Chapter 4

Relationship with the Government

The Central Bank is often described as the government's bank and again as the bankers' bank. These two functions emphasize the fact that the central bank is primarily a bank which controls and supervises banking operations effectively in order to maintain the confidence of the government and the public in the banking system.[1] In its relationship with the government, the central bank has two main functions; namely, operational and advisory functions. A common feature of modern central banks throughout the world is that they have the main operational responsibility for official dealings, both in domestic and external markets. At the advisory level, the degree of final responsibility borne by the central bank for policy decisions varies from country to country. In some cases, statutory authority for certain matters is placed directly with the central bank, while in other cases the final responsibility lies with the government.

The widely held practice at the beginning of this century was that the central bank should get on with its own business and not pay too much

---

1 Lord Cobbold, "Some Thoughts on Central Banking, "Journal of the Institute of Bankers, February, 1963.

attention to government and political considerations. After the great depression, governments in both developed and developing countries began to intervene directly in the process of socio-economic development in their countries. These interventions spread to the extent that governments became unwilling to permit the availability and cost of money and credit to be determined entirely by market forces. As a consequence of these developments, there has been a strong movement towards integrating central banks into the government structure while preserving their autonomy. The generally accepted view in modern central banking is that the central bank should act in close harmony with the government while retaining independence in its operations and its thinking. In fact, monetary and fiscal policies have become integral parts of the overall economic policy of the government. A central bank obviously cannot pursue a policy that runs counter to the objectives of national economic policies. Thus, the relationship between the government and the central bank has tended to become more uniform in most countries in recent decades.

Central Bank Autonomy

Prior to the great depression of the 1930s, private ownership of the central bank was considered to be essential for monetary stability[2]. In line with this thinking, the Bank of England remained a privately owned institution without any participation by the government in its management and supervision. The German Bank Act also made the Central Bank of Germany (the Reichsbank) independent of government control. The other central banks established during this period also enjoyed similar status. However, since the 1930s, there has been a rapid transformation of the legal status of central banks all over the world. In the process of this transformation, most of the central banks have become state owned institutions. It has become generally accepted that the control of money and credit should be a public trust. In fact, in modern economics, governments have assumed increasing responsibility in the fields of education, public health and economic

2 Wiegand, "The Central Banking System and the Government" in James W. Bell and W.E. Spahr (Ed). A Proper Monetary and Banking System for The United States, New York, Ronald Press, 1960, pp.152-157.

development. Hence the modern view of the realtionship between these two institutions has been influenced by statute and local circumstances.

The central bank may be described in one country as "independent within the government", while in another country as "independent, subject to the final responsibility of the government". It can be described by other phrases as well. Nevertheless, there are some clear examples that explain the division of responsibility between the government and the central bank. One extreme is where legislation governing the central bank provides unconditional power to the government in the policy making process. For instance, the Bank of England Act of 1946 which transformed the Bank of England into a state owned institution, states that "the Treasury may from time to time give such direction to the Bank as, after consultation with the Governor of the Bank, they think necessary in the public interest." In India, the Reserve Bank Act gives powers to the government to remove the Governor from office. Furthermore, the Act does not compell the government to explain to Parliament the reasons for such removal. Similarly, the Bank of Japan is required to ensure that its policies are consistent with the economic policy favoured by the Ministry of Finance.

At the other extreme, there are some central banks which enjoy a considerable degree of autonomy in their operations. For instance, the Central Bank of the Federal Republic of Germany (the Deutsche Bundesbank) can exercise the powers conferred on it under the law concerning the Bundesbank, independent of the Federal Government. Although the capital of the Bundesbank is held by the Federal Government, the government cannot derive rights which might affect the independence of the Bank. The Bank Act contains regulations which compel both sides to seek co-operation and mutual consultations. In fact, the Bank is obliged to advise the Federal Government in monetary policy matters of major importance and to provide information at the government's request[3]. The Federal Reserve System of the United States of America also enjoys a similar degree of autonomy with regard to monetary policy. The joint statement issued by the government and the Federal Reserve System in March, 1951, states that the two institutions have reached an accord with respect to debt management

---

3 Deutsche Bundesbank, Special series No. 7, July, 1989, pp.5-11.

and monetary policy[4]. Similarly, the Australian Banking Law prohibits the Central Bank from supporting any government policy that might adversely affect the stability of the currency.

The Central Bank of Sri Lanka too has some unique features. It was established as a government owned bank in 1949. The Monetary Board which formulates monetary policy, consists of the Governor (Chairman of the Board), the Secretary to the Ministry of Finance and a member appointed by the President. The law governing the appointment of the Governor provides a certain degree of autonomy to the Central Bank. The Governor, who is appointed by the President for a six year term, cannot be removed from office unless "he has done any act or thing which in the opinion of the President, is of a fraudulent or illegal character or is manifestly opposed to the objects and interests of the Central Bank." However, as in the case of the Bank of England, if there is a difference of opinion between the Minister of Finance and the Monetary Board, the Minister is vested with the authority to direct the Board to follow government policy. Nevertheless, it must be stated that proper institutional arrangements have been established to promote continuous interaction between the Central Bank and the government and at the same time to ensure a great degree of independence. The Report on the Establishment of a Central Bank for Ceylon explains this point as follows. "The decision to make the Permanent Secretary to the Ministry of Finance a Member of a Board of only three grows out of the underlying conceptions of what the Monetary Board relations with the government ought to be....... The idea which it is hoped that the proposed law will achieve is one in which there will be continuous and constructive co-operation between the Monetary Board and the government. The principal instrument for achieving this co-operation should be the Permanent Secretary to the Ministry of Finance whose membership on the Board will ensure at all times that his Minister's views will be made known to the other members of the Board"[5].

4 Federal Reserve Bulletin, March, 1954. p..267.

5 Government of Ceylon, Sessional Paper XIV - 1949, "Report on the Establishment of a Central Bank for Ceylon" November 1949, pp.12 - 13.

The experience in many countries suggests that the use of powers by either institution is a delicate one and needs consideration and understanding from both sides to promote a strong working relationship between the government and the central bank. Very often central banks claim that governments expect monetary policy to carry too much of the burden of fighting inflation without adequate support from the fiscal side. Similarly, governments often argue that they are prevented from doing the things they would like to do by strong objections from central banks. Of course, central banks and governments need not have identical considerations. Governments must be concerned with political aspects. Their judgements must reflect political considerations. The central bank, on the other hand, though it must be aware and conscious of politital developments, should not concern itself with them unduly. In fact, central banks should concern themselves with general economic facts and be able to approach problems with full knowldege. Thus, the central bank can form its judgements from an economic point of view, independently of politics. These views can be examined at the highest level of authority, where close administrative co- operation between the central bank and the government is established.

The case for an independent central bank rests on the premise that a government needs such an institution to deal with monetary matters free from short term considerations and political interests of the party in power. At the second reading of the Monetary Law Bill, Mr. J.R. Jayewardena, then Minister of Finance, highlighted this aspect : "it is very difficult to say that the Central Bank should be entirely a department of the Government or subservient to the Government. We have tried, as far as we could, in this Act to make the Central Bank or at least the Monetary Board, independent as far as its advice is concerned. We want it to consider the problems of Ceylon, ... to see how far it is necessary that the credit structure of Ceylon should be influenced for the purpose of full employment and the balance of payments. We want it to consider this question apart from political considerations and give its advice without fear or favour to the government. But ultimately, in the last analysis, I think it would be admitted that the Monetary Board cannot come into direct conflict with the government."[6]

6 Parliamentary Debates (Hansard) Vol. 7 No.10, 22nd Nov., 1949. p.721.

Certainly the government must be supreme because of its sovereign responsibilities. However, the central bank should have the freedom to act against ill-conceived government policies and actions and to pursuade the government to adopt sound economic and financial policies by creating a better understanding of economic problems. In fact, the law accommodates government representation in the central bank because such an arrangement makes the government an active participant in the formulation of monetary and credit policies and at the same time promotes direct communication between the government and the central bank. Hence, legislation enacted in many countries has attempted to promote a close administrative co-operation between the two sides on the understanding that the central bank maintains a degree of autonomy and responsibility for the formulation and implementation of the country's monetary and credit policies.

Economic Considerations

Central banks all over the world fulfil the functions of banker, agent and adivsor to the government. The central banks perform these functions not only because of administrative convenience but also because of the close connection between public finance and monetary management. The concept of modern monetary management has come to depend upon the activities of the central bank, which has some key responsibilites in any economy. It is well known that the determination of the total volume of credit is one of the fundamental responsibilities of the central bank. In doing so, the central bank has to take into account the monetary impact of government fiscal operations. This itself establishes the importance of the relationship between the central bank and the government. The other responsibilities of the central banks are also important in analysing the relation between the two institutions. For instance, the central bank, besides being concerned with the volume of credit, is also responsible for the formulation of policies dealing with the level and structure of interest rates, the distribution of credit and volume of financial savings in the country.

These policies are closely connected with the management of the balance of payments, which is an over-riding responsibility of the central bank. These policies cannot be formulated in isolation. They must be consistent with government objectives of achieving economic and social development on the one hand and price stability and a desired level of international reserves on the other. This shows the importance of full participation of the central bank in the determination of the proper mix of policies in the financial and economic field. Furthermore, the proper relation between the government and the central bank is vital, particularly when a government is faced with fiscal difficulties. Very often the central bank faces extreme pressure to accommodate fiscal deficits, which not only affect the effectiveness of monetary policy, but also distort the rational distribution of bank credit.

The hypothesis of stimulating economic growth through credit expansion is well known, particularly in developing countries. However, credit expansion can be adopted as a policy strategy only if the economy is not constrained by paucity of external reserves. In fact, there is wide agreement that large fiscal deficits financed by the central bank lead to disruption of the flow of savings, balance of payments difficulties, low foreign reserves and a low rate of economic growth[7]. This means that the central bank will have to resist certain courses of action adopted by the government in order to defend its most essential responsibilities. In this context, the autonomy of the central bank is vital. However, this does not mean that the central bank can operate outside the institutional framework of the government. Even the most independent central banks, like the Bundesbank of the Federal Republic of Germany, are required to support the general economic policy of the government. Autonomy of the central bank essentially means that it must be allowed to be a full-fledged partner in the process of economic decision making. In fact, greater co-ordination between fiscal and monetary policies has been recognised as an essential ingredient in effective economic management. It must also be recognised that the government and the

---

7 The World Bank, World Development Report - 1988.

central bank have mutual interests and complementary responsibilities in their operations.

Conflicts between Central Bank and the Government

The role that the central bank can play independently depends not only upon its constitutional autonomy but also upon the circumstances under which policies are formulated. In most countries autonomy of the central bank is ensured by legal provisions as well as by certain conventions. For instance, the tenure of office of the Governor is legally secured in most of central banks. Similarly, the independence of the central bank is assured when the government recognises the authority and superiority of the central ank in formulating monetary policy consistant with government objectives. Nevertheless, proper communication and continuous interactions between the central bank and the government is important if the central bank wants to safeguard its independence in conducting monetary and credit policies. Experience shows that lack of communication can lead to conflict between the two institutions. The US experience provides a good example. When the US economy experienced high inflation during the Vietnam war, the government of President Johnson continued to favour expansionary policies. Since the government was unwilling to follow contractionary fiscal measures to combat inflation, the Federal Reserve System decided to follow tight monetary policies in the latter part of 1965. This resulted in a serious conflict between the government and the Federal Reserve System as there was no proper dialogue or understanding between the two institutions. However, the conflict was settled as both parties argued that the disagreement was caused basically by a difference in judgement. This shows that proper communication between the two institutions is an essential ingredient in avoiding conflict.

Conflict between the central bank and the government can arise due to various other factors as well. One possible area for such conflict is the selection of instruments to solve a given set of economic problems. In theory, the government has the authority to use fiscal instruments to achieve its objectives while the central bank is allowed to use monetary policy instruments to achieve the objectives of the monetary system. However, in practice, the selection of instruments is not so obvious and also depends on a variety of other considerations. Very often the selection of instruments is determined on the basis of socio-political considerations rather than on pure monetary factors. There can also be disagreement between the government and the central bank about the effectiveness of various policy instruments. For instance, interest rate policies in many countries have been based on a variety of factors rather than on pure monetary considerations, for some valid reasons. The same argument can also be true with respect to credit policies of many developing countries. In dealing with these complex issues the central bank cannot take a pure monetarist view point.

There are also cases where the government has a general tendency to focus on short term objectives, while the central bank is keen to attain long term goals. Sri Lanka's experience provides a good example of this. In the early years of the 1950's, the Central Bank of Sri Lanka took the position that it would be unwise for the Bank to extend credit to the government for its welfare oriented fiscal policies, as maintaining the external reserve position in the presence of high fiscal deficits was no longer feasible. On these gounds, the Governor refused to accommodate the government's request for bank credit. It was hoped that this measure would compel the government to restrain public expenditure, particularly expenditure on food subsidies. However, the Central Bank was not successful in influencing government policies as the government was constrained by political considerations. These examples demonstrate certain constraints under which central banks and governments perform their duties.

The conflicts between the central bank and the government can be avoided in most circumstances. The central bank must recognise that it is the government that is ultimately responsible for the overall economic policy of the country and is directly answerable to its people. At the same time, the government should recognise the fact that the responsibility of the central bank involves taking a detached view of the economy, free from political bias. In fact, central banks are established essentially to safeguard the economy from potential economic hazards, particularly of a monetary nature. However, the efforts of fighting inflation and macro economic imbalances through monetary policies alone cannot succeed fully if fiscal deficits are not kept under control. In many countries, despite restrictive monetary policies, the inflation rate climbed and external reserves deteriorated mainly due to large budget deficits.

Governments must therefore remain committed and able to take appropriate measures to reduce fiscal deficits. In this regard, the central bank has to play a vital role in advising and exerting pressure on the government to adopt sound fiscal policies. In most countries, monetary targets are set by the central bank in agreement with the Treasury. In this manner, the central bank compels the government to take responsibility to pursue fiscal and other policies that are in the best interests of the country.

Central Bank of Sri Lanka and the Government

The main functions of the Central Bank of Sri Lanka are broadly the same as those of other central banks world-over. They are: to act as currency issuing authority, bankers' bank, banker to the government and fiscal and financial advisor to the government. Besides these traditional and universal functions, the Central Bank is also entrusted with a wide range of functions relating to the growth and development objectives of the country within the framework of general government policy.

Successive governments in Sri Lanka since Independence, have attached great significance to economic development in the country. Accordingly, governments have assumed a greater responsibility for economic management. A sustainable rate of economic growth, a high level of employment, raising the standard of living and a reasonable balance in the country's external account have come to be recognised as primary objectives of national economic policy in Sri Lanka. As a consequence, the role of the Central Bank too has changed. The principal objectives of the Central Bank in this context are to preserve the stability of the exchange rate of the Sri Lanka rupee vis-a-vis foreign currencies, provide necessary banking and credit facilities, provide financial and economic advice to the government, create monetary stability and sound financial structure in the economy, maintain a high level of production and employment and encourage the development of the country's productive resources. Thus, the main objectives of the Bank form a part of the broader goals of economic policy of the government.

The Bank's relationship with the government is a unique one. In the field of economic development, the Bank is an active partner with the government. In matters relating to public debt and exchange control, the Bank acts as an agent of the government. It also acts on behalf of the government or government agencies in guaranteeing, insuring or participating in any banking transaction. It functions as banker to the government. In the context of economic management of the country, the Bank plays an advisory role. Here, the Bank functions as financial advisor and fiscal agent to the government. Hence, it is clear that there are many aspects to be considered in explaining the Bank's relations with the government.

Although there is a formal institutional separation, the Central Bank of Sri Lanka can be regarded as an arm of the government. Accordingly, it contributes to the national economy in creating conditions conducive to the achievement of growth and development objectives, particularly through its ability to influence the availability and cost of money and credit. In regulating money supply and the cost of credit, the Central Bank can use several instruments. It can use Bank Rate to influence the interest rate structure in keeping with the prevailing monetary conditions. The Bank can also use open market operations and variable reserve ratios to deal with the liquidity situation in the country.

In achieving monetary policy objectives, the Bank can also impose credit ceilings. However, in keeping with growth and development objectives of the government, the Central Bank can be more selective in the use of monetary policy instruments. Hence, in managing money and credit, the Bank relies heavily on specific measures such as selective credit controls, refinance schemes etc., in order to ensure an adequate supply of credit to priority sectors in the economy while achieving monetary stability. When there is inflationary pressure and a deterioration in the country's external reserves, the government has to turn to the Central Bank for guidance and advice. If budgetary policy is responsible for such developments in the economy, the Central Bank's influence becomes clearly visible as the government is prevailed upon to reduce large fiscal deficits to mainten balance of payments objectives and control inflation. The Central Bank's intervention and timely action to arrest such economic problems are important aspects of its functions. In this context, the Central Bank provides the government with a more detached but considered view of policies to be followed in achieving national economic objectives.

to achieve national development objectives within the framework of monetary stability.

The law stipulates that the Central Bank of Sri Lanka is the authority responsible for the administration and regulation of the monetary and banking system of Sri Lanka. As banker to banks, it maintains accounts of commercial banks and acts as the lender of last resort. The Bank provides refinance facilities to commercial banks to channel adequate credit to priority sectors. Bank supervision, which is a statutory duty and an integral part of the operations of the Bank, aims at protecting depositors' interests and promoting efficiency in the banking and financial system. The bank examinations and supervisory functions are of particular value to the Central Bank in formulating monetary policy measures in the field of banking and finance and in providing advise to the government on monetary and fiscal matters as well.

Through its daily operations in foreign exchange markets, close interactions with commercial banks and other financial institutions, supervision of banking and financial institutions and performance of banking functions to the government, the Central Bank gains technical knowledge and practical experience in financial and economic management of the country. This, in turn contributes greatly to the Bank's competence to provide financial and economic advice to the government. Like other central banks, the Central Bank of Sri Lanka acts as an adivsor to the government, not only on policies concerning banking and financial matters, but also on a wide range of economic issues including those in the field of planning and resource mobilization. In recent years, open market operations through Treasury bills have contributed to raising a substantial volume of resources for government's fiscal operations from non-bank sources in the country. The Central Bank has special responsibility in respect of policies and measures concerning development finance, development of banking and capital markets, and legislation affecting banking and credit in the country.

The Central Bank is the main channel of communication between government agencies and banks and financial institutions. In the discharge of its obligations to the government, the Central Bank is called upon to report periodically on the development of the economy so as to act as an early warning mechanism. The Bank also keeps the government informed of the developments in the financial sector from time to time. Through the Bank's publications released to the public, and confidential communications addressed to the government, the Central Bank constantly offers advice on vital issues of economic importance confronting the country from time to time. For effective discharge of these advisory functions, the Bank undertakes research activities relating to policy decisions and their impact on the economy. Certain studies undertaken by the Bank are published in the Central Bank Staff Studies. The Annual Report of the Central Bank which is submitted to the Minister of Finance examines the economic performance every year and gives an unbiased view of the developments in the economy[9]. This report is widely used by parliamentarians, the business community and the general public when they discuss economic issues. Thus, the Central Bank provides necessary information and analyses on various issues on a regular basis, to adopt policies that can increase financial and economic activity with growth in production, income and employment in the country.

As detailed earlier, in many countries various legal provisions have been made to establish co-operation between the Central Bank and the government. In Sri Lanka, the Monetary Board of the Central Bank has been constituted to include the Secretary to the Ministry of Finance in order to ensure that government views will be made known to the Monetary Board at all times in conducting monetary policy. The Governor, who is also the Chairman of the Monetary Board, is also appointed by the President. Therefore, there is a close and direct link with the government at the very highest level of authority. The Monetary Board is required to meet once a fortnight. Whenever economic and financial circumstances require the attention of the government, the Monetary Board is obliged to report these developments to the Minister of Finance. The Monetary Board is also obliged to submit annually a report for the use of the Minister of Finance in formulating the annual government budget[10]. In this confidential document, the Monetary Board reviews the economic performance and development in prices, external accounts and monetary movements and suggests appropriate

---

9 According to Section 35(1) of the Monetary Law Act, the Monetary Board is required to submit the Annual Report of the Central Bank within four months after the end of each financial year. The report shall include the condition of the Central Bank and the review of the policies and measures adopted by the Monetary Board during the year and an analysis of the financial and economic circumstances of the country.

10 The Report under Section 116(1) of the Monetary Law Act.

fiscal measures that the Central Bank would consider necessary for the government to adopt in order to achieve certain macro economic objectives. In this manner, the views of the Central Bank are conveyed to the government and close liaison between the Central Bank and the Ministry of Finance is maintained. The Monetary Board also provides a forum for those at the highest levels of authority to discuss and examine economic issues and take appropriate actions.

The Central Bank is also regarded as the representative of the government in matters relating to the International Monetary Fund. In this regard, the Central Bank plays the role of negotiator and very often as sponsor for government proposals. The Central Bank also plays a vital role in annual consultation with the International Monetary Fund. In the process, government policies are placed before the Fund for negotiation. In this manner, the Central Bank plays a dual role as advisor to the government and as the spokesman of the government.

The Central Bank of Sri Lanka also undertakes promotional activity on behalf of the government in order to enlarge the base of the financial structure and also to promote the growth and development objectives of the government. In its development role, the Central Bank acts through commercial banks and induces them to lend to sectors which would promote growth. However, commercial banks, being basically profit oriented institutions, tend to focus on low risk lending activity. Hence, the Central Bank of Sri Lanka has introduced refinance facilities to provide both short term and medium term loans. In this manner, the Central Bank provides an enhanced supply of financial resources for growth. Since the rural sector plays a dominant role in Sri Lanka's economy, the Central Bank has become directly involved in rural sector development activities. In this context, the Central Bank has implemented small scale agricultural and industrial credit programmes to assist rural economic activities. The Bank has taken the initiative to encourage rural banking and mobilization of rural deposits to promote saving in the country. Under the Regional Rural Development Bank Scheme, it is hoped to ensure a smooth flow of credit into priority areas within the rural sector. In keeping with government development efforts, the Central Bank has become involved in matters relating to national credit planning, financial intermediation and provision of concessional lending to priority sectors such as export promotion. Furthermore, the

Bank has initiated institutional reforms in the banking sector. It has been responsible for the establishment of banking and savings institutions inclusive of joint venture commercial banks. The Bank's effort in this field of activity is to enhance the provision of credit and to promote savings which are vital for Sri Lanka's development effort.

As explained earlier, there can be conflict between the government and the Central Bank in reaching conclusions on economic issues. During periods of macro economic instability, the Central Bank has a duty to warn the government against the adverse consequences of unstable macro economic conditions such as rapid growth in money supply, inflation and external deficits. However, the government may be reluctant to take unpopular policy measures and could take a different policy stance from the Central Bank. The management of the Budget is a common area of conflict between the Central Bank and the government. As mentioned before, such a conflict occurred in 1953, when the Central Bank was critical of the government budget, particularly with regard to the question of deficit financing. In the case of deficit financing of the budget, the Central Bank pointed out that the government must make two critical decisions regarding the deficit. They were (a) the safe limit of the deficit and (b) the proper purposes for which the deficit ought to be incurred. The Central Bank took the position that the room for deficit financing in Sri Lanka was limited as fiscal expansion would lead to an erosion in the external assets through an increase in imports. The Bank also argued the case against excessive subsidies. The 1952 Annual Report argued that "as subsidies grow, government may be forced into the most unenviable position of having to decide to forgo much needed development expenditure rather than raise the price of rationed rice"[11]. However, these kinds of conflicts should be viewed as differences of opinion between the government and the Central Bank. While government is keen on pursuing short term policies in the expectation of immediate results, the Central Bank looks for long term sustainable solutions within the framework of monetary and macro economic stability in the economy.

11 Central Bank of Ceylon, "Annual Report of the Monetary Board To The Minister of Finance". 1952. p.7.

Concluding Remarks

The foregoing sections have brought out the fact that the relationship between the central bank and the government is based on some unique considerations. In broad terms, central banks have become an integral part of governments, though in many respects they are independent, particularly in their operations and their thinking. Although the central bank is primarily responsible for monetary policies while the government is responsible for general economic policies and fiscal matters, there is no clear demarcation between these two sets of policies. In essence, all these policies fall within the broad macro economic framework of the government. Hence, it can be said that the successful macro economic management in a country requires a close working relation between the central bank and the government. The closer and more effective the working relationship between the two sides, the better is the management of the economy.

The relationship between the central bank and the government has mutual benefits. On the one hand the government can benefit from technical advice which the central bank can provide on the monetary implications of government policies. The central bank can also facilitate the implementation of government policies by taking appropriate monetary policy measures and actions. On the other hand, the central bank requires complementary actions by the government. In fact, monetary policy objectives can be achieved more effectively if fiscal policy measures are taken in conjunction with monetary policies. All these aspects of the central bank - government relationship depend very much on the way that the relationship is maintained. David L. Grove assigned a great responsibility to the central bank in this regard. He argued that "An effective government - central bank relation requires the exercise of great tact and discretion on the part of the central bank. The bank must know when and how far to oppose government policies which it considers ill advised, but it must also know when and how to compromise and to make the best of a bad situation. A central banker therefore must at the same time be a master of the art of diplomacy"[12].

12 David L. Grove, "Central Bank Independence and the Government - Central Bank Relationship," Financial Institutions and Monetary Policy, Vol.II, Economic Development Institution.

The experience in Sri Lanka suggests that there has been close and harmonious relationship between the Central Bank and the government. The Central Bank has dealt with different governments on different and complex economic issues such as adverse movements in external terms of trade, oil price shocks, balance of payment difficulties, high budget deficits, domestic inflation, consumer subsidies etc., and has assisted the government in taking appropriate policy measures that helped Sri Lanka to overcome those economic problems. The relationship between the government and the Central Bank can be further strengthened in this manner through co-ordinated work programmes and policy dialogue on the basis of mutually reconcilable goals.

References

Basu, S.K. "Central Banking in the Emerging Countries : A Study of African Experiments," Asia Publishing House, 1967.

De Kock, M.H. "Central Banking "(3rd ed.), Staples Press Limited, 1954.

Galbraith,J.A. "The Economics of Banking Operations", McGill University Press, 1963.

Government of Ceylon, Sessional Paper XIV - 1949. "Report on the Establishment of a Central Bank of Ceylon," November, 1949.

Grove, David L. "Central Bank Independence and the Government - Central Bank Relationship," in Financial Institutions and Monetary Policy Vol. II, Economic Development Institute.

Karunatilake, H.N.S. "The Banking and Financial System of Sri Lanka," Centre for Demographic and Socio- Economic Studies, Colombo, 1986.

Karunatilake, H.N.S.. "Central Banking and Monetary Policy in Sri Lanka," Lake House Investments Limited, 1973.

Lord Cobbold. "Some Thoughts on Central Banking," Journal of the Institute of Bankers, February, 1963.

Mittra, Sid."Central Bank versus Treasury: An International Study", University Press of America, 1978.

Rasaputra, Warnasena. "Banking Development in Sri Lanka",UMBC Economic Review, Vol.XIX, No.1, 1983

Rasaputra, Warnasena ."Relationship of Central Banks with Treasuries, Planning and Development Agencies in the Government," Occasional Paper No. 10, Central Bank of Sri Lanka, 1985.

Southard Jr., Frank A. "The Central Bank in the Policy Making Process," Finance and Development; Vol.V, No. 1, March, 1968.

The Deutsche Bundesbank. "The Deutsche Bundesbank, Its Monetary Policy Instruments and Functions" (3rd ed.) Special Series, No. 7, July, 1988.