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Surviving in White Waters – Stabilising Domestic Financial Markets

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During the pre-Central Bank period, the financial system of the country was rudimentary and fragmented. Issue of Ceylon rupee notes and coins under the Currency Board System (CBS) was limited only to the extent of Indian rupees in possession or lodged with the Reserve Bank of India. This provided a self balancing mechanism to the balance of payments as any additions or reductions of reserves were accompanied by respective expansion or contraction of currency issues. As the financial market of the country was shallow and narrowly based, market activities were limited with low public involvement. Although the self balancing CBS seemed to have facilitated a reasonably smooth financial market during the pre independence era, the newly gained independence demanded a completely new monetary structure mainly on incompatibility issues.[1] The creation of the Central Bank was expected to provide the flexibility to achieve rapid and sustained economic expansion and the full employment of resources.

The influence of the Central Bank on the economic activities and financial markets of the country is not only through the basic functions entrusted upon it by the law but also through enormous powers that it has for liquidity creation almost at will. Since the inception, the Central Bank's ability to create money and liquidity in the system has had a significant influence on the financial market of the country. The measures adopted by the Bank to stabilise the financial

1 Between relatively rigid nature of the CBS and flexibility in the systems demanded by the newly gained status to maintain independent monetary policy to suit changing conditions and the needs of the new country.

markets in the country during the last 60 years resemble a closer relationship to the changing economic landscape and policies adopted in different economic regimes. This paper identifies and reviews the following specific periods, which reflect different approaches to financial market stabilisation in Sri Lanka: (a) Liberal Economic Era: 1950 – 1959; (b) Controlled Regime: 1959 – 1977; (c) Open Economy – Early Stage: 1977 – 1988; and (d) Open Economy – Mature Stage: 1988 – to date.

Market Stabilisation in Liberal Economic Era: 1950 – 1959

During its first decade since the establishment, the economic environment was reasonably liberal and the focus was more on economic growth with a reasonable level of price stability. Export growth, promotion of food production to substitute the dependence particularly on rice imports had been considered the main drivers of growth. The Central Bank relied more on conventional monetary policy instruments in achieving price stability. Since banking activities were limited to a wealthy few and conventional products, the real challenge was not emanating from the risk of instability in the financial market but was mainly from inadequacy of the system and initiatives to cater to widening needs of the economy and its agents.

The Korean War and the subsequent tea boom resulted in a massive accumulation of external assets by the country. The resultant monetisation had encouraged increased financial market activities and spending. A very high level of monetary expansion challenged the Central Bank with the threat of eroding the value of the Sri Lankan rupee. With excess liquidity, a potentially dangerous base for creation of excessive credit, the major thrust of the Central Bank was to have the appropriate policies in place to prevent the inevitable overheating of the economy.

Consequently, the country witnessed several changes to the Statutory Reserve Requirement (SRR), increased forward exchange (purchase) rates and introduction of working balance (exposure) limits on foreign currency operations of banks. Restrictions in the form of ceilings on commercial bank credit and the accommodations at Bank Rate were introduced in 1950 and revised on a few occasions during this period. The Central Bank went beyond the conventional policy measures and allowed commercial banks to invest their foreign currency balances abroad creating a corresponding temporary outflow to ease the impact on the rupee liquidity. Though the increase in external assets was temporary, the exchange rate was kept unchanged assigning the entire burden to be absorbed by the monetary policy. The resultant new excess liquidity in the market required the Central Bank to engage in a variation of open market operations by issuing its own securities. Despite these, efforts were visibly drawn on offering subsidised credit and new welfare programmes. Consequently, Korean War surpluses were sufficient only to finance import requirements of the country for a period of 13 months. By 1953, excess reserves of commercial banks had fallen to Rs. 26 million and the contraction in money supply allowed the Central Bank to reduce the SRR on demand deposits back to its original 10 per cent.

The period after 1955 witnessed a sharp fall in the country's external assets exerting a destabilising force on its Balance of Payments (BOP). Failure of the country to reinvest such surpluses in the productive sector aiming at sustainable economic development resulted in evaporation of these surpluses leading to severe BOP problems later on. Low interest rates maintained seemingly to ease budgetary problems of the government resulted in negative real interest rates encouraging consumption and discouraging savings. In the absence of bank failures, volatile interest rates resulted from uncontrolled market liquidity and inconsistent economic policies became the main market de-stabilisers during this period.

Market Stabilisation in the Controlled Regime: 1959-1977

By 1959, Sri Lanka was experiencing its first post-independence BOP difficulties. There were large issuances of government securities due to the expanding budget deficit and liquidity position of commercial banks was insufficient to absorb them. The Central Bank absorbed a substantial portion of the Treasury bills issued by the government (over 80 per cent of the Treasury bills issued) in addition to providing temporary advances of 10 per cent of the estimated government revenue (Rs. 133 million in 1959) injecting substantial liquidity into the system. The Bank Rate was used by the Bank to contain the demand. However, there was an intervention by the government in an interest rate decision of the Central Bank for the first time in the history[2] in the wake of rapid increase in interest rates in response to its increased demand for funds. Under the circumstances, selective import and credit controls were introduced to abate the pressure on the external position[3] and the country opted to draw Rs. 53.8 million from the International Monetary Fund (IMF) to face the deterioration in external assets.

Up to about 1962, the country had enjoyed a relative stability in price levels. However, the government borrowing through Treasury bills to finance its budget deficit continued unabated.[4] The Bank rate continued to guide the market interest rates and central bank credit continued to be the major source of monetary expansion exerting upward pressure on prices. In this environment, SRR continued to be a major instrument of influencing the market demand though its application was not uniform[5]. New credit controls[6] in effect for demand management resulted in deceleration in money supply leading to relative price stability again in 1966. However, the Central Bank's thrust on its development objective to drive agricultural production possibly to relieve pressure on foreign exchange for the food imports, reduction of interest rates on various refinancing facilities, etc. even in the presence of inflationary government financial operations, prior to allowing the economy to cool down to an appropriate level, seemed to have reignited a higher increase in the price level soon after in 1967.

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2 The Government directed the Monetary Board to bring down Bank Rate from three per cent to two and a half per cent in 1959, the first and only time in history.

3 Import coverage in gross official assets of the country had fallen below three months of imports for the first time in the history of the Bank in 1961 and the decline continued till 1964.

4 By 1963 the statutory limit on Treasury bills was Rs. 1150 million while the amount held by the Central Bank was Rs. 1006.9 million and the budget deficit which stood at just Rs. 1.2 million in 1956 increased to Rs. 1366 million by 1972.

5 Different SRR were applicable for different types of deposit accounts while state banks were provided with preferential treatment.

6 Credit controls include restriction of bank credit to a pre determined level (e.g. loans for purchase of estates were limited to one third of purchase price of such assets) with the exception of credit granted to priority sectors.

With continued decline in the country's external asset position[7], the Sri Lankan rupee was devalued by 20 per cent in 1967 and a system of multiple exchange rates through operation of Foreign Exchange Entitlement Certificates (FEECs) was introduced in 1968[8]. Liberalisation of imports under the new exchange rate environment resulted in a substantial increase in the demand for credit and the Central Bank continued with credit at subsidised rates[9]. GDP growth has witnessed its highest ever in the decade at 8.3 per cent. The impact of demonetisation of large value currency notes in 1970, though helpful in curtailing the monetary expansion, was short lived. Credit ceilings, increases in SRR and Bank Rate were visible in the subsequent period but subsidised credit by the Central Bank distorted the effective cost of credit and resource allocation continuously. Low increase in CCPI[10](1.2 per cent) prompted the Central Bank of Sri Lanka (CBSL) to ease its monetary policy stance further in 1976. However, by that time money supply was showing a phenomenal increase[11]. Consequently, monetary policy was further tightened by withdrawing the accommodation of vault cash of commercial banks in computation of SRR, a facility extended to ease the pressure on their credit creating ability.[12]

Market Stabilisation in the Open Economy – Early Stage: 1977-1988

With the opening of the economy in 1977/78, significant changes were introduced to relieve the economy from a host of administrative controls and inefficient resource allocation. Multiple exchange rates applicable under FEECs were abandoned and the Monetary Law Act was amended to introduce a managed floating exchange rate system. The Bank Rate was increased significantly to better align it with economic fundamentals while removing controls in market interest rates. Penal rates on CBSL accommodations[13] were increased substantially. Preferential credit[14] was rationalised with new interest rates at 15 – 25 per cent. Ceiling on credit to government corporations was withdrawn. As an incentive to foreign investments, offshore banking facilities were introduced to facilitate and complement the activities of export processing zones. The CBSL moved away from direct controls to market based tools to implement monetary policy.

7 Country's external asset position declined to an extremely critical level of little more than one month of imports at the end of 1966.

8 Under this scheme, a substantially depreciated exchange rate was applicable for exporters of nontraditional products and most other foreign exchange earners and for essential imports creating a multiple exchange rate system.

9 Bank Rate remained at five per cent but refinancing facilities by the Central Bank at rates as low as one and a half per cent had aggravated the preferential and directed interest rate structure which was misaligned (substantially lower) with the market interest rates while lowering the effectiveness of Central Bank actions.

10 Colombo Consumers Price Index that measures the level of increase in price levels i.e. inflation.

11 Money supply increased almost in three fold during 1973 – 1977 with bulk increase in 1976/77 with 34.9 % in 1976 and 29% in 1977.

12 This was introduced in 1962 to accommodate a fraction of vault cash holding by commercial banks and changed in 1968 to accommodate entire such holdings in SRR computations.

13 Penal rates are Interest rates higher than market interest rates charged by the CBSL for its accommodations to the participating banks beyond specified limits with a view of discouraging frequent request for such funding by the participants.

14 These facilities were provided under various refinance schemes of the CBSL. These rates were revised to align them with market rates and thereby minimise (or reduce) distortions in the interest rates.

Consumer inflation averaged at 26 per cent with domestic credit providing the main thrust in 1980 while recording a growth of 23 per cent in money supply and GDP growth of 5.5 per cent. Call money rates were as high as 25 per cent. Bank credit was set to govern through the national credit plan placing more emphasis again on directed lending. Entry of money brokers in 1982 added a new dimension to market liquidity, information availability, transparency, and transacting ease. Fiscal imbalances caused from ambitious long gestation investment without much regard to the domestic resource constraints had been the major contributor of financial market instability in the early stages of the new era. Public investments which averaged eight per cent during 1970 -77 had grown to 15 per cent in 1978-83.[15] Financial Market development became an important part of the CBSL activity and development of new instruments and new institutions had a bearing on its decisions.[16] Although continued aid flow and high export prices enabled the country to maintain a higher foreign reserve position during 1977/78, the government resorted to heavy borrowings abroad in the subsequent period. In 1983 a BOP crisis resurfaced compelling the country to resort to a temporary BOP support facility from the IMF.[17]

The low cost central bank refinancing credit continued throughout with exports related credit dominating (95 per cent) bank credit in 1984. The year 1985 recorded the lowest consumer price inflation after 1978, an achievement through tightening monetary policy mechanism, quantitative restrictions on accommodations at the Bank rate with gradually increased penal rate for accommodations beyond the given quota supported by fiscal consolidation though short lived. Irrespectively, the excess liquidity remained high due to newly imposed credit ceilings.

In terms of market activities, the capital market failed to reflect any significant growth. As such the activities of the share market were streamlined in 1984 under the Colombo Stock Exchange. Voluntary deposit insurance scheme introduced by the CBSL in 1987 to provide a safety net for the most vulnerable segment of the depositors of the regulated deposit taking institutions, received weak market acceptance for multiple reasons. Irrespective of these developments, Sri Lanka experienced the first major instability in its financial system during 1986 – 1988 with the failure of a number of finance companies and this situation resulted in substantial strengthening of regulatory and legal framework.[18]

The liberalised policy package introduced in 1977 alone proved insufficient for achieving sustainable high growth. Weaknesses in the external sector due to non harmonised monetary and

15 Total investments had grown from 16 per cent to 28 per cent of GDP in respective periods.

16 Insurance companies, finance companies, specialised financial institutions such as merchant banks, venture capital companies, investment trusts, brokerages, etc as well as debt securities, OMO, structured instruments, technological development etc were all assisted in expansion of financial market activities.

17 A facility of SDR 100 million was launched in mid 1983. However, this was abandoned in 1984 after utilising only about 50 per cent of the committed funds as favourable international commodity price cycle rescued the country from the difficulties that prevailed. By this time the current account deficit had declined from 19.8 per cent to 3.6 per cent of GDP.

18 This has resulted in the introduction of the Banking Act No 30 of 1988 and the Finance Companies Act No 78 of 1988.

fiscal policies seemed to have reduced the flexibility in managing foreign reserves. Repetition of external shocks and resorting to IMF facilities testifies to the absence of willingness and commitment in making necessary structural adjustments, once the external situation normalised. Although the managed exchange rate released slightly lower pressure to foreign exchange market, significant volatility in the external reserve position and sporadic inflation increases caused significant volatility in the market interest rates.

Market Stabilisation in the Open Economy – Mature Stage: Post 1988

The period commenced with a severe BOP crisis that witnessed a sharp drop in foreign currency inflows and reserves. Although large increases in net credit to government (NCG)[19] facilitated the temporary bridging of government expenditure gap in the domestic front, dwindling foreign reserves made local banks unwilling to open LCs even for essential imports as their foreign counterparts were refusing to honour them without specific foreign currency backing. In the midst of ongoing civil unrest, the local banks seemed to have exhausted all the available credit lines by then. The CBSL had to intervene and arrange several short term financing facilities from its counterparts on an uncovered basis by pledging its limited asset base to ensure continued flowing of at least essential imports to the country. In this environment, a broader reform agenda was needed to resurrect the falling economy. The country had resorted to Compensatory Financing Facility and Structural Adjustment Facility from the IMF to concentrate on much needed structural adjustments in the economy in 1988 and 1989.

Secondary market trading of Treasury bills was introduced to facilitate increased liquidity and ease of trading in government securities, an introduction that led to broader acceptance of government securities by the market participants. Technological and process improvements,[20] transparency of the transaction processes and information availability had provided broader support for increased securities market activities while being instrumental in reducing lead time in transaction processing and settlement, facilitating around the clock financial services. Divestiture of the ownership of state enterprises reduced inefficiencies in the fiscal front while reducing the pressure on BOP. Consequently, the period of 1988 - 1989 witnessed the first conscious effort to reduce the Treasury bill holdings of the CBSL and reduce the level of monetary financing.[21] Slow growth in reserve money resulted from low government borrowing from the banking system (only Rs. 54 million in 1989) and the gradual improvement in the money market ensured the success

19 NCG by the CBSL increased by 34 per cent while that from commercial banks increased by eight per cent during 1988 alone.

20 Automated transaction processing, ATMs, plastic card technology (credit cards), cheque clearing (Sri Lanka Automated Clearing House-SLACH) and transaction processing were the significant introductions during the period.

21 The share of CBSL holdings in total Treasury bills outstanding declined from 88 per cent in January 1988 to 57 per cent in December 1988 while Treasury bills on issue increased from 15 per cent of GDP to 20 per cent of GDP during the period.

in Open Market Operations (OMO). Debt Recovery Act of 1990 ensured faster debt recovery but not without questions on fairness. Establishment of the Credit Information Bureau was a major step towards information integration and accessibility. The period witnessed the restructuring of a troubled bank and the country joining a global instantaneous transaction link.[22] Creation of appropriate infrastructure for development and stability of the capital market were among the major contributions for market development during the period.[23]

The period from 1990 to 1994 witnessed steady and continuing foreign exchange inflows to the country supported by buoyancy in commodity export prices, recovery of tourism, better utilisation of foreign assistance and structural adjustment measures adopted to improve economic performance. As a result, the external assets of the banking sector showed a significant improvement together with improved external reserves, BOP position and private investments. Credit control mechanism, which was in place since 1989, was eliminated while refinance facilities available from very early stage under the Medium and Long Term Credit Facility of the CBSL was suspended, removing impediments for the CBSL to rely completely on market based indirect instruments for monetary policy management. Expansion of SRR to cover foreign currency deposits and further revision to the SRR rate was helpful in bringing down inflation in 1994 – 95. By 1995, though private investment was high, escalating government expenditure resulted in a budget deficit of 10 per cent of GDP. The BOP reverted to overall deficit while showing a significant expansion in bank credit.

The bomb blast at the CBSL in 1996, though it caused substantial physical damage, did not create any instability in the financial market. Introduction of Reverse Repurchase transactions (together with repurchase transactions introduced in 1993), activation of interest rate corridor and streamlining primary dealer system were instrumental in increasing the orderliness and stability of the market interest rates. Higher interest rates and SRR were required to address the increasing threat of credit growth and inflation.

Introduction of commercial paper (a short term corporate borrowing instrument) and long term government bonds were helpful in filling market gaps and bringing flexibility to the financial markets. The period witnessed several significant changes in the operating environment including, shifting to an `independently floating exchange rate regime, linking net open position of commercial banks to prudential limits by basing it on capital and reserves of banks and permitting

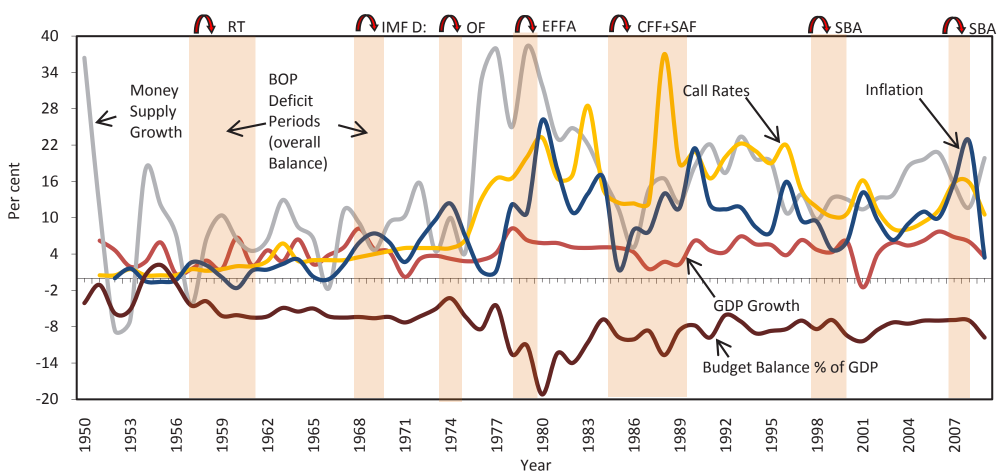
22 Suspension and restructuring of the operations of the local branch of Bank of Credit and Commerce International (BCCI) by the CBSL, following the collapse of its worldwide operations without any significant impact on domestic financial system in 1991 while instantaneous transactions and settlements were made possible by the country joining the Society for Interbank Financial Telecommunication (SWIFT) in 1993.

23 Introduction of Share Investment External Rupee Accounts (SIERA) to facilitate nonresident investments in shares of domestically listed companies, establishment of Securities and Exchange Commission (SEC) for regulation and direction of capital market activities, creation of Central Depository System (CDS) to facilitate speedy and secure transaction settlement and facilitation of Unit Trusts to enhance participation of small investors in securities markets had contributed significantly in creating appropriate infrastructure.

non-residents to invest in US dollar denominated government securities. The establishment of a clearing institution (Lankaclear), Real time Gross Settlement System (RTGS) and Scripless Securities Settlement (SSS) system enhanced the operating ease, reliability and stability of the transactions, payments and, settlement functions. The operations of the CBSL were restructured and streamlined to suit the changing economic environment by concentrating more on overall focus. Creation of several dedicated departments and two important internal committees namely Monetary Policy Committee (MPC) and Financial System Stability Committee (FSSC) on the lines of international best practices were important milestones of strategic refocus of the CBSL activities on stability.

Chart 6.1

Inflation, GDP, Money Supply, BOP, Fiscal Position and Call Rates 1950-2009



Despite these positive developments, weak fiscal discipline and external vulnerability remained the main causes of instability in the financial market that required external assistance (Chart 6.1). Efforts of the CBSL kept the financial market volatility in check, though in intermittent periods with limited consistency. As in the past, the period following the external shock, domestic financial markets as well as the economy reflected movement towards relative stability. However, reversal to monetary expansion preceded lasting stability in most instances refilling threat of inflation and volatility in market interest rates keeping economic growth range bound.

The period prior to the global economic crisis witnessed very high commodity prices including petroleum and crude oil. The civil conflict had also created an unprecedented demand on the country's external resources for its requirement on import of implements for counter terrorism activities. Consequently, the country was facing a very large trade deficit. On top of this, the intensification of global economic slowdown with liquidity crisis in 2007/8 resulted in reversal of external financial flows meant mainly for investment in rupee denominated government securities and other portfolio investments. Interventions by the CBSL prevented faster depreciation of the exchange rate of the rupee, but with drastic reduction in external assets. Global credit crisis prevented further lending by overseas banks and dried down almost all the foreign currency credit lines available to domestic banks. In the domestic market interbank money market almost dried down on concerns on viability of some smaller/weaker domestic banks. The CBSL responded by addressing concerns in the rupee market through a multitude of measures to strengthen the banking system, collateral values and market liquidity directly and indirectly. Reduction of SRR and purchase of Treasury bills by the CBSL released substantial amount of liquidity to the banking system. Removal of restrictions on Reverse Repurchase facility improved the access of the banking system to liquidity. In the foreign exchange front, the CBSL provided liquidity support for needy banks by way of placing foreign currency deposits domestically and lending in foreign currency on other acceptable collateral, even going beyond the conventions.

Decline in property prices created a dent in the asset and collateral valuations hitting hard on property linked investments and loan portfolios. At the same time, few registered businesses were illicitly accepting deposits in disguise offering very high interest rates. Businesses of realtor services and financing were affected. Delinquencies and non performing components on the loan portfolios of banks were on the increase. These developments encouraged investors to shift from yield to quality. The first casualty was those illicit deposit takers and finance company deposit takers. However, the shock was manageable except in a few cases where a domestic bank and a few other financial institutions related to a business conglomerate having significant exposures in such sectors were involved.

Concerns about the related business conglomerate that was in a highly leveraged[24] operating environment and stressed finance companies in the group, on to which the bank in the group had substantial exposure triggered a run on its deposits though the financial position of the bank in general remained sound. The CBSL intervened and exercised its powers vested under the Monetary Law Act and removed the directorate immediately and vested the operations with the largest state commercial bank with a new directorate with vast banking related experience. A host of other related exercises initiated by the new board involving its employees under the guidance of the CBSL prevented further downturn and re-established the depositor confidence. Involvement of a large state commercial bank was helpful in reducing credit concerns of the bank involved. The CBSL provided the necessary temporary liquidity on extended collaterals during the period until market doubts cleared off.

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24 High debt financing compared to substantially small equity (ownership) financing facilitated due to highly exaggerated cross holding (inter-company holding) structure.

Further the interventions by the CBSL in introducing financing facility to establish a floor price for real estate assets/securities and other liquidity support prevented a broader calamity in the financial market and restored public confidence. Interbank market fell short of liquidity and extreme risk aversiveness with visible reluctance to lend, both in foreign exchange and rupee. The CBSL provided liquidity in both the markets until normalcy was restored. However, all these measures were taken amidst a worsening BOP position aggravated by an expanding current account deficit and world liquidity and credit crunch forced borrowing difficulty. The CBSL ventured out of convention and established a few foreign currency swap lines with friendly central banks in the region and regional financial clubs. To avert an impending BOP crisis, the country resorted to the IMF for a facility under a Stand-By Arrangement. By then, the world had shown signs of recovery from the deepest slowdown since the Great Depression.

Almost simultaneous cessation of civil conflict created new foreign investor demand for Sri Lanka government securities on relatively high domestic interest rates, resulting in an unprecedented excess liquidity in the market. Stand-By Arrangement with the IMF was unprecedented in terms of size (US dollars 2.6 billion) and was instrumental in re-establishing much needed investor confidence and was instrumental in alleviating concerns on future payment capability and disciplined economic management. Tight monetary policy pursued by the CBSL together with freed up domestic production, decline in external trade and low international commodity prices helped in reducing domestic inflation to mid single digit level resulting in a significant decline in market interest rates. Yields of government securities reflected a speedier adjustment. Challenged with the excess liquidity and low demand for credit by the private sector, the CBSL employed all conventional tools at its disposal for liquidity absorption. OMO were intensified with increased frequency and volume. Instrument cluster was increased by introduction of new instruments such as foreign exchange swaps to supplement OMO. Operational environment was further relaxed by lowering official interest rates, SRR and by removing a host of exchange control restrictions. Although the daily liquidity in the interbank market was brought down to a manageable level, the CBSL is saddled with continued cost of sterilisation not months but years ahead. Market seems to have convinced that stability in the economic environment will be maintained from here as reflected in the falling yields (already in single digit) of longer dated government securities (five and ten years).

Domestic foreign exchange market is showing regained stability after long years of depreciation with rupee appreciation over two per cent during the year upto September 2010. Although the corporate bond market is yet to emerge, the share market has shown a significant and continuous growth in the past few months. Money market rates are already below or around official rates and bank lending rates were on a declining trend. Assets of the financial institutions almost equalled the GDP compared to just around four per cent in 1948, showing decades of maturity and growth. Still the budget deficit remains high with continued financing though at a lower scale by the CBSL. Stabilising financial markets in the past six decades resembles manoeuvring in roaring white waters, but the journey is not finished yet; the future could at times be more tiresome and challenging, but courage, commitment and correct application would draw success. From here, the challenge for the country would be to move out of cyclical instability by moving onto a high growth path with proper regard to the potential capacity and stability of the economy. Stable financial markets would provide impetus for such an end and beyond.

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