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How the Central Bank of Sri Lanka Implements Its Monetary Policy

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1. Introduction

The main goal of monetary policy of central banks is to achieve price stability through the maintenance of the internal value of domestic currency. The Central Bank of Sri Lanka (CBSL) also aims to achieve economic and price stability as one of its core objectives. The CBSL conducts monetary policy to achieve price stability by influencing the cost (interest rate) and the availability of money (market liquidity). In order to achieve its primary objective, the CBSL employs a set of monetary policy instruments and procedures. The monetary policy implementation process of the CBSL plays a crucial role in order to achieve price stability through liquidity management. Accordingly, the CBSL implements monetary policy by conducting market operations to steer the Average Weighted Call Money Rate (AWCMR), which is the operating target of the current Monetary Policy Framework along a desired path within the Standing Rate Corridor (SRC) by managing liquidity in the domestic money market so as to be consistent with the prevailing monetary policy stance. For this purpose, the Domestic Operations Department (DOD) which is responsible for implementation of Monetary Policy of the CBSL uses different instruments to inject or absorb liquidity. The main objective of this article is to explain how monetary policy decisions are implemented using the available monetary policy implementation strategies by the CBSL.

2. Monetary Policy Implementation

2.1 Evolution of Monetary Policy Implementation Targets

Although there is no single ideal structure for monetary policy targets or money market operations, similar to most of the emerging economies, the CBSL targets to achieve price stability as its final policy target. During the early 1980s, monetary management of the CBSL was based on a monetary targeting (MT) framework. Under this, the price stability was to be achieved by influencing changes in broad money supply (M2b), which was linked to reserve money through a money multiplier. Accordingly, the monetary aggregates became the key measures of conducting monetary policy in Sri Lanka. Under the MT framework, the reserve money was used as the operating target. However, due to rising volatility in the money multiplier and velocity, relationship between money supply and inflation has weakened and the role of monetary targets as a nominal anchor has become uncertain. Also, it complicated the CBSL's communication strategy. The instability of the relationship between monetary aggregates and goal variables (inflation and nominal income) makes monetary targeting problematic (Mishkin, 2000).

In line with global developments in monetary policy frameworks, the CBSL also moved away from the MT framework. Accordingly, at present the CBSL conducts its monetary policy with features of both MT and flexible inflation targeting (FIT). The CBSL is working towards implementing a FIT framework by 2020 to conduct monetary policy in a proactive and forward-looking manner. Under the proposed FIT framework, the CBSL will aim to preserve price stability of the economy by targeting an inflation to be maintained in a range of 4% to 6% over the medium term. As the operating target, the AWCMR is being used by the CBSL to guide short term interest rates. Broad money supply (M2b) remains the key indicative intermediate variable to guide the monetary policy.

2.2 How monetary policy is operationalized?

There are several steps that are followed by a central bank daily for the purpose of monetary policy implementation. These include;

a) Estimating overnight excess/ deficit liquidity.

   Liquidity estimate is an essential part of monetary policy operations in central banks. In order to conduct, Open Market Operations (OMOs) efficiently, central banks need to forecast daily liquidity position of the banking system. A reasonably accurate liquidity forecast may help to decide the level of market demand for OMO transactions with central banks.

   Market liquidity is the total amount of funds available in the current accounts of commercial banks with the central bank at a given point of time. These account balances are called reserve balances of banks with the central bank. A forecast of liquidity for the day and ahead is done by considering all the money that is injected and absorbed by the central bank operations during the day. On a given day, the forecast liquidity could be either in a deficit or a surplus due to transactions of commercial banks and balances maintained by commercial banks in the settlement account of the central bank. Hence, the banking system is considered in excess (excess liquidity) on a given day if its cumulative aggregate deposit balances with the central bank is higher than the balance that it would need to maintain in the reserve account under Statutory Reserve Requirement (SRR). Conversely, the banking system is considered in deficit (deficit liquidity) on a given day if its cumulative aggregate deposit balances with the central bank is lower than the balance that it would need to maintain on account of SRR. In order to fulfill an existing shortage, short term financing has to be done in the overnight market through borrowing or by reducing deposits kept at the central bank. Similarly, commercial banks can invest their surplus in the central bank or lend in the overnight or short-term market.

b) In the case of Sri Lanka, the daily Market Operations Committee (MOC) meeting that has the authority to take decisions on daily monetary operations, decides whether to conduct auctions based on available information; if so, its type, quantity and maturity. Scale and type of OMOs are dependent on the liquidity estimates. On the basis of these estimates, the MOC determines the amount to be absorbed or injected to achieve desired interest rate behavior/path. Auctions conducted under OMOs could be either to inject funds (reverse repo) or absorb funds (repo) from the market. Each of these auctions address specific types of liquidity management requirements.

c) Following the MOC, DOD announces the decisions of the MOC to the market through the electronic bidding system. These decisions relate to whether to conduct an auction and if so, its type, quantity and maturity.

d) Participating institutions; Licensed Commercial Banks (LCBs), Stand-alone Primary Dealers (SPDs)[1] and Employees' Provident Fund submit bids in the case of conducting auction and the Tender Board makes the decision on auction outcome.

e) Making decisions by the Tender Board on OMOs Auctions (TB-OMOA) on the auction outcome. Accordingly, TB-OMOA makes decisions on the auctions that are conducted such as the bids to be accepted and cut off rates.

f) Making the standing facilities available to participating institutions to meet their further liquidity requirements.

2.3 Instruments used in Monetary Policy Implementation

In implementing monetary policy, a central bank can act directly, using its regulatory powers, or indirectly, using its influence on money market conditions as the issuer of reserve money (Alexander et al, 1996). Hence, monetary policy instruments are two types, namely direct and indirect instruments.

Direct Monetary Policy Instruments refer to those instruments which could be used to influence target objective in a one-to-one correspondence or relationships between the instrument being used (credit ceiling, interest rate ceiling etc.) and the policy objective to be achieved. For example credit ceiling, sectoral credit allocation, administrative control of interest and exchange rates, which are direct instruments, operate through regulations.

Indirect Monetary Policy Instruments are market-based instruments that influence the policy objective through a process. As such, they require a sound and functional financial market. Such instruments affect overall monetary and credit conditions through the changes in the supply and demand for liquidity. Using indirect instruments, the central bank can determine the supply of reserve money. Main indirect instruments used by the CBSL are OMOs, standing facilities and reserve requirements.

In the case of Sri Lanka, the CBSL employs widely used tools to achieve its monetary policy goals. Instruments used in monetary policy operations are divided into three main types; policy interest rates and policy rate corridor, OMOs and SRR. With the development in the domestic financial markets, OMOs or buying and selling securities in the open market to influence the reserve market conditions has already become a more effective and frequently used monetary policy instrument. The CBSL also uses policy instruments known as standing facility rates to establish policy

1. A Liquidity Support Facility for SPDs was introduced by the CBSL to fulfill their short-term liquidity requirements and to ensure smooth functioning of the domestic money market from September 2019.

interest rate corridor. Standing facilities establish the minimum ceiling and floor for interest rate to behave in it for monetary policy operations. Previously, SRR played a vital role in monetary policy implementation, but this has been used by the central banks fairly less frequently in recent times. In addition, the CBSL uses bank rate, foreign exchange operations, quantitative restrictions on credit, ceilings on interest rate, refinance facilities, moral suasion as well as certain macro-prudential measures such as imposing margin requirements and loan to value ratios as other monetary policy instruments.

The main monetary policy instruments used by the CBSL are explained in detail as follows.

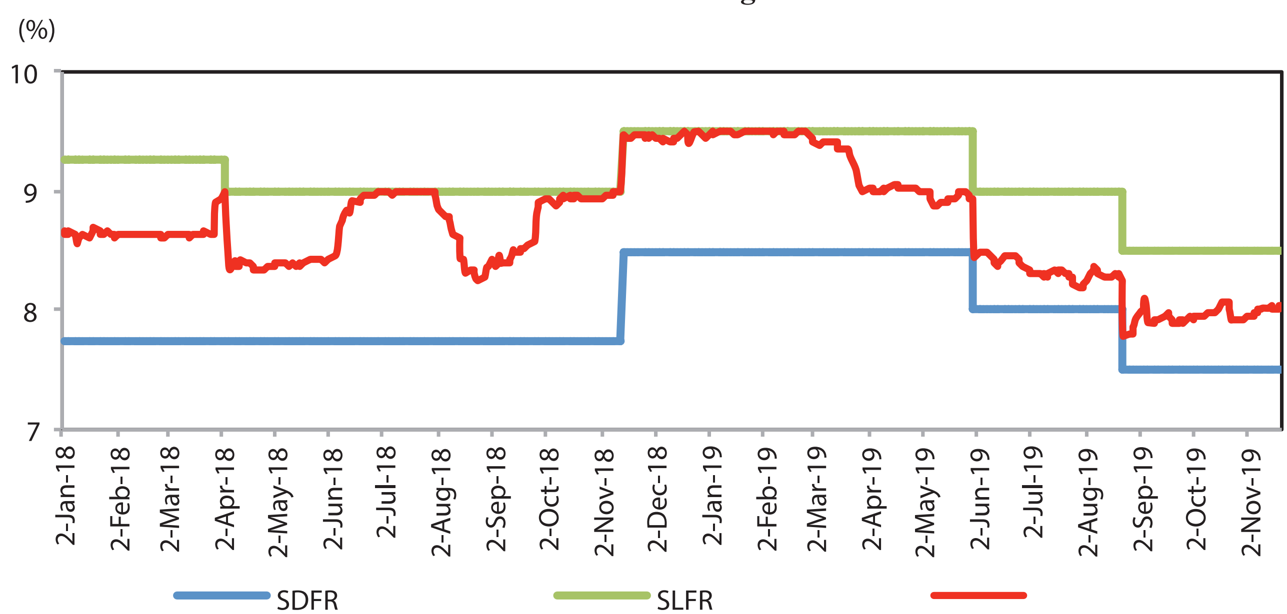
(1) Policy Rate Corridor

The policy rate corridor, currently known as the SRC, is formed by Standing Deposit Facility Rate (SDFR) at which the banks deposit their excess funds at the end of the day with the CBSL and the Standing Lending Facility Rate (SLFR) that will allow banks to fulfill their temporary and frictional liquidity deficiencies from the CBSL (Chart 1). The SRC is subject to regular review (usually eight times per year) by the Monetary Board of the CBSL and revised if necessary. Thus, the corridor limits potential large fluctuations in short-term interest rates in the market.

(2) OMOs

OMOs are the most flexible and frequently used means of implementing monetary policy by central banks. OMOs have become the major instrument of monetary policy implementation in the developed and developing countries. It is an intervention of central banks either to absorb or inject liquidity to/from market through selling/ buying government securities on repurchase/

Chart 1: AWCMR and Standing Rate Corridor



Source: CBSL

reverse repurchase agreement or outright basis in order to achieve monetary policy target to maintain the stability of short term interest rates. OMOs are used for influencing interbank interest rates either to reduce volatility of short term interest rates, or to steer the interbank market rates towards a level considered appropriate with desired stance of monetary policy and consistence with macroeconomic policies. Normally central banks seek to exploit their monopoly in the creation of base money to regulate overall liquidity conditions in the economy by influencing underlying demand and supply conditions for central bank money. This is done aiming at influencing the balance sheet of commercial banks through the balance sheet of the central bank. The central bank liquidity management comprises forecasting the liquidity needs of the banking system for the central bank money and supplying or absorbing the appropriate amount of liquidity through OMOs.

(3) Statutory Reserve Requirement (SRR)

SRR is the proportion of the rupee deposit liabilities that commercial banks are required to keep as a cash deposit with the central bank. Under the section 94 of the Monetary Law Act (MLA), LCBs are required to maintain reserves with the CBSL at rates determined by the CBSL. At present, demand, time and savings deposits of LCBs denominated in rupee terms are subject to the SRR. The CBSL can inject liquidity to the market or absorb liquidity from the market on a permanent basis by changing SRR ratio. When the CBSL increases SRR ratio, LCBs are required to keep more rupee deposit liabilities with the CBSL, limiting the ability of credit creation. By contrast, once the CBSL reduces SRR ratio, LCBs are required to keep less rupee deposit liabilities with the CBSL, enhancing the ability of credit creation. Accordingly, if the market is in the excess liquidity position, the CBSL can increase the SRR to absorb liquidity from the market while if the market is in the short position, the CBSL can reduce the SRR to inject liquidity to the market. Increase of SRR by the CBSL would reduce funds available for lending in the banking system while increasing cost of funds for LCBs as these reserves are not remunerated. Similarly, a decrease in SRR would inject additional funds into the banking system to lend while reducing its cost of funds on idle funds.

2.4 How CBSL conducts OMOs?

The CBSL conducts OMOs as an instrument of monetary policy to achieve the core objective of price stability by influencing the volume of money and its cost in the economy. Considering the trend of moving away from non-market oriented monetary policy tools like credit ceilings and quantitative controls to market based instruments, which operate through market forces of the demand and the supply, the CBSL moved from a system of “Passive” OMOs from end February 2003 to a system of more “Active” OMOs (Table 1) in order to improve the effectiveness of monetary policy implementation with effect from 03 March 2003 (Annual Report of the CBSL, 2002). Passive OMOs focused on managing short term liquidity by offering unlimited repurchase (Repo) and reverse repurchase (Reverse Repo) while offering discounting and re-discounting facility to long term liquidity management. Active OMOs mainly focus on market orientation of monetary policy operation and improvement of effectiveness of the system, which create an opportunity to improve competition in the money market, while creating a broader range for LCBs to improve their liquidity management.

Table 1: Features of Passive and Active OMOs

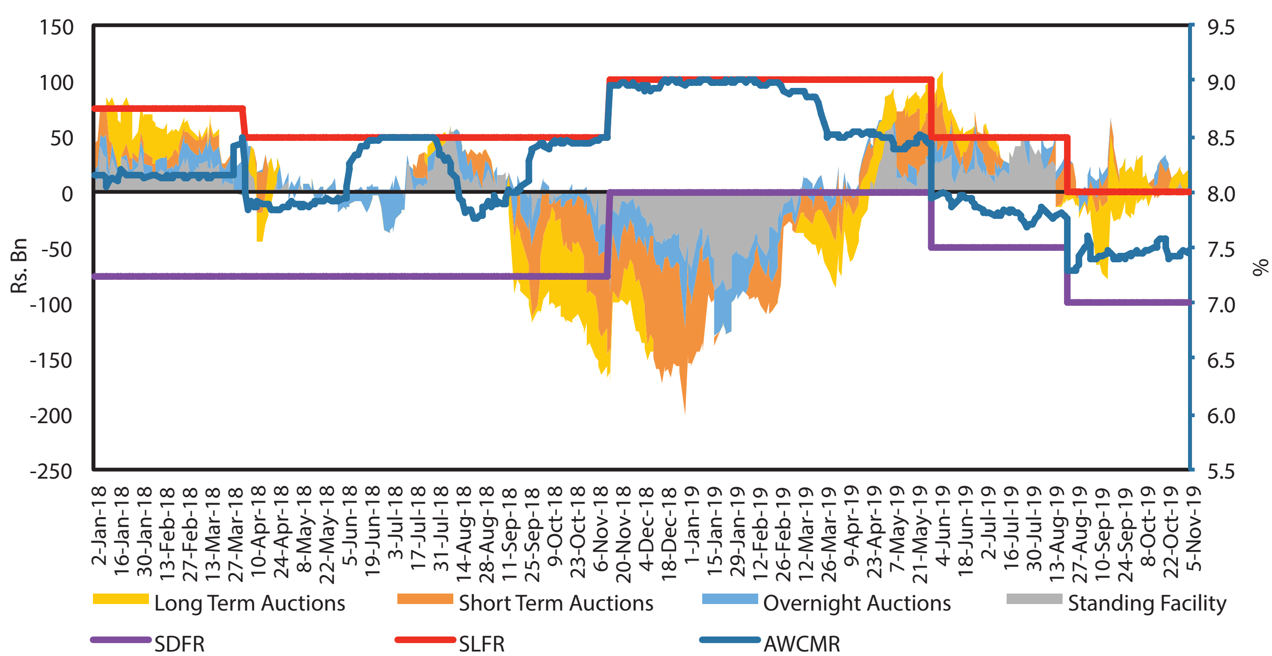
Passive OMOs	Active OMOs
1. Offered unlimited Repurchase (Repo)[1] and Reverse Repurchase (Reverse Repo)[2] facilities to manage short term liquidity. 2. Discounting[3] and re-discounting[4] facility to manage market liquidity on a longer-term basis.	1. Formed an interest rate corridor. 2. Daily auction of either Repo or Reverse Repo to maintain the interbank rate stable with in the corridor. 3. Standing Facilities. 4. Outright buying/selling of Treasury bills/ bonds.

1. *Repo - Selling government securities to LCBs and primary dealers with an agreement to purchase them back within an agreed period at an agreed price*
2. *Reverse Repo - Buying government securities from LCBs and primary dealers with an agreement to sell them back with an agreed period at an agreed price.*
3. *Discounting - The CBSL sold Treasury Bills outright out of its holding and absorbed liquidity on a permanent basis.*
4. *Re-discounting - The CBSL purchased Treasury Bills on an outright basis with a consequent injection of liquidity on a more permanent basis.*

Source: Annual Report of the CBSL, 2002

Following (Chart 2) shows instruments used under OMOs to manage liquidity of the CBSL.

Chart 2: Liquidity Management through OMO Auctions



Source: CBSL

2.4.1 Instruments used for OMOs

The CBSL uses different types of instruments under OMOs to inject/ absorb liquidity to facilitate the maintenance of overnight interbank interest rates at a desired Path. Accordingly, instruments used for OMOs are briefly discussed below.

i. Short-Term Auctions

ii. Long-Term Auctions

iii. Outright Auctions

iv. Forex Swap Transactions

i. Short-Term Auctions

The CBSL conducts OMOs by way of conducting repo/reverse repo auctions for a determined amount, in order to inject or absorb market liquidity and thereby to reduce undesirable fluctuations in the inter-bank call money market rate. The magnitude of the CBSL intervention depends on the overall liquidity excess or shortfall, prevailing interest rate level as well as the macroeconomic environment of the country. This process is mainly based on the daily liquidity assessment of the CBSL and decision of the MOC to determine whether there is a need to conduct auctions. Short term auctions are conducted as a strategy to absorb liquidity up to one week on a same day settlement basis. The short-term auctions conducted in the form of repo and reverse repo auctions. The tenure of a short term auction shall be overnight to one week. The exact tenure and the amount offered shall be decided by the MOC.

ii. Long -Term Auctions

Long term auctions shall be in the form of repo and reverse repo auctions. A long-term liquidity shortage would be removed by purchasing Treasury bills and bonds in the secondary market and buying Treasury bills in the primary market. Similarly the CBSL conducts term auctions to absorb liquidity from the market to address long term liquidity issues. The tenure of a long-term auction shall be more than one week. Settlement is made the following day and liquidity stays for an extended period. This creates an opportunity to address long term liquidity issues.

iii. Outright Auctions

The CBSL may decide to conduct outright auction/s to sell Treasury bills and/or bonds outright from its holdings or to purchase them outright from the secondary market[2]. Outright transactions are conducted at the discretion of the CBSL to address long-term liquidity issues. If a relatively large liquidity surplus exists and is likely to persist for a long period, it can be absorbed by selling Treasury bills outright completely out of the holdings of the CBSL, and if a sufficient stock of Treasury bills is not available, by issuing the CBSL's own securities or borrowed securities under the bond borrowing programme of the CBSL. Currently, the Employees' Provident Fund is eligible to be a lender of securities to the CBSL. The main difference between outright and term auction is, in the outright auctions liquidly absorbed in permanent basis and in the term auctions liquidity absorbed only term basis but not a permanent basis.

2. The CBSL commenced outright purchases of Treasury bonds to inject liquidity to the domestic money market on a permanent basis from september 2019.

iv. **Forex Swap Transactions**

The CBSL commenced engaging in forex Swap transactions with the intention of diversifying its use of instruments under OMOs in 2009. The MOC of the CBSL may decide to conduct forex Swap transactions as an instrument in monetary policy operations either to absorb or inject liquidity from or to the market. Forex Swap transactions are those that involve the purchase of one currency against another at an initial date with an agreement to reverse that transaction at a future date at an agreed rate. As long as the nature of the transaction is concerned, forex Swaps are similar to repos, but with collateral being the foreign currency in place of government securities.

2.4.2 Standing Facilities

Under the standing facility, participating institutions shall have access to the following instruments;

i. Standing Deposit Facility (SDF)

ii. Standing Lending Facility (SLF)

Standing facilities are available for participating institutions which were unable to fulfill their liquidity requirements at the daily auction. That is, even after the daily auction, if a participant has excess money, it could deposit such funds with the CBSL on its SDF. Similarly, if a participant needs liquidity to cover any resulting shortage at the end of the day, it could borrow funds on reverse repurchase basis from the CBSL under its SLF. Accordingly, these facilities help contain wide fluctuations in interest rates due to any last minute and temporary variations of bank reserve conditions known as temporary or fictional liquidity conditions. Standing facilities set floor and the ceiling for interest rate changes in the short-term money market. These facilities remove the necessity for banks to move significantly away from the interest rate desired by the CBSL.

Conclusion

At present, the monetary policy places greater reliance on market based policy instruments. The implementation of monetary policy involves making of desired changes in short term interest rates to ensure sustainable price stability. Similar to most of the central banks in the world, the CBSL also uses a mix of instruments to achieve its final objective of price stability. As a consequence, policy rates, OMOs and SRR are the main monetary policy instruments used by the CBSL. Accordingly, this article explained, how monetary policy decisions are implemented using the available monetary policy implementation strategies by the CBSL.

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SUPERVISORY INTERNAL RATINGS OF FINANCIAL INSTITUTIONS

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In simplest terms, financial system is the system that enables lenders and borrowers to exchange funds and it consists of financial markets, intermediaries, infrastructure and safety net mechanisms. It is important to maintain a stable, safe and sound financial system enabling the system to withstand any internal or external shocks. One of the core objectives of Central Bank of Sri Lanka is to maintain the financial system's stability. In this context, maintaining a resilient banking and financial institution sector which needs to be facilitated by a sound regulatory and supervisory mechanism is a must to sustain a safe and sound financial system.

The regulatory and supervisory methodology would provide flexible and responsive supervision promoting safety and soundness of financial institutions while providing a comprehensive assessment. Having a comprehensive internal rating system is one of the mechanisms that can be used to support the supervisory methodology. Having such a system in place would enable the regulator to;

1. Compare relative strength of regulated institutions (RIs).
2. Assess inherent risk exposures
3. Assess the adequacy of internal systems and controls, resources and governance structures of RIs.
4. Distinguish satisfactory RIs from those posing regulatory concerns.
5. Characterize or describing an RI.
6. Analyze the degree of uniformity, stability and compliance of individual RIs across different geographies
7. Assist in maintain the degree of consistency of compliance among regulators.

Depending on the nature of the financial system and types of RIs, different regulators operating in different jurisdictions may follow different frameworks to compile a comprehensive rating system. Irrespective of what structure is used, an analysis should involve charting financial data and compiling a set of financial ratios to detect the trends and anomalies in the RIs mixed with a set of qualitative considerations comprehensively covering the entire institution. Quantitative analysis plays an important consideration when determining the strength of an RI's financial position, where qualitative factors which zoom in on issues beyond the numbers and ratios play a critical role in assessing the creditworthiness of an RI. In addition, it is also important to assess the external factors such as the operating environment, economic scenarios and expected future economic developments as well.

Common areas for Consideration

Capital Adequacy: Capital adequacy focuses on an RIs ability to absorb future losses. In general, RIs health is typically gauged through the capital adequacy requirements set by the regulatory authority. Therefore, if an RIs capital is impaired, it is at risk of being perceived to have failed in the eyes of the regulator. Further, it is also important to address whether an entity's capital is eroded because of an unsustainable business strategy.

Asset Quality: As the primary business of an RI is all about providing credit, asset quality by default becomes the greatest source of decisive factor in an RI's earnings where improvement or deterioration in the portfolio of assets can result in changes to profitability, liquidity and ultimately to the capital. Therefore, it is a must to look at the portfolio of non-performing loans, irregular loans that are susceptible for being bad, re-scheduled and re-structured loans, provisioning or impairment polices, sectoral exposures and risks, large and related party exposures and the asset composition. This could be viewed as one of the most critical areas or elements of a rating framework as deterioration of asset quality is typically viewed as the root cause of many problems.

Management Assessment and Corporate Governance aspects: This factor is of qualitative nature. However, the importance cannot be undermined as it is the management that sets up polices and directions which eventually determine the performance of an RI. Under this, it is important to look at the experience, stability, continuity experience level, the decision making process and level of compliance to regulatory directions including the corporate governance requirements. Further the active board and senior management oversight, implementation of adequate policies, procedures, limits and comprehensive internal controls are also need to be considered under this.

Management Information systems (MIS): These have become an important part in today's management decision making process. The availability, quality, accuracy and the depth of the information that are readily available to the management is critical as business decisions are highly depended on them.

Operational Risks aspects: These include the risks of direct or indirect losses due to inadequate or failed internal processes, people and systems. Cyber Security, Anti-Money Laundering (AML) and Countering Financing of Terrorism (CFT) are also playing a part in managing the operational risk aspects and it is important to understand the area and nature in managing them.

Earnings Quality (Performance): Growth in income and profits, contribution of core and non-core income, profitability ratios, interest margins, cost efficiencies and sustainability are few indicators that are needed to assess the earnings quality of an RI. Further, level of income that is sustainable in the future and the underlying strength of RI which requires to maintain a healthy profitability levels needs to be accessed as well.

Liquidity and Funding: Funding and liquidity position of an RI focuses in its ability to raise funds to overcome short-term difficulties. It all depends on an RIs ability to meet daily expenses and satisfying demands for deposit withdrawals while keeping its assets funded. In the long-term, this is measured by the degree to which core assets are funded with stable liabilities. Expected cash flows, capacity to borrow, funding lines and the stock of readily realizable high-quality liquid assets are areas that needs to be assessed in looking at the liquidity risk.

One important thing that needs to be noted is that each component or area mentioned above is interrelated with each other and it is important to understand these connections when assigning ratings. Further, there can be areas of risk assessment and interests that may fall outside the above listed areas as assessment itself is highly subjective and may vary according to the assessor's degree of risk appetite.

Examples and the complexities

Depending on the nature of the financial systems and types of RIs, different regulators may follow different frameworks to compile a comprehensive rating system. For a successful outcome, it is important that both supervisory framework and the rating mechanism will interact with each other.

One such common framework is the CAMELS which stands for (C) Capital, (A) Asset Quality, (M) Management, (E) Earnings, (L) Liquidity and (S) Sensitivity to Market Risk. ROCA which stands for (R) Risk Management, (O) Operational Controls, (C) Compliance, (A) Asset Quality is another framework. Without restricting to specific areas as done in CAMELS or ROCA risks can be assessed under separate areas of Indicators for risk exposures, indicators for risk mitigation, compliance to directions/norms, management attitude, cooperation towards the regulator and future directions. Irrespective of what framework is used, it becomes the responsibility of the assessors to ensure that the scope of the framework covers all or most of the risks as mentioned earlier under separate sections through quantitative and qualitative considerations.

One major drawback in a rating result is the difficulty of comparisons created due to the heterogenous nature of operating models and business activities performed by individual RIs. Further, the use of a rating system should be confined to internal purposes and may only share individual rating details with respective individual financial institutions with the objective of improving them. Since ratings would give a comparative position as per the assessed criteria, if published, public would perceive one RI being better that another. Though internally, having a comparative scale is helpful for the supervisory activities, it would not be ethical to publish a rating list as the regulator needs to treat all RIs equally. In addition, there can be a difficulty to explain the underlying assumptions at all times, as a considerable portion is represented by qualitative factors which are dependent on the judgement of individual assessors and can be argued otherwise. Rating output being reviewed by a panel and supported by a set of guidelines will minimize the issue related to this supervisory judgement.

However, as practiced by certain other countries, ratings can be shared with other regulated institutions or with other units within the regulator. One such example is sharing the ratings with the unit or the department entrusted to carry out the depository insurance and resolution function. In such a scenario, when shared, depository insurance entity can decide to charge a higher premium on RIs which have fallen behind on their rating score/ position. This could indirectly influence the RIs to take necessary action to improve themselves. Eventually, if an RI falls back on its ratings, it would become the regulators responsibility to communicate individually and to take necessary steps by imposing regulatory action on such RI ensuring to improve its position.

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Money is Laundered through Financial as well as Non-Financial Institutions

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1. Introduction

It is prohibited to earn money illicitly as well as spending them on illegal activities. Even so, in many countries there are considerable amounts of transactions, that inevitably go beyond the legally accepted framework of the country. Such illegal transactions which occur beyond the formal economic framework pose a detrimental effect on the regular economic activities of any country. Therefore, various rules and regulations are in place in countries around the world to prevent the adverse impact of such abusive transactions.

There is a high risk of transferring illegally earned money and spreading of the adverse impact of such transactions to other countries especially as an impact of globalization. Therefore, there are strict enforcements towards the global standards, that are the global recommendations in preventing such illegal transactions and blocking the impact of such abusive transactions. In such a situation, if a person or group generates money in an illegal manner, it is necessary for them to conceal the origin or the illegal source of funds, as and when they require to spend such monies within the legal economic framework. In this process, mostly the financial institutions are being used. However, the threat of using non-financial institutions for these purposes is also being increased. Hence, this article mainly discusses the ways of money laundering using non-financial institutions. However, it gives a brief introduction to money laundering and its process, the impact of money laundering the economy, utilization of financial institutions during the money laundering process and global conventions against them.

1.1 Money laundering

Among other things, illicit drug trafficking, arms trading, animal and human trafficking, prostitution, organized crimes, smuggling and tax evasion are key means of earning funds illicitly. Integrating funds earned from such illicit means into the accepted legal framework is essential in using those funds in day to day transactions. Accordingly, if the criminals are to integrate illicitly generated money with legally accepted sources of money, it should to be done in a very sophisticated manner, because doing so is illegal.

Thus, the process of "legitimizing the money generated from illicit means by concealing their illicit sources of money generated to pretend as they were earned through legitimate economic transactions, is called money laundering". Accordingly, generating money through activities designated as illegal in any country, using such monies for legal economic activities while hiding the illicit source of money and thereby legitimizing the wealth unlawfully collected and then using such accumulated wealth for purposes such as spending a luxurious life, increasing criminal activities/ illegal acts or otherwise, nurturing terrorist groups/activities is identified as the process of money laundering. This process is typically given in three major phases;

Diagram 1:

In phase 1 shown in the above diagram, the illegally earned money is transferred to the formal economic framework through entities engaged in lawful economic activities. Often, this is done through financial institutions, especially through commercial banks. Also, non-financial institutions have a high potential for being misused during this phase.

During phase 2, money launderers tend to transfer the money which they have already placed in the formal economic framework to different accounts. This is a very complicated process, which further attempts to keep unseen the hidden nature of the money generated, so that the root of the transactions cannot be easily detected. In this phase, transferring money to both domestic and foreign personnels bank accounts, and splitting such amounts into small units are common. In most cases, electronic money transfer systems are used.

In phase 3, the money layered during phase 2 is integrated with legally earned money by engaging in legal economic activities. At this phase, mostly non-financial businesses are used. For example, money launderers tend to purchase luxury goods, lands/properties and invest in various types of businesses, such as night clubs, food stores, hotels etc. These investments do not seek economic profits, they are simply carried out to further hide the illegal sources of funds and the funds invested will be taken away as and when it is required to clear their monies. Therefore, such investments always end up with a damage to the society, not a benefit. By this phase, money launderers able to largely suppress the illicit nature of money-generated.

1.2 Money laundering and its impact on economic activities

Money laundering has a detrimental effect on the economic activities of a country. The perceived risk of investing laundered money in businesses or purchasing of properties is that they are not invested for pure economic profits or properties are not purchased for living/investing in such properties. They will soon be able to withdraw these investments or sell these properties and re-generate their improper money. Therefore, employments are always at risk in such businesses. Also, there is a high possibility of using such funds to further their fraudulent, criminal activities or to nurture terrorism. Similarly, purchasing expensive items such as gems and jewellery is also being carried out by some people with such purposeful aims. As a result of this unduly demand, the prices of these commodities and their market values will hike up, without a proper economic cause. Such incidents will interrupt the smooth functioning (demand and supply process) of those economies. As a result of such actions, generating of artificial prices and market values cannot be prevented, as opposed to prices determined by the real demand and supply forces of the market. Also, there is a higher risk of worsening of the fraudulent and criminal activities which may lead to collapse of the legal economic framework, thereby diverting economies to many social, economic and political instabilities.

1.3 Money laundering through financial businesses and global conventions against them

a). The use of banking and financial institutions for money laundering:

Financial businesses are one of the main ways through which money laundering has been occurring from the past. It is widely known that banks and other non-banking financial institutions have been used in attributing a legal appearance for the wealth earned illegally. For example, Mexican and Colombian drug smugglers have placed into the banking system an estimated US $ 881 million worth of monies between 2003 & 2010 which they earned by illegal drug trafficking through world-renowned bank. Since this bank did not have prudent measures, the bank was a breeding ground to convert drug traffickers illicit money into legitimate money. Following the investigations, in 2012, the bank was charged a fine of USD $ 1.9 billion by the US law enforcement officials. Also; court orders were imposed for immediate enforcement of internationally accepted standards which should be complied with domestically by the banking institutions in prevention of money laundering (Source: Seven Pillars Institute for Global Finance & Ethics).

b). Financial Action Task Force

With the globalization and advancement in technology, the illicitly earned money is not only laundered through financial institutions, but also their adverse effect on various countries around the world is being increased. Considering that money laundering occurs heavily through financial institutions and its adverse effect to the economies and societies as well as the global financial system, in 1989 systematic arrangements were initiated with the heads of the G-7 countries to control the impact of money laundering on global economy. Later, with the worldwide expansion of these requirements, the Financial Action Task Force (FATF), an inter-governmental organization to guide and coordinate global standards for money laundering was set up. As these global standards became crucial around the world, restrictions were imposed on laundering illicit money through financial institutions, i.e. banks as well as other non-bank financial institutions such as stock brokers, insurance agents, money exchangers and primary dealers. This trend led money launderers to search for new ways and means to carry out money laundering. Accordingly, the threat to the non-financial businesses and professions began to increase as money launderers approach such industries for laundering proceeds from illicit activities.

2. Money laundering through non-financial businesses and professional services

In any economy, the non-financial sector has a very wide scope, which consists of a range of different formal as well as informal industries and professional services. The common feature in many countries in the non finance sector is the absence of a proper institutional structure overseeing the segment and lack of legal requirements to issue proper business licenses for some sectors (however, this situation is not relevant for the professions such as legal, and accounting). For this reason, the worldwide organizations attempting to prevent money laundering face many difficulties in applying the globally accepted compliance measures for financial sector to prevent such acts in the non-financial sector. When looking at the money laundering cases appearing around the world, non-financial businesses such as real estate businesses, gem and jewellery dealings, including precious and semi-precious metals and stones, gambling houses and casinos as well as professional services such as accounting, legal, notary and company service providers are among the key sectors which are being heavily used by money launderers. The way in which money laundering is carried out using such non-financial businesses and professions (with or without their knowledge) is discussed below.

2.1 Money laundering through real estate businesses

The following example explains how to exploit real estate transactions in laundering money. A person who had engaged a hundred million rupees in drug trafficking could use such drug proceeds to buy a real estate property by hiding the source of funds. Also, when buying real estate properties, it is often not necessary for them to take over such properties under their own names. The following example illustrates that they follow very sophisticated strategies in such instances. An investigation by the Belgian legal authorities has found that a racketeer in that country had used the customers' accounts of a notary public to purchase real estate properties. As the investigations have revealed, he had established a trading company for this, and, this person was the sole shareholder of this shell company. He had misused the service of notary public through the accounts of his shell company and paid for the purchase of immovable properties while using the notary public as the front man to cover his identity. Later, he was found to be a well-known drug dealer in Belgium. *(Source: Report on Money Laundering and Terrorist Financing using the Real Estate sector by the Financial Actions Task Force).* He had bought immovable properties for illicit drug proceeds, and worked to conceal the source of money by using the professional service of a notary public while covering his true identity.

2.2 Money laundering through gem and jewellery transactions

Money derived from unlawful activities is also used to purchase precious metals and stones including gems and jewellery. For example, the money retained without paying taxes is used to purchase precious gems and they can easily be transported from one country to another without getting the attention of customs officials as they can be easily fixed onto a jewel or attire. Ultimately, in the second country, the gem is sold at a very high price and he re-owns his ill-gotten wealth.

Such examples show that money laundering is taking place through a variety of means, and they are used to conduct a series of very complex even cross border transactions based on precious stones and metals such as gems and jewellery, instead of placing ill-gotten money directly into the formal economic framework through financial institutions. It also appears that non-financial businesses are used in these activities with or without their knowledge.

2.3 Misusing casino transactions for money laundering

Gambling businesses, such as casinos, are considered as high-risk entities for money laundering where these transactions can be easily misused in the process of transforming unlawfully earned cash into legitimate cash. There are many global studies in which the casino businesses deal with money laundering. The risk of money laundering at casinos is also high as casinos are vastly cash sensitive. Many customers make gambling in cash. Also, the amount of money involved in a transaction is high. Further, these entities are mostly used by foreign customers, and due to these reasons the possibility of laundering money in casinos and gaming is high. For example, there are cases of exchanging small denominated (such as Rs.20, Rs.50, Rs.100) currency earned from selling drugs for large denominated currency notes (such as Rs. 1,000 and Rs. 5,000) using casinos. Further, some casinos maintain personal accounts for their gamblers, and there are instances where illicit money has been transferred to various accounts from such gamblers' accounts.

2.4 Misuse of professional services for money laundering

Among other services, the professional services provided by lawyers, accountants and the notaries are the main sectors that attract money launderers. In this case, money launderers use the knowledge of those professional service providers (they will be charged for it, while providing such services willingly) with or without any knowledge of them. Money launderers are motivated to misuse these professional services as there was no requirement of disclosing the source of the funds when real estate properties are purchased through lawyers and notaries, and money is invested in other businesses, through lawyers or accountants.

It is also widely reported that managing and maintaining properties purchased from the laundered money or such money invested in other businesses were ultimately assigned into trust arrangements. As these trust service providers have the necessary legal conditions to act on behalf of trustees, the money launderers could easily hide their identity behind such arrangements. These arrangements also help keep the real beneficiaries of those properties or transactions covered.

3. **Prevention of money laundering occurs through non-financial businesses**

The Financial Task Force (FATF) has now introduced recommendations that prohibit the charging of legality to illegally generated money using the non-financial sector. Accordingly, proper implementation of the regulations for anti-money laundering, countering the financing of terrorism and the prevention of destructions of mass weapons and financing of proliferation as required by the FATF is an obligation for all its member countries. The government of each country is obliged to facilitate the legal framework and the institutional set up in this regard.

Accordingly, the 40 recommendations of FATF on prevention of money laundering, terrorist financing and proliferation of weapons of mass destructions should be adopted by every country. Out of those 40 recommendations, the three major recommendations (Recommendation No. 22, 23, and 28) are directly applicable to the non-financial businesses and professions. Under theses major recommendations, the other key recommendations relevant to financial institutions will also apply to the non-finance businesses and professions. The FATF from time to time evaluates countries on their level of compliance with such recommendations through its assessments. Also, actions are taken against the countries on their failures to comply with the global standards against money laundering, terrorist financing and weapons of mass destructions and proliferation financing.

The FATF's 40 recommendations require countries to make it a legal obligation of conducting customer due diligence on the customers of non-financial businesses and professions. Accordingly, dealing with a customer without proper due diligence should be considered as a non-compliance of that entity and measured should be that to reaction. The customer also should provide sufficient identity information to the non-financial businesses and professions. Similarly, if a transaction is suspected or the source of the money related to a transactions is suspected, the details of such transactions should be reported immediately to an authority committed in the prevention of such fraudulent transactions as a suspected transaction. In Sri Lanka, the authority established for the said purpose is the Financial Intelligence Unit (FIU-SL) which has been established under the administration structure of the Central Bank of Sri Lanka. The FIU-SL acts as the autonomous authority to prevent money laundering in Sri Lanka within the powers delegated by the Financial Transactions Reporting Act No. 06 of 2006 (FTRA).

Accordingly, the FIU-SL functions in accordance with the FTRA to impose legal actions against Financial Institution and non-financial institutions if they act in contrary to the FTRA or if it does not act in accordance with the FTRA. All these are to detect, control & prevent Money Laundering in Sri Lanka.

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1. Annual reports of the FIU-SL
2. FATF guidance issued for DNFBPs and FATF Recommendations 2012
3. News and information published on money laundering on the related websites in internet. Ex. www.riskscreen.com - KYC 360
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Contribution of Spices Sector to the National Economy

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Additional Director, Statistics Department

1. Overview

Growing demand for convenient and healthy food options, fascination for ethnic cuisine, demand due to changing dietary patterns of consumers and increasing disposable income, along with rapid urbanization, has fueled sales of food additives - including spices - all over the world. The rising consumer awareness regarding the medicinal benefits associated with the consumption of spices, accompanied by the growing interest towards the use of organic food and beverages have also contributed to the increase in demand for spices and seasonings globally. Consequently, the global spices and seasonings market is estimated to be valued at USD 11.5 Billion in 2015 and is predicted to reach USD 14.8 Billion by 2020.[2] The United States of America (USA) is currently the largest importer and consumer of spices capturing a significant share of the global market - whilst India is the world's largest exporter of spices.

Sri Lanka has been famous for producing high quality spice varieties throughout the world for centuries. Historical sources illustrate that spice cultivation was the main source of income in ancient Sri Lanka; particularly before the British colonization. The same sources highlight that the spice cultivation and exports have taken place during the era of the Anuradhapura, Polonnaruwa, Dambadeniya, Yapahuwa, Kotte and Kandy kingdoms. However, the dawn of the 20th century showed the dominance of tea and other plantation crops, which resulted in significant reduction in spice cultivation in Sri Lanka. This situation has not changed significantly since, even after Sri Lanka gained independence in 1948. In recent history, government intervention to revive the industry goes back to the late 1960s, where the marginal tea lands were required to diversify into important minor export crops such as cocoa, cinnamon, black pepper and nutmeg. This initiative - coupled with economic liberalization in late 1970s - resulted in foreign exchange earnings from spices to increase from Rs. 50 million in 1970 to Rs. 559 million in 1985; a 10-fold increment.[3] During this period, the spice exports from Sri Lanka to the world

1. The article is based on the speech delivered by the author at the International Symposium on Agriculture and Environment in January 2018.
2. Market and Markets (2016): https://www.marketsandmarkets.com/Market-Reports/spices-market-739.html
3. https://www.scribd.com/doc/29745354/Production-Export-of-Spices-in-Sri-Lanka

market accounted for 49 per cent of Sri Lanka's total exports. Although the spice trade is no longer a profitable venture as it once was, Sri Lanka is currently a main producer of spices and remains as the world's leading source of true cinnamon (*Cinnamomum verum*), producing four-fifths of the world's cinnamon production. However, Sri Lanka's present contribution to the world trade in this sector is far from its true potential and merely consists of unprocessed primary products.

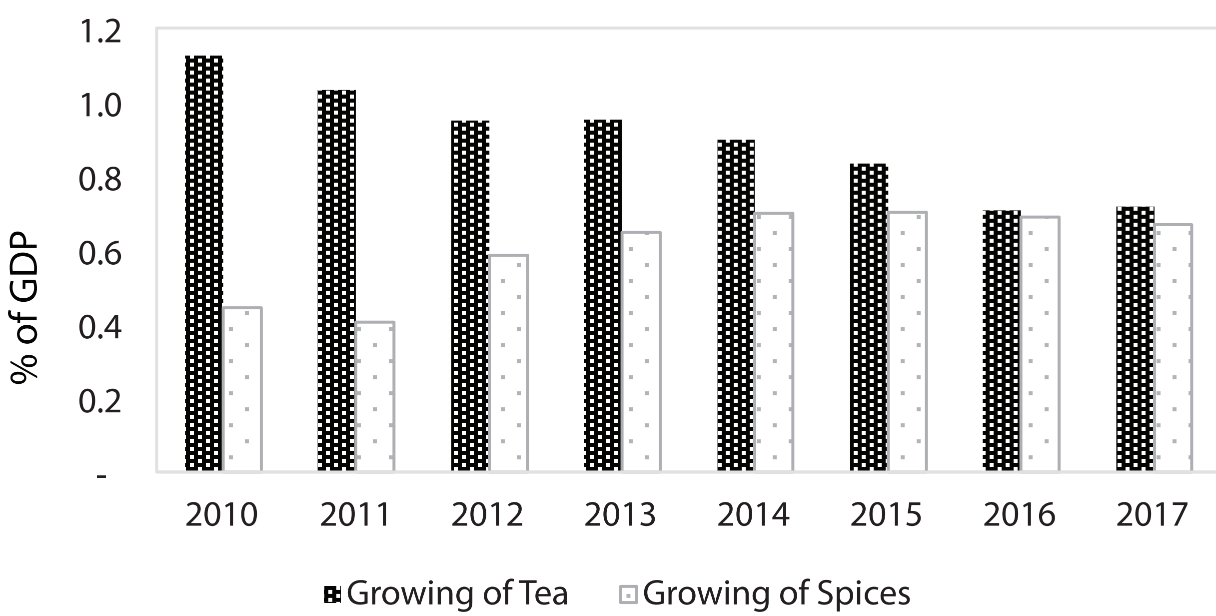
2. Contribution to the National Economy

Being the cornerstone of the economic and social development of Sri Lanka, the agriculture sector has a great influence on Sri Lankan life style - particularly on Sri Lankans living in rural areas - and its culture. Despite its contribution to country's GDP being only around 7 per cent, the agriculture sector provides livelihood for around 33 per cent of country's labour force. The agriculture sector comprises of paddy, tea, rubber, coconut, spices and many other primary products. Among these, the spice crop sector - mainly consisting of cinnamon, black pepper, clove, cardamoms, nutmeg and mace - accounts for less than one per cent of overall GDP.

Figure 1 shows the contributions from two key agriculture commodities to GDP over the past few years. As depicted in Figure 1, the spices crop sector share was as low as 0.5 per cent in 2010 but has increased to 0.7 per cent in 2016; just catching up with the share of tea sector to GDP.

Simultaneously, the spice crop sector provides livelihood for a significant proportion of the rural population in Sri Lanka, as its production

Figure 1: Contribution of Tea and Spices to GDP

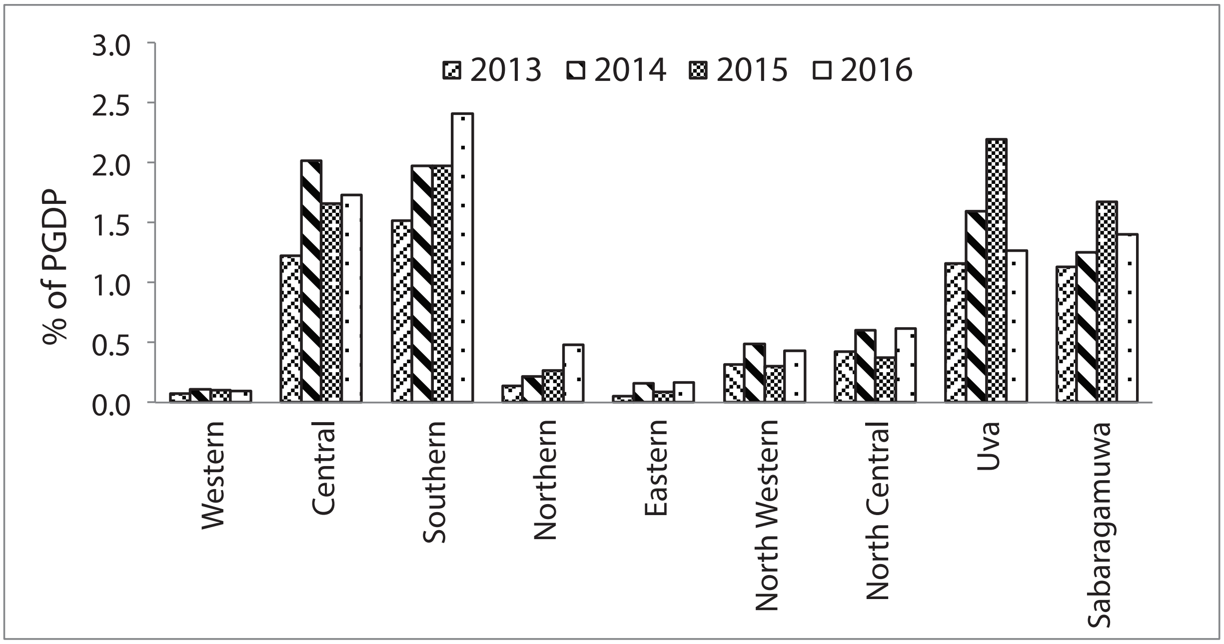


Source: Department of Census and Statistics[4]

4. http://www.statistics.gov.lk/agriculture/hcrops/index.html

is mainly concentrated in small holdings throughout the country. Figure 2 shows the spice sector's contribution to provincial GDP over the past 4 years. Contribution of the spice sector to provincial GDP is relatively higher in per cent over the period 2000-2016, whilst the estimated production almost doubled during this period, mainly due to the significant contribution from cinnamon and black pepper.

Figure 2: Contribution of Growing of Spices, Aromatic Drug and Pharmaceutical Crops Sector to Provincial GDP (PGDP)



Source: Central Bank of Sri Lanka[5]

the Central, Southern, Uva and Sabaragamuwa provinces, highlighting the importance of spice sector in regional development. Additionally, the spices also contribute notably to regional development through employment generation by means of cultivation, processing and trading.

Rising world demand for spices, together with a consistent increase of prices and additional support given by the government to promote the spice crops sector, the estimated extent under main spice crop production has increased by nearly 30

Spices have long been recognized for their foreign exchange earning capability. Export earnings of the country have registered an average growth of 4.4 per cent during 2010-2017 period and reached US$ 11,360 million in 2017. However, earnings from agricultural exports increased by about 3.2 per cent during 2010-2017, mainly due to the growth in the exports of tea, coconut and spices, which together accounts for nearly 84 percent of agricultural exports. Similar to Ceylon tea, spices from Sri Lanka also receive premium prices in the international market due to its high quality, even when the price of most other commodities declined due to low global demand. Export earnings from

5. https://www.cbsl.lk/eResearch/

Figure 3: Production of Main Spice Crops

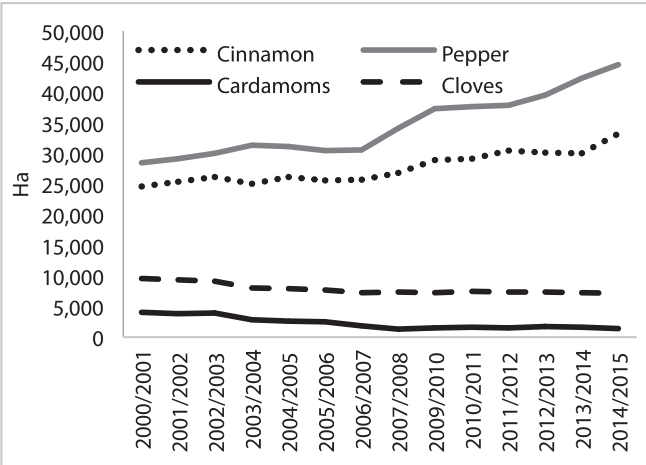
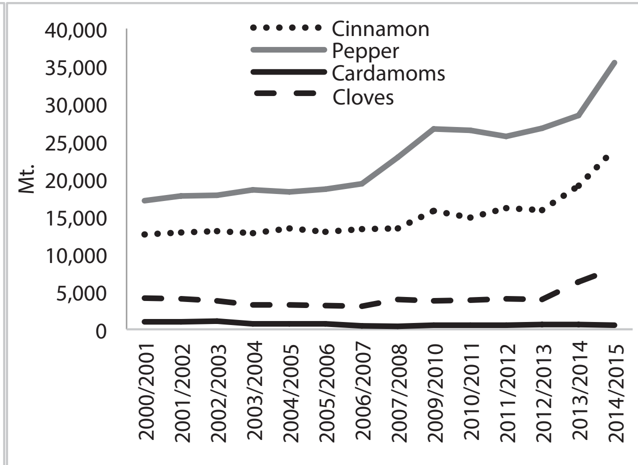


Figure 4: Cultivated Extent of Main Spice Crops



Source: Department of Census and Statistics[3]

spices have increased by almost hundred per cent during 2010-2017 (Table 1). Out of the total export earnings from spice crops, cinnamon accounted for 54 per cent in 2017, which was an increase of around 123 per cent when compared to that of 2010. Meanwhile, export earnings from black pepper and nutmeg have increased by 94 per cent and 95 per cent respectively during 2010-2017 while that of cloves increased by 25 per cent. Further, it is noted that, apart from clove, all the other main spices exports have increased in terms of volume during the period.

Meanwhile the unit price of each of these spices has also increased considerably during 2010-2017. Thus, in order to reap the maximum benefits from rising global demand for spices and its derivatives, the country needs to take initiatives to expand the spice crop cultivation thereby increasing production and export volumes continuously with sufficient quality.

Challenges and the Way Forward

The spice industry carries a great potential to Asia - to Sri Lanka in particular. Sri Lanka is conferred with suitable climatic conditions, appropriate land conditions for cultivation and consists of the most sought after varieties of spices which makes Sri Lanka the hotspot of spice trade. Nevertheless, like many other countries which produce agricultural products for trade, Sri Lanka fails to perform in production and in the export front, due to some adverse inherent conditions. Therefore, the country must make use of proactive strategies in order to bring the spice industry forward.

The extension service is one of such strategies which can play an important role in improving spice cultivation in Sri Lanka. It provides critical access to the knowledge and information that farmers need to increase the productivity and sustainability of their production system, thereby improving the standard of living of farmers. However, the extension service needs to be highly professional and be able to inform and educate farmers on domestic as well as global developments of the spices sector. The farmers should be well informed by the extension officers in the industry on the future global prices. The spice farmers are

Table1: Export Earnings from Major Spices

		2010	2017	% Change 2010-2017
Spices (Total)				
Value - USD Million		**207.31**	**406.25**	**96.0**
Quantity -'000 kg		**38,231**	**44,326**	**15.9**
o/w				
Cinnamon	Value: USD. Million	98.06	218.41	122.7
	Volume: '000 kg	13,681.80	16,966.57	24.0
	Price: USD / kg	7.17	12.87	
Pepper	Value: USD. Million	45.40	88.05	93.9
	Volume: '000 kg	12,971.13	13,777.94	6.2
	Price: USD / kg	3.50	6.39	
Cloves	Value: USD. Million	38.28	47.69	24.6
	Volume: '000 kg	8,534.61	7,815.00	-8.4
	Price: USD / kg	4.49	6.10	
Nutmeg and Mace	Value: USD. Million	18	35	94.7
	Volume: '000 kg	2,314	2,491	7.6
	Price: USD / kg	8	14	

Source: Central Bank of Sri Lanka

not involved in a trade that is marketed in the country alone but also abroad, hence there should be a mechanism to inform the extension officers on the global demand factors and trade, for them to calculate the Sri Lankan contribution and give advice to farmers accordingly.

The Ministry of Small Industries is providing considerable financial support for farmers in spice production. However, farmers face greater difficulties due to large price fluctuations and issues arise from such fluctuations. To rectify such issues, authorities could introduce a form of commodity futures which would help in reducing the volatility associated with pricing. Commodity hedging is also an important business tool which acts as an insurance policy against risks associated with price fluctuations in world commodities.

The spice industry, like many others, is also affected by the shortage of skilled personnel. There is a strong need to upgrade workers in the spice sector, in particular cinnamon peelers and technicians, with dignity to recognize their contribution. Vocational training institutes can play a major role in boosting the image of cinnamon peelers in Sri Lanka.

The spices sector encounters great quality loss after harvesting due to various reasons. Thus, innovative technology needs to be introduced to the industry to reduce such post-harvest losses. In this regard, most processing techniques need to be reviewed and new processing techniques must be identified for each spice crop sector. However, these innovations need to go beyond the experimental stage and must reach the operational level in order to bring the spice industry forward.

Most of the spice exports of Sri Lanka are of raw forms or are limited to basic value additions, such as grinding or grading. Exporting of raw spices limits not only the overall development of the spice industry but also generates fewer employment opportunities and low return to the spice investments. Therefore, adding value to raw spices to develop new products with higher commercial value is also essential for the development of the spice sector and is a vital factor in order to be competitive in the international market.

The demand for the organic spices is growing rapidly; particularly in high end markets. Hence, promoting organic spice production under the certification of recognized international organizations is an important way forward. Moreover, the European countries have imposed rules and regulations with regard to imported food products, including the need for quality certificates of such products. Therefore it is also vital for Sri Lankan exporters - following established international guidelines - to obtain such certificates from reputed organizations.

Research and development focusing on value addition and product development is an essential requirement for the spice industry of Sri Lanka. Research and development programs to improve production, productivity and the quality of the final product, by focusing on high end markets are currently of need. Market promotion is also one of the key areas in maintaining the current demand, and creating new market opportunities. With these strategies in place, Sri Lanka's status in the global spice industry could be repositioned and even surpass the contributions made by the plantation crop production sector.

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