ACHIEVING STABILITY AMIDST UNCERTAINTY

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> *ONE CAN SAY IMPORT SUBSTITUTION IS THE WAY FORWARD. BUT I THINK WE CAN RELY ON THE SAME ONLY UP TO A CERTAIN EXTENT. THAT IS NOT THE ONLY SOLUTION. LOCAL BUSINESSES SHOULD FOCUS ON INCREASING LOCAL VALUE ADDITIONS*

> *“CAUSE FOR THIS CRISIS IS THE CUTTING DOWN OF THE TAX RATES CHARGED BY THE GOVERNMENT WITH THE INTENTION OF BOOSTING ECONOMIC ACTIVITY. HOWEVER, GIVEN THE TAX REFORMS WERE CARRIED OUT DURING THE VERGE OF THE PANDEMIC, THE EXPECTED TRIGGER WAS NOT VISIBLE DUE TO THE DECELERATED VOLUMES OF ECONOMIC ACTIVITY. ACCORDINGLY, THE RESULT WAS, DETERIORATED GOVERNMENT INCOME RESULTANT FROM REDUCED TAX RATES, WHICH GAVE RISE TO THE NECESSITY FOR THE GOVERNMENT TO PRINT MONEY TO FINANCE THE GOVERNMENT BUDGET DEFICIT”*

What do you believe as the main causes that led to the existing forex situation in Sri Lanka?

Well, it is a known fact that Sri Lanka is currently facing a strongly felt economic crisis, and when this economic crisis is discussed, one main aspect which has made Sri Lanka burdened severely is its debt servicing requirement. Years extending from 2021 to 2025 mark the duration within which we, as a country, being obliged to make the highest ever debt repayment in -our history, amounting to approximately 4.4 billion USD on average, annually.

Even though this commitment was a known fact, since 2019 the foreign inflows to our country got negatively affected mainly due to the combined impact of easter attacks and the upsurge of the Covid-19 pandemic. Due to the global pandemic, the forex inflows from our main exports such as tea, rubber, and garments underwent a sharp decline due to the fall in global commodity prices. Furthermore, the remittance from tourist arrivals, which was one of the major foreign currency earning streams to Sri Lanka, also dropped drastically due to the travel restrictions and health related concerns of the Covid-19 pandemic.

Furthermore, our foreign currency inflows had a strong hit, as many of the Sri Lankan workers employed aboard lost their jobs due to the spillover effects of the pandemic, resulting a drop in remittances.

Amidst all this chaos, in order to keep the economy relatively stable and trigger economic activity, several measures were taken. As an internal measure taken by the governing authorities of the country, the foreign exchange rate was fixed for a longer period by depending on the rupee using the reserves. Furthermore, interest rates were maintained at a relatively low level for a longer period of time, which gave rise to an increase in private credit. This subsequently led to increased consumption as well as heightened demand for imports.

Another cause which I can highlight as a cause for this crisis is the cutting down of the tax rates charged by the government with the intention of boosting economic activity. However, given the tax reforms were carried out during the verge of the pandemic, the expected trigger was not visible due to the decelerated volumes of economic activity. Accordingly, the result was, deteriorated government income resultant from reduced tax rates, which gave rise to the necessity for the

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government to print money to finance the government budget deficit. I believe these are the main causes that led to the foreign exchange crisis which we are currently facing as a country.

How does the current forex crisis impact the stock market performance?

I can say, the crisis situation has led to mixed outcomes simply because, when the context is analysed, it can be seen that, the export-oriented companies have been better off, whereas companies relying on material importing have been negatively affected. When talking about the listed companies engaged in importing raw materials for production purposes, we can clearly see that those listed companies have been negatively affected due to the exorbitant increase in their production costs triggered by the currency depreciation and also due to import restrictions. An important comment to be made at times like this is that any positive news on forex will boost investor sentiment and affect the stock market performance positively. In fact, at this moment of time, we are facing mixed outcomes as mentioned before. However, we are now in a transition phase and any slight positive news will affect the stock market positively.

What kind of impact does it have on investments done by foreigners? Does the current forex crisis result in dollar outflows in terms of foreign investors leaving the country? How does it further accelerate the problem?

During the pandemic situation, it could be seen that all Central Banks across the world were reducing interest rates, and Sri Lanka also did the same. When reflecting on our stock market performance, it could be seen that it has been performing well since 2020. The foreign investor contribution to our market in year 2018 was as high as 44%, whereas in 2021, the foreign investor contribution was only 5%. Accordingly, during 2021 local investors were dominating the market. It was during this time; Sri Lanka's rating was downgraded by several leading global rating agencies. This was a situation that was pre-read by foreign investors well in advance, which was the reason for the net foreign outflows recorded since 2018, when the peak of the outflows happened in 2021. During this time, the exchange rate was fixed, and foreign investors were anticipating a currency devaluation in the time to come, so they left the market at its peak. After January 2022, we were able to see the indexes were crashing. By March 2022, the currency was allowed to be depreciated, and as a result, we could see foreign inflows during the March-April 2022 period. This is actually a good sign. Even up to this point in the month of May, we could see foreign inflows. If you carefully look at the situation, you will be able to see that most foreigners exited the market before the crisis because they had pre-read the situation very well. Hence, after the devaluation, the stocks have become very cheap for them, hence they are showing a coming back tendency.

What do you think are the biggest challenges faced by Sri Lanka in overcoming this situation in the short run?

As of now, we are having clear issues in purchasing essential items, especially food, medicine, fuel, and gas. This has resulted in the formation of massive ques all over the country, and it is currently one of the most serious challenges facing everyone in Sri Lanka, including you and me.

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Furthermore, we have announced a suspension of external debt payments and now we are in the process of restructuring. Once we restructure external debt, we can possibly seek assistance from the IMF program, and we will be eligible for the expedited fund assistance program as well. If we can sign up with the IMF program, it will surely boost investor confidence and also support the reserve base and, subsequently, the currency value. However, it will take approximately 3-6 months to sign the IMF agreement to bail out, and until such time, we will need support from other multinational organizations such as the World Bank, and Asian Development Bank as well as friendly nations. We need to have a bridging mechanism to manage this time gap until the IMF program activates support towards the fulfillment of these immediate essential item requirements. Since we have currently suspended external debt, we have the ability to hold payments until we do the debt restructuring. Once restructuring is done, we will be eligible for a longer tenure for debt repayment, which will reduce the pressure on our reserves and currency. With the signing of the bailout agreement with the IMF, we can anticipate some investments and aid. I think then we will be able to resolve this issue.

What do you think are the long-term repercussions of a prolonged forex crisis?

Currently, due to the absence of essential items such as food, medicine, fuel, gas, etc., there are clear signs of social unrest. It has already affected people, especially those who are in the vulnerable segment of society. Therefore, it is extremely clear that these essential item shortages and exorbitant price increases have badly affected the vulnerable segment of society.

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Hence, adapting the social net to protect them is vital. Therefore, we really need to address these issues as soon as possible without giving room for these problems to worsen.

And also, if this forex crisis continues for a longer period, it will clearly affect the business climate as well. Today, most businesses are facing difficulties in terms of sourcing raw materials as well as due to prolonged power cuts. The input costs have increased resulting in product price increases, which in turn has hindered the competitiveness of local exporters among global companies in the world market. Some foreign companies may discontinue buying from Sri Lankan companies/ parties and they may decide to relocate their orders to other countries that are in the same business. As of now, it can be seen that sincere and valid concerns are being raised by foreign buyers because they doubt our ability to supply their shipments on time. If these foreign clients decide to relocate their business deals to companies elsewhere, Sri Lanka will have to face bigger problems such as job losses, and export reduction, which will in turn affect the forex inflows. Since almost all these issues have interconnectedness, it is vital that all possible steps are taken to solve this crisis as soon as possible.

What is your opinion in government seeking assistance from IMF in the current situation?

Seeking assistance from the IMF is a must. Being frank, we are already late. We should have gone to the IMF a long time before. We have started technical level discussions with the IMF. As of now, the IMF's view on our debt situation is that it is unsustainable. Therefore, we need to take immediate steps to restore debt sustainability as per the advice of the IMF. Currently, we are already in the process of restoring debt sustainability. As per the initial IMF advice and assistance, we have now taken steps to tighten the monetary policy as well. In par with the executions, the Central Bank of Sri

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Lanka also announced that open account imports have been suspended. Sri Lanka really has to seriously seek an IMF bailout now to get out of this hard situation. We have sought IMF assistance 16 times in the past. Hence, an IMF bailout or working with the IMF is not a very new thing to Sri Lanka.

What steps can local businesses adopt to limit the outflow of foreign currency from Sri Lanka?

One can say import substitution is the way forward. But I think we can rely on the same only up to a certain extent. That is not the only solution. Local businesses should focus on increasing local value additions. We currently import, reprocess, and export because we are an import-dependent country as of now. If a comparison is being made, our import value is double the value of the exports we do. However, what the local businesses should focus more on is improving the local value additions and, subsequently, improving the exports. Such a vision and strategy will help us to reduce the trade gap we are currently facing as a country., Another area we can capitalize on is our service exports. Sri Lanka can even have a strategic direction to emerge as a service outsourcing destination. These are the main things I can think of as an answer to your query.

What do you think as the long-term policy measures required in attracting sustainable dollar inflows to the country?

I think most countries have gone through similar crisis situations in the past, and the most recent experience I can recall is the Asian financial crisis. If we look at the countries affected by the Asian financial crisis, it could be observed that almost all affected countries have recovered and are doing well at present. Therefore, what we, as a country, need to do is to consider this hard situation as a blessing in disguise. We can actually consider this to be a golden opportunity we have gotten once in a lifetime to correct our structural weaknesses. When looking at this forex crisis, it cannot be viewed as an isolated problem. We cannot seperate the forex crisis and discuss and solve it because all that we are discussing are interconnected problems. When Sri Lanka is concerned, it is a country with a twin deficit. We, as a country, have a trade deficit as well as a fiscal deficit. Hence, it is important that we attempt to solve these twin deficits whilst solving the forex crisis since all these are interconnected. Hence, the best approach is to try and address all these 3 problems simultaneously to arrive at a sustainable solution.

To address this issue, we have already made the currency float and raised interest rates in order to tighten monetary policy, which will aid in slowing private credit and imports. Furthermore, we strongly need to ensure political stability, which will trigger investors as well as multinational lenders to support us with the necessary reforms. Adding to that, we need to focus on external debt restructuring. Currently, we are in the process of appointing legal and financial consultants for this cause. Once appointed, these erudite parties can initiate discussions with our creditors, which will enable us to receive extensions to our debt repayment period, which will immediately help us to resolve the pressure on the country's foreign reserves. Furthermore, we have to parallelly focus on increasing taxes and the number of taxpayers, which will enhance our tax-revenue-to-GDP ratio.

Currently, we have one of the lowest tax-revenue-to-GDP ratios in the world. If we enhance our focus on this, we will be able to increase government revenue, which will help reduce the fiscal deficit we are facing as a country. Subsequently the government can reduce money printing and the Central Bank credit can also be reduced. However, while making all of these changes, it is critical to maintain the social networks in order to protect the most vulnerable segment of society. This is because when the taxes are increased, the commodity prices will increase, and consequently it will affect the poor segment of the economy. Therefore, a well-designed mechanism to protect those people is required. It is possible to get assistance from multinational lenders such as the IMF and World Bank to get a suitable social net program designed.

Subsequently, we will have to have reforms with market pricing related to fuel, gas, and other state services. We can start off with cost recovery pricing, after which we can subsequently move on to market based pricing. We also need to take steps to reduce inflation. By the end of April 2022, inflation has risen to nearly 30% and Sri Lanka has been identified as the nation with the second highest inflation in the world. This inflation is a result of both supply and demand implications. Hence, we need to focus on reducing inflation results from both sides, which will help the country to have a smooth impact in the medium term as well. Another thing that can be done immediately is the potential sale or lease of state-owned commercial assets, which will ease the foreign reserve crisis as well. However, this needs to be done smartly. On medium and long-term basis, what I see is, we need to improve "the doing business index" and also focus on improve country ratings. If we can do so, we will be able to attract new investments and FDIs, and then we need to work on diversifying the exports while focusing on increasing local value additions. Another important thing to be considered is reforming the state sector to attract foreign investment to rebuild the economy and repay the loans. These structural economic reforms are extremely important. As I mentioned before, we have actually received a golden opportunity to restructure the needful aspects of our economic system. Therefore, we need to take all possible steps and efforts to bring in the much needed and much delayed structural reforms that will assist us to rebuild the economy. Simultaneously, we need to address and increase the tax revenue -to-GDP ratio. Improving focus on enhancing the skill portfolio of the labor force in line with global requirements is another advisable move we can take as a country. This will help the locals to find overseas jobs, which will lead to a future inflow of foreign remittances. Promoting tourism should also be a major focus, as it will have an overall positive impact on our dollar reserves.

By Tharani Sooriyaarachchi & Vageesha Rajapakse