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Keynote Address

Integrated Governance for Sustainable Development in the Post Pandemic Milieu

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It gives me great pleasure to be with all of you this morning at the 8th Ruhuna University International Conference on Humanities and Social Sciences – 2022. The theme of today's conference is "Integrated Governance for Sustainable Development in the Post-Pandemic Milieu." I firmly believe that we all share the same view that the COVID-19 crisis is global, and never have we experienced such a health crisis in history. We are now living in the "new normal" era. However, we refer to it as post-COVID-19, in which everyone must be ready for changes, including leaders, organizations, government agencies, and citizens.

As we all know, the COVID-19 pandemic started in China sometime in late November 2019 and has spread to other parts of the world since early 2020, which resulted in roughly 633 million cases and 6.6 million deaths as of last week. As the number of cases increased rapidly, the WHO declared the COVID-19 pandemic on March 11, 2020. On September 14, 2022, a few months ago, the WHO announced, "We are not there yet, but the end is in sight". This is the beginning of the new normal, but there have been 18 million cases reported globally during the last two months. It is not entirely over yet, but many governments have decided to continue relaxing the rules and restrictions imposed during the pandemic. It is well accepted that the COVID-19 pandemic is not only a health crisis faced by people in every corner of the world, but that it has also had a detrimental effect on people's lives and economies globally.

The effect of COVID-19 on the world economy threatens various sectors, but the impact will vary from sector to sector and country to country. Today, governments are fighting against rising inflation caused by high oil prices due to growing demand during the post-pandemic. As a result, we are experiencing unaffordable commodities prices that create havoc in our daily life, increasing poverty and inequality domestically, especially in developing countries.

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Currently, every government is facing challenges in supporting economic recovery. However, there is no unique solution to this problem; therefore, governments may make different choices to overcome economic and social challenges depending on their priorities, aiming to recover hugely impacted sectors due to the pandemic to support economic recovery. Some experts suggest increasing investments, increasing revenue while reducing costs, and creating jobs to support the workforce who lost jobs and people who had to postpone employment opportunities due to the pandemic.

Let's have some background on the financial landscape in the post-COVID-19 period. During the global financial crisis, the Fed's expansionary monetary policy was in line with its dual mandate of maximum employment and price stability, which necessitated a decline in the unemployment rate and an increase in the inflation rate.

During the early stage of the pandemic, the Fed took similar policy actions by cutting its target interest rates to zero and quantitative easing as a solution for the economic recovery from the pandemic. As a result, inflationary pressures from supply chain disruptions were compounded by a quick recovery in demand and a tighter labour market.

However, Russia's invasion of Ukraine and its effects on commodity markets, especially on oil prices and supply chain disruptions, caused high inflation resulting in a slowdown in global growth, making expansionary monetary policy unsuccessful.

Major problems plaguing the financial system today include inflation at multi-decade highs, deteriorating economic outlooks in many regions, and ongoing geopolitical uncertainties that tighten financial conditions despite central banks' efforts to ease them through interest rate hikes.

In theory, central banks increase interest rates to curb rising inflation and maintain price stability. A higher interest rate discourages consumption and investment by raising the minimum lending rate to individuals and businesses. As a result, inflationary pressures ease as aggregate demand falls.

The Fed raised interest rates for the sixth consecutive time this year, with the latest hike coming in November 2022. (This brought borrowing costs to their highest level from zero to 3.75 – 4%). In response to the interest rate hike, inflation was eased slightly, yet the decline is not compelling enough. This means the federal fund rate is expected to continue rising in the coming months, even surpassing 4%.

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Nonetheless, the Fed raising the interest rate to curb the elevated domestic inflation in the US has had sweeping implications across Asia and the globe. High external borrowing costs, persistently high inflation, and volatile commodities markets are just a few of the threats that these countries must contend with. Similarly, Sri Lanka is also confronted with heightened uncertainty regarding the global economy and policy tightening in advanced economies.

First, the rising interest rate may hinder Sri Lanka's recovery from the pandemic by reducing global liquidity. The international liquidity in Sri Lanka in terms of the total reserves (excluding Gold), plunged by 21.59% from 2020 Q1 – 2022Q2, although the real GDP of the economy improved by 7.99%.

Nevertheless, businesses may experience a tighter credit environment paying more to borrow money, which cuts into their profits and discourages them from investing. Consumers are less likely to make large purchases when interest rates go up, especially on durable goods and services. As a result, export- and manufacturing-dependent economies like Sri Lanka will feel the effects of a decline in global demand and growth. Increasingly stringent financial constraints, weakening fundamentals, and significant susceptibility to commodity price volatility have all contributed to deterioration in the state of Sri Lanka, especially for a smaller developing economy.

Because of the United States' ever-increasing influence over Asia, investors have pulled money out of the region's economies in response to recent monetary tightening, leading to a depreciation of the regional currencies. Investors have become more risk apprehensive due to rising economic and policy uncertainty, which puts pressure on global markets. As monetary policy has tightened, the economic outlook has worsened, recession fears have intensified, and the value of financial assets has declined. Borrowing costs for many governments and firms have reached their highest levels in a decade or more as bond yields have risen across the board.

Sharp currency depreciation further increased the inflationary pressures through higher import prices of food, worsening of commodity prices and oil prices, and worsening of the current account balance. In Sri Lanka, the inflation rose sharply by 29.96% from 2020Q1 to 2022Q2, followed by a worsening trade balance of 38.25% from 2021Q2-2022Q2. Recently, Sri Lanka experienced an all-time high inflation hike of 69.60$ in September of 2022. This may indicate that Sri Lanka is experiencing a hike in imported goods prices, thus exacerbating the domestic prices in the economy. Furthermore, with these sudden hikes in domestic prices, household consumption in Sri Lanka drastically dropped by 9.34% from 2020Q1 to 2022Q2.

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With the sharp hike in inflation, economies like Sri Lanka with high import levels may struggle to pay for necessities imported from outside and interest on their loans incurred abroad. Furthermore, governments of similar situation economies are incurring more and more debt, and nonbank financial organizations like insurers, pension funds, hedge funds, and mutual funds are particularly susceptible due to their increased exposure to market risk. Rising rates have added a new layer of challenges for businesses with weak (or leveraged) balance sheets. The loans and advances amount to an 11.09% increase from 2020Q1 – 2022Q2, and 21.05% drop in commercial banks' deposits in Sri Lanka.

Accordingly, Sri Lanka must be wary and watchful about its enormous or rapidly expanding debt burden, which could exacerbate economic and financial vulnerabilities. This is especially true for economies like Sri Lanka that rely heavily on dollar-denominated debt from foreign lenders and are already grappling with rising servicing costs or cash shortages. Nonetheless, the policy responses of Asian economies to the Fed tightening of the monetary policy largely depend on the prospect of domestic inflation, growth, and financial stability in these economies. In the case of Sri Lanka, it is evident that the inflationary pressures continue to rise with a slight fall in the unemployment level.

Central banks in the region have raised their policy rate in response to these events, influencing all other interest rates, such as the commercial bank interest rate applied to their borrowers and depositors. In other words, a rise in the policy rate discourages the purchasing decisions by households and corporates due to higher borrowing costs, thus reducing inflation. However, as Sri Lanka is facing persistent currency depreciation pressure, hiking up of policy rates may not be sufficient to control capital flow management policies to deal with potentially destabilizing and unwanted capital outflows.

Generally, there is an increase in financial instability, capital outflows, and currency devaluation in Asian economies when the US tightens its monetary policy. The fluctuation of interest rates creates asset price uncertainties, making it more difficult and taking longer for certain asset classes to trade at a given price. In combination with existing weaknesses, low market liquidity might accentuate any sudden, uncontrolled reprising of risk.

This suggests that the high inflation rate linked with a rise in commodity prices presents policymakers with difficult issues, as they must balance the competing goals of maintaining price stability and fostering economic growth. These difficulties

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are especially severe in Sri Lanka and other developing economies because of the severe economic downturn and poor economic recovery from the COVID-19 crisis.

The above scenarios suggest that Sri Lanka will not be immune to spillovers from global markets, especially the pressure from rising commodity prices globally. In this environment, understanding the risks to the economy is more important than ever. This presentation will focus on three economic sectors impacted by the COVID-19 pandemic; (1) commodity prices, (2) financial sector, and (3) currency market to assess the risk spillover and connectedness among assets for the pre-COVID and COVID periods.

The vast literature suggests that the interconnectedness of risks between commodity, currency, and equity markets has strengthened over time. Broadly, interconnectedness refers to the degree of interactions between financial institutions, markets, or economies. According to conventional wisdom, the highly interconnected structure of banking systems or markets is caused by globalization. Cecchetti (2012) argues that financial globalization benefits the economy up to a point and that high levels of integration could weaken the financial system. COVID-19, apart from being a health crisis, has also created uncertainties in various sectors of the economy, with an increase in market volatilities as the economies become much closer during the crisis. When countries are more connected, the spillovers from one economy to another or market to another may transmit systemically. Systemically transmitted risk can be broadly defined as the likelihood that an event at the institutional level could trigger severe instability or collapse of an entire sector or economy.

To further explore the mechanism of the transmission and repercussions of the connectedness, firstly, I present the finding on the intensity of risk spillover for the commodity market in detail. From the regulatory perspective, analyzing the role of dependencies among financial markets could help policymakers understand the risk exposure that distress the economy. Secondly, the findings on the strength of the interconnectedness in the financial sector, which measure the roles of direct and indirect dependencies, are presented.

The connectedness of financial and economic variables has increasingly become more critical for financial market participants and policymakers alike, especially after the global financial crisis (GFC). An in-depth understanding of the connectedness of the commodity market is vital in determining Sri Lanka's international financial risk level.

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In the context of Sri Lanka, it is critical to understand how the connection between the prices of financialised commodities and oil prices affects the domestic economy. With the depreciating domestic currency and the high dependence on oil, a spillover effect of financial risk increases the stress between the price movements in the international market and the risk indicators, creating price uncertainties in the domestic market.

Therefore, the proposed methodology for examining spillover by Diebold and Yilmaz (2009), and extended work by Chatziantoniou (2021) is used for the analysis to provide insight into the connectedness of the commodity market and assess the spillover effect. This approach allows us to better capture the connectedness dynamics within the network of our selected financial variables. The empirical findings of this study will be useful as a source of information in formulating economic policies for the post-COVID period.

A daily data set including prices of commodities such as oil, corn, cocoa, gold, cotton, gas and exchange rates, and the financial market index of Sri Lanka for the period of 1991-01-02–2022.09.23 is used for the analysis. The dataset was transformed into logarithmic return series for the empirical analysis. The study uses time-varying parameter vector autoregression (TVP-VAR) to analyze the connectedness of energy prices, commodity prices and the stock market.

Preliminary data analysis shows that, at the beginning of January 2022, the level of volatility displayed by the LKR exchange rate and the CSE 100 stock market index in Sri Lanka was unusually high. Both the price of oil and the price of gas had a high degree of volatility throughout the same period. The costs of essential commodities like corn showed high volatility throughout this period. The price volatility of energy prices was persistent even during the COVID-19 pandemic period. This is due to the unexpected increase in the prices of commodities and energy that followed the spillover of US monetary policy to Sri Lanka's economic fundamentals and commodity market, in addition to the ramifications of the war between Russia and Ukraine. This occurred due to the spillover of US monetary policy to Sri Lanka's economic fundamentals and commodity market.

In the year 2022, there was a noticeable uptick in the severity of the risk spillover associated with the disparity in price between oil and gas. Pre-COVID-19, oil was considered a net risk transmitter of 1.21%; however, during COVID-19, it was reclassified as a net spillover receiver of 0.23%. Cocoa went from being a net receiver of 0.79% of risk pre-COVID-19 to becoming a net transmitter of risk of 2% during COVID-19. Gas and Corn remained as net receivers of risk spillover values

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of 0.58% and 0.41% pre-COVID-19 and 0.73% and 0.23% during-COVID-19, respectively.

There are several takeaways from these findings. Firstly, these findings suggest that COVID-19 caused a change in the risk behavior of oil and cocoa prices, placing them in a state of distress. Secondly, the intensity of the risk spillover for gas dramatically rose from 0.58 to 0.73. In addition, the severity of the risk spillover associated with corn increased from 0.41 to 1.66. Similarly, the prices of several commodities were impacted by the gas risk spillover that occurred throughout this period. This was a trend that continued throughout the entire year. Thirdly, the risk spillover in commodities between corn and cocoa was significantly high at the beginning of 2020 but gradually declined as the year progressed. This indicates the gradual adjustment to food and supply chain issues that the economies faced at the beginning of the pandemic, causing the steep rise of risk spillover in the commodity market and the total connectedness amongst these markets.

This analysis clearly shows that the price volatility of the commodity market was very high and affected people's consumption and economies overall. Though Sri Lanka's influence on the global market is minimal, global prices influence a lot when the country struggles with foreign reserves.

The COVID-19 pandemic has brought out changes in how people live, how companies do their business, and how governments can move forward with digital transformations to serve their citizens effectively. Consumers, companies, and governments have moved toward online services during the pandemic. These rapid digital transformations of interacting with customers or providing efficient government services online are some positives of the pandemic. The COVID-19 outbreak has also caused disruptions in most education systems, impacting in-person learning due to lockdowns and the closure of educational institutions. However, the pandemic pushed key stakeholders to transform from the existing in-person education to online or hybrid education, providing more digital services for students. As the pandemic has been boosting progress in digital access to services and how people can interact via online facilities, it is time for governments to consider extending digital transformations into every sector as a preparation for the development of the economy in the post-COVID era. Nevertheless, managing public and private resources efficiently and effectively in the new digital age and adopting sustainable development goals as a policy is a way to a better future in the post-COVID era.