

Speech at the Parliament on 04 May 2022 by
Honorable Ali Sabry, the Minister of Finance
to brief on the Present Status of the Sri Lankan Economy and Way Forward

Honorable Speaker, At this critical juncture of Sri Lanka's post-independence history, I am addressing this august house today to deliver my first special statement as the Minister of Finance.

The country is battling with unprecedented socio-economic and political challenges. The root causes of these challenges go back to several decades of economic history although more recent developments have aggravated the situation into an acute crisis.

There are critical developments that need urgent attention. Inflation has risen to extremely high levels making the cost of living unbearable, foreign exchange reserves have depleted significantly, and the exchange rate has rapidly depreciated, all of which have contributed to the crisis. A foreign debt repayment standstill has been announced as an interim measure. There is a shortage of essential items, including fuel, LP gas, pharmaceuticals, and raw materials while power outages continue, and people are demonstrating on the streets against their economic hardships.

Fundamental macroeconomic weaknesses in the economy have been decades in the making. This includes fiscal instability, accumulated debt overhang, low productivity and persistent current account deficits. Recent shocks such as the COVID-19 pandemic and the Ukraine conflict have exposed these underlying weaknesses. However, **we should also be humble enough to admit that this situation has occurred due to some of the misaligned and imprudent policies implemented in the recent past** as well.

This is indeed a serious situation. **I believe the time has come to follow a professional approach in resolving these issues rather than being swayed by ideological inclinations.** I accept the fact that the aggravation of the issues was due to the delay in restoring fiscal and debt sustainability and failing to preemptively address the decline in foreign reserves. Sri Lanka should have focused on regaining capital market access by establishing a credible path of macroeconomic stabilization, supported by institutions such as the IMF.

But now, rather than trying to find fault, it is important to identify the reasons for this situation and concentrate on the way forward. **The public protests send the message that we need to be serious in providing professional and sustainable solutions.** An important part of this is being transparent and forthright regarding the challenges ahead of us and the fact that there are no painless solutions to choose from.

Often times in Sri Lanka's history, successive political actors have painted rosy pictures and made promises that lack realism and credibility. Every time there has been an attempt to establish long term solutions, these are reversed in the next election cycle with a promise of short-term benefits and relief. We see today the adverse outcome of these stop-go policies – and the public has rejected this as reflected in the protests we see today.

It is time for Sri Lanka to establish a broad political consensus on the economic path forward for the country. An economic path underpinned by fiscal and monetary discipline, a focus on enhancement of productivity, and ensuring equitable outcomes by protecting the most vulnerable sections of our society.

We must understand the root cause of the issue, i.e. the unsustainable fiscal policies adopted by many successive governments. We should be humble enough to accept the fact that **we as a country have lived beyond our means.** Without proper checks and balances, all governments have spent much more than what they earned, of course with the approval of this august assembly, as the responsibility for public finances comes under the Parliament according to our Constitution. In my view, what is happening right now is that “**we reap what we sow**”.

The time has come to focus on sustainable solutions. The fundamentals of the remedies are quite straightforward. Manage expenditure within the framework of a reasonable revenue stream **with a sustainable debt position, rather than placing the burden of a huge debt pile on generations to come.**

But, to do that, we must make changes. Changes to the way we manage the fiscal operations and the entire economy. We should undertake reforms, to remove bottlenecks that hinder our economic progress. **We must be futuristic and wise to take decisions** in the name of the progress of the economy, progress of the country.

The Parliament must give priority to implement tax reforms to increase government revenue and rationalize expenditure whilst ensuring public investment in critical areas such as education, healthcare, and social protection. Macroeconomic policy must be tailored towards boosting national savings, channeling public and private investment towards productive sectors, whilst driving productivity and competitiveness in all aspects of the economy.

We need to take tough decisions in reforming state owned business enterprises, encourage competitive market mechanisms where possible to achieve best outcomes at lowest cost to society. We must learn to harness the immense productive potential of market forces, whilst being fully aware of market failures and providing appropriate intervention to ensure just outcomes for society. We need to build up credible systems to improve public sector efficiency and productivity.

The decision to seek the assistance of IMF is important in this context. An IMF programme will be a catalyst to undertake these much-needed reforms and will provide a signal to the rest of the world that we are serious in addressing our economic difficulties. But we must realise that the economic reform programme we embark upon must be a programme with Sri Lankan ownership. We must put forward a professional and analytically robust economic plan, where the IMF will also provide technical assistance and then endorse. Without that Sri Lankan ownership, and without broad consensus of the legislature, we would not succeed in providing permanent solutions for our longstanding economic issues.

Whilst we are facing deep economic challenges at present and our first priority is macroeconomic stabilization, let us not lose sight of the immense potential Sri Lanka has as an Indian ocean economy at the doorstep of the most dynamic economic growth centres in the world. We must continue to position ourselves to take advantage of these opportunities through appropriate engagement in regional and global economic value chains. Towards this end, we must invest in education, healthcare, clean energy, public transportation, social protection, and sustainable infrastructure.

In this process, **the private sector needs to play a greater role in driving employment and growth.** Sri Lanka needs to have a more globally competitive, export-oriented economy that is conducive to Foreign Direct Investments (FDI) with appropriate policies.

In so doing, we should take decisions underpinned by evidence-based research. I am in the process of establishing a Research and Analysis Division in my office at the Ministry of Finance. Very soon we will have a set of Advisors also in the Ministry of Finance. This will help us to promote new ideas and deliver a professional approach to economic policy making.

How did the situation escalate to the present crisis?

- The **budgetary operations of Sri Lanka, over the past several decades continued to suffer several weaknesses**, as reflected by most of the key fiscal variables. This includes a sharp decline in government revenue mobilisation, high and rigid recurrent expenditure, high concentration of capital expenditure towards certain sectors and persistent fiscal deficits that resulted in huge debt accumulation.
- The **spillover effects of the above fiscal imbalances** complicated the conduct of monetary and exchange rate policies as well.

- Thus, the Sri Lankan economy displayed twin deficits, having both an external current account deficit and a government budget deficit, simultaneously.
- Continuous budget deficits have led to accumulated public debt, which is now unsustainable.
- In this process, I do not rule out the element of corruption, and this is why we need to emphasize the institutional factors such as an independent judiciary, a credible Central Bank and a strong public service.
- At present, the Sri Lankan economy is in an extremely challenging situation and this has triggered social turbulence and political instability. This may lead to catastrophic consequences if the fundamental issues are not addressed immediately.

What triggered the recent crisis in Sri Lanka?

- As I indicated above, the fiscal sector was suffering from persistent weaknesses over many years.
- However, in late 2019, the government introduced substantial tax cuts, aimed at stimulating economic activity without addressing the fundamental weaknesses I mentioned above.
 - However, the intended results of this measure were not realized with the outbreak of the COVID-19 pandemic in Sri Lanka, which aggravated the situation in Sri Lanka.
 - Further, **the revenue foregone due to the tax cuts introduced in late 2019, which was estimated to be more than Rs. 500 billion**, has resulted in sovereign rating agencies to downgrade Sri Lanka to near default levels.
 - **In my view, these tax cuts should have been gradually reversed in the new environment created by the COVID-19 pandemic.** What transpired instead was that the revenue loss led the Central Bank to print money and help the government to finance the deficit.
 - The rating action amidst volatility in global liquidity conditions, constrained Sri Lanka from accessing international capital markets.

- This prevented the government from raising fresh capital to refinance the maturing debt.
- As such, the country gradually utilised its foreign currency reserves to maintain its unblemished debt service record.
- Meanwhile, the major hit to the tourism industry together with the slowdown in the workers' remittance inflows, further aggravated the tight foreign currency liquidity position in the market, exerting further pressure on reserves.
- The price controls, in the form of a fixed exchange rate, regulated interest rates, unrealistic petrol, diesel and LP gas prices, and other administered prices, made the situation more complex. The release of these pressure points is now reflected in high inflation.
- The developments in the global economy after the COVID-19 pandemic and the more recent Ukraine crisis added further pressures on the Sri Lankan economy.
- By end 2019, the Central Bank reserves amounted to USD 7.6 billion. By end 2020, the reserves were declined to USD 5.7 billion as a result of gross inflows of USD 5.8 billion and outflows of USD 7.8 billion, including foreign currency debt service payments of USD 6.0 billion.
- The reserves declined further to USD 3.1 billion by end 2021 consequent to the gross inflows of USD 7.9 billion and outflows of USD 10.4 billion, including foreign currency debt service payments of USD 6.8 billion and provision of foreign exchange of USD 1.2 billion to finance essential imports.
- Given the shortage of foreign currency flows to the commercial banks, **the official reserves at the Central Bank were utilized to meet foreign exchange needs related to the import of essential items**, including fuel, coal and LP gas, pharmaceuticals, and other essential items, starting from August 2021.
- Consequently, official reserves declined to USD 1.9 billion by end March 2022. However, the bulk of these reserves, including the USD 1.5 billion equivalent SWAP facility from People's Bank of China (PBOC), are not usable to settle USD denominated payments.
- **Hence, as of now, the usable liquid reserves are at negligible levels, severely impacting importation of essentials, including fuel, LP gas and pharmaceuticals.**
- **I would not hesitate to inform this august assembly that the government is struggling to find enough foreign exchange to finance these essential imports.** Therefore, we need urgent solutions as a country to restore supply chains on

essential items, to address the grievances of the people and to move forward on a reform programme and to work on bridging financing and also to implement medium to long-term growth-related policies.

- **However, political stability and support from all parties including the private sector are vital factors for us to implement this much needed reform agenda.**

Conclusion

- The above analysis summarises the major issues faced by the country right now, particularly in the fiscal sector.
- We have a critical and deeper issue at hand that needs careful consideration and well-thought-out solutions.
- These are accumulated issues in the past over many decades under successive governments. Fortunately, or unfortunately, the current Parliament has been compelled to find solutions.
- So, it is our responsibility to work as a team to better understand the situation and come up with solutions with much needed reforms with the support of all the members.
- There is no doubt that many of these reforms will be painful. Hence, we must take care of the vulnerable segments in the society through appropriate robust social safety nets.
- I take this opportunity to appeal the citizens of Sri Lanka on this matter at this critical juncture. I wish to say that we hear your voice very well. What we need to do is make corrections to the previous mistakes and put the fiscal operations and for that matter, the country's future path, in the right direction.
- It will be very challenging, but we must do it for the betterment of the present generation as well as the generations to come.
- **As the proverb we all are familiar with says, "A Journey of a Thousand Miles Begins with a Single Step".**
- What this means is that the great things commence with simple beginnings.
- So, we must begin our journey to reach the goal of creating a sustainable fiscal position and a better and stronger country in the future for our citizens, by taking these first steps, with determination.
- This is important now more than ever¹.

¹ A note on "*Fiscal Sector Performance*" is given in Annex I, the Information Series Note No. 1 published on 28.04.2022 by the Ministry of Finance on the "*Fiscal Sector: Present Situation and Way Forward*" is given in Annex II and press release on "Recent Visit of the Sri Lankan Delegation to Washington DC to attend IMF/World Bank Spring Meetings" published on 28.04.2022 is given in Annex III for the information of the Members of the Parliament.