P Nandalal Weerasinghe: Navigating Sri Lanka's economic revival

Keynote speech by Dr P Nandalal Weerasinghe, Governor of the Central Bank of Sri Lanka, at the HSBC Market Outlook 2024 "Navigating Sri Lanka's economic revival", Colombo, 8 November 2024.

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Good morning, everyone,

First of all, let me thank HSBC for inviting me to this important event. I have attended this forum several times in the past, both as the Governor and, before that, as a Deputy Governor. I believe this is an important opportunity for the Central Bank to share our views. My focus today will primarily be on the local economic developments and outlook for Sri Lanka. I'm sure the other speakers will cover the regional and global perspectives, so I won't touch on those areas.

To begin with, I want to briefly explain the recent events. As we all know, Sri Lanka went through its worst economic crisis starting in 2021, and this continued into 2022. This crisis was triggered by major issues in macroeconomic management. Inflation, for example, soared to 70% in September 2022. We also faced severe balance of payments pressures, which depleted our official reserves and external buffers to non-existence levels. This led us to announce a temporary debt standstill and initiate sovereign debt restructuring.

The root cause of this crisis was the long-standing fiscal imbalances, which had led to unsustainable sovereign debt. The IMF announced this situation in 2020, though the previous government did not take corrective action. Instead, fiscal expansion continued, worsening the situation. As a result, we faced a severe sovereign debt crisis and balance of payments crisis, which came together for the first time in 2022. This, in turn, triggered socio-economic and socio-political challenges.

However, that is now part of our history. Since then, we have been focusing on the stabilization process. This has involved the prompt and coordinated implementation of fiscal and monetary policy measures, along with structural reforms, all supported by the IMF's Extended Fund Facility (EFF). This marks the 17th time Sri Lanka has received a bailout package from the IMF.

Looking back, it's clear that these measures have been successful in restoring macroeconomic stability, bringing us to a much better position than where we were in 2021 and 2022. One key consequence of the crisis was the sharp contraction of the economy in 2022 and the first half of 2023. However, we are now on a recovery path. Sri Lanka has broken the cycle of six consecutive quarters of economic contraction on a year-on-year basis since the second half of 2023.

Starting from that point, we are now in the fourth consecutive quarter of reporting positive growth. In the first half of the year, we recorded a growth rate of around 5%. This year, we expect to achieve growth well above 4%, which is significantly higher than earlier expectations. Even the IMF's baseline scenario had projected growth around 2%, but we are now exceeding that.

Now, I'd like to discuss monetary policy in more detail, as this is a key area of our responsibility. As I mentioned earlier, we faced very high inflation, but we have successfully brought it down to a single-digit level within just one year. This is a record disinflation process. I haven't heard of a similar achievement anywhere else in the world. Supported by the very tight monetary conditions we had to implement, we were able to stabilize the economy and bring inflation down to a very low level in a short period.

Since then, we have maintained low and stable inflation. In fact, in some months, inflation has been below the target we agreed with the government, which is a medium-term target of 5%. Currently, we are experiencing a period of deflation, but this is largely due to unexpected administrative price changes, particularly in energy and petroleum pricing. If you look at the underlying inflation, such as core inflation, it remains around 3% to 4%, still below the inflation target.

Looking ahead, we expect to return to a normal inflation regime within about a year. In our monetary policy formulation, we consider current inflation, the future outlook, potential output gaps, as well as the balance of payments situation, external vulnerabilities, and the acquisition of external buffers. We now have a very robust monetary policy framework, which is evidence-based, data-driven, and scientific, to ensure price stability in the future. Through that we have also successfully anchored inflation expectations, which is a positive development for the economy moving forward. This current low-inflation environment is providing stability and comfort to both livelihoods and business activity, especially after a period of very high inflation helping the economy and businesses to recover.

One of the significant milestones under the program, which had been planned for some time but not implemented until recently, was the enactment of the Central Bank of Sri Lanka Act, which came into effect in September 2023. This law has granted us greater independence in making monetary policy decisions, while also enhancing our accountability to the public, Parliament, and the markets. This is a very significant development, and it has helped to further strengthen the robust monetary policy framework we have now in place.

Under the new Act, the independence of the Central Bank has been reinforced, primarily by limiting direct monetary financing and eliminating government representation in the monetary policy decision-making process. As a result, the monetary policy framework and governance have been significantly improved. The new Monetary Policy Framework is now recognized and incorporated into law as a Flexible Inflation Targeting Framework.

I must highlight this point, as there has been considerable discussion to better understand the structure of our monetary policy. The Flexible Inflation Targeting Framework that we are now formally adopting with the new Central Bank Act is regarded as the best monetary policy framework we have ever had in this country. In fact, our recent performance has proven that this is the best framework for Sri Lanka. This approach has also been successful in other emerging markets with similar frameworks. Therefore, we are very proud to have implemented what is now considered as one of the best monetary policy frameworks in Sri Lanka's history.

Under the flexible inflation targeting regime, the exchange rate is determined by market forces, based on supply and demand. I must clarify here that under the flexible exchange rate regime, exchange rates are broadly determined by market forces and aligned with overall economic fundamentals in the medium to long term.

However, just to be clear, this is not a fully floating exchange rate. It is a flexible exchange rate regime within an inflation targeting framework, which allows us the flexibility to intervene when necessary. We intervene primarily to build our foreign exchange reserves and to stabilize the market in times of excess volatility. This is our responsibility, and we act transparently in the market.

Our goal is to develop and deepen the foreign exchange market, making it more liquid over time. When the market becomes more developed it will reduce the need for interventions, like in other countries. Until that point, we will continue to intervene, with the intention of building external buffers through official reserves. As a result of this policy, we have built up foreign exchange reserves to around $ 6.5 billion.

While allowing for exchange rate flexibility, we have seen the exchange rate appreciate from 370 to 300, and it is now slightly below 300. Despite this appreciation, we have continued to intervene to smooth out volatility. We have successfully built-up reserves from very low levels to more comfortable levels, but I must emphasize that we are not yet satisfied. We need to continue building our reserves, as this level is not sufficient for long-term stability.

An important milestone is that, for the first time in a long period, Sri Lanka's current account of the balance of payments has generated a surplus in 2023.

This year also, we are on track to generate a surplus. This marks two consecutive years of a current account surplus, a first for Sri Lanka in a long time. In fact, I don't think we've seen this level of current account balance surplus at least since 1977. Of course, there are still certain restrictions in place, but overall, this is a significant development.

Looking ahead, many people have asked when we will ease the restrictions on motor vehicles, which is the only area where restrictions still apply. We have informed the government that we are in a position to manage and are ready for the government to relax these restrictions. However, it is up to the government and the Ministry of Finance to decide the timing and pace of this relaxation. Ultimately, these decisions fall under fiscal policy, and we do not wish to intervene in that process. What we have emphasized is the importance of maintaining and building external buffers while carefully considering the need for imports to support the next phase of economic recovery.

For the recovery to gain momentum, we must prioritize growth, and to facilitate that growth, we need to relax import restrictions. Without sufficient access to necessary imports, businesses and the economy as a whole will struggle to function effectively.

On the subject of monetary policy, I'd also like to address the recent debate about money printing. It is a positive development that this debate has emerged, as it shows growing public interest and awareness. The discussion was sparked by a statement from a website claiming that the Central Bank printed 100 billion rupees through open market operations. Typically, we would ignore such statements, but this time, the issue has escalated into a larger public debate, which I believe is a good and healthy development.

The first point I want to make is that, under the new Central Banking Act, there is no room for direct monetary financing. This means that the Minister of Finance cannot influence the Central Bank to finance the budget deficit through direct money creation. This practice is now prohibited under the Act. It has not happened since 2023, and it will not happen going forward. That is the first key point I want to emphasize: direct monetary financing, or what was previously referred to as "money printing" by the Central Bank, is no longer allowed.

That said, the Central Bank still has a responsibility to manage day-to-day liquidity in the domestic rupee market through open market operations. We have been conducting open market operations for several years-this was first introduced in Sri Lanka back in 2002. It is important to note that these operations are not related to direct monetary financing; they are simply aimed at providing sufficient liquidity to the interbank market. These operations are part of our current monetary policy framework, which focuses on maintaining liquidity and managing short-term interest rates.

Our primary objective through these open market operations is to target short-term interest rates in the interbank market, the call money rate. This is the rate at which commercial banks lend to each other overnight. Our goal is to keep the call money rate within a range that we believe is most appropriate for the current stance of monetary policy. For instance, if we decide to adjust our policy rates, such as the bank deposit rate or the lending rate set by the Central Bank, we do so with the aim of maintaining the call money rate within a specific range that aligns with our overall policy objectives.

The key point is that monetary policy transmission occurs through the management of the call money rate. This is the tool that central banks around the world use to influence short-term interest rates and guide monetary policy. It is not a new approach for the Central Bank of Sri Lanka. With our inflation targeting framework now in place, we have established a clear policy for managing liquidity and maintaining short-term interest rates at levels that are consistent with our broader goals for inflation control and economic stability.

This is a completely independent process and the Central Bank is free from any influence or pressure from external parties. The decisions we make are entirely our own. I must make it clear: there is no fiscal dominance or external influence over our open market operations. We have always conducted these operations independently, and we will continue to do so.

So, when we carry out open market operations, our primary objective is to manage short-term interest rates - specifically the call money rate - within the target range that we deem appropriate for the overall stance of monetary policy. This is how we manage monetary policy transmission into the broader economy. For example, if the current call money rate is moving closer to the lower bound of 8.25%, we aim to maintain it within that range because we are following an accommodative monetary policy stance. We want to avoid excessive volatility in short-term rates. If we see any pressure in the interbank market, where short-term rates may become volatile, we intervene by injecting liquidity on a short-term basis - overnight or weekly - to stabilize rates.

There are several ways we inject liquidity into the market. One of these methods is through foreign exchange operations. When we purchase foreign exchange from the market, we inject rupees into the interbank market, thereby creating liquidity. Additionally, other factors like currency in circulation - when currency flows out of the system - can create a liquidity deficit in the interbank market. Furthermore, credit deployment by commercial banks can also contribute to liquidity shortages. To manage this, we continuously assess liquidity on a daily, weekly, and monthly basis. Based on these assessments, we plan the necessary interventions in the domestic rupee market, which we carry out independently, without any influence from outside parties. I want to be very clear about this point: our open market operations are done with complete independence, and we will continue to operate in this way.

Some people, however, may look at our interventions and misinterpret them as "money printing." I want to assure you that this is not the case. Through our operations, we are careful to avoid unnecessary monetary expansion - something that occurred before the enactment of the new Central Banking Act. Under the old system, when the Minister of Finance could directly instruct the Central Bank to purchase treasury bills, there was little control over monetary expansion. However, under the new framework, we no longer engage in direct monetary financing or purchase treasury bills directly from the government.

Even within our open market operations, we are mindful of the potential for excessive expansion of the monetary base. We carefully consider the long-term implications of any intervention, even when we focus on our short-term objective of maintaining appropriate short-term interest rates.

This clarification is important, as we want to ensure that everyone understands the nature of our monetary policy operations and that there is no undue expansion of the money supply. It is our responsibility to explain our actions clearly so that everyone understands how our operations take place, the nature of our independence, and how the Central Bank operates. As I mentioned earlier, this is not an unusual approach. Under the best monetary policy framework we've ever had, we are operating within a proven and prudent system. This is consistent with the practices of central banks worldwide in managing day-to-day liquidity in domestic currency markets.

Now, moving on to another area - exchange rates. As I've already mentioned, we've been able to maintain external buffers close to $6.5 billion. We plan to continue building these reserves going forward to ensure strong external buffers. For example, this year alone, we have purchased $2.3 billion worth of foreign exchange from the market. This is the highest level of foreign exchange purchases the Central Bank has ever made in a single year. We are still in the process of building our reserves, and we expect this to continue. In addition to our market purchases, inflows from multilateral institutions, such as the IMF, World Bank, and Asian Development Bank (ADB), have also supported this build-up. As part of our monetary policy framework, we continue to maintain the flexible exchange rate regime, and we will continue to do so going forward.

Let me also make a few remarks on fiscal consolidation. Fiscal performance is the root cause of the macroeconomic imbalances we've faced. On the fiscal front, there have been very positive developments over the past two years. We've seen substantial reductions in the fiscal deficit, improvements in fiscal balance moving towards a primary surplusin the fiscal accounts. There has also been a significant increase in revenue mobilization, which is a very positive sign for fiscal sustainability.

Another key development has been the implementation of the cost-reflective pricing mechanism. This has eased the burden of financing for the Treasury and reduced the need for direct financing of state-owned enterprises (SOEs). Previously, the banking sector was often required to finance loss-making state-owned enterprises, but this practice has now been addressed. Going forward, there will be no more direct financing for SOEs to cover their losses. We have also asked commercial banks to reduce their exposure to SOEs, particularly their large exposures, as stipulated in the new Banking Act.

We have given the state-owned enterprises (SOEs) time to adjust, and the cost-reflective pricing mechanism has been implemented to help them reduce their exposure to financial stress. Moving forward, these corporations should be able to mobilize financing from the broader banking sector, rather than relying solely on state-owned banks. This revenue-based fiscal consolidation path has proven effective, and tax policy reforms are continuing in parallel.

On the matter of external debt restructuring, as I mentioned earlier, after announcing the temporary debt standstill with the goal of restructuring our sovereign debt obligations, we are now nearing the final stages of completing the external debt restructuring process. I am confident that we will successfully complete this and provide the necessary space for the government to manage its external debt servicing obligations, while also ensuring that sufficient resources are available for spending on other priorities. This will create the necessary fiscal space for the country to enter a sustainable growth trajectory over the next several years.

Let me now turn to a few remarks on financial system stability, which is one of the key mandates of the Central Bank. The financial sector has had to endure difficult macroeconomic conditions over the past two years, but it has remained resilient throughout the crisis, largely due to the proactive and prudent regulatory actions we've taken.

At one point, there were significant concerns, particularly from international financial institutions like the World Bank and IMF, about the possibility of a banking crisis - especially given the sovereign debt crisis, the exposure of state banks to sovereign debt, and the deterioration in the asset quality of commercial banks. However, we have worked diligently with the banking sector to strengthen its resilience, and we now feel confident that the sector has weathered the storm. All key indicators are improving - capital adequacy, liquidity, and non-performing loans (NPLs) are on a recovery path.

During this period, we also implemented several important reforms, including amendments to the Banking Act, which have strengthened the regulatory and supervisory oversight of the Central Bank. We have provided regular guidance to banks and non-bank financial institutions on maintaining capital and liquidity, and we've conducted an asset quality review for all large banks. Based on these assessments, and using forward-looking stress testing tools, we are confident that the banking sector - with the exception of the two state-owned banks - is well-positioned to build its own capital without relying on taxpayer funds.

The two state-owned banks, however, will need some support from the government. As you know, the IMF program allocated Rs.450 billion to help recapitalize these banks if necessary. Our latest assessments suggest that the full amount may not be needed; in fact, around one-third of this allocation may be sufficient to address any potential capital shortfalls arising from the restructuring of their foreign exchange obligations. The foreign exchange debt restructuring of the state banks has progressed better than anticipated, and once Parliament ratifies the necessary measures, we expect the final phase of restructuring to be completed by the end of this year.

Starting next year, the government will face a significantly lighter debt servicing burden, and the banking sector will be in a much stronger position to support the economic recovery. With sufficient capital and liquidity, the banking system will be better equipped to drive economic growth and offer businesses and households the financial support they need with greater confidence.

Next, I'd like to briefly mention the Banking Sector Special Provisions Act, which was also passed by Parliament with the aim of establishing a resolution framework in the event that any financial institution faces solvency or liquidity issues. While we certainly hope we will not need to use this framework, it is in place, and we are prepared to act quickly if necessary. This new framework empowers the Central Bank as the official resolution authority for both banks and non-bank financial institutions under our supervision. We now have the necessary resources and regulatory tools to address any concerns related to the solvency of financial institutions. Should any issues arise, we are ready to implement the resolution process promptly and effectively.

In conclusion, Sri Lanka has rebounded faster than expected from the economic crisis. However, building a stronger and more resilient economy requires the continued collective efforts of the monetary authorities, fiscal authorities, and other stakeholders, including the private sector and the public. The foundation for macroeconomic stability has already been strengthened, and it is now time to focus on growth and development. The stability phase is almost complete, and we must now transition to the next phase - one focused on enhancing growth and expanding the country's capacity to grow. This will require the implementation of critical structural reforms aimed at boosting the country's long-term growth potential.

For these efforts to succeed, it is crucial that the private sector and investors play an active role in driving sustainable and inclusive growth going forward. This is also essential for maintaining the country's debt servicing capacity and economic sustainability beyond the IMF program, which is scheduled to conclude in 2027. Our goal is to ensure long-term debt sustainability well beyond the IMF program's end, laying the groundwork for Sri Lanka's continued growth and stability.

Thank you very much.