

# Financial Globalization, International Economic Developments and Implications for Monetary Policy in Sri Lanka

H. N. Thenuwara Ph. D.  
Assistant Governor  
Central Bank of Sri Lanka

# Financial Globalization

- Extent to which countries are linked through cross-border financial holdings
- IMF research suggests a way of quantifying the financial globalization of a country
- The de facto globalization is the ratio of total assets and liabilities to the GDP

# Global Position in Financial Flows

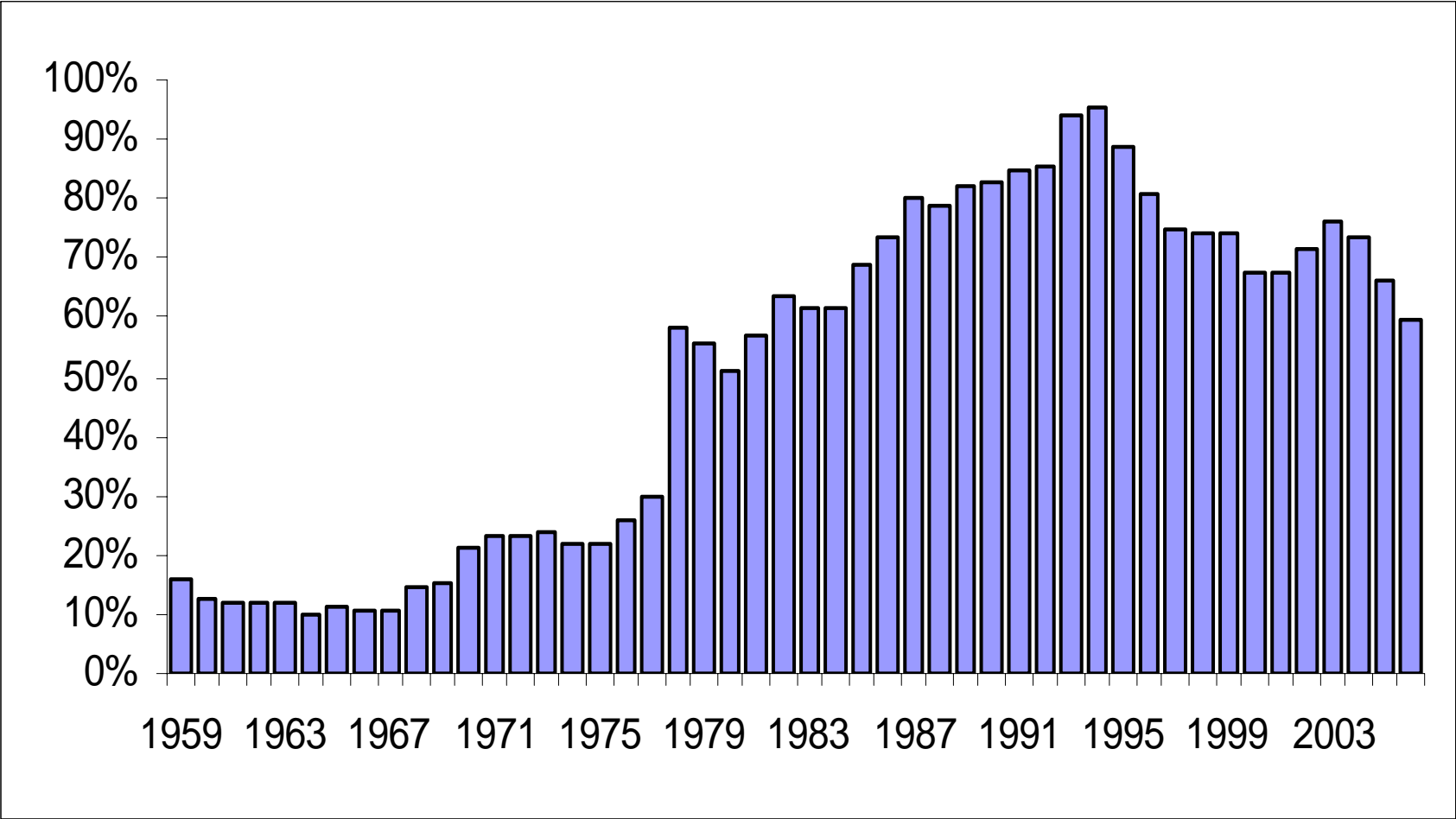
- In many countries, gross external assets and liabilities relative to GDP has increased dramatically over the past three decades.
- This trend has been particularly evident in advanced economies.
- Emerging and developing countries too have experienced relatively moderate increases in their external stock positions

# Sri Lanka's Financial Globalization

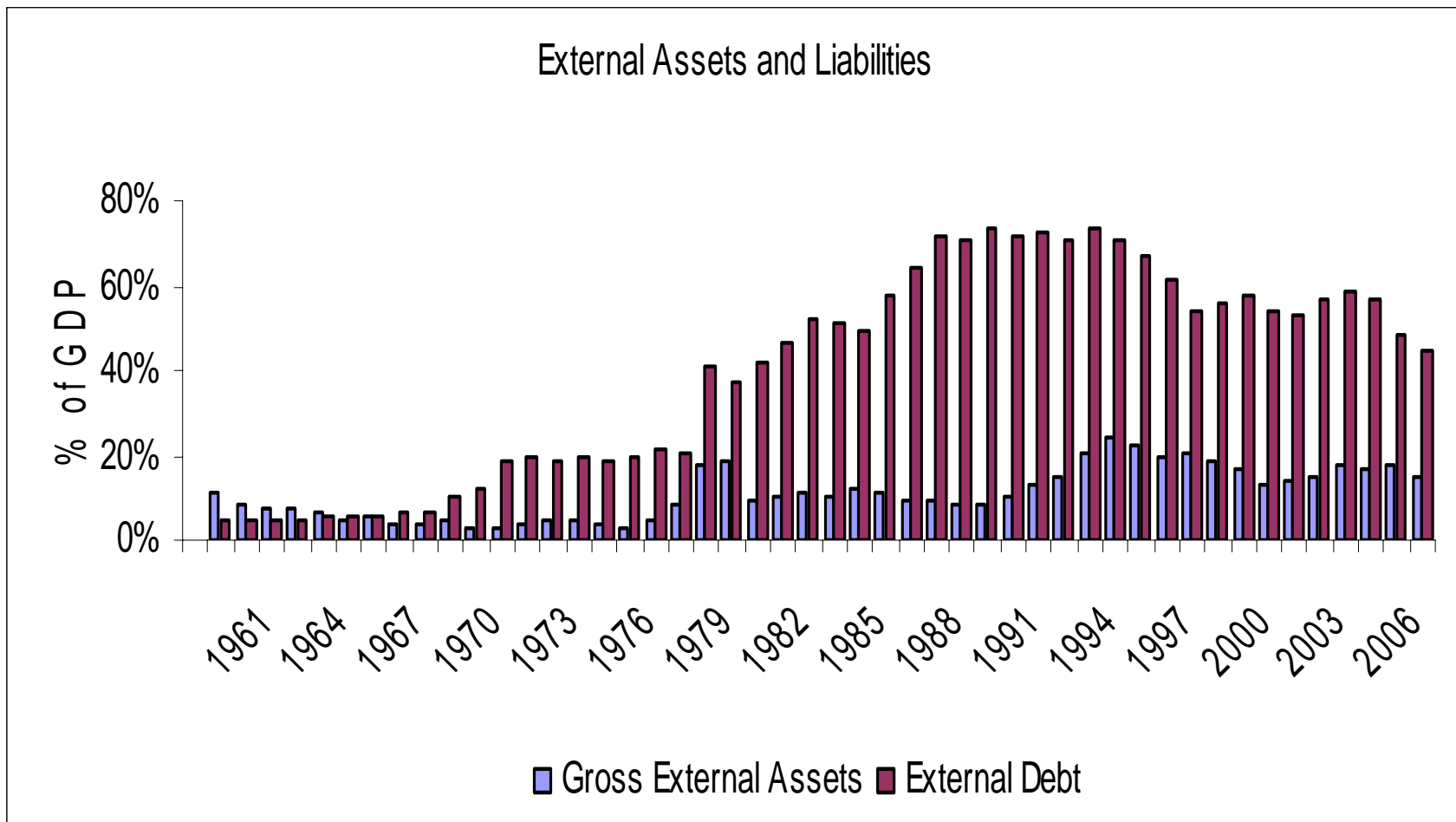
## **De jure globalization**

- Full current account convertibility and partial capital account convertibility.
- Freely floating exchange rate regime
- Recent measures to further liberalize capital account.
- Non-residents are allowed to invest in equity market without any restriction.
- up 5% of government bonds is open to foreigners.
- Various incentives to promote FDIs, including tax holidays and duty-free import facilities.
- Investments outflows are subjected to exchange control regulations, but have usually been encouraged.
- Debut sovereign bond was highly successful and oversubscribed by over 3 times. This will serve as a benchmark and pave way for local corporates to raise capital from international markets.

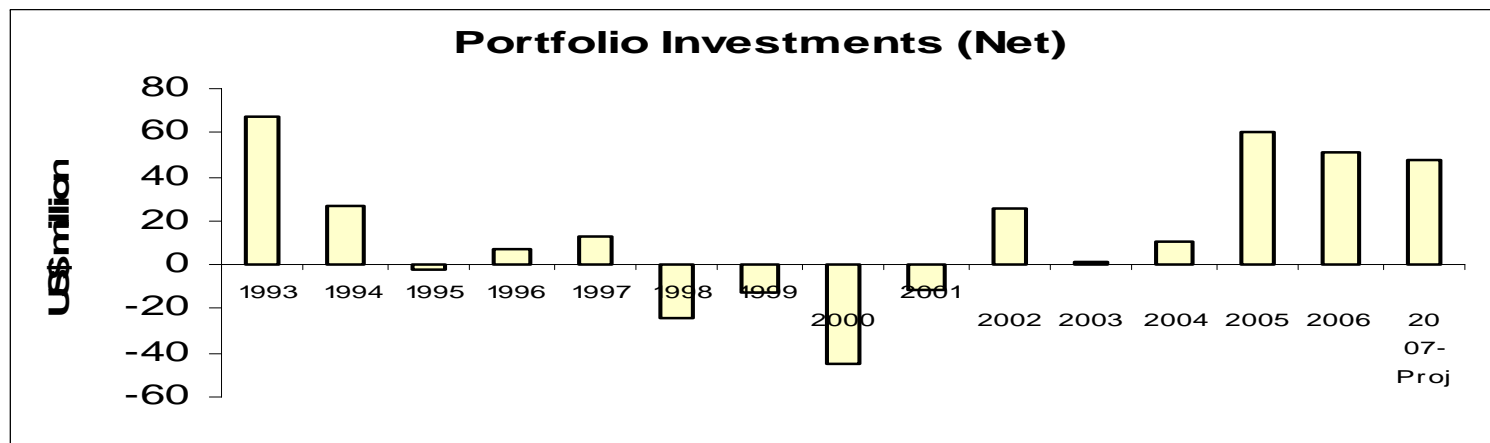
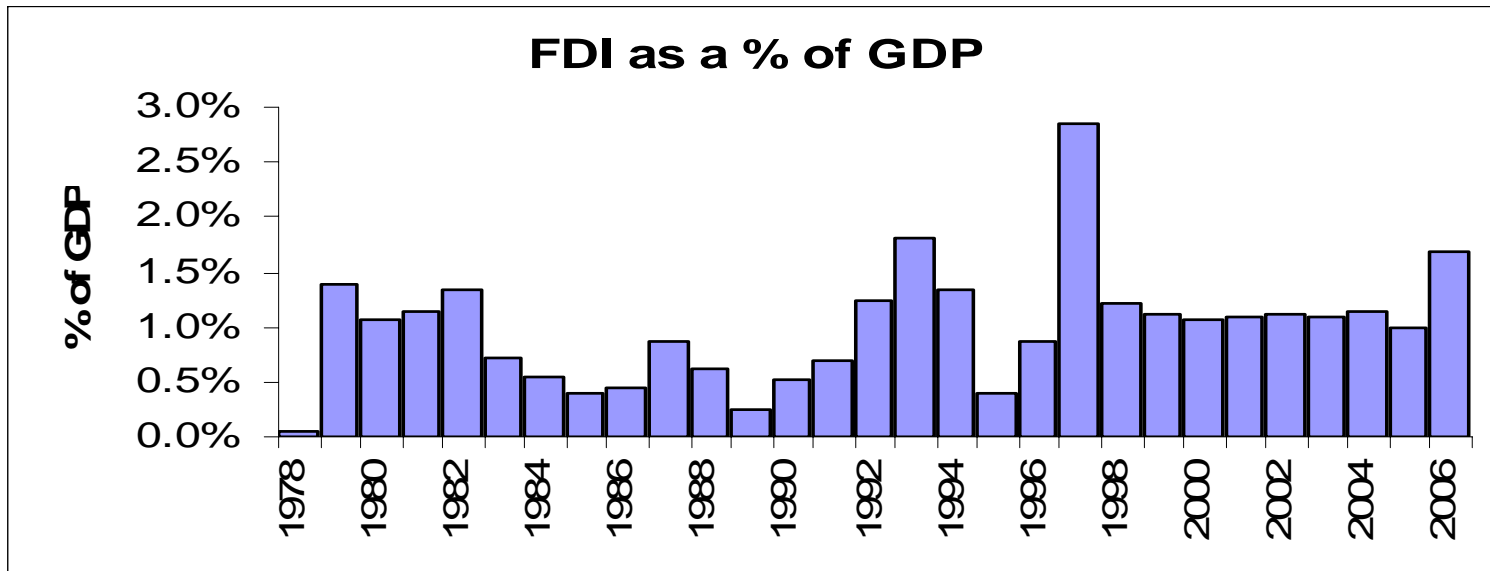
# De facto Financial Globalization in Sri Lanka



# Developments in External Assets and Liabilities



# Capital Flows into Sri Lanka

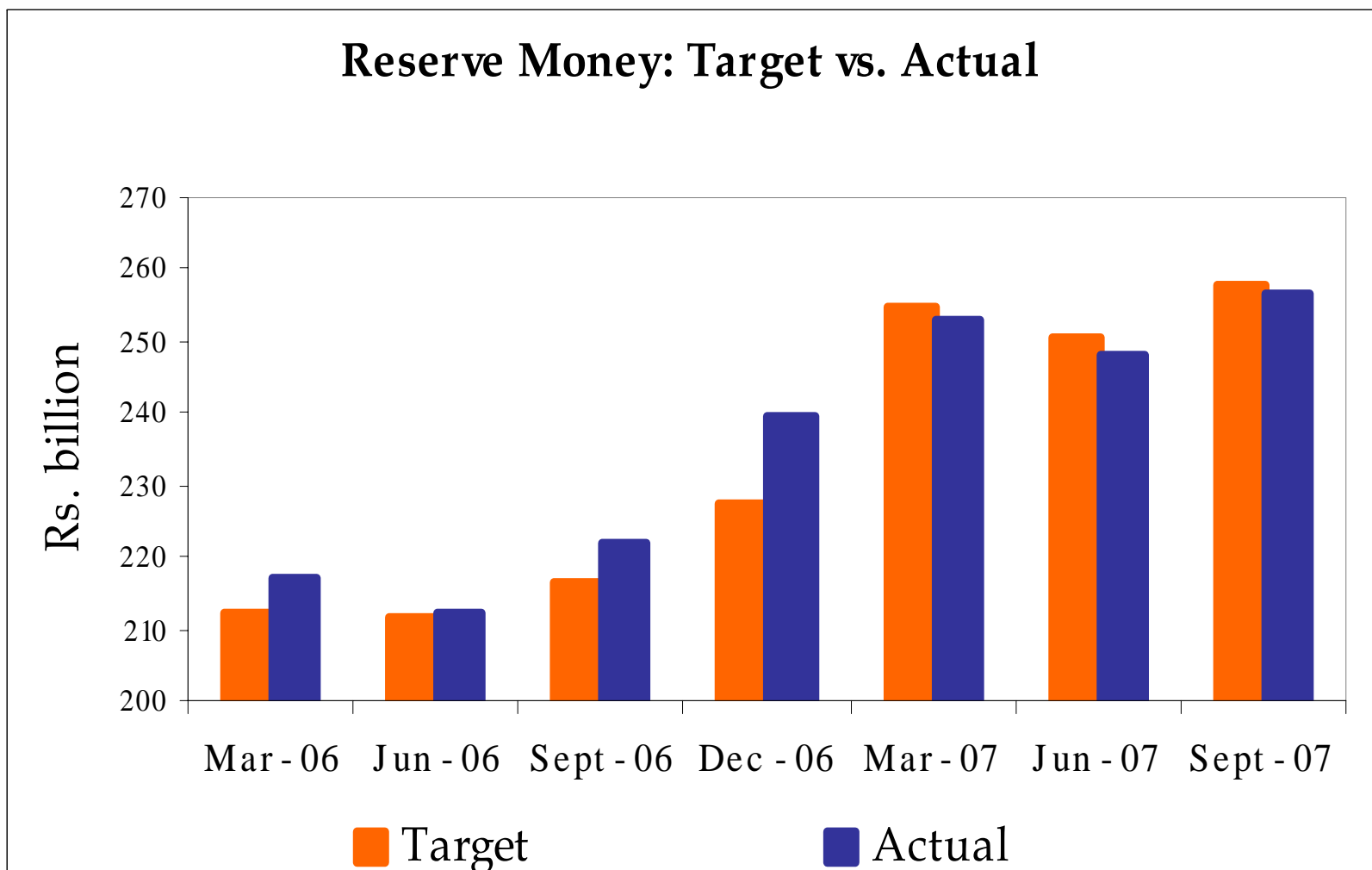


# Monetary Policy Framework in Sri Lanka

- Monetary targeting framework
  - Reserve money as the operational target and Broad money as the indicative target
  - An implicit inflation target
- Some obstacles in moving to Inflation Targeting
  - Non availability of a representative Price Index: currently being addressed
  - High budget deficit to be reduced to an acceptable level in the medium term
- Relatively stable velocity of money and the high correlation between money supply and inflation, encourages to continue with monetary targeting.

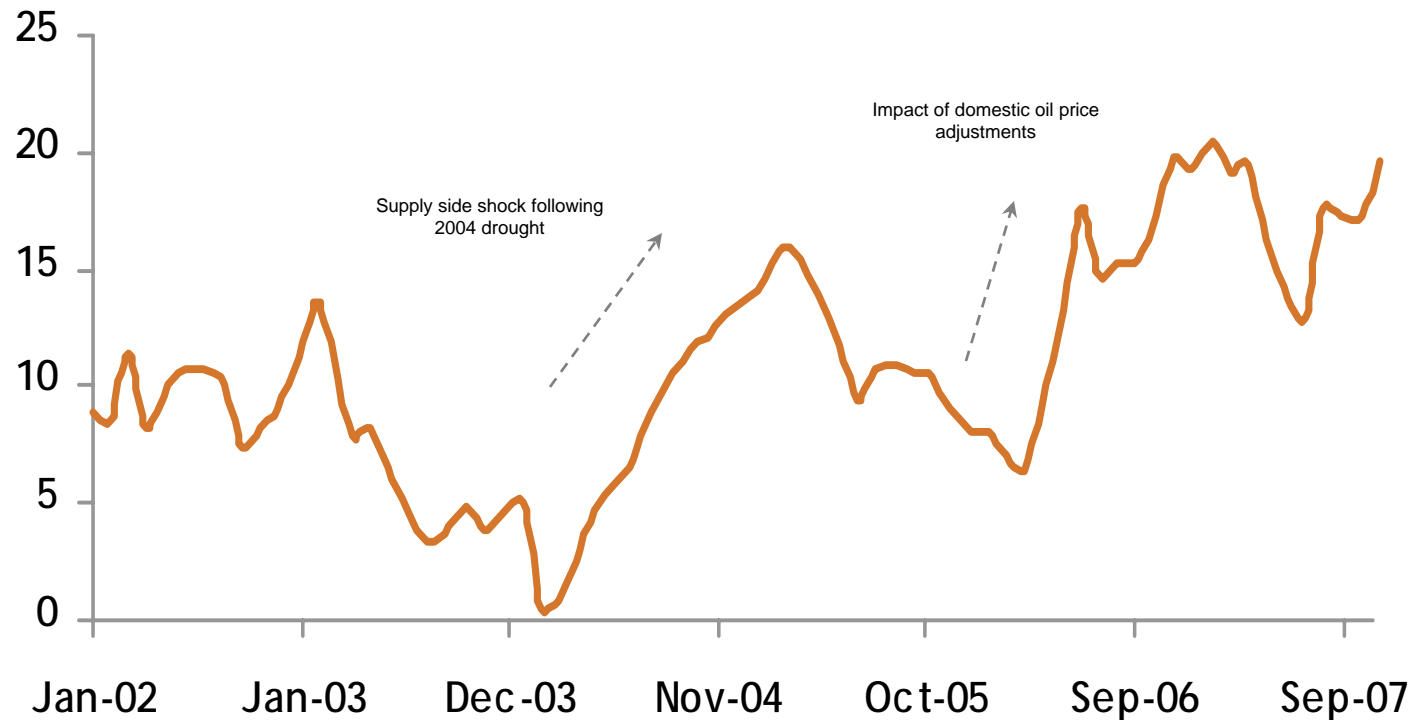


# Tight monetary targets have been achieved...



# Inflation in has picked up in Sri Lanka, notwithstanding the tight monetary policy...

Inflation (%)



# Challenges in the Conduct of Monetary Policy

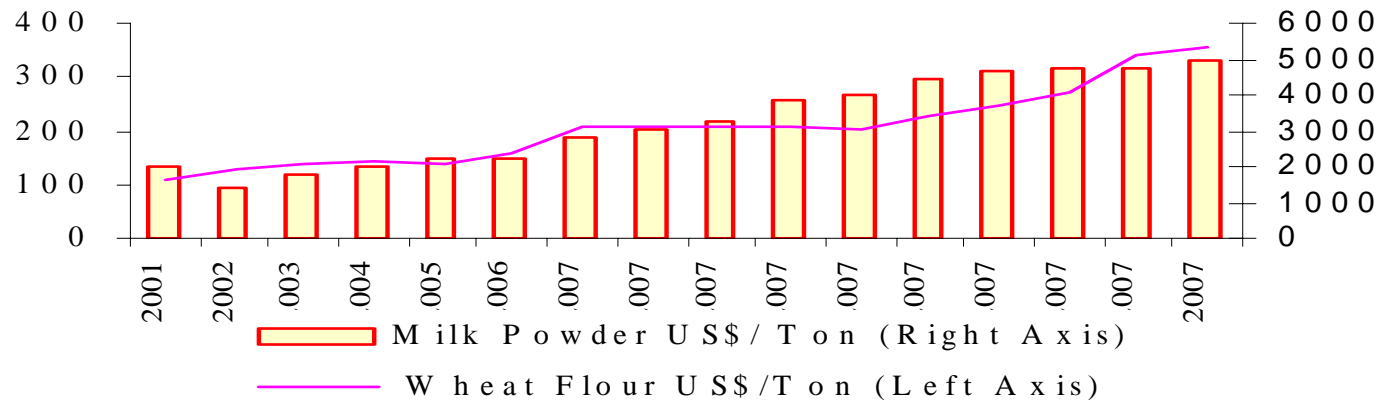
- Errors in measuring inflation
- Heavy component of imported inflation
- Fiscal sector issues
- Conflicting role of banker to the government

# Errors in Measuring Inflation

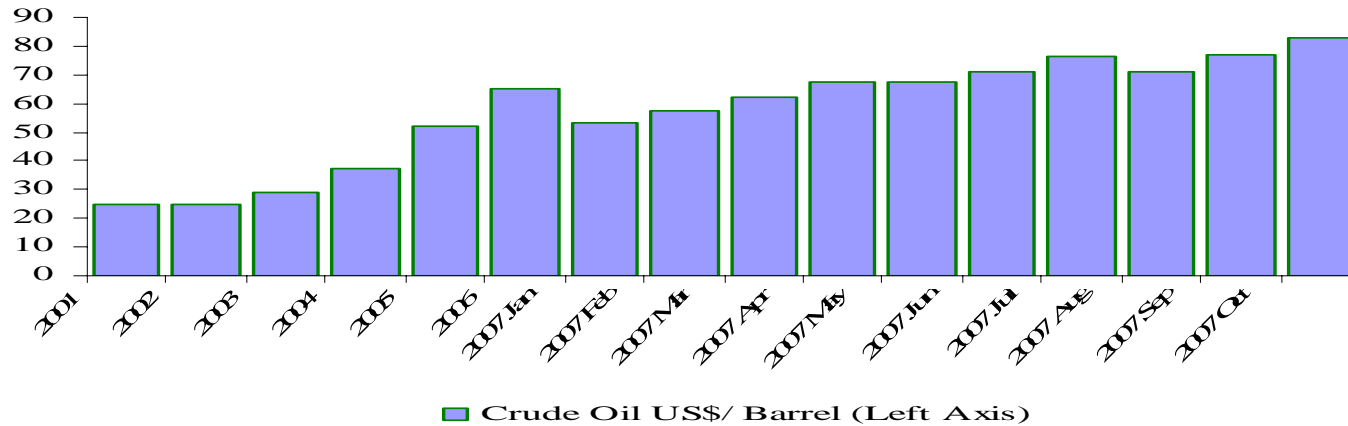
- The current official price index, the Colombo Consumer Price Index (CCPI) is with a base year of 1952.
- The consumption basket does not include several items now consumed by people. Eg. Gas, Telephone services
- Certain items (Eg. Electricity) are underrepresented while certain others are over represented (Eg. Kerosene)
- CCPI is not a national index and only covers the Colombo Municipality
- However, a new representative price index is underway

# Imported Inflation

## International Prices 2002-07

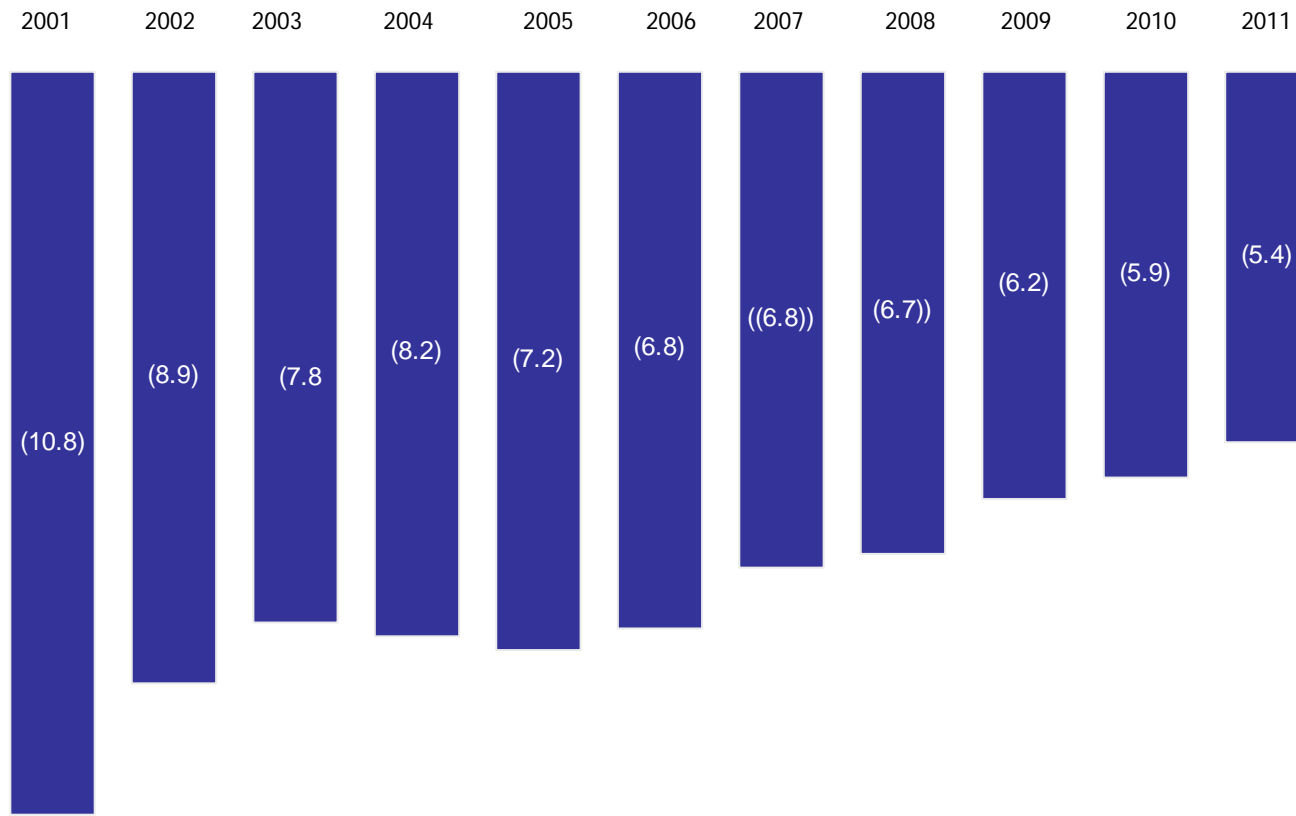


## Crude Oil US\$/ Barrel (Left Axis)



# Fiscal Sector Issues

High budget deficit is a challenge for monetary policy and need to be reduced gradually as per the government's medium-term macroeconomic policy framework.



# Banker to the Government

- By the Monterey Law Act, which established the Central Bank, the government has the legal authority to draw up to 10 per cent of its estimated revenue as an advance from the Central Bank.
- Needless to say that consecutive governments have been enjoying this facility, notwithstanding its expansionary impact.

# Way Forward

- Clarity in measuring inflation
- Resolving the policy ambiguity in dealing with imported inflation
- Seeking for further fiscal consolidation
- Bringing required amendments to the Monetary Law Act
- Further opening up of capital account
- Improving the financial sector competition and facilitating financial innovation