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60th Anniversary Oration of the
Central Bank of Sri Lanka

"Central Bank-Government Relationship in the Context of Emerging Economic Environment"

Speaker

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The Central Bank Relationship with the Government in the Context of Emerging Economic Environment in Sri Lanka

Introduction

It is an honour and a great pleasure for me to participate in this celebration marking the 60th Anniversary of the Central Bank of Sri Lanka. I would like to congratulate the Governor, the two Deputy Governors who are my batch mates in the Central Bank and the staff of the Central Bank on this occasion and extend my best wishes for your eventful 60th Anniversary. I recall in 1990 the then Governor late Dr. H N S Karunatilake, who was a career central banker, a distinguished economist and an independent thinker invited a team of senior officials of the Central Bank to write a series of articles to publish a Commemorative Volume to celebrate the 40th Anniversary of the Central Bank. I had the rare honour to contribute to that landmark publication by writing a paper on the subject- "Central Bank Relationship with the Government". Thereafter in 2001, the then Governor Mr. A. S. Jayawardena who is also a career central banker, a respected economist and who also served as Secretary to the Ministry of Finance and Planning before becoming the Governor of the Central Bank, invited me to deliver a lecture here at the Central Bank on 'Current issues in Public Finance and Future Direction of Fiscal Policy'. When Governor Cabraal invited me to deliver the 60th Anniversary oration without knowing this background, in fact has provided me another similar opportunity after 10 years since I presented that paper in this auditorium as the Secretary, Ministry of Finance and Planning.

Therefore Governor, I am delighted once again being able to contribute to an anniversary celebration at the Central Bank which has been an intellectual power house in this country ever since it was established in 1950. I, being a career central banker who later turned to a career in the Government, thought I should speak at this occasion on 'The Central Bank Relationship with the Government', the topic Dr. Karunatilake assigned to me to research in 1990, as I can share with you my own working experience as a member of the Monetary Board in addition to what I have learnt from reading material. Of course, I have expanded the subject to discuss the Government - Bank relationship in the context of an emerging economy environment, as between 1990 and 2010, the Sri Lankan economy has gone through a unique transition from a less developed, conflict trapped economy to a middle income, post conflict economy under a difficult global and domestic environment and also there is a paradigm shift in the economic policy strategy under '*Mahinda Chinthana - Vision for the Future'* - the 10 Year Development Framework, since 2005 - a break from the past.

Economic Transformation in Sri Lanka

In 1990, the Sri Lankan economy with a per capita income of US$ 400 was a less developed economy. The economy performed in the midst of an island wide insurgency in the South and a prolonged conflict in the North. The economy was trapped in a power crisis and in a severe capacity constraint in the available infrastructure, particularly a road network and telecommunication facilities. More seriously Governor, in 1990 Sri Lanka witnessed an annual average inflation of 21.5 percent and a monetary expansion of 15 percent. The gross official assets of the economy were US$ 435 million in comparison to the country's total current account deficit of US$ 580 million. External debt to GDP was 55 percent and external debt service had reached 20 percent. Budget deficit had been near 10 percent of GDP with the adjustment burden regrettably falling on public investments which had declined from 18 percent of GDP in 1980 to 7.0 percent of GDP in 1990. Reflecting the impact of successive high fiscal deficits, weakening of the exchange rate and a low economic growth, the level of Government debt in relation to GDP had reached near 100 percent. The rate of unemployment was 15.9 percent and households living below the poverty line were in excess of 25 percent. Economic policies of the 1980s and 1990s were very much influenced by multi lateral lending agencies and reforms based on privatization and liberalization, placing trust only on the private sector for economic development.

Today it's a different story and more encouragingly with a promising outlook. There is a paradigm shift in economic policy since 2005, recognizing the importance of infrastructure development and associated investments in the service economy, policy bias towards domestic value addition in production, integrated rural and agriculture development and placing trust on both private and public sector for economic development. The Sri Lankan economy is enjoying over US$ 2,000 per capita income and has graduated to a middle income economy status. The progress has been rapid since 2005, during which period the economy has sustained an average growth of 6 percent in spite of adjustment difficulties in the midst of a global oil price hike, financial crisis and intensified conflict till it ended in mid 1999. Unemployment has declined to 5 percent from 15 percent in 1990. Reflecting a relatively high growth and a decline in unemployment, the incidence of poverty has declined from 24 percent in 1990 to 15 percent. Public debt has been reduced to near 80 percent of GDP and the budget deficit has been contained at around 8 percent, with public investment sustaining at little over 6 percent of GDP. External debt to GDP has fallen to around 35 percent and the debt service ratio has declined to around 14 percent now. Much progress in the development of infrastructure in power generation, port and aviation facilities, road and expressway network, irrigation and supply of water and urban development and in connecting the rural economy to emerging townships so as to ensure an integrated development of the whole economy has been made in recent times in comparison to 1990s.

More importantly, the Central Bank can proudly claim for achieving the annual average inflation of around 6 percent with lower growth in monetary expansion - a great success the Central Bank has achieved in performing its primary responsibility - the price stability. Maintaining stability in exchange rate movements and reducing interest rates almost by 100 percent from the range of 22-30 percent in late 2008 are signs of economic stability. In this context, I think, our graduation to a middle income country status and the management of the early stage of a middle income economy over the last 5 years have been credible. Now that the 26 year old conflict is history and contagious effects of the recent global financial crisis have been arrested and at least Asian economies have continued to sustain high growth performance, the economic outlook for Sri Lanka is promising. If the analysis done by the Central Bank of Sri Lanka and the Institute of Policy Studies are correct, the ending of the conflict alone must add 2 percentage points to our economic growth.

There have been many changes between 1990 and 2010 in Sri Lanka's economic structure as well. The service sector share of GDP in our economy has increased from 48 percent in 1990 to almost 60 percent in 2010. The share of primary agriculture in the economy has declined drastically from 26 percent to around 12 percent of GDP, underscoring a marked structural shift towards a service sector based economy. In the external sector the dominance of primary export economy characteristics has been marginalized with a rise in manufactured exports from 60 percent to 80 percent. The structure of imports has also reflected a marked change with a decline in consumer goods imports from 26 percent in total imports in 1990 to 19 percent as of now. The combined share of intermediate and investment goods of the total imports accounting for almost 80 percent in comparison to 70 percent in 1990 reflects the gradual transition of the economy to a more value creation process in GDP and emerging as a value added economy, in meeting both domestic and external demands. In the case of consumer goods, import of food items has declined from 14.5 percent to 12.2 percent reflecting a greater success in import substitution particularly in rice and selected food crops.

In the export sector, a similar trend can be seen in relation to several commodities such as tea, rubber, cinnamon and gem and jewellery with more value addition taking place domestically. Textiles and garment exports which were a less than 40 percent domestic value added industry has engaged with a domestic value addition close to 60 percent, in addition to the fact that this industry has shifted its reliance from protected markets to competitive markets. The turnover in external services has reached a 3.5 billion dollar scale in comparison to US$ 700 billion in 1990. The remittance economy which was around US$ 400 million in 1990 has now reached a US$ 4 billion scale, altering the entire outlook of the country's Balance of Payments.

The economic transformation that has taken place between 1990 and 2010 is a result of a series of policy initiatives that have been implemented by successive Governments. During 1980-2000, successive Governments followed policies favouring liberalization and privatization. The trade and payments liberalization that has taken place throughout the 20 year period has made Sri Lanka's economy more liberal and globally integrated. Exports are virtually tax free and the average import duty rate has been reduced to around 4 percent from over 10 percent prior to 1990. The exchange rate regime has become a freely floating convertible currency. By 2005, a large part of plantation agriculture, manufacturing, construction, financial services, public transport, telecommunications, selected petroleum services, hotels and trade which were fully state-owned regulated activities had been privatized or deregulated. These, policies have transformed Sri Lanka in to a predominantly private enterprise economy. Even some other sectors which are still predominantly in the domain of the public sector such as the postal service, electricity , petroleum, port and air port services , vocational training and hospital services, have shown the gradual entry of the private sector in varying degrees. State monopolies as at present are confined only to railways, water supply, electricity and education. Consequently, the share of private sector in GDP has increased to approximately 80 percent.

There have been some unique changes in the fiscal front too. The tax to GDP ratio has dropped from around 18 percent in 1990 to 14 percent, reflecting the decline in tax revenue generated from export and import trade which have declined from around 5.5 percent of GDP in 1990 to around 2 percent, in line with trade liberalization. Growth in revenue from income tax and other domestic taxes has not been commensurated with the development in the private sector. The facets of public expenditure reflect the complex public finance dynamics. The financial sector liberalization towards market oriented debt instruments has made the national budget being sensitive to developments in the debt market and the conduct of monetary policy. This together with successive high budget deficits has raised expenditure on interest on public debt as a major component of the budget. Financing of the Budget through administrative borrowings from captive sources, has been replaced with borrowings through market sources based on a market determined maturity structure and interest rates. A sizable expenditure on public sector salaries and pensions, and security related expenditure have been a strain on the conduct of fiscal policy though other recurrent expenditure and transfer payments have been subject to structural changes.

The conduct of monetary policy and the operations of the Central Bank itself have been subject to similar influence. The manage float exchange rate regime that prevailed in 1990, has gone through a major transformation, first in 1993 when Sri Lanka adapted Article VIII status of the IMF which made the Sri Lankan rupee freely convertible for all current accounts transactions and then in 2000 when the exchange rate was floated permitting market forces to determine the exchange rate subject to broad surveillance of the Central Bank. During this 20 year period, the Central Bank has also systematically moved away from engaging in quasi – fiscal activities by doing away with Central Bank refinance facilities provided under the Medium and Long Term Credit Fund and removing credit controls and interest rate ceilings and promoting market determined interest rate structure and credit disbursements. The reliance on the required reserve ratio, deposit margins and other administrative interventions in conducting monetary policy was substantially minimized, or used as temporary emergency measures. In comparison to 1990, the Central Bank today relies entirely on market based policy instruments such as, interest and exchange rates for the conduct of monetary policy. The recent initiatives promoted by the present Governor, such as operations of the Monetary Policy Committee and the announcement of a Monetary Policy Road Map at the beginning of the year are further progressive steps, reflecting the maturity of the Central Bank.

Hon. Minister, not only these changes signify the institutional image of the Central Bank but also the composition of the Monetary Board of the Central Bank itself is fundamentally different from what it was in 1990. As you may be aware, in 1990 there were only 3 members in the Monetary Board with only one position opened to the private sector, as the appointed member. The Governor himself was a public sector personality. The Secretary to the Treasury represented the Government as per the provision of the Monetary Law Act as the official member interfacing fiscal-monetary corporation. Since 2002, it is a different chemistry. Three positions have been created in the Monetary

Board for appointed members, essentially to accommodate members from outside the public sector. Since 2005, the Governor of the Central Bank has also been selected from the private sector. In a five member board, Secretary to the Treasury is the only ex-officio member. This change in the composition itself is to provide a wider forum for interaction among the Central Bank, the Government and the private sector. In fact, the private sector has a wider voice and influence in this composition now than in 1990.

The framework for conducting fiscal policy has also gone through some major changes. Until 2002, it was only the Constitutional provisions and enabling legislation with regard to revenue, expenditure and borrowings that were available for fiscal authorities to perform their responsibilities in respect of the country's public finance. However, since 2002 with the enactment of the Fiscal (Management) Responsibility Act, further responsibilities have been assigned on fiscal authorities by way of specific legal requirements and obligations to be fulfilled with regard to the issuance of Government guarantees, management of debt, preparation of the Budget and associated documents. Special responsibilities of the Minister of Finance and the Secretary to the Ministry of Finance have also been specified. Consequently, the preparation of the Annual Report, special reports to the Parliament to be presented with the National Budget, Mid-year Report, Pre-Election Assessment Report etc. have been introduced.

Country's unique and fast recovery from the worst ever natural disaster - the Tsunami and the worst ever manmade disaster- the 26 year long LTTE terror, demonstrate how the country is capable of mobilizing its resources and strengths to address such challenges without compromising the fundamental economic policy framework. In fact these challenges have been managed without compromising the soundness in the conduct of monetary policy or fiscal policy or seeking debt forgiveness from lenders. The country has also not reversed its prudent economic policies in the midst of the recent global food crisis and financial crisis during which time many countries resorted to interventionist and protectionist policies. It has also proved its capability of re-engineering economic policies to make it home-grown and suit country needs while respecting fundamental economic principals and the global economic framework as amply demonstrated in the '*Mahinda Chinthana – Vision for the Future*' - the 10 year Development Framework.

All these, not only explain various building blocks that have been built into the system of macroeconomic management over a 20 year transition to a middle income economy, but also explain the many progressive steps that have taken place under the extremely difficult and unpredictable environment Sri Lanka had to go through, due to the 26 year conflict. Anybody commenting on Sri Lanka and its Central Bank-Government relationship needs to give due recognition to these improvements. I am not aware of any conflict affected nation that had gone through all these reforms and still sustained not only economic progress but also improvements in human resource development, social indicators and bio-diversity in the natural environment.

Hon. Minister, the Governor, Staff of the Bank, Ladies and Gentlemen, I just touched upon some critical milestones to reflect how our economic policy and institutional developments have evolved during the last 20 year transitional phase and to set the stage to discuss the evolving relationship between the Central Bank and the Government.

Functions of the Central Bank

The Central Bank is often described as the banker to the Government and also as the banker to commercial banks, which is of course a last resort option. The Central Bank as such controls and supervises banking operations in order to maintain the confidence of the Government and the public in the banking system. In its relationship with the Government, the Central Bank has two main functions, namely operational and advisory. The common feature of modern Central Banks world over is that they have operational responsibility for official dealings both in domestic and external markets, particularly with regard to external asset management and domestic market operations. The final responsibility in certain advisory and operational matters such as foreign exchange management and monetary policy decisions are placed directly with the Central Bank while the responsibility on broader economic issues lies with the Government. As there are greater links in exchange rates, interest rates and the rest of the economy and the public policy, the advisory role, in fact, brings the Central Bank closer to the Government through its interactive process with the Government.

Prior to the great depression in the 1930s, the widely held practice was that the Central Bank should get on with its own business and not give too much attention to the Government and political considerations. With the great depression, Governments all over the world were compelled to intervene directly in the process of socio economic development similar to what we once again witnessed during the 2008 global financial crisis, when almost all countries including advanced as well as emerging economies had to mobilize not only the Central Banks and the Treasuries but also the international financial institutions such as the International Monetary Fund (IMF), to work in close harmony to restore economic and financial order. In the post depression period, Government interventions spread to the extent that most Governments became unwilling to permit the availability of money and credit, determined entirely by market forces. As a consequence of these developments, in the post depression era there has been a strong movement towards integrating the Central Bank into the Government structure while preserving Central Bank's autonomy with regard to regulating the banking and financial system, functioning as the banker to banks and performing an advisory role to the Government. Although the world between the 1929 depression and the 2008 global financial crisis has moved along with a massive globalization process and financial integration, during both these crisis periods, Governments have adopted similar policy actions, interventions and strategies reminding the need for much integrated institutional coordination and cooperation with the Government, while remaining independent in its operations and thinking.

In fact monetary and fiscal policies have become integral parts of the overall economic policy of Governments. As demonstrated during the recent financial crisis, well established Central Banks such as the Federal Reserve Bank of the United States, the Bank of Japan and the Bank of England joined hands with respective Governments to provide economic stimulus and to restore failed financial institutions by injecting massive sums of printed money to get their economies back on track. No Central Bank can pursue policies that run counter to the objectives of national economic policies, however much some critics keep talking of the need for the separation of the two institutions. It is in this background that the relationship of the Government and the Central Bank has tend to become more uniform in most countries in recent times.

The Concept of Central Bank Autonomy

Prior to the great depression of the 1930s, private ownership of Central Banks was considered to be essential for monetary stability. The Bank of England, the Central Bank of Germany and Central Banks established during that period enjoyed independence from Government control. However the legal status of Central Banks rapidly changed all over the world and most of the Central Banks after the great depression became state owned institutions as Governments assumed increasing responsibilities in the field of economic development.

The autonomy of the Central Bank can be described in many ways. In one country, the Central Bank may be described as being independent within the Government while in another as independent subject to the final responsibility being vested with the Government. However, the division of responsibility between the Government and the Central Bank can be established in many ways. For instance the Bank of England Act of 1946 which made the Bank of England a state owned institution, recognizes that the Government from time to time may be able to give directions to the bank after consultation with the Governor, when they consider such directions are necessary in the public interest. Similarly in Japan, the Bank of Japan is to ensure that its policies are consistent with the economic policy of the Government. The Bank Act of Germany which provides a considerable degree of autonomy to the operations of the Central Bank contains provisions which compel the Government and the bank to seek cooperation and mutual consultation. There are many instances in the US which indicate that the Government and the Reserve Bank work in close collaboration on debt management and monetary policy issues.

The Central Bank of Sri Lanka which was established as a government owned institution in 1950 enjoys a fair degree of autonomy. One such aspect of autonomy is reflected in the appointment of the Governor of the Central Bank. The Governor who is appointed by the President for a 6 year term, cannot be removed from office unless he has done any act which is in the opinion of the President is of a fraudulent or illegal character or is against the interest of the Central Bank. On the other hand, as in the case of the Bank of England if there is a difference of opinion between the Minister of Finance and the Monetary Board, the minister has the authority to direct the board to follow Government policy. Further the Monetary Law Act provides a proper framework to promote continuous interaction between the Central Bank and the Government and at the same time to ensure greater independence.

The report on the establishment of a Central Bank for Sri Lanka prepared by John Exter who served as the first Governor of the Central Bank from 1950 to 1953 explains the institutional framework and the coordination mechanism as follows. '*The decision to make the Permanent Secretary to the Ministry of Finance a member of a Board of only three grows out of the underlying conceptions of what the Monetary Board relations with the government ought to be…… The idea which it is hoped that the proposed law will achieve is one in which there will be continuous and constructive co-operation between the Monetary Board and the government. The principal instrument for achieving this co-operation should be the Permanent Secretary to the Ministry of Finance whose membership on the Board will ensure at all times that his Minister's views will be made known to the other members of the Board*'. [1]

Ladies and Gentlemen, the experience of the Government-Bank relationship in many countries suggest that the use of power by each institution needs considerable understanding of issues confronted by both sides. Very often central bankers and researches favoring autonomy of the Central Bank claim that Governments put too much burden on Central Banks in the fight against inflation without adequate support from the fiscal front. Conventional wisdom is that the Government must cut down their excess spending, so that it is easy for the Central Bank to use monetary policy to fine-tune money and credit. Similarly Governments and researchers who promote an increased role for the Government in socio–economic development often argue that Governments are prevented from engaging in development activities by strong objections from the Central Banks and tight monetary policy strategies followed by them. Of course, Governments must be concerned with political aspects and their judgment must reflect political

[1] Government of Ceylon, Sessional Paper xiv – 1949 Report on the Establishment of a Central Bank of Ceylon, number 1949, pp-12-13.

realities. Central Banks on the other hand should concern themselves with general economic facts and be able to approach problems with full knowledge, in order to form its judgments purely from an economic point of view, independent of politics.

It is well known that the determination of the total volume of credit is one of the fundamental responsibilities of the Central Bank. In doing so, the Central Bank takes into account the monetary impact of the Government fiscal operations, since ultimately the total sum of claims by the Government and the private sector influences monetary aggregates. This explains the importance of the working relationship between the two institutions.

In the context of open economy environment, macroeconomic policies are closely connected with the management of the Balance of Payments which is an overriding responsibility of the Central Bank. The Balance of Payments reflects the real economy on the one hand and the financial sector links on the other. They all depend on Government policy strategies, private sector behavior and several multi faceted socio economic considerations. The decision of the Central Bank to influence the overall monetary aggregates and thereby balancing both price stability and a desired level of external stability, probably measured by the level of overall external reserves, therefore cannot be formulated in isolation. In a sense, the consolidated bank balance sheet which is translated in to the well known monetary survey for economic analysis, measures the impact of the National Budget and the Balance of Payments on monetary aggregates.

This relationship is even more complex when fiscal accounts are in disequilibrium i.e. fiscal surplus or deficits. Often, the central bankers face extreme difficulties and get frustrated when such fiscal outcomes guide the conduct of monetary policy. If one goes through all Annual Reports of the Central Bank of Sri Lanka and its policy reports regularly submitted to the Minister of Finance, you will no doubt find a consistent reference to fiscal imbalance as a cause for concern.

Very often, the Government deficit is a claim on credit which the Central Bank may think is available to the private sector otherwise. To that extent, they think fiscal deficits crowd out private demand. The Central Bank also thinks sometimes that private consumption is even better than government investments in their analysis. Nevertheless there is no disagreement that large and successive fiscal deficits financed by the Central Bank and the banking system lead to a disruption to the flow of savings, external reserves, economic growth and price stability. This means that the Central Bank will have to resist in accommodating government claims in order to defend its own performance.

Based on these concerns the Bank tends to recommend the reduction in government expenditure, targeting of welfare expenditure and subsidies, improving the performance of public enterprises, opening various activities undertaken by the Government to the private sector, reduction in large scale recruitments, the removal of tax concessions and increasing taxes and wage restraint in the public sector, as measures in support of balancing the Budget, so that the monetary policy is not subject to pressure from Government fiscal operations. Of course, these are theoretically sound, standard set of recommendations that the Central Bank or for that matter even international financial institutions recommend to the Government. However, application of such policies to the real economy depends on the circumstance within which fiscal policy and government programs are conducted. Prolonged conflict, external vulnerabilities, natural disasters etc., may not always permit the implementation of certain theoretically sound recommendations which support the conduct of monetary policy. So we need to appreciate the limitations when it comes to application and find a proper mix of actions, policy compromises and trade-offs by both sides.

Reconciling conflicting objectives and concerns needs greater appreciation of the problems that each side has to manage. Let me refer to few instances in Sri Lanka which would help us to understand how the Central Bank and the Government confronted in certain situations and also work together respecting each other's view points and managed with a greater degree of appreciation of ground realities in certain other instances. One major event was the controversial removal of the rice subsidy in 1952 to address severe Balance of Payments and fiscal difficulties. The Central Bank took the position that it would be unwise for the bank to extend credit to the Government to support its welfare oriented fiscal policy. On these grounds the Central Bank refused to accommodate the Government request for bank credit. The Central Bank thought that it would compel the Government to restrain public expenditure, particularly expenditure on food subsidies. However, the relationship between the two sides was tensed. Although, the Government attempted certain revisions in the rice subsidy, the ultimate adjustment problems led to a national strike and political crisis.

Another event was the decision to float the exchange rate in 2001 when the Sri Lankan economy was confronted with macro economic problems stemming from the world recession influenced by September 11 attacks, foreign exchange crisis, the severe drought, and the terrorist attack on the airport.[2] The prevailing managed-float exchange rate regime virtually became non-functional as the market pushed the exchange rate on a daily basis towards the upper band. Eventually a bold decision was taken to float the exchange rate, a regime which has worked for 10 years. Again, the associated political tension seemingly due to inadequate consultations at Cabinet level together with other economic and political problems eventually led to a change of Government in 2001.

More recently, when the world market prices of fuel increased dramatically for over two and half years till mid 2008 - hitting almost US$ 100/ barrel, caused a severe mismatch in the Balance of Payments as well as fiscal accounts. The cost of import of oil increased to US$ 3 billion and fiscal subsidies on fertilizer and fuel increased to about Rs. 50 billion or over 1 percent of GDP. The Central Bank and the Government had to find viable solutions to overcome emerging economic difficulties. Having assessed the views of the Central Bank as well as the Treasury and in consultation with the National Economic Council and the Cabinet of Ministers, His Excellency the President was bold enough to make the hard choice of adjusting to the ground reality and made decisive moves in fuel and wheat flour prices in a politically difficult environment. The price increases in fuel, transport, electricity, water, food – all were very large and inflation rose to near 25

[2] The Central Bank of Sri Lanka estimated the output loss due to the combined effect of all these factors at Rs. 56 billion or 6.5 percentage points, the loss in external earnings at US$ 1,175 million and the increase in the fiscal deficit by 2.2 percent of GDP – Annual Report 2001- page 6.

percent reflecting these adjustments. If not for such adjustments, the economy would have suffered greatly.

Of course, the Government was successful in managing the Budget and external reserves and putting the economy right this time. The Government also seemed to have managed politics right. Unlike in the previous two instances, there was no change in the Government. In fact the incumbent Government received a stronger mandate, the Central Bank was able to build reserves and the Treasury was able to manage the budget without compromising development spending that are required for long term growth in the economy. The economy now enjoys the dividends of these painful decisions by way of high growth of around 7 percent, low inflation of 6 percent and reserves in excess of US$ 6 billion. So these instances demonstrate that a consultative approach and well established working relations between the Central Bank and the Government is necessary for greater success.

In referring to this complex relationship and managing the delicate balance, Hon. Mr. J R Jayawardena, then Minister of Finance made the following observations when he participated at the second reading debate of the Monetary Law in Parliament. '*We have tried as far as we could in this Act to make the Central Bank or at least the Monetary Board independent as far as its advice is concerned. We want it to consider the problems of Ceylon …….. to see how far it is necessary that the credit structure of Ceylon should be influenced for the purpose of full employment and the Balance of Payments. We want it to consider this question apart from political considerations and give its advice without fear or favour to the Government. But ultimately, in the last analysis, I think it would be admitted that the Monetary Board cannot come into direct conflict with the Government'.* [3]

The most important contribution the Bank-Government relationship and their coordination can make is to provide an environment of monetary stability which is conducive to economic growth and development. The Central Bank of Sri Lanka's current theme of stability with growth probably stands for this important role of the Bank. Although in advanced countries, the focus of the Central Bank is only in its core

[3] Parliamentary debates (Hansard) Vol. 7 No. 10, 22nd Nov. 1949. P 721

responsibility, in emerging market economies, Central Banks are often at the center of resource and expertise that is asked to take on a number of development functions. It is worth noting that historically many Central Banks have played an important role in developing the financial sector capability on behalf of the Government. In Sri Lanka too, a number of development financing activities such as the implementation of refinance facilities under the Medium and Long Term Credit Fund, the operation of credit guarantee schemes for a wide range of sectors in the economy and implementation of entrepreneur development programs, have been undertaken by the Central Bank from time to time in complementing the Government's development initiatives. Further, the Central Bank of Sri Lanka has contributed by implementing foreign funded development programs in the financial sector and nurtured development banks including the National Development Bank and Regional Development Banks, in the initial stage of their development.

In the case of Sri Lanka, the Central Bank also undertakes several responsibilities on behalf of the Government. Accordingly, the Central Bank of Sri Lanka manages public debt and the administration of the exchange control regime. Public debt management covers the issuance and retirement of Government securities and debt servicing responsibility. As part of debt management, annual borrowing programs of the National Budget are formulated by the Government and the Central Bank, taking into account the developments in debt markets. With regard to foreign funding, the process involves a collective responsibility among the line Ministries and the Department of National Planning, External Resource Department, the Economic Research Department of the Central Bank and the Monetary Board, the Attorney General's Department and the Public Debt Department as well as the approval of the Minister of Finance, the Cabinet of Ministers and the final authority from the President, under Foreign Loans Act. Similarly domestic borrowings are undertaken by the Public Debt Department on request from the Treasury Operation Department within the legal framework. All these take place in line with Parliamentary approved fiscal limits.

This process reflects the comprehensive institutional interaction in managing public debt by the Government and the Central Bank. Since the Government is undertaking large development projects, the size of loans also has increased in recent times in comparison to conventional donor funded projects undertaken in the past. As a consequence of Sri Lanka becoming a middle income country, the access to grant aid and concessionary credit have become limited. So the Ministry of Finance like in other countries has moved on to alternative resource mobilization arrangements such as IBRD, ADF and Exim Bank credit. The Government has also entered into international capital markets placing increased responsibility on the role of the Central Bank in debt management in the recent times.

In the administration of exchange control during the fixed exchange rate period, the Central Bank had to take administrative measures to preserve the exchange rate in terms of Government policy priorities while in the floating exchange rate system the Central Bank was responsible to intervene in the market to provide exchange rate stability. All over the world, Central Banks are regarded as the representative of the Government in matters relating to the International Monetary Fund. In this regard the Central Bank plays a vital role in annual consultations and in sharing of financial and economic information.

Let me turn to another area where the Central Bank has performed to the satisfaction of Government by safeguarding public interest. The Monetary Board of the Central Bank is vested with full responsibility in managing the Employees' Provident Fund which was established in 1958. In comparison to the performance of many private as well as public provident Funds including the Provident Funds of the state banks and selected enterprises, the employees provident fund has performed exceptionally well by the selection of a cautious fund management approach. Consequently unlike in several other provident funds in which the Government had to inject capital, the Employees Provident Fund has become strong and the largest contractual saving institution in the country. Thus in managing public debt, foreign exchange administration, international financial relations and the Employees Provident Fund the Central Bank has demonstrated the highest level of competence and the capacity to act in the national interest with least amount of Government intervention. These are also special responsibilities that the

Central Bank has performed by maintaining a close coordination with the Government at both policy and operational levels, specially with the Ministry of Finance.

Although, there is a danger in the Central Banks shouldering too many tasks and loosing focus in the process, it is implicitly expected to play a crucial role on behalf of the Government when it comes to development functions in the financial sector. In performing these tasks Central Banks also have to step in to replace disrupted and dislocated markets, intervene to minimize volatility in inter-bank transactions, foreign exchange swaps and in Government bond markets to ensure working of the monetary transmission mechanism. The usual relationship between policy rates and interest rates applicable to the real economy cannot be permitted to be disrupted. If credit and liquidity spreads widen beyond tolerable levels, the Central Bank and the Government need to find a mechanism to intervene to ensure proper functioning of financial markets and decide the funding costs to households, financial institutions, the corporates and the Government.

Our own experience in the past several decades explains how under very exceptional circumstances the two institutions have achieved a delicate fiscal-monetary balance, being able to work towards achieving a common vision. The rise in government claims in the last 2 -3 decades on the monetary and financial system reflected the impact of security related expenditure which necessitated in defending the sovereignty of Sri Lanka, honouring high debt payments to maintain international credit worthiness or supporting public investment in essential infrastructure, which are all vital to create a space for development. One could ask what kind of economic and political outcomes would have occurred if the Central Bank worked in isolation and resisted unilaterally any of these claims - compromised national security and or time consuming infrastructure development at a cost of high economic growth. On the other hand, one could also ask whether there were better options that the Government and the Central Bank could have considered in addressing these concerns. I would argue that both the institutions under great difficult conditions have managed the process relatively satisfactorily while preserving the Central Bank's autonomy. The working arrangements to coordinate macro financial policy between the Central Bank and the Government have proved effective, particularly at exceptionally challenging times of major disasters and economic shocks that this country has confronted in recent times.

The Contemporary Issues

As discussed so far, the Central Bank - Government relationship is facing a wide range of challenges and complex issues. As the present monetary system is a system to control money and credit and regulate financial institutions, the institutional culture and professional functioning in such an institutional set up are critically important for a Central Bank. The first priority in the Central Bank is the banking operations. In this task the Central Bank itself is a bank which implements policy actions and also functions as the lender of last resort. These operations require wide ranging operational knowledge such as collateral setting in banking and the financial system, payments and settlement arrangements, securities and debt collection mechanism by banks, dealing with failed financial institutions etc. In this background, the Central Bank also needs the knowledge that is required to assess subtle workings of the financial system and its interaction with the macro economy.

In managing the Monetary Policy, money-price relationship ideologically dominates policy actions required to control the money supply. While such a relationship is well established in economic theory, its empirical validity depends on market conditions and the economic characteristics of each economy. Very often with imperfections in the market and financial system and structural characteristics particularly with regard to supply side behaviours in commodity markets and external trade, controlling the money supply through various instruments itself may not be sufficient though necessary to establish price stability. This debate again requires much serious research as well as understanding in economic behaviour beyond the simplistic statistical and econometric models which have become popular to analyze economic behaviour. Over reliance on such models may also have over simplified the framework for understanding complex socio economic and real factors influencing price.

In introductory economic text books, money is described as a mechanical concept, and Governor and I very often hear at the Monetary Board, as a product of the monetary base and money multiplier. In my view, such a way of understanding money misses the important role that money plays. As we see in the real economy and more increasingly in recent times, money is created as a product of maturity mismatches and leveraging financial transactions. This indicates that a Central Bank cannot understand development in the financial system and the macro economy without hands-on knowledge on how banking and financial institutions operate. Conventional pre-occupation with the working of deposit accepting commercial banks is grossly inadequate for the Central Bank to analyze the behavioral characteristics of much more diversified commercial banks nowadays engaged in a wide range of products outside the deposit system.

More seriously, behavioral characteristics of non bank financial institutions that are engaged in leasing, investment banking, corporate restructuring etc. are more complex. The rapid financial innovation in the 1990s and 2000s led to securitization techniques and chain of intermediaries. Rating agencies gained influence as pricing of new financial products are largely based on their assessment. At the same time mark-to-market calculation rules became wide spread among newly emerging financial intermediaries. However, it also appears that all these have led to develop a shadow banking and financial system largely outside the regulatory environment with potential instability and risks due to illiquid system of credit risk distribution. In the context of the global market environment these systemic risks have threatened the stability of the formal financial system, triggering massive damages to the real economy.

The current global financial crisis and some of the bitter experiences we ourselves in Sri Lanka have gone through in some finance companies and commercial banks which had tried to by-pass or overlook the Central Bank as a regulator, clearly show that the Central Bank needs considerable hands-on knowledge in their conduct to safeguard Government finance from systemic risks in the financial system. This situation has become more challenging, particularly since the system is threatened with money laundering, terrorist financing and so many other irregular financial transactions parallely taking place in the unregulated economy. Why this matters to the Government and why such matters have become the central focus in the Government-Central Bank relationship is that the ultimate burden falls on the National Budget and thereby on the taxpaying community.

We in Sri Lanka though have been fortunate to avoid contagious effects of the banking fall out in 2009 due to timely interventions by the Government and the Central Bank, the collapse of investment banks the financial institutions in the United States and in advanced countries in 2008 amply demonstrate that regulatory failures can cause financial Tsunamis with disastrous socio economic consequences. The 2008 global financial crisis underscores that financial institutions have priced risks poorly and have gone into finance exceptionally large portions of interests of the corporate world without adequate safeguards but with high leveraging. The associated risks and the mismatch in asset and liabilities of these institutions have imposed a severe burden to their respective Governments, which in turn have caused large fiscal deficits posing threat to the global financial system.

In the Bank- Government relation in Sri Lanka, the Government often draws attention to the bank to the exceptionally large spread between the deposits and lending rates as well as the lackluster development in the Treasury Bill market outside the banking system in this country. Despite the primary dealerships being given to commercial banks, these instruments have not gained much attraction among the ordinary people in this society as much as bank deposits which provide much lower yield than government securities. Since the Central Bank is the agent for the Government in managing national debt and also the institution which is responsible to nurture financial sector development, it may be time to revisit the working of our primary dealership system and to see whether commercial banks are the best institutions to perform the role of primary dealers in this country. The Government is also concerned as to why our commercial banks charge a high spread for their lending and making enormous profits without being sensitive to the development needs of the country. We in the Treasury often hear from our private sector, the difficulties of borrowing. Access to finance as well as high cost of interest despite a well distributed branch network across the country, are two main concerns that the entire private sector keeps raising from the Government with one voice. There is a concern over the rigidity towards downward adjustments in lending rates as well as over the long lag involved in such adjustments.

The Central Bank as the regulator for both banking and non-bank financial institutions may have to consider whether our banks are sufficiently competitive in their operations, although most of them may have complied with regulatory requirements under the Banking Act and directions given by the Central Bank. Here again the private sector particularly the SMEs make representation to the Government that they cannot easily change their banks due to various market imperfections which have resulted in there being non-competitive working arrangement features in the banking system. The Central Bank may also need to consider the working of the Credit Information Bureau (CRIB) which supplies credit information to shareholder member banks and institutions as this infamous CRIB has created a situation where bankers use such information to discourage borrowers and reject their requests.

As a regulator, time has come for the Bank Supervision Department to undertake examinations not just to ensure that banks have complied with prudential requirements such as capital adequacy, liquid assets, non performing loans etc., but also to see whether the intermediary costs by way of salaries and other benefits, operational expenses and so on are justifiable. In the recent financial crisis, banking and financial institutions were found fault for the payment of extravagant salaries and other benefits to their senior executives. So these are areas that the Government focuses in the financial sector development which are addressed through the Central Bank and not directly by the Government – a healthy feature of Bank-Government relations.

In the post conflict context, our private sector deserves some relief from the banking system. Private sector has performed in a high interest rate regime where their cost of borrowing has been in excess of 30 percent. Many defaulting customers have been subject to penal rates and their names appear in the CRIB. In many instances banks have recovered the capital through very high interest and debt capitalization. Borrowers continued to remain in high debt positions despite the fact they have paid capital and interest well in excess of the initial debts. Debt recovery legislations have made the risk taking farmers and industrialists vulnerable to legal actions. Only very few banks have gone for restructuring of non-performing loans and underperforming businesses to recover their loans. Instead, most of the banks have resorted to easy options of applying the provisions of debt recovery legislations.

Paradigm Shift

Governor, the present generation of the Central Bank may only know the challenges faced by the bank due to Balance of Payments difficulties and or fiscal deficits, particularly, since the post liberalization Sri Lankan economy has not seen any surpluses in these accounts.

Let me draw your attention to possibly a different scenario that you may be responsible to spearhead in your second term as the Governor. The paradigm shift that has occurred in this country in 2005 under the Presidential Vision '*Mahinda Chinathana –Vision for the Future*' may transform the Sri Lankan economy from a deficit economy to a surplus economy. The country may witness an emergence of several extra export and foreign exchange earning activities. You may see an export structure that will reflect new areas of exports beyond tea and garments and include more value added manufactured products as well as IT and enabling industries that generate over US$1,000 per annum by each activity. These may raise our export earnings by US$ 3-4 billion over next 3-5 years. In the import structure, reflecting the deep commitment of this Government towards food and energy security, new imports competing economic activities in energy supply and related industries and food production may take place. In terms of current prices these may replace at least a billion dollars of imports to this country. In terms of the Government's vision to create port and aviation hubs as well as a knowledge based economy, Sri Lanka may also see a future of a rapid surge in export of services and skills generating huge inflow of foreign exchange strengthening the service account as well as income account of the Balance of Payments. The remittance earning supported with a knowledge based economy driven by high skills and professionals as well as knowledge based industries such as IT, research and associated business establishments may create an entirely new dimension in the real economy which has been explained in the past with primary and secondary economic activities only. Imagine the impact of a US$ 8 billion remittance income instead of the projected level of US$ 4 billion for the current year in our banking system and on the real economy. Tourism and associated leisure industry activities are also likely to alter the Sri Lankan economic landscape into a different perspective both in terms of foreign earnings and foreign and domestic private investments.

All these, the Governor, may be seen by some with skepticism and some others by historical influence in their mindset, as not feasible. But some may still give the benefit of the doubt, in favour of this scenario and visualize a surplus in external accounts and corresponding real economy under this scenario. If one starts from the Balance of Payments, it may be seen a story of external assets build up, far beyond one would probably imagine. But that is not the end. A large and continuous build up of external assets eventually will exert pressure to strengthen exchange rates. This means that this country will need a much stronger productivity drive in all sectors in the economy. The practice in the past was to accommodate inefficiencies through exchange rate depreciation. Economists relied on the calculation of real effective exchange rate to use as a policy tool to guide the exchange rate devaluation to maintain the competitiveness in external trade. The emerging scenario suggests the limited use of these indicators and the need for new analytical information, tools and skills to manage financial flows, trade and real economy linkages. All emerging market economies are facing this challenge.

Similarly, the Government in its medium term road map presented in the 2010 Budget Speech has committed to a gradual reduction in fiscal deficits and thereby a debt to GDP ratio below 70 percent. This means that claims by the Government on the Central Bank and the banking and financial system will also decline gradually. The increased availability of funds in the hands of banks and financial institutions will eventually compel banking and financial institutions to work in a low interest rate regime which they have never experienced in the post-1977 economy in Sri Lanka. The low interest rate regime will also compel them to look for medium to long term financial instruments as well as alternative banking products to mobilize funds. Provident funds and other

institutional investors may be required to look for long term equity and debt instruments outside the Government.
The current investment level of around 24-26 percent of GDP is expected to move towards 33-35 percent of GDP largely with the increase in domestic and foreign direct investments. The underlying real economy supports a wider middle income population with different spending priorities and demanding goods and services emanating from the service economy than from the primary sector. This macro economic scenario points to a per capita income of US$ 4,000 as targeted in government economic policy strategies. Of course, this is the direction as far as I see, the Sri Lankan economy is heading in the next 10 years as an 'Emerging Economy in Asia'.

This paradigm shift in our economy will certainly elevate the Government – Central Bank relationship also to new heights. At this 60th Anniversary, my message to young career Central Bankers and Finance Ministry officials is to get ready to manage this emerging scenario which requires a higher level of competence, skills and sophistication to perform your tasks than what we have had in the past. The Bank-Government relationship for the future therefore needs to be built not only on the historical experiences that the Bank and the Government have already gained over the last 60 years but also on new knowledge and vision that is needed to manage a sound monetary / fiscal policy collaboration and a strong regulatory environment for a financial system that will support high economic growth with stability.

Concluding Reflections

Hon. Minister, let me go to a close. The forging sections have brought out the fact that the relationship between the Central Bank and the Government is based not on a mere legal framework, but also on multifaceted political economic considerations. Although in many respects the Central Bank is independent, it has become an integral part of the Government, particularly in managing macroeconomic challenges. The recent financial crisis in most advanced countries has put the Central Banks and Governments on to one mission and to work in close collaboration.

Although there is a separation of responsibility in terms of the Central Bank being primarily responsible for monetary policy while the Government is responsible for fiscal affairs and general economic policies, in reality such a demarcation is only a myth. In essence all these policies come within the purview of the broad macro economic framework. The effectiveness of the workings of the two institutions depends very much on the way that the relationship is maintained. David L Grove on the subject of Central Bank independence and the Government- Central Bank relationship argues that '*an effective Government - Central Bank relation requires the exercise of great tact and discretion on the part of the Central Bank. The bank must know when and how far to oppose Government policies which it considered ill advised, it must also know when and how to compromise and to make the best of a bad situation. A Central Banker therefore must at the same time be a master of an art of diplomacy*'.

I think, what David Grove argued on the relationship between the Central Bank and the Government is relevant to the many so called independent agencies in the Government as well. After all, many Government institutions - mainly regulatory agencies, oversight bodies and facilitating agencies are made independent not to confront or oppose the Government but to be complementary and to provide best advice and make the Government work. It is the Government that is ultimately responsible for the overall economic policy of the country and is directly answerable to its people.

The Central Bank – Government relationship in Sri Lanka which I have seen from the literature as a career central banker and as the official member of the Monetary Board representing the Government can be described as a close, harmonious and constructive one in dealing with many complex political economic issues. The Central Bank which celebrates its 60th Anniversary has dealt with different Governments on different and complex economy issues. The experience in dealing with the oil price shock, Balance of Payments difficulties, the high budget deficit, domestic inflation, external reserve management, consumer subsidies, the Tsunami and the conflict as well as the performance by the Bank on delegated responsibilities to the Bank and the Monetary Board by the Government etc., clearly demonstrate the mature relationship that the two institutions have developed over time.

Sri Lanka is a middle income country and within the next 5 years it can very well be one of the most promising emerging market economies in Asia. The Government has committed to navigate this task and commands all necessary resources - political and global economic environment and a strong leadership. The relationship between the two institutions therefore needs to be further strengthened through coordinated macroeconomic policy management and a policy dialogue on the basis of the common vision that has been placed before the country by His Excellency the President. We all need to be fully conversant of the policy strategies and the paradigm shift that the Government has made. It is not a re-branding exercise for Sri Lanka or one designed by outsiders. It, as His Excellency the President said at the opening ceremony at the new port at Hambanthota recently, is our own creation and one that can be delivered only by us.

Let me conclude by saying that President Rajapaksa has woken up the 'Sleeping Lion of Asia' and prepared him for a long marathon of high economic growth in excess of 8 percent per annum. This unstoppable marathon for which the macroeconomic foundation has been laid through collaborative work by the Government and the Central Bank during the past five years, demands greater collaboration between the two institutions towards managing macroeconomic challenges in the emerging market economy environment.

Thank You!