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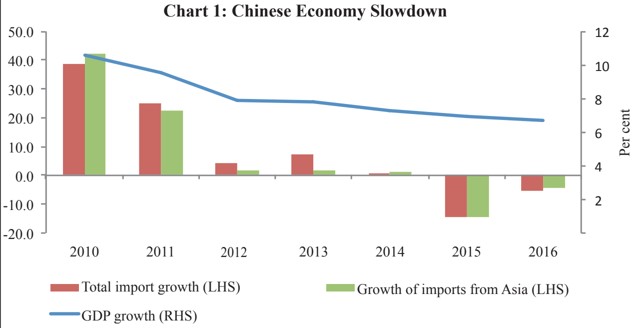
# Spillover Effects of Chinese Economy Slowdown on Asia

**K.A.U.S.K. Thilakarathne**
Senior Economist & Head Public Finance Division
Economic Research Department
Central Bank of Sri Lanka

## Chinese Economy Slowdown

After many years of high economic growth Chinese economy is slowing down and the service sector has become the main growth driver. Accordingly, during 2000-11 China's real GDP growth was averaging at around 10 per cent,[1] showing extraordinarlly high growth rates. However, real GDP growth rate moderated at around 7-8 per cent during 2012-2014 and it further declined to below 7 per cent after 2015 due to the Chinese transition to a new slower growth phase. According to Chinese authorities[2] Chinese economy realised a new normal of stable growth in 2014. Further, according to Dizioli et. al. (2016), change in composition in economic growth also exhibits concentrating more on the service sector from industry sector and there are tentative signs of rebalancing from investment to consumption.

**Chart 1: Chinese Economy Slowdown**




Sources: International Monetary Fund
World Integrated Trade Solution, World Bank Group

1. International Monetary Fund Data Base
2. National Bureau of Statistics of China, 20 January 2015

The recent slowdown in Chinese growth entails an impact especially on the Asian economies as economic growth of most of these countries are highly depend on exports to China. Rhee (2015) has estimated that a one percentage point slowdown in Chinese growth translates into a 0.3 per cent decline of growth for other Asian countries. He further explains that such spillovers to China's neighbours in Asia might have become even larger lately, as impact will flow through global financial market linkages in addition to the impact observed through trade in the near term. According to Atradius Economic Research (2015), China's slowdown and rebalancing are generating spillovers to other countries through three main channels, namely, trade spillovers, financial spillovers and commodity market spillovers. Hence, these three channels are discussed as follows, with a view of analysing the impact of China's slowdown on Asian economies.

## Trade Spillovers

The first channel via which a Chinese slowdown would spillover to other countries is trade. Countries with high concentration of exports to China are the most vulnerable as the countries that are highly export dependent are vulnerable to fluctuations in their export revenues, which could have an impact on their overall economic growth. Exposures to China through trade channel are significant for the Asian economies, especially through imports[3] to China. In 2010, Chinese imports from Asia amounted to US dollars 593.5 billion or 42.5 per cent of total Chinese imports. However, this ratio declined to 39.3 per cent in 2016. In 2010, Chinese imports from Asia showed a growth of 42.0 per cent in comparison to 2009, recovering from global financial crisis and also increased in 2011 by 22.3 per cent. However, after that, the growth of imports to China from Asia declined significantly, recording an average growth of 1.6 per cent during 2012-2014. Illustrating the impact of the slower growth and lower demand in Chinese economy, Chinese imports from Asia recorded a negative growth of 14.3 per cent in 2015, continuing the same trend with a negative growth of 4.0 per cent recorded in 2016.[4]

According to the Table 1, countries such as Mongolia, Hong Kong, Lao PDR, Myanmar and South Korea have higher shares of exports to China.[5] Further, it is observed that exports to China have declined in most of the Asian economies during the 2015-2016 period with low Chinese import demand.

Growth in exports is an important part of economic growth in countries with open economies. Table 1 suggests that countries such as Mongolia, Oman, Lao PDR, Myanmar, South Korea, which have higher export shares to China are the most vulnerable through trade channel as the decline in exports to China as a percentage of GDP is greater than other countries. Meanwhile, countries such as Japan, Malaysia, Kazakhstan, Indonesia and Thailand, which have lower export shares with China, are least vulnerable.

**Table 1**

**Impact of Chinese Economy Slowdown on Exports to China**

| | Exports to China/ country's total exports: 2016 (%) | Export growth to China (%) | | Exports to China/ GDP (%) | | | |
|---|---|---|---|---|---|---|---|
| | | 2015/2014 | 2016/2015 | 2014 | 2015 | 2016 | Difference 2016 - 2014 |
| Mongolia | 78.98 | -25.6 | -4.6 | 41.8 | 32.4 | 32.8 | (9.1) |
| Hong Kong | 55.27 | 1.0 | 31.0 | 4.3 | 4.1 | 5.2 | 0.9 |
| Oman | 43.61 | -36.8 | -20.0 | 29.3 | 21.8 | 18.0 | (11.3) |
| Lao PDR | 40.08 | -13.0 | -12.1 | 13.4 | 10.8 | 8.5 | (4.9) |
| Myanmar | 40.84 | -65.1 | -24.8 | 23.8 | 9.2 | 6.5 | (17.3) |
| South Korea | 25.12 | -8.2 | -8.9 | 13.5 | 12.6 | 11.3 | (2.2) |
| Japan | 17.65 | -12.3 | 1.9 | 3.4 | 3.3 | 2.9 | (0.4) |
| Singapore | 12.99 | -10.5 | -5.7 | 9.9 | 9.1 | 8.4 | (1.5) |
| Malaysia | 12.54 | -4.3 | -7.5 | 16.5 | 18.0 | 16.6 | 0.2 |
| Kazakhstan | 11.46 | -40.0 | -17.8 | 0.2 | 0.4 | 0.6 | 0.4 |
| Indonesia | 11.62 | -18.8 | 7.7 | 2.7 | 2.3 | 2.3 | (0.5) |
| Philippines | 11.00 | -9.6 | -8.3 | 7.4 | 6.5 | 5.7 | (1.7) |
| Thailand | 11.05 | -3.0 | 3.7 | 9.4 | 9.3 | 9.4 | (0.1) |
| Vietnam | 10.23 | 49.9 | 24.6 | 10.7 | 15.6 | 18.5 | 7.8 |

Sources: International Monetary Fund
World Integrated Trade Solution, World Bank Group

## Financial Spillovers

The second impact channel is through financial spillovers and it would have a lesser impact in comparison to other two channels, namely trade channel and commodity market channel. According to the Atradius Economic Research (2015), investments from China have increased during past

3. imports of China can be considered similar to the exports to China from other countries

4. It is noteworthy to mention that total imports of China from rest of the world also affected severely showing a decline even in nominal terms by 14.3 per cent in 2015 and 5.5 per cent in 2016, in comparison to the average growth reported in imports of 31.9 per cent during 2010-2011 and average growth of 4.0 recorded during 2012-2014.

5. All countries in the Asian region, with a share of 10 per cent or more exports to China, are listed in the Table 1.

few years and billions of loans have been mobilised to other countries, particularly on energy and metals. However, they say that China will not reduce its foreign investments drastically even though China is facing an economic slowdown as holding the investments on the areas of energy and metal production would be strategically important.

### Commodity Market Spillovers

Commodity market spillovers are the third impact channel as China is a major player in commodity markets. Dizioli et. al. (2016) articulate that China accounts for 50 per cent of the global demand for metals. They further explain that lower growth in China and investment in particular, along with increasing supply, has put downward pressure on the prices of fuel (including oil and coal), metals, and agricultural products. Deceleration in Chinese investment growth has put downward pressure on commodity prices. Asian countries which export minerals, fuels and metals to China, are particularly vulnerable with the commodity market decline. Mongolia, Oman, Lao PDR and Myanmar have very high shares of these types of exports to China and suffered severely from the commodity market price decline.

**Table 2**

**Share of country's total exports to China : 2016**

| | Minerals | Fuels | Metals |
|---|---|---|---|
| Mongolia | 54.4 | 33.2 | 1.6 |
| Oman | 0.3 | 95.1 | 0.4 |
| Lao PDR | 76.2 | 0.5 | 1.4 |
| Myanmar | 0.4 | 30.1 | 5.3 |

Source: World Integrated Trade Solution, World Bank Group

### Conclusion and Way Forward

Economic downturn in China will mostly impact Asian countries through imports of China and prices of minerals, fuel and metals. Countries, such as Mongolia, Oman, Lao PDR and Myanmar which have a less diversified export structure and concentration on China were the most vulnerable. Further deceleration in China's growth has been projected by the IMF (WEO, 2019). Accordingly, GDP growth in China is projected to decline to 5.5 per cent by 2024 from the current growth level of 6.6 per cent in 2018. GDP growth in emerging and developing Asia is also projected to decline to 6.1 per cent from 6.4 per cent in 2018. Hence, Asian economies have to be more vigilant on depending heavily on Chinese imports as a decline in their export revenue would have an impact on the economic growth. Further, measures are needed diversify their export destinations and products rather than concentrating on a few basic export commodity items.

It would be noteworthy to identify the impact of the Chinese economic slowdown on Sri Lankan economy as well. Exports to China from Sri Lanka have been increased during the last two decades. Accordingly, in 2000, Sri Lanka's exports to China recorded at 0.09 per cent of total exports of Sri Lanka and that share was increased to 2.0 per cent by 2018. Although Sri Lanka's export share to China is marginal now, it would be increased in future. Hence, Sri Lanka should also be cautious on the dependency on exports to China with their economic slowdown■

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# Measures of Active Risk: Tracking Error & Information Ratio

M.N.P. Jayaweera
Deputy Director
Risk Management Department

**Introduction**

The Central Bank of Sri Lanka (CBSL) is vested with powers to manage foreign exchange reserves by the Monetary Law Act (MLA) and the funds of Employee's Provident Fund by the EPF Act. Further, CBSL manages a few other internal funds which have been set up for different purposes. Though all these funds are invested mostly in fixed income securities, they follow different approaches due to differences in the objectives, sizes, and the nature of the markets in which the funds are invested. Among all these funds, foreign exchange reserves are managed closely in line with the internationally accepted best practices of fund management.

Recently, International Operations Department (IOD) commenced managing foreign exchange reserves against a set of benchmarks. This approach, commonly referred to as investing on a benchmark-relative basis encompasses an objective to either match or exceed the rate of return generated by the benchmark portfolio. When the objective is to beat the benchmark return, portfolio managers have to deploy different investment strategies and therefore, take different risks than those of the benchmark. However, there is no guarantee that by taking more risk than the benchmark, the portfolio will generate excess return over the benchmark. It could underperform the benchmark.

The risk arising due to mismatches between a portfolio's risk profile and the corresponding benchmark's risk profile is called the active risk, tracking risk or the tracking error. It measures the variability of excess return of the portfolio over the benchmark return. Lower the tracking error, the closer the portfolio's return is to the benchmark's return. Taking risk that is different to that of the benchmark portfolio is expected to deliver a different performance. Therefore, just a comparison between rate of return figures of the benchmark portfolio and the actual portfolio is not sufficient to measure the performance of the actual portfolio. Performance of the actual portfolio should be evaluated in comparison with the additional risk taken by the portfolio. The Information Ratio provides a better insight into the risk adjusted performance of the actual portfolio; the average excess return per unit of volatility in excess return.

This paper reviews risk measures i.e. tracking error as a measure of relative risk and information ratio as a risk adjusted performance measure while highlighting the importance of applying such new measures in order to strengthen the portfolio management and risk management activities in the Central Bank.

**Risk Exposures of a Fixed Income Securities Portfolio**

Fixed income securities portfolio, also called the bond portfolio, is a collection of bonds. The primary risk factor for a bond is the interest rate. As the fixed income securities portfolio consists of many bonds maturing in different time periods, the primary risk factor for a bond portfolio is the yield curve. Changes in the yield curve will have impact on the value of the bond portfolio. There are three major types of changes to the yield curve:

i) A parallel shift in the yield curve. That is changing the interest rates for all maturities by the same amount.

ii) A twist in the yield curve. A twist occurs when the interest rates at two different maturities moves in opposite directions. For an example, while two-year interest rate increases ten-year interest rate decreases.

iii) Other curvature changes of the yield curve. This type of changes is also called as butterfly shifts in the yield curve.

Among these three types of yield curve movements, parallel shifts in yield curve contributes mostly to the variation of total return of a bond portfolio. This risk is called as interest rate risk and it is measured by the duration of the portfolio. The risk arising due to twists in the yield curve is known as the yield curve risk and is measured through key rate durations and present value of a dollar (PV01).

A typical bond portfolio consists of bonds with different maturities, issued by different type of issuers, i.e. bonds issued by national governments, local governments, government agencies, supranational agencies and corporates. A security issued by a non-governmental organization generally offers a higher yield than a government bond with the same maturity. This difference between yield on a government bond and a non-government bond is referred as the spread. The spread will vary with the time. This risk is called the spread risk. Moreover, a bond portfolio which consists of non-government bonds is also exposed to credit risk, i.e. the risk of defaulting or rating downgrade. Apart from those risks, a multi-currency bond portfolio will be exposed to the foreign exchange or the currency risk. However, currency risk is managed separately through a technique called currency overlay and is not discussed in this paper.

Generally, any bond portfolio is exposed to some or all of the risks mentioned above all the time. Therefore, a risk profile of a bond portfolio, either an actual portfolio or a bond index, would typically be assessed on the following risk factors.

i) Duration: this measures the sensitivity of the value of the bond portfolio for a small parallel shift in the yield curve. However, for large changes in yield, a convexity adjustment is required. Therefore, this measure alone will not capture the full impact of the changes in interest rate on a bond portfolio.

ii) Key Rate Duration and PV01: These measures capture the impact of non-parallel shift of the yield curve. Key rate duration measures the interest rate sensitivity of the portfolio for a change in interest rate only at a certain point of time while interest rates for all other points remain unchanged. PV01 measures the present value of future cash flows in non-overlapping time buckets.

iii) Sector and Quality Percent: This reflects the percentage of the portfolio invested in different sectors of the market and different credit ratings. Here, the sector refers to issuer classification such as government, government agencies, supranational and corporate. This may be sub divided further based on the credit ratings of the issuer. For an example, a bond portfolio may have 8 percent of its bond holdings in AAA corporate issues and so on.

iv) Sector Duration Contribution: For different sectors, there will be different yield curves. As a consequence, sensitivity of the value of a portfolio for a change in interest rate will vary according to the sector. This sensitivity is measured by sector duration, which is the duration of a portfolio which comprises of bonds of only that sector.

v) Quality Spread Duration Contribution: This is the sensitivity of the value of a bond portfolio for the change in spread.

vi) Issuer Exposure: This is the exposure to a particular issuer which helps control the event risk. Lower the exposure to a single issuer, the lower the event risk relevant to that issuer.

## Tracking Error

A bond portfolio manager who decides to manage the portfolio against a benchmark, typically a bond index, can choose to follow either a passive approach or an active approach. In the event that the portfolio manager chooses to follow a passive strategy, the intention is to replicate the risk profile of the benchmark bond index. In active management strategy, the portfolio manager will choose to deviate the risk profile of the actual portfolio from that of the benchmark portfolio. Active management involves significant mismatches in risk profiles in major risk factors such as duration, sector and quality exposures. However, except for the pure indexing strategy, where the portfolio manager exactly replicates the risk profile of the benchmark index, in both passive investment strategies and active strategies, there will be mismatches in one or more risk factors between the benchmark and the actual portfolio. The degree of mismatches and the risk factors vary from one strategy to another.

This additional risk, arising due to the mismatches between the benchmark and the actual portfolio is called the active risk. This is the additional risk assumed by the portfolio manager over the benchmark. This is also known as tracking risk and tracking error. This measures the variability of the excess return of the actual portfolio over the benchmark and is defined as the standard deviation of the excess return (or active return).

Tracking error = $\sqrt{\frac{\Sigma(R_P - R_B)^2}{n-1}}$ Where,

$R_P$ – the return on the actual portfolio

$R_B$ – the return on the benchmark portfolio

n – number of periods considered

The tracking error measures how closely the portfolio risk profile is maintained to that of the benchmark. Lower tracking error indicates that the risk profile of the portfolio is closely matched with the risk profile of the benchmark. Any changes made to the portfolio that changes any of the six risk factors discussed earlier will increase the tracking error.

Tracking error is interpreted as follows:

We expect that two-thirds of the time, the portfolio return to be within the range of return on the benchmark plus or minus tracking error under the assumption that the returns are normally distributed. For example, the tracking error of 100 basis points (bps) can be interpreted as “two thirds of the time, we can expect the return on the portfolio to be within the range of benchmark return plus or minus 100 bps”.

## Information ratio

Tracking error reveals how closely the portfolio manager manages the portfolio relative to the benchmark. If the tracking error is high that indicates the portfolio manager is taking relatively high risks with the portfolio. High risk may lead to high returns too. But the question is whether the additional risk taken is adequately compensated by the higher returns. To answer this question, another measure called Information Ratio (IR) is used. Information Ratio is a risk adjusted return of the portfolio. The higher the information ratio the higher the active return which implies that the portfolio manager has consistently beaten the benchmark. Generally, information ratio above one-half is considered as a sign of consistent performance.

Information Ratio is defined as follows:

$$IR = \frac{E(R_P - R_B)}{TE}$$

Where,

E(.) – Expectation operator

$R_P$ – the return on the actual portfolio

$R_B$ – the return on the benchmark portfolio

TE – Tracking Error

**The way forward**

Currently, IOD manages foreign exchange reserves against a set of benchmark indices and follows the enhanced indexing approach which is considered to be a passive investment strategy. However, enhanced indexing approach will also carry some mismatches between the risk profiles of the actual portfolio and the benchmark with the intention of outperforming the benchmark return. These mismatches can be small, yet it generates some active risk and requires the use of appropriate risk measures such as tracking error. Tracking Error is an internationally accepted risk measure used to measure the active risk. However, risk is only one factor to be considered. In the meantime, performance of the portfolios should be monitored. Earning a rate of return above the benchmark return does not necessarily reflect better performance. The reason is that the actual portfolio may have taken high risk compared to the benchmark. Therefore, the return should be adjusted for the risk. Information ratio is the widely used risk adjusted performance measurement in fund management. Therefore, introduction of tracking error and information ratio as a risk measure and a risk adjusted performance measure would enhance the quality of the portfolio management and risk monitoring process of the foreign exchange reserves. Further, the same measures can be introduced to EPF and internal funds once appropriate benchmarks are assigned to those funds and further strengthen the quality of fund management and risk management activities carried out by the Central Bank of Sri Lanka■

# Classifications of Corporate Governance: An Overview

**A.A.I.N. Wickramasinghe**
Deputy Director
Legal and Compliance Department

## 1. Introduction

The term governance is ancient and it derives from the Greek word for steering (Carroll & Buchholtz, 2009). However, the term corporate governance as a discipline in its own is relatively young (Fidanoski, Mateska, & Simeonovski, 2013) and it becomes a focal point in the financial systems due to the proliferation of crisis over the past few decades and the collapse of the well-established and high profile institutions such as Enron, Worldcom, Tyco, Freddie Mac, Lehman Brothers, American Insurance Group, etc. In the present context, corporate governance become an essential element in the financial systems around the world. The concept of corporate governance is vague and it is a multidiciplinary subject. Therefore, academics, researchers, scolars, regulatory bodies, and institutions attempt to define corporate governance with reference to their deciplines as well as their interests. Further to above, corporate governnce has been adopted by different countries to suit their legal and regulatory framework, financial system, culture,etc. This article attempts to elaborate the concept of corporate governance by using different definitions and the corporate governance systems around the world which are commonly practiced. Further to above, special attention is paid the the corporate governace system followed by Sri Lanka.

## 2. The Concept of Corporate Governance

Defining corporate governance is not an easy task. By exploring a range of contemporary definitions of corporate governance, Van den Berghe (2012) states that it is hard to define the corporate governance without any ambiguity. Roche (2005) states that it is difficult to define corporate governance since boundaries of this concept are perpetually expanding. Corporate governance is uniquely complex and multi-faceted subject(Cadbury, 2000). It is further stated that paradigm, diagnosis and solutions of corporate governance lie on multidisciplinary fields such as economics, finance, accountancy and others. Researchers in different fields such as law, economics, accountancy and management define this concept favourable to their field. Accordingly, it is expected to examine the different definitions given for the term corporate governance by individuals as well as the well known institutions.

When analyzing the definitions given for corporate governance by individuals, it was observed that some of the researchers tend to define it within a limited framework and give a narrow definition by considering only a few aspects such as the interests of the shareholders, business directions of the company, etc. Grundfest (1993) defines corporate governance as a promise to repay a reasonable return for the capital invested and committed to operate the institutions efficiently. Shleifer and Vishny (1997) also have a similar view. They also believe that the corporate governance should be adopted for the financial interest of the investors. They identify corporate governance as a deal which assures the suppliers of finance of a corporate to get their return on investment. However, later on, Shleifer together with Laporta and Lopez tried to improve the above narrow definition and define corporate governance as a set of mechanisms which protect the outside investors from and against expropriation by insiders namely the manager and the controlling shareholders (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2000). Rwegasira (2000) moved a little beyond the above definition and theorized corporate governance as a structure within which corporate entity receives its basic direction or orientation. As per Sternberg (2004), corporate governance is a way of ensuring that corporate actions, agents and assets are directed to achieve the corporate objectives established by the shareholders of the corporate. Even in the recent past, some researchers tried to justify the above definitions. They state that there is a possibility of misusing assets such as stealing profits, selling output, assets and securities by insiders and therefore, corporate governance should be there to protect the investors(Yusoff & Alhaji, 2012).

When analyzing these definitions, it appears that the above researchers mainly consider the rights and interests of shareholders. Therefore, it could be argued that their ultimate purpose is to protect the interests of shareholders within the definition of corporate governance. However, some researchers try to deviate from the above narrow definitions of corporate governance. Under the broad definitions, researchers tried to compress all the good things that may happen to a corporation under the term corporate governance. Accordingly, Demb and Neubauer (1992) define corporate governance as the process by which companies are made responsive to the wishes and rights of stakeholders. Anyone who has an interest in a business may be considered as stakeholders and it includes owners, managers, workers, customers, suppliers, the community etc. In view of the above it is explicit that scholars tried to explore the concept of corporate governance for the sake of all the participants of the business. Maher and Andersson (2000) argue that the narrow stand point of corporate governance aims to maximize and protect the shareholders while from broader perspective, the corporate or business responsible for a wider constituency of stakeholders other than shareholders.

Some scholars tend to classify corporate governance under two parts based on internal and external mechanisms of it.(Bushman & Smith, 2001; Cremers & Nair, 2005; Dalwai, Basiruddin, & Abdul Rasid, 2015; Denis & McConnell, 2003; Fanta, Kemal, & Waka, 2013; Farinha, 2003). Internal corporate governance mechanisms comprise the internal components associated with corporates such as ownership structure, board of directors, independence, executive compensations, financial disclosures, audit committees, etc while external corporate governance mechanisms include legal infrastructure, product market competing, proxy fights, regulatory systems, managerial labour markets etc. Farinha (2003) did a survey to categorize internal and external mechanisms. According to his survey, internal mechanism include institutional shareholders, insider ownership, Board of Directors, compensation packages, dividend policy and debt policy while external mechanisms include takeover threat, product market competition, mutual monitoring by managers, legal environment, managerial labour market, security analysis and the role of reputation. It appears that corporate governance mechanisms are divided into two parts based on the mechanisms which are derived within the organization and out of the control of the organization. Further to above, factors such as nature of business, economic condition of the country, cultural and social situation, legal environment and development level of the country are also influenced to such categorization.

Committees and institutions also came forward to provide definitions for corporate governance due to the ambiguity and complexity of the concept of corporate governance. By providing a classic definition, Cadbury

Committee on the Financial Aspects of Corporate Governance define the corporate governance in 1992 as follows (Cadbury, 1992).

> "*Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board's actions are subject to laws, regulations and the shareholders in general meeting*".

It is explicit that this definition is also mainly focused on the interests of the shareholders. Even though, UK still follows the Cadbury definition of corporate governance, they tend to give a wide interpretation for corporate governance in the present context. It is accepted in the UK Corporate Governance Code of 2012 that the purpose of corporate governance is to facilitate effective, entrepreneurial and prudent management which can deliver the long term success of the company.

Being one of the main international organizations which engage in the development of corporate governance, OECD (2015) defines corporate governance as follows:

> "*Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined*".

Bank for International Settlement (BIS) plays a vital role in introducing corporate governance principles to the domestic banking sectors of the world. However, BIS also adopts the same definition given by OECD for corporate governance. On the basis of the literal interpretation, one could argue that the OECD definition is limited to the internal control and management of the company. However, it always refers to the relationship of shareholders as well as stakeholders. Stakeholders may include the persons who have internal and external relationships to the company. On the other hand, it is required to consider the ultimate objectives of the said definitions. It is clearly mentioned in OECD (2015) principles that the corporate governance principles are developed with a view to support economic efficiency, sustainable growth and financial stability. It is accepted in the BIS Principle also that the primary objective of corporate governance should be to safeguard the stakeholders' interest in conformity with the interest of the public on a sustainable basis(BIS, 2015). Under these circumstances, it is explicit that the ultimate purpose of corporate governance is to improve the corporate performance and thereby to achieve economic efficiency, sustainable growth and financial stability of a country.

## 3. Different Corporate Governance Systems

Researchers and scholars have identified different categories of corporate governance systems by considering the characteristics and features followed by different countries. Maher and Andersson (2000) identify two systems of corporate governance namely the insider and outsider systems of corporate governance. As per Maher and Andersson (2000) outsider system is mainly followed by the USA and UK while insider system is followed mainly by Europe (except UK), Japan and Korea. Becht, Bolton, and Röell (2003) divide corporate governance systems as Anglo- American market based system (followed by the USA and UK) and German-Japanese long term investor system (followed by Germany and Japan). When analyzing the categorization of corporate governance systems, it could be observed that some researchers tend to deviate from these two broader categorization. Manawaduge (2012) categorized corporate governance systems into three categories namely as market based system (i.e. Anglo- Saxon model), network oriented system (relationship-based model) and emerging governance model. Khurana (2012) described four models as Anglo-American Model, German Model, Japanese Model and Indian Model.

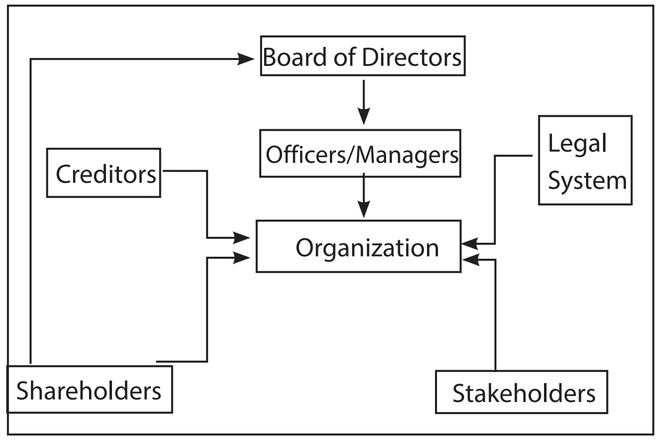
When analyzing the above categorization of corporate governance systems, it was observed that Anglo-American and German systems are popular even though different names have been used to identify these systems. Further it is widely accepted that USA, Germany, Japan and UK has some of the best corporate governance systems of the world (Shleifer & Vishny, 1997). Considering the above facts, it is expected to examine the Anglo-American, German and Japanese Corporate governance systems for the purposes of this article. Further to the above, it is expected to examine the corporate governance model followed by Sri Lanka as well.

### 3.1 Anglo-American System of Corporate Governance

Anglo-American system is based on the fiduciary relationship between the shareholders and the management (Otman, 2014). Different authors and researchers use different terminology to name Anglo-American system. Some of the commonly used terminologies for Anglo- American model are outside model, Anglo-Saxon model and unitary system. Further to the above, some of the scholars identify this model as "market-based" or "market oriented" systems of corporate governance since most of the countries which follow these systems are market oriented where capital markets play a vital role in corporate governance (Becht et al., 2003; Maher & Andersson, 2000; Manawaduge, 2012; Otman, 2014; Tosuni, 2013). This system could also be recognized as " disclosure-based model" since dispersed investors require adequate and reliable information flows to make informed investment decisions (Manawaduge, 2012).

Anglo-American system of corporate governance is mostly seen in the countries such as UK, USA, Australia and Canada. These countries have well developed capital markets and they have well established laws and regulations to govern the capital markets. Legal frameworks of these countries clearly define the rights and responsibilities of the key players of corporate governance systems namely shareholders, directors and management. The nature of the Anglo-American system is elaborated in a flow chart as in Figure 1.

**Figure 1: Anglo-American Model of Corporate Governance**




Source: Khurana (2012)

In this system, equal ownership is provided to both institutional and individual shareholders. This model highlights the interests of the shareholders. Further to the above, more influence of shareholders than other stakeholders on management decisions, single-tiered board of directors, important role played by the company in stock market, separate ownership and management functions, independence of managers and directors, active market for corporate control, widely dispersed ownership, frequent takeovers, performance based compensation for executives, concise and comprehensive disclosure norms, strict rules against the manipulation of organizational code of conduct and close monitoring of the company on short term basis could be observed as the key features of the Anglo-American system of corporate governance (Gay, 2002; Khurana, 2012; Tosuni, 2013). It is widely accepted in this system that the markets reward or punish the good or bad performance of the companies (La Porta et al., 2000; Shleifer & Vishny, 1997)

Many criticisms are observed against this system. Some scholars define Anglo-American system as "myopic model" since managers tend to obsess with quarterly performance and act extremely on the short term perspective which cause the threat of hostile takeovers (Becht et al., 2003; Charkham, 1995; Keasey, Thompson, & Wright, 1997). On the other hand there are differences in the corporate governance practices in the individual countries who follow the Anglo-American system of corporate governance due to their legal and regulatory framework. The best example could be seen in the USA and UK who are pioneers of this model. USA follows the "rule based" system while UK follows the "principle based" systems. In USA, directors are subjected to penalties for their non-compliance as per the Sarbanes Oxley Act of 2002. In UK, as per the UK Corporate Governance Code of 2014, companies are required to comply with the same or if not, to give explanations for non-compliance. Another difference is that UK does not accept CEO duality (i.e. CEO and the chairman are one and the same person) while USA does not have such reservation.

Further, Anglo-American system of corporate governance was severely criticized with the financial crisis in 2008-2009. Clarke (2009) points out that the universal acceptability of Anglo-American system of corporate governance is questionable due to the financial crisis. The simple example is the collapse of Enron and WorldCom which exercise all the characteristics of a good Anglo-American corporation (Clarke, 2009; Htay, Salman, & Meera, 2013). Under these circumstances, it could be argued that whether Anglo-American system of corporate governance is ideally suited to the existing economies, businesses and market environments which have been continuously influenced by the advanced technology, communication and globalization.

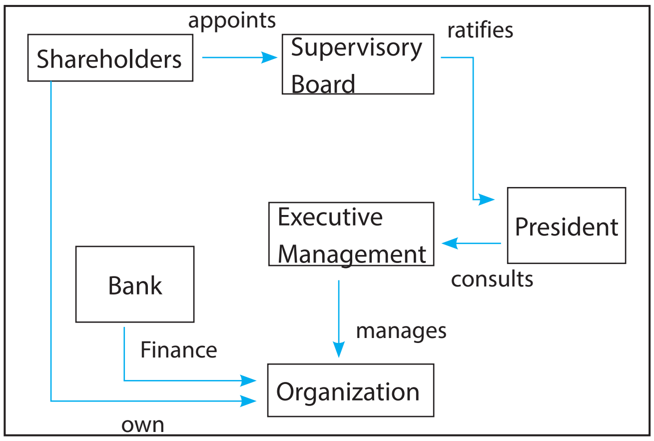
### 3.2 Japanese System of Corporate Governance

This system is also called as a business network model. In Japan, it is known as 'Kieretsu' (Khurana, 2012). Simply, Kieretsu means systems and rows. As per Kieretsu, industrial groups are linked by trading relationships as well as cross shareholding of debt and equity. The key features of Japanese corporate governance systems are; the high level of stock ownership by affiliated banks and companies, developed legal and policy framework to promote Kieretsu, strong and close relationship between the bank and company, board of directors composed by insiders in most of the time, and the complicated procedure to exercise shareholders votes. Equity ownership is a special feature of the Japanese system since insiders and their affiliates hold the major shareholding of Japanese companies. Insiders always play a major role within the company while marginal attention is given to the interests of the outside shareholders (Allen & Zhao, 2007; Aronson, 2014; Khurana, 2012).

There are four key players in the Japanese corporate governance systems namely banks (major inside shareholder), affiliated company or Kieretsu, management and the government. The board of directors are also almost composed by the insiders. Japanese boards are generally larger when compared to other countries and as an average the board contains 50 members. Disclosure requirement in Japanese corporate governance is relatively high. However, it is not stringent as in the USA. The nature of Japanese corporate governance system is presented in Figure 2.

It is generally accepted that Japan is the first non-western country which is economically developed and enriched with its own experience and traditions with advanced corporate governance systems. In 1980s, Japanese corporate governance was praised due to its long run nature of relationships between the multiple stakeholders in company which created a greater involvement by employees and suppliers (Shleifer & Summers, 1988). However, it was observed that Japanese corporate governance system is also strongly criticized in the present context. Aronson (2014) criticized this system as being slow to reform and remaining fixed on the interest of employees over shareholders. Unresponsiveness to global trends such as the spread of independent directors is also seen as a week point of this system. Aronson (2014) points out that the Japanese corporate governance system fails to capture the changes and ongoing evolution over the past 15 years and it focuses only on the business performance and increasing 'corporate value' for stakeholders. It also creates problems due to the uncertain relationship between corporate governance and business performance. In the present context, it appears that Japan also tries to incorporate some features of other corporate governance systems such as Anglo-American system to minimize the weaknesses of the existing system. Therefore, it is evident that one country cannot be isolated even though they are developed due to the effects of globalization.

**Figure 2: Japanese System of Corporate Governance**



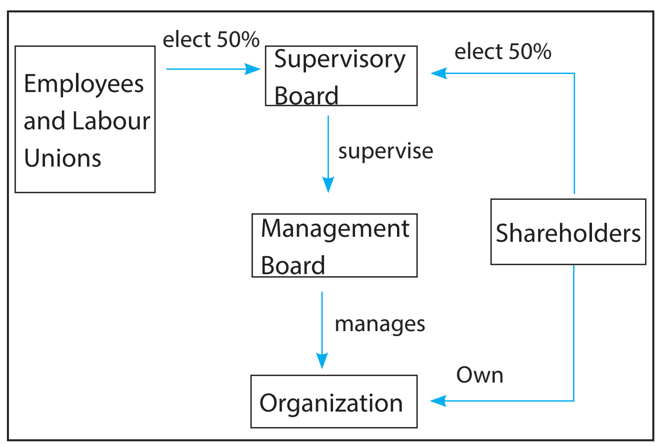

Source: Khurana (2012)

### 3.3 German System of Corporate Governance

German corporate governance system significantly differs from the Anglo-American systems of corporate governance. However, some elements in Japanese corporate governance system are adopted in German system. Due to this reason, most of the academics tend to combine these two systems and define it as 'Continental European model', 'German-Japanese model' or 'insider model' of corporate governance (Maher & Andersson, 2000; Manawaduge, 2012; Otman, 2014; Tosuni, 2013). This system is mainly adapted in Germany, Holland and France. The structure of this model is presented in Figure 3.

Banks hold long term equity stakes of German companies and bank representatives are selected to the boards as in Japanese Systems. However, the unique feature of German corporate governance system is the board composition and shareholder rights. German companies consist of a two-tiered board structure namely as management and supervisory boards. Management board composed only of insiders such as executives of the company while supervisory board composed of employees and representatives of shareholders (Hopt, 1998; Wójcik, 2001). Due to this special nature of the German corporate governance system, it is named as 'two-tier board model' as well (Khurana, 2012). The other unique feature is the legal restrictions imposed for voting rights. As per these restrictions, shareholders' right to vote is limited to a certain percentage of share capital of the company regardless the share ownership position. Most of the time, key players of the German corporate governance system are banks and corporations. German system deviates from the Anglo-American and Japanese model due to few main reasons. One is the mandatory composition of labour/employee representatives to the German supervisory boards. The other one is the size of the supervisory boards which are set by law. The level of ownership concentration of German corporate governance system is also very high (Gorton & Schmid, 1996). The stock market plays a minor role in the governance of German companies (Wójcik, 2001).

**Figure 3: German System of Corporate Governance**




Source: Khurana (2012)

The German corporate governance system has also been criticized. It is argued that the technological progress and globalization of economic activities have increased the productivity and capacity which require corporate restructuring. But German corporate governance system failed to address such restructuring requirements and thereby it hinders the development in Germany (Wójcik, 2001). It is argued that the German corporate governance is converging towards Anglo-American system due to the introduction of the principles of shareholder value, stock based remuneration packages, international accounting standards, improvements in stock markets and the removal of multiple voting shares. However, in a research conducted to examine whether German corporate governance system converges towards the Anglo- American model, it was found that German corporate governance system is still in place due to the barriers to converge towards the Anglo-American system such as concentrated corporate controls, two-tiered board system, separation of ownership and controls through devices (i.e. pyramids and proxy votes), important role played by banks, legal, institutional and cultural barriers to hostile takeovers and the regulatory framework deeply rooted in to the German legal doctrine (Goergen, Manjon, & Renneboog, 2008). In line with the above, it appears that even though some features of other corporate governance systems (i.e. Anglo-American system) have influenced the German corporate governance model, it has not affected the originality of the model. Under the circumstances, it could be argued that there is no harm of adopting features of other systems, if they positively affect the development and performance of the corporate bodies of a country.

### 3.4 Sri Lankan System of Corporate Governance

Basically, there are four institutions engaged in developing the corporate governance framework of Sri Lanka [i.e. Institute of Chartered Accountants of Sri Lanka (ICASL), Securities and Exchange Commission (SEC), Colombo Stock Exchange (CSE) and the Central Bank of Sri Lanka (CBSL)]. When analyzing the provisions of corporate governance codes, rules and directions issued by the above institutions, it is observed that the key features of the Anglo-American model of corporate governance are adopted in the Sri Lankan system. It is evident from the fourth edition of the Best Practices of Corporate Governance issued by the ICASL and SEC. It is accepted in the forward of this edition that the expert panel engaged in developing the corporate governance code for Sri Lanka review the corporate governance codes in UK, USA, Singapore, Australia, Malaysia and India which follow the key features of Anglo-American system. Under the circumstances, it could be strongly argued that the intention of the expert panel was to implement a corporate governance system in Sri Lanka which is similar to Anglo-American system.

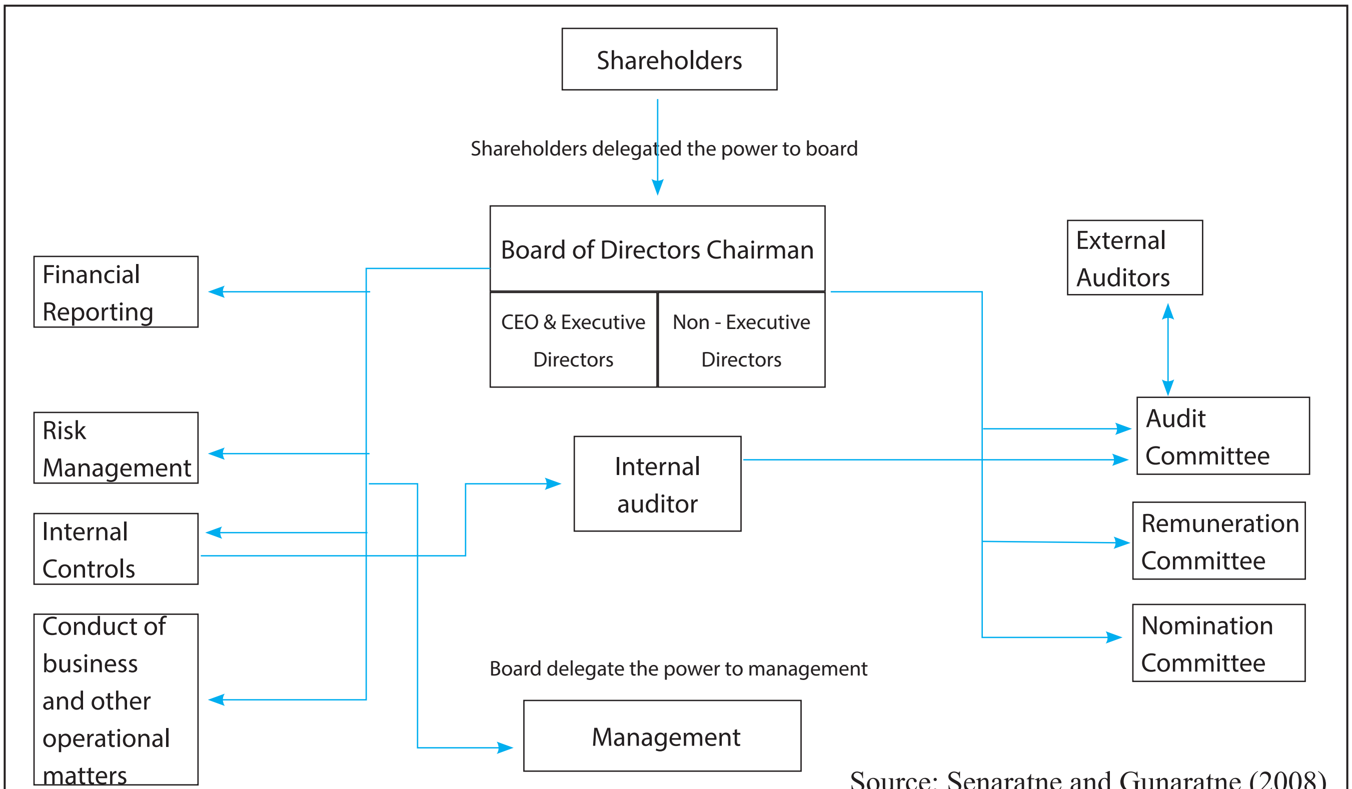
It is accepted that most of the commonwealth countries follow the Anglo-American model of corporate governance (Khurana, 2012). Sri Lanka was also a British colony. By considering such factors, Senaratne and Gunaratne (2008) point out that the corporate governance system of Sri Lanka has been developed in line with Anglo-American model due to both economic and historical reasons. However, some of the distinguished features of insider based corporate governance models of Continental European such as ownership concentration could also be observed in Sri Lanka. Therefore, Senaratne and Gunaratne (2008) highlight that a hybrid system of corporate governance currently prevails in Sri Lanka. By considering these factors Senaratne and Gunaratne developed a corporate governance system for listed companies in Sri Lanka and it is given in figure 4.

When analyzing the mandatory corporate governance principle applicable to the banking sector of Sri Lanka (i.e. Directions Nos. 11 and 12 of 2007 issued by the Central Bank of Sri Lanka), it was observed that those are imposed in terms of sections 46(l) and 76(j)(l) of the Banking Act and section 5 read with section 10(c) of the Monetary Law Act. Violation of these provisions are offences in terms of the sections 79(4) of the Banking Act and section 122 of the Monetary Law Act. Under these circumstances, it could be argued that the corporate governance principles applicable to the banking sector of Sri Lanka are "rule based" as in USA. Senaratne and Gunaratne (2008) try to highlight that

Sri Lanka has a hybrid system of corporate governance which consists of features of both outsider (i.e. Anglo-American System) and insider (i.e. Continental European or German system) models of corporate governance. However, the question is that both these models are implemented in developed nations. Further, these two models have been developed from a long period by considering the economic, cultural, financial and legal framework of these countries. Therefore, it is questionable whether it is prudent to implant such a system to a developing country like Sri Lanka.

2004). On the other hand researchers and academics in emerging economies are not strong enough to compete with developed countries. Therefore, most of the time corporate governance models constructed by academics in developing countries remain unexplored whether they are good or bad. However, every individual country should have a right to develop their own governance model in line with their economic, political social, financial and legal factors. Mayer (1997) states that individual countries should be given a chance to choose the model applicable to them and not to try

**Figure 4: Corporate Governance System of Sri Lanka**




Source: Senaratne and Gunaratne (2008)

It could be observed that researchers attempt to identify a separate corporate governance models for emerging economies. Countries in South Asia and Asia Pacific have a cultural diversity and different economic, political and social conditions. Even though researchers took efforts to develop a separate corporate governance model for emerging economies, it was not successful since they tend to develop it in line with the relationship-based (i.e. Continental European model) and market based ( i.e. Anglo-American Model) systems (Manawaduge, 2012; Praveen Bhasa, pick winners. On the other hand it is not advisable to import and implant corporate governance systems of developed countries as it is, to a developing country like Sri Lanka since its economic, social, cultural and legal frameworks are totally differed from developed countries.

## 4. Conclusions

Defining and classifying of corporate governance is not an easy target as it is a multidisciplinary subject.

It relates to different fields such as law, economics, finance, management, politics, sociology and psychology and therefore, researchers in all these fields are aimed at understanding the corporate governance in relation to their field. On the other hand, complexity of the concept itself causes the emergence of different definitions and classifications of corporate governance. With that backdrop, this article attempted to identify the different definitions and classifications adopted in relation to the corporate governance. It explored the definitions adopted by individuals as well as the well-recognized institutions. Different systems around the world are discussed under the classifications of corporate governance systems which include Anglo-American, German, Japanese and Sri Lankan systems of corporate governance.

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**Dr. (Mrs.) Y M Indraratne**

Director, Economic Research Department, Central Bank of Sri Lanka

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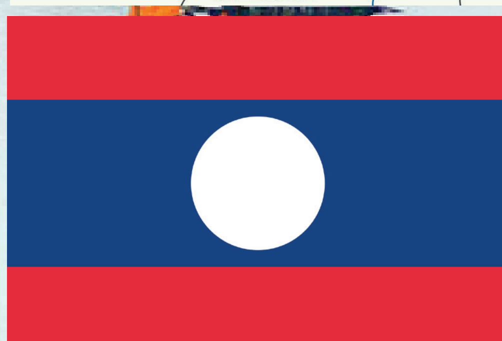
Director, Legal and Compliance Department, Central Bank of Sri Lanka

# LAOS

| | |
|---|---|
| Area | |
| Total | 236,800 sq km |
| Land | 230,800 sq km |
| Water | 6,000 sq km |
| Population (July 2018 est.) | 7,234,171 |
| Population Growth Rate (2018 est.) | 1.48% |
| Birth Rate (2018 est.) (1,000 population) | 23.2 births |
| Death Rate (2018 est.) (1,000 population) | 7.3 deaths |
| (Life Expectancy at Birth (Years) (2018 est.) | 65 years |
| Infant Mortality Rate (2018 est.) (1,000 live births) | 48.4 deaths |
| Unemployment (2017 est.) | 0.7% |
| Distribution of family income – Gini index (2008) | 36.7 |
| Labour Force (2017 est.) | 3.582 million |
| GDP (Official Exchange Rate) (2017 est.) | $16.97 billion |
| GDP – Real Growth Rate (2017 est.) | 6.9% |
| GDP – Per Capita (PPP) (2017 est.) | $7,400 |
| GDP – Composition, by sector of origin (2017) | |
| Agriculture | 20.9% |
| Industry | 33.2% |
| Services | 45.9% |
| Budget Surplus (+) or Deficit (-) as a percentage of GDP (2017 est.) | -5.5% |
| Reserves of Foreign Exchange and Gold (2017 est.) | $1.27 billion |
| Inflation Rate (Consumer Prices) (2017 est.) | 0.8% |
| Imports (2017 est.) | $4.976 billion |
| Imports - Commodities | Machinery and equipment, vehicles, fuel, consumer goods |
| Imports - Partners | Thailand 59.1%, China 21.5%, Vietnam 9.8% |
| Exports (2017 est.) | $3.654 billion |
| Exports - Commodities | Wood products, coffee, electricity, tin, copper, gold, cassava |
| Exports - Partners | Thailand 42.6%, China 28.7%, Vietnam 10.4%, India 4.4% (2017) |

Source: https://www.cia.gov/library/publications/the-world-factbook/geos/la.html

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Currency Department, Central Bank of Sri Lanka, 30, Janadhipathi Mawatha, Colombo 1

+94 112477253  +94 112477726  currency@cbsl.lk

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