Arjuna Mahendran: Role of the Central Bank in the Sri Lankan context

Speech by Mr Arjuna Mahendran, Governor of the Central Bank of Sri Lanka, at the Sri Lanka Legal Summit 2015 "Governance, Regulation and Investment – The Way Forward", Colombo, 5 March 2015.

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Ladies and Gentlemen,

I am greatly privileged to address your distinguished audience on this topic with which I am reasonably conversant.

The Central Bank of Sri Lanka today is a talking point among the public. Further, world over, central banks are in the public eye due to their specific role in staring off the global financial crisis, which caused a mini depression in 2009.

The Central Bank of Sri Lanka is probably the single state authority with enormous influence in the economy and economic welfare of the general public. This influence comes from the powers and functions conferred upon the Central Bank from a number of statutes led by the Monetary Law Act (MLA) of 1949. In my view, when compared with statutes governing Central Banks in other countries, MLA is the single piece of legislation that provides for time invariant powers and functions of the Central Bank. The law has worked reasonably well during last 65 years without any major amendments. The drafting of the law in 1949 has been supervised by the renowned economist Mr. John Exter from the Federal Reserve Bank of New York who also in recognition of his stellar efforts was the first Governor of the Central Bank. In his report submitted to the Government on establishment of the Central Bank, he stated as follows.

I quote *"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. When a new central bank is being established it is impossible to predict the course of its development. This will depend upon the environment within which it works and upon those who, determine its policies. Many of its 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. It would be foolhardy to assume, with the record of the war – and depression – induced economic crises of the last 30 years plainly before us, that the Ceylon economy will somehow escape such crises in the future. The safer assumption is the one underlying the drafting of the present bill: it is better in an uncertain economic world to be prepared for any eventuality.*

Many features of the draft bill have been developed in the Western Hemisphere. Others are found in one form or another in central banking legislation within the Commonwealth. The basic pattern is suited for countries which are introducing central banking systems for the first time because it contains certain signposts and warning signals which should prove useful to administrators who do not have long established traditions and years of personal experience upon which to rely. It also provides a legal structure which is flexible and adaptable to changing economic conditions. Within the structure there is ample room for the development of policies that are appropriate to the times.

Good central banking is less good law than good practice. The Central Bank of Ceylon may make its influence felt more effectively through the development of day-to-day relations of confidence and understanding between itself and the various banking institutions than through the exercise of all of the powers given it under this bill. Such influence is known in the textbooks as "moral suasion" and should be especially important in a small country where *it should be possible to develop close relations between the Central Bank and each of the fairly limited number of banking institutions…..*"

Having worked as an economist in the Central Bank and banker and investment banker in global financial environment, I perfectly understand what Mr. Exter meant. I invite you all to read the Exter Report if you are interested in knowing what type of institution the Central Bank is? I would pray that you, after reading the Exter Report, may not complain that Central Bank has not done enough to Sri Lanka economy and economic welfare of the public in terms of the mandate given to it by the public.

The Central Bank's all powers and functions center around two objectives. Those are the securing of economic and price stability and financial system stability with a view to encouraging and promoting the development of the productive resources of Sri Lanka. This is not the forum for me to define technically each objective as there is no single accepted definition. However, those objectives in nutshell mean securing stability of the economy. Economic and price stability means the economy running on a sustainable growth path with a supportive low rate inflation. Financial system stability means financial institutions and markets operate without bubbles or contagious failures where the trust of the public in the financial system is maintained, stability of the Economy, prices and the financial system are inter-dependent. The stability of the Economy helps the public to make and keep their plans for the future which ultimately encourages and promotes development of productive resources of Sri Lanka. This is what will promote living standard of the public by increasing production, employment and real income. This is what the MLA has empowered the Central Bank to do. Thus, you may understand the enormous national interest entrusted to the Central Bank.

For securing these objectives, the Central Bank has been granted the authority for administration, supervision and regulation of the monetary, financial and payment system of Sri Lanka through actions authorized by the MLA. Therefore, we must clearly understand the scope of our mandate. The Central Bank cannot directly undertake business to provide employment or create income or construct buildings to promote financial or business centers. The Central Bank's scope of mandate for the stability of Sri Lanka economy is essentially the regulation and supervision of monetary, financial and payment system of Sri Lanka.

Accordingly, the functions or activities the Central Bank carries out in its normal operations are the issue of the currency or legal tender, implementation of monetary policy, supervision of banks and financial institutions, management of an international reserve, operation of payment systems and financial related services to the Government as the Government agent. How the Central Bank carries out these functions with the help of nearly 1,500 staff is a complex and technical subject. The judiciary and legal community present today here may recall a number of court cases being heard now and judgments delivered in the past connected with certain operations of the Central Bank, because either Central Bank procedures are not prudent for safeguarding the public trust or the public ignored the scope of the mandate of the Central Bank to get involved in financial sector developments. For example, the Central Bank is a respondent in all court cases recently filed in connection with unauthorized and failed investment schemes as the petitioners are of the view that the Central Bank is responsible for the loss of investors' money. Let me therefore elaborate on Central Bank functions.

First, the issue of currency

Central banking is a concept originated from the issue of currency. In the evolution of money, private banks started issuing their own bank notes, initially based on their gold holding and later as their own liabilities. The bank in which the public placed the highest trust started operating as a central bank in the market. Later in the history, legislation was brought to empower the Central Bank to print bank notes or currency which function as the intermediary between all economic transactions. Currency in issue at present in Sri Lanka is about

Rs. 422 billion and is a liability of the Central Bank, even as it is an asset to the rest of us. The Central Bank is prepared to pay against any currency note in any other value of legal tender preferred by the public. The Central Bank maintains a cash counter for this. In order to protect the public trust in currency, the Central Bank primarily undertakes two actions. First, it attempts to issue currency notes with intrinsic material security making it difficult for counterfeiting and designs are chosen to facilitate easy recognition of different currency notes by people including the blind. Still, the world over currency counterfeiting and design concerns prevail irrespective of modern technology. Second, it attempts to protect the real value of currency by maintaining inflation at low levels through monetary policy. If prices or inflation rise day by day, the value of currency in terms of goods and services it can buy gets less and less and people will tend to dispense with currency as money and tend to use other international currencies as their preferred media of exchange. In such events, the currency system will collapse and the existence of the Central Bank will be questioned. This happened in Germany in 1920 and Zimbabwe in recent years.

Second, the conduct of monetary policy

Monetary Policy contains measures to regulate the supply, availability, cost and international exchange of the country's money. Accordingly, levels of interest rates, exchange rate and credit in the economy are under the control of the Central Bank. These economic variables determine almost all economic activities of the public such as investments, savings, international transactions, production and employment. Their changes first affect our expenditure (what is called aggregate demand) its impact on production, income and employment. This course of effects is termed the monetary policy transmission mechanism. As these variables are part and parcel of our day-to-day life and their effects vary on different segments of people, the world over Central Banks get their fair share of praise or blame for whatever ensues in the economy. Savers criticize the Central Bank for low interest rates whereas producers who fund their production activities from bank loans appreciate low interest regime. The Central Bank is also routinely criticized by various segments for its policy for managing the exchange rate. Ultimately, the Central Bank manages monetary policy to suit its mandate to secure the objectives it priorities, given the economic knowledge of the authorized officers and the Monetary Board Members.

It is the monetary policy that determines how much money the Central Bank should print to facilitate the economy. Under the MLA, the Central Bank has the powers to print money by acquiring several kinds of assets. Those assets are provisional advances to Government, purchase of Government securities, purchase of foreign exchange and lending to banks. In conducting monetary policy, the Central Bank determines the annual growth of money desirable for the economy taking into consideration price inflation and production growth. In line with the desirable growth of money, the Central Bank maintains its asset growth to facilitate new money required. In the US and Euro area during the last six years, central banks have been expanding their assets many times to print money so that the economy is flooded with money to be invested in production and creating employment while keeping interest rates at rear zero levels.

Third, regulation and supervision of banks and financial institutions

Banking, finance and leasing businesses fall within the purview of the Central Bank under the MLA and relevant statutes. State supervision according to the global literature has three specific dimensions. i.e., the prudential aspect, conduct of sound business and consumer protection. Prudential supervision promotes the safety and soundness of institutions through their risk management. Conduct of sound business supervision covers fair and orderly conduct of businesses. Consumer protection covers safeguarding interest of consumers. The Central Bank's supervision mainly covers prudential supervision in three areas, i.e., issues of regulations, examinations and problem resolution. Issues of regulations covers maximum limits on business to limit risks, minimum requirements on risk mitigation instruments such as minimum capital, liquidity, loan loss provisions and governance. Periodical examinations cover the assessment of risk management capacity and early warnings of impending problems to take early remedial actions. Problem resolution covers solution to institutions in crisis or distress such as restructuring, bailing out and liquidation. This supervision has two perspectives at the Micro and Macro levels. Micro supervision means dealing with individual institutions. Macro supervision means actions to protect the system stability. Although the differentiation between the two is barely understood by many, the central banks' supervisory actions are clearly understood from how central banks have acted in crisis times. The best example is permitting the failure of small ailing institutions and bailing out of systemically important institutions. However, the customers of each ailing institution want the Central Bank to bail them out, despite risky behaviour of both customers and institutions. The Central Bank has no mandate to bail out each such institution and repay their investments. Similarly, the Central Bank cannot reasonably be held responsible for institutions and persons engaged in banking, finance and leasing businesses without authority. Such unauthorized institutions attract investments by offering unusual products. The persons associated with such institutions are usually preying on greed, bypassing many licensed institutions in the country. They oppose the Central Bank when they are investigated, but they start blaming the Central Bank when they start failing. The Central Bank has traditionally strived away from intervening such failed unauthorized institutions. However, in response to public pressure, the bank may take a more interventionist approach, henceforth.

Fourth, maintenance of a foreign reserve

This is a responsibility of the Monetary Board. International reserve as authorized under MLA should consists of gold and liquid foreign currency assets such as foreign currency notes, foreign government securities, deposits with international banks and international fund transfer instruments Greek bonds. Such reserve has been about 70% – 80% of assets of the Central Bank. There is a misunderstanding even among staff of the Central Bank that the foreign reserve should be managed like assets portfolio with a preferred risk- return balance for business and profit. This is wrong. International reserve under MLA is a reserve, not a trading portfolio, held for the purpose of meeting foreseeable deficit in the international balance of payment of the country and thereby to support greater exchange rate stability and free use of Sri Lanka rupee for current international transactions. Therefore, international reserves should comprise a highly liquid reserve without any known or estimated risk-taking.

These days, some people are concerned about the fall of this international reserve. Some complain that the reserve contains funds mobilized by the Government through foreign borrowing and not from net receipts from trade. Those views are subject to various technical arguments. What the Central Bank does is; it buys excess foreign exchange in the market and sells out of its reserve to meet the deficit in the market in order to maintain the exchange rate at a desirable level, given the relevant economic circumstances. If the reserve falls short of desired level, the Central Bank has the standard arrangements to replenish it. This reserve at US$ 7 billion at present is adequate to pay for four months of imports or 70% of the country's short-term foreign borrowing if the necessity arises. The reserve is there for use in rainy days, not for showing off imaginary visits of a country living within its means.

Fifth, Supply of payments and settlements services

Economic transactions are essentially the receipts and payments made through cash and non-cash methods. Non-cash payments such as cheques and fund transfers need systems to ensure that the payment is received by the due receivers. The Central Bank maintains cheque clearing through LankaClear system. That is why you get your cheque realized on the same day, if deposited before 12.00 noon. Further, all fund transfers among the banks are cleared and settled through the Central Bank's RTGS system. In the RTGS, the Central Bank provides intra-day funding to deficit banks to settle payments. Such payments services make the payments safer and faster. Payments are the circulation of money which is the life blood of the economy.

Sixth, agent of the government

This is the function that leads to a lot of criticism on the independence of the Central Bank. Six most important agency functions are the management of public debt, fiscal agent, official depository, financial adviser, management of Employees' Provident Fund and Administration of Exchange Control Act.

The most important agency function of the Central Bank is the financial/economic adviser to the Government. In this regard, as the Central Bank is responsible for the monetary policy in its entire scope and escalation. Conventionally central banks have had the responsibility to advise the Government on fiscal and other operations to the extent that they impinge on the economy and advise as to what should be the best course of policy action for the economy. Given the nature of the central banks' functions, advance access to macroeconomic and financial information and their expertise, central banks are the closest economic advisers to the Government. The Central Bank statutorily submits a number of reports such as the Central Bank Annual Report as part of this advice. In addition, the Central Bank provides advice on various policy matters on an on-going basis to the Government. However, central banks world over are blamed for not providing constructive and impartial advice because of the independence issue. I will talk on central bank independence in a moment.

As the Manager of Public Debt, the Central Bank raises local and foreign debt to meet expenditures approved through the Consolidated Fund, maintains such loan records and service such loans out of funds at Government Account with the Central Bank. The popular criticism here is the monetization of the budget deficit through Central Bank funds. The Central Bank's purchase of Treasury bills is the cause of this criticism. The Central Bank purchases Treasury bills in order to use them for regulation of the domestic market liquidity (Open Market Operations) as permitted in the MLA and not for lending to Government. Further, under the MLA, the Central Bank is authorized to provide provisional advances to the Government up to 10% of the estimated Government revenue of the current financial year, subject to recovery of each advance within 6 months, and such advances are only to meet the expenditures authorized under the Consolidated Fund. Managing public debt by the Central Bank is beneficial for the country since the Central Bank can raise public debt in line with interest rate structure envisaged in its monetary policy. If the debt management is undertaken by a separate Government office, it may attempt to raise debts without regard to market interest rates and monetary policy and that will cause immense conflicts with the current monetary policy. The opposite view is that as the Central Bank manages public debt, its monetary policy is constrained by the need to attempt to raise and maintain public debt at low cost.

The Central Bank as the banker to the Government maintains accounts of the General Treasury and Government institutions and agencies. The Treasury Account, known as DST Account, is the main transaction account to handle public debt flows. In terms of the MLA, Government or Government institutions and agencies must obtain the advice of the Monetary Board on the implications if any borrowing on the monetary conditions before raising such debts. This is to ensure that Government borrowing is made with the concurrence of the Monetary Board in line with the monetary policy.

Two other important agency functions are the management of Employees' Provident Fund and administration of Exchange Control Act, both of which have evolved controversy. In the case of Employees' Provident Fund, the Monetary Board is empowered to manage the fund including investment of surplus funds in securities the Monetary Board considers fit. I know you have heard enough on some of the EPF investments made in the recent past. Given the nature of the EPF and responsibilities of the Government, EPF funds are, I would submit meant only for safer investments.

The Exchange Control Act is to regulate and manage foreign exchange flows of the country which is essentially a part of macroeconomic management. In economics, exchange controls are about the regulation of the quantity or volume in the foreign exchange market. Conversely, the Central Bank regulates the price or exchange rate in the market under the MLA. Therefore, provisions of the Exchange Control Act strengthen the macro-economic policy hand of the Central Bank. In nutshell, implementation of the Exchange Control Act is focused nowadays to facilitate financing investment – savings gap of the country through foreign resources which is essential for the development of the country. At present, foreign exchange transactions involving trade, services, travel and most of foreigners' investments are largely free capital transactions of residents are subject to controls. You will appreciate that, if not for the exchange control liberalization since 1977, the country's economic development and living standard would not have achieved at present level.

Consequences from previous regulatory interventions

There are both success stories and consequences from previous regulatory interventions in the market. This is common to any central bank. I wish to brief you few issues and challenges confronted in the past and the way forward.

The Central Bank's intervention in 1988/89 finance companies crisis could bailout depositors to some extent and get new laws passed to regulate finance companies. However, the Central Bank lost public funds amounting to Rs. 6 billion (need to check.) and the COPE is still complaining about the Central Bank not being able to recover money. Again after 10 years, finance company crisis hit in another form where depositors have lost their savings in the failed companies and the Central Bank has been unable to resolve the crisis even after six years. In line with the new Government's announced policy, the Central Bank now gives the priority to it to have due justice to the depositors. We need to fix the finance companies sector and their risky business models through strong regulation and market discipline. Otherwise, this sector will pose risk to the financial system stability in next 10 years.

Another regulatory intervention that created immense macro economic consequences was the attempt to appreciate and maintain the currency highly over-valued during the period 2009 – 2012 at around Rs. 109 – 110 per US Dollar. For this purpose, the Central Bank lost about US$ 3.5 billion of foreign reserves leading to a foreign exchange crisis. Finally, crisis was managed by raising a loan of US$ 2.6 billion from the IMF to restore the international reserve and allowing a sharp depreciation of the currency to around Rs. 134 per US$ in June 2012. This intervention led to raise interest rate, control credit and raise fuel prices which had dampening impact on the growth of the economy reducing to 6.3% in 2012. In this regard, although some raise concerns over current intervention in the exchange rate, we are comfortable with current level of international reserve, pending already arranged inflow of foreign resources to strengthen the reserve.

Another case in point is the Pramuka Bank failure in 2002 – 2004. The Central Bank's decision to liquidate the bank was challenged in the Court of Appeal which quashed the Central Bank decision on the ground that the Central Bank had not followed the due procedure given in the Banking Act. Finally, the Government as a part of political decision in the interest of depositors bailed out the bank by vesting the bank with a new state bank set up for the purpose. If the Central Bank was conscious of its responsibilities, it could have resorted to a different path to resolve the bank at the very early stage. World over, central banks are blamed for delayed action, not effective to resolve problems. World over, regulators fall behind the market although they are expected to correct the market. Regulators are burdened with laws, procedures and bureaucracy and lack of latest market information. They work for office hours. However, market participants work 24 hours and are innovative for regulatory arbitrage. The human greed supported with moral hazard of regulation creates bubbles cyclically leading to financial and economic crises from time to time. The regulators and politicians create new laws, but they fail to prevent the next bubble. As a person being in both regulator and markets, I will do a lot of work to address this universal issue hopefully. However, as financial regulators cannot control the greed, financial bubbles and crises are to happen.

Finally, the Central Bank independence is the confusing and very technical subject. No Central Bank is divine. Central banks are also state institutions, but with greater functional independence provided for in the respective statutes due to its specific nature of operations involving printing of money and conducting monetary policies. The simple reason for the central bank independence is that a Government cannot have one hand to spend through the fiscal policy and other hand to print money to finance expenditure through the monetary policy. Therefore, the clear separation between the Treasury and Central Bank is necessary, otherwise, economies and monetary systems will collapse sooner or later. Therefore, the Central Bank independence and the close co-operation between the Central Bank and the Treasury are highly recognized.

I wish to quote from the Exter Report on this matter as the best piece of literature. 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 even in the absence of some such formula as the British or the Australian, 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.*

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.

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 co-operation 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. One further point is well worth making. There is a clear need in Ceylon for some sort of economic council at Cabinet level to achieve improved co-ordination of Government economic policies. If in future such a council is set up it is suggested that the Governor of the Central Bank should have a place upon it……"

Finally, officers of the central banks are not gods to know all problems in advance and give 100% solutions. We are all human beings and make mistakes. But we need to do things in an accountable manner and use our statutory discretion credibly to protect the public trust in us. For that we need to maintain credible procedures for decision-making where the public and courts can scrutinize to judge whether we have made decisions in fair manner considering all available information. In that regard, the Central Bank has long way to go. My initial days of office are spent to put in place these procedures in line with the mandate and nature of public interest. I know it is not easy to change things that have been there for long time. A lot of sacrifices are necessary.

Ladies and Gentlemen,

I know what I have stated here are confusing you enough. However, I am sure you had some technical insight into the Central Bank. I have no doubt you now appreciate that the Central Bank is the heart of the economy as many state so.

Thank you very much for listening to me.