PROFESSOR H.A. DE S. GUNASEKERA MEMORIAL ORATION 2017

24th October 2017

at

3.00pm

Senate Room
University of Peradeniya

The Professor H.A. de S. Gunasekera Memorial Oration 2017

Programme

3.00-3.05 **Opening Ceremony**

3.05-3.10 **Welcome and Introductory Remarks**
Head, Department of Economics and Statistics

3.10-3.15 **Vice Chancellor's Address**
Vice Chancellor, University of Peradeniya

3.15- 3.20 **Introducing the Speaker**
Dean, Faculty of Arts

3.20-4.20 **Oration**
Prof. Sirimevan Colombage
Open University of Sri Lanka

4.20-4.30 **Vote of Thanks**
Secretary, Prof. H.A. De. S. Gunasekera
Memorial Trust Fund

4.30- 5.00 **Refreshments**
Committee Room, Senate Building

Professor H.A. de S. Gunasekera Memorial Oration 2017

The Political Economy of Central Banking in Sri Lanka

Sirimevan Colombage

Emeritus Professor
Open University of Sri Lanka

Abstract

It is the prime responsibility of the central bank to insulate monetary policy from the pressures of inflation-biased and electorate-targeted populist policies of political authorities, and to execute its policy instruments independently to achieve price stability. Hence, central bank independence is considered crucial. In this oration, I explore how far the Central Bank of Sri Lanka has been able to conduct monetary policy independent of political pressures. I find that amid fiscal dominance, the Central Bank has been severely constrained in adopting rule-based decisions, and as a result, monetary policy has been discretionary and pro-cyclical. Inflation targeting will not be successful without enforcing stringent fiscal rules for which unwavering political commitment is imperative. The use of the exchange rate as a nominal anchor in the context of capital flows has compelled the Central Bank to give up independent monetary policy.

Delivered on 24th October 2017 at the University of Peradeniya

Professor H.A. de S. Gunasekera Memorial Oration 2017

The Political Economy of Central Banking in Sri Lanka

Sirimevan Colombage

Vice Chancellor, Deputy Vice Chancellor, Deans of the Faculties, Heads of Departments, Administrative Officers, members of the Gunasekera family, members of the Prof. H. A. de S. Gunasekera Memorial Trust Fund, Ladies and Gentlemen, friends and students.

I consider it a great privilege and an honour to deliver the Professor H. A. de S. Gunasekera Memorial Oration to pay tribute to our most respected teacher, scholar, top-level administrator and policymaker.

This year's oration is even more significant, as it coincides with the 75th Anniversary Celebrations of the University of Peradeniya and that of the Department of Economics. I take this opportunity to extend my best wishes to this prestigious University and the Economics Department from where I began my academic life.

Before turning to the subject matter of my oration, I would like to highlight why this is a special occasion for me.

Preamble

I was fortunate to be in the last batch of students taught by Prof. Gunasekera at Peradeniya. Our batch graduated in 1969, and Prof. Gunasekera moved from Peradeniya to take up the position of Secretary, Ministry of Planning and Economic Affairs in early 1970. The Economics Department during that time was in a warehouse-type building of the colonial era, whereas all other departments in the Arts Faculty, as well as in other faculties were located in more elegant buildings reflecting Kandyan architecture. Ours was the most

economical building in the university, perhaps symbolizing the subject we learned – Economics! But that outmoded building was never a negative factor in our learning function in the midst of inspiring teachers headed by Prof. Gunasekera.

Prof. Gunasekera led a simple life, setting an example of Mahathma Gandhi's ideal: "plain living high thinking". I recall with gratitude how lucidly he taught us the rigorous theories of Monetary Economics. He explained John Maynard Keynes's classic, *The General Theory of Employment, Interest and Money*, word for word. Eventually, we became Keynesians by the time we graduated! The stern-looking professor compelled us to master the advanced literature on the subject in the vast university library. That helped us in a big way to enrich our knowledge and ability not only to pursue higher studies and research, but also to actively engage in policymaking in the complex field of economics in later years.

After graduation, I worked for a short period as an Assistant Lecturer here at Peradeniya. However, circumstances prompted me to join the Central Bank as an economist. Having heard about my move, Prof. Gunasekera called me to his office in the Planning Ministry, and insisted that I should go back to Peradeniya. That did not in any way mean that I was indispensable, but it was mostly a reflection of the kindness of a mentor. That was Prof. Gunasekera. But I could not comply with his request. I regretted my decision at times, given the rigid bureaucratic atmosphere in the Central Bank vis-à-vis free academic life in the soothing environs at Peradeniya.

Having returned to academia followed by a long spell in the Central Bank, I have had the rare opportunity to reflect on both monetary theory in textbooks and monetary policy in practice. That is one reason why I have chosen this topic focusing on the Central Bank for today's oration. The other reason is that central banking was at the very centre of the scholarly work of Prof. H.A.de S. Gunasekera. His book, '*From Dependent Currency to Central Banking in Ceylon: An Analysis of*

Monetary Experience 1825-1957', which was based on his doctoral thesis at the London School of Economics, remains a seminal contribution to date in the field of central banking and monetary policy.

He asserted, in his book, that the Central Bank had not justified its existence in its formative years, as it had failed to prevent the volatility of money supply emanated from fiscal deficits and export fluctuations. These arguments of Prof. Gunasekera, on the limitations of the central bank in a developing economy saddled with the twin objectives of economic development and stabilization, still remain valid.

Now, let me begin my address on the theme, "The Political Economy of Central Banking in Sri Lanka".

1. Introduction

The relationship between the central bank and the government varies from country to country. There is a general consensus that a country's central bank should be completely independent from the government, as political pressures could hurt the bank's ability to conduct sound monetary management aiming at price stability, which has surfaced as the core responsibility of the monetary authority nowadays. The alternative view is that the central bank should be under the direct control of the government since the bank should respond to the will of the people in a democratic society. In practice, however, central banks operate between these two extreme paradigms, and enjoy different degrees of independence in each country.

Political authorities usually have a tendency to incur high government expenditure for populist welfare measures, offering various subsidies and income transfers to households and creating jobs in the public sector, so as to retain their electoral vote base. These policies lead to large budget deficits which are then financed through borrowings.

The unfinanced portion of the deficit has to be accommodated by the central bank which has the ability to use its monopoly power to create 'fiat money', to lend to the government.[1] Revenue generation by the government through money creation, known as 'seigniorage', results in an increase in the central bank's monetary base, which brings about a multiple expansion of the aggregate money supply, causing inflation. In order to insulate monetary management from such inflation-biased political pressures, central bank independence becomes crucial. It is broadly recognized that more independent central banks perform better in achieving their main objective – price stability.

As the country's monetary authority, the Central Bank of Sri Lanka (CBSL) is entrusted with the tasks of issuing currency and implementing monetary policy, among other functions. Although the CBSL was set up as an autonomous body, it was expected to coordinate with the government in policy implementation. Accordingly, the CBSL has been conducting monetary policy within the frameworks of the economic ideologies of different political regimes over time.

The CBSL has faced many challenges in implementing monetary policy in liaison with the political authority, as political economy exerts considerable pressure on monetary policy. The government's continuous dependence on expansionary financing to meet its budget deficit is a recurring problem faced by the CBSL. Hence, coordination between monetary and fiscal policies has always been difficult.

In this oration, I explore how political economy has influenced central banking in Sri Lanka. My presentation is organized as follows. Section 2 presents an overview of the evolution of central banking in Sri Lanka. Section 3 examines central bank independence. Fiscal dominance over monetary policy is discussed in Section 4. In Section 5, I will focus on the dilemma of rules versus discretion in the conduct of monetary

[1] Fiat money or paper money is not backed by any commodity such as gold. Fiat money became popular after the collapse of the Bretton Woods system in 1971, when the U.S. government ceased conversion of the dollar into gold.

policy in Sri Lanka. Section 6 examines how the CBSL has conducted exchange rate management. The final section presents conclusions.

2. Evolution of Central Banking in Sri Lanka

At independence, the Currency Board system managed the money supply of Sri Lanka (then Ceylon). The Ceylon rupee was indirectly linked to the sterling pound through the Indian rupee. The amount of Ceylon rupees issued was positively related to the reserve stock of Indian rupees. A major drawback of the Currency Board system was that the link between the level of reserves and the money supply prevented managing domestic liquidity to meet domestic needs (Gunasekera, 1952). Hence, it was decided in the late 1940s to establish a central bank to meet the growing financial needs in the post-independence economy.

In response to a request made by the government, the Federal Reserve System of the United States assigned its economist, John Exter, to frame proposals for a draft constitution to set up a central bank. Exter who arrived in Ceylon in 1948 finalized the report in the subsequent year. The Monetary Law Bill based on the Exter Report was passed in to law in the Parliament as the Monetary Law Act (MLA) No. 58 of 1949. Accordingly, the Central Bank of Sri Lanka (CBSL) was established in 1950 as the monetary authority marking an important turning point in the country's economic and financial landscape. [2]

At the second reading of the Monetary Law Bill in the Parliament in 1949, the following statement made by the then Minister of Finance J.R. Jayawardene capsulizes what I am going to discuss now:

> "it is very difficult to say that the Central Bank should be entirely a department of the Government or subservient to

[2] The Bank had been called the Central Bank of Ceylon until it was renamed as the Central Bank of Sri Lanka by an amendment to the Monetary Law Act in 1985.

> the Government. We have tried as far as we could, in this Act, to make the Central Bank or at least the Monetary Board, independent, as far as its advice is concerned. We want it to consider the problems of Ceylon … to see how far it is necessary that the credit structure of Ceylon should be influenced for the purpose of full employment and the balance of payments. We want it to consider this question apart from political considerations and give its advice without fear or favour to the government. But, ultimately, in the last analysis, I think it would be admitted that the Monetary Board cannot come into direct conflict with the government." [3]

The CBSL has had to adjust its role and functions to suit the ideologies and economic thinking of the alternative political parties that came to power after each parliamentary election. Accordingly, the focus of the monetary policy, in tandem with the national economic policy strategy, oscillated from to time between two broad objectives – economic development and economic stability. Theoretically, these two objectives are complementary, but they may conflict with each other in actual practice. This dilemma is reflected in the country's monetary management throughout the post-independence period.

In the initial phase of 1950-1959, stabilization was the major focus of monetary policy. The economy was open to foreign trade. A major challenge faced by the CBSL in the first half of the 1950s was to neutralize the expansionary impact of the export surpluses on the money supply. This was the only period that the country experienced monetary expansion from a surge in foreign exchange inflows. Since then, government borrowings became the main driver of money supply growth. The CBSL used open market operations (OMO) by selling government securities, but it was unsuccessful due to its limited portfolio of such securities. Since then OMO disappeared for a long

[3] Parliamentary Debates (Hansard) Vol. 7 No. 10, November 22, 1949, p.721.

time, and reemerged only in the 1990s as the most widely used monetary policy instrument thereafter. The Statutory Reserve Ratio (SRR) was also used in the 1950s to reduce liquidity.

By the late 1950s, banks faced tight liquidity conditions due to the balance of payments deficits and heavy government borrowings. The Bank Rate was raised to discourage commercial bank borrowings from the CBSL.[4] But the Minister of Finance, exercising his authority under the Monetary Law Act, directed the CBSL to withdraw the rate hike. It is recorded as the first instance of political interference in monetary policy which caused adverse effects on economic stability.

The CBSL changed its policy stance dramatically during the period 1960-1965 to suit the prevailing leftist political ideology that was oriented towards nationalization, stringent administrative controls and import substitution. Concurrently, the focus of monetary policy was shifted from the stabilization objective to the development objective. The nationalization of the Bank of Ceylon and the establishment of the People's Bank in 1961 made a significant impact on the financial sector. The CBSL raised the SRR on bank deposits as a major contractionary policy measure. Multiple interest rates were fixed for different credit purposes. Selective credit controls were a major policy instrument used during that period. The CBSL provided concessionary financial assistance for priority areas under special schemes.[5]

Partial trade liberalization was implemented during the period 1965-1970 with the devaluation of the rupee in 1967. It was the first time that the exchange rate was adjusted since the establishment of the CBSL in 1950. A dual exchange rate system, known as the Foreign Exchange Entitlement Certificate Scheme (FEECS), was introduced in 1968 to promote non-traditional exports and to discourage non-essential imports. Import restrictions were partially relaxed with accompanying revisions in import tariffs.

[4] The CBSL raised the Bank Rate from 2.50 percent to 3.00 percent in December 1959.
[5] In 1964, the CBSL established the Medium and Long-Term Credit Fund for the purpose.

The government that came to power in 1970 adopted socialist-oriented policies, and intensified import and price controls that had been in effect before 1965. The Five-Year Plan (1972-1976) launched in 1971 formed the basis for centrally-planned economic strategies.[6] The period 1970-1977 saw the most stringent trade restrictions and other administrative controls ever to be implemented in Sri Lanka. The dual exchange rate system was continued. Following the breakdown of the Bretton Woods system in 1971, the exchange rate depreciated gradually. By 1977, the country faced a severe economic crisis with food shortages and foreign exchange shortfalls.

Central banking and monetary policy underwent considerable reforms following the adoption of the far-reaching economic liberalization package in 1977, which was linked to a financial programme with the International Monetary Fund (IMF).[7] An export-led growth strategy was introduced in place of the import substitution strategy. The main elements of the liberalization package included the removal of import and exchange controls, financial sector liberalization and attracting foreign capital inflows. Interest rates were allowed to fluctuate in response to market forces. Simultaneously, a flexible exchange rate system was introduced, in place of the fixed exchange rate regime.

The CBSL reformulated its monetary policy by moving away from direct controls to market-based tools so as to match the liberalized economic environment. It gradually eliminated credit controls and overall credit ceilings. The policy of maintaining administratively-determined low interest rates was abandoned in line with the emerging theoretical developments relating to financial repression.[8] Accordingly,

[6] Prof. H.A.de S. Gunasekera, as the Secretary to the Ministry of Planning and Economic Affairs, played a leading role in formulating the Five-Year Plan.

[7] The government entered into agreements with the IMF for a Standby Arrangement in 1977 and for an Extended Fund Facility in 1979. These were supplemented by another Standby Arrangement in 1983 and a Structural Adjustment Facility in 1988.

[8] McKinnon (1973) and Shaw (1973) were the first to explain the notion of financial repression. It refers to a set of government regulations, laws and other non-market restrictions that prevent the financial intermediaries of an economy from functioning at full capacity. The policies that cause financial repression include interest rate ceilings, liquidity ratio requirements, high bank reserve requirements, credit ceilings and directed credit allocation.

upper ceilings on interest rates were removed, and the Treasury Bill rate was allowed to fluctuate within a narrow margin since 1981. The SRR continued to be a major policy instrument. The use of the Bank Rate was abandoned.

In the early phase of liberalization up to around 1989, the CBSL had to cope with fiscal deficits that had considerable adverse consequences on macroeconomic fundamentals. Therefore, both development and stabilization objectives became important in monetary policy formulation during that period.

Since the early 1980s, the CBSL has used monetary targeting (MT) in its monetary policy framework with an extensive use of OMO. Accordingly, the final target of economic and price stability was to be achieved through an intermediate target of the broad money supply which, in turn was linked to the operating target – reserve money. The Treasury Bill market expanded due to several initiatives including weekly primary auctions, appointment of accredited dealers, and the creation of a Repurchase (Repo) market.

The second wave of economic reforms that began in 1989 focused on deeper reforms relating to financial sector liberalization, privatization and public-sector restructuring. Economic stability became the prime objective of monetary policy from 1989 onwards since it was recognized as a prerequisite to achieve economic growth.

The year 2001 marked a major turning point in monetary policy with the adoption of a freely floating exchange rate system. In 2002, the Monetary Law Act was amended to consolidate the functions of the CBSL to achieve two objectives, i.e. (*a*) economic and price stability, and (*b*) financial stability. In March 2003, as a major policy reform, the CBSL shifted to an active OMO system. [9]

[9] In order to ascertain the underlying trend in inflation for monetary policy purposes, the measure of 'core inflation' has been compiled in Sri Lanka since 2002. Core inflation is computed by removing food and energy items from the conventional 'headline inflation'.

In Sri Lanka, the MT framework has become somewhat ineffective, as in the case of many other countries, due to the instability of the money multiplier caused by the endogeneity of money supply (Colombage 2011).[10] Fast developing financial technology, which has given rise to E-money and E-banking, makes monetary management even more difficult.[11] In view of the shortcomings of the MT framework, a number of countries have been shifting towards inflation targeting (IT) as their monetary policy framework during the last two decades. In line with global trends, the CBSL is now in the process of reforming its monetary policy framework to align it with a flexible inflation targeting (FIT) framework. At present, it uses an enhanced monetary policy framework incorporating both MT and FIT features.

3. Central Bank Independence

It is widely recognized that a sufficiently high level of central bank independence (CBI) is desirable to achieve price stability, which is the sole objective of modern central banks.[12] The most prominent argument put forward in favour of CBI is the time inconsistency problem (Kydland and Prescott, 1977).[13] This problem arises when a policymaker prefers a certain policy to be implemented in a future period, but it is no longer desirable when that period actually comes. So, the policymaker has to revise the pre-announced plan. As regards monetary policy, the time inconsistency problem occurs when politicians attempt to manipulate the trade-off between unemployment vis-à-vis inflation. In order to retain popularity ahead of an election, the government may be tempted to reduce interest rates so as to induce employment. This helps to boost employment and incomes in the short-run delivering the anticipated gains to politicians, but it causes inflation

[10] Our estimates based on the Vector Error Correction Model (VECM) and Impulse Response Functions reveal that the money multiplier, which was thought to be exogeneous, is in fact, influenced by commercial bank credit.
[11] The potential growth of E- money and E-banking in Sri Lanka is analyzed in Colombage (2009, 2010).
[12] In the literature, the term 'autonomy' is used interchangeably with the term 'independence'. Autonomy implies operational freedom while 'independence' entails lack of institutional constraints.
[13] Further contributions were made in Barro and Gordon (1983) and Rogoff (1985).

in the long run. The necessity to maintain central bank autonomy implies, in a way, that political authorities are not trustworthy. Empirically, it is found that countries with independent central banks experience lower inflation as compared with countries with government-controlled central banks.[14]

Various indices have been used in empirical studies to measure the relationship between CBI and inflation. Most empirical studies on the autonomy of central banks are based on legal or *de jure* independence. However, it should be emphasized here that legal provisions are necessary for autonomy, but not sufficient. The reason is that central bank independence in actual practice or *de facto* may be quite different from what is laid down in law.

The most widely used CBI index is the one developed by Cukierman (1992) and Cukierman *et al.* (1992).[15] This index is based on four characteristics of the central bank's charter. They are: (*a*) terms and conditions of appointment and dismissal of the governor, (*b*) government's involvement in policy decisions of the central bank, (*c*) importance given to the price stability objective in the charter, and (*d*) limits on government borrowings from the central bank.

Let us now examine how far the CBSL is autonomous with respect to the above norms. In terms of Section 8(1) of the MLA, the Monetary Board is responsible for powers, duties, functions and management of CBSL. At present, the Board has five members consisting of the Governor as the Chairman, Secretary to the Ministry of Finance and three appointed members.[16] In terms of Section 12 of the MLA, the Governor of the CBSL is appointed by the President on the recommendation of the Minister of Finance. The three appointed

[14] For example, Klomp and de Haan (2010), based on their meta-regression analysis, conclude that there is a significant 'true effect' of CBI on inflation.
[15] Alternative indices have been developed by Alesina (1988) and Grilli *et al*. (1991)
[16] The size of the Monetary Board was expanded to five members in 2002. Until then, it consisted of three members since its inception, except for the period 1974-1977 when the Board was expanded to four members to include the Secretary to the Ministry of Planning and Economic Affairs who happened to be Prof. H.A. de S. Gunasekera.

members are also assigned on the same basis. Thus, the government has direct influence over these appointments.

The Governor is expected to fall in line with the ideology and policies of the government, and therefore, the affiliation with the political authority is an obvious criterion in choosing the individual for the post. Persons who had held the post in the earlier decades displayed much integrity, reflecting their sound professional background and strong personalities. This enabled the CBSL to keep its distance from politics. The cultured political environment prevalent during that period also helped to nurture professional central banking. The situation, however, has deteriorated over the last two decades with undue involvements of Governors, in what I call, 'monetary politics'.[17]

A positive factor that helps to strengthen the autonomy of CBSL is the longer term of office of the Governor, which is six years. Usually, a term of office exceeding five years is considered helpful to retain autonomy (Cukierman, 1992). The three appointed members also have a six-year term. The autonomy is further ensured by the law that the Governor or an appointed member cannot be removed for reasons other than those specified in the MLA, and such removal is directed by the President on the recommendation of the Minister of Finance.

The Secretary (earlier, Permanent Secretary) to the Ministry of Finance is an *ex-officio* member of the Monetary Board since its inception. This displays the desire of John Exter, the architect of the CBSL, to inculcate a cordial relationship with the Government through the Ministry Secretary. The CBSL enjoyed some degree of independence in its initial stages despite the presence of the official representative.[18]

[17] A few years ago, a former Governor was alleged to have been involved in misusing the Central Bank's funds for bidding for the upcoming Commonwealth games and for lobbying for the government abroad. The ongoing investigations on the well-publicized Treasury Bond scandal reveal the government's direct involvement in the bond auctions and a former Governor's close dealings with a market player. These pose major threats to the independence and credibility of the CBSL.

[18] Sir Arthur Ranasinghe, Governor, in a memorandum submitted to the Radcliffe Committee in 1958, stated, "The Central Bank of Ceylon is in its eighth year of existence and has had in practice a wide measure of independence and little interference from the government – the relations between them being cordial and mutually beneficial".

However, by virtue of his position in the Monetary Board, the Secretary has pressurized the CBSL from time to time to accommodate fiscal needs restraining central bank independence.

In the event of any disagreement on monetary policy between the Minister in charge of the subject of Finance and the Monetary Board, the Minister has the authority to overrule the decision of the Board, and to direct the Board to carry out the decision in accordance with the opinion of the government, in terms of Section 116(2) of the MLA. The government is required to accept the responsibility for such policies. This provision has considerably weakened the autonomy of the CBSL as the directives given by the government are likely to be discretionary rather than rule-based.

The independence of the CBSL is severely constrained by the fact that it has to perform multiple roles simultaneously. Apart from the conduct of monetary policy, the Central Bank has to act as the fiscal agent and the manager of the public debt, and also as the manager of the employees' provident fund. At the same time, the foreign reserves of the country come under the purview of the CBSL.

The literature identifies different types of central bank independence such as goal independence and instrument independence. The broadest concept is goal independence which authorizes the central bank to decide its primary objective. It is generally accepted that the goals of monetary policy should be left to be decided by the government, as the elected political authorities are accountable to the electorate (Mishkin, 2011). In the case of Sri Lanka, the objectives of the CBSL are stipulated in the MLA, as discussed earlier.

Instrument independence refers to the central bank's ability to freely adjust policy tools to achieve its goals. The instrument independence of the CBSL has been impeded by a decision taken in 2015 to transfer the subject of central banking and monetary policy from the Ministry of Finance to the Ministry of National Policies and Economic Affairs

headed by the Prime Minister.[19] Accordingly, this Ministry has been assigned the functions of the formulation of monetary policies and macroeconomic management in coordination with the CBSL, and liaising with donor agencies and international financial institutions, among others. The Ministry has also been given the mandate to implement several Acts including the Monetary Law Act, which had been the prerogative of the CBSL.[20] This obviously retards the limited independence enjoyed by the CBSL thus far.

4. Fiscal Dominance over Monetary Policy

Fiscal deficits have been cited as a major cause of persistent inflation in developing countries due to the monetization of a significant share of the deficits that are not financed either by foreign borrowings or domestic non-bank borrowings. Once their governments get stuck with such imbalances, they are compelled to resort to seigniorage, as I have already mentioned. The resulting increase in the CBSL's monetary base increases the aggregate money supply by several times depending on the size of the money multiplier.[21] The excess liquidity causes inflation. In general, governments prefer this type of 'inflation taxation' as it helps them avoid becoming unpopular by mobilizing direct or indirect taxes from its citizens.

As I have already pointed out, freeing the central bank from political interference is essential for price stability. However, several studies suggest that central bank independence is only a necessary, but not a sufficient condition to attain price stability. Presenting his famous presidential address to the American Economic Association in 1968, Milton Friedman, the architect of monetarism, explained what monetary policy can do, and what it cannot. He mentioned that

[19] Gazette Notification No. 1933/33 of September 21, 2015

[20] Other Acts are the Exchange Control Act, Banking Act and Loans Recovery Act.

[21] On the asset side of the CBSL's balance sheet, the monetary base or reserve money can be expressed as follows:

$$B = NFA + NCG + ACB + OA$$

where B = Monetary base; NFA = Net foreign assets; NCG = Net credit to government; ACB = Advances to commercial banks and OA = Other assets. The aggregate money supply is: MS = mB, where m = Money multiplier

monetary policy cannot influence output, employment or real rates of return on assets in the long run. But he stressed that monetary policy can exercise considerable control over inflation in the long run.

Friedman's argument was first challenged by Sargent and Wallace (1981) in their "unpleasant monetarist arithmetic" doctrine. They assert that the government's approach to the problem of fiscal solvency can severely limit the scope available for monetary policy options. If the fiscal authority sets its deficit independently, and when such a deficit cannot be financed solely by selling new bonds, the central bank is compelled to create money and allow inflation to rise.

According to Sargent and Wallace, the extent to which the government's budgetary constraints bind the monetary authority, and thereby limits its ability to control inflation on a permanent basis partly depends on the way fiscal and monetary policies are coordinated. According to them, there are two polar forms of coordination, namely monetary dominance and fiscal dominance.

Monetary dominance prevails when monetary authorities focus entirely on controlling inflation, whereas the fiscal authorities adjust budgetary operations to remain solvent subject to the exogenous flow of seigniorage. Accordingly, the central bank independently sets monetary policy, and thus, determines the amount of revenue that it will supply to the fiscal authority through seigniorage. Monetary dominance can be considered as a situation where monetary policy is 'active' and fiscal policy is 'passive'.

By contrast, fiscal dominance exists when monetary policy is subject to the constraint of providing sufficient seigniorage to the government to ensure fiscal solvency. Under this coordination scheme, the central bank faces the constraint imposed by the demand for government securities, as the bank is compelled to finance with seigniorage, that part of the budget deficit that is not financed by other sources. This

limits the ability of the central bank to control its monetary base and to reduce inflation.

The solution offered in the standard monetarist doctrine to achieve price stability is to make sure that the central bank has an unwavering commitment to price stability. The monetarist doctrine recognizes the importance of both fiscal and monetary policies in achieving price stability. However, it asserts that if the central bank is sufficiently tough, the fiscal authority would be compelled to adopt appropriate fiscal policy.

In the 1990s, several economists have disagreed with the monetarist doctrine, and developed an alternative view to suggest that a committed and tough central bank alone is not sufficient to ensure price stability. According to the 'Fiscal Theory of the Price Level' (FTPL) developed by Woodland (1995), price stability requires not only appropriate monetary policy but also appropriate fiscal policy.[22] According to this theory, the government's choice of how to finance its debt plays a crucial role in the determination of the time path of inflation.

The FTPL has changed the way we think about the role of central banks. It emphasizes that the central bank with the mandate of price stability should not only put its house in order but also should insist that the fiscal authority adopt harmonious budgetary policies to secure price stability. It is just like performing a symphony orchestra with different musical instruments in harmony.

In an effort to arrest fiscal dominance in Sri Lanka, the Fiscal Management and Responsibility Act (FMRA) was enacted in 2002 with a view to introducing fiscal rules. The two prominent objectives stipulated in the Act were (*a*) to reduce the government debt to prudent levels by ensuring the budget deficit does not exceed 5 percent from the year 2006 onwards, and (*b*) that total government liabilities

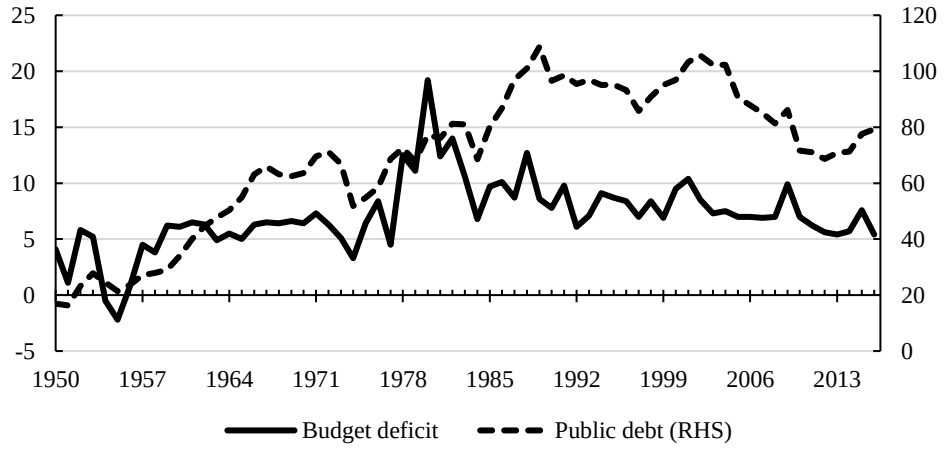
[22] Leeper (1991), Woodford (1994, 1995), Sims (1994, 1999), Cochrane (1998) and Dupor (2000) are the key proponents of FTPL.

(including external debt) do not exceed 85 percent of GDP, commencing 2006, and that they do not exceed 60 percent of GDP, commencing 2013.

However, the fiscal authority has failed to comply with the rules pertaining to the budget deficit and debt, as stipulated in the FRMA throughout the period 2003-2016 (Figure 1). This was due to the rise in recurrent expenditure for social welfare, salaries, interest payments and transfers to loss-making state enterprises. Thus, legal (*de jure*) fiscal targets have little meaning in actual practice (*de facto*). In 2013, the government raised the debt target to be achieved in 2013 from the original limit of 60 percent GDP to 80 percent, and postponed the 60 percent target until 2020.

The limited space available to the government to meet its politically-induced expenditure through revenue or borrowings from foreign and domestic non-bank sources, has triggered monetary accommodation by the CBSL over the decades. Hence, fiscal dominance has been evident in Sri Lanka continuously since the inception of the CBSL. This counteracts the overriding objective of monetary policy, which is price stability.

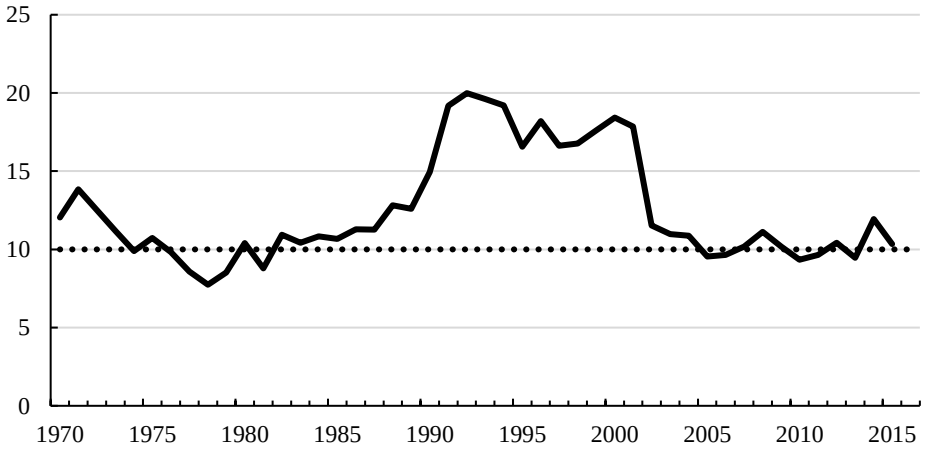
Figure 1: Budget Deficit & Public Debt
(% of GDP)



Source: Central Bank of Sri Lanka, *Annual Reports.*

The lending provided by the CBSL to the government consists of 6-month provisional advances and credit against collateral of government securities. In terms of the Monetary Law Act, 6-month advances should not exceed the statutory limit of 10 percent of government revenue each year.[23] However, this statutory limit has not been strictly followed (Figure 2). The actual amounts of advances disbursed exceeded continuously during the period 1982-2004. Since then it has hovered around the statutory limit.

Figure 2: CBSL's 6-month Advances as % of Government Revenue

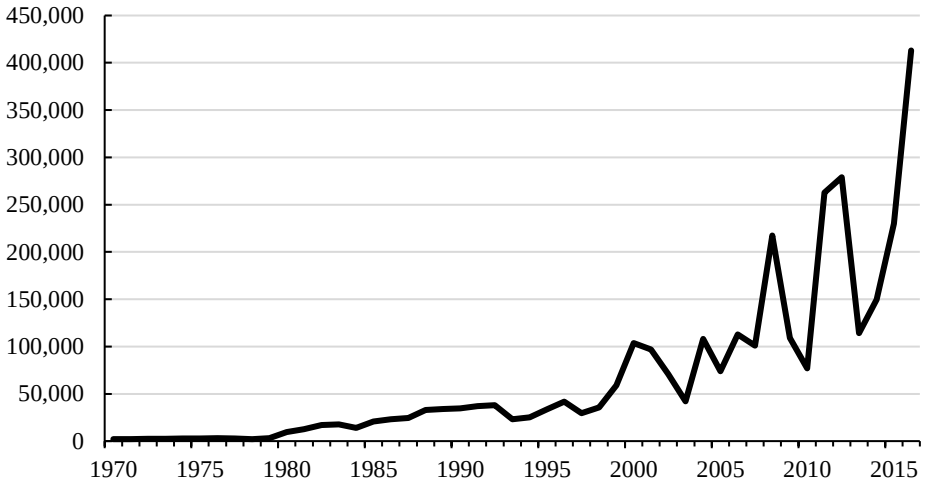


Source: Central Bank of Sri Lanka, *Annual Reports.*

The CBSL purchases Treasury bills in both primary and secondary markets. In some countries, the central bank is prohibited to buy government securities in the primary market as it clashes with monetary policy operations. The total outstanding amount of CBSL's net credit to government shows a phenomenal increase since 2010 (Figure 3).

[23] The CBSL ceased to levy interest on these short-term advances in 1954.

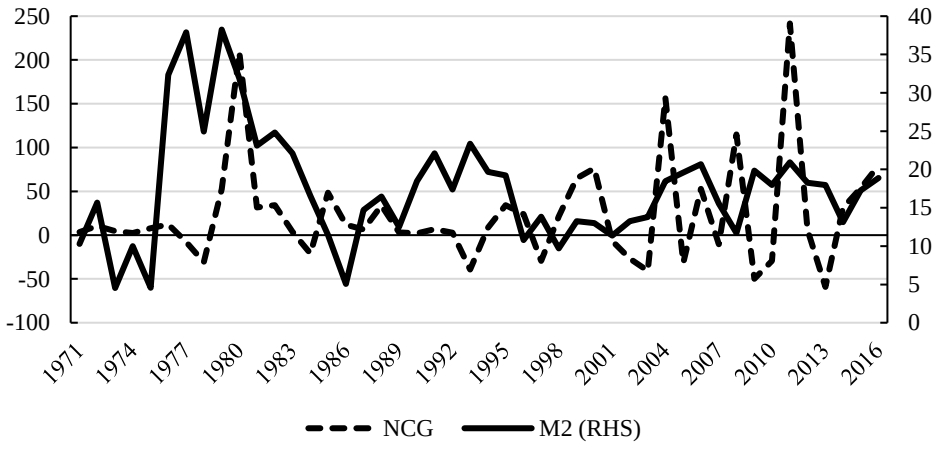
Figure 3: Net Credit to Government, Rs. Mn.



Source: Central Bank of Sri Lanka, *Annual Reports.*

There is a close positive relationship between changes in net credit to the government and money supply growth in Sri Lanka (Figure 4). The correlation coefficient between the two variables is 0.88 for the period 1970-2016. Our cointegration test indicates a long-run relationship between the two variables at the 5 percent significant level.[24]

Figure 4: Net Credit to Government and Money Supply, (% changes)



Source: Central Bank of Sri Lanka, *Annual Reports.*

The government's excessive reliance on 'captive sources' (including the state-owned banks and the employees' provident fund) to finance

[24] Based on the Johansen cointegration test.

fiscal deficits, is another factor that constrains monetary policy.[25] These institutions, which dominate the money market, act as a 'single family' in lending to the government on a large scale at low interest rates. Such lending has detrimental effects on interest rate flexibility.

5. Monetary Policy Rules vs. Discretion

The superiority of rules vis-à-vis discretion has been a central theme of monetary policy literature over the last three decades. The most common measurement that has been used to evaluate monetary policy is the rule developed by Taylor (1993) which is based on the evidence that the US Federal Reserve adjusted the policy Federal Funds Rate in response to past inflation and the output gap (actual minus potential output) during 1987-1992.

The Taylor rule prescribes the adjustment of policy interest rates in a systematic manner in response to changes in inflation and macroeconomic activity.[26] It implies that central banks facing higher expected inflation should raise nominal interest rate by more than the rise in expected inflation so as to ensure price stability.

I estimated the monetary reaction function for the post-liberalization period (Annex I). It reveals that the CBSL has not satisfied the Taylor rule. Both the short and long-term coefficients on inflation deviation are less than unity indicating the poor reaction of the monetary authority to inflation expectations (Annex Table A1).

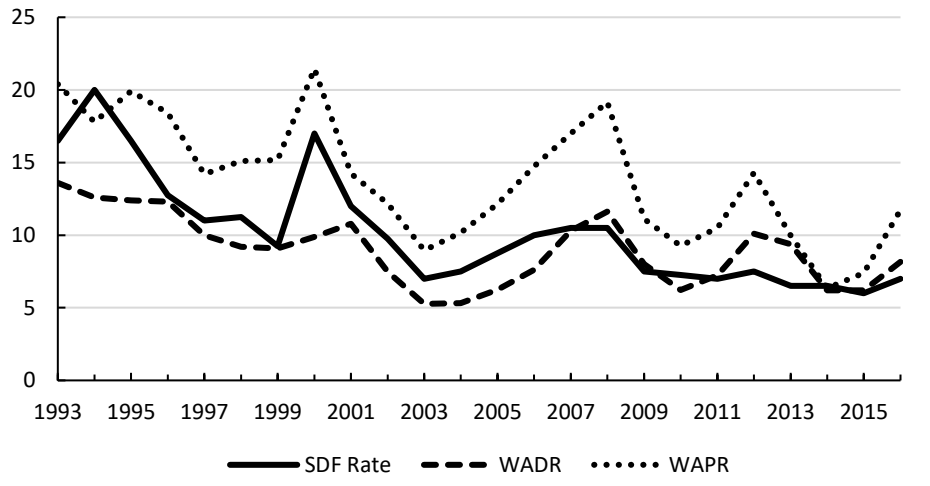
[25] Bank of Ceylon, People's Bank and National Savings Bank are state-owned banks.
[26] See Annex I for technical details.

Figure 5: Actual vs. Rule-based Interest Rates, %

Source: Rule based interest rates were computed by the author.

The plotted data of Taylor rule-based interest rates against actual interest rates indicate that the period 1979-1987 can be identified as a Taylor rule-based era, as actual interest rates lie closer to the rule-based rates (Figure 5). Since then, there has been wide divergence between the two rates. Specifically, the periods 1988-1996 and 2009-2016 can be identified as prolonged discretionary eras. The actual interest rates were higher than the ruled-based rates in the earlier period, and lower in the latter period.

Figure 6: Policy Rates & Market Interest Rates, %

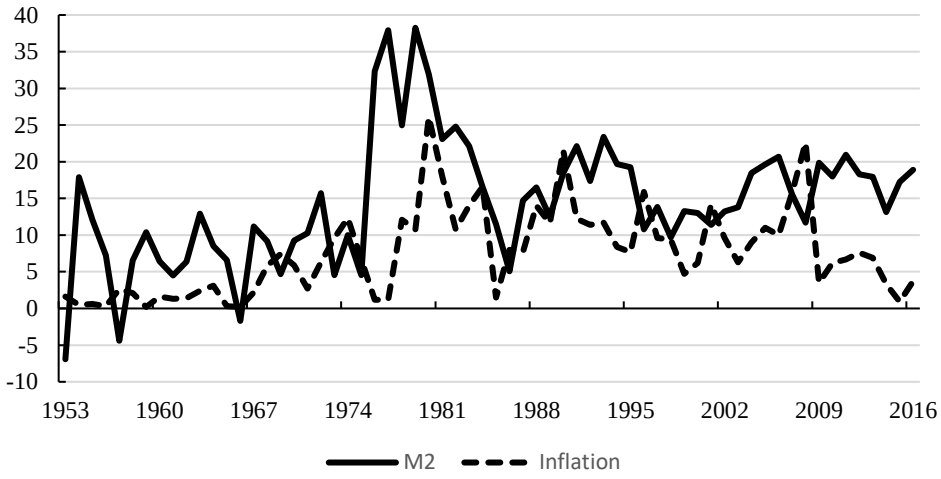


Source: Central Bank of Sri Lanka, *Annual Reports.*

Since the mid-1990s, the CBSL has adopted a relaxed interest rate policy, as reflected in the downward shift of its policy rate – Standing Deposit Facility Rate (Figure 6).[27] In response, commercial banks reduced their deposit and lending rates.[28]

The relaxed monetary policy led to accelerate money growth since the second half of the 1990s, fueling inflation (Figure 7).

Figure 7: Money Supply & Inflation (% changes)



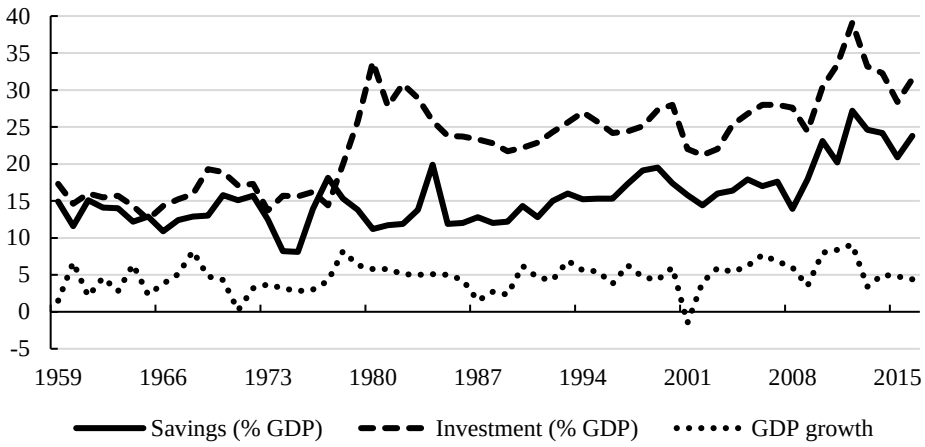
Source: Central Bank of Sri Lanka, *Annual Reports.*

The discretionary monetary policy of the CBSL has had adverse implications for savings, investment and economic growth (Annex Table A2). Low interest rates discouraged savings widening the gap between domestic savings and investment (Figure 8). A major objective of the low interest rate regime was to encourage investment.

[27] The CBSL uses two policy interest rates to influence market interest rates, i.e. (*a*) Standing Deposit Facility Rate (SDFR) which is applicable for placement of overnight excess funds of commercial banks with CBSL, and (*b*) Standing Lending Facility Rate (SLFR) which is applicable for lending of overnight funds by CBSL to commercial banks.

[28] WADR = Weighted Average Deposit Rate; WAPR = Weighted Average Prime Lending Rate.

Figure 8: Domestic Savings, Investment & GDP Growth, %



Source: Central Bank of Sri Lanka, *Annual Reports.*

Given economic uncertainty, however, businessmen opt to engage in activities that bring them quick profits, rather than investing in agriculture or industry which involve longer gestation periods and greater risk. Accordingly, a significant increase in investment is evident in activities such as real estate, construction, trading and other service-related ventures which generate quick returns with minimum risks. Greater availability of lending and leasing facilities at low interest rates also boosted the importation of durable consumer goods such as motor vehicles, exerting considerable pressure on the balance of payments.

As a result, the growth of Gross Domestic Product (GDP) is highly dependent on trading and speculative activities. The potential GDP growth rate is stagnant around 5.0 percent a year, as the country has failed to divert financial resources to high-valued added and high-tech production ventures, so as to move from 'factor-driven' growth to 'technology-driven' growth.

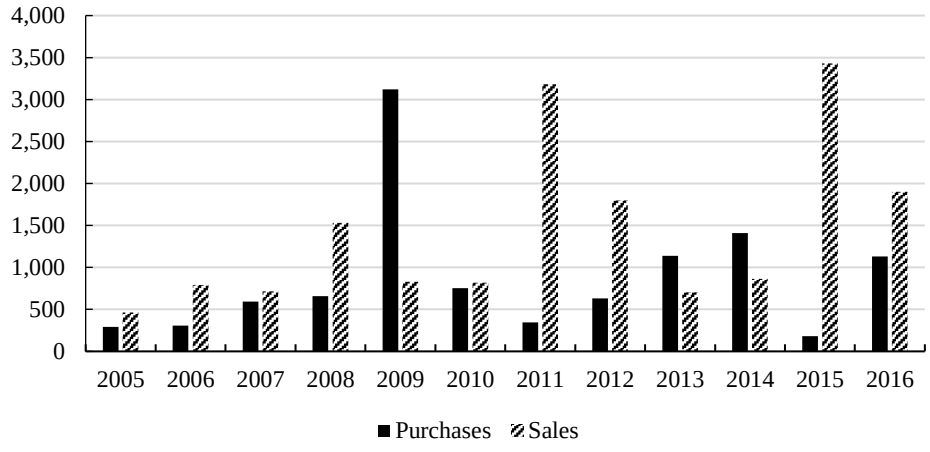
6. Exchange Rate Management

The external sector imbalances also pose severe challenges to monetary management. The current account of the balance of payments has been

in deficit continuously, reflecting the sluggish export performance and rapid increase in imports (Annex Table A2). If not for migrant worker remittances, the balance of payments situation would have been much worse. The external deficit was financed through international sovereign bonds, commercial borrowings and short-term credit exerting further burden on debt service payments.

The CBSL has attempted to maintain a pre-determined exchange rate by engaging in selling foreign exchange to the market (Figure 9). It has sold considerable amounts of its foreign reserves to the foreign exchange market in recent years to defend the rupee.

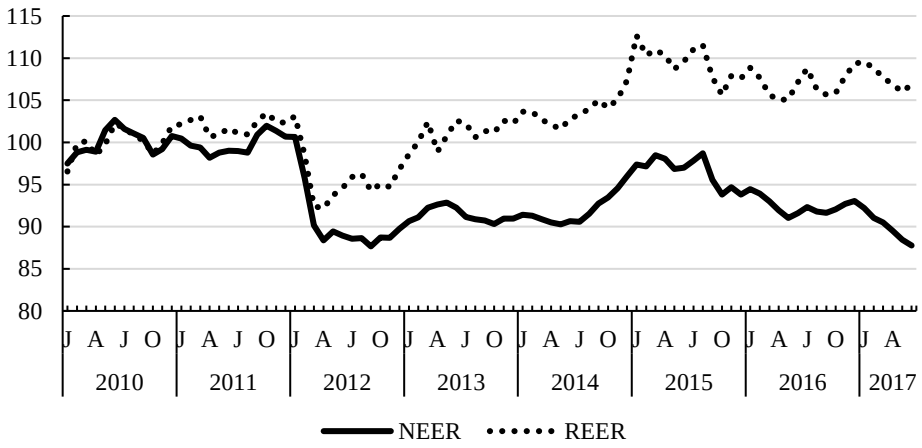
Figure 9: CBSL's Foreign Exchange Interventions ($ Mn.)



Source: Central Bank of Sri Lanka, *Annual Reports.*

The movements of the Nominal Effective Exchange Rate (NEER) partly reflect the attempt made by the CBSL to stabilize the exchange rate (Figure 10). It appreciated considerably in 2012, and remained around the same level until it began to depreciate in mid-2015. Since then, the NEER has shown an appreciation. The Real Effective Exchange Rate (REER) shows a similar pattern reflecting the erosion of the country's competitiveness with emerging domestic inflationary pressures.

Figure 10:Nominal & Real Exchange Rate Indices,
(2010=100)



Source: Central Bank of Sri Lanka, *Annual Reports.*

The limitations faced by the CBSL in conducting independent monetary policy are deeply rooted in the twin deficits – fiscal deficit and current account deficit of the balance of payments.[29] These deficits will continue to remain in the medium-term of 2017-2020, as per official projections (Annex Table A2). Persistent fiscal deficits restrain interest rate flexibility, while continuous deficits in the balance of payments restrict exchange rate flexibility. In the absence of the flexibility of these two price instruments, an open economy cannot reach equilibrium, as expounded in the Mundell-Fleming model (Mundell 1963 and Fleming 1962).

The 'Impossible Trinity' theorem derived from this model suggests that a monetary authority can choose only two out of the three policy options – stable exchange rate, free capital flows and independent monetary policy. Based on this premise, I argue that the CBSL has been compelled to sacrifice independent monetary policy, as it uses the exchange rate as a nominal anchor when there exist free capital flows.[30]

[29] Cointegration and error correction model estimations carried out for Sri Lanka reveal a significant long-term relationship and bi-directional causality between the twin deficits (Colombage 2015)

[30] Although Sri Lanka's capital account is not fully liberalized, capital flows take place in the form of foreign borrowings and portfolio and foreign direct investments. These capital movements have a bearing on international reserves and money supply.

7. Conclusion

Reflecting the profound influence of political economy on central banking, persistent fiscal dominance has severely restricted the independent conduct of monetary policy in Sri Lanka. In the absence of adequate revenue and other means to meet its fast-growing expenditure, the government has resorted to seigniorage and thereby monetized its debt. The resulting increase in the monetary base has caused multiplier effects on the aggregate money supply and inflation.

The CBSL has not been powerful enough to resist such expansionary fiscal pressures propelled by political authorities. My estimated monetary policy reaction function reveals that the CBSL has not followed any rule-based mechanism to adjust its policy rates in response to inflation expectations. The monetary policy decisions have been taken at the discretion of the CBSL, mostly to accommodate fiscal needs. This undermines the CBSL's prime objective – price stability. As a result, monetary policy has been pro-cyclical, aggravating macroeconomic imbalances.

On the fiscal side too, there is no rule-based policy formulation. The government has failed to adhere to the targets of budget deficit and public debt stipulated in the fiscal responsibility law adopted two and a half decades ago. The fiscal situation has deteriorated drastically over the years due to politically-dominated factors including populist welfare programmes, unviable infrastructure development, loss-making state-owned enterprises, extravagant spending and widespread corruption. Resource balancing at the macroeconomic level has been totally ignored in budget preparation due to the lack of a coherent public investment programme over the last two decades.

The CBSL faces many challenges in managing the exchange rate and international reserves as well. Whilst using the exchange rate as a nominal anchor in the midst of capital flows, the CBSL has had to sacrifice independent monetary policy. As the fiscal and external

deficits will continue to remain in the medium-term, the CBSL will not be in a position to move towards independent monetary policy in the near future.

The CBSL is now in the process of shifting monetary policy to an inflation targeting framework under which the central bank itself will be accountable for attaining price stability. I consider this a suicidal attempt by the CBSL, as the monetary authority alone cannot fulfill inflation targets whilst the fiscal authority fuels inflation by resorting to seigniorage for its solvency. Sensible conduct of monetary policy, therefore, requires stringent fiscal rules for which unwavering political commitment is imperative.

To recapitulate, I contend that central banking in Sri Lanka is heavily influenced by "Monetary Politics", rather than by Monetary Economics.

I wish to conclude my oration with an appropriate quotation of Prof. H.A.de S. Gunasekera extracted from his monumental book:

> "The record of central banking during this period [1950-1957] is far from impressive. …… In all these fields, it can achieve a lot. Yet its influence on the economic system has been superficial. The Bank, in fact, tossed backwards and forwards by the fluctuation of world prices… The root cause of this situation is the structure of the economy itself – the abject dependence of its national income on export production. As a result, the supply of money and the level of prices and incomes are all dominated by forces beyond the control of the Central Bank. …. The government's fiscal operations often conflict with the requirements of central bank policy. In the event of such a conflict the needs of the government have priority." (Gunasekera, 1962)

I have demonstrated in this presentation, quite unintentionally, that monetary management in Sri Lanka is still subject to the constraints of fiscal and foreign exchange imbalances, as rightly predicted by Professor H. A.de S. Gunasekera more than five decades ago.

Thank you

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Annex I

Estimating the Taylor Rule for Sri Lanka

We test here whether the policy adjustments of the CBSL during the post-liberalization period (1978-2016) can be explained by the Taylor rule. The formula used in the original version of Taylor rule can be expressed as follows:

$$i_t = \pi^* + \bar{r} + \delta_1 (\pi_t - \pi^*) + \delta_2 (y_t - y^*) \quad (1)$$

where i_t is the nominal policy interest rate, $\bar{r}$ is the long-term equilibrium real interest rate, π_t is the inflation rate, π^* is the targeted inflation rate, y_t is the actual output and y^* is potential output.
The coefficients δ_1 and δ_2 measure the sensitivity of the interest rate to variations in inflation and output gap, respectively. According to the Taylor rule, the coefficients δ_1 and δ_2 should be positive. Taylor proposed values of δ_1 = 1.5 and δ_2 = 0.5

We use the following monetary policy reaction function for estimation[31]:

$$i_t = \delta_0 + \delta_1 (\pi_t - \pi^*) + \delta_2 (y_t - y^*) + \delta_3 i_{t-1} + \epsilon_t \quad (2)$$

The lagged interest rate is introduced in Equation (2) to capture inertia in monetary policy as specified by Woodford (2001). The yield rate of 91-day Treasury bill rate is used to represent the interest rate. As a target inflation rate is not used for monetary policy in Sri Lanka, the trend inflation rate is used here. We have used the Hodrick-Prescott filter to estimate the trend inflation and potential output.

[31] We use here a contemporaneous monetary policy reaction function, though backward-looking and forward-looking specifications can also be used for estimation. Also, in some studies augmented Taylor rule specification is used to capture exchange rate movements.

As the variables are found to be stationary as per Augmented Dickey-Fuller test, the OLS was applied for estimation. The results given in Table A1 indicate that both δ_1 and δ_2 have the expected positive signs and they are significant at 10 percent level.

However, both the short term and long-term coefficients on inflation deviation are less than unity implying that the Taylor rule is not satisfied in the case of Sri Lanka. The short-term coefficient on the output gap is less than unity, but it is higher than the coefficient of inflation. Also, the long-term coefficient on the output gap is larger than unity indicating that the CBSL responds more vigorously to output fluctuations.

The higher value of the coefficient for lagged interest rate, which is significant at 1 percent level, indicates that the CBSL pursues the smoothening of interest rates. It is also an indication of monetary policy inertia.

Table A1: Taylor's Rule Estimation Results for Sri Lanka

Variable	**Coefficient**
Inflation gap	0.22 (2.01)**
Output gap	0.55 (1.83)*
Lagged interest rate	0.65 (5.39)***
Constant	4.46 (2.79)
Long-run coefficient on inflation gap	0.61
Long-run coefficient on output gap	1.53

Note: ***significant at 1%; ** significant at 5%; * significant at 10%
t-statistics are given in parentheses
Source: Computed by the author.

Annex II

Table A2: Sri Lanka - Key Economic Indicators

Variable	1960-1976	1977-1986	1987-1996	1997-2006	2007-2016	2017-2020*
Real sector						
GDP growth %	3.9	5.4	4.4	4.5	6.3	4.9
Domestic savings (% of GDP)	12.8	14.0	14.1	17.1	21.3	26.8
Investment (% of GDP)	15.8	25.5	24.0	25.0	30.8	32.4
Savings - Investment gap (% of GDP)	-2.9	-11.5	-9.9	-7.9	-9.5	-5.7
Inflation (%)	4.1	11.9	12.2	9.0	7.7	5.0
Fiscal sector						
Government revenue (% of GDP)	21.6	23.1	22.1	17.2	13.7	15.8
Government expenditure (% of GDP)	27.7	34.3	30.8	25.1	20.4	20.2
Budget deficit (% of GDP)	-6.1	-11.1	-8.7	-8.0	-6.7	-4.5
Public debt (% of GDP)	56.6	76.0	97.8	96.1	76.3	76.0
Foreign debt (% of GDP)	12.8	36.0	54.8	43.8	33.0	35.2
External sector						
Exports (% of GDP)	18.7	23.6	25.1	28.8	16.0	13.3
Imports (% of GDP)	21.6	36.8	35.8	38.0	27.7	24.1
Trade deficit (% of GDP)	-2.9	-13.2	-10.7	-9.2	-11.7	-10.8
Current account balance (% of GDP)	-2.6	-6.2	-5.7	-2.8	-4.3	-2.2
Monetary sector						
Broad money supply growth (%)	9.1	23.6	17.5	14.7	17.2	14.0
Reserve money growth (%)	8.4	21.2	17.2	11.7	13.9	12.8
Broad money multiplier	2.1	3.0	2.9	3.9	5.3	5.8
Broad money velocity	4.4	3.9	3.5	3.3	3.4	2.2

Sources: Central Bank of Sri Lanka, *Annual Reports*
IMF, *Country Reports*

* Computed by the author based on official projections

Prof. H.A. de S. Gunasekera was Professor of Economics and Head of the Dept. of Economics of the then University of Ceylon. He succeeded Prof. Das Gupta to become the second occupant (and the first Sri Lankan occupant) of the Economics Chair in 1961. He also served as the Dean of the Faculty of Arts at Peradeniya (1963-1969) and later on as Secretary, Ministry of Planning (1970-1977) under Prime Minister Sirimavo Bandaranaike. He was a much respected academic and public servant. A large number of his students have made outstanding contributions to both academic and public life in Sri Lanka and overseas.

Prof. Sirimevan Colombage, served on the academic staff of the Department of Economics, University of Ceylon, Peradeniya, briefly before joining the Central Bank of Sri Lanka. Following a career of 30 years in economic research and statistics at the Central Bank, he returned to academia as the Chair and Senior Professor of Social Studies at the Open University of Sri Lanka.

Prof. Colombage has wide expertise in central banking and monetary policy, fiscal operations, international trade and finance and econometric modelling, and his research includes collaborative studies with the University of California, University of Manchester and University of Lund. He is a member of the Working Committee on Social Sciences, National Science Foundation and a Co-Editor of the Sri Lanka Journal of Social Sciences. He has a B.A. First Class Hons. (Economics) from the University of Ceylon, Peradeniya, and an M.A. (Economics) and Ph.D. (Economics) from the University of Manchester, UK.