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Evolution of the Conduct of Monetary Policy in Sri Lanka

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Overview

On the 28th of August 1950, the Central Bank of Ceylon[1] was established to succeed the Board of Commissioners of Currency as the monetary authority of independent Ceylon. The powers of the Board of Commissioners of Currency were limited to the automatic issue of Ceylon rupee notes and coins against an equivalent value of assets in foreign currency, and the converse process of retiring such notes and coins whenever the Board was required to pay out of its foreign exchange reserves. In contrast, as a central bank, the Central Bank of Ceylon could issue currency and create deposits against foreign as well as domestic assets. In addition, a central bank also has the power to control the expansion and contraction of credit granted by commercial banks and other financial intermediaries. These powers are vested with a central bank by law, given the significant role of money in an economy and hence the need to influence and control money circulating in the economy. Accordingly, with the establishment of the Central Bank in August 1950, Sri Lanka gained monetary sovereignty.

Conduct of monetary policy by the Central Bank to influence and control monetary conditions in the country has changed over the past sixty years in step with the progress of the country's economy, and in particular, with the progress of the financial sector. While the set of

1 Later, on 31st December 1985, the Bank was renamed the 'Central Bank of Sri Lanka'.

monetary policy instruments and procedures adopted by a central bank constitutes its operational framework, in the case of the Central Bank of Sri Lanka, the procedures adopted for the conduct of monetary policy have undergone significant change over the past sixty years. Monetary policy instruments used by the Bank include policy interest rates, open market operations, statutory reserve ratios, and moral suasion. Direct control of interest rates and credit has also been exercised by the Bank in the past, from time to time. However, the Bank's reliance on market-based policy instruments has increased considerably during the last two decades. In the meantime, as is the practice globally, communication is increasingly used by the Bank to manage inflation expectations of the public and thereby reinforce its monetary policy.

The principles governing the operations of central banks globally have changed in keeping with the evolution of monetary economics as well as in response to significant economic events. Global trends in central banking, in turn, have naturally had a bearing on the shaping of domestic monetary policy. Streamlining objectives of the Central Bank of Sri Lanka in 2002, to maintaining economic and price stability, and financial system stability, demonstrates that the Central Bank of Sri Lanka has moved in step with the progress of modern central banking.

Monetary Policy directed at securing Monetary Stability and Economic Development

Since its inception until 2002, the Bank was guided by multiple objectives. As the authority responsible for regulating and administering the monetary and banking system in Sri Lanka, the Central Bank was charged with the responsibility of regulating the supply, availability, cost, and international exchange of money, so as to secure the following objectives: (a) stabilisation of domestic monetary values; (b) if there has been a determination of the par value of the Sri Lanka rupee, the preservation of the par value of the Sri Lanka rupee and the free use of the rupee for current international transactions; (bb) if there has been no determination of the value of the Sri Lanka rupee, the preservation of the stability of the exchange rate of the Sri Lanka rupee in relation to foreign currencies; (c) the promotion and maintenance of a high level of production, employment, and real income in Sri Lanka; and (d) the encouragement and promotion of the full development of the productive resources of Sri Lanka. In designing monetary policy, greater weight has been placed by the Central Bank on stabilising domestic monetary values during certain periods while at other times, the development objective has received greater weight.

During much of the period since the Bank's establishment till the mid-1950s, markets were liquid, owing mainly to the favourable performance of exports and the resulting inflows of foreign exchange. In 1956 therefore, the Central Bank issued Central Bank securities for the first time, for the purpose of mopping up excess market liquidity, given that its holdings of government securities were not adequate for conducting open market operations. Thereafter however, balance of payments deficits coupled with increased government borrowing led to tight market liquidity conditions by 1958, which compelled commercial banks to borrow funds from the Central Bank to meet their temporary liquidity requirements. While commercial banks were allowed to obtain funds from the Central Bank by rediscounting their holdings of Treasury bills, the Central Bank also lent funds to commercial banks against the pledge of government securities, at the Bank Rate, a policy interest rate that was extensively used by the Central Bank till the mid-1980s, along with the statutory reserve ratio (SRR)[2].

Economic development was given precedence in formulating monetary policy during the period from the late 1950s until the early 1980s. During this period, the Central Bank exercised direct control on credit as well as interest rates with the intention of directing resources to selected sectors of the economy, primarily with a view to promoting industrial growth and rural development, while maintaining monetary stability. During the 1960s as well as in the 1970s, until 1977, monetary policy instruments were used to support the policy of import substitution too.

Given the selective treatment of different sectors of the economy during the period from the late 1950s until the early 1980s, the Bank adopted a similar approach to managing inflationary pressures too. Accordingly, although the Bank rate and the SRR were raised in the early 1960s, when confronted with rising inflationary pressures, exemptions were made in respect of refinancing facilities made available by the Central Bank to commercial banks in relation to ‘priority’ sectors of the economy. Credit ceilings imposed in respect of ‘non-priority’ sectors as well as cash margins imposed on letters of credit in relation to selected non-essential imports were also among the monetary policy measures taken during the early 1960s, when inflationary pressures were rising.

In the mid-1960s, the Central Bank made available refinance facilities to credit institutions through its Medium and Long-Term Credit Fund, which was established in 1964, to augment the availability of long-term funds. During the period from April 1966 to November 1968, these funds were made available at 3 per cent for the promotion or development of industry or agriculture, although the Bank rate was at 5 per cent from 28th May 1965 to 6th May 1968, having been raised from 4 per cent, at which level it had remained since 13th August 1960. In the late 1970s and the early 1980s, the Bank acted in a somewhat similar manner in trying to control rising inflationary pressures following a significant expansion of credit. In view of rising demand pressures, since December 1979, refinance facilities made available by the Central Bank to commercial banks over and above a stipulated quota had been subject to a graduated scale of penal rates. The stipulated quota of refinancing facilities granted at the Bank rate consisted of general accommodation and export credit refinancing. With inflationary pressures intensifying, in April 1980, the Central Bank raised the Bank rate from 10 per cent to 12 per cent, while at the same time raising the penal

2 The statutory reserve ratio (SRR) applicable to demand deposits and the SRR applicable to time and savings deposits were unified in 1987. The SRR applicable to foreign currency denominated deposits placed abroad was removed in 1997. Since 4th August 2000, the SRR is applicable only to rupee denominated deposits.

rates from a range of 15 - 25 per cent to a range of 20 - 30 per cent. While this tight monetary policy stance was continued into 1981, in 1981, the amount of export credit refinancing made available by the Central Bank at the Bank rate was increased while its general accommodation at the Bank rate was reduced. In June 1981, the Central Bank raised the SRR in respect of both demand deposits as well as savings and time deposits, to bring down the level of excess market liquidity, while in August 1981, it raised the Bank rate by two percentage points to 14 per cent while at the same time raising the penal rates on Central Bank accommodation to commercial banks to a range of 21 to 30 per cent. However, export credit refinancing continued to be granted at 12 per cent, the level at which the Bank rate had been maintained before it was raised to 14 per cent. Further, while growth of total credit granted by commercial banks to the private sector was to be contained to 25 per cent in 1981, as per the National Credit Plan, which was introduced to guide the allocation of credit among different sectors, exports, along with industry, agriculture and tourism, were considered priority areas by the Central Bank when formulating the National Credit Plan for 1981, and hence were given special weight when allocating shares in total credit granted to the private sector and government corporations.

With the adoption of 'open economy' policies from 1977 however, the Central Bank gradually moved away from direct controls to market based tools of monetary policy. The Bank has also actively engaged in financial market development, that is, development of financial institutions, financial instruments, as well as payment and settlement systems. Nevertheless, the SRR applicable to deposit liabilities of commercial banks, which is administratively determined, continued to be a key monetary policy instrument used by the Central Bank to control inflationary pressures in the economy during the 1980s and early 1990s. Development of the domestic financial sector enabled the Central Bank to adopt open market operations as a key monetary policy tool from the late 1990s.

Broad Money - M_2

The 1980s saw a significant change in the parameters within which the Central Bank conducted monetary policy. While the Central Bank had monitored the movements of narrow money (M_1) for the purpose of formulating monetary policy since its inception until 1980, the Central Bank commenced compiling broad money (M_2) in 1980, to use as a guide for monetary policy decisions. M_2 includes currency and demand, savings and time deposits denominated in rupees, held by the public with commercial banks, whereas narrow money (M_1) includes only currency and demand deposits denominated in rupees held by the public with commercial banks. The decision to broaden the definition of the monetary aggregate used for monetary policy purposes was based on the fact that developments in the financial sector had resulted in savings and time deposits becoming more liquid. For example, the relaxation of restrictions on the withdrawal of funds from savings accounts had diluted the distinction between savings and demand deposits while facilities for premature withdrawal of time deposits and borrowing against the security of time deposit had rendered time deposits more liquid.

Monetary Targeting

A fundamental change with respect to the conduct of monetary policy during the 1980s was that the Central Bank adopted the monetary targeting framework for monetary policy. Accordingly, the Central Bank commenced preparing a monetary programme annually, which was to guide monetary policy. The monetary programme is prepared in accordance with the expected developments with respect to key macroeconomic variables, namely, the balance of payments, the budgetary outcome, gross domestic product (GDP) growth, and inflation. Following the determination of the average money multiplier (ratio of broad money to base money, i.e., reserve money) for the relevant year, a target for base money is stipulated, so as to achieve the targeted growth of broad money, which had been derived on the basis of the anticipated GDP growth and inflation during that year. Monetary policy is then conducted to maintain reserve money at the desired level.

The Central Bank continues to operate within a monetary targeting framework for monetary policy. The continued presence of a systematic link between broad money and inflation enables the Bank to do so. In the meantime, steps have been taken to continuously refine the monetary policy operations of the Bank within the monetary targeting policy framework. A policy decision taken in this direction in recent years was that, from 2008, targets for both broad money and reserve money are to be stipulated in terms of the annual average growth, rather than in terms of the growth as per the end-period levels in any two consecutive years concerned. This is a more disciplined approach to guiding monetary conditions in the country, as the impact of any temporary developments that could lead to short-term volatility in monetary aggregates is thereby largely eliminated.

Broader Monetary Aggregates - M_{2b} and M_4

Progressive steps taken by the Central Bank have enlarged the scope for disciplining the course of money and hence inflation in the country. From around the mid-1990s, the Central Bank commenced compiling monetary aggregates with a broader coverage, so as to capture the movement of money circulating in the economy with greater accuracy. The economic liberalisation that took place since the late 1970s and the parallel development of the financial sector warranted the coverage of a broader set of financial instruments in computing broad money. Accordingly, from 1996, M_{2b}, which includes demand, savings and time deposits denominated in foreign currency, held by the public with commercial banks, in addition to currency and demand, savings and time deposits denominated in rupees held by the public with commercial banks included in M_2, has been used to guide monetary policy. M_{2b} reflects the operations of the offshore banking units (OBUs) of commercial banks in addition to those of the domestic banking units (DBUs) of commercial banks and the Central Bank, which are covered by M_2. Meanwhile, in 1999, the Central Bank began compiling M_4, that is, broad money computed on the basis of the financial survey, which has a wider coverage than the monetary survey conducted for the purpose of compiling M_{2b}. M_4 includes savings and time deposits held by the public with specialised banks and finance companies, in addition to currency and demand, savings and time deposits denominated in rupees as well as foreign currency, held by the public with commercial banks, included in M_{2b}. While it is observed that the course of M_4 has continued to closely follow that of M_{2b}, mainly due to the fact that commercial banks continue to dominate the financial sector in Sri Lanka, the Central Bank continues to use M_{2b} to guide monetary policy. Accordingly, the monetary programme has also been prepared to guide the course of M_{2b}, since 1998.

The Policy Interest Rate Corridor

A further significant development during the 1990s was the introduction of the Repurchase facility by the Central Bank in October 1993. Accordingly, the Central Bank would enter into overnight repurchase agreements with institutions participating in the monetary operations of the Central Bank at the Repurchase rate, from October 1993, by way of absorbing excess market liquidity on an overnight basis. Given the large inflows of capital during the early 1990s and the accompanying build-up of excess market liquidity, the Repurchase rate was introduced to prevent a sharp fall in the overnight money market rates. Initially, the Repurchase rate was fixed at one per cent less than the weighted average yield on 3-month Treasury bills at the previous auction, given that the underlying securities involved in repurchase transactions are Treasury bills. Subsequently however, the Bank established the practice of setting the Repurchase rate taking into consideration such factors as the overall liquidity conditions in the market and other economic conditions.

In November 1995, the Central Bank introduced a reverse repurchase facility to stabilise call money rates, which showed a tendency to rise to unacceptably high levels in view of the prevailing shortage of market liquidity. Institutions participating in the monetary operations of the Central Bank could therefore borrow from the Central Bank on an overnight basis whenever they encountered a deficit in their funds required for daily operations. However, this facility was discontinued in January 1996, as it had not succeeded in stabilising market interest rates, partly due to structural weaknesses in the market as well as the limited amounts of funds offered. The reverse repurchase facility was re-introduced in November 1998, to make available funds to commercial banks and primary dealers, that is, participants in the monetary operations of the Central Bank, on an overnight basis. Following the re-introduction of the facility in November 1998, funds were made available at the Reverse Repurchase rate, without any limits on the amounts so lent, provided government securities were offered as collateral. The re-introduction of the facility served as an assurance to the market that stability in interest rates would be preserved. Since then, the Repurchase rate (Repo rate) and the Reverse Repurchase rate (Reverse Repo rate) constitute the benchmark floor and ceiling, respectively, for call money rates. Hence, these policy interest rates indicate the monetary policy stance of the Central Bank.

Legal Mandate and Institutional Framework for Monetary Policy

A noteworthy development in respect of monetary policy during the decade ending 2010 is the amendment to the Monetary Law Act by Parliament in December 2002. It redefined the objectives of the Central Bank of Sri Lanka as (a) economic and price stability, and (b) financial system stability, with a view to encouraging and promoting the development of the productive resources of Sri Lanka. As such, it gives greater flexibility to the Central Bank in conducting monetary policy.

In 2001, the Bank's Monetary Policy Committee was established, with a view to expanding the scope of policy discussions in relation to monetary policy. Its mandate is to review the Bank's monetary policy stance on a monthly basis and recommend to the Monetary Board the appropriate monetary policy measures to be adopted, given the outlook for domestic economic conditions. Subsequently, the Bank also began issuing monthly press releases on monetary policy decisions, in accordance with an advance release calendar. In 2007, the Bank established the Monetary Policy Consultative Committee, with a view to broadening its dialogue in relation to monetary policy with private sector agents. These measures as well as the launching of the 'Road Map' for monetary and financial sector policies to be implemented, at the beginning of each year, since 2007, have helped the Bank enhance its communication with the public in relation to monetary policy.

Implementing Monetary Policy - Active Open Market Operations

A significant development with respect to the implementation of monetary policy by the Central Bank was the introduction of active open market operations (OMO) in March 2003. Beginning March 2003, the Central Bank discontinued the standing facility for the outright purchase or sale of government securities, at its Discount and Re-Discount rates. Since then, the Central Bank would conduct auctions for the outright sale of government securities or Central Bank securities or the outright purchase of government securities, totalling a pre-determined amount, only if it considers it necessary to absorb or inject liquidity on a permanent basis, so as to maintain market liquidity at a level compatible with the targeted path for reserve money. Further, since March 2003, the Bank conducts OMO Repurchase (Repo) auctions or OMO Reverse Repurchase (Reverse Repo) auctions, if it considers it necessary to absorb or inject a pre-determined amount of liquidity on an overnight or term basis, in order to stabilise overnight rates in the call money market at a level considered appropriate within the policy rate corridor so as to be able to achieve reserve money targets. Meanwhile, to fulfil any further liquidity requirements, participating institutions could access the Bank's standing facilities for Repurchase and Reverse Repurchase transactions, which are made available at the Bank's Repurchase rate and Reverse Repurchase rate.

From around December 2006 till May 2009 however, the Central Bank deviated from the practice of conducting active OMO, with a view to quickly arresting the growing demand for credit and the use of the Central Bank's funds to feed the demand for credit at the time, given that monetary expansion was already too high and inflation was increasing rapidly. During this period, the Central Bank restricted access to its funds by limiting access to its reverse repurchase facility. During the period from January to March 2007, access to the Central Bank's reverse repurchase facility by banks was restricted to six times per calendar month, and subsequently, until August 2007, participating institutions were allowed to access this facility only three times per calendar month. In order to ease the considerable pressure on market interest rates, restrictions on access to the Central Bank's funds through the reverse repurchase facility were removed at the end of August 2007. However, in view of the mounting demand pressures in the economy, the number of times that participating institutions could access the Central Bank's funds through its reverse repurchase facility was restricted again from December 2007 and these restrictions remained effective until May 2009. Meanwhile, in 2008, the Central Bank tightened its monetary policy stance further by stipulating stringent targets for reserve money in terms of daily average reserve money, rather than in terms of end-period levels as has been the practice up to then. In addition, a penal rate of interest was charged by the Central Bank on its reverse repurchase transactions during the period from 3rd December 2007 to 21st May 2009, whenever participating institutions exceeded the stipulated number of times that they were allowed to borrow at the Reverse Repurchase rate. Also, while the Penal rate was in force, the Bank refrained from conducting OMO reverse repo auctions. These contractionary monetary policy measures resulted in domestic market interest rates rising significantly. Consequently, credit and other monetary aggregates decelerated markedly in 2008, thus helping prevent the second-round effects of sharp increases in international commodity prices at the time from becoming more broad-based. While the Central Bank was thus able to bring down inflation to manageable single-digit levels early in 2009, it therefore removed restrictions on access to its funds by May 2009. Meanwhile, as the average weighted call money rate, which was contained to levels below the Penal rate following its introduction, declined to levels within the policy interest rate corridor formed by the Repo rate and the Reverse Repo in March 2009, the Penal rate of interest on reverse repos was gradually lowered from January 2009 and removed in May 2009. Its removal reinforced the policy interest rate corridor.

Alongside the policy interest rates and OMO, the Central Bank uses the SRR as a key monetary policy instrument, to manoeuvre its monetary policy stance and market liquidity conditions. For example, the SRR was reduced on three occasions in the aftermath of the onset of the recent global financial crisis, to offset the sharp decline in liquidity in domestic financial markets. However, the SRR is no longer a frequently used monetary policy instrument, as the Bank now relies more on market oriented policy instruments such as the policy interest rates, which are reviewed monthly by the Bank, and OMO, to guide market liquidity conditions. Moral suasion meanwhile, continues to be a monetary policy instrument used by the Bank at its discretion. The Bank rate, which is now applicable to lending by the Central Bank in its capacity as the lender of last resort, is also amongst the policy tools at the disposal of the Central Bank, but it is rarely in effect and does not necessarily reflect the monetary policy stance of the Bank.

Concluding Remarks

The Central Bank of Sri Lanka has taken progressive steps over the past years to increase its effectiveness in maintaining price stability and thereby create a stable macroeconomic environment that would foster economic growth and development. The Bank is now of the view that it should move from its current monetary targeting framework for monetary policy to an inflation targeting policy framework in the years ahead, so as to be able to maintain price stability on a more sustainable basis. However, there are several pre-requisites to be fulfilled before moving to an inflation targeting regime. Hence, the Bank will continue its efforts to strengthen the framework for monetary policy within which it operates, by way of progressing towards a more effective regime for monetary management.

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