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இலங்கை மத்திய வங்கி
CENTRAL BANK OF SRI LANKA

Issued By Communications Department
Date 04.01.2023

Monetary and Financial Sector Policies for 2023 and Beyond

Sri Lanka encountered the most challenging year in 2022 in the post-independence economy. Headwinds due to consecutive economic shocks in recent years, including the Easter Sunday attacks in 2019, the outbreak of COVID-19 in 2020, and its protracted impact on activity in the aftermath in 2021, the socioeconomic and political crisis in 2022 amidst catastrophic balance of payments (BOP) pressures, along with unprecedented policy tradeoffs, have severely affected economic activity, inflicting unimaginable hardships to individuals and businesses. Livelihoods were lost, while real incomes suffered the most. Structural economic impediments that existed across various spheres of the economy over decades were compounded by these economic shocks, along with ill-timed policy choices, thereby loosening the macroeconomic balance and resulting in a sudden and multipronged setback for the nation.

The Government and the Central Bank were compelled to implement painful, but unavoidable policy measures during 2022 aimed at restoring macroeconomic balance. Monetary policy was tightened by an unprecedented adjustment in interest rates to prevent inflationary pressures from worsening while arresting any adverse inflation expectations over the near to medium term. A temporary suspension of selected foreign debt was announced amidst the dire foreign exchange shortage while initiating measures to consolidate public debt with the envisaged support from an extended fund facility (EFF) arrangement from the International Monetary Fund (IMF). Foreign exchange outflows, which were spared due to the suspension of certain debt servicing, helped make the immediately required operational space to contain the burgeoning BOP pressures, along with inflows of foreign exchange from friendly nations and multilateral sources. Foreign exchange outflows were further contained by several other measures, including the prioritisation of imports. These measures ensured the availability of foreign exchange for essential imports, including fuel, coal, cooking gas, medicine, and food items, among others, thereby relieving socioeconomic unrest to a greater extent. Meanwhile, exchange rate stability was restored by a consultation process with market participants, following a significant overshooting in early 2022. Further measures were initiated to improve foreign exchange liquidity in the domestic foreign exchange market with the repatriation and conversion requirements of foreign exchange, thereby disincentivising activity in the grey market. Meanwhile, an array of measures was implemented to preserve stability in the financial system, thereby avoiding any far-reaching consequences on the entire socioeconomic structure. Further, the Government has embarked on long-overdue reforms to rectify structural deficiencies in fiscal operations, as well as other sectors of the economy, that are imperative in ensuring a sustained recovery of the economy.

In parallel with the implementation of near-term economic stabilisation measures, negotiations with the IMF for an EFF arrangement were initiated by the Government and a staff level agreement was reached in September 2022. Meanwhile, measures are underway to secure financing assurances from official creditors for the debt restructuring process aimed at ensuring medium term public debt sustainability. With significant progress being made at present in relation to the interaction with the Sri Lankan creditors, the envisaged IMF facility is expected to materialise in early 2023.

The near-term economic stabilisation measures implemented thus far are unprecedented. The sacrifice made by individuals and businesses during these difficult times would be meaningful only when economic stability is restored over the medium to long term. Towards that end, collective and coordinated efforts are needed from all corners of society to ensure that the economy makes a sustainable recovery.

The outlook for the economy for 2023 and beyond and the major aspirations of the Monetary Board of the Central Bank for regaining macroeconomic stability are laid out below:

Inflation and Economic Growth

i. *The rapid acceleration of inflation that began from early 2022, turned around in October 2022, supported by the tight monetary policy measures implemented to contain inflationary pressures, the fiscal consolidation efforts and supply side policies of the Government, along with the relative easing of price pressures globally, among others.*
ii. *Headline inflation is expected to move along a disinflationary path with a deceleration in the first half of 2023 and reaching the desired levels of inflation towards the end of 2023. If any upside risks to inflation emerge in the period ahead, that would be addressed through appropriate policy measures.*
iii. *Inflation expectations remain well anchored along the projected disinflation path.*
iv. *The Sri Lankan economy, which is projected to register a real contraction of around 8.0 per cent in 2022, is expected to record a gradual recovery from the second half of 2023 and sustain the growth momentum beyond.*

Monetary Policy and Interest Rates

i. *The monetary policy will remain focused on ensuring price stability over the medium term.*
ii. *The forthcoming Central Banking Act, of which the draft has already been approved by the Cabinet of Ministers, will further strengthen the independence and accountability of the Central Bank, thereby reinforcing its core objective of ensuring price stability within the flexible inflation targeting (FIT) framework.*
iii. *The Central Bank will start publishing a forward-looking Monetary Policy Report to better inform the public on the outlook of the economy, thereby further improving the transparency of monetary policy actions.*

iv. *The excessively high levels of interest rates observed at present are expected to moderate in the period ahead as money market liquidity conditions improve and the risk premia attached to debt restructuring concerns assuage.*

v. *As guided by the near-term inflation outlook, market interest rates could adjust downward, yet maintain reasonably tight monetary conditions until inflationary pressures are sufficiently contained.*

vi. *The Central Bank has already requested the banking and non-banking sector institutions to avoid unhealthy competition for raising deposits by offering high rates of interest, which has led to excessive adjustments in all market interest rates, including the lending rates, well above the adjustment of policy interest rates. The market interest rate structure (of both deposit and lending interest rates) is expected to moderate in the period ahead with improving market liquidity conditions. If such adjustment would take longer time than anticipated, the Central Bank will consider taking administrative measures, as appropriate.*

vii. *Further flexibility in the determination of the exchange rate will be restored in line with the medium to long-term equilibrium levels that help foster competitiveness.*

Financial Sector

i. *Ensuring financial system stability also remains at the forefront of the Central Bank's reform and stabilisation plan.*

ii. *The Central Bank ensures liquidity support to fulfil cashflow requirements of banking institutions to enhance the resilience of the financial sector.*

iii. *The proposed Banking (Special Provisions) Act is expected to provide the required legal framework to ensure that the banks are adequately capitalised, and upgrade their resolution framework, safeguard the interests of depositors, and strengthen the regulatory powers of the Central Bank.*

iv. *Existing regulations relating to capital and liquidity will be reviewed in order to preserve the capital and liquidity levels of the banking sector to withstand emerging risks. Moreover,* *the current regulation on single borrower exposure limits will also be reviewed to reduce the sovereign-bank nexus.*

v. *Consolidation of financial institutions in both the banking and non-banking financial sectors will be carried out/ facilitated to improve capital with the benefit of economies of scale, synergy, and efficiency, while enhancing the financial strength, resilience and overall stability of those entities and their ability to cater to the growing demands of the business community in the period ahead.*

vi. *Amendments to the Finance Business Act No. 42 of 2011 and the Finance Leasing Act No. 56 of 2000 in line with the market developments will be introduced aiming at ensuring stability of the non-bank financial sector. Moreover, the proposed Microfinance and Credit Regulatory Authority Act will improve the market conduct and consumer protection of overall non-banking sector customers. Further, measures will be prioritised to bring the Licensed Micro-Finance Companies (LMFCs) and unregulated moneylenders under the regulatory purview.*

Foreign Exchange Management

i. *Cross border and domestic foreign exchange transactions monitoring system (i.e., International Transactions Reporting System - ITRS) introduced in 2022 will be further optimised to enhance data coverage in the external sector, improve regulatory monitoring and support informed decision making.*

ii. *The demand management measures imposed on curtailing certain imports will be assessed vis-à-vis the foreign exchange liquidity and monetary conditions.*

An efficient implementation of the identified near-term stabilisation measures and the medium to long term structural reforms both by the Central Bank and the Government is vital to position Sri Lanka on a fast track to recovery on a sustained basis. Nevertheless, formulating macroeconomic policies and recovery strategies during a crisis is fraught with enormous uncertainties. This requires timely adjustments to policies and strategies as new information becomes available.

The Central Bank will remain committed to achieving its mandate through appropriate policy measures while closely observing developments to take corrective policy and regulatory measures. The Central Bank appreciates the unwavering support, cooperation, and sacrifice of the financial sector participants, the business community, and the public at this crucial moment of Sri Lanka's socioeconomic history, and reiterates the need for steadfast commitment to remaining in focus until the crisis is overcome through collective efforts.