Annex 32R -

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**Ajith Nivard Cabraal**
Governor
**Central Bank of Sri Lanka**
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**STRICTLY CONFIDENTIAL**

10th March 2022

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

TRUE COPY

Dilini Wilathgamuwa
Attorney - at - Law
Commissioner for Oaths
Deputy Director
Legal Department
Central Bank of Sri Lanka

My dear Minister,

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

Further to my previous correspondences under the Sections 64 and 68 of the Monetary Law Act, this confidential report is submitted to apprise you of the prevailing vulnerable economic conditions and the remedial actions taken by the Central Bank, while highlighting the need for implementing urgent policy actions by the Government to complement the Central Bank policy actions.

The economy is currently going through an unprecedented challenging time. The external sector is extremely challenged with drastic depletion of official reserves to an alarmingly low level. Honouring foreign debt service payments, meeting Central Bank forex liabilities and allocating funds for essential imports such as fuel on a continuous basis, have become almost impossible. Price stability is threatened with the continued acceleration in inflation and de-anchoring inflation expectations.

Considering the severity of the prevailing economic conditions, the Central Bank announced *a comprehensive policy package* on 04 March 2022 containing both traditional and non-traditional measures, along with other initiatives that have an impact on the overall economy, to counter economic headwinds and to support greater macroeconomic stability.

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**Inflation continues to increase, requiring proactive policy measures to reduce inflation to the desired level.** The headline inflation based on the Colombo Consumer Price Index (CCPI) increased to 15.1 per cent, year-on-year (y-o-y) in February 2022 from 14.2 per cent in January 2022. The National Consumer Price Index (NCPI) based y-o-y headline inflation also increased to 16.8 per cent in January 2022 from 14.0 per cent in December 2021. Inflation, which has accelerated to double digit levels since the latter part of 2021, could be expected to increase further in the period ahead with evolving global and domestic supply conditions. In addition to the supply disruptions and increase in global commodity prices that contributed to this acceleration, rising demand pressures, primarily due to the continuation of excessive monetary expansion, is also visible from the increase in core inflation.

- **As a part of *the policy package* to curb the inflationary pressures and complement greater stability in the external sector, the monetary policy stance of the Central Bank was further tightened on 04 March 2022 by raising the policy interest rates of the Central Bank by 100 basis points, while revising interest rate caps on some lending products upwards.** Accordingly, during the current tightening cycle, the Central Bank has increased policy interest rates by 200 basis points. The increase in interest rate consecutively in this magnitude is an unprecedented move by the Central Bank, taking into consideration of the threat to the price stability.

- **The Central Bank has also allowed greater flexibility in the exchange rate commencing 07 March 2022.** While allowing greater flexibility, the Central Bank has given guidance to the banks that foreign exchange transactions should take place at levels which are not more than Rs. 230 per US dollar in order to ensure some initial stability in the domestic forex market, while the additional incentive of Rs. 8.00 per US dollar offered by the Central Bank on the conversion of workers' remittances and the incentive of Rs. 10.00 per US dollar on the conversion of foreign currency notes held in hand have been discontinued. While there would be no assurance that the exchange rate would be around that specific rate, the Central Bank expects that the greater flexibility in the exchange rate would boost workers' remittances, discourage imports as well as benefit local exporters. However, to improve sentiments and confidence of the market, (particularly given the unavailability of foreign reserves to manage a market driven exchange rate at desired levels) certain complementary measures will also have to be implemented by the Government.

- **Accordingly, to complement the Central Bank's efforts, the following *8-point strategy* has been proposed to the Government for immediate implementation:**
    a) **introducing measures to discourage non-essential and non-urgent imports** urgently based on the previous recommendation made by the Central Bank
    b) **increasing fuel prices and electricity tariffs immediately**, to reflect the cost
    c) **incentivising investments** and **foreign remittances** through the measures, which are not linked to the exchange rate
    d) **implementing energy conservation measures**, while accelerating the move towards renewable energy
    e) **increasing government revenue through suitable tax increases** on a sustained basis
    f) **mobilising foreign financing and non-debt forex inflows** on an urgent basis
    g) **monetising the non-strategic and underutilised assets**, and
    h) **postponing non-essential and non-urgent capital projects**

The above measures would ensure that a coordinated approach is adopted to overcome the challenging economic circumstances faced by the country and to prudently exit the COVID-related policy accommodation.

- **While appreciating the Government's efforts to improve workers' remittances through incentives, the Central Bank is of the view that the proposed additional incentives for workers' remittances by the Government should not be linked to the exchange rate due to the Article VIII considerations of the IMF, but may be implemented in an alternative manner.** Moreover, provision of additional compensation by way of an incentive scheme for exporters may need to be implemented continuously at this stage, given that the Central Bank has now allowed greater flexibility in the exchange rate, which is a natural incentive for those expatriate workers.

- **In addition to the above *8-point strategy*, the following recommendations are also made for the consideration of the Government.**

    - Take urgent measures to address the prevailing power crisis and fuel shortages

    - Discontinue further monetary financing as the Central Bank is no longer in a position to finance Government requests to meet its regular cashflow requirement through issuance of Treasury bills to the Central Bank.

    - Reduce the Significant borrowings by the two state banks from Central Bank's overnight window

**Finally, let me assure you that the Central Bank is pursuing every possible measure to overcome the difficult period faced by the economy at present. At the same time, we remain hopeful of the efforts and commitment of the Government to resolve the current economic situation, which is vital to strengthen the stability of the overall economy.**

Yours sincerely,

Ajith Nivard Cabraal

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

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