Changing financial systems in open economies: Sri Lanka's experience

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1. Introduction

After gaining independence in 1948, Sri Lanka has come almost full circle with respect to economic policy regimes. In the early 1950s, the country followed pro-enterprise liberal economic policies with little direct government involvement in economic activity and with minimum intervention in foreign trade and exchange controls. However, direct government intervention in and control over economic activity commenced in the late 1950s and increased in the 1960s, transforming Sri Lanka basically into a semi-planned mixed economy. By the early 1970s, the economy had become highly regulated and controlled. In 1977, a complete turnaround in the country's economic policy was initiated with the introduction of a market-oriented policy package featuring the deregulation of market activities and the reduction of direct government participation in the economy. The liberalisation programme was continued in the 1980s, making the economy the most liberalised in the southern Asian region.

2. Financial sector developments

At the time of the establishment of the Central Bank of Sri Lanka (CBSL) in 1950, the financial system in Sri Lanka was at a very early stage of development. It comprised only ten commercial banks, largely branch offices of foreign banks, and a limited number of non-bank financial institutions such as savings banks and long-term lending institutions, which were still rather in their infancy. Thus, at the time the central bank was founded, the institutional system of both the monetary sector and the

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non-monetary sector was woefully inadequate in relation to the aspirations of an independent developing nation. In this context, as in other developing countries, an important function of the Government and the CBSL was to promote the development of the country's financial system.

In the 1960s and 1970s, the major emphasis was on localising and expanding the financial system into remote areas with state support and participation. The Government intervened in the financial sector directly by establishing new public sector financial institutions and introducing new regulations and controls on financial sector activities. Consequently, the banking sector, until then dominated by expatriate banks which mainly met the financial requirements of the foreign trade sector and the need for working capital of the plantation sector, underwent a radical change as local state banks instead gained the dominant position in the financial system. The state banks continuously increased their relative share in the banking sector by extending their services into new economic sectors and into the remote areas of the country. Meanwhile, there was little or no private sector involvement in financial activities during this period. The private sector was even restricted in taking up or expanding business in particular areas of the financial services industry, which created a public sector monopoly in these segments of the financial sector.

Financial sector reforms

When the new liberalised economic policies were introduced in 1977, the financial sector was therefore highly controlled and regulated, as well as being dominated by public sector institutions, suppressing the dynamism of the financial system and impeding the efficient allocation of financial resources. However, the liberalised economic policies which placed more emphasis on market forces in economic decision-making and on the private sector in economic development necessitated commensurate changes in the financial system. At the same time technological developments improved the integration of financial markets and facilitated the introduction of more sophisticated new financial instruments, diluting the effectiveness of traditional non-market-oriented monetary policy measures. In this context, a financial sector reform programme was undertaken after 1977 with the objective of creating an efficient and dynamic domestic financial system, taking into account financial sector developments in the rest of the world. In summary, the main features of

the financial sector reforms undertaken after 1977 were deregulation of financial sector activities and greater reliance on market-oriented measures in the implementation of monetary policies. Reform measures centred on the following areas:

– deregulation;
– reform of institutions and instruments;
– the setting of interest rates;
– credit allocation;
– reducing the cost of financial intermediation;
– strengthening the legal, accounting and regulatory frameworks for financial institutions and improving financial sector management; and
– emphasising market-oriented policy measures in monetary management.

Accordingly, barriers to the development of the financial system were removed and incentives were provided to spur its growth without direct government participation. As entry restrictions were removed, foreign banks of good repute were allowed to open branches in Sri Lanka while the domestic private sector was permitted to establish new banks to improve competition. Consequently, 15 new foreign banks opened branches while share issues for two new domestic private banks were successfully launched. Similarly, the private sector was permitted to create new special financial institutions, including finance companies, merchant banks, leasing companies, unit trusts and foreign currency banking units. Furthermore, financial institutions were allowed to introduce new financial instruments and services in line with the emerging financial requirements of the economy and technological developments. The legal framework of the financial system was improved by amending existing and enacting new legislation. Already, a number of steps have been taken under the new legislation, covering financial sector licensing, minimum liquidity and capital adequacy ratios, single borrower limits and limits on share ownership, guidelines on lending to directors, auditing and accounting standards, and bad debt provisioning.

Financial markets

Following the economic reforms of 1977, financial markets in Sri Lanka underwent rapid change. As the new economic policies emphasised

private sector involvement in economic activity, improvements in the functioning of the money, foreign exchange and capital markets became necessary. Measures taken to create a more favourable financial environment in which the money market could better develop included the introduction of new instruments, a liberal regime for establishing new institutions and the reform of existing institutions and instruments. Consequently, major segments of the money market, such as the interbank call-money market, and the primary and secondary Treasury bill markets, as well as the internal foreign exchange market and the offshore exchange market, expanded rapidly. The development of the Treasury bill market has served a number of useful purposes. First, it has helped to improve monetary management through greater control of the monetary base. In particular, it enabled the monetary expansion resulting from high fiscal deficits to be contained. Secondly, it has provided a convenient short-term investment outlet for financial institutions with excess liquidity, inducing them to continue their deposit mobilisation efforts unabated. Thirdly, it opened up a market-based borrowing source for the Government. Operations in central bank securities market were also conducted in the open market during periods of excess liquidity. In 1977, with the introduction of a unified exchange rate system under a managed floating exchange rate regime, most of the previous exchange controls were abandoned. The external liberalisation programme was implemented in stages and culminated in the acceptance of the obligations of Article VIII of the IMF Articles of Agreement in March 1994.

Sri Lanka has been following a gradual but continuous process of financial sector reform as a major part of its overall economic reform programme launched in 1977. In terms of timing, the reform of the domestic financial sector proceeded in parallel with the liberalisation of the current account, but preceded the programme for opening the capital account.

3. Monetary management in the new environment

In Sri Lanka, the central bank bears responsibility for formulating and implementing an appropriate monetary policy so as to maintain the stability of the Sri Lankan rupee while simultaneously allowing the economic development objective to be pursued. The stabilisation objec-

tive includes maintaining the domestic as well as the external value of the currency, while the development objective requires promoting and supporting a high level of domestic production, employment and real income on the one hand, and encouraging a full development of the productive resources of the country on the other. The requisite authority to influence the cost and availability of money is vested with the central bank by the Monetary Law Act (MLA). In formulating its monetary policy package, the CBSL takes into account the prevailing and prospective domestic economic situation, the stance of government policies and budgetary operations and emerging external sector developments. Short-term economic developments, particularly monetary and price developments, exchange rate fluctuations and changes in the external asset position are continuously monitored by the CBSL and monetary policy measures are designed accordingly within the framework of the MLA. Moreover, the MLA stipulates that, whenever domestic monetary stability is threatened or abnormal movements in the money supply and/or the price level endanger stability, the CBSL must submit a report to the Government covering causal factors, probable effects on the economy and required corrective measures. The MLA defines such abnormal movements as an annual change of more than 15% in the money supply or a change in the consumer price index of more than 10% on a point-to-point basis.

Monetary policy instruments

The CBSL has at its disposal a wide range of instruments, both direct and indirect, for the conduct of monetary policy. Indirect measures include the Bank rate, the variable reserve ratio and open market operations. The imposition of credit ceilings, minimum ratios of bank capital and surpluses to assets, cash margins against letters of credit (LCs), control over bank interest rates and directed lending are available under the direct instrument category. By imposing effective restraint on the volume of commercial banks' operations, these direct controls serve to regulate money and credit. Such measures are particularly useful to the authorities for quickly restoring order in the credit market should conventional indirect policy measures fail or be slow to bring about the desired results. The CBSL has been using both types of measures as the particular situation demands. In addition, monetary targets are pursued from time to time by applying

moral suasion, whereby the commercial banks are requested to exercise caution in their lending.

Relative importance of objectives and choice of instruments

In the Sri Lankan experience with respect to the emphasis place on particular monetary policy objectives, four periods can be identified for analytical convenience: 1950–59, 1960–77, 1978–89 and 1990 onwards. During the 1950s, when the macroeconomic situation was characterised by reasonable economic growth coupled with a fair degree of price stability and overall economic policy was directed at developing a mixed economic system, monetary policy was used mainly for stabilisation purposes. In the context of a worsening balance-of-payments situation and a changing stance of overall economic policy towards a more controlled and regulated system, monetary policy graduated from being a mere stabilisation instrument into a policy with a wider scope encompassing development issues as well. Accordingly, during the 1960s and 1970s, while the basic orientation of monetary policy was towards preserving monetary stability and protecting the balance of payments, a number of measures were also taken to facilitate the flow of financial resources to selected vital sectors of the economy. The economic liberalisation programme implemented after 1977 gave monetary policy a particularly significant role to play, not only in achieving stability, but also in creating an appropriate financial climate in which the goals of the new economic strategy could be realised. During this early liberalisation phase, monetary policy also had to cope with the continuing pressure of a sharp fiscal expansion which worsened macro balances in the economy. Thus, the major feature of the choice of monetary policy objectives during 1977–89 was the attempt to strike a balance between stabilisation and development objectives, taking specific short-term developments into consideration. Following the introduction of the second phase of the economic liberalisation programme in 1989, the chief emphasis in monetary policy was placed on economic stability, since this was viewed as a precondition for achieving sustainable economic growth.

Over the years, the CBSL has had recourse to a wide range of instruments in implementing monetary policy. Initially, conventional instruments such as the Bank rate and the statutory reserve ratio were used extensively; open market operations in the CBSL's own securities were relied

upon to mop up the excess liquidity which resulted from occasional export booms. In the 1960s and 1970s, direct control measures continued to be used extensively in addition to the traditional indirect measures. However, in the most recent past the salient feature of monetary management has been the shift towards more market-oriented monetary policy instruments and the reduced reliance on non-market-oriented measures.

New developments

A number of improvements have taken place in the implementation of monetary policy in the period since 1978. First, a new money supply aggregate was introduced to take account of changes in the financial system. As time and savings deposits became as liquid as demand deposits owing to technological developments and a high-interest-rate policy regime caused depositors to move more funds into interest-bearing deposits, the narrow money definition, covering only currency and demand deposits held by the public, became less suitable for measuring the demand for money. In order to adopt a realistic monetary aggregate for policy purposes, a new broad monetary aggregate, M_2, was introduced in 1980 including the time and savings deposits held by the public with commercial banks. Secondly, the entire monetary policy strategy was refined by identifying new monetary indicators, such as the monetary base and the money multiplier, that could serve as targets for policy purposes. Thirdly, action was taken to develop the necessary prerequisites – essentially a well-functioning money market – to implement market-oriented monetary policy measures, while maintaining compatibility with the overall new economic policy orientation. Finally, each year a monetary programme has been prepared that takes into account economic growth, expected inflation, budgetary operations and the balance-of-payments situation, and steps have been taken to ensure its compatibility with commercial banks' credit and deposit mobilisation programmes.

4. Move towards market-based monetary measures

As noted, a prominent shift in the implementation of monetary policy in the recent past was the move towards a greater market orientation of policy instruments. In 1977, Sri Lanka chose to adopt a new economic strategy that marked a significant departure from the closed economy

model adhered to until then. The main features of the new strategy included a greater reliance on the market mechanism for resource allocation, the gradual dismantling of import and exchange controls, the establishment of an outward-oriented growth strategy and attracting private foreign capital to supplement domestic resource flows. Monetary policy thus had to be refocused accordingly. This involved a gradual transformation of policy from direct controls to market-based policy measures which were considered to be more efficient in creating a healthy environment for resource allocation, as well as qualitative changes in the scope, coverage and strategy of monetary policy. The low-interest-rate policy that had played a central role in the stance of monetary policy during the pre-1978 period with a view to maintaining a low inflation rate and encouraging investments gave way to a new policy package in which interest rates were allowed to respond freely to market forces. Consequently, the entire structure of interest rates moved to a higher plateau, in the process raising real interest rates and encouraging financial savings while discouraging wasteful spending.

Open market operations have been the most intensively used market-based instrument in the recent past. In the mid-1980s, the CBSL issued its own securities (CBSs) to mop up the excess liquidity that had resulted from a tea export boom. However, CBSs lacked a secondary market. More recently, open market operations have largely been conducted with Treasury bills. With this shift, new institutional and operational procedures for the Treasury bill market were developed rapidly, including weekly primary auctions, an active secondary window at the CBSL, the introduction of Treasury bills with different maturities, the appointment of accredited dealers and the creation of a repurchase (repo) market. The operations in the Treasury bill market have made the management of short-term liquidity in the economy more efficient and have guided reserve money growth. More intensive use of open market operations as a monetary policy tool has resulted in a number of favourable developments, e.g. an expansion in short-term money market activity, and an improvement in resource allocation as distortions from non-market-oriented measures were reduced and fiscal management was made more easy. Another favourable impact has been the greater effectiveness of the interest rate weapon as an instrument of monetary management. With the development of the Treasury bill market, the Treasury bill rate soon became a reference rate for other short-term rates in the money market.

Although the adverse impact of direct measures of monetary control was well known, the CBSL had to resort to them at times when conventional, market-oriented policy measures failed to remedy an expansionary monetary situation. However, the CBSL always tried to shift back to market-oriented policy measures as soon as the situation improved to a satisfactory level. Some of the direct measures, in particular margin requirements against LCs and ceilings on import credits, could be considered as short-term policies that were complementary to exchange rate policies aimed at improving the country's balance-of-payments position. Similarly, the refinancing facilities that were provided to exporters so as to improve their export competitiveness through a lowering of the cost of their funds reduced the exchange rate adjustments that would otherwise have been required under the export promotion policy. However, the authorities were able to move away from all these non-market-oriented policy measures and rely basically on indirect methods of monetary management.

5. Policy responses to capital inflows

Capital inflows into Sri Lanka rose significantly during the period 1991 to 1993, decelerating somewhat in 1994 owing to external as well as internal factors. In 1993, annual net capital inflows were high at about 4.5% of GDP; including private transfers, they stood at about 5.5%. As in other developing countries, both the favourable and the negative effects of capital inflows were evident in Sri Lanka. A positive result was the increase in domestic investment of about 3–4% of GDP during the high capital inflow period. More negative was its contribution to rapid monetary expansion, fuelling the already high domestic inflation rate. Thus the policy dilemma was how to accommodate and encourage the potentially favourable impact of the inflows on investment and growth while at the same time curbing their destabilising effects. The principal response of the authorities was to attempt to sterilise the impact of the inflows on monetary aggregates. Sterilisation was based mainly on raising statutory reserve ratios and on open market operations. However, the degree of sterilisation was eased in 1993 as concerns grew regarding its impact and effectiveness in response to sustained capital inflows. First, by raising domestic interest rates, sterilisation reduced the beneficial impact of capital inflows

on investment and growth. Secondly, the sharp rise in interest rates was viewed as intensifying the conditions that, at least in part, had originally attracted inflows. Finally, the large quasi-fiscal costs to the central bank and the increase in budgetary debt service payments, reflecting rising interest rates, were also matters of concern.

Thus the experience of the recent past, including the growing openness of the economy, shows that sterilisation through monetary policy has become a less effective policy response to capital inflows. But neither is accommodation of capital inflows through exchange rate appreciation a medium-term solution for a developing country. Hence accommodation of capital inflows through fiscal measures supported with appropriate monetary and exchange rate policies is left as the only sustainable policy measure.

6. Constraints and problems in moving towards market-based instruments

It is well known that a developed and active money market is a prerequisite for the effective and successful conduct of open market operations, the CBSL's favoured policy instrument. In Sri Lanka, the money market is still narrow and the spectrum of available instruments and existing institutions is limited. The interbank market is thin, being confined to the call-money market and the central bank's secondary window for Treasury bills. Call-money rates are volatile, reflecting the high cost of arbitrage between the interbank market and the Treasury bill market. However, the recently introduced repo market based on Treasury bills has stabilised call-money rates at the lower level. Moreover, the CBSL is planning to introduce reverse repo facilities based on Treasury bills with a view to stabilising call-money rates at the upper level as well.

Because of the lack of other money market instruments, banks' Treasury bill holdings can show sharp short-term fluctuations. These fluctuations could be minimised by developing a greater variety of money market instruments, as well as by establishing deeper primary and secondary markets for these instruments.

One of the major challenges which the CBSL faced in the past when formulating its policies was the expansionary pressure exerted continuously on the money supply by the need to finance large government

deficits. The country's institutional system and the arrangements for day-to-day policy decision-making have not been particularly conducive to maintaining consistency between the respective stances of monetary and fiscal policy. By creating excess liquidity in the economy, the expansion of government deficits in those circumstances resulted in an additional burden for monetary policy. More recently, the Government has attempted to reduce its financing requirement but has been only partially successful. Moreover, even this partial correction on the fiscal front was achieved mainly at the expense of capital expenditure, thus sacrificing long-term growth prospects.

Unexpectedly large fluctuations from abroad, affecting both commodity and financial markets, can create difficulties for monetary management in small open economies. As noted before, the tea boom experienced in 1984–85 forced the CBSL to market its own securities in order to mop up the resulting excess liquidity.

Efficient financial intermediation is a prerequisite for effective monetary management implemented with market-based instruments. However, a number of fiscal policies, such as the taxation of financial instruments, are not conducive to an efficient intermediation system.

The oligopolistic nature of Sri Lanka's commercial banking system, in which two state banks dominate business (still accounting for about 60% of deposits and credit), militates against a smooth functioning of the market. These two dominant banks can exert undue influence on the determination of interest rates and liquidity in the call-money market. Moreover, their inefficiency is one of the major reasons for the prevailing high interest spread (about 6%) in the banking sector.

The existence of a large semi-government sector, which is not cost-sensitive, constitutes a further constraint on market-based monetary management. As several large public corporate borrowers are not very responsive to interest rate changes, the effectiveness of monetary policy is eroded. Although the public enterprise reform programme forced a number of public corporations into the interest-sensitive private sector, heavy, non-interest-sensitive quasi-fiscal borrowing continues to prevail, reducing the impact of interest rate changes on the flow of credit.

It is difficult to implement successfully a market-based monetary policy system when overall macro policies lack a clear market orientation. Given that in a modern economy the government sector and the external sector are closely linked with the monetary sector, there is a need to align

fiscal and exchange rate policies with the stance of monetary policy. High and volatile inflation rates and an unrealistic exchange rate are not conducive to implementing a market-based monetary policy system.

A final major constraint observed in moving towards market-based monetary management has been the underdeveloped bond market. Competitive markets in medium and long-term government bonds have yet to be established. Moreover, almost all resources flowing into the captive market for long-term deposits are used for deficit financing, discouraging the development of a domestic bond market. Steps needed to develop the long-term bond market would therefore include a market-determined interest rate for government securities and the release to this market of long-term resources currently held captive.