Chapter 5

Promoting Investment and Foreign Trade

The Central Bank has played an effective role in helping to promote domestic investment and foreign trade in Sri Lanka. Adequate levels of investment and foreign trade are imperative to achieve economic growth. However, economic growth achieved through strenuous efforts is not sustainable in the long run unless economic stability is ensured. Therefore, the Central Bank is also expected to help attain economic stability in the country through its monetary policy instruments. Domestically, the general price level needs to be stabilised. Externally, the balance of payments should reach equilibrium. Inflation has adverse effects on the export sector and the resulting external payments imbalance tends to disturb the growth momentum. The responsibility of the Central Bank in this context is to help in setting up an economic environment for a steady growth path without disrupting stability either internally or externally. The Central Bank of Sri Lanka has performed this task successfully over the past four decades by adopting various policy measures including the use of monetary instruments, control of the banking system and non-bank financial institutions, exchange rate management and exchange control.

The monetary and financial management adopted by the Central Bank, from time to time, has been geared to facilitate the achievement of broad economic objectives of different regimes.[1] In this connection, it is significant to note that the Central Bank has diversified its functions to meet the challenging demands of a growing economy, particularly with respect to investment and foreign trade expansion. The expansion of these functions of the Central Bank has been significant since 1977. A package of fundamental policy reforms was introduced in 1977. These policies were aimed at more efficient resource allocation through trade liberalisation, a flexible pricing and exchange rate system, a rationalised tariff structure and prudent monetary and financial policy measures. These policies were expected to promote economic growth and employment prospects. The Central Bank actively participated in the formulation and implementation of these policies.

Historical Background

During the first decade following Independence (1948-1959), Sri Lanka initiated several development programmes. A salient feature of these programmes was the emphasis given to promote production activities other than the plantation crops sector, which had been given high priority during the colonial administration. This was stressed in the Six Year Plan of 1948, the first planning document after Independence.

The establishment of the Central Bank in 1950 marked a significant step towards promoting economic activities. The Central Bank actively participated in the implementation of programmes laid down in the development plans adopted since the 1950s. The second Six Year Plan was begun in 1954 in consultation with the World Bank. The Central Bank's participation has been crucial in the meetings with the World Bank Missions since then. In the development plans, priority continued to be given to agriculture, including irrigation and land development. The balance capital expenditure was allocated among transportation, power, health and education.

1 For a detailed analysis of the evolution of the Central Bank, please see Dr. H.N.S.Karunatilake, "The Banking and Financial System of Sri Lanka", 1986.

The economic strategy adopted under the new administration of 1956 departed from the previous policies. The broad development strategies followed during this period were reflected in the First Interim Report[2] and the Ten Year Plan[3]. These documents identified the basic problems of the economy and stressed the need to raise domestic investment in the sectors of agriculture and industry.

By the beginning of the 1960s, the country was confronted by several economic problems. During this period, the Central Bank had to play a more active role in the overall management of the economy in view of the emerging economic instability. On the external front, the balance of payments began to deteriorate in the late fifties, mainly due to the faster increase of imports over exports. Inflationary pressures were also beginning to surface in the late fifties due to monetary expansion. The promotion of both export trade and domestic investment was considered essential to overcome these problems. Import restrictions and tight monetary measures were viewed as the most appropriate corrective measures during that period.

The balance of payments deficit had been financed mainly by drawing down external reserves prior to 1961. The reserves went down to substantially low levels by 1960 and therefore, foreign assistance was sought to meet the external deficits after 1961. Drawings were made from the IMF in 1961 and 1962 to prevent further depletion of reserves. The Central Bank played a crucial role in negotiating with the Fund to obtain such assistance. Also, the Central Bank was expected to help import substituting industries indirectly by enforcing exchange control regulations. These included margins on Letters of Credit and quantitative restrictions on bank advances for imports. Domestic savings and investment in relation to GDP showed a marginal improvement during 1960-64 as compared with the previous decade. The average annual GDP growth rate moved from 3.1 per cent in 1948-59 to 4.1 per cent in 1960-64.

The adverse impact of the quantitative restrictions on economic activities was felt by 1965. The immediate task of the Government which

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2 Planning Secretariat, First Report, National Planning Council, 1957.

3 Planning Secretariat, Ten Year Plan, 1959.

took over office in that year was to promote economic growth and expand employment opportunities while maintaining a reasonably sound balance of payments position. For this purpose, a larger inflow of capital and intermediate goods was necessary. Since export earnings were not adequate to meet this demand, mobilisation of foreign aid was considered to be inevitable. The planned targets and investment allocations were laid down in the Annual Development Programme 1966-67. Accordingly, the Budget proposals for 1966-67 provided for a 31 per cent increase in investment. For the first time, policy makers emphasised the need to obtain foreign aid to meet the investment targets.

The Central Bank has played a key role in mobilising resources for enhanced investment, particularly from foreign sources, since the mid sixties. These resources were obtained mainly through the Sri Lanka Aid Consortium set up in 1967. The annual aid group meetings have been held since then and the outcome of these meetings largely depended on the development and stabilisation programmes prepared by the local authorities in collaboration with the International Monetary Fund and the World Bank. The Central Bank has been an important participant in the preparation of these programmes, since it coordinates and provides the necessary factual information for the conduct of regular and specific consultations with these two organisations.

On the recommendation of the Central Bank, several policy measures were taken in the second half of the 1960's to promote exports. In order to encourage the minor export crop sector, the Bonus Voucher Scheme was introduced in 1966. Since the exchange rate was found to be unrealistic, the rupee was devalued by 20 per cent in 1967. As a further incentive to the export sector, a dual exchange rate was introduced in 1968 under the Foreign Exchange Entitlement Certificate (FEEC) Scheme which provided a depreciated exchange rate system for non-traditional exports and non-essential imports. This Scheme was administered by the Central Bank.

By the beginning of the 1970's, the problems of unemployment and balance of payments deficits became acute. In the background of these problems, the Five Year Plan (1972-76) was presented in 1971. It envisaged a gradual increase in domestic savings and investment over the medium term so as to attain a higher growth rate. The FEEC scheme continued to be in operation during this period. The Convertible Rupee Account (CRA) Scheme was introduced in 1972 to boost further the minor export sector by granting exporters a share of export earnings in foreign currency. Mobilisation of foreign resources also showed an increase during this period. However, external assistance was maintained at a low level during 1970-77 and therefore, domestic investment was largely financed by domestically generated savings. Hence domestic investments remained low until 1972. The Five Year Plan was not successful for various reasons.

Post-1977 Policy Reforms

The change of the government in 1977 marked a turning point in economic policies. The contribution made by the Central Bank to facilitate these policy reforms was substantial. The capacity of any economy to grow depends largely on the ability to save and invest. As discussed above, both savings and investment remained at a low level during 1970- 77. Private sector savings were at a low level due to limited activities. Government sector savings also did not improve due to increased recurrent expenditure. The savings of public corporations were hampered partly by their inefficiency. The policies that were followed up to 1977 were geared to maintain stability at the expense of growth. Accordingly, policy makers preferred to maintain a low economic growth without creating imbalances in the government budget and balance of payments. Various direct administrative controls were imposed to achieve this end. As a result, investment was not much higher than domestic savings. A different policy strategy was introduced by the government that came into power in 1977. It was realised that the restrictive policies that were followed during the earlier period constrained domestic economic activities and resulted in a slow growth process. It was necessary to overcome problems such as unemployment, balance of payments difficulties and production shortfalls immediately. As mentioned above, the capital stock was not raised during the previous regime. In order to revitalise the economy, therefore, action was taken to promote public and private investment to unprecedented levels after 1977.

Production activities were also constrained by the limited imports of intermediate and investment goods during the period prior to 1977.

Stringent import and exchange controls were in operation during that period. This resulted in production shortfalls in both import substituting and export oriented production sectors. In view of these adverse repercussions of administrative controls, the Central Bank took part in the preparation of a policy package to liberalise and simplify the exchange and trade system in 1977. The basic strategy of these reforms was to allow the price mechanisms to determine economic activities and to eliminate the influence of import and exchange controls. Accordingly, action was taken to remove the prior licensing requirements for a wide range of imports and service payments. Under these reforms, prior licensing was restricted only to certain items that had a bearing on essential consumption and national security. The trade liberalisation that was started in 1977 continued to be widened in subsequent years by the removal of more goods from the prior licensing requirement.

The export oriented growth strategy that was followed after 1977 called for the steady maintenance of export competitiveness, mainly through a managed floating exchange rate system. In this regard, the task performed by the Central Bank in exchange rate management has been noteworthy. Until November 1977, a dual fixed exchange rate system had been in operation in Sri Lanka. Under the floating exchange rate system that has been adopted since then, the Central Bank intervenes in the determination of the exchange rate on a daily basis, taking into account various factors including the demand and supply situations in the foreign exchange market and domestic and foreign inflation. In this context, a primary concern of the Central Bank is to prevent any abrupt fluctuations in the exchange rate that could adversely affect the export competitiveness of the country.

The Central Bank also made a significant contribution to rationalise the tariff structure, which was a major element of the trade reforms introduced after 1977. In line with the aim of the trade liberalisation, it was necessary to revise the import and export duty structure so as to improve the efficiency of the price mechanism and to reduce distortions. For this purpose, the Tariff Review Committee was established after the liberalisation. The Committee recommended several changes in import tariffs. Subsequently, a Presidential Tariff Commission was appointed to rationalise the tariff structure. Following this, a major tariff reform was introduced in 1984. The Central Bank provided the necessary technical support and policy guidelines for the formulation of these reforms.

The Central Bank also had to bear a considerable burden in mobilising the enormous financial resources that were required to realise the unprecedented investment levels envisaged after 1977. The efforts of the Central Bank in this connection were partly reflected in the increased activities in the money and capital markets in this period.

A major objective of policies followed since 1977 was to raise .domestic investment to a substantial level so as to revitalise the stagnant economy. For this purpose, it was necessary to raise the capital expenditure of the public sector. It was also realised that there was a need to allow the private sector to participate in economic activities more liberally unlike in the previous period. Accordingly, the private sector was expected to engage extensively in the production of goods and services and government participation was to be confined to providing the necessary economic infrastructure to facilitate the production activities. This strategy was reflected in the Public Investment documents published since 1977[4]. The bulk of public investment was allocated to upgrade the infrastructure of the country. Investment targets envisaged for both public and private sectors were relatively high, as against the low level of domestic savings. In this context, the Central Bank had to play a vital role in the mobilisation of financial resources from both domestic and foreign sources so as to match the enhanced investment requirements. In particular, the Central Bank was instrumental in conducting negotiations with the IMF and the World Bank which provided extensive financial support to Sri Lanka to carry out the investment programme.

The motivation of the private sector to invest depends on the prevailing investment climate to a considerable extent. Therefore, private investors should have confidence in the economic policies that are to be followed. Their confidence was disturbed during the earlier regime due to factors such as nationalisation policies, direct government intervention and low rates of return for investments. The elimination of these deficiencies was not an easy task. The Central Bank, which is at

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4 These programmes were published annually by the National Planning Department of the Ministry of Finance and Planning on a "rolling plan" basis.

the apex of the banking and financial system, was instrumental in reviving confidence among private investors so as to promote private investment. For this purpose, a package of monetary and fiscal policies has been introduced since 1977. These included interest rate reforms, extending credit facilities to the private sector, development of the share market, encouragement to open foreign bank branches and incentives to foreign investors. The Central Bank also took action from time to time through its monetary controls, to help maintain stability in the general price level and the balance of payments. The assurance of stability in these two spheres is a prerequisite to attracting domestic and foreign investment.

The guidance given by the Central Bank to financial institutions has been very effective. Since 1981, the Central Bank has formulated the National Credit Plan annually as a guide to credit operations of commercial banks and long-term credit institutions. These plans indicate the targetted credit allocations to each sector in terms of national priority. This was very effective in diverting investible resources to more productive purposes in terms of national priorities.

In order to attract foreign investors so as to promote the export sector, it was considered useful to allow internationally reputed foreign banks to open branches in Sri Lanka. The Central Bank played the leading role in this innovative action. The Bank designed a suitable scheme for this purpose and a number of foreign bank branches were opened after 1979. At present, 18 foreign banks operate in Sri Lanka. The arrival of foreign banks was an important step taken towards attracting foreign investors, since the existence of these banks reflects the soundness of the investment climate.

As a further measure to promote investment in export oriented industries, the Central Bank introduced the concept of off-shore banking in 1979. From the initial stages, the Central Bank has been engaged in the development of these banking units, which are known as Foreign Currency Banking Units (FCBUs). The FCBUs fulfil the financial needs of entrepreneurs in the Investment Promotion Zones, who require specialised banking facilities that are not available in an ordinary banking system. Transactions in these units are carried out in foreign currencies and such transactions are restricted to non-residents, approved residents and GCEC enterprises. It was expected that this scheme would facilitate foreign investment transactions. It was also expected that the FCBUs would help to develop an international money market in Sri Lanka.

From among the measures adopted in recent years by the Central Bank to promote savings and investment, the expansion of the Treasury bill market was one of the most significant. Treasury bills have been used as a major means of financing the government budget deficit throughout. However, investment activities in the Treasury bill market had been largely confined to contributions made by the Central Bank until recent times. The participation of the public was limited and therefore, the market was not active. A major reason for this was the absence of a developed money market in Sri Lanka. In the context of poor contributions from the non-bank sector, the Central Bank continued to subscribe to the share of Treasury bills that was not purchased by the public or institutional investors and this share was very large. As a result, the share of Treasury bills held by the Central Bank was about 90 per cent. In view of the expanding budget deficits, the need arose in the late seventies to mobilise more resources from the non-bank sector so as to contain the inflationary implications of deficit financing. For this purpose, the Central Bank introduced a secondary market for Treasury bills in 1981. Under this scheme the Central Bank sells its holdings of Treasury bills purchased in the primary market to commercial banks and other investors and also purchases Treasury bills depending on the market conditions. This reform has provided an impetus to banks and the general public to engage in short-term investment. Accordingly, this scheme has helped to popularise savings habits and investment. This is evident from the increased participation of the non-bank sector in the Treasury bill market in recent years.

Development of the Share Market

The Central Bank has made a significant contribution towards the growth of the share market during the last decade. The share market in Sri Lanka began in the early 19th century and was active in meeting the capital requirements of the plantation sector during the colonial regime. The market became weak with the introduction of exchange control regulations in the 1950's and subsequent policies geared towards nationalisation of private enterprises.

Following the liberalised economic policies adopted since 1977, the private sector was expected to play a more important role in revitalising the economy. Therefore, the Government introduced a series of policy reforms to encourage private sector participation. The Central Bank initiated most of these and provided the necessary technical assistance to formulate and implement these measures. A number of fiscal incentives and tax concessions were granted to shareholders and companies issuing shares to the public. The outdated Companies Ordinance of 1938 was amended in 1982.[5] The new Act has helped to build up much needed confidence among the public so as to popularise share market activities.

The establishment of the Colombo Stock Exchange in September 1982 was a further step in the expansion of the share market. The Central Bank initiated setting up a Capital Issues Committee to facilitate share market transactions in 1982. Action was also taken to encourage the establishment of specialised intermediaries such as share brokers, merchant banks, development banks and management consultancy firms. In order to regulate the activities of the market, the Securities Council Bill[6] was passed in Parliament in 1987. These measures have contributed to the increased activities of the share market as shown in Table 5.1.

Concessions for Medium and Long Term Capital Formation

The Central Bank has been actively involved in the promotion of investment in productive sectors. A major instrument that has been used for this purpose is the Medium and Long-Term Credit Fund (MLCF). The MLCF was established in July 1964[7]. The need for the Central Bank to engage in promoting credit facilities in such a manner was foreseen in the Exter Report[8].

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5 Companies Act No. 17 of 1982.

6 Securities Council Act No. 36 of 1987.

7 The MLCF is governed by Section 88 of the Monetary Law Act introduced by the Finance Act No. 11 of 1963.

8 Report on the Establishment of a Central Bank for Ceylon, Sessional Paper, November 1949, p.7

Table 5.1
Share Market Indicators (1985-1989)

	1985	1986	1987	1988	1989
Market Capitalisation as at 31st December (Rs. Mn.)	10,029	12,026	18,728	15,571	17,087
Total number of Shares issued as at 31st December (Mn.)	733	779	819	919	1,048
Value of Shares issued as at 31st December (Rs.Mn.)	7,334	7,790	8,196	9,190	10,404
Number of Shares Traded (Mn.)	5	6	17	13	12
Value of Shares Traded (Rs.Mn.)	79	142	334	3,792	55
CSE All Share Price Index Annual Average (1985 = 100)	100.0	136.8	177.9	170.8	176.8
CSE Sensitive Price Index Annual Average (1985 = 100)	100.0	257.2	305.2	269.9	325.7
Percentage of the Total Issued Capital Traded	0.74	0.82	2.1	1.43	1.17
Value of Shares Issued as a Percentage of GDP	4.52	4.34	4.17	4.12	4.12
Value of Shares Traded as a Percentage of GDP	0.05	0.08	0.17	0.17	0.10

Source: Colombo Securities Exchange (GTE) Ltd.
Central Bank of Sri Lanka

"It is obvious that the resources of the Island cannot be fully developed unless credit is made more freely available. But a Central Bank cannot force a commercial bank to lend when it does not want to lend. It is therefore advisable that in Ceylon the Central Bank should have authority to lend at certain times to credit institutions other than commercial banks and that it should have the authority to take measures to reduce some of the normal risks of lending in Ceylon...... In order to reduce risks of lending in Ceylon the Central Bank should have the authority to act as agent of the Government in such systems of loan insurance or loan guarantees as may be established in the future".

The objective of the MLCF was to encourage lending by credit institutions for productive purposes by making available refinance facilities. The productive purposes were defined to include industry, agriculture, trade, commerce and business as the Monetary Board may determine from time to time. The capital resources of the Fund are based on periodic transfers from the reserves of the Central Bank, capital repayments of loans and interest charges on loans granted. The Central Bank has utilised the resources of the Fund to provide financial accommodation to financial institutions with respect to the advances provided by them for the above-mentioned productive purposes. Accommodation provided by the Central Bank is repayable within a period not exceeding 15 years and should be secured by an assignment to the Bank by way of pledge of debts owed to such institutions and of mortgages given as security to such institutions. At present, refinancing facilities are administered by the Development Finance Department and the Rural Credit Department of the Central Bank.

The Monetary Board has been empowered to prescribe such conditions, as it may deem necessary, subject to which loans and advances will be made available out of the MLCF. The Monetary Board also has the authority to determine the interest rate to be charged by the Central Bank on such loans and advances and the interest rate to be charged by the borrowing institutions. Thus, control of the MLCF has been fully entrusted to the Central Bank. This scheme provided immense support to meet the medium and long term investment needs of the economy. In view of the risk involved and the low rate of return with respect to this type of investment, the traditional banking system is not normally prepared to accommodate such needs. Using the MLCF, the Central

Bank has stimulated the financial institutions to grant loans for capital formation in productive activities at concessional terms and conditions while maintaining prudent returns for such loans.

The MLCF became operational effectively only in mid-1966 since there were no loan applicants until then. The annual disbursements in the three years following 1966 remained below Rs.34 million. The Central Bank supported the Tea Factory Modernisation Scheme during that time and agreed to refinance the domestic credit cost of the Project. The foreign exchange cost of the project was to be financed by a loan from the Asian Development Bank. Refinance provided to the project became an important component of the MLCF in subsequent years.

Financial assistance provided under the MLCF began to accelerate in the second half of the 1970s consequent to the expanded investment in hotel projects sponsored mainly by the Development Finance Corporation of Ceylon (DFCC). The willingness of commercial banks to accept the MLCF as a source of investment also helped to extend the scheme.

In order to meet growing financial needs, the Central Bank undertook a major revision of the MLCF in the latter half of 1979. This revision was expected to direct resources into priority sectors in the economy. This was achieved by means of changes in the amount of refinance, rate of refinance and other terms and conditions. Taking into account the export oriented growth strategy introduced after 1977, the Central Bank expanded the scope of the MLCF further in 1980 so as to enable commercial banks and credit institutions to participate more comprehensively in the promotion of export- oriented industries. Accordingly, export-oriented industries designated by the Export Development Board qualified for concessional finance from commercial banks and credit institutions. Loans granted under the scheme are eligible to receive upto 80 per cent refinance from the MLCF at a refinance rate of 10 per cent.

Following the revision, the projects that qualify for assistance under the MLCF have been divided into four categories.

Category I: loans given for agriculture and fisheries under schemes approved by the Ministries;

Category II : loans granted for promotion or development of exports from Sri Lanka, including production of goods and commodities for export and activities antecedent to such production like cultivation of agricultural products and setting up of facilities for procuring and manufacturing for export of agricultural and industrial goods;

Category III: loans given for approved investments carrying tax holidays (under Section 17 of the Inland Revenue Act No. 28 of 1979) and loans given for agriculture and fisheries outside the schemes approved by the Ministries; and

Category IV: loans granted for purposes other than those spelt out above, which the Monetary Board may consider at its discretion as coming within the meaning of "productive purposes" as defined in Section 88 of the MLA.

The amount of loans refinanced has increased considerably following the reforms of the MLCF. The refinanced amount of loans increased from Rs.122 million in 1980 to Rs.441 million in 1989 as shown in Table 5.2. It is also significant that increased assistance has been given to sick industries under the MLCF in recent years.

The Central Bank introduced a package of relief measures to the tourist industry which was hampered by civil disturbances. This scheme provided a moratorium on the repayments of principal and interest on loans upto March 1987, to be followed by a rescheduling of outstanding debt over an extended period and refinancing of 60 per cent of the interest arrears by the Central Bank. Following the continued setback in the tourist industry, the moratorium was extended to March 1989 with a further concession of 100 per cent rescheduling of loans.

The role played by the Central Bank in the provision of credit facilities to the rural sector is also noteworthy. The Bank introduced a series of rural credit schemes over the past three decades, e.g. the New Agricultural Credit Scheme (1967), the New Agricultural Credit Scheme (1973) and the New Comprehensive Rural Credit Scheme (1986). All these schemes were aimed at delivering credit to the rural sector at reduced costs. The Central Bank also played the role of the credit executing agency for the rural based projects funded by foreign agencies such as the Asian Development Bank and International Fund for Agricultural Development. The Inland Bill Scheme introduced by the Central Bank in 1989 has eased the working capital requirements of the tea processing industry. These functions are handled by the Rural Credit Department of the Bank.

Table 5.2
Medium and Long Term Credit Fund
Approvals of Refinance Under Categories II, III and IV

(Rs.Mn.)

	1980		1983		1986		1989	
	LA	RA	LA	RA	LA	RA	LA	RA
Category II								
Export Sector	-	-	43.7	36.5	41.4	29.0	46.2	32.3
Category III and IV								
(a) Agriculture	1.0	0.7	27.8	19.2	134.4	80.6	14.7	8.8
(b) Industry	62.1	49.0	9.7	7.0	1.0	0.6	38.4	21.2
(c) Hotels	52.0	36.0	13.2	8.6	2.5	1.5	-	-
(d) Other	60.0	36.0	5.8	3.5	6.5	14.7	80.0	80.0
Assistance to Sick Industries	-	-	-	-	325.4	316.4	463.1	298.2
Total	175.1	121.7	100.2	74.8	521.4	442.8	639.4	440.5

Source: Central Bank of Sri Lanka

Note:
LA = Total amount of loans;
RA = Refinanced amount of loans

As a further measure to promote domestic investment, the Central Bank has been involved in the issue, service and repayment of government guaranteed debentures on behalf of several organisations including the National Housing Department, the State Mortgage and Investment Bank, the Development Finance Corporation and the Urban Development Authority. The Bank began this function in 1954. These activities are administered by the Public Debt Department of the Bank.

Credit Guarantee Schemes

A major problem faced by small and medium scale enterpreneurs in obtaining credit facilities from the banking system in Sri Lanka, as in many other developing countries, is the lack of acceptable securities against which loans would be granted. From the viewpoint of solvency, commercial bankers generally require valuable securities against the loans they grant. As anticipated in the Exter Report, the Central Bank had to intervene in the credit supply process by introducing a Credit Guarantee Scheme.

The Central Bank commenced issuing credit guarantees under the Small Scale Industries (SSI) Scheme in April, 1978, in collaboration with the Industrial Development Board. It covered loans granted to small industrialists by the People's Bank, the Bank of Ceylon and the Development Finance Corporation. The Central Bank guaranteed 75 per cent of the original sum granted or amount in default, whichever was less. The issue of guarantees under the SSI was completed in 1981. A total of 767 loans amounting to Rs.31.2 million was covered under the SSI Scheme. Of this, the Central Bank guaranteed a sum of Rs.23.4 million.

The Small and Medium Scale Industries (SMI) Scheme came into operation in July 1979 under an agreement signed by the Government with the International Development Association (IDA). A sum of US Dollars 12 million was made available to the National Development Bank (NDB) to refinance SMI projects and a further sum of US Dollars 4 million was given to the Industrial Development Board to meet the costs of technical assistance with respect to these projects. The SMI Project loans were to be refinanced by the IDA and administered by the ADB.

Since 1979, the following SMI schemes have been in operation:

SMI I Scheme

This Scheme commenced operations in 1979 and was completed in 1982. A total of 1,668 loans amounting to Rs.286 million was made available under this Scheme. The total amount of loans guaranteed was Rs.158 million.

SMI II Scheme

The issue of credit guarantees under this Scheme commenced in 1982 and was completed in 1989. The total number of loans provided under the Scheme was 2,531 for a sum of Rs.1,392 million. Of this amount, Rs.714 million was guaranteed.

SMI III Scheme

The third SMI Scheme became effective in July 1988. As at end of 1989, a total of 1,047 loans amounting to Rs.637 million had been issued under the Scheme. Of this Rs.440 million was guaranteed.

A summary of the performance of SMI II and III during 1982- 89 is given in Table 5.3.

Working Capital for Marketing and Export

In addition to the medium and long term credit provided under the MLCF, the Central Bank has also offered refinance to meet short-term borrowing requirements for the promotion of marketing of certain agricultural commodities. These facilities are provided to commercial banks under the Guaranteed Price Scheme (GPS) and Floor Price Scheme (FPS) to enable them to deliver subsidised credit to government departments, corportions, statutory bodies and individuals for the procurement of paddy and twelve other crops (viz. maize, sorghum, black gram, ground nuts, soya beans, gingelly, dried turmeric, cowpea, green gram, dried chillies, big onions and red onions). These refinance schemes help promote the purchase, sale and storage of locally grown agricultural products. The amounts outstanding under these schemes are indicated in Table 5.4.

Table 5.3
SMI II and III Schemes, 1982-89
Industry-wise Classification

Industry	No. of Loans	Amount of Loans Rs.Mn.	Guaranteed Amount Rs.Mn.
1. Food Processing	1,052	604.2	327.2
2. Other Agro Industries	73	31.5	17.9
3. Rubber Products	115	98.2	54.7
4. Metal Products	334	163.1	90.6
5. Construction Materials	262	140.3	87.6
6. Construction Contracting	40	40.3	22.3
7. Wood Products	241	94.1	59.4
8. Garments	206	124.1	71.3
9. Textiles	78	63.2	35.3
10. Repair Workshop	147	56.7	35.2
11. Miscellaneous	1,030	616.7	353.3
Total	3,578	2,032.6	1,154.7

Source: Central Bank of Sri Lanka.

The Central Bank also provides short term working capital to exporters by means of two refinance schemes; i.e. the Pre-shipment Export Credit Refinance Facility and the Supplementary Refinance Facility. Under the Pre-shipment Export Credit Refinance Facility, the Central Bank has supplied concessionary financing through commercial banks to the exporters of tea, rubber, coconut, gems, garments and sea-food products. Refinancing is provided for a period of 60 days extending to 90 days on a case by case basis. The interest rebate paid by the Central Bank to exporters is 4 per cent per annum. The objective of the Supplementary Financing Facility is to promote non-traditional exports and to induce commercial banks to deliver pre-shipment financing to small scale exporters. This facility can be utilised by exporters of products not accommodated under the Pre-shipment Export Credit Refinance Facility. Refinance is granted to exporters for a period of 90 days by way of discounting promissory notes tendered to commercial banks. The interest component borne by the Central Bank is 4 per cent.

Table 5.4
Refinance for Marketing of Agricultural Products

(Rs. Mn.)

End of Period	GPS Refinance	Agricultural Credit Refinance
1979	271.7	90.0
1980	115.3	112.8
1981	214.0	145.9
1982	165.5	98.6
1983	674.4	95.3
1984	297.6	112.5
1985	156.7	220.6
1986	540.6	187.9
1987	211.7	128.4
1988	260.9	7.6
1989	210.1	7.4

Source: Central Bank of Sri Lanka

Institutional Reforms

The Central Bank has initiated several institutional changes over the past four decades and the bulk of such reforms were aimed at promoting savings, investment and trade. In the mid 1950s, the Central Bank forwarded a proposal to the Government to establish the Development Finance Corporation of Ceylon (DFCC) to provide long-term capital facilities to the private sector. Following this proposal, the DFCC was set up in 1955[9]. The basic objective of the DFCC was to mobilise domestic and foreign savings for the promotion of industrial, agricultural and commercial enterprises in the private sector. The activities of the DFCC have expanded considerably since 1970.

On the basis of a recommendation of the Central Bank, the People's Bank was established in 1961[10]. The purpose of this bank was to promote

9 Development Finance Corporation of Ceylon Act No. 35 of 1955.
10 People's Bank Act No. 29 of 1961.

credit availability to agriculture and related activities. Since the early fifties, the Central Bank had urged the Government to restructure the Co-operative Federal Bank (CFB) so as to help fulfil its function in financing the co-operative credit system. However, the CFB was found to be unviable and therefore, the Central Bank suggested that a more efficient institution be set up instead. The Government approved the proposal and decided to set up the People's Bank in 1961. The Central Bank contributed to drafting the legislation for the setting up of the People's Bank. The People's Bank has aided greatly in meeting investment needs, particularly in the rural sector.

The National Development Bank (NDB) was established in 1979[11]. The NDB was expected to provide medium and long-term financial facilities for industry, agriculture, commerce and other productive activities with particular emphasis on the rural sector. The Central Bank contributed to the establishment of the NDB. As explained earlier, the NDB was given funds to refinance small and medium-term industrial projects under a loan agreement with the National Development Association. The NDB was also expected to help in expanding the capital market of the country.

A further contribution of the Central Bank towards developing an appropriate institutional framework was reflected in the establishment of the National Savings Bank in 1972. The Central Bank pointed out that the Post Office Savings Bank and the Ceylon Savings Bank needed to be amalgamated to mobilise domestic savings more efficiently. The NSB initiated several savings plans to mobilise the resources, particularly from small savers. The NSB has been a major subscriber to government securities.

Another institution that was set up on the recommendation of the Central Bank is the Sri Lanka Export Credit Insurance Corporation (SLECIC).[12] The SLECIC, which was established in 1978, issues credit guarantees for pre-shipment and post-shipment credit. These guarantees have helped to promote the availability of bank credit to the export sector by providing insurance coverage for risks involved. Thus,

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11 National Development Bank of Sri Lanka Act No. 2 of 1979.

12 Sri Lanka Export Credit Insurance Corporation Act No. 15 of 1978.

the SLECIC has become a key institution in the provision of guarantee facilities to the export sector.

Action was taken at the beginning of the eighties to decentralise the Central Bank in order to serve rural areas more efficiently. Since 1981, three regional branch offices of the Central Bank have been established in different parts of the country. The decentralisation of the Bank has enabled it to co-ordinate the savings and investment activities of commercial banks and other financial institutions more comprehensively at the regional level.

The Central Bank extended its decentralisation process by establishing the Regional Rural Development Banks (RRDBs) in 1985[13]. This innovative scheme reflected the commitment of the Central Bank to participate directly in the mobilisation of rural savings and the diversion of such savings to priority sectors. It was expected that RRDBs would supplement the activities of commercial banks with respect to rural credit and thereby would help to promote investment in rural areas. Unlike in conventional commercial banking, where considerable importance is attached to securities in the disbursement of loans, RRDBs were to base their loan assessments on the viability of each project. The RRDBs are found to be successful in savings mobilisation and credit delivery with respect to small enterpreneurs in the rural sector, mainly due to the positive attitude of the officers towards providing credit to the rural poor for production purposes. It appears that these banks have helped to realise the concept of "bare foot" banking in rural areas.

Protective Measures for Financial Institutions

The stability of financial institutions is a pre-requisite to promoting both savings and investment. In the latter part of the 1980's several non-bank financial institutions in the private sector underwent severe liquidity problems and as a result, some of them collapsed. This was partly due to the mismanagement of such companies. By the end of the 1980's

13 Regional Rural Development Bank Act No. 15 of 1985.

commercial banks began to be disturbed by financial pressures emerging from bad and doubtful debts, mainly on account of wilful defaulters.[14] These tendencies were harmful to the growing savings and investment activities of the economy and therefore, the Central Bank took timely action to overcome difficulties so as to restore the stability of financial institutions.

In order to regulate and supervise finance companies, the Central Bank established a new department in 1988, i.e. the Department for Supervision of Non-Bank Financial Institutions[15]. Under the new Law, the Central Bank was vested with more powers to control these companies. Accordingly, the Monetary Board was permitted to impose penalties on errant finance companies.

Substantial rates of default emerged as a major threat to commercial banks and other financial institutions in the late eighties. This problem was more accute in the two state owned commercial banks. In view of these considerations, the Minister of Finance appointed a Committee in August 1989, with the Governor of the Central Bank as Chairman, to report on non-performing advances and other current problems, including rising intermediation costs and credit delivery. In its Report[16] the Committee highlighted the gravity of the debt recovery problem and recommended several measures to expedite the procedures. The Committee presented a plan of action aimed at proper debt recovery, low intermediation costs and efficient credit delivery.

A significant contribution of the Central Bank towards developing a climate conducive to investment is the recent initiative taken by the Bank to adopt new legislation to regulate debt recovery procedures. Accordingly, 13 Acts (including amendments to certain existing Acts) were passed in Parliament in March, 1990. Shortcomings of the existing legislation were largely responsible for the prolongation of debt

14 Bad and doubtful debts have caused considerable financial distress for many financial institutions in developed and developing countries. For an analysis of such failures, see World Development Report, World Bank, 1989.

15 Finance Companies Act No. 78 of 1988.

16 Report of the Commitee on the Two State Banks, February 1990 (unpublished).

recovery. The new Law[17] provided for special recovery procedures with respect to lendings of licensed commercial banks, development banks and finance companies. Under the new regulations,[18] the parate execution powers hitherto enjoyed by the state banks have been extended to all commercial banks and the DFCC. As part of the policy package of credit recovery, the Credit Information Bureau[19] was set up in June 1990 to centralise the data on loan defaulters.

Conclusion

The Central Bank has effectively evolved over the past four decades, reflecting its ability to meet the challenging demands of a growing economy. In meeting these challenges, the priority that should be given to promote savings, investment and foreign trade is undebatable. The analysis of this paper revealed that the Central Bank has actively participated in the country's efforts to promote these economic activities.

The magnitudes of savings, investment and foreign trade depend to a large extent on macro economic behaviour. The Central Bank has been instrumental in formulating and adopting the appropriate macro-economic policies to achieve this end. As the economic advisor to the Government and the monetary authority of the country, the Bank has played a dynamic role in development activities. The appropriate use of monetary policy instruments, exchange rates and other macroeconomic tools by the Central Bank has helped to attract domestic and foreign investors and to stimulate the export sector, particularly since 1977. The Bank, however, did not restrict itself to conventional central banking practices, but extended its functions to new types of activities so as to take part in the development process in a more direct manner. This is reflected in the contribution made by the Bank to fulfil the long and medium term capital requirements as well as working capital needs of the production sectors. The specialised institutions that were set up following the recommendations of the Central Bank have effectively contributed to promote savings, investment and foreign trade.

17 Debt Recovery (Special Provisions) Act No. 2 of 1990.
18 Recovery of Loans (Special Provision) Act No. 4 of 1990.
19 Credit Information Bureau of Sri Lanka Act No.18 of 1990.

The determined effort taken by the Central Bank to adopt comprehensive debt recovery legislation in 1990 can be recorded as a major contribution towards developing a healthy investment climate in the country. This fulfilled a long-felt need. Loan defaults have led to the liquidation of a number of commercial banks and other financial institutions in developing and developed countries in the recent past[20]. Such financial distress has adverse economic consequences. The new regulations will help to avoid such crises in Sri Lanka by protecting the solvency of financial institutions. These protective measures will facilitate the development of healthy market conditions required for enhanced savings and investment.

The present policies of the Central Bank reflect its deviation from orthodox approaches. In the promotion of savings, investment and foreign trade, the Bank has recognised the importance of efficient credit delivery as well as speedy credit recovery. In particular, the need to promote savings habits and investment in rural areas has been identified as a major policy concern. Further extension of banking facilities to small enterpreneurs will help to harness more resources in the rural sector enabling them to expand production capacity.

20 The World Bank, World Development Report, 1989.