Chapter 1

Economic And Financial Background

Sri Lanka gained political independence in 1948 and became a self-governing nation, after nearly 150 years of British rule, thus giving Sri Lankan authorities greater room for manoeuvre both politically and economically. At Independence, she displayed the usual characteristics of a 'less developed' economy emerging from colonial administration. The per capita income was considerably lower than in the countries in the western world, though somewhat higher than many of the neighbouring countries. Population was growing at a very rapid rate - the rate of growth during the period 1948-50 being 3.1 per cent. The country remained predominantly rural and peasant agriculture was the dominant economic activity in terms of the population engaged in it. Agricultural production accounted for over 30 per cent of the Gross Domestic Product (GDP). Industrial activity in the country was still in its infancy and was largely confined to the processing of agricultural commodities for export. Manufacturing industry was virtually non-existent.

In certain respects, however, Sri Lanka stood out in marked contrast to other LDCs in the region. For instance, the standard of education and, therefore, the literacy rate was considerably higher than in other LDCs. Similarly, public health standards being high, the mortality rate was

relatively low. Both these changes were due to considerable increases in government expenditure on health, education and food subsidies towards the tail-end of the colonial rule.

The Dual Economy

The contrast in economic organisation between the advanced modern sector and the backward traditional sector has been referred to as the most striking characteristic of a dual-economy. At the time of gaining Independence Sri Lanka offered a good example of such an economy. Sri Lanka's resource endowment led her to specialise in agriculture and she emerged basically an agricultural economy by the end of the colonial rule. Sri Lanka's agriculture, however, was highly specialised and consisted of two distinct sectors which provided the most obvious manifestation of the country's structural problem - a highly organised plantation sector producing for export, complemented by a small urban sector which housed government and commerce providing services to the plantation sector, existing side by side with a peasant sector of relatively low productivity, depending on small scale cultivation of paddy (rice) and production of traditional handicrafts.

The peasant sector was by far the most important sector in the economy in terms of population engaged in it. Peasant farming was almost entirely family farming and the areas cultivated by each family were small. Paddy is the single most important crop cultivated in the peasant sector and it was grown throughout Sri Lanka, largely as a subsistence crop. In addition, a few other agricultural commodities were also grown for domestic consumption, mostly under chena cultivation. The cultivation of paddy was not profitable enough to attract the foreign and indigeneous interests bent upon the extension of plantation crops. The techniques employed in the cultivation of paddy and other crops, which were characterised by heavy use of labour, gave very poor yields. As production in the peasant sector could not keep pace with the population growth, an increasing proportion of the food-stuffs consumed had to be imported, with foreign exchange earnings received from a few plantation crops. The rural peasant, however, was not particularly dependent on imports of manufactured goods. With limited awareness and resources, the peasant farmer was condemned to a low standard of living.

The plantation sector of the Sri Lankan economy was dominated by three main commercial crops - tea, rubber and coconut - which together took up two-thirds of the cultivated land and employed roughly 30 per cent of the work force. At the time of gaining Independence, these three crops were responsible for almost the entire export income of Sri Lanka, while contributing about 15 per cent to the GDP. Tea alone accounted for approximately 50 per cent of export earnings. The plantation sector, which was the modern sector of the economy, was entirely of colonial origin. The plantations, particularly tea and rubber, were developed by British capital and entrepreneurship, with labour drawn from South India. The services sector too, particularly banking, trade, insurance and transportation, was closely linked to the plantation sector.

An important feature of the plantation economy in Sri Lanka was that it grew up isolated from the rest of the economy. It had very little influence on the traditional agricultural sector and not many of the indigenous population were able to share directly in the economic benefits generated by this sector. While the bulk of the earnings accrued to foreign factors and was repatriated abroad, the income from local investment went to a small group of people who either reinvested in export industry or spent them on the consumption of luxuries. The funds generated in the export sector were seldom directed for investment in the rest of the economy. Whatever income that was extracted by the government from this sector was to a large extent reinvested in providing improved transport and public utility services to the plantations. Nor did this sector consume the products of the rest of the economy since these were limited in quantity and variety. The consumption requirements of the export sector were largely met through imports. In view of this comparative isolation, the plantation sector failed to create growth impulses for the rest of the economy. The 'spread effects' of this sector on the peasant sector was relatively insignificant. In short, there was little or no integration between the plantation sector and the peasant sector.

Population

At the time of gaining political independence, Sri Lanka had a population of about 7.2 million, consisting of a number of linguistic and religious groups. Around this time, the population started increasing at an exceedingly high rate. The high rate of population growth was due to

a very high birth rate superimposed on a relatively low death rate. Sri Lanka had attracted wide attention as a pioneer amongst the LDCs in the process of reducing death rates. For decades malaria had been endemic over large parts of Sri Lanka causing considerable damage in terms of human lives and keeping the crude death rate extremely high. From about 1946, however, there had been a dramatic turn of events in that a successful method of eradicating mosquitoes was instituted with the use of D.D.T. The anti-malaria campaign, together with the general extension of medical services and education, and the widespread use of drugs and antibiotics resulted in a spectacular decline in the death rate. The crude death rate, which was 20 per thousand of population in 1946, decreased to 14 in 1947 and 13 in 1948. Meanwhile, the birth rate remained significantly high averaging about 40 per thousand per year. The combined effect of the high birth rate and the steeply falling death rate set the foundation for the high rate of population growth experienced in Sri Lanka during the immediately pre- and post-Independence period. Meanwhile, the growth of employment opportunities being slow, the rate of unemployment remained high, exceeding 15 per cent of the work force.

Patterns of Trade

Like most other colonies, Sri Lanka emerged as a classical export economy. Foreign trade played a dominant role in determining the economic conditions of the country and judging by the ratio of foreign trade (both export and import) to Gross National Product (GNP), Sri Lanka was one of the most open economies in the world at the time. Exports contributed over one-third of the GNP directly, and indirectly somewhat more, if processing and distribution of the three export crops were treated separately from their production. Apart from the high degree of openness of the economy, Sri Lanka's exports were also highly concentrated, in that three primary commodities - tea, rubber and coconut - accounted for about 95 per cent of total domestic exports. In view of this narrow concentration of exports, fluctuations in the prices of agricultural commodities in the world market made Sri Lanka's export earnings subject to a considerable degree of instability. At the same time, being subject to vagaries of weather, the output of these commodities too tended to fluctuate heavily, making the country's export sector still more vulnerable.

The evolution of Sri Lanka's economy as an export-import economy resulted in a pattern of specialisation in which the country obtained a substantial volume of her consumption and investment requirements from abroad. This meant that the country was heavily dependent on imports both for sustenance and for growth. Imports as a ratio of GNP were as high as 35 per cent in 1948. In view of the need to import large quantities of basic food requirements, the share of consumer goods in total imports amounted to over 70 per cent around this period. Of the consumption goods imports, an overwhelmingly large share consisted of food imports. On the whole, the import structure led to a very high and stable demand for imports, leaving little room for controlling the volume of imports. The two combined, i.e. a highly vulnerable export sector and a high and steady demand for imports, made the country's balance of payments face heavy short-term fluctuations.

Financial System

At the time of Independence, the financial system in Sri Lanka remained rudimentary and fragmentated. The commercial banking system was dominated by foreign banks which were almost exclusively engaged in the financing of the plantation sector and the import-export trade. Of the 12 commercial banks operating in 1950, 10 were branches of foreign banks. These belonged to two groups - the exchange banks and the Indian banks. The exchange banks were branches of big banks that had far flung interests in a number of Asian countries. In 1950, there were six such exchange banks operating in the country. These banks conducted most of their business with European firms and expatriate customers and financed largely the trade between Sri Lanka and United Kingdom. The Indian banks were concerned primarily with the financing of trade between India and Sri Lanka.

The Bank of Ceylon and the Hatton Bank Ltd. were the only indigenous commercial banks operating in the country at the time. The operations of the Hatton Bank Ltd. being limited in scope and geographical coverage, the only indigenous bank of some consequence catering to the banking needs of the local population was the Bank of Ceylon.

There were only 28 commercial bank branches operating in the country in 1950, suggesting an extremely low density of banking. Commercial banking facilities were largely concentrated in Colombo with a few branches in provincial capitals, while such facilities were non existent in other areas. Financial institutions other than commercial banks were few in number and were relatively modest in the scope of their operations. There was the Co-operative Federal Bank of Ceylon which was established under the Co-operative Federal Bank of Ceylon Ordinance of 1948 to become a source of credit for the co-operative movement in Sri Lanka. The bank functioned as a balancing medium for the surplus funds of co-operative societies while carrying on banking and credit activities. Among the savings institutions were the Post- Office Savings Bank, Ceylon Savings Bank and the National Savings Movement catering to small time savers who were not familiar with the commercial banking system. However, the mobilisation of deposits by these institutions was on a very limited scale. Lack of private capital for investment and the cautious attitude of the commercial banks led to the establishment of two long term financial institutions - the Ceylon State Mortgage Bank and the Agriculture Industrial Credit Corporation - but the scale of their operations remained small as they depended largely on public sources for their funds. Furthermore, these two institutions concentrated heavily on loans to agricultural borrowers for the acquisition and improvement of land rather than for industrial and other ventures. There were a large number of insurance companies which were almost fully foreign owned and there being no law regulating the activities of the insurance companies, they tended to hold the bulk of their assets outside Sri Lanka.

The Monetary System

At the time of Independence, the monetary system prevailing in the country was the Currency Board System. The Currency Board System had been functioning in Sri Lanka since the enactment of the Paper Currency Ordinance No.32 of 1884. Under its provisions, the currency issue and its management were entrusted to a Board of Commissioners of Currency consisting of the Colonial Secretary, the Treasurer and the Auditor General. The notes issued by the Board were legal tender in the country and were convertible on demand to Indian rupees.

The Paper Currency Ordinance was subject to minor amendments from time to time but continued to be the principal mechanism governing the currency issue in the country. However, a major amendment was made in 1941 by Ordinance No.21 of that year, which resulted in the creation of a separate Ceylon rupee as the standard unit of value. The Board of Commissioners was empowered to issue Ceylon rupees against the tender of Indian exchange at the rate of 1 Ceylon rupee to 1 Indian rupee. Thus, 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 equivalence 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 reductions 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 was in surplus, i.e. when the country's foreign exchange receipts were in excess of its foreign exchange expenditure, the currency issue was automatically expanded by the extent of that surplus. Conversely, the currency issue got automatically contracted when the balance of payments was in deficit. The Currency Board played a purely passive role in the expansion and the contraction of the currency issue.

The Currency Board System as it operated had serious shortcomings. One of its principal shortcomings was the 100 per cent reserve base and the automatic link between the level of reserves and the volume of currency issue. Since any addition/reduction to reserves was accompanied by an expansion/contraction of the currency issue, the total currency issue tended to be automatically responsive to fluctuations in the balance of payments. Currency and demand deposits held by the public accounted for the total money supply in the economy. In the Currency Board System, the most important variable which influenced the volume of bank deposits was the balance of payments. Thus, both the currency issue and the volume of bank deposits being directly responsive to balance of payments surpluses and deficits, the money supply tended to move in sympathy with balance of payments changes rather than with the cash requirements of domestic economic activity. The Currency Board as such could not influence the money supply in any way to make more funds available for the growing needs of an expanding economy.

This excessive rigidity imposed undue hardships in periods of economic crisis although it worked satisfactorily under normal balance of payments conditions.

Another serious weakness of the Currency Board System was the manner in which the international value of the Ceylon rupee was determined. Under the System, the Ceylon rupee was linked at par to the Indian rupee and the Sri Lankan authorities did not have the freedom either to fix or to determine the manner in which the international value of the rupee was to be maintained. The Ceylon rupee was linked to the Indian rupee, which in turn was linked to Sterling. Its international value remained stable both with respect to the Indian rupee and the Pound Sterling as a matter of course. As long as the Indian rupee remained stable with respect to Sterling with complete freedom of convertibility between the Indian rupee and the Pound Sterling, the system worked smoothly as if the rupee was tied directly to Sterling. However, certain developments which took place in the 1940s created difficulties in maintaining the stability of the Indian rupee in relation to the Pound Sterling and these brought to surface the problems of continuing with a monetary unit, the value of which was tied to the Indian rupee. 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. Meanwhile, when India agreed with the International Monetary Fund upon a gold par value for the Indian rupee in 1945, the link of the Indian rupee to Sterling which hitherto existed, was broken. In addition, in 1947 the Indian authorities instituted exchange controls over transactions with other countries in the Sterling Area. With these developments, the automatic link between the Indian rupee and the Ceylon rupee could not be maintained.

Apart from the limitations of the Currency Board System and the changes with respect to the Indian rupee and the Pound Sterling which determined the par value of the Ceylon rupee referred to above, considerations of economic nationalism also played a role in creating an awareness of the need for a new monetary system. 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 authorities outside Sri Lanka was contrary to the spirit of Independence. Further, the Currency

Board System was viewed as an inherent feature of colonial administration and its continuance after independence seemed to be inconsistent with the newly gained political status. It was felt that this anomalous situation could be rectified only by the establishment of an independent monetary system in the country.

Development Problems in Perspective

It was thus seen that, at the time of gaining political independence the Sri Lankan economy was suffering from structural weaknesses, resulting from the dominance of traditional agriculture, on the one hand, and export of primary products, on the other. This was followed by a heavy dependence on imports for basic consumer requirements, particularly food. This combination made the country's balance of payments extremely unstable. The economic structure that emerged at the end of the colonial rule provided neither a satisfactory framework nor the required flexibility to achieve rapid and sustained economic expansion. The export sector in particular proved to be highly vulnerable to world market forces. Consequently, the diversification of the structure of production presented itself as one of the basic development objectives of post-independence Sri Lanka. Structural changes required the development of new exports and the creation of a more flexible import structure. Then, there was an urgent need to transform and rationalise the traditional sector of the economy and to reduce disparities between the plantation sector and the rural sector.

At the same time, there was a need for creating employment opportunities for a rapidly growing work force, as the pattern of development based on plantation agriculture was no longer adequate for this purpose, particularly with an increasingly educated workforce with growing economic and social aspirations.

The achievement of these objectives necessarily called for a financial system which was broad-based and responsive, and a monetary system with the required degree of flexibility for meeting the development aspirations of an emerging nation. The financial system that existed at Independence was too narrowly based and lacked both depth and vigour to cope with the financial needs of an economy striving for economic and social emancipation. The monetary system was too rigid and was

inadequate for meeting the liquidity requirements of an expanding economy. Further, it was incapable of creating appropriate conditions for a rapid assault on under-development in the context of a rapidly increasing population. Meanwhile, the system which lacked basic elements of monetary sovereignty proved highly incompatible with the newly gained political status. Thus, one of the earliest initiatives of the post-independence administration was the setting-up of an independent monetary authority with "broad powers to administer and regulate the entire money, banking and credit system" in the country.

Establishment of the Central Bank

In the context of this background, it was a landmark in Sri Lanka's economic history when the Governor General announced in the Throne Speech to Parliament on November 25, 1947 that "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". It was to the Government of the United States of America that the Sri Lankan authorities turned for expert advice and the man behind the expert advice was Mr John Exter, an economist of the Federal Reserve System. Mr 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.

Having submitted an interim report in June, 1949, Mr Exter submitted his Final Report, consisting of two parts, 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 Lankan economy, while the second contained a draft bill and also reasons, where necessary, for recommending particular clauses in the bill.

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 passed by the Parliament on November 25, 1949 and became the Monetary Law Act, No.58 of 1949. The Central Bank of Sri Lanka commenced business on August 28, 1950. The Bank was given the sole right and authority to issue currency in Sri Lanka and all currency notes and coins issued by it became legal tender in Sri Lanka for the payment of any amount. Simultaneously, the Currency Board ceased to function. The Central Bank assumed liability for the notes and coins issued by the Currency Board and in circulation on that date 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 Central Bank became the custodian of the international reserves of the country. 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. The Bank took over the management of the clearing house from August 29, 1950, from the Imperial Bank of India, which had hitherto functioned as the clearing bank.

An Institution of Much Economic Significance

With the establishment of the Central Bank an institution of much economic significance emerged. Its influence on the economic life of the country rested not only in the basic functions entrusted to it by law but also in its enormous powers at liquidity creation, almost at will. Still more significant was its strategic role in influencing national economic policies which, in turn, affect growth, employment and the balance of payments.

The main objectives of the Bank as specified in Section 5 of the Monetary Law Act were:

"(a) the stabilisation of domestic monetary values;

(b) if there has been a determination of the par value of the Sri Lanka rupee, the preservation of the par value of the Sri

Lanka rupee and the free use of the rupee for current international transactions;

(bb) if there has been no determination of the par value of the Sri Lanka rupee, the preservation of the stability of the exchange rate of the Sri Lanka rupee in relation to foreign currencies;

(c) the promotion and maintenance of a high level of production, employment, and real income in Sri Lanka; and

(d) the encouragement and promotion of the full development of the productive resources of Sri Lanka."[1]

Thus, it is observed that the objectives of the Bank in the main were two fold: the stabilisation objective and the developmental objective - two objectives which do not necessarily seem compatible or harmonious at all times. With respect to the former, the Bank was expected to maintain monetary stability so as to preserve both the internal and external value of the rupee. In the case of the latter, the Bank was expected to conduct its affairs and initiate action for promoting growth and employment, and full development resources of within the Sri Lankan economy. The Monetary Law Act gave the Central Bank very wide powers relating to monetary control of a quantitative and qualitative nature to enable the Bank's objectives to be achieved. Economic development and diversification of the economy figured prominently in the economic policy of the country during the period. It was felt that the Central Bank would play an important role in achieving these objectives not only indirectly by maintaining stable monetary conditions, but also directly by promoting the development and expansion of the financial system and directing credit to areas with the greatest development potential. Once established, the Central Bank became the hub of the financial system and because of its ability to acquire assets at will and create liquidity, its operations began to have a permeating influence on the financial system of the country. Its role in shaping the economic life of the country in general was even more pervasive and transcending by its ability to influence the economic policies of successive post-Independence governments. In this 40th year Commemorative Issue, some of its operations and achievements are discussed.

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1 **(bb) above was added on in 1978 to accommodate the abandonment of the par value system.**