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The Long March of the Central Bank-
60 Years of Central Banking in Sri Lanka

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The day 28 August 1950, marked the dawn of a new era in the economic and social development history of Sri Lanka. The year witnessed the birth of a great institution called the Central Bank of Ceylon[1] with the strong expectation that it would contribute to the prosperity of the country and raise the welfare of the people. Immediately after independence, the political leadership realised that uplifting the economic status of the country and its people should go hand in hand with economic independence and the Central Bank was set up to establish financial autonomy. This was a ray of hope for Ceylonese people who were grappling with low per capita income, high level of absolute poverty and rising unemployment. The Central Bank of Sri Lanka (CBSL) was statutorily empowered under the Monetary Law Act No.58 of 1949, equipped with all the necessary instruments to manage financial conditions of the country and was expected to bring prosperity primarily by maintaining stability both in prices and the financial system.

In 2010, the CBSL completed 60 years of its service to the nation. Its journey of six decades has been highly challenging but rewarding with many fulfilling outcomes. Political developments, technological advancement and developments in economic theory and practice caused the role of the CBSL to evolve and mature. There were also several important lessons learnt. The CBSL experienced some of the great ups and downs of the Sri Lankan economy while grappling with episodes of economic turbulences, global shocks, domestic shocks, civil war, terrorist attacks

1 The name 'Central Bank of Ceylon' was changed to 'Central Bank of Sri Lanka' on 31 December 1985.

and natural disasters. During these six decades, Sri Lanka has experienced a modest average annual growth of 4.4 per cent and an annual inflation rate of 8 per cent. By end 2010, average inflation stood at 5.9 per cent and the country was moving towards a high growth trajectory. Reflecting the strong potential of the economy subsequent to the ending of the internal conflict, the Sri Lankan economy recorded an impressive growth of 8 per cent in 2010. Per capita income of the country reached a level of US dollars 2,399 in 2010 compared with US dollars 120 in 1950 promoting Sri Lanka into the middle income category. Living standards have improved considerably with the poverty headcount ratio reducing to 8.9 per cent and the unemployment rate decling to 4.2 per cent. The CBSL played a pivotal role and led the economy in achieving all these impressive outcomes by creating right monetary conditions conducive for people to create more wealth, maintaining a robust financial system, building and developing financial and debt securities markets, managing volatilities in money and exchange markets and adopting latest technology and best international practices in the financial spectrum. In fact, throughout the period, the CBSL maintained its credibility and earned public respect through its admirable record of work.

Commissioning of Central Bank of Ceylon

Looking back at the time of the establishment of the CBSL, the country remained predominantly rural and peasant agriculture was the main source of employment. The financial system was rudimentary and fragmented. At independence, all monetary matters in Sri Lanka were handled by a Currency Board system. Under this system money supply had an automatic link with the foreign exchange earnings; the amount of currency issued expanded when the balance of payments of the country was in surplus and contracted when it was in deficit. Hence, though it provided an automatic adjustment to balance of payments, the Currency Board mechanism did not have the flexibility required by the authorities to accommodate the growing needs of the expanding economy.

Considering all the above and also influenced by the intended setting up of central banks in Korea and the Philippines, the first finance minister of independent Ceylon, Mr. J. R. Jayawardena requested assistance from the Federal Reserve Bank, USA to set up a Reserve Bank in Ceylon in 1948. In response, Mr. John Exter, an eminent economist of the Federal Reserve Bank, USA who had been associated with establishment of central banks in Korea and Phillipines was sent to the country. He was requested to frame proposals for a draft constitution for the Reserve Bank for Ceylon. The Monetary Law bill, prepared on the basis of the recommendations made by John Exter, through his report known as the “Exter Report” was presented to the Parliament in 1949. Diverse views were expressed by the House of Representatives. Overall, the Exter Report was greatly admired considering its clarity, directness, succinctness and sustained relevance to the subject matter. Some however, were doubtful about the effectiveness of the Central Bank and some House Representatives enunciated that “Minister of Finance is in danger of putting too great value or overestimating its function as it is not equipped with the required other infrastructure and institutional setup". In contrast, several members stated that "it was much more important than even the Independence bill". Amidst all these, the "Central Bank of Ceylon" was established in 1950.

John Exter, as the first Governor of the Central Bank of Ceylon clearly spelt out the rationale for the establishment of the CBSL. He strongly emphasised that the Central Bank is a necessary condition for future prosperity and the Bank's contribution must necessarily be a long run contribution. Further, he explained that the Bank does not itself produce goods and services, and it cannot directly get involved in economic activities. The Central Bank's only weapon is to print money (fiat money) or create credit. Hence, the prime responsibility of the Bank is to create the right monetary conditions for maintaining price stability or creating an inflation free environment conducive for people to take a medium to long term view and create more wealth. In a stable monetary environment, which is conducive to create real wealth, the task of the government and the private sector is to take appropriate measures for the same. The CBSL was also empowered to examine and supervise commercial banks in order to strengthen the banking system, which would in turn enhance flow of credit promoting expansion of economic activities. John Exter believed that such powers will prevent banks from engaging in unsound practices and protect the depositors from bank failures. Meanwhile, Exter also believed that the CBSL could support efficient handling of public finances by acting as the government's fiscal agent, banker and financial adviser. Since the CBSL was regarded as the most trustworthy and capable agent of the government, somewhat non central banking functions were also assigned to the Bank both at the time of establishment and later on. Among those were the implementation of exchange control regulations, management of the Employee's Provident Fund, public debt management, financial intelligence unit (FIU), etc. On the whole, as stipulated in the Monetary Law Act, the Bank was expected to maintain monetary stability, preserve both internal and external value of the rupee and to initiate actions for promoting growth and employment and full development of resources within the Sri Lankan economy. In fact, the tasks assigned to the newly established Bank were extremely challenging, as such targets were not necessarily seen compatible and harmonious at all times.

Role of the CBSL in Managing the Economy

Monetary Policy in the Early Era

When the Bank started business in 1950, the economy was favourably placed with an external assets portfolio sufficient to finance 12 months of imports, surpluses in the trade account, the current account, and the overall balance of the balance of payments (BOP) and the budget deficit and debt containing at around 4 per cent and 16 per cent of the gross domestic product (GDP), respectively. Fixed exchange rate system was maintained and the Sri Lankan Rupee was pegged to the Sterling Pound. The challenge ahead was to achieve high growth while maintaining stability in the domestic economy. The first challenge the Bank had to face was the Korean boom, which threatened the Sri Lankan economy in several ways. The sharp rise in export prices in

1949 and 1950 in the context of the Korean war resulted in large balance of payments surpluses requiring the Bank to sterilise the expansionary impact of higher export proceeds to avert inflationary pressures. The CBSL used conventional monetary measures such as raising SRR on demand deposits, credit controls and to a limited scale, open market operations. The efforts were reinforced by adopting unconventional policy measures, and commercial banks were allowed to invest their foreign exchange working balances abroad so that the monetisation of proceeds were postponed until the domestic economic situation was free of a threat to stability. Despite these efforts to contain the expansion in aggregate demand, external assets declined by 43 per cent in 1953 due to the fall in export income, adverse terms of trade and increased level of imports. The creation of huge domestic purchasing power through expansionary fiscal deficits funded by the Central Bank, high consumption expenditure of the government and reluctance of the people to get readjusted to a normal expenditure pattern even after the boom subsided were the key reasons for the deterioration in the external position. The situation was relieved to a certain extent with the tea boom, which occurred in 1954, improving government finances and generating budget surpluses in 1954 and 1955. The CBSL issued its own securities for the first time in 1956 to mop up excess liquidity.

In the next few years, the Bank had to face a serious challenge posed by the expansionary fiscal policies associated mainly with large food subsidies, the deficits arising from which were mainly financed by the banking sector. The budget surplus enjoyed in 1955 turned out to be a deficit by next year and it rose up to 6 per cent of GDP by 1959. The Bank pointed out the danger of inflationary financing and repeatedly advised the government to curtail excessive subsidies on consumption, which led to large budget deficits. The CBSL finally took a bold decision in 1959 to raise the Bank rate to reflect true cost of borrowing in the wake of escalating budget deficits and deteriorating BOP situation, despite differences of opinion between the Ministry of Finance and the Monetary Board. By the end of the decade, the Korean war surplus, which was sufficient to finance about 12 months of import requirement of the country dwindled away creating a severe BOP crisis mainly due to the sharp increase in import expenditure. Nevertheless, the country remained committed to its fixed exchange rate arrangements and monetary policy measures were not strong enough to arrest the situation. The effectiveness of monetary policy measures during the first 10 years was impeded by the continuous reliance on expansionary fiscal policies and the government pressure to maintain a low interest rate policy as evidenced by the directives issued in 1959 by the government to reduce the Bank rate revoking the decision of the Monetary Board. In a nutshell, Sri Lanka lost a valuable opportunity, which could have laid a foundation for sustainable growth by an appropriate interest rate policy in coordination with a set of appropriate fiscal and exchange rate policies.

Monetary Policy in a Controlled Regime

In the next 17 years, macroeconomic management was severely threatened by two key factors i.e., (a) worsening balance of payments situation resulting mainly from low growth in exports and failure to diversify the export structure and (b) high fiscal deficits associated with increasing subsidies on food, health and education, which were financed by the banking sector. The key set of policy measures adopted by the government in this environment was strict exchange controls, import substitution, reliance on the domestic sector and gradual expansion in the size of the public sector. In keeping with the government policies, the focus of monetary policy had to be placed both on stability and development objectives. This made the task of the CBSL more difficult as the two objectives conflicted with each other. Throughout the period, the Bank had to make concerted efforts to deal with severe BOP crises that resulted in a sharp fall in external assets while financing escalating fiscal deficits associated with increasing subsidies, which in turn affected the BOP. In the meantime, the CBSL, with a view to achieving the development objective had to provide subsidised credit to priority areas through refinances, thereby building such concessionary credit schemes permanently into the monetary policy structure. Strict exchange controls and low production created a scarcity of goods while inflationary financing of fiscal deficit and concessionary refinance schemes added fuel to inflation. Throughout the period, the budget deficit remained at 5-6 per cent level but sprang to 8 per cent by 1976.

The Bank adopted a restrictive monetary policy stance with some concessions throughout the period and a conducive environment for market oriented monetary management did not exist. Thus interest rates were not effective as an instrument of monetary policy and the CBSL had to depend largely on direct control measures such as credit controls and credit ceilings including imposing credit controls on non essential imports. Throughout the period, the Bank was very critical of the policies of the government of that time and the measures implemented to the detriment of the country and its people. In a nutshell, the CBSL found it difficult to operate effectively in a highly controlled restrictive and regulated economy. The monetary policy adopted during this era was a mixture of concessions, subsidies and controls giving short term solutions to emerging macroeconomic problems. The outcomes were a continuous expansion in the money supply, which reached to 34 per cent by 1976, the highest recorded deficit in the budget since 1950, a sharp fall in foreign assets to a level sufficient for financing 3 months of imports, which were heavily controlled through regulations, economic growth as low as 3 per cent and a shortage of goods with suppressed inflation through price controls.

Fostering Growth and Maintaining Stability in a Liberalised Environment

In 1977, Sri Lanka significantly departed from the closed economic policies and introduced policies to liberalise the economy. There was a fundamental change in the policy spectrum from the narrow objective of import substitution through extensive controls to an outward looking export oriented industrial development programme. The main features of the new policy included greater reliance on the market system for resource allocation, abandoning of import and exchange controls, harnessing of private foreign capital, etc. The year marked a significant milestone in the history of the Central Bank, as it took leadership in driving the economy into the new era by setting appropriate monetary and exchange rate policies, establishing new institutional, legal and financial infrastructure and setting the right environment for investments.

The most significant reform was the readjustment of the exchange rate mechanism. Sri Lanka maintained a fixed exchange rate system through the 60s and most of the 70s with a rigid system of exchange controls. The Rupee was first devalued by 20 per cent in 1967 and supplemented with even a more depreciated exchange rate for nontraditional exports and non essential imports under a system of dual exchange rate in 1968. With the suspension of the convertibility of US dollar for gold in August 1971 by the United States, the rupee was linked to the US dollar, allowing the parities against other currencies to be determined on the basis of their cross rates with the US dollar in international foreign exchange markets. Sri Lanka moved from a hard peg to a single currency, to a basket peg in May 1976. The exchange rate system was changed to a crawling peg system in 1977 allowing it to reflect changes in macroeconomic fundamentals with the intention of making the exchange rate more realistic.

In monetary policy spectrum, policy was strengthened by improving scope, coverage and the strategy. The Bank redefined the monetary aggregates used for the policy purposes to take into account innovative instruments and practices introduced in the banking system. First, in 1980, the definition of money supply was broadened from the narrow definition of M_1 to M_2 by including the time and savings deposits of the public held with commercial banks. Second, the entire strategy of monetary policy was refined by applying appropriate instruments to influence and target monetary indicators more effectively. Third, the bank commenced preparing an annual monetary programme on a quarterly basis, which was compatible with the projected basic macro variables such as BOP, budgetary outcome, growth rate, and inflation in the country. The programme facilitated the use of monetary policy instruments in a more effective manner in order to maintain the monetary base at a desired level.

The CBSL was instrumental in developing the money market particularly with the aim of successful implementation of the Open Market Operations (OMO). Repurchase facility was introduced for the first time in 1993 to absorb excess liquidity in the market and reverse repurchase facility was introduced in 1995 to provide liquidity on overnight basis and thereby containing the excessive volatility in the market. Money brokers were allowed to operate while new features were added to the market by establishing a secondary market for Treasury bills in the Central Bank. More importantly, the interest rates were allowed to move freely in the market in response to demand and supply forces thereby facilitating monetary policy transmission mechanism, promoting investments, encouraging savings and discouraging wasteful expenditures.

During the first 20 years since 1977, the thrust of the monetary policy was placed on achieving both stability and development objectives. The key challenges were to tame overheating of the growing economy and address huge BOP deficits experienced throughout the period partly due to external shocks. The challenge was intensified by expansionary fiscal deficits cropped up by the internal conflict, which started in the early 1980s and aggravated in 1983, 1987, 1992, and 1996. Most of the time, the CBSL had adopted a rigid monetary policy stance to address all these issues by using conventional direct monetary policy instruments while at the same time continuing with development oriented refinance schemes extensively for priority sectors. Recognising the limited effectiveness of direct instruments, the emphasis was shifted to open market operations from mid 1984 and the bank issued its own securities to mop up the excess liquidity in the economy and the bank was successful in controlling monetary expansion in many instances. In order to make the implementation of monetary policy more effective while improving the government debt securities market, the bank took major steps during 1985-1999, especially opening the discounting and rediscounting window for Treasury bills at the CBSL and thereby encouraging secondary market for Treasury bills and introducing weekly auctions and long maturities for Treasury bills, introducing Treasury bonds, reforming primary dealer system introduced in 1992, etc. Meanwhile moving towards more liberalisation in 1994, having completed the removal of restrictions on current international transactions, Sri Lanka accepted obligations under Article viii of the IMF articles of Agreement.

The year 1996 is marked as a grey year in the history of the Central Bank. The most devastating and horrendous bomb explosion destroyed lives of 41 officers and made the bank totally uninhabitable. The commitment, dedication and tireless effort made by the staff enabled the bank to restart its business the following day and rebuild the shattered business confidence within a very short period. Immediately after this event, the Bank had to deal with the Asian crisis, which took place in mid 1997 but the bank was fared well in handling economic affairs compared to most of its peer countries.

Maintaining Economic and Price Stability in a Turbulent Environment

With the dawn of the new millennium, the Bank had to face a series of external as well as internal turbulences. In 2001 there was a sharp fall in external reserves as a combined effect of recession in the world economy, which severely reduced external trading activities, frequent terrorist attacks, which sharply curtailed tourism and business confidence and unfavourable weather, which resulted in a fall in domestic output. Having carefully considered this evolving condition, the Bank took a vital decision and moved in to an independently floating exchange rate regime in 2001 enabling a turn around in the reserve loss by opening another channel to absorb the burden of external shocks. Despite an initial volatility that was short lived, the shift to a floating exchange rate system was well managed and supported by high interest rates and prudential measures on forex transactions issued to the authorised dealers. With the market gaining experience under the present exchange rate system, by adjusting policy rates gradually, rates of interest in the market were brought to their lowest by 2003 supported by improved macroeconomic environment, and prudential measures were relaxed gradually and withdrawn over time.

With the shift to a floating exchange rate regime, the exchange rate could no longer serve as a nominal anchor for monetary policy. Consequently, highlighting an important shift in the monetary policy strategy, the CBSL placed greater emphasis on reserve money, which became the operative target in the overall monetary programme, in pursuing the final objective of the price stability. In fact, with the financial market becoming more stable while strengthening economic and price stability, the bank introduced a system of Active Open Market Operation in 2003. This enabled the Bank to actively manage liquidity, to maintain interest rate stable within a corridor formed by its Repo and Reverse Repo rates while signalling a change in the monetary policy stance by shifting the corridor and thereby to attain its monetary policy targets more effectively.

Tsunami in December 2004 posed another challenge to the Bank in the conduct of its monetary policy. In recognition of the importance of keeping the banking system well liquid to ensure smooth operations and deal with any contingency, the Bank released liquidity quite liberally and even suspended the absorption of liquidity through daily auctions under OMO for a limited period. In fact the Bank took precautionary measures and kept the payment systems open to meet any contingency. A special scheme was also implemented to assist people and businesses affected by Tsunami in their rehabilitation and reconstruction efforts. Under the circumstances, this accommodative policy stance had to be adopted despite rising pressures as indicated by higher monetary expansion and rising inflation.

On the whole, the Bank has adopted a tight monetary policy stance since the beginning of the decade and was able to maintain inflation at single digit level until end 2004. In 2005 the inflationary pressures started to rise in particular due to supply related factors such as escalating oil prices in the international market and unfavourable weather conditions prevailed. In the meantime, the internal conflict that had ravaged the country for almost 3 decades reached a critical juncture by this time requiring a huge magnitude of resources and imposing severe pressure on banking system. The Bank had to be mindful of its responsibility in a war environment but recognised the need to maintain a balance between containing demand pressures and accommodating pressing requirements of resources. Accordingly, the Bank was rather conscious in adjusting its policy rates, but tightened its monetary policy stance gradually by imposing quantitative restrictions on access to the Central Bank funds by commercial banks and primary dealers and introducing a penal rate of interest for access beyond the limit.

The year 2008 will be remembered as one of the most difficult and challenging year in the CBSL history. Achieving of both objectives, economic and price stability and financial system stability, were severely threatened by unprecedented global shocks. Despite the tightened monetary policy stance adopted over the last few years, inflation accelerated to the highest ever recorded level owing to the impact of food and energy crisis in the global economy in 2008. However, the lagged impact of the tight monetary policy was observed since the latter part of the year and inflation sharply dropped from 28.2 per cent in June 2008 to 7.6 per cent by end February 2009 with the improvement in supply side and tumbling food and energy prices with slowing down in global economy.

The financial crises that emerged in the USA in 2007 intensified and turned into a global finance turmoil in September 2008. The turmoil triggered a sharp reversal of capital flows, resulting in a loss of 50 per cent of external official reserves as foreign investors, owing to their own liquidity constraints liquidated their investments in government securities. The country also had to settle certain liabilities arising from petroleum imports and certain other imports as liquidity in international financial market virtually dried out with the financial crisis. The Bank was prepared to face the situation as it built up reserves when foreign investments were flowing into the government securities market, but as decline in reserves continued, measures were taken to obtain liquidity including commencing dialogues with friendly nations for SWAP arrangements and negotiations with the IMF for a Stand-By Arrangement (SBA). With the ending of the war in May 2009, there was a sharp improvement in investor confidence, which was further supported by the approval of the SBA facility in July 2009 and the fact that investors were able to liquidate their investments even at the peak of the financial crisis without incurring any losses. In fact, financial inflows commenced even before the approval of the IMF facility. There were inflows in large volumes even for long term Treasury bonds and the country was successful in floating its second sovereign bond in 2008 at a very competitive rate. While maintaining stability in the domestic foreign exchange market, measures were also implemented to ensure stability in the money market, as the rupee liquidity drained with the outflow of foreign exchange. Accordingly, the market liquidity was maintained by reducing SRR from 10 per cent to 7 per cent by end February 2009 in three steps and by acquiring as and when deemed necessary government securities both at the primary issues and in the secondary market. The implementation of these measures was supported by the gradual decline in inflation and inflation outlook as observed since late 2008. The decline in inflation, lower interest rates and renewed investor confidence contributed to the robust performance of the equity market, which became one of the best performing stock markets globally today. Undoubtedly, this remarkable recovery in the Sri Lankan economy was bolstered by the conscious, timely and coordinated policy efforts made by the Bank during these years.

Improving Transparency and Managing Expectations

In early years, central banks did not recognise the importance of sharing information particularly, those pertaining to policy decisions with the general public and always maintained secrecy. Conducting monetary policy was a mystery to the public. However, central banks around the world have become noticeably more open and transparent over the past fifteen years with the realisation of the importance of managing expectations in achieving their objectives. In line with this trend and the best practices adopted by other central banks during last decade or so, there has been a shift toward more transparency and openness in operations of the central banks while enhancing the predictability of its policy stance. As an integral part of making its monetary policy decisions and operations more transparent, the Bank appointed a Monetary Policy Committee to review the monetary policy stance on regular intervals and make recommendations to the Board and commenced issuing a monetary policy statement on an advanced release calendar, following the monetary policy review by the Board, announcing the monetary policy decisions and underlying macroeconomic conditions. The decision making process pertaining to monetary policy has been further streamlined by appointing a Monetary Policy Consultative Committee made up of various stakeholders drawn from the private sector and academia, to independently review the Bank's monetary policy actions and make suitable recommendations to the Board. With the objective of enhancing the policy predictability by keeping the public informed in advance, the Central Bank commenced announcing its Road Map for Monetary and Financial Sector Policies in January 2007. The communication strategy has been further strengthened through regular and occasional press releases on important economic developments and issues, Governor's speeches in various forums on economic affairs and public lectures and seminars.

As Promoter and Regulator of the Financial Sector

Over these 60 years, the CBSL has continued to preserve the soundness, efficiency and stability of the financial system while acting as a promoter and regulator of the financial sector. When the Central Bank was established in 1950, the banking system was in a rudimentary state with one domestic bank and some 10 foreign banks. None of these banks were lending outside their traditional spheres of activity and the emphasis in their business was largely on financing commerce and trade. The expansion in the banking sector especially branch expansion started with the establishment of Peoples Bank in 1962, an initiative of the CBSL. With the liberalisation of the economy in 1977, the CBSL took the leadership in thriving financial sector by way of building institutions and financial infrastructure, strengthening legal and regulatory framework, allowing market determination of interest rates and opening areas for the private sector participation. Encouraged by this new initiatives, foreign banks entered in to the Sri Lankan market while the domestic private sector was also encouraged to start commercial banking, creating a competitive environment in banking industry. Almost all banks started Foreign currency banking units (FCBUs). Financial market was further strengthened by introducing new types of financial institutions such as Money brokers, venture capital companies, merchant banks, unit trusts etc. The Bank was instrumental in setting up of certain large financial institutions such as Development Finance Credit Corporation (DFCC), National Development Bank (NDB), National Savings Bank (NSB), to undertake specific banking functions, which were subsequently brought under the regulatory authority of the Central Bank as licensed specialised banks. In summary, over these 60 years, type of institutions, instruments, range of services, and the geographical coverage of the financial sector expanded significantly. The financial system has been evolved from a rudimentary financial system to a highly diversified system, from highly controlled to a system that functions with great market orientation, from a highly fragmented to a more consolidated system. Today Sri Lanka has a dynamic, vibrant and technologically advanced financial sector with 22 commercial banks, 14 long term financial institutions, 35 Finance companies, 74 Leasing companies and other entities such as Merchant/Investment banks, Venture capital companies, Mortgage banks etc.

The CBSL has the sole authority of regulating and supervising the financial system in Sri Lanka. However, in early decades the need for extensive supervision of banks was not felt as the degree of complexity remained modest. The Banking Act No. 30 of 1988 strengthened regulatory powers of the CBSL in ensuring smooth functioning of the financial system safeguarding the interest of depositors. Meanwhile, a legal framework for regulating finance companies was enacted giving powers to the Central Bank to regulate and supervise finance companies in 1980. During 1986-88 there were failures of a number of finance companies and the Bank intervened to address and build confidence in the industry. A new Debt Recovery Law was enacted to make the banking system more viable while, a Credit Information Bureau was established in 1990 to share information with banking institutions to establish creditworthiness of prospective borrowers.

With the rapid integration of the Sri Lankan economy with global financial markets, there is a potential threat to the financial system from financial turmoil in other countries. Further, money laundering, terrorist financing, pyramid schemes, unauthorised finance entities etc. have enhanced the severity of the threat. Having recognised these challenges and in line with the international best practices, the CBSL introduced new regulatory standards based on international guidelines provided by the Basel agreements in 1998. Supervisory and regulatory framework was further evolved in the recent decade with the introduction of prudential guidelines in the area of capital adequacy, liquid assets, loan loss provisioning and single borrower limit and the prudential regulatory framework has been evolved from a compliance-based approach to a risk based approach, limiting risk concentrations and requiring financial institution to establish strong risks control systems.

The year 2008 witnessed the implementation of a major policy initiative to strengthen the risk management system in banks with the adoption of pillar one of the Basel II capital adequacy standards. The implementation of the direction on corporate governance was a further milestone in this respect. The preemptive measures taken over the past years in the financial system and the enhanced risk management infrastructures placed the financial system on a strong footing to absorb the impact of the recent global financial turmoil. Meanwhile, the financial crisis originated from the collapse of the US sub prime mortgage market quickly spread throughout the financial markets in advanced as well as developing countries in 2008. This has had adverse effects at varying intensities on developing countries depending on their interaction with global economy. In the case of Sri Lanka, because of the fact that the capital account has not been fully liberalized and that many local banks did not trade in complex financial instruments, the direct impact of the global financial crisis on the financial sector was minimal. However, towards the end of 2008 a crisis leading to a run of deposits was triggered in relation to Seylan Bank PLC (SBP) due to the contagion effect of the collapse of one of the companies of the Ceylinco Group, the Golden Key Credit Card Company Ltd. The sudden withdrawal of deposits resulted in a significant deterioration of the liquidity position of the SBP. As SBP is a systemically important bank, any failure of the bank to honour payments would have had a ripple effect on the entire financial system, perhaps causing a systemic crisis.

The Central Bank took immediate action to resolve this situation. First, the resolution framework that was already in existence was activated by the Bank to respond to the situation in order to avert a potential danger to the stability of the financial system. The key strategy adopted by the Bank was to revive SBP through rebuilding customer confidence. The bank appointed a new Board of Directors to SBP, and allowed all employees to continue their work without interruption. Managerial assistance was provided through Bank of Ceylon and rupee liquidity was accommodated under the Central Bank Reverse Repo window. The depositors were assured safety of their deposits and SBP was requested to raise capital of around Rs. 3 billion to further strengthen capital management and operations of the bank. The actions of the CBSL to rebuild customer confidence on the bank resulted to improve capital adequacy and liquidity levels of the bank significantly. The bank has successfully overcome the crisis and a year later recorded a healthy financial performance to build a sustainable business for the future. The timely and speedy action of the CBSL halted a crisis in the SBP and enabled the bank to safeguard the interest of all stakeholders without incurring public funds or any mode of nationalisation as occurred in many developed countries.

In 2008/2009 there was a crisis in the non banking sector that spurred from the loss of public confidence in shadow banks which were either unregulated or less regulated. The crisis was confined to a few companies and the common features of affected companies were excessive exposure to the real estate sector, unauthorised deposit taking, weak risk management, imprudent related party transactions, unethical business practices, negative capital, accumulated losses, etc. Similar to the case of SBP, the CBSL adopted a specific resolution mechanism to promote customer confidence and rehabilitation of businesses of those institutions. The Bank was of the opinion that no public funds to be used as the crisis was due to the lapses of the directors and managers. The specific measures implemented were appointment of managing agents, ceilings on total deposit liabilities, stimulus package to raise funds using their marketable assets, removal of executive powers of directors, appointing a panel of experts to advise the business companies on business restructuring, strengthening regulatory framework relating to RFCs, etc. As a result of these measures, affected companies were able to rebuild their businesses with new capital and strategic investors.

In 2010, the regulatory and prudential framework of the financial sector was further strengthened with emphasis on capital enhancements, improvements to cooperate governance and risk management infrastructure in financial institutions. A financial safety net for depositors was introduced in 2010 with the implementation of the CBSL operated mandatory deposit insurance scheme for banks and finance companies to protect small depositors. In view of the deficiencies in the existing law a new law, for the regulation of finance businesses has been finalised to combat unauthorised deposit taking entities and to upgrade regulation of finance companies. The Banking Act is also being amended to enable consolidated supervision of banking groups with new provisions for mergers and acquisitions and bank resolution measures.

As a Debt Manager

The Bank as an agent of the government played a crucial role in improving government debt management over the 60 years. The CBSL initiated vital steps in developing the Government securities market as it is essential for raising required resources at lowest cost with a minimum risk and also for better liquidity management. In particular over the last 20 years activities in the market was greatly facilitated by introducing new market instruments such as Treasury bonds (1997), Sri Lanka development bonds (2001), Treasury bills with multiple maturities (1989), etc, while market structure was strengthened by introducing secondary market for Treasury bills (1981), weekly auction system (1986), accredited Primary dealer (PD) system (1992), which was further improved as a dedicated PD system (2000) and Electronic bidding system (1998), etc. In addition, a comprehensive and modern depository, delivery and settlement system that facilitates the issuance and settlement of debt securities improving market efficiency was in place since 2004. Initiatives were taken to develop a secondary market for Treasury bills by introducing discount and rediscount windows at the CBSL. The CBSL' s decision to open the Treasury bill and bond market for foreigners in 2006 and 2008, respectively, enhanced the depth and breadth of the debt securities market. The CBSL was instrumental in getting country Credit Rating in 2005 and at the height of civil war; the CBSL raised US dollars 500 million through its debut sovereign bond issue in the international market in 2007. The subsequent sovereign bond issues in 2009 and 2010 were even more successful and enabled better rearrangement of the public debt portfolio.

Accommodating Special Needs

Since early 60's, the CBSL has involved in addressing abject poverty in rural areas, supporting government policies. Having recognised its responsibility towards underprivileged groups, the bank actively engaged in designing and formulating rural credit schemes and providing subsidised credit through refinance schemes. The Medium and Long Term Credit Fund (MLCF) was introduced in 1964 to provide refinance for agriculture as well as industrial activities on a relatively long term basis while these efforts were strengthened by introducing credit guarantee schemes in 1974. The CBSL directly involved in regional development activities by instituting RRDBs in 1985 while the Rural Banking and Staff Training College was set up in 1980 mainly for capacity building. In 2004, the CBSL played a vital role in rebuilding Tsunami affected people by providing concessionary credit schemes. Considering monetary implications, although the CBSL's direct refinancing has been reduced to a minimum in the recent decade, the CBSL is still involved in donor funded credit delivery process and capacity building as an agent of the government. All these years, the Bank was instrumental in building of institutional infrastructure and system development required for promotion of credit delivery in the regions. The Bank took the leadership in instituting the Development Finance Corporation of Ceylon, People's Bank and National Development Bank while opening its own branches in Matara (1980), Anuradhapura (1982), Matale (1985) and Jaffna (2010). Since 2009, the CBSL has become actively involved in uplifting living conditions and improving financial inclusion in the Eastern and Northern region.

Modernising Central Bank

Over the 60 years, the CBSL has been modernised in many ways. At its inception, the Bank commenced its operations with 250 people and five departments. The bank has now grown in strength to 26 departments and 1,500 people to accommodate its expanded roles. In early 2000, the CBSL embarked on a special modernisation programme with the objective of creating a lean, modernised and efficient central bank by upgrading its systems and procedures, governance systems and by establishing a core financial infrastructure required for an evolving bank. After several years of discussions and deliberations the MLA was amended in 2002 and the amendments focused on the Bank's objectives, expanding its governing Board and the powers of delegation, increasing the flexibility and effectiveness of monetary policy and exchange rate policy, improving payment and settlement system and strengthening the regulatory role of the bank. Before 2002, the bank had multiple objectives such as maintaining domestic monetary values, presenting the stability of exchange rate, the promotion of a high level of production, employment encouragement, real income and promotion of the full development of the productive resources of Sri Lanka. However, the bank realised that this achievement of multiple objectives was not easy as such an objective could be in conflict or be inconsistent. Hence, the bank focused on two key objectives namely price stability and the financial sector stability since 2002. The departure from the multiple objectives helped the bank to focus on key areas of central banking, which has also been advocated by international best practices. The size of the Monetary Board was expanded to have more representation of the private sector. The decision making process was strengthened with the establishment of the Monetary Policy Committee, Financial System Stability Committee, and the Audit Committee. The Bank adopted the International Accounting Standards for the Central Bank to have acceptable disclosure policy. The Bank introduced technologically advanced Real Time Gross settlement system (RTGS) in 2003, strengthening the payment and settlement system while eliminating undue risk exposure of the Bank in an end day net settlement system. Sri Lanka was the first country in South Asia to introduce such an advanced Payment and Settlement system. Government securities market was modernised and made more efficient by issuing securities in scripless form in a Scripless Securities Settlement system (SSS) with a Central Depository system (CDS). The SSS and CDS known as LankaSecure is linked to the RTGS to handle the fund settlement part of securities transactions to ensure the safety of investors in government securities, by effecting transactions on Delivery vs Payment basis and maintaining records of all transactions.

Conclusion

The Central Bank of Sri Lanka has completed 60 years of fruitful operations while facing enormous challenges in preserving monetary and financial stability. The long journey will continue but the CBSL is likely to face unforeseen and unpredictable challenges, and also unprecedented opportunities. Sri Lanka is entering into a high growth path but in a more globalised environment over which the CBSL has little control. The recent financial turmoil has clearly demonstrated the uncertainties and dilemmas of macroeconomic management in a globalised world. It was clearly evident that because of the interconnectedness of the financial markets, external developments influence domestic macroeconomic conditions in a complex, uncertain and unpredictable manner and central banks need to deepen their understanding of these interactions. The challenge for the CBSL is to better understand the interplay of global factors and domestic variables, and develop appropriate strategies and policy alternatives to handle the macroeconomy while building confidence internationally as well as domestically. Sustaining the low inflation and managing expectations will be the most challenging task in the monetary policy front. The bank will have to look for an even more appropriate monetary policy framework to well focus on the core objectives of price stability by moving away from the present system of targeting monetary aggregates, which could be less appropriate eventually in a modern financial system with a range of innovative instruments. In line with practices in other central banks, the communication strategy needs to be further developed as greater predictability can be of great help in shaping market expectations in line with the stance of monetary policy. With increased globalisation, financial sector stability is to be bolstered effectively and systemic oversight must be strengthened notably. As clearly evidenced by the recent global financial turmoil, the CBSL should have a more forward looking assessment of the risks to financial stability. Supervision has to be strengthened in line with the best international practices as the financial markets and products are evolving rapidly. Improved corporate governance in financial institutions is a must to ensure that the general public has confidence in the financial system. Improving independence and accountability of the CBSL operations is crucial in building public confidence in the CBSL policies, which is essential in meeting the Bank's policy objectives effectively. Finally, capacity building of the institution itself is a challenge and committed, dedicated and well prepared staff is essential to take up these future challenges and for the CBSL to become a more dynamic and credible Bank contributing to prosperity of the country.

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