Central Banking in the Sri Lankan Developmental State

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> The root of wealth is economic activity and lack of it brings material distress. In the absence of fruitful economic activity, both current prosperity and future growth are in danger of destruction.
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> Kautilya, *Arthashastra*

The broadly defined policy framework and institutional structure, which carried Japan after World War II and the so-called newly industrialised countries (NICs) in East and South East Asia subsequently, into high growth trajectories has been widely described as a "developmental state" structure. This is not a conceptually defined, distinct and unique category of state formation – but a practical combination of systems, institutions and practices with clearly laid down intentions of achieving developmental objectives. The expression had one of its earliest appearances in development literature in the well-known study of Charmers Johnson titled *MITI and the Japanese Miracle* (1982) which examined how postwar Japan had achieved its very rapid development. It is the post war Japanese state system with its idiosyncratic elements that he tried to capture with this name. One way of describing the developmental state structure is to see it as a combination of selected items of two contradictory systems – the capitalist market economy and the socialist command economy. Expressed alternatively, the

developmental state, according to Charmers Johnson himself, is a "plan-oriented market economy system". The institutional framework of the developmental state can be constructed and established in countries characterized by fundamental structures either of capitalism or of socialism, as these latter terms are widely understood. Developmental state structures have operated, both, before and after this term came into vogue in development literature, within diverse socio-economic and political contexts. Naturally, institutional structures and rules of the game of developmental state do not and cannot, therefore, be uniform across countries. Amid differences, one observes certain key similarities in developmental states in different countries:

1. Market mechanisms and processes are carefully planned, closely monitored, and guided by the state, if the overall system is market-based and dominated by markets. Alternatively, if the overall system is socialist and centrally planned, markets are allowed to freely operate in permitted subject areas. A developmental state is in some strategic sense, a mixed economy with markets and state mechanisms operating side by side in a manner that is complementary and mutually reinforcing. A highly penetrating central state apparatus has been developed for effective guidance of markets with the singular focus on productivity growth and industrial upgrading.
2. The developmental state builds up and rests on a coalition of three forms or agents of capital for the promotion of accumulation: (i) domestic private capital, (ii) foreign private

capital and (iii) domestic state capital. The existence of this coalition among the 3 forms of capital and their relative roles is consciously accepted, with their respective roles allowed to change with the passage of time. Depending on underlying socio-political and economic conditions, the relative strength and prominence of different elements in this three-party coalition had varied in different countries which adopted developmental state structures as well as over time.

3. Countries which adopted developmental state structures have invariably been those experiencing late and uneven processes of development. These countries used the developmental state structure to catch up with their forerunners. Mercantilist/ protectionist policies, therefore, would characterize development policy in general, and industrial policy, in particular, of a developmental state, at least in early stages. In respect of particularly strategic industries, protection has been provided through prudent use of tariffs, subsidies, technological assistance and targeted finance. Realising that comparative advantage of a country is dynamic and changeable, through conscious actions the developmental state would use its industrial policy for consistent industrial upgrading and creation of export opportunities. Having built up their strength in production activities in terms of productivity levels, catering initially to the domestic market, developmental states have generally become at somewhat higher levels of development, very strongly export-oriented.

4. Developmental states have also developed the characteristic of working as corporations do with respective business models. Like in a corporation, the Government in a developmental state would plan and guide the country's development processes. An insulated and development-minded bureaucracy, largely comprising of technocrats, has been a characteristic feature of these states enabling them to achieve their corporate-like character, justifying the use of "Inc." following the country name in expressions like Japan Inc., Korea Inc, China Inc. and so on. There is already a group of activists strongly suggesting that we too must start calling ourselves Sri Lanka Inc.
5. Of great significance in developmental states of East and South-East Asia have been the structures of matching and mutually complementary institutions. These institutions were not operative all at once, but gradually brought into being as required by changing circumstances and needs. In addition to the effective bureaucracy noted above, the institutional structure comprised of the judiciary, property rights regime including intellectual property rights, capital markets, legal systems, financial structures including banking, corporate governance systems, public finance institutions, social welfare and labour institutions, technology transfer and innovation systems and so on, and structured to promote and guide socio-economic development. These institutional arrangements were brought into being gradually with development, learning about the types and characteristics of

institutions to be set up, from financial experiences in other countries.

This gives me the opening to enter the topic chosen for this Anniversary Oration – the central bank and central banking in a developmental state structure. The central bank, as an institution came into even today's developed countries relating late in their processes of development. The establishment of a central bank in Sri Lanka just two years after political independence was indeed quite a speedy and conscious politically motivated action. Having experimented with different development policy stances and frameworks, Sri Lanka has now arrived at a watershed like situation where the people seem to have opted for shared and inclusive socio-economic development through a state-guided policy regime. The policy-making systems and approaches, and administrative and other mechanisms are being developed to facilitate the above result. Sri Lanka appears to be on its way to develop its own developmental state model. In this context, the Central Bank of Sri Lanka, with its 70 years history, is being expected to play its role as an agent of development.

As an economic institution, the central bank has come to be considered a cornerstone of a stable economic system. As an institution, the central bank had to go through a long historical evolution to gain this lofty status and this history was indeed full of debate and contention about central banking concepts. This debate was about the nature of the role of a central bank, vis-à-vis, a country's stability and growth. According to H.A. de S. Gunasekera *(From Dependent Currency to Central*

Banking), unlike in many countries which established central banks in inter-war and post-war periods, in Sri Lanka, the central bank was set up in conditions of public indifference and apathy in respect of such an institution for the country. *The Report on the Establishment of a Central Bank for Ceylon* presented by John Exter, whom the Government of Ceylon invited from the US Federal Reserve to advise on the subject, was indeed the draft Monetary Law bill, interspersed with short comments/reasonings about certain proposed provisions in that bill. The Report was conspicuous in its absence of any in-depth analysis of basic problems of money and credit in Sri Lanka then, although in the letter of submittal John Exter referred to his having collected "sufficient material …. for a further report" which however, was never released. What was done therefore, appears as a mere superimposition of a central bank on the extant banking and credit structure of the country. The Central Bank proposed by Exter, who later helped operationalise his proposed Bank as its first Governor, however, has had strong elements of longevity. It survived 70 years, subject to only relatively minor changes, in its governing legislations.

Even at the time of its establishment, there were concerns that the Central Bank "…. ignored the vital relationship between central banking policy and policies of long-term economic development" (Gunasekera, 1962, p. 261). This was despite Exter including, certain developmental objectives as the last two items in the famous four-fold objectives he assigned to the proposed Central Bank:

(i) the stabilisation of domestic monetary values,

(ii) the preservation of the par value of rupee and the free use of the rupee for current international transactions,

(iii) the promotion and maintenance of a high level of production, employment, and real income, and

(iv) the encouragement and promotion of full development of the productive resources of the country

Even though items (iii) and (iv) above were included in Central Bank objectives, Exter himself was skeptical about a central bank's ability to achieve these objectives, directly. He shows his non-agreement with Keynesian policies for full employment through deficit financing in respect to the "chronic" type of unemployment in Sri Lanka. In support of his contention, he also highlighted the adverse balance of payments implications of any such demand expansion policy for employment generation in the import-dependent Sri Lankan economy. Thus, even in Exter's thinking, the stability objective was perhaps predominant.

The hypothesis about the incompatibility of a central bank's stability objective with needs and concerns of economic development applies, perhaps more strongly, today with the reduced two-fold stability objectives which govern the Central Bank actions since the 2002 revision to the Monetary Law Act. The reduced two-fold objectives are that of maintaining; (i) economic and price stability, and (ii) financial system stability. The absence here of the fundamental objectives of spurring economic development is quite conspicuous.

In addition, with our move towards the neo-liberal framework of economic policy, particularly after 1990s, one could see the emergence

and strengthening in Sri Lanka, too of the mainstream view of a central bank that is independent of the Government. Furthermore, this mainstream view also highlights the use of indirect methods of monetary policy, i.e., working through financial markets and interest rates, as opposed to direct credit allocation methods like subsidised interest rates, capital controls, credit ceilings and targeted lending. The implications of these principles of central banking as espoused in mainstream theory, are far reaching as Gerald Epstein argues in *Postwar Experiences with Developmental Central Banks: The Good, the Bad and the Hopeful*, UNCTAD/2009. The concept of central bank independence implies that no central bank should be subject to pressures from the Government to finance its activities and expenditures. It probably does not leave room for even collaborative development - targeted activities of fiscal - monetary authorities. The dominant focus on avoidance of inflation implies that the central bank should not be directly concerned with objectives like full employment and development. However, one could argue that even in the strictest practical inflation targeting regimes, a central bank seeks to achieve price stability by stabilising the economy around its potential, which is an indirect acceptance of the importance of maximum employment.

In relation to the indirect instrument of interest rate, the Central Bank has broadly allowed market forces to determine lending and deposit interest rates while guiding them with policy interest rates. Although with hesitation, the Bank has recently moved to exercise intervention in markets to keep Treasury bill and bond rates at low levels. This has

helped to maintain a low interest rate regime for promotion of developmental expenditures and of source, to ease the fiscal burden of debt repayment. However, there has been widespread criticism of stubbornly high margins kept by banks, and sluggish and asymmetric adjustments in their lending rates, in response to changes in policy and other rates under central bank control. The Central Bank has intervened from time to time by introducing regulated interest rates to rectify these adverse outcomes at least to some extent, although these are frowned at by the banking community. The latest in this type of intervention is comprises regulation of interest rates on credit card advances, pawning and temporary overdrafts, as well as on chargeable penal interest rate margins. The need for such intervention was felt even in 2019, during which regulations on, both deposit and lending rates of banks were introduced.

The Central Bank has generally attempted during its period of existence to keep its policies and measures within the confines of the relevant mainstream thinking as defined by the MLA of 1949 as marginally revised subsequently. Despite the revision of Central Bank objectives in 2002, the MLA still had whatever provisions of the 1949 formulation that were included in it to accommodate non-stability objectives or to be used "in particular situations" or "for use in crises or to forestall a crisis." In any case, the force of events which unfolded through interactions of socio-political and economic factors, both of domestic and global origin, has compelled the Bank, on many occasions, to move beyond the domain as defined by mainstream central banking theory. In order to do

this, the Central Bank has effectively used, to the extent possible, the flexibility that was there in the MLA.

Exter himself had alluded to these conflicts and accommodations that were required in the implementation of the Bank and he proposed:

> *A monetary system that is stable and at the same time responsive to the needs of a growing country is a necessary but not a sufficient condition of orderly economic development.*
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> *An alert reader, especially one who is familiar with the interplay of economic forces, will readily realize the potential conflicts and inconsistencies involved in the above objects… Many governments and central banks have tried to promote economic development at the sacrifice of monetary stability. Such conflicts cannot be avoided. Compromise is the essence of every economic decision. It must remain for those who are charged with the responsibility for determining the policies of the Central Bank constantly to weigh each of the above objects in the balance against the others and to decide from time to time the degree to which it can be achieved or must be sacrificed.*

The Central Bank was expected to establish monetary conditions in the country that would enable increased productive utilisation of the country's human and material resources. In this regard, there was inherent recognition that freedom in monetary affairs reflected in the presence of a central bank would vastly influence the welfare and growth of the people through enabling effective mobilization of national

resources for production. In this scheme of things, the Central Bank considered stable monetary conditions as the cornerstone to income and employment growth and also the lifeblood of foreign trade. As part of the economic institutional establishment of the state, it participated in activities proposed by elected Governments to promote long-term objectives of growth and employment generation, using the broad mandate it received from the MLA.

Compromise, prioritisation and reprioritisation, and balancing of objectives, as Exter himself indicated, are inherent in policy making at a point of time, as well as in the evolution over time. Under different regimes and policy paradigms, we in Sri Lanka have achieved a great deal in terms of our desired national objectives of production and employment growth and overall socio-economic development over the last 72 years of decolonisation. Within its mandate, the Central Bank had participated in facilitating the implementation of these various policy packages, sometimes grudgingly but often accommodatingly. The people are, however, not content with socio-economic results achieved so far through various policy packages. Economic analysts, commentators and historians who have examined Sri Lankan achievements since Independence, in historical and international comparative perspective are equally unsatisfied about performance of these various policy packages. Any careful reading of socio-political, economic and related developments in the country since 2019 would clearly indicate that we are yet again in a transitional phase in terms of many things, and economic policy matters occupy a dominant position

in this transitional process. On innumerable occasions, we hear of the nation moving into an alternative economic and social policy framework. The Central Bank is naturally required to positively respond to these changes.

The COVID-19 experience which, I hope, we are moving out of, provided an emergency type phase for these required Central Bank changes in policy and practice. In order to address the unprecedented problems, issues and challenges thrown up by this pandemic, the Central Bank of Sri Lanka, following its peers in other countries, hand-in-hand with the other agencies of the Government, has provided the flow of required funds into the economy to meet the needs of the people under lockdown conditions. COVID-19 experience has provided the country's policy makers a valuable learning ground in their search for an alternative policy framework to lift the people on to a higher platform of social and economic achievements.

Direct or indirect financing of fiscal deficits has been viewed with caution in Sri Lanka. Nevertheless, there have been several occasions in the past when the Central Bank has stepped in to assist the Government in most difficult times. The most prominent examples of these are the large expansions in Central Bank financing of the Government in the early 1980s during the beginning of the so-called open economy regime, at the height of the internal conflict in 2009, and very recently as already noted, during the COVID-19 pandemic. When fiscal deficits need to be expanded to accommodate essential expenditure, it has now become an established practice for the Central Bank also to subscribe to

such expansion, and act as a conduit in mitigating fiscal pressures to some extent. This function has become easier this year in the context of the prevailing low inflation environment.

As the German Development Institute in a briefing paper titled *Financing Global Development: The Role of Central Banks* highlights the changing approaches of central banks in the world:

> *In many developing and emerging economies, central banks have begun over the past decade to place renewed emphasis on the promotion of economic development and structural transformation, looking beyond narrow mandates for macroeconomic stability.*

History of the role played by central banks in other countries, in the early stages of evolution of central banking, as well as in more recent times in the post-World War II period, shows that there were many instances in which these banks played an important role as agents and facilitators of development, although there were also unpleasant episodes such as the period of German hyperinflation. In the more recent world history, the central bank's "development agent role" came out very clearly in East Asian developmental states. These central banks have done this by using subsidised interest rates, legal restrictions, economic controls, directed credit and moral suasion to promote particular markets, institutions and sectors. Central banks, playing their role as agents of development, have used credit controls to modify the pattern of credit availability, and to influence credit allocation patterns and interest rate structures.

Market forces do not necessarily channel credit flows towards sectors that have the potential to generate employment and add value in the domestic economy. The Central Bank has, therefore, occasionally acted to directly intervene in respect of credit allocation patterns. At present, a mandatory lending requirement of 10 per cent of total credit granted is in place in favour of agriculture credit. The inherent risks associated with this important economic sector and the consequent hesitancy on the part of banks to lend to agriculture were the factors responsible for this direct credit allocation intervention. The credit schemes operated by the Central Bank itself, also take into consideration the reluctance of banks to lend to the small and medium scale enterprises (SMEs) and are often designed to absorb a large portion of credit risk. If the Central Bank were to take a more active responsibility as a developmental agent, these isolated types of exercises will need to be transformed as carefully crafted schemes of directed credit, operating within well designed economic plans.

Central banks in many countries have provided capital to development institutions, such as industrial and agricultural development banks. The development banks as opposed to commercial banks have been the source of funding for new investments. Central banks have often provided part of the equity of development banks. Sri Lanka has a poor history of development banking. However, discussions are under way in the Central Bank to establish a national entrepreneurship development bank, which could support SMEs and startups. Also under discussion is a plan to introduce a permanent credit guarantee institution. These are

avenues through which central banks in developmental states have actively supported domestic industries to grow and become global giants.

In addition to maintenance of the exchange rate at an appropriate level to support exports, capital controls and development finance systems have been used by these central banks to achieve developmental objectives. These methods were used effectively to bring down government's borrowing costs, to promote the development of particular economic sectors or industries, and to stimulate overall structural transformation of their economies. In the developmental states, central banks became important mechanisms of industrial policy which helped as the main policy mechanism and the development model for economic transformation and diversification - the springboard for sustainable socio-economic development. It is time, I believe, for Sri Lanka Inc. to develop its own business model.

From the time of introduction of open economy policies, together with relaxation of conditions governing determination of exchange rates, the exchange value of the rupee has continuously depreciated. The last decade, in particular, has seen depreciation pressures building up from time to time driven by various domestic and external reasons. In the search for alternative economic policies since the change of Government in 2019, the Central Bank has intervened in foreign exchange market actively to bring about a relatively more stable exchange rate regime. Despite the limitations in official reserves, the Central Bank intervention has managed to stabilise the rupee exchange rate. Greater success in

this intervention requires successful action elsewhere in the economy – careful management of export-import trade activities, in important areas of export-oriented and import-replacing production and in sources of inflow of foreign exchange. If not for interventions in the foreign exchange and other markets, there would have been widespread panic in domestic markets, particularly during the COVID-19 related disruptions.

Of course, times have changed since 1940s and 1950s when there were frequent external current account surpluses to continued deficits, resulting in increased reliance on foreign borrowings to support the balance of payments, in the absence of adequate growth of exports and a regular inflow of foreign direct investment. While timely intervention by the Government and the Central Bank has resulted in improvement of official reserve buffers to levels that are adequate to meet the country's upcoming debt obligations comfortably, an irrefutable fact is that the country must aspire to enhance its foreign exchange earnings through sustainable means in order to help achieve the nation's developmental objectives. We are confident that the ongoing focused efforts of the Government will help break this vicious cycle of current account deficits and overreliance on foreign debt.

As for inflation, monetary policy seeks to contain its demand-pull aspect. But, a large portion of the consumption basket in Sri Lanka, 28 per cent in CCPI and 44 per cent in NCPI, comprises food items. Given this large weightage on food in overall inflation, maintaining price stability requires close intervention by authorities to influence domestic production of

food items. It is noted with satisfaction that the current long-term policy is one of restricting imports of food items which can be produced, domestically.

The looked-for alternative development policy framework would depend heavily on a productively and efficiently run sector of state-owned enterprises (SOE) and other public organizations. The dominance of large state-owned institutions in the financial sector often attracts criticism. But, in the Sri Lankan developmental state, these large state-owned financial institutions play a crucial role from several angles to assist and promote development. These provide the support the Government needs. Without them, the financial sector would have become private sector-dominant with very little flexibility toward policy-dictated demands from the Government. In addition, these large state-owned banks have operated for many decades in taking banking services to the people in areas remote from the metropolises, thus facilitating the outreach of banking services to unbanked segments of the population. In the meantime, the existence of a few weak non-bank financial institutions has plagued Sri Lanka's financial system, highlighting the need for consolidation, either voluntarily, or forcibly, if we are to maintain stability of the financial system. The Central Bank's function of ensuring the financial system stability remains critically important not only for stable economic conditions, but also for growth of production and employment.

As the role of the state was of paramount importance, in early stages of a country's development – to build up various elements of critical

infrastructure and to undertake large investments in strategically important directly productive activity areas. In addition, the Governments have large funding needs for various developmental purposes – eg. solidifying and extending their political authority, unifying the disparate components of the country under a central administration, promoting state-led and state-financed economic development projects as means of increasing state power, and, perhaps most important of all, purpose of protection of the nation against other competing states (Gerald Epstein, *Central Banks as Agents of Economic Development*, WIDER, 2006). Large private economic entities which could take up these responsibilities were a later development. This pattern of development meant that, in the early phases of development of a country, the state required financing on a scale beyond the capabilities of individual private sector financial institutions. Many governments depended on central banks to fill the consequent institutional gap in respect of financing.

In the past several years, the Central Bank of Sri Lanka has implemented various measures to direct funding towards needy and productive sectors of the economy, such as the agriculture sector. It has implemented other measures to control the cost of credit and provide relief to disaster-struck industries such as tourism. It will enhance its efforts to direct lending to productive sectors in the future.

Given the practical issues in Sri Lanka's financial system today, the responsibility of the Central Bank in respect of maintaining a healthy financial system acquires great developmental significance. The issues

affecting the health of the financial sector, which includes non-bank financial institutions with varied financial strengths, require careful and firm handling. The failure of one or a few such companies does not create a systemic impact, but such a failure causes significant impacts on society. Taking care of depositors of these companies is part of the social responsibility of the Central Bank. Similarly, the intervention and guidance of the Central Bank are sought by stakeholders in various unregistered and unregulated small financial units among which there are micro-finance providers and small money changers. In terms of existing legal frameworks, the Central Bank has no responsibility in respect of lending agencies which do not take deposits from the public. Yet, the country's perennial issue of extensive indebtedness among people at low income levels is causing serious harm on the welfare of people. Their lack of bargaining power in the face of unfair practices of lending institutions, requires the intervention of the Central Bank to safeguard the rights of borrowers. This would indeed be part of its responsibility in its developmental role. The presence of a large informal sector in the economy makes the developmental role of the Central Bank difficult and complicated.

With the establishment of the Central Bank of Ceylon, an institution of great economic significance emerged in the policy scape of the country. To date, its influence has not been limited only to areas of activity entrusted to it legally, but has extended to wider areas of significance. Over the past seven decades, Sri Lanka has crossed several milestones and made significant socio-economic progress. As rightly anticipated by

Exter, the Central Bank of Sri Lanka has walked a tightrope in balancing economic stability with economic growth. While we can justly be proud of some achievements, we must acknowledge that the country is yet to attain its potential. Despite the few spurts of growth observed, the overall growth trajectory has neither been significant nor sustained over time. Despite achievements, the important activity areas underlying growth, agricultural progress, industrial expansion and diversification, export growth and diversifications, savings and investment etc. have not advanced to achieve the country's potential. Against this backdrop, the growth of the economy, thus far, has not been of an inclusive nature. The alternative policy framework that is being developed has a lot to achieve. In the emerging developmental state, the Central Bank stands ready and willing to join hands with fiscal and policy planning authorities to help open up the vistas of prosperity for the benefit of the people.

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