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MONETARY POLICY FRAMEWORK IN SRI LANKA AND ITS IMPACT ON THE FINANCIAL SECTOR: A REVIEW

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Abstract

Monetary policy is a prominent stabilization mechanism often used to accomplish price and economic stability in a country. The success of monetary policy depends on the operating economic environment, the institutional framework adopted, and the choice and mix of the instruments used. The aim of this paper was to review the evolution of the monetary policy framework in Sri Lanka and its impact on the financial sector. The review is important, and monetary policy is intended to impact aggregate spending in the economy to contribute to the goals of full employment, price stability, sustainable economic growth, and balance of payments equilibrium. The paper reviewed more than twenty-five research and review papers using a thematic approach. The paper explains the historical evolution of monetary policy regimes in Sri Lanka and the reasons for adopting various monetary and exchange rate policy regimes from time to time. The review considers national and international studies on monetary policy regimes and their impact on the financial system. The paper concludes that the Currency Board could not influence the money supply in any way, and until the adoption of open economy policies in 1977 under the fixed exchange rate regimes, the Central Bank had no control over domestic inflation. The review also identifies that flexible inflation targeting is the international best practice of Central Banking, and flexible inflation targeting enables the maintenance of low inflation, thereby helping economies achieve a high and stable growth path. However, it emphasizes that it should be maintained sustainably subject to several conditions through government intervention.

Keywords: Central Bank of Sri Lanka, Exchange Rate Regime, Monetary Policy Framework

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1. INTRODUCTION

Monetary policy is the process by which a central bank manages the supply and the cost of money in an economy, mainly with a view to achieving the macroeconomic objective of price stability (CBSL, 2020). Monetary policy plays an important role in the achievement of macroeconomic and financial sector stability, while an integrated financial market is essential for the rapid development (Nnanna, 2001). Monetary policy objectives traditionally include economic growth, employment, price stability, and nominal GDP. Depending on the country, monetary policy objectives, as many countries have done in recent years, place greater emphasis on the objective of price stability (Khan et al., 2002). Several Asian central banks adopt explicit inflation-targeting frameworks (morgan and Peter, 2013). In Addition, Monetary policy may also seek other objectives, including the stability of long-term interest rates and financial markets, including foreign exchange markets, and may target economic activity in particular sectors of the economy.

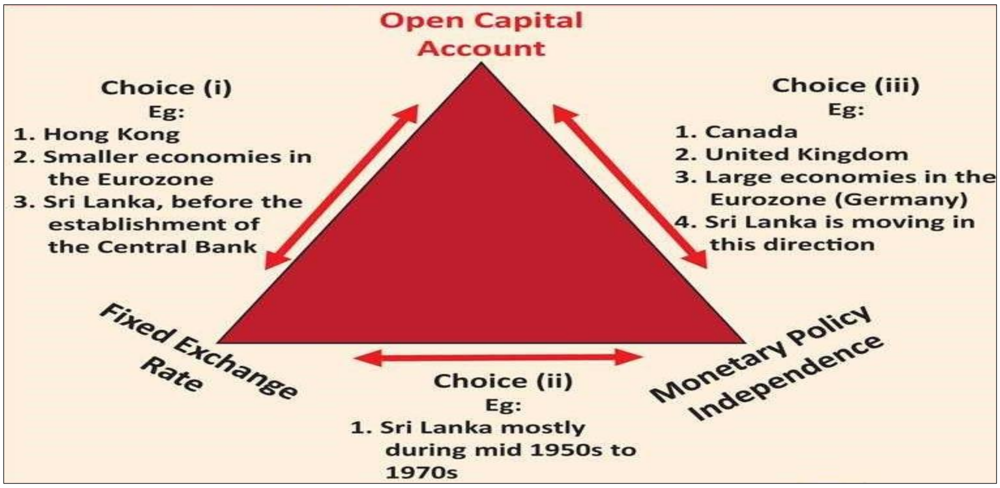
The Central Bank of Sri Lanka's primary goal is the maintenance of price stability. As price stability is crucially dependent on stable macroeconomic conditions, one of the core objectives of the Central Bank of Sri Lanka is therefore specified as economic and price stability. As the experiences of other countries have demonstrated, the financial system's stability is crucial in improving the economy's resilience. Hence, financial system stability was also identified as a core objective of the Central Bank of Sri Lanka. The two objectives are correlated and complement each other. Financial system stability is important, as monetary policy is transmitted through financial intermediaries to achieve price stability. Hence, the two objectives are in harmony, enabling the Central Bank to perform its main functions more effectively. The Central Bank of Sri Lanka has been given high autonomy to achieve its objectives (CBSL,2019).

Monetary policy instruments are generally classified as either direct or indirect, Direct instruments operate under the regulatory authority granted to the central bank; indirect instruments operate as a function of the central bank's ability to issue reserve money on money market conditions. Indirect instruments are also termed "market–based instruments" since their transactions occur with financial and non-financial institutions. The most common direct instruments are administratively set interest rate ceilings, individual bank credit ceilings, and directed lending. There are three main types of indirect instruments. (1) Open market operations, (2) Central banking lending, and (3) Reserve requirements.

Countries' practices of conducting monetary policy vary, depending on macroeconomic and financial market conditions. Hence, different types of monetary policy regimes can be observed in today's world. Further, monetary policy frameworks have evolved in response to economic and financial crises and increasing trade openness and global financial integration. In determining the monetary policy framework, a monetary authority must abide by the condition of "impossible trinity," i.e., the choice between independent monetary policy, fixed exchange rate, and capital account openness (CBSL, 2019). Monetary policy transmission depends on these macroeconomic and financial market conditions and the choice of monetary policy frameworks. The monetary policy transmission mechanism is defined as the process through which economic activities are affected by monetary policy decisions. Koop, Gonzalez & Strachan, (2009) showed that the transmission mechanism, the volatility of exogenous shocks and the correlations between exogenous shocks are all changing. According to the “impossible trinity” condition, a country cannot simultaneously have a fixed exchange rate, an open capital account, and an independent monetary policy. If the capital account is closed, monetary policy penetrates domestic demand, regardless of the exchange rate regime. On the other hand, with free capital mobility, monetary policy transmission depends on the exchange rate regime. This framework helps highlight the trade-offs faced by policymakers in small open economies and what choices they have made to resolve them (Moreno, 2011)

Based on the concept of the impossible trinity, at least three different monetary policy combinations can be made by countries depending on their macroeconomic and financial market conditions. (i)Maintaining an open capital account and a fixed exchange rate while forgoing monetary independence (ii) Independent monetary policy with a fixed exchange rate, along with capital controls (iii) Maintaining an open capital account and monetary independence, with a flexible exchange rate (CBSL,2019). Choice (i) above is essentially a fixed exchange rate regime, including a Currency Board arrangement, a dollarized economy, or a hard peg. Choice (ii) involves capital controls, which have become increasingly unpopular. Choice (iii) allows the exchange rate to float with capital account openness while enabling the Central Bank to conduct monetary policy independently. Monetary policy regimes under Choice (iii) include inflation targeting, whereas monetary targeting could be conducted under both Choices (ii) and (iii) with varying successes. Some countries attempt to conduct monetary policy using interim combinations, such as managed floating exchange rates and partially controlled capital flows [See Figure 01]. Similar to many other countries, Sri Lanka’s monetary policy framework evolved from Choice (i) and moved towards Choice (iii) during the past 70 years (CBSL, 2019). The Central Bank of Sri Lanka believes that flexible inflation targeting under Choice (iii) is the most suitable monetary policy framework for Sri Lanka.

Improving the operational framework should be a central focus in countries striving to modernize monetary policy framework. Shortcomings in the operational framework and weak liquidity management are in many cases the major obstacles to effective monetary policy. A well-functioning operational framework is needed to ensure that policy objectives are achieved reliably and efficiently. Therefore, it is needed to consider factors such as liquidity risk, exchange rate, interest rates, interbank rates, and the central bank policy rate. Open market operations affect short-term interest rates, which in turn influences longer-term rates and economic activity. The key element of the Open Market Operations framework is the interest rate corridor formed by the policy interest rates which is referred to as the Standing Rate Corridor (SRC). When central banks lower interest rates, monetary policy is easing. When they raise interest rates, monetary policy tightens. Therefore, a well-managed interest rate needs to be implemented in any country.



Source: Central Bank of Sri Lanka

Figure 01: The Impossible Trinity

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Emerging economies face many challenges because of their developing financial systems and vulnerability to international capital flows. Therefore, according to experience, developing countries without developed financial systems are not capability face the economic shocks. Then, the impact and transmission of monetary policy framework on the real economy is still contentious. The literature shows that monetary policy transmission differs between developed and emerging countries mainly due to different financial market conditions. Monetary policy changes affect the real economy by changing interest rates, asset prices and exchange rates; hence, the strength of monetary policy depends on the functioning of different financial markets. Although over the last few decades there has been an increase in the number of papers examining the effectiveness of monetary policy in Sri Lanka its shows that the reliability of content is low. Therefore, this paper aims to review the evolution of the monetary policy framework in Sri Lanka and its impact on the financial sector. At this juncture, the paper focuses on the changes that took place in two main periods in Sri Lanka.

I. Period from Currency Board System to Open Economic Policy Initiative

II. Aftermath of open economic policy

The method of analyzing the facts is descriptive, as the paper is based on the available past literature related to the monetary policy framework. An extensive review of relevant information gathered from journal papers, research articles, and reports has been undertaken. The remainder of the paper is structured as follows. Section 2 presents the evolution of the monetary policy framework in Sri Lanka while discussing different aspects of monetary policies and the recent development in the monetary policy framework in Sri Lanka and the rest of the world. Finally, the paper summarizes the findings and conclusion.

2. LITERATURE REVIEW

2.1 Evolution of monetary policy framework in Sri Lanka

The central banks implement price stability through one of three operational frameworks: inflation targeting, monetary targeting, and exchange rate targeting. Of these three, inflation targeting has seen increasing adoption around the world. first in New Zealand in 1989 then reported in a growing number of advanced and emerging economies (Ghate & Ahmed, 2022), Before establishing the Central Bank of Sri Lanka (Ceylon) in 1950, the Sri Lankan monetary system was a Currency Board system whereby the Currency Board would automatically issue or retire Ceylon rupees against an equivalent value of the Indian.

The reasons cited in the Joan Exter Report (1949) for the establishment of a Central Bank in place of the Currency Board are primarily twofold: first, the need to establish an independent monetary system that can issue currency and create deposits against domestic as well as foreign assets; second, the need to establish an institution with powers to control the expansion and contraction of credit by commercial banks. Concerning the first reason, Exter (1949) shows that, as the role of the Currency Board must remain purely passive, it cannot influence the money supply in any way and thus relieve the pressure to which rapid swings in the balance of payments may sometimes subject the economy. The second reason that Exter explains is that demand deposits subject to transfer by cheque have, in most countries of the world, become a more important form of money than actual currency, and variations in the volume of demand deposits resulting from changes in the cash positions or the credit policies of commercial banks frequently have more profound economic effects than variations in the supply of actual currency.

These arguments are still valid for Sri Lanka, and a Currency Board arrangement is not appealing for a small open economy like Sri Lanka’s, where the relative share of domestic demand in aggregate demand is very high, as this system shall only be credible if the Central Bank holds sufficient foreign exchange reserves to cover the country’s gross monetary liabilities consistently. At this stage of development, such a return to a Currency Board will result in an agonizing macroeconomic adjustment and a sharp reduction in social welfare, thus rendering this arrangement a non-option.

Although there was renewed interest in establishing Currency Boards after the collapse of the Soviet Union, the Argentinian currency crisis, and the Asian financial crisis, these efforts were mainly aimed at taming inflation by introducing a non-discretionary policy regime. It is for the same purpose that some countries sometimes adopt another country's currency, known as dollarization. From the time of the establishment of the Central Bank of Sri Lanka in 1950 until the adoption of open economy policies in 1977, Sri Lanka has followed a fixed exchange rate regime. Capital controls were non-existent in the initial years when there were no concerns related to the balance of payments, but controls were introduced soon in the 1950s. The international monetary system under the Bretton Woods agreement, essentially a pegged exchange rate system, was followed by Sri Lanka until its collapse in the early 1970s (Weerasinghe,2017).

Under the fixed exchange rate regimes, the Central Bank had no control over domestic inflation, as domestic inflation was directly linked to foreign inflation, and therefore, there was no need for it to be managed by an explicit monetary anchor. However, the fixed exchange rate system worked well only as long as Sri Lanka earned sufficient foreign exchange to meet expenditure on imports. For example, during the periods of export booms, particularly in the early 1950s, the fixed exchange rate regime worked well, as foreign exchange earnings, which arose due to external factors rather than domestic export promoting policies, were not only sufficient to meet current expenditure but also helped build up foreign reserves so that currency peg could be maintained without foreign grants or borrowings. In general, during most periods, the Central Bank had to support the exchange rate peg by restricting the use of available foreign reserves and imposing severe import restrictions. The Central Bank also failed to satisfy its multiple stabilization and development objectives that prevailed at the time (Weerasinghe, 2017).

During Sri Lanka’s fixed exchange rate regime, successive governments did not continuously pursue export-oriented policies. There were when policies focused on export promotion, but there were more times of policy reversals towards encouraging import substitution and inward-looking policies. From a long-term perspective, such policies were inconsistent with the need to maintain a fixed exchange rate regime. Under these circumstances, the key challenge the Central Bank had to face was how to defend the exchange rate peg amidst policies that did not promote exports.

The solution of the Central Bank was to restrict the use of available foreign reserves and impose severe exchange control restrictions. In addition to pursuing inward-looking economic policies, successive governments ran high budget deficits mainly to provide subsidies and various free entitlements. Such budget deficits, even at moderate levels, caused more demand for imports amid weak export performance, creating continuous current account deficits, while the Central Bank was required to maintain a fixed exchange rate regime. Also, during that time, the Central Bank, from time to time, either devalued the rupee or maintained a dual exchange rate along with severe restrictions on the use of foreign exchange. This monetary policy framework locked credibility and created severe distortions to market pricing.

The 1973 oil crisis caused inflation escalations in all countries, including Sri Lanka, often resulting in a destructive wage–price spiral. In Sri Lanka, inflation increased to 14.4 percent by 1973, the highest level of inflation the country experienced until then during its post–independent history.

2.2 Market-Oriented Monetary Policy Framework

A market-oriented reform is a policy measure that allows and induces the competitive participation of private agents in a sector, activity, or market. Thus, the key concepts underlying market-oriented reforms are private participation and competition among private agents (Loayza & Soto, 2003). In November 1977, Sri Lanka embarked on a major economic liberalization move, marking a paradigm shift from inward-looking restrictive policies towards a liberal regime under which trade and payments were largely liberalized. To be consistent with the new liberal regime, the Central Bank abandoned the fixed exchange rate regime and moved to a more market-based system of exchange rate management (Weerasinghe, 2017). The dual exchange rate system was abolished by introducing a unified exchange rate, while the rupee was initially depreciated by 46 percent. With the unification, the exchange rate was allowed to float, providing scope for the exchange rate to be determined largely based on demand and supply conditions in the market (Gunaratna, 2011).

The Bank has also actively engaged in financial market development, that is the development of financial institutions, financial instruments, and payment and settlement systems. Nevertheless, the statutory reserve ratio (SRR) applicable to deposit liabilities of commercial banks, which is administratively determined, continued to be a key monetary policy instrument used by the Central Bank to control inflationary pressures in the economy during the 1980s and early 1990s. The development of the domestic financial sector enabled the Central Bank to adopt open market operations as a key monetary policy tool from the late 1990s (Wimalasuriya,2011). As the Sri Lankan economy had adopted a range of economic and financial sector reforms since the 1980s, with acceleration in the 1990s, the transmission of monetary policy and its effectiveness may have improved considerably (Perera, 2012)

This sharp devaluation addressed the overvaluation of the rupee observed under the fixed regime. The subsequent managed exchange rate regime allowed some flexibility to determine the value of currency largely based on market demand and supply while attempting to prevent the overvaluation of the rupee by maintaining the real value of the rupee against movements of a basket of major currencies.

2.3 Implementation of the managed floating system

The managed floating exchange rate system introduced in 1977 made the monetary system more complex. Introducing the managed floating exchange rate was a welcome move from the perspective of a liberal macroeconomist. This resulted in new challenges to the conduct of monetary policy, particularly as the exchange rate was no longer available to anchor inflation expectations like in the past. The Central Bank also faced a new challenge, as the government started to run extremely large fiscal deficits funded mainly by concessional external funding to develop public infrastructure. Year-on-year inflation averaged 15.6 percent during February 1978 and January 1985, with a peak of 32.5 percent in August 1980 (Weerasinghe, 2019). It must be mentioned here that rising inflation was the main cause of the 1980 general strike, which resulted in over 40,000 public and private sector workers losing their jobs. In that situation, the Central Bank of Sri Lanka started looking for a new framework to contain inflation and inflation expectations without the pegged exchange rate system.

2.4 Monetary Aggregate Targeting in Sri Lanka

The first mention of desired monetary targets in a Central Bank annual report in Sri Lanka could be found in 1982. The 1982 annual report states that the National Credit Plan for 1982 was formulated against the perspective of the prevailing monetary and credit policies. It attempted to rationalize the use of private sector credit among different sectors of the economy as an instrument of selective credit policy (Wimalasuriya,2011).In that period, having considered the real growth, the estimated rate of price increase, and the increased monetization of the economy, the desired monetary targets were set in the Plan to maintain the consistency between financial and real output flows. The monetary targets were then translated into a permissible level of credit to the private sector by commercial banks after allowing for the impact of the external sector's behavior and the government's credit requirements.

Even after introducing monetary aggregate targeting in the early 1980s, the exchange rate remained a nominal anchor. With expanding twin deficits, it was increasingly becoming difficult to manage the exchange rate, and the Central Bank experimented with numerous permutations of managed floating exchange rate regimes, including "soft peg" arrangements. These efforts, which often resulted in a loss in international reserves of the Central Bank, culminated with Sri Lanka announcing a floating exchange rate regime in January 2001 and the subsequent amendment to the Monetary Law Act to streamline the objectives of the Central Bank.

2.5 Recent developments in the monetary policy framework

Monetary policy conducted under the monetary targeting frameworks assumes that there is a strong and reliable relationship between the goal variable and the nominal anchor. If the relationship is weak, monetary aggregate targeting will not work and may not deliver the expected results of monetary policy. This seems to have been a serious problem in many countries all over the world and given the breakdown of the relationship between monetary aggregates and goal variables such as inflation, as well as the changes in money demand function, many countries have adopted inflation targeting as their monetary policy framework. Inflation targeting is characterized by (1) an announced numerical inflation target, (2) an inflation forecast, which facilitates forward-looking monetary policy decision-making, and (3) a high degree of transparency and Accountability. The inflation targeting framework is generally associated with an institutional framework by the trinity of a mandate for price stability, independence, and accountability for the central bank, enabling more effective anchoring of inflation expectations. A country needs to fulfill several prerequisites prior to or parallel to adopting an inflation-targeting framework and the efficacy of the policy transmission mechanism. Since adopting inflation targeting by New Zealand in 1989, many countries have been shown in Table 01(CBSL,2015).

Table 01: Inflation Targeting Countries

Year Adopted Inflation Targeting	Countries
1989-1994	New Zealand, Canada, United Kingdom, Sweden, Australia
1995- 1999	Czech Republic, Israel, Poland, South Korea, Brazil, Chile, Colombia
2000- 2004	South Africa, Thailand, Mexico, Iceland, Norway, Hungary, Peru, Philippines

Source: Central Bank of Sri Lanka

In practice, inflation targeting is flexible rather than strict, and most of the central banks do not only aim at stabilizing inflation around an inflation target but also put efforts into stabilizing other macroeconomic variables in the economy. Most central banks conduct flexible inflation targets (FIT) rather than strict inflation targets (SIT). FIT means that monetary policy aims at stabilizing both inflation around the inflation target and the real economy, whereas strict inflation target (SIT) aims at the stability of the real economy. e.g., the Reserve Bank of India and the Ministry of Finance in India have agreed to implement a monetary policy to focus on a flexible inflation target framework (CBSL,2015).

In the global economy, such a monetary policy framework that emphasized the role of expectations and credibility existed. Inflation targeting was quickly chosen as the monetary policy framework in Canada, the United Kingdom, Australia, and Sweden. Encouraged by the success of inflation targeting, several other advanced and emerging market economies adopted this framework. These countries used inflation targeting either to bring down inflation to stubbornly high levels or to maintain inflation at low and stable levels on a sustained basis. Considering the success of flexible inflation targeting in advanced and emerging markets, the Central Bank of Sri Lanka also considered this the best framework to adopt in the medium term (Weerasinghe,2017).

In the modern world, only a few countries practice exchange rate targeting as the monetary policy framework, as it requires a sizable international reserve to support the regime's credibility. Exchange rate targeting is the process through which a Central Bank intervenes in the market to maintain the exchange rate at a desired level or a predetermined target. Singapore presents itself as a success story, with the exchange rate being used as its key monetary policy instrument in its monetary policy conduct. An economy heavily reliant on external trade and finance, with imports and exports far exceeding the country's GDP, the exchange rate has historically played a pivotal role in determining inflation in Singapore. Moreover, as Singapore operates a managed floating exchange rate regime, it has greater control over the exchange rate, particularly in the form of direct interventions in the domestic foreign exchange market. The exchange rate can fluctuate within a policy band, allowing it to cushion against short-term volatilities arising from imperfections in the real economy

(CBSL,2019). Under this exchange rate-based monetary policy framework, Singapore can ensure exchange rate stability while allowing greater capital mobility but has no control over domestic interest rates and money supply. While alleviating the impact of short-term macroeconomic pressures, the exchange rate-based monetary policy framework has also ensured that the exchange rate remains aligned with Singapore's macroeconomic fundamentals (CBSL,2019).

Furthermore, greater fiscal discipline, flexible factor markets, a robust financial system, as innovation have supported and led to the success of Singapore's exchange rate-based monetary policy framework. However, such an exchange rate-based monetary policy framework may not be suited for a country like Sri Lanka as the country is experiencing persistent current account deficits and fiscal deficits with relatively large debt service payment requirements. Also, channeling efforts to maintain the exchange rate at a particular level would be at the expense of the country's limited foreign exchange reserves. Moreover, the success of such a framework would require strong macroeconomic fundamentals such as fiscal surpluses, robust products, factors, and financial markets, as well as greater policy stability and consistency.

As we are concerned in Sri Lanka, the Central Bank of Sri Lanka prompted the modernization project, resulting in legislative, procedural, and operational changes in relation to central banking in Sri Lanka. Regarding legislative changes, the amendments to the Monetary Law Act (MLA) in 2002 were the most important. Despite these modifications to the framework of conducting monetary policy over time, Sri Lanka continued to suffer from double-digit inflation until 2009 as a combined outcome of high budget deficits and loose fiscal policy, reactive rather than proactive monetary policy, frequent domestic supply disruptions, and international commodity price shocks. In June 2008, inflation increased to 28.2 percent, the highest level of inflation since 1980. To manage this situation within the monetary targeting framework, the central bank used strict quantitative monetary targets with increased policy interest rates.

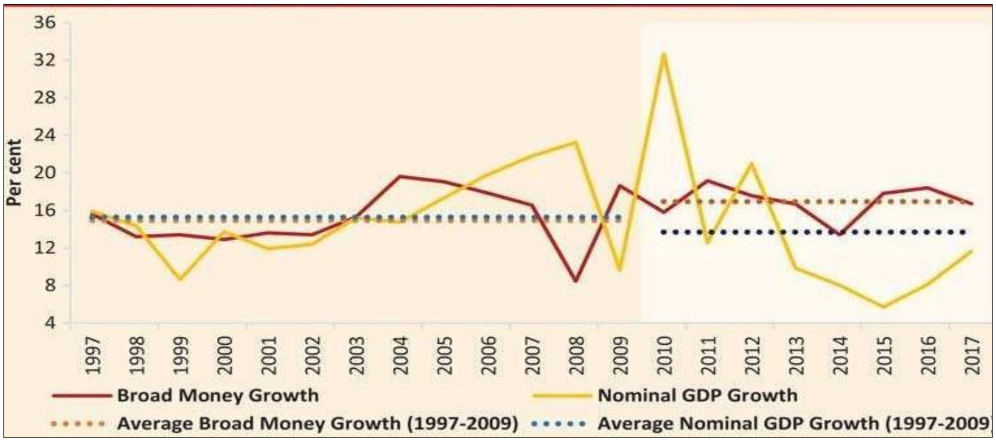
Although inflation spiked during some periods under the monetary targeting framework with managed floating or free-floating exchange rates, following strict monetary targets sometimes enabled the Central Bank to bring inflation back to tolerable levels. For instance, implementing strict quarterly reserve money targets when inflation peaked at over 28% in 2008 enabled rapid disinflation during a short period. At the same time, the requirements for the successful implementation of monetary aggregate targeting, namely a close relationship between nominal GDP growth and broad money growth and a close relationship between money growth and inflation, were visible until around 2009.

However, the gap between nominal GDP growth and broad money growth has widened notably since 2009. Even at high money and credit growth times, inflation has remained single digit. The ability of the Central Bank to contain inflation in single digits for a continued period of over 120 months, despite relatively high average money and credit growth, can be partly attributed to technological innovations that have changed the behavior of the public. However, it is likely that the efforts of the

Central Bank to anchor inflation expectations around mid-single digit levels through active communication and commitment to maintaining inflation at such levels have contributed significantly towards this achievement.

As the eventual breakdown of the relationship between monetary aggregates, inflation, and GDP growth [See Figure 02] was anticipated in line with developments in several other advanced and emerging market economies, by the late 1990s and the beginning of 2000s, the Central Bank had commenced an internal process to upgrade the monetary policy formulation and implementation process while strengthening research on alternative monetary policy frameworks.

In addition to moving to a floating exchange rate regime and streamlining the objectives of the Central Bank, the upgrades included the introduction of the Monetary Policy Committee (which is a technical committee that makes monetary policy recommendations to the Monetary Board), strengthening the independence of the Central Bank by expanding the membership of the Monetary Board, commencing active open market operations and a policy rate corridor approach, signaling the changes in the monetary policy stance based on policy interest rates, announcing the monetary policy stance through a regular press release based on an advance release calendar.



Source: Central Bank of Sri Lanka

Figure 02: Nominal GDP Growth vs Broad Money Growth in Sri Lanka

In addition, enunciating broad policies of the Central Bank for the medium term through an annual Road Map announcement, establishing a Monetary Policy Consultative Committee to obtain views of the private sector and academia, commencing an inflation expectations survey, encouraging the Department of Census and Statistics to update the inflation index and publish core inflation and continued strengthening of modeling and forecasting capabilities of the technical staff of the Central Bank is action taken by Central bank of Sri Lanka. With these developments, the Central Bank has gradually moved to a de facto inflation-targeting monetary policy regime. The Central Bank has announced that its target for monetary policy is to maintain inflation around 4-6%, which is considered a suitable inflation range for an emerging market economy to support sustained economic activity (CBSL, Road Map,2019).

The Central Bank projects key macroeconomic variables such as inflation and GDP growth in relation to its potential and uses the monetary policy instruments, mainly policy interest rates, to address sustained deviations of inflation from the target range. The interest rate in the short-term interbank money market acts as a key operating target for monetary policy, and open market operations are used to steer this short-term interest rate along a desired path. The exchange rate is allowed to float freely without maintaining a peg or a target exchange rate, and the Central Bank intervenes in the domestic foreign exchange market to curb excessive volatility, typically arising from domestic and global speculative activity, and to build up its international reserve.

The Central Bank continues to monitor several other macroeconomic indicators, including movements in reserve money, broad money, credit disbursements, market lending, and deposit rates, benchmark yield curve, the balance of payments developments, nominal and real exchange rates, fiscal developments, leading indicators for real sector developments, headline inflation, core inflation, food, and non-food inflation, administered price adjustments, etc., to help guide monetary policy decision making within this data-driven forward-looking approach to monetary policy.

The Central Bank of Sri Lanka has introduced a series of operational changes in the recent past with a view to improving the framework for monetary policy implementation. One such change was the extension of the periods of reserve maintenance by licensed commercial banks in June 2013. Other measures were streamlining the policy rate corridor of the CBSL and renaming it as the standing rate corridor in January 2014. The first Change was an extension of the reserve maintenance period (RMP). In Sri Lanka, all commercial banks must reserve a specific percentage of the Statutory Reserve Ratio (SRR) of their deposit liabilities as a cash deposit with the central bank.

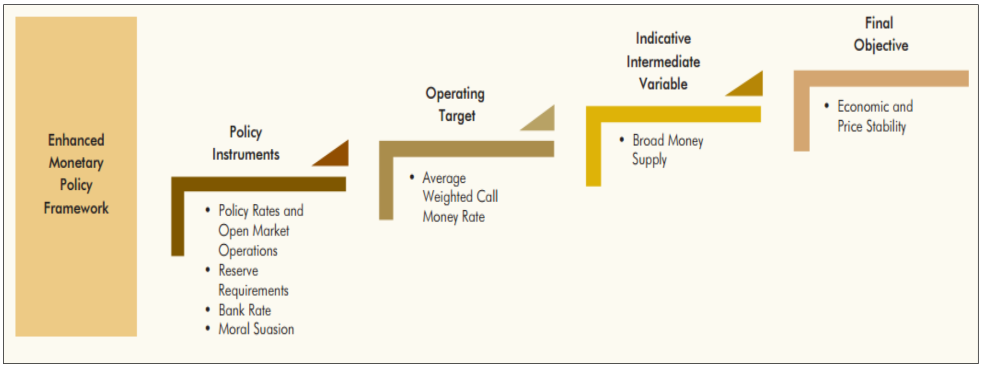
The second change was the establishment of the standing rate corridor (SRC). The Policy interest rate corridor of the CBSL, an important feature of the Open Market Operations (OMO), was restructured in January 2014 and renamed to streamline monetary operations. Policy rates are periodically reviewed and adjusted appropriately, if necessary, to guide the interest rate structure of the economy to achieve the desired path of inflation. This is an ongoing process, and it is expected that these improvements will strengthen monetary policy transmission, enabling the central bank to ensure economic and price stability while supporting financial system stability (CBSL,2013)

2.6 Flexible inflation targeting framework

In 2017, “Road Map; Monetary and Financial Sector Policies for 2017 and beyond”, the Central Bank announced its intention to officially adopt flexible inflation targeting as its monetary policy framework in the medium term. Flexible inflation targeting means that monetary policy aims at stabilizing both inflations around the inflation target and the real economy, whereas strict inflation targeting aims at stabilizing inflation only, with little regard for the stability of the real economy (Svensson, 2000).

The Central Bank is given independence to conduct monetary policy with the aim of achieving the envisaged inflation targets while it is also held accountable for its actions. This rule-based framework enhances the credibility of monetary policy, thus allowing additional welfare gains for the entire economy. This is because the financial market and the general public are assured of inflation being maintained at the targeted level on average, thus requiring only little adjustment in policy interest rates by the Central Bank to bring inflation back to target levels.

As an interim arrangement, the Central Bank conducts its monetary policy in an enhanced framework with both monetary aggregate targeting and flexible inflation targeting framework features. Under this enhanced monetary aggregate targeting, the central bank focuses on establishing inflation in the mid-single digit over the medium term while supporting growth objectives and flexibility in exchange rate management. In addition, instead of reserve money, the central bank currently uses the average weighted call money rate (AWCMR) as its operating target and increasingly relies on its market policy instruments (CBSL,2015).



Source: Central Bank of Sri Lanka

Figure 03: Modification of Monetary Policy Framework in Sri Lanka

The macroeconomic projection capabilities of the Central Bank are currently being strengthened. The Central Bank of Sri Lanka has developed the medium-term dynamic stochastic general equilibrium (DSGE) and forecasting policy analysis system (FPAS) for building technical infrastructure for the successful implementation of flexible inflation targeting (CBSL,2019). This system is currently being integrated into the monetary policy formulation process of the central bank. Going forward, the monetary policy framework is in line with the dynamic global environment to ensure both price and real sector stability on a sustainable basis.

The accommodative monetary policy adopted by almost all central banks across the globe continued amidst weak economic activity. Growing uncertainty, triggered by the second wave of Covid 19 has led the Central Bank to expand unconventional policy measures further. The Central Bank relaxed its monetary policy stance to unprecedented levels in 2020 to revive the economy affected by the pandemic. In response, both market deposit market rates have declined to single digital levels, while some have reached their historic lows (CBSL,2021).

Musthafa, Le & Suardi (2023) examined the paper empirically investigates effects of monetary policy shocks on Sri Lankan economy with particular focus on the strength of credit and exchange rate channels using a VAR model for 2003–2019 period. The focus is placed on the effect of monetary policy shocks on the real economy and the role of credit and exchange rate channels in monetary policy transmission. Results show that an unexpected monetary policy shock decreases output, money supply and commercial bank lending to the private sector and monetary policy shocks have more significant and persistent impacts on domestic variables.

This is a policy decision taken after careful analysis, and it is expected that flexible inflation targeting will enable the country to institutionalize its achievement of a decade of single-digit inflation within a transparent and accountable framework. It is worth noting that in Sri Lanka, time and again in the past, inflation has often been highlighted as “public enemy number one” (Gunarathne,2011, p. 51). It is to tame this public enemy of inflation on a sustainable basis that the Central Bank is continuing to work on, thus removing one key barrier that could hinder the country’s progress.

3. METHODOLOGY

The researcher conducted a literature review on the monetary policy framework in Sri Lanka and its impact on the financial sector. The review is done following a thematic approach. In this context, a comprehensive search of the literature in English published between 1949 and 2023 was conducted. Although many studies were found, the reliability of such quality and content is low and 25 studies were identified after completing the screening process. First, studies that addressed monetary policy framework were selected, followed by studies that addressed its impact for financial sector. The facts reported here are based on research and reports identified through searching academic journals and abstracting databases, internet searches, and the websites of key organizations. The researcher used the selection criteria to search for articles. Here, quantitative, qualitative, and mixed methods study reports were used. In searching for research papers, no restrictions were placed on the country where the research was conducted. But researchers focused more on research on monetary policy framework in Sri Lanka.

4. RESULTS AND DISCUSSION

From establishing the Central Bank of Sri Lanka in 1950 to adopting open economy policies in 1977, Sri Lanka has followed a fixed exchange rate regime. Under the fixed exchange rate regimes, the Central Bank had no control over domestic inflation. The fixed exchange rate system worked well only as long as Sri Lanka earned sufficient foreign exchange to meet expenditure on imports. During Sri Lanka’s fixed exchange rate regime, successive governments did not continuously pursue export-oriented policies. However, there were more times of policy reversals towards encouraging import substitution and inward-looking policies. The Central Bank, from time to time, either devalued the rupee or maintained a dual exchange rate along with severe restrictions on the use of foreign exchange. This monetary policy framework locked credibility and created severe distortions to market pricing.

In Sri Lanka, inflation increased to 14.4 percent by 1973, the highest level of inflation the country experienced until then during its post–independent history. Introducing the managed floating exchange rate was a welcome move from the perspective of a liberal macroeconomist. In November 1977, Sri Lanka embarked on a significant economic liberalization move. The Central Bank abandoned the fixed exchange rate regime and moved to a more market-based system of exchange rate management. The statutory reserve ratio (SRR) applicable to deposit liabilities of commercial banks and open market operations continued to be a key monetary policy instrument used by the Central Bank to control inflationary pressures in the economy during the 1980s and early 1990s.

As the Sri Lankan economy had adopted a range of economic and financial sector reforms since the 1980s with acceleration in the 1990s, the transmission of monetary policy and its effectiveness may have improved considerably. A fundamental change with respect to the conduct of monetary policy during the 1980s was that the Central Bank adopted the monetary targeting framework for monetary policy. If the relationship between the goal variable and the nominal sector is weak, monetary aggregate targeting will not work and may not deliver the expected results of monetary policy. Hence, many countries have adopted inflation targeting as their monetary policy framework. Most of the central banks not only aim at stabilizing inflation around an inflation target but also put efforts into stabilizing other macroeconomic variables in the economy. In the modern world, only a few countries practice exchange rate targeting as the monetary policy framework, as it requires a sizable international reserve to support the regime's credibility. The Central Bank continues to monitor several other macroeconomic indicators, including movements in reserve money, broad money, credit disbursements, market lending, and deposit rates, benchmark yield curve, the balance of payments developments, nominal and real exchange rates, fiscal developments, leading indicators for real sector developments, headline inflation,

The Central Bank of Sri Lanka prompted the modernization project, resulting in legislative, procedural, and operational changes in relation to central banking in Sri Lanka. With regard to legislative changes, the amendments to the Monetary Law Act (MLA) in 2002 were the most important. However, it is likely that the efforts of the Central Bank to anchor inflation expectations around mid-single digit levels through active communication and commitment to maintaining inflation at such levels have contributed significantly towards this achievement. The Central Bank of Sri Lanka has introduced a series of operational changes in the recent past with a view to improving the framework for monetary policy implementation. The Central Bank conducts its monetary policy in an enhanced framework with both monetary aggregate targeting and flexible inflation targeting framework features.

5. CONCLUSION AND POLICY IMPLICATIONS

The objective of this paper was to review existing literature on the historical evolution of monetary policy regimes in Sri Lanka. Before establishing the Central Bank of Sri Lanka, there was a currency board system in Sri Lanka. Gradually, it transmitted to a fixed exchange rate system, but the Central Bank implemented a Managed floating system due to some weaknesses. Therefore, the paper addresses the different aspects of monetary policies and reasons for adopting various monetary and exchange rate policy regimes from time to time.

When reviewing the monetary system in Sri Lanka, it is observed that as the role of the Currency Board must remain purely passive, it cannot influence the money supply in any way. The literature emphasizes that Sri Lanka needs to establish an independent monetary system and an institution with powers to control the financial sector. Therefore, a currency board system was not appealing for a small, open economy like Sri Lanka. As a result of this situation, Sri Lanka has followed a fixed exchange rate policy after 1977. However, evidence and examples showed that the central bank had no control over domestic inflation under that system. However, the fixed exchange rate system worked well only as long as Sri Lanka earned sufficient foreign exchange to meet expenditure on imports.

As the Sri Lankan economy had adopted a range of economic and financial sector reforms since the 1980s, with acceleration in the 1990s, the transmission of monetary policy and its effectiveness had improved considerably. Inflation targeting is flexible rather than strict, and most central banks aim not only to stabilize inflation around an inflation target but also put efforts into establishing other macroeconomic variables in the economy. In the global economy, such a monetary policy framework that emphasizes the role of expectations and credibility exists. According to the inflation target monetary policy framework, the Central Bank of Sri Lanka maintains its monetary policy within an enhanced framework with both monetary aggregate targeting and flexible inflation targeting framework features. The current conditions and the expected solutions to longstanding macroeconomic issues have prompted the Central Bank of Sri Lanka to adopt flexible inflation targeting by 2023.

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