

---

## Chapter 3

---

### Monetary Policy and Instruments

An important function performed by the Central Bank is the formulation and implementation of national monetary policy so as to maintain the stability of the value of the Sri Lanka rupee, while pursuing its development objectives. Monetary policy, which wholly comes within the ambit of the Central Bank, consists of conscious policy measures taken by it in order to influence the cost and the availability of money. The cost of money is the opportunity cost of acquiring money, viz., the rate of interest; the availability of money is the supply of money in adequate amounts to the economy through the credit creating processes of the banking system. The Central Bank is equipped with a number of instruments to influence these two variables, though the degree of efficacy of these instruments, and hence their relative costs, vary considerably depending on the nature of the money market conditions prevailing in the country. It therefore behoves the Central Bank to select the most efficient monetary policy instrument or a combination of instruments by reference to the prevailing market conditions in order to reach the desired money and credit levels. The monetary policy measures implemented by the Bank during the past 40 years conformed to the wisdom embodied in this basic rule.

This chapter will first discuss the relationship between monetary policy and the Central Bank's main objectives and then present an over-view

of the monetary policy instruments available. The last section of the Chapter will confine itself to a review of the evolution of monetary policy in Sri Lanka in relation to the different economic regimes that existed in the country during the past 40 years.

### **The Link between Monetary Policy and the Bank's Objectives**

Monetary policy underlies the main strategy to be adopted by the Central Bank in achieving its objectives. The objectives of the Bank, as laid down in the Monetary Law Act (MLA), can be classified under the following two broad headings:

- (a) The Stabilisation objective; and
- (b) The Development objective.

The stabilisation objective includes the stabilisation of the domestic value (maintenance of reasonable price stability) and the external value (maintenance of reasonable stability in the exchange rate) of the Sri Lanka Rupee. The development objective requires the Bank, by using monetary policy, to promote and maintain a high level of production, employment and real income in Sri Lanka, on the one hand, and encourage the full development of productive resources of the country, on the other. These two objectives of the Bank obviously conflict with each other, in the sense that the policy measures necessary to achieve the two objectives operate in the opposite direction: the stabilisation objective requires the Bank to curtail the growth of money and credit, while the development objective dictates the opposite.

The long run stable relationship observed between the stock of money and the general price level has formed the economic rationale behind the control of the stock of money so as to achieve stability in both domestic and external values of the Sri Lanka Rupee. With the growth in the real output and an expansion in the proportion of the monetised transactions, the Bank is required to supply an adequate quantity of money to the economy in order to ensure smooth functioning of the system. However, if the money supply grows over and above these requirements, such excess money will create additional liquidity in the economic system, eventually exerting upward pressure on the general price level. To the extent that the excess demand so created is met via imports, it leads to a deficit in the balance of payments (BOP) requiring a continuous depreciation of the currency in order to correct the BOP

dis-equilibrium. Therefore, whenever the domestic price stability or the stability of the exchange rate is threatened by excessive growth of money and credit, the Central Bank is required to arrest the situation by raising interest rates and curbing domestic credit expansion, both measures forming a restrictive monetary policy stance.

The corollary of the adoption of restrictive monetary policy measures is a curtailment of the domestic credit creation, forcing all economic agents to demand a smaller amount of bank credit. However, since bank credit plays a vital role in the economy, this measure amounts to a general contraction of domestic economic activities. In this context, the role of bank credit in an economy could be identified as follows: in the first place, bank credit helps an economy to maintain the current level of output by providing short-term working capital to business enterprises. Secondly, bank credit enables the economy to expand the current production levels by providing long term investment capital. Thirdly, bank credit could help business enterprises to sell out their accumulated inventories by boosting consumption with short term consumption credit granted to individual customers. It is in this sense that a liberal credit policy is required on the part of the Central Bank to achieve its development objective. Since the measures to be taken by the Central Bank to achieve its objectives conflict with each other, it is necessary to reach a compromise between the two objectives as demanded by the prevailing economic conditions of the country. Whenever the economy is threatened by hyper-inflation, the Central Bank would normally give the highest priority to the stabilisation objective keeping the development objective at a low key. Similarly, when there is a general economic recession coupled with a high rate of unemployment, it is advisable for the Central Bank to concentrate on the development objective by temporarily abandoning the stabilisation objective. In normal economic situations, the Bank would maintain an appropriate balance between the two objectives by trying to achieve certain pre-set targets of growth of money, prices and output.

Traditionally, central banks are required to promote economic activities not by direct participation, but by using monetary policy. This general rule is based on two factors which call for a central bank to play a neutral role in the economy. First, if a central bank gets involved directly in economic enterprises, it would lead to a "conflict of interest", since the bank, as the monetary authority, is required to apply its powers and

regulatory controls in a non-discriminatory manner. It is natural that any enterprise owned by a central bank will receive favourable treatment as against other enterprises at a time of severe credit restrictions. In order to avoid such a situation, the Central Bank has been prohibited by the MLA from acquiring a direct interest in any business enterprise in the economy. Second, unlike the government or any other enterprise, the Central Bank is equipped with only a nominal instrument that permits it to create additional money in the economy. As a result, if the Bank attempts to raise the level of economic activities by creating money, the result would be the building-up of inflationary pressures, negating the achievements on the growth front in the long run. Therefore, central banks are normally required to promote economic activities indirectly by using only monetary policy, i.e., by regulating interest rates and credit levels in the economy.

The Central Bank of Sri Lanka, during the past 40 years of its operation, has made a conscious attempt to adhere to this cardinal principle as circumstances permitted. However, the 1970s witnessed the emergence of a new ideology which questioned the rationale and the validity of this non-intervention policy of the Central Bank in the context of the catalytic development role to be played by it in a developing economy. For a central bank to influence economic activities only by means of monetary policy, a pre-requisite is the existence of a well behaved market system willing and ready to act appropriately in response to market signals. However, the markets in developing countries are said to be lacking in these ideal qualities, making monetary policy geared to the development objective virtually impotent. In this background, the new school of thought maintained that there was no harm in the central bank getting involved directly in the development of the financial infrastructure of the country on a limited scale. Accordingly, since the late 1970s, the Central Bank chose to deviate from its accepted policy and provided capital contributions to a number of new financial institutions, thus engaging itself directly in economic activities. The National Development Bank, Sri Lanka Export Credit Insurance Corporation and Regional Rural Development Banks were the new institutions so added to the financial infrastructure of the country, with the Central Bank's direct participation. It was held that the expansionary impact of the Bank's participation in the share capital of these institutions would be insignificant, since the capital so contributed was generated by monetising the reserves of the Bank which had arisen from its past

operations, and had thus far remained in sterilised form. However, the Bank has been mindful of refraining itself from over-using this channel by limiting its direct participation in economic activities to these few institutions in the financial system.

### **Instruments of Monetary Policy**

Monetary policy instruments represent a set of discretionary powers vested with the Central Bank to influence selected monetary variables as an intermediate target and, through it, the broad macro- variables in the economy as the final target. These discretionary powers encompass a wide array of activities undertaken by a central bank, ranging between its statutory and regulatory powers at one end and friendly persuasive strategies on its part, at the other. Activation of these instruments by the Central Bank in the conduct of day to day monetary policy gives rise to a number of monetary policy indicators which not only guide the authorities in the correct direction but also help them achieve the intermediate targets of policy. A schematic presentation of the relationship of the policy instruments with indicators and intermediate and final targets is given in Table 1.

Monetary policy instruments available to the Central Bank are expected to affect the money supply via two channels. First, open market operations (OMO) and Bank Rate affect the money-supply through the monetary base, while the statutory reserve ratio operates through the money multiplier. This channel is expected to yield the desired results by influencing the cost and the availability of inputs of the banking system and hence forms a market related indirect control method. Second, the direct controls and moral suasion strategies aim at restricting the final output of banks and therefore, cannot be applied on a permanent basis without inflicting a severe disincentive effect on the banking system. A money supply model outlining the relationship between the quantum of base money and the money supply through the multiplier process as applicable to Sri Lanka is presented in the Technical Appendix to this Chapter.

As developed in the model, the money supply is equal to the product of the monetary base in the economy and the money multiplier of the banking system as follows:

$$MS = mB$$

where MS = Broad money supply,  
 B = Quantum of Base money

$$m = \left[ \frac{[(CP/TD + 1)]}{[(CP/TD + CKB/TD + RR/TD + DOI/TD)]} \right]$$

CP/TD = Ratio of public's currency holdings to total deposits

CKB/TD = Ratio of commercial bank's currency holdings to total deposits

RR/TD = Statutory reserve ratio.

DOI/TD = Ratio of deposits of other institutions to total deposits.

All market related monetary policy instruments are expected to affect the money supply by influencing either the monetary base or the money multiplier.

#### (a) The Statutory Reserve Ratio.

The statutory reserve ratio takes the form of an officially regulated fraction of deposit liabilities of commercial banks to be held in such asset forms as may be determined by the Central Bank. In the past 40 years, rupee deposits with the Central Bank have been the principal form of statutory reserve holdings by commercial banks. The reserve ratio is negatively related to the money multiplier and therefore, any increase in the ratio will lead to a lowering of the credit creating capacity of commercial banks. The Central Bank has widely used this instrument in order to regulate the money supply of the country within the broad limits set out by law. In terms of Section 94 (1) of the MLA, the ratio to be imposed should be not less than 5 per cent and not more than 20 per cent in the case of time and savings deposits and not less than 10 per cent and not more than 40 per cent in the case of demand deposits. To alleviate any adverse repercussions on commercial banks, the reserve ratio should be raised in a gradual manner with only a maximum increase of 4 percentage points to be made within a period of 30 days. Furthermore, when such revisions are made, a minimum of 14 days' notice should be given to commercial banks by the Central Bank. However, the Bank is empowered to impose a reserve ratio of upto 100

per cent on any increase in deposit liabilities of commercial banks from a pre-determined date as an anti-inflationary measure during periods of severe inflation or when inflation is anticipated. With a unified reserve ratio in force since 1987, the Bank's ability to manipulate reserve ratios has been further narrowed, with the reserve ratio unified should be within 10 and 20 per cent of total deposit liabilities of banks.

The importance of the statutory reserve ratio as an effective monetary policy instrument has been waning in the recent past due to a number of reasons. First, on account of the rapid growth of commercial banks and the facilities provided by them, the public's preference for currency as against deposits had been falling continuously, exerting an expansionary impact on the money multiplier. For instance, the ratio of currency to deposits stood at 0.64 in 1968, but this ratio gradually declined to 0.34 in 1989. Consequently, in order to neutralise the resultant increase in the money multiplier, the Central Bank has resorted to raising the statutory reserve ratio in large jumps. However, such a move is possible only up to the statutory ceiling of 20 per cent in the case of the unified reserve ratio. Even though it is possible to impose this maximum ratio, it may not be advisable, since high reserve ratios add to the costs of banks thereby acting as an agent of disintermediation. Hence, the Central Bank has, of late, shifted its emphasis from the statutory reserve ratio to more effective instruments of monetary policy such as the open market operations.

#### **(b) Bank Rate**

Bank Rate, one of the traditional instruments of monetary policy, represents the rate of interest at which the Central Bank accommodates the commercial banks as the lender of last resort. Hence, by manipulating the Bank rate, the Central Bank influences the cost of borrowings of commercial banks at the margin and their resort to resource acquisition by way of borrowing from the Central Bank, a convenient liability management technique available to them. Accordingly, Bank Rate influences the quantum of base money in an indirect manner and gives a signal to the market as to the direction in which the interest rates should move.

The efficacy of Bank Rate as a monetary policy instrument has been diluted in Sri Lanka due to two reasons. First, the experience in Sri Lanka shows that Bank Rate functions as an effective monetary policy

instrument only when commercial banks undergo a severe liquidity constraint. In normal situations, commercial banks are in a position to avoid borrowing from the Central Bank, since the entirety of their liquidity requirements could be met from the inter-bank money market. Second, on account of the existence of a large number of concessionary re-finance windows in the Central Bank, the banks hardly need to borrow at Bank Rate. The existence of the refinance windows creates a wide divergence between the published Bank Rate and the effective average Central Bank interest rate which stands for the weighted average interest rate applicable to all borrowings from the Central Bank. For instance, in early 1980s, when Bank Rate was as high as 12 per cent with a graduated scale of penal rates ranging from 20 and 30 per cent on borrowings above the basic quota, the effective average Central Bank interest rate amounted only to 6 per cent. Hence, even as an impartor of market signals as to the direction of interest rates, Bank Rate cannot be said to have performed a useful role. Accordingly, on a number of occasions, the market interest rates failed to adjust adequately in response to changes in Bank Rate.

### **(c) Open Market Operations**

Open Market Operations (OMO) involve the purchase and the sale of securities by the Central Bank in the open market so as to maintain the monetary base at the desired level and, through the monetary base, the money supply within the target level. Unlike Bank Rate, OMO directly affect the monetary base and, therefore, the direction of monetary policy can be seen more clearly. The MLA empowers the Bank to use Government or Government Guaranteed Securities or its own securities for OMO purposes. When the Central Bank has acquired a large volume of short-term government paper in its credit operations with the Government, it is more advantageous for the Bank to divest itself of such paper as a part of its OMO rather than issuing its own securities.

In addition to influencing the monetary base, OMO could be used by the Central Bank to build up an orderly and stable market for government securities. Since bond prices and market interest rates are inversely related, the Bank is in a position to influence the latter by pushing bond prices up and down appropriately. Hence, the real strength of OMO lie in their capacity to alter the structure of interest rates and siphon off the excess liquidity in the system.



A pre-requisite for the success of the OMO is the existence of a developed money market in the country, so that any move on the part of the Bank is swiftly and appropriately responded to by market agents. The under-developed money market in Sri Lanka, therefore, hinders the Bank's efforts to make use of OMO as the major instrument of monetary policy, even though OMO are considered to be superior to other instruments in many respects. However, despite these limitations, there are signs of the OMO emerging as the main monetary policy instrument in the country.

#### **(d) Direct Controls**

The direct controls exercised by the Central Bank to regulate money and credit are designed to achieve their intended purpose by imposing an effective restraint on the final output of commercial banks. Thus, these measures help the authorities to bring the credit markets back to order by creating a "shock effect" in banks, when the conventional market oriented policy measures fail to arrest an expanding monetary situation. Hence, it is of utmost importance that the authorities resort to direct control measures as sparingly as possible, and only under extra-ordinary circumstances that warrant swift action on their part, and then shift the emphasis of policy back to market oriented policies as quickly as possible. The following direct control methods are frequently adopted by the Central Bank to regulate money and credit.

##### **(i) Selective Credit Controls**

Selective Credit Controls (SCC), which take the form of discriminatory application of direct controls, are basically intended to alleviate adverse repercussions of restrictive monetary policy measures, on the one hand, and cause a forced allocation of resources to pre-determined sectors by influencing the lending policy of banks, on the other. While the traditional methods of monetary control affect all the sectors without discrimination, the SCC affect specific economic activities, thereby helping authorities to achieve specified objectives such as discouraging consumption, speculative types of imports, etc. Under the SCC, the Central Bank is empowered to fix the maximum permissible maturities of loans and investments, ceilings on bank credit and maximum interest rates on loans and advances and deposits of commercial banks. The credit ceilings coming under the SCC take the form of portfolio ceilings where the Central Bank prohibits commercial banks from increasing

their loans and investments, or fixes the rate at which such loans and investments could be increased within a given period.

(ii) Cash Margins against Letters of Credit.

The Central Bank is empowered to specify different cash margins for different kinds of transactions to be financed by means of letters of credit so as to ensure that bank credit is not granted for speculative purposes which probably bring about a destabilising effect on the balance of payments. Most often, the authorities select luxury or non-essential items when specifying such cash margins, so that any adverse impact on the consumers could be kept at a minimum.

**(e) Moral Suasion**

Though it has no legal backing, moral suasion constitutes a policy instrument used very frequently by the Central Bank in order to get commercial banks to fall in line with its broad objectives. Since there exists a cordial and harmonious relationship between the Central Bank and commercial banks, an opportunity exists for the former to persuade the latter to adopt practices and policies that are conducive to the implementation of on-going programs of the Central Bank and of the Government. One of the areas where the Central Bank used moral suasion to a significant extent was in the implementation of the National Credit Plan (NCP) under which the Bank's annual monetary program was combined with a diversion of commercial bank credit to pre-determined priority areas. This enabled the Central Bank to allocate a significant amount of bank credit to vital sectors in the economy, while commercial banks benefitted from the improved management environment emanating from the system of corporate planning they were required to carry out under this scheme.

### **The Evolution of Monetary Policy in Sri Lanka**

The monetary policy measures pursued by the Central Bank during the past 40 years exhibited a very close correspondence to the type of economic policies adopted in different economic regimes that prevailed in the country during this period. When the economic policies were geared to achieving broad macro-economic objectives, monetary policy played a conducive role of stabilising the domestic economy, while the eras of development oriented economic policies were followed by

supplementary monetary policies aimed at a higher domestic resource mobilisation. It is therefore appropriate to analyse the evolution of monetary policies in Sri Lanka in relation to different periods marked by such economic regimes. In this context, the following three major periods of monetary policy can be identified for convenience of analysis:

- (a) 1950 - 1959
- (b) 1960 - 1977
- (c) 1978 - 1989

**(a) Monetary Policy in a Liberal Economic Era - 1950-1959.**

The first decade of monetary policy in Sri Lanka was mainly geared to the achievement of the stability of domestic currency by activating conventional monetary policy instruments available to the Central Bank. The emphasis of economic policy in this period was on growth via external trade, with import substitution of rice receiving a high priority. The macroeconomic scenario in this era was characterised by a reasonable economic growth coupled with a fair degree of price stability. The Korean-war boom of the early 1950s had resulted in a massive accumulation of external assets by the country, the monetisation of which would have inevitably led to a monetary explosion, threatening the internal and external stability of the Sri Lanka rupee. Hence, the major thrust of the monetary policy in the first half of the period was placed on policies to prevent the inevitable over-heating that would plague the economy.

In order to arrest the much anticipated monetary expansion, the statutory reserve ratio and Bank Rate were activated by the Central Bank in 1950. The reserve ratios which had been fixed at their minimum levels of 10 per cent for demand deposits and 5 per cent for time and savings deposits, were revised upward to 14 per cent in respect of demand deposits in late 1950. Meanwhile, Bank Rate was fixed at 2 1/2 per cent, and later raised to 3 per cent in 1953. Adopting an unconventional policy measure, the Central Bank allowed commercial banks to invest their foreign exchange working balances abroad, so that the monetisation of surplus export proceeds could be deferred to a future date when the monetary conditions were suitable for such a conversion. In the context of rising external assets, the Bank did not want to revalue the currency, since the war boom was considered to be a transitory phenomenon. Hence, the

entire burden of adjustment in this period was thrust upon monetary policy.

The restrictive policies adopted to mop up excess liquidity in early 1953 resulted in a contraction of money supply in the first half of 1953. The consequent reduction in the resources of commercial banks led to a critical point where the banks were obliged to restrict their lending to the private sector, causing a far reaching impact on the smooth functioning of the economy. The monetary base further contracted due to the outflow of foreign exchange for imports and the Government's repayment of a part of its borrowings from the Central Bank on account of an improved cash position. Hence, it became necessary to relax the restrictive monetary policy stance so as to relieve the banking system of the pressures under which it was operating. Accordingly, the reserve ratio on demand deposits was lowered back to 10 per cent in September, 1953, while Bank Rate was reduced to 2 1/2 per cent in June in the following year, so that a part of the reserves absorbed earlier could be ploughed back into the banking system in order to restore its lending ability.

The liberal monetary policies so adopted in the early 1950s proved to be injurious to Sri Lanka, since the period after 1955 witnessed a sharp fall in the external assets bringing in a major destabilising force on the country's balance of payments. The Central Bank attempted to arrest the situation partly by engaging in open market operations in a limited way in early 1956. Accordingly, the Bank issued its own securities amounting to Rs.10 million in February, 1956 and raised it further to Rs.15 million in early 1957. In the latter case, securities with two maturity periods - one with a 6 month's maturity at 1 per cent per annum and the other with a maturity of 13 months at 1 1/2 per cent per annum, were issued mainly to the non-bank private sector. However, given a monetary base of Rs.600 million for 1956, the securities issued were able to sterilise less than 3 per cent of the base money.

The experience of the Korean-war boom and its aftermath point to a failure of the country's monetary policy to lend itself to a sustained growth in the economy by an appropriate interest rate policy in co-ordination with a set of appropriate fiscal and exchange rate policies. The Korean-war surplus, which was sufficient to finance about 13 months' import requirements of the country in 1949, soon dwindled

away, creating a severe BOP problem for the country in the following decade, mainly on account of the country's failure to re-invest the surplus in productive sectors. The low interest rate policy adopted in this period primarily to alleviate the government's budgetary problems, resulted in the establishment of a negative real interest rate, discouraging savings and favouring consumption. The pressures under which the Central Bank was compelled to maintain a low interest rate policy can be gauged by the directive issued in 1959 by the Government to the Bank to reduce Bank Rate from 3 per cent to 2 1/2 per cent. In this manner, Sri Lanka lost a valuable opportunity of sustaining its growth momentum by not ensuring a continuous re-flow of investable funds which she had accumulated during the Korean-war boom.

### **(b) Monetary Policy in a Controlled Regime - 1960-1977**

In view of the worsening BOP situation, resulting mainly from Sri Lanka's low growth and failure to diversify its export structure, the authorities were compelled to resort to a set of economic policies that provided a palliative in the short-run, but was disastrous to the long-term growth objectives. These policies included an imposition of strict exchange and import control measures, inward looking policies with a greater emphasis on import substitution industries, reliance as far as possible on domestic resources and a gradual expansion of the public sector to cover a wide range of economic activities. During this period, the monetary policy, which simply remained a stabilising measure in the previous era, graduated into a more active role by expanding its scope to cover development issues as well. Accordingly, while the policy was basically directed to preserving the stability of the currency, a number of new measures were implemented to facilitate a free credit flow to vital sectors in the economy.

The monetary policy measures implemented in this era were marked by a mixture of concessions and subsidies, on the one hand, and controls and regulations, on the other. In order to promote economic activities, selective policy measures were implemented in the form of interest rate ceilings, Central Bank re-finance, and the exclusion of priority sectors when credit restrictions were imposed on commercial banks. In August, 1960, Bank Rate was raised from 2 1/2 per cent to 4 per cent as a restrictive monetary policy measure, but the commercial banks' borrowings against the pledge of usance promissory notes relating to the financing of certain essential imports and domestic production and

exports continued to enjoy a concessionary rate of 2 1/2 per cent with a ceiling on the on-lending rate fixed at 6 per cent. This concessionary rate was later raised to 4 per cent in 1961, while the ceiling on the on-lending rate was withdrawn. However, at the same time, a new re-finance scheme was introduced for financing the purchase, sale or storage of locally grown agricultural products at 3 per cent per annum. In order to encourage medium and long-term lending by banking institutions, a Medium and Long-Term Credit Fund (MLCF) was established in the Central Bank in July, 1964. The re-finance provided under the MLCF Scheme for the promotion or development of industry, agriculture, trade, commerce or business carried a rate of 5 per cent per annum. In respect of re-finance loans for industry and agriculture, the rate was later reduced to 3 per cent in 1966 with a maximum on-lending rate of 6 per cent. The Central Bank thus continued to gear its credit policy to promoting production in the economy by maintaining a two-tier interest rate structure, one at subsidised rates and the other at on-going market rates, which were heavily influenced by the restrictive monetary policy measures in force. While it is necessary to subsidise the vital sectors in order to encourage new economic activities, the danger in the continuation of such a policy is the development of a subsidy/concession syndrome in the economy in the long run and the difficulty which the authorities may encounter later when attempting to withdraw such subsidies owing to the pressures coming from powerful lobbying groups. Consequently, the inevitable outcome is the building of such concessionary credit schemes permanently into the monetary policy structure thus narrowing the freedom of the authorities in manipulating the monetary policy to achieve the stabilisation objective.

The failure of successive governments to mobilise resources in adequate amounts to finance ever expanding government activities resulted in government's resorting to expansionary financing which, in turn, led to a creation of excess liquidity in the system. The pressures which this excess liquidity brought on the BOP and the domestic price level compelled the monetary policy to bear the full brunt of the emerging macro-economic instability of the country. Accordingly, the monetary policy stance pursued in this period recorded a gradual tightening of the monetary conditions in a bid to contract the money supply to desired levels.

The major thrust of the monetary policy during this period was placed on Bank Rate, statutory reserve requirement and direct controls. While the credit granted for non-essential purposes was brought under credit ceilings, cash margins were imposed on letters of credit on selected import items. Bank Rate which was raised to 4 per cent in 1960, underwent several upward revisions thereafter; 5 per cent in 1965, 5 1/2 per cent in 1968, 6 1/2 per cent in 1970, a penal rate of 2 1/2 per cent on the excess amounts to be borrowed over a minimum available at Bank Rate as from 1975, and finally 10 per cent in 1977. Meanwhile, the statutory reserve requirements were also extensively used as a restrictive monetary policy measure. In August, 1960, the reserve ratio on demand deposits was raised from 10 to 12 per cent, while that on time and savings deposits remained unchanged at 5 per cent. When these measures failed to arrest the situation, a special reserve ratio on demand deposits equal to 38 per cent of the increase in such deposits over the level as at February 1, 1961 was imposed from February 10, 1961. The People's Bank which commenced business after this date was made subject to this special reserve ratio at a rate of 28 per cent in November, 1965. The reserve requirements were further tightened in 1975 by requiring commercial banks to maintain the entirety of their reserves in the form of rupee deposits with the Central Bank. Action was also taken to reduce gradually the till cash concession in reserve requirements given to commercial banks from October 29, 1976. These increases in the reserve ratios to such high levels were instrumental in raising the intermediation costs of commercial banks.

A salient feature of the monetary policy measures implemented during this period was the increasing reliance by the authorities on direct control methods thereby making them a permanent feature of monetary policy. These direct controls took the form of a restriction of bank credit to a pre-determined level with the exception of the credit granted to priority sectors. In 1963, commercial banks, lending to customers for the purpose of purchasing estates was restricted to a third of the purchase price of such estates. In 1965, a ceiling on credit to private sector was imposed for a period of 12 months. This ceiling was reimposed in 1968 in a modified form where the banks were required to limit the increase in specified forms of advances to 8 per cent of such advances as at the end of August, 1968. This ceiling was continued in the period following with certain modifications introduced from time to time until 1977, when bank credit was completely frozen in May, except for production

and export purposes. The following year the ceiling was somewhat relaxed, but the restriction on credit for non-essential purposes continued.

In sum, during the period under reference, the monetary policy pursued by the Bank was characterised by the provision of short-term palliatives to emerging macro-economic problems of the country. Even though attention was paid to developmental issues, the subsidies and concessions provided resulted in trapping the economy in a vicious circle of subsidies/concessions making it difficult to break away from such a circle without severe adverse repercussions on the economy. The authorities were continuously engaged in adopting restrictive policy measures, but the need for the development of an infra-structure conducive to undertaking monetary management efficiently was wholly neglected. The outcome of this policy was the necessity for the continued reliance on direct controls as a stabilising measure in the absence of an appropriate environment to pursue more efficient market oriented monetary policy measures.

#### **(c) Monetary Policy in an Open Economy - 1978 - 1989.**

In late 1977, Sri Lanka chose to adopt a new economic policy marking a significant departure from the closed economy policy pursued till then. The main features of the new policy included a greater reliance on the market system for resource allocation, gradual dismantling of import and exchange controls, establishment of an outward oriented industry and harnessing of private foreign capital to supplement domestic resource flows. Consequently, the main strategy of the country's monetary policy had to be re-formulated so as to fall in line with the new economic policy. This involved a gradual transformation of the policy from direct controls to market oriented monetary policy measures which were considered to be more efficient in creating a healthy environment for resource allocation. This new challenge required the Central Bank to bring about qualitative changes in the scope, coverage and strategy of the monetary policy measures adopted in the country.

The period under reference witnessed a number of changes in the application of monetary policy by the Central Bank. In the first place, action was taken to re-define the monetary aggregate used for policy purposes to be in line with the recent developments in the banking system. The monetary aggregate used for monetary policy purposes until



1980 constituted currency and demand deposits held by the public as defined in the MLA in 1949. Though this definition adequately covered the money supply at the time the MLA was enacted, and possibly a decade or two later, a number of innovations that were introduced to the banking system in late 1960s made it too narrow a monetary aggregate for practical policy purposes. These innovations were instrumental in making time and savings deposits as liquid as demand deposits so that the distinction traditionally observed between the two classes of deposits no longer existed. These innovations included, in the case of savings accounts, relaxation, in practice, of restrictions on the withdrawal from savings accounts, automatic transfer facilities combining current accounts with savings accounts, introduction of checkable savings accounts and the installation of Automated Teller Machines which disregarded the distinction between current and savings accounts for operational purposes. In the case of time deposits, the introduction of certificates of deposit which bore the characteristics of a currency note, facilities for premature withdrawal and easy borrowing against the security of time deposits made time deposits more liquid than before. Consequently, in order to adopt a realistic monetary aggregate for policy purposes, it was decided in 1980, to broaden the definition of money supply by including the time and savings deposits of the public held with commercial banks.

Second, the entire strategy on monetary policy was refined by identifying new monetary policy indicators such as the monetary base and the money multiplier and applying appropriate instruments to influence these indicators more effectively. The choice of the instruments to be used to achieve policy objectives was made by reference to the relative efficacy of such instruments at the particular time the measures were introduced. In line with this policy, the Central Bank commenced preparing an annual monetary program which was compatible with the basic macro variables such as the BOP and the budgetary outcome, the projected growth rate and the anticipated inflation in the country. The monetary program was then translated into a target level for the monetary base set for each quarter for the purpose of monitoring the progress. This allowed the Central Bank to use open market operations (OMO) in a more effective manner in order to maintain the monetary base at the desired level.

Third, for the successful implementation of the OMO, action was taken to create the necessary pre-requisites by promoting the country's money market. Money brokers were allowed to operate so as to lower intermediation costs, while new features were added to the market by establishing a Secondary Market for Treasury bills in the Central Bank. The interest rates were allowed to move freely in the market in response to the emerging demand and supply conditions. The Primary Market for Treasury bills was also used as far as possible to achieve the broad objectives of the monetary policy.

Fourth, the annual monetary program introduced earlier enabled the Central Bank to divert a significant portion of credit to pre-determined priority sectors by means of a National Credit Plan (NCP), implemented in collaboration with commercial banks. In order to facilitate the flow of credit under the NCP, a number of re-finance windows were opened in the Central Bank, while the resource base of the existing schemes was considerably enhanced. The NCP provided a situation for the use moral suasion by the Central Bank to make its wishes known to commercial banks, on the one hand, while also providing a forum for commercial banks to bring their problems to the notice of the Central Bank, on the other.

The maintenance of a low interest rate policy so as to keep the inflation down and encourage investments played a central role in previous monetary policy packages. Recognising the long-term adverse implications of such low interest rates, the present policy package allowed interest rates to move freely in the market in response to demand and supply forces. Accordingly, the entire interest rate structure in the country moved to a higher plateau, raising the real interest rates and thereby encouraging financial savings and discouraging wasteful expenditure. For instance, the 1 year real fixed deposit rate of commercial banks which stood at 5.0 per cent in 1976 rose sharply to 12.8 per cent in 1977 and continued to be positive till 1980 in which year the real rate became negative on account of the failure of the nominal rates to adjust adequately in response to rising inflation rates. Consequently, the financial savings of the country which amounted to 8 per cent of GDP in 1977 rose progressively to 12 per cent in 1979, but recorded a gradual declining trend thereafter since the real interest rates remained either negative or low.

The Central Bank had to take up two challenges when formulating appropriate monetary policy measures during the period under reference. The first challenge was the expansionary impact which both the external and the government sectors continuously exerted on the money supply during this period. On account of the receipt of a large volume of concessionary foreign aid, and later by reason of the tea boom in 1984, the overall balance of the BOP yielded a surplus upto about 1985, causing a corresponding monetary expansion. Similarly, the government sector which depended heavily on bank financing, especially from the Central Bank, reinforced the monetary expansion brought about by the external sector. Both these developments were beyond the direct control of the Central Bank and had to be neutralised by extremely restrictive monetary policy measures. Thus, the second challenge before the Central Bank was the choice of appropriate monetary policy measures for this purpose without defeating the broad growth objectives of the open economic system.

The Central Bank resorted to a wide range of policies in order to curb the excessive growth of money and credit in the economy. Initially, the conventional instruments such as Bank Rate and the statutory reserve ratio were extensively used by the Bank. However, with the realisation of the limitations of these instruments, the Bank resorted to direct controls on a number of occasions. Since all these instruments failed to achieve the desired results, it was decided to shift the emphasis of the policy to open market operations from around mid 1984.

In June, 1984, the Central Bank commenced issuing its own securities with a view to mopping up the excess liquidity in the economy, which had arisen from the high tea prices of 1984 and the excessive government expenditure mainly from borrowings from the Central Bank. In 17 Auctions conducted between June, 1984 and February 1986, securities amounting to Rs.5.5 billion were offered in the market and bids were received almost for the entire amount. The net cumulative absorption by the Central Bank securities increased from Rs.139 million in the 1st Auction to Rs.1,280 million in the 15th Auction sterilising, on average, about 8 per cent of the monetary base by the end of 1985. The resultant deceleration in the rate of monetary expansion was mainly instrumental in lowering the inflation rate to 1.5 per cent in 1985.

One of the destabilising forces after 1985 was the heavy borrowings effected by the Government from the banking system, especially from the Central Bank. The net credit to Government (NCG) by the banking system increased by Rs.2 billion in 1986, by Rs.4.5 billion in 1987 and Rs.9 billion in 1988. The appropriate OMO thus indicated that a significant proportion of the Treasury bills held by the Central Bank should be divested to the non-bank sector in order to moderate the expansionary impact exerted by such borrowings. Hence, after 1988, a conscious effort was made by the Central Bank to reduce its holdings of Treasury bills raising the Treasury bill rates both in the Primary and the Secondary Markets. Accordingly, the Treasury bill rate in the primary market moved up from an average of 9.5 per cent in early 1988 to 17 per cent in late 1989. Reacting to this aggressive interest rate policy, the share of the Central Bank's holdings in the total Treasury bills declined sharply from 88 per cent in January 1988 to 57 per cent in December, 1989. The success of these OMO could be gauged from the slow growth in the monetary base and the negligible amount of the Government's borrowing from the banking system, amounting to only Rs.54 million in 1989. Thus, the stabilisation program undertaken by the Central Bank under the new economic policy recorded considerable success by the end of 1989 with the annual inflation rate decelerating to 12 per cent, despite the heavy odds against such an achievement during the year on account of the widespread disruptions to economic activities owing to civil disturbances.

In conclusion, the evolution of monetary policy in Sri Lanka, since the inception of the Central Bank, records a gradual transformation into a fair degree of maturity with an expansion in the coverage of the policy, encompassing both stabilisation and development objectives. In the initial years, the emphasis of the monetary policy was mainly on the achievement of the stabilisation objective by activating the two traditional policy instruments, namely, Bank Rate and the statutory reserve requirement. Over time, when limitations of these policy instruments were felt by the authorities, attention was paid to the development of alternative instruments to achieve the objectives of the policy. With the development role of the Central Bank coming into prominence in the 1960s, a liberal credit policy was pursued by the Bank, involving the provision of concessionary credit facilities to pre-determined priority sectors. Though such promotional activities on the part of the Bank are necessary to break an economy away from the

vicious circle of underdevelopment, the continuation of subsidised schemes traps the economy in an equally undesirable vicious circle of a subsidy/concession syndrome, frustrating the realisation of long-run growth objectives. With a shift in the economic policy to an open economic system in late 1970s, the monetary policy was reformulated so as to bring about a qualitative change in the application and the coverage of the policy. While the monetary aggregate was re-defined to take cognizance of the new innovations in the banking system which had led to a complete change in the liquidity spectrum of the monetary assets, the implementation of the policy was refined by the preparation of annual monetary programs compatible with the developments of the major macroeconomic variables in the economy. Finally, the gradual improvements in the money market enabled the Bank to rely on OMO to achieve its monetary policy objectives more effectively and efficiently.

## Technical Appendix

### The Money Supply Process in Sri Lanka

Reserve money, (also known as base money, monetary base or high-powered money) produced and supplied by the Central Bank is used by commercial banks to create credit and deposits in their day to day operations. The reserve money consists of all sight liabilities of the Central Bank to the public and the commercial banks but not to the Government. The following are the three major components of these liabilities:

- (a) Currency held by the public and commercial banks (CP + CKB)
- (b) Deposits of commercial banks with the Central Bank (RR),
- (c) Deposits of other institutions with the Central Bank (DOI).

The relationship of these sight liabilities of the Central Bank with its operations could be gauged from the simplified balance sheet of the Central Bank that follows.

#### A Simplified Balance Sheet of the Central Bank

| Liabilities                       |               | Assets                       |               |
|-----------------------------------|---------------|------------------------------|---------------|
| Currency held by the Public       | (CP)          | Advances to Commercial Banks | (AKB)         |
| Currency held by Commercial Banks | (CKB)         | Credit to Government         | (CGCB)        |
| Deposits of Commercial Banks      | (RR)          | International Reserves       | (FACB)        |
| Deposits of Other Institutions    | (DOI)         | Other Assets                 | (OACB)        |
| Government Deposits               | (DGCB)        |                              |               |
| Foreign Borrowings                | (FBCB)        |                              |               |
| Other Liabilities                 | (OLCB)        |                              |               |
| <b>Total Liabilities</b>          | <b>(TLCB)</b> | <b>Total Assets</b>          | <b>(TACB)</b> |

Since total assets are equal to total liabilities, the relationship between assets and liabilities in the above balance sheet could be represented in the form of an equation as follows:

$$(1) \quad CP + CKB + RR + DOI + DGCB + FBCB + OLCB = AKB + CGCB + FACB + OACB$$

By retaining the items classified as reserve money on the left hand side and transferring all the other items to the right hand side and re-arranging the same, the following two equations could be derived.

$$(2) \text{ Reserve money} = B = CP + CKB + RR + DOI$$

$$(3) B = AKB + (CGCB - DGCB) + (FACB - FBCB) \\ + (OACB - OLCB)$$

In equation (3), the net result of (CGCB - DGCB) denotes the net credit to the government by the Central Bank, viz., (NCGCB). Similarly, the item (FACB - FBCB) denotes the net foreign assets of the Central Bank (NFACB), while the item (OACB - OLCB) denotes its net other assets. (NOACB). Thus, at any point of time, the reserve money in the system is equal to the sum of the variables in equation (4), as follows:

$$(4) B = AKB + NCGCB + NFACB + NOACB$$

The variables on the right hand side of equation (4) represent the factors affecting the reserve money and any change in these factors will cause the reserve money to change in the same direction. These factors are as follows:

- (a) Advances to Commercial banks by the Central Bank
- (b) Net credit to Government by Central Bank
- (c) Net Foreign assets of the Central Bank
- (d) Net other assets of the Central Bank

When the Central Bank produces reserve money by changing the level of the above factors, commercial banks could mobilise the same in order to create multiple credit and deposits, raising money supply in the process. The relationship between the money supply and the reserve money could be identified as follows:

For the purpose of deriving this relationship, money supply will be defined as follows:

$$(5) MS = CP + DDP + TSP$$

In terms of equation (2), reserve money is as follows:

$$(2) B = CP + CKB + RR + DOI$$

The total deposits of the banking system could be defined as follows:

$$(6) \quad TD = DDP + TSP$$

Then, equation (5) and (2) are divided by TD and the following results are obtained.

$$(7) \quad \frac{MS}{TD} = \frac{CP}{TD} + 1$$

$$(8) \quad \frac{B}{TD} = \frac{CP}{TD} + \frac{CKB}{TD} + \frac{RR}{TD} + \frac{DOI}{TD}$$

By dividing equation (7) by equation (8), and solving for MS, the following results could be obtained.

$$(9) \quad MS = \left[ \frac{[ CP/TD + 1 ]}{[ CP/TD + CKB/TD + RR/TD + DOI/TD ]} \right] B$$

As equation (9) shows, the money supply at any point of time is equal to the product of two factors, viz., the money multiplier shown within brackets, and the level of reserve money in the economy.



**Chart 3.1**  
**Schematic Presentation of Monetary Policy Instruments,**  
**Indicators and Targets**

