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July 10, 1950 — Dec. 12, 1950 :	John Exter, Governor Chairman T. D. Perera, C.M.G. Permanent Secretary to the Ministry of Finance J. Tyagaraja Appointed Member
Dec. 13, 1950 — June 30, 1953 :	John Exter, Governor Chairman Sir Arthur Ranasinha, Kt. C.M.G., C.B.E Permanent Secretary to the Ministry of Finance J. Tyagaraja Appointed Member
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Oct. 14, 1954 — Aug. 23, 1956 :	Sir Arthur Ranasinha, Kt. C.M.G., C.B.E. Governor Chairman L. J. de S. Seneviratne Permanent Secretary to the Ministry of Finance J. Tyagaraja Appointed Member

Aug. 24, 1956 — June 30, 1959 :	Sir Arthur Ranasinha, Kt. C.M.G., C.B.E. Governor Chairman S. F. Amerasinghe, O.B.E. Permanent Secretary to the Ministry of Finance J. Tyagaraja Appointed Member
July 1, 1959 — May 31, 1961 :	D. W. Rajapatirana, O.B.E. Governor Chairman S. F. Amerasinghe, O.B.E. Permanent Secretary to the Ministry of Finance J. Tyagaraja Appointed Member
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Dec. 19, 1963 — Aug. 30, 1967 :	D. W. Rajapatirana, O.B.E. Governor Chairman H. J. Samarakkody Permanent Secretary to the Ministry of Finance J. Tyagaraja Appointed Member
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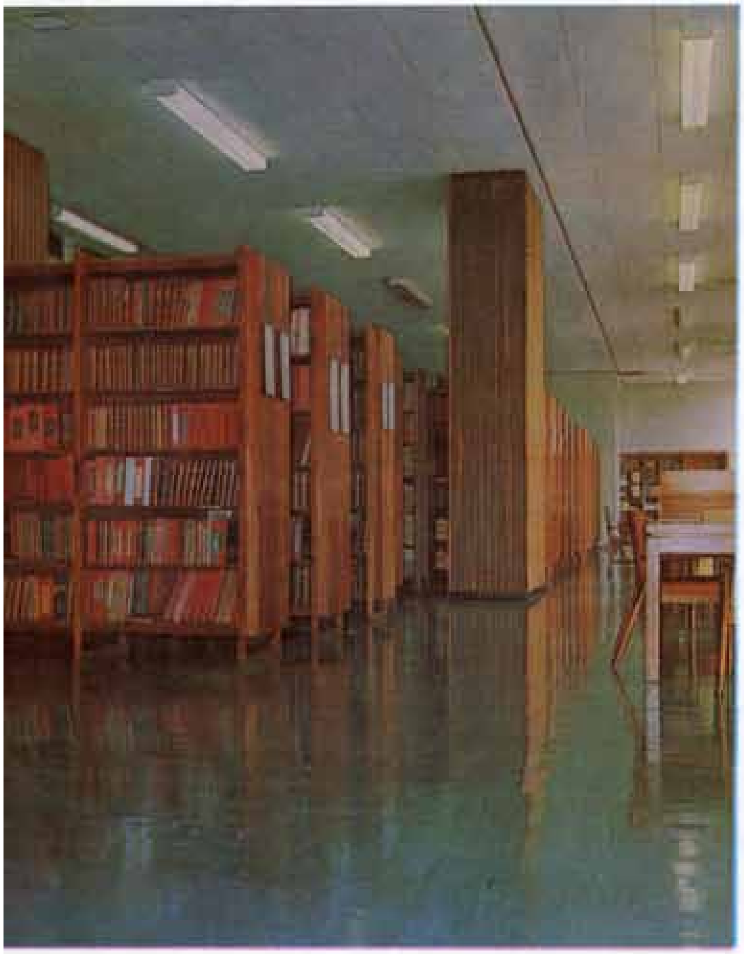

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The Board Room

Deputy Governors of the Central Bank of Ceylon
1950 — 1975

N. U. Jayawardena

Dr. Theodore Morgan

D. W. Rajapatirana O.B.E.

Dr. B. B. Das Gupta

W. Tennekoon

D. C. Gunasekera

S. E. P. Jansz

Dr. Gamani Corea

Dr. W. M. Tilakaratna

P. V. M. Fernando

Dr. W. Rasaputram

H. L. D. Selvaratnam

'THE CENTRAL BANK OF CEYLON, 1950 - 1975'

CENTRAL BANK OF CEYLON
1950 - 1975

This year the Central Bank of Ceylon completes 25 years of service. During the last two-and-a-half decades it has played a significant role in the economic life of the country not only directly by the large number of services that it has performed both for and on behalf of the government but also indirectly through its influence on the economic policies of successive governments. The Monetary Law Act which established the Central Bank gave it very wide powers relating to monetary and economic policies. While these powers have very largely remained unchanged over the years, the scope of the Bank's functions has been widened by subsequent additions to its responsibilities. In this Commemorative Volume the establishment of the Central Bank of Ceylon, its powers and duties, its operations and organisation, and its role in the national economy are briefly discussed.

1 ESTABLISHMENT OF THE CENTRAL BANK OF CEYLON

Sri Lanka is among the pioneers in the South East Asian region to establish a Central Bank soon after gaining political independence. A primary objective of the post-independence administration was the setting up of an independent monetary system with the required degree of financial autonomy to cope with the problems of monetary management in an emerging nation. As in the case of most British colonies, the monetary system prevailing in the Island was the Currency Board System.

A. THE CURRENCY BOARD SYSTEM

The Currency Board System had been functioning in Sri Lanka since the enactment of the Paper Currency Ordinance of 1884. It was a 100 per cent reserve system with the Indian rupee constituting the reserve currency. The Board of Commissioners of Currency could issue Ceylon rupee notes and coins only to the equivalent of Indian rupees in its possession or lodged with the Reserve Bank of India. This meant that the additions to reserves were accompanied by an expansion of the currency issue and the reduction of reserves by a contraction of the currency issue. Thus, the most salient feature of the Currency Board System was the automatic link between the currency issue and the balance of payments. When the balance of payments is in surplus, i.e., when the country's foreign exchange receipts are in excess of its foreign exchange expenditure, the currency issue is automatically expanded by the extent of that surplus. Conversely, the currency issue gets automatically contracted when the balance of payments is in deficit. The Currency Board played a purely passive role in the expansion and contraction of the currency issue.

Currency and demand deposits held by the public account for the total money supply in the economy. In the Currency Board System a considerable proportion of total bank deposits represented merely the monetization of balance of payments surpluses. In any case balance of payments surpluses usually arise during export booms and during such periods the demand for bank advances for financing exports automatically increases. Thus, both the currency issue and the volume of demand deposits being directly responsive to balance of payments surpluses and deficits, the money supply tends to move in sympathy with balance of payments fortunes rather than with the requirements of domestic economic activity. The Currency Board as such could not influence money supply in any way to make more funds available for the growing needs of an expanding economy. Instead it reacted automatically to fluctuations in the balance of payments.

Under the Currency Board System the Ceylon rupee was linked to the Indian rupee at par and the Sri Lanka authorities did not have the right either to fix or to maintain the international value of the rupee. The exchange value of the Ceylon rupee depended on the value of the Indian rupee which in turn was linked to sterling. Thus, the Ceylon rupee was linked to sterling via the Indian rupee and its value remained stable both with respect to the Indian rupee and the pound sterling. In 1944, the Currency Ordinance was amended providing for the direct exchange of Ceylon rupees for sterling but the convertibility continued to be solely through Indian rupees until the severing of the link with the Indian rupee in September, 1949.

B. THE NEED FOR AN INDEPENDENT MONETARY AUTHORITY

Several factors contributed to the need for the establishment of a Central Bank in Sri Lanka. Of these, the limitations of the Currency Board System, considerations of economic nationalism and the changes with respect to the Indian rupee and the pound sterling which determined the par value of the Ceylon rupee were the most important. In this regard mention should be made of Mr. J. Tyagaraja, Member for Mannar-Mullaittivu in the State Council of Ceylon who gave notice of a motion in the State Council on September 20, 1945 and on November 7, 1945 moved in the State Council the motion to convert the Bank of Ceylon into a state-owned Central Bank.

Although the Currency Board System contained inherent qualities for a stable monetary system such as the automatic preservation of the exchange value of the Ceylon rupee and the prevention of recurrent balance of payments deficits, its limitations in relation to the monetary requirements of a growing economy were overwhelming. As already explained, its fundamental shortcoming was the complete inflexibility with respect to the currency issue and the control of bank credit. This meant that the Currency Board System was institutionally and functionally incapable of financing the growing needs of an expanding economy; moreover the system characteristically provided a consistently deflationary bias in the context of a rapidly increasing population.

With independence, certain provisions of the Currency Board System became incompatible with the new political status. For instance, the automatic determination of the international value of the Ceylon rupee by the Indian authorities was contrary to the spirit of independence. In any case, the Currency Board System was viewed as an inherent feature of colonial administration and its continuance after independence appeared to be inconsistent with the newly gained political freedom. It was felt that this anomalous situation could be rectified only by the establishment of an independent monetary authority.

Certain events that occurred during the second half of the forties both in India and in England sharpened the issues relating to the determination of the value of the Ceylon rupee via the Indian rupee. In 1946, the link of the Indian rupee to sterling was broken when the Indian authorities agreed with the International Monetary Fund on a gold value for the Indian rupee. This was followed by the imposition of exchange control restrictions by India in 1947 and by Sri Lanka in 1948 over transactions with other countries in the sterling area. With those changes "the relationship of the Ceylon rupee to sterling by way of the Indian rupee was broken, and such logic as once existed in the system was destroyed". In fact, following the decision of the British Government to devalue sterling in 1949 it became necessary for the Currency Ordinance to be amended to sever the link between the Ceylon rupee and the Indian rupee and to fix the value of the Ceylon rupee in terms of gold.

C. THE DECISION TO ESTABLISH A CENTRAL BANK

In the Throne Speech to Parliament of November 25, 1947, the Governor General announced: "in regard to finance, my government intends to seek expert advice with regard to changes in our financial structure which may be necessitated by the transition from a colonial to a free, national economy". Consequent on this decision the Minister of Finance proceeded to seek the assistance of the United States of America for suitable expert advice for setting up of a central bank. Accordingly, in July 1948 the Government of Sri Lanka requested from the Government of the United States the services of an official of the Federal Reserve System. The Board of Governors of the Federal Reserve System decided to send to Sri Lanka one of their economists, Mr. John Exter, who had been associated with the establishment of a central bank in the Philippines.

Mr. John Exter arrived in Sri Lanka on December 28, 1948 to report on the financial and economic conditions prevalent in the country and to make recommendations for the establishment of a central bank. His terms of reference were:

(a) to report on the organization and the function of a Reserve Bank for Ceylon, with a view to ensuring within the limits of monetary action, full employment of the economic resources of the country, and, if need be, on the promotion of supplemental credit institutions in furtherance of this policy;

(b) to frame proposals for a draft constitution of the Reserve Bank for Ceylon.

D. THE MONETARY LAW ACT

Mr. Exter lost no time in the execution of his task. After reviewing the country's currency system he proceeded to recommend a new monetary system for the country with considerable powers of management of money and credit. On June 7, 1949 he submitted an interim report with preliminary recommendations regarding the monetary system, the organization of the Central Bank, the principles of monetary administration and instruments of central bank action. The Final Report consisting of two parts was presented to the Government on November 4, 1949. The first part of the Report dealt with the significance of a central banking system in the context of the Sri Lanka economy, while the second contained a draft bill and also reasons, where necessary, for recommending particular clauses in the bill.

The Currency Board System came under heavy criticism in the Exter Report. After commenting on the inadequacy of the system for meeting the requirements of an expanding economy and its incompatibility with the newly gained political freedom, the Report pointed out the lack of a logical basis for its continuation in the context of changes in the par value of the Indian rupee and the pound sterling. Declaring that a voluntary linking of one's currency to another is "tantamount to a renunciation of a basic element of monetary sovereignty" the Report strongly recommended the establishment of an independent monetary authority with "broad powers to administer and regulate the entire money, banking and credit system."

The Monetary Law Bill incorporating legislation for the establishment of a Central Bank to administer and regulate a new currency system for Sri Lanka was presented in the House of Representatives during October/November, 1949. During the debate in Parliament the Exter Report received commendation from both sides of the House. On November 25, the Bill was passed by the House of Representatives and subsequently became the Monetary Law Act, No. 58 of 1949. The event was described as "a landmark in the progress of the people of Ceylon to economic freedom."

E. THE BANK COMMENCES BUSINESS

The Central Bank of Ceylon commenced business on August 28, 1950. Simultaneously the Currency Board ceased to function. Notes and coins issued by the Currency Board and in circulation on that date became liabilities of the Central Bank and the Bank took over the unissued stocks of notes and coins from the Board. In terms of the Monetary Law Act, the Ceylon rupee was designated the standard unit of monetary value of Sri Lanka and its par value was fixed at 2.88 grammes of fine gold (which had been already adopted by the Currency Ordinance No. 40 of 1949). The capital of the Bank was fixed at Rs. 15 million which was appropriated from the Board of Commissioners of Currency out of the excess of assets over liabilities as of August 28, 1950 Mr. John Exter who was appointed the first Governor of the Bank, Sir Charles Jones, C.M.G., the Permanent Secretary to the Ministry of Finance and Mr. J. Tyagaraja were the first members of the Monetary Board. Mr. N.U. Jayawardena was appointed Deputy Governor.

In terms of the Monetary Law Act the Bank's financial year is the calendar year. The Central Bank rate of interest on advances to commercial banks was fixed at $2\frac{1}{2}$ per cent per annum under Section 87 of the Monetary Law Act, effective from August 28, 1950. The Central Bank took over the management of the clearing house as from August 29, 1950 from the Imperial Bank of India, which had hitherto functioned as the clearing bank.

2 ADMINISTRATION, POWERS, FUNCTIONS AND DUTIES OF THE CENTRAL BANK

The governing body of the Central Bank is the Monetary Board. The Governor of the Central Bank, who is the Chairman of the Monetary Board, is the chief executive of the Bank and is responsible for its operations and internal management. Functionally, the Central Bank differs from the operations of ordinary banking institutions. Unlike other banks, it does not accept deposits from the public or extend loans directly to the public. The principal function of the Bank is the control of the monetary and credit system of the country and towards this end it has been entrusted with very wide powers. It has also to perform a number of statutory obligations. It acts as fiscal agent and financial adviser to the Government. Its overall functions include tendering economic advice and providing numerous services to the Government as well as acting as Government's agent in various fields.

A. THE MONETARY BOARD

In terms of the Monetary Law Act, "the powers, duties and functions of the Central Bank" are vested in the Monetary Board which is charged with the responsibility for "the management, operation, and administration" of the Bank. Initially, the Monetary Board consisted of three members - the Governor of the Central Bank (Chairman), the (Permanent) Secretary to the Ministry of Finance, and an Appointed Member. Thus, it was one of the smallest Boards which was vested with the responsibility of administering one of the most important national institutions. The size and composition of the Board remained unchanged for approximately 24 years. By an amendment to the Monetary Law Act which became effective in October 1974 the membership of the Board was increased to four, to include the Secretary, Ministry of Planning and Economic Affairs. Both the Governor and the Appointed Member are appointed by the Governor General (now by the President of the Republic) on the recommendations of the Prime Minister, while the Secretary, Ministry of Finance and Secretary, Ministry of Planning and Economic Affairs become members by virtue of their official status.

The Monetary Law Act provides for the Governor, or in his absence the Senior Deputy Governor, to preside over the meetings of the Monetary Board, which should be held at least once in two weeks. The Board was first constituted on July 1, 1950 and has been functioning continuously since then. During the 25 year period under review 933 meetings have been held which means that, on average, the Monetary Board had been meeting once in every ten days. During this period six Governors, eleven Secretaries to the Ministry of Finance, two Appointed Members and one Secretary to the Ministry of Planning and Economic Affairs have served on the Board. The first Appointed Member, Mr. J. Tyagaraja, served on the Board for a period of 21 years.

The restriction of the membership of the Monetary Board to a small number was a deliberate act to attract outstanding men with sufficient interest and greater responsibility. The Exter Report emphasized that the effectiveness of the Central Bank would, to a great extent, depend on the Monetary Board. One important factor which predominated in the decision with respect to the composition of the Monetary Board was the need to strike the right balance between its independence and the harmonious relationship with the government. For the purpose of performing its basic function more effectively, i.e. the control of money and credit in the interest of public welfare, it is important that the Monetary Board should be a non-political body with a considerable degree of independence so that it can take a more detached and objective view of contemporary economic problems. On the other hand, on many important matters relating to monetary, fiscal and exchange rate policies, the Bank must maintain close harmony with the policies and objectives of the government. The Governor and the Appointed Member are expected to maintain the required degree of independence, subject to the limitation that their tenure of office "is limited by the ultimate power of the government to change the law." The Appointed Member in particular is not required to represent any particular interest and can pursue a balanced and independent policy purely in the interest of the economic well-being of the country. The 'restrictions' and 'disqualifications' surrounding his appointment generally insulate him from official influence and interference.

The presence of the Secretaries to the Ministries of Finance and Planning and Economic Affairs on the Board enables it to be kept informed of the wishes of the Ministers concerned thus promoting collaboration and co-ordination between the Central Bank and the government on important matters relating to monetary fiscal and economic policy.

B. THE GOVERNOR

The Governor is the chief executive officer of the Bank. His term of office is six years and he is eligible for re-appointment. The Governor is expected to devote his full professional time to the work of the Bank and cannot accept or hold any other office paid or unpaid. He could, however, hold any academic office or position or be appointed as a member of a commission under the Commission of Inquiry Act No. 17 of 1948 for investigating matters relating to money, banking, finance or issues of a general economic nature.

As the chief executive, the Governor is responsible for the execution of policies and measures adopted by the Monetary Board. Subject to such policies and measures he is also responsible for the direction, supervision and control of the operations of the Bank and its internal management and administration. In the temporary absence of the Governor, the Deputy Governor designated 'Senior' is vested with the duties and functions of the Governor and presides over the meetings of the Monetary Board.

C. THE POWERS, FUNCTIONS AND DUTIES OF THE CENTRAL BANK

I. Statutory Powers

The scope of the powers, duties and responsibilities of the Central Bank is much wider than that of the Currency Board. In terms of the Monetary Law Act the Central Bank of Ceylon was made "the authority responsible for the administration and regulation of the monetary and banking system in Ceylon". Accordingly, the most significant feature of the new monetary system is its ability to regulate the supply of money and credit in the economy. Towards this end of controlling the money supply, the Central Bank was given the sole right and authority to issue currency notes and coins, and control demand deposits of commercial banks. Whereas the currency issue under the Currency Board System was linked to the level of foreign exchange resources, the currency issue under the Central Bank was made to depend on the requirements of the general public, according to "the sound judgement of the Central Bank's management". The Bank is expected to promote monetary stability so as to stabilize and preserve the value of the Sri Lanka rupee. In the administration of monetary policy the Bank has been entrusted with very wide powers which include controls on credit both of a quantitative and qualitative nature.

II. Statutory Obligations

Among the Bank's statutory obligations is the requirement to publish a monthly statement of its assets and liabilities within eight days after the expiry of each month. Every year the Monetary Board is obliged to submit to the Minister of Finance and publish an Annual Report which should contain a review of the economic and financial situation of the country as well as policies and measures adopted by the Board during the year. This Report, which must be published within 3 months from the close of each financial year (extended to four months by the Monetary Law (Amendment) Law No. 37 of 1974) should also include an analysis of developments in such fields as money and banking, balance of payments and external assets, prices and wages and external trade during the year.

The Monetary Law Act requires the Monetary Board to submit a detailed report on the need for achieving domestic monetary stabilization to the Minister of Finance whenever at the end of any month the money supply has increased or decreased by more than fifteen per cent over the year or the cost of living index has increased by more than ten per cent over the level at the end of the corresponding month in the previous year. In terms of Section 68, the Monetary Board should submit a similar report to the Minister whenever there is a sharp drop in the International Reserve so as "to be a threat to the international stability of the Ceylon rupee", indicating the measures already adopted by the Board and outlining those which it wishes to recommend for adoption by the Government.

III. Other Duties

The Central Bank is the banker, agent and fiscal adviser to the Government of Sri Lanka. As the banker, not only has it to maintain the Government's accounts but it also has to meet the credit requirements of the Government. The Bank is the agent of the Government for the management of the Public Debt, Employees' Provident Fund and administration of Exchange Control, and it represents the Government at international institutions. In addition, by agreement between the Minister of Finance and the Monetary Board, the Bank can be asked to undertake any other activity on behalf of the government, which is not specifically authorized by the Act. As the Banker's Bank, the Central Bank is obliged not only to provide banking facilities to commercial banks, but also to act as the lender of the last resort. It also has the powers to inspect, supervise and regulate the operations of the banking system.

3 OPERATIONS OF THE CENTRAL BANK

The guidelines for the operations of the Central Bank of Ceylon are set out in the Monetary Law Act. These relate to the performance of the Bank's principal functions such as the regulation of banking and credit, the issue of currency, banker to Government and the commercial banks, which are, of course, the traditional functions of a central bank. In practice, however, the work of the Central Bank of Ceylon is much wider in scope and includes such activities as promotion of healthy commercial banking, provision of credit to certain priority sectors through refinance facilities and any other matter specifically entrusted to the Bank.

A. MONETARY POLICY

The most important function of the Central Bank of Ceylon is the implementation of a national monetary policy with the objective of promoting monetary stability so as to preserve the value of the Sri Lanka rupee and promote sound economic growth. Thus, whenever there is a threat to the domestic monetary stability or there are sharp movements in the money supply or in the price level or there is a sharp decline in the International Reserve that is considered to be a threat to the external value of the rupee, the Central Bank is expected to take appropriate remedial measures. The Monetary Law Act provides for a wide range of powers to be used as instruments of monetary policy. This gives the Bank the freedom of choosing appropriate instruments for meeting particular situations. Some of the instruments are of course meant to be kept in reserve rather than for general use.

In the administration of monetary policy the Central Bank has to ensure that it is in harmony with the objectives of the Government. Before important measures relating to monetary policy are adopted not only does the Monetary Board give very careful consideration to their necessity but it also apprises the government of the situation. Such economic variables as the money supply, external assets, internal prices, and balance of payments are periodically examined by the Monetary Board. Moreover, the presence of the Secretaries to the Ministries of Finance, and Planning and Economic Affairs on the Monetary Board enables the government to be kept informed of the deliberations of the Board.

If the objective of maintaining monetary stability is to be achieved, the Central Bank has to ensure that monetary expansion takes place only in conformity with the requirements of the economy. Excessive monetary expansion will only result in an inflationary situation with all the attendant distortions and will make the management of the balance of payments more difficult. Thus, whenever there is excessive monetary expansion which is likely to threaten domestic and international stability of the Sri Lanka rupee the Bank has a clear responsibility to siphon-off excess liquidity in the economy.

As indicated earlier, the Central Bank possesses a wide range of instruments for regulating bank credit. These involve controls on the Bank's transactions with commercial banks especially those relating to the grant of loans and advances to commercial banks. For instance, the Bank can suspend its credit facilities to the banking sector thus forcing the commercial banks to cut down on their credit operations, if in the view of the Monetary Board there is an excessive expansion in the money supply. It could also restrict its accommodation to a fixed proportion of their assets in certain specified items. This instrument could prove to be very effective in curbing excessive credit expansion, in a situation where the banks are frequently borrowing from the Central Bank. The Exter Report has emphasized the effectiveness of non-traditional instruments of monetary policy in the context of Sri Lanka's economy.

Monetary policy involves both the control of the volume and the direction of credit. Control over volume is generally known as quantitative control of credit while control over the direction of credit is referred to as qualitative or selective control of credit. The Central Bank of Ceylon has been operating both types of controls fairly extensively although their use during the fifties was very infrequent. During the fifties there was no need to be unduly concerned with the rate of monetary expansion since the demand for credit and the operation of the banking system did not result in excessive credit creation. Since then, however, both the rate of monetary expansion which was considerably higher than the rate of growth of the volume of goods and services, and the developments in the balance of payments necessitated the application of controls on a fairly rigorous scale.

I. **Quantitative Methods of Credit Control**

The Central Bank of Ceylon possesses wide powers of quantitative and qualitative credit control. Chief among the quantitative controls are Open-Market Operations, Variable Reserve Ratio and Interest Rates. Of these the Bank has tended to rely heavily on reserve ratios and interest rates as the main instruments of credit control. It has not been able to use open-market operations for this purpose in view of the under-developed nature of the money and capital markets in Sri Lanka.

(a) *Bank Rate*

Bank Rate is one of the most traditional instruments of monetary policy in the armoury of a central bank. It is the interest rate at which the Central Bank is prepared to provide accommodation to commercial banks as lender of the last resort. Section 88 of the Monetary Law Act provides for the Monetary Board to prescribe the conditions subject to which the credit facilities of the Central Bank are made available to banking institutions. Thus, during periods of inflation or when the balance of payments is under severe pressure the Central Bank would raise the Bank Rate thereby making Central Bank accommodation more costly to the commercial banks. The commercial banks would in turn raise their lending rates and the higher interest rates would gradually percolate into the whole credit market thereby reducing the demand for credit. The Central Bank, of course, could provide accommodation to commercial banks at a rate lower than the Bank Rate in respect of certain transactions, if it thinks that such transactions are of the highest national importance.

Bank Rate which was fixed at the inception of the Central Bank of Ceylon at 2½ per cent has been progressively raised and stands at 6½ per cent at present. The first change in the Bank Rate was in July, 1953 when the rate was changed from 2½ per cent to 3 per cent. This was done as a guide to commercial banks as regards their interest rate policy. The thinking at that time was that the whole interest rate structure was too low in relation to the level of prosperity of the economy, and in relation to the market rates particularly for Treasury bills and government securities which had been rising during the immediately preceding period. Following the increase in Bank Rate the commercial banks made a moderate increase in their scale of charges on loans and overdrafts. However, the Bank Rate was lowered to the previous level, i.e. 2½ per cent, in June 1954. Since then it remained unchanged for the rest of the decade.

The continued pressure on the balance of payments necessitated more frequent changes in the Bank Rate after 1960 which progressively increased from 2½ per cent in July 1960 to 6½ per cent by January 1970. As is evident from the following Table, with the rise in the Bank Rate there had been parallel, though not equal, increases in the commercial banks' lending rates. This shows that the Bank Rate had been effective in making the cost of credit high during a period when the economy had been subject to unprecedented pressure both with respect to the balance of payments and the internal price level.

Bank Rate and other Interest Rates

Date	Bank Rate	Deposit Rates of Commercial Banks		Inter-bank Call Loans		Interest Rates on Loans and Advances	
	%	Min. %	Max. %	Min. %	Max. %	Min. %	Max. %
July 1960	2½	2½	2½	1¾	1¾	4½	8
August 1960	4	2½	2½	2½	2½	4½	8
May 1965	5	2½	2½	2¾	3	6	9
May 1968	5½	3	3½	3½	3½	7	9½
January 1970	6½	4½	4¾	4½	4½	8	12

(b) *Statutory Reserve Ratio*

The variation of the statutory reserves of commercial banks has proved to be a monetary weapon of much practical use in Sri Lanka. In terms of the Monetary Law Act, the commercial banks are required to maintain reserves against their deposit liabilities. These generally take the form of rupee deposits at the Central Bank. Section 94 of the Act empowers the Central Bank to prescribe and modify the reserve ratios against different types of deposit liabilities subject to a minimum of 5 per cent and a maximum of 20 per cent in the case of time and savings deposits and a minimum of 10 per cent and a maximum of 40 per cent in the case of demand deposits. While increase in the reserve ratios in respect of existing deposit liabilities should be made in a gradual manner, subject to a ceiling of 4 percentage points in any one month and a 14-days' notice to commercial banks, the reserve ratios in respect of increases in deposit liabilities from a given date can be made in any manner. In special circumstances, such as during critical inflationary periods, the reserve ratio can be increased upto 100 per cent of any increase in deposits after a specified date. The effect of raising reserve ratios is "to limit the volume of money created by the credit operations of the banking system".

In view of the relative ineffectiveness of the traditional instruments of control such as the discount rate and open-market operations in the context of the Sri Lanka economy, the flexible reserve requirement became the Central Bank's most effective means of credit control. In the context of Sri Lanka's monetary system, the reserve ratio had the primary effect of eliminating excess reserves which was considered to be a pre-condition for making monetary policy more effective because so long as banks carry excess reserves there would be no need to seek accommodation from the Central Bank. Thus, the reserve ratio weapon, apart from its direct impact on liquidity and, therefore, on the volume of bank credit, helped to make monetary policy more effective because it tended to make the commercial banks dependent on Central Bank accommodation. This not only gave the Central Bank greater control over the commercial banks but also helped to make the Bank Rate policy more effective.

At the time the Bank commenced business in August 1950 the reserve ratios were fixed at 10 per cent of demand deposits and 5 per cent of time and savings deposits. These were the minimum reserve requirements permitted under the Monetary Law Act. Soon afterwards the Bank used the reserve ratio weapon to reduce excess liquidity in the economy resulting from balance of payments surpluses during the Korean boom, when it increased the reserve requirements in respect of demand deposits from 10 per cent to 14 per cent, with effect from January 5, 1951. The collapse of the Korean boom and the contraction in money supply that followed led to a sharp reduction in the liquidity of the banking system. There was evidence to suggest that the commercial banks were short of employable resources and they were nearing a point where they might be obliged to restrict their lending. At the same time, there was a noticeably greater demand by them for short term accommodation from the Central Bank. With these developments the Central Bank took action to reduce the reserve ratio of commercial banks and in September 1953 the rate on demand deposits was reduced to 10 per cent at which level it remained for the rest of the decade. The effect was to increase substantially the commercial banks' employable resources and to permit them to extend credit further to the private sector.

It was from August, 1960 that the Central Bank of Ceylon used the reserve ratio weapon more intensively to restrict the credit operations of the banking system. In August 1960 the reserve ratio was raised to 12 per cent of demand deposits. From February 1961 in addition to the general reserve requirement of 12 per cent of demand deposits, the commercial banks were required to maintain a special reserve of 38 per cent against any increase in their demand deposits over the level of such deposits as at the close of business on February 1, 1961. This in effect, meant that for all new deposits, the required reserve ratio was 50 per cent. The People's Bank which commenced business only in July 1961 was exempted from the special reserve requirement on the ground that the new measure would heavily penalise the growth of the new bank. However, in 1965 the People's Bank was brought within this regulation when it was required to maintain special reserves of 28 per cent against any increase in demand deposits above the level of such deposits as at close of business on June 9, 1965. In implementing the special reserve requirement, the Central Bank agreed to allow the commercial banks to keep a part of these reserves in their own vaults rather than as deposits at the Central Bank. This concession was given as the Bank was of the view that, some banks, particularly the indigenous ones, required a large volume of cash to meet the needs of their branch networks. If all the required cash was to be deposited with the Central Bank, commercial banks would frequently run short of cash for meeting their daily requirements, thus necessitating frequent transport of cash between branches at very short intervals.

The Central Bank withdrew the special reserve requirement of commercial banks introduced in 1961 and 1965 by a Gazette Notification issued on April 7, 1975. Thus, the commercial banks are now required to maintain as reserves only 12 per cent of demand deposits and 5 per cent of time and savings deposits.

(c) *Open-Market Operations*

In terms of Section 90 of the Monetary Law Act, the Central Bank is authorized to engage in Open-Market Operations, i.e. sell or purchase securities issued by the government or those fully guaranteed by the government as an instrument of monetary policy. In addition, the Central Bank has also been given the authority which is not found in the armoury of most other central banks, to issue, buy and sell its own fully negotiable securities. This provision was made as the normal flow of securities into the market was thought to be inadequate, and the issue of Central Bank securities would broadbase the market.

The record during the last 25 years shows that the Cental Bank has been very sparing in the use of this weapon as an instrument of monetary policy. During the initial period the Bank both bought and sold government securities so as to stabilize the money supply and to give support to the prices of government securities. But as years passed by the Bank tended to rely less and less on this instrument. In 1956 and 1957 when the economy was unusually liquid the Central Bank issued its own securities to mop up excess liquidity. The third occasion when the Bank issued its own securities was in 1964. The other factors which influenced the decision to issue Central Bank securities were firstly, the possibility of developing the Central Bank paper as security specially attractive to the non-bank private sector and secondly, the need to expand the existing small security market of the country. However, the practice of issuing Central Bank paper was not continued and by 1966 the Bank had redeemed all its outstanding securities.

The problem with the Open - Market Operation instrument is that for it to operate effectively, it is necessary that the money and capital market should be well developed and capable of responding and reacting quickly to measures taken by the Central Bank. In fact, the Exter Report emphasized that in view of the very narrow market for securities in Sri Lanka this weapon was meant to be kept in reserve to be used when the conditions for its effective operation are present.

Although the Open - Market Operation weapon has not been in much use, the Central Bank has taken steps to broaden the market for securities by advising the government with respect to the maturity pattern of new issues so as to make them more attractive to the investors.

II. Qualitative Methods of Credit Control

In special situations where the traditional methods of credit control are not very effective or appropriate, central banks have been often provided with qualitative or selective instruments of monetary control. The general deflation in the economy brought about by quantitative credit controls is sometimes inappropriate for a country like Sri Lanka as such a policy would lead to a reduction in investment. A general reduction in economic activity would affect adversely not only development and employment but also Sri Lanka's exports. A more selective approach to credit control is, therefore, needed where emphasis is placed on the reduction of credit for certain specific purposes such as for the import of any non-essential commodities.

In the Monetary Law Act qualitative credit control measures are referred to as "Additional Regulation of Credit Operations of Banking Institutions". Under these additional regulations a wide range of methods to control money and credit is available to the Central Bank of Ceylon under the law. One of the main aims of qualitative controls is to encourage certain lines of economic activity which are regarded as essential or of high priority and to discourage those which are relatively less important. For instance, every endeavour has been made to make credit available for production purposes while restricting those for non-essential purposes.

The main instruments of selective credit control provided in the Monetary Law Act are the fixing of maximum permissible maturities for loans and investments or classes of loans and investments of commercial banks, ceilings on commercial bank credit, fixing of minimum ratios of the capital and surplus of commercial banks to their assets, stipulation of cash margins against letters of credit, and control over bank interest rates. The fixing of maximum permissible maturities for loans and investments made by commercial banks was intended to limit the diversion of credit into unsound and speculative lines of activities.

(a) *Portfolio Ceilings*

In terms of Section 101 of the Monetary Law Act, the Monetary Board has the power to prohibit commercial banks from increasing the amount of their loans and investments or to fix limits to the rate at which the amount of loans and investments may be increased within specified periods. This restriction which is popularly known as "portfolio ceilings" could take the form of either ceilings on loans and investments as a whole or ceilings on any particular category or categories of investments. This meant that the regulation could be used both as an anti-inflationary measure, i.e. to control the overall quantum of credit, as well as for selective credit control, i.e. to prevent or slow down the increase of a particular type of credit such as that for consumption.

Since 1961, the Central Bank has been using this instrument at very frequent intervals in order to restrict bank credit for certain areas of activity. In October 1961 loans and overdraft facilities granted to foreign firms other than those in the export trade were required to be curtailed by one-third. In December 1962, the Central Bank directed that commercial bank credit for the purchase of estates (plantations) should not exceed $33\frac{1}{3}$ per cent of the purchase price of such estates. On a number of occasions the Central Bank also directed the commercial banks to restrict or to cease granting advances for importing certain goods and for hire-purchase purposes. In 1965, the Central Bank restricted the increase in commercial bank advances to the private sector during the 12 month period commencing June 15, 1965. In October 1968, new ceilings limiting the increase in specified forms of commercial bank credit to 8 per cent of their level as at the end of August or September of that year whichever was higher was also imposed. In 1971, ceilings on bank credit were modified providing for a new basis — the inclusion of medium and long term loans to industries and agriculture in the items of bank credit subject to ceilings. In addition, new credit ceilings were fixed for government corporations and for the rest of the private sector during the year.

The ceilings on bank credit which had been in force in the preceding years were removed with effect from April 1, 1972. However, banks were requested to refrain from increasing credit over the level of such credit as at March 31, 1972 for non-essential purposes such as consumption and speculative stock building. During the period that followed there was a sharp increase in commercial bank credit and the Central Bank had once again to intervene to check the growth of bank credit. Thus, with effect from May 24, 1974 banks were required not to exceed the level of bank credit outstanding on that day. Export financing and agricultural credit were exempt from this ceiling. With effect from April 8, 1975 the ceiling on bank credit imposed on May 24, 1974 was withdrawn. However, this was not meant to be a relaxation of the control over the growth of bank credit. The withdrawal of the credit ceiling was combined with a number of other measures such as restricting Central Bank accommodation to commercial banks and withdrawal of the till cash concession with respect to statutory reserves. These were designed to provide a more effective management of credit and monetary policy and to improve administration of the reserve requirements.

(b) *Minimum ratios of Capital and Surpluses to Assets*

Another qualitative instrument is the power to fix minimum ratios of the capital and surpluses of commercial banks to the total volume of their assets or to any specified categories of such assets. Thus the Monetary Board could prescribe higher ratios of capital and surpluses to certain classes of loans which it wishes to discourage and lower ratios for types which it wishes to encourage. This measure was designed to achieve certain other objectives too, such as to preserve solvency of banks and thereby protect deposits, and to serve as an instrument of quantitative control. Thus, this instrument combines the qualities of quantitative and selective credit control. During the last 25 years the Central Bank of Ceylon has not had occasion to use this weapon as an instrument of monetary policy.

(c) *Cash Margins against Letters of Credit*

A selective instrument which has been in operation in Sri Lanka has been the stipulation of cash margin requirements on letters of credit. Under this provision the Monetary Board could specify different cash margins for different kinds of transactions to be financed by means of letters of credit. The objective is to restrict the use of bank credit for certain classes of imports of luxury or other non-essential goods by prescribing higher margins against them.

The policy of fixing cash margins against letters of credit was introduced for the first time in August 1960 when a 50 per cent cash margin against letters of credit for importation of certain non-essential commodities was fixed. Banks were also requested not to grant advances for the purpose of providing these margins. With effect from August 1965, margin requirements against letters of credit for imports were withdrawn. In January 1969 cash margin requirements against letters of credit were re-introduced (50 per cent) in respect of certain classes of imports.

The major difficulty in using the cash margin requirement effectively has been the ability of the importers to obtain their credit requirements for imports from non-bank sources. In a seller's market profit margins have been more than sufficient to cover higher costs of borrowing from non-bank sources.

(d) *Control over Commercial Bank Interest Rates*

Another instrument by which the Central Bank of Ceylon can exercise influence on bank credit is through its powers of control over bank interest rates both on advances and deposits. Under this provision the Monetary Board can specify the maximum rates which commercial banks may pay on various classes of deposits or charge for different types of loans. The objective is to regulate the terms and the quantum of credit flowing into different types of economic activities in order to make the interest rate more effective. The Monetary Board could refuse to accept for discount or re-discount specific types of credit instruments held by commercial banks if they have exceeded the maximum rates specified.

(e) *Moral Suasion*

The use of selective credit controls has been one of the important instruments of monetary policy in Sri Lanka since 1960. In addition moral suasion has also been used to achieve certain desired objectives. From time to time the Bank has requested the commercial banks to exercise caution in their lending, specially lending for speculative purposes such as for the purchase of shares, and these requests were very favourably received.

B. BALANCE OF PAYMENTS & EXCHANGE RATE POLICY

I. Balance of Payments Policy

Of the economic problems faced by Sri Lanka during the last 25 years, the problem of balance of payments has been the most formidable, involving far reaching implications for the economy and its people. The problem has received the Bank's continuing attention.

In terms of the Monetary Law Act, two of the basic functions of the Central Bank on balance of payments policy are the preservation of the external value of the rupee and the maintenance of convertibility. During periods when the balance of payments is under pressure the ability of the Bank to achieve these objectives depends to a very great extent on the volume of the country's foreign exchange reserves. Therefore, the Bank was made the custodian of the International Reserve and it was expected to maintain "an international reserve adequate to meet any foreseeable deficits in the international balance of payments". The ability of the Bank to maintain an adequate international reserve was continuously impaired by the chronic balance of payments deficits, which in turn affected the Bank's ability to maintain convertibility and the external value of the rupee.

Sri Lanka's external payments position after experiencing mixed fortunes during the first six years of the establishment of the Central Bank came under continuous pressure since then. Two important factors which led to this have been the adverse terms of trade and domestic monetary expansion. During 1950-51, Sri Lanka experienced considerable prosperity in her external payments position resulting from the Korean boom. However, it was very shortlived and by mid-1951 the prices of Sri Lanka's major exports were already on a declining trend. Accordingly, the favourable balance of payments position in the period 1950-51 reversed itself rather sharply during 1952-53 causing a large reduction in the country's external assets. However, during 1954-55, the situation improved appreciably and Sri Lanka made a remarkable balance of payments recovery. This was very largely the outcome of very fortuitous circumstances affecting tea exports.

From 1958 onwards Sri Lanka's balance of payments followed a completely different trend. From about 1959 the prices for exports and from 1963 those for imports have been generally unfavourable to Sri Lanka. The combined effect of these two movements, i.e. a downward movement in export prices and an upward movement in import prices, was a considerable deterioration in the terms of trade of the country from 148 in 1960 (1967 = 100) to 58 in 1974.

The adverse effects of the terms of trade on the balance of payments were made worse by the expansionary impact of the government budget financed significantly by Central Bank credit. During the initial period the main impact of government deficits was on the balance of payments as additional demand generated by expansionary financing had to be satisfied through imports. Successive budget deficits financed from expansionary sources helped swell the total money incomes in the economy which increased the demand for goods and services. Consequently, Sri Lanka's total outlays abroad rose faster than current external receipts, resulting in recurrent balance of payments deficits. During this period, the Central Bank repeatedly insisted on the need for total imports to bear a closer relationship to Sri Lanka's import capacity, i.e. current earnings from abroad plus long-term external borrowings. The Bank emphasized that the deficits in the balance of payments and the drain on external assets were essentially budget-induced and stressed that the basic corrective measure would be a substantial reduction in the budget deficit.

The ability of a country to tolerate a basic balance of payments deficit depends upon the level of accumulated reserves. Sri Lanka had accumulated a substantial volume of external assets during the war years owing to enforced reduction in imports due to non-availability of supplies on the one hand, and Allied military expenditure, on the other. Later, the two brief periods of boom conditions in her exports during the fifties helped the external assets position to remain strong until 1956. During the period 1957-60, the assets were rapidly drawn down: external assets which stood at Rs. 1,276 million at the end of 1956 were reduced to Rs. 541 million by the end of 1960.

The recurrent deficit in the balance of payments called for urgent corrective action. With the depletion of external assets, the very high demand for imports had to be suppressed by vigorous controls and the rationing of foreign exchange. Thus, in 1960 the government introduced a series of import saving measures. The Central Bank supplemented these measures by further action through monetary policy. These included higher bank rates and reserve requirements, cash margins on letters of credit, ceilings on advances for importing certain types of goods and restrictions on hire purchase finance.

Despite widespread and stringent import and exchange restrictions, the country failed to stabilize her external account. Consequently, whilst continuing to run down the accumulated reserves, the country also accumulated a substantial external debt. The total long-term external debt which amounted to only Rs. 489 million in 1965 increased to Rs. 2,974 million by the end of 1974. In addition, the country also accumulated substantial external liabilities on account of short-term commitments; the outstanding liabilities on account of suppliers' credits, International Monetary Fund (I.M.F.) drawings and bank borrowings at the end of 1974 being over Rs. 1,400 million.

It should be noted that the strength or the weakness of a currency depends to a very large extent on the state of the country's balance of payments. With the continuous adverse balance of payments eating into reserves and the accumulation of external liabilities, it was natural that the external value of the rupee would have been very seriously affected. Consequently the Central Bank's ability to maintain the convertibility of the rupee for current international transactions was seriously impaired.

Another aspect of the balance of payments policy which received the attention of the Bank has been the rapid build up of the short-term debt. By the end of the sixties Sri Lanka had accumulated a substantial short-term debt. As the share of resources provided by current exchange earnings continued to decline, financial prudence required that an increased absorption of resources should consist of long-term capital. In point of fact the amount of resources provided by long-term capital inflows more or less stagnated since 1967; consequently the increased volume of resources was obtained from short-term finance. In the context of the balance of payments picture that emerged towards the end of the sixties, further use of short-term credit on an extensive scale was clearly inappropriate. The balance of payments problem which Sri Lanka faced was not of a temporary or cyclical character. It was structural in character because it had been the result of changes which seemed unlikely to reverse themselves in the foreseeable future.

The problem about the short-term debt is the rapidity with which the debt service payments fall due, and the tendency for service payments to absorb a larger share of export earnings within a relatively short period. The Central Bank Annual Report for 1969 observed: "given a persistent resource gap, it is preferable to finance it through long-term aid ....rather than placing reliance on short-term foreign credit because the latter tends to aggravate the balance of payments situation by imposing a heavy debt servicing burden in the short-run". These prognostications of the Bank became real before long when there was a sharp increase in the service payments on the short-term debt. During the period 1970 to 1974 debt service payments absorbed as much as 21.7 per cent of current exchange earnings from exports of goods and services.

II. Exchange Rate Revisions and Exchange Reforms

(a) *Revaluation*

Under Section 69 (1) of the Monetary Law Act, the Monetary Board could recommend a change in the par value of the rupee to the Minister of Finance. In 1951, there was considerable public opinion in the country for an upward revision of the exchange rate as a measure to combat inflation. The Monetary Board, however, by unanimous decision recommended against such an upward revision because the Board felt that the long-term considerations outweighed the immediate benefits of a lower cost of living and more equitable distribution of income.

(b) *Devaluation of the Rupee*

From the balance of payments standpoint the most noteworthy event during the period under review was the devaluation of the Sri Lanka rupee by 20 per cent in November, 1967. The Central Bank observed that in view of the external payments problem which prevailed since 1957, the par value of the Sri Lanka rupee had been maintained only by stringent controls on foreign payments. With the continuous deterioration of the balance of payments and the depletion of the country's exchange reserves that followed, it was clearly apparent from the early sixties that the exchange rate was over-valued. When India devalued her currency in June 1966 the government after careful consideration decided not to follow suit. However, the devaluation of sterling in November 1967 brought out the weaknesses of the Sri Lanka exchange rate into sharper focus and the Monetary Board recommended to the government a 20 per cent devaluation of the rupee. The Central Bank was of the view that a devaluation of this magnitude would provide sufficient incentives to greater export efforts by producers of major export products. In fact, it was felt that the margins provided to these exporters would have been too high and a part of it was siphoned-off through higher export duties. It was also felt that this devaluation would help to bring domestic prices into line with the scarcity value of foreign exchange and would help to do away with a substantial array of controls on foreign payments. Although devaluation should have been accompanied by the removal of controls on foreign payments, at least partly, the Bank was of the view that the relaxation of controls was not possible immediately because, on the one hand, the new rate was not sufficiently realistic to permit liberalisation on a substantial scale and, on the other, the economy was too liquid. However, it was argued that the situation was appropriate to enter into a phase of gradual decontrol with adequate monetary and fiscal safeguards and that any process of liberalisation should be highly selective.

(c) *The Foreign Exchange Entitlement Certificate Scheme*

The Foreign Exchange Entitlement Certificate (FEEC) Scheme which came into effect on May 6, 1968, had two main objectives; one was to promote and diversify exports, and the other was to allow the market mechanism to regulate the flow of imports rather than to rely on quotas and stringent controls in the face of falling exchange reserves. The liberalisation of imported inputs, particularly of industrial and agricultural raw materials, and investment goods at a price approximating closely to the true scarcity value of foreign exchange was meant to enable the more efficient and progressive industries to increase output. This was the first attempt made through the exchange rate to provide incentives to select growth sectors with export potentialities. At the same time the scheme imposed an additional rupee cost on selected imports and other payments.

Under this Scheme, FEECs are issued to those who surrender foreign exchange to commercial banks on export of certain goods and services and these Certificates are encashable at the ruling price. The foreign exchange receipts that qualified for Certificates were all visible earnings other than from the export of tea, rubber and coconut products (including fresh nuts) and various invisible earnings such as investment income and tourist receipts.

In terms of import control notices issued on May 5, 1968, merchandise imports were classified into 'A' and 'B' categories. All payments for 'A' category imports were to be made at the official rate, while the payments for 'B' category imports required the surrender of Certificates to the full value of such imports.

An important feature of the Scheme was that a substantial range of imports specified in category 'B' was brought simultaneously under Open General Licence (OGL), thus removing the restrictions with respect to import quotas and licences. These goods consisted predominantly of raw materials for industries. However, OGL imports were permitted only against letters of credit and commercial banks were required to obtain Certificates to the full value of the letters of credit at the time of opening. Over the years the items falling into the 'B' category have been enlarged by transfers from the 'A' category. All payments for services require the surrender of Certificates of equivalent value, unless specifically exempted by the Controller of Exchange.

Although the prices of the Certificates were initially to be determined by market forces which were to be reflected in tender prices of Certificates offered weekly, the Central Bank decided to fix the price of Certificates at Rs. 44/- per Rs. 100/- worth of Certificates. The price has been increased twice since then and now stands at Rs. 65/-.

On August 4, 1970, the FEEC Scheme was further modified with respect to imports by the OGL Scheme being withdrawn.

III. The Exchange Rate System

With the *de facto* floating of the U.S. dollar in August 1971 and the general resort by the monetary authorities to floating, the question arose whether the exchange value of the rupee should be determined by a fixed relationship to sterling or a new link with the U.S. dollar should be forged. Since the float, the dollar had depreciated against sterling, and maintaining a fixed relationship between the rupee and the pound would have amounted to a revaluation of the rupee against the dollar. The consequences would then have been that Sri Lanka's exporters to the Dollar Area would have realised less rupees for their exports. This was not desirable from the point of view of the balance of payments. Another important argument for a dollar-rupee link was that several countries which were in competition with Sri Lanka in export markets, had moved with the dollar. These matters were the subject of careful study by the Government and in November 1971, the decision was taken to align the exchange rate with the dollar. When the float of the U.S. dollar ended with the Smithsonian Agreement, new exchange rates were fixed based on the previously existing relationship between the U.S. dollar and the rupee.

It soon became necessary to review these decisions when, in June 1972, the pound sterling was allowed to float. All the previous arguments for linking the rupee to the pound sterling still remained valid, while, additionally account had to be taken of the fact that failure to re-link the rupee to the pound would adversely affect Sri Lanka's export trade with the Sterling Area. Accordingly on July 8, 1972, exchange rates for the rupee were revised on the basis of a fixed relationship with the pound sterling since the balance of payments position of Sri Lanka did not warrant a revaluation of the rupee against a major currency. The implementation of this decision has indirectly resulted in a mild depreciation of the rupee against major currencies. This depreciation afforded some much-needed relief to domestic exports (particularly those exports which do not qualify for Foreign Exchange Entitlement Certificates), while also making some small contribution towards restraining the demand for imports.

C. BANK OF ISSUE

The Central Bank of Ceylon is the sole currency issuing authority in Sri Lanka and all currency notes and coins issued by the Bank constitute legal tender for the payment of any amount. When the Bank was set up in 1950, it assumed responsibility for all currency notes and coins issued by the Board of Commissioners of Currency and also took over the unissued stock in their hands to be issued as legal tender. It was in 1952 that the Central Bank issued for the first time currency notes designated and printed under its authority. These were in denominations of Rs. 10/-, Rs. 2/- and Re. 1/-. This was followed in 1953 with the issue of currency notes in denominations of Rs. 100/-, Rs. 50/- and Rs. 5/-.

The Act does not prescribe a minimum cover in gold or foreign exchange against the note issue; instead the Central Bank of Ceylon has been given a free hand to issue currency to satisfy the public demand for notes and coins. However, the Bank is expected to maintain a foreign exchange reserve adequate to meet any foreseeable deficits in the balance of payments. The Central Bank is under no obligation to surrender gold or foreign currency in exchange for its own currency.

The total currency issue of the Central Bank which stood at Rs. 367 million in December 1950 registered a near 400 per cent increase and stood at Rs. 1,829 million by the end of 1974. Currency in circulation, i.e. currency in the hands of the public, which is one of the two components of money supply, has increased from Rs. 325 million to Rs. 1,539 million over the same period - an average annual increase of approximately 15 per cent. The other component of the money supply is demand deposits held by the public. Over the years the relative importance of currency in circulation in the money supply has increased while correspondingly that of bank deposits has declined. As at the end of 1974, currency in circulation accounted for 52 per cent of the money supply as against 36 per cent at the end of 1950.

Currency notes were demonetized twice during the period under review. On August 26, 1955, the Central Bank called in for replacement of old pattern currency notes of the denominations of Rs. 10/-, Rs. 5/-, Rs. 2/- and Re. 1/- and subsidiary notes of the denominations of -/50 cents, -/25 cents and -/10 cents, i.e. notes bearing the date prior to December 31, 1950 and the signature in facsimile of the Commissioners of Currency. These currency notes and subsidiary notes ceased to be legal tender after August 31, 1956. The notes not redeemed before this date were accepted for exchange at the Central Bank and at all Kachcheries upto August 31, 1957 and thereafter at the Central Bank only. The second demonetization was on October 25, 1970 when the currency notes of the denominations of Rs. 100/- and Rs. 50/- bearing a date prior to October 26, 1970 ceased to be legal tender after November 3, 1970. On the same date two new currency notes of the same denominations were issued.

During the period under review the Bank issued new currency notes of various denominations on a number of occasions. With the issue in 1957 the portrait of Her Majesty Queen Elizabeth II was replaced by the Armorial Ensigns of Ceylon. In 1961, the Central Bank issued for the first time currency notes of various denominations incorporating a metallic thread. As in the case of currency notes, the Central Bank continued to issue coins minted by the Currency Board. The Central Bank issued its own coins for the first time in 1957 when two special coins in the denominations of Rs. 5/- and Rs. 2/- were issued to commemorate the 2,500th Anniversary of Buddhism and the birth of the Nation. Both these coins were legal tender in Sri Lanka for the payment of any amount. In 1963 the coins issued under the Currency

Board were replaced by coins issued by the Central Bank bearing the Armorial Ensigns of Ceylon. A new cupro-nickel coin of the denomination of Rs. 2/- was issued in October, 1968 in connection with the special Food and Agriculture Organization (FAO) coin issue.

D. FISCAL AGENT & FINANCIAL ADVISER TO GOVERNMENT

As the agent of the government the Bank can be called upon to undertake various activities on behalf of the government, even those not specifically authorized in the Act. The management of the Public Debt and the Employees' Provident Fund and the administration of the Exchange Control are some of the important activities the Central Bank of Ceylon has undertaken on behalf of the government. It has also been one of the chief sources of credit to the central government.

I. Maintenance of Government Accounts

The services which the Central Bank of Ceylon provides in maintaining government accounts are akin to those normally provided by commercial banks to their customers. The Central Bank is the principal keeper of accounts of the government and its agencies and institutions. However, it does not pay any interest on deposits of the government or its agencies and institutions. In the same vein, it is not expected to collect any commissions, fees or other charges for services which it renders to the government or its agencies and institutions.

The Central Bank also administers on behalf of the government various clearing accounts opened from time to time in accordance with the provisions of Trade & Payments Agreements. At present, the Bank maintains clearing accounts of the People's Republic of China, the Union of Soviet Socialist Republics, the Arab Republic of Egypt, the German Democratic Republic, Bulgaria and Syria. Further, the Bank attends to operations arising from various Credit and Economic Co-operation Agreements with countries such as the United Kingdom, the United States of America, the Union of Soviet Socialist Republics, Japan, France, Denmark, Poland, Czechoslovakia and the People's Republic of China.

II. Source of Funds to Government

(a) *Provisional Advances*

The Central Bank is empowered to provide provisional advances to the government to finance expenditures authorized to be incurred out of the Consolidated Fund. There are, however, legal limitations on the amount and period of such advances. The total amount of such advances outstanding at any time should not exceed 10 per cent of the estimated revenue of the government for the year in which they are made and are repayable within a period not exceeding six months. Thus, while the law has provided for direct access of the government to Central Bank credit, it has also placed specific limits to the magnitude of such borrowings. This was a safeguard against excessive recourse to Central Bank credit by the government. The record during the last 25 years shows that the government has been regularly making use of this facility pending the collection of revenue. Initially provisional advances were subject to an interest charge but with effect from October 1, 1954 the Central Bank ceased to charge interest on such loans. It is observed that with the progressive increase in the volume of government revenue over the years the level of provisional advances has also correspondingly increased.

(b) *Purchase of Treasury Bills*

There are no statutory regulations governing the Bank's subscription to Treasury bills. Generally, the pattern has been for the Central Bank to subscribe for that share of a Treasury bill issue which has not been purchased by the public or other institutional investors. At present the Bank holds over 90 per cent of the total of Treasury bills outstanding and these holdings account for over 40 per cent of its total assets. The guiding principle behind the investment in Treasury bills has been the accommodation of financial requirements of the government rather than the need to hold short-term bills. The only limit on the Central Bank purchases of Treasury bills has been the ceiling on the Treasury bill issue itself imposed by Resolutions of the National State Assembly (formerly the House of Representatives). This ceiling has been raised from time to time to enable the government to have continued recourse to Treasury bill financing to bridge budget deficits. With the persistence of overall budget deficits there was a need for successive increases in the ceiling itself. Thus, although the Bank had a statutory obligation to protect the internal and external value of the rupee, government demand for funds has been an overriding concern. The absence of a statutory requirement for a gold or foreign exchange cover against the currency and demand liabilities enabled the Bank to meet government requests for more funds readily. It must be emphasized that if the government were determined to make use of Central Bank credit to meet its budgetary shortfalls, the Central Bank, being a creature of the government, would have no alternative but to comply.

(c) *Purchase of Government Securities*

Unlike in the case of Treasury bills, the Monetary Law Act expressly forbids the Central Bank to subscribe directly to any issue of government securities or purchase the unsubscribed portion of such issues. The Bank is, however, not debarred from acquiring government securities through open market purchases to be used in open market operations designed to stabilize the market for securities or to control the money supply. Thus, while the Bank is allowed to make open market purchases of government securities for sound monetary reasons, it is not expected to do so as an indirect means of making available Central Bank credit to finance budget deficits. In discharging its obligations the Bank has been purchasing small quantities of government securities from time to time in the open market and at the end of 1974 its holdings amounted to Rs. 173.5 million. However, the fact that the Bank's portfolio of government securities represents less than 3 per cent of total government securities outstanding shows that the Bank's purchases of securities have been very small.

III. Agent of the Government

Among the services rendered by the Central Bank as the agent of the government are the management of the Public Debt, the management of the Employees' Provident Fund, the administration of Exchange Control and the guaranteeing of loans granted by banking institutions for specified purposes. The scope of these services will be discussed in a subsequent section.

IV. Representation at International Institutions

The Central Bank represents the government of Sri Lanka in its dealings with the International Monetary Fund and the International Bank for Reconstruction and Development. Sri Lanka became a member of the IMF and the IBRD on August 29, 1950, the day after the opening of the Central Bank, and in terms of the IMF and IBRD Agreements, the Central Bank was designated the fiscal agency for transactions with the IMF and the IBRD, respectively, as well as the depository for the holdings of Sri Lanka currency of these two institutions.

In terms of Article 14, Section 4 of the IMF's Articles of Agreement, member countries are required to hold Consultations annually with the IMF if the member continues to retain any trade and payments restrictions which are inconsistent with Article 8 of the Articles of Agreement. The first such Consultation between Sri Lanka and the IMF took place in Washington in 1952. During the next two years Consultations continued to be held in Washington. It was in 1955 that for the first time the IMF Consultations under Article 14 were held in Sri Lanka. Since then Consultations between Sri Lanka and the IMF became more or less an annual feature and were normally held in Sri Lanka.

At the time Sri Lanka joined the IMF she was given a quota of $ 15 million of which 5 per cent was paid in gold and the balance 95 per cent in Sri Lanka rupees. During the period 1955 to 1957 Sri Lanka repurchased from the IMF Sri Lanka rupees to the value of U.S. $ 3.0 million, thus reducing the IMF's holdings of Sri Lanka rupees to 75 per cent of the original quota. Since then Sri Lanka's quota at the IMF has been increased a number of times and at present stands at SDR 98.0 million (approximately U.S. $ 117 million).

Upto 1961, Sri Lanka had not obtained any resources from the IMF. However, as Sri Lanka's balance of payments position continued to weaken since the early sixties the IMF became an important source for balance of payments support. In April 1961, Sri Lanka for the first time purchased the equivalent of $ 11.25 million from the IMF representing the gold tranche drawing; another drawing followed in February 1962. The first Standby arrangement with the IMF was for a period of one year, effective June 15, 1965, under which Sri Lanka secured the right to purchase foreign exchange in instalments upto a value of U.S. $ 30 million. Since then, Sri Lanka has successfully negotiated six more Standby arrangements with the IMF for a total sum of U.S. $ 118 million. Sri Lanka also became eligible to draw from the IMF under the Compensatory Financing Scheme of the IMF in 1966, in view of the sharp deterioration in export earnings. Since then, Sri Lanka has made five more drawings under this Scheme.

Sri Lanka has also been a participant of the SDR allocations of the IMF and received allocations of SDR 13.1, 10.5 and 10.4 million, in 1970, 1971 and 1972, respectively. The most recent facility approved by the IMF is the Oil Facility under which the IMF's resources are made available to members most seriously affected by the oil price increase. In all, Sri Lanka drew a sum of $ 43.1 million under the 1974 Oil Facility. Altogether resources to the tune of Rs. 1,473 million have been obtained from the IMF between 1961 and January 1975.

V. Financial Adviser to Government

The Central Bank has throughout acted as economic, financial and fiscal adviser to the government. In the preparation of the annual government budget, the Central Bank plays a major role as the fiscal adviser. On or before September 15, (formerly May 15) each year, the Monetary Board submits a confidential report to the Minister of Finance which describes the monetary situation in the country and sets out the current monetary policy of the Board. It further examines the effect of the current fiscal policy of the government in relation to the principal objectives of the Central Bank. Generally this report is used as a background paper for the preparation of the annual budget and some of the proposals of the Bank eventually become a part of the budgetary policy.

The Annual Report published each year gives the Finance Minister a comprehensive picture of the state of the economy. These reports have objectively dealt with government budgetary policy, monetary and exchange rate policy. In raising new loans the government needs to seek the advice of the Monetary Board upon the monetary implications of the proposed loan or issue.

VI. Supply of Expertise to Government

The Central Bank of Ceylon has been one of the chief suppliers of expertise to the government. The Bank has a pool of trained and qualified economists whose services have been sought by Ministries, Government Departments and Corporations. Its officers have served in such Ministries as Planning & Economic Affairs, Finance, Foreign and Internal Trade, Industries and Scientific Affairs, Shipping and Tourism and Plantation Industries. In addition to serving in a number of public corporations, Central Bank officers have served on various Commissions and Committees set up by the government. Central Bank economists have played a significant role in drawing up various national plans, such as the Six Year Programme of Investment, the Ten Year Plan, the Three Year Implementation Programme and the Five Year Plan.

E. BANKER TO BANKS

The Central Bank of Ceylon is banker to the commercial banks in Sri Lanka and acts as lender of last resort. It maintains close relationships with commercial banks and is empowered to take various measures which promote a sound banking system in the country. It also has powers to require banks to submit regular returns on both domestic and foreign exchange transactions to enable the Bank to assess the financial and foreign exchange situation at a particular point of time.

I. **Bankers' Bank**

All commercial banks in Sri Lanka are expected to maintain a current account with the Central Bank to record transactions arising from statutory reserve requirements, clearing and credit operations with the Central Bank. Under the reserve requirement, commercial banks are required to maintain in deposit with the Central Bank a certain percentage of their deposit liabilities. Required reserves are calculated weekly, every Friday, on the basis of deposit liabilities of commercial banks as on the previous Wednesday. The Central Bank of Ceylon provides clearing house facilities as one of its services to the banking system and inter-bank settlement after the daily clearing of cheques is made through the accounts of commercial banks at the Central Bank.

II. **Lender of Last Resort**

As lender of last resort the Central Bank stands ready to provide the banking system with liquid funds in times of need. This is a normal central banking function essential for the proper and smooth working of the banking system. When a commercial bank is temporarily short of funds due to unforeseen circumstances the Central Bank of Ceylon is the ultimate source of funds to tide the bank over the temporary difficulty. The existence of the Central Bank as a lender of last resort promotes confidence in the orderly operation of the banking system.

Sections 82 to 88 of the Monetary Law Act set out the terms and conditions under which Central Bank credit is available to banking institutions. Ordinarily, there are three types of credit facilities available to commercial banks — commercial credits, production credits, and loans and advances. Commercial credits refer to discounting, re-discounting, buying and selling of bills, acceptances, promissory notes and other credit instruments of maturities not exceeding 180 days arising from certain commercial transactions such as export and import trade. Production credits are similar to commercial credits except for the fact that the maturity period is upto 270 days and the credit instruments arise from transactions relating to production, manufacture or processing of agricultural, animal, mineral or industrial products. Central Bank advances are granted for periods not exceeding 180 days upon promissory notes secured by the pledge of gold coins or bullion, negotiable securities of the government, Central Bank Securities and specified credit instruments. In special circumstances credits may be granted on instruments having a longer maturity period but not exceeding one year. In order to enable the Central Bank to fulfil its function as the lender of last resort in financial crises, the Bank is authorized to grant to banking institutions extraordinary loans or advances secured by any assets which are defined as acceptable for the purpose. The interest and discount rates to be charged by the Bank on its credit operations are fixed by the Monetary Board taking into account the soundness of credit conditions, the needs of the market, and the general requirements of national monetary policy.

F. PROMOTIONAL ACTIVITIES

An important function of most central banks in less developed countries is to engage in promotional activities, especially in the field of development of banking and financial institutions. Since its inception the Central Bank of Ceylon has been associated with a wide range of activities not specifically spelt out in the Monetary Law Act. The vast majority of these are essentially promotional in character. At the time the Central Bank was established in 1950, the deficiencies of the then existing financial system were evident in many ways. Commercial banking facilities were concentrated almost exclusively in the city of Colombo with few branches in provincial capitals, while such facilities in other areas, both urban and rural, were non-existent. Financial institutions other than commercial banks were very few in number and were in a very early state of development. In short, the institutional set up with respect to banking, money and credit was woefully inadequate in relation to the development aspirations of the nation. Therefore, the Central Bank had to play an extensive role in the development of appropriate financial institutions and credit schemes.

I. **Institutional Changes Sponsored by the Central Bank**

(a) *Commercial Banks*

In 1955, the Bank Supervision Department of the Central Bank examined the Co-operative Federal Bank of Ceylon Ltd. This bank had been established in 1949 as the apex bank of the co-operative banking structure which consisted of provincial co-operative banks and district co-operative banks. These banks provided credit to the primary co-operative societies, the banks themselves obtaining credit from the Co-operative Federal Bank. The results of the Central Bank examination showed that the role which the Co-operative Federal Bank was performing and indeed the co-operative banking structure itself was outmoded and there was a need for an institutional change. Appropriate recommendations were made to the government and the result was that the Co-operative Federal Bank was replaced by the creation of the People's Bank in 1961 as a full fledged commercial bank with its primary purpose as the development of the co-operative and agricultural sectors of the economy. The provincial and district co-operative banks were progressively absorbed by the People's Bank and by 1971 all these banks had become branches of the People's Bank. Consequent on the recommendations of two Commissions of Inquiry on the working and administration of the People's Bank and the Bank of Ceylon, it was considered appropriate to invest these two banks with wider powers and functions than they had under the legislative enactments which established them. The Central Bank of Ceylon acted as an adviser to the government in the formulation and implementation of proposals to revamp these two institutions and rendered assistance in the drafting of the necessary amendments to the People's Bank Act and the Bank of Ceylon Ordinance.

Since 1965, the Central Bank and government have held discussions with British banks operating in Sri Lanka with a view to their more effective participation in financing economic development. Commercial banks which were prepared to reorient their structure and policies were to be designated "approved" banks with the right to open new accounts for citizens of Sri Lanka under the provisions of the Finance Act No. 36 of 1968. (Previously they were prohibited by the Finance Act No. 65 of 1961 from opening such accounts).

The establishment of the Commercial Bank of Ceylon and the Hatton National Bank are further instances of Central Bank participation in banking development. The matter of reducing the presence in Sri Lanka of foreign banks and replacing their branches with banks incorporated in Sri Lanka as banking companies engaged the attention of the Central Bank. Action was taken by the Central Bank to promote the formation of banking companies in collaboration with foreign banks. The arrangement was for foreign banks to confine business to Colombo and give up their provincial offices to the collaborative ventures in the capital of which they were to have a share. The result was the establishment of the Commercial Bank of Ceylon in 1969 with participation in its share capital by government corporations, the public and the Eastern Bank. In a later development the bank took over the three provincial branches of the Mercantile Bank. In 1970, the Hatton National Bank was formed as a banking company with its share capital subscribed by a local company, the public and the National & Grindlays Bank (now Grindlays Bank). At the same time the newly established bank took over two branches of the National & Grindlays Bank. Both the Commercial Bank of Ceylon and the Hatton National Bank have subsequently opened additional branches in Sri Lanka. In 1974, the Hatton National Bank took over the remaining two branches of the Mercantile Bank including its main office in Sri Lanka.

(b) *Savings Institutions*

In the task of promoting savings, it was felt that great potential lay in the Post Office Savings Bank if the procedures were streamlined. In 1963, the Monetary Board directed the Director of Bank Supervision to examine the Post Office Savings Bank, a banking institution within the meaning of the Monetary Law Act. The bank was duly examined and it was recommended in the Report that there should be a fundamental change in the organisation, structure and management of existing savings institutions and in the nature and scope of their activities. It was considered that there should be a National Savings Organisation capable of devoting its time fully to the mobilization of personal savings. The Monetary Board accepted this suggestion and recommended to the government that a National Savings Bank be established by an Act of

Parliament charged with the implementation of an aggressive savings promotion programme.

The draft bill for the establishment of a National Savings Bank was placed before the government for consideration in 1968 and was tabled in Parliament in August 1969. There was a delay in the bill becoming law due to the change of government in May 1970 but the bill was eventually passed in 1971. The National Savings Bank, which was established by amalgamating the Post Office Savings Bank, the Ceylon Savings Bank and the National Savings Movement, commenced operations on April 1, 1972.

(c) *Long-term Credit Institutions*

The Central Bank from time to time considered the need to reorganize the long-term credit institutions in order to enable them to play a more dynamic role in the economic development of the country. An important case in point is that of the State Mortgage Bank. The State Mortgage Bank as originally constituted granted loans for agricultural and other prescribed purposes on the primary mortgage of immovable property situated in Sri Lanka. In order that the State Mortgage Bank might play a more dynamic role in the development process, especially the development of agriculture, it was considered desirable to enlarge the powers of the Bank and to expand its activities, and to substitute certain outmoded practices and procedures with modern banking methods. It was recommended that the scope of the State Mortgage Bank's activities as well as its powers, be enlarged especially those connected with the acceptability of title to land and the ability of the State Mortgage Bank to borrow under the refinance schemes of the Central Bank. The amendments proposed by the Central Bank were embodied in Act No. 33 of 1968. The Central Bank also initiated a proposal to amend the Agricultural and Industrial Credit Corporation Ordinance to enable the institution to borrow under the Central Bank's refinance scheme. This proposal was given effect to, by the Agricultural and Industrial Credit Corporation Amendment Act No. 5 of 1970.

Experience showed that during the early fifties the level of bank credit made available to the private sector other than for commercial purposes was influenced by the conservative lending policies of most commercial banks largely due to factors such as unsatisfactory title to land and restrictions on speedy realization of collateral. As this conservatism became too rigid a creed in the lending policies of commercial banks, the volume of credit created was grossly inadequate to meet the needs of a rapidly developing economy. The Central Bank was of the view that there was a definite gap in the financial structure of the economy and made a proposal to the government to set up a Development Finance Corporation. The purpose of the corporation was primarily to promote and assist new enterprises in industry, and the expansion and modernization of agricultural concerns. The Central Bank and the I.B.R.D. collaborated in the preliminaries towards the establishment of the corporation as a private corporation, with local and foreign capital, to provide long-term and medium-term credit to the private sector. The Development Finance Corporation of Ceylon was established by an Act of Parliament in September 1956 and an officer of the Central Bank served as its pro-tem. Secretary. The Deputy Governors of the Central Bank and other Senior officers of the Bank served as government nominees on the Board of the Corporation.

The Central Bank also rendered advice and assistance in the matter of amalgamating the two medium and long-term credit institutions--the Ceylon State Mortgage Bank and the Agricultural and Industrial Credit Corporation of Ceylon. It was considered that the amalgamation of these two credit institutions would, by a pooling of resources, both financial and human, and by the vesting in a single institution of extensive powers and functions, enable the medium and long-term credit needs of the economy to be met more effectively than could be done by two institutions operating separately in the same field. The State Mortgage and Investment Bank Bill which sought to amalgamate the Ceylon State Mortgage Bank and the Agricultural and Industrial Credit Corporation of Ceylon was passed in the National State Assembly and has now been enacted.

(d) *The Banker's Training Institute*

With the progressive expansion of banking facilities consequent on the setting up of the People's Bank and the nationalisation of the Bank of Ceylon there was a need to provide an adequate supply of trained bank personnel to the banking sector. Accordingly, in April 1963, the Central Bank of Ceylon in association with the Bank of Ceylon, People's Bank and the Commercial Banks' Association established the Bankers' Training Institute. The Institute offers suitable training to bank employees, provides facilities for discussion of matters of interest to banks, encourages the study of the theory of banking and generally provides information on banking and allied subjects by lectures, library facilities and lecture study notes. The main objective was to provide courses of study in all aspects of banking and to conduct examinations somewhat similar to examinations held by the Institute of Bankers, London.

The office of the Institute is located in the Central Bank building. A Deputy Governor of the Central Bank is the Chairman of the Governing Body, and two other senior officers also serve on the Governing Body. Among the lecturers of the Institute are several officers of the Central Bank.

It was evident from the initial response that the Institute was providing a long felt need. By December 1965, 1,150 persons had registered in the Institute and as at June 1975 the membership was 5,171.

II. **Provision of Credit Facilities**

(a) *New Agricultural Credit Scheme*

The New Agricultural Credit Scheme was established in September 1967 to replace the Agricultural Credit Scheme administered by the Department of Agrarian Services. Under this Scheme, credit to the rural sector is channelled through the commercial banks, and the Central Bank refinances them at rates of interest below those applicable to normal Central Bank advances. The mode of operation is that at field level the farmer obtains his credit through primary co-operative societies which in turn obtain their credit requirements from a commercial bank against usance promissory notes in favour of the relevant commercial bank. The commercial bank thereafter countersigns the promissory notes and obtains refinance from the Central Bank. In addition, the Central Bank guarantees on behalf of the government the credit granted by commercial banks under this Scheme. The guarantee covers upto 75 per cent of the amount of the loan in default. Such a guarantee is very important to maintain the viability of the Scheme as the degree of risk involved in cultivation loans is considerably higher than that associated with normal commercial loans. Loans under this Scheme are given for the purpose of cultivation of paddy and other specified subsidiary crops.

Credit provided to farmers through the banking system played a major role in the increased use of fertilizer that was essential to realise the yield potentials of the hybrid varieties of paddy. With the shift in emphasis in government policy in favour of import substitution in agriculture rather than in industry, bank credit was increasingly required to finance the costs of inputs of farmers, for the marketing and storage of the products, as well as for the purchase of agricultural equipment such as tractors that are essential for the timely cultivation of these crops. With the shift in emphasis in economic policy, financing of the small farmers, whose holdings account for the major area cultivated in domestic food crops, became critical to the successful implementation of the government's development plans. Hence, the decision to change the basis of financing the small farmers from a direct government operation undertaken by the Director of Agrarian Services in spatially limited areas, to an island-wide credit scheme managed and operated through the Bank of Ceylon and the People's Bank. This change greatly increased the role of the Central Bank in the field of agricultural credit. Loans granted by the commercial banks under the New Agricultural Credit Scheme were not subject to the credit ceiling imposed by the Central Bank from time to time as part of overall monetary policy.

(b) *The Medium and Long-term Credit Fund*

In 1964, the Central Bank of Ceylon established the Medium and Long-term Credit Fund for the purpose of stimulating the flow of medium and long-term credit, both through the long-term credit institutions and the commercial banks, by providing refinance facilities within the framework of the amendments to the Monetary Law Act introduced by the Finance Act of 1963.

The object of the Fund was to provide financial accommodation to credit institutions in respect of advances made by such institutions for productive purposes such as the promotion and the development of agriculture, industry, trade, commerce or business. The capital resources of the Fund were to come partly from capital repayments of loans, from interest charges on loans granted, and other funds which may be transferred to it out of the resources of the Central Bank from time to time by the Monetary Board. Under this scheme the Central Bank has been authorized to make advances by way of refinance facilities against the pledge of debts to such institutions. The Monetary Board has the right to prescribe the rate of interest to be charged by the Central Bank on such loans and advances, the rate of interest to be charged by the borrowing institutions, the purposes for which loans are made and any other matters connected with the credit policy of the borrowing institutions.

The Medium and Long-term Credit Fund became operative in April, 1964 with the transfer of Rs. 10 million from the general reserve of the Central Bank. Since then the resources of the Fund have been steadily enhanced by transferring part of the profits of the Bank from time to time. The rate of interest on refinance loans granted under this Scheme would vary according to the purpose for which loans are granted by the credit institutions. Since 1967, credit institutions have been making increased use of the refinancing facilities under the Medium and Long-term Credit Fund. In 1968, the Central Bank agreed to make available the facilities of this Fund for refinancing loans granted by credit institutions for the modernization of tea factories. Some categories of medium and long-term advances granted by commercial banks under this Scheme were exempted from the credit ceilings imposed by the Central Bank from time to time.

(c) *Refinance Scheme for the Marketing of Agricultural Products*

With the development of an adverse balance of payments situation and the loss of external reserves, several corrective policies and measures were adopted by both the Government and the Central Bank of Ceylon in the early sixties. One of the general measures adopted by the Bank was the raising of the Bank Rate from $2\frac{1}{2}$ per cent to 4 per cent with effect from August 13, 1960. In order, however, that the increase may not adversely affect the cost of commercial bank credit for essential trade and production purposes, the Bank provided for a special concessionary rate of $2\frac{1}{2}$ per cent on advances granted to commercial banks against the pledge of usance promissory notes relating to the financing of the import of certain essential items, as well as of activities connected with domestic production and exports. At the same time, the maximum rates of interest chargeable by banks on advances in respect of these transactions were fixed at the rates obtained on August 12, 1960 subject to the condition that the rates will in no case exceed 6 per cent. The concessionary rate of $2\frac{1}{2}$ per cent as well as the ceiling on interest rates were, however, withdrawn in January 1961, because of the apparent leakage of credit from one category of transactions to another.

The concessionary rate scheme was re-introduced in August 1961, for a more restricted purpose. With a view to making adequate credit available for the purchase, sale or storage of locally grown agricultural products, the Central Bank offered advances to commercial banks from this date at a concessionary rate of 3 per cent against the pledge of usance promissory notes of co-operative societies. The scheme was drawn up to facilitate primarily the purchase of paddy under the Guaranteed Price Scheme (GPS) of the Government because experience had shown that the co-operatives often found it difficult to purchase paddy offered by farmers due to lack of access to credit. The volume of funds made available by the Central Bank under this scheme has expanded considerably over the years. The importance attached to the scheme by the Central Bank is reflected in the fact that the rate of interest charged by the Bank still remains at 3 per cent, although the Bank Rate has since moved up to $6\frac{1}{2}$ per cent.

The merit of the scheme is that the farmer receives payment immediately after he sells his produce since the co-operatives are able to obtain credit readily from the People's Bank which in turn has access to Central Bank credit at concessionary rates. The scheme thus serves to encourage domestic agricultural production.

III. Other Promotional Activities

With the continued decline in the export prices of tea in the sixties, the tea industry was increasingly faced with a situation requiring cost reductions as well as the improvement in the quality of tea. This meant that new investment had to be undertaken to improve productivity in factory and field. Despite this necessity for investment, tea producers were increasingly confronted with a reluctance on the part of banks to lend against the conventional security of stocks of tea and the security of the land and fixtures of tea producers. With land reform measures tea land ceased to have an accepted market value. Hence the Central Bank took the initiative in suggesting to the government the institution of a scheme of credit guarantee for the tea industry, to be operated by the Central Bank on behalf of the government under Section 108 of the Monetary Law Act. This scheme was put into operation in 1974. Subsequently, the government extended the scheme to provide cover in respect of loans given for the purpose of paying gratuities to repatriates under the Indo-Ceylon Agreement of 1964 (Sirima-Shastri Pact).

The Central Bank also became aware of the increasing difficulties faced by the small entrepreneurs in obtaining credit for the production of raw material, components, tools, finished products etc. The reluctance of commercial banks to lend to small entrepreneurs was again because of the inadequacy or the unsatisfactory nature of the security they could offer to the banks. The value of stocks of machinery and equipment in small enterprises is generally low in relation to their financial requirements. Besides, the premises on which these enterprises are located are often leased or rented unlike in the case of large enterprises which as a rule own the land and buildings in which machinery and equipment are installed and the stocks held. Hence the Central Bank suggested to the government that the Monetary Law Act be amended to enable the Central Bank to guarantee on its own behalf, loans given to small enterprises by credit institutions. The government accepted this proposal and the Monetary Law Act was amended accordingly in 1974.

In 1968, the Central Bank was associated with the arrangements made to finance the modernization of tea factories. The foreign exchange costs of these arrangements were to be met from a line of credit provided by the Asian Development Bank. A Loan Committee was set up, chaired by a Deputy Governor of the Central Bank, and including the Tea Controller, to regulate the institutional arrangements made to ensure the proper use of funds and the absorption of the line of credit within the stipulated time period. The Central Bank also provided refinance facilities to the commercial banks in respect of loans for tea factory modernization, and also undertook the work of appraisal of these projects. In 1970, a second line of credit was negotiated for the same purpose from the Asian Development Bank.

In 1973, the Central Bank agreed to set up a Loan Committee to co-ordinate and administer the activities connected with the absorption of a line of credit provided by the Asian Development Bank for the development of the fishing industry. This line of credit was to be used to import engines, materials and fishing gear required for the construction and operation of fishing boats. Credit was required for the purchase of these boats by the co-operatives as well as by the private sector. Hence the absorption of the line of credit was very much dependent on the availability of the required finances from the banking system. Under the scheme agreed to with the Asian Development Bank, the required finances were to be provided by the Bank of Ceylon and the People's Bank for the purchase of boats by the co-operative societies, and by all banks for the purchase of boats by the private sector. The responsibility cast on the Central Bank is in the co-ordination of the activities of the commercial banks in keeping with the time-table for the construction of boats, because of the necessity to obtain prior commitment for the purchase of boats being built both in Sri Lanka and abroad.

In 1974, the Central Bank participated in discussions on the use of a line of credit to be provided by the International Development Association for the development of the dairy industry of Sri Lanka. Under this scheme, farmers within designated project areas in the low and mid elevations of the country, were to be provided bank loans for the purchase of the animals to be made available under the project. These animals were to be made available either by import or by local breeding, to be undertaken by a specially established organisation designated the Project Technical Unit which was to look after the technical aspects of the project, including the maintenance of the stock farms required for breeding animals. The loan also provided for the importation of vehicles for the storage and transport of milk, both by co-operative societies and by the Milk Board. The line of credit includes a balance of payments support element in respect of local expenditure. A record of transactions involved between IDA on the one hand, and the various organs of government on the other, as well as an account of IDA funds allocated for specific purposes, are to be maintained by the Central Bank. The Loan Committee established to administer this scheme is to be chaired by the Secretary to the Ministry of Plan Implementation. The Director of Development Finance of the Central Bank of Ceylon is represented on this Committee in view of the key role that credit is expected to play in the operation.

G. INTERNATIONAL RELATIONS

The Central Bank of Ceylon has throughout maintained close contact with other central banks in the Asian region with the objective of promoting co-operation and exchange of ideas among central banks of the region. From 1965 onwards, conferences of Governors of Central Banks in South East Asia (SEACEN) have been held periodically. The eighth SEACEN conference was held in Sri Lanka in January 1973. At the fifth SEACEN conference held in Bangkok in 1970 a Technical Committee consisting of representatives from the Central Bank of Ceylon, the Bank of Thailand and Bank Negara, Malaysia was set up to study information relating to banking legislation and practices and agricultural credit facilities. The Central Bank of Ceylon was designated to act as a "Clearing House" for this purpose. The Committee issued its first report in February 1971 on banking legislation and agricultural credit facilities. This was followed by a report on facilities for financing industry in December, 1972.

When the Governors of the Central Banks in the South East Asian region met in London in the mid-fifties the idea of commencing a training programme for central bank officials was mooted by the Governor of the Commonwealth Bank of Australia. Consequently, a series of training programmes sponsored by the Central Banks of South East Asia, New Zealand and Australia (SEANZA) were inaugurated in 1956. The first two courses under this scheme were held in Australia and Sri Lanka hosted the seventh SEANZA Programme in 1968. Apart from the provision of training facilities, SEANZA was conceived as a forum for expanding the knowledge of central banking and as a clearing house for experience gained by central banks functioning in countries with various stages of economic development. Originally, the membership was confined to only five countries - Australia India, New Zealand, Pakistan and Sri Lanka, but by the end of 1974 the membership had increased to fifteen.

Since the mid-sixties several feasibility studies for the establishment of an Asian Clearing Union and an Asian Reserve Bank were initiated by the United Nations Economic Commission for Asia and the Far East (ECAFE,-now ESCAP). In March 1971, the Preparatory Committee on the establishment of an Asian Clearing Union with the participation of 15 Asian countries unanimously adopted an agreed draft establishing an Asian Clearing Union. The Asian Clearing Union was formally established in December 1974 and its first meeting was held in Bangkok on December 9, 1974. The primary aim of the Asian Clearing Union is to facilitate the settlement of payments for current international transactions between participants on a multi-lateral basis through the promotion of the use of participants' currencies for intra-regional payments. It is also aimed at promoting monetary co-operation and trade expansion among the member countries. The signatories to the Agreement establishing the Asian Clearing Union are the monetary authorities (Central Banks) of Bangladesh, India, Iran, Nepal, Pakistan and Sri Lanka. The Asian Clearing Union is managed by a Board of Directors which includes a Director from each member country. The Governor of the Central

Bank of Ceylon who is the Director for Sri Lanka, was elected Chairman of the Board of Directors for the current year.

4 ORGANISATION OF THE CENTRAL BANK

A. GENERAL

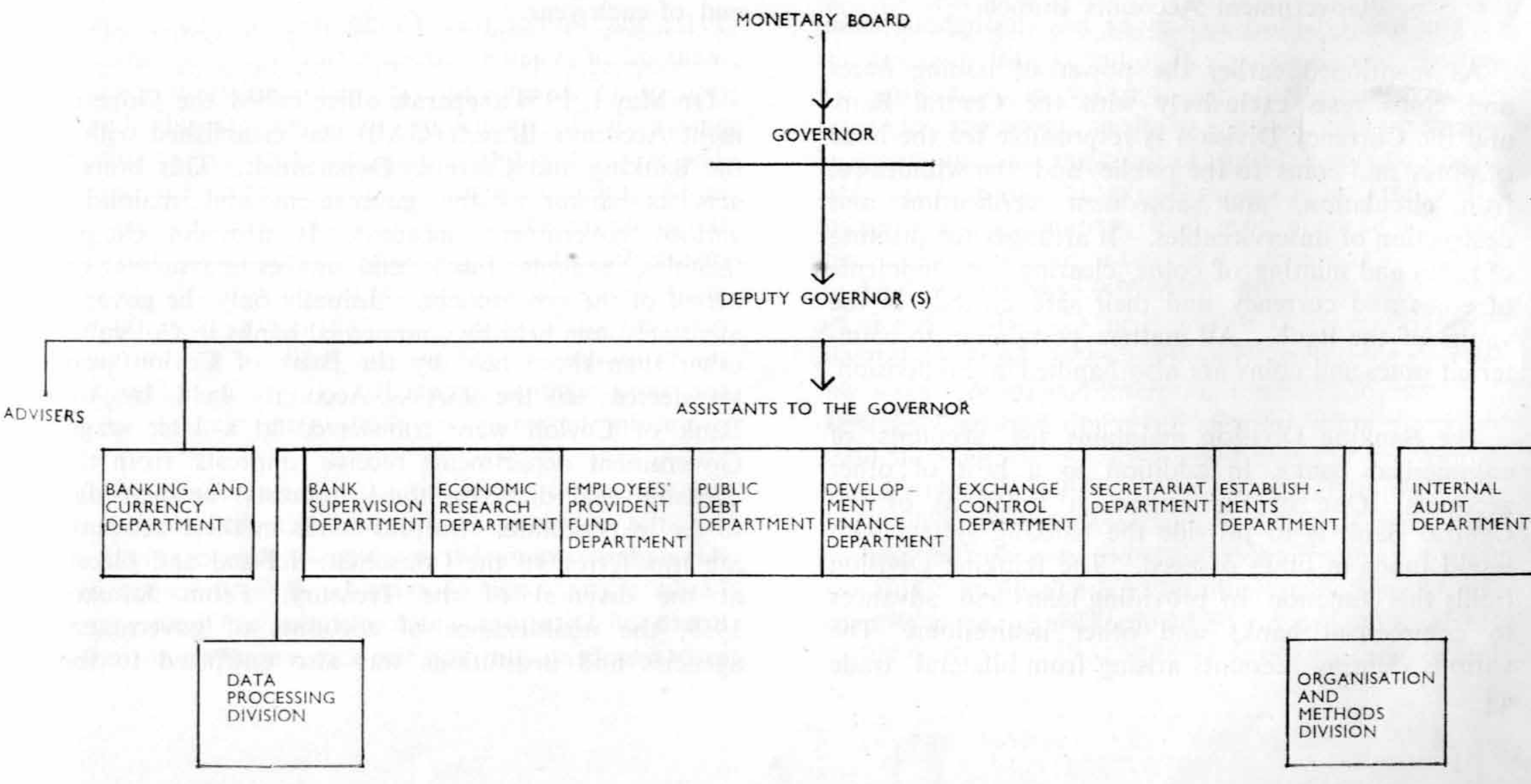
The Central Bank of Ceylon operates through a number of departments. The organisational structure is not very rigid and the Monetary Law Act has empowered the Monetary Board to establish and maintain any department besides those specified in the Act if considered necessary for the proper and efficient conduct of the business of the Bank. Over the years the Bank has had to adapt itself to rapid social and economic changes resulting in its undertaking new duties and responsibilities. Within the departments, units had to be set up to handle specialised functions and some of these have later become departments. In certain instances, entirely new departments had to be set up to undertake new functions.

In 1950, when the Bank commenced business, the administration comprised only five departments: Banking and Currency, Economic Research, Exchange Control, Public Debt and a Secretariat, with a total staff of about 250. The Bank Supervision Department was set up in 1951. By 1975, the number of departments had exactly doubled. The Establishments and Internal Audit Departments which formerly functioned as sub-departments were given identities of their own in 1967 and 1964, respectively. The Employees' Provident Fund Department was established in 1958, to undertake the management of the Employees' Provident Fund. In 1974, the Development Finance Department which functioned as a Division within the Bank Supervision Department was made a separate department. The total number of employees in the Bank has risen to over 1,700 by 1975.

B. ORGANISATIONAL STRUCTURE

The present organisational structure of the Bank is shown in the following chart :

CENTRAL BANK OF CEYLON - ORGANISATION CHART



It is seen that at present the Bank is organized into ten major departments. There are also two Divisions under the direct supervision of Assistants to the Governor. In what follows the reasons for the establishment of the respective departments and their functions are briefly described.

C. DEPARTMENTS AND THEIR FUNCTIONS

I. The Banking & Currency Department

The Banking & Currency Department, which became operative from the inception of the Bank, is the principal operational department of the Bank particularly for the implementation of monetary policy. It carries out almost all functions relating to a bankers' bank, banker to government and bank of issue. It also deals with foreign exchange transactions both on its own behalf and on behalf of commercial banks, Government and Government agencies and institutions. The department is headed by the Chief Accountant. Administratively the Department has three divisions:

Banking Division;
Currency Division; and
Government Accounts Branch.

As mentioned earlier the power of issuing notes and coins rests exclusively with the Central Bank and the Currency Division is responsible for the issue of notes and coins to the public and the withdrawal from circulation, and subsequent verification and destruction of unserviceables. It arranges for printing of notes and minting of coins, clearing of shipments of coins and currency and their safe custody in the vaults of the Bank. All matters pertaining to counterfeit notes and coins are also handled in this division.

The Banking Division maintains the accounts of commercial banks, in addition to a host of other accounts. One of the important functions of the Central Bank is to provide the banking system with liquid funds in times of need. The Banking Division fulfils this function by providing loans and advances to commercial banks and other institutions. The various clearing accounts arising from bilateral trade and payments agreements are maintained in the Banking Division. The accounts of the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD) are maintained here. It is through the Banking Division that the Central Bank provides clearing facilities for commercial banks with respect to their day to day operations. Inter-bank clearing takes place twice on each working day in which every commercial bank participates. Inter-bank settlement after the daily clearing of cheques is made through the accounts of commercial banks at the Central Bank. The Division also ensures that instructions given to banks on credit restrictions are implemented. It is in the Banking Division that the various refinance facilities provided by the Central Bank are being administered.

One of the recent duties undertaken by this Division is the administration of the Foreign Exchange Entitlement Certificate Scheme (FEECs) introduced in May 1968. The Division has to ensure that both the sales and purchases of FEECs by the commercial banks are correctly accounted for. The Division also prepares the Balance Sheet of the Central Bank at the end of each month and the Profit and Loss Account at the end of each year.

On May 1, 1954 a separate office called the Government Accounts Branch (GAB) was established within the Banking and Currency Department. This branch acts as banker to the government and maintains various government accounts. It provides cheque facilities, accepts funds and makes payments on behalf of the government. Initially only the government accounts held by commercial banks in Colombo, other than those held by the Bank of Ceylon were transferred to the GAB. Accounts held by the Bank of Ceylon were transferred at a later stage. Government departments receive 'imprests' from the Treasury and draw on these 'imprests' for their day to day expenditure. Surplus funds in these accounts are transferred to the Consolidated Fund and placed at the disposal of the Treasury. From January 1959, the maintenance of accounts of government agencies and institutions was also entrusted to the

GAB. In January 1971 the government introduced the Compulsory Savings Scheme and a special fund was created for this purpose. The accounts of the fund are maintained by the GAB and funds are regularly invested in government securities.

II. **The Bank Supervision Department**

The Bank Supervision Department is one of the two statutory departments in the Central Bank and is responsible for the supervision and examination of banking institutions. The function of the department is to provide the required degree of confidence in the banking system. By exercising its powers of examination and supervision, the Department can prevent banking institutions from engaging in unsound banking practices resulting in bank failures.

The Department is charged with the duty of the continuous supervision and periodical examination of all banking institutions in Sri Lanka. Banking institutions comprise commercial banks, agencies or institutions acting on behalf of the government which make loans, advances or investments or accept deposits from the public and any other person or body of persons declared by the Minister of Finance to be a banking institution.

The Director of Bank Supervision is required to examine (or cause an examiner of his Department to examine) the books and accounts of every commercial bank in Sri Lanka at least once in each examination period. He is also required to "make such further examinations in respect of any specified bank whenever required so to do by the Governor." With regard to banking institutions other than commercial banks, examinations of such institutions are to be made "if directions in that behalf are given by the Monetary Board". An examination period is "each period of such duration as may be fixed for the purpose by the Monetary Board."

The Monetary Law Act provides wide powers for conducting examinations of banking institutions and for taking corrective measures where necessary. The Director of Bank Supervision (or an examiner of his Department) is authorized to require any director, officer or employee of a banking institution to furnish such information as the Director (or examiner) may consider it necessary to obtain "for the purpose of enabling the true conditions of the affairs of the institution to be ascertained" and also to produce any books, records or documents containing or likely to contain such information. The law also requires that such director, officer or employee should extend every assistance to the Director and to his examiners to whom full opportunity must be afforded to examine the books, records, cash, available assets, full liabilities and the general condition of a banking institution.

The Monetary Law Act accords the Monetary Board powers to suspend or restrict the business of a banking institution. Such powers are exercised if the Director of Bank Supervision reports that a banking institution is insolvent or is likely to be unable to meet the demands of its depositors, or that its continuance in business is likely to involve loss to its depositors or to its creditors. When the Monetary Board directs a banking institution to suspend business in Sri Lanka it could direct the Director of Bank Supervision to take charge of all the books, records and assets of the institution and to take such measures as may be necessary to prevent the continuance of business by the institution. There is also provision in the law for the Monetary Board, if it decides that a banking institution should not be permitted to resume business, to cause the Director of Bank Supervision to make application to Court for the winding up of the institution. The law also requires that the Director of Bank Supervision shall be appointed the liquidator in cases of winding up of banking institutions.

An examination of a banking institution, particularly of a commercial bank, is primarily an appraisal of its assets. Loans and overdrafts are carefully appraised and close scrutiny is made of investments for soundness and maturity patterns. Other aspects are also examined; capital structure for adequacy and various systems, procedures and controls for security and efficiency. In a developing economy it is essential that banks should play a vital role in economic development. Banks could do this by mobilisation of deposits and by providing financial assistance to priority sectors of the economy. In examining banks the Department of Bank Supervision obtains first-hand knowledge of the lending policies of banks. The Department has found it necessary to appraise such policies not only from the standpoint of their contribution to the soundness and viability of a bank but also from the point of view of the direction of bank lending. It is, therefore, not unusual for the Director of Bank Supervision to indicate to the bank concerned that it should review its lending policy with a view to its orientation towards providing financial assistance to sectors which have been specifically designated as requiring such assistance in the interests of overall economic development.

A report on the results of each examination conducted by the Department of Bank Supervision is furnished to the Governor. Such reports, apart from the appraisal they contain of the condition of a bank, include information which could be of value to the Monetary Board in its formulation of policies and measures in the field of banking and in tendering advice to the Government on monetary, banking and fiscal matters. Examination reports are usually made available to the banks concerned and afford useful information to the management or to the Board of Directors of a banking institution.

The reduction of expatriate staff in the commercial banks has been engaging the attention of both the Government and the Central Bank over the years. The Department's assessment of the quality of management in the Sri Lanka branches of foreign banks has been of assistance in formulating programmes of a phased reduction of expatriate staff. In the early sixties there were 64 expatriate personnel in the branches of the 9 foreign banks operating in Sri Lanka. By the end of the sixties there was a progressive reduction and the number of expatriate personnel was reduced by half. At present there are 7 branches of foreign banks operating in Sri Lanka with only 13 expatriate personnel.

There have been instances when the Department's vigilance over the banking system prevented persons from establishing institutions and making them out to be commercial banks when such institutions were not capable of undertaking commercial banking functions.

The Bank Supervision Department was entrusted with the supervision of the implementation of the Bank Debits Tax first introduced in 1957. The bank debits tax is a tax on debits to current accounts. At present it is 1/10th of 1 per cent and is collected by commercial banks and remitted to the Central Bank for credit to the Consolidated Fund of Sri Lanka. The Central Bank is authorised to inspect the books and records of commercial banks in order to ascertain whether the banks have complied with the law.

III. The Economic Research Department

At the time of the establishment of the Central Bank, statistics on important economic variables such as national income, balance of payments, money and banking were scanty. The effective functioning of the Bank depended on the availability of satisfactory factual information on the economy as well as on a competent body of expertise to guide the Monetary Board in discharging its most important functions such as the formulation of monetary policy and tendering advice to Government on financial and economic matters. Further, the government itself needed analyses and data on all aspects of the economy for the purpose of formulating policies for the rapid development of the economy. Therefore, the greatest emphasis was given to the Economic Research Department in the Report recommending the establishment of the Central Bank.

In terms of the Monetary Law Act the function of the Economic Research Department is to prepare data and conduct economic research for the guidance of the Monetary Board and the Governor, for the formulation, implementation and execution of policies and measures, and to provide the public with information on subjects like money and banking, balance of payments etc. Various statistical series and data have also been compiled and prepared to service international organisations like the I.M.F. and other foreign creditors in the assessment of the country's credit worthiness. The Director of Economic Research has statutory powers to obtain information deemed necessary for the proper discharge of the functions and responsibilities of the Central Bank.

An important function of the Department is the preparation of the Annual Report. Section 35 of the Monetary Law Act provides that within four months after the end of each year, the Monetary Board should submit to the Minister of Finance an Annual Report reviewing the policies and measures adopted by the Board during the year and an analysis of the economic and financial circumstances which prompted them. Accordingly, one of the first assignments of the Department was the preparation of the Annual Report for the year 1950. Although the Bank started functioning from August 28, 1950, the Annual Report carried the record of events for the whole year. Since then for every year the Bank has been publishing an Annual Report. Over the years the coverage has been progressively improved to include new areas of economic activities.

Another important publication of the Bank is the monthly Bulletin. Its publication is not a statutory requirement but it has been published regularly since November 1951. The Bulletin contains statistics and analyses on a wide range of economic and financial subjects of interest to the public specially to the business community. Among the other publications of the Bank are reports of surveys conducted by the Economic Research Department, Research Studies by staff members undertaken during post-graduate training periods and Staff Studies (a bi-annual journal containing research papers written by members of the Bank's staff).

Functionally, the Department is divided into a number of specialised divisions each headed by a Senior Economist. Apart from studying various problems pertaining to a particular branch of economic activity, each division is responsible for the collection of information for the statistical tables and the preparation of the texts for the Bulletin and the Annual Report. However, much of the research and report writing is not made public as they are of a confidential nature, and are designed to brief the Monetary Board or the Government on economic matters.

During the last 25 years the Economic Research Department has carried out a number of specialised surveys. The first survey was on consumer finances carried out in 1953. This survey was repeated in 1963 and 1973 with wider coverage. Commencing September 1956, the Department began a half-yearly survey of commercial bank deposits and advances. After 1964, the Department carried out a number of of other surveys and towards the end of the decade the survey work of the Department became more intensified. Some of the important surveys carried out in more recent years are survey on the Cost of Production of Paddy (1969), the Survey of Private Investment (1970), Survey of Rural Credit and Indebtedness (1971), Survey of Defaults in the Repayment of New Agricultural Loans (1972) and the Determinants of Labour Force Participation Rates in Sri Lanka (1973).

The Economic Research Department maintains an up-to-date Research Library for the purpose of assisting in the research work of the Department. Over the years the Library has accumulated a considerable stock of books, reports and periodicals in economics and related subjects. In 1964, the Economic Development Institute of the IBRD gifted a large number of books on Economics to the Library. At present the Library has approximately 24,000 books, in addition to a considerable number of periodicals and reports. Although the general public has no access to the Library special permission is generally given to graduate students and visiting specialists on individual requests.

Another important function performed by the Research Department is the servicing of Sri Lanka's relationship with the International Monetary Fund. The Research Department not only supplies the IMF with statistical material and other information at very frequent intervals but also organises and participates in the Annual and Standby consultations with the IMF. In recent years these consultation discussions have become very penetrative as Sri Lanka has made increasing recourse to the resources of the IMF with the continued deterioration in the balance of payments.

IV. The Employees' Provident Fund Department

The Employees' Provident Fund Department (EPF) was set up on August 1, 1958 consequent on the passing of the Employees' Provident Fund Act to establish a Provident Fund for employees in the private and semi-government sectors. This Department works in close co-operation with the Labour Department which is charged with the responsibility of administering the EPF as well as of enforcing the provisions of the Act. The EPF Department of the Central Bank administers the accounting side of the operations, i.e. receipt of contributions, maintenance of the accounts, and the effecting of refunds. The investment of money in the Fund is the responsibility of the Monetary Board. Upto 1969 the individual accounts of members as well as individual employments were maintained on a punch card system. With the installation of a computer by the Central Bank in 1970 the accounting procedures and the submission of periodical returns have been considerably streamlined.

As at December 1973 there were 2,151,181 individual accounts in the Fund, in a total of 41,700 employments. Initially, the contribution to the Fund was fixed at 4 per cent of the salary by the employee and 6 per cent by the employer. In 1971 these rates were raised to 6 per cent and 9 per cent respectively. Simultaneous with the increase in the rate of contribution, the coverage under the Act was widened to include all employments, including those with a single employee, (except domestic servants). The contributions received by the Fund have sharply increased over the years. Whereas in 1959, the first year of operation, the total annual contributions amounted to only Rs. 12 million, by 1974 the annual figure was as high as Rs. 209 million. Similarly investments rose from Rs. 9 million a year to Rs. 198 million a year over the same period. Investments are entirely in government and government guaranteed securities. The EPF is also required to pay interest on members' balances out of the excess of income over expenditure. The rate was fixed at a minimum of $2\frac{1}{2}$ per cent by the EPF Act. The actual rate of interest has been progressively raised to 6 per cent by the end of 1974. The upward revision in the rate of interest together with the increased contributions led to a sharp increase in the annual interest commitment of the Fund. In 1959 the interest commitment was Rs. 0.1 million; by 1974, this has spiralled to Rs. 96 million.

As years passed the Fund has also had to entertain an increasing number of refund applications. In 1962, Rs. 1 million was paid out, whereas in 1974 the amount refunded amounted to Rs. 89 million involving 60,406 refund applications.

V. The Public Debt Department

In terms of section 113 of the Monetary Law Act the responsibility for the management of the Public Debt was vested in the Central Bank as agent of the government. Accordingly, a department was set up at the very inception of the Bank to take over the management of the Public Debt. Prior to the establishment of the Central Bank the Public Debt Office of the General Treasury was responsible for the management of the Public Debt. The Department of Public Debt issues Treasury bills and government securities on behalf of the Government. Government securities are issued in accordance with the authority to raise loans provided for in the annual budget. It is the duty of the Department to ensure that adequate subscriptions are forthcoming once the new issues are announced. The terms, maturity and other conditions governing the new issues are decided by the Monetary Board in consultation with the Treasury and it is the duty of the Public Debt Department to ensure that the new issues conform to these conditions.

Treasury bills are issued within the ceilings specified by resolutions in the National State Assembly. In the case of Treasury bills, which are issued fortnightly, the Superintendent of Public Debt publishes a notice in the press and the government gazette inviting tenders for Treasury bills. Before the tenders are awarded they are examined by the Treasury Bills Committee consisting of the Governor, the Deputy Governor, the Chief Accountant and the Director of Economic Research in order to make a decision to award the tender according to the rate of interest which the Central Bank considers appropriate. The registers in respect of both Treasury bills and Government Securities are maintained by the Public Debt Department. The record of work includes the issue of half yearly dividend warrants and redemption of maturing securities. When conversion stock is issued the Department handles the accounting and other allied aspects. The Department also maintains registers in respect of all foreign loans and credits which are availed of by Government and Government Agencies.

When the Central Bank assumed the responsibility for the management of the Public Debt, certain procedural arrangements governing the management of rupee loans and their sinking funds, sterling loans managed by the Crown Agents and Treasury bills were agreed to between the Treasury and Central Bank. These arrangements have continued unchanged; the only major change was in respect of the procedure for management of the sinking funds for rupee loans when it was considered expedient to establish a Joint Investment Fund with effect from September 1, 1971.

In 1954, the Department of Public Debt assumed responsibility for the issue and management of National Housing Debentures issued under section 6(1) of the National Housing Act No. 37 of 1954 and the National Housing (No.2) Regulations 1954, as well as the administration of the sinking funds established for their redemption. These functions were undertaken by the Central Bank in terms of section 106(1) of the Monetary Law Act and the procedural arrangements governing the issue and servicing of these Debentures followed now are those agreed to between the Central Bank and the Commissioner of National Housing. The Superintendent of Public Debt was appointed by the Monetary Board as Registrar for these Debentures for the purposes of the National Housing (No. 2) Regulations 1954.

Another noteworthy development in the activities of the Department of Public Debt occurred in 1957 when two important legislative enactments were passed by Parliament: the Tax Reserve Certificates Act No. 22 of 1957 and the Foreign Loans Act No. 29 of 1957. Of these, the former made provision for the issue of Tax Reserve Certificates for the purpose of facilitating payment of Income Tax and Profits Tax. Under the provisions of this Act the Central Bank was authorised to issue Tax Reserve Certificates upto such amount and of such denominations as the Minister of Finance may from time to time specify by Order published in the Gazette. The Superintendent of Public Debt was vested with the responsibility for management of each issue. Act No. 22 of 1957 was amended in subsequent years and Tax Reserve Certificates can now be surrendered for payment of Income Tax, Profits Tax, Wealth Tax and Gifts Tax. Procedural arrangements governing these Certificates were agreed to between the Central Bank and the Commissioner of Inland Revenue. As at end of December 1974, the value of Tax Reserve Certificates outstanding was Rs. 67.9 million.

The Foreign Loans Act No. 29 of 1957 made provision for the signing of agreements for foreign loans to the Government of Sri Lanka. This Act was amended in subsequent years by the Foreign Loans (Amendment) Act No. 2 of 1962 and Act No. 1 of 1963. Loans raised under the Foreign Loans Act form part of Sri Lanka's Public Debt as all sums payable under such loans are a charge on the Consolidated Fund of Sri Lanka and therefore the management of these loans is the responsibility of the Department of Public Debt. In addition to these loans, a few government-to-government loans obtained under agreements signed by Ministers with Cabinet approval and published in the Treaty Series are also managed by the Department. As at the end of 1974 the gross foreign debt was Rs. 2,973.7 million which was 24 per cent of the Gross Public Debt.

Two other items of Public Debt included in the statement of Public Debt published in the Accounts of the Government of Sri Lanka (Part I) in respect of each financial year are Central Bank Advances and National Development Bonds. Central Bank Advances to Government consist of (a) Direct provisional advances (Revolving Credit made available) to the Government under Section 89 of the Monetary Law Act to finance expenditure authorised to be incurred out of the Consolidated Fund, and (b) Special Loans to the Government to meet membership subscriptions to international institutions. These loans are raised by the Minister of Finance on behalf of the government by the creation and issue to the Central Bank of non-interest bearing and non-negotiable notes or obligations which are a charge on the Consolidated Fund.

Section 28 of the Registered Stock & Securities Ordinance (1937) lays down that a separate sinking fund shall be established for each loan raised under the Ordinance. This has been adhered to except in the case of loans raised under the National Development Loan Act No. 3 of 1950 which specifically exempted the loans raised under it from the establishment of sinking funds. In the case of short-term loans only a token sinking fund contribution is provided. In the case of medium and long-term loans sufficient provision is made to meet in full the repayment of the loan on maturity. Sinking fund contributions normally commence one year after the date of issue of the loan. Contributions to each sinking fund are appropriated from the Consolidated Fund of the government on half yearly interest payment dates.

Sri Lanka's public debt has shown a steep increase from the levels recorded in 1950. The growth of public debt has brought in its wake the tasks of orderly debt management, synchronising debt policy with the requirements of monetary and fiscal policy objectives as well as of servicing of loans. The statistics given below reveal the magnitude of growth in each class of public debt and implicitly the management tasks involved.

Sri Lanka's Public Debt 1950 - 1974

Rs. Million

Year	External Debt		Rupee Loans		Treasury Bills	Tax Reserve Certificates	Central Bank Advances	Total Domestic Debt		Total Public Debt	
	Gross	Net	Gross	Net				Gross	Net	Gross	Net
1950 Sept.	125.4	75.7	436.0	366.0	78.6	—	—	514.6	444.6	640.0	520.3
1974 Dec.	2973.7	2921.5	6590.5	5289.5	2250.0	67.9	497.9	9406.4	8105.4	12380.1	11026.9

VI. The Development Finance Department

The provision of adequate credit facilities to meet the development needs of the country is another responsibility of the Central Bank. This responsibility which includes the provision of adequate short-term credit to vital sectors of the economy such as exports, domestic food production and new industries assumed special significance with the moves towards increased import substitution.

In August, 1965, the Central Bank appointed an internal committee known as "Banking Development Committee" for the purpose of reporting on deficiencies in the existing credit, banking and savings facilities, and to suggest ways and means of overcoming such deficiencies. On the recommendation of this Committee, the Monetary Board approved the setting up of a Development Finance Division within the Department of Bank Supervision. The functions of this Division were to examine closely the availability of medium and long-term finance for both industry and agriculture.

In 1974, the Development Finance Division was made a separate Department. At present the work in the Department is confined mainly to appraising the financial viability of those proposals which qualify for refinancing facilities from the Central Bank. With the increasing demands for funds it was necessary for the Central Bank to examine more closely the projects that were to be financed with the loans in respect of which refinance was sought.

The examination of term loans for investment in industry and agriculture requires familiarity with techniques of project appraisal and their application. Besides, a knowledge of these techniques was necessary for evaluation of projects undertaken at the request of various government departments. Thus, the responsibilities of the Department include the promotion of training schemes designed to equip officers for tasks requiring new skills and knowledge. Over the years the Development Finance Department was able to assemble a body of trained personnel conversant with new techniques of financial and economic evaluation of projects and enterprises.

The Development Finance Department has been increasingly associated with the examination and review of the operational aspects of various schemes of agricultural credit including the schemes financed from lines of credit provided by international lending agencies. Successful implementation of these schemes designed to increase the productivity of small farmers is greatly dependent on the examination and review of operational aspects pertaining to credit availability, its use and repayment.

VII. The Exchange Control Department

Exchange Control which was introduced in Sri Lanka at the outbreak of war in 1939 in respect of transactions outside the Sterling Area was extended in June 1948 to cover all transactions with the rest of the world. The aim of the extended form of exchange control was to conserve foreign exchange by ensuring that foreign exchange was used for only approved purposes and that payments from abroad are actually received and accounted for. In his first Administration Report issued in 1948, the Controller of Exchange stated that the administration of exchange control in Ceylon has suffered owing to the lack of a Central Bank. Thus, with the formation of the Central Bank of Ceylon a department was established to take over the function of exchange control as the agent of the government. Initially the work of the Department was placed in charge of a Deputy Controller of Exchange who was a permanent officer of the Bank. The Monetary Board was appointed as the Controller of Exchange subject to policy directions by the Minister of Finance.

The Exchange Control Act No. 24 of 1953 which came into operation on August, 15, 1953 superseded the earlier regulations covering exchange control. The new Act required the Central Bank, as agent of the government, to establish a Department of Exchange Control with a Controller as the Head, who would function under the immediate direction of the Governor. However, the Department continued to be subject to such directions on exchange control policy as might be made from time to time by the Minister of Finance.

Although practically all external transactions came within the purview of exchange control with effect from June 1948, the bulk of the transactions was subject to a minimum degree of control during the early period. In fact, in view of the improving balance of payments situation during the Korean boom some relaxation of restrictions was effected in the period 1949-1951. Also, much of the authority for approving current transactions remained in the hands of 'Authorised Dealers' to enable them to attend promptly to the requirements of the public. However, with the deterioration in Sri Lanka's balance of payments following the collapse of the Korean boom, certain restrictions on remittances abroad had to be re-imposed during 1952. In February 1955, a scheme involving the daily examination of documents relating to imports from certain countries was introduced in order to prevent over-invoicing of imports.

In 1960, a comprehensive review of exchange control policies and measures was undertaken with the worsening of the balance of payments situation in order to arrest the decline in the country's foreign exchange reserves. From 1961, payments for imports were allowed by the Exchange Control in terms of licensing regulations of the Controller of Imports and Exports. During the year, import licensing covered a wide range of commodities and many items were totally banned. Since then, the intensity of foreign exchange restrictions progressively increased and by the mid-sixties there was hardly any remittance which could be made without an exchange control permit. In 1964, import licensing by the Controller of Imports and Exports was extended to cover all items of imports into the country. With the intensification of exchange restrictions the work involved in policing the regulations also increased. Thus, over the years the Exchange Control Department has been growing in importance and at present it is one of the largest Departments in the Bank in terms of number of employees.

The Finance Act, No. 11 of 1963, provided for the introduction of an exchange tax, under which the Minister of Finance was empowered to impose and levy an exchange tax at varying rates for specified purposes on the sale of foreign currency. With effect from January, 1964 sales of foreign exchange were classified into two categories and exchange taxes of 10 and 20 per cent were introduced with specific exemptions on current and capital remittances. A separate unit was set up in the Exchange Control Department to implement this decision. The exchange tax was withdrawn on October 1, 1965.

The year 1968 saw a change in exchange control procedures with the introduction of the Foreign Exchange Entitlement Certificate (FEEC) Scheme in May 1968. Holders of FEECs were able, subject to import and exchange control requirements, to purchase foreign exchange from commercial banks at their selling rates by surrendering Certificates of equivalent face value for payment for certain imports and other remittances.

In July 1972 the Convertible Rupee Account (CRA) Scheme was introduced. Under this scheme exporters of 'non-traditional' or minor export products and some services were permitted to credit a percentage of their gross earnings to convertible rupee accounts which they could utilize for the payment of imports against licences issued by the Controller of Imports and Exports and to effect certain other invisible payments, such as for foreign travel. In 1971, a scheme of Special Accounts designed primarily to attract the small savings of Sri Lanka nationals employed abroad was introduced. The Exchange Control Department plays a major role in the administration of these schemes.

Substantial amendments to the Exchange Control Act were made during the period 1971-1973, in addition to the enactment of the Foreign Exchange Amnesty Act in 1971 and the setting up in 1973 of a Criminal Justice Commission to try exchange control offences. The Exchange Control Act No. 24 of 1953 was first amended in 1956 by Act No. 35 of that year and thereafter by Act No. 47 of 1957. Between 1957 and 1971 there were no further amendments to the Act. In 1971, it was amended by the Exchange Control (Amendment) Act No. 17 of 1971. Thereafter, the Act was amended in 1972 by the Exchange Control (Amendment) Law No. 14 of 1972, which was followed in 1973 by further amendments by the Exchange Control (Amendment Law) No. 39 of 1973. The Foreign Exchange Amnesty Act granted amnesty to persons who had accumulated assets abroad in violation of the provisions of the Exchange Control Act, if such persons declare such assets to Exchange Control and comply with directions issued under the Act.

From the inception the Department has performed the task of checking the returns made by authorized dealers through whom foreign exchange transactions are effected. These returns have been used to extract data in preparing balance of payments statements. The existence of exchange control made it possible for balance of payments statistics to be compiled with a degree of accuracy not known before in Sri Lanka.

VIII. **The Secretariat Department**

One of the first Departments to be established with the formation of the Central Bank was the Secretariat. The first task of the Secretariat was to find accommodation for the new Bank, recruit staff, and obtain equipment. At the beginning, the Secretariat was a composite Department with a multitude of duties. Over the years some of these duties have been removed while some new ones have been added.

At present the Department performs general administrative functions required in the day to day running of the Bank. These may be broadly classified as the payment of salaries and other current emoluments to bank employees, maintenance of superannuation benefits of bank employees such as pensions, provident funds and widows' and orphans' pension benefits, the administration of employee welfare schemes, supply of all items and materials required by the Bank such as furniture, stationery, office equipment, etc., the implementation of general administrative matters such as leave, railway warrants, maintenance, upkeep and security of the Central Bank buildings, and other multitudinous functions connected with general administration.

An important Divison of the Secretariat is the Welfare Division which is concerned with employee welfare. The Bank's main welfare schemes are the medical benefit scheme, the staff benefit loans scheme and the housing loans scheme. In addition to the administration of these schemes, the Welfare Division is also responsible for providing assistance to employees in the event of ill-health or emergency.

IX. The Establishments Department

The Establishments Department was set up in 1953 to undertake the work connected with recruitment and all matters pertaining to staff which were hitherto handled by the Secretariat. This Department continued as a separate entity until 1958. Thereafter, it functioned as a Division of the Secretariat until 1967. In the period between 1958 and 1967, the Bank recruited a fairly large number of employees, particularly to service the needs of the Employees' Provident Fund Department established in 1958. These increasing numbers inevitably resulted in a corresponding increase in all aspects of establishment work. In addition, with the progressively increasing functions and duties the Bank was called upon to perform, there was a need to increase staff at different levels. With the increasing problems associated with such increased staff it was found necessary to set up a separate Establishments Department in 1967.

At present the Department handles recruitment of staff, promotions, reports on work performance, disciplinary action, etc., which have become more specialized subjects in view of the large number of employees involved. From a staff strength of approximately 271 in January 1951 the staff position on the completion of 25 years is 1,748.

In 1972, a separate training division was established within the Establishments Department to provide for the training of those recruited to the Bank service. The training schemes have sought to provide training facilities for staff officers (executives) at post-graduate levels in Economics and other fields of study and also to provide practical training in approved fields of study where the Bank's functions and duties warrant such training.

X. The Internal Audit Department

The Internal Audit Department which commenced as a sub-department in 1951 became a department in 1964. The Department conducts pre-audits, running audits and post-audits, especially on the financial transactions of the bank and books and records connected therewith. The emphasis is now laid more on test audits to ascertain whether the appropriate systems and procedures are established, maintained and operated in the various departments of the Bank than on detection of errors through a detailed check of all transactions.

The Data Processing Division and the Organisation and Methods Division

Apart from the departments described above there are two divisions which do not come within the purview of a Head of a Department but function as independent units under the direction of an Assistant to the Governor. These are the Data Processing Division and the Organisation and Methods Division.

The Central Bank entered the era of electronic computing in 1970. A third generation computer leased from IBM was installed together with the necessary ancillary devices. This system has been upgraded since 1970 and is today one of the most competent systems in Sri Lanka capable of handling a wide variety of scientific and accounting work. The principal work undertaken by the Data Processing Division is the accounting of the Employees' Provident Fund. The Division also undertakes the preparation of payrolls for the Central Bank, Air Ceylon, the National Textile Corporation and the Government Factory and assists the Public Debt Department of the Central Bank and the National Housing Department in maintaining accounts. In 1972 the processing of the General Certificate of Education Ordinary and Advanced Level examination results was undertaken.

The cost of processing the results per candidate was reduced by almost 50 per cent and the Examination Department was able to absorb a significant increase in the number of candidates without any delay in processing the applications or releasing the results. The Division also processes statistical data for the Economic Research Department of the Central Bank and a few organisations such as the Ceylon Government Railway and the World Health Organisation.

An Organisation and Methods Division was set up in 1972 with a special officer in charge under an Assistant to the Governor. The functions of this Division are the review of existing procedures and staff requirements in various departments of the Bank, review of forms and registers in use, study of the adequacy of internal checks and controls and any other specific tasks that may be assigned to the Division. In 1975, the Division took steps to arrange with the National Institute of Management to conduct courses of lectures for officers of the various grades in the service of the Bank. During the past three years the Division submitted several reports to the management most of them relating to staff requirements of the Bank.

5 THE CENTRAL BANK AND THE ECONOMY

Since its very inception, the Central Bank of Ceylon, although a key institution in the economic fabric of the country, has also been one of the least understood. This could be largely explained by the unique role it is designed to play in the economy on the one hand, and the very responsible, but sometimes conflicting, nature of the functions entrusted to it on the other. The general public often finds it difficult to understand and appreciate either the need for, or the consequent overall effects of, measures recommended or adopted by the Bank. Consequently, measures adopted and the advice tendered with the best of intentions and in the interest of the general public welfare have been on occasions misunderstood and resented.

The Central Bank of Ceylon occupies a very central place in the monetary and the credit structure of the country and exerts a permeating influence on the life and growth of the economy. By maintaining sound monetary conditions in the economy it is possible for the Bank to be the driving force behind economic growth. Its role in influencing the economic policies of the government eventually guides the course of economic events.

Over the last 25 years two broad areas which received the Bank's most urgent attention have been the fiscal policy of the government and commercial bank credit creation. In the Monetary Law Act the basic functions of the Central Bank are stated to be the maintenance of monetary stability, preservation of the international value and convertibility of the rupee, and the promotion of a rising level of production, employment and real income. Though the Central Bank possesses wide powers of monetary management, its ability to achieve these objectives was seriously undermined by the course of economic events since the mid-fifties.

The importance of maintaining liquidity in the economy at the appropriate level need not be overemphasised, because too little or too much of it can seriously interfere with economic activity. Inadequate resources can act as a brake on growth while excessive expansion of credit can generate inflationary pressures which will push up domestic prices and create balance of payments difficulties. Monetary stability is essential for the development effort, in promoting savings, encouraging investments and efficient utilization of resources. It is generally conceded that economic development and growth require stable conditions.

One difficulty in the area of monetary management for the Central Bank has been the conflict which arose between its stability objective and its obligations with respect to the government demands for funds. It was a duty of the Central Bank as banker to the government to keep the government supplied with sufficient funds to carry out its operations. The Bank performed this function by extending short-term credit to the government by means of both direct advances and the purchase of Treasury bills. On the other hand, the Bank's responsibility with respect to monetary stability dictated that there should be no excessive credit creation on behalf of the government. However, the Bank was not in a position to give priority to the stability objective as it had to give priority to meeting the financial requirements of the government.

Recourse to Treasury bills as a method of borrowing from the Central Bank was concomitant on the unbridged gaps in the overall government budget. The Treasury had to finance its expenditures increasingly by resort to Treasury bills despite the fact that no significant tenders were forthcoming to absorb the successive issues of Treasury bills. The responsibility of absorbing the unsubscribed portion of the Treasury bill issue fell on the Central Bank. Though the Central Bank was aware of the adverse effect on monetary stability of the undue expansion of Central Bank credit, the Bank in its statutory function as agent of the government had no alternative but to assist in meeting budget commitments.

A major drawback in the financing of budget deficits with central bank credit is that, while the process involves an expansion in the money supply, it is not necessarily accompanied by a corresponding increase in national product. Consequently, increased demand emanating from central bank financing of budget deficits had to be satisfied by increased recourse to foreign supplies with resulting pressure on the country's external payments. Thus, though the Government fiscal problem and the balance of payments deficits were two distinct problems, they were nevertheless inter-related, in that the balance of payments deficits and loss of external assets arose partly out of the method by which the Government sought to finance its budget deficits. With the continued loss of reserves and the accumulation of external liabilities, the ability of the Central Bank to maintain the international value of the rupee was gradually undermined.

During the period under review the Central Bank, mindful of its statutory obligations, repeatedly stressed the need to reduce government expenditure as a pre-requisite for keeping monetary expansion within manageable limits, thereby reducing pressure on the balance of payments. The Bank has often advised the government to reduce expenditure on transfer payments. Of course, it would have adversely affected the community; but on the other hand continual budget deficits could have resulted in other hardships caused by more widespread and sustained increases in living costs and a fall in the internal value of the rupee. The Bank's view was that such a process if not effectively countered could have exerted far reaching consequences, both social and economic, of a very adverse nature. The Bank's advice on government expenditure, particularly those on food subsidies, should be viewed in this context.

Although the ability of the Central Bank to take effective monetary action was severely limited by the government's fiscal policy, within these constraints, the Bank endeavoured to restrain monetary expansion so as to secure a closer correspondence between aggregate demand and aggregate supply. The credit policy of the Bank has been one of controlled expansion geared to meeting genuine credit needs of economic development, while simultaneously restraining any undue expansion of credit for speculative and non-essential purposes. Thus, from the beginning of the early sixties the bank continued to maintain several measures with the objective of restraining the momentum of credit expansion by commercial banks. Whilst providing for the credit needs of the productive sectors of the economy, action was taken to avoid increases in credit for non-essential purposes. In particular, a close surveillance was kept on increases of credit for speculative purposes. The objectives of Central Bank policy were, on the one hand, to ensure that the base for credit expansion was itself not excessive in the light of the overall monetary situation and, on the other, to encourage selective channelling of credit for production and essential purposes. The various directions issued to commercial banks imposing restrictions on their operations and the impact of these on the financial requirements of the business community, should thus be viewed in the light of the Bank's responsibility for maintaining monetary stability in the overall interests of the economy.