax policy changes of President Gotabaya Rajapakse, which resulted in the grant of several tax reductions, were already announced and begun to be implemented prior to my appointment as Governor of the CBSL.

    b. the Monetary Board, under the Act, does not determine fiscal policy, as it is a matter entirely within the purview of the Government and the Parliament of Sri Lanka.

    c. during my tenure as Governor of the CBSL and Chairman of the Monetary Board, I carried out my duties in terms of the Act;

    d. during my tenure as Governor of the CBSL and Chairman of the Monetary Board, the Monetary Board carried out its duties in terms of the Act;

    e. in my role as Governor, CBSL and Chairman, Monetary Board, I have always fulfilled my role and duty according to Law, exercised due diligence and worked in the best interest of Sri Lanka.

    f. the allegations made by the Petitioners are entirely baseless and speculative.

44. Answering paragraphs **15, 16, 17, 18, 19, 20, 21, 22, 23, 24, 25, 26, 27, 28, 29, 30, 35, 36, 42 of the Petition,** I state that save and except for the fact that the Government led by President Gotabaya Rajapakse had introduced several tax cuts pursuant to his election in November 2019 prior to my appointment as Governor of the Central Bank and Chairman of the Monetary Board. I am unaware of the remaining averments contained therein and accordingly deny the same. I further state that determining fiscal policy falls within the realm of the Government and Parliament and is not determined by the Monetary Board or the Central Bank of Sri Lanka.

45. Answering paragraphs **37** and **38** of the Petition, I state that the averments contained therein have no reference to me and are allegations raised against the President and the 2nd Respondent and accordingly the same is denied.

46. Answering paragraphs **49, 50, 51, 52, 53** and **54** of the Petition, I admit only the annual report of the CBSL and the provisions of the Monetary Act and deny the rest of the averments contained therein.

47. Answering paragraphs **55, 56, 57, 59, 60, 61, 62, 63, 64, 65, 66, 67, 68, 69, 70** and**71**, I state that the allegations contained therein do not refer to me. However, without prejudice, in relation to my tenure as Governor of the CBSL during the period of 24th December 2019 - 14th September 2021, I state that the daily exchange rate movements within the exchange rate regime as determined by the Government, was properly and suitably managed under the careful scrutiny of the CBSL within the framework of the Law in keeping with the objectives of maintaining economic and price stability and financial system stability.

48. Answering the averments contained in paragraphs **58** of the Petition, I only admit the role of the Monetary Board in terms of the Act, and deny the rest of the averments contained therein.

49. Answering paragraphs **79, 80, 81, 82, 83,84, 85, 86, 87** and **88** of the Petition, I state that the averments contained therein refer specifically to the President, 2nd, 3rd and 7th Respondents and do not refer to me and accordingly the same is denied.

50. Answering paragraphs **95**, **96** and **97** of the Petition, I state that the averments contained therein do not refer to me and are specifically in relation to the President and accordingly deny the same.

51. Answering paragraphs **99, 100, 101, 102, 103, 107, 108** and **109** of the Petition, I admit only the provisions of the Constitution contained therein and deny the rest of the averments.

52. Answering paragraph **105** of the Petition, I admit only the doctrine of public trust and deny the rest of the averments contained therein.

53. Answering further, I state that I have not infringed the Fundamental Rights of the Petitioners or of the Citizens of Sri Lanka and that I have always acted and discharged my professional obligations in accordance with the law and in the best interest of the Central Bank and the Monetary Board.

SRI LANKA 50.00

The Affirmant having read over and understood the contents hereof, Affirmed to and placed his signature In my presence at Colombo On this 19th day of July 2022.

Before Me

Justice of the Peace/ ~~Commissioner for Oaths~~

W. Sarath Wijesinghe
Justice of the Peace (Whole Island)
(Ministry of Justice of Sri Lanka
Reg. No. 17/03/WP/WI/403)
No. 91/2/1/A,
Mahalwarawa, Pannipitiya.
Tel: 071 7697427

TRUE COPY

Attorney - at - Law

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PART I

KEY ECONOMIC INDICATORS

	2013	2014	2015	2016	2017	2018	2019 (a)
DEMOGRAPHY							
Mid-year population ('000 persons) (b)(c)	20,585	20,778	20,970 (d)	21,203 (a)	21,444 (a)	21,670 (a)	21,803
Growth of mid-year population (per cent) (b)	0.8	0.9	0.9	1.1 (a)	1.1 (a)	1.1 (a)	0.6
Population density (persons per sq.km.) (b)	328	331	334	338 (a)	342 (a)	346 (a)	348
Labour force ('000 persons) (e)(f)	8,034	8,049	8,214	8,311	8,567	8,388	8,592
Labour force participation rate (per cent) (e)(f)	53.7	53.2	53.8	53.8	54.1	51.8	52.3
Unemployment rate (per cent of labour force) (e)(f)	4.4	4.3	4.7	4.4	4.2	4.4	4.8
OUTPUT (g)							
GDP at current market price (Rs. billion)	9,592	10,361	10,951	11,996	13,328 (d)	14,366 (a)(d)	15,016
GNI at current market price (Rs. billion)	9,366	10,125	10,676	11,676	12,975 (d)	13,977 (a)(d)	14,584
GDP at current market price (US$ billion)	74.3	79.4	80.6	82.4	87.4 (d)	88.4 (a)(d)	84.0
GNI at current market price (US$ billion)	72.5	77.6	78.5	80.2	85.1 (d)	86.0 (a)(d)	81.6
Per capita GDP at current market price (Rs.) (h)	465,976	498,660	522,204	565,773	621,531 (d)	662,949 (a)(d)	688,719
Per capita GNI at current market price (Rs.) (h)	454,993	487,298	509,103	550,697	605,076 (d)	644,970 (a)(d)	668,894
Per capita GDP at current market price (US$) (h)	3,609	3,819	3,841	3,886	4,077 (d)	4,079 (a)(d)	3,852
Per capita GNI at current market price (US$) (h)	3,524	3,732	3,745	3,782	3,969 (d)	3,968 (a)(d)	3,741
REAL OUTPUT (percentage change) (g)							
GDP	3.4	5.0	5.0	4.5	3.6 (d)	3.3 (a)(d)	2.3
Major economic activities of GDP							
Agriculture	3.2	4.6	4.7	-3.7	-0.4 (d)	6.5 (a)(d)	0.6
Industry	4.1	4.7	2.2	5.7	4.7 (d)	1.2 (a)(d)	2.7
Services	3.8	4.8	6.0	4.8	3.6 (d)	4.6 (a)(d)	2.3
GNI	2.8	5.1	4.8	4.3	3.6 (d)	3.2 (a)(d)	2.2
AGGREGATE DEMAND AND SAVINGS (per cent of GDP) (g)							
Consumption	75.4	75.8	76.4	79.4	75.6 (d)	77.0 (a)(d)	78.7
Private	67.6	67.4	67.4	71.0	67.1 (d)	67.8 (a)(d)	69.3
Government	7.8	8.4	9.0	8.5	8.5 (d)	9.1 (a)(d)	9.4
Investment	33.2	32.3	31.2	27.9	31.6 (d)	30.4 (a)(d)	27.4
Net exports of goods and services	-8.6	-8.1	-7.5	-7.3	-7.2 (d)	-7.4 (a)(d)	-6.1
Exports of goods and services	20.3	21.1	21.0	21.2	21.8 (d)	22.9 (a)(d)	23.1
Imports of goods and services	28.9	29.2	28.5	28.5	29.1 (d)	30.3 (a)(d)	29.2
Domestic savings	24.6	24.2	23.6	20.6	24.4 (d)	23.0 (a)(d)	21.3
Net primary and secondary income from rest of the world	5.2	5.6	5.2	5.2	4.6 (d)	4.2 (a)(d)	4.0
National savings	29.9	29.8	28.8	25.7	29.0 (d)	27.3 (a)(d)	25.3
PRICES AND WAGES (percentage change)							
National Consumer Price Index (2013 = 100) - annual average	-	-	3.8	4.0	7.7	2.1	3.5
National Consumer Price Index (2013 = 100) - year-on-year (end period)	-	-	4.2	4.2	7.3	0.4	6.2
Colombo Consumer Price Index (2013 = 100) - annual average	-	-	2.2	4.0	6.6	4.3	4.3
Colombo Consumer Price Index (2013 = 100) - year-on-year (end period)	-	-	4.6	4.5	7.1	2.8	4.8
Colombo Consumer Price Index (2006/07 = 100) - annual average (i)	6.9	3.3	0.9	3.7	-	-	-
Colombo Consumer Price Index (2006/07 = 100) - year-on-year (end period) (i)	4.7	2.1	2.8	4.1	-	-	-
Producer's Price Index (2013 Q4 = 100) - annual average	-	-	3.6	1.7	17.0	6.3	2.9
GDP deflator (g)	6.2	2.9	0.6	4.8	7.3 (d)	4.3 (a)(d)	2.2
GNI deflator (g)	6.2	2.9	0.6	4.9	7.3 (d)	4.3 (a)(d)	2.1
Nominal wage rate index for workers in all wages boards (1978 Dec =100)	5.7	3.7	2.9	0.0	0.0	0.6	2.9
Nominal wage rate index for public sector employees (2016 =100)	-	-	-	-	-	0.2	4.7
Nominal wage rate index for public sector employees (2012 =100)	6.3	10.5	31.7	3.9	0.0	0.1	3.2
Nominal wage rate index for informal private sector employees (2012 =100)	9.8	7.6	7.3	7.9	9.5	13.2	6.2
EXTERNAL TRADE							
Trade balance (US$ million)	-7,609	-8,287	-8,388	-8,873	-9,619	-10,343	-7,997
Exports	10,394	11,130	10,546	10,310	11,360	11,890	11,940
Imports	18,003	19,417	18,935	19,183	20,980	22,233	19,937
Terms of trade (percentage change)	4.6	4.3	2.7	4.0	1.2	0.02	-1.6
Export unit value index (2010 = 100) (percentage change)	-0.3	2.7	-9.4	-1.5	2.4	4.2	-6.3
Import unit value index (2010 = 100) (percentage change)	-4.7	-1.5	-11.8	-5.3	1.2	4.1	-4.8
Export volume index (2010 = 100) (percentage change)	6.7	4.3	4.6	-0.7	7.6	0.5	7.2
Import volume index (2010 = 100) (percentage change)	-1.5	9.5	10.6	7.0	8.1	1.8	-5.8
EXTERNAL FINANCE (US$ million)							
Services and primary income account (net)	-572	72	312	678	984	1,381 (d)	423
Current private transfers (net)	5,619	6,199	6,167	6,434	6,316	6,155	5,757
Current official transfers (net)	21	28	27	19	11	8	9
Current account balance	-2,541	-1,988	-1,883	-1,742	-2,309	-2,799 (d)	-1,808
Overall balance	985	1,369	-1,489	-500	2,068	-1,103	377

(a) Provisional
(b) As reported by Registrar General's Department
(c) Based on the Census of Population and Housing - 2012
(d) Revised
(e) Household population aged 15 and above is considered for the calculation of labour force.
(f) In July 2016, the Department of Census and Statistics published a re-weighted and revised labour force data series for 2011 onwards.
(g) Rebased GDP estimates (base year 2010) of the Department of Census and Statistics have been used.
(h) Estimates are updated with the latest population figures
(i) Compilation of this index was discontinued since January 2017.

KEY ECONOMIC INDICATORS (Contd.)

	2013	2014	2015	2016	2017	2018	2019 (a)
Current account balance (per cent of GDP) (g)(j)	-3.4	-2.5	-2.3	-2.1	-2.6	-3.2	-2.2
Total foreign assets (months of the same year imports) (k)	5.7	6.1	5.9	5.3	6.0	5.2	6.3
Gross official reserves (months of the same year imports)	5.0	5.1	4.6	3.8	4.6	3.7	4.6
Overall debt service ratio (l)							
As a percentage of export of goods and services	26.8	21.7	28.2	25.6	23.9	28.9	29.7
As a percentage of current receipts	18.7	15.2	19.8	18.0	17.3	21.3	21.9
Total external debt (per cent of GDP) (g)(j)	53.7	54.1	55.7	56.8	59.0 (d)	59.2 (d)	66.6
EXCHANGE RATES							
Annual average							
Rs/US$	129.11	130.56	135.94	145.60	152.46	162.54	178.78
Rs/SDR (m)	196.19	198.35	190.16	202.39	211.49	229.90	246.97
NEER (2017 = 100) (24 - currency basket) (n)	104.39	105.29	109.40	104.89	100.00	94.05 (d)	88.18
REER (2017 = 100) (24 - currency basket) (n)(o)	96.33	98.92	102.84	100.79	100.00	95.45 (d)	90.30
Year end							
Rs/US$	130.75	131.05	144.06	149.80	152.85	182.75	181.63
Rs/SDR (m)	201.36	189.86	199.63	201.38	217.69	253.51	251.17
GOVERNMENT FINANCE (per cent of GDP) (g)(p)							
Revenue and grants	12.0	11.6	13.3	14.1	13.8	13.5	12.6
Revenue	11.9	11.5	13.3	14.1	13.7	13.4	12.6
o/w Tax revenue	10.5	10.1	12.4	12.2	12.5	11.9	11.6
Grants	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Expenditure and net lending	17.4	17.3	20.9	19.5	19.3	18.7	19.4
Recurrent expenditure	12.6	12.8	15.5	14.7	14.5	14.5	15.3
Capital expenditure and net lending	4.8	4.6	5.4	4.8	4.8	4.2	4.1
Current account balance	-0.7	-1.2	-2.3	-0.6	-0.7	-1.2	-2.7
Primary balance	-0.8	-1.5	-2.9	-0.2	0.02	0.6	-0.8
Overall fiscal balance	-5.4	-5.7	-7.6	-5.3	-5.5	-5.3	-6.8
Deficit financing	5.4	5.7	7.6	5.3	5.5	5.3	6.8
Foreign	1.3	2.1	2.2	3.3	3.3	2.3	2.1
Domestic	4.1	3.7	5.4	2.1	2.2	3.0	4.7
Central government debt	71.8	72.3	78.5	79.0	77.9	83.7	86.8
Foreign	30.9	30.0	32.4	33.7	35.4	41.5	42.6
Domestic (q)	41.0	42.2	46.2	45.3	42.5	42.3	44.1
MONETARY AGGREGATES (year-on-year percentage change)							
Reserve money	0.9	18.3	16.5	27.1	9.8	2.3	-3.0
Narrow money (M_1)	7.7	26.3	16.8	8.6	2.1	4.7	4.2
Broad money (M_{2b}) (r)	16.7	13.4	17.8	18.4	16.7	13.0	7.0
Net foreign assets of the banking system	-195.5	119.8	-2,071.2	22.4	152.6	-155.1	291.4
Net domestic assets of the banking system	18.3	10.5	26.0	15.9	9.8	16.3	4.2
Domestic credit from the banking system to							
Government (net)	24.5	10.3	22.5	12.1	10.0	16.1 (d)	9.9
Public corporations	24.8	23.5	17.7	-3.2	4.5	40.7	8.3
Private sector	7.5	8.6	25.0	21.6	14.7	15.9	4.3
Money multiplier for M_{2b} (end year)	7.00	6.71	6.78	6.31	6.71	7.42	8.18
Velocity of M_{2b} (average for the year) (g)	2.99	2.85	2.62	2.43	2.26 (d)	2.12 (d)	2.04
INTEREST RATES (per cent per annum at year end)							
Standing Deposit Facility Rate (SDFR) (s)	6.50	6.50	6.00	7.00	7.25	8.00	7.00
Standing Lending Facility Rate (SLFR) (s)	8.50	8.00	7.50	8.50	8.75	9.00	8.00
Money market rates							
Average weighted call money rate (AWCMR)	7.66	6.21	6.40	8.42	8.15	8.95	7.45
Treasury bill yields							
91 days	7.54	5.74	6.45	8.72	7.69	10.01	7.51
364 days	8.29	6.01	7.30	10.17	8.90	11.20	8.45
Deposit rates							
Commercial banks' average weighted deposit rate (AWDR)	9.37	6.20	6.20	8.17	9.07	8.81	8.20
Commercial banks' average weighted fixed deposit rate (AWFDR)	11.78	7.33	7.57	10.46	11.48	10.85	10.05
NSB savings rate	5.00	5.00	5.00	4.25	4.00	4.00	4.00
NSB 12 month fixed deposit rate	9.50	6.50	7.25	11.00	11.00	10.50	9.83
Lending rates							
Commercial banks' average weighted prime lending rate (AWPR)	10.13	6.26	7.53	11.52	11.55	12.09	9.74
Commercial banks' average weighted lending rate (AWLR)	15.18	11.91	11.00	13.20	13.88	14.40	13.59
CAPITAL MARKET							
All share price index (ASPI) (1985 = 100)	5,912.8	7,299.0	6,894.5	6,228.3	6,369.3	6,052.4	6,129.2
S&P SL 20 index (2004 Dec = 1,000)	3,263.9	4,089.1	3,625.7	3,496.4	3,671.7	3,135.2	2,937.0
Value of shares traded (Rs. million)	200,468	340,917	253,251	176,935	220,591	200,069	171,408
Net purchases by non nationals (Rs. million)	22,783	21,217	-5,372	338	17,655	-23,239	-11,735
Market capitalisation (Rs. billion)	2,459.9	3,104.9	2,938.0	2,745.4	2,899.3	2,839.5	2,851.3

(j) Based on GDP estimates in US dollars

(k) Excludes foreign assets in the form of direct investments abroad and trade credit and advances received

(l) Overall debt service ratios were reclassified to capture debt servicing in accordance with the External Debt Statistics Manual (2003) of the International Monetary Fund (IMF).

(m) Special Drawing Rights (SDR), the unit of account of the IMF

(n) Exchange rates have been defined in terms of indices so that the appreciation/ depreciation of the rupee relative to other currencies is reflected by a rise/fall in the values of the effective exchange rate indices.

(o) CCPI is used for the computation of the Real Effective Exchange Rate (REER). The REER is computed by adjusting the Nominal Effective Exchange Rate (NEER) for inflation differentials with the countries whose currencies are included in the basket.

(p) Based on the revised GDP estimates for 2017 and 2018 released on 31 March 2020 by Department of Census and Statistics

(q) Outstanding balance of Treasury bonds issued to State Owned Business Enterprises (SOBEs) has been included.

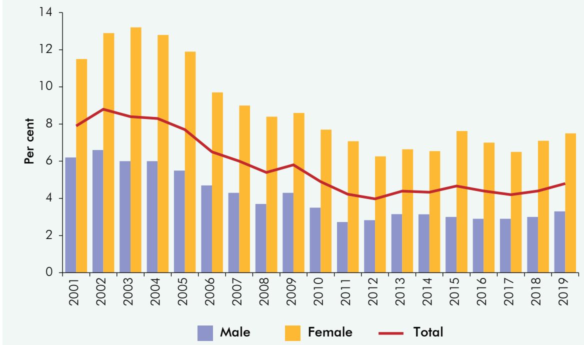
(r) Figures from 2015 include assets/ liabilities of DFCC Bank PLC, which merged with DFCC Vardhana Bank, with effect from 1 October 2015.

(s) Repurchase rate and Reverse Repurchase rate renamed as Standing Deposit Facility Rate (SDFR) and Standing Lending Facility Rate (SLFR) respectively, with effect from 2 January 2014.

Growth of the services sector halved to 2.3 per cent in 2019 compared to 2018, as the impact of the Easter Sunday attacks slowed activities in most of the subsectors. The accommodation, food and beverage activities subsector, which was the most affected subsector, contracted by 4.6 per cent in 2019, compared to the growth of 5.7 per cent in 2018. Reflecting the spillover effects of the Easter Sunday attacks and the general slowdown in economic activity, a deceleration was observed in growth of activities in several other subsectors, including wholesale and retail trade (growth of 3.0 per cent), transportation of goods and passengers, including warehousing (growth of 1.4 per cent), financial service activities and auxiliary financial services (growth of 2.0 per cent), real estate activities, including ownership of dwelling and other personal services (growth of 2.4 per cent) in 2019. Meanwhile, activity in public administration and defence grew by 2.1 per cent in 2019 compared to a contraction of 0.6 per cent in 2018. The telecommunication and information technology subsectors displayed a robust performance, growing at 17.2 per cent and 13.1 per cent, respectively, during 2019.

Reflecting subdued economic activity, the unemployment rate increased to 4.8 per cent in 2019 from 4.4 per cent in 2018. Male and female unemployment rates rose to 3.3 per cent and 7.4 per cent, respectively, during 2019, from 3.0 per cent and 7.1 per cent, respectively, in the previous year. Meanwhile, the Labour Force Participation Rate (LFPR) increased marginally to 52.3 per cent in 2019 from 51.8 per cent in 2018, primarily due to an increase in LFPR of females. Accordingly, LFPR for females increased to 34.5 per cent in 2019 from 33.6 per cent in 2018. However, the male LFPR remained unchanged at 73.0 per cent in 2019. Despite the increase in the unemployment rate, the employed population increased by 2.1 per cent

Figure 1.3
Unemployment Rate



Source: Department of Census and Statistics

to 8.181 million in 2019 along with a higher LFPR. Meanwhile, the services sector, which is the largest sector of the economy, contributed 47.1 per cent of the total employment, followed by the industry and agriculture sectors, contributing 27.6 per cent and 25.3 per cent of the total employment, respectively, in 2019. In terms of employment status, shares of public sector employees, private sector employees, employers, own account workers, and contributing family workers were 14.9 per cent, 43.0 per cent, 2.6 per cent, 32.5 per cent, and 7.0 per cent, respectively, in 2019.

Despite transient supply side disturbances, both headline and core inflation moved broadly in the desired range of 4-6 per cent during 2019, mainly as a result of subdued demand conditions and well anchored inflation expectations. With survey based upward adjustments to house rentals and education fees, headline inflation as measured by the movements in the Colombo Consumer Price Index (CCPI, 2013=100) accelerated at the beginning of 2019. Contributed also by the revisions of administratively determined prices and taxes on certain food and non food items, CCPI based year-on-year headline inflation accelerated from 3.7 per cent in January 2019 to 5.0 per cent in May 2019, before easing during the ensuing three months to record 3.4 per cent in August 2019. However, subsequent adverse weather

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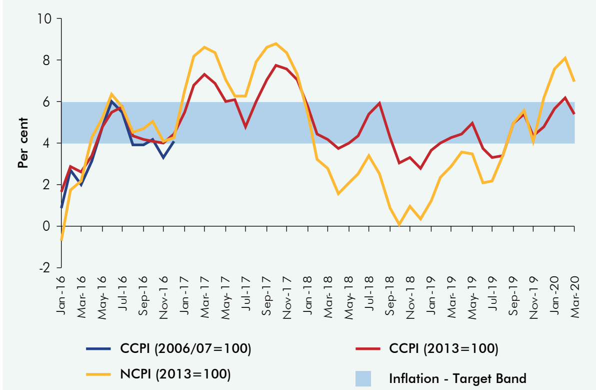
conditions caused high food inflation, resulting in an acceleration of headline inflation to reach 5.4 per cent in October 2019, following which headline inflation remained below 5.0 per cent during the remainder of the year. Accordingly, CCPI based year-on-year headline inflation was recorded at 4.8 per cent in December 2019, in comparison to 2.8 per cent in December 2018. Meanwhile, headline inflation, based on the National Consumer Price Index (NCPI, 2013=100) that attributes a higher weight to food items, followed the trend of CCPI based inflation during the first half of 2019, although remaining notably low. Nevertheless, NCPI based year-on-year headline inflation accelerated during the second half of 2019, reflecting the impact of supply side disruptions, and reached 6.2 per cent in December 2019, compared to 0.4 per cent recorded at end 2018. Meanwhile, year-on-year headline inflation based on both the CCPI and the NCPI accelerated at the beginning of 2020, mainly due to persistently high food inflation. As such, year-on-year headline inflation based on the CCPI reached 6.2 per cent in February 2020, while year-on-year inflation based on the NCPI peaked at 8.1 per cent in February 2020. However, as food inflation eased, year-on-year headline inflation based on the CCPI and the NCPI decelerated to 5.4 per cent and 7.0 per cent, respectively, in March 2020, in spite of the disruptions caused by the spread of the COVID-19 pandemic. Meanwhile, core inflation, which excludes volatile food, energy and transport groups from headline inflation, registered an increase at the beginning of 2019 due to the impact of the revision of house rentals and education fees in the CCPI basket, and remained at elevated levels during the remainder of the year. Accordingly, in December 2019, year-on-year core inflation based on the CCPI and the NCPI remained at 4.8 per cent and 5.2 per cent, respectively, compared to 3.1 per cent recorded by both the indices in December 2018. In the first

Figure 1.4
Headline Inflation (Year-on-Year)



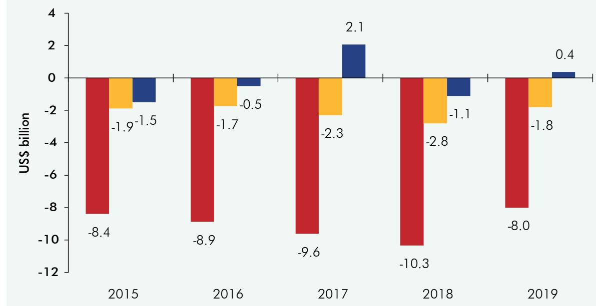
Sources: Department of Census and Statistics
Central Bank of Sri Lanka

quarter of 2020, core inflation based on the CCPI and the NCPI decelerated, mostly on account of the base effect, and was recorded at 2.9 per cent and 3.2 per cent, respectively, in March 2020.

External Sector Developments

Policies to curtail import expenditure resulted in a notable improvement in the trade and current account balances, which, along with significant inflows to the financial account, helped strengthen gross official reserves and stabilise the exchange rate. The improvement in the trade balance was mainly due to the reduction in import expenditure amidst the policy induced contraction in merchandise imports, while the modest growth of export earnings also contributed to a lower trade deficit in 2019. The surplus in the services account moderated in 2019, mainly reflecting the adverse impact of the Easter Sunday attacks on tourist earnings and receipts from air passenger services. The deficit in the primary income account widened during the year with an increase in dividend payments and reinvested earnings by direct investment enterprises (DIEs), while interest payments on portfolio investment also rose marginally during 2019. Meanwhile, the surplus in the secondary income account narrowed further in 2019 reflecting the continued moderating trend in workers' remittances observed over the past few years. Overall, the current account deficit declined in 2019, as the improvement in the merchandise trade balance outweighed the moderation in trade in services and secondary income as well as the widening of the primary income deficit. Meanwhile, the financial account recorded significant inflows in 2019, including proceeds of the International Sovereign Bonds (ISBs) and the receipt of two tranches of the Extended Fund Facility of the International Monetary Fund (IMF-EFF). However, inward foreign direct investment (FDI) moderated, while foreign investment in the government securities market and the Colombo Stock Exchange (CSE) recorded net outflows in 2019. Meanwhile, notable debt repayments were recorded by the government in 2019, including the settlement of two ISBs and the scheduled repayments on syndicated loan facilities. Despite the large foreign currency debt service payments by the government, significant inflows of foreign currency to the government and the Central Bank strengthened gross official reserves. This reflected the surplus in the overall balance of BOP in 2019. Meanwhile, the Sri Lankan rupee recorded a marginal appreciation of 0.6 per cent against the US dollar in 2019, compared to the significant depreciation recorded in 2018. This appreciation of the currency mainly reflected the impact of the notable contraction in the trade deficit, in spite of pressure witnessed in the domestic foreign exchange market in the aftermath of the Easter Sunday attacks and amidst outflows of foreign investment from the government securities market during the second half of 2019. The Central Bank maintained flexibility in the determination of the exchange rate during the year, while intervening only to prevent any excessive volatility of the Sri

Figure 1.5
Balance of Payments



Source: Central Bank of Sri Lanka

Lankan rupee and buildup reserves. Reflecting the nominal appreciation of the Sri Lankan rupee against the currencies of several major trading partners together with the movements in the cross currency exchange rates, both the Nominal Effective Exchange Rate (NEER) and the Real Effective Exchange Rate (REER) indices appreciated in 2019.

Earnings from merchandise exports increased marginally in 2019 compared to 2018, as the growth in export earnings from industrial exports was partly offset by the contraction in earnings from agriculture and mineral exports. Accordingly, earnings from merchandise exports increased by 0.4 per cent to US dollars 11,940 million in 2019 from US dollars 11,890 million in 2018. Earnings from industrial exports, which accounted for about 79 per cent of total export earnings, increased by 1.8 per cent to US dollars 9,426 million in 2019. Earnings from industrial exports were supported by the growth of earnings from textiles and garments (5.2 per cent), gems, diamonds and jewellery (10.0 per cent), transport equipment (21.3 per cent) and base metals and articles (6.7 per cent). However, certain categories of industrial exports recorded a decline in 2019, including petroleum products (16.2 per cent), leather, travel goods and footwear (30.3 per cent) and machinery and mechanical appliances (8.0 per cent). Earnings from agricultural exports, which accounted for about 21 per cent of total exports, declined by 4.6 per cent to US dollars 2,462 million in 2019, reflecting lower earnings from most sub categories, in particular tea (5.7 per cent) and spices (13.2 per cent). However, earnings from coconut exports increased by 6.0 per cent, as the export of both coconut kernel and non kernel products increased in volume terms. Meanwhile, earnings from mineral exports declined by 1.4 per cent in 2019. The USA remained the major export destination accounting for 26.3 per cent of Sri Lanka's exports, followed by the UK (8.4 per cent), India (6.4 per cent), Germany (5.4 per cent) and Italy (4.4 per cent) in 2019. The export volume index increased by 7.2 per cent, while the unit value index declined by 6.3 per cent, implying that the low growth in export earnings was driven by lower prices in 2019, compared to 2018.

Expenditure on merchandise imports declined notably in 2019, reflecting the impact of policy measures implemented to curtail non essential imports, while lower import prices also contributed to this decline. Accordingly, expenditure on imports declined by 10.3 per cent to US dollars 19,937 million in 2019 from US dollars 22,233 million in 2018. Meanwhile, expenditure on non fuel imports declined by 11.3 per cent to US dollars 16,045 million in 2019. Expenditure on intermediate goods imports, which accounted for 57 per cent of total imports, declined by 9.0 per cent in 2019, led by the decline in expenditure on gold (99.4 per cent), fuel (6.3 per cent), base metals (17.6 per cent) and fertiliser (15.4 per cent). However, an increase was recorded in import expenditure on mineral products (34.0 per cent) and textiles and textile articles (1.8 per cent) in 2019. Expenditure on consumer goods imports, which accounted for about 20 per cent of total imports, declined significantly by 20.5 per cent to US dollars 3,957 million in 2019, reflecting the decline in expenditure on both food and beverages and non food consumer goods. Import expenditure on food and beverages declined by 11.2 per cent, due to lower expenditure on food categories such as rice (88.0 per cent), sugar and confectionery (19.4 per cent) and dairy products (6.1 per cent), while an increase was recorded in expenditure on seafood (8.8 per cent), vegetables (2.0 per cent) and spices (1.3 per cent). Meanwhile, expenditure on the import of non food consumer goods declined by 25.0 per cent in 2019, compared to 2018. This notable reduction was mainly due to the decline in personal vehicle imports by 48.2 per cent to US dollars 816 million in 2019, supported by the policy measures implemented during the latter part of 2018 and the increased tax structure on most categories of personal vehicle imports in the government Budget 2019 presented in March 2019. However, some acceleration of vehicle imports was observed towards the end of 2019, with the resumption of imports under concessionary permits given to public officials. The restrictions imposed in 2018 on the selected non essential consumer goods were also removed in March 2019. Nevertheless, expenditure on most non essential consumer goods continued to decline in 2019, while import expenditure on medical and pharmaceuticals and household and furniture items increased. With sluggish economic growth, expenditure on investment goods, which accounted for about 23 per cent of total import expenditure, declined by 1.9 per cent to US dollars 4,603 million in 2019. In terms of the countrywise distribution of Sri Lanka's import expenditure, China accounted for the largest share of 20.2 per cent, followed by India (19.6 per cent), the United Arab Emirates (8.4 per cent), Singapore (4.8 per cent) and Japan (4.4 per cent).

The import volume index and the unit value index recorded declines by 5.8 per cent and 4.8 per cent, respectively, in 2019, indicating that the decline in import expenditure was due to a combined effect of lower volumes and prices, compared to 2018. Meanwhile, considering the possible impact of the COVID-19 pandemic on the BOP, measures were implemented in March 2020, to suspend the importation of certain categories of motor vehicles and non essential consumer goods for a period of three months.

The trade balance improved significantly in 2019, recording the lowest deficit since 2013. This was driven by the sharp contraction in import expenditure, which was mainly attributed to the reduction in imports of motor vehicles and gold in 2019, responding to the policy measures implemented by the government and the Central Bank in 2018 to curtail such imports amidst external sector pressures. Meanwhile, earnings from exports, which rose notably during the first half of 2019, moderated in the second half of the year, recording only a modest growth in 2019. The trade deficit in 2019 was recorded at US dollars 7,997 million, a decline of US dollars 2,346 million, compared to the deficit of US dollars 10,343 million recorded in 2018. The trade deficit, as a percentage of GDP, declined to 9.5 per cent in 2019 from 11.7 per cent in 2018.

Mainly driven by the contraction in the trade deficit, the current account balance improved significantly in 2019, despite the widening of the primary income deficit and the moderation of services and secondary income balances. The surplus in the services account weakened to US dollars 2,849 million in 2019 from US dollars 3,766 million in 2018, mainly due to modest earnings from tourism reflecting the impact of the Easter Sunday attacks, which resulted in a decline in tourist arrivals to 1.9 million in 2019 from 2.3 million in the previous year. The deficit in the primary income account widened in 2019 to US dollars 2,426 million in 2019, compared to US dollars 2,385 million in the previous year, due to increased dividend payments and re-invested earnings of DIEs, while interest payments also increased marginally in 2019. Meanwhile, workers' remittances continued to moderate in 2019, thus reducing the surplus in the secondary income account to US dollars 5,766 million in 2019 in comparison to US dollars 6,163 million in 2018. Consequently, the current account deficit narrowed notably to US dollars 1,808 million in 2019, which was 2.2 per cent of GDP, compared to 3.2 per cent in 2018.

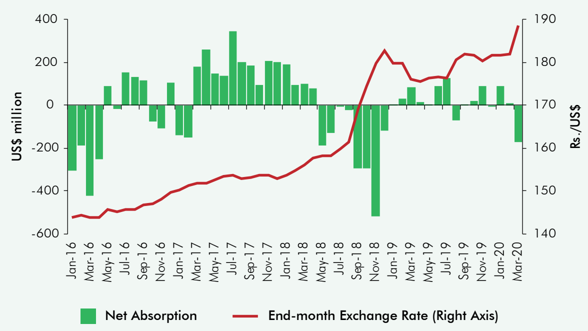
In 2019, the financial account recorded significant inflows, mainly to the government, amidst outflows of portfolio investment and large debt repayments. The financial account was strengthened by the two ISB issuances in March and June 2019 amounting to US dollars 4.4 billion and the receipt of the sixth and seventh tranches of the IMF-EFF amounting to US dollars 327 million. However, FDI inflows moderated in 2019 compared to the previous year, while foreign investment recorded net outflows from the CSE and the government securities market, driven by the dampened investor sentiment in the aftermath of the Easter Sunday attacks and uncertainties in global markets in the second half of 2019. Financial flows on account of foreign debt service payments increased in 2019 with the maturity of two ISBs amounting to US dollars 1.5 billion, in addition to the scheduled payments of syndicated loans. Financial flows in relation to the banking sector, private sector and state owned business enterprises (SOBEs) recorded net outflows, mainly reflecting the increased debt repayments in 2019. Outflows, particularly from the government securities market, continued in the first quarter of 2020, amidst heightened uncertainties in global financial markets with the spread of the COVID-19 pandemic.

Gross official reserves improved by end 2019, supported by significant inflows to the government and the Central Bank, despite large foreign currency debt service payments by the government in 2019. Gross official reserves increased to US dollars 7.6 billion by end 2019 from US dollars 6.9 billion at end 2018. The proceeds from the issuances of two ISBs, the receipts of two tranches of the IMF-EFF and the purchase of foreign exchange by the Central Bank from the domestic foreign exchange market, primarily contributed to enhance gross official reserves by end 2019. The country's gross official reserves at end 2019 could cover about 4.6 months of imports and about 57 per cent of its short term liabilities. Furthermore, total international reserves, which consist of gross official reserves and foreign assets of depository corporations, increased to US dollars 10.4 billion by end 2019, equivalent to 6.3 months of imports.

Sri Lanka's external debt increased further by end 2019, mainly due to the rise in external debt of the government. Total external debt of the country increased to US dollars 55.9 billion by end 2019, which was equivalent to 66.6 per cent of GDP, compared to 59.2 per cent of GDP recorded by the end of 2018. The outstanding balance of ISBs, based on market value, increased to US dollars 15.2 billion at end 2019, reflecting the net impact of new ISB issuances and maturities. The outstanding balance of non residents' holding of Treasury bonds declined notably in 2019, while the non residents' holdings of Treasury bills recorded a marginal increase during the year. Meanwhile, the outstanding balance of foreign loans of the government declined marginally due to net repayments in 2019. The outstanding external liabilities of the Central Bank increased with the receipt of the IMF-EFF tranches and the marginal increase in liabilities to the Asian Clearing Union (ACU) by end 2019. However, the external liability position of the banking sector declined due to the maturity of an international bond issued by the National Savings Bank and the decrease in outstanding loan liabilities of Licensed Commercial Banks (LCBs). The intercompany borrowings by DIEs recorded an increase, reflecting the increase in intercompany loans as well as shareholder advances by major companies at end 2019.

The exchange rate remained broadly stable during 2019, supported by a significant improvement in the current account, despite some transient volatility experienced amidst outflows of portfolio investment, responding to domestic and global developments. The exchange rate strengthened during the first four months of 2019, as a result of the significant contraction in the trade deficit and an increase in financial inflows. However, the exchange rate experienced some pressure in the immediate aftermath of the Easter Sunday attacks, and towards the latter part of 2019, reflecting the impact of heightened uncertainties in global markets, which resulted in some unwinding of portfolio investment by foreigners. Nevertheless, favourable liquidity conditions that prevailed in the domestic foreign exchange market during most of 2019 enabled the Central Bank to absorb US dollars 387 million, on a net basis, in 2019. Overall, the Sri Lankan rupee appreciated by 0.6 per cent against the US dollar in 2019, compared to the significant depreciation of 16.4 per cent in 2018. Aligning with the nominal appreciation of the Sri Lankan rupee against the

Figure 1.6
Exchange Rate and the Central Bank Intervention in the Domestic Foreign Exchange Market



Source: Central Bank of Sri Lanka

currencies of several major trading partners, and together with the movements in the cross currency exchange rates, both the NEER and REER indices appreciated in 2019. However, the REER indices remained below the base year level, reflecting the country's competitiveness in terms of the exchange rate. The Central Bank continued to allow flexibility in the determination of the exchange rate based on market fundamentals, while intervening in the domestic foreign exchange market only to prevent excessive volatility of the Sri Lankan rupee and to build reserves. Meanwhile, the exchange rate, which remained stable up to the second week of March 2020, witnessed significant pressure with the spread of the COVID-19 pandemic, while speculation by market participants and foreign investors also weighed on the stability of the currency. The government and the Central Bank introduced several measures to curb the excessive pressure on the external sector, while allowing the rupee to depreciate in line with currencies of regional peers.

Fiscal Sector Developments

The process of fiscal consolidation faced significant challenges in 2019, amidst the notable decline in government revenue and the rise in government expenditure. Due to the political impasse in the fourth quarter of 2018, the submission of the government Budget 2019 was delayed until March 2019, and fiscal operations were conducted on a Vote on Account from January through early April 2019. The government Budget 2019, which was approved on 5 April 2019, aimed at reducing the budget deficit to 4.4 per cent of GDP in 2019 from 5.3 per cent of GDP in 2018, while targeting surpluses in the current account and the primary balance of 0.2 per cent and 1.5 per cent of GDP, respectively. However, fiscal performance worsened in 2019 due to the notable decline in government revenue caused by the sizeable import compression, particularly of motor vehicles, subpar economic activity exacerbated by the Easter Sunday attacks, as well as the rise in recurrent expenditure mainly on account of subsidies and transfers, and salaries and wages. Further, the delays in implementation of certain revenue measures proposed in the government Budget 2019 also contributed to weak revenue performance in 2019. Consequently, the major fiscal indicators deviated from the envisaged levels in the Budget 2019, and also in comparison to 2018. Accordingly, the budget deficit rose to 6.8 per cent of GDP in 2019, from 5.3 per cent of GDP in 2018. The current account deficit, which reflects the government's dissavings, increased to 2.7 per cent of GDP in 2019, from 1.2 per cent in the previous year, and the primary balance, which excludes interest payments from the overall budget deficit, recorded a deficit of 0.8 per cent of GDP in 2019, compared to a surplus of 0.6 per cent of GDP in 2018. Consequently, central government debt as a percentage of GDP rose to 86.8 per cent by end 2019 from 83.7 per cent at end 2018, reflecting the impact of higher net borrowings to finance the budget deficit and the relatively modest growth in nominal GDP in 2019.

in tapping activities due to the unfavourable weather conditions in the latter part of the year and abandoning of tapping activities due to low prices domestically and globally contributed to the contraction in rubber sector activities in 2019. Further, marine fish production was affected by inclement weather, such as cyclones and heavy rains, during most part of 2019, resulting in a contraction of 5.5 per cent in the marine fishing and marine aquaculture subsector. Further, forestry and logging activities also registered a contraction of 4.8 per cent in 2019.

The industry sector performance somewhat improved in 2019, recording a growth of 2.7 per cent during the year, compared to the growth of 1.2 per cent in 2018. The construction and mining and quarrying subsectors grew by 4.0 per cent and 2.8 per cent, respectively, in 2019, mainly supported by the government infrastructure development projects, compared to contractions of 2.5 per cent and 5.2 per cent, respectively, recorded in 2018. Meanwhile, manufacturing activities, which accounted for 15.6 per cent of GDP, registered a subdued growth of 1.9 per cent in 2019, compared to the growth of 3.6 per cent in the preceding year. In 2019, the manufacturing of textiles, wearing apparel and leather products subsector grew by 3.9 per cent, compared to the growth of 3.4 per cent in 2018, with the gradual recovery in demand for exported goods. Meanwhile, the growth of the manufacture of food, beverages and tobacco subsector decelerated to 3.4 per cent in 2019 from 4.0 per cent in the previous year, reflecting the impact of dampened domestic demand in the aftermath of the Easter Sunday attacks. The manufacture of coke and refined petroleum products subsector grew notably by 23.4 per cent in 2019, compared to the contraction of 8.2 per cent in 2018, amidst the temporary shutdown of the refinery of the Ceylon Petroleum Corporation (CPC) for maintenance purposes.

Table 1.3
Gross National Income by Industrial Origin at Constant (2010) Prices (a)(b)

Economic Activity	Rs. million		As a Percentage of GDP (%)		Growth (%)		Contribution to Change (%)	
	2018 (c)	2019	2018 (c)	2019	2018 (c)	2019	2018 (c)	2019
Agriculture, Forestry & Fishing	**683,816**	**687,857**	**7.1**	**7.0**	**6.5**	**0.6**	**13.5**	**1.8**
Agriculture and Forestry	565,337	574,472	5.8	5.8	7.9	1.6	13.4	4.1
Fishing	118,479	113,386	1.2	1.1	0.2	-4.3	0.1	-2.3
Industries	**2,540,315**	**2,608,211**	**26.3**	**26.4**	**1.2**	**2.7**	**10.0**	**30.8**
Mining and Quarrying	225,505	231,893	2.3	2.3	-5.2	2.8	-4.0	2.9
Manufacturing	1,512,800	1,540,969	15.6	15.6	3.6	1.9	16.8	12.8
Electricity, Gas, Water and Waste Treatment	144,940	151,978	1.5	1.5	6.0	4.9	2.7	3.2
Construction	657,070	683,371	6.8	6.9	-2.5	4.0	-5.5	11.9
Services	**5,555,303**	**5,680,757**	**57.5**	**57.4**	**4.6**	**2.3**	**78.2**	**56.8**
Wholesale and Retail Trade, Transportation and Storage, and Accommodation and Food Service Activities	2,234,394	2,273,836	23.1	23.0	3.5	1.8	24.6	17.9
Information and Communication	63,421	73,378	0.7	0.7	9.6	15.7	1.8	4.5
Financial, Insurance and Real Estate Activities including Ownership of Dwellings	1,366,490	1,400,468	14.1	14.2	9.6	2.5	38.6	15.4
Professional Services and Other Personal Service Activities	1,104,097	1,128,115	11.4	11.4	2.9	2.2	10.2	10.9
Public Administration, Defence, Education, Human Health and Social Work Activities	786,902	804,959	8.1	8.1	1.2	2.3	3.0	8.2
Gross Value Added at Basic Price	**8,779,434**	**8,976,825**	**90.8**	**90.8**	**3.7**	**2.2**	**101.6**	**89.4**
Taxes less Subsidies on products	889,166	912,553	9.2	9.2	-0.6	2.6	-1.6	10.6
Gross Domestic Product at Market Price	**9,668,600**	**9,889,379**	**100.0**	**100.0**	**3.3**	**2.3**	**100.0**	**100.0**
Net Primary Income from Rest of the World	-264,507	-281,083			-6.0	-6.3		
Gross National Income at Market Price	**9,404,093**	**9,608,296**			**3.2**	**2.2**		

(a) Based on the GDP estimates (base year 2010)
(b) Provisional
(c) Revised

Source: Department of Census and Statistics

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சனாதிபதி அலுவலகம்
PRESIDENTIAL SECRETARIAT

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23rd March 2020

Prof. W. D. Lakshman
Governor
Central Bank of Sri Lanka
Janadhipathi Mawatha
Colombo 01

Dear Prof. Lakshman,

Banking Facility and Credit Support to the Local Economy

As you are well aware, with the "Global Forced Shutdown", Central Banks and Governments in many countries have implemented proactive policy measures to assist people and businesses in each country to overcome their difficulties. Federal Reserve Bank, Bank of England, Reserve Bank of Australia and Reserve Bank of New Zealand have been very active with Central Banks themselves providing liquidity to the system. The World Bank, Asian Development Bank, too have pledged support to overcome human cost of COVID-19.

While appreciating some of the measures taken by the Central Bank of Sri Lanka, such as the reduction in reserve requirements on bank deposits and providing Rs. 50Bn to the General Treasury, these initiatives are not in proportion to the government actions and to the need of the humanitarian concerns due to social distancing initiatives, anxiety in every corner of business and the society.

In this backdrop, further to the directions issued by the Secretary to the Cabinet of Ministers, following the Cabinet Meeting held on 18.03.2020, His Excellency the President announced this morning (23.03.2020) several initiatives of which the Central Bank of Sri Lanka is expected to take strong actions and direct commercial banks, finance companies and leasing agencies to pass the benefits to the people and businesses which have been adversely affected from the prevailing "Social distancing" initiatives. His Excellency the President observed that measures taken by the banking system is grossly inadequate and financial institutions remain passive despite the country has gone into a difficult phase. Amongst such actions, His Excellency the President directed me to urge you to take following measures with immediate effect.

1. Direct all banks to keep their branches open from 8.00 a.m. to 1.00 pm with least number of officials to assist customers seeking access to finance.

2. Provide Rs. 50Bn from the Central Bank of Sri Lanka to implement a refinancing facility by the Central Bank of Sri Lanka to licence commercial banks, finance companies, leasing companies etc, to implement a 6 months debt moratorium for affected industries in tourism, apparel,

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plantation, IT and related logistic service providers to remain resilient and look after large number of affected employees.

3. Provide working capital requirements and waive off interest payments for at least 6, months as part of the above mentioned re-financing facility.

   This 6 months refinance facility could be recovered from profits of the Central Bank of Sri Lanka and the balance if any from the Government when the Appropriation Bill comes into a law or from the "Fuel Price Stabilization Fund" which has been setup by the Government to build savings from the sharp reduction in oil prices.

4. Suspend payment transactions involved in secondary markets for Treasury Bills and Treasury Bonds till 31.03.2020. Chairman of the Securities and Exchange Commission too has been advised to suspend Colombo Stock Exchange in the context of global situation to prevent further capital outflows.

5. Impose a maximum interest rate of 15 percent on local credit card transactions with the reduction of minimum payment by 50 percent to those who have monthly credit below Rs. 50,000.00.

6. Facilitate Bank of Ceylon, Peoples' Bank, National Savings Bank, Sri Lanka Insurance Corporation Limited, Employees' Trust Fund and Employees' Provident Fund to work as "one corporate team" working in the national interest to bring down the yield rate of Treasury Bills and Bonds to around 7 percent. This will also enable the Government to reduce its interest cost on domestic debt which is estimated to be around Rs. 750 Bn, for 2020. Such fiscal savings could also be used to re-position the Central Bank of Sri Lanka and reverse the intervention measures once the world and Sri Lanka return to normal with trade, tourism and investments stabilizing in global economy.

7. Provide 3-6 months flexibility in regulatory requirements imposed by the Bank Supervision Department of the Central Bank of Sri Lanka on Licenced commercial banks since almost all such banks have enjoyed decent profits until the country was hit by COVID- 19 impact.

8. Direct Lanka Clear to be fully operational as and when banks require.

9. Take immediate steps to stabilize Exchange Rate preferably around Rs. 185/USD (Commercial banks selling rate) to prevent uncertainties to the business community and unwarranted speculation. Further, such deprecation does not seems helping export promotion, import substitution, debt servicing as fiscal consolidation.

The Ministry of Finance, Economy and Policy Development has already taken several measures to curtail non priority expenditure and target large tax payer community as well as large business transaction to create sustainable fiscal strategy. The Ministry has also taken steps to clear all arrears payments and clear its accounts to focus on quality public spending. As regards, foreign financed projects steps have been taken to re-examine and lineup only those public investment projects that will be fiscally affordable. Recent attempts to professionalize State Enterprises management will also provide much needed comforts to the conduct of Macro Fiscal Policy Strategies which will be complementary to Monetary Policy that will be development friendly with financial system stability.

It is encouraging to note that the Government has decided to setup a Fuel Price Stabilization Fund at the Cabinet Meeting held on 18th March 2020, to generate savings for economic stability. In fact, the General Treasury has shown that if petroleum prices were not reduced in 2015, and vehicle imports particularly motor vehicles were not encouraged, the country could have generated nearly USD 10Bn, during the five year period from 2015 to 2019. The fuel price reduction have also increased import of fuel, urban traffic and environmental pollution as well – the economic and social cost has not been quantified.

I also wish to mention that almost all trade chambers including Ceylon Chamber of Commerce, Federation of Chamber of Commerce of Sri Lanka, Joint Appeal Association Forum and Hotels Association of Sri Lanka have urged intervention of His Excellency the President since the banking system has not responded to their concerns.

His Excellency the President is also of the view that the country should reduce its import dependency for food and energy by exploiting local agriculture and renewable energy resources so that Food and Energy Security concerns could also be addressed in a sustainable manner. As you are aware, His Excellency has given highest priority for poverty reduction, promoting public healthcare system and education and Skills development.

In the background of this "People First" human resource based development strategy, His Excellency's priority is to ensure public welfare particularly of the poor and vulnerable people is well looked after and assisted during COVID-19 phase of transition.

Therefore, I shall be most thankful if you could issue above mentioned directions as His Excellency the President directed me to follow up his directives with you as Head of the Central Bank of Sri Lanka and with Line Ministry Secretaries, Head of State Departments and Institutions to ensure these actions will serve the intended public welfare.

Yours sincerely,

P. B. Jayasundera
Secretary to the President

Copy : Secretary to the Prime Minister
Secretary to the Cabinet of Ministers
Secretary, Ministry of Finance, Economy and Policy Development

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நிதி அமைச்சு
MINISTRY OF FINANCE

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Strictly Confidential

Prof. W. D. Lakshman
Governor
Central Bank of Sri Lanka
31, Janadhipathi Mawatha
Colombo 01

My dear Governor,

Short Term Macro-Economic Policy Initiatives

Copy issued to
Prof. W. D. Lakshman

I refer to your letter dated 26th July 2021 and content is noted. I have been in regular dialogue with you since I became the Finance Minister in July 2021, while you and the Monetary Board have been working on these issues for the past 18 months. I have noted that the import restrictions have been tightened to reduce trade deficit. In fact, if not for the cost of vaccination and fuel the imports have been significantly lower reflecting that such restrictions have had their impact. However, we must also recognize the limitation of such restrictions as policy tools in highly integrated global economy.

As you are aware, I am scheduled to present the 2022 Budget Speech in early November, 2021 and currently engaged in assessing the economic environment both local and international. The challenges highlighted in your reports are not new and as you have mentioned in your report, the external sector has been vulnerable even prior to covid-19 due to the rolling over of large external debt for some time. Your report also explains that the source of the problem has been the reliance on external borrowings and increasing dependency on external debt creating sources on financing external and internal deficits over the past several decades. In this context, this government taking a decision to avoid such debt creating financing and relying on investments as well as expanding foreign earning avenues are welcome features.

Your report suggests to consider approaching IMF to address these challenges. It indicates that such involvement of IMF requires aggressive reforms in the fiscal sector, interest rates, exchange rate and even restructuring of debt stock of the Government. I would like the Central bank of Sri Lanka to clearly advise me why such reforms cannot be done without resorting to IMF loan programme, for instance as Malaysia did to manage the challenge of Asian Financial Crisis. The country may need a fresh thinking altogether as Sri Lanka has had 16 IMF programmes since 1965.

The government is in a critical juncture since the country is confronted with the Covid-19, 3rd wave having implications on all aspects of socio economic life. In this backdrop, the government has devoted its attention and resources to undertake an intensified vaccination program, while having to provide other health facilities to ensure that people have access to public healthcare which remains a top priority of the Government. The vaccination program which costs about US$ 300 million, has already reached 95 percent of the population above the age of 30 years. The second dose is also being carried out aggressively to empower people minimize their health risks. The vaccination program (second round) envisages to vaccinate 50 percent of the target group by the end of August 2021 and 100 percent of the target group by the end of 2021. This will place the Sri Lankan population in much better health standards in comparison to other nations, enabling the country to operate in the "New Normal" environment.

In the meantime, the cost of interruptions and associated uncertainties also have a serious economic cost. I have observed the following at macroeconomic level.

1. Treasury Bills holding of the Central Bank of Sri Lanka have been on the rise and has reached exceptional levels, with revenue lags and expenditure leads of the Government which often happen in trouble times having influenced Treasury Bill / Treasury Bond market conditions.

2. There is also a shortage of foreign exchange in the Forex Market as has been reported by shipping lines, the business community and the media. This has resulted in a large number of containers at the Colombo port not being cleared. I have also noticed that most of the cargo comprises of essential food and raw material which are essential for the smooth functioning of day to day life and country's economy.

3. As revenue generating activities have been shrunk, there is a strong pressure on the fiscal deficit and more importantly on treasury operations which involve payment of salaries and pensions, debt servicing and contractual payments on account of public investments.

4. There is also growing anxiety among market participants due to passive forex market operations that promote speculation among producers and suppliers, creating panic buying and selling as well as pilling of stocks.

5. These market sentiments are been a subject of interest to correspondent banks and rating agencies, in assessing the country risk.

6. Despite the Government of Sri Lanka having maintained a credible debt servicing record and honored Letters of Credit in a timely manner even in difficult times, such as during the 30 year war and during high oil price periods, there is a perception of a possible default risks, unwarranted. The counting of adverse media report on these issues in my view is a responsibility of the Central Bank of Sri Lanka.

7. It is regrettable to note that while the Central Bank of Sri Lanka has requested banks to provide 10 percent as the Loss Given Default (LGD) percentage on the sovereign bond portfolio, the Chartered Institute of Sri Lanka has recommended 20 percent. This discrepancy is not in the best interest of economic stability. Central Bank of Sri Lanka as a Regulator, should not allow other entities to undermine its regulatory judgments.

As you are aware, International Monetary Fund (IMF) in appreciation of global challenges has mobilized member country support to increase global reserve levels and Sri Lanka as a member of the IMF is expected to benefit from this initiative by the end of this month. I am made to understand that the quota allocation should provide some strength to restore the macroeconomic stability and support the economy, as expected by the IMF.

The Government also has taken serious measures including the following to increase capital inflows through Foreign Direct Investments.

1. The long standing dispute with regard to Kantale Sugar between MG Sugars Lanka (Private) Limited and the Government has been resolved with a Settlement Agreement. This has saved having to pay the cost of the Arbitration Award which should have been a large foreign payment. In fact, the Settlement Agreement is expected to bring in a cash inflow of US$ 70 million by end August 2021.

2. I am also on a constant dialog with the Chinese Authorities to get them to expeditiously disburse the loan of RMB 2,000 million (USD 350 Million) from China Development Bank. The loan disbursement is expected in August 2021.

3. Foreign investment agreement for West Coast Power Project is being finalized. This transaction is expected to attract USD 250 Mn soon after agreement is executed. The delay is due to the officials who are involved in finalizing are on quarantine.

4. The investment agreements for West Terminal of Colombo Port and Athurugiriya expressway have been executed to raise USD 1500 FDI over next three years.

5. The much waited Colombo Port City Economic Commission Act was enacted in May 2021 and this has pave way to create an impetus for FDIs within the Special Economic Zone – Colombo Port City.

6. Tax/ Foreign Exchange Amnesty Bill was cleared by the Supreme Court and is expected to take up in Parliament next week.

7. Special Goods and Services Tax legislation has also been finalized.

8. The consent of the Cabinet of Ministers have been obtained to curtail non-priority public spending and costly capital projects.

9. Several legislations including emigration and immigration laws to relax restrictions to attract foreign inflows and legislative changes to improve doing business have been lined up to place before Parliament.

10. Steps have been taken to regain tourism based on bubble concept applicable for hotels above 3 star category.

In this background I am also of the view that following measures would be necessary to be initiated by the Central Bank of Sri Lanka, to signal market to move on to a stabilization path.

1. Release a total of USD 250 Mn immediately to all Commercial Banks, since they are in need urgent foreign exchange to honor payments on account of imports under various trade instruments (DP term of payment, Sight LCs etc.). This will enable all cargo currently at the Ports to be cleared. This should be subject to the Central Bank of Sri Lanka instructing that selling rate of each commercial bank shall not exceed LKR 202 per USD. A further USD 250 Mn be released in early September 2021, to meet petroleum and LP gas financing.

2. Increase the present policy rate by 50 basis points to raise the prevailing Central Bank deposit rate and lending rate from 4.5% and 5.5% to 5.5% and 6% respectively.

3. Conduct open market operations aggressively to reduce its Treasury Bills holdings while allowing the maximum Treasury Bill rate to increase by 75 -100 basis points.

4. Increase the interest rate on local overdraft and term loan facility on BOI companies from domestic banking system to encourage the inflow of foreign remittances and prevent interest rate arbitrage.

5. Impose an interest rate ceiling on interest payable on Forex Deposits by Commercial Banks.

6. Introduce Letters of Credit as a mandatory requirement for all imports (in place of imports being made under various trade instruments) till 31st December 2021 and impose a 2% tax on LC's other than medicine, essential food items and raw material.

7. Increase the Statutory Reserve Ratio by 2 percentage points to 4 percent and earmark such funds (approximately LKR 250 Bn) to set up a "Green Finance Facility" (GFF) to lend through commercial banks at 4% for organic fertilizer manufacturing, renewable energy projects, forestry and organic agricultural development.

8. Increase the limit of inward cash declaration at Customs from USD 10,000 to USD 25,000 for visiting travelers and Sri Lankan arriving the country from overseas travel.

9. The Ministry of Finance will request all major import companies to organize USD 150 Mn to 250 Mn medium term Credit Lines from the respective countries that they import, so that heavy import payments will not exert pressure on the FOREX market.

10. The Department of External Resources is working with bilateral and multilateral agencies to increase foreign funding to address external resource requirements.

I wish to seek the cooperation of the Monetary Board to proceed with the macro policy initiatives that I have outlined in this letter with immediate effect and urge Central Bank of Sri Lanka to take necessary steps to give effect to the policies connected with the policy rates, open market operations and Forex market activities to restore confidence.

I would also request you to conduct media briefing and clearly explain the market on the rational of the policy actions to improve confidence.

I propose to brief the Cabinet of Minister of the proposed initiatives on Monday 16th August 2021.

Copy issued to
Prof. W. D. Lakshman

Yours sincerely,

Basil Rajapaksa
Minister of Finance

Copies : His Excellency the President
Hon. Prime Minister
Hon. State Minister of Money & Capital Market and State Enterprise Reforms
Secretary to the Treasury

For closely follow up with the Governor of the Central Bank of Sri Lanka

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சனாதிபதி அலுவலகம்
PRESIDENTIAL SECRETARIAT

6R4

21st June 2021

Prof. W. D. Lakshman
Governor
Central Bank of Sri Lanka
30, Janadhipathi Mawatha
Colombo 01

Dear Governor,

Proposals to Impose 150 Percent Deposit Margin on Letters of Credit

Secretary to the Treasury has brought to my notice that despite his objection the members of Monetary Board are pursuing a proposal to impose a 150 percent deposit margin on letters of credit to curtail imports to manage international reserves.

I wish to mention that this has far reaching implications on the post Covid 19 economic recovery prospects as the Government is supporting restriction free exports as well as imports for exports in order to raise country's export revenue. The targeted exports for 2021 is USD 12,400 Mn.

Furthermore, Government policy initiatives has put significant emphasis to curtail imports through the encouragement of viable import substitution production activities with food production including dairy, grains, fish and dried fish, organic fertilizer manufacturing, essential drugs and vaccines, renewable energy sources, IT and enabling services which are on the top of the list. These import substitutions are being pursued through rigorous and front loaded policy initiatives and actions. The targeted import is around USD 17,000 Mn. to keep trade deficit below USD 5,000Mn.

In this background, imposition of 150 percent deposit margin without clearly defined items being identified, may have serious repercussions on a much needed economic recovery in both domestic and in export industries and recreating employment and livelihood opportunities to the people.

Government from its part has already raised fuel prices in order to reduce the use of fossil fuel. However, the price elasticity of such consumption may not be conducive to curtail

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volumes of fossil fuel imports. The government has restricted the imports of motor vehicles including the suspension of duty free vehicle facilities for public sector to curtail the growth of vehicle fleet. The Government strategy also envisages the encouragement of the use of electric vehicles when the Balance of Payments reflects such initiatives are affordable through the underlying structural transformation in the Balance of Payments takes place in the country. Actions has already being taken to issue license on sugar and gold imports. Several large items have been placed on Negative List or high special commodity levies or Cess. It is also proposed to accelerate the implementation of renewable energy projects and low cost energy generation projects to reduce the importation of fossil fuel on a volume basis.

At the meeting held on the 01st June 2021 at 4.00 pm with His Excellency the President, members of the Monetary Board agreed that the Exchange Management Regulations will be issued shortly to allow all commercial banks to enter in to the Sovereign Bond market and also to promote overseas secondary market. It was also agreed that the commercial banks will be permitted to increase their foreign currency borrowings exposure from present level by at least USD 100 – 200 million considering the fact that external debt of both the Government and the banking system has declined in 2020. I have not seen such regulations being issued yet. The debt reduction of around USD 4 Bn in 2021 may further reduce external exposure and higher fiscal savings.

I would also like to invite the attention of the members of the Monetary Board to the "Report on the Establishment of a Central Bank for Ceylon; Sessional Paper XIV – 1949" explanatory note given to paragraph 08 in order to emphasize the importance of close working relation with the Government. "This clause provides for a Monetary Board of only three members. Experience in many countries has shown that a small board is likely to be more effective than a large one. Greater prestige attaches to membership on a small board, thus making it easier to attract outstanding men. In contrast with large boards where responsibility often tends to be so diffused that members do not take sufficient interest; a small board makes for a healthy concentration of responsibility. Some central banks, such as the Commonwealth Bank of Australia, have gone so far as to place the entire responsibility for both policy and administration in the Governor or the Bank. There is also an Advisory Council, but as its names implies it is purely advisory. In Ceylon it was considered preferable to adopt the principle of a board in order to preserve the deliberative character of policy-making.

The decision to make the Permanent Secretary to the Ministry of Finance a member of a board of only three grows out of the underlying conception of what the Monetary Board's relations with the Government ought to be. This problem of the relationship of the Central Bank to the Government has vexed law-makers for many years. In most countries the exact relationship has not been precisely defined. However, various legal formulas have been attempted. In Australia, for example, the most recent Commonwealth Bank Act, passed in 1945, provides that the Bank shall from time to time inform the Treasurer or its monetary and banking policy. In the event of a difference or opinion between the Bank and the Government as to whether this policy is directed to the greatest advantage of the people of Australia, the Treasurer and the Bank are to endeavor to reach agreement ; if they are unable to do so, the Treasurer may inform the Bank that the Government accepts responsibility for the adoption by the Bank of a policy in accordance with the opinion of the Government. The Bank must then give effect to that policy. The Bank of England Act of 1946, which nationalized the Bank of England, provides that the Treasury can from time to time give such directions to the Bank as, after consultation with the Governor of the Bank, they think necessary in the public interest.

Such a formula may be called for, as it was in England, in order to clarify the relationship between a central bank and a government al the termination of a long period of private ownership and control of the central bank. It does not appear to be necessary in the case or Ceylon where a central bank is being established which from the very beginning is to be entirely under Government auspices. Such formulas come very close to making central banks departments of finance ministries. This might conceivably be done, or it might even be possible to make the Central Bank a separate ministry. There are, however, sound reasons for doing neither - reasons which may be understood in the light of a brief analysis of how a government owned central bank ordinarily fits into the political and economic structure of a country. From the governmental point of view a central bank is basically an independent. regulatory, and supervisory agency of a type which has become increasingly common in many countries of the world in recent years and in connection with which there has grown up a whole body of administrative practices and political conventions. Central banking embraces problems which are of an unusually technical nature and which require a degree of expertness and specialization not often demanded of Government officials. Also, the administration of a central bank must necessarily be promptly adapted to economic conditions which change rapidly.

From the economic point of view, a central bank puts the government into the business life of a country at especially critical points - namely banking and other credit activities, capital markets, foreign exchange markets, and the supply of hand- to-hand currency. There is a very wide area in which the regulatory functions and business activities of a central bank are non-policy-making in character. For this reason alone it would be desirable that central banks should be non-political and should have a considerable amount of independence.

There are, however, many important problems of monetary policy, especially those relating to fiscal policy, on which a central bank must necessarily work in close harmony with the government. On such problems experience in many countries has shown that a central bank with a degree of independence of the government proper can make economic analysis and hold views which are more detached and objective than those of a government department. Many governments have learned to value and to use the sort of independent and objective advice on monetary and other aspects of economic policy which central banks have been able to give. On matters of vital interest to the state, however, it must be recognized that even in the absence of some such formula as the British or the Australian, it would be impossible for the Central Bank to adopt a policy or pursue a course of action contrary to the policy of the Government of the day. No agency which is a creature of the Government can be entirely independent of the Government. While the Government may be prepared to give an independent regulatory agency rather wide discretion in a field such as that of money, there is no gain-saying that in the last analysis the Government must assume responsibility for monetary policy as for other policies. The Governor and the appointed member of the Monetary Board cannot help being acutely conscious of the fact that, since no Parliament can bind its successors, their independence and tenure in office under the proposed legislation is limited by the ultimate power of the Government to change the law.

The exact degree and independence of the Central Bank is likely to vary from time to time. For example, central banks, can ordinarily act more independently in stable, peace-time economic conditions than in time of war or other national emergency. They also tend to take stronger stands on issues which are primarily monetary in character than on related issues which may simply have monetary repercussions.

The ideal which it is hoped that the proposed law will achieve is one in which there will be continuous and constructive co-operation between the Monetary Board and the Government. The principal instrument for achieving this co-operation should be the Permanent Secretary to the Ministry of Finance whose membership on the Board will ensure at all times that his Minister's views will be made known to the other members of the Board. The effectiveness of this co-operation and coordination between the Board and the Government will depend more upon the men occupying the key positions at particular times than upon any legal formula, no matter how carefully or elaborately it might be worked out. A relationship as complex, and sometimes as delicate, as this one is certain to be, cannot be established full-blown by a piece of legislation. It must be the result, as in other countries, of years of experience and .the slow growth of political conventions.

One further point is well worth making. There is a clear need in Ceylon for some sort of economic council at Cabinet level to achieve improved co-ordination of Government economic policies. If in future such a council is set up it is suggested that the Governor of the Central Bank should have a place upon it".

Copy issued to
Prof. W. D. Lakshman

In this practical spirit that the architect of the Central Bank of Sri Lanka has nurtured in framing the Legal Framework through the Monetary Law Act, I would request the Central Bank to collaborate with the Government Policy. Further, for small developing economies such approach seems unavoidable to overcome post Covid – 19 economic challenges.

Therefore, it is advisable that the Monetary Board refrains from the imposition of deposit margins on LC's without proper appraisal and approval of the Cabinet of Ministers.

Yours Sincerely,

P. B. Jayasundera
Secretary to the President

Copy: Mr. D. Fernando - Secretary to the Cabinet
Mr. S. R. Attygalle Secretary to the Treasury
Dr. (Mrs). Rani Jayamaha - Member of Monetary Board
Mr. Sanjeewa Jayawardena P.C. - Member of Monetary Board
Mr. Samantha Kumarasinghe - Member of Monetary Board

6R5

Deshamanya Professor W D Lakshman
GOVERNOR
Central Bank of Sri Lanka
30, Janadhipathi Mawatha, Colombo 1, Sri Lanka

13 July 2021

Dr. P B Jayasundera
Secretary to the President
Presidential Secretariat
Galle Face
Colombo 01

My dear Secretary,

Proposals to impose 150 percent deposit margin on Letters of Credit

We refer to your letter dated 21.06.2021 on the above subject and wish to present some clarifications about the actions taken by the Central Bank of Sri Lanka (CBSL).

(i) The imposition of non-interest bearing minimum cash margin deposit requirements of 150 per cent and 100 per cent of import value against imports of non-essential and non-urgent goods was proposed to the Monetary Board by several departments of the CBSL as a short-term measure to address the problem of critically low official reserve position, continued pressure on the exchange rate and the urgent need to deter further foreign exchange outflows. As the proposal did not receive the Cabinet approval, it was not proceeded with.

(ii) Reference is made also to paragraph 6 in your letter. In this regard, the following changes made to Exchange Management Regulations are to be noted in response to matters raised in the above paragraph.

   (a) Banking Act Directions No. 8 of 2021 on Amendments to Banking Act Directions No. 11 of 2018 on Foreign Currency Borrowings by Licensed Banks issued on 25.05.2021 (Annex 1).

   (b) Banking Act Directions No. 10 of 2021 on Investments in Sri Lanka International Sovereign Bonds by Licensed Commercial Banks and National Savings Bank issued on 16.06.2021 (Annex 11).

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(iii) Thank you very much for your exposition of the concept of the essential need for collaboration between the CBSL and the Government. As an individual with a long period of economics teaching and research, this is a position I held all along. I have also expressed this view within the Central Bank every time this came up for discussion. Thank you very much also for making me go into Exter Report once again in detail.

We wish to inform you that the CBSL will continue to support the economy in line with the policies of the Government whilst working towards the achievement of statutory objectives of the CBSL to the utmost. In this regard we wish to annex a list of policies/actions taken by the CBSL during the COVID -19 affected period for your kind attention (Annex 111). We further ensure that the provisions of the Monetary Law Act in respect of any economic disturbances that are likely to threaten domestic monetary stability are diligently addressed. The CBSL will continue to apprise His Excellency the President, the Hon. Prime Minister and Hon. Minister of Finance on the nature, causes and magnitude of these concerns and on the monetary, fiscal and administrative measures proposed to be taken by the Government.

Yours sincerely,

Copy issued to
Prof. W. D. Lakshman

WD Lakshman

Deshamanya Prof. W D Lakshman
Chairman of the Monetary Board/Governor
Central Bank of Sri Lanka

Cc : Mr. D Fernando, Secretary to the Cabinet of Ministers
Mr. S R Attygalle, Secretary to the Treasury/Ministry of Finance and Member of the Monetary Board
Dr. (Mrs.) Ranee Jayamaha, Member of the Monetary Board
Mr. Sanjeeva Jayawardena, Member of the Monetary Board
Mr. Samantha Kumarasinghe, Member of the Monetary Board

Encl.

Annex I

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இலங்கை மத்திய வங்கி
CENTRAL BANK OF SRI LANKA

Updated as of 05.07.2021

Policy and Operational Measures Taken by the Central Bank of Sri Lanka during the COVID-19 Pandemic to Support Economic Activity

1. Measures to Reduce Interest Rates, Enhance Market Liquidity, and Finance the Government

- **30 January 2020:** Policy interest rates of the Central Bank were reduced by 50 basis points. The Central Bank of Sri Lanka was "the first central bank to reduce policy interest rates after the outbreak of the coronavirus in China began to affect financial markets", according to the global central bank news website "www.centralbanknews.info".

- **26 February 2020:** The Central Bank transferred Rs. 24 billion as profits to the government.
- **05 March 2020:** While maintaining policy interest rates at reduced levels, the Central Bank signalled that it stands ready to provide liquidity to domestic financial markets as necessary to mitigate any adverse impact stemming from the COVID-19 outbreak.
- **13 March 2020:** The Central Bank purchased Rs. 50 billion of Treasury bills from the primary market to fulfil urgent cash requirements of the government under exceptional circumstances.
- **16 March 2020:** Policy interest rates of the Central Bank were reduced by 25 basis points with effect from 17 March 2020 and the Statutory Reserve Ratio (SRR) on all rupee deposit liabilities of licensed commercial banks (LCBs) was reduced by 1.00 percentage point to 4.00 per cent. This resulted in the injection of permanent liquidity of Rs. 65 billion to the market.
- **23 March 2020:** The Central Bank purchased Rs. 50 billion of Treasury bills from the primary market to finance the establishment of the energy stabilisation fund by the government.

- **24 March 2020:** A circular was issued to LCBs, Licensed Specialised Banks (LSBs) and leasing companies informing relief measures to assist businesses and individuals who were adversely affected by the outbreak. This included a debt moratorium on capital and interest, provision of working capital at an interest rate of 4.00 per cent per annum, capping of interest rates charged on credit card payments, reduction of minimum monthly payment dues on credit cards, extension of the validity of cheques, and to keep all branches of licensed banks open on non-curfew days and corporate branches to be kept open during curfew days.
- **25 March 2020:** The above circular was interpreted to include Licensed Finance Companies (LFCs).
- **27 March 2020:** The Central Bank established a Rs.50 billion refinance scheme and a supplementary circular to the above circular was issued to LCBs and LSBs informing eligibility to participate in the re-financing facility to support businesses affected by COVID-19 including self-employed businesses and individuals commencing 01.04.2020, and set out the operational guidelines to give effect to the re-financing facility. These concessions include debt moratorium (capital and interest) and a working capital loan at the interest rate of 4.00 per cent per annum for eligible customers.

- **30 March 2020:**
    - Extended the provision of long term liquidity assistance for LCBs from 14 days to 90 days. This helped LCBs to source their long term liquidity needs with certainty.
    - Initiated the provision of long term liquidity assistance to Standalone Primary Dealers in addition to the overnight facility.
- **03 April 2020:** Policy interest rates were reduced by a further 25 basis points to 6.00 per cent and 7.00 per cent, respectively, effective from the close of business on 03 April 2020.
- **03 April 2020:** The Central Bank purchased Rs. 60 billion of Treasury bills from the primary market to facilitate the government to make salary payments in April.
- Commencing the Treasury bill auction on 25 March 2020, the Central Bank purchased the shortfall in Treasury bill issuances. Since then, the Central Bank has purchased Treasury bills worth Rs 67.4 billion to fulfil such shortfalls.

- **09 April 2020:** Interest rate charged under New Comprehensive Rural Credit Scheme (NCRCS) reduced from 7 per cent to 4 per cent and Rs 40,000 was given for home gardening.
- **16 April 2020:** The Bank Rate of the Central Bank, which is an administratively determined rate that could be used in periods of emergency, was reduced for the first time since 2003, by 500 basis points while allowing the Bank Rate to automatically adjust in line with the SLFR, with a margin of +300 basis points.
- **16 April 2020:** Reduced the minimum daily reserve requirement limit from 90 per cent to 20 per cent. This measure provided further space for LCBs to manage their overnight liquidity needs without any undue strains.
- **27 April 2020:** Considering the necessity to provide relief to low income individuals who are engaged in the pawning of gold jewellery to meet short-term financing needs due to the adverse economic situation resulting from the COVID-19, licensed banks were instructed on the maximum interest rate to be charged on pawning advances, i.e., 12 per cent per annum or 1 per cent per month for advances with a tenure of less than one year.
- **28 April 2020:** Licensed banks were informed on the extension of the deadline until 15May 2020 for submission of requests by eligible borrowers to avail concessions under the credit support scheme.

- **04 May 2020:** Initiated the provision of short term liquidity assistance for Standalone Primary Dealers to manage their liquidity on a short term basis.
- **06 May 2020:** Policy interest rates of the Central Bank were reduced by a further 50 basis points to 5.50 per cent and 6.50 per cent, respectively, effective from the close of business on 06 May 2020. Bank Rate was also reduced by a further 50 basis points.
- **16 June 2020:** The Statutory Reserve Ratio (SRR) applicable on all rupee deposit liabilities of LCBs was reduced by 200 basis points to its lowest level of 2.00 per cent. This reduction resulted in the injection of around Rs. 115 billion of additional liquidity to the domestic money market.
- **16 June 2020:** The Central Bank implemented three Credit Schemes in support of businesses affected by COVID-19 (construction and other needy sectors) at the concessional rate of 4.00 per cent per annum.

- Accordingly, in addition to the already allocated Rs. 30 billion under the refinance scheme introduced on 01 April 2020, the Central Bank provides funding to LCBs at the concessionary rate of 1.00 per cent against the pledge of a broad spectrum of collateral, on the condition that LCBs in turn will on-lend to domestic businesses at 4.00 per cent, while ensuring the greatest possible distribution of this facility and operating Instructions were issued on 19 June 2020. This scheme along with the existing refinance Scheme will provide Rs. 150 billion in total to the businesses affected by the COVID-19 pandemic.
- In addition, the construction sector enterprises will be provided with a facility to borrow from LCBs, using guarantees issued by the government equivalent to the amount due on account of contracts carried out in the past, under a new dedicated credit scheme funded by the Central Bank and made available at the aforementioned concessionary rates.
  - **18 June 2020:** Operating Instructions were issued to all LCBs on the Liquidity Facility to the Construction Sector enabling to borrow construction sector enterprises from LCBs, upon Promissory Notes/Guarantees Issued by the Government.
  - **03 July 2020:** Operating Instructions that were issued on 18 June 2020 was repealed by new Operating Instructions to enable the construction sector enterprises to borrow from LCBs backed by 'a Letter of Acceptance of Payments of Outstanding Bills Due to Contractors' issued by the Treasury on behalf of the Government in place of the Promissory Notes/Guarantees issued by the Government and LCBs to obtain credit from the Central Bank at a concessionary rate of 1% on a promissory note backed by pledged Treasury bills and bonds.

  - **24 July 2020:** "Liquidity Facility to the Construction Sector (LFCS)" was expanded to cover the contractors and suppliers of the government in the construction, pharmaceutical sectors and such other identified sectors upon a Letter of Acceptance of Payments issued by the Treasury for Outstanding Bills due to such contractors and suppliers of the government. As of 31 December 2020, total approved amount by the Treasury was Rs. 9.65 bn however from that LCBs made request only for Rs. 7.23 bn accordingly CBSL disbursed the same for LCBs under this scheme. At present loans granted under LFCS are fully settled by the LCBs to the CBSL.

- **01 July 2020**: The Central Bank introduced a Credit Guarantee and Interest Subsidy Scheme (CG & ISS) to accelerate lending by banks to businesses adversely affected by the COVID-19 pandemic. This scheme operates in parallel with the "Saubagya COVID-19 Renaissance Facility" and the new Facility extended within the already announced threshold of Rs. 150 billion.

    - Under the CG & ISS, the Central Bank provides a credit guarantee to banks, ranging from 80 per cent for smaller loans to 50 per cent for relatively large loans, enabling banks to grant loans to address working capital requirements of the affected businesses. The premium of 0.5 per cent is paid by the banks to the Central Bank as the credit guarantee fee. With the Central Bank absorbing a significantly higher percentage of the credit risk, banks are in ease in lending to vulnerable businesses focusing on viability and cashflows of such businesses rather than collateral.

    - Under the CG & ISS, banks use their own funds, particularly the additional liquidity of close to Rs. 180 billion provided by the Central Bank through the cumulative reduction in the Statutory Reserve Ratio (SRR) of 300 basis points thus far during the pandemic period, to grant loans at 4 per cent to businesses. The Central Bank provides an interest subsidy of 5 per cent to cover the cost of funds of banks.

- **01 July 2020**: The Central Bank reduced the interest rate charged under existing "Saubagya Loan Scheme" the Flagship loan scheme operated by the Central Bank, to the end borrower from 8 per cent per annum to 6 per cent per annum. Under this Scheme loans are granted to the Micro, Small and Medium size businesses, that add value with a maximum loan size of Rs. 25 million.
- **09 July 2020**: Policy interest rates of the Central Bank were reduced by a further 100 basis points to 4.50 per cent and 5.50 per cent.
- **30 July 2020**: Licenced banks were instructed to accommodate requests for loans by private bus owners engaged in public transport services in order to meet expenses of bus repair and maintenance, under the Credit Guarantee and Interest Subsidy Scheme of the Saubagya COVID-19 Renaissance.

- **20 August 2020:** The central bank decided to continue its accommodative monetary policy. Accordingly, the Central Bank decided to adopt targeted measures to reduce specific interest rates that it considered to be excessive, which would help marginal borrowers, while leaving policy rates of the CBSL unchanged. Downwards revisions made to regulated interest rates are as follows;
    - Maximum interest rate on Credit Cards revised downward to 18 per cent per annum commencing from the next billing cycle
    - Maximum interest rate on pre-arranged temporary overdrafts revised downward to 16 per cent per annum
    - Maximum interest rate on pawning facilities collateralised by personal articles made of gold accepted as a pledge revised downward to 10 per cent per annum for all new pawning advances and existing pawning facilities that are renewed
    - Penal interest rate over the regular interest rate charged on the relevant credit facility was capped at 2 percentage points
- **26 August 2020:** Debt moratorium to tourist related industries which implemented since April 2019 in the aftermath of Easter Sunday attacks, was further extended for a period of six months commencing from 1 October 2020 to 31 March 2021 considering COVID-19 affected businesses and individuals in the tourism sector.
- **06 November 2020:** Extended the initial 6 months grace period by another 3 months to the borrowers affected by COVID-19 under the Saubagya Covid 19 Renaissance Facility Loan Scheme.

- **26 November 2020:** Complementing the concessional loans schemes proposed by the Government in the Budget 2021, the Central Bank introduced a maximum interest rate on mortgage-backed housing loans for salaried workers in both public and private sector. Licensed banks must charge only 7 per cent per annum for such loans, at least for the first five years of the loan tenure. The remaining tenure of the loan is to be charged at the monthly Average Weighted Prime Lending Rate (AWPR) plus a margin of up to 1 percentage point.
- **19 January 2021:** In order to support a broad-based economic revival, the central bank decided to introduce priority sector lending targets for the micro, small and medium scale enterprises (MSME) sector in consultation with the banking community.

- The Monetary Law Act order mentioning priority sector lending targets was issued on 21 April 2021. Licensed banks need to grant credit to individuals and businesses in MSME sector and ensure a growth rate of not less than 20 per cent per annum on year-on-year basis, over the outstanding stock of lending to MSMEs at the end of the previous year.
- This lending target should be prioritised in the following economic subsectors but shall not be restricted.
  - Food and beverage processing; Production of medical utilities and related products; Development of distance learning facilities, Domestic cottage industry, Rubber and rubber products; Ship and boat building; cosmetics; Batik and handloom; Gem and jewellery; Health and wellness; Electronics and electrical components; Motor vehicle assembly; pharmaceutical manufacturing; Porcelain, ceramics and pottery

- **10-12 March 2021**: With a view to meeting the challenges faced by businesses and individuals engaged in passenger transportation sector due to COVID-19 pandemic, the Central Bank directed licensed banks and non-bank financial institutions to provide concessions for lease facilities obtained by COVID-19 affected businesses and individuals engaged in passenger transportation services commencing from 01 April 2021 for a period not exceeding six months.
- **19 March 2021**: With a view to meeting the challenges faced by businesses and individuals engaged in tourism sector due to COVID-19 pandemic, the Central Bank decided to extend the debt moratorium granted for tourism sector further by six months commencing from 01 April 2021 to 30 September 2021.
- **24 March 2021**: Six months moratorium given up to the 30 September 2021 to the tourism sector borrowers affected by COVID-19 under the Saubagya Covid 19 Renaissance Facility Loan Scheme.

- **25 May 2021:** With the outbreak of the third wave of COVID-19 pandemic, the Central Bank requested licensed banks to extend the following concessions to COVID-19 affected businesses and individuals.
    - Deferment or restructuring of existing credit facilities in the performing category as at 15 May 2021.
    - Concessions (rescheduling) for credit facilities in the non performing category as at 15 May 2021
- **09 June 2021:** Extended the grace period up to 30 September 2021 and the repayment period for twelve (12) months (total repayment period up to 36 months including grace period) for the working capital loans granted to the businesses and individuals, under the Saubagya Covid 19 Renaissance Facility Loan Scheme.
- **09 June 2021:** Considering the difficulties faced by the borrowers of LFCs and Specialised Leasing Companies, due to the third wave of COVID- 19 pandemic, the Central Bank extends the concessions for COVID-19 affected businesses and individuals, requesting to provide concessions to affected borrowers similar to licensed banks.
- **During 2021** the Central Bank has continued to maintain a substantial liquidity Surplus to support the banking and financial system and encourage credit disbursements. In addition, provisional advances and profit transfers as well as Treasury bill purchases by the Central Bank at the primary auctions during the year 2021 contributed to smooth out government cash flow operations while enhancing the liquidity in the domestic money market.

2. Measures taken to Manage Foreign Exchange Flows, Maintain Exchange Rate Stability and Preserve International Reserves

- **19 March 2020:** With a view to easing the pressure on the exchange rate and the stress on financial markets due to the impact of the COVID-19 pandemic, the Central Bank issued Banking Act Directions to LCBs and National Savings Bank to:
    - suspend facilitation of the importation of;
        - all types of motor vehicles, other than those excluded specifically under the Banking Act Directions, under Letters of Credit;

- non-essential goods specified in the Directions under Letters of Credit, Documents Against Acceptance and Advance Payment;

o suspend the purchase of Sri Lanka International Sovereign Bonds.

Both measures were introduced for a period of 3 months.

- **19 March 2020**: To further ease the pressure on the exchange rate from the demand side, the Central Bank issued Directions to Authorised Dealers informing them to issue foreign currency notes up to a maximum of US dollars 5,000 (or its equivalent in other foreign currency) as travel allowance to persons resident in Sri Lanka travelling abroad for any purpose, from the previously permitted travel allowance of US dollars 10,000.

- **20 March 2020**: In conjunction with the Banking Act Directions issued on 19 March 2020, the Central Bank also issued Directions to Authorised Dealers, requesting them to suspend release of foreign exchange with immediate effect for the importation of certain non-essential consumer goods under the Documents Against Payments and Open Account Payment terms, for a period of three months until 20 June 2020.

- **20 March 2020**: The Central Bank introduced Sell-Buy Forex SWAP Auctions for Licensed Commercial Banks (LCBs) to provide foreign currency liquidity on term basis without depleting the foreign reserves as the access of LCBs to external financing sources has been restricted owing to the uncertainty created by the COVID-19 pandemic.

- **02 April 2020**: Introduced following temporary regulatory measures on outward remittances for a period of 3 months.

    o Suspend the general permission granted to make outward remittances through the Outward Investment Accounts for the purpose of investing overseas by persons resident in Sri Lanka excluding the following;

        - investments to be financed out of a foreign currency loan obtained by the investor from a person resident outside Sri Lanka under the provisions of the Foreign Exchange Act, or

        - investments to be made to fulfil the regulatory requirement in that country.

- Suspend outward remittances through Business Foreign Currency Accounts or Personal Foreign Currency Accounts held by persons resident in, Sri Lanka other than for the remittances on current transactions.
- Suspend the repatriation of funds under the migration allowance through Capital Transactions Rupee Accounts by emigrants who have already claimed migration allowance.
- Limit the eligible migration allowance for the emigrants who are claiming the migration allowance for the first time has been limited up to a maximum of US dollars 30,000.
- The Monetary Board to grant permission for investments on a case by case basis, when they exceed the limits specified in the general permission granted in Schedule I of the Foreign Exchange (Capital Transactions in Foreign Exchange carried on by Authorised Dealers) Regulations No. 1 of 2017 provided that,
  - the proposed investment is to be financed out of a foreign currency loan obtained by the investor from a person resident outside Sri Lanka under the provisions of the Foreign Exchange Act, or
  - the proposed investment is to be made to fulfil the regulatory requirement in that country.

- **03 April 2020:** Alongside other regulatory measures taken by the Central Bank to support businesses and individuals affected by the COVID-19 outbreak, directions were also issued to Authorised Dealers informing them to recover any foreign currency loans granted to Business Foreign Currency Account holders in Sri Lanka Rupees, when recovery of such loans in foreign currency is remote, as a last resort by converting such loans to Sri Lanka Rupee denominated loans, where necessary.
- **08 April 2020:** Hon. Minister of Finance in consultation with the Monetary Board and with the approval of the Cabinet of Ministers issued regulations to introduce a Special Deposit Account for any Sri Lankan individual resident in or outside Sri Lanka including Dual Citizens, Citizens of other States with Sri Lankan origin and any person resident outside Sri Lanka

including funds, corporate bodies, association and other well-wishers with the following special features.

- Minimum tenure: 6 months.
- Interest payable: 1 percentage point and 2 percentage points per annum above the deposit rates applicable on normal deposits for SDAs with a tenure of 6 months and 12 months, respectively, payable at maturity of the deposit.
- Repatriation of Funds: Freely convertible and repatriable outside Sri Lanka on the maturity of the term deposits.

- **09 April 2020:** Net open position (NOP) limits of LCBs were curtailed on a selective basis to prevent speculative activities in the foreign exchange market.

- **16 April 2020:** Directions issued to Authorised Dealers informing that loans granted to Sri Lankans employed abroad shall be recovered in Sri Lanka Rupees, as a last resort where necessary when recovery of such loans in foreign is remote.
- **24 April 2020:** The Central Bank commenced intervening in the forward foreign exchange market to manage the excessive volatility in the forward exchange rate.
- **1 July 2020:** Hon. Minister of Finance in consultation with the Monetary Board and with the approval of the Cabinet of Ministers has taken further measures to encourage opening of Special Deposit Accounts (SDAs) as stated below.
  - Any person who has arrived in Sri Lanka from overseas on or after 01.01.2020 can open SDAs with any Authorized Dealer on or before 07.10.2020, out of foreign exchange legitimately acquired and brought into Sri Lanka by such person subject to:
    - a declaration made to the Sri Lanka Customs at the port of arrival where the amount of such foreign exchange exceeds USD 15,000 or an equivalent amount in any designated foreign currencies.
    - a declaration to the relevant Authorized Dealer where the amount of such foreign exchange is equal or less than USD 15,000 or an equivalent amount in any designated foreign currencies.

- Any person in, or resident in, Sri Lanka can open SDAs with any Authorized Dealer on or before 07.10.2020, out of foreign currency notes in his possession up to the limit of USD 15,000 and subject to such terms and conditions of the prevailing Regulations and Orders, subject to a declaration on the source of funds to the Authorized Dealer.

- **01 July 2020**: the amount of foreign currency that can be retained by a person in, or resident in Sri Lanka in his possession has been increased from USD 10,000 to USD 15,000 with effect from 01.07.2020 which has also been permitted to be credited into a SDA.
- **01 July 2020**: obtained ACU currency SWAP facility from the ACU secretariat to settle the ACU bi-monthly net settlement obligation of the CBSL for the period May and June 2020 and the net payment of USD 272 million was settled on 04.09.2020.
- ACU secretariat has already approved the ACU currency SWAP facility to the CBSL for the next bi-monthly settlement period i.e. May and June 2021.
- **02 July 2020**: Introduced following temporary regulatory measures on outward remittances for a period of 6 months.

  i. Suspend the general permission granted to make outward remittances for investments overseas through the Outward Investment Accounts by persons resident in Sri Lanka excluding the following;

  a. investments to be financed out of foreign currency loans obtained by the investor from a person resident outside Sri Lanka under the provisions of the Foreign Exchange Act,
  b. an additional investment to be made to fulfil the regulatory requirement in the investee's country applicable on the investment already made in a company or a branch office in that country,
  c. an additional investment/infusion of funds (as applicable) to be made by eligible resident companies in already established subsidiaries or branch offices in overseas up to a maximum of USD 20,000, for the purpose of working capital requirements of the investee,

d. the remittances up to a maximum of USD 20,000, for the purpose of maintenance of liaison, marketing, agency, project, representative or any other similar offices already established in overseas.

ii. Suspend the outward remittances through Business Foreign Currency Accounts (BFCAs) or Personal Foreign Currency Accounts (PFCAs) held by persons resident in Sri Lanka, other than for the remittances on current transactions up to any amount or capital transactions up to a maximum of USD 20,000.

iii. Limit the eligible migration allowance for the emigrants who are claiming the migration allowance for the first time, up to a maximum of USD 30,000.

iv. Limit the repatriation of funds under the migration allowance by the emigrants who have already claimed migration allowance up to a maximum of USD 20,000.

v. Limit the authority of the Monetary Board of the Central Bank of Sri Lanka to grant special permission for investments on case by case basis, which exceeds the limits specified in the general permission, only to those satisfying the criteria mentioned in i.a and i.b above.

- **31 July 2020:** The Central Bank obtained funds under the bilateral currency SWAP agreement with the Reserve Bank of India amounting to USD 400 mn in support of country's balance of payment requirements.
- **23 September 2020:** Operating Instructions were issued to LCBs to introduce a new USD/LKR Buy-Sell Currency SWAPs Scheme namely, "Inward Investments SWAPs – IIS Scheme" to hedge the foreign exchange risks of non-resident investors. This is to encourage the fresh foreign inflows to the country.
- **28 September 2020:** The Central Bank obtained a Repo Facility of USD 1,000 million from the Federal Reserve Bank New York, in support of meeting the contingent liquidity needs of the government.
- **06 October 2020:** Authorized Dealers (ADs) were permitted to renew and continue SDAs, beyond the designated date of maturity with the interest rates offered by the ADs for normal term deposits and to freely convertible and repatriable outside Sri Lanka on the maturity of the term deposit.

- **07 October 2020:** Directions were issued to ADs informing them to facilitate transfer c maturity proceeds including the interest of SDAs to Personal Foreign Currency Account (PFCAs) and Inward Investment Accounts (IIAs), provided such SDA holders are eligible t open and maintain PFCAs/ IIAs.
- **17 November 2020:** Hon. Minister of Finance in consultation with the Monetary Board an with the approval of the Cabinet of Ministers has extended the opening of Special Depos Accounts (SDAs) by eligible persons during the period of 12 months from 08 April 2020.
- **20 November 2020 and 22 January 2021:** In order to facilitate large foreign exchang outflows, negative NOP limits of selected Licensed Banks were enhanced with an intention c avoiding any potential pressure on the exchange rate due to such large foreign exchang outflows.
- **23 November 2020:** Second series of Sell-Buy Swaps auctions was commenced in order t facilitate the temporary liquidity shortage prevailed in the domestic foreign exchange mark subsequent to the emergence of the second wave of Covid-19 pandemic and the impact du to the consecutive sovereign rating downgrades by global rating agencies, with an intentic of curtailing the excessive volatility in the exchange rate without depleting the foreig reserves.
- **25 November 2020:** Directions were issued to ADs informing of the extended period f opening SDAs also permitting SDAs to open for eligible persons with funds credited Personal Foreign Currency Accounts during the period from 07 October 2020 to 12 Octob 2020.

- **11 December 2020:** Banking Act Directions were issued to licensed commercial banks ar National Savings Bank suspending the purchase of Sri Lanka International Sovereign Bon (ISB) for a period of six months unless such purchase of ISBs is funded by using new forei currency inflows to the banks from sources abroad.
- **18 December 2020:** Extended the temporary regulatory measures on outward remittanc issued on 02 July 2020 for a further period of 6 months from 02 January 2021.
- **22 December 2020:** In line with the Budget proposal for 2021, Operating Instructions we issued to Licensed Banks to pay extra Rs. 2.00 above the normal exchange rate per each dollar converted through Licensed Banks from foreign worker remittances, where the cost

the said incentive will be borne by the Government of Sri Lanka, with an intention to encourage more worker remittances to the country through formal fund transferring channels.

- **23 December 2020:** Banking Act Directions were issued to licensed commercial banks and National Savings Bank suspending the purchase of Sri Lanka International Sovereign Bonds (ISB) for a period of three months, considering the undue pressure to the domestic foreign exchange market added by licensed banks using inflows to the current account of the balance of payments for the purchase of such ISBs.

- **15 January 2021:** Directions were issued to ADs permitting them to open Temporary Special Foreign Currency Accounts for Licenced Finance Companies to hedge the foreign exchange risk pertaining to the repayment of foreign currency loans.
- **25 January 2021:** Banking Act Directions were issued informing LCBs to refrain from entering into forward contracts of foreign exchange for a period of three months with immediate effect with a view to avoiding excess volatility in the foreign exchange market and the impact on banks' risk management.
- **25 January 2021:** An amendment to Banking Act Directions on Capital Requirements under Basel III for LCBs and LSBs were issued revising the risk weight of 10 per cent on foreign claims on Central Government to be applicable for the year 2021 only. Further, with respect to exposures denominated in foreign currencies issued by the sovereigns, it was permitted to apply a minimum Loss Given Default of 10 per cent when computing expected losses for the year 2021.
- **27 January 2021:** In association with the Operating Instructions issued to Licensed Banks on 22 December 2020, Licensed Banks are required to sell 10 percent of converted workers remittances to the CBSL in USD, in order to build-up foreign exchange reserves.
- **03 February 2021:** Revised Regulations and orders were issued (came into operation with effect from 22.03.2021) under the Foreign Exchange Act, No.12 of 2017 (FEA) addressing the practical issues and concerns of the Authorized Dealers (ADs) and other stakeholders with the purpose of achieving greater efficiency in the domestic foreign exchange market.
- **18 February 2021:** Rules issued under the Monetary Law Act (MLA), in respect of repatriation of export proceeds into Sri Lanka within 180 days from the date of shipment and convert

twenty-five per centum (25%) from and out of the total of the said export proceeds recei
in Sri Lanka into Sri Lanka Rupees, through a Licensed bank, immediately upon such recei

- **18 February 2021**: Operating Instructions were issued to licensed banks, requesting to sel per cent on the 25 per cent of mandatory converted exporter proceeds under the Rules 1 of 2021 as published in the Gazette extraordinary No.2215/39 dated 18.02.2021, to Central Bank of Sri Lanka, in order to increase / maintain the level of foreign excha reserves of the country.
- **09 March 2021**: Repatriation of export Proceeds into Sri Lanka Rules issued under N amended, extending the time-period applicable for conversion up to 14 days.
- **17 March 2021** - Temporarily suspended the Operating Instructions issued to licensed ba requesting to sell 10 per cent of inward workers' remittances (Operating Instructions da 27.01.2021) and 50 per cent on 25 per cent of mandatory converted export proce (Operating Instructions dated 18.02.2021) to the Central Bank of Sri Lanka, in or arrest/minimize the pressure on the exchange rate and the liquidity shortage in the dome foreign exchange market.
- **18 March 2021**: Banking Act Directions were issued suspending the purchase of Sri Lanka I by LCBs and NSB with effect from 23 March 2021 until 09 April 2021 to ease pressure on exchange rate and considering the substantial amount of possible/potential outflow foreign exchange by banks, and its impact on banks' risk management.

- **18 March 2021**: Directions were issued to ADs (effective from 22.03.2021) in line with revised Regulations and orders in respect of opening and maintenance of foreign excha accounts and carrying out current/ capital transactions under FEA.
- **26 March 2021**: An Order was issued under FEA, permitting hotels registered with the Lanka Tourism Development Authority to accept foreign currency from persons residen Sri Lanka who have foreign currency in their possession, as a measure to attract fore currency at the hands of residents into the formal channels giving an opportunity to pay tl local hotel bills in foreign currency.
- **29 March 2021**: "Buy-Sell, USD/LKR SWAP Auctions" were introduced and relevant Opera Instructions were issued to licensed banks, in order to increase / maintain the level of fore exchange reserves of the country.

- **07 April 2021:** Hon. Minister of Finance in consultation with the Monetary Board and with the approval of the Cabinet of Ministers has further extended the opening of Special Deposit Accounts (SDAs) by eligible persons during the period of 24 months from 08 April 2020.
- **09 April 2021:** Banking Act Directions were issued extending the suspension of purchase of Sri Lanka ISBs by LCBs and NSB until 23 April 2021.
- **09 April 2021:** Repatriation of export Proceeds into Sri Lanka Rules issued under MLA further amended, extending the time-period applicable for conversion up to 30 days and reducing the conversion requirement up to ten (10%) percent.
- **23 April 2021:** Banking Act Directions were issued extending the suspension of purchase of Sri Lanka ISBs by LCBs and NSB until further notice.

- **25 April 2021:** Banking Act Directions were issued restricting LCBs from entering into forward contracts of foreign exchange with value beyond spot date, subject to some exceptions, to avoid excess volatility in the foreign exchange market and the impact on banks' risk management.
- **25 May 2021:** An amendment to Banking Act Directions No. 11 of 2018 on Foreign Currency Borrowings by Licensed Banks was issued informing that the existing short-term foreign currency borrowing limits are revoked for a period of one year with immediate effect while maintaining the existing foreign currency borrowing limit of 10 per cent subject to licensed banks ensuring that appropriate risk mitigation practices are in place to mitigate any excessive foreign exchange risk arising from such foreign currency borrowings. Licensed banks are also required to inform the Director of Bank Supervision of details of the Foreign Currency Borrowings by Licensed Banks prior to such borrowings while ensuring compliance with all other requirements of the cited Direction.
- **28 May 2021:** Repatriation of export Proceeds into Sri Lanka Rules issued under MLA further amended, enhancing the conversion requirement up to twenty-five (25%) percent with a provision for partial exemptions to be granted by the Monetary Board at its discretion up to a percentage not less than ten (10%) per cent.
- **28 May 2021:** Operating Instructions were issued to licensed banks to recommence the selling of foreign exchange to the Central Bank of Sri Lanka, requesting to sell 10 per cent on the 25 per cent of mandatory converted exporter proceeds and 10 per cent of converted

inward workers' remittances, in order to increase / maintain the level of foreign exchan

reserves of the country.

- **16 June 2021:** Banking Act Directions were issued permitting LCBs and NSB to purchase IS in the secondary market subject to certain conditions *inter alia* such investments for ISBs LCBs and NSB should be funded by fresh borrowings from overseas, investments should made in ISBs and Sri Lanka Development Bonds (SLDBs) in the proportion of 50% each a licensed banks are required to adopt proper risk mitigation measures to prevent any matu mismatches between the borrowings and investments in addition to other risk mitigat measures that are already being prescribed/followed by banks.
- **02 July 2021:** Introduced following temporary regulatory measures on outward remittan for a period of 6 months.
    - Suspend the repatriation of funds under the migration allowance out of fu received as monetary gifts by an emigrant from an immediate family member parents, grandparents, siblings and spouse of the Emigrant).
    - Limit the repatriation of funds under the migration allowance through Ca Transactions Rupee Accounts by the emigrants who have already claimed migra allowance under the general permission, up to a maximum of USD 10,00 equivalent in any other designated foreign currency.
    - Limit the eligible migration allowance for the emigrants who are claiming migration allowance for the first time under the general permission, up to a maxi of USD 30,000 or equivalent in any other designated foreign currency.
    - Limit the repatriation of any current income or accumulated current income (inclu Employees Provident Fund (EPF), Employees Trust Fund (ETF), gratuity and pen or any other retirement benefits) by the emigrants through the Capital Transa Rupee Accounts or Emigrant's Remittable Income Accounts, under the ge permission, up to a maximum of USD 30,000 or equivalent in any other desig foreign currency.
    - Limit the outward remittances or issuance of foreign exchange for any Sri La individual who resides in or outside Sri Lanka and has obtained Temporary Resi

Visa of another country which falls into a category of visa that entitles the individual to obtain permanent residency status or citizenship in that country at a future date, up to a maximum of USD 20,000 or equivalent in any other designated foreign currency.

- Limit the issuance of foreign exchange for any person resident in Sri Lanka who intends to leave Sri Lanka under the Temporary Residence Visa of another country up to a maximum of USD 10,000 or equivalent in any other designated foreign currency.
- Suspend the general permission granted to make outward remittances through the Outward Investment Accounts for the purpose of investing overseas by persons resident in Sri Lanka excluding the following;
  - investments to be financed out of a foreign currency loan obtained by the investor from a person resident outside Sri Lanka under the provisions of the Foreign Exchange Act, or
  - an additional investment to be made to fulfill the regulatory requirements in the investee's country applicable on the investment already made in compliance with the provisions of the Act or repealed Exchange Control Act, in a company or a branch office in that country, or
  - an additional investment/infusion of funds (as applicable) to be made by eligible resident companies in already established subsidiaries or branch offices in overseas incorporated/established subject to the provisions of the Act or repealed Exchange Control Act, up to a maximum of USD 15,000 or equivalent in any other designated foreign currency, for the purpose of working capital requirements of the investee, or
  - the remittances for the purpose of maintenance of liaison, marketing, agency, project, representative or any other similar offices already established in overseas subject to the provisions of the Act or repealed Exchange Control Act, by eligible resident companies, up to a maximum of USD 30,000 or equivalent in any other designated foreign currency.

- Limit the outward remittances on capital transactions through Business Foreign Currency Accounts or/and Personal Foreign Currency Accounts held by a person resident in Sri Lanka, up to a maximum of USD 20,000 or equivalent in any other designated foreign currency, during the effective period of this Order.
- The Monetary Board shall have the authority to grant permission in terms of the Section 7(10) of the Foreign Exchange Act for the investments on case-by-case basis which exceeds the limits specified in the general permission granted in the Regulation No 1 of 2021 provided that,
  - the proposed investment is to be financed out of a foreign currency loan obtained by the investor from a person resident outside Sri Lanka under the provisions of the Foreign Exchange Act, or
  - the proposed investment is to be made to fulfill the regulatory requirement in the investee's country applicable on the investment already made in a company or branch office in that country in compliance with the provisions of the Act or repealed Exchange Control Act.

- **06 July 2021:** Hon. Minister of Finance in consultation with the Monetary Board and with the approval of the Cabinet of Ministers has granted permission to rollover the Special Deposit Accounts (SDAs) opened under the Regulations, with 6 months and 12 months tenures, provided that the accumulated period of said SDAs does not exceed the maximum of 24 months from the initial date of placing such deposits. SDAs so rolled over will be eligible for the additional interest rate offered by the Government.

3. Measures to Maintain Financial System Stability and Enhance Credit Flows

- **27 March 2020:** Considering capital and liquidity buffers and other factors which affect the safety and soundness of the banking sector, the Central Bank decided to introduce extraordinary regulatory measures for licensed banks to support businesses and individuals affected by the outbreak of COVID-19. Accordingly, the following extraordinary regulatory measures were introduced.

- Permit Domestic Systemically Important Banks (D-SIBs) and non D-SIBs to draw down their Capital Conservation Buffers by 100 basis points and 50 basis points out of the total of 250 basis points, respectively.
- Permit licensed banks to provide an additional 60-day period to settle loans and advances which are falling due during March 2020 and permit licensed banks to not consider such facilities as 'past due' facilities until the end of the 60-day concessionary period with respect to borrowers who are not entitled to other concessions.
- Allow licensed banks to consider all changes made to payment terms and loan contracts from 16 March 2020 to 30 June 2020, due to challenges faced by customers amidst COVID-19 outbreak, as modifications to loans and advances instead of restructuring for classification of loans & advances and the computation of impairment.

- Withdraw the requirement to classify all credit facilities extended to a borrower as non-performing when the aggregate amount of all outstanding non-performing loans granted to such borrower exceeds 30 per cent of total credit facilities.
- Permit the conversion and recovery of loans in foreign currency to Rupee denominated loans, where necessary, subject to banks ensuring that borrowers do not take undue advantage at the cost of country's foreign reserves or cause pressure on the exchange rate and proper documentation regarding the aforementioned is maintained.
- Defer the enhancement of capital by licensed banks, which are yet to meet the minimum capital requirement of end 2020, until end 2022 subject to certain conditions.
- Reset the timelines for rectification of supervisory concerns/findings, if necessary, prioritising the severity/importance of the concerns raised for rectification. Banks which are required to meet timelines to address supervisory concerns/findings during the period up to 30 May 2020, shall be granted an extension of 3 months.

- Extend the reporting period for submission of statutory returns to the Bank Supervision Department by two weeks and publication of quarterly financial statements by one month until further notice. Depending on the circumstances, the Director Bank Supervision may permit further extensions.

- 31 March 2020: The Central Bank introduced a number of measures to provide flexibility to LFCs and Specialised Leasing Companies (SLCs) facilitating them to support businesses and individuals affected by the outbreak of COVID-19 as follows:
  - Reduction of maintenance of liquid asset requirement, i.e., for time deposits and non-transferable certificates of deposits to 6 per cent from 10 per cent, savings deposits to 10 per cent from 15 per cent, borrowing to 5 per cent from 10 per cent and approved government securities to 5 per cent from 7.5 per cent which shall be maintained by LFCs and reduce the minimum liquid asset requirement to 5 per cent from 15 per cent which shall be maintained by SLCs for a period of 6 months with immediate effect, due to sudden withdrawal of cash by depositors and non-repayment of loan rentals.
  - An extension of 1 year to comply with minimum core capital requirements. Accordingly, the timeline of 01 January 2020 and 01 January 2021 already set for the enhancement of capital up to Rs. 2 billion and Rs 2.5 billion will be extended until 31 December 2020 and 31 December 2021, respectively.

  - Defer the enhancements of minimum capital adequacy requirements due by LFCs/SLCs on 01 July 2020 and 01 July 2021, for a further period of one year until 01 July 2021 and 01 July 2022, respectively.
  - Relax deadlines to submit statutory returns to the Department of Supervision of Non-Bank Financial Institutions within two weeks of the commencement of normal business operations of such LFCs/SLCs.

- 08 April 2020: To assist the meeting of liquidity difficulties of Licensed Microfinance Companies, the requirement to maintain liquid assets under the Microfinance Act Directions No. 04 of 2016 on Maintenance of Minimum Liquid Assets Ratio, was withdrawn with immediate effect.

- **05 May 2020:** Licensed banks were permitted to consider the following assets as liquid assets for the computation of Statutory Liquid Assets Ratio until 30 June 2021.
    - Unpaid interest subsidy on Senior Citizen Special Deposit Scheme
    - Exposures to State Owned Entities guaranteed by the government and classified in Stage 1 under SLFRS 9: Financial Instruments for financial reporting purposes with maturity not exceeding one year with hair cut of 10 per cent.
    - Fixed Deposits held by banks in other banks (remaining maturity exceeding 1 year but less than or equal 2 years, the hair-cut to be 20 per cent and if the remaining period exceeds 2 years but less than or equal 3 years, hair-cut to be 30 per cent.
    - Loans secured by deposits under lien equivalent to 20 per cent of deposits
    - Receivables from Employees Provident Fund (EPF) in settlement of loans
- **05 May 2020:** Reduction of the minimum requirement for Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) to 90 per cent with enhanced supervision and frequent reporting up to 30 June 2021.

- **06 May 2020:** Frequently Asked Questions (FAQs) on Circular Nos. 04, 05 and 06 of 2020 on Concessions granted to COVID-19 hit Businesses including Self-Employment and Individuals, the Letter Dated 27 March 2020 on Extraordinary Regulatory Measures, and the Monetary Law Act Order No. 1 of 2020 on Maximum Interest Rates on Pawning Advances of Licensed Banks were published on the website of the Central Bank of Sri Lanka.
- **13 May 2020:** With a view to strengthening the liquidity position of licensed banks, the Central Bank restricted the following discretionary payments of licensed banks until 31st December 2020.
    - Declaring cash dividends that have not already been declared for financial year 2019 and any interim cash dividends for financial year 2020
    - Repatriation of profits not already declared for financial years 2019 and 2020
    - Buying back of its own shares
    - Increasing management allowances and payments to Board of Directors

- Further, licensed banks were required to exercise prudence and refrain from incurring non-essential expenditure such as advertising, business promotions, sponsorships, travelling and training etc. as much as possible while exercising extreme due diligence and prudence when incurring capital expenditure during the above-mentioned period.
- **12 June 2020**: With the view to support the liquidity position of LFCs due to the implementation of the credit support scheme to assist COVID-19 affected businesses and individuals, and the need to meet other urgent liquidity needs of LFCs, the Monetary Board had decided to provide Liquidity Support amounting to a total of Rs.20 billion for LFCs based on the expected maximum of interest income losses due to the moratorium, on proportionate basis under Sri Lanka Deposit Insurance and Liquidity Support Scheme (SLDILSS).
- **19 June 2020**: Suspension imposed on the purchase of Sri Lanka International Sovereign Bonds (ISBs), introduced on 19 March 2020, was further extended by an additional three months, subject to the fact that such purchases of ISBs are funded by using new foreign currency inflows to the banks.
- **19 June 2020**: Amendments to FAQs on Circular Nos. 04, 05 and 06 of 2020 were issued to licensed banks informing to cap the additional interest charged at 7 per cent per annum for the moratorium period in relation to the Equal Monthly Instalment (EMI) loans. Such additional interest is to be recovered at the end of the modified remaining tenure of the loan for other types of facilities granted in Rupee or foreign currency. The licensed banks and the borrower need to agree on a concessionary interest rate for the deferred instalments.

- **7 July 2020**: The Central Bank, considering the short term nature of the exposures backed by Letter of Acceptance issued by the Government until 31 December 2020, exceptional circumstances of the economic impact of COVID-19 and as a transitionary measure to provide liquidity to licensed commercial banks, permitted licensed commercial banks to consider exposures backed by Letter of Acceptance of payments of outstanding bills to construction contractors issued by the Government, as liquid assets, until 31 December 2020, subject to a haircut of 10%. As the Letter of Acceptance of payments of outstanding bills to contractors issued by the Government qualifies as an acceptable risk mitigant for credit exposures, such exposures were permitted to be risk weighted at zero percent, for the purpose of computation of capital adequacy ratio.

- **16 July 2020:** LCBs were permitted to initially classify the new credit facilities granted to the construction sector against "Letter of Acceptance of Payments of Outstanding Bills to Contractors" issued by the Government, as performing loans without considering the current classification status of other existing facilities, provided that the new facility is granted for the purpose of new economic activities. However, LCBs shall ensure compliance with all other requirements relating to classification of loans and advances, in case of subsequent default or potential risk of such borrowers. LCBs were informed that the Credit Guarantee provided under Phase III of Saubagya COVID-19 Renaissance Facility qualifies as an acceptable risk mitigant for credit exposures, such exposures were permitted to be risk weighted at zero percent, for the purpose of computation of capital adequacy ratio.

- **16 July 2020:** Considering the potential adverse impact of COVID-19 pandemic on tourism sector businesses and individuals, a Circular was issued to licensed banks, LFCs and SLCs to provide additional relief measures to eligible borrowers. Accordingly, financial institutions were required to extend the existing 6-month moratorium period to 12 months in respect to capital outstanding of leasing facilities granted to tourism-related vehicles. Financial institutions may recover interest during the moratorium period from eligible borrowers in a manner that is not inconvenient to such borrowers and the accrued penal interest in respect of such leasing facilities to be waived off.
- **16 July 2020:** An amendment was issued to the Banking Act Directions No. 01 of 2016 on Capital Requirements under Basel III for licensed banks informing that the annual turnover threshold for SMEs shall not exceed Rs. 1 billion.
- **21 July 2020:** Licensed banks were informed to cap the additional interest charged at 4% per annum for leasing facilities granted for busses providing public transport and shall recover such amounts in equal instalments over 2 year period or during the remaining tenure of the leasing facility, commencing from 01 October 2020.
- **29 July 2020:** A special concession was granted to private bus owners in public transport service to obtain a loan facility of Rs. 300,000 at an interest rate of 7 per cent per annum

through Bank of Ceylon and People's Bank for maintenance of private buses used for public transport service.

- **30 July 2020:** License Finance Companies were permitted to consider the following assets as liquid assets in the computation of liquid asset ratio in facilitating to improve liquidity position of LFCs which were adversely affected due to COVID-19 pandemic.
    - Sri Lanka Government Treasury Bonds maturing in more than 12 months, free from any lien or charge
    - Sri Lanka Development Bonds and International Sovereign Bonds issued by the Government of Sri Lanka, free from any lien or charge
- **26 August 2020:** The Central Bank requested licensed banks to provide a debt moratorium to COVID-19 affected businesses and individuals in the tourism sector for a further period of six months commencing from 1 October 2020 to 31 March 2021, considering the ongoing travel restrictions, disruption to economic activities and representations made by the Ministry of Tourism and related agencies.
- **30 September 2020:** Considering the ongoing travel restrictions, disruption to economic activities and representations made by the Ministry of Tourism and related agencies Circular No. 09 of 2020 on Extension of Debt Moratorium for COVID-19 Affected Businesses and Individuals in the Tourism Industry was issued for Licensed Finance Companies (LFCs) and Specialised Leasing Companies (SLCs) revoking the Circular No. 07 of 2020 to provide the debt moratorium for all types of loans granted to COVID-19 affected businesses and individuals in the tourism sector for a further period of six months commencing from 01.10.2020 to 31.03.2021.

- LFCs/SLCs are required to convert the capital and interest falling due during the moratorium period into a term loan and such converted loan shall be recovered from 1 July 2021 onwards and repayment period shall be minimum of two years. LFCs/SLCs may charge an interest rate for the converted loan, not exceeding the latest auction rate for 364-days Treasury Bills, available as at 1 April 2021, plus 5.5 per cent per annum and shall not exceed 11.5 percent per annum.

- **30 September 2020:** Considering the challenging operating environment due to the prolonged impact of COVID-19 pandemic, it was decided to extend the reduction of maintenance of liquid asset requirement by further 6 months until 31.03.2021 and to exclude unsecured foreign borrowings from the computation of liquid assets until 31.03.2021 in order to improve the liquidity position of the sector.
- **09 November 2020:** A Circular was issued informing the licensed banks of the extension of the debt moratorium for COVID-19 affected businesses and individuals for a period of six months commencing from 01 October 2020 to 31 March 2021, considering the challenges faced by such businesses and individuals due to the second wave of COVID-19.
- **09 November 2020:** With a view to meeting the challenges faced by businesses and individuals due to the second wave of COVID-19, the CBSL requested LFCs/SLCs to extend a debt moratorium to COVID-19 affected businesses and individuals for a maximum period of six months commencing from 01 October 2020.

- **04 December 2020:** A Monetary Law Act Order was issued informing the maximum interest rate of 7 per cent, per annum, for mortgage-backed housing loans obtained by salaried employees in the public and private sector with a view to expanding the homeownership while providing an additional stimulus to the domestic construction sector and its supply chain.
- **13 January 2021:** A Circular was issued instructing licensed banks to suspend recovery actions against SME paddy millers for a period of six months, considering the Government initiatives to support SME paddy millers amidst COVID-19 outbreak for the upcoming harvesting seasons.
- **19 January 2021:** Banking Act Directions were issued relaxing the restrictions on discretionary payments of licensed banks. Accordingly, licensed banks were permitted to pay cash dividends and repatriate profits after completion of the audit of the financial statements for the year 2020. Further, licensed banks were required to refrain from engaging in share buy backs and increasing non-essential expenditure, while exercising extreme due diligence and prudence when incurring capital expenditure until 30 June 2021.

- **17 February 2021:** In order to facilitate the credit expansion of the LFCs/SLCs sector, an amendment was issued to the Directions on LTV Ratios of LFCs and SLCs for Credit facilities granted in respect of motor vehicles, with a revised rate of 80% in respect of registered vehicles which have been used in Sri Lanka for more than one year after the first registration.
- **10 March 2021:** A Circular was issued instructing licensed banks to provide concessions for lease facilities obtained by COVID-19 affected businesses and individuals engaged in passenger transportation services for six months, commencing from 01 April 2021.
- **12 March 2021:** Deferment of lease instalment for a period not exceeding 6 months commencing 01.04.2021 to 30.09.2021 for lease facilities obtained by businesses and individuals in passenger transportation sector in the LFC/SLC sector.
- **31 March 2021:** Reduction of maintenance of liquid asset requirement extended for a further period of three months until 30.06.2021, in order to facilitate the LFCs to overcome the stress on liquidity due to the present challenging environment. Further, CBSL decided to defer the implementation of new direction on classification and measurement of credit facilities due to the present challenging environment.

- **21 April 2021:** Having recognised the need to promote economic sectors in terms of high domestic growth and exports, leading to broad-based revival of the economy, Banking Act Directions were issued to licensed banks introducing a priority sector lending target on credit granted by licensed banks to businesses and individuals in the Micro, Small and Medium Enterprises (MSME) sector. Accordingly, licensed banks shall grant credit to individuals and businesses in MSME sector of not less than 20 per cent per annum on Y-o-Y basis, over the outstanding stock of lending to MSMEs at the end of the previous year.
- **25 May 2021:** With a view to meeting the challenges faced by businesses and individuals due to the 3rd wave of COVID-19, a Circular was issued to licensed banks to extend concessions businesses and individuals affected by the third wave of COVID-19. The proposed concessionary scheme will include deferring the recovery of capital, interest or both for one or more of the existing credit facilities granted in Rupees or foreign currency of borrowers who are affected by the third wave of COVID-19, on case-by-case basis, during the period from 15 May 2021 up to 31 August 2021. Alternatively, licensed banks

may restructure the existing credit facilities, over a longer period, considering the repayment capacity of the borrower and an acceptable revival plan. Banks are requested to extend the due dates of revolving credit facilities during the period up to 31 August 2021, provided such due dates fall during 15 May 2021 to 31 August 2021. Penal Interest shall not be accrued or charged during the concessionary period. Licensed banks shall suspend all types of recovery actions against non-performing facilities until 31 August 2021, provided that such facilities have been classified as non-performing on or after 01 April 2020. Other general concessions provided under this Scheme are as follows:

- Extend the validity period of cheques valued less than Rs. 500,000 until 30 June 2021.
- Discontinue charging for cheque returns and stop payments in relation to all cheque payments until 30 June 2021.
- Discontinue late payment fee on all credit cards and other credit facilities during the period up to 30 June 2021.
- Not charge any early settlement fee, in the case where a borrower has expressed his willingness to settle his/her existing credit facilities on or before 31 August 2021 instead of opting for deferment or restructuring of the existing credit facility/facilities.

4. Measures to Ensure Uninterrupted Currency Operations and Payments and Settlements Systems

- Ensured uninterrupted operations of the payment and settlement systems of the country in collaborations with LCBs and other financial institutions by activating the Business Continuity Plan.
- Carried out uninterrupted settlements for the foreign reserve management operations of the country enabling maintenance of sufficient liquidity in terms of foreign currency to meet country's external debt obligations and meet the government's foreign exchange needs.
- **17 March 2020:** Increased the ceiling of Rs 500 million on emergency cash withdrawal and relaxed two emergency cash withdrawals limit per month (per bank) by LCBs until 15 May 2020 to meet the public demand for cash during lockdown.

- Following actions were taken to facilitate customers to register for online transactions during the period with travel restrictions within the country due to COVID - 19 outbreak;
    - **20 March 2020:** Instructions were issued to Financial Institutions to waive off registration fees and charges for providing online banking services and to facilitate existing customers to register for online banking products without having to physically present themselves at bank branches for registration.
    - **26 March 2020:** Financial institutions were allowed to open wallet or wallet facilitation accounts by digitally fulfilling know your customer (KYC) requirements. However financial institutions were instructed to physically verify the KYC details subsequently.
- **30 March 2020:** In order to facilitate transactions of e-money account holders, approval was granted to increase the e-money wallet limit from Rs. 10,000 to Rs. 25,000 during this period temporarily.
- **01 April 2020:** Increased the maximum per transaction value limit from Rs. 10,000 to Rs. 25,000 for mobile app based transactions carried out through JustPay payment solution of LankaClear (Pvt) Ltd.

- Following approvals were granted to facilitate the public to access their funds:
    - **02 April 2020:** Approval was granted to a remittance service provider to provide cash home-delivery services enabling disbursement of foreign remittances to be delivered to beneficiaries during the period.
    - **04 April 2020:** Considering the difficulty of withdrawing cash from ATMs during this period, approval was granted to a LCB to provide door-step cash delivery services.
- **06 April 2020:** Considering the government's request, financial institutions were instructed to waive off fees charged from Senior citizens for cash withdrawals carried out through ATMs connected to the Common ATM Switch.
- **10 April 2020:** Enhanced limits applicable for merchants of a mobile phone based e-money system in order to facilitate more digital transactions during the period.

- **12 May 2020:** Waived off the service charge on currency notes deposits (serviceable currency notes) by LCBs for three months period from 01 April 2020 to 30 June 2020 considering the pandemic situation.
- **15 May 2020:** Validity period of cheques of value less than Rs. 500,000 was extended.
- **04 June 2020:** Validity period of cheques issued by Employees' Provident Fund Department (EPF) of the Central Bank were extended to 30 June 2020. This was further extended to 31 July 2020 on 30 June 2020.
- **08 June 2020:** Online payments by customers to government and other institutions through the LankaPay Online Payment Platform were further enabled through increasing the maximum per transaction value limit.
- In addition, approval was granted to several mobile application based payment products to operate subject to certain restrictions, in order to further facilitate digital transactions during the period with travel restrictions within the country.

- **10 May 2021:** Considering requests from the banking community regarding the safety and transportation difficulties faced by bank employees, the operational hours of the LankaSettle system was reduced to 2.10 p.m., with effect from 11.05.2021. However, all necessary operations of the LankaSettle system were continued.
- **19 May 2021:** In order to facilitate salary payments of all employees through the Sri Lanka Inter-bank Payment System (SLIPS), the operational hours of the LankaSettle system was extended until 4.00 p.m. on 20.05.2021 and 21.05.2021. An additional settlement cycle of the SLIPS was also executed in the system to ensure salary payments to all employees on the above two days.

5. Measures to Manage the Public Debt and Ensure Uninterrupted Debt Service Payments

- Since the start of the pandemic in mid-March 2020 to end June 2021, Central Bank conducted regular Treasury bill, Treasury bond and Sri Lanka Development Bond issuances to around Rs. 4.7 trillion without interruption to meet Government's financing requirements.

Out of this total amount raised, auction-based financing amounted to around Rs. 3.1 trillion during this period through weekly and periodic auctions conducted for respective Government securities within the overall borrowing limit specified.

- Since April 2020, in line with Government's policy direction to reduce overall interest rate structure and cost of financing of Government securities, maximum yield rates of acceptance was announced for issuance of Treasury bills at weekly auctions.
- May 2020, deviating from the established practice of conducting only one Treasury bond auction per month, the Central Bank doubled the frequency of Treasury bond auctions during the months of May, June and July in 2020 and January, March and July in 2021 to finance the Government's funding requirements. Since fourth quarter of 2020, the number of ISINs offered at auctions also enhanced in line with market conditions/ requirements at regular Government securities offerings.
- On 13 May 2020, Central Bank administratively issued Treasury bonds to the tune of Rs. 100 billion on book value basis to allow adjustments in other instruments of Government's cash flow management such as the overdraft with state banks. Again, on 29 September 2020, further Rs. 50 billion worth of Treasury bonds were issued to convert part of the overdraft facility provided to the Government by a state bank.

- On 30 December 2020, Central Bank administratively issued Treasury bonds worth of Rs. 250 billion on payable value basis to convert a part of overdraft facility provided by State Banks to term loans, to ease cash-flow management measures of the Government.
- On 31 March 2021, Central Bank administratively issued Treasury bonds worth of Rs. 50 billion on payable value basis to convert a part of overdraft facility provided by State Banks to term loans, to further ease cash-flow management measures of the Government.
- On 7 April 2021, Central Bank administratively issued Treasury bonds worth of Rs. 18 billion on payable value basis in favour of SriLankan Airlines (SLA) and Ceylon Petroleum Corporation (CPC).

- On 30 June 2021, Central Bank administratively issued Treasury bonds worth of Rs. 40 billion on payable value basis to convert a part of overdraft facility provided by State Banks to term loans, to further ease cash-flow management measures of the Government.
- On debt servicing front, Sri Lanka continued to maintain its unblemished debt servicing record in the midst of lockdowns and travel restrictions and made payments amounting to Rs. 3.3 trillion to service 1,604 loan payments during the period from 16 March 2020 to 31 December 2020.
- Since January to 05 July 2021, the total debt service payments made amounting to Rs. 2.4 trillion to service 918 loans on a timely manner.

- These payments include, on 2 October 2020, the Central Bank of Sri Lanka successfully completed the settlement of the maturing International Sovereign Bond (ISB) of US dollars 1 billion along with the due coupon payments, on behalf of the Government of Sri Lanka.
- During the Covid-19 period, through appropriate issuance and appropriate market preference and resource availability arrangements alongside supportive monetary policy environment, the Central Bank was able to reduce the weighted average domestic currency debt financing cost during 2020 to 6.35 per cent compared to 9.49 per cent in 2019, on an average cost basis. It was further reduced to 5.65 per cent as of 05 July 2021, on an average for finances contracted domestically through issuance of Government securities so far during 2021. These efforts have enabled to reduce the debt service cost of the Government by many billions in the Annual Budget and future Budgets, across the term of Government securities issued during this period.
- Strategic measures in line with Government policy direction and driven by unfavourable market conditions to access international capital markets, efforts are now focussed to reduce foreign currency debt in the medium term. As a result, foreign currency debt as a share of total Outstanding Central Government debt reduced to 47.5 per cent as end 2020 and further reduced to 46.7 per cent (provisional) as end June 2021 compared to 54.0 per cent as end 2019. As at end 2020, the foreign debt stood around 40 per cent of GDP and this is expected further reduce in the medium-term.

- During the pandemic period, due to challenges in accessing international capital market and paying-off some of the foreign currency debt, the Average Time to Maturity (ATM) of foreign currency debt portfolio increased to 6.89 years (provisional) as end June 2021 compared to 6.72 years as end 2020.

- As a result of Government increasing recourse to Treasury bill finances amidst restrictive market conditions, the short-term maturing debt (remaining maturity lesser than or equal 1 year) as a share of total Outstanding Central Government debt stood around 20 per cent as end 2020 and as end June 2021.

- On 19 May 2021, the advance issuance calendar of Treasury bills and bonds for the period May – December 2021 was published to further enhance the predictability and transparency of the primary issuance of Government securities, amidst challenging market conditions imposed by the Covid-19 pandemic.

- Market interactions were continued with domestic and international investors/institutions/ financial intermediaries mainly through virtual arrangements to facilitate information sharing and clarity on Sri Lanka's macroeconomic and debt financing initiatives. Further, a higher-level delegation headed by State Minister of Money & Capital Market and State Enterprise Reforms alongside a Senior Central Bank representation, and Senior Officers of major Sri Lankan Banks visited to Middle East in April 2021 in order to explore investments in Government securities, enhancement of credit lines for counterparty banks, and other real investments through engagements with financial intermediaries/institutional investors.

- Since 20 January 2021, the Central Bank made available an issuance window for SLDBs, immediately after the close of an SLDB auction until the close of business of the day prior to settlement date of the relevant auction for investors to subscribe for SLDBs at the Weighted Average Fixed Rate (WAFR)/ Weighted Average Margin (WAM) determined at the auction for any maturity offered, up to any undersubscribed volume at the corresponding primary auction held, on first come first served basis. Under the Direct Issuance Window, the Central Bank has managed to raise US dollars 83.56 million in addition to the amounts raised at auctions, since introduction.

- Since 07 June 2021, opportunity for investments of US dollar funds raised offshore by the private sector in SLDBs, in line with the WAFR/WAM determined at the immediately preceding SLDB auctions or levels mutually agreed through Designated Agents (DAs), has been made available.
- During the period where island wide curfew was imposed from March to May 2020 in the first wave of Covid-19 pandemic, the LankaSecure System was operated a total of 35 days out of 38 working days. And During 2nd, 3rd wave of the pandemic during October to December 2020 and April 2021 to date, LankaSecure System was operated on every working day, to facilitate Government securities transactions.
- Number of Government securities ISINs serviced during the year 2020 by the Public Debt Department was 148 and 129 for Treasury bills and bonds, respectively, while 80 and 74 ISINs were serviced during 2021 (until 05 July 2021) for Treasury bills and bonds, despite Covid-19 pandemic restrictions.

- By end June, Central bank has purchased Treasury bills amounting to Rs. 522.9 bn to support government cash flow operations for the fiscal year 2021.
- While these operations for uninterrupted financing of Government cash flow was facilitated, Public Debt Department and the Central Bank took number of initiative to keep Government informed, particularly the Ministry of Finance, on challenges of financing and gradual requirement to move in to the market arrangements of raising finances in the domestic market while exploring opportunities through syndicate and bilateral/ multilateral arrangements to augment foreign currency requirements to meet regular foreign currency debt service requirements. These measures were highlighted primarily on account of no significant foreign currency inflows to meet debt service related resources and to offset imbalances arising in domestic financing arrangements.

MONETARY BOARD
CENTRAL BANK OF SRI LANKA

25 May 2021 | BANKING ACT DIRECTIONS | No. 08 of 2021

AMENDMENTS TO BANKING ACT DIRECTIONS NO. 11 OF 2018 ON FOREIGN CURRENCY BORROWINGS BY LICENSED BANKS

The Monetary Board of the Central Bank of Sri Lanka having considered the need to stimulate capital formation within the real economy and supplement the foreign currency needs of the country, hereby issues the following amendments to Banking Act Directions No. 11 of 2018 on foreign currency borrowings by licensed banks.

Copy issued to
Prof. W. D. Lakshman

Accordingly licensed commercial banks and licensed specialised banks, hereinafter referred to as licensed banks, are hereby informed that:

1. With immediate effect, for a period of one year, the existing short-term foreign currency borrowing limits are revoked, while maintaining the existing total foreign currency borrowing limit up to 10 per cent subject to the licensed banks ensuring, through appropriate risk mitigation practices, that such foreign currency borrowings do not give rise to any excessive foreign exchange risk and informing details specified in Direction 9.1 of the Banking Act Directions No. 11 of 2018 on foreign currency borrowings by licensed banks to the Director of Bank Supervision, prior to such borrowings.

2. Licensed banks shall ensure compliance with all other Directions of the cited Directions.

3. Licensed banks shall report the position of total foreign currency borrowings as at end of each month to the Bank Supervision Department, within 15 working days, commencing 30 June 2021, as per the attached format.

Prof. W D Lakshman
Chairman of the Monetary Board and
Governor of the Central Bank of Sri Lanka

Name of Bank:
Monthly Statement of Foreign Borrowings
Period:

Name of Counterparty (Lender)	Country	Business Unit (DBU / OBU)	Nature of Transactions (Product/Instrument) (1)	Currency Type (2)	Rate of Interest, %	Other Charges	Amount Borrowed, In FC value	Outstanding Amount In FC value	Outstanding Amount In Rupee Equivalent	Purpose of borrowing	Whether included for Tier II capital (Yes/No)	Date of Borrowing	Date of Maturity	Repayment Capital	Repayment Interest	Risk Mitigation, SWAP arrangements Counter-party	Amount, in FC value	Exchange rate, first leg (sold at)	Exchange rate, second leg (Buy at)	Rating of Counterparty (Lender) instrument
Total																				

MONETARY BOARD

CENTRAL BANK OF SRI LANKA

16 June 2021 BANKING ACT DIRECTIONS No. 10 of 2021

INVESTMENTS IN SRI LANKA INTERNATIONAL SOVEREIGN BONDS BY LICENSED COMMERCIAL BANKS AND NATIONAL SAVINGS BANK

Issued in terms of the powers conferred by Sections 46(1) and 76(J)(1) of the Banking Act No. 30 of 1988, as amended.

1. The Central Bank of Sri Lanka (CBSL) hereby revokes the Banking Act Directions No. 06 of 2021 dated 23 April 2021 on Investments in Sri Lanka International Sovereign Bonds (ISBs) by Licensed Commercial Banks (LCBs) and National Savings Bank (NSB), subject to the conditions set out in this Direction.
2. LCBs and NSB may purchase ISBs in the secondary market subject to the following conditions:
   (i) Source of funds to be limited to fresh borrowings from overseas and it should be established to the satisfaction of the CBSL. For this purpose, LCBs and NSB are required to provide documentation of the borrowings overseas as specified in Direction 9.1 of the Banking Act Directions No. 11 of 2018 on Foreign Currency Borrowings by Licensed Banks, to the Director of Bank Supervision (DBS).
   (ii) Investment of funds sourced as per 2 (i) above in Sri Lanka Development Bonds (SLDBs) and ISBs in the proportion of 50 per cent each, and LCBs and NSB shall submit the following information on their investments in ISBs and SLDBs to DBS and the Superintendent, Public Debt Department.
      a. Date of investment
      b. International Securities Identification Number (ISIN)
      c. Amount invested in ISBs and SLDBs
   (iii) LCBs and NSB to adopt risk mitigation measures to prevent maturity mismatches between the borrowings and the ISB/SLDB investments, adopting appropriate risk mitigation arrangements to bridge any short-term maturity mismatches that may occur, in addition to other risk mitigation measures already prescribed/followed.

Prof. W D Lakshman
Chairman of the Monetary Board and
Governor of the Central Bank of Sri Lanka

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CENTRAL BANK OF SRI LANKA

ANNUAL REPORT
(Volume I)

OF THE MONETARY BOARD TO THE
HON. MINISTER OF FINANCE

FOR THE YEAR

2021

KEY ECONOMIC INDICATORS

	2015	2016	2017	2018	2019	2020	2021 (a)
DEMOGRAPHY							
Mid-year population ('000 persons) (b)(c)	20,970	21,209 (d)	21,444 (a)	21,670 (a)	21,803 (a)	21,919 (a)	22,156
Growth of mid- year population (per cent) (b)	0.9	1.1	1.1 (a)	1.1 (a)	0.6 (a)	0.5 (a)	1.1
Population density (persons per sq.km.) (b)	334	338	342 (a)	346 (a)	348 (a)	350 (a)	353
Labour force ('000 persons) (e)(f)	8,214	8,311	8,567	8,388	8,592	8,467	8,553 (g)
Labour force participation rate (per cent) (e)(f)	53.8	53.8	54.1	51.8	52.3	50.6	49.9 (g)
Unemployment rate (per cent of labour force) (e)(f)	4.7	4.4	4.2	4.4	4.8	5.5	5.1 (g)
OUTPUT (h)							
GDP at current market price (Rs. billion)	10,951	11,996	13,328	14,291	14,997 (d)	15,027 (a)(d)	16,809
GNI at current market price (Rs. billion)	10,676	11,676	12,975	13,901	14,556 (d)	14,604 (a)(d)	16,403
GDP at current market price (US$ billion)	80.6	82.4	87.4	87.9	83.9 (d)	81.0 (a)(d)	84.5
GNI at current market price (US$ billion)	78.5	80.2	85.1	85.5	81.4 (d)	78.7 (a)(d)	82.5
Per capita GDP at current market price (Rs.) (i)	522,304	565,613	621,531	659,479	687,848 (d)	685,587 (a)(d)	758,680
Per capita GNI at current market price (Rs.) (i)	509,200	550,541	605,076	641,500	667,604 (d)	666,285 (a)(d)	740,328
Per capita GDP at current market price (US$) (i)	3,842	3,885	4,077	4,057	3,848 (d)	3,695 (a)(d)	3,815
Per capita GNI at current market price (US$) (i)	3,746	3,781	3,969	3,947	3,734 (d)	3,591 (a)(d)	3,722
REAL OUTPUT (percentage change) (h)							
GDP	5.0	4.5	3.6	3.3	2.3 (d)	-3.6 (a)(d)	3.7
Major economic activities of GDP							
Agriculture	4.7	-3.7	-0.4	5.8	1.2 (d)	-2.2 (a)(d)	2.0
Industry	2.2	5.7	4.7	1.3	2.6 (d)	-6.9 (a)(d)	5.3
Services	6.0	4.8	3.6	4.6	2.3 (d)	-1.6 (a)(d)	3.0
GNI	4.8	4.3	3.6	3.2	2.2 (d)	-3.5 (a)(d)	4.0
AGGREGATE DEMAND AND SAVINGS (per cent of GDP) (h)							
Consumption	76.4	79.4	75.6	77.6	79.8 (d)	81.3 (a)(d)	79.9
Private	67.4	71.0	67.1	68.4	70.4 (d)	71.0 (a)(d)	70.3
Government	9.0	8.5	8.5	9.2	9.4 (d)	10.3 (a)(d)	9.6
Investment	31.2	27.9	31.6	29.9	26.3 (d)	25.1 (a)(d)	27.7
Net exports of goods and services	-7.5	-7.3	-7.2	-7.4	-6.1 (d)	-6.4 (a)(d)	-7.6
Exports of goods and services	21.0	21.2	21.8	23.0	23.2 (d)	16.1 (a)(d)	17.7
Imports of goods and services	28.5	28.5	29.1	30.5	29.3 (d)	22.5 (a)(d)	25.3
Domestic savings	23.6	20.6	24.4	22.4	20.2 (d)	18.7 (a)(d)	20.1
Net primary and secondary income from rest of the world	5.2	5.2	4.6	4.3	3.9 (d)	4.8 (a)(d)	3.7
National savings	28.8	25.7	29.0	26.7	24.1 (d)	23.6 (a)(d)	23.8
PRICES AND WAGES (percentage change)							
National Consumer Price Index (2013 = 100) - annual average	3.8	4.0	7.7	2.1	3.5	6.2	7.0
National Consumer Price Index (2013 = 100) - year-on-year (end period)	4.2	4.2	7.3	0.4	6.2	4.6	14.0
Colombo Consumer Price Index (2013 = 100) - annual average	2.2	4.0	6.6	4.3	4.3	4.6	6.0
Colombo Consumer Price Index (2013 = 100) - year-on-year (end period)	4.6	4.5	7.1	2.8	4.8	4.2	12.1
Colombo Consumer Price Index (2006/07 = 100) - annual average (j)	0.9	3.7	-	-	-	-	-
Colombo Consumer Price Index (2006/07 = 100) - year-on-year (end period) (j)	2.8	4.1	-	-	-	-	-
Producer's Price Index (2018 Q4 = 100) - annual average	-	-	-	-	-	5.8	10.9
Producer's Price Index (2013 Q4 = 100) - annual average (k)	3.6	1.7	17.0	6.3	2.9	5.7 (d)	-
GDP deflator (h)	0.6	4.8	7.3	3.8	2.6 (d)	4.0 (a)(d)	7.9
GNI deflator (h)	0.6	4.9	7.3	3.8	2.5 (d)	3.9 (a)(d)	8.0
Nominal wage rate index for workers in all wages boards (1978 Dec = 100) (l)	2.9	0.0	0.0	0.6	2.9	0.2	74.4
Nominal wage rate index for public sector employees (2016 = 100) (l)	-	-	-	0.2	4.7	9.2	0.0
Nominal wage rate index for public sector employees (2012 = 100) (l)(m)	31.7	3.9	0.0	0.1	3.2	-	-
Nominal wage rate index for informal private sector employees (2012 = 100) (l)	7.3	7.9	9.5	13.2	6.2	3.3	9.2
EXTERNAL TRADE							
Trade balance (US$ million)	-8,388	-8,873	-9,619	-10,343	-7,997	-6,008	-8,139
Exports	10,546	10,310	11,360	11,890	11,940	10,047	12,499
Imports	18,935	19,183	20,980	22,233	19,937	16,055	20,637
Terms of trade (percentage change)	2.7	4.0	1.2	0.02	-1.6	2.5	-8.6
Export unit value index (2010 = 100) (percentage change)	-9.4	-1.5	2.4	4.2	-6.3	-6.8	5.4
Import unit value index (2010 = 100) (percentage change)	-11.8	-5.3	1.2	4.1	-4.8	-9.1	15.2
Export volume index (2010 = 100) (percentage change)	4.6	-0.7	7.6	0.5	7.2	-9.7	18.0
Import volume index (2010 = 100) (percentage change)	10.6	7.0	8.1	1.8	-5.8	-11.4	11.5
EXTERNAL FINANCE (US$ million)							
Services and primary income account (net)	312	678	984	1,381	388	-1,386 (d)	-432
Current private transfers (net)	6,167	6,434	6,316	6,155	5,757	6,194	5,221
Current official transfers (net)	27	19	11	8	9	13	6
Current account balance	-1,883	-1,742	-2,309	-2,799	-1,843	-1,187 (d)	-3,343
Overall balance	-1,489	-500	2,068	-1,103	377	-2,328	-3,967

(a) Provisional
(b) As reported by Registrar General's Department
(c) Based on the Census of Population and Housing - 2012
(d) Revised
(e) Household population aged 15 and above is considered for the calculation of labour force.
(f) In July 2016, the Department of Census and Statistics published a re-weighted and revised labour force data series for 2011 onwards.
(g) Average of four quarters of 2021
(h) Rebased GDP estimates (base year 2010) of the Department of Census and Statistics have been used.
(i) Estimates are updated with the latest population figures
(j) Compilation of this index was discontinued since January 2017.
(k) Compilation of this index was discontinued since November 2021.
(l) Annual average percentage change
(m) Compilation of this index was discontinued since April 2020.

KEY ECONOMIC INDICATORS (Contd.)

	2015	2016	2017	2018	2019	2020	2021 (a)
Current account balance (per cent of GDP) (h)(n)	-2.3	-2.1	-2.6	-3.2	-2.2	-1.5 (d)	-4.0
Total foreign assets (months of the same year imports) (o)	5.9	5.3	6.0	5.2	6.3	6.4	3.6
Gross official reserves (months of the same year imports)	4.6	3.8	4.6	3.7	4.6	4.2	1.8
Overall debt service ratio (p)							
As a percentage of export of goods and services	28.2	25.6	23.9	28.9	29.7	35.2 (d)	30.0
As a percentage of current receipts	19.8	18.0	17.3	21.3	21.8	22.6 (d)	21.8
Total external debt (per cent of GDP) (h)(n)	55.7	56.3	59.0	59.5	65.3	60.5 (d)	60.0
EXCHANGE RATES							
Annual average							
Rs/US$	135.94	145.60	152.46	162.54	178.78	185.52	198.88
Rs/SDR (q)	190.16	202.39	211.49	229.90	246.97	258.61	283.18
NEER (2017 = 100) (24 - currency basket) (r)	109.46	104.91	100.00	94.05	88.17	85.93	78.64
REER (2017 = 100) (24 - currency basket) (r)(s)	103.01	100.55	100.00	95.45	90.42	91.52 (d)	86.13
Year end							
Rs/US$	144.06	149.80	152.85	182.75	181.63	186.41	200.43
Rs/SDR (q)	199.63	201.38	217.69	253.51	251.17	268.48	280.53
GOVERNMENT FINANCE (per cent of GDP) (h)(t)(u)							
Revenue and grants	13.3	14.1	13.8	13.5	12.7	9.1	8.7
Revenue	13.3	14.1	13.7	13.4	12.6	9.1	8.7
o/w Tax revenue	12.4	12.2	12.5	12.0	11.6	8.1	7.7
Grants	0.1	0.1	0.1	0.1	0.1	0.04	0.04
Expenditure and net lending	20.9	19.5	19.3	18.8	22.3	20.2	21.0
Recurrent expenditure	15.5	14.7	14.5	14.6	16.2	17.0	16.3
Capital expenditure and net lending	5.4	4.8	4.8	4.2	6.1	3.3	4.6
Current account balance	-2.3	-0.6	-0.7	-1.2	-3.6	-7.9	-7.7
Primary balance	-2.9	-0.2	0.02	0.6	-3.6	-4.6	-6.0
Overall fiscal balance	-7.6	-5.3	-5.5	-5.3	-9.6	-11.1	-12.2
Deficit financing	7.6	5.3	5.5	5.3	9.6	11.1	12.2
Foreign	2.2	3.3	3.3	2.3	3.6	-0.6	-0.1
Domestic	5.4	2.1	2.2	3.1	6.0	11.7	12.3
Central government debt (v)	78.5	79.0	77.9	84.2	86.9	100.6	104.6
Foreign	32.4	33.7	35.4	41.7	41.3	40.3	38.6
Domestic (w)	46.2	45.3	42.5	42.5	45.5	60.3	66.0
MONETARY AGGREGATES (year-on-year percentage change)							
Reserve money	16.5	27.1	9.8	2.3	-3.0	3.4	35.4
Narrow money (M_1)	16.8	8.6	2.1	4.7	4.2	36.0	24.0
Broad money (M_{2b}) (x)	17.8	18.4	16.7	13.0	7.0	23.4	13.2
Net foreign assets of the banking system	-2,071.2	22.4	152.6	-155.1	250.3	-308.0	-368.8
Net domestic assets of the banking system	26.0	15.9	9.8	16.3	4.6	27.8	20.9
Domestic credit from the banking system to							
Government (net)	22.5	12.1	10.0	16.1	11.1	62.7	28.2
Public corporations/SOBEs	17.7	-3.2	4.5	40.7	8.3	22.5	18.6
Private sector	25.0	21.6	14.7	15.9	4.2	6.5	13.1
Money multiplier for M_{2b} (end year)	6.78	6.31	6.71	7.42	8.18	9.75	8.15
Velocity of M_{2b} (average for the year) (h)	2.62	2.43	2.26	2.11	2.04	1.77 (d)	1.65
INTEREST RATES (per cent per annum at year end)							
Standing Deposit Facility Rate (SDFR) (y)	6.00	7.00	7.25	8.00	7.00	4.50	5.00
Standing Lending Facility Rate (SLFR) (y)	7.50	8.50	8.75	9.00	8.00	5.50	6.00
Bank Rate (z)	15.00	15.00	15.00	15.00	15.00	8.50	9.00
Legal Rate of Interest / Market Rate of Interest (aa)	7.76	5.98	7.06	9.08	11.50	11.64	10.12
Money market rates							
Average weighted call money rate (AWCMR)	6.40	8.42	8.15	8.95	7.45	4.55	5.95
Treasury bill yields							
91-day	6.45	8.72	7.69	10.01	7.51	4.69	8.16
364-day	7.30	10.17	8.90	11.20	8.45	5.05	8.24
Deposit rates							
Commercial banks' average weighted deposit rate (AWDR)	6.20	8.17	9.07	8.81	8.20	5.80	4.94
Commercial banks' average weighted fixed deposit rate (AWFDR)	7.57	10.46	11.48	10.85	10.05	7.14	5.94
Commercial banks' average weighted new deposit rate (AWNDR)	6.96	11.17	10.06	10.94	8.89	4.93	6.45
Commercial banks' average weighted new fixed deposit rate (AWNFDR)	7.13	11.44	10.65	11.27	9.17	5.08	6.67
NSB savings rate	5.00	4.25	4.00	4.00	4.00	3.50	3.50
NSB 12 month fixed deposit rate	7.25	11.00	11.00	10.50	9.83	5.25	5.50
Lending rates							
Commercial banks' average weighted prime lending rate (AWPR)-Weekly	7.53	11.52	11.55	12.09	9.74	5.81	8.61
Commercial banks' average weighted lending rate (AWLR)	11.00	13.20	13.88	14.40	13.59	10.29	9.87
Commercial banks' average weighted new lending rate (AWNLR)	10.19	13.94	14.31	14.54	12.80	8.38	9.48
CAPITAL MARKET							
All share price index (ASPI) (1985 = 100)	6,894.5	6,228.3	6,369.3	6,052.4	6,129.2	6,774.2	12,226.0
S&P SL20 index (2004 Dec = 1,000)	3,625.7	3,496.4	3,671.7	3,135.2	2,937.0	2,638.1	4,233.3
Value of shares traded (Rs. million)	253,251	176,935	220,591	200,069	171,408	396,882	1,173,157
Net purchases by non nationals (Rs. million)	-5,372	338	17,655	-23,239	-11,735	-51,356	-52,649
Market capitalisation (Rs. billion)	2,938.0	2,745.4	2,899.3	2,839.5	2,851.3	2,960.7	5,489.2

(n) Based on GDP estimates in US dollars

(o) Excludes foreign assets in the form of direct investments abroad and trade credit and advances received

(p) Overall debt service ratios were reclassified to capture debt servicing in accordance with the External Debt Statistics Manual (2003) of the International Monetary Fund (IMF).

(q) Special Drawing Rights (SDR), the unit of account of the IMF

(r) Exchange rates have been defined in terms of indices so that the appreciation/ depreciation of the rupee relative to other currencies is reflected by a rise/fall in the values of the effective exchange rate indices.

(s) CCPI is used for the computation of the Real Effective Exchange Rate (REER). The REER is computed by adjusting the Nominal Effective Exchange Rate (NEER) for inflation differentials with the countries whose currencies are included in the basket.

(t) Based on the revised GDP estimates for 2019 and 2020 released on 29 March 2022 by the Department of Census and Statistics

(u) According to the Ministry of Finance, some fiscal sector statistics of 2019 have been restated as announced in the Budget Speech for 2020

(v) As per the guidelines of compiling government debt statistics in the Manual of Government Finance Statistics published by the IMF in 2014, non resident holdings of outstanding SLDBs have been classified under foreign debt and resident holdings of outstanding ISBs of the Sri Lankan Government have been classified under domestic debt from 2019 onwards.

(w) Outstanding balance of Treasury bonds issued to State Owned Business Enterprises (SOBEs) has been included.

(x) Values from 2015 include assets/ liabilities of DFCC Bank PLC, which merged with DFCC Vardhana Bank, with effect from 01 October 2015.

(y) Repurchase rate and Reverse Repurchase rate renamed as Standing Deposit Facility Rate (SDFR) and Standing Lending Facility Rate (SLFR), respectively, with effect from 02 January 2014.

(z) The rate at which the Central Bank grants advances to banking institutions as the lender of last resort.

(aa) The Legal Rate is defined under the Civil Procedure Code (Amendment) Act No. 6 of 1990 and is applicable to any legal action for the recovery of a sum of money. The Market Rate is defined under the Debt Recovery (Special Provisions) Act No. 2 of 1990 and is applicable only in relation to legal actions instituted by lending institutions for the recovery of debt exceeding Rs. 150,000 arising out of commercial transactions, where there is no agreed rate of interest. The Monetary Board of the Central Bank determines the Legal Rate and Market Rate for each year and publishes in the Government Gazette in the month of December to be applicable for the forthcoming year. The Legal Rate and the Market Rate for the year 2022 is 7.48 per cent per annum.

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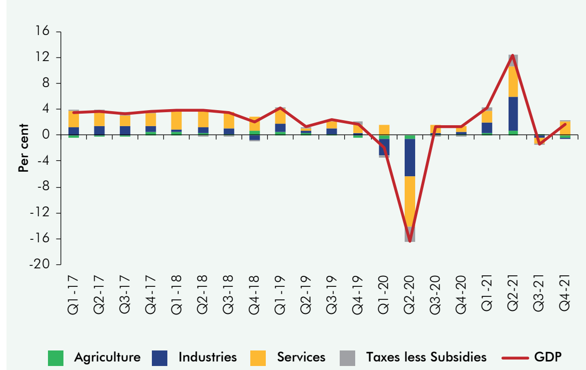
1.2 Macroeconomic Developments in 2021

Real Sector Developments and Inflation

The Sri Lankan economy rebounded in 2021, following the COVID-19 induced contraction in 2020. As per the provisional national accounts estimates of the Department of Census and Statistics (DCS), the Sri Lankan economy recorded a growth of 3.7 per cent in 2021, in real terms, compared to the contraction of 3.6 per cent recorded in the preceding year. All sectors of the economy registered growth during the year (agriculture, forestry and fishing by 2.0 per cent; industry by 5.3 per cent; and services by 3.0 per cent). The performance of the agriculture, forestry and fishing sector was buoyed by the notable growth recorded in the subcategories of growing of cereals (except rice), oleaginous fruits, and tea, while the contraction in the growing of rice and other beverage crops weighed negatively on the sectoral performance. The majority of subcategories within the industries sector registered robust growth. A notable exception was manufacturing activities related to coke and refined petroleum products which recorded a contraction of 30.5 per cent due to occasional refinery shutdowns during the year. All subcategories in the services sector registered growth with IT programming, consultancy, and related activities, and the telecommunications sectors recording sizeable growth of 21.7 per cent and 16.2 per cent, respectively, highlighting the

Figure 1.1
Activity-wise Contribution to GDP Growth



Source: Department of Census and Statistics

Table 1.2
Gross National Income by Industrial Origin at Constant (2010) Prices (a)(b)

Economic Activity	Rs. million		As a percentage of GDP (%)		Growth (%)		Contribution to Growth (%)	
	2020 (c)	2021	2020 (c)	2021	2020 (c)	2021	2020 (c)	2021
Agriculture, Forestry & Fishing	**672,930**	**686,478**	**7.1**	**6.9**	**-2.2**	**2.0**	**-0.2**	**0.1**
Agriculture and Forestry	578,407	590,632	6.1	6.0	0.6	2.1	0.0	0.1
Fishing	94,522	95,845	1.0	1.0	-16.6	1.4	-0.2	0.0
Industries	**2,427,872**	**2,556,998**	**25.5**	**25.9**	**-6.9**	**5.3**	**-1.8**	**1.4**
Mining and Quarrying	202,873	208,505	2.1	2.1	-12.5	2.8	-0.3	0.1
Manufacturing	1,481,325	1,587,489	15.5	16.1	-3.9	7.2	-0.6	1.1
Electricity, Gas, Water and Waste Treatment	150,702	156,595	1.6	1.6	-0.8	3.9	0.0	0.1
Construction	592,972	604,410	6.2	6.1	-13.2	1.9	-0.9	0.1
Services	**5,595,176**	**5,760,308**	**58.7**	**58.3**	**-1.6**	**3.0**	**-0.9**	**1.7**
Wholesale and Retail Trade, Transportation and Storage, and Accommodation and Food Service Activities	2,158,494	2,187,426	22.6	22.1	-5.0	1.3	-1.2	0.3
Information and Communication	83,444	97,636	0.9	1.0	13.7	17.0	0.1	0.1
Financial, Insurance and Real Estate Activities including Ownership of Dwellings	1,470,197	1,552,626	15.4	15.7	4.7	5.6	0.7	0.9
Professional Services and Other Personal Service Activities	1,061,663	1,073,914	11.1	10.9	-5.9	1.2	-0.7	0.1
Public Administration, Defence, Education, Human Health and Social Work Activities	821,378	848,706	8.6	8.6	2.0	3.3	0.2	0.3
Gross Value Added at Basic Price	**8,695,978**	**9,003,784**	**91.2**	**91.1**	**-3.2**	**3.5**	**-2.9**	**3.2**
Taxes less Subsidies on products	836,931	877,612	8.8	8.9	-8.1	4.9	-0.7	0.4
Gross Domestic Product at Market Price	**9,532,909**	**9,881,397**	**100.0**	**100.0**	**-3.6**	**3.7**	**-3.6**	**3.7**
Net Primary Income from Rest of the World	-263,075	-238,607			8.3	9.3		
Gross National Income at Market Price	**9,269,834**	**9,642,790**			**-3.5**	**4.0**		

(a) Based on the GDP estimates (base year 2010) of the Department of Census and Statistics
(b) Provisional
(c) Revised

Source: Department of Census and Statistics increased usage of telecommunications services amid the pandemic and growth in the Information Technology/ Business Process Outsourcing (IT/ BPO) sector. The taxes less subsidies component of GDP grew by 4.9 per cent in 2021 driven by improvements in tax revenues, when compared to 2020, in line with the post COVID-19 recovery in economic activity and declines in subsidies.

In nominal terms, the Sri Lankan economy recorded a notable growth of 11.9 per cent in 2021, compared to the tepid expansion of 0.2 per cent observed in 2020. Accordingly, the overall size of the economy expanded to US dollars 84.5 billion in 2021 from US dollars 81.0 billion in the previous year. Per capita GDP grew to US dollars 3,815 in 2021 from US dollars 3,695 in 2020. On the expenditure front, final consumption expenditure recorded a significant growth of 9.9 per cent at current prices in 2021, compared to the relatively modest growth of 2.0 per cent seen in 2020. This growth was largely driven by household consumption expenditure which grew by 10.8 per cent during the year, compared to just 1.0 per cent growth during the previous year. However, government consumption expenditure at current prices grew at a relatively modest pace of 3.7 per cent in 2021, compared to the growth of 9.9 per cent that was observed in 2020. The share of consumption expenditure in GDP at current prices stood at 79.9 per cent in 2021. Meanwhile, gross domestic capital formation registered a growth of 23.2 per cent in 2021, compared to the contractions recorded in both 2020 and 2019. The share of gross capital formation in nominal GDP improved marginally to 27.7 per cent in 2021. Net external demand for goods and services deteriorated sharply, registering a decline of 31.6 per cent in 2021 with the growth in imports outweighing the growth in exports. While a rise in private savings led to a notable growth of 20.3 per cent in domestic savings, the low government revenue led to an increase in government dissavings. Accordingly, domestic savings as a percentage of GDP stood at 20.1 per cent in 2021, compared to 18.7 per cent in 2020.

Table 1.3
Aggregate Demand and Savings-Investment Gap at Current Market Prices (a)(b)

Item	Rs. billion		Growth (%)		As a percentage of GDP (%)	
	2020 (c)	2021	2020 (c)	2021	2020 (c)	2021
1. Domestic Demand	**15,993.3**	**18,081.0**	**0.5**	**13.1**	**106.4**	**107.6**
1.1 Consumption	12,214.3	13,425.2	2.0	9.9	81.3	79.9
Private	10,662.0	11,814.9	1.0	10.8	71.0	70.3
Public	1,552.3	1,610.3	9.9	3.7	10.3	9.6
1.2 Investment (Gross Capital Formation)	3,779.1	4,655.8	-4.2	23.2	25.1	27.7
2. Net External Demand	**-966.0**	**-1,271.7**	**-5.1**	**-31.6**	**-6.4**	**-7.6**
Exports of Goods and Services	2,418.5	2,981.6	-30.3	23.3	16.1	17.7
Imports of Goods and Services	3,384.5	4,253.3	-22.9	25.7	22.5	25.3
3. Total Demand (GDP) (1+2)	**15,027.4**	**16,809.3**	**0.2**	**11.9**	**100.0**	**100.0**
4. Domestic Savings (3-1.1)	**2,813.1**	**3,384.2**	**-7.0**	**20.3**	**18.7**	**20.1**
Private	3,993.5	4,674.6	12.2	17.1	26.6	27.8
Public	-1,180.4	-1,290.4	-121.2	-9.3	-7.9	-7.7
5. Net Primary Income from Rest of the World	**-423.1**	**-406.6**	**4.2**	**3.9**	**-2.8**	**-2.4**
6. Net Current Transfers from Rest of the World (d)	**1,150.8**	**1,030.3**	**11.7**	**-10.5**	**7.7**	**6.1**
7. National Savings (4+5+6)	**3,540.8**	**4,007.9**	**-2.1**	**13.2**	**23.6**	**23.8**
8. Savings-Investment Gap						
Domestic Savings-Investment (4-1.2)	-966.0	-1,271.7			-6.4	-7.6
National Savings-Investment (7-1.2)	-238.2	-648.0			-1.6	-3.9
9. External Current Account Balance (2+5+6) (d)	**-238.2**	**-648.0**			**-1.6**	**-3.9**

(a) Based on the GDP estimates (base year 2010) of the Department of Census and Statistics
(b) Provisional
(c) Revised
(d) Any difference with the BOP estimates is due to the time lag in compilation.

Sources: Department of Census and Statistics
Central Bank of Sri Lanka

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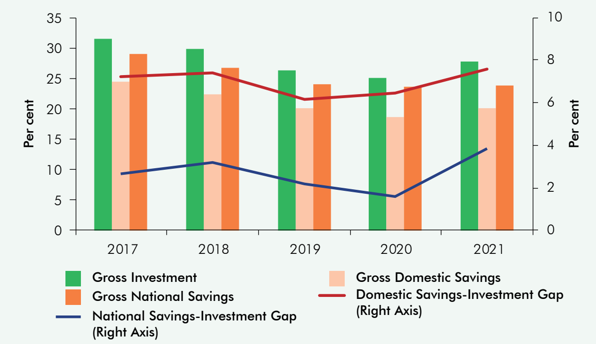
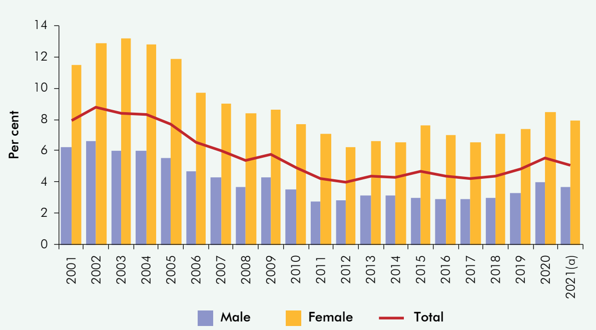
Figure 1.2
Savings, Investment and the Savings-Investment Gap (as a percentage of GDP)



Sources: Department of Census and Statistics
Central Bank of Sri Lanka

Figure 1.3
Unemployment Rate



(a) Average of four quarters of 2021

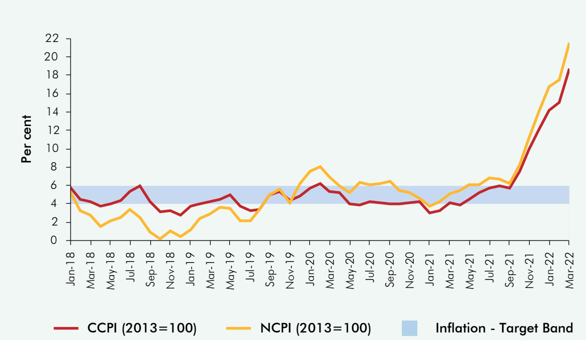
Source: Department of Census and Statistics

The domestic savings-investment gap widened to -7.6 per cent of GDP in 2021, compared to -6.4 per cent of GDP in 2020. The national savings-investment gap widened from -1.6 per cent of GDP in 2020 to -3.9 per cent of GDP in 2021, driven by the growth in investment expenditure.

While the steady recovery of the economy led to the decline in the unemployment rate, the increase in both the labour force and inactive population led to a decline in labour force participation during the year. The unemployment rate declined to 5.1 per cent in 2021 from the 5.5 per cent recorded during the previous year. Unemployment rates amongst males and females also followed suit, declining to 3.7 per cent and 7.9 per cent, respectively, in 2021, from 4.0 per cent and 8.5 per cent, respectively, in 2020. Meanwhile, the economically inactive population increased by 3.7 per cent to 8.6 million in 2021, compared to 2020 with dampened interest in active job search and pandemic induced hardships on usual routines. This development, alongside the marginal increase of 1.0 per cent in the labour force resulted in a decline in the overall labour force participation rate (LFPR) to 49.9 per cent in 2021 compared to 50.6 per cent in 2020. LFPR of both males and females declined from 71.9 per cent and 32.0 per cent, respectively, in 2020, to 71.0 per cent and 31.8 per cent, respectively, in 2021. The agriculture, industry, and services sectors accounted for 27.3 per cent, 26.0 per cent, and 46.7 per cent of the total employment, respectively.

Headline inflation accelerated in 2021 driven mainly by global and domestic supply side disturbances, the surge in global commodity prices and upward revisions to administered prices, while core inflation also accelerated reflecting the lagged effect of significant monetary accommodation. As reflected by the year-on-year change in both the National Consumer Price Index (NCPI, 2013=100) and the Colombo Consumer Price Index (CCPI, 2013=100), the acceleration in headline inflation was attributed to the acceleration in both food and non food inflation, though food inflation accounted for a larger share. Several upward revisions made to energy prices and other administrative prices reflected the rise in prices in the international market as well as volatile food prices stemming from the pandemic related supply side disruptions and the loss of production of certain items, mostly contributed to such acceleration in inflation. Spillover of the aforementioned revisions alongside external shock absorption methods, such as the removal of maximum retail prices also partly contributed to the rise in inflation. Accordingly, year-on-year headline inflation, as measured by the CCPI, which was recorded at 4.2 per cent at end 2020, accelerated to 12.1 per cent by end 2021, breaching

Figure 1.4
Headline Inflation (Year-on-Year)



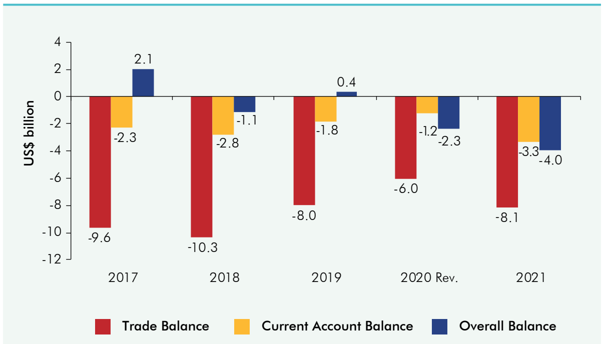
Sources: Department of Census and Statistics
Central Bank of Sri Lanka

the target level of 4-6 per cent. Following a similar trend, year-on-year headline inflation, based on the NCPI, also accelerated and was recorded at 14.0 per cent by end 2021, compared to 4.6 per cent at end 2020. The upward trend of headline inflation has continued thus far in 2022. Accordingly, year-on-year headline inflation based on the CCPI accelerated to 18.7 per cent in March 2022, while that of NCPI also accelerated to 21.5 per cent in March 2022. Core inflation, which measures underlying demand pressures, also accelerated sharply from mid 2021, reflecting demand driven inflationary pressures triggered by the impact of the lagged effects of pandemic related significant monetary policy accommodation. Accordingly, year-on-year core inflation, based on the CCPI accelerated to 8.3 per cent by end 2021 from 3.5 per cent recorded at end 2020. NCPI based core inflation accelerated to 10.8 per cent, year-on-year, by end 2021 in comparison to 4.7 per cent at end 2020. Further, continuing the same trend, CCPI based year-on-year core inflation rose to 13.0 per cent by March 2022, while NCPI based year-on-year core inflation rose to 17.3 per cent by March 2022. The strong proactive policy measures taken by the Central Bank are expected to arrest further build-up of demand driven inflationary pressures and adverse inflation expectations, supporting to revert inflation rates towards the target range in the period ahead.

External Sector Developments

Sri Lanka's external sector continues to face numerous challenges, including a sharp widening of the current account deficit, limited inflows to the financial account, depletion of gross official reserves (GOR) as a result of large debt servicing requirements and significant depreciation of the Sri Lanka rupee. Regardless of the notable momentum in merchandise exports compared to the previous year, a high increase in merchandise imports, which outpaced the growth in exports, widened the trade deficit in 2021. Increased import expenditure was mainly due to the combined effect of sharp revival in imports, particularly in the latter part of the year, primarily driven by higher commodity prices, including prices of fuel, increased demand for imported items due to normalisation of economic activity, higher importation of medical and pharmaceutical items such as vaccines, and the relaxation of some of the restrictions on importation of non essential goods. The services sector surplus remained subdued, compared to the pre-pandemic level. However, there was a gradual increase in earnings from tourism towards the end of the year whilst a healthy growth was observed in exports of computer services. The deficit in the primary income account recorded a contraction with a reduction in interest and coupon payments as well as dividend payments. Meanwhile, the surplus in the secondary income account reduced as a result of a notable contraction in workers' remittances received by the banking system. With these developments, the deficit in the external current account widened significantly to US dollars 3.3 billion in 2021 (4.0 per cent of GDP), compared to US dollars 1.2 billion in 2020 (1.5 per cent of GDP). The financing of the current account deficit was achieved by drawing down GOR amidst

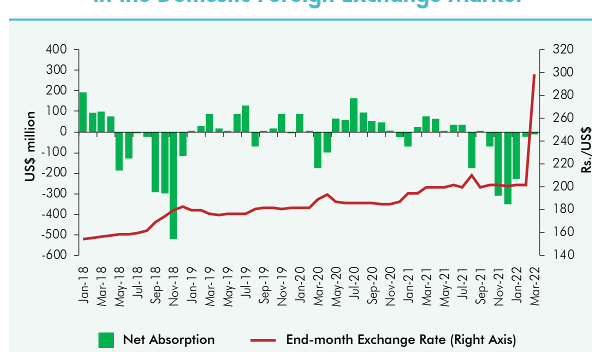
Figure 1.5
Balance of Payments



Source: Central Bank of Sri Lanka

moderate inflows to the financial account and continuous foreign debt service payments. Foreign investment in the form of FDI remained modest while foreign investment to the stock market and the government securities market recorded net outflows during the year. Amidst significant debt servicing obligations falling due during the year, the Government and the Central Bank received some inflows that enabled replenishment of the GOR to a certain extent. These included the Special Drawing Rights (SDR) allocation by the IMF, two foreign currency term financing facilities from the China Development Bank, and international currency swap agreements with the People's Bank of China (PBOC) and the Bangladesh Bank. However, there were substantial outflows from official reserves due to debt service payments as well as the supply of foreign exchange to the domestic foreign exchange market to facilitate the importation of essential goods. As a result, the GOR declined to US dollars 3.1 billion by end 2021, compared to US dollars 5.7 billion recorded as of end 2020. Accordingly, the overall balance of the BOP recorded a significant deficit of around US dollars 4.0 billion in 2021. Meanwhile, the total external debt of the Government, based on market value, declined marginally as a result of the combined effect of the decline in market prices of Sri Lanka's outstanding International Sovereign Bonds (ISBs) and the repayment of an ISB, although the outstanding foreign loans of the Government recorded an increase during the year. Further, the outstanding external liabilities of the Central Bank increased significantly due to the net impact of international currency swap arrangements. Consequently, Sri Lanka's total external debt increased to US dollars 50.7 billion by end 2021 from US dollars 49.0 billion as of end 2020. Sri Lanka settled the ISB of US dollars 1 billion that matured in July 2021 and the ISB of US dollars 500 million that matured in January 2022. The Sri Lanka rupee was maintained broadly at stable levels during 2021 and in early 2022, partially aided by moral suasion to keep the currency stable around Rs. 200 levels. However, considering the severity of the external shocks and further adverse developments in the global and domestic fronts, the Central Bank allowed flexibility in the exchange rate, yet intending to keep the rate of depreciation at a certain level, since early March 2022 as a part of the comprehensive policy package announced to alleviate the difficult situation in the external sector. However, the large pressures witnessed in the domestic foreign exchange market caused a large overshoot in the Sri Lanka rupee. Consequently, the Sri Lanka rupee, which depreciated by 7.0 per cent in 2021,

Figure 1.6
Exchange Rate and Central Bank Intervention in the Domestic Foreign Exchange Market



Source: Central Bank of Sri Lanka

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Deshamanya Professor W D Lakshman
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Strictly Confidential

04 August 2020

Hon. Mahinda Rajapaksa
Minister of Finance, Economic and Policy Development
Ministry of Finance, Economic and Policy Development
The Secretariat
Colombo 01

Honourable Minister,

Report to the Hon. Minister of Finance as required under Section 68(1)(b) of the Monetary Law Act

In accordance with Section 68(1)(b) of the Monetary Law Act (MLA), the Monetary Board is required to submit to the Minister in charge of the subject of Finance a detailed Report whenever the Monetary Board anticipates that there may develop a deficit in the balance of payments (BOP) which may cause a serious decline in the international reserve, or whenever there is an imminent threat of a serious decline in the international reserve, or whenever the international reserve actually falls to a level which the board considers to be a threat to the international stability of the Sri Lanka rupee. The purpose of this Report, submitted to you in terms of the above provision of the MLA, is to apprise you, as the Hon. Minister of Finance, of the current position and expected decline of gross official reserves, the movements of the exchange rate in the recent past and possible threats to external sector stability and that of external value of the rupee. The Report also describes the measures the Monetary Board has already taken in view of the above issues and further policy measures that can be proposed for adoption.

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1. **Sri Lanka's external sector has continually faced vulnerabilities over the past few decades emanating from global economic, financial and geo-political developments as well as from significant challenges on the domestic front.** Sri Lanka's external sector has been characterised by persistent current account deficits driven by large trade deficits, mounting external debt and resultant high debt service payments and inadequacy of non-debt creating capital flows such as foreign direct investment (FDI). The current account deficit as a share of GDP has been 3.4 per cent on average for the period from 2000 to 2019. The current account deficit is mainly caused by the widening deficits in the trade and primary income accounts (mainly interest payments) that are too large to be offset by the surpluses in services and secondary income accounts (mainly workers' remittances). Export performance has been lacklustre as reflected by the sharp decline in exports as a share of GDP from 33 per cent in 2000 to 14 per cent in 2019. On the other hand, expenditure on imports has increased at a faster pace leading to large trade deficits. Workers' remittances have demonstrated a moderate downward trend since 2015. However, on a positive note, services exports have increased notably by over US dollars 5.0 billion over the past decade, primarily supported by a significant growth in tourism and transport services and in Information Technology (IT) and Business Process Outsourcing (BPO) sectors. In the meantime, following Sri Lanka's graduation to the lower middle-income economy status in 2010, the availability of concessional foreign sources to finance the current account deficit has declined rapidly. This has increased the country's dependence on market-based foreign borrowings. These borrowings have increased the country's vulnerability to vicissitudes in global financial conditions. Increasing external debt has resulted in a significant rise in interest expenses. This is reflected by the significant expansion in the primary income account deficit from US dollars 0.6 billion in 2010 to US dollars 2.4 billion in 2019. Attracting FDI has also been challenging as evidenced by FDI inflows being limited to US dollars 1.4 billion per annum on average over the past decade, which is remarkably low in comparison to its regional peers. Meanwhile, outstanding foreign investment in the government securities, which peaked at US dollars 3.9 billion by end May 2014 has declined to US dollars 69 million by end July 2020. In this backdrop, this Report seeks to highlight the increasing vulnerabilities Sri Lanka is facing in its external economic relationships in spite of some promising developments noted

below in appropriate places, during June-July 2020. The Report also proposes measures to ensure the stability of the external sector in the near future and in the medium term.

2. **Sri Lanka's external sector was adversely affected by the developments following the Easter Sunday attacks in 2019.** With the gradual widening of the trade deficit especially towards the end of the year, and the decline in earnings from tourism and workers' remittances, the current account recorded a deficit of US dollars 1.8 billion (2.2 per cent as a share of GDP), which nevertheless remained significantly below the deficit of US dollars 2.8 billion (3.2 per cent as a share of GDP) in 2018 due to measures taken to curtail imports. Despite significant debt service payments during the year including the settlement of maturing ISBs amounting to US dollars 1.5 billion, gross official reserves increased to US dollars 7.6 billion by end 2019, benefitting from the two issuances of ISBs amounting to US dollars 4.4 billion. Following 16.4 per cent depreciation recorded in 2018, the exchange rate remained broadly stable in 2019, reflecting the reduced current account deficit and increased financial flows during the year.

3. **With the positive momentum created after the Presidential election in November 2019, the external sector showed signs of improvement during the first two months of 2020 before encountering the unprecedented vulnerabilities caused by the COVID-19 pandemic.** The pandemic and the consequent global economic downturn are expected to significantly impact Sri Lanka's external sector performance in 2020. The Sri Lankan rupee, which remained relatively stable up to the second week of March 2020, depreciated significantly until mid-April 2020 with the spread of the COVID-19 outbreak. However, the exchange rate appreciated and stabilised thereafter, due to the policy measures implemented. The tourism sector, which recovered to pre-Easter Sunday attack levels by early 2020, faced a severe hit with the travel restrictions imposed globally and the closure of the airports and seaports in Sri Lanka. The services account surplus is expected to contract significantly, as there would be a substantial drop in earnings from tourism, passenger transport and freight services. Workers' remittances will also reduce significantly, with key source countries of workers' remittances being affected by this crisis. Some migrant workers returned home, and others faced reduced compensation and

redundancies. On the external trade front, despite a significant reduction in exports in March and April, merchandise exports have shown signs of recovery based on export data for May, June and July 2020. However, export performance in the period ahead heavily depends on the speed of recovery of the global economy. Imports have contracted due to temporary restrictions on imports of non-essential goods from mid-March 2020. Even though a reduction in the trade deficit could be expected, the current account deficit for 2020 is likely to widen compared to 2019, due to anticipated lower inflows related to services and workers' remittances.

4. **The projected performance of the external sector may worsen with any possible re-emergence of the pandemic.** With the rapid spread of the pandemic at a rate exceeding 250,000 daily new cases across the globe, many countries have witnessed increased disruptions to economic activity. Any such occurrence in Sri Lanka affecting the normalisation of domestic economic activity and causing a delay in opening the borders for foreign tourists would worsen already uncertain external sector performance in 2020. Any significant disruption to economic activity is likely to hamper export oriented manufacturing and trade related services. Worsening global conditions may also lead to very little prospect of tourist arrivals in the remainder of the year and may limit Sri Lanka's ability to attract FDI and even foreign debt creating flows.

5. **Strong policy concern ought to be focused on Sri Lanka's ability to meet its external debt service obligations.** With increased commercial borrowings, particularly in the form of International Sovereign Bonds (ISBs), the external debt burden has increased rapidly over the past decade and has been categorised by rating agencies and development partners as approaching unsustainable levels, as the country's economic growth and the growth of foreign currency earnings have not been on par with the rising debt stock. In the current context, secondary market yields of Sri Lanka's already issued ISBs have increased drastically making it extremely difficult for Sri Lanka to access international capital markets to raise foreign financing in order to meet its debt servicing obligations.

6. **Some measures have already been taken to ease the pressure on the external sector after the COVID-19 outbreak.** Import restrictions, already noted, have kept import payments under control. In addition, several measures were introduced to restrain foreign exchange outflows. The purchase of Sri Lanka ISBs by licensed banks in Sri Lanka was restricted. Restrictions on outward remittances on certain identified capital transactions including the reduction in the maximum limit on migrant transfers were imposed by the Central Bank. The issuance of foreign currency notes as travel allowance was limited to US dollars 5,000 or its equivalent in other foreign currency. Further, a Special Deposit Account scheme has been introduced to attract foreign exchange inflows. Meanwhile, the government has also decided not to proceed with debt-funded large scale infrastructure projects until conditions improve. The positive impact of these developments was reflected in the exchange rate, with the rupee appreciating since mid-April 2020, while enabling the Central Bank to absorb foreign exchange on a net basis by July 2020.

7. **Amidst all these measures implemented, there is a high probability that international reserves could drop to critical levels in 2020 due to the large foreign debt service payments falling due in the period ahead.** The gross official reserves, which stood at US dollars 6.5 billion at end May 2020, increased to around US dollars 7.0 billion by end July 2020. Restrictions placed on outflows as well as the absorption of foreign exchange from the domestic market by the Central Bank, the receipt of the proceeds of the SAARCFINANCE SWAP facility with the Reserve Bank of India (RBI) and the postponement of liabilities to the Asian Clearing Union (ACU) helped this enhancement of reserves. Continued efforts are required to speed up such repletion. Nevertheless, scheduled debt servicing obligations (excluding SLDB and FCBU loans) of around US dollars 2.3 billion are falling due in the last five months of 2020. This includes the settlement of an ISB of US dollars 1 billion, due to mature on 4 October 2020. Given the current gross official reserve levels and future debt servicing obligations, the Central Bank has been extremely prudent in intervening in the domestic foreign exchange market. With the scheduled debt service obligations, reserves are likely to fall below US dollars 6 billion by end October 2020, in the absence of potential refinancing sources prior to the payment of the ISB. A significantly low level of gross official reserves with higher future debt servicing is likely to result in a

deterioration of investor confidence and appetite for Sri Lanka's equity and bond markets. Sri Lanka has already been downgraded by Fitch Ratings from B to B- in April 2020 and by S&P Global Ratings from B to B- in May 2020. There is a possibility of further downgrades of Sri Lanka's credit rating by sovereign rating agencies, if the planned funding arrangements do not materialise. Another downgrade within a short span of time would have catastrophic consequences. On the one hand, a downgrade may further add on to the already high risk premium of the country and result in higher borrowing costs in the future. On the other hand, it will trigger automatic prepayment clauses in some syndicated and project loan arrangements.

8. **Hence, there is an urgent need to make available the foreign financing options soon after the October ISB is paid.** There are different options available for Sri Lanka to raise external funds albeit under difficult circumstances and possibly with more stringent conditions and/or higher risk premium. Active engagement with major multilateral and bilateral development partners is essential. The following are some of the sources, that have been or that could potentially be used to raise additional external finances in 2020. There is the remainder of the foreign currency term financing facility of around US dollars 700 million from the China Development Bank. The SAARCFINANCE SWAP arrangement with the Reserve Bank of India (RBI) has already made US dollars 400 million available at end July 2020. A syndicated loan of US dollars 500 million is being negotiated by the government. Further, discussions are currently underway to enter into an additional SWAP arrangement of around US dollars 1 billion with RBI and also a SWAP arrangement with People's Bank of China for a sum of around 10 billion in Chinese Yuan. Sri Lanka is currently negotiating with several multilateral institutions to obtain financial assistance. There are the proceeds from loans of US dollars 87 million from the World Bank to be drawn. The International Monetary Fund's Rapid Financing Instrument (IMF-RFI) of a maximum of US dollars 790 million, loan of US dollars 500 million from the Asian Development Bank (ADB), a joint loan of US dollars 500 million from ADB, OPEC Fund for International Development (OFID) and Asian Infrastructure Investment Bank (AIIB) and a loan of around US dollars 120 million from the French Agency for Development (AFD) are also potential sources earmarked for negotiation.

Most of the loans from the multilateral sources referred to above are likely to follow an IMF facility, for which the IMF has indicated debt sustainability to be a significant impediment. Even if the IMF-RFI is received and facilitated funding options from other multilateral lenders in 2020, refinancing risk could persist beyond the year. External debt servicing of 2021 is currently estimated at US dollars 6.6 billion (including an ISB repayment of US dollars 1 billion falling due in July 2021). It is expected that the investor confidence will improve with the restoration of political stability following the general election of August 2020. However, in order to sustain the positive momentum, it is imperative to implement a coherent macroeconomic stabilisation programme which would bring improved confidence to foreign investors and other external stakeholders.

9. **In the absence of an IMF programme in the near future, the options available are to seek bilateral financial assistance from friendly nations and to explore avenues of commercial borrowings.** It is unlikely that a single bilateral lender is able to offer significant parts of financing requirements continuously over the next few years. Commercial borrowings, possibly at high rates with shorter repayment periods, may have to be considered in addition to bilateral loans from friendly nations. This could have adverse medium-term fiscal and debt sustainability effects.

10. **It is only by achieving at least a sustainable current account deficit, if even a marginal surplus is not feasible, Sri Lanka will be able to maintain external sector stability in the long run.** Any long term effort in addressing the persistent issues faced by the external sector should be focused on strategies to achieve a significantly reduced trade deficit by increasing both merchandise and services exports while seeking the possibility of gradually discouraging non-essential imports through appropriate import substitution policies. Further, services exports are vital in cushioning the deficit in the current account and hence it is imperative to exploit the full potential of services exports including tourism, transportation, telecommunication and emerging sectors such as IT/BPO to bring continuous foreign exchange inflows to the country in the near and medium term. Promoting inward remittance flows to the country by implementing appropriate policies related to skilled and semi-skilled labour migration and remittances will also positively impact the current account. Further, a greater emphasis should be placed on improving the investment climate of Sri Lanka in order to attract more

FDI to the country. These non-debt creating flows will help reduce the heavy reliance on external borrowings and resolve the challenge of bunching of foreign debt repayments in the forthcoming years. In a best case scenario, an improved current account along with non-debt creating financial flows may result in gradual net inflows to the domestic foreign exchange market. In such a situation, this surplus foreign exchange could be absorbed by the Central Bank to build up reserves, which may be utilised to repay at least a portion of the foreign debt of the government.

Under the circumstances described above, the Monetary Board of the Central Bank of Sri Lanka is of the view that the country's external sector stability remains vulnerable, necessitating corrective measures without delay. Every possible policy initiative should be taken by all stakeholders in real, financial and fiscal sectors to prevent further depletion of the country's official reserves. Securing emergency financing from multilateral lenders and/or friendly countries is essential. The CBSL is making every effort to obtain such financing support to prevent adverse market speculation as that could lead to unwarranted volatility in the exchange rate and a faster depletion of reserves. The potential for the Central Bank to intervene in the domestic foreign exchange market would be limited, given the critically low level of reserves relative to the impending debt service payments. Medium to long term policies to enhance the country's capacity to earn foreign exchange are essential to address the mounting debt servicing obligations in the coming years.

Yours sincerely,

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

cc: Mr. S R Attygalle, Secretary to the Ministry of Finance, Economic and Policy Development

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Deshamanya Professor W D Lakshman
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Central Bank of Sri Lanka
30, Janadhipathi Mawatha, Colombo 1, Sri Lanka

CONFIDENTIAL

17 December 2020

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

Honourable Prime Minister,

Report to Hon. Minister of Finance as required under Section 64 (2) of the Monetary Law Act

Copy issued to
Prof. W. D. Lakshman

The Sri Lankan economy has performed relatively well compared to other south Asian economies as well as key developed nations in the face of the COVID-19 pandemic. This has been reflected in the recently released national accounts statistics, which reported a growth in real Gross Domestic Product (GDP) of 1.5 per cent in the third quarter of the year, following a sharp contraction in the second quarter. In this backdrop, the government's stimulus programme for micro, small, and medium scale as well as large corporates, helped by the Central Bank's funding, needs to be commended as these measures stemmed the pandemic triggered economic decline. These relief measures including the successive moratoria together with the accommodative monetary policy stance ensured that businesses received adequate impetus to stay afloat despite the intermittent shutdowns within, as well as globally, which slowed down global trade

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causing disruptions to supply chains. The monetary policy measures involving successive downward policy rate adjustments helped in the management of both the public and private sector debt. These measures have facilitated the improvement of cash flows of both types of entities.

The measures articulated above have resulted in an overall expansion in money supply beyond established norms, which have been articulated for normal times with settled market conditions, and written into the Monetary Law Act. Section 64(2) of the Monetary Law Act (MLA) thus requires the Monetary Board to submit to the Minister in charge of the subject of Finance a detailed report, if, at the end of any month, the Board observes that the amount of money supply has increased or decreased by more than fifteen per cent or the cost-of-living index has increased by more than ten per cent, of its level at the end of the corresponding month in the preceding year.

It is as per this statutory requirement that this report is submitted. Money supply has expanded by over fifteen per cent, on a year-on-year basis, every month from end July to end October 2020. The Monetary Board clearly realises that the above increase in money supply was caused by extraordinarily different and difficult conditions requiring that scale of money supply expansion to meet the crisis, and particularly to help the vulnerable strata of society. The Board also does not envisage this money supply expansion to pose any immediate threat to monetary stability of the country. Affected by the prevailing pandemic and related conditions, the country's aggregate demand is not keeping up with aggregate supply and the supply of loanable funds exceeds the demand for loans. Hence the absence of an imminent threat to monetary stability.

The following summarises the relevant data. Broad money supply (M_{2b}) grew by 15.7 per cent, year-on-year, at end July 2020, and gradually accelerated thereafter to reach 20.9 per cent by October 2020. The acceleration in the growth of money supply thus far during the year was driven by the increase in domestic credit, particularly credit extended to the public sector. The spread of COVID-19 in two stages, and general and selective lockdowns and social distancing imposed to meet the challenges of these, led to significant declines in production, employment and incomes. Naturally, there were very few revenue sources for the government.

The government relied on domestic financing to meet the revenue-expenditure gap created by action taken to support the domestic economy in the ten months ending October 2020. Credit obtained by State Owned Business Enterprises (SOBEs) from the banking system also expanded during the ten months ending October 2020, reflecting the impact of disruptions to business activity and cashflows resulting from the outbreak and spread of COVID-19. The credit to these public enterprises however was less than 10 per cent of domestic credit, and not at very critical levels. Encouragingly, there were some gains in recent months in the finances of at least some of these enterprises due to improving managerial efficiencies, as envisaged by the government. Meanwhile, credit extended to the private sector, which remained subdued since 2019, increased notably during the period from August to October 2020, strongly reflecting a revival in business confidence. Money supply, without doubt, had to expand. Money supply expansion at this stage had to play a counter cyclical role.

As anticipated, the decline in economic activity had two implications for monetary policy. First, there was only moderate private sector credit growth on aggregate. Excess liquidity found itself back into the Central Bank in the overall macro framework of maintaining price stability, and helped keep yields on gilts at single digit level. Second, the domestic market appetite shifted towards gilt edged securities during the pandemic, as other assets for investment were scarce. The Central Bank also provided required urgent financing to the government by purchasing government securities from the primary market during this period, which in turn added further liquidity to the system. We expect market conditions to remain stable and supportive of the overall macro framework of the government through availing low cost credit to the private sector as well as to the government, thereby creating the much-needed fiscal space.

Meanwhile, the consumer price inflation remained in mid-single digits so far during 2020 buttressed by well anchored inflation expectations amidst subdued aggregate demand pressures. Core inflation, which continued to remain below 5 per cent so far during the year, also affirms subdued demand pressures in the economy. Therefore, the Monetary Board is of the view that the expansion in broad money above 15.0 per cent, year-on-year, during July to October 2020, does not pose an immediate threat to price stability as the economy continues to operate below its potential. It is anyway gradually making headway in the emerging new normal conditions characterized by living with COVID-19. Going forward, reflecting the lagged impact of the extraordinary stimulus measures put in place in support of businesses and individuals affected by the COVID-19 pandemic, inflationary pressures could emerge over the medium term.

The Central Bank is of the view that the current stable exchange range policy brought about by the rationalisation of imports and the push toward a trade surplus is a much-needed policy shift and the benefits of such a policy framework would become evident in the coming years. The expected improvements in the supply side, resulting from the impetus provided by the government through tax incentives for local as well as foreign direct investments, would help counteract some of the possible pressures stemming from the demand side. The possible intervention of the government through adjustments to indirect taxation on certain commodities would also help control price pressures to some extent. A strong recovery of the economy in 2021 is now a foreseeable possibility, from the expected contraction in 2020. This is likely to cause an acceleration in private sector credit. Nevertheless, the recovery of government revenue streams and the continuation of net repayments from SOBEs, observed during the months of September and October 2020, would also help decelerate the growth of money.

The Monetary Board will closely monitor developments in money and credit aggregates and would take appropriate monetary policy measures as necessary to restrain any inflationary pressures and maintain inflation at the targeted 4-6 per cent range over the medium term, while supporting the economy to rebound in 2021 and maintain the envisaged high growth trajectory thereafter.

Copy issued to
Prof. W. D. Lakshman

Yours sincerely,

Deshamanya Professor W D Lakshman
Governor
Central Bank of Sri Lanka

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

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Deshamanya Professor W D Lakshman
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STRICTLY CONFIDENTIAL

06 April 2021

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

Honourable Prime Minister,

Copy issued to
Prof. W. D. Lakshman

Report to the Hon. Minister of Finance as required under Sections 64(3) and 68(2) of the Monetary Law Act

1. As the Honourable Prime Minister/ Minister of Finance is aware, the Sri Lankan economy is undergoing a challenging period, with a need to support a rebound of economic growth on the one hand, and a need to maintain macroeconomic stability on the other. These are, to a large extent, legacy issues coming particularly from the second half of the 2010s. The challenges inherited by the present Government have been exacerbated by the effects of the COVID-19 pandemic, which affected the entire global economy, including Sri Lanka.

2. In this background, the Monetary Board of the Central Bank of Sri Lanka is of the view that it is appropriate to apprise the Honourable Prime Minister in terms of Sections 64(3) and 68(2) of the Monetary Law Act of the possible challenges to domestic monetary stability and the decline in international reserves, the remedial action that has been taken, and on the need for further action to ensure the stability of the Sri Lankan economy.

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External Sector Conditions, Challenges and Remedial Measures

3. As a result of the COVID-19 pandemic and the resultant slowdown in global and domestic economic activity, there was a significant decline in merchandise exports, particularly during March-May 2020. Tourist arrivals came to a standstill with the suspension of entry for foreign visitors during the period from mid-March 2020 until late December 2020. Workers' remittances declined sharply up until June 2020, with some migrant workers returning home and some facing layoffs and reduced compensations. There were significant financial outflows as well, with notable outflows of foreign investment from the government securities market as well as from the Colombo Stock Exchange. Inflows in the form of Foreign Direct Investment (FDI) remained at low levels.

4. Upon 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 a result of these policy measures as well as lower global petroleum prices and lower domestic demand, the deficit in the trade account contracted notably in 2020. The trade deficit declined, reflecting the impact of the large reduction of merchandise imports that outpaced the decline in merchandise exports during 2020. The decline in monthly export earnings observed during early 2020 reversed from July 2020, enabling monthly export earnings to reach the pre-pandemic monthly average of close to US dollars 1 billion in the second half of 2020. Workers' remittances, which recorded a decline of 8.9 per cent during the first half of the year, recovered at a faster pace from June 2020 to record a growth of 5.8 per cent, year-on-year, for 2020. In 2020, the current account deficit has improved considerably to US dollars 1.1 billion from US dollars 1.8 billion in 2019, in spite of the contraction in earnings from tourism and certain other services exports.

5. Despite the implementation of appropriate policy measures, the external sector continues to experience increased vulnerabilities due to high foreign currency debt service payments made utilising international reserves, sovereign rating downgrades, gradual pick up in imports, rise in petroleum prices and so forth. The exchange rate has become highly volatile and experienced depreciation pressure since end November 2020, primarily driven by gradually increasing import bills and subdued inflows to the domestic foreign exchange market. The Central Bank also took the unprecedented measure of directing all licensed commercial banks to refrain from entering into forward market contracts other

than interbank forward market transactions in the domestic foreign exchange market. Following the Government's initiative to pay additional Rs. 2 per US dollar for workers' remittances converted at the licensed banks, the Central Bank instructed all licensed banks to sell 10 per cent of such remittances converted to Sri Lankan rupees, to the Central Bank. Further, the Central Bank imposed a rule 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, of which 50 per cent is to be sold to the Central Bank. The latter two measures have helped the Central Bank to absorb over US dollars 80 million from the domestic market into the international reserve so far in 2021. However, these two requirements, which required the licensed banks 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 foreign exchange liquidity pressure experienced by the banks.

6. Furthermore, given the Government's stance not to approach the International Monetary Fund (IMF) for emergency financing, the Central Bank is actively working with the Government to facilitate enhancing non-debt sources of foreign exchange inflows. Accordingly, 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 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. While stakeholders have reiterated the immense potential of these sectors, they seek the Government's support to expeditiously address the impediments and bottlenecks that have hindered achieving this potential over the past several decades. The success of these measures will help Sri Lanka achieve the expected outcome of reducing dependence on foreign debt through enhancing real inflows and domestic economic development over the medium term.

7. With sizable debt service obligations of capital and interest payments of US dollars 6.0 billion during 2020 (including Sri Lanka Development Bonds and Offshore Banking Unit (OBU) loans of US dollars 1.6 billion), gross official reserves declined to US dollars 5.7 billion by end 2020, compared to US dollars 7.6 billion at end 2019. This reduction in gross official reserves was due to the lack of foreign financing inflows to the Government, particularly as a result of

the inability of the country to issue International Sovereign Bonds (ISBs) in 2020 due to unprecedented global market uncertainties, sovereign rating downgrades and the resulting distortion in secondary market yields of ISBs during the pandemic. With continuous foreign currency debt service payments thus far in 2021, the gross official reserves are estimated to have declined further to around US dollars 4.0 billion, at present.

8. The decline in official reserves to levels below US dollars 4 billion is likely to make it challenging for the Central Bank to meet the foreign currency debt service obligations of the Government by drawing down reserves any further. Therefore, it is essential for the Government to secure adequate foreign financing on an urgent basis in order to maintain Sri Lanka's unblemished record of debt servicing. During the remainder of the year, the Government foreign currency debt service obligations amount to US dollars 4.8 billion (including US dollars 2.9 billion of foreign liabilities and US dollars 1.9 billion of domestic liabilities). Further, supply of foreign exchange to the domestic foreign exchange market by the Central Bank may sometimes be required to curb undue volatility in the exchange rate. This is not feasible given the current low level of reserves.

9. There have been some positive developments in terms of securing foreign financing to the Government and the Central Bank. The agreement pertaining to an international swap facility with the People's Bank of China (PBOC) of US dollars 1.5 billion equivalent in Yuan has been signed and will remain as a stand-by facility, while the two state-owned commercial banks have secured a facility of US dollars 180 million from the Asian Infrastructure Investment Bank (AIIB). Discussions are continuing with the China Development Bank (CDB) to obtain the remaining US dollars 700 million of the syndicated loan facility agreed in 2020. Furthermore, the Reserve Bank of India (RBI) has indicated the possibility of a fresh swap facility of US dollars 400 million under the SAARCFINANCE arrangement in August 2021 after a cooling off period of six months following the settlement of the previously obtained facility in February 2021.

10. Nevertheless, these inflows are barely sufficient to finance the remaining debt service obligations and the likely deficit in the balance of payments in 2021. Furthermore, these facilities provide only temporary relief, as debt service payments remain large over the near to medium term. Therefore, the

Government's foreign currency debt service challenge is considerable, particularly in the context of the sovereign rating downgrades by all three credit rating agencies in 2020. These downgrades have reduced the country's ability to access the international capital markets at a reasonable cost.

11. The next four months remain crucial, given the low level of reserves, the upcoming debt service payment requirements, and the lack of substantial confirmed inflows to the reserves prior to end July 2021. The Central Bank, together with the Government will take every possible step to continue timely debt servicing. Any lapse on this count will have harsh and prolonged ramifications on the domestic banking system, international trade, local manufacturing and other economic activities. It may have significant social and political consequences as well, leading to further economic, social and political unrest. The cost of such instability will be disproportionately high for the poor and the vulnerable, and the impact of such instability on the ordinary citizen will be severe.

12. It is essential therefore, for the country to continue its efforts to enhance its foreign exchange earnings, while managing and rationalising outflows on account of non-essential imports, non-essential foreign travel and outward investment. A reasonable time period needs to be allowed to enhance foreign exchange earnings and to attract foreign investment inflows. It is with confidence that the Central Bank predicts a strong revival in domestic and external economy in the second half of 2021. But firm action is required to address the external sector issues of the next three months. It is essential to maintain or further tighten the restrictions on non-essential imports and such other outflows. Continued discussions with multilateral agencies and friendly nations are necessary to secure short term financing required to tide over the impending debt service requirements and the likely shortfall in the balance of payments in 2021. The Central Bank is engaged in these dialogues and suggests the indispensability of the involvement of the Government in this regard.

Monetary Conditions, Challenges and Remedial Measures

13. Meanwhile, as the economy traversed through challenging times, the Central Bank continued to allow an unprecedented level of monetary accommodation in order to support the Government, state-owned business enterprises, private sector businesses, and individuals. This resulted in an inevitable expansion in

money supply, at a rate of more than fifteen per cent, year-on-year, during the period from July 2020 through February 2021. Given the severity of the health crisis and the consequent slump in economic activities, this Central Bank intervention was unavoidable and helped to avert an unprecedented human disaster.

14. Broad money supply (M_{2b}) grew by 23.8 per cent, year-on-year, by end February 2021 compared to the growth of 23.4 per cent at end 2020 and 23.7 per cent in January 2021. The acceleration in the growth of money supply was driven by the increase in domestic credit, particularly credit extended to the public sector. The Government relied on bank financing to meet the revenue-expenditure gap during the period. Accordingly, net credit to the Government (NCG) by the banking system, which increased by Rs. 1,752 billion in 2020, increased further by Rs. 245.1 billion during January-February 2021, although the expected borrowing from the banking system was estimated in the Government Budget 2021 at Rs. 319 billion for 2021.

15. Supporting the government policy of maintaining a low interest rate regime for the purpose of promoting investment, the Central Bank has acted consistently and brought down interest rates to lowest levels recorded so far since the 1980s. As in the case of every economic variable, this action has dual effects. Low interest rates encourages investment while discouraging savings. Thus, market participation at government securities' auctions remained subdued at the published maximum yield rates for acceptance. The Central Bank was required on many occasions to purchase a sizeable quantum of the underallocated Treasury bills at the primary market. Accordingly, the Central Bank's holding of government securities increased significantly to Rs. 842.2 billion (on face value basis) as at end March 2021, compared to Rs. 74.7 billion at end 2019, which is an eleven-fold increase within 15 months. Accordingly, the Central Bank now holds 46.4 per cent of the outstanding Treasury bills, compared to that of 8.3 per cent at end 2019.

16. Credit extended to the private sector increased notably since August 2020, yet the growth of credit towards productive sectors of the economy appears to remain inadequate. Hence, the Central Bank has begun discussions with the banking community and other stakeholders to rectify deficiencies in extending credit to productive and growth supporting sectors. In the meantime, as growth of credit to the private sector gathers pace, there is a need to ensure fiscal

consolidation along the envisaged path in the Government's policy statement, which would also help the country to manage the external sector pressures, reduce the debt stock to sustainable levels and prevent further sovereign rating downgrades.

17. In spite of the rapid expansion in money supply, consumer price inflation has remained in mid-single digit level and inflation expectations were well anchored in the presence of subdued aggregate demand pressures. Headline inflation, based on the Colombo Consumer Price Index (CCPI, 2013=100), recorded at 4.1 per cent, year-on-year, in March 2021, compared to 4.2 per cent, year-on-year, by end 2020. Inflation, based on the National Consumer Price Index (NCPI, 2013=100), also remained moderate and recorded at 4.2 per cent, year-on-year in February 2021, compared to 4.6 per cent, year-on-year, by end 2020. Core inflation based on both indices also continued to remain subdued during the period. Inflation is expected to remain subdued in the near term in the absence of large demand pressures. Overall, inflation according to widely used price indices was at single digit level, but there have been widely expressed concerns over food inflation. Envisaged improvements on the supply side however will bring food inflation under control. Higher than anticipated improvements in domestic and external demand, together with the normalisation of global energy and food prices, could create inflationary pressures over the medium term, although the expected improvements in domestic supply conditions in the post-pandemic recovery are likely to neutralise the build up of inflationary pressures to some extent in the period ahead. However, continued expansion of money supply through excessive monetary financing of the government budget deficit could pose a threat to domestic price stability. Therefore, the Monetary Board is of the view that the current practice of purchasing Treasury bills from the primary market by the Central Bank should be brought under restraint with the support of the Treasury to prevent the buildup of macroeconomic imbalances, particularly considering the normalisation of most economic activity. Any tightening of monetary policy in order to correct these imbalances would be counterproductive given the measures being initiated to ensure a high and sustained growth of the economy.

Concluding Remarks

18. In the context of the extremely challenging external sector conditions as described above, the Monetary Board is of the view that coordinated efforts of the Government, the Central Bank, other government agencies, commercial banks, particularly the state banks, and private sector organisations, with the support of the general public, are essential for the country to overcome these difficulties and ensure a gradual, yet steady strengthening of the external sect of the economy. In the meantime, the Monetary Board will continue to monitor developments in the balance of payments, the exchange rate, and official reserves, and take necessary steps to maintain stability in these variabl to the maximum possible extent, and apprise the Government of further actions necessary.

19. The Monetary Board will also closely monitor developments in money and credit aggregates and would take appropriate monetary policy measures as necessary to maintain inflation at the targeted 4-6 per cent range over the medium term, while continuing with its accommodative monetary policy sta to support the economic rebound towards the envisaged high growth trajectory.

20. The Monetary Board and I stand ready to provide any further information th the Honourable Prime Minister may require in this regard.

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

Copy to: Mr. S R Attygalle, Secretary to the Treasury/ Ministry of Finance

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STRICTLY CONFIDENTIAL

30 June 2021

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

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.

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 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 fail 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

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 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.

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.

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 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.

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

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

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Deshamanya Professor W D Lakshman
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STRICTLY CONFIDENTIAL

26 July 2021

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

Honourable Minister,

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

On behalf of the Central Bank of Sri Lanka and personally, let me once again extend warmest congratulations on your appointment as the Minister of Finance. We wish you all the success in discharging the duties and responsibilities of this demanding role during an extremely challenging period with exceptionally important and far-reaching outcomes, and I am certain that you would be able to successfully steer this country towards prosperity and splendour amidst the strong headwinds that the economy is facing at present.

It has been the practice of the Central Bank of Sri Lanka to submit to the Minister in charge of the subject of Finance a detailed report by the Monetary Board in terms of Sections 64 and 68 of the Monetary Law Act (MLA), of the evolving challenges to domestic monetary stability and external stability from macroeconomic developments. As per the Section 64, whenever the Monetary Board observes that the amount of money supply has increased or decreased by more than fifteen per cent or the cost of

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living index has increased by more than ten per cent, of its levels at the end of the corresponding month in the preceding year, the Monetary Board is required to apprise the Minister of Finance if it anticipates that such developments are likely to threaten domestic monetary stability. Similarly, as per the Section 68, a detailed report would be submitted to the Minister of Finance whenever the Monetary Board anticipates that there may develop a deficit in the balance of payments (BOP), which may cause a serious decline in the international reserve, or whenever there is an imminent threat of a serious decline in the international reserve, or whenever the international reserve actually falls to a level, which the Monetary Board considers to be a threat to the international stability of the Sri Lanka rupee.

In this background, the Central Bank of Sri Lanka has continuously communicated through several detailed reports under Sections 64 and 68 to the Honourable Prime Minister as the Minister in charge of the subject of Finance on 04 August 2020, 17 December 2020, 06 April 2021 and 30 June 2021, on the evolving macroeconomic developments and the ensuing risks to domestic monetary stability and external stability (copies of these reports are attached under Annex I to this report). In the same vein, considering the recent developments in the economy and also the potential developments, particularly in the short to medium term, the Monetary Board of the Central Bank of Sri Lanka is of the view that it is appropriate to continue to apprise the Honourable Minister of Finance, in terms of Sections 64 and 68 of the MLA, of the evolving challenges to monetary stability and external stability due to the sustained expansion of money supply and the decline in international reserves to critical levels, followed by remedial actions that have been taken thus far to prevent any detriment, and the need for further action to ensure the overall stability of the Sri Lankan economy. In this regard, a brief report on the economy and risk assessment of all major sectors of the economy in the current context are also attached to this report for Honourable Minister's reference (Annex II).

As you are aware, the Sri Lankan economy has been treading through troubled waters, showing resilience amidst the challenges posed by the ongoing third wave of the COVID-19 outbreak. Further to the efforts taken by the Government to support the revival of the economy, a series of monetary stimulus measures that were taken by the Central Bank of Sri Lanka provided impetus to the economic recovery efforts through the provision of timely support for businesses and individuals affected by the pandemic. Accordingly, this led to the unavoidable expansion of money supply at a rate in excess of 15 per cent since July 2020 with a notable expansion of domestic credit amidst an environment of historically low interest rates, thus preventing the COVID-19 related health crisis from developing into an economic and financial crisis. As a consequence, it is observed that the Sri Lankan economy made a steadfast recovery since the third quarter of 2020, with economic activity during the first quarter of 2021 reaching above the pre-pandemic levels although this momentum was somewhat affected by the ongoing third wave of COVID-19. While the revival of the domestic economy broadly appears to be on track, there is also the need to ensure greater macroeconomic stability to sustain this momentum of recovery in domestic economic activity.

The external sector of the country remained vulnerable even prior to the COVID-19 pandemic, due to the rolling over of large external debt of the country, resulting in continuously increasing debt service payments (interest and principal payments). This large debt service payment requirements were a combined result of financing the country's external current account deficit through external borrowings and the increasing dependence on external debt creating sources on financing the budget deficit over the past several decades. Over time, with the limited foreign currency inflows through non debt creating sources, the country had to raise new debt even to service increasing interest payments, making the level of external debt unsustainable. The outbreak of COVID-19 has aggravated these vulnerabilities to alarming levels on multiple counts. The pandemic resulted in a complete loss of earnings from tourism as well as some moderation in exports of goods and services, limited foreign investment inflows and intensified portfolio outflows, particularly foreign investments to the government securities market and the Colombo Stock Exchange (CSE). Further, new foreign direct investment inflows remained significantly low following the pandemic. Moreover, the country's ability to access international financial markets remains restricted with the sovereign credit rating downgrades. Despite these multitude of challenges, Sri Lanka continued to maintain its unblemished record of foreign debt servicing, which was largely accommodated through utilising gross official reserves, resulting in a significant depletion in gross official reserves at present.

External Sector Conditions, Challenges and Remedial Measures

Sri Lanka's external sector continues to face significant vulnerabilities, mainly due to limited foreign exchange inflows to the country amidst large outflows. Impacted by the COVID-19 related travel restrictions, earnings from tourism have declined to negligible levels compared to US dollars 4.4 billion in 2018. In the initial stage of the pandemic, the trade deficit reduced as a result of swift policy measures taken by the Government and the Central Bank, to restrict non-essential imports while exports rebounded closer to pre pandemic levels. However, prior to the third wave of the pandemic, there were signs of increased import expenditure, while earnings from exports have not recorded a notable growth. 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 June 2021 have been around US dollars 478 million and US dollars 388 million, respectively. With heightened uncertainties, limited foreign direct investments were observed in 2020 and in the first quarter of 2021. Amidst these challenges, despite the inaccessibility to the conventional international capital markets with global developments and Sri Lanka's sovereign rating downgrades, Sri Lanka has continued to service its foreign debt service obligations. The Government and the Central Bank repaid around US dollars 6.7 billion of foreign currency debt (including foreign currency swap facilities with commercial banks), on both external and domestic debt, in 2020. So far in 2021, up to mid July, the Government and the Central Bank have repaid around US dollars 4.7 billion of foreign currency debt obligations, and this had resulted in the gross official reserve that stood at US dollars 7.6 billion at end December 2019, to decline to US dollars 5.7 billion at end 2020, and to US dollars 4.0 billion at end June 2021. This level of gross official reserves was equivalent to only 2.6 months of imports compared to the international standard of a minimum of 3.0 months of imports.

The recent widening of the deficit in the trade account despite import restrictions is a serious concern in terms of external sector stability. Based on preliminary customs data for June, the trade deficit during the first half of 2021 has widened to US dollars 4.4 billion compared to a trade deficit of US dollars 3.3 billion in the corresponding period in 2020. Reflecting the low level of liquidity in the domestic foreign exchange market with limited foreign exchange inflows and large outflows partly stemming from the high import demand, the Sri Lankan rupee has depreciated by 6.7 per cent against the US dollar up to mid July in 2021. Developments in the external sector has led market participants to make speculation of the rupee depreciation, and that has resulted in importers stockpiling of imports while exporters being reluctant to convert exports proceeds, thereby adding further depreciation pressure on the exchange rate.

Considering above developments, 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. Restrictions on the importation of non-essential goods were imposed by the Government aiming at easing the pressure on the balance of payments (BOP) and the exchange rate. The Central Bank imposed restrictions on certain identified capital transactions, such as the reduction in the maximum limit on migrant transfers. 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. Further, the Central Bank imposed rules related to export proceeds repatriation and conversion of such repatriated exports proceeds to Sri Lankan rupees. Also, the Central Bank mandated all LBs to sell a percentage of workers' remittances and exports proceeds converted to Sri Lankan rupees to the Central Bank, with the aim of replenishing gross official reserves. In addition, a number of measures including restrictions on purchase of Sri Lanka international sovereign bonds (ISBs) by licensed banks (LBs) and the removal of short term foreign currency borrowing limits of LBs have been executed with due consideration to financial system stability.

Furthermore, in recognition of the long overdue necessity of strengthening 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 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.

Several positive developments have also occurred recently in the external sector. These include entering into the bilateral currency swap agreement of standby nature with the People's Bank of China, the receipt of foreign loan proceeds of US dollars 500 million from China Development Bank (CDB) and expected receipt of yuan denominated foreign loan equivalent to around US dollars 300 million from CDB. Further, the Central Bank has been able to secure an international swap arrangement of US dollars 200 - 250 million with the Bangladesh Bank which is currently being finalised. The swap arrangement with the Reserve Bank of India of US dollars 400 million under the framework on Currency Swap Arrangement for South Asian Association for Regional Cooperation (SAARC) countries for 2019 – 2022 and the new SDR allocation by the International Monetary Fund (IMF) of around US dollars 780 million are expected by September. In addition, the enactment of the Colombo Port City Act will also help to strengthen investor confidence while creating positive sentiments in terms of foreign direct investments.

Despite the above measures implemented to revive the external sector, several crucial risks still remain as follows.

i. 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). Of this, US dollars 3.3 billion is to be paid in the remainder of the year, with the major debt servicing of US dollars 1 billion on 27 July 2021 for the maturing ISB that was obtained in 2011. In addition, foreign currency debt service obligations of the Central Bank, which include swap arrangements with commercial banks and payments to the IMF in terms of the Extended Fund Facility (EFF), are projected at US dollars 2.1 billion in 2021, of which around US dollars 377 million is to be paid during the remainder of 2021. These payment obligations are remarkably high compared to the current level of gross official reserves of US dollars 4.0 billion at end June 2021. Rollover of the swaps and OBU loans as well as the reissuance of SLDBs remain challenging, particularly with the low level of liquidity in the domestic foreign exchange market.

ii. With the repayment of the ISB in late July 2021, the gross official reserves could decline to around US dollars 2.6 - 3.3 billion by end July 2021, which is likely to be equivalent to around 1.7- 2.2 months of imports. Depletion of a large portion of gross official reserves with the bullet repayment of US dollars 1 billion in July 2021 could impact investor sentiment to some extent. However, the successful repayment of the ISB could help improve the market confidence, negating adverse speculation. Nevertheless, further rating action by Sovereign rating agencies, which is likely with the decline in reserves, could negate such improvement in market sentiments.

iii. The reserve level is expected to augment to some extent from August 2021 onwards with the receipt of the remainder of the loan from CDB, two international swaps from Bangladesh and India and the IMF SDR allocation. Even with these expected receipts, gross official reserves are projected to remain at a critically low level of around US dollars 3.5 billion by end 2021.

iv. 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 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. Without any further significant foreign exchange inflows in the pipeline, it is likely that the reserves will be depleted to around US dollars 1.5 billion by end March 2022.

v. Given the currently estimated inflows and scheduled debt service payments, it is likely that the Central Bank will no longer be in a position to repay foreign currency debt obligations of both the Government and the Central Bank by end 2021. As a result, it is estimated that, with some portion of reserves needed to cover repayment of maturing Central Bank liabilities, the reserves that are effectively left to settle any of the Government's debt service obligations will no longer be available by January 2022.

vi. The outlook on the balance of payments and the exchange rate remains negative. Considering the preliminary customs data for June, the trade deficit during first half of 2021 widened to US dollars 4.4 billion compared to a trade deficit of US dollars 3.3 billion in the corresponding period in 2020. A further widening of the trade deficit is expected during the rest of the year with higher global oil prices and other commodity prices as well as due to relaxation of import controls. Although, workers' remittances continued to increase, the tourism sector remains at a standstill and expected financial flows to the private sector remains significantly limited with investment sentiment on Sri Lanka deteriorating under the current circumstances. Capital flows to the BOP also remain significantly limited. Moderate, but continuous outflows of foreign investments from the CSE and government securities market are recorded. The revival of FDIs depends mainly on the success of the Port City project but could be further delayed by the negative investor sentiment due to the country's current macroeconomic forecast in the short to medium term.

vii. The exchange rate currently remains stable just at Rs. 200 per US dollar, driven by significant moral suasion. However, maintaining the rupee/US dollar rate at current levels is not sustainable, and the lack of adequate US dollars is driving up the exchange rate offered by money changers. Commercial banks are currently facing and likely to face increasing forex liquidity issues with additional costs involved in short term foreign financing. It appears that informal foreign exchange market and channels are gradually building-up to transact at higher exchange rates, mainly due to the scarcity of foreign exchange liquidity in the banking system.

viii. There is a high risk of the exchange rate to overshoot if the rupee/US dollar rate is failed to be managed through moral suasion. Under the current circumstances, the Central Bank is not in a position to defend the exchange rate by supplying foreign exchange to the market, as the limited amount of gross official reserves are to be preserved for serving the upcoming external debt requirements to avoid a Sovereign default. This leaves the exchange rate extremely vulnerable to speculation and possible further depreciation. If the situation further escalates, it is likely to result in further sovereign rating downgrades, a sharp depreciation of the exchange rate, culminating in all imports, essential and nonessential, needed to be curtailed. This will ultimately result in an eventual macroeconomic and financial system instability.

ix. The rating agencies have raised their concerns on the ability of servicing Sri Lanka's foreign currency debt in the period ahead. Most recently, on 19 July 2021, Moody's Investors Service placed Sri Lanka's sovereign credit rating 'under review for downgrade'. The major concerns raised by the rating agency were lack of reserve adequacy, which spans beyond the immediate scheduled debt service payments, the large share of interest payments to government revenue, which the rating agency claims one of the highest among the peer countries and lack of a credible financing plan by the Government to honour scheduled foreign debt service payments. In 2020, all three rating agencies downgraded Sri Lanka's sovereign credit ratings citing risks on the deterioration of fiscal balances amplified by the COVID-19 pandemic, external debt repayments and external financing plans. In April and May 2020, Fitch Ratings and S&P Global Ratings downgraded Sri Lanka's sovereign ratings to 'B-', while asserting the outlook at negative and stable, respectively. In September 2020, Moody's Investors Service, which placed Sri Lanka's ratings of 'B2' under review in April 2020, downgraded Sri Lanka's sovereign ratings by two notches to 'Caa1' and changed the outlook to stable from negative. In November 2020, Fitch Ratings downgraded Sri Lanka's sovereign credit rating to 'CCC'. In December 2020, S&P Global Ratings downgraded Sri Lanka's sovereign credit rating to 'CCC+' with a stable outlook. It is important that the concerns of rating agencies are addressed urgently to prevent any further rating downgrades in the near future, failing which would keep international investors further away from Sri Lanka and would further reduce the possibility of accessing international capital markets. The decline in reserves below the critical levels would also prompt the friendly nations and central banks to reconsider the provision of financing that are being negotiated at present.

x. Considering these developments, further substantial policy measures are needed to address the current vulnerabilities in the external sector as summarised below.

a. Maintaining and strengthening 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, on a temporary basis. 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. Further discouraging of non-essential and non urgent imports through increasing taxes by the Government and introducing appropriate LC margins by the Central Bank is also proposed. The import restrictions imposed since March 2020 have not materially impacted the importation of intermediate and investment goods, in fact a growth has been observed in import expenditure in these categories, as a whole, during the first half of 2021, in comparison to the corresponding period in 2020.

c. The Government to take urgent action to secure adequate foreign financing sources by way of syndicated or bilateral loans, as well as tapping into non-conventional green financing sources. This could be further supported by expediting divestment of earmarked non-strategic assets, through high level Government intervention at the earliest.

d. The Government may alternatively consider approaching the IMF; the globally accepted lender of last resort, in order to avert a disorderly sovereign default, together with a Central Bank default, and a resulting economic, financial, and social crisis, if the current situation gets further aggravated.

Monetary Conditions, Challenges and Remedial Measures

The Central Bank intervention through the adoption of a series of accommodative monetary policy measures at an unprecedented scale commencing early 2020 led to the notable, yet unavoidable, expansion of broad money supply from the latter half of 2020 through May 2021, at a rate exceeding fifteen per cent, on a year-on-year basis. This excessive expansion in money supply alongside a notable growth in domestic credit was allowed with a conscious view of supporting the ongoing efforts of the Government to resuscitate the economy from the adverse effects of the pandemic and related containment measures.

The year-on-year growth of broad money supply remained elevated at 21.0 per cent by end May 2021 from 7.0 per cent at end 2019, with the overall stock of broad money expanding by almost a third from Rs. 7.6 trillion at end 2019 to Rs. 10.0 trillion by end May 2021. This expansion of broad money supply was driven largely by net credit to the Government (NCG) from the banking system, as government revenue mobilisation was significantly lower mainly owing to the tax reforms introduced in December 2019 and the impact of the pandemic, and there were essential COVID-19 related expenditures to be met by the Government to protect lives and livelihoods amidst the absence of fiscal space. Consequently, NCG from the banking system increased by Rs. 475.9 billion during the period from January to May 2021, surpassing the Government's expected borrowing from the banking system of Rs. 319 billion for 2021, as estimated in the Budget 2021. Further, credit obtained by state-owned business enterprises (SOBEs) also expanded by Rs. 110.6 billion during the period from January to May 2021. Meanwhile, credit extended to the private sector gathered momentum, expanding by Rs. 330.6 billion during January to May 2021, compared to the increase of Rs. 374.1 billion during 2020, supported by the conducive monetary and credit conditions created by the Central Bank.

Amidst these developments, there are several underlying vulnerabilities and challenges that require expeditious remedial action through close coordination between fiscal and monetary authorities in order to restore and ensure macroeconomic and financial system stability.

i. At present, the Central Bank purchases the under-allocated quantum of Treasury bills from the primary market and the Government's large value foreign currency debt payments were also made by borrowings from the Central Bank via Treasury bill placements. Such monetary financing through direct Treasury bill allocations augmented the Central Bank's holding of government securities from a measly Rs. 74.7 billion at end 2019 to Rs. 917.1 billion (on face value basis) by mid July 2021, leading to the share of Treasury bills held by the Central Bank increasing to 47.9 per cent of the outstanding stock of Treasury bills issued by the Government, compared to that of 2.9 per cent at end 2019. This has led to a substantial expansion in the domestic assets of the Central Bank, while also draining its foreign assets as a result of the continuous supply of foreign exchange to the Government in order to meet the foreign currency debt servicing requirement without any replenishment. Accordingly, the equity to domestic assets ratios of the Central Bank have deteriorated significantly, thereby severely impacting its financial strength as well as its potential to intervene through the purchases of Treasury bills from the primary market and servicing of the Government's foreign currency debt using the Central Bank's reserves in the future.

ii. Low government revenue mobilisation coupled with COVID-19 related expenditures to protect lives and livelihoods amidst the absence of fiscal space, and the resultant increase in the Government's borrowing requirement along with non-fulfilment of obligations by major SOBEs have posed challenges in liquidity management of the state banks in terms of both local currency as well as foreign currency.

iii. Further, as the Government envisages to gradually reduce the foreign component of outstanding debt, its reliance on the domestic banking system to finance its spending, particularly from state banks, has exerted added pressure on short term money market rates and yields on government securities. If the large increase of borrowing of the Government and SOBEs from the banking system continues, a reversal in the accommodative monetary policy would be unavoidable in the period ahead, thus potentially derailing the process of providing much needed monetary policy support for a faster economic recovery. Accordingly, concerted efforts are required to gradually scale down public sector borrowings from the banking system with a view to enhancing funding avenues for the private sector.

Meanwhile, headline consumer price inflation has been broadly maintained at the targeted range of 4-6 per cent thus far during the year underpinned by well-anchored inflation expectations and subdued aggregate demand conditions, despite the elevated levels of monetary expansion and high volatility of food inflation due to supply side disruptions. Accordingly, headline inflation based on the Colombo Consumer Price Index (CCPI, 2013=100) was recorded at 5.2 per cent, year-on-year, in June 2021, compared to 4.5 per cent in May 2021 and 4.2 per cent at end 2020. Meanwhile, National Consumer Price Index (NCPI, 2013=100) based headline inflation was recorded at 6.1 per cent, year-on-year, in both May and June 2021, compared to 4.6 per cent in December 2020. Reflecting the subdued demand pressures in economy, core inflation based on both consumer price indices remained low thus far during the year.

However, several factors need close attention in relation to maintaining inflation at the targeted range in the period ahead. Such factors include the significant expansion of money supply resulting largely from monetary financing of the budget deficit, the adjustments made to domestic petroleum prices and other commodity prices in line with global developments, the possible pressures on food prices during the initial phase of the implementation of nationwide organic farming, and the likely depreciation of the exchange rate, among others. These factors could destabilise inflation expectations and generate inflationary pressures ahead of time, thus posing significant challenges towards maintaining domestic price stability. As upside risks to inflation outlook intensify, the Central Bank would be required to proactively intervene to rein in the buildup of inflationary pressures in the period ahead, in which increasing policy interest rates would be a key measure that the Central Bank will compel to be taken. Meanwhile, the Government would need to further strengthen the efforts to address concerns of the public on rising food prices in the near term through the adoption of appropriate measures.

Concluding Remarks

In the context of 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 a certain extent. However, there is a dire need of urgent implementation of drastic policy measures as proposed above aiming at restoring the stability of the external sector of the economy to reduce foreign exchange outflows and increase foreign exchange inflows, avoiding the sharp depletion of gross official reserves of the country and a resultant loss in confidence on the macroeconomic stability of the country by key stakeholders, including foreign lenders, potential investors, corresponding foreign banks of local banking sector. The Government may alternatively consider approaching the globally accepted lender of last resort for balance of payments needs, the Internal Monetary Fund (IMF). The intervention of the IMF, whilst bolstering the confidence of international investors on the Sri Lankan economy, may on the other hand require aggressive reforms in the fiscal sector, interest rates and the exchange rate, and even restructuring of the debt stock of the Government.

The Central Bank intervention through the adoption of series of accommodative monetary policy measures has led to an unavoidable expansion of money supply. Such excessive monetary expansion was allowed with a conscious view of supporting the ongoing efforts of the Government to revive economic activity affected by the pandemic. However, there are several underlying vulnerabilities that need to be addressed through close coordination between fiscal and monetary authorities in order to restore and ensure macroeconomic and financial system stability.

The Government's increased reliance on borrowings from the banking system, if continued, could create several macroeconomic imbalances, in which a number of signs are already visible. This necessitates concerted efforts to improve government revenue and slowdown non-urgent expenditure thereby easing pressure on the budget, and building space for essential expenditure, including the COVID-19 related expenditures. Maintaining stability in the exchange rate and interest rate remains crucial in the period ahead in order to ensure macroeconomic stability and sustained economic growth.

Given the weakening of the financial strength of the Central Bank in terms of the decline in foreign assets, the Central Bank would no longer be in a position to supply foreign exchange for the Government to meet foreign currency debt servicing, unless there is a firm commitment by the Government to immediately replenish the foreign exchange reserves utilised for such purpose upon receiving foreign exchange inflows to the Government. Moreover, continuation of the current practice of accumulating government securities from the primary market could have severe repercussions on the Central Bank balance sheet as well as the overall economy, in the form of future inflationary pressures.

The Monetary Board will continue to monitor developments in money and credit aggregates and would take appropriate policy measures to maintain inflation at the desired 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. Further, the Monetary Board will continue to monitor developments in the balance of payments, exchange rate, and official reserves, while working alongside the Government to maintain stability in the economy and apprising the Honorable Minister of the state of the economy at regular intervals.

Copy issued to
Prof. W. D. Lakshman

Yours Sincerely,

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

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

Encl.

Annex I: Reports submitted under Sections 64 and 68 of the MLA to the Honourable Prime Minister as the Minister in charge of the subject of Finance on 04 August 2020, 17 December 2020, 06 April 2021 and 30 June 2021.

Annex II: Report on the economy and risk assessment.

6R12

Deshamanya Professor W D Lakshman
GOVERNOR
Central Bank of Sri Lanka
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STRICTLY CONFIDENTIAL

14 September 2021

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

Honourable Minister,

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

As Hon. Minister is aware, along with my officials, I have had a close dialogue with you and your officials at the Ministry of Finance on several occasions to discuss the current economic conditions and the way forward. The content in your letter dated 12 August 2021, and the decisions of the Cabinet of Ministers, dated 17 August 2021, on the Note to Cabinet submitted by you on 'Short Term Macroeconomic Policy Measures' are suggestive of Honourable Minister's intentions on initiating urgent measures to address multifaceted challenges faced by the economy at present. The Central Bank has already implemented a number of measures in line with the course of action suggested by you to the Cabinet of Ministers.

As you are aware, macroeconomic policy measures, by nature, take time to impact the economy. Thus, the conditions identified in the Monetary Board reports submitted previously under Sections 64 and 68 of the Monetary Law Act still remain.

Gross official reserves have declined significantly as large external debt servicing requirements were met in the absence of adequate financial inflows. Sri Lanka's external debt obligations remain high, resulting in large foreign currency requirements for debt servicing in the period ahead. Limited foreign investment inflows- including modest foreign direct investments and net outflows of portfolio investment- aggravated the conditions in the external sector. Nevertheless, Sri Lanka

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managed to maintain its unblemished record of timely servicing of foreign debt through the utilisation of gross official reserves, resulting in a significant depletion in these reserves. Meanwhile, with the increased deficit in the trade account, the domestic foreign exchange market continues to face a notable shortage of foreign exchange liquidity. The recent intervention in the foreign exchange market by the Central Bank at the request of the Government has helped to ease conditions in the supply of essential imports, but could also weaken the country's external position further, if the expected inflows are further delayed.

The expansion of money supply continued with likely adverse pressures on domestic price stability. The extraordinary monetary stimulus measures, implemented by the Central Bank, in response to the devastating effects of the COVID-19 pandemic led to a sustained, yet inevitable expansion of broad money supply since mid-2020. The broad money supply increased above the indicative threshold of 15 per cent as stipulated in the Monetary Law Act, driven by the rapid expansion of credit to both public and private sectors of the economy. The eased monetary conditions helped the individuals and businesses affected by the pandemic. Some imbalances in the external sector and financial markets, however, emerged due to an interest rate anomaly created by interest rates on rupee deposits being lower than the interest rates paid on foreign currency deposits. Further, a buildup of inflationary pressures was projected over the medium term. Such economic conditions necessitated some monetary policy intervention to rollback some of the extraordinary stimuli offered thus far.

Against the above backdrop, this report highlights the remedial measures that have been taken so far to address these challenges, and some further measures to be adopted in order to ensure stability of the Sri Lankan economy.

External Sector Conditions, Challenges and Remedial Measures

Sri Lanka's external sector continues to face heightened vulnerabilities with limited foreign exchange inflows to the country amidst significant outflows. The external current account remained stressed due to the widening trade deficit, the absence of earnings from tourism, and the moderation of workers' remittances. Based on the preliminary data from Sri Lanka Customs for July, the trade deficit during the period from January to July 2021 has widened to US dollars 4.9 billion, compared to the deficit of US dollars 3.5 billion in the corresponding period in 2020. Such expansion of the trade deficit can be attributed, among others, to the notable increase in imports resulting from increasing economic activity, and the increase in global commodity prices, including fuel. Export earnings rebounded closer to pre-pandemic levels. Monthly workers' remittances, which recorded a healthy growth since mid 2020, have moderated since June 2021. Foreign investment in the government securities market and the Colombo Stock Exchange continued to record net outflows. Foreign direct investment remained modest amidst heightened uncertainties due to the pandemic.

Since the onset of the COVID-19 pandemic, several measures were taken by the Government and the Central Bank to stabilise the external sector. Restrictions on the importation of non-essential goods were imposed by the Government aiming at easing the pressure on the balance of payments and the exchange rate. The Central Bank imposed restrictions on certain identified capital transactions, such as the reduction in the maximum limit on migrant transfers. The Central Bank also directed all licensed banks (LBs) to refrain from entering into forward market contracts other than interbank forward market transactions in the domestic foreign exchange market. Further, the Central Bank imposed rules related to export proceeds repatriation and conversion of such repatriated export proceeds to Sri Lankan rupees. Also, the Central Bank mandated all LBs to sell a percentage of workers' remittances and export proceeds to the Central Bank for Sri Lankan rupees based on the customer conversions, thereby to help replenish gross official reserves. In addition, a number of measures, including restrictions on the purchase of ISBs by LBs and the removal of short term foreign currency borrowing limits of LBs, have been executed with due consideration to financial system stability. Further, the recent monetary policy tightening measures are aimed at primarily addressing external sector imbalances.

Furthermore, in recognition of the long overdue necessity of strengthening 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 initiative that is led by the Honourable Minister, several committees involving relevant Cabinet Ministers and State Ministers, have been established with the participation of public and private stakeholders in the selected merchandise exports sectors, including apparel, tea, rubber, coconut, gem and jewellery, fisheries, spices, and other exports crops. Such committees have also been appointed to monitor progress of trade in services, such as tourism and IT, and also for areas such as foreign employment and remittances, as well as financial inflows. These committees are expected to facilitate the growth of foreign exchange earnings by identifying bottlenecks to growth and proposing solutions that could be used to overcome such barriers. The Central Bank welcomes the leadership of the Hon. Minister of Finance and coordination efforts on a regular basis. In addition, we are also aware of the efforts of the Government on high level negotiations to seek the possibility of securing financial assistance from friendly nations. Initiatives to obtain a credit facility for fuel imports would help ease the pressure on the domestic foreign exchange market in facilitating the import demand for petroleum in the short run. Further, the Government's effort to secure foreign investments for the divestiture of non strategic state assets as well as investment to the West Terminal of the Colombo Port, development of logistic hubs and investment in large scale local manufacturing industries are also some important steps in improving the foreign exchange cashflow of the country. The Central Bank strongly endorses these efforts by the Government.

Challenges in the external sector were heightened by the inaccessibility to conventional international capital markets due to global developments and Sri Lanka's sovereign rating downgrades. Undeterred by these adversities, Sri Lanka continued to service its foreign debt service obligations. So far in 2021, up to end August, the Government and the Central Bank have repaid around US dollars 5.3 billion of foreign currency debt obligations. Intensive efforts are required to increase inflows of foreign exchange to arrest further deterioration of international reserve buffer in the period ahead.

The following are the major points to be noted in relation to the level of official reserves, and estimated outflows and envisaged inflows.

- With the repayment of the international sovereign bond (ISB) in July 2021, gross official reserves have declined to a substantially low level of US dollars 2.8 billion by end July 2021, equivalent to around 1.8 months of imports.
- Gross official reserves have increased to around US dollars 3.5 billion by end August 2021, with the receipt of the SDR allocation from the International Monetary Fund (IMF) and the foreign currency swap with Bangladesh Bank.
- Due payment to the Asian Clearing Union (ACU) was postponed in July 2021 by two months.
- The remainder of the syndicated facility from China Development Bank (CDB), equivalent to about US dollars 300 million, was received in early September 2021.
- The foreign currency swap facility of US dollars 400 million from the Reserve Bank of India (RBI) and envisaged proceeds from divestment of state assets require actions to expedite processes.

- The ACU liabilities, of which the settlement was postponed in July 2021, had to be met in early September 2021. This amounted to about US dollars 965 million. Another US dollars 1.4 billion of foreign currency obligations are due for settlement in the remainder of 2021.
- Gross official reserves could decline to around US dollars 2.0 billion by end 2021 if expected inflows do not materialise. This level of reserves would only cover around 1.2 months of imports. Even if certain unconfirmed inflows materialise during the remainder of the year, gross official reserves could remain below US dollars 4.0 billion by end 2021, with an import cover of less than three months.
- Sizable debt service payments fall due during the first seven months of 2022. In the first quarter of 2022, total foreign currency obligations are around US dollars 3.3 billion, including an ISB payment of US dollars 500 million. The envisaged inflows have to be strengthened and expedited, and forex earnings (exports, tourism, remittances etc.) and their repatriation need to be enhanced significantly, if the exhaustion of all official reserves is to be avoided by the

end of first quarter of 2022. The Central Bank stands ready to assist the Hon. Minister in whatever way it can in avoiding any such eventuality.

- Foreign currency debt obligations due in 2022 and 2023 are around US dollars 12-13 billion. Strong proactive measures have to be taken to ensure an accumulation of foreign exchange in the near term, continuing to maintain our reputation of no default. There is reason to be optimistic about conditions in medium and long term as the export-oriented growth policy appears to show good results.

- The movement of sovereign credit ratings is a major factor here. It may be noted that recently S&P Global Ratings revised the Sovereign rating outlook on Sri Lanka to 'negative' from 'stable', while Moody's Investor Service has placed Sri Lanka's rating 'under review for downgrade'.

- In order to alleviate scarcities in essential imports in the domestic market and to provide a degree of confidence to the market, the Cabinet of Ministers, as mentioned above, has directed the Central Bank to release a notable sum of foreign exchange from gross official reserves. The need for such intervention of the Central Bank in the forex market will arise in future also, but will hardly be feasible in conditions of continuously depleting gross official reserves. The Central Bank is looking into improving conditions of exports proceeds repatriation to resolve this issue and to bring in some restraint on imports. The Central Bank recently imposed margin requirements on imports of certain non-essential and non-urgent items with the aim of compressing the rising imports expenditure.

Despite significant policy efforts, risks to external sector stability still remain. Thus, concerted policy measures are needed to address the current vulnerabilities in the external sector, as summarised below.

- **Immediate need to secure substantial sums of financing as bridging facility:** Obtaining a sizable amount of bridging foreign financing to manage the current short term liquidity crisis is of utmost importance, given the strong need of restoring confidence in the Sri Lankan economy urgently. Every effort must be made to initiate Government to Government collaboration, including that of securing the RBI swap facility and any potential syndicated loan arrangements. The US dollars 400 million RBI swap is a facility we expected more or less as a right of a member of SAARC. But for unknown reasons, RBI is not making that available.

- **Exchange rate adjustment:** After following various types of exchange rate regimes in the world, we have moved to a flexible exchange rate regime since 2001, in which the rupee has been allowed to fluctuate according to market forces. Because of the extensive adverse side effects (on government debt, domestic price level, etc.) we have attempted over the last few months to maintain the exchange rate at around Rs. 202 per US dollar. To do this effectively for a long period of time, the Central Bank does not have the intervention strength in terms of reserves to be supplied to the market, and moral suasion on banks alone is unable to sustain exchange rate stability. If exchange rate stability could be maintained, it is better than continuous depreciation as it happened since late 1970s. To maintain such a policy;

a) the policies being taken to achieve a current account balance (if not a surplus) need to indicate a gradual success and

b) a large replenishment of reserves through a significant inflow of funds is needed.

If these do not take place, then some sacrifice in the exchange rate stability objective of the Government may have to be made.

- **Reducing the current account deficit:** The Government is aggressively engaging in increasing Sri Lanka's merchandise and services exports and workers' remittances through targeted policy support, which is a welcome development. These efforts should go hand-in-hand with keeping imports at manageable levels through possible taxation and other methods. As a beginning to make required structural changes in domestic industries, those producing for both domestic and external markets have to be encouraged to begin a gradual increase in domestic provision of intermediate production requirements. These measures will begin to bring the trade deficit down to manageable levels. If the trade deficit of the country remains manageable, together with the revival of the tourism sector and growth in sectors such as IT/BPO and other services, the current account deficit may even turn in to a marginal surplus. Though difficult, these changes have to be made immediately, even in the difficult contexts of the current pandemic situation. Reducing the current account deficit through a manageable trade deficit remains a key structural change, needed to ensure long term stability of the external sector of the country. In the aftermath of the Asian Financial Crisis, some countries, such as Malaysia and Thailand, completely turned around their current account deficits to surpluses through significant currency devaluations. Such an approach may or may not work here, but through the promotion of domestic production for export as well as for import substitution through whatever resources available is absolutely essential.

- **Building up reserves through non borrowed sources is necessary to ensure external debt sustainability:** The country's foreign currency debt is largely serviced utilising gross official reserves at present. Any strategy towards sustainable debt management should focus on servicing at least the interest component of the country's foreign currency debt obligations through non debt creating inflows, without capitalising interest payments. In 2021, the interest component of the Government's and the Central Bank's foreign currency debt service payments were around US dollars 1.5 billion. Implementing a policy of accumulation of reserves through foreign currency purchases by the Central Bank from the domestic market requires adequate forex liquidity in the domestic foreign exchange market on a continuous basis. This can be achieved whilst reducing the country's external debt burden only through a marginal current account surplus or a manageable current account deficit, supported by non debt creating inflows, such as foreign direct investments, to the financial account of the balance of payments.

- While continuing to stress the importance of raising non debt creating forex inflows, it must also be highlighted that Sri Lanka will have to make some foreign borrowings as well, at least in the interim period until significant non debt creating inflows are generated. The country will not be able to totally avoid foreign borrowings. That is where the need for unlocking international markets arises, and the efficacy of fulfilling that need depends on results of the measures for addressing key economic issues.

Monetary Conditions, Challenges and Remedial Measures

As highlighted in the previous reports, the Central Bank adopted a series of monetary policy easing measures at an unparalleled scale since early 2020, with a view to reviving the domestic economy that had been adversely impacted by unfortunate events in 2019 (terrorism) and 2020 (COVID-19). As a result, the year-on-year growth of broad money supply has persistently exceeded the rate of 15 per cent, which is the threshold indicated in the Monetary Law Act, since mid-2020 through July 2021. By end July 2021, broad money grew at an accelerated pace of 21.1 per cent, year-on-year, with the overall stock of broad money increasing to Rs. 10.3 trillion from Rs. 7.6 trillion at end 2019. The rapid expansion of domestic credit by the banking system contributed to the overall expansion of broad money supply, in spite of the sharp decline in net foreign assets (NFA) of the banking system. Within domestic credit, net credit to the Government (NCG) from the banking system increased notably by Rs. 965.3 billion during January to July 2021, three times the level estimated in the Budget 2021 for the whole year. Credit extended to state-owned business enterprises (SOBEs) increased by Rs. 138.7 billion during this period, with half of it being extended in foreign currency. Supported by the lagged effect of easy monetary policy, credit extended to the private sector also recorded a notable increase. Credit expansion to the private sector accelerated from 6.5 per cent at end 2020 to 14.3 per cent, at end July 2021. Surplus liquidity in the domestic money market during the period from January to mid-August 2021 provided space for the banking system to expand credit to both the public and private sectors. A notable decline in liquidity is witnessed thereafter. This is likely to significantly crowd out the availability of bank credit to the private sector, unless the Government reduces its borrowing from the domestic banking system.

To address imbalances in the external sector and financial markets and to preempt any buildup of inflationary pressures, the Central Bank took measures to tighten monetary policy in mid-August. Accordingly, the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) of the Central Bank were increased by 50 basis points each, to 5.00 per cent and 6.00 per cent, respectively, and the Statutory Reserve Ratio (SRR), applicable on all rupee deposit liabilities of licensed commercial banks (LCBs), was increased by 2.0 percentage points to 4.00 per cent, with effect from 01 September 2021. Moreover, maximum interest rates on foreign currency deposit products of LCBs and National Savings Bank were also introduced by the Central Bank, considering the anomalies in the prevailing interest rates offered and paid on the rupee and foreign currency deposits.

The need for the fiscal and monetary authorities to work closely and expeditiously to overcome a multitude of challenges encountered by the economy with a view to ensuring greater macroeconomic and financial system stability is emphasised here.

i. Monetary financing of the Government's budget deficit has led to a substantial increase in the Central Bank's holdings of government securities from Rs. 74.7 billion at end 2019 to Rs. 1,261.1 billion as of 03 September 2021. Accordingly, the Central Bank holdings of Treasury bills, as a share of the outstanding total stock of Treasury bills issued by the Government, rose to 58.4 per cent as of 03 September 2021. This was 2.9 per cent at end 2019. This has led to the rapid expansion of net domestic assets (NDA) of the Central Bank to Rs. 1.1 trillion by end July 2021. This was Rs. 36.6 billion at end 2019. Allocations of Treasury bills to the Central Bank have led to a notable deterioration in the Equity to Domestic Assets and the Prudential Equity to Domestic Assets ratios of the Central Bank. The ratios of Equity to Domestic Assets and the Prudential Equity to Domestic Assets deteriorated to around 23.6 per cent and 9.2 per cent, respectively, by end July 2021, from healthy levels of 74.6 per cent and 33.5 per cent, respectively, at end 2019.

ii. Furthermore, NDA of the Central Bank, as a share of reserve money, has increased substantially to around 99 per cent by end July 2021 from 3.9 per cent at end 2019, indicating that the country's monetary base is built almost entirely on the domestic assets of the Central Bank. Moreover, NCG by the Central Bank has remained in excess of the country's monetary base, consecutively for six months since February 2021, with the previous occasion being recorded for a shorter period in 2009. Without any corrective measures to retire the large stock of Treasury bills held by the Central Bank, investor sentiment and public confidence in the operations of the Central Bank and the Government are likely to be severely affected.

iii. With the utilisation of foreign exchange reserves of the Central Bank to repay foreign currency debt obligations of the Government, NFA of the Central Bank have deteriorated sharply from Rs. 896.0 billion at end 2019 to a critically low level of Rs. 10.3 billion by end July 2021, thereby significantly weakening the strength of the balance sheet of the Central Bank to unprecedented levels. The current level of foreign assets remains barely sufficient to meet the foreign currency liabilities of the Central Bank. Even though the swap facilities from friendly Central Banks will help improve reserves in the short term, the Central Bank has the liability to repay them at maturity. This entails a significant risk to the Central Bank balance sheet, particularly if the inflows from such swaps are used for government's debt servicing and there was no replenishment of the reserves by the Government.

iv. Although measures have been taken to tighten the monetary policy stance, particularly by curtailing liquidity through the raising of the SRR commencing 01 September 2021, which reduced overnight domestic money market liquidity by around Rs. 160 billion, the Central Bank has had to continue with its practice of underwriting Treasury bill primary auctions, while accommodating direct allocations to facilitate certain expenditure of the Government. Since the monetary policy announcement on 19 August 2021, the Central Bank has purchased Rs. 86.7 billion worth of Treasury bills to provide funding for the Government to meet its financing needs. The repeated requests by the Ministry of Finance for such Central Bank financing, particularly through the underwriting of Treasury bill auctions, will continue to inject liquidity into the domestic money market, which is in contrast to the expectation of the Central Bank, and the premise of the decisions by the Cabinet of Ministers with regard to the above mentioned Note to the Cabinet submitted by you, dated 17 August 2021. Continued monetary financing will negate the impact expected from the recent tightening of monetary policy, and could require further increases in interest rates in the near term.

v. State banks have increasingly come under pressure in terms of securing liquidity to meet the financing requirements of the Government and the non-settlement of debt obligations of key SOBEs. As a result, the state banks have had to persistently run large shortages in liquidity forcing them to source funds at elevated rates from the domestic money market. The timely settlement of such obligations to state banks would be essential to alleviate the pressure on operations of state banks as their domestic rupee liquidity positions have been impacted further with the increase in SRR that took effect on 01 September 2021. For this purpose, the Government would need to implement the required reforms, including revenue enhancement and expenditure rationalisation measures urgently, while allowing appropriate cost-reflective price adjustments on public utilities.

Further to the aforementioned challenges on the money and credit fronts, the Central Bank has also observed some acceleration in domestic consumer price inflation thus far during the year, supported by relatively well-anchored inflation expectations and with the domestic economy operating below its potential. The recent uptick in headline inflation was largely the result of supply side disruptions affecting food prices. As a result, Colombo Consumer Price Index (CCPI, 2013=100) based year-on-year headline inflation accelerated to 6.0 per cent in August 2021, compared to 4.2 per cent at end 2020. Further, year-on-year headline inflation based on the National Consumer Price Index (NCPI, 2013=100) also accelerated to 6.8 per cent in July 2021 from 4.6 per cent at end 2020. Core inflation, which reflects underlying trends in inflation that could be broadly attributed to demand side factors, remained subdued so far during 2021, but has also shown some signs of acceleration in recent months partly owing to the fiscal and monetary stimulus measures adopted in 2020.

In spite of these near term challenges, the Central Bank remains hopeful that headline inflation would remain within the desired target range of 4-6 per cent during the remainder of 2021. The Government, however, will need to take appropriate measures to ease the pressure on food prices in the near term that has arisen due to pandemic-related supply side disruptions, as well as adverse weather effects. Further, the Central Bank observed that risks to inflation over the medium term are increasingly tilted to the upside due to the expected recovery in domestic economic activity, improvement in fiscal and monetary stimuli-led aggregate demand, possible destabilisation of inflation expectations, significant expansion of money supply triggered by large scale monetary financing, cost-reflective adjustments to domestic prices of petroleum, energy and other commodities to match global price developments, possible disruptions to domestic food production, possible second round effects of administered price adjustments and the depreciation of the rupee anticipated by market players. Although the Central Bank tightened its stance of monetary policy to preempt the buildup of excessive inflationary pressures that could arise over the medium term, further policy intervention would be necessary should inflationary pressures persist in the period ahead.

Also, we are aware and mindful that the measures taken at the last monetary policy review to address the emerging imbalances in the external and domestic financial sector, and the possible buildup of inflationary pressures over the medium term, could dampen the expectations of high growth, increased employment, and poverty alleviation objectives of the Government in the short run, and we will adopt an extremely careful approach to balance these often conflicting sets of objectives, against the need to ensuring greater macroeconomic stability amidst heightened uncertainty and adversity.

The Need of Structural Reforms

In this context, the implementation of an agenda for structural reforms is a must to achieve economic prosperity. As you have indicated in your above mentioned letter, we welcome a reform package without the IMF, and in fact, we endorse this as the most preferred way forward as a country, as many other countries have graduated by implementing far-reaching economic reforms.

A reform agenda for Sri Lanka needs to aim at achieving the following at a minimum; consolidate the government fiscal operations to have sustainable and prudent levels of budget deficit and debt levels; restore a strong and sustainable balance of payments position; build up of gross official reserves through non debt creating inflows by absorbing foreign exchange directly from the market; allow a market based exchange rate to operate while ensuring that other surrounding conditions are conducive to retain exchange rate stability; implement cost reflective pricing mechanisms for fuel and utilities, electricity and water; remove impediments to a high and sustainable growth by addressing obstacles that impede the effective operation in key sectors in the economy, including the SOBEs; carry out fundamental reforms in our large SOBE sector operations; and create an investor friendly doing business environment, that will enhance the confidence amongst stakeholders, including domestic and foreign investors, rating agencies and international agencies. This requires a strong commitment and some sacrifices from all stakeholders of the economy, and adequate independence for institutions. Further, some kind of foreign debt restructuring or a liability management mechanism will have to be looked into amidst the lack of sizable potential foreign currency inflows. The need to commence these reforms, well thought out and planned with the forthcoming budget may need to be considered by the Government. A firm beginning will itself bring about positive results soon.

As you have stated in the above mentioned letter, there are situations in history where countries have not sought IMF assistance, such as Malaysia during the Asian Financial Crisis. Country situations vary, eventually leading to significant structural reforms. We can only gain advice from different country situations as well as historical cases of structural reforms even within our own country (a detailed explanation on country experiences is given in the Annexure). We are prepared to work with you, learning from past experiences of our own and other country experiences to get out of the present difficulties through required structural reforms. Although under totally different domestic and international conditions, Sri Lanka also achieved external sector stability without an IMF intervention during early 1970s. In 2009, we obtained an IMF a programme, which was negotiated within the broader framework of the Government policy agenda of the time, *Mahinda Chinthana*.

While the Government, with a strong commitment to long lasting structural reforms, may consider a decisive reform agenda to be implemented gradually, there are advantages of maintaining links with the IMF, backed by a well-structured policy. The countries, which obtain financial assistance from the IMF are increasingly encouraged to implement home grown reforms. Accordingly, if Sri Lanka decides to obtain an IMF programme in 2021 as well, negotiations could be based on the Government's policy framework "Vistas of Prosperity". The advantages that would be gained by indicating to the market that we are closely working with the IMF, even without any commitment to an IMF stabilisation programme, could boost confidence among international financial community, so that conditions for borrowing, if the need arises, could be made easy. Even a home-grown reform programme may entail significant sacrifices to be made.

Concluding Remarks

The Monetary Board wishes to reiterate that the implementation of a comprehensive structural reform plan covering all the sectors of the economy is essential to overcome the macroeconomic challenges faced by the country at present. We welcome the concerted efforts of the Government to increase Sri Lanka's export earnings, workers' remittances and foreign investment inflows, which could help enhance non debt creating inflows to the country over the medium term. Building up gross official reserves through Central Bank purchases of foreign exchange from the domestic market is the long term solution to ensure the country's external sector stability. If we remain in the flexible exchange rate regime, allowing flexibility for the exchange rate to fluctuate is needed, and a more stable exchange rate appears impractical at present, given the current low level of reserves and the large demand for foreign exchange liquidity relative to its supply. At the same time, a firm commitment by the Government to a long term plan on fiscal consolidation to bring down budget deficit and public debt to a sustainable level is required to restore investor confidence and to resolve the external sector imbalances stemming from fiscal sector imbalances. Meanwhile, urgent action of the Government is required to secure adequate foreign financing sources through high level Government intervention at the earliest in order to manage the foreign exchange liquidity crisis experienced at present and to rebuild gross official reserves.

Measures have been taken by the Central Bank to tighten the monetary policy stance by rolling back some extraordinary support provided to correct imbalances in the economy. The needed Government support for the success of this endeavour is abundantly clear. Its reliance on the Central Bank to finance its operations has to be reduced. The Government has increasingly resorted to Central Bank reserves to meet its foreign debt service obligations by using direct allocation of Treasury bills that has significantly impaired the underlying strength of the Central Bank's balance sheet to even meet its own foreign obligations.

Some countries in the world, even Sri Lanka in some past occasions, have successfully steered through crises without the IMF support in the past. But as different country experiences show, being engaged with the IMF even without an agreed programme would bring in much needed investor confidence and improve the sentiments of all other stakeholders, including multilateral and bilateral lenders and Sovereign rating agencies. This could prevent any further credit rating downgrades and may pave the way to attract foreign exchange inflows while helping to unlock the access to international markets gradually. This point is presented for the consideration of the Government.

Lastly, considering the critical juncture that the economy is currently in, the importance of close coordination between the Government and the Central Bank remains paramount. This would enable development and implementation of a holistic, focused and feasible approach to overcome the challenges that lie ahead. The Monetary Board will also continue to monitor developments in the balance of payments, exchange rate, and official reserves, and, work with the Government, taking necessary steps to maintain stability as a foundation for sustainable growth of the economy to the maximum possible extent. Further, the Monetary Board will continue to closely monitor developments in money and credit aggregates and take further monetary policy measures as appropriate to maintain inflation at the desired target range of 4-6 per cent over the medium term, while supporting economic recovery efforts and ensuring domestic economic stability.

Copy issued to
Prof. W. D. Lakshman

Deshamanya Professor W D Lakshman

Governor and the Chairman of the Monetary Board
Central Bank of Sri Lanka

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

Annexure
Collaboration with the IMF: Country Experiences

Malaysia (1997): During the Asian Financial Crisis from 1997 to 1999, Malaysia was the only country among the five severely affected Asian countries (Thailand, Indonesia, Philippines and South Korea were other four countries) that did not resort to an IMF supported economic programme. Malaysia did not require a large official financing package or debt rescheduling due to its strong external and fiscal fundamentals, unlike the other peer countries who went through the crisis. At the onset of the economic crisis in mid 1997, the market confidence weakened as was the case in other neighbouring countries. Equity and property values fell significantly, and large portfolio investment outflows were recorded. The Malaysian ringgit came under tremendous pressure due to speculative positions taken by currency traders. Consequently, capital flight intensified and exacerbated liquidity problems in the banking sector causing financial distress. Due to the sharp drop in prices of real estate and equities, the corporate sector experienced losses and their income declined leaving some entities unable to service debt resulting in increased non performing loans. Although Malaysia went through a currency crisis and a banking crisis as result of the above developments, it was spared from an external debt crisis due to its low level of external debt.

Malaysia had a strong fiscal position with a fiscal surplus of around 2.5 per cent of GDP in 1997. Total public debt as a percentage of GDP stood at 54.5 per cent and external public debt was around 23.7 per cent of GDP in 1997. Federal Government's external debt was only around 4.6 per cent of GDP. Malaysia's external debt was around US dollars 43.9 billion, and of which about 25 per cent was short term external debt. Malaysia's low level of short term external debt enabled the country to maintain a healthy level of gross official reserves. International reserves of US dollars 21.5 billion was adequate to cover nearly 2 times of its short term external debt and was equivalent to around 3.6 months of imports of goods and services at end 1997.

Ecuador (2018-2020): Ecuador faced significant financing constraints that prompted the recent debt restructuring in 2020. Foreseeing rising debt vulnerabilities, the authorities proactively restructured their global bonds in a market-friendly operation with very high participation. The authorities have successfully completed a bond exchange with the support of 98 percent of bondholders holding US dollars 17.4 billion of Ecuador's global bonds in August 2020. The debt exchange generated significant reductions in interest payments (US dollars 5.7 billion over 2020–25) and amortizations (US dollars 5.6 billion over 2022–25). In addition, the reprofiling of bilateral obligations to Chinese creditors was expected to yield around US dollars 815 million in savings in 2020–21. To achieve this, Ecuador took significant steps in fiscal consolidating including significant cuts to capital expenditure. The parameters of structural reforms in Ecuador were structured around the debt sustainability targets provided in the Rapid Financing Instrument provided by the IMF, which were to reach a debt-to-GDP ratio of 55 and 45 percent in 2025 and 2030, respectively, and average gross financing needs of 6 percent over 2025-30.

Zambia (2020): Zambia became the first African nation to default in the era of the COVID-19 pandemic in November 2020. Zambia's problems long predate the COVID-19 crisis, with its economy constrained by structural factors, such as low wealth, high fiscal deficits and a heavy debt burden despite being one of Africa's largest copper and other mineral producers. The main problem for Zambia was the country's excessively lax fiscal deficit. Since 2015, the country's fiscal deficit averaged around 8 per cent of GDP. With accompanied sharp depreciation of the Zambian currency, the country's external debt rose from 36 per cent in 2014 to 92 per cent by end 2020. Following the default in late 2020, Zambia was not able to come to an agreement with its bondholders on restructuring programme as the bondholders insisted on securing IMF backing for the debt restructuring process. Zambia's experience emphasises that even with positive IMF engagement, it will take a significant period of over a year for a staff level agreement with the IMF to materialise and remaining solvent until such time without a debt default is an incredibly challenging task.

Annex II

Report on the Economy and Risk Assessment

1. Introduction to Real Economy

- The Sri Lankan economy recorded a notable contraction in 2020 due to the spread of COVID-19 pandemic and related containment measures to control the spread of virus. Accordingly, the economy contracted by 3.6 per cent in real terms in 2020 with a notable contraction of 16.4 per cent in the second quarter of the year. Meanwhile, there were positive signs of gradual recovery in economic activities since the second half of 2020 supported by the unprecedented policy measures taken by the authorities, which resulted in a positive growth of 4.3 per cent in real GDP during the first quarter of 2021.
- However, with the resurgence of COVID-19 outbreak since the latter part of April 2021, economy continued to face several negative risks associated with the prolonged pandemic conditions. With the emergence of new variants of COVID-19 virus and their rapid spread have continued to threaten the world as well as Sri Lanka, making the recovery process vulnerable.
- Prolongment of the pandemic and plausible lockdown measures would possibly result in loss of GDP that ranges in Rs. 2.3 – 7.0 bn per day depending on the level to which economic activity is being restricted. The loss estimation and the assumption applied therein are as follows:

Table 1.1: Loss to the Economy in Nominal Terms due to Plausible Lockdown

	Loss to the Economy in Nominal Terms		
	5% contraction	10% contraction	15% contraction
Daily Loss (Rs. bn)	2.33	4.67	7.0
Loss for 30 days (Rs. bn)	70	140	210

Assumptions:
(a) If no lockdown/mobility restrictions are imposed, the daily GDP (in nominal terms) in June 2021 is equal to the average daily GDP in Q3 2020, during which mobility restrictions were eased to a greater extent
(b) GDP deflator growth rate is 5 per cent
(c) Different contraction rates are assumed since contraction in GDP will depend on the level of restrictions imposed on different economic activities.

- The agriculture related activities of the economy could be dampened to a greater extent with the shortage of fertilizer and agrochemicals with the Government decision to suspend fertilizer imports with the aim of promoting organic agriculture. Although, organic agriculture appears to be a sustainable farming method in the long run, sudden shift of the entire agriculture sector from conventional farming to organic farming could result in a notable reduction in agricultural production. If there is a considerable decline in agricultural production as predicted by numerous agriculture sector professionals, especially in relation to essential food items such as rice, vegetables, other field crops and sugar, Sri Lanka may have to import food to meet the domestic requirement. Although fertiliser import cost can be saved by this policy decision, reduced agriculture production could result in a significant foreign exchange drain. In addition, this fertiliser and agrochemical import ban could result in reduced foreign exchange earnings, particularly in relation to tea and spices exports. Reduction in agriculture supplies could exert upward price pressures, in particularly on food inflation, while increasing the cost of living of the country. From the employment perspective, this ban could affect the livelihood of a large segment the labour force, since agriculture sector contributes to around 29 per cent of employed population. In addition, subdued performances in the agriculture sector could have negative spillover effects to industrial and services activities in the food value chains.

- Meanwhile, increased oil and commodity prices could create foreign currency liquidity pressure on importing companies as well as the banking sector. For example, global oil prices have increased by 46.7 per cent by 13 July 2021 from end 2020. Meanwhile, FAO food price index that averaged 127.1 points in May recorded the highest monthly average since September 2011. Increased oil and commodity prices affect domestic prices through imported inflation. Retail prices of the petroleum products have already been revised upwards in June 2021 and some market pressures are there to increase prices of several other commodities such as milk powder, gas and wheat flour in line with price movements in international markets. This will further pressurize the domestic inflation.

- Weaker financial performance of the State-Owned Business Enterprises (SOBEs) continued to remain as a major vulnerability of the government, while SOBEs continue to face mounting pressures in relation to foreign currency debt servicing.
- Nevertheless, there are positive risks to the real sector in relation to the rapid measures taken to contain COVID-19 pandemic in global as well as domestic level. This progress of the vaccine administration in the country have been made in a very short period of time and so far around 5.7 million doses have been given to the public. This indicates the possibility of containing threat of the pandemic going forward, if the vaccination process carried out at the same pace. Further, with the passage of the Colombo Port City Economic Commission Act, the project will attract FDIs to the country, which will essentially cushion the foreign reserves of the country, while promoting investment activities promoting overall growth.
- Meanwhile, headline consumer price inflation has been broadly maintained at the targeted range of 4-6 per cent thus far during the year underpinned by well-anchored inflation expectations and subdued aggregate demand conditions, despite the elevated levels of monetary expansion and high volatility of food inflation due to supply side disruptions.

2. Risk Assessment

A. Real Sector

- Amidst the COVID-19 pandemic, the real sector of the Sri Lankan econom continues to face numerous risks that can potentially affect economic growtl prices, employment and living standards of people. Prolongment of th pandemic with several other waves emerging domestically and globally coulc hinder the economic revival process, with a loss of GDP to the economy that may range in Rs. 2.3 – 7.0 billion per day in nominal terms depending on the level to which economic activity is restricted. Increased oil and commodity prices in global markets, for example, global oil prices have increased by 46.7 per cent by mid July 2021 from end 2020, compelling Ceylon Petroleum Corporation (CPC) to heavily borrow from the banking sector, in foreign currency terms. Due to the increased fuel bill, total foreign currency payables of the CPC to state banks have increased by around 19.2 per cent to US dollar 3.4 bn by end May 2021 from US dollar 2.8 bn recorded at the end of 2020. The overdue foreign loan amount of the CPC accounted for 44.5 per cent of total foreign currency exposure of the state banks by end May 2021, mainly due to delay in debt servicing amidst pressures in the domestic foreign exchange market. Possible further increase in global prices could worsen foreign currency liquidity position in the financial markets. Meanwhile, key State-Owned Business Enterprises are continuing to make heavy financial losses due to administered prices set below the actual costs. For instance, during the five months period ending from May 2021, CPC and Ceylon Electricity Board (CEB) have recorded financial loss of Rs. 58.9 billion and Rs. 5.4 billion, respectively, Weak financial performance of SOBEs such as CPC, CEB and SriLankan Airlines is more likely to continue in the period ahead, which will result in larger contingent liabilities for the Government and deterioration of domestic currency liquidity position and the balance sheet of the state banks. Further, increased global oil and commodity prices can increase domestic prices through imported inflation, deteriorating the purchasing power and living standards of people. Fertiliser and agrochemical shortage due to the ban on their importation could affect agricultural production, resulting in higher food imports and reduced export earnings, particularly in relation to tea and spices exports. Further, lower agriculture production can have spillover effects on industrial and services activities in the food value chains. Import restrictions imposed to ease external sector pressures can dampen domestic production in other industrial activities which use imported raw materials, such as manufacturing of wearing apparel and construction activities, due to limitations in intermediate inputs.

B. External Sector

- The country's gross official reserve (GOR) position continues to deteriorate. With the scheduled repayment of the International Sovereign Bond (ISB) in the latter part of July 2021, the GOR is expected to drop to around US dollars 3.3 billion by end July 2021, under some optimistic assumptions. Although the reserve level is expected to increase with the receipt of two international swaps from Bangladesh and India and the IMF SDR allocation, almost all sizeable inflows are to the Central Bank and foreign currency inflows to the Government remain significantly limited. Under the currently estimated inflows and scheduled debt service payments, it is likely that by end of 2021, the Central Bank will no longer be in a position to repay the foreign currency debt obligations of both the Government and the Central Bank. With some portion of reserves needed to cover repayment of maturing Central Bank liabilities, the reserves that are effectively left to pay debt of the Government will become negative by January 2022. The outlook on the balance of payments and the exchange rate remains negative. Further widening of the trade deficit is expected in the rest of the year with higher global oil prices and other commodity prices as well as due to relaxation of import controls. The tourism sector remains at a standstill and expected financial flows to the private sector remains significantly limited with investment sentiment on Sri Lanka deteriorating under the current circumstances. Meanwhile, the liquidity in the domestic foreign exchange market also remains significantly limited and the current stability of the exchange rate is maintained with a high degree of moral suasion. The Central Bank is not in a position to defend the exchange rate for a prolonged period, given the low level of reserves and the upcoming debt servicing needs, leaving the exchange rate extremely vulnerable to speculation and possible further depreciation. If the situation further escalates, it is likely to result in further sovereign rating downgrades, a sharp depreciation of the exchange rate, culminating in all imports, both non essential and essential, needed to be curtailed. This will ultimately result in eventual macroeconomic and financial system instability.

C. Monetary Sector

- With the gradual transmission of monetary policy easing measures, most market interest rates declined to their historic lows, facilitating a faster economic recovery. However, the upward pressure on yields on government securities continued due to excessive Government borrowing from the domestic market. Further, state banks' borrowings due to Government transactions created an upward pressure on interbank call money market rate, in spite of the high level of excess liquidity in the domestic money market. Continued excessive borrowing from domestic sources by the Government will result in further upward pressure on yields on government securities and short term money market rates. Meanwhile, interest rates on foreign currency deposits domestically have increased significantly, driven by the intense competition among market participants due to limited liquidity in the foreign exchange market, which is likely to weaken the effectiveness of monetary policy. A notable expansion of broad money supply was observed thus far in 2021, primarily due to significantly high monetary financing and large government and state owned enterprises (SOEs) borrowing from the banking system. With continuous expansion of credit to the public sector, along with the acceleration of private sector credit, the growth of broad money is expected to remain at elevated levels going forward. Inflationary pressures could emerge sooner than anticipated, primarily due to continued expansion of money supply. The depreciation of the Sri Lankan rupee against the US dollar, the increase in domestic petroleum and other commodity prices in line with global developments and destabilisation of inflation expectations could further fuel inflationary pressures, affecting the objective of maintaining domestic price stability. Lack of market appetite for increased volumes of government securities at the published maximum yield rates for acceptance has necessitated significant Central Bank intervention. Resulting continuous increase in holdings of government securities by the Central Bank have led to the deterioration in the equity to domestic assets ratios and the Central Bank balance sheet, thereby affecting the delivery of the Central Bank's statutory responsibilities under the Monetary Law Act. Further, foreign currency debt service payments on behalf of the Government have resulted in a sharp depletion of the net foreign assets of the Central Bank. The likelihood of net foreign assets of the Central Bank becoming negative in the near future is high, undermining the deep fundamentals of central banking.

D. Fiscal Sector

- Fiscal sector performance, which has deteriorated steadily over the past few years owing to the structural budget deficits, expenditure overruns, persistent government revenue slippages, rising gross financing needs and debt levels and restricted access to foreign currency borrowing, is likely to aggravate further in the near term. The fiscal deficit that widened notably to 11.1 per cent of GDP in 2020 and the widened deficit in the current account and primary balance raise the fiscal consolidation risks in the period ahead. In 2021, the budget deficit is likely to deviate from the MOF estimate of Rs. 1,565 billion (9.5 per cent of GDP) to Rs. 1617 billion (9.8 per cent of GDP) as per the provisional estimates of the Central Bank. Also, the rate of growth in government revenue, which has failed to keep pace with the rate of growth of income owing to various tax exemptions/holidays, tax evasion and weak tax administration, could weaken further due to the continuation of plethora of tax incentives introduced since the late 2019 that steered the economy towards a low tax regime, and more direct and indirect tax concessionary reforms introduced since the onset of the pandemic and under the Budget Proposals 2021. As per the estimates of the Central Bank, government revenue is expected to fall short of about Rs. 157.7 billion from the approved budget estimates of Rs. 1,951 billion for 2021. The expenditure rationalisation plan could dawdle with the pressure of rigid non discretionary recurrent spending, of which the major share being the debt service cost and public sector wage bill, and additional spending requirements on public health services and direct and indirect financial support for households and businesses affected by the pandemic. In line with the Central Bank estimates, government recurrent expenditure is expected to exceed by Rs. 114.2 billion over the MOF estimates of Rs. 2,466 billion for 2021. As a result, the financing gap to be fulfilled during the remainder period of 2021 will be increased by around Rs. 439 billion. Though this could be possibly covered by the increase in Treasury bill limit, if the Government raises additional funds to meet such financing requirements, the available gross borrowing limit of Rs. 2,997.0 billion for 2021 should require an enhancement. As per the debt sustainability analysis (DSA), central government debt is expected to increase to 105.6 per cent of estimated GDP (Rs. 17,379 billion), which is significantly higher than Government envisaged target of 98.0 per cent by end of 2021 and 101 per cent at end 2020. Therefore, government liquidity risk, that is already high, may continue to elevate as reflected by the increase in the debt stock over one trillion within a very short time span of four months from Rs. 15,117.2 billion at end of 2020. Meanwhile, the variation of the Sri Lankan rupee against the debt denominated foreign currencies is also expected to exert pressure on the outstanding central government debt, as reflected by the estimated the parity impact of the outstanding foreign currency denominated central government debt of Rs. 553.4 billion at end April 2021. As per the macro stress test scenario of DSA, with the combined effect of the shocks of interest rate, exchange rate, real GDP and primary balance, the public debt ratio could rise over 108 per cent of GDP

in the near term. The access to foreign capital markets has been se
constrained amidst the downgrades of the country's sovereign debt r
The current sovereign credit ratings along with the ongoing pandemic gl
raising financing through international capital market by issuing ISBs v
challenging in the near term. The external debt servicing obligations
Government over the near to medium term remain one of major risk fa
The annual external debt repayment commitments of the Government
dollars 5 - 6 billion, on average, falling due over the medium term could
significant rollover risks. The rollover risks could intensify if the uncertai
associated with the access to foreign capital markets worsen in the pe
ahead, given the unappealing sovereign ratings, global financial ma
uncertainties, and appetite for safe heaven assets. The secondary market yi
of Sri Lanka's ISBs prevail above 15 per cent, at present, with a significa
high level of the yield rates of beyond 30 per cent for the ISB maturing in J
2021. Particularly, the substantial external debt servicing requirements for
remainder of the year could weaken the exchange rate that has depreciated
6.7 per cent thus far in 2021, thereby worsening the debt dynamics. T
Government inclination to absorb more domestic resources, which are alrea
insufficient to meet the deficit financing and the foreign liabilities, could p
pressure on interest rates, thereby heightening debt servicing requiremen
further. Further, the amount of government borrowing exceeding the intere
and capital payment of existing debt, and the resultant capitalisation of intere
payments, would intensify debt management risks in the period ahead.

E. Financial Sector

Domestic Foreign Exchange Market

- A sizable and persistent FX liquidity shortage has been observable in the domestic FX market through-out 2021. As a result, almost all Licensed Commercial Banks (LCBs) have been recording negative/short (i.e.: oversold) net foreign exchange open positions (NOPs) and hence, expose to a significant exchange rate risk, liquidity risk and default risk (credit risk). The acute FX liquidity shortage has adversely affected the Central Bank also by limiting the funding availability for SWAPs and outright purchases and the SWAPs have become costlier for Central Bank too. This is negatively affecting on the building-up of FX reserves of the country. The outstanding import trade facilities as reported by the banks to the Central Bank have increased from USD 3.5 billion in Sep-2020 to USD 5.3 billion in Jul-2021. Accordingly, the continuation of imports with a rising trend has a significant negative impact on the FX liquidity shortage in the domestic FX market. The outstanding foreign currency (FCY) obligations of Ceylon Petroleum Corporation (CPC) to Bank of Ceylon and People's Bank (PB) are in excess of USD 2.1 billion and the outstanding LCs were at around USD 1.1 billion. Hence, effectively, the total FCY obligations of CPC would be at around USD 3.2 billion. Given this situation, the CPC's FCY position is highly unsustainable and pose a significant threat to the stability of the financial system and macro-economy as a whole. The prevalent FCY position at PB is a serious threat to the stability of the financial system as a whole, due to its weak FCY inflows and significantly higher import related FCY outflows, including to the imports of state-owned enterprises. Currently, in order to avoid possible default in its FCY commitments, PB was compelled to borrow USDs from the domestic inter-bank currency SWAP market at costs in excess of 20% per annum. This has been resulted in distorting the cost structure of the domestic currency SWAP market, while adding an additional cost to the PB. Recently, there were number of complaints from corporates due to non-issuing of FCY by the banks to pay their import related and other FCY requirements. These requirements are legitimate payments which are well within the existing regulatory directions and administrative guidelines. However, due to insufficient FCY liquidity at the domestic FX market, banks have either denied or deferred to honour such payments. Continuation of such would lead to supply disruptions and deterioration of foreign investors' confidence.

Banking Sector

- Potential risks and envisaged impact stemming from the current FX liquidity shortfall in the domestic FX market on the banking sector.
  1. Inability to establish Letters of Credit (LCs) by Licensed Banks (LBs) as required by all bank customers and only selected customers are provided with LC facilities by LBs due to shortage in FX liquidity in the domestic FX market
  2. LBs are requesting to temporarily enhance their Negative Net Open Position (NOP) limits to meet payments in lieu of LCs opened in the past, until projected inflows from ISB settlements are received by them.
  3. Significant FX borrowing settlements due in 2nd half of 2021
     (a) A major share of foreign borrowings is due to mature in Q3 and Q4 2021
     (b) High potential FX risk, if such existing credit lines are not rolled over
     (c) Breach of covenants in respect of foreign currency borrowings leading to difficulties in sourcing foreign currency funds
  4. High cost of FX Funds impacting profits and capital of LBs
     (a) Mobilizing FCY deposits at rates higher than the commonly agreed interest rate of 5% by LBs
     (b) During the last few months People's Bank (PB) has been engaging in SWAP transactions at a discount resulting in substantial losses to the bank
  5. Significantly low FX Liquidity in Banks
     (a) Very low USD LCR ratios in most banks
     (b) Frequent rollover of FX exposures of Government of Sri Lanka (GOSL) and State -Owned Entities (SOEs)
     (c) Significant FX demands of GOSL and SOEs
     (d) Number of large and medium sized banks remain highly vulnerable to threats arising from the deterioration in the FX position

(e) Difficulties in accessing foreign credit lines for FX liquidity requirements

6. Potential threat of FCY deposit withdrawals by Non-Residents due to Sovereign Rating downgrade

7. Potential erosion of public confidence towards LBs