

Financial Sector Reforms in Sri Lanka: *Some Reflections*

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Instrumentality of Financial Sector Reforms

The financial sector liberalisation programme of Sri Lanka was introduced in late 1977 as part of a wider set of reforms such as trade liberalisation, reforms in the incentive system, and the privatisation programme. It is documented that reform of the financial system of Sri Lanka was primarily triggered by the numerous macroeconomic difficulties that the country faced, particularly in the latter part of the 1970s and, to a certain extent, the influence of the world-wide trend towards financial liberalisation and deregulation. The overall reform programme placed greater reliance on the neo-classical model market mechanism while the financial sector reform was of the McKinnon-Shaw-type.¹ This framework was believed to stimulate economic growth while ensuring social justice. The private sector was considered to be the 'engine of growth' in the new environment. Tariffs and exchange devaluation came into play a major role in place of existing quantitative restrictions to ease the anti-export bias. The objective of the programme was to raise the level and rate of investment and the efficiency of capital for rapid economic growth.

As mentioned in a few other studies, Sri Lanka's reform programme of 1977 was not a wholesale removal of all regulations on economic activities in one full sweep.² The empirical literature says that it is always tricky to find the appropriate timing in changing important economic variables towards achieving the set goal with

macroeconomic stability, and this has become a major issue over time.³ The reforms in Sri Lanka characterised a gradual or organic process that consisted of two major phases from 1977 to 1988 and 1989 to 1994 (see, for example, Dunham and Kelegama, 1994; Dassanayake and Herat, 1997) with a view to avoiding possible macroeconomic shocks to the system.

In the initial phase, reforms were centred on the banking system, exchange system, and monetary policy, and later extended to reforms of bond and equity markets and capital flows. To facilitate these changes, banking laws were amended to provide more autonomy to the Central Bank and to strengthen its capacity in banking supervision and setting prudential regulations. The interest rate as an instrument of monetary policy played a prominent role. Based on the McKinnon-Shaw stylised setting, a high-interest rate policy became the norm instead of a cheap money policy, primarily to encourage domestic savings. The high-interest rate policy was also expected to address two important macroeconomic issues; firstly, to depress the growing inflationary pressures in the economy through increased demand for real money balances; and secondly, to keep the real interest rate positive, so that financial flows into the banking system would be encouraged, increasing the loan giving capacity of financial institutions.

The major thrust of the interest rate reform was an upward revision in the Bank rate (BR). The BR was raised to 10 percent from 8.5 percent, with a view to making the BR more effective in influencing the deposit and lending rates of

commercial banks. Immediately after the change in the BR, the National Savings Bank (NSB) rates on its deposits were also raised sharply from 7.5 percent to 12 percent per annum for six-month deposits, 15 percent per annum for 12-month deposits. The NSB being the price setter in the market for time and saving deposits, this sharp upward revision of NSB rates compelled commercial banks and other financial institutions to follow suit. Interest rates on bank deposits immediately went up, making real interest rate positive. However, as a result of growing inflation the positive real interest rate was short-lived, and consequently the NSB rate was raised to keep the real interest rate at positive levels. Other participants in the financial market naturally followed suit by increasing their rates of interest. It is interesting to note that there was no interference in the determination of lending rates during the post-reform period.⁴

An overhaul of the exchange rate regime was the other important major change in the macroeconomic setting in the post-liberalisation period. To realign the exchange rate, domestic currency underwent a sharp devaluation in November 16, 1977 against the US \$ by 46 percent. The objective was to counter external sector disequilibrium through an effective import substitution and export promotion. In addition, the exchange rate was unified. The fixed exchange rate regime and the existing dual exchange system were abandoned. And thereafter a managed-float exchange rate system came into operation. The Sri Lanka rupee was allowed to float in terms of a basket of international currencies. The climax of the exchange rate policy reform started in 1977 was reached when Sri Lanka accepted the obligations under Article VIII (i.e., full current account convertibility) of the IMF charter in March 1994.

¹ In 1973, Edward Shaw and Ronald McKinnon presented a new perspective on the role of money in economic development based on the notion that high interest rate and capital accumulation, investment, real economic growth are positively and strongly correlated. To them, administrative resource allocation or financial repression is not only inefficient but also the source of macroeconomic instability in developing countries and thus presented a strong case in favour of the liberalisation of the financial system and interest rate (for details, see McKinnon, 1973; Shaw, 1973; Fry 1995).

² In the literature, the rapid approach is known as the 'big bang' or 'shock therapy', which advocates economic liberalisation, stabilisation, and privatisation within a relatively shorter time span.

³ The employment of both fiscal adjustments and market-based instruments of monetary policy towards the establishment of a sound macroeconomic environment might bring adverse economic consequences if the financial system lacks the flexibility to adjust itself in line with the growing financial needs of real sector enterprises. (see, for example, Gregorio, 1992; Funke, 1993; Dabrowsky, 1996; Visser and van Herpt, 1996; Demirgüç-Kunt and Detragiache, 1998; Blackburn, 1999).

⁴ It is argued that the authorities should establish upper limits boundaries up to which the lending rate can be raised without incurring additional dimensions of distortion in the economy (see, for example, Kapur 1983; McKinnon, 1988, 1989; Beckerman, 1986).

The Implications for the Money Market

Following the liberalisation there has been a substantial growth in the commercial banking system in several respects. The prohibition placed on the establishment of new foreign bank branches was relaxed in 1979, expanding the possibilities for foreign banks to penetrate the domestic money market. Consequently, new foreign banks started business operations in Colombo giving more opportunities for international exposure and room for competition. The total number of foreign commercial banks operating in the domestic market increased threefold, from 7 banks at the end of 1971 to 21 by the mid 1980s. However, the number of foreign banks operating in the domestic market declined to 16⁵ at the end of 1999 from a peak of 25 foreign banks in 1982.

Following the financial sector reforms, the number of domestic private sector commercial banks operating in Sri Lanka rose from 2 at the end of 1977 to 7 by 1999 deepening the domestic money market. Domestic commercial banks have also registered a sustained improvement measured by the phenomenal expansion of their banking activities into rural and semi-urban areas. The number of private sector bank branches rose to 296 by 1999, from only one bank branch at the end of 1977 (CBSL Annual Report, 1999). State sector banks also increased the number of branches to 637 in 1996, from 151 in 1970. Since 1977, the foreign banking sector has also shown a substantial improvement in terms of both branches and assets expansion. The number of foreign bank branches at the end of 1999 was 42, as compared with only 13 branches at the end of 1970. As a result of this increased network of bank branches, the number of people per bank branch decreased⁶ substantially.

Increased activities in the financial system following the reforms have brought several other noteworthy improvements as well as some positive changes in the behaviour of banks, including the large state banks. One example was the development of distinctions between different categories of financial institutions that helped to increase the specialisation in the market. In line with this, certain financial services like lease financing, and merchant banking started branching out from the conventional banking system. This helped the diversification of the domestic financial system and eventually several leasing companies and merchant banks were operating in the domestic market. Another example was that in 1993 Sri Lanka joined the Society for World-Wide Inter-Bank Financial Telecommunication (SWIFT) system, and in the same year commercial banks in Sri Lanka established instantaneous global electronic links. In addition, commercial banks have introduced many new financial products and facilities such as Automated Teller Machines (ATM), credit cards, electronic fund transfer facilities, the Sri Lanka Inter-bank Payment System (SLIPS), tele-banking and internet banking, and several financial derivatives, increasing the diversity and the efficiency in payment and settlement systems of the domestic money market. Bank clearing, too, has registered an increase in the post-liberalisation period. The monthly average value of bank clearing has grown in real terms by 22 percent per annum in 1978-89, and 21 percent per annum in 1990-98 compared with 13.2 percent a year in 1970-77 (Source: own calculations based on CBSL information).

The renewed volume of activities of commercial banks after the reform has

resulted in a rapid expansion of banking assets. Commercial bank assets swelled at an annual growth rate of 17 percent in real terms⁷ between 1978 and 1993, and 13.4 percent in the 1994-98 period. This steady expansion in assets helped the commercial banking sector to retain its position as the biggest source of external financing for the private sector. In 1998 commercial banks as a whole contributed 63.5 percent of the total private sector financing needs. The relative significance of the banking sector as a source of private sector financing, however, has shown a marginal decline over the years (see table 1.1). The underlying reason for this decline is probably the gradual development of alternative sources of financing for the private sector during the post-liberalisation period (Table 1.1).

All commercial banks operating in Sri Lanka were given the green light to establish Foreign Currency Banking Units (FCBUs) in 1979. FCBUs were allowed to undertake offshore banking services, such as accepting deposits and granting loans in selected foreign currencies to non-residents,⁸ commercial banks, enterprises in free trade zones, and residents approved by the Central Bank. By the end of 1984, all commercial banks operating in Sri Lanka had established FCBUs. The growth in total assets of FCBUs has shown large variations

Table 1.1

Sources of External Financing for the Private Sector 1960-1998

Institutions	1960	1970	1995	1996	1998
Central Bank	3.3	6.7	—	—	—
Commercial Banks	80.4	77.1	72.3	66.3	63.5
FCBUs	0.0	0.0	12.5	12.3	13.2
Finance Companies	0.0	0.9	2.9	4.7	4.9
Development Banks ^a	2.8	3.2	8.1	10.7	12.3
Other Credit Institutions ^b	13.5	12.1	4.3	6.0	6.1

a - DFCC and NDB, b - SMIB, HDFC, NSB, Rural Banks, RRDBs, RDBs, TCCSs, and other Savings and Development Banks.

Source: Figures in 1960 and 1970 are taken from Karunasena, 1998, and others are own calculations based on CBSL Annual Report, 1998.

⁵ Bank of America ended its operations in Colombo in 1986. The branch of Dubai Bank merged with Union Bank of Middle East in 1983 and subsequently it was taken over by HNB in 1989. Algemene Bank Netherlands was amalgamated with AMRO Bank in 1991. The operation of the branch of the Bank of Credit and Commerce International was suspended in 1991 and its operations resumed after a few weeks under the management of Seylan Bank Ltd., a private sector local commercial bank. Middle East Bank Ltd., was taken over by Muslim Commercial Bank. The newest private sector domestic bank, Nation's Trust Bank (NTB), started operating in June 1999. NTB acquired the business operation of Overseas Trust Bank of India Ltd and Nova Scotia Bank. Korea Exchange Bank ceased its operation in Colombo in 1998.

⁶ In 1970 there were 63,533 customers per bank branch, and by 1996 customers per bank branch decreased to 13,477, indicating a positive trend of banking development. The banking index (number of bank branches per 10,000 people) also rose sharply from 0.157 in 1970 to 0.742 in 1996.

⁷ 1990=100

⁸ This facility was further extended to Sri Lankan residents who obtain foreign currency by opening Resident Foreign Currency (RFC) accounts.

over the period, and hence, calculating an average growth rate for FCBU assets for the whole period of time is pointless. Therefore, the study summarises the growth in FCBU assets for three sub-periods: between 1980 and 1983, assets registered 53 percent growth per annum; between 1984 and 1987, growth in assets was 0.7 percent per annum; and from 1988 to 1998, FCBU assets grew at 14 percent a year.⁹ The high growth in assets registered in the beginning was short lived and it is after 1988 that FCBUs managed a more stable growth rate. The growth of FCBU assets, albeit with high volatility, enabled them to contribute 13.2 percent of total private sector financing in 1998, thus becoming the second-largest credit provider for the private sector (Table 1.1).

Following the financial sector reforms, the activities of Finance Companies (FCs), too, registered an unprecedented expansion¹⁰ in several respects. The volume of assets of FCs registered steady growth over the years that helped this group of institutions to emerge as another important source of financing for the private sector. According to the information available, in 1998, FCs managed to provide 4.9 percent of total private sector financing needs. This is more than 95 percent expansion compared with the 1977 level. The growth of FCs as mobilisers of deposits has also been impressive. After the interest rate reforms in 1977, FCs were able to compete for funds with commercial banks by offering attractive rates of interest. By the end of 1996 about 6 percent of the total time deposits and about 3 percent of all deposits mobilised by the financial institutions were through the FCs, mainly in the form of fixed deposits (CBSL, Annual Reports). This growth has enabled FCs to be ranked as the third-largest deposit mobiliser in the financial system. This satisfactory expansion in the asset bases of these

three groups of financial institutions (i.e., FCs, FCBUs, and commercial banks) has enabled them collectively to emerge as the largest source of private sector financing, contributing 82 percent of the total private sector financing needs in 1998 (Table 1.1).

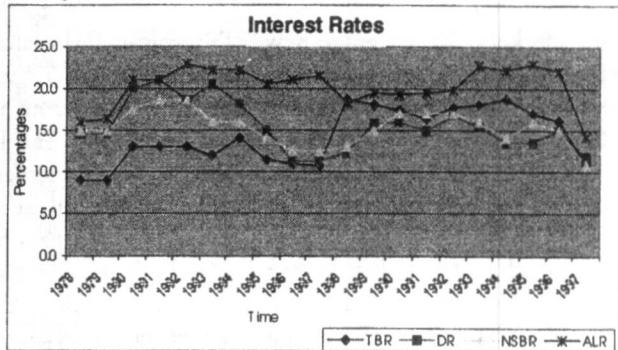
Another important development in the money market was the emergence of a very active TB market. Before 1977, rates offered for TBs were not sufficient to attract commercial bank and non-bank sectors. As a

result of very attractive yields offered, compared with other short-term instruments and related infra-structural¹¹ development, TBs have gained rapid popularity as a short-term investment opportunity, especially among commercial banks and the non-bank public sector, since the mid 1980s. In absolute terms, the value of TBs offered and purchased in 1996 was Rs. 227 billion.¹² This is a fourfold increase when compared with the amount purchased and sold in 1982 (Rs. 58 billion). On average, the volume of TBs sold and purchased grew at 10.6 percent per annum during the 1982-1997 period. As a result of this increased volume in TB trading, the TB rate has subsequently been functioning as a general indicator of interest rates, or in other words a floor to other prominent interest rates in the market (Figure 1.1).

The emergence of an active inter-bank market is another important development in the money market. The major task of an inter-bank market is to smooth out fluctuations in receipts and payments by commercial banks and similar financial institutions in the market. Following the financial liberalisation, the entry of new foreign commercial banks into the money market since 1977

has largely been responsible for this rapid expansion in the inter-bank market. The annual turnover of the inter-bank market grew to Rs. 1016 billion in 1997. This is a 2063 percent growth when compared with the value in 1982 (Rs.49.2 billion). During the post-liberalisation period the

Figure 1.1



Source: CBSL annual reports, various issues.

inter-bank rate has been market driven and has also been functioning as an important indicator of the liquidity condition in the system.

Implications for the Capital and Long-Term Credit Market

In the course of financial sector reforms, the equity market of Sri Lanka has entered into a new era of progress in terms of both the quantity and quality of trading activities. The development of a stock market is considered very important because, on the one hand, it is an essential element as a source of finance to fund risky investment projects, emerging in the growing sectors of the economy, and on the other hand as a leading indicator of economic activity. The increased stock market capitalisation as a percentage of GDP improves the economy's ability to mobilise capital and diversify risk (see, for example, Levine, 1996; Arestis and Demetriades, 1997). Since the financial sector liberalisation in 1977, certain bold and pragmatic changes have been adopted to develop the capital market in Sri Lanka. The Colombo Stock Exchange¹³ (CSE) in 1984 and Securities and Exchange Commission

⁹ Growth rates are in real terms, 1990=100.

¹⁰ However, after a sudden failure of many finance companies in the 1980s, and as a result of improved legislative measures, the number of finance companies actually operating in the money market declined to 25 in 1997 from a peak of 72 in the early 1980s.

¹¹ Introduction of TBs with different maturities; CBSL appointed 18 accredited primary dealers to tender for TBs in the primary market; "Secondary Window" of CBSL with a view to developing and expanding the secondary market in TBs.

¹² In 1997 it was Rs. 195 billion and in 1998 it was Rs. 217 billion.

¹³ The Colombo Securities Exchange Ltd., was set up in 1985 by amalgamating the trading floors of Colombo Brokers' Association and the Stock Brokers' Association, which were formed in 1894. CSE is entirely owned by brokers and have provisions for dealers to join. In 1990 the name was changed from Colombo Securities Exchange to Colombo Stock Exchange.

(SEC) in 1991 were commissioned to strengthen and to systematise the operations in the capital market. SEC is an independent regulatory body and its responsibility extends to issuing licences and to formulating rules and regulations for the operation of stock exchanges and unit trusts, for proper conduct of market operation, and to safeguard investor interests. In 1991,

Table 1.2

Market Capitalisation as % of GDP in Selected Countries, 1990-1996

Country	1990	1995	1996
Sri Lanka	11.4	16.2	15.1 ^a
India	12.7	39.2	38.1
Indonesia	7.6	33.6	42.8
Philippines	12.9	79.3	37.4
Pakistan	7.0	15.3	16.9
Malaysia	113.8	261.1	94.3
Thailand	29.7	84.7	12.7

Source: GOSL, 1992; World Bank, 1998 (table 2.3 of attachment 2.3), a - The ratio has declined further to 11.5% in 1998.

the Central Depository System Ltd. was instituted as a subsidiary of CSE to improve the efficiency of the increasing volume of trading activities. As a result, the Central Depository System (CDS), a state-of-the-art centralised settlement system that eliminates the delays involved in settlement of transactions, was introduced to hold shares. The CSE also introduced a fully automated trading system to assist post-trading operations. This enabled the CSE to become the world's seventh fully automated and integrated stock exchange. With these technical and institutional developments, there has been much progress, amidst large fluctuations in the volume of business, in the availability of a range of financial products that helped the CSE to become an emerging stock market in Asia. These technical and legislative developments have attracted a number of new business establishments, such as investment trusts and companies, regional and country funds¹⁴ on to the trading floor of the CSE. These developments, coupled with the gradual removal of exchange regulations, have

transformed the CSE into a vibrant market.

As Figures 1.2 and 1.3 indicate, market capitalisation and price indices, though highly volatile, have registered an upturn, particularly between 1989 and 1994. After 1994 all indicators registered a decline. In the period between

Figure 1.2



Source: CBSL, Annual Reports MC: Market Capitalisation

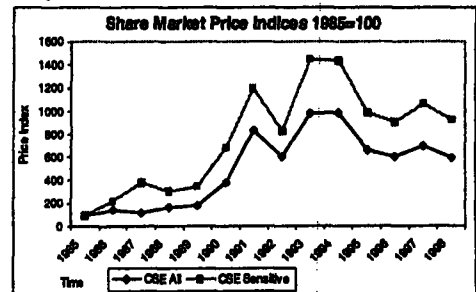
1982 and 1989, market capitalisation as a percentage of GDP was on average 8.4, and that level increased to 17.1 during the 1990-98 period. The highest level recorded was 24.8 per cent of GDP in 1993. The total number of shares traded on the CSE also increased significantly. On average, 33 million shares were traded annually between 1985 and 1992, and thereafter this amount increased to 384 million shares per year from 1993 to 1997. As a result of this progress, the capital generated through the CSE has also increased. During the period from 1982 to 1989, the CSE contributed on average 21 percent of the total long-term capital generated in the market (CBSL, Annual Reports). This level, however, has declined to 13.2 percent from 1991 to 1997. Despite this progress, the size of the CSE in relation to GDP and compared with other developing Asian countries still remains small and shallow due to several problems¹⁵ (Table 1.2).

It is evident that there has been a phenomenal increase in the number of institutions in the market for long-term credit. The National Development Bank (NDB) was set up by the government through the National Development Bank Act No. 2 of 1979 that raised the number of development banks in the

market to two. The bank was expected to mobilise funds for project financing, equity funding, and refinancing to public and private sector enterprises in priority areas. Like the DFCC, NDB was empowered to borrow money from both domestic and foreign sources to carry out its business activities. Since, the financial reforms, the activities of these two development banks have been on the increase. The DFCC on average managed to contribute 23.1 percent of the total medium-to-long-term credit during 1980-1997 while NDB's contribution was 39 percent. Collectively, these two development credit institutions were able to contribute 62 percent of the total medium-and long-term credit. During the same period, almost half of the capital raised through the capital market was from these two institutions. In 1998 these two development banks contributed 12.3 percent of the total private sector financing requirement in the country (Table 1.1).

In line with the initiative to broaden the scope of and to diversify the financial system, four new long-term

Figure 1.3



Source: CBSL, Annual Reports.

credit institutions started business operations under the auspices of the government. They are the State Mortgage and Investment Bank (SMIB)¹⁶ and the National Insurance Corporation (NIC) in 1979, and the National Housing Development Authority (NHDA) and the Housing Development Finance Corporation of Sri Lanka (HDFC) in 1984. The objective was to channel long-term credit for agriculture, industry, and housing construction. The setting up of these

¹⁴ By 1998 there were 8 venture capital companies, 10 unit trusts, and a number of country and private fund management companies operating in Sri Lanka.

¹⁵ For example, government ownership has prevented most large companies from being listed in the CSE; private sector small and medium-sized, mostly family-owned companies are reluctant to broad base the ownership, and the number of companies listed on the CSE still remains small (there were only 239 companies listed on the CSE as at the end of 1997); there is high volatility in the market, largely due to political instability.

¹⁶ The State Mortgage Bank and Agricultural and Industrial Credit Corporation, which were established in 1931 and 1943 respectively, were amalgamated in 1979 to form the SMIB.

Table 1.3

Annual Growth Rates of GDP, Exports, Prices, and the Average Level of Unemployment 1970-1997				
Period	GDP ^a	Exports ^a	Price	Unemployment
1970-77	3.10	19.10	5.70	18.30
1978-89	4.80	22.10	12.60	14.95
1990-98	5.31	21.10	12.00	12.81

Source: Own calculations based on CBSL information
a. in real terms 1990=100.

institutions increased the number of housing finance institutions to three and the number of medium-to-long-term credit institutions to seven.

In 1985, Regional Rural Development Banks (RRDBs) were established with a view to developing the rural credit structure, providing increasing amounts of credit to rural enterprises which have limited access to credit from the organised banking sector. By 1993 the number of RRDBs stood at 17, with more than 170 branches islandwide. However, their ability as mobilisers of financial resources remained insignificant.¹⁷ They mobilised less than 1 percent of total deposits of the financial system in 1996.

Other important aspects in the long-term credit market are the establishment of a new pension fund¹⁸, the entry of several private sector insurance companies, and private and public sector long-term credit institutions¹⁹. Despite the rapid institutional developments in the long-term credit market, its relative size as a source of private sector financing remained small. This market as a whole provided 14 percent of the total private sector financing needs in 1996, while its share of total financial assets grew to 5.3 percent in 1996 from 2 percent in 1970.

Implications for the Real Sector of the Economy

In liberalisation theory, improvement on the supply side is considered vital, in particular to reduce the rate of domestic inflation and to increase real

GDP growth. Supply-side improvements immediately after the reforms were a glowing success by conventional standards. One simple indicator to assess the supply-side improvements would be GDP growth. The growth rate in real terms rose to 8.2 percent and 6.3 percent in 1978 and 1979 respectively, and the economy was able to maintain an average annual growth rate of 4.8 percent for the period from 1978 to 1986.²⁰ This is, however, a moderate improvement compared with 3.1 percent GDP growth²¹ during the 1970-77 period (see Table 1.3 and Figure 1.4).

On the whole, from 1978 to 1998 the economy managed to grow, on average, 5 percent per annum. This order of growth was made possible by the positive supply-side responses registered in the manufacturing sector at 6.3 percent per annum, followed by the service sector at 5.3 percent per annum and the agricultural sector at 2.3 percent per annum between 1978 and 1997. The relative importance of the financial sector to the national economy has also increased following the liberalisation. The contribution of the financial sector to GDP was 1.32 percent during 1970-77. It increased more than fourfold to 7.12 percent in 1996 (Ariyadasa, 1997).

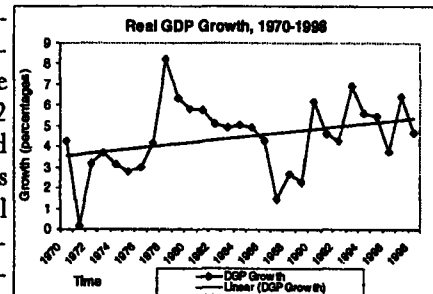
Performance of total exports is another useful indicator in understanding the improvements on the supply side. According to table 1.3, growth in exports has been reasonably rapid in the post-liberalisation period. The real growth of exports during the first half of the liberalisation programme is slightly

Table 1.4

Structural Composition of the Economy 1970-1997 As a percentage of GDP (at constant factor cost prices)				
Period	Agriculture (1)	Manufacturing (2)	Services (3)	(4)=(1)+(2)
1970	28.3	16.7	48.7	45.0
1977	30.7	23.1	41.2	53.8
1980	27.6	17.7	43.8	45.3
1985	27.7	14.7	47.5	42.4
1990	26.3	14.9	48.9	41.2
1995	23.1	15.7	51.9	38.8
1998	21.4	16.8	53.5	38.2

Source: own calculations based on CBSL information

Figure 1.4



Source: CBSL, Annual Reports, various issues.

higher than in the second half (from 1990 to 1998). However, when the growth rate in exports in the post-reform period is compared with their growth rate in the pre-reform period, the difference does not seem very significant.

The level of unemployment registered a fall to 15 percent by 1980 from a peak of almost 20 percent in 1975. Increased employment opportunities in the economy were largely created through the execution of large public investment programmes immediately following the reforms, and the expansion of employment opportunities, particularly in labour-intensive manufacturing in the private sector. Increased activities in the private sector, particularly in the second phase of the reform programme, created a major share of the new employment, and by 1997 the private sector had absorbed 80 percent of the employment, of which 27 percent was in the form of self-employment (CBSL, Annual Reports).

Contd. on page 26

¹⁷ As a result, in 1998 a programme was commenced to restructure RRDBs with a view to enhancing their contribution to the financial system.

¹⁸ To broaden the retirement benefits to employees in the private sector and to promote employee participation in the ownership of enterprises in the private sector, the Employees Trust Fund (ETF) was created in 1980 in addition to the existing Employees Provident Fund (EPF).

¹⁹ By 1997, in addition to two government-owned insurance companies, there were four private sector insurance companies, two private sector long-term credit institutions and one co-operative sector long-term credit institution in the long-term credit market.

²⁰ However, from 1978 to 1989 the average growth was just 2.2 percent a year.

²¹ In 1971 (the first youth insurrection), the economic growth declined to 0.2 percent. If the year 1971 is excluded, the difference between average growth rates in pre- and post-liberalisation periods becomes even smaller.

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Total public sector employment registered a gradual decline due to public sector reform policies coupled with privatisation of plantation companies and other government business ventures. Increased activity in the financial sector has also positively contributed towards employment generation. The financial sector contribution to employment increased to 1.8 percent by 1994, from 0.7 percent in 1971 (Ariyadasa, 1997), indicating a growth of more than 150 percent. The decline in unemployment in the second half of the post-liberalisation period, however, is slower than that of the first half. On the other hand, the decline in overall unemployment should be seen in the context of increased exports of labour since 1977. As a result of the removal of restrictions on employment abroad, at least 100,000 labourers have migrated annually since 1977, particularly to Middle Eastern countries.

The general price level has increased following the liberalisation of the financial sector. In the new environment, the price control mechanism was abolished immediately except for a few essentials. Hence, the price level differences between pre- and post-reform periods are somewhat misleading. However, the important message in table 1.3 is that the rate of change in prices remained high throughout the post-liberalisation period. The decline in inflation in the second sub-period after the liberalisation is negligible. In conclusion, what can be seen is that a fairly strong response from the real sector in the initial years of the liberalisation programme gradually fading away to a certain extent until the early 1990s.

The relative size of the agricultural sector as a percentage of GDP has shown signs of decline (Table 1.4), particularly after 1977, which is quite usual and could be expected in a developing economy that is in transition. Basically, in most developing countries the general tendency is that initially a larger growth in the industrial

sector manifests itself in a substantial rise in that sector's share of GDP in a process of structural changes, while the share of the agricultural sector in GDP registers a rapid decline (see, for example, Meier, 1989). However, the growth in the industrial sector has not resulted in a rise in its share of GDP in the case of Sri Lanka, which could be a somewhat strange economic occurrence. In fact, the share of the manufacturing sector is lower in 1998 than in 1977 (Table 1.4). As liberalisation theory predicts, rapid expansion in industrial sector's share in GDP is vital to higher economic growth. This, however, has not taken place in the case of Sri Lanka, which could be a cause for concern for the Sri Lankan planning authority.

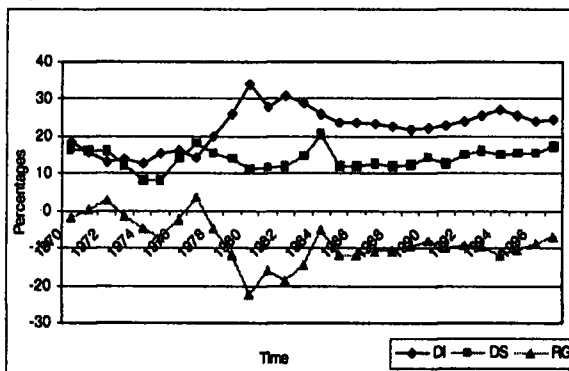
The other important circumstance indicated in table 1.4 is a steady decline in the share of the aggregate production of the agricultural and manufacturing sectors throughout the post-reform period (the last column of Table 1.4). This is an important issue because the financial liberalisation theory believes that in-

financial sector, may directly or indirectly depend on what is happening in the manufacturing sector. Hence, the study argues that a rapid expansion in the manufacturing sector would be crucial to sustain growth for a long period of time.

The overall growth in real GDP is largely attributable to a sharp increase in investment. The reform programme included massive public sector investment projects²² largely financed by concessionary aid inflows. As a result, the gross domestic capital formation reached unprecedented heights. The rate of investment increased to 33.8 percent of GDP in 1980 from 14.4 percent of GDP in 1977 (Figure 1.5). During the 1978-82 period, the economy managed to invest on average 27.8 percent of GDP per annum. The public sector doubled its usual level of investment in the period immediately after the financial sector liberalisation through its planned investment projects. The public sector share in

total investment, therefore, rose to almost 60 percent in 1980, and in most years throughout the period until 1988 the public sector contribution was more than half of the total domestic capital formation. However, given that a major objective of reforms implemented in 1977 was to reduce the interventionist role of the government and to allow market forces

Figure 1.5 Investment Saving Profile 1970-98 as % of GDP



DI: Domestic Investment, DS: Domestic Savings, RG: Resource Gap
Source: CBSL Annual Reports, various issues.

created production of goods plays a major role in easing inflationary pressure in the long-run after generating an initial deflationary stimulus through higher interest rate and increased demand for money. The growth of the manufacturing sector is emphasised in this discussion because a strong manufacturing base is an important element sustaining higher real economic growth. The development of most of the other sectors in the economy, including the

to determine economic activities, the government's undertaking of direct investment activities of this magnitude was, in fact, a major exception. The trend was reversed during the second phase of the liberalisation programme, thereby allowing the private sector to take the lead in domestic capital formation.

What is interesting in the post-liberalisation period is that, even

²² (1) Accelerated 'Mahaweli' river project, (2) urban development programme, (3) housing development programme.
²³ Between 1970 and 1977, average domestic saving as a percentage of GDP was 13.7 percent a year.

though the level of investment registered a sharp increase, averaging slightly over 25 percent of GDP per annum, the growth of domestic savings has been sluggish (Figure 1.5). From 1978 to 1998 the average level of domestic saving was 14.3 percent of GDP per annum, which is not significantly different from the average level of savings in the pre-reform period.²³ It seems that domestic saving was not very sensitive to the higher interest rate, contrary to the expectations. As empirical information suggests, the higher levels of investment were financed largely through increased reliance on foreign savings as measured by the external deficit. Hence, some studies have highlighted the financial sector reform of Sri Lanka as an example for a successful external resources mobilisation effort (see, for example, Jayawardena et al. 1987; Moor, 1990).

Monetary Policy

The pro-liberal economic policy regime implemented in 1977 had a substantial impact on monetary management and the challenge to monetary policy was to find the proper balance between the development and stabilisation objectives of the economy. Direct and discretionary forms of credit control were supposed to become less important in the new policy environment. Instead, market-based methods such as repurchase agreements in the inter-bank market, TB auctions, secondary transactions in TBs, and other government securities, rediscount facilities, etc., were to gain emphasis in managing the level of liquidity in the system. On the external front, the exchange rate and its rate of depreciation were supposed to promote the supply side further through changes to costs of inputs and the rate of profits of productive enterprises.

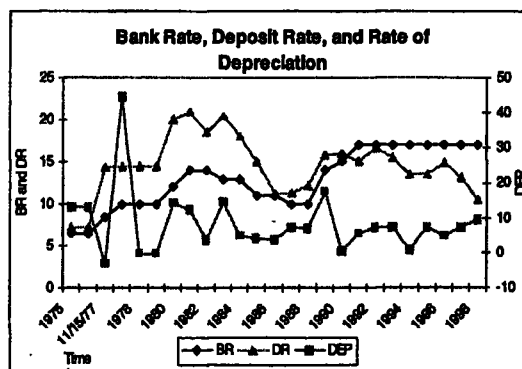
As discussed earlier, a sharp increase in the interest rate and a large depreciation of the exchange rate were the initial changes which came into effect under the new setting (Figure 1.6). At the same time, controlling the growth of the monetary base has become a major concern of the monetary authorities following the liberalisation. This is basically due to the belief in a strong positive relationship between the growth of the monetary base and domestic inflation at the theoretical level (see, for example, Mathieson, 1979; Kapur, 1983; McKinnon, 1989, 1993; Fry, 1995, 1997), and perhaps in some countries at the empirical level as well (see, for example, Zaki, 1995; Demirgüç-Kunt and Detragiache, 1998). On the other hand, a higher interest rate, a realignment in the exchange rate, and controls on the growth of the monetary stock are the basic policy mix given in the McKinnon-Shaw-type liberalisation theory for rapid economic growth with macroeconomic stability (see, for example, Mathieson, 1979; Kapur, 1983; McKinnon, 1989; Fry, 1995, 1997).

phoning-off excess liquidity in the system.

According to the Central Bank estimates, the volume of liquidity in the system continued to grow due to increased borrowing by the government from the banking system, increased banking credit to the private sector, and continuous growth of external banking assets. Hence, in addition to the reduction of Central Bank rate, statutory reserve requirements, and supplementary selective measures²⁴ were adopted with a view to maintaining a balance between the dual macroeconomic objectives of stability and growth. As CBSL says, the objective of the introduction of selective measures was to reduce the interest cost to priority sectors to promote supply of goods and services into the market as a counter measure to control the level of prices. However, some of these restrictive policy measures do not fit in with the standard financial liberalisation programme.

For example, employment of selective credit and increased reserve requirements are regarded by proponents of financial liberalisation and financial structuralists as policies that could distort the efficient allocation of resources. However, on the other hand, the literature on the optimal degree of financial repression argues that the effects of such regulation should be assessed in terms of their consequences on the rate of economic growth. In other words, the correct dose of such regulation would be useful in guiding the economy towards a state of high economic growth with less instability

Figure 1.6



DEP: The Rate of Depreciation, BR: Bank Rate, (Central Bank Discount Rate), DR: Deposit Rate (annual average of 12-month deposit rate of commercial banks).

Source: CBSL Annual Reports, various issues.

Therefore, the general feature of the monetary policy stance in the 1980s was the introduction of a restrictive monetary policy package with a view to si-

phoning-off excess liquidity in the system.

²³ In 1981, the CBSL introduced a national credit plan with a view to provide more funds to vital and growing sectors in the economy. However, priority was often on the government sector. In 1983, the central bank's rate of refinancing to commercial banks on pre-shipment export credit was reduced. For the first time CBSL introduced a reserve ratio of 16 percent on unutilised overdrafts to the private sector held with commercial banks. In 1985, the liquid asset ratio of finance companies was raised to 15 percent. In 1988, a ceiling was imposed on commercial bank credit to the private sector, and CBSL issued its own securities to mop up excess liquidity in the system. In 1989, partial credit ceilings were imposed on commercial bank credit to non-priority sectors.

²⁴ In 1990, the bank rate and refinancing rate were raised. In 1991, the bank rate was increased again, the cash reserve ratio applicable to commercial banks was raised. However, in 1992 the 100 percent deposit margin on letters of credit and credit ceilings on non-priority sectors were removed in order to shift to more market-oriented monetary policy measures. In 1993, the CBSL again issued its own securities to reduce liquidity, continued restraints on CBSL refinancing credit. In 1994, too, the CBSL issued its own securities to reduce liquidity, CBSL refinance facilities were terminated, and granting of new refinancing facilities was also stopped. In 1996, commercial banks were permitted to borrow abroad up to 5 percent of their capital and reserves as a measure of further liberalisation of transactions. In 1997, monetary policy was relaxed due to the economic downturn in 1996-97. The statutory reserve requirement was reduced twice in the year. In 1998, a reverse repo facility was introduced by the CBSL.

(see, for example, McKinnon and Mathicson; 1981, McKinnon, 1989, 1993).

In the 1990s, too, the authorities were obliged to continue with the restrictive monetary policy²⁵ stance adopted in the 1980s. As CBSL says, this was due to the pressure of high growth in inflation, largely through an increased flow of credit to the private sector and inflow of foreign assets. BR has been kept constant at its 1991 level basically to control the growth of credit to the private sector (see Figure 1.6). In addition to this, it seems that the rate of depreciation, too, has largely been used as a deflationary measure, particularly in the later part of the 1990s. Domestic currency was allowed to depreciate at a very slow pace compared with the rate of depreciation in the period between 1977 and 1989. During the period from 1977 to 1989, the Sri Lanka rupee was depreciated on average at 10.3 percent per annum, whereas the average rate of depreciation was only 5.6 percent per annum during the 1990 to 1998 period (see Figure 1.6). Given the objective of export led-growth, a rate of depreciation lower than the rate of domestic inflation²⁶ clearly indicates that the authority had given more weight to the exchange rate to stabilise the domestic price level than to the economic growth²⁷ objective. However, the Central Bank's opinion is that the rapid increase in external assets in the 1990s reduced the necessity for large depreciation of the exchange rate. To the CBSL, given a substantially large share of imports in GDP, the rate of depreciation has been a crucial factor in determining the level of domestic prices. Therefore, the objective of the CBSL could have been to minimise the impact of imported inflation on the domestic price level, employing a moderate rate of depreciation while using the external reserves to finance the balance of payments deficit.

The overall effectiveness of the monetary policy in achieving the set ob-

Period	Change in M2	Change in Price ^b	Change in External Assets ^a	Change in Domestic Credit	Growth Rate
1970-77	15.6(12.8)	5.70(4.0)	70.3(2575.3)	16.6 (16.5)	3.1(1.3)
1978-89	20.2 (9.2)	12.6(6.1)	13.4 (33.6)	23.9 (18.9)	4.8(1.9)
1990-98	17.2 (4.8)	12.0(4.3)	34.5 (32.9)	13.3 (6.7)	5.3(1.0)

Standard deviations are in parentheses.

Source: own calculations based on CBSL information.

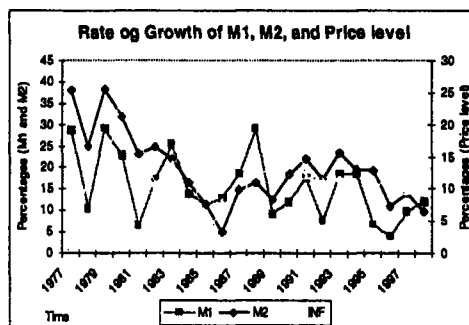
a - Only the official external assets are taken into account. Average growth rates of external assets are grossly misleading due to extraordinarily high volatility in growth of external assets. For example, average growth of external assets between 1970 and 1977 is exaggerated due to unusually high growth in external assets in 1976 and 1977. The average growth in external assets between 1990 and 1998 is 34.5 percent. However, from 1994 onwards, growth in external assets has continuously declined. In 1998 the growth in external assets was just 8 percent.

b - Under the overall reform programme, the existing price control mechanism was removed with exception of a few essentials. Overnight, most prices of goods and services went up and prices were allowed to be determined largely through market forces. Therefore, the low inflation in the 1970-77 period is grossly artificial.

jective of growth with macroeconomic stability can basically be analysed through the economic outcomes in the post-reform period. As revealed in Figure 1.7, the growth in M2 declined steadily from 1979 to 1987, between 1988 and 1995 it grew at an increasing rate, and thereafter there was a sizeable decline in its rate of growth. Inflation

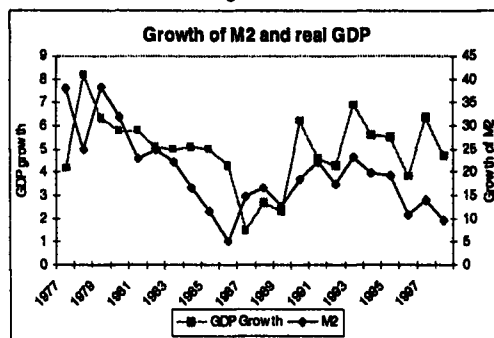
looks rather independent from the movement of M2, particularly until the mid 1980s. Thereafter, both M2 and price level indicators show roughly a similar path of growth over time, except in few years, suggesting that there may have been an impact on inflation from monetary growth, at least to some extent, as expected in

Figure 1.7



Source: CBSL Annual Reports, various issues

Figure 1.8



Source: CBSL Annual Reports, various issues

the theory. Figure 1.8 probably indicates that the growth in real GDP is tightly related to M2, suggesting a closer relationship between growth in money supply and real GDP. Do these relationships mean that monetary growth causes the rate of inflation to rise as explained in the theory? If so, would strict monetary control then adversely affect real GDP growth, given a closer relationship between M2 and real GDP at empirical level? However, to examine what is the cause and what is the effect is beyond the scope of this discussion. The aim of this discussion is merely to highlight such issues.

According to the CBSL, the increase in public sector investment programmes, especially during the first phase of the reforms, the liberalised price system, and increased flow of external assets have jointly raised inflationary expectations in the economy,

²⁵ Average rates of inflation are given in the third column of table 1.6

²⁶ See Aghevli, et al., (1991) for a discussion on the role of the exchange rate in developing countries.

²⁷ The budget deficit as a percentage of GDP of over 10 percent on the average became the norm of the fiscal stance in the post-liberalisation period except for a few years.

²⁸ From 1983 to 1991, unexpected changes in the domestic as well as external environments posed tough new challenges to the reform process, which are partly responsible for the slow growth and macroeconomic difficulties. For example, the Tamil separatist war, the second wave of the youth insurrection, operation 'Desert Storm' in Iraq etc.

thereby reducing effectiveness of monetary policy in arresting inflation. In other words, what the CBSL says is that monetary growth fuelled by increased public expenditure and external reserves has led domestic inflation to rise.

The information in Table 1.6 indicates that growth in the domestic credit and money supply declined substantially in the 1989-98 period compared with the previous period, largely due to the tight monetary policy adopted by the CBSL. It is evident that the monetary authorities have curtailed the growth of domestic credit, particularly in terms of the supply of credit to the private sector, in order to offset the expansionary impact of the government deficit and increased foreign reserves. However, despite heavy controls on monetary growth, the average rate of inflation has not shown a significant decline, contrary to the expectation.²⁸ In addition, the average rate of GDP growth in the post-liberalisation period does not seem significantly higher than the growth in the 1978-89 period.²⁹ Hence, the notion that high interest rate with monetary controls and moderate rate of depreciation would lead to less inflation and high growth seemed to be in doubt. On the other hand, more emphasis on stability³⁰ through strict controls on domestic credit expansion and moderate rate of depreciation may have caused the growth of GDP to slow down indicating a trade-off situation between stability and growth³¹ in the post-liberalisation period (see, for example, Figure 1.9; Gregorio, 1992; Blackburn, 1999).

Some Observations: Future Agenda for Reforms

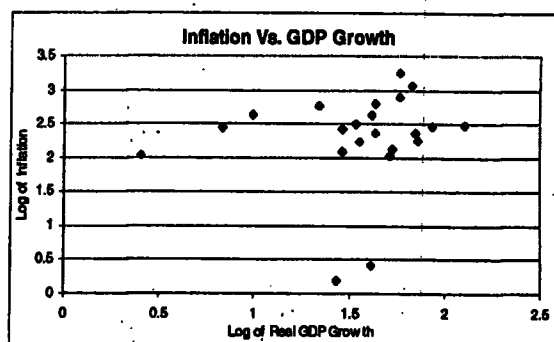
The spectacular shift to a market-oriented financial system in 1977 was primarily driven by increasing inefficiency of direct controls in achieving the development objective of the country. Even though the economic consequences, particularly in the real sector of the economy, were not very

dramatic, the economy has managed to yield some positive outcomes in certain areas of the financial system. Such developments in fact, had some spillover impacts as well on the other sectors in the economy. Increased contribution of the financial sector to employment generation and real GDP growth are some examples. The structure of the economy has also been changed in response to the liberalisation. As empirical evidence indicates, a service sector-dominated economic structure has emerged.

The financial sector reform process in Sri Lanka has been a gradual one. This helped economic agents and institutions to accommodate themselves to the changing economic environment. The financial system seems stable and secure and thus as a whole it has been successful in gaining public confidence in it. This helped particularly to improve the system's capacity to pool savings, increasing liquidity and profitability of financial institutions, and to build a broad consensus among economic agents for further reforms. This is, a significant accomplishment since it is a well-documented fact that financial liberalisation itself has caused many banking crises and banking risks in many other countries (see, for example, Diaz-Alejandro, 1985; Demirgüç-Kunt and Detragiache, 1998). In that sense, the Sri Lankan experience can be an interesting example for other countries with severe macro-economic instability and financial sector weaknesses that coincide with the reform process.

Financial reforms have successfully stimulated the financial system of Sri Lanka in several respects, such as specialisation of services, development of different types of financial markets and new financial instruments, increased number of participants, and more importantly, modernisation of the financial industry, particularly in terms of the

Figure 1.9



Source: Own calculations based on CBSL Annual Reports, various issues

application of modern financial technologies. The scope and diversity of the financial system have improved a lot during the post-reform period, indicating that the financial reforms have been successful in creating the necessary dynamism in the financial system, even though the same may not be true in the case of the real sector of the economy. However, the dominance of commercial bank credit over other sources of private sector finance probably reveals the inadequacy of alternative financial possibilities available in the financial system. This heavy dependence on bank credit might increase the risk of credit crunches that would have adverse repercussions on economic growth. Hence, further development of alternative sources of finance would be a cause for concern in the future.

Economic performance was reasonably good in the initial years of the financial sector liberalisation programme. The growth rate, however, slumped in the later part of the first phase of the programme. The share of the manufacturing sector as a percentage of GDP has not registered satisfactory growth. As I argued earlier, in the absence of a strong manufacturing base higher growth rates could not be sustained. It seems that financial liberalisation has probably failed to create the necessary dynamism in the manufacturing sector. This is in fact an important cause for concern for the authorities in designing the nature of further reforms in the financial sector in the near future.

²⁸ In addition to monetary controls, the exchange rate has been used to stabilise domestic price levels (see figure 1.6).

²⁹ Figure 1.12 is a scatter plot diagram that represents the relationship between inflation and growth from 1977 to 1998. The majority of the data points are grouped in the north-eastern part of the graph with very few outliers, indicating that both inflation and GDP were moving in the same direction to a great extent.

Increased government investment expenditure has played a major role in raising economic growth in the post-liberalisation period. Therefore, the study argues that the government should continue its efforts in growth-related infrastructure projects, creating a favourable environment for private sector investment to grow. As the empirical information indicates, a high level of investment in Sri Lanka has been possible with the help of increased foreign savings.

By and large, the financial sector liberalisation has failed to improve the rate of domestic saving, creating a wider resource gap. Heavy dependence on external financing is not viable in the long run due to debt-related problems. In addition, exchange rate depreciation would be under pressure because depreciation of the exchange rate balloons the amount of debt to be paid in domestic currency. Therefore, a proper identification of what determines domestic saving in Sri Lanka would be an important task reserved for the future to implement necessary policies to promote domestic savings. Reduction in government investment would not be a solution to narrow the resource gap since government investment plays a major role in raising economic development and social welfare in Sri Lanka.

It is evident that high inflationary pressure became a problem in the post-liberalisation period. On the whole it seems that the higher interest rate policy may have failed to reduce inflation, contrary to the expectation. The monetary authorities have basically adopted a tight monetary policy and moderate rate of depreciation to combat inflation. However, the average rate of inflation has not registered a significant decline. Therefore, whether the increased rate of domes-

tic inflation and slow rate of real economic growth were due to lack of efficiency in the co-ordination of supplementary policies during the reform programme, or perhaps were due to the other reasons such as the increased cost of finance, would be an important area of concern for the authorities to deter-



Rapid reforms are being effected in the systems and service delivery of Local Banks under re-engineering to suit the changing environment.

mine the nature of further financial reforms in the near future.

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