# Ajith Nivard Cabraal: Harmonizing fiscal and monetary policies to deliver stability and growth

Text of the 18th Annual Oration by Mr Ajith Nivard Cabraal, Governor of the Central Bank of Sri Lanka*, organized by the Faculty of Taxation, Institute of Chartered Accountants of Sri Lanka, Colombo, 27 August 2013.

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***Also: Past President, Institute of Chartered Accountants of Sri Lanka; Past President, South Asian Federation of Accountants; Former Secretary, Ministry of Plan Implementation.***

Chairman, Mr. Sujeewa Rajapaksha, President, CA Sri Lanka;

Honourable Ministers;

His Lordship Mohan Pieris, Chief Justice;

Dr. P B Jayasundera, Secretary, Ministry of Finance & Planning;

Secretaries to Ministries;

Your Excellencies;

Mr. H.A.S. Samaraweera, Auditor General;

Deputy Governors and my colleagues at the Central Bank;

Vice President and Council Members of CA Sri Lanka;

Mr. N. R. Gajendran, Chairman, and Members of the Tax Faculty of CA Sri Lanka;

Mr. Esmond Satarasinghe;

Fellow Chartered Accountants;

Members of the Business Community;

My dear friends,

At the outset, let me thank CA Sri Lanka for inviting me to deliver the 18th Annual Oration on Taxation organized by the Faculty of Taxation of CA Sri Lanka. I consider myself deeply privileged to have this unique opportunity. I am further pleased because the topic of the Oration, "***Harmonizing Fiscal and Monetary Policies to deliver sustainable growth and Stability***" is one that is relevant and timely, since there are a large number of global and national developments which regularly underscore the vital importance of harmonization of the Monetary and Fiscal policies in countries as well as in regions.

## Monetary policy and fiscal policy

In order to set the backdrop for today's Oration, let me initially provide you with a brief insight as to what Monetary policy and Fiscal policy entails.

***Monetary policy is the means by which a central bank seeks to achieve macro-economic stability.*** In Sri Lanka, the authority responsible for the formulation and implementation of monetary policy is the Central Bank of Sri Lanka. The Monetary Law Act No.58 of 1949 is the legislation under which the Central Bank (CB) was established, and it provides a wide range of instruments that could be used by the Central Bank for monetary management. Developments in the economy and the financial system have led to a gradual evolution of the objectives, and the framework for the conduct of monetary policy. In 2002, in an amendment to the Monetary Law Act No. 58 of 1949, the objectives of the Central Bank

were re-defined as “economic and price stability” and “financial system stability”, with a view to encouraging and promoting the development of the productive resources of Sri Lanka.

***Fiscal policy is the framework that is implemented by the government in order to influence economic activities via the allocation of resources towards achieving the overall goals of stability and growth.*** This policy framework is mainly implemented through the Ministry of Finance (MoF) in Sri Lanka, with the ***traditional policy tools used for this purpose being taxation, government expenditure & borrowing, and debt management.***

In the meantime, it would also be noted that the financing of the budget and debt management has monetary implications, while the composition of debt instruments, the timing of debt issues and their maturities, has a close relationship with both fiscal and monetary implications. We need to understand that Fiscal policy is broader than taxation. Therefore, perhaps the next post-budget seminar of the Institute should attempt to convey this position so that the popular misconception amongst many Chartered Accountants that “fiscal policy is only about taxation” is removed, thereby encouraging Accountants to focus on fundamental fiscal philosophies and implementation methods at their important pre and post-budget seminars. Needless to say, a greater appreciation of the entirety of the fiscal policies would enable Chartered Accountants to pay more attention to the wide range of subjects encompassing fiscal policy, so that the Accountants’ knowledge and ideas in this field could be regularly harnessed for the benefit of the country at large.

Mr. Chairman, while it may be reasonably easy to define what Monetary Policy and Fiscal Policy means, it would not be so easy to define as to under whose purview such policies would fall into, when it comes to implementation. Of course, it is clear that the bulk of the Monetary Policy would be the direct responsibility of the Central Bank, and the bulk of the Fiscal Policy would be the responsibility of the Ministry of Finance. However, there are several grey areas and overlaps, which blur the boundaries of these policy frameworks, and therefore, there are many instances of policy actions of one institution impacting and influencing upon the policy framework of the other, and *vice versa*.

### Relationship between the central bank and the ministry of finance

With that in mind, let us now examine as to how the relationship between the Central Bank and the Ministry of Finance have been structured according to our Laws.

Mr. Chairman, as I already stated, the basic law governing the operations of the Monetary Board and the Central Bank, is the Monetary Law Act No.58 of 1949. The Monetary Law Act, (popularly called the MLA), covers the powers and purposes of the Central Bank, Monetary Board, Governor and Deputy Governors, Departments of the Central Bank, Reports and Publications, Profits and Losses and the Accounts of the Bank etc. In addition, chapters are devoted to the powers and purposes of the Central Bank, National Monetary Policy, instruments of the Central Bank, and the Central Bank’s relationship with the Government.

What perhaps is most relevant for today’s discussion is how the MLA has defined the Central Bank’s relationship with the Government. Towards that end, a careful examination of the MLA as well as ***John Exter’s “Report on the establishment of the Central Bank of Ceylon” in November 1949, (popularly called the Exter Report),*** will provide some useful insights as to the objectives and background of one of the most important pieces of legislation in our country.

At this stage, a quick introduction of ***John Exter*** may also be relevant. John Exter was a senior official of the Federal Reserve System who was seconded for service in late 1948, to the Government of Ceylon by the US Government, to advise the Government of Ceylon about the organization and the functions of a Reserve Bank for Ceylon, and to frame proposals for a draft constitution for the Reserve Bank of Ceylon. Exter who was a brilliant banker and scholar, fulfilled his mission and was thereafter appointed as the first Governor of the Central Bank of Ceylon in 1950. John Exter’s Report, now serves as the most important

and authoritative reference for Central Bankers in Sri Lanka, and is referred to often by academics and practitioners of Central Banking, whenever a clarification is required on any issue relating to central banking in Sri Lanka.

Getting back to our topic, what does this analysis of the MLA reveal? In my view, some very interesting positions:

***First: The MLA has been designed to ensure that the Central Bank functions as an independent body, with a high degree of autonomy to fashion and implement its policies, which have far reaching implications for the people.***

Mr. Chairman, let me now cite from the first paragraph of the Exter Report where he deals with the significance of the Central Bank System. I quote: *"The decision of the Government of Ceylon to establish a central bank was a decision with far reaching implications for the people of Ceylon. One implication already stands out very clearly: in taking steps to establish an independent monetary system to be administered by a central bank, the Government has demonstrated unmistakably its intention to achieve **genuine economic freedom** as a corollary of the political freedom achieved a year and a half ago."*

Having set the stage, Exter goes on to elaborate the responsibilities to be undertaken by the Central Bank: *"A central bank thus undertakes a great responsibility, and the broad powers given to the Central Bank of Ceylon under the draft bill in Part II of this report are **commensurate with the magnitude of this responsibility.** The Bank should not be hampered by rigid limitations which might prevent it from fulfilling its purpose."*

***Second: Exter reports on the need for the Central Bank to function in the context of the other agencies of government.***

He reports, and I quote: "*Under the draft law, the Central Bank will be the principal monetary authority, but it is obvious that it cannot exercise its authority in the monetary field as in a water-tight compartment, from which the various ministries and other agencies of the Government, are excluded. **There is no fine line separating monetary policy from other policies, such as fiscal and trade policies.** The Minister of Finance through his fiscal policy, or the Minister of Commerce and Trade through his authority to control imports and exports, can exert a powerful influence upon monetary conditions in Ceylon. But it is the clear intent of the Bill to concentrate, in so far as it is considered practicable and constitutional to do, **as much monetary authority and responsibility as possible in a single regulatory and operating agency – the Central Bank***"***.***

***Third: The Monetary Law Act (Chapter 6) envisages the Central Bank acting as the Fiscal***

***Agent, Banker and Financial Advisor to the Government.***

Sections 106, 113, and 114 set out clearly the Central Bank's role in relation to the management of the public debt and the borrowings by the Government and any agencies of Government. Those Sections read as follows:

> "***Section 106.*** *(1)* ***The Central Bank shall act as the fiscal agent and banker of the Government and of agencies or institutions acting on behalf of the Government,*** *whether established by any written law or otherwise.*"
>
> "***Section 113.*** *The Central Bank shall, as agent of the Government,* ***be responsible for the management of the public debt.***"
>
> "***Section 114.*** *No new loan shall be raised and no new issue of stock or debentures shall be made by the Government or by any agency or institution referred to in subsection (1) of section 106, whether in pursuance of authority conferred by any written law or otherwise,* ***unless the advice of the Monetary Board has first been obtained upon the monetary implication of the proposed loan or issue.***"

The Exter Report elaborates the thinking behind these sections: "*In a small country like Ceylon, it is clearly advantageous to place the responsibility for co-ordinating the activities of all Government credit institutions in the Monetary Board of the Central Bank.* ***The Board determines monetary and credit policy in general, and should have some means of ensuring that the policies of other credit institutions conform.***"

He further clarifies: "***The Board should be able to co-ordinate both the borrowing and the lending and investment operations of such institutions.*** *With respect to borrowing, co-ordination is necessary in order to prevent separate Government agencies from competing with each other and 'spoiling' the market, especially in the early stages of its development, and to make possible the formulation of a properly diversified pattern of interest rates and maturities for the entire Government borrowing program."*

Those Sections of the MLA that I referred to, and the relevant annotations in Exter's Report, strongly suggest that ***the Central Bank should play a dynamic role in the formulation of fiscal policy, particularly in relation to a significant part of fiscal policy's sphere of influence, namely that of borrowing and lending.*** In that context, it may be safely argued that, whilst the overwhelming responsibility for monetary policy has to be assumed by the Central Bank, a sizeable part of the responsibility in relation to fiscal policy is ***also*** cast upon the Central Bank.

***Fourth: Exter explains the unique position of the Governor, and the need for the Governor to be independent.***

This position is assured by the fact that the Governor is appointed for a 6 year term and cannot be removed from office, unless he has done any act, which in the opinion of the Governor General, (now, the President), is of a fraudulent or illegal character, or is against the interest of the Central Bank.

***Fifth: Exter discusses the limitations of the Central Bank:***

Once again, let me quote: *"A central bank influences the economic life of a nation principally by monetary action. While such action can be tremendously effective under certain conditions, its limitations should be frankly recognized.* ***Thus, through its control of money the Central Bank can <u>assist</u>, but by no means <u>ensure</u>, the achievement of the above objects.*** *A monetary system that is stable and at the same time responsive to the needs of a growing country is a necessary, but not a sufficient condition of orderly economic development."*

***Sixth: Exter reports on the vital importance of harmonizing between the Government policies and the Central Bank policies.***

Here, Exter's comments are unambiguous and far reaching. I quote: "***There are, however, many important problems of monetary policy, especially those relating to fiscal policy, on which a central bank must necessarily work in close harmony with the government.*** *On such problems, experience in many countries has shown that a central bank, with a degree of independence of the government proper, can make economic analyses and hold views which are more detached and objective than those of a government department. Many governments have learned to value and to use the sort of independent and objective advice on monetary and other aspects of economic policy which central banks have been able to give. On matters of vital interest to the state, however, it must be recognized that… it would be impossible for the Central Bank to adopt a policy or pursue a course of action contrary to the policy of the Government of the day.* ***No agency which is a creature of the Government can be entirely independent of the Government.*** *While the Government may be prepared to give an independent regulatory agency rather wide discretion in a field such as that of money, there is no gain-saying that, in the last analysis,* ***the Government must assume responsibility for monetary policy as for other policies.*** *The Governor and the appointed member of the Monetary Board cannot help being acutely conscious of the fact that, since no Parliament can bind its successors, their independence and tenure in office*

*under the proposed legislation is limited by the ultimate power of the Government to change the law.*"

Exter also makes a further useful observation: *"The exact degree and independence of the Central Bank is likely to vary from time to time. For example, central banks can ordinarily act more independently in stable, peace-time economic conditions, than in time of war or other national emergency.* ***They also tend to take stronger stands on issues which are primarily monetary in character, than on related issues which may simply have monetary repercussions***"***.***

***Seventh: Exter describes the ideal situation as contemplated by the MLA.***

I quote once again: "***The ideal 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. The effectiveness of this cooperation and co-ordination between the Board and the Government will depend more upon the men occupying the key positions at particular times than upon any legal formula, no matter how carefully or elaborately it might be worked out. A relationship as complex, and sometimes as delicate, as this one is certain to be, cannot be established full-blown by a piece of legislation. It must be the result, as in other countries, of years of experience and the slow growth of political conventions.***"

A reading and understanding of these Exter annotations clearly indicate the delicate and complex nature of the envisaged relationship between these two vital institutions, and the men (or women!) occupying the key positions. ***It would also be observed that Exter is suggesting, and the MLA is legislating, a somewhat paradoxical situation.*** On the one hand, (now, I am speaking like a traditional Economist!), the Central Bank must exercise a high degree of independence, while, on the other hand, the Central Bank must act in harmonization with the policies of the Government! It is of course obvious that this paradox is not unintentional, and has, in fact, been carefully thought through and deliberately introduced, and has obviously been done in order to establish an extremely vital and far reaching principle. That is, ***the need for the Central Bank to retain intellectual and operational independence, but to temper it with the pragmatism of the national deliverables of the economic agenda that has been decided by a democratically elected government.*** Going further, Exter's comment that "the effectiveness of this cooperation and coordination between the Board and the Government will depend more upon the men occupying the key positions at particular times, than upon any legal formula", emphasizes the complexity and the delicateness of the relationship, which he has described in lucid and clever language.

Mr. Chairman, All these positions that I described to you now highlight another very important fundamental principle that was set out in Exter's Central Bank Report of 1949. That is, Exter's wise words that "***good central banking is less good law than good practice***". After 7 years as the Governor, I can tell you that that is one of the wisest comments in the Exter Report, and an appreciation of that principle must be understood by all stakeholders, especially at the current turbulent times, when Sri Lanka is on a fast track to economic development.

In fact, over the past several decades, monetary policy objectives, instruments and operating mechanisms have changed significantly. Today, in the aftermath of global financial crisis, the key focus of central banks is both the successful conduct of monetary policy and macroprudential policy, in order to reinforce each other to stabilize economies. In Sri Lanka too, monetary policy formulation, operational framework and strategies adopted, have all evolved in line with the changing structure of the economy, developments in the financial markets, and the availability of data and communication strategies. I do not intend to discuss

these changes in detail here, but would like to highlight that a greater coordination of monetary and fiscal policies would become even more crucial in the implementation of monetary policy and achieving macroeconomic stability, in the future than in the past.

Another position that should be clear to us is that the need for harmonization between the Central Bank and the Ministry of Finance, is not a virtue that has been suggested recently, but a vital ingredient that had been provided for, since the establishment of the Central Bank, in order to ensure the sound economic management of the country.

### The recent evolution of our economy

Armed with that background, I would now like to proceed to share with you, some instances of harmonization that has taken place in the recent past in our country. However, before I do that, I think it is necessary to first touch upon the recent evolution of our economy in order to set the stage for what would follow.

***To do so, let us initially examine a snap shot of our economy in 2005.*** Growth in 2005 was 6.2%, with the average growth for the 7 years, 1999 to 2005, being 4.3%; Foreign reserves were around US$ 2.7 billion, or about the equivalent of 2 ½ months imports; The country was at the mercy of a ruthless terrorist group and on the brink of war; Unemployment was at 7.2%; Poverty was at a level over 15%; Inflation was on a sharp rising trend; The banking system was vulnerable and displaying several worrisome cracks; Public debt to GDP level exceeded 90%; Per capita income was under US$1,250; GDP was around US$24 billion; The Western Province share of GDP was an overwhelming 51%; Infrastructure development was almost non-existent; The fiscal deficit was over 7% although very little infrastructure development work had been carried out. All in all, a rather bleak picture, and worse still, a bleak outlook.

***Let us now see what it is like today:*** Growth is over 7%, and average growth from 2006 to 2012 has been 6.7%; Growth appears to be on course to reach around the 8% level from next year; Foreign reserves exceed US$ 6.3 billion and around 4.4 months of imports; The country enjoys peaceful and stable conditions; Foreign investment inflows are strong and foreign Investment via international sovereign bonds and Government paper amounts to about US$7.0 billion; Unemployment is around 3.6%; Poverty is down to about the 6% mark; Inflation has been at single digit levels over the past 4 ½ years; GDP is at about US$60 billion; Per capita income is around US$ 3,000; The economy is being diversified under a 5Hub + Tourism strategy to avoid the middle income trap; The Fiscal deficit has been limited to 6.4% in 2012, and on a reducing trend; The Debt to GDP level is below 80% and falling; The level of infrastructure has improved tremendously; The Doing Business global rank is at the 81st, and is poised to jump about 10 places this year; Regional development has made tangible progress and the Western Province share of GDP has dropped to around 43%; Regular foreign investment is flowing into banks and the stock market; Private remittances have reached nearly 10% of GDP, or about US$ 6 billion in actual inflows; The banking system has been stable and even in the midst of very difficult global circumstances, the country enjoys favourable reviews from many influential international quarters.

Mr. Chairman, a dispassionate comparison of the conditions prevailing in 2006 and 2013 tells us that our economy has made an unprecedented transformation over the past 7 years, with strong economic growth, and stable macro-economic conditions.

### Harmonization of monetary and fiscal policies – case studies

The discussion point that then arises is, as to what factors, processes and conditions contributed to this current level of growth and stability. Of course, we are all aware that many factors contributed to the current state of affairs of the country, and those could be the subject of, maybe 50 other Orations! ***But, for today's discussion, let us confine ourselves***

***to examining the background of some significant initiatives that would have influenced the current state of the economy, and to understand how the present day outcomes were supported and/or impacted by the harmonization of the Fiscal and Monetary policies.***

One striking feature in the implementation of Monetary and Fiscal policy over the past 7 years, has been that both institutions, MoF and CB have been taking a keen and enduring interest in both monetary and fiscal policies. ***We realized that a "blame game" would be of no value to the country or to the stakeholders, and that it was absolutely vital that we should deliver on both fronts simultaneously.***

Mr. Chairman, having said that, we will now discuss some case studies that would throw some light about the degree of harmonization that took place between the policies of the Central Bank and the Ministry of Finance, in order to deliver some of the vital results to our country and economy, over the past 7 years.

***Case Study 1: Opening out Sri Lanka Treasury Bills and Bonds to foreign investors***

Mr. Chairman, the first case study that I would like to cite is the November 2006 move to open out Sri Lanka Treasury bills and bonds to foreign investors. By late 2006, in Sri Lanka, a massive infrastructure development programme had been launched, and the critical humanitarian operation had begun. These twin programmes had demanded a regular, steady and massive flow of funds, and it was becoming increasingly clear that we would not be able to secure the new fund requirements only via local taxes and local borrowing. If such a quantum of funds were to be sourced from within, an enormous pressure would have been exerted upon the entire economy. In fact, such an attempt would have pushed interest rates to unacceptable levels, and may have even dragged the economy towards negative territory, and placed the entire monetary system at considerable risk. Such fears may have perhaps been one of the reasons that prompted successive governments of the past, to avoid large scale infrastructure development programmes or attempt to launch a full scale counter action programme against terrorism. However, the government of President Mahinda Rajapaksa took the bold decision to undertake both these missions, and the fiscal and monetary authorities had then to find innovative ways to support those missions, without placing the economy under undue risk or peril.

As a response therefore, in late 2006, the Treasury and the Central Bank decided to open out a small portion of the Government Treasury bills and bonds to foreign investors. This was the first move to attract ***foreign investment into Government rupee paper,*** and it was naturally a fresh and exciting experience for both the Sri Lankan authorities as well as foreign investors. You may note that I said, "foreign investment", and not "foreign direct investment" or FDI. That is because, in our view, what was vital was that "foreign investment" should be allowed to flow through convenient instruments to supplement the shortfall in savings and investments in our country's economic structure, and such inflows need not necessarily have been only via FDI. The move resulted in new and quick inflows, and as a result, debt management became more dynamic and robust. It also provided a new tool to address the wide fluctuation of interest rates that was taking place in the country, prior to the move.

This initiative of course necessitated close cooperation and follow up between the MoF and CB, particularly because it resulted in a significant infusion of forex into the country that needed to be properly managed from the point of view of the Central Bank. In retrospect, I can also state that this important move enabled the economy to face the emerging challenging times confidently, with the new inflows assisting the Government to maintain the growth momentum, while also allowing the Central Bank to maintain stability.

One of the important lessons that we would take away from this case study is that the initiative was implemented as a result of the close harmonization between the MoF and the Central Bank. Had any one of the two agencies not fully supported this bold and imaginative move, the initiative would have failed, or worse still, been still-born.

### *Case Study 2: Debut International Sovereign Bond*

The second case study that I would describe this evening is the debut international sovereign bond of Sri Lanka, in 2007.

Mr. Chairman, as you may recollect, by the second half of 2007, the country was fully engaged in the major humanitarian operation, while the global environment was becoming more and more unstable. The local environment was also tense, notwithstanding all efforts. Inflation was high; interest rates were high; the exchange rate was under threat; and the fiscal deficit was expanding rapidly, because of the ever increasing need for finances to fund the massive infrastructure development programme and to meet the costs of the humanitarian operation. To deal with this challenging situation, the MoF and the CB decided that it was vital that a further sizeable injection of long term foreign funds was given to the economy. It was only such an infusion that would allow us to maintain stability, as well as be able to have the much needed funds to keep the infrastructure development effort going. Some financially savvy members of the Opposition too, realized the significance of such a fund infusion into the economy, and tried their utmost to scuttle that effort. But, fortunately, we were able to defeat those endeavours, and raise the all important bond, and tide over the risky period.

The infusion of the new funds immediately brought stability to the economy and also acted as an important stimulus for growth, with the new additional resources quickly filtering down into the economy. Hence, as a result of the move, the Fiscal framework was supported with the moderation of interest rates; the monetary framework was facilitated with the stabilization of prices; and exchange rate was supported by the buttressing of international reserves.

Mr. Chairman, I believe that, some day when Sri Lanka's economic history is being written, this 2007 infusion of US$ 500 million through the international sovereign bond, would be marked as a major "turning point" in our economic landscape. I also believe that the benefits of this land mark move has been of an enduring and permanent nature, as evidenced by the fact that, over the next 5 ½ years, the Government has been able to raise a further US$3 ½ billion from international bonds, with the coupon rates tightening considerably each year. Another benefit that this initiative entailed, was that it paved the way for several banks and corporates to also issue international bonds, thereby accessing savings from outside the country. By doing that, we had also been able to bridge the chronic savings/investment gap that has been regularly referred to by a never ending stream of experts since independence, as a major deficiency that was hampering growth in our economy.

### *Case Study 3: Intervention to stabilize a systemically important bank*

The third case study that I would like to illustrate is the instance where the Central Bank and the Ministry of Finance teamed up to stabilize a systemically important bank that was facing a liquidity crisis in late 2008/early 2009.

Mr. Chairman, If we take our minds back to that period, in late 2008, we would recollect that the external environment, internationally and locally, had become even more hostile and highly uncertain. Internationally, the global financial crisis had taken a major toll, with hundreds of banks collapsing across the world. Each day, we were hearing about the collapse or the imminent failure of many big names in the global financial landscape. In many countries, the Ministers of Finance and the Governors of the Central Banks were huddled in endless discussions as to what should be done to arrest the crises, or how to stop the bleeding. Businesses were going bankrupt by the thousands. Business confidence level was at rock bottom. People in all parts of the world were in panic. Locally, our humanitarian operation had entered a final and most critical stage, and enormous pressure was being exerted on the economy.

In that background, when a systemically important bank showed signs of a liquidity crisis, we knew that such an event, if allowed to escalate, could have dragged our economy to chaos, and our humanitarian operation to a standstill. We had to act decisively, and fast. We could

not have delayed responding to this grave threat, or got it wrong. Fortunately, the Central Bank was ready. We had already developed a bank intervention operation, code named “Sigiriya”, to deal with a situation of a liquidity crisis in a bank. The time had come to activate such a mission. But to do so, the first step was vital. That was to apprise the Minister of Finance and obtain his approval to make the intervention. If the Minister of Finance were to approve such an intervention, if would be the first time ever, in Sri Lanka, that such a rescue operation was attempted. At the same time, the experiences of other countries during that period, were not too encouraging. In many countries, including the UK, (as in the case of the Northern Rock Bank), the Finance Ministers and the Governors of the Central Banks had been in protracted discussions for many weeks about this type of intervention, without reaching agreement.

Fortunately for Sri Lanka however, such procrastination did not take place. The Minister of Finance was decisive, and after a single “one-on-one” discussion with me, he gave the approval for the Central Bank to proceed with implementation of the intervention plan. The rest is history. The newly appointed directors and the managing agents, with the Central Bank in the background, were able to stabilize the bank within a short period of about 2 weeks. Thereafter, within a few months, the bank was able to infuse new capital and thereby qualify to exit from the close monitoring system of the Central Bank, in less than a year.

This episode will be an important lesson for those who wish to study the way Governments and Central Banks should cooperate to bring stability, in the face of any instability in the banking sector. It also confirmed the validity of an important annotation in Exter’s Report. Let me quote once again from the first Chapter of his Report: *“Many of its (Central Bank’s) powers may go unused for long periods, because they are designed for particular situations, some of which may never arise. Others are intended for use only in crises or to forestall a crisis, but prudence dictates that they be included now, so that they will be at hand in case of need. …”.*

***Case Study 4: The creation of our present day “virtuous cycle”***

Mr. Chairman, I would like to now place before you, yet another significant example of harmonization between the Monetary and Fiscal policies, which led to the creation of a new “virtuous cycle” in relation to inflation, interest rates, investor confidence and sustained growth, in our country.

As we are all aware, Sri Lanka had been long trapped in a “vicious cycle” of high fiscal deficits leading to high inflation; high inflation leading to high interest rates; high interest rates leading to low investor confidence; low investor confidence leading to sluggish investment; sluggish investment leading to low growth; low growth leading to high debt; and high debt once again leading to high fiscal deficits. This was the vicious cycle that we had been trapped, for more than 5 decades since independence. It is true that we have had one-off spurts of high growth or short periods of low inflation at various times in our history. However, we have to acknowledge that, other than in 2010 and 2011, we have never had over 8% growth in consecutive years, or, for that matter, been even able to record an average growth of over 5% over a 5 year period, prior to 2006! At the same time, other than the period February 2009, till now, Sri Lanka had never enjoyed a period of even two continuous years of single digit inflation, and, believe it or not, our level of average inflation was over 12% prior to that! What was worse was that there was almost a sense of acceptance of such performance among many officials of both the MoF and CB, who harboured the internal view that it may be our country’s “karma” to have low growth, large fiscal deficits and high inflation! In fact, many Central Bank officials were often heard to lament that the continuous high fiscal deficits of the Government was pushing inflation up and grumble that the Government will never stop doing that. In turn, MoF officials used to complain that the tight and in-sensitive monetary policies of the CB was the root cause for the fiscal deficit always being out of control!

It was therefore clear that a change in attitude and a change in action was vital. It was also necessary to make some effective interventions to change the equilibrium of this vicious cycle, so that a fresh equilibrium could be created. Le Chatelier, the famous French Scientist who introduced the "Equilibrium Law" to the world in 1898, had taught us that, in order to disturb an equilibrium, you only need to disturb one component of the equilibrium. Then, the entire system will move into a new equilibrium. So, a key decision had to be made, as to which of the offending components of our vicious equilibrium should be disturbed and dealt with first. Towards that end, I remember, having several "one-on-one" discussions with the Secretary to the Treasury, Dr. P.B. Jayasundera in late 2006 and early 2007, to jointly decide on this all important priority. Based on such discussions, we decided that we would take the necessary initiatives to ***improve investor confidence*** ***so as to ensure the continuous investment via the Government and the local private sector, whilst specifically targeting new foreign investment.***

Accordingly, many initiatives were implemented, and over a comparatively short period of time, such efforts started showing results, and the country started to record a steady inflow of foreign investment through major government projects, investments in Treasury Bills and Bonds, and investments in international sovereign bonds. This regular flow of investments enabled the economy to record sustained high growth, even whilst the conflict was raging. As a consequence, Sri Lanka recorded ***an average growth of 6.7% through 2006 to 2012,*** which was one of the most difficult periods in our history. In fact, the growth levels of 2006: 7.7%, 2007: 6.8%, 2008: 6%, 2009: 3.5%, 2010: 8%, 2011: 8.2%, and 2012: 6.4%, were the highest ever in any seven year period in our history! That meant that our joint strategy had paid off, with sustained growth being recorded. With such sustained growth and with the pipeline of continuous investments, the economy was gradually transformed to a more stable level, and with that, all other key factors in the vicious cycle also began to change for the better.

Initially, certain critics did not believe that we would be able to escape from the vicious cycle that had trapped the country for decades. They wrote to the newspapers and gave TV interviews stating that the initial successes were flukes and were not sustainable. They warned that the economy would return to the vicious cycle once again. They continued to support their arguments with many high sounding theories and hair-splitting formulas, and Dr. Jayasundera and I were ridiculed, and often described as the villains responsible for the impending disaster. We were regularly featured in some unflattering, but nevertheless enjoyable cartoons as well!

But, today, Mr. Chairman, those critics are finding it increasingly difficult to sustain their criticism, in the face of the gradually emerging new equilibrium of the "virtuous cycle" that our new harmonized policy framework had been able to generate. Presently, even though a minority stubbornly refuse to see what is unfolding before their very own eyes, this new cycle has taken shape: Low inflation leading to real interest rates; real interest rates leading to enhanced savings; enhanced savings leading to a regular pipeline of investment; regular investment leading to lower debt levels; lower debt levels leading to sustained growth; and sustained growth once again leading to low inflation. What that tells us is that we have been able to break free from the previous vicious cycle, and have now placed the country on a more virtuous cycle! The challenge therefore would be to carefully nurture and guard this new equilibrium, knowing fully well that the disturbance in even one of those components could change that situation with adverse results.

***Case Study 5: The establishment of the Deposit Insurance Scheme***

Let me now illustrate yet another example of harmonization. This is in relation to the establishment of the Deposit Insurance Fund and Scheme.

My colleagues at the Central Bank have told me that discussions in connection with the setting up of a Deposit Insurance Scheme had been taking place at various times, over the past two decades! However, there was no consensus reached on a suitable mechanism,

particularly because the large initial capital that was required for the establishment of such a scheme, could not be allocated by the Government for many years due to the intense pressure upon the need to allocate funds for other more pressing needs of the state. Nevertheless, it was considered vital that such a fund and a scheme should be established, and hence an innovative method had to be structured, without placing an additional burden upon the Government coffers.

In 2010 too, internal discussions were once again taking place with regard to the possible setting up of a Deposit Insurance Fund. At that time, we noted that the abandoned properties of the banks, which constituted the dormant account balances of over 10 years, had risen to a sizeable amount, and according to the law, those funds had to be placed by the banks with the Government for safe keeping. Accordingly, it was then decided by the MoF and the CB to use the funds so placed, as the nucleus of the Deposit Insurance Fund. Thereafter, the regular premia paid by the banks and finance companies, based on a pre-determined formula, could be credited to this new Fund, and thereby, build up the Fund.

In order to implement such plan, an arrangement had to be made with the Government, in that, instead of crediting the abandoned property funds to the fiscal coffers of the Government, such funds could be retained by the CB for the purpose of initiating the Deposit Insurance Fund. In that manner, the new deposit insurance fund was created, and as a result, a long felt need was fulfilled! In fact, that scheme was innovatively designed not only to provide for a "pay out" in the event of a financial institution collapsing or being rendered dysfunctional, but also to provide funds for the purpose of reviving and/or restructuring viable financial institutions that face liquidity crisis from time to time.

In that context, I am pleased to state that the Monetary Board has recently decided to invest a part of the fund to deal with some of the structural imbalances that have arisen in certain finance companies, so that such an infusion would encourage new investors to take over, revive and restructure such troubled institutions, with greater confidence and certainty.

### *Case Study 6: Stabilization measures of 2012*

Mr. Chairman, the next illustration I want to present to you is one of the clearest examples of policy co-ordination between fiscal and monetary policy. That was the stabilization package of 2012, which was introduced by the MoF and the CB from February to April 2012, in response to the pressure on the balance of payments, high imports, high credit growth and pressure on the exchange rate.

As we all know, to deal with that growing tension, the Central Bank increased the policy interest rates, allowed the exchange rate to be more flexible and placed a 18% credit ceiling upon banks' lending. In tandem, the Government imposed higher duties on the import of vehicles and a few other commodities, and increased the administratively determined prices of petroleum products. These measures were implemented in a carefully planned out and logical sequence. As a consequence, the desired stability within the economy was achieved quickly, with the Balance of Payments returning to positive territory, and the exchange rate stabilizing. In fact, this new situation enabled the Monetary Board to relax the monetary policy tightening cycle that commenced in February 2012, as early as in December 2012.

This joint exercise therefore shows how quickly and effectively, a coordinated fiscal and monetary policy could deliver results, instead of the implementation of stand-alone monetary or fiscal policies, which usually take a long time to impact the economy, thus resulting in to the entire economy having to suffer from tight policies for longer periods of time.

### *Case study 7: Judicious use of fiscal policies, based on inflation behavior and other macro-economic factors*

Mr. Chairman, I have so far discussed 6 case studies that confirm the co-operation and harmonization between the MoF and CB. The co-ordination however, went even further and was applied in several other situations as well. Now, I am going to describe one general

example out of several similar instances which took place from time to time, over the past few years.

Let us take our minds back to October/November 2011. At that time, the global oil prices had soared to dizzy heights, and the Ceylon Petroleum Corporation was incurring rather heavy losses. As a natural response therefore, an increase in the administrated prices in petroleum products seemed like a sensible action. However, at that time, inflation in the country was around the 7% level. Inflation projections for the next 2 months too, were around the 7% to 8% levels. In that background, our view was that, if the petroleum prices were to be adjusted upwards significantly, the inflation figures would have risen above 10%, and had that happened, the favourable sentiments that had been built up carefully over the previous 33 months would have been badly damaged. Then, we would have had to start our inflation control efforts all over again, and inflation expectations too would have suffered considerably. So, a balance was struck and the decision to increase the petroleum prices was postponed until February 2012, because we knew that, by that time, the inflation figures would be very low, at less than 3%, and that benign situation would then give us a comfortable cushion to make the price adjustment, without harming the inflation numbers or the inflation outlook.

This was then, just one, but a representative case study of holding on to a difficult position in the short term, to realize a long term position, so as to benefit by an even more significant outcome. It was, as Exter may have been happy to acknowledge had he been present, a pragmatic decision of the Government working closely with the Central Bank, cooperating on a complex and delicate issue, to deliver stability and growth in the long term.

### A "shared vision" and "goal congruence"

Mr. Chairman, I am often asked by people as to the exact definition of the economic philosophy behind our country's economic policies. As is usual in any field of learning, academics and scholars like to categorize a series of policies, according to a general character, or to place them in a framework of a pre-determined school of thought. Where then would our current economic policy framework, fit in? Is there a particular model that Sri Lanka follows?

To respond to such questions, let us try to understand what exactly our economic planners are doing, and what they are attempting to achieve. In my view and understanding, it is clear as to what our goals are, and I must say, there are quite a few: Maintain a low level of inflation; Consolidate the fiscal deficit on a planned basis; Promote SMEs; Ensure food security; Encourage import substitution; Enhance exports; Diversify our external sector by adding new areas to the external sector; Record a current account surplus by 2016; Deliver balanced regional development; Ensure that infrastructure development takes place in all parts of the country; Improve the way we do business; Consolidate our debt position; Encourage more savings; Eradicate poverty; Reduce unemployment to very low levels; Continuously maintain sufficient levels of foreign reserves; Improve the living standards of all the people.

What then would a collection of policies that are designed and are being implemented to deliver the above outcomes, be called? In all humility, I must admit, I don't know. That perhaps could be for the academics and scholars to propose, debate and decide. But for the time being, let me say that, whatever those policies may be collectively called, we are determined to implement them through a harmonized approach that is designed to take us forward, towards all those vital targets simultaneously. I would also argue that, for such approach to be successful in the long term, we must always retain one of the most important features of our current economic management, which is that the MoF and CB must have a "shared" vision and "shared objectives". That shared vision has been the platform that has helped the two institutions to achieve "goal congruence" in the recent past, and there is also no doubt that the resulting harmonization has been the powerful driving force behind our steady progress.

In the meantime, we must also appreciate that a large segment of our economic activities are carried out by the private sector, to which many of you belong. Your contribution then, has also been a vital factor in maintaining the momentum and thrust of our economy. Therefore, let me acknowledge today that, no amount of harmonization of Monetary and Fiscal policies could ever be a substitute for the commitment and dedication of a vast number of entrepreneurs who take risks, as well as burn the mid-night oil, to deliver value in our economy.

## A future role for the accountancy profession

Where do we go from here? In my view, Sri Lanka has only just begun an exciting and adventurous journey, and we are steadily moving towards a US$ 100 billion economy that would be more diversified and more stable. Needless to say, the success of our journey would depend to a great extent on harmonized policies, clarity of communication, quick implementation, and the maintenance of a vibrant momentum on a continuous basis.

In that context, I see the accounting profession playing an increasingly significant role. I see the Accountants being vital partners in the operationalizing of the 5 major hubs, and in particular, the commercial and knowledge hubs that we are keen to establish in our country. The CAs have expertise in accounting, auditing, taxation, information technology, financial management, banking, planning, financial analysis and project management, among many other skills. The contribution they could make in the new Sri Lanka that is unfolding before us, therefore, is immense. The skills that they possess in finance, planning and business are also varied, and hence they could play a very important role in many spheres of public and private enterprise of our country. I am confident they would respond to that call, and all of you would enhance your role in our country's economic activities in the future.

## A finance man as governor?

Let me now strike a slightly personal note before I proceed to conclude this address.

In order to do so, let me quote from what Exter had to say about the person to be selected as the Governor: *"Although the ultimate authority rests in the Monetary Board, the draft law nevertheless recognizes need for a* ***strong chief executive for the Central Bank.*** *Accordingly, the Governor is made the Chairman of the Monetary Board, and is given control of the agenda for its meetings. He is to be responsible for the execution and administration of policies and measures adopted by the Monetary Board, for the direction, supervision and control of the operations of the Central Bank, and for its internal management and administration. He is to be chief representative of the Bank in its relations with outside persons, …..* ***Accordingly, the Governor should be a man of recognized and outstanding competence in, and understanding of, the economic and financial problems of Ceylon, and of unquestioned integrity and responsibility...***"

Exter then states, and I quote further: "***It is important that the Governor should have had actual financial experience.*** *In many countries this point has actually been incorporated in legislation, as the following quotation from De Kock's book on Central Banking shows: '… in the case of some central banks it has been laid down by statute that the Governor and Deputy-Governor shall be 'men of* ***proven financial experience****', as in Canada, or 'persons possessed of actual* ***banking experience****', as in New Zealand, or 'persons of* ***recognized banking and financial experience****', as in Argentina, or that the Governor shall be a 'person of tested* ***banking experience****', as in the Union of South Africa and Mexico.'"*

Mr. Chairman, you may remember when I was first appointed Governor, there were some who claimed that a person with "financial experience", was not a suitable choice, to undertake the duties of the Governor. While I firmly believe it is up to history to judge as to whether I have been successful or not in discharging my responsibilities as Governor, I also believe that even at this late stage, it may be useful for those critics to reflect on the profile

that John Exter had in mind for the position of Governor when drafting the MLA, and then perhaps consider, whether or not, I fitted the envisaged profile!

In that background, I am inclined to believe that the education, training, and professional skills imparted by the Institute of Chartered Accountants of Sri Lanka, had a major role in my being appointed to this pivotal position as the Governor of the Central Bank of Sri Lanka. Therefore, please permit me to officially and publicly thank the Institute of Chartered Accountants of Sri Lanka for the tremendous impact that the Institute has had on my academic and professional career, in addition to the singular honour you bestowed on me this evening, by inviting me to deliver this prestigious Oration.

**Conclusion – running between the wickets!**

Mr. Chairman, let me now conclude, with a little story.

About 6 months ago, a journalist friend asked me to explain the official relationship between the Governor and the Secretary, Treasury.

In response, I gave him a long lecture for about half an hour, like what I have done today! While listening to me, I could see that he was quite restless, and somewhat bored. So, I was not surprised when he remarked that he was not sure as to how he can explain all what I had said to him, to ordinary people, as my explanation seemed too technical and high-flown.

He then told me, “Governor, Can you please explain what you just said to me, in layman’s language?”

This was my reply to that challenging question:

“To score runs in a cricket match, when one batsman strikes the ball, both batsmen have to run, each to their opposite ends. When the second batsman strikes the ball, once again, both batsmen have to run, each to their opposite ends. That is how the team will be able to accumulate its runs. For an effective partnership to be built, both batsmen have to diligently run for each other’s strikes. In the same way, for an economic partnership of the country to succeed, it is vital that there is a clear understanding between the Governor and the Secretary, Treasury. And, each time the Governor strikes, both the Governor and the Secretary have to run, and when the Secretary strikes, both the Governor and the Secretary have to run once again. That is the type of relationship that has to exist between the Governor and the Secretary to the Treasury.”

My journalist friend’s eyes brightened and his boredom vanished. The expression on his face indicated to me that he had finally understood what this complex relationship is all about.

Then, he said “Ah, so it’s like running between the wickets!”

Mr. Chairman, I sincerely hope my address to you today, helped you and everyone here present, to also understand this complex and delicate relationship, in the same manner my friend did!

Thank you.