Why Central Bank Independence Matters – in Crisis, in Recovery, and Beyond

75th Anniversary Oration of the Central Bank of Sri Lanka

by

Governor Dr. Nandalal Weerasinghe

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1. Opening remarks

I am deeply honoured to be delivering this oration on the occasion of the 75th Anniversary of the Central Bank of Sri Lanka (CBSL). As the Governor of this great national institution, I accepted the task of delivering this oration on central bank independence at this landmark moment with a deep sense of responsibility, knowing that the work of central bankers is never complete. The lessons the country, its people, the Central Bank, its staff and leadership have learnt over this long history must be recorded and shared, enabling future generations to build on and contribute to the prosperity of the people of Sri Lanka better.

Before I begin, I would like to take this opportunity to extend my heartfelt thanks to all well-wishers and stakeholders - especially the dedicated staff - for their invaluable contributions towards achieving the objectives of the Central Bank over the past 75 years. In particular, I wish to express my deep gratitude to the members of the Central Bank Boards and the staff for their exceptional commitment over the past three years. Their tireless efforts played a pivotal role in stabilising the economy and laying the foundation for a swift and sustainable recovery from the most profound socio-economic crisis Sri Lanka has faced since independence.

Seven and a half decades ago, in 1950, our nation took a momentous step towards economic sovereignty with the establishment of the Central Bank of Ceylon. This was a decision that our founder Governor John Exter noted as demonstrating our "intention to achieve genuine economic freedom as a corollary of the political freedom" that Sri Lanka had gained just 2 years earlier. Looking back, we see that the journey of the CBSL has been one of continuous learning and evolution to enable such freedom through "the fuller use of the nation's human and material resources and a rising standard of comfort for all" as described by Exter.

Today, we will reflect on how the CBSL has evolved over last 75 years and the need to protect gains in terms of independence and accountability. While addressing some common myths and criticism, I will also examine the challenges that central bank independence faces amid evolving domestic and global pressures. Accordingly, over the next hour, I expect to carefully build my case on why and how every Sri Lankan must preserve the Central Bank's independence and its accountability to protect the bedrock of stability for our nation to thrive in the period ahead.

2. Understanding central bank independence

2.1 What is central bank independence?

Deutsche Bundesbank President Joachim Nagel recently stated that "independence is part of the DNA of central banks". Allowing a central bank to make its decisions and operate without being influenced by the government or politicians for short-term political milage is called independence. This will allow a central bank to focus on its mandates, such as maintaining price stability and financial system stability. While political institutions, and by extension fiscal institutions, typically focus on a shorter horizon such as an election cycle, institutions such as central banks function best with independence, since maintaining stability, the core function of central banking, is a long-term necessity for any economy pursuing prosperity.

Moreover, central bank independence does not imply complete detachment from the government; rather, it is the ability to exercise technical and professional judgement in pursuing its objectives, without interference from the government for short-term political gains.

At the same time, independence does not mean that a central bank can formulate and execute policies without being answerable to anyone. The independence of a central bank comes with greater accountability and transparency.

That central bank independence is beneficial to modern economies is backed by both theoretical approaches and practical case studies, including Sri Lanka. Jerome Powell, the Chairman of the Federal Reserve stated in 2024 that "the record is pretty clear" that central bank independence is "a good institutional arrangement that serves the public well." Central bank independence, which has been often discussed in literature across multiple spheres including goal independence, instrument independence, operational independence and financial independence, seeks to protect central bank policies from the short-term pressures of electoral swings, i.e., pressures that help win votes today but can cause damage to the economy for years to come. Empirical evidence shows that central bank independence is associated with lower and more stable inflation without the trade-off of long-term growth stagnation.[1]

During the last three decades in particular, there has been a strong trend toward enhancing central bank independence, in both advanced and emerging economies. Notable examples include the Bank of England Act 1998, which created the independent Monetary Policy Committee; the European Central Bank's statutory independence enshrined in EU treaties; and reforms in countries such as Chile (1989), South Africa (1996), Indonesia (1999), India (2016) and Brazil (2021).

2.2 Why does independence matter?

In the first place, central bank independence matters because it allows monetary policy to be shaped to support long-term economic stability without being subject to short-term political pressure. Economic theory, and especially

[1] See, for example, Cukierman, A., Webb, S., and B. Neyapti (1992), "Measuring the Independence of Central Banks and Its Effect on Policy Outcomes", Alesina & Summers (1993) – "Central Bank Independence and Macroeconomic Performance", Berger, de Haan & Eijffinger (2001) – "Central Bank Independence: An Update of Theory and Evidence", and Dall'Orto Mas et al. (2020) – "The Case for Central Bank Independence: A Review of Key Issues".

the time inconsistency problem put forward by Kydland and Prescott, suggests that governments and politicians may encourage short-term growth or alleviate temporary rises in unemployment, often by money creation or simply by keeping interest rates artificially low. As discussed earlier, this, in turn, leads to very high levels of inflation with eventual adverse consequences for people and, of course, the credibility of the central bank.

If the central bank is independent and has a clear mandate, which in most cases is aimed at maintaining price stability, it can help a central bank to stand against such temptations and act objectively on available data in pursuit of its longer-term objectives. This builds trust among markets and the public, helps contain cost of living pressures, prevents wage-price spirals, keeps inflation expectations well-managed, makes production costs more predictable, and therefore sets the stage for being able to maintain economic stability, thereby producing positive spillovers that ultimately improve public welfare.

Central bank independence is also a critical requirement for maintaining the stability of the financial system. The ability of a central bank to enforce micro and macroprudential regulation uniformly across all deposit-taking institutions, irrespective of their ownership structure and devoid of political or market influence would ensure a sound and stable financial system.

Central bank independence facilitates financial innovation as well. The IMF's 2024 working paper titled "A New Measure of Central Bank Independence" shows that financial independence and governance autonomy are foundational for central banks to experiment with new instruments and technologies. Essentially, independence is not just about maintaining stability, it is also the engine that allows central banks to shape the future of finance.

As I will discuss in a later section, unfortunately the Sri Lankan public and businesses had to learn the hard way the repercussions of lack of central bank independence and the consequences of fiscal dominance during the buildup to the 2022 crisis. While many do not speak about this anymore, Sri Lankans also experienced the benefits of allowing the Central Bank to operate independently, most notably the sharp disinflation process and protecting the financial sector from near-collapse, both of which enabled the economy to record a rapid rebound from the depth of the crisis.

2.3 Role of accountability

Alan Blinder, former Vice Chair of the Federal Reserve and Professor of Economics, stated that “because monetary policy actions have profound effects on the lives of ordinary people, a central bank in a democracy owes these folks an explanation of what it is doing, why, and what it expects to accomplish. It’s their economy, not ours.”

It has to be emphasised that independence cannot stand alone. Central bank independence is not an end in itself. It must be matched with strong provisions to ensure accountability. Because independence has been granted to fulfill the central bank’s mandate, the institution is obliged to explain, and *ex post* justify its decisions. Independence and accountability are essentially two sides of the same coin. Central banks do not, and should not, operate in a vacuum. Therefore, as institutions in the service of the general public, central banks must ensure that the public and politicians see their decisions as underpinned by their mandate and the broader interest of society.

Therefore, for the central bank’s independence to be democratically legitimate (Bernanke, 2010), there must be a two-way dialogue. As an institution that directly affects people’s lives, the central bank must be open to scrutiny while consistently explaining and justifying its actions, openly, clearly, and in ways that resonate with the ordinary member of the public.

Transparency helps bridge independence and accountability. This commitment to a high degree of openness about policies, operations, governance and outcomes focuses on explaining the central bank’s work not just to the financial elite but to every citizen, no matter how bitter the truth may be or how painful the central bank decisions may appear to be. As the South African Reserve Bank Governor Lesetja Kganyago said, “For society to appreciate our roles, we…have got to take society along with us, such that when central banks come under attack, it is not just going to be us defending our independence.” This is why broader society must understand what the central bank does and why it does so. This is why central banks need to be accountable and transparent.

2.4 Global case studies

Beyond theory, experience across countries shows us, time and again, that independent central banks can act decisively, conducting credible monetary policy and safeguarding financial system stability, even during periods of turmoil.

2.4.1 When independence has worked

Take New Zealand, for example. Since gaining independence in 1989, the Reserve Bank has been a pioneer in inflation targeting. Its clear mandate, operational autonomy, and commitment to transparency enabled it to respond swiftly during crises such as the Asian Financial Crisis and the Global Financial Crisis. By adjusting policy rates and supporting domestic banks through liquidity facilities, it helped anchor inflation expectations and stabilise markets.

Canada's experience is similarly instructive. Since 1991, the Bank of Canada has operated within a well-defined inflation-targeting framework. It has successfully navigated multiple shocks – from the dot-com bubble to the 2008 financial crisis – through a combination of conventional and unconventional monetary tools. Its data-driven decisions and transparent communication have consistently reinforced market confidence.

In the United Kingdom, the Bank of England was granted operational independence in 1997. During the Global Financial Crisis and subsequent fiscal shifts, it responded with timely interest rate adjustments and quantitative easing. Its ability to act free from political interference has preserved public trust and ensured that monetary policy remains effective.

Sweden's Riksbank, independent since 1999, responded to the Global Financial Crisis with aggressive rate cuts and liquidity support. Its credibility allowed it to act countercyclically, softening the downturn and enabling a faster recovery than many of its peers.

Germany's Bundesbank, long regarded as a symbol of monetary discipline, played a pivotal role in post-war recovery and in managing inflationary shocks throughout the 20th century. Though monetary policy now rests with the European Central Bank, the Bundesbank continues to oversee banking supervision and financial stability, reinforcing its legacy of independence.

The European Central Bank itself, institutionally independent by design, demonstrated remarkable resolve during the euro area sovereign debt crisis. Despite political divisions, it launched bold liquidity operations and the landmark Outright Monetary Transactions programme – underpinned by Mario Draghi's now-famous commitment to "do whatever it takes."

In the United States, the Federal Reserve's operational independence has enabled it to implement unconventional policies such as quantitative easing and forward guidance. Analysts have noted that this independence helped prevent inflation expectations from de-anchoring, even amid political uncertainty and trade tensions.

Amongst emerging market economies, Chile offers a compelling case of a country that enshrined central bank independence in its constitution to overcome a history of persistent, high inflation. For decades, political interference and weak institutional frameworks meant that the Central Bank of Chile was unable to secure the stability of the currency, with inflation frequently reaching triple digits. However, in 1989, Chile made a landmark decision by enshrining the central bank's independence directly into its constitution through the Basic Constitutional Act; the nation collectively committed to prioritising long-term stability over short-term political expediency. The Central Bank of Chile has since brought inflation down to stable, single-digit levels, providing the essential foundation for sustained economic growth and investor confidence.

The experience of India also provides useful insights. For decades, the Reserve Bank of India (RBI) has navigated a path of evolving independence, seeking to balance its mandate of monetary stability with the demands of a rapidly developing nation. This created an environment that, at times, required difficult and steadfast policy decisions. However, India has consistently demonstrated a commitment to strengthening the RBI's role, culminating in the formalisation of its inflation-targeting framework and the amendment to the Reserve Bank of India Act of 1934 in 2016. This landmark legislative step enshrined a clear and singular objective for the central bank: to maintain price stability, while keeping in mind the objective of growth.

These examples show us that independence is not merely a legal construct – it is a functional enabler of stability, credibility, and innovation.

2.4.2 When independence was compromised

Agustin Carstens, former General Manager of the Bank for International Settlements (BIS), aptly observed that, "through history, we have had quite substantial episodes where monetary policy mismanagement has led to devastating effects – in inflation, in financial systems, affecting the wellbeing of individuals and firms, oftentimes bringing countries to the brink."

Germany's hyperinflation in the 1920s, Argentina's recurring debt and inflation crises, Zimbabwe's collapse in the late 2000s, and the United States' Great Inflation of the 1960s and 1970s – all serve as reminders of the risks when central banks are pressured to finance fiscal deficits or support short-term political goals. Writing his autobiography in 2018, Paul Volcker, former Chairman of the US Federal Reserve, reminisced that, in 1979, when he was summoned by the US President to be appointed as the Chairman of the Federal Reserve, he made the following three points to the President: "[that he] felt strongly about the independence of the Federal Reserve; the Fed would have to deal head-on with inflation; and [he] would advocate tighter policies than Miller [the previous Fed Chair] had." Volcker and the Federal Reserve under him managed to tame high and stubborn inflation only through appropriate monetary policies they implemented as an independent institution.

As we reflect on these global experiences, we see that the lesson is clear: central bank independence is not a privilege but a necessity. The ability of a central bank to act decisively, maintain credibility, and provide a steady anchor in the storm of economic uncertainty, is the result of independence. This independence is what allows central banks, including ours, to safeguard the future of economies.

3. From the Monetary Law Act of 1949 to the Central Bank Act of 2023

3.1 Pressing need for new legislation on central banking

Over the past 75 years, the Monetary Law Act of 1949 (MLA) has been the subject of much discussion and debate. I will not attempt to revisit every argument about its strengths and weaknesses. However, I believe we can all agree on one fundamental point: the MLA was a piece of legislation far ahead of its time. It incorporated many forward-looking features and provisions designed to facilitate sound central banking practices and principles – some of which remain relevant even today.

While the MLA had served its purpose for decades, it had not undergone a comprehensive review in line with the evolving challenges of monetary and financial stability. By the early 2000s, it was increasingly evident that the MLA was outdated, both in terms of institutional design and in providing the credibility required for modern monetary policymaking. Sri Lanka was also preparing to move towards a Flexible Inflation Targeting (FIT) framework in line with global best practices, a regime that demands a clear mandate for price stability, greater independence, and robust accountability mechanisms. Without reform, the existing legal framework risked undermining credibility and weakening the effectiveness of monetary policy.

Another key deficiency of the MLA was that the success of policymaking was person dependent. This was recognised by John Exter, who, while proposing the establishment of a central bank for Ceylon, also noted that its success in serving the nation would depend on “proper skill and understanding in its management”. Referring to the relationship with the Government, Exter noted that “the effectiveness of co-operation and coordination between the Monetary 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.”

History bears out Exter’s insight. While the autonomy of the Central Bank was compromised from time to time, there were notable instances where the Monetary Board exercised independent judgement – even with the Secretary to the Treasury as a member. Two examples stand out:

- In December 1959, the Monetary Board raised the Bank Rate to counter inflationary and balance of payments pressures. This move, perceived as contrary to Government policy, prompted the Minister of Finance to direct the Board to reverse the decision and assume responsibility for the action.
- In 2019, the Monetary Board restricted monetary financing to the Government, recognising its adverse consequences. This decision, too, was reversed in 2020 following Government instructions.

These episodes confirm Exter's view that "good central banking is less good law than good practice" and that "the exact degree of independence of the Central Bank is likely to vary from time to time".

Recognising these deficiencies and evolving needs, the CBSL initiated a process to modernise its governing legislation in 2017.[2] In April 2018, a Cabinet Memorandum was submitted seeking approval in principle for reforms to the country's Central Bank law. The subsequent approval gave momentum to the drafting of a new Central Bank Act (CBA), with the CBSL playing a lead role in shaping the provisions. The drafting was guided by three overarching objectives:

i. Strengthening the governance of the institution
ii. Securing independence and accountability to support the adoption of FIT and ensure durable price stability
iii. Enhancing financial sector oversight and resilience.

The draft legislation reflected several critical reforms: Price stability was formally recognised as the primary objective of the CBSL, supported by a strengthened institutional setup for monetary policy formulation. Clearer checks and balances were introduced, alongside updated provisions for monetary operations and instruments, and greater exchange rate flexibility. Importantly, the draft sought to safeguard the financial strength of the CBSL, institutionalise stronger fiscal-monetary coordination, and impose limits on monetary financing to avoid the pitfalls of fiscal dominance.

[2] It must be noted that there was a short-lived attempt in early 2000s to rewrite the MLA as well.

The new Central Bank Bill was consistent with global standards on independence, governance, and accountability. Following multiple rounds of consultations with stakeholders, the Bill was finalised and submitted to the Parliament in 2019. However, the political environment at the time prevented its passage, and the reform was left in abeyance.

3.2 An Aside: What if the New CBA had been in place during the crisis?

The failure to enact the new CBA in 2019 was a missed opportunity of historic proportions. Had this legislation been passed, Sri Lanka would have entered the subsequent years with a stronger, more independent Central Bank – better equipped to withstand the pressures that ultimately led to the crisis.

Under the revised framework, the CBSL would have been empowered to resist excessive monetary financing, maintain a credible commitment to price stability, and allow greater exchange rate flexibility. The prohibition of monetary financing could have helped keep inflation under control. Moreover, the absence of Central Bank financing might have compelled the Government to avoid ill-timed and reckless tax cuts – decisions that severely damaged Sri Lanka's external credit ratings. A firm commitment to price stability through a flexible inflation targeting regime would have allowed the exchange rate to act as an automatic stabiliser, curbing excessive demand pressures caused by a suppressed currency. These institutional safeguards could have prevented the build-up of vulnerabilities that ultimately pushed the economy to the brink.

Instead, what prevailed was the public reprimanding of Central Bank officials by political and fiscal authorities – actions applauded by many who failed to grasp the long-term benefits of Central Bank independence. Even if the crisis, rooted in fiscal mismanagement, could not have been entirely avoided, an empowered and independent Central Bank would have acted sooner and more decisively, mitigating the severity of the economic distress faced by our people.

Sri Lanka's recent experience has reaffirmed a fundamental truth: as often repeated in global central banking circles, central bank independence is not a luxury – it is a necessity. The journey toward a modern, rules-based central bank policy framework was never a mere technical exercise. It was, and remains, essential to ensure that monetary policy and financial stability policies serve the broader public interest rather than short-term expediency. The efforts undertaken before 2019 show that the CBSL recognised this imperative well in advance. The subsequent crisis has underlined, in stark terms, the cost of delay in strengthening independence and accountability as well as the cost of not exercising available independence and accountability even under the MLA.

3.3 How the Central Bank helped stabilise the economy following the crisis – even under the MLA

Patrick Honohan, former Governor of Bank of Ireland, opined in 2024 that "price stability and prevention of crises are indeed the core goals of central banking. But it is the central bank's ability to react effectively to crisis situations that most test their skills and preparedness. Over the years, failure to contain financial crises has entailed enormous economic costs."

Sri Lanka faced such a test in 2022 – an unprecedented crisis marked by severe balance of payments pressures, social and political unrest, and a profound loss of confidence in institutions, all while an external debt default loomed. The roots of this crisis lay in structural weaknesses, persistent fiscal imbalances, and a series of imprudent policy decisions that created an unsustainable debt burden and mounting external pressures.

Under intense domestic and international pressure, the Government eventually sought IMF assistance and announced a debt standstill as an interim measure, paving the way for debt restructuring negotiations. This culminated in an Extended Fund Facility (EFF) arrangement with the IMF in 2023.

As documented elsewhere, the Government and the Central Bank implemented a bold stabilisation package. Notably, replacing the MLA with the new CBA enshrined greater independence and accountability in the new legislation. However, since the CBA was enacted only in September 2023, most stabilisation measures had to be executed under the MLA. This underscores an important truth: even under the MLA, stability could be achieved when the

Central Bank exercised its available independence with strong coordination with fiscal authorities.

Still under the MLA, the CBSL adopted an extensive array of measures to stabilise the economy from its dire straits since the onset of the crisis in early 2022. Monetary policy was tightened significantly in April 2022, following a substantial depreciation of the Sri Lanka rupee in March as the exchange rate was allowed a measured adjustment. These measures, though painful, were necessary. They brought inflation down from a peak of nearly 70 per cent in September 2022 to single digits by mid-2023 and maintained price stability since then. This disinflation process has been hailed globally as one of the fastest in recent history.

Equally critical was safeguarding the financial system. At the height of the crisis, many predicted a banking collapse. Yet Sri Lanka avoided a systemic banking crisis – a remarkable achievement given the depth of the economic and debt turmoil. Had a banking crisis materialised, public deposits would have been at risk, trust in the financial system shattered, and the economic rebound severely compromised.

As these measures took hold, macroeconomic conditions improved steadily supported by greater fiscal discipline and consolidation. Inflation fell sharply, risk premia eased after debt restructuring, and the external sector stabilised. The Central Bank worked tirelessly to restore public confidence – through frequent communications, press briefings, and transparent explanations of policy decisions. This commitment to openness anchored inflation expectations and stabilised markets, laying the foundation for recovery.

3.4 Provisions for independence and accountability in the New CBA

The enactment of the CBA in 2023 marked a landmark structural reform, significantly strengthening the independence of the CBSL to perform its streamlined mandate.

3.4.1 Key provisions on independence and accountability

Several key provisions underscore this transformation, including the following:

- The CBA establishes the Central Bank's primary objective as achieving and maintaining domestic price stability, which takes precedence over all other functions. Ensuring financial system stability is recognised as the secondary objective (Section 6). This prioritisation reflects the critical responsibility entrusted to the CBSL as the sole authority to maintain low and stable inflation for the greater public good.
- In addition to the Governing Board, which oversees all activities other than monetary policy, the Act introduces a Monetary Policy Board (Section 11) tasked with formulating monetary policy and implementing a flexible exchange rate regime in line with the Flexible Inflation Targeting (FIT) framework. This institutional arrangement reinforces the importance of sound and independent monetary policymaking.
- The Secretary to the Treasury is excluded from the Central Bank's policy boards, ensuring greater independence. Provisions are in place to ensure that members of the Boards have the required competencies, integrity, and ethical conduct.
- Recognising the need for fiscal-monetary coordination, the Act establishes a Coordination Council comprising the Governor and the Secretary to the Treasury (Section 83). This forum facilitates the exchange of information and views to support coherent policy formulation while preserving institutional autonomy.
- The CBA explicitly prohibits monetary financing of fiscal deficits (Section 86), thereby eliminating the risk of fiscal dominance. While provisional advances to the Government are permitted, they are subject to stricter conditions than under the previous Monetary Law Act.
- Under the FIT framework, the inflation target is jointly determined by the Minister of Finance and the Central Bank through a Monetary Policy Framework Agreement (Section 26). If the target is missed, the Central Bank must publicly disclose the reasons, outline remedial measures, and specify the timeframe for returning inflation to target—ensuring transparency and accountability.

- The Act mandates the publication of a Monetary Policy Report every six months, detailing recent inflation trends, the medium-term outlook, and associated risks, and informing the public on monetary policy implementation and the achievement of objectives as well (Sections 27 and 80). Additionally, within four months of the financial year's close, the Central Bank must publish an Annual Report reviewing economic conditions, policy objectives, and the performance of its policies (Section 80).
- Section 80 also provides for the Governor, members of the Board and Deputy Governors to be heard by the Parliament.
- The CBSL enjoys full administrative and financial autonomy (Section 5), enabling it to manage its internal affairs independently – an essential prerequisite for credible and effective central banking.
- The appointment of the Governor and members of the Governing and Monetary Policy Boards requires the approval of the Constitutional Council (Sections 15 and 19). Clear provisions govern their removal by the executive and legislative branches of the Government in the case of misconduct or negligence, ensuring accountability without compromising independence.
- The Act explicitly prohibits any person or entity from attempting to influence the Governor, Board members, or employees of the Bank (Section 5), reinforcing the principle that the autonomy of the Central Bank must always be respected.

While the CBA addresses the need to rely on individuals it is still necessary for properly appointed members to exercise independence empowered by CBA. It is only then the provisions of the CBA, which require well-thought-out appointments to be made with the involvement of the executive, as well as the legislative through the Constitutional Council.

3.4.2 How do CBA provisions on independence and accountability, and activities since the introduction of the CBA benefit the nation?

- Prior to the enactment of the CBA, the CBSL could finance fiscal deficits through mechanisms such as providing advances to the Government or purchasing Government securities in the primary market. Successive Governments increasingly relied on such monetary financing, despite its adverse implications for macroeconomic stability. Excessive Government borrowing from the CBSL contributed to an expansion in the money supply, generating excessive demand-driven inflationary pressures. In many instances, monetary financing conflicted with the CBSL's mandate of maintaining price stability and undermined the effectiveness of monetary policy transmission. Such monetary financing no longer occurs under the CBA.

- Several provisions have been made in the CBA to increase the accountability of the Central Bank under the FIT framework. If the Central Bank fails to meet the inflation target by a margin determined under the agreement for two consecutive quarters, the CBSL must publicly explain the reasons and outline corrective actions. Accordingly, under section 26 of the CBA, the Monetary Policy Board of the Central Bank should submit a report to the Parliament through the Minister of Finance, explaining the failure to achieve the inflation target, the remedial actions proposed to be taken by the Central Bank, and an estimate of the time period within which the inflation would reach the target.

  Accordingly, the Central Bank has submitted and made available to the public several reports as inflation remained below the target and recorded a period of deflation mainly due to supply side factors. Such information would be useful in improving the awareness of the public on the reasons for inflation volatility, future path of inflation as well as risks on inflation projections, thereby facilitating informed decisions by the economic stakeholders, leading to well anchored expectations on inflation.
- Further, with the improved accountability of the Central Bank, there is evidence that public trust in policy decisions has improved, which has significantly supported building business confidence, positive investor sentiments, etc.

- One of the most transformative features of the CBA is the formal designation of the CBSL as the Macroprudential Authority in Sri Lanka. This designation empowers the CBSL to independently monitor systemic risks and proactively safeguard financial system stability, an essential foundation for system stability. The Act provides the CBSL with a comprehensive legal mandate and a suite of tools to mitigate systemic risk, contain unsustainable credit growth and leverage, and ensure the uninterrupted functioning of the financial system, even under adverse economic conditions. Together, these tools enable the Central Bank to address emerging systemic risks with precision and agility, protecting the deposits of the public while ensuring the stability of the financial system.
- To ensure public oversight on the health of the financial system, the CBSL is required to publish an annual Financial Stability Review. This comprehensive publication assesses the health of the financial system, identifies emerging risks and vulnerabilities, outlines the corrective measures undertaken by regulators, and tracks progress on cross-agency recommendations. In doing so, it not only strengthens institutional accountability but also reinforces public confidence in the resilience and integrity of the financial system.
- In addition to the reforms introduced under the CBA, the CBSL has also played a pivotal role in strengthening the broader legal framework that governs Sri Lanka's financial sector, ensuring that institutional reforms are supported by a strong and coherent legislative foundation. With a view to strengthening the resilience of the banking sector and reinforcing the integrity of the regulatory framework, the Banking Act was amended in June 2024. This comprehensive reform introduced a wide range of critical enhancements to modernise and strengthen the regulatory landscape. Stronger governance requirements were extended across the entire sector, including state-owned banks. Importantly, greater autonomy and strengthened legislation have allowed enforcing similar regulations across all banks, irrespective of their ownerships structure.

- Another key milestone in this effort was the enactment of the Banking (Special Provisions) Act, No. 17 of 2023, which strengthens the CBSL's role as the Resolution Authority, empowering it to take timely and decisive action in addressing distressed financial institutions. This landmark legislation introduced critical features, including enhanced resolution powers, robust financial safety net mechanisms, and statutory recognition for the Deposit Insurance Scheme, thereby reinforcing public confidence and the stability of the financial system. The Act also established clear procedures for the orderly winding-up of licensed banks, while allowing resolution measures to be extended to Licensed Finance Companies when appropriate.
- Meanwhile, the Central Bank has intensified its efforts to advance financial inclusion and enhance financial literacy, while steadfastly safeguarding the integrity of the financial system. These initiatives are not merely social objectives – they are fundamental to ensuring the effective transmission of monetary policy and preserving financial stability. In this context, the Bank has engaged extensively with a wide spectrum of stakeholders, both domestic and international, while also reaching out to grassroots communities. Such engagements are designed to deliver tangible benefits to the public and businesses alike, fostering a more inclusive and resilient financial ecosystem.

4. Addressing common myths and criticism

As Raghuram Rajan observed in 2017, "any public job involves both undue praise and unfair criticism... yet it is the latter that is probably more useful in helping you sharpen your message." In that spirit, let me take this opportunity to address in this section some of the common myths surrounding the functions and operations of the Central Bank of Sri Lanka.

4.1 Is there no coordination between the Central Bank and the Government?

While independence is vital, it does not and must not mean operating in isolation. Coordination between monetary and fiscal authorities remains essential. The CBA ensures this through the establishment of a statutory Coordination Council, where representatives from both the CBSL and the Ministry of Finance meet quarterly to review economic, fiscal, and financial conditions, emerging risks for better policy coordination and timely decisions to address concerns.

In addition, we continue to work closely with the Government, international financial institutions, and other regulators, particularly in the areas of crisis management and financial system oversight. We do this through bodies like the Financial Sector Crisis Management Committee and the Financial System Oversight Committee.

4.2 Is the CBSL beyond Sovereignty and accountable only to external agencies such as the IMF?

The CBSL is an arm of the State and functions as a public corporation under the Constitution of the Republic. The CBA provides a robust framework to ensure the CBSL's accountability to Parliament and, ultimately, to the people of Sri Lanka.

Appointments to the positions of Governor and members of the CBSL's Boards are made by the Executive and the Legislature, subject to checks and balances through the Constitutional Council, as stipulated in the Constitution and the CBA. Once appointed, however, these appointees are expected to operate independently of political affiliations and irrespective of who appointed them. The Executive may remove the Governor or any Board member with the approval of the Constitutional Council, subject to the safeguards in the CBA.

The Ministry of Finance shares responsibility for setting the inflation target jointly with the CBSL. If no agreement is reached, the Cabinet of Ministers determines the target to be achieved by the CBSL. Unlike in the past, the CBA now mandates that Parliament or its Committees summon the Governor, Board members, and Deputy Governors at least once every four months to review the CBSL's functions. If any policy or operation is perceived to deviate from the CBSL's mandate, it can be questioned during these sessions, ensuring strong democratic oversight.

The CBSL also serves as the Government's representative in fostering international relations with institutions such as the International Monetary Fund (IMF). Currently, Sri Lanka is engaged in the EFF arrangement with the IMF. While the programme's economic and financial policies are prepared in consultation with the IMF, they remain fully owned by the Sri Lankan authorities.

4.3 Is the CBSL's financial independence a new concept?

The CBSL's independence is not entirely a new thing, but it has been significantly strengthened under the CBA. Even under the MLA, the CBSL was vested with a high degree of financial independence – the ability to operate without relying on Government funding. Accordingly, the former Monetary Board of the CBSL was entrusted with the power to approve the CBSL's budget. Similar provisions are available in the CBA, enabling the CBSL to operate without reliance on the Government's financial allocations, which could have jeopardised the independence of the CBSL. At the same time, all expenditures are subject to internal governance, Board oversight, and external audits, ensuring transparency and accountability. The CBSL is also required to maintain transparent financial reporting and is subject to independent external audits, which have been in place for several decades to ensure discipline in the financial operations of the CBSL. New law enforcements under the CBA have further strengthened the financial and operational independence of CBSL, by way of clearly defining the profit transferring ability of the CBSL and provision for recapitalisation, if needed, to ensure that the CBSL will remain financially sound and capable of fulfilling its core mandate without the fear of making losses or capital depletion.

4.4 Independence vs. expectations: What can the CBSL truly deliver?

Misunderstanding the CBSL's objectives and functions often leads to unrealistic expectations about what the CBSL can deliver and how it should operate. Our core objective is to achieve and maintain domestic price stability. Alongside this, we are also tasked with securing financial system stability. Both objectives are pursued, aiming to encourage and promote long term economic stability and growth.

A frequent misconception is why the CBSL does not directly promote economic growth or development. Questions often arise as to why the Bank does not actively empower businesses – particularly MSMEs – promote exports, develop industries, or alleviate poverty. The answer lies in our mandate: the CBSL's role is to create an enabling environment of stability, within which the Government and other authorities can implement growth-oriented policies. History has shown that when central banks pursue multiple, often conflicting objectives with limited tools, the result is inefficiency and instability. Central banking is fundamentally about stability.

Another common misunderstanding is that the CBSL fixes the exchange rate. Under the current flexible exchange rate regime mandated by the CBA, the value of the Sri Lanka rupee is determined by market forces of supply and demand. The CBSL intervenes only to build reserves and smooth excessive volatility – not to fix or target a specific rate.

When these roles are misunderstood, criticism could arise, especially when difficult but necessary policy decisions are made in the long-term interest of the economy.

4.5 The Central Bank's role in conducting agency functions

Since its establishment, the CBSL has been entrusted through various statutes with the responsibility of carrying out various other functions on behalf of the Government. Such functions include public debt management, management of the Employees' Provident Fund, exchange control (later foreign exchange management), financial intelligence and regional development.

The need for the CBSL to carry out agency functions on behalf of the Government has arisen due to the public trust placed in the CBSL as well as the absence of other acceptable institutional arrangements to carry out such functions elsewhere. Some of these functions have resulted in conflicting objectives for the CBSL, necessitating establishing and strengthening firewalls in the governance structure of the CBSL. At times, allocation of resources to carry out agency functions is a severe strain on human resources and dilutes the core functions of the Central Bank.

Accordingly, the implementation of concessional loan schemes for targeted sectors by the CBSL has been phased out. The CBSL's regional engagement has shifted towards enhancing financial inclusion and improving financial literacy among the public under the current set up. This is in line with the Government's efforts to strengthen the development finance function under the Ministry of Finance, ensuring a more focused institutional framework for such initiatives.

Furthermore, the transfer of the public debt management function from the CBSL is currently underway, with the establishment of a dedicated Public Debt Management Office under the Ministry of Finance. This marks another important step in ensuring that operational responsibilities are properly aligned with the appropriate institutions, while allowing the CBSL to focus more on its core monetary and financial stability mandates.

Looking ahead, as the market matures and suitable institutional arrangements are made, the CBSL has no objection to transferring the remaining agency functions out of the Central Bank as well. This will enable us to focus fully on the CBSL's core objectives and better utilise our resources towards maintaining stability.

5. Concluding remarks: Preserving independence

In an often complex and unpredictable political and economic environment, preserving the independence of the Central Bank is not merely important – it is indispensable to safeguarding the stability and prosperity of a nation.

History and global experience demonstrate that central banks with clearly defined mandates, well-established boundaries, and adequate operational autonomy are best positioned to deliver on their promises. A clear mandate not only guides the institution but also provides a transparent benchmark for accountability to both policymakers and the public. Narrowly defined roles prevent central banks from straying into policy domains that rightly belong to elected governments. The CBA enshrines this clarity for the CBSL.

Transparency and open communication – on our mandate, policy actions, and their rationale – are essential to building public trust. Adopting global best practices in disclosure and accountability serves as a powerful safeguard against undue influence. At the same time, independence does not mean isolation. Effective macroeconomic management requires constructive dialogue and coordination between the Central Bank and the Government, particularly on fiscal, monetary, and financial sector policies. The CBA provides a legal framework for such coordination without compromising autonomy. Recent experience during Sri Lanka's economic crisis, financial sector vulnerabilities, and debt restructuring illustrates how close collaboration – anchored in mutual respect for roles - can accelerate stability and recovery.

Christine Lagarde, the President of the European Central Bank, recently observed that "while recent research suggests that de jure central bank independence has never been more prevalent than it is today, there is no doubt that the de facto independence of central banks is being called into question in several parts of the world." In this context, a timely reminder to policymakers across the world of Alan Blinder's enduring advice that "central bank independence is a fine institution that ought to be preserved where it exists and emulated where it does not" could be profoundly relevant.

Having witnessed both the benefits of independence and the costs of its absence, I firmly believe it is the responsibility of future generations to protect, preserve, and promote the independence of the Central Bank. Only then can it continue to serve as a steadfast anchor of stability – an essential foundation for sustainable growth and shared prosperity.

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