Central Bank of Sri Lanka

News Survey

Volume 37 Number 3 July - September 2017

IN THIS ISSUE

ISSN 1391-3589

ISSN 1391 3589

The views expressed in the articles are those of the writers and are not necessarily those of the Central Bank of Sri Lanka.

Price per copy: Rs. 60.00 /
Annual subscription (Inclusive of postage): Rs. 420.00

Loans without Groans – Urge for Customer Protection Regulation in Sri Lanka

I U Colombage
Senior Assistant Director
Department of Supervision of Microfinance Institutions

Microfinance was introduced to the world with the view of enabling financial access to low income people inducing social mobility. Rapidly, it became a lucrative sector for institutions with profit motives. Nowadays, the microfinance sector is crowded with institutions with profit motives which at times lead to unethical and irresponsible lending practices. Urge for customer protection regulation for the microfinance sector is stemmed through this phenomenon. Smart principles[1] on customer protection namely; appropriate product design and delivery, prevention of over-indebtedness, transparency, responsible pricing, fair and respectful treatment of clients, privacy of client data and mechanism for compliant resolution, comprehensively addresses the customer protection aspects. This article explores the possibility and relevance of adopting such principles to the microfinance sector of Sri Lanka.

Introduction

Microfinance is an initiative which provides financial services to the financially excluded people with low-income levels. Thus, microfinance was able to address the main problems in obtaining credit such as lack of a credit history, inability to provide guarantors and non-availability of collateral. Initially, institutions provided microfinance with the ultimate motive of serving such low-income persons with the goal of livelihood development and alleviation of poverty. Nevertheless, the high profitability of the sector resulted from high interest rates and high performing rates of such loans have made it lucrative for many investors with profit motives.

Under such circumstances, the number of microfinance providers has substantially increased which is observed in the Sri Lankan context also. The main objective of microfinance which is to serve a deprived sector in the world through financial inclusion is blurred in such a situation. Instead, microfinance service providers are involved in various malpractices and irresponsible lending activities leading people for further deprivation, e.g., exorbitant interest rates, deceptive marketing, mental and physical abusing and harassing for recovery action.

Irrespective of such supply side issues, demand side of microfinance also contributes to the problems observed in microfinance. Customers are less experienced and educated to obtain financial services and fail to make long term decisions. Accordingly, they become content with the easy money obtained from loans and fail to consider the repercussions. The over-indebtedness, taking loans to settle other loans, utilizing loans for non-income generating activities are few such consequences customers conveniently ignore.

Therefore, this situation with microfinance service providers and consumers urges the requirement of regulatory intervention (Alliance for Financial

1. “Smart Principles are issued by the Smart campaign which is a global effort to unite microfinance leaders around a common goal: to keep clients as the driving force of the industry.” (Smart campaign 2017)

Inclusion 2010), without which people will lose confidence in the financial sector and exclude themselves from obtaining financial services. Thus, an initiative which was targeted to improve financial inclusion may result in financial exclusion if consumer protection aspects are not effectively and promptly dealt with.

The status of consumer protection in Sri Lanka, consumer protection definition, pre-requisites for a consumer protection framework, principles on consumer protection and way forward for Sri Lanka is discussed in this paper.

Status of Regulation on Consumer Protection in Sri Lanka

It is observed that in Sri Lanka, the microfinance sector is diverse and provided by regulated and unregulated institutions. At present regulation and supervision of the regulated entities are mostly concentrated on prudential requirements which crowd out the concerns on malpractices carried out by such entities. This has been the main motive for countries to move towards a "Twin-Peak" regulatory structure where the responsibility of prudential regulation and market conduct & consumer protection are carried out by two authorities (Godwin et al. 2016). Hence, specific regulation and supervision on consumer protection needs to be formulated and initiated through the regulated sector of Sri Lanka.

What is Consumer Protection?

"Consumer protection encompasses all the means necessary to safeguard the interest of consumers and empower them to know their rights and make wise, educated decisions". (Porteous and Helms 2005. pp.2).

Numerous international authorities have categorized microfinance principles and aspects with differing terminology which ultimately originate from similar beliefs. According to Brix and Mckee (2010), there are three basic principles where a consumer protection framework needs to be built around, i.e., disclose key information clearly, at appropriate points, before, during and after a transaction is completed; treat customers fairly and ethically; and offer recourse mechanisms for effective resolution of errors, complaints, and disputes. The smart campaign sets out seven principles, namely: appropriate product design and delivery, prevention of over-indebtedness, transparency, responsible pricing, fair and respectful treatment of clients, privacy of client data and mechanisms for complaint resolution. As stated by Porteous and Helms (2005), main aspects of consumer protection are disclosure requirements, lender practice prohibitions & requirements, mechanisms for handling complaints & disputes, and consumer education.

These principles and concepts can be used to inspire a robust and comprehensive consumer protection framework for Sri Lanka.

Prerequisites for the Successful Implementation of Consumer Protection Regulation

A policy and a code of conduct to be followed by all employees on consumer protection, approved by the Board of Directors is one of the must have pre-requisites in order to apply the customer protection principles uniformly. To facilitate adherence to the code of conduct, recruitment and training policies of the microfinance service providers should also be in line with this policy (Bangko Sentral ng Pilipinas (BSP) 2014). This may be complimented through the entity's remuneration and incentives structure that is designed to reflect responsible business conduct (BSP 2014) in order to not contradict with the consumer protection policy. Further, specific sanctions also should be included in the code to ensure conformity to the policy.

Smart Principles on Consumer Protection

a) **Appropriate Product Design and Delivery**

   "Take adequate care to design products and delivery channels that do not cause clients harm. Products and delivery channels will be designed with client characteristics taken into account".

As the first step of customer evaluation, the microfinance service provider is expected to identify the financial and non-financial needs of the consumer and should only provide a product that caters such need (World Bank 2017). Such meticulously designed products should be delivered to the customer without changing the characteristics of the product which should then be monitored in order to prevent default.

b) Prevention of Over-Indebtedness

"Take adequate care in all phases of their credit process to determine that clients have the capacity to repay without becoming over-indebted".

Special emphasis needs to be given to identify the creditworthiness of the customers and ensure the prevention of over-indebtedness. Best practices in this regard are obtaining reports from credit information bureaus and checking the debt-income ratio of the customer, identify repayment capacity, etc., (World Bank 2017). Carrying out credit counseling and advisory services to make customers aware of the best practices in utilizing and managing loan funds may also ensure the repayment of the loan.

c) Transparency

"Communicate clear, sufficient, and timely information in a manner and language clients can understand so that clients can make informed decisions".

Microfinance service providers should ensure that customers have holistic and reasonable information regarding the products offered by an entity for effective decision making which is not false or misleading at any nature. This can be mandated by specifying disclosure requirements which has been widely addressed by many regulators. This may be imposed on the advertisement stage and shopping stage, pre-contractual stage, contractual stage, and upon request (World Bank 2017).

Advertisement and Shopping Stages - Advertisements should reflect the true nature of products offered by a microfinance service provider.

Pre-contractual Stage - Standard document for a loan agreement, which the customer places his /her signature agreeing to terms and conditions, should be made available. The document should be concise, easy to understand, accurate and explained to the customers by the entity before entering into the agreement, the contents and financial implications. It should be given to the customer in his/her preferred language (World Bank 2017).

Contractual Stage - A product statement needs to be given to the customer periodically, free of charge. Any change to the terms and conditions needs to be notified to the customer and agreed upon in writing.

Upon Request - Upon a query made by a customer, microfinance service providers should be willing to support by providing information free of charge.

d) Responsible Pricing

"Pricing, terms and conditions will be set in a way that is affordable to clients while allowing financial institutions to be sustainable".

Terms and conditions of the product that are unfair, excessively unbalanced or abusive, excludes or restricts the liability of the financial service provider, excludes or restricts the right of the consumer, discriminate certain segments of the population should not be imposed on customers (World Bank 2017).

Interest Rates

Major part of the product pricing is the interest rate. There is a consensus that microfinance service providers charge exorbitantly high interest rates. This has resulted in installments which cannot be serviced by the consumers leading them to default the loan and face adverse recovery action. Therefore, the most apparent answer is a ceiling on interest rates. However, according to Porteous and Helms (2005), this step comes with a negative effect. That is microfinance lenders being reluctant to grant loans to low-income people resulting in limiting access to credit for such people. Therefore, Porteous and Helms (2005) is of the view that it is best to let the interest rates be determined by market forces.

Disclosures on interest rates are appropriately made and financial education is extensively carried out island wide, information will be widely available enabling comparison between entities which will stimulate price competition. This will be reflected in a fair and justifiable interest rate driven by market forces (Porteous and Helms 2005).

Further, it is observed that calculating interest rate on a reducing balance method rather than a fixed interest rate method is more beneficial for the consumer. This is indicated in the National Bank of Cambodia (2001) regulation stating that "Interest charged on any loan granted by an entity must be calculated taking into account the repayment of principal already made on that loan. Consequently, interest charged on a loan for a given period shall be calculated on the loan outstanding balance at the end of that period".

e) Fair and Respectful Treatment of Clients

"Treat clients fairly and respectfully without discrimination and ensure adequate safeguarding to detect and correct corruption and abusive treatment".

Loan collection and recovery actions are known to be bitter experiences for microfinance customers due to the malpractices carried out by certain microfinance service providers. Therefore, such practices should be avoided through this principle.

f) Privacy of Client Data

"The privacy of individual client data will be respected in accordance with local laws and regulations and will only be used for purposes specified when the information is collected, unless otherwise agreed with the client".

Ensuring privacy of client data also should be honored and has been mandated by almost all customer charters around the world, e.g., BSP, RBI, Central Bank of Sri Lanka Customer Charter for Banks.

g) Mechanisms for Complaint Resolution

"Have in place timely and responsive mechanisms for complaints and problem resolution for clients and use them to resolve problems and improve products and services".

Every institution should have a specific employee/division identified to be responsible for handling complaints/grievances (World Bank 2017). A dedicated telephone number should be allocated for such complains and should be displayed in a prominent place. Thereafter, a quick and effective grievance handling procedure should be put in place.

Every complain should be recorded and maintained in a database which will enable the company to monitor common reasons for complaints and identify patterns and take measures to prevent occurrences of similar complaints (BSP 2014).

Way forward for Consumer Protection in Sri Lanka

Undoubtedly, Sri Lanka needs a regulation on customer protection especially for microfinance service providers. Hence, it is suggested that a comprehensive customer charter inspired by the Smart principles is imposed on the regulated entities as the first step. Thereafter, an island-wide awareness campaign should be carried out to educate the microfinance customers of their rights when borrowing money and what best practices to look for in microfinance service providers. Gradually, a unified financial customer protection framework similar to a "Twin Peak" regulatory approach may be introduced to the entire financial sector of Sri Lanka.

Eventually such attention to customer protection will enable to gain the lost confidence on the regulated microfinance service providers of Sri Lanka. This will contribute towards persuading the financially excluded people to obtain financial services and will be able to attract people from the unregulated sector back to regulated sector. As a result, microfinance with effective customer protection framework is the answer for groans emerging from microfinance loans■

List of References:

Alliance for Financial Inclusion. 2010. [Online] Consumer Protection, Leveling the playing field in Financial Inclusion. Available from: *https://www.afi-global.org/sites/ default/files /publications/afi_policynote_consumerprotection_en128.pdf. [Accessed 04 April 2017].*

Bangko Sentral ng Pilipinas. 2014. [Online] BSP Regulations on Financial Consumer Protection – Circular 857. Available from: *http://www.bsp.gov.ph/downloads/regulations/ attachments/2014/c857.pdf. [Accessed 10 April 2017].*

Bangko Sentral ng Pilipinas. 2016. [Online] Amendment to the Cooling-off Provisions of the BSP Regulations on Financial Consumer Protection – Circular 898. Available from: *http://www.bsp.gov.ph/downloads/regulations/attachments/2016/c898.pdf. [Accessed on 10 April 2017].*

Brix, L., Mckee. K. 2010. Consumer Protection Regulation in Low Access Environments: Opportunities to promote Responsible Finance. Focus Note 60. Consultative Group to Assist the Poor (CGAP). Washington D.C.

Godwin, A., Kourobas, S., Ramsey, I. 2016. Twin Peaks and Financial Regulation: The challenges of Increasing Regulatory Overlap and Expand Responsibility. The International Lawyer. 49: 273-277.

Porteous, D., Helms, B. 2005. Protecting Microfinance Borrowers. CGAP. Washington D.C.

Porteous, D. 2009. Policy Focus Note 2: Consumer Protection in Credit Markets. Financial Access Initiative. CGAP. Washington D.C.

Reserve Bank of India. 2012. [Online] Fair Practice Code. Available from: *https://rbidocs.rbi.org.in/rdocs/notification/PDFs/26MFP010711F.pdf. [Accessed on 10 April 2017].*

Reserve Bank of India. 2014. [Online] Non-Banking Financial Company – Microfinance Institution Directions. Available from: *https://rbidocs.rbi.org.in / rdocs/Notification /PDFs/544CRLMFIA070415.Pdf. [Accessed on 10 April 2017].*

Smart Campaign. 2017.[Online] Smart Campaign official website, Available from: *http://www.smartcampaign.org/about. [Accessed 04 April 2017].*

National Bank of Cambodia. 2001. [Online] Prakas on the Calculation of Interest Rate on Microfinance Loans. Available from: *https://www.mftransparency.org/wp-content/ uploads/2012/05/MFT-BRF-303-EN-Cambodian-Law-on-the-Calculation-of-Interest-Rate-on-Microfinance-Loans-2011-10.pdf. [Accessed on 10 April 2017].*

World Bank. 2017. Global Financial Inclusion and Consumer Protection Survey. World Bank. World Bank, Washington D.C.

"Export transformation is crucial for growth - Governor"

Speech delivered by Dr. Indrajit Coomaraswamy at 20th Annual General Meeting of the Exporters Association of Sri Lanka

Delivered on 28th July 2017

Today, in addition to the growth and employment objectives, we have this onerous debt problem that we have to address. We can't really address that without a significant improvement in our export performance.

Now, by way of introduction, before I get into the issues relating to the export sector, specifically, let me just give by way of background, some remarks about the growth model that the government is trying to put into place. It is private sector driven with exports and FDI as key figures.

If I may say a few words about each of those: I've been a public servant all my life, so I don't subscribe to the view that the private sector is the panacea for all our ills. In fact, if you look around the world, you get different mixes of the private sector and the State in terms of delivering good development outcomes. But in our case, the public debt and deficit dynamics are such, that the State simply cannot lead the development process. It's nothing to do with ideology. It is a purely pragmatic assertion that it has to be the private sector that has to drive the growth in the regeneration process of this country.

Why exports and FDI are key pillars: when you have a domestic market of twenty-one million people and purchasing power of now almost four-thousand US dollars, you simply cannot sustain the 6% or more growth that we need to achieve by just selling into this domestic market. It's simply not possible.

And why do we need 6% growth? We have a very aspirational society now or more. It's an educated society which is exposed to all the latest communication technologies so people know what is available around the world and they aspire to achieve a lot of material benefits for their families. So if one cannot deliver that, clearly there could be tensions in terms of our social and political stability.

So it has to be growth in exports that drives our growth process to the point where we can achieve 6% plus growth to meet the aspirations of our people.

And FDI, if you look around Asia, which has been the most successful continent in terms of growth and export performance, whether it is a country as large as China or one as small as Singapore, FDI has played a key role in the export transformation that has driven those economies.

So that's the model that the government is trying to put in place. It is doing a number of things to sustain that model in terms of the macro-economic policy making. There are three frameworks that have been put in place. The government has a revenue enhancement-based Fiscal Consolidation

Program which is intended to bring the budget deficit down to 3.5% of GDP by 2020.

The Central Bank is putting in place a Flexible Inflation Targeting framework which is intended to bring about monetary policy formulation which is pro-active and forward-looking. Today's interest rates, i.e. when setting interest rates today, the full pass-through effects of the transmission does not have full effects in the system for about twelve months. So, in setting interest rates today we have to have an educated view of what inflation is going to be in twelve months' time.

In the past, we tended to do too little too late. We allowed the economy to overheat and then we would move. This is why we have had big fluctuations in our interest rates which have made business planning very difficult. We are trying to put in place a framework which will now enable us to set forward-looking, pro-active monetary policy, which should smooth out these sharp fluctuations in interest rates. They will still go up and down, but you won't get the spikes and troughs that we have had in the past, if we are able to implement the flexible inflation targeting regime properly. That's what we are trying to do.

Equally, on the exchange rate, in the past, we tried to defend an over-valued exchange rate. We used depleted borrowed foreign reserves to do that. In doing so, we lost a large amount of foreign reserves and then eventually there was an inevitable sharp depreciation in due course. This doesn't make any sense, so we are trying to follow a more flexible exchange rate policy, which will, we hope, enable us to have a competitive and stable exchange rate. If we get fiscal policy and monetary policy right, then the pressure on the exchange rate is reduced. So that's crucial. You have to take all three macro-economic instruments together. If you are able to implement the other two macro policies well, then there won't be pressure on the exchange rate and it will be possible to have a competitive and relatively stable exchange rate, which is what we want to try to get to.

In addition, the Government is also very much in the forefront in terms of improving the investment climate, investment promotion, trade facilitation and trade policy. So, hopefully we are moving in the right direction in terms of macro-economic stabilization and the framework is being put in place to improve the investment climate, as well as the trading environment.

Let me now turn to the matters in hand today and focus on the export sector. I must thank my colleagues in the Economic Research Department of the Central Bank who helped me to put these remarks together.

Sustained export growth is crucial for the development of Sri Lanka, particularly given the relatively small size of its domestic economy. Relying on the domestic economy is not sufficient to enhance growth. Sri Lanka was ahead of its regional peers in liberalizing its economy in 1977. The adoption of liberal economic policies, such as private sector development, export networks and encouragement of FDI led to immediate improvements in the foreign trade openness of the country.

Trade Openness which was 36.4% in 1977, nearly doubled to 72.2% by 1979 while exports which were 18.7% of GDP in 1977, increased significantly to 29.2% by 1979, just two years after opening of the economy.

Despite the turn-around in the immediate aftermath of the adoption of liberal policies, Sri Lanka's international trade performance has been lackluster since then, regressing to levels that were seen during the pre-liberalization era. In 2015, Sri Lanka's Trade Openness was 36.5% - it was 36.4% in 1977. While exports, relative to GDP, declined to 12.7% in 2015, having increased to 29.2% in 1979, and it rose as high as 32% in 2000.

So we've gone backwards. And we have gone back to almost where we were in 1977, in terms of trade performance.

Although the common notion is that there is a by-directional relationship between export and economic growth, this relationship has not been seen in relation to Sri Lanka. This was especially so between 2000 and 2016, wherein GDP increased by a compounded annual growth rate of 10.4%, while exports grew only 4%.

Sri Lanka's economic growth during the past decade or so has mainly been generated by the expansion of domestic demand, rather than increased exports. The tradable sector, that is Imports and Exports as a percentage of GDP, declined from nearly 80% to 45% from 2005 to 2015. As a Small Open Economy you simply cannot do that. The problems were compounded by a heavy recourse to foreign commercial borrowing for projects with low returns. That is what has led to the debt problems and many of the other difficulties we are having.

When compared with regional peers and competitors, Sri Lanka's export performance has lagged behind significantly. The Export Value Index presented by the World Bank shows the extent to which Sri Lanka's export sector has been lagging in comparison to its regional counterparts, during the period from 2000 to 2015. Sri Lanka has only increased its exports by 1.9 times in that period 2000 to 2015, while Vietnam and Bangladesh have increased by 11.2 times and 5.1 times respectively. Even South Korea and Thailand which have a much higher base, increased their exports by 3.1 times, whereas we, as I said only recorded a 1.9.

A key weakness as far as Sri Lanka's exports structure is concerned is a lack of diversity in products and markets, as well as low complexity in the export basket. Exports continue to be concentrated on two traditional products, namely garments and tea, which account for more than half of total exports. No major export item has been developed since the 1990s. The Export sector shows a lack of diversification in terms of markets as well. Europe and the USA continue to account for over half of total exports. Further, approximately 70% of tea exports are to the Middle East and Commonwealth of Independent States, where demand is sensitive to oil prices which have been transformed by shale technology.

The absence of effective trade finance also contributed to the subdued promotion of exports. At present, despite the share of industrial exports being around 77% of total exports, it is estimated that high-tech exports account for less than 1% of Sri Lanka's total manufactured exports.

Improving this ratio entails investment in machinery, technology and skilled labour. It is necessary for our exporters to compete in complex products that are more technologically advanced. We are no longer a low wage economy, therefore we need to invest in, and become competitive in fairly complex export products, if we are to meet the aspirations of our people.

Now, there was, I think, a very legitimate question asked about the availability of labour. If you get into higher value exports, you create jobs which will give attractive wages, which will then make it much more likely that people who are going to the Middle East, to Korea, to Italy, to wherever they are going now, would prefer to remain at home rather than migrate temporarily without their families, which will help address a number of social problems as well.

So it is a question really, of relative wages. If we can create higher paying jobs, and jobs in the export sector tend to be higher paying in other countries, particularly if they are created by FDI. Sri Lanka does not have a labour shortage problem. It is just that the labour is in the wrong places. We have 27% of our workforce in agriculture, giving us 7% of GDP. It is politically difficult to move people from low-productivity, low-income agriculture to higher productivity, higher income activities, like the export sector.

We have 15% of our work force in the Public Sector Service – 1.5 million people. It has increased from 700,000 in 2005 to 1.5 million. So there is plenty of labour. We have to create the incentives and the types of jobs to get people into the competitive and modern sectors. And that's to do with relative wages. And so we need to get the investment to get higher value employment.

Penetrating global value chains and production sharing networks will also boost industrial exports. Intra-firm trading in Asia has been the most dynamic segment of the international trading system. Sri Lanka has a minimal presence in these networks. This has to be reversed for Sri Lanka to transform its export performance by leveraging its geographical location in Asia.

I need to say something about location at this point. A lot of people say: you are talking about export led growth, FDI etc., when the global economy is rather subdued. That this is a low-growth, sluggish international trade environment era and we are trying to say that we want to pursue an export led growth model. The answer to those people, in my view, is that our location, and our international relations help to overcome the headwinds in the global economy. We are right in the middle of China's Maritime Silk Road. We are twenty-miles from the fastest-growing large economy in the world, India, and the five Southern States of India, are growing at 10% plus, and have been for a number of years. The middle class has been increasing dramatically in these States.

We also have excellent relations with the Capital surplus countries of East and South-East Asia – Japan, China, Korea, even some of the ASEAN countries. And in Asia, you can leverage government-to-government relations to bring investment into your country. So, whatever is happening in the global economy, we can trump that with the advantages of location and excellent international relations.

As Sri Lanka's per capita GDP continues to rise, the country is losing its competitiveness in terms of its labour costs as wages increase. As a result, Sri Lanka will not be able to compete in exporting labour-intensive, low-value products, since exporters with low wage structures such as Bangladesh, Cambodia and Vietnam will become more competitive.

At present, Sri Lanka is not able to match the competitiveness of countries such as Malaysia and Thailand. So we are in little bit of a limbo. We find it difficult to compete on wages with Bangladesh's, Myanmar's, Cambodia's and Laos's, and we find it difficult to compete on productivity and competitiveness with Malaysia and Thailand. So we have to have an absolute laser-like focus on increasing productivity and competitiveness. That is how we have to move to support our export drive.

The modernization of the services sector is also important, as the production flow processes are now largely dominated by services. Service exports have increased rapidly since the end of the conflict, with significant increases recorded in tourism, transport, and ICT. By transport I mean logistics as well. However, given the competitive advantages the country enjoys, particularly in relation to its location, there is great potential for further increase in services exports.

Persistent large trade deficits, which have become a fundamental weakness in the balance of payments of Sri Lanka, are a serious concern that needs to be addressed in the long-term interests of the country. The substantial trade deficit indicates that comprehensive strategies, which focus on promotion of high-value exports, expanding the export base, and diversifying markets by strategically planned trade in growing economies, particularly in Asia, are essential for its reduction.

We clearly need to protect, consolidate and if possible increase our traditional markets in the US and Europe. But the real exponential increase that we are looking for has to come from Asia - from India, from China, etc. and as we know incomes and growing markets are expanding in these countries - we need to get part of that action.

Restoring external sector stability in a challenging environment requires the building up of external buffers with policies to reduce spill-over effects from adverse developments in other areas. In this connection, priority has to be attached to fiscal sustainability and prudent monetary policies to ensure that excess demand is not pumped into the system. The generation of higher export revenue will, in turn, increase the capacity to service the large accumulated stock of foreign liabilities. It can also be utilized for the stabilization of the exchange rate, and the building up of a sustainable level of reserves which we serve to increase the country's economic resilience.

In addition, a renewed focus on exports can help divert investment to more efficient segments sectors of the economy, thus raising overall productivity.

This is what I was saying – to shift people and financial resources to more productive sectors of the economy. Growth in exports also entails several other benefits, such as the creation of an efficient price mechanism, inflow of new technology, employment creation, greater economies of scale, and expansion of the productive resource base of the country.

In the last decade, increasing reliance on unsustainable levels of foreign borrowing was an inevitable consequence of growth which was dependent on non-tradeable domestic goods. If you go for an inward looking growth strategy, as we did in the last 10-12 years, inevitably you run into the difficulties we now confront because you have to borrow to invest and we haven't created the capacity to earn the foreign exchange to service that debt.

The country requires a growth process which is driven by a surplus in the current account of the balance of payments. In the past, we have experienced high growth supported by unsustainable budget deficits. If you look at our growth performance, and you correlate it with the size of the budget deficit, our high-growth years are also characterized by high budget deficits. When growth is created by pumping money into the system through excessive fiscal deficits, it is just not sustainable, because it is not productive; it is essentially driven mainly by consumption. In the past, we tended to keep our interest rates low, and our exchange rate over-valued, so people borrowed and imported. After a couple of years you have balance of payment problems, and also pumping money into the system creates inflation.

When you look at the last thirty or forty years, you see repeating cycles of stop-go-policies. So, the trick is to attack the budget deficit, which is crucial. If you are able to do that, then other things will fall into place.

The Government has taken several measures recently to boost exports. By recognizing the need for broad-based institutional support, the Government has already taken steps to create an Agency for International Trade. The AFIT is taking the lead in negotiating a series of trade Agreements. An early harvest is being sought to increase the benefits from the existing FTA in goods with India. These include Mutual Recognition Agreements among Standard Institutions and relaxing quotas on goods of interest to Sri Lanka. Negotiations are also underway to deepen and broaden the Agreement in goods through adjustments to the negative lists. The ETCA will also extend the application of negotiated rules to services, investment, training and technology. Similar agreements are being negotiated with China and Singapore.

Now there is a natural concern, natural nervousness about a small country like Sri Lanka negotiating Partnership agreements with enormous countries like China and India. We are not the first small country to negotiate trade agreements with a large country. Mexico is not a small country, but it is interesting that Mexico has benefited most from NAFTA, much more than the US or Canada. So it shows that a smaller country can still benefit by negotiating Partnership Agreements with a much larger economy.

For that to happen, the Agreement has to be based on two principles. One is the principle of non-reciprocity, that is, the larger country has to do much more than the smaller country. And two, special and differential treatment in terms of the phasing of the trade liberalization. So you build in mechanisms which take into account the asymmetry in the economies. Both China and India recognize the principles of non-reciprocity and special and differential treatment. Their negative lists would be much shorter than ours; their positive lists would be much longer than ours. They will allow us, I am confident, o negotiate safeguard agreements. These mean that if you have a sudden surge in imports,; if say imports go up by say 20-25% over a short period of time, you can automatically put in place safeguards through increased tariffs. That's a well-used practice, so that you get protection as a small country against import surges from larger countries. Equally, you can negotiate a good dispute resolution mechanism, which gives you a chance to address your issues that come up when in dealing with a larger country. So, there are these mechanisms, well tried and tested mechanisms, which can be used for us to ensure that we get a good deal. Our trade negotiators are well aware of these principles and mechanisms and I am sure they will negotiate effectively.

Now in addition to all the deals which that have been negotiated with India, China and Singapore, we have the bilateral FTA in goods with Pakistan which is being invigorated, and on top of that, of course we have EU GSP plus. If you take all this together, if we are able to conclude these Trade Negotiations successfully, Sri Lanka could have access, preferential access, to a market of 3 billion people, which is a massive USP. Now I think Singapore has preferential access to both China and India. But they don't have preferential access to EU. So there is no other country in the world that I know of, which has preferential access to China, India and Europe. I know that GSP plus is only for four years. But four years is enough time for us to take advantage of it.

So that is a massive opportunity. Now, of course this market of three billion people is going to provide opportunities for our own exporters. But on top of that the trick is to use this preferential access to this 3 billion person market to leverage the trade/ investment nexus. We can tell people you can come and locate here and sell on a preferential basis to China, India and Europe. That is a massively attractive narrative one can offer for potential investors from all over the world.

Now, if I may talk about some of the policy support offered by the Government. The EDB has initiated a National Export Strategy which, as you know, is a collaborative effort between the Government and the private sector and it provides a five-year action-oriented frame work for the development of trade and competitiveness.

Simultaneously, a National Trade Policy has now been drafted. It is a very neat 20-page document, very tightly and coherently drafted, and this is the first time we have formulated, in this concise way, the country's trade policy, which for me, is actually very well presented.

An Anti-dumping bill is also in Parliament. It is very important, if we are going to open up some sectors as part of the trade agreements. The Government is also working on a Trade Adjustment Package with the World Bank and the International Trade Center, in Geneva. What that intends to do is to assist companies, which are going to be affected by liberalization to become more competitive, and also to assist workers, whose jobs have been threatened, to re-train.

Now, I've talked on SMEs, for export promotion. There are four areas where they require support. 1. Training; 2. In-puts, including technology; 3. Access to finance; and 4. Marketing.

Invariable the biggest challenge is marketing. To get them to produce output that they can sell in the domestic market and abroad. So one challenge is really how we link our SMEs into International Supply Chains, either through larger companies, or directly. We really need to think in terms of linking up our SMEs to supply chains.

The Government has already taken some decisive measures to overcome the short-comings of the export sector. With some improvement in the performance in the export sector, so far, there are signs that the initiatives are favourable. Since March, we have now seen an improvement in export numbers. We've got numbers up to May – in March April and May the numbers have shown an up-turn in export revenue. Hopefully that will gather momentum. I think with the GSP-plus kicking in, and hopefully, a more stable macro-environment, export growth will continues.

As I said, Sri Lanka cannot attain 6-7% growth on a sustained basis without transformation of its export performance. Nor can we overcome the constraints associated with our external debt burden without significantly enhanced non-debt creating foreign exchange receipts, generated, inter alia, by increased exports. So, export transformation is crucial for both boosting growth and employment, as well as to stabilize our vulnerability stemming from our external debt. The performance of the EASL will be a key determinant of the future prosperity of all Sri Lankans■

Thank you very much.

Model Based Approach to Monetary Policy Analysis in Sri Lanka

Annual Report - 2016
Central Bank of Sri Lanka

The Central Bank of Sri Lanka (CBSL) is currently improving its monetary policy framework and increasingly aligning it with a flexible inflation targeting (FIT) framework.[1] In a broad sense, FIT denotes the setting of policy rates in a manner so as to stabilise inflation around the targeted rate with due regard to the stability of the economy (Palmqvist, 2007). Therefore, within a FIT framework, the inflation forecast will be the centric element to manage and communicate the shortrun output-inflation trade off.

In the transition to a FIT regime, it is essential that a central bank becomes increasingly transparent and forward-looking. The use of structural models for medium term projections and policy analysis has become indispensable for this purpose. These models would equip the central bank with the ability to determine the path of monetary policy actions needed to bring inflation to its medium term objective while stabilising real output at its potential level. The model outcomes can also pave the way for structured debate about underlying assumptions, risks and policy issues, and will permit greater transparency in policy decisions and communication (Alichi and Benes, 2015).

Inflation Targeting – An Overview

A unique advantage of inflation targeting is that it comprises a framework for monetary policy that combines elements of both 'rules' and 'discretion.' The inflation target, therefore, provides a rule-like framework on which economic stakeholders can anchor their expectations about future inflation, whilst the central bank can exercise its discretion in reacting to shocks (Hammond, 2012).

1. For a detailed discussion, see Box Article 01 in the Central Bank of Sri Lanka Annual Report 2007 and Box Article 10 in the Central Bank of Sri Lanka Annual Report 2015.

The key essential elements of an inflation targeting framework are:

(i) Public announcement of a quantitative target for inflation.

(ii) Monetary policy is based on a wide set of information, including a medium term inflation forecast, which facilitates forward looking monetary policy decision making.

(iii) High degree of transparency and the presence of accountability mechanisms.

Several pre-requisites have been identified as essential to the establishment of a successful inflation targeting framework. These include the central bank's operational independence and an explicit mandate to achieve price stability, central bank's freedom from fiscal dominance, reasonably well understood monetary transmission channels, proper coordination between monetary and fiscal policies, a flexible exchange rate regime, a sound methodology for macroeconomic analysis and forecasting, and a well-developed financial system and transparent policies to build accountability and credibility of the central bank (Schaechter et al., 2000).

The CBSL has already met certain prerequisites of an inflation targeting framework. Along with the CBSL's independence in selecting operating instruments and with a mandate to maintain price stability, it has taken several initiatives during the recent past to further equip the monetary policy framework for inflation targeting. Accordingly, the CBSL has begun to enunciate its policies through a public policy document, developed in-house macroeconomic forecasting tools, published expected path for future inflation and commenced the conducting of the inflation expectations survey (CBSL, 2017). Over this period, the CBSL has also strengthened its technical capacity in data collection and management, and modelling and forecasting of key macroeconomic variables.

Since the adoption of inflation targeting by the Reserve Bank of New Zealand in 1989, the best practices of IT evolved over time, and now all inflation targeting central banks conduct FIT rather than strict inflation targeting (Palmqvist, 2007; Svensson, 2009). The term "flexible inflation targeting" was introduced by Svensson (1999) to define a situation where the central bank minimises welfare loss to the society, as measured by inflation's deviation from its target as well as output's deviation from its potential level. However, in practice, the flexibility associated with FIT can be interpreted not only in terms of its consideration of real economic developments, but also in terms of the target horizon and how quickly the central bank tries to rein inflation back to the targeted rate following a deviation (Palmqvist, 2007).

The Need for Model based Projections and Policy Analysis for FIT

The successful implementation of FIT hinges on reliable medium term forecasts and the knowledge of the monetary transmission mechanism. Advanced macroeconomic models can help in gathering a thorough understanding of the economy and evaluating potential risks and their impact on the future path of key macro variables. Hence, these models can increase the robustness of the policymaking process. Further, monetary policy impacts inflation and output through a complex transmission mechanism which involves a number of linkages among macroeconomic variables and expectations of economic stakeholders. Therefore, it is vital to possess reliable forecasting and policy analysis tools that also take into account the unique characteristics of the Sri Lankan economy.

It is typical of FIT central banks to possess a suite of models to determine the medium path of the economy (Black et al., 1994; Black et al., 1997; Coats et al., 2003). Although the CBSL has been engaged in macroeconometric forecasting in the past, with a view to further strengthening its policy formulation and modelling capacity, it initiated structural modelling with customised training and technical assistance from the International Monetary Fund (IMF). As such, a joint effort has been made by the CBSL and the IMF in developing a structural model-based Forecasting and Policy Analysis System (FPAS) over the medium term, to strengthen the monetary policy decision making process and to support Sri Lanka's transition to FIT.

With the creation of a permanent Modelling and Forecasting Division in the Economic Research Department (ERD), the CBSL has taken a key step in the effective implementation of FPAS. Several initiatives are underway to upgrade the technical capabilities of relevant staff so as to strengthen all macroeconomic projections, including inflation projections, using short-term and medium term forecasting tools and techniques. Accordingly, the ERD, with inputs from other departments of the CBSL, is managing a comprehensive analytical database, which will not only serve the data requirements of FPAS but highlight potential areas for research.

FPAS – An Overview

FPAS is a medium term pre-emptive policy analysis system which brings together information and judgment in a coherent and logical manner. It includes collecting, analysing and processing information and assumptions for the formulation of forward-looking policies, with preference often given to long term stabilisation. Moreover, FPAS combines several tools and processes which equip staff with the ability to conduct high-quality macroeconomic analysis and forecasting exercises that will support decision making. The structural model at the core of FPAS facilitates quality policy discussions about forecasts, potential risks to forecasts and appropriate responses to various shocks, and allows to construct policy scenarios. The prevalence of a structured FPAS system entails several other benefits. These include:

- Improved communication between all staff engaged in the forecast and policy debates, which creates important synergies and paves the way for continual improvement of the process of reaching a unanimous decision.
- A more structured debate about potential risks, allowing policymakers to better identify and communicate key policy issues.
- Development of a database to assess the efficiency of historical forecasts and thereby identify areas for new research.
- Development of a highly specialised pool of macroeconomic forecasting and research staff.
- Development of institutional knowledge about the monetary transmission mechanism and the impact of emerging shocks or disturbances.
- Potential for increased transparency about the systematic aspects of monetary policy and the means by which the forecast is developed. (Laxton, 2009)

While several central banks such as those in Canada, Brazil, Australia, Singapore, Thailand and India have successfully established FPAS, a number of other central banks are currently in the process of developing such a system.[2] An essential element of FPAS is the Quarterly Projection Model (QPM), which is a semistructural, forward looking open economy gap model that assists in the generation of a medium term policy path that is consistent with meeting of targets under the FIT regime (RBI, 2016). It is based on the principles of new-Keynesian open economy which embody the general view that monetary policy influences aggregate demand and output dynamics in the short run. In the long run, the policy influences only nominal variables (e.g. inflation), whereas real variables (e.g. real GDP growth) are determined by factors beyond the control of the monetary policy (e.g. growth in productivity, fiscal policies affecting income redistribution, etc.). These models are also built on micro-foundations and rational expectations.

Accordingly, under FPAS, the CBSL has finalised the development of the baseline version of a semi-structural QPM for forecasting and analysis of monetary policy.[3] The benchmark model consists of four main behavioural equations, which represent aggregate demand (Investment-Saving or IS curve), aggregate supply (Phillips curve), the uncovered interest rate parity (UIP) condition, and the monetary policy-reaction function (Taylor-type interest rate rule combined with a foreign exchange rule).

The QPM also accounts for multiple shocks that the Sri Lankan economy is prone to. These are broadly categorised as aggregate demand, supply, exchange rate, monetary policy and risk premium shocks.

Currently the CBSL utilises several econometric models to conduct near term forecasting (NTF) exercises for GDP and inflation. A set of advanced NTF models is supposed to complement the QPM in better capturing the idiosyncratic shocks to inflation and GDP over the short-term.

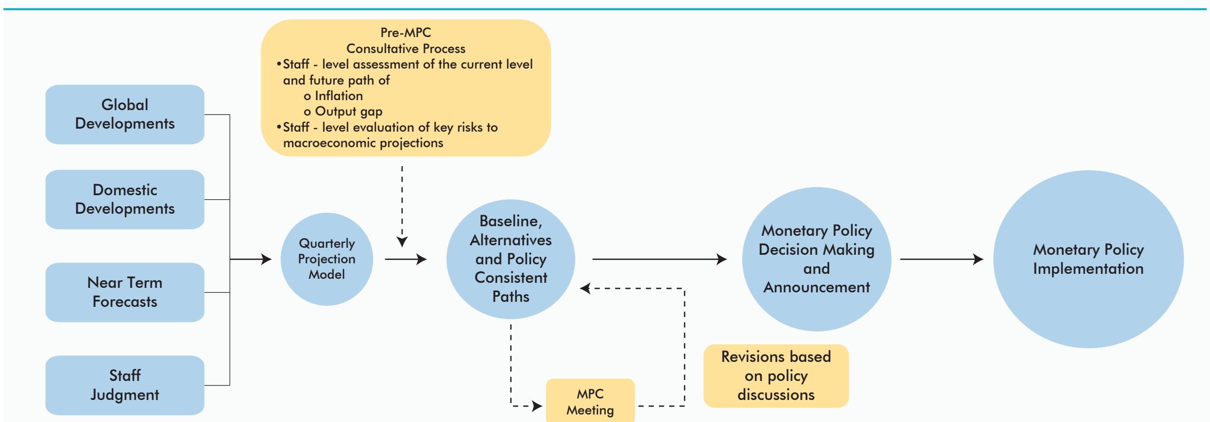
Additionally, the implementation of FPAS will help enhance the CBSL's communication with the stakeholders and general public, as it will complement the communication of the projected medium term path, with a comprehensive analysis and explanation of assumptions and judgments underpinning the projection, and the potential risks to the realisation of such projections.

Way Forward

The complete adoption of FPAS requires material changes in the monetary policy formulation process as well (Chart B 1.1). Accordingly, the number of Monetary Policy Committee (MPC) meetings has already been reduced to 8 meetings per year in 2017 from the previously conducted 12 meetings per year. This revised MPC process will enable more time for staff to conduct a comprehensive analysis of economic developments and thereby facilitate the provision of in-depth and more forward looking insights to the monetary policy formulation process.

In the long term, FPAS will also have a pivotal role to play in the adoption and subsequent success of the FIT framework, as the CBSL will communicate the medium term forecasts of key macroeconomic variables to the public. IT central banks have referred to inflation targets and forecasts, conveyed through inflation reports, as their primary communication tools in order to anchor inflation expectations. In the past, a thorough understanding of monetary policy decisions has been a difficult task for the public. However, the publication of inflation reports in the future is expected to largely bridge this information gap between the CBSL and the public. Such reports will also compel policymakers to remain not only transparent, but

Proposed Monetary Policy Formulation Process



2. http://www.douglaslaxton.org/fpas.html
3. Amarasekara, C., Anand, R., Ehelepola, K., Ekanayake, H., Jayawickrema, V., Jegajeevan, S., Nugawela, T., Ratnavadivel, P., Remo, A., Plotnikov, S., Yatigamanna, R. An Open Economy Quarterly Projection Model for Sri Lanka. Forthcoming 2017.

also accountable for announced targets. In the event of missed targets, policymakers will be obliged to provide an exhaustive justification for the underperformance and the public will also be equipped to understand policy shortcomings. These changes are also expected to be supplemented by necessary legislative amendments aimed at strengthening the CBSL to conduct monetary policy more independently within a flexible exchange rate regime.

A coherent framework based on FPAS will equip policymakers in a FIT regime to generate proactive policy analysis that will enable the creation of a growth conducive, low-inflation environment■

References

Alichi, A. and J. Benes. 2015. "Frontiers of Monetary Policymaking: Adding the Exchange Rate as a Tool to Combat Deflationary Risks in the Czech Republic." International Monetary Fund Working Papers 15-74.

Benes, J., K. Clinton, A. T. George, P. Gupta, J. John, O. Kamenik, D. Laxton, P. Mitra, G. V. Nadhanael, R. Portillo, H. Wang, and F. Zhang. 2016. "Inflation-Forecast Targeting For India: An Outline of the Analytical Framework." RBI Working Papers, 07.

Benes, J., K. Clinton, A. T. George, J. John, O. Kamenik, D. Laxton, P. Mitra, G. V. Nadhanael, H. Wang, and F. Zhang. 2016. "Quarterly Projection Model for India: Key Elements and Properties." RBI Working Papers, 08.

Black, R., V. Cassino, A. Drew, E. Hansen, B. Hunt, D. Rose, and A. Scott. 1997. "The Forecasting and Policy System: the Core Model." Reserve Bank of New Zealand Research Papers 43.

Black, R., D. Laxton, D. Rose, and R. Tetlow. 1994. "The Steady-State Model: SSQPM: The Bank of Canada's New Quarterly Projection Model." Bank of Canada Technical Reports 72, Part 1.

Central Bank of Sri Lanka. 2017. "Road Map: Monetary and Financial Sector Policies for 2017 and Beyond."

Coats, W., D. Laxton, and D. Rose. 2003. "The Czech National Bank's Forecasting and Policy Analysis System."

Gonçalvez, C.E.S. and J.M. Salles. 2008. "Inflation Targeting in Emerging Economies: What Do the Data Say?" Journal of Development Ecnonomics, 85, pp. 312-18.

Hammond, G. . 2012. "State of the Art of Inflation Targeting." Centre for Central Banking Studies Handbooks.

International Monetary Fund. 2015. "Evolving Monetary Policy Frameworks in LowIncome and other Developing Countries."

Laxton, D., D. Rose, and A. Scott. 2009. "Developing a Structured Forecasting and Policy Analysis System to Support Inflation-Forecast Targeting (IFT) " International Monetary Fund Working Papers, 09-65.

Palmqvist, S. 2007. "Flexible Inflation Targeting: How should Central Banks take the Real Economy into Consideration?" Sveriges Riksbank Economic Review, 2:61.

Schaechter, Andrea, Mark R. Stone, and Mark Zelmer. 2000. "Adopting Inflation Targeting: Practical Issues for Emerging Market Countries." International Monetary Fund.

Svensson, L.E.O. 1999. "Inflation Targeting: Some Extensions." Scandinavian Journal of Economics, 101:3, pp. 337-61.

Svensson, L. E.O. 2009. "Flexible Inflation Targeting: Lessons from the Financial Crisis."

REVIEWER ACKNOWLEDGEMENT

The Communications Department of the Central Bank of Sri Lanka would like to thank the reviewers who have contributed to the July – September 2017 (Volume 37, Number 3) issue of News Survey

Mr. D A G K Wijetunga

Director, Department of Training and Development,

Central Bank of Sri Lanka

Published by the Central Bank of Sri Lanka, Janadhipathi Mawatha, Colombo 1, Sri Lanka
Printed at the Central Bank Printing Press, 58, Sri Jayewardenepura Mawatha, Rajagiriya, Sri Lanka