Essay series | Sri Lanka: from debt default to transformative growth

Disinflating an economy in crisis: the case of Sri Lanka

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About this publication

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Acronyms

GDP	gross domestic product
IMF	International Monetary Fund
SRR	Statutory Reserve Requirement

Disinflating an economy in crisis: the case of Sri Lanka

Summary

Sri Lanka recorded its highest levels of inflation in 2022. However, the country was also able to rapidly reduce inflation to single-digit levels within 10 months of the peak. This essay summarises this experience and highlights the importance of Central Bank independence for successful inflation management, which is a prerequisite for sustained high growth of a country.

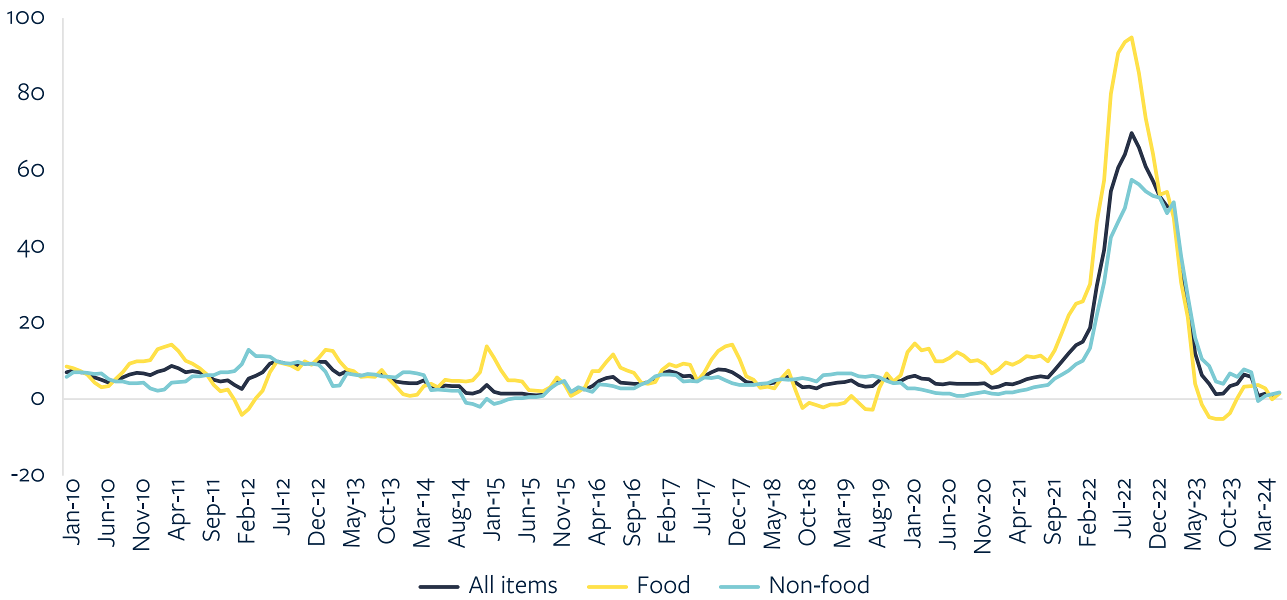
1.1 Introduction

Sri Lanka's economic crisis in 2022, including the lead-up and its causes and consequences, is well documented. Similar to other nations that launched multipronged policy stimuli in the wake of the COVID-19 pandemic, Sri Lanka eased monetary policy significantly from early 2020, among several fiscal measures. While there was some tightening from August 2021, monetary policy remained broadly accommodative until April 2022. The exchange rate was maintained around Rs 200 per US dollar from late April 2021 until early March 2022, despite the continued decline in official international reserves. Continuation of debt servicing under trying conditions without corresponding foreign exchange inflows to the government, along with the need to finance essential imports, resulted in useable international reserves declining to near-zero levels by early April 2022. The drying-up of foreign financing to the government also prompted an unprecedented increase in Central Bank lending to the government.

Meanwhile, shortages of essentials and upward revisions to administratively determined prices, together with adverse speculation, destabilised inflation expectations. Inflation moved to double digits from December 2021, breaking the 12-year streak of single digit inflation. When allowed to float freely in March 2022, the exchange rate showed a sharp adjustment. This, along with adjustments to domestic petroleum and electricity prices and continued shortages of food and non-food items, escalated inflation further.

As the economic crisis continued to escalate, the government sought the assistance of the International Monetary Fund (IMF) in March 2022. Discussions with the IMF towards securing an adjustment programme commenced in April 2022, while the process of public debt restructuring was initiated. To contain demand-driven inflationary pressures, re-anchor inflation expectations and also stem the sharp depreciation of the rupee, the Central Bank tightened monetary policy significantly, almost doubling policy rates at once. Meanwhile, the government also commenced adopting corrective fiscal and quasi-fiscal measures to address the severe imbalances that prevailed, thereby working with the Central Bank to stabilise the economy. Inflation peaked at 69.8% (Colombo Consumer Price Index (CCPI)-based, year on year) in September 2022, while food inflation shot up to a staggering 94.9% in the same month. In response to decisive measures adopted mainly by the Central Bank and also by the government, the country experienced rapid disinflation, which brought inflation back below 5% by August 2023. Figure 1.1 illustrates these movements, together with the historical evolution of inflation. This appears to be the sharpest disinflation observed in a country coming out of a crisis of a similar magnitude.

Figure 1.1 Headline inflation: food and non-food (CCPI, year on year), 2010–2024 (%)



Source: Department of Census and Statistics

1.2 Causes of high inflation

Continued high fiscal deficits amid dwindling revenues and the absence of foreign financing, along with continued debt servicing, resulted in the government relying increasingly on the Central Bank for rupee liquidity as well as foreign exchange liquidity. This resulted in an unprecedented escalation of Central Bank credit to the government, and an exhaustion of usable reserves. Severe mispricing of domestic petroleum products and electricity as well as the non-market clearing exchange rate masked the build-up of underlying aggregate demand pressures in the economy. Abrupt policy decisions, such as the reduction of direct and indirect taxes and the ban on chemical fertiliser, taken without proper analysis, added significant pressures to the domestic economy. While these developments de-anchored inflation expectations and resulted in inflation moving to double digits by end 2021, corrective measures inevitably caused further upward pressures on prices, thereby accelerating inflation further, before aggregate demand contracted. This section summarises these causal factors of high inflation.

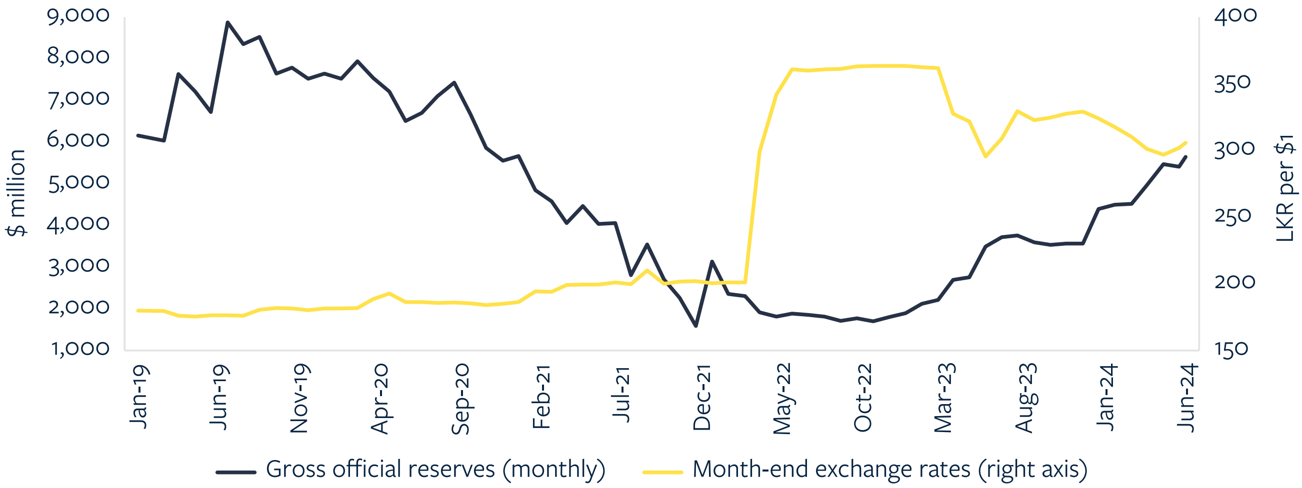
Mispricing of domestic petroleum and electricity supplies and resultant shortages

A key factor that destabilised inflation and inflation expectations was the shortages of fuel supplies. In late 2019, the government abandoned the formula-based pricing of domestic petroleum products introduced under the previous IMF programme. Domestic petroleum prices were adjusted only twice during the period between September 2019 and December 2021 in spite of notable fluctuations in global petroleum prices. Amid accumulating losses to the Ceylon Petroleum Corporation, the shortage of foreign exchange and the drying-up of foreign credit lines resulted in an escalation of the effective cost of petroleum imports, at the same time as impacts on availability. Coal and cooking gas imports faced similar challenges. Meanwhile, dry weather conditions in early 2022 and limited supplies of petroleum also affected electricity generation. By then, the Central Bank had commenced providing foreign exchange to finance essential imports, including fuel and medicines. However, the sharp decline in reserves amid continued financing of essential imports and debt servicing meant that depreciation and domestic price adjustments were inevitable. Inadequate adjustments in prices and inability to import adequate supplies caused shortages of petroleum and cooking gas, as well as power cuts, by early 2022. The combination of these factors prompted a sharp acceleration of inflation, while fuel rationing and scheduled power cuts had to be continued for a prolonged period of time.

Depletion of international reserves and exchange rate depreciation

The onset of the pandemic had severe impacts on Sri Lanka's foreign exchange inflows, particularly in terms of tourism earnings, while concerns on fiscal sustainability following the tax cuts in late 2019 had restricted the country's access to international capital markets. From early 2020, some restrictions were introduced on imports and selected capital outflows to dampen the imbalances in the external sector. Although the exchange rate was allowed to adjust with limited foreign intervention by the Central Bank early on, adverse speculation was building up, with official international reserves continuing to deplete. Attempts to maintain the exchange rate within a very narrow margin also led to the emergence of an active parallel market for foreign exchange, which attracted remittance inflows and financed outflows circumventing the restrictions. Global developments, particularly rising oil and other commodity prices, resulted in a continued deterioration of the external sector conditions, and the liquidity crunch in the domestic foreign exchange market worsened. Usable reserves were fully exhausted by March 2022 owing to continued provision of foreign exchange for essential imports and debt servicing of the government by the Central Bank amid sovereign rating downgrades affecting credit lines to the government and the financial sector. Figure 1.2 shows the continuous depletion of official reserves since the onset of the pandemic and the sharp movements in the exchange rate since early 2022.

Figure 1.2 Movements of gross official reserves and exchange rate, 2019–2024



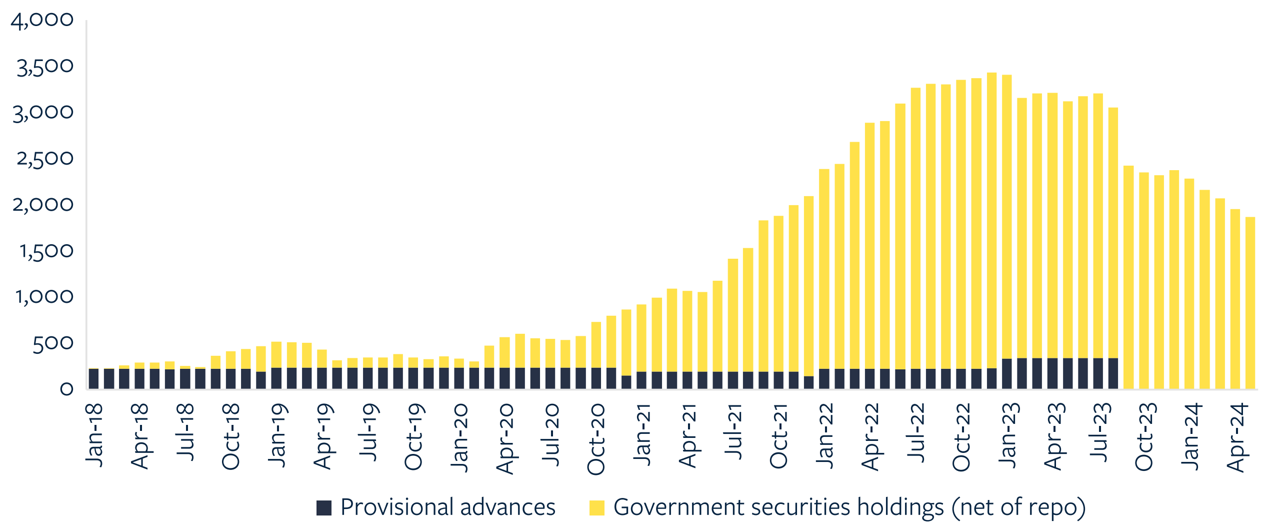
Source: Central Bank of Sri Lanka

A gradual adjustment to the exchange rate was no longer a feasible policy option by then, and the exchange rate was allowed to float by early March 2022, without a policy anchor to dampen any overshooting. As a result, the exchange rate experienced an unprecedented depreciation pressure until mid-May, and the rupee (commercial bank selling rate) depreciated against the US dollar by 46.2% between end February 2022 and 12 May 2022. Heavy depreciation in the official market and financing of imports through the parallel market at an even higher exchange rate led to a sharp rise in the prices of imported items. Moreover, second-round impacts of these increases in the prices of imported goods were also notable. The combined impact of these two effects of depreciation explains a greater share of the acceleration in inflation during mid-2022.

Fiscal deficits and monetary financing of such deficits

Prolonged and substantial monetary support provided by the Central Bank to the economy, including the government and the private sector, during the pandemic emerged as a source of demand-driven pressure on inflation from late 2021, although it helped enable a faster revival of the economy from the pandemic impact. As a combined effect of the series of sovereign rating downgrades and adverse global financial conditions, the government's access to financing was largely limited to domestic sources from 2020. In spite of limited access to foreign financing, fiscal deficits grew, as a result of the government's decisions to reduce taxes from end-2019 and increased expenditure owing to the pandemic. The overall fiscal deficit increased from 9.0% of gross domestic product (GDP) in 2019 to 10.7% in 2020 and 11.7% in 2021. The primary balance worsened from a surplus of 0.6% of GDP in 2018 to a deficit of 5.7% by 2021. In these circumstances, the Central Bank was compelled to finance the government to smooth fiscal operations, though the implications of a large increase in monetary financing were communicated by the Central Bank to the government in line with the provisions of the Monetary Law Act. Figure 1.3 illustrates the acceleration of financing of fiscal deficits by the Central Bank during 2021–2022.

Figure 1.3 Central Bank's financing to the government, 2018–2024 (LKR billion)



Source: Central Bank of Sri Lanka

6.3 Remedial measures and corrective actions

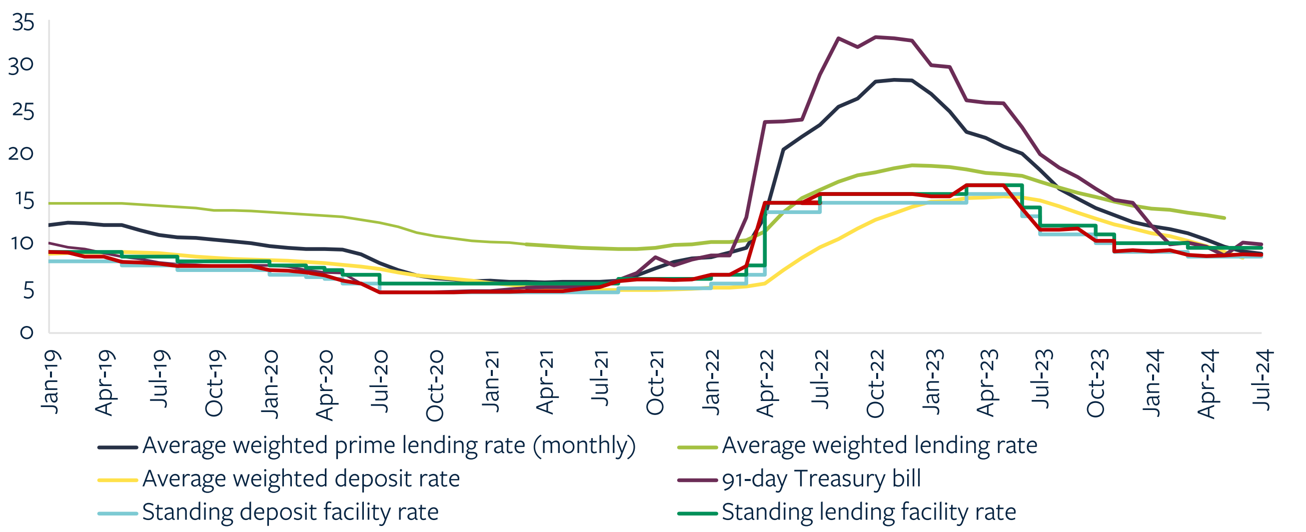
Monetary policy measures

The Central Bank commenced tightening monetary policy in August 2021 by increasing policy interest rates by 50 basis points (bps) along with a doubling of the Statutory Reserve Requirement (SRR) to 4.0%. This was followed by two more policy rate increases in January and March 2022, by a total of 150 bps. Nevertheless, the extent and the frequency of multiple risks emanating from supply shortages, exchange rate fluctuations and global commodity price dynamics rendered monetary tightening effected during August 2021 to March 2022 inadequate. Meanwhile, with the exhaustion of usable reserves, the exchange rate was allowed to adjust in March 2022. The floating of the exchange rate and resultant spike in imported inflation warranted further tightening of monetary policy, which was carried out in April 2022. An unparalleled monetary policy tightening was conducted in April 2022, with the historically highest overnight increase in policy interest rates, by 700 bps, aimed at decisively taming inflation and adverse inflation expectations while also seeking to address external stability concerns. Monetary policy communication emerged as an important policy tool in managing expectation towards the disinflation process during the unpopular policy drive. Policy tightening continued until March 2023 with a further increase in policy rates by 200 bps.

Monetary policy measures were complemented by several other targeted administrative measures and restrictions to restore price and external sector stability. Introduction of market guidance of the daily exchange rate by the Central Bank with a band in May 2022 and the continuation of the same until early March 2023 helped avoid a further escalation of price pressures through exchange rate depreciation. Other administrative measures that were already in place to limit forex outflows from the country, such as a restriction on non-essential imports, several exchange controls and capital flow measures and a surrender requirement for export proceeds, were also instrumental in stabilising the external sector and thereby the price pressures. Foreign exchange leakages through parallel market activities were also tackled through targeted measures, such as prohibiting open account imports of non-essential items. Tight monetary policy along with tightened rupee liquidity conditions, as well as high-risk premia attached to government securities, resulted in a sharp increase in market interest rates, thereby accelerating the disinflation process.

These coordinated policy efforts from the Central Bank, along with tight fiscal policy, helped in containing aggregate demand and managing adverse inflation expectations. These demand measures, with the support of easing supply conditions, helped achieve an impressive path of disinflation within a record time period and sustain inflation at low levels thereafter. Allowing the exchange rate to be determined mainly by market forces, with the Central Bank intervention being limited to building up international reserves and dampening excessive volatility in the exchange rate, brought back confidence to the foreign exchange market and resulted in an appreciation of the rupee. This contributed favourably to muted inflation from late 2023, although some imported prices continue to exhibit downward stickiness. With inflation declining faster than expected by many, the Central Bank was also able to normalise monetary policy within a short period of time, which would help with the revival of the economy in the period ahead. Figure 1.4 illustrates the increase in market interest rates, reflecting aggressive monetary policy tightening and risk premia associated with debt restructuring-related uncertainties. The figure also depicts the normalisation of market interest rates since 2023 supported by monetary policy easing following the successful disinflation.

Figure 1.4 Movements of policy interest rates and market interest rates, 2019–2024 (%)



Source: Central Bank of Sri Lanka

Fiscal measures

Notable policy adjustments in the fiscal sector that have already been introduced and are in the pipeline are expected to arrest excessive aggregate demand pressures in the economy. With the ongoing revenue-based fiscal consolidation process, government revenue has already increased from its lowest levels of between 8.2% and 8.7% of GDP observed in 2020–2022 to 11.0% by 2023. A primary surplus of 0.6% of GDP was recorded in 2023 while the overall deficit was contained at 8.3%. Under the IMF programme, the government is expected to continue to generate primary surpluses in the period ahead, thereby reducing the country's debt burden over time. Reduced financing requirements of the government and state-owned enterprises will enhance the availability of financial resources to the private sector, enabling an expansion of production capacity and efficiency of resource use, assisting in a sustainable lowering of inflation in the medium term. Meanwhile, as the impact of past high inflation on the general price level has lingered, strengthened social safety nets to improve living conditions as well as adequate adjustments to real wages of the public sector workforce will be required, along with measures to improve efficiency and productivity of the public sector.

Pricing policies

Under the IMF stabilisation package, monthly cost-reflective domestic petroleum price adjustments were reintroduced in March 2022; electricity prices were also adjusted from August 2022, initially on a six-monthly basis, followed by quarterly adjustments. The government also introduced regular cost-reflective price adjustments for cooking gas as well as water supply. Demand adjusted in response to cost-reflective prices. Although frequent revisions to domestic energy prices initially induced a more than complete passthrough to prices of related goods and services, the magnitude of direct and second-round effects of these adjustments on inflation has largely reduced since late 2023.

Central Bank independence

At the height of the socioeconomic crisis, the government recognised the need to allow the Central Bank to carry out monetary policy independently. This was reflected in the 700 percentage-point upward adjustment in the policy interest rate in April 2022. To stabilise the economy, the Central Bank maintained its close coordination with the government, as monetary policy alone, in terms of interest rate and exchange rate management, would have taken a longer time, with sharper adjustments, to lift the economy out of the crisis. This coordination required the continuation of monetary financing for a further period until fiscal policy measures generated adequate revenues.

The long-felt need for Central Bank independence, along with enhanced transparency and accountability, was answered by the introduction of the Central Bank Act in September 2023, replacing the Monetary Law Act of 1949. The new Act established achieving and maintaining domestic price stability as the prime objective of the Central Bank; introduced flexible inflation targeting as the monetary policy framework, along with a flexible exchange rate policy; removed government representation on Central Bank boards while establishing channels for coordination between the Central Bank and the government; streamlined the appointment processes of the governor and the members of the Central Bank boards; specified provisions for transparency and accountability to the Parliament and the general public; and, most importantly, prohibited monetary financing of fiscal deficits.

Since then, as envisaged in the Central Bank Act, the Central Bank and the government have entered into a monetary policy framework agreement that specifies 5% as the inflation target to be maintained by the Central Bank over the medium term, with a margin of ±2%. Half-yearly Monetary Policy Reports are published explaining inflation developments and outlook, with awareness programmes carried out at the time of their publication. Press releases are issued after each bi-monthly monetary policy review, followed by a well-attended press conference chaired by the governor of the Central Bank. The Central Bank also makes efforts to regularly update the Parliament through its Standing Committees on various issues, and has continued to improve its transparency in terms of data and information releases and other modes of communication. While the Central Bank has been able to contribute to the government's domestic debt optimisation exercise by restructuring its accumulated lending to the government, a strategy is in place to gradually reduce this stock of restructured bonds until its full exhaustion.

1.3 The way forward

The ability of the Central Bank to disinflate the economy from historic highs to low single digits in less than one year, among other achievements of stabilising the exchange rate, building up official international reserves and maintaining financial system stability, reflects the benefits to the economy of empowering the Central Bank and allowing it to operate independently. This, however, by no means represents a declaration that the difficulties facing the general public or the challenges facing the country amid its deep-rooted economic crisis are over. But the counterfactual of Central Bank inaction or delayed action could have dragged the country deeper into a crisis of unthinkable proportions. While economic conditions have stabilised, thereby providing some footing for the economy to achieve its potential, it will be essential to sustain the hard-earned gains in terms of stability in the equally challenging period that lies ahead.

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