Monetary And Financial Sector Policies For 2010 And Beyond

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For the fourth consecutive year, the Central Bank announced its policies on the second day of the New Year – a practice since 2007 having understood the importance of communicating with the public and ensuring transparency. At a recent presentation on the road map for the year 2010, the Governor of the Central Bank, Ajith Nivard Cabraal reviewed the key economic developments and the policy actions pursued in 2009 and set out the policies and programmes for the year 2010 and beyond.

Background

2009 was one of the most critical and difficult years in the history of economics. The global economy went through serious stress and it is said to be the worst recession since the great depression. Sri Lanka faced many challenges; the internal conflict reached a critical state, inflation rose while reserves declined. However, by the end of the year, we were able to make a remarkable recovery and the economic growth that slowed down considerably in the first half picked up in the second half. Inflation that was at double digits was controlled and we ended the year with the lowest average inflation in 25 years. Foreign reserves that declined to difficult levels reached historically high levels by the end of the year and the end of the conflict brought new hope to our nation.

During the massive global recession, there was a high reserve loss as a result of flight of capital. In addition, Sri Lanka also had the security threat and a lot of misconceptions to deal with. However, the timely actions taken by the Government together with the Central Bank made it possible to deal with these difficult situations.

Thus, today we can come to certain benign times. Yet, even in benign times, the task of the Central Bank is onerous as economic and price stability has to be attained and it has to maintain system stability.

In 2007 and 2008 Central Bank adopted stringent monetary policy measures and they were instrumental in achieving the record low level of inflation and the decline in market interest rates. Maintaining financial stability was even tougher while many banks and financial institutions around the world failed and many governments and reserve banks had to pump large amounts of money to their economies to ensure that they could move forward. However in Sri Lanka, the Central Bank ensured the orderly functioning of the financial markets without having to pump in money. It also successfully maintained stability in the financial infrastructure and the payments and settlements system.

Key macro-economic developments in 2009

Though the negative impact of the global economic crisis hindered growth prospects, the performance of the Sri Lankan economy was remarkable considering that many countries including UK, USA, Canada, Malaysia, Thailand, Singapore and Japan recorded negative growth rates whereas the Sri Lankan economy grew by 2.6% in the first three quarters of 2009 and is expected to grow by 3.5% in 2009. Sri Lanka steadily recovered from the massive global shock.

There was mixed performance in the agricultural sector and the industrial sector performance was moderate due to the slowdown in the global economy. However, the decline in inflation and interest rates and a stable exchange rate helped the industrial sector to maintain its competitiveness. A growth momentum that has built up in telecommunication, banking, finance and transport sectors and the full integration of the North and the East with the rest of the economy are expected to have a huge impact in the future. While unemployment rate slightly increased, it was moderated towards the second and the third quarter of 2009.

Some progress in the fiscal performance was noted and the overall fiscal strategy is aimed at reducing the budget deficit to 5% of the GDP by the year 2011, which is a challenging task that the incoming government needs to work towards. The declining trend in revenue in the first half of 2009 improved from September onwards and a 13% growth was recorded for the first nine months of 2009.

In 2009 a high-powered Tax Commission was appointed with a mandate to study the existing tax system and to propose suitable measures to enhance the tax revenue to a desirable level.

Recurrent expenditure was higher than expected because of the steps taken to strengthen the national security, provide welfare facilities to the IDPs and resettlement and development activities under the ‘Wadakkil Wasantham’ programme. Capital expenditure continued while investments were made in many large-scale and small-scale infrastructure development projects such as the Puttalam Coal Power Plant, Upper Kotmale hydro-power project, Colombo South harbour, Hambantota sea port, Oluvil port, Southern expressway, Colombo-Katunayake expressway, Moragahakanda project and a large number of ‘Gama Neguma’ and ‘Maga Neguma’ projects which stimulated the economy.

Many countries suffered from high deficits in 2009. In Sri Lanka the budget deficit as a percentage of the GDP has been declining over the recent years and the Government adopted many measures to maintain the budget deficit at 7% of the GDP in 2009. This commitment has to continue. The Government debt to GDP ratio which was at 105% in 2002 had declined to 84% by the end of 2009 but we should aim at around 60% mark, towards which we are moving with a lot of commitment.

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With the deepening of the financial crisis, there was a sharp outflow of foreign investments, a non-roll over of certain short term debts and a significant depreciation of several currency reserves which put pressure on our external account, but the external sector recovered strongly after the internal conflict was resolved and the IMF loan was granted.

In the first half of 2009, when there was pressure on the reserves and the exchange rate, there were many steps taken by the Central Bank and the Government to ensure that we do not reach any critical stage. The Central Bank entered into SWAP arrangements with certain countries, arranged special funding lines from friendly countries in case the reserve reached very low levels, actively promoted investments in treasury bills, paid bonus on the interest earned on NRFC and RFC deposits, introduced tax concessions on foreign income, allowed greater flexibility in the exchange rate to enhance the export competitiveness and provided fiscal stimulus to certain export industries. All these measures contributed to manage particular situations so it does not reach any critical levels.

IMF support was sought to build up the reserves and in July 2009 a US$2.6 bn worth Stand-by Arrangement (SBA) was approved. The first tranche was received in July and the second tranche was received in November 2009. In August, the IMF approved a general and special allocation of SDRs based on each country's quota with the IMF, to strengthen the international reserves in order to face any liquidity constraint due to the global financial crisis. Accordingly Sri Lanka received SDR 325mn under these allocations.

In 2009 our country ratings improved. S&P Ratings affirmed the long-term foreign currency Issuer Default Rating at ‘B’ and Fitch Ratings revised Sri Lanka’s sovereign rating outlook to ‘stable’ from ‘negative’ in October. Further work is underway towards improving the country rating.

In 2009, exports declined due to the global slowdown, but Sri Lanka’s reduction in exports compared to other countries was not as sharp as what some other countries had experienced. The initial set back in exports reversed in the last quarter, hence, there is hope that it will improve in time to come. Though the imports also declined dramatically particularly because of the decline in oil prices, the ongoing large-scale infrastructure development projects around the country and the reconstruction activities in the newly liberated areas are expected to produce a strong pick up this year.

Tourism is moving up strongly every month since May 2009. This year is expected to have record numbers of tourist arrivals, which will be far greater than the 566,000 arrivals we had in 2004.

After 33 years, since 1976, the current account is set to record a surplus and in 2009 we would record a surplus particularly because of the narrow trade deficit, which was offset by higher inflows of workers’ remittances, which was 25% above the trade deficit.

Even though financial flows to the private sector declined mainly due to the drying-up of credit lines in the aftermath of the global crisis, financial flows to the Government in the form of loans, grants and investments increased during the first eleven months of 2009. One contributing factor has been the ability to pay back on demand and without any difficulty to anyone who had invested in Sri Lanka. The global investments suffered during the crisis and as a result the FDIs were not as strong as expected. However, with renewed investor confidence and the easing of the global economic slowdown, FDI is expected to increase significantly in 2010. The second international sovereign bond was an extraordinary success and it was over subscribed by more than 13 times – the highest number of over-subscriptions of any sovereign US dollar bond offering in 2009 by any country.

The gold reserves were increased in order to provide a strong and long-term stable cushion to the country's reserves. The BOP surplus is at a historically high level, at around US$2.7bn and the foreign reserves are also at historically high levels with the total reserves being around US$5.2bn and this level of reserves is equivalent to approximately 6.3 months of imports. A reasonably stable exchange rate was maintained even in times of the crisis and this helped Sri Lanka to manage the crisis much better than if the exchange rate was allowed to have serious volatility.

The monetary policy in 2009 was focused on supporting the recovery of the domestic economic activity. The tight monetary policy stance of the Central Bank in the past 2-3 years and the easing of commodity prices in international markets, complemented by favourable domestic supply side developments, resulted in the deceleration of inflation during 2009. Since the level of inflation has come down to about 3.5% it has to be maintained at the lower single digit level throughout the next few years and the Central Bank will be working to deliver on that. Monetary policy was eased within reasonable limits, policy rates and the statutory reserve ratios were relaxed in order to stimulate the economy further.

We have now entered a low inflation, low interest regime and that provides growth prospects for the economy. During 2009 our reserve money targets were adjusted and was also brought down because we had a reduction in the Statutory Reserve Ratio (SRR). It was also possible to manage our reserve money well within the targets that had been set out.

Though the growth in broad money supply continued to remain subdued during the first half, it picked up towards the latter part of the year, but on an annual average basis the growth in broad money remained within the targeted levels. The performance of our capital markets was outstanding and market capitalisation exceeded Rs 1,000bn which was recognised as one of the best performing markets in the year 2009.

Monetary policy strategy for 2010 and beyond

The economy is expected to grow by 3.5% in 2009 and the gradual recovery of the global economy and the end of the conflict is expected to provide a strong impetus to the domestic economy in 2010. This year it would probably be between 6-7% but beyond 2011 the growth is expected to be between 7-9% in the medium term.

Imports and the exports are expected to increase generating higher economic activities. Despite the expected increase in the workers remittances and higher inflows into the inflows account, the current account is expected to record a deficit of less than 3% in the medium term as well. However higher capital and financial inflows into both the private and Government sector in terms of higher FDI, foreign borrowings and portfolio investments will be more than adequate to finance the deficit in the current account. A healthy BOP surplus is also expected in the medium term.

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On the fiscal front, the overall budget deficit is expected to reduce in the medium term and improvement in the financial position of both the Government and the public corporations is expected to release resources to the private sector in time to come. It is an important factor in achieving economic growth between 7-9%.

The monetary programme for 2010 has been designed in light of this medium term framework/assumptions relating to real, external and fiscal sectors. Accordingly, the targets for monetary aggregates have been based on a level commensurate with the expected real GDP growth of around 7% and a GDP deflator of 6% for 2010. The operating target for monetary policy, which is set within the monetary target framework will continue to be reserve money. The setting of quarterly average targets for reserve money enables the continuous monitoring of actual development and ensures that monetary policy is conducted to achieve the desired outcomes for both growth and inflation.

The possible variations in which the money might multiply, which depends on factors such as the level of SRR, the public’s preference to hold currency versus deposits and the average level of excess reserves held by banks were assessed in setting the quarterly reserve money targets for this year. The lowering of the SRR and the observed decline in the preference of the public to hold currency raised the money multiplier from 5.6 % in 2008 to around 6% in 2009. A similar level is expected to prevail this year as well. The velocity of money is expected to broadly remain stable.

The average growth in broad money supply this year has been estimated at 14.5%, a level sufficient to facilitate the smooth functioning of economic activities. A 14.5% growth in reserve money has also been estimated. Similar to the board money growth, the money multiply is expected to remain unchanged at the 2009 level. The average growth in reserve money in the first two quarters of 2010 is expected to be high, mainly on account of the base effect of lower monetary expansion in the first half of 2009. Considering the sources of monetary aggregates, the growth in broad money is a combined outcome of an increase in both the Net Foreign Assets (NFA) and Net Domestic Assets (NDA) of the banking system, which includes both the Central Bank and commercial banks. The main source of reserve money growth in this year is expected to be the expansion in Net Foreign Assets (NFA) as Net Domestic Assets (NDA) of the Central Bank is expected to contract further in 2010. The overall balance of payments, which constitutes the NFA component in reserve money is projected to record a surplus of US$700 million this year.

The improvement in the BOP would be a result of the combination of a number of factors. The services account is expected to perform well in 2010. The end of the internal conflict is expected to enhance workers remittances substantially this year. The opening of new bank branches in the Northern and Eastern provinces would ensure higher inflows of workers’ remittances and expatriate remittances through official channels. Higher remittances from the Sri Lankan Diaspora are also expected.

With the expected global economic recovery and the renewed investor confidence in the Sri Lankan economy, capital inflows in terms of Foreign Direct Investment and loan capital would also increase in 2010. Foreign loans and grant dispersals to the Government are also projected to increase in 2010. Although the provisional advances to the Government by the Central Bank may increase, the Central Bank does not expect a significant increase in the holding of treasury bills in 2010. The excess liquidity that will be created due to the significant increase in NFA will be absorbed by the Central Bank. In the absence of sufficient stock of treasury bills, alternative instruments such as Central Bank securities and foreign exchange swaps will be used to absorb the excess rupee liquidity in the domestic money market in order to maintain rupee liquidity at levels consistent with the targeted money path reserve.

Certain Central Bank securities have been identified as instruments to absorb excess liquidity. Hence there are plans to introduce a programme to borrow Government securities for open market operations on a repo basis from long-term investors such as the EPF and ETF insurance funds. It will provide an avenue for such investors to earn a free income for their idle securities while at the same time Government securities thus borrowed will be sold on a repo basis to mop up the excess liquidity effectively. Such borrowing of securities is a standard practice in several other countries.

2010 will be a challenging year because several large-scale infrastructure development projects and reconstructive efforts and activities in the North and East are continuing. Considering the availability of resources in the domestic economy as well as from foreign sources, the Government borrowing from the banking system is expected to be maintained at a level that will facilitate higher credit to the private sector. Therefore, any new reckless public spending in billions of rupees in recurrent expenditure will be disastrous to the economy and will reverse the sound macro economic fundamentals prevailing now. It is important to understand that any money printing without proper discipline could erode all the successes that were achieved in the past several years.

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The performances of the public corporations would depend to some extent on the price of crude oil and fertilizer in the international markets. Credit utilisation by these entities as well as credit to the Governments would impact on the credit available to the private sector as well. Unless these entities arrange part of their financing from abroad, a significant increase in credit to the public sector could put the recovery of the private sector at risk. Therefore we would like to see some of those public sector corporations going to the market on the strength of their balance sheets and being able to borrow money for their major development activities.

An undue increase in the overall money supply caused by accommodating increases in credit to all sectors could endanger the projected low inflation environment in the ensuing period. Therefore, it is essential that Budget 2010, when it is prepared, gives due priority to these areas and ensures that borrowing from the banking system does not exceed the stipulated levels. In 2010 inflationary pressures are expected to be moderate enabling inflation to be maintained in single digits during the year. On an annual basis inflation is projected to be around 5-6% by the end of year 2010.

In keeping with the international best practices of carrying out periodic revisions to the basket of goods, the department of census and statistics will have their new survey. Based on this new survey there will be a new index based on the Household Income and Expenditure Survey- 2006/2007 and that would greatly help the Central Bank in its monetary policy decisions. Headline inflation needs to be controlled and dealt with, but as far as the Central Bank is concerned, what is most important is the core inflation. Core inflation has room for improvement and it is desirable to see that taking place within the coming year.

Analysis of the policy actions taken to improve the stability of the financial system in 2009

2009 was an extremely challenging year for those who were in the banking business and the preventive measures that we had taken over the past few years helped us deal with that situation when it did occur. The fact that Sri Lanka's banks had a capital adequacy ratio of over 14% helped to deal with the shock when it did come through. It is one of the important reasons as to why there was no major systemic impact on Sri Lanka's financial system because almost all our banks were strong enough to face the situation. The Central Bank continued to preserve the soundness, efficiency and the stability of the financial system. During 2009, the regulatory and supervisory framework and the risk management systems were strengthened and good corporate governance standards and practices in all the banks were continued. Immediate measures were taken to restore confidence in financial institutions.

It is important that there is greater financial inclusion in the country. Even before the conflict ended the Central Bank was ready with its policies to ensure that there was greater financial inclusion, being brought in, in the North and East. Throughout the year, there were new bank branches being formed, new banking outlets being opened, new ATMs being opened and that was to ensure that there was additional inclusion within the banking sector so that people could get included into the banking system as well.

Central Bank also made certain timely interventions in the registered financial companies. There were a few companies that had some difficulty but together with the Government, we were able to formulate a stimulus package that ensured that the financial sector, particularly the registered finance companies were given the necessary support, so that they could face the difficulties with confidence and that there was no fall out of the situations.

The SME sector was also focused upon intensely. The Central Bank supported the SME sector openly and strongly through various projects and programmes. All those projects helped to bring cash as well as resources closer to the ordinary people of our country who form the bedrock of economic activity in this country. In the meantime, Central Bank continued and monitored the implementation of Basel II. It monitored the implementation of the Basel II Capital Adequacy Standard in Banks with a view to improving the safety and soundness of the banking system and encouraging ongoing enhancements to risk management. It facilitated the adoption of International Accounting Standards. Stress testing was also undertaken to see whether the banks were having any difficulties. Central Bank continued its dialogue with the strategic stakeholders and continued the public awareness campaign very strongly to ensure that people do not invest their money in unauthorised deposit taking institutions.

Greater attention was paid to robust risk management and new directions were issued to licensed commercial banks on foreign exchange risk management. New directions on classifying and transferring customers’ unclaimed assets to a special account at the Central Bank were issued in order to protect the assets of customers of banks, who have not carried out any transactions for a long period of time. Central Bank also issued the Service Providers of Payment Cards Regulations. Sri Lanka’s first Certification Authority, LankaSign, to issue digital certificates, was established with the authorisation of the Central Bank.

Anti-money laundering and combating the financing of terrorism are also being dealt with and the Central Bank has been continuously monitoring the inflows, which can sometimes be suspicious. It has also introduced LankaFIN, a web based, online reporting system for institutions and the Financial Intelligence Unit.

Proposed financial system stability policies for 2010 and beyond

The main thrust of the policies will be to cater to the increasing demand for diversified financial services. Several policies will be taken in the year 2010 and in the medium term to strengthen the institution and market infrastructure and to remove impediments. Central Bank also aims to develop an export and import (EXIM) bank, which can play an important role in integrating the Sri Lankan economy in the global economy by promoting and financing international trade and investment throughout the year.

Key financial sector legislation is also being strengthened to reinforce legal framework and we will bring in amendments to the Banking Act. Amendments will be made to the Finance Companies Act to enhance the powers of the Central Bank with respect to the examination of RFCs, the determination of capital and other prudential requirements and new laws will be introduced to regulate and supervise micro-finance institutions, (MFIs) to enable them to better serve the economy.

In 2010 the Central Bank will move forward in implementing the pillar two under Basel II and the Central Bank will take measures to commence consolidated supervision of banking groups. Central Bank will undertake a “group-wide approach” to the supervision of licensed institutions. Well-articulated internal rating systems for the banks will also be brought in, so that it is possible to monitor banks with a greater degree of certainty and where there are weak banks the Central Bank will monitor them more closely than the stronger banks.

As a further measure to ensure financial system stability, mandatory deposit insurance schemes will be formulated with a view to safeguard small depositors and to strengthen public confidence in the financial sector. In view of the importance of small and medium sector enterprises, establishing a credit guarantee scheme for SMEs has been proposed as well. Central Bank plans to further strengthen its payments and settlement system and improvements will be made to ensure the smooth operation of the SWIFT system. Central Bank will also continue its efforts to enhance international co-operation.

As Asia is now emerging as a main contributor and promoter of the world economic growth the Central Bank will also work together with other financial companies, markets and central banks. Deeper financial integration will help channel Asia's large pool of savings and promote intra-regional trade and investment flows. The Central Bank has looked at the GSP+ issue from a risk position and has ensured that the risks are dealt with if they materialise.

Other policies implemented in 2009 to strengthen the economy further and policies for 2010

Managing of the public debt was challenging but the Public Debt Department was able to perform well – enough to raise over 600 bn from domestic sources and over 300 bn from external sources and retrieve nearly Rs 600bn.

According to the external debt sustainability indicators of Sri Lanka, based on the UN ESCAP, Sri Lanka now falls among the less indebted countries except in one area where we are still in the 'moderate indebt status'. The Central Bank is committed to ensure that all our factors and indicators point to the 'moderate indebt status'. Our market yield curve has fallen substantially and is also being extended.

With the build up of external reserves, controls on foreign exchange transactions will be relaxed in 2010. These will include allowing Sri Lankans to open and maintain accounts with banks abroad, to invest in equity or short- term debt instruments in overseas companies. This will allow foreigners to invest in rupee denominated debentures issued by local companies, insurance companies to invest part of their assets of general fund or technical reserve, in foreign assets, listed companies to list foreign stock exchanges and certain foreign companies to open places of business in Sri Lanka and foreigners on tour or business in Sri Lanka to open Sri Lanka Rupee accounts.

This year will coincide with the 60th anniversary of the Central Bank and the 11th series of currency notes will be issued on the theme of development, prosperity and traditional dancers of Sri Lanka. A new money museum in Matara will be opened.

In areas of Provincial development, the Central Bank has helped many people all over the country; particularly the new programme of reawakening the Northern & Eastern provinces has touched farmers, families, and entrepreneurs alike.

This year, the Central Bank will initiate the transformation of the existing frame of EPF to a banking model where people will be able to see their balances in a moments notice. A sound risk return profile, in future, will generate a positive rate of return in the long-term and in this stage, we will also have, a new scheme where informal sectors of all types; farmers, fisherman, overseas migrant workers, etc could also invest in EPF. About 500,000 new people are expected to join the EPF by the end of 2012 and 2 million by 2015.

Looking at the future, there are many challenges ahead, however, Sri Lanka is on the fast track to prosperity. It is necessary to contribute to re-building the North and East, which suffered immensely through the conflict. This will be another important segment of the activities in development.

The Central Bank is targeting US$4,000 per capita income with its proper distribution, which many programmes of the Central Bank together with the banks are hoping to implement this year and beyond. The world is emerging out of the economic slow down and that is an important factor to keep in mind as we look to the future.