



# MANAGING VULNERABILITIES TO SUSTAIN STABILITY

## Action by the Central Bank

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### **Abstract**

This paper deals with the role of the central bank in achieving stability in an economy, particularly the financial sector. The study discusses the policy measures that the Central Bank of Sri Lanka implemented during 2007-2011 to achieve stability of the macro economic parameters of the economy while highlighting the nexus to theoretical approach. Later, the study discusses the outcome of the stability measures implemented by the Central Bank with an emphasis on maintaining price, economic and financial system stability which is the main objective of the Central Bank of Sri Lanka.

### **1.0 Introduction**

Managing economic stability is a subject coming under social sciences. Economic stability refers to an absence to excessive fluctuations in the macro economy. An economy with a fairly constant output growth and a low and stable inflation would be considered economically stable. If there are recessions, business cycles, variable inflation or frequent financial crises it can be considered as economically unstable. One of the objectives of central banks around the world is to maintain economic and price stability. Economic stability would create an environment which is conducive for maintaining favourable living standards. Economic stability will provide grounds for social and political stability too.

A central bank is one of the entities available in an economy to maintain economic stability. Central banks in collaboration with other regulators implement different policies in order to achieve its stability objectives. In order to maintain economic and price stability, countries have monetary policies as well as fiscal policies. Implementation of monetary policy is one of the principal activities of a central bank. Fiscal policy refers to policies to manage government revenue, expenditure and borrowing programmes of the government, which is basically a responsibility of a government.

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\* The views expressed in the paper are of the author and do not necessarily represent the views of the Central Bank of Sri Lanka.



The stability may be short term or long term. Most of the central banks attempt to achieve long term stability by managing short term fluctuations in macro economic variables. In order to maintain price stability, central banks use monetary policy, under which money supply is regulated to achieve a certain level of prices. In order to achieve stable prices central banks use interest rate and exchange rate policies under monetary policy instruments. There may be a series of policy instruments that can be used by a central bank in order to achieve its stability objectives.

Under monetary policy, central banks can attempt to achieve stability through demand management and supply management. Most of the time supply management could be handled through fiscal policies. However, demand management policies can be implemented by using monetary policy instruments.

Volatility can take place due to external and domestic shocks. These shocks may be demand driven or supply driven. International volatility in external prices, volatility in external rate and reserves, contagion effects from international crises can reflect in domestic volatility of an economy. Domestically, macro economic conditions and other conditions such as natural disasters can create instability. Some of these situations cannot be overcome by implementing macro economic policies. Central banks by implementing their monetary policies attempt to minimize the volatility, thus creating a conducive environment for the people to live in harmony, although there can be volatilities which can take place irrespective of the involvement of central banks. Any instability would affect human lives.

In this paper action taken by the Central Bank of Sri Lanka (CBSL) along with a theoretical approach to achieve stability is analysed. The period covered in the study is from 2007 to 2011. During this time there was a global financial crisis, especially due to sub-prime mortgage financial crisis in the United States of America (US) followed by crisis in the European region. Section 2 is devoted to explaining a theoretical approach to stabilization policies. Section 3 analyses the background and policy measures adopted by the CBSL during the period under review to maintain macro economic stability in the country, particularly, to maintain price and financial sector stability of the country. Section 4.0 of the paper analyses the achievements of stability measures. Finally, the paper presents some conclusions.

## **2.0 Role of the Central Bank in Maintaining Expected Stability**

Maintaining economic and price stability and maintaining financial system stability with a view to encouraging and promoting the development of the productivity resources are the two objectives of the CBSL. In order to maintain price stability in the domestic economy the Central Bank can regulate money supply through its monetary policy. Price stability is the economic term used to refer to a situation where the general price level covering consumer goods remain unchanged or if it does change, it holds at a lower rate, so that it is not strong enough to make any significant inflation on economic decisions of participants in an economy viz., household and firms. The conduct of monetary policy is one of the principal objectives of a central bank.

Regulating money supply is important not only for maintenance of price stability but also maintenance of financial system stability. Financial system stability is defined as the ability of the financial system to perform its key functions of resource mobilization and allocation, risk management and the settlement of payments, effectively at all times and even under stressful circumstances. (Financial System Stability Review 2011, p.vii). In order to maintain this financial system stability it is required to gain public confidence in the financial system. Financial system may include financial institutions, financial markets, financial infrastructure and financial regulatory framework. The maintenance of price stability and financial system stability are two objectives that are correlated and complement each other. Ensuring financial system stability is of prime importance as monetary policy is transmitted through financial intermediaries (institutions) to achieve price stability. Hence, the maintenance of price stability and maintenance of financial system stability are in harmony and it enables the central bank to perform its main functions more effectively.

Central banks can supervise and regulate individual financial institutions under the powers contracted by law to maintain the financial stability. Further, it may also include oversight of the financial system and crises management and resolution. Central bank can take steps to maintain financial system stability on these aspects.

Maintaining price and financial system stability is important to a country as it protects the life style of the people from economic vulnerabilities which sometimes leads to disasters. Maintaining stability is also required for a country to maintain investor appetite to engage in business activities. The central bank can ensure the stability of price, system and overall economic activities of an economy by using instruments available to it. Policy instruments available for a central bank vary from one country to another.

In order to maintain price stability, central banks are entrusted with a series of monetary policy instruments. Some countries target price levels while some other countries target other parameters such as targeted inflation rate, level of money stock or a specific exchange rate. Some countries may have mixed targets. Depending on underlying monetary policies, the types of instruments that are used to achieve monetary policy targets may also differ. Low level of price variations is expected to be achieved by controlling the money stock which in turn is expected to be achieved by regulating a specific level of reserve money (base money) kept as the operational goal. The achievement of these goals is monitored by the central bank and when any deviation from the target is observed, appropriate policies are implemented using policy instruments.

As stated earlier, one of a major objectives of a central bank is to maintain price stability that requires controlling money supply. The relationship between price and money stock can be explained by using Irving Fisher's Identity as given below:

$$\bar{M}\bar{V} = \bar{P}\bar{T}$$

Where,  $\bar{M}$  = Money stock

$\bar{V}$  = Velocity of money

$\bar{P}$  = Price level

$\bar{T}$  = Number of transactions



If  $\bar{V}$  and  $\bar{T}$  are assumed to be constant or do not change, the changes in  $M$ , which is the money supply, will determine the changes in price level ( $P$ ).

That is, if  $M$  is increased by 10%, then the other side of the identity which is  $P$  will also be increased by 10%, assuming  $V$  and  $T$  are constant. Hence, there is a direct effect from the changes of money supply to the price level and by controlling money supply, the central bank can influence the average price level of the economy, which is determined by using an index such as Consumer Price Index (CPI) or Core Inflation Index (CII)<sup>2</sup>. By controlling the changes of money supply the changes of price level can be controlled. In order to maintain stability in prices there is a requirement to maintain stability in the money supply using various instruments.

The money stock is determined by the interaction of money multiplier and the stock of high powered money, which is also known as reserve money or monetary base. The relationship among money stock ( $M$ ), money multiplier ( $m$ ) and high powered money ( $H$ ) can be further established as given below:

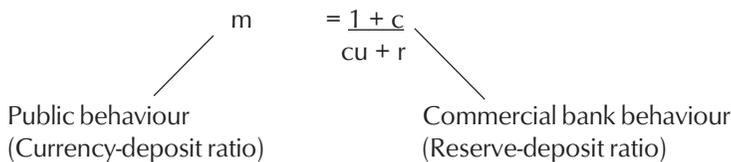
$$M = m\bar{H}$$

Where,  $M$  = Money Stock (M1 or M2)

$m$  = Money multiplier (public and bank behaviour)

$\bar{H}$  = High powered money (commercial bank behaviour)

Components in  $m$  and  $\bar{H}$  can be regulated by the central bank using monetary policy instruments. Hence, money stock is determined by interaction of public, commercial banks and the central bank.  $m$  is an outcome of the public behaviour and commercial bank behaviour, which can be with one another as follows:



$m$  can be regulated through the central bank's monetary policy instruments via changing currency deposit ratio (public behaviour) and reserve deposit ratio (bank behaviour). If interest rates are raised by the central bank, public preference for deposits in the banks will increase resulting in a drop in currency deposit ratio and a higher money multiplier. Similarly, if reserve ratio of the commercial banks is changed it will affect the money multiplier. For instance, if reserve ratio is raised by the central bank,  $m$  will decline (interest rates and reserve ratio are policy

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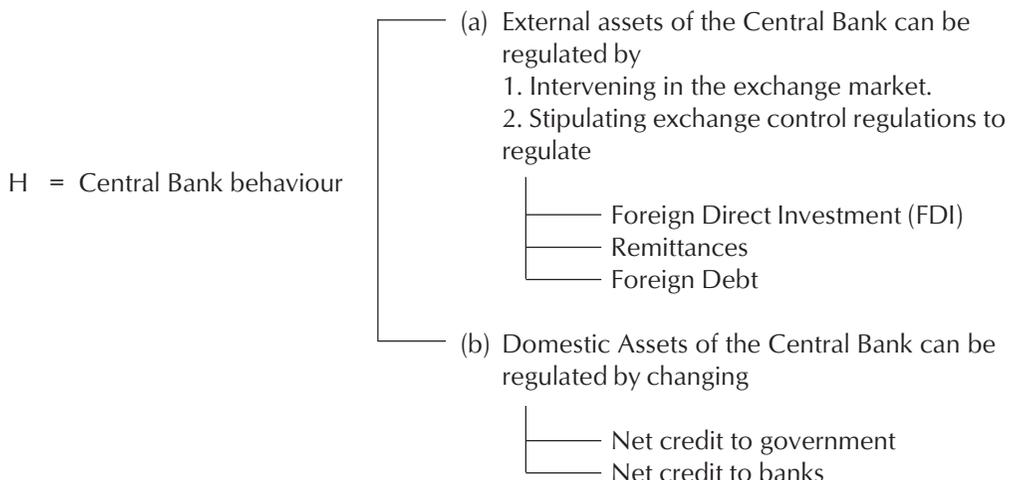
<sup>2</sup> These are two indicators computed by Department of Census & Statistics of Sri Lanka and used by the Central Bank of Sri Lanka to measure the movements of inflation. Core inflation index is estimated by removing some items from the basket of CPI.

instruments of the central bank which will be discussed later in this section). Hence, factors contributing to an increase in currency deposit ratio and reserve deposit ratio will reduce  $m$  resulting in a drop in money supply ( $M$ ). The reverse will take place when currency deposit ratio and reserve deposit ratio are declined. Similarly, other monetary policy instruments can also be used to regulate  $m$  through which the stock of money supply is regulated.

The second component that determines the money stock is the high powered money, which is determined by the behaviour of the central bank. The central bank has a dominant role in a country in determining the money stock. The level of money stock can be changed by changing reserve money.

$H$  or the reserve money can be obtained from asset side (use side) or from liability side (source side) of the central bank's balance sheet. According to source side  $H$  consists of two types of assets i.e., external assets and domestic assets of the central bank. External assets are generated by the central bank while engaging in transactions with the external sector. Domestic assets are generated by the central bank while engaging in domestic market activities. Central bank can regulate the reserve money or  $H$  by implementing policies to influence external assets or domestic assets of the bank.

By analysing the factors contributing to the use side of the balance sheet, the behaviour of  $H$  can be examined as follows.





- Moral suasion: This is one of the effective monetary policy instruments that the Central Bank can use to direct financial institutions based on the information it may have. Banks can be directed to do certain activities or may be requested to refrain from doing certain activities based on the information available to the Central Bank from time to time.

At present, the monetary policy places greater reliance on market based policy instruments. As a result, open market operations and statutory reserve requirements are the main policy instruments used by the CBSL.

In recent years, the CBSL has stopped using policy instruments such as the quantitative credit restrictions, interest ceilings and refinance facilities. Furthermore, since moving to a floating exchange rate regime in 2001, the exchange rate is no longer available as a tool of monetary policy.

These instruments can be used to regulate the availability of money to the economy and to determine the cost of money in achieving stability objectives.

In addition to price stability, in order to ensure a stable and sound financial system in the country, the CBSL has been empowered to license, regulate and supervise the banks and other financial institutions canvassing deposits and other investments of funds from the public. CBSL issues directions and guidelines from time to time in order to regulate the financial institutions thus ensuring the soundness of their activities and to maintain stability of the financial system.

In the exercise of maintaining economic, price and system stability, the CBSL is empowered by many Parliament Acts to carry out its activities.

Monetary Law Act No. 58 of 1949 as amended, Banking Act No. 30 of 1988 as amended, Finance Companies Act No. 78 of 1988 as amended, Exchange Control Act No. 24 of 1953 as amended, Employees' Provident Fund Act No. 15 of 1958 as amended, Local Treasury Bill Ordinance No. 8 of 1923 as amended, Registered Stocks and Securities Ordinance No. 7 of 1973 as amended, Finance Leasing Act No. 56 of 2002, Payment and Settlement Systems Act No. 28 of 2005, Prevention of Money Laundering Act No. 5 of 2006 and Convention on the Suppression of Terrorist Act No. 25 of 2005 and Financial Transactions Reporting Act No. 6 of 2006 and Finance Business Act No. 42 of 2011 are the Acts that empower the CBSL to conduct monetary policy, regulate and supervise the banks and financial institutions and to take appropriate action in order to ensure the soundness of those institutions and to regulate the payment and settlement systems in Sri Lanka.

While conducting CBSL's activities as a banker to the government, banker to the commercial banks and performing its role as an agent of the government and facilitating to maintain a sound payment and settlement system CBSL acts to ensure economic stability of the country. While being a banker to the government, the CBSL performs a wider role in achieving country's economic growth. The relationship it maintains with the government helps in achieving this objective.

Financial institutions are directed accordingly to achieve economic stability. Mobilizing deposits and directing credit of the financial institutions are monitored by the CBSL considering the importance of maintaining economic stability. Directing credit and diverting financial assistance to lagging sectors under the CBSL agency functions is also an activity of the Central Bank to achieve a balanced economic growth. Exchange control measures are helpful to guide the directions of external fund flows ensuring maximum utilization of resources of the country thus facilitating to achieve economic stability.

### **3.0 Recent Policy Measures adopted by the CBSL to Maintain Stability**

#### **3.1 Background to Measures**

The period from 2007 to 2011 is a period of turbulence which threatened the financial stability of several countries. CBSL took a series of policy measures to overcome the problems experienced by the country due to recent global and domestic turbulences. Posing a serious threat to price stability in the country, international prices, particularly oil and food prices surged during 2007 and in the first half of 2008. Annual average increase of the price index in 2008 was 22.6 per cent while recording a peak of 28.2 per cent in June 2008. The CBSL had to implement a tight monetary policy to reduce impact of adverse prices. Partly due to these policies, the average inflation in 2009 declined to 3.4 per cent, the lowest since 1985. As a result, Sri Lanka was able to relax its tight monetary policy stance that was maintained prior to the third quarter of 2008. During the latter part of the period under reference, the global economy deteriorated with slow economic growth, high commodity prices and elevated volatility in financial markets due to the Eurozone sovereign debt crisis. However, the Sri Lankan economy grew at a higher rate with low inflation and a low interest rate environment. The global recovery process weakened during 2011 due to a confluence of factors such as a significant rise in energy, food and commodity prices, the Eurozone sovereign debt crisis, fiscal consolidation effects, structural issues, weaker demand in some advanced economies, the slow pace in addressing imbalances and the natural disasters like earthquakes and the tsunami in Japan (Financial Stability Review 2011, p.2). Coordinated and timely adoption of monetary policy of the CBSL and the fiscal policies of the government helped in preserving price, economic and financial system stability of the country despite global adverse macro economic conditions that prevailed.

The financial system of the country was not directly affected by the crisis. No banks collapsed in Sri Lanka due to contagion effects of the crisis which took place in the West after 2008. However, some registered finance companies faced difficulties in 2008, although there was no serious threat from the financial crisis to financial stability in the country. However, it was required to maintain public confidence in financial institutions and to avoid panic, for which CBSL had to intervene.

The adverse effects of global slowdown impacted on the balance of payments of Sri Lanka. If not due to measures implemented, the country was likely to be affected by the global turbulences particularly the impact from the US sub-prime mortgage crisis. The following section analyses the macro economic conditions in brief due to these adverse developments.



Sri Lanka had to take corrective action in order to avoid the adverse impact from the global developments during the latter part of the period under study. Because of the fact that the capital account has not been fully liberalized in Sri Lanka and that many local banks did not deal with complex financial instruments, the direct impact of the global financial crisis on the Sri Lankan economy was minimal. However, with the intensification of the crisis that spilled over into the real sector of the economy, the effects of the US crisis was felt strongly in the Sri Lankan economy, particularly in the external sector.

As a result of the financial crisis, many foreign investors who had invested in short-term investments repatriated their investments back to their countries for meeting rising liquidity requirements in their countries. The foreign funds which were invested in debt instruments, such as Treasury bills and long-term bonds in Sri Lanka were withdrawn from the country partly as a result of the global financial crisis. At the end of 2008, there was a sudden reversal of short-term capital inflows to Sri Lanka. The net outflow amounted to US \$ 213 million due to withdrawal of US \$ 430 million in the last quarter of 2008.

The demand for Sri Lankan exports, particularly apparel products declined substantially due to a slow down in the crisis-driven countries. This was a combined effect of the reduction in the global demand for Sri Lankan textile exports and stiff competitiveness among exporters. There was a decline in exports such as tea and rubber from Sri Lanka. The decline in exports was a result of the downfall in demand for these products from trading partners such as Middle East countries and Russia and a decline in prices. The growth of textile and leather product category recorded a slow growth of 3.1 per cent in 2008 compared to 7.3 per cent in 2007 due to the downturn in the demand from US and European countries. Also the growth of industrial sector was low in 2008 compared to 2007. In addition, exports of rubber-based products, diamond and jewellery industries were also affected due to the decline in demand. In the meantime, some local industries resorted to short-term lay-offs of workers as a result of the depressed demand for export products. The services sector growth also declined from 7.1 per cent in 2007 to 5.6 per cent in 2008 (Annual Report of the Central Bank, 2008). These created some de-stability in the domestic economy demanding adoption of measures to correct the situation.

Another sector affected due to global crisis was the tourism sector. Tourist arrivals dropped by 11.2 per cent in 2008 partly due to the global crisis (Annual Report of the Central Bank, 2008). The tourist arrivals from the Western Europe and North American countries dropped by 15 per cent in 2008 when compared to 2007.

The decline in export earnings and withdrawal of short-term investments by foreigners, particularly in the government securities market, resulted in a balance of payments difficulty in Sri Lanka. The high growth of imports and lower growth of exports too contributed to expand the trade deficit in 2008. As a percentage of GDP, the trade deficit deteriorated from 11.3 per cent in 2007 to 14.4 per cent in 2008. As a result of these developments, the balance of payments which recorded a surplus of US \$ 515 million as at end of July 2008 turned into a deficit of US \$ 1,225 million at the end of 2008.

The increase in the value of imports was further intensified due to an increase in the prices of imports, particularly of petroleum. Owing to the slow growth of exports and low demand for exports from the western countries that resulted from the crisis contributed to this adverse impact on reserves and thereby building pressure on the exchange rate. The central bank sold its foreign reserves to protect the exchange rate from devaluation. At the end of 2008 total external official reserves dropped to US \$ 1,594 million indicating reserves were sufficient to finance only 1.4 months of imports although accepted number is 3 months. This depletion of reserves, coupled with decline in export earnings prompted the policy makers to search for mechanisms to increase the level of reserves.

The crisis in the US and its contagion effects in western countries required Sri Lanka to change its external portfolio investments to minimise risks. CBSL had to make a concerted effort to manage its investments of foreign reserves by changing strategies and shifting them into safer destinations. This was required for minimising risks while at the same time increasing returns.

The impact of the global crisis through the channels as explained above ultimately resulted in a slow rate of economic growth in Sri Lanka. The impact on economic growth due to crisis and recession in the world was severely felt during the last quarter of 2008 and first half of 2009. The Gross Domestic Product (GDP) growth dropped to 4.3 per cent in Q4 of 2008 compared to 6.3 per cent in Q3 and 7.0 per cent in Q2 of 2008. The lowest economic growth of 1.6 per cent in the first quarter 2009 indicated the adverse effects of the global crisis on the Sri Lanka economy. Economic growth in 2009 was 3.5 per cent compared to 6 per cent in 2008, which showed the adverse impact of the financial crisis on the Sri Lankan economy.

Partly due to the adverse effects of the crisis there was a lower growth in government revenue which was significantly below the target level. The borrowing requirement increased both due to slow growth of revenue and increased expenditure as a result of undertaking massive projects under infrastructural development and requirements in the North and East. Due to tight liquidity conditions in the international capital markets it led the government to depend heavily on domestic borrowings during the first half of 2009. Lower growth in GDP and increased government borrowings resulted in an increase of Debt/GDP ratio of 86.2 per cent in 2009. An effort had to be made to borrow from international market due to the tight liquidity situation in the local market.

In order to overcome the adverse impact on the macro economic conditions in the country the CBSL took a series of measures during the reference period.



### **3.2 Measures Taken by the CBSL for Stability**

Measures adopted by the CBSL as given below were helpful in maintaining the price, economic and the financial system stability of the country.

#### **Monetary Policy Measures**

- Under its monetary policy, CBSL took several measures during the period under consideration. The tight monetary policy stance demonstrated its effectiveness by recording a year on year inflation of 7.6 per cent in February 2009 from the peak of 28.2 per cent in June 2008. Deceleration in prices earmarked the CBSL to relax its tight monetary policy stance in 2009. Under a series of measures, Statutory Reserve Requirements (SRR) and restrictions in accessing the Reverse Repo Facility of the Central Bank by Commercial Banks and Primary Dealers were removed. These measures were supported by reducing policy rates of the CBSL which helped to manage the liquidity situation in the market and enable the banks to lend at a lower rate.
- During 2004-2008 the interest rate corridor was revised upward, following which market interest rates also increased. Conversely, in order to avoid adverse effects from the global financial crisis, CBSL relaxed its monetary policy since the third quarter of 2008. A series of policies such as reduction of SRR of the banks and policy rates and removing penal rates hitherto existed was introduced under a relaxed monetary policy. The CBSL policy rates were brought down. During 2010-2011 an accommodative monetary policy with further moderation of interest rates continued. Table 1 shows the recent monetary policy measures implemented by the CBSL.

**Table 1**  
**Recent Monetary Policy Measures**  
**(2007-2011)**

Date	Repurchase Rate	Reverse Repurchase Rate	Statutory Reserve Ratio	Per cent per annum
				Penal Rate on Reverse Repos
23 February 2007	10.50	12.00	-	-
21 November 2007	-	-	-	19.00
13 October 2008	-	-	9.25	-
25 November 2008	-	-	7.75	-
12 January 2009	-	-	-	17.00
11 February 2009	10.25	11.75	-	16.50
24 February 2009	-	-	7.00	-
18 March 2009	-	-	-	14.75
22 April 2009	9.00	-	-	13.00
21 May 2009	-	11.50	-	Removed
16 June 2009	8.50	11.00	-	-
11 September 2009	8.00	10.50	-	-
18 November 2009	7.50	9.75	-	-
09 July 2010	7.25	9.50	-	-
20 August 2010	-	9.00	-	-
11 January 2011	7.00	8.50	-	-

*Source: Central Bank of Sri Lanka*

- CBSL with the support of the government took several steps to increase the level of foreign reserves, such as (a) negotiating with three countries for SWAP arrangements (for US \$ 200 mn) (b) promoting investments in Treasury bills and bonds among Sri Lankan Diaspora and migrant workers (c) paying bonus interest of 20 per cent in rupee terms on interest earned on NRFC & RFC deposits.
- CBSL and the government negotiated with IMF for a standby arrangement to improve the external reserve position of the country. IMF under this arrangement promised 2.6 billion US dollars to be given to Sri Lanka. This measure, in addition to improving the foreign currency situation of the country helped creating, more importantly, the confidence of foreigners for investments and other dealings with Sri Lanka. The supply of IMF funds to Sri Lanka increased the level of foreign reserves, substantially in the country.
- During the period of relaxed monetary policy, reduction in Repo and Reverse Repo rates, removal of penal interest rates, removal of margin requirements for importers, withdrawing restrictions on participating banks in the repo and reverse repo window, purchasing Treasury bills from the primary market by the CBSL, reduction in SRR and engaging in aggressive open market operations were the policy instruments used. The Repo rate was reduced from 10.5 per cent in February 2009 to 7 per cent in January 2011 while the Reverse Repo rate was reduced from 12 per cent to 8.5 per cent during the same period.



Moral suasion was used extensively. The banks and other financial institutions were requested to follow instructions given by the CBSL from time to time.

### **Measures taken to maintain System Stability**

The CBSL implemented a series of measures to maintain financial system stability of the country during the turbulence due to crisis. The following are some of those measures.

- The global financial environment which was marked by intensified turbulences, particularly due to US sub-prime mortgage crisis, Sri Lanka's financial sector came under pressure to some extent. While existing regulatory framework safeguarded the domestic financial system, under the procedures and policies adopted for supervision the adaptation of Basel II capital adequacy standards for commercial banks in Sri Lanka, effective from January 2008, provided a framework to foster integrated risk management in banks. All banks were required to maintain their capital adequacy ratios and credit ratios as per the guidelines in Basel II which contributed to promote higher standards of risk management among the banking institutions thus mitigating risks.
- The issuance of some directions to financial institutions under the corporate governance ensured the improvements in common standards of their behaviour which improved the public confidence and thereby contributed positively towards financial stability despite the adverse experiences faced by western financial institutions. Application of the assessment of fitness & propriety to officers in executive grades of banks came under the corporate governance directions.
- Further, among the directions, there were directions to limit credit facilities on microfinance and loans for share transactions. A direction on Integrated Risk Management (IRM) was issued. Guidelines covered the management of credit, market, operational, liquidity and interest rate risks, stress testing and disclosure requirements in an IRM framework. Banks were required to transfer a proportion of profits to specify accounts which can be used for investments and lending purposes of selected activities.
- The strict guidelines for maintenance of non-performing loans (NPL) were also helpful to maintain levels of loans as well as to reduce the risk arising from delivery of credit.
- Improving of the financial structure with systems, such as business continuity planning, commencing of risk based supervision and the first time implemented measures such as Know Your Customer (KYC) policy for banks were the other prudential measures implemented by the CBSL to avoid the impact of the crisis.
- Licensed Commercial Banks were instructed not to effect pre-payment of import bills in order to minimize the pressure on external reserves. The CBSL imposed a 100 per cent margin on specific items to avoid possible un-healthy speculation in foreign exchange

transactions and to help minimise the risks of banks.

- As a measure to avoid the impact of crisis on financial institutions, the CBSL also appointed managing agents for some banks and finance companies. The directions on the existing Boards of Directors prevented possible un-healthy situations in operations of financial institutions. It also helped to minimise the risk of banks.
- The CBSL also placed limits on the borrowings of commercial banks and introduced credit guarantee schemes for bank loans granted to registered finance companies and specialized leasing companies. This was also helpful to protect banks from falling into vulnerabilities.
- Under the legal arrangements several laws relating to financial institutions were amended and guidelines for banks issued. Some guidelines imposed limitations on payments to executive staff.
- The liquidity problems of some of the domestic banks (eg. Seylan Bank) and some finance companies arose partly due to drying up of external credit lines for their operations. Those were resolved by measures directing them to issue shares and banks to get listed in the Stock Exchange. Measures were taken to restructure and recapitalize distressed banks. Capital raising measures, additional capital infusion and appointment of Board of Directors were recommended by the restructuring process. The financial condition and soundness of non-bank financial institutions improved. The minimum capital requirements for non-bank financial institutions were increased. Also CBSL, in conjunction with The Ministry of Finance, introduced special stimulus packages to assist troubled finance companies.
- The law required to regulate and supervise micro financial institutions was being amended. It was proposed to establish a statutory body to look after the interest of microfinance business and to regulate and supervise institutions which are engaged in microfinance businesses. The systems such as scripless securities settlement (SSS) system, real time gross settlement system (RTGS) and cheque imaging and truncation (CIT) system were strengthened for the system stability. During the period under reference, business continuity arrangements were strengthened. Regulations with regard to mobile payments and international banking were drafted. Work was in progress in regard to establishment of a national payment system to facilitate electronic retail payments.
- Investor awareness programmes and advertisements by CBSL were also helpful in creating public confidence thus avoiding panics which are harmful to the stability.

These carefully thought and timely implemented measures by CBSL with the government contributed towards ensuring public confidence to maintain stability.



## Other Measures

The following are the other measures taken by the CBSL in order to maintain macro economic stability of the country.

- The restrictions on movements of foreign capital flows in Sri Lanka such as permitting the deposits in foreign currencies under specific schemes, requirement of prior approvals for debt capital and other capital transactions and permitting investments in shares through share investment external rupee account, and requirement to maintain foreign currency deposits subject to certain limits helped to minimise adverse impacts of the US finance crisis. Foreign investments in government securities are subjected to a total cap of 10 percent of outstanding government securities. Although, the CBSL opened the Treasury bill and Treasury bond market to foreigners, these limits were helpful to avoid any threat to external finance from a sudden capital flight. Requirement of foreigners to open a separate account in a licensed commercial bank in Sri Lanka and the permitted limit at 10 percent of the total value of outstanding Treasury bills and Treasury bonds were helpful in preserving Sri Lanka's reserve position.
- The regulatory mechanisms implemented in the country for releasing of foreign exchange only for importers who have licenses issued by Controller of Imports and Exports was also another contributory factor to manage foreign currency situation. There are limits in respect of capital transfers, which have been changed from time to time. Capital account has been prevented from falling into vulnerabilities through these control measures. These policy measures have been helpful in preventing sudden capital outflows from Sri Lanka.
- CBSL has implemented some measures, such as allowing limited entry into forward contracts for sale and purchase of foreign exchange, preventing pre-payment on import bills and raising margin deposit requirements against Letters of Credit for importing motor vehicles under the Central Bank's vigilance to maintain a stable exchange rate. These policies were helpful to relieve the pressure on external reserves which could have impacted due to volatility in the domestic foreign exchange market.
- Further, as a measure to reduce the pressure on the real sector, the CBSL, considering the significant adverse impacts on domestic economy, favoured a limited depreciation of the Sri Lankan rupee against foreign currencies. As a result, the export sector was not affected too much during the crisis period. The imposition of 100 per cent cash requirement on Letters of Credit opened for the imports of some specific items was also helpful to reduce the outflow of foreign exchange during the crisis period.
- The maintenance of CBSL's reserves with highly rated international commercial banks ensured 100 percent security and safety of country's reserves. The earnings of foreign currency investments in the international market enabled CBSL to supply a part of the



foreign exchange requirement to meet the demand for external funds. Also, the CBSL revised its operating instructions issued to authorized dealers in respect of foreign currency sales and purchases enabling the banks to prevent any kind of misuse of foreign currencies. Therefore, the foreign currency dealers are bound to do their business under strict guidelines issued by the CBSL, which helped to maintain safety in external positions.

- CBSL intervened in the foreign exchange market in such a way that it stabilised the exchange rate during the crisis period. During the first four months of 2009 increased foreign exchange outflows exerted the pressure on the exchange rate to depreciate and CBSL supplied foreign exchange. Increased inflows since May 2009 exerted pressure to appreciate the exchange rate and CBSL intervened to maintain stability by buying foreign exchange from the market, issuing regulations and using moral suasion.
- CBSL's issuance of directions to commercial banks on releasing of foreign currencies for travel and other purposes depending on the purpose was another measure to protect foreign currencies of the country. The requirement of producing documentary evidence was helpful to regulate the movements of foreign exchange transactions.
- In order to create confidence among investors/public, CBSL created a sinking fund thus avoiding undue pressure from withdrawals in the exchange market.

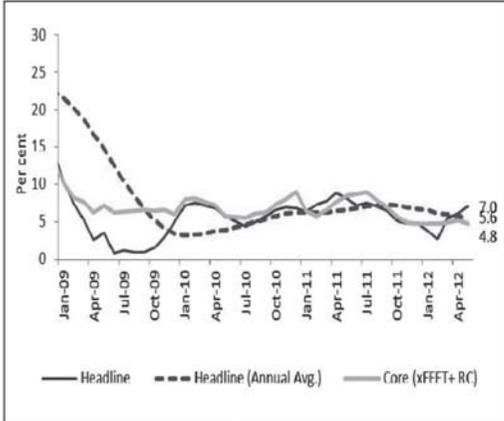
As a result of all these measures by the CBSL (of course with the help of government too), helped preserving macro economic stability of the country. The following section analyses some results of these measures implemented.

#### **4.0 Stability Achieved due to Measures**

Price stability was maintained due to prudent macroeconomic policies. Inflation was under check and maintained at a low level between 4.7 per cent (year-on-year) and 8.8 per cent in 2011 compared to 28.2 per cent in June 2008 (Figure 1). As shown in Figure 2, variations of inflation are more or less stable after November, 2009. This was due to money supply growth being kept under control and remaining within the targets. The relaxed monetary policy stance allowed credit to expand while managing excess liquidity which arose from absorption of foreign exchange inflows which increased as a result of issue of sovereign bonds, increase in net foreign investments in government securities and other inflows of foreign exchange for both the government and the private sector.

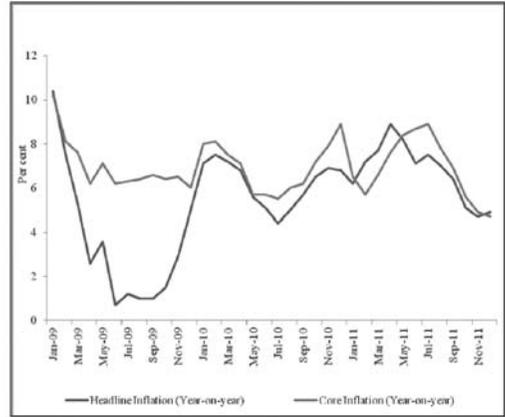


**Figure 1**  
Movements of Head Line and Core Inflation



Source: Central Bank of Sri Lanka

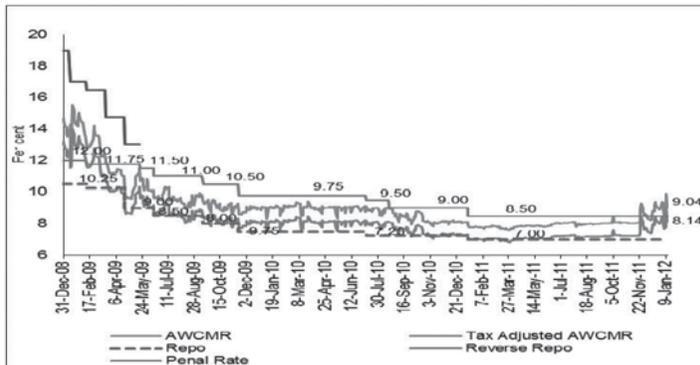
**Figure 2**  
Variations of Head Line and Core Inflation



Source: Central Bank of Sri Lanka

Under the relaxed monetary policy, the CBSL reduced its policy interest rates several times which resulted in downward adjustments in market interest rates. Due to monetary policy implementation, the interest rates stability was maintained. During the crisis period interest rates were highly volatile. However, during 2009-2011 the market rate (call money rate) was behaved within the policy interest rate corridor showing stability in the interest rates (Figure 3).

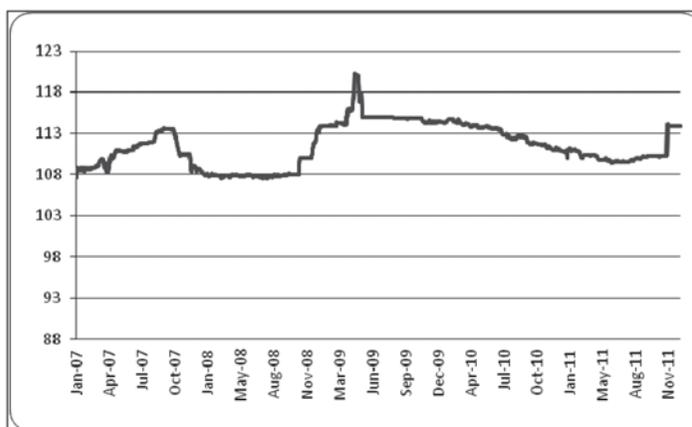
**Figure 3**  
Inter-Bank Market Rates and Policy Rates



Source: Central Bank of Sri Lanka

The volatility in the exchange rate experienced prior to 2008 was minimized by intervention in forex market by the CBSL. As seen from the Figure 4 the LKR per US\$ recorded limited changes, specially after 2009. Due to external sector policies, coupled with impressive level of foreign remittances, especially from the Sri Lankans working abroad and due to government foreign borrowings country's external reserve position improved. External reserves, which dropped to the level of 1.8 months (sufficiency for import of goods and services in 2008), rose to a sufficiency of 5.9 months in 2010. Total external reserves at end of 2011 amounted to US \$ 5.958 million. (Figure 4, Figure 5)

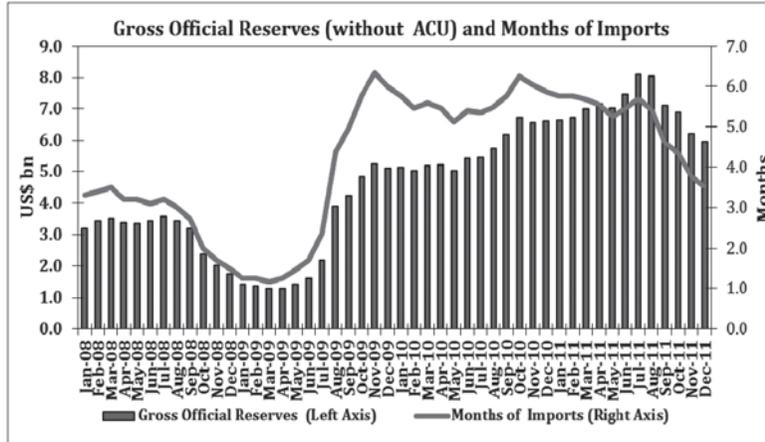
**Figure 4**  
**Movements of Rupee per USD - 2007-2011**



Source: Central Bank of Sri Lanka



**Figure 5**  
**Gross Official Reserves (without ACU) and Months of Imports**



Source: Central Bank of Sri Lanka

The BOP showed a noteworthy improvement starting from the second half of 2009. The country's BOP, which was in a deficit of US \$ 1,225 mn at end of 2008 improved to a surplus of US\$ 2,725 mn in 2009 and to US \$ 921 mn in 2010 along with supportive macroeconomic policies that were implemented. The inflows of foreign exchange increased due to several reasons including receipt of the Standby Arrangement from the IMF, floating of 2<sup>nd</sup> international sovereign bond of US \$ 501 mn in October 2009, and foreign investments due to renewed investor confidence and stable exchange rates. Coupled with these, low international interest rates encouraged foreign inflows to government securities, which attracted US \$ 1,369 mn inflows in 2009 as against net outflow of US\$ 213 mn in 2008. In 2010 the third international sovereign bond of US \$ 1.0 bn with a tenure of 10 years was floated successfully. However, BOP turned into a deficit in the last quarter of 2011 due to adverse global developments.

Improved socio-economic conditions after concluding the war and favourable developments in political environment in the country were helpful to increase output of factory industry and services sector along with revival of demand from both external and domestic sectors. These conditions resulted in an improved performance of the Colombo Stock Exchange (CSE) in which market capitalisation increased to Rs.2.2 trillion at end of 2010 from Rs. 1 trillion at end of 2009 showing a rise in the ratio of market capitalisation/GDP to 42 per cent in 2010 compared to 23 per cent in 2009. Share price indices increased substantially during 2010 resulting in the CSE becoming one of the best performing markets in the world. (Figure 6)

**Figure 6**  
**All Share Price Index (ASPI), Milanka Price Index (MPI) and**  
**Market Capitalization of the Colombo Stock Exchange**



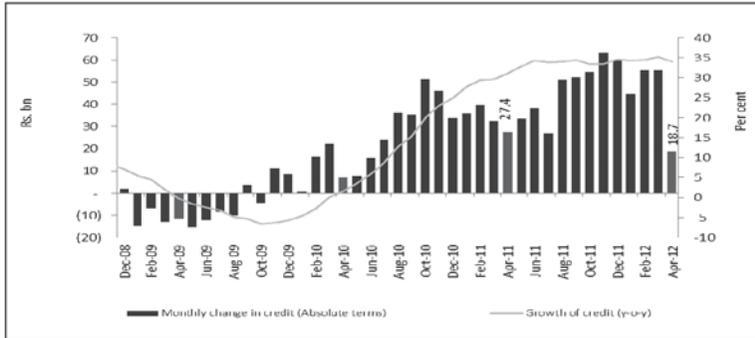
*Source: Central Bank of Sri Lanka*

The increase in domestic economic activities and strong recovery in imports increased government revenue which as a percent of GDP increased to 14.6 per cent in 2010. The overall budget deficit declined to 7.9 per cent of GDP in 2010 compared to 9.9 per cent of GDP in 2009. This was helpful in reducing borrowings from domestic banks and therefore, in conducting monetary policy.

The banking sector was resilient to external and domestic developments. No bank in Sri Lanka collapsed due to the financial crisis in the world. Financial System stability improved due to implementation of supportive regulatory and supervisory measures. Investor confidence improved and schemes such as mandatory deposit insurance helped improve confidence among the public. Banks operated soundly and profitability and capital adequacy of banks increased (Figure 7). Performances of finance companies in distress also improve in 2010 and 2011. Credit to private sector from banks grew and economic activities reactivated (Figure 8). Coupled with these developments plus a supportive regulatory and supervisory framework ensured improved performances in the financial sector and system stability.

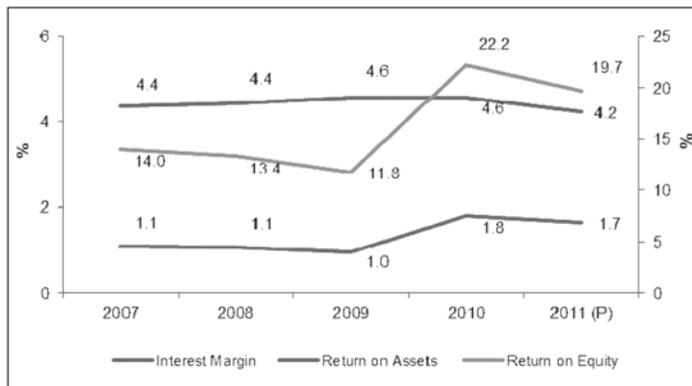


**Figure 7**  
**Volume and Growth of Loans and Advances to the Private Sector by Commercial Banks**



Source: Central Bank of Sri Lanka

**Figure 8**  
**Profitability of the Banking Sector**



Source : Central Bank of Sri Lanka

Banking services expanded. Expansion in financial institutions (Table 2) at the grass root level provided better services to the public. Bank branch networks expanded to grass root level, particularly to the North and East areas, which had suppressed financial performances due to unsettled conditions for many years. Payment and settlement systems with state-of-the-art technology ensured confidence and convenience in financial transactions/services.

**Table 2**  
**Improvements in Selected Financial Services**

Item	End 2009	End 2010	Change in 2011	
			Total	Of which: North & East
Bank Branches	1,847	1,970	122	35
Other Banking Outlets	3,831	3,951	79	26
Registered Finance Companies including leasing	434	600	104	23
ATMs	1,876	2,020	220	n.a
RTGS transactions (volume '000)	233	247	20	n.a

*Source: Central Bank of Sri Lanka*

As a result of the conducive environment for economic activities, the economy grew at a faster pace. Unemployment rate declined to 4.9 per cent in 2010 which was 8.8 per cent in 2002. Economic growth at 8 per cent in 2010 and 8.3 per cent in 2011 showed the results of the recovery was satisfactory after the economic crisis of 2008-2009 (Table 3).

**Table 3**  
**Quarterly Growth and Unemployment**

Item	End 2009	End 2010	Change in 2011	
			Total	Of which: North & East
Bank Branches	1,847	1,970	122	35
Other Banking Outlets	3,831	3,951	79	26
Registered Finance Companies including leasing	434	600	104	23
ATMs	1,876	2,020	220	n.a
RTGS transactions (volume '000)	233	247	20	n.a

*Source: Central Bank of Sri Lanka*



However, the progress achieved by Sri Lanka was not only due to policies implemented to recover from the financial crisis but also due to persistent favourable socio economic conditions, including the conclusion of the civil war which was fought for a period of three decades. Monetary and fiscal policies implemented during 2008-2011 also helped in achieving a remarkable performance of the economy.

## 5.0 Conclusions

This paper analysed the stability of the financial sector and related activities of the Central Bank of Sri Lanka along with results of measures implemented while explaining the theoretical base to them. The Central Bank of Sri Lanka's objectives are to maintain price, economic and financial system stability of the country. The paper concludes that mainly due to measures implemented by the Central Bank of Sri Lanka during the period from 2007-2011, the Bank was successful in maintaining price, economic and system stability, thus responding positively to migrate from vulnerabilities. However, this was not only due to CBSL interventions but also due to certain other factors such as, limited openness of the financial sector to external sector and existing peaceful environment of the country. The study used macro economic indicators such as inflation, interest rates, exchange rate for USD, external reserves, price movements in the stock market, credit to private sector by banks, services provided to financial sector and growth and employment to show the stability was achieved in price, economic and financial system avoiding vulnerabilities.

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