

The Money Supply and the Balance of Payments in Ceylon

I

The Currency Board System.

Until the establishment of the Central Bank of Ceylon in July 1950, Ceylon's monetary system was an exchange standard broadly similar to those in operation in most British Colonies and generally known as the « Currency Board System ». Colonial monetary standards (1) are usually linked to the pound sterling through the mechanism of a Currency Board. Apart from a few minor local variations the system is a sterling exchange standard where the international value of the monetary unit varies with that of sterling, and the currency reserves of the country are held in the form of sterling assets. But unlike the monetary system of an independent country, the law requires that the colonial currencies should be backed 100 per cent by foreign assets. Domestic securities, that is those of the colonial government itself, are not eligible as cover for the note-issue (2). Parity with sterling is ensured by the Currency Board's statutory obligation to redeem and issue domestic currency against sterling at par.

The functions of a Currency Board are much more limited than those of a Central Bank or other monetary authority. It is no more than a glorified money-changer. It has no control over the amount of currency it issues. All it has to do is to issue domestic currency against sterling (3) and issue sterling drafts in exchange for domestic currency. Such transactions are generally conducted through the local banking system. Ceylon's

(1) Cf. *Banking in the British Commonwealth*, ed. Sayers, (Clarendon Press), Ch. 13 for an account of colonial standards.

(2) The reason for this provision is that colonial securities might not be realisable in time of panic. The securities of the British Government, the Dominions, or of other colonial territories were eligible.

(3) Or other « superior » currency.

currency mechanism was similar to the above except that the Ceylon rupee was directly linked not to sterling but to the Indian rupee. The « Board of Commissioners of Currency » was required to deal in Indian rupees and rupee drafts. But since the Indian rupee was linked to sterling, Ceylon was on a sterling exchange standard at one remove. The closeness of the island to the Indian sub-continent, the historical connexions and the intimate trade and economic relations between them seemed to justify the direct link with the Indian currency.

The *raison d'être* of the colonial exchange standard is that it ensures exchange stability and provides for the automatic conversion of the money of the colony into a « superior currency » and vice-versa. As such it was ideally suited to a period of colonial expansion and capital migration. There is no risk of a depreciation of capital or profits nor of an interference with prices and exchanges through a domestically engineered inflation. In many respects, therefore, it resembles the international gold standard with its rigid exchanges and its automatic brake on inflation.

The main purpose of this article is to consider the forces which influenced the money supply in Ceylon under the Currency Board System. It then goes on to consider the influence of the new Central Bank of Ceylon on the money supply and the limitations of central banking policy in Ceylon. Much of what is said here would apply with but little modification to the currency arrangements of the British colonies, especially of those which, like Ceylon, specialise in the production for export of a narrow range of primary commodities. Ceylon is a typical example of such an « export economy ». Nearly 40 per cent of her national income is produced by the three export industries — Tea, Rubber and Coconut products. The majority of other trades and avenues of em-

ployment are indirectly sustained by export income. The chief characteristic of an export economy is that its national income and level of employment is determined by the prices for its exports (4). Booms and slumps originating in the more developed countries have a magnified effect on such an economy. A fall in export prices sets in motion a « chain-reaction » which affects all other prices and incomes. Similarly in times of rising export prices, the domestic price-structure rises in sympathy. It is the export sector which sets the pace. Booms and depressions loom large in the country's list of imports. In addition, these economies rely largely on foreign sources for their requirements of food, clothing and manufactured goods. Production for a domestic market is negligible. The propensity to import is high and the cost of living is determined primarily by external influences. The adequacy of the currency mechanism must be judged against this background of the country's economic structure.

If the currency issue has to be backed entirely by foreign assets, the availability of such assets influences the amount of the currency circulation. A gain or loss of foreign assets depends on whether there is a surplus or deficit in the balance of payments. From this it has been argued that under the Currency Board System the currency circulation of the country fluctuates with its balance of payments — a surplus leading to an equivalent increase and a deficit leading to an equivalent contraction. This argument has been very clearly stated in the report on a Central Bank for Ceylon, on which was based Ceylon's monetary legislation of 1949:

« Under the Ceylon system », says the Report, « under which a 100 per cent reserve is required against the note-issue and the use of cheques is not highly developed, the money supply tends to be automatically responsive to surpluses and deficits in the balance of payments. Whenever Ceylon is acquiring foreign exchange faster than she is utilising it (i.e.

(4) National Income = C + I + B + E - M, where C = consumption, I = investment, B = budget deficit, E = exports and M = imports. Of these, E is the only major independent variable. I, C, M are in varying degrees functions of the level of National Income. In the absence of a Central bank, B depends on the willingness of the commercial banks to take up government securities. This depends on the liquidity of the banks which varies as between boom and slump.

when there is a surplus in the balance of payments) the banks purchase Ceylon rupees from the Currency Board with their surplus exchange. The Currency Board pays the banks by drawing rupees from its unissued stocks and it holds the foreign exchange in Bombay or London...

On the other hand, when the country is utilising foreign exchange faster than she is acquiring it, the banks meet the demand by purchasing it from the Currency Board with rupees. The Board retires the rupees from circulation and transfers the exchange to the bank by draft or telegraphic transfer » (5).

Before examining this proposition it is necessary to make clear what meanings are attached to the terms « money supply » and « balance of payments ». The money supply of a country consists of (a) the amount of currency in circulation and (b) the demand deposits in the banking system. The currency circulation may be « gross » or « active ». The gross circulation comprises the entire note-obligations of the issuing authority, while the active circulation excludes from the above the cash-holdings of the government and of the banking system. The quotation refers to *gross* circulation. It ignores altogether the other component of the money supply (viz. bank deposits) on the ground that the issue of cheques is « not highly developed ».

The term « balance of payments » includes both current and capital accounts. For our present purposes the balance of payments may be broken up as follows:

A. Balance on current account.

B. Balance on capital account, consisting of:

(i) Autonomous capital movements;

(ii) Changes in the external assets of the banking system;

(iii) Changes in the currency reserves, i.e. the assets of the Currency Board (6).

It is an elementary proposition in the theory of international economics that the

(5) Ceylon Government Sessional Paper XIV of 1949, p. 4.

(6) Items (ii) and (iii) would be « accommodating finance » in Prof. Meade's terminology. Cf. MEADE, *The Theory of Economic Policy*, Vol. I, pp. 11-12. As will be seen the distinction between autonomous capital movements and accommodating finance is that the former is independent of the state of the balance of payments, while the latter is the result of action by the monetary authorities or the banks to offset a positive or negative balance.

balance of payments must necessarily balance. The passage (7) argues that changes in the gross circulation are strictly and exclusively determined by the balance of payments. In other words, it argues that surpluses and deficits in current account which are not offset by autonomous capital movements must wholly be offset by changes in the currency reserves (item B iii) which changes are accompanied by an equivalent rise or fall in the gross currency circulation. This would be true only on the assumption that item B (ii) — the external assets of the banking system — remains constant so that a demand for foreign currencies in exchange for rupees is met by turning over rupees to the Currency Board, and any foreign exchange bought by the banks is paid for by obtaining rupees from the same source.

Now in Ceylon, as in most colonial countries, this assumption is particularly false (8). The local banking system consists of the branches of large overseas banks and one indigenous bank. They all transact foreign exchange business through London and hold a large proportion of their assets in the form of short-term investments in the London Money Market (9). It is not the policy of the banks to maintain their foreign assets constant or even to preserve a constant ratio between these assets and their total deposit liabilities. Perhaps the most striking characteristic of the meagre banking statistics available in Ceylon is the volatility of the banks' ratio of foreign assets to total deposits. Under the Currency Board System these assets can be switched to and from between Ceylon and London or Bombay. They are as good as cash because they can be converted into rupees at the Currency Board. The size and ratio of the external assets were in practice

(7) Cf. also article by J. MARS on *Monetary and Banking System of Nigeria*, in «Mining, Finance and Commerce in Nigeria», Vol. II, ed. Perham (Faber & Faber), p. 86. «In fact, the increments and decrements of East African currency is the one item that brings about equality between all the positive and negative items in the balance of payments».

(8) Ceylon became a Dominion in 1947. Her financial institution still resemble those of a colony except that there is now a Central Bank at the apex of the credit structure.

(9) This follows from the country's membership of the Sterling Area.

varied considerably whenever it was advantageous or necessary to do so. For the same reason the banks' reserves of cash were variable between wide limits. Under a Currency Board System no distinction need be made between cash and external assets — the two are interchangeable.

As can be seen from the Table No. I, both the external assets ratio and the cash ratio have been subject to wide fluctuations. Between 1943 and 1950 the external assets ratio was at its peak in December 1945 at 67 per cent and fell by stages to 13 per cent in September 1949 and has since been fluctuating between 15 and 30 per cent. Similarly the cash ratio was as low as 4.7 per cent in December 1943 while in December 1949 it was 36.5 per cent.

TABLE I

Date (a)	External Assets Ratio	Cash Ratio
Dec. 1943	67.0	4.7
Dec. 1944	63.5	5.0
Dec. 1945	45.0	21.6
Dec. 1946	40.0	20.7
Dec. 1947	22.8	31.9
Mar. 1948	21.2	29.3
Jne. 1948	21.0	30.7
Sep. 1948	22.2	28.2
Dec. 1948	25.0	30.3
Mar. 1949	21.5	26.4
Jne. 1949	24.0	17.4
Sep. 1949	13.0	34.0
Dec. 1949	15.4	36.5
Mar. 1950	27.8	20.1
Jne. 1950	25.0	19.0

(a) End-month figures.

A balance of payments deficit can thus be offset by a compensatory fall in the banks' external assets. Similarly, a surplus can be absorbed into external assets without its leading to a rise in the gross currency circulation. A change in the external assets of the banking system can act as a buffer between fluctuations in the balance of payments and the gross circulation. This «buffer action» requires not merely the variability of the external assets but also the existence of surplus

cash reserves in the banking system. The chain of events will be somewhat as follows:

— surplus leads to rise in deposits, rise in external assets ratio and fall in the cash ratio.

— deficit leads to fall in deposits, fall in the ratio of external assets and a rise in the cash ratio.

Mechanistic accounts of this typically colonial type of monetary system tend to overlook altogether the existence of overseas assets which play the role of equilibrating capital movements. They also tend to forget that the local banks are but branches of huge overseas banks with their Head Offices usually in London. Colonial banking has been dominated by them, and their branch offices are scattered over the British colonial territories. There is no reason to assume that the Head Offices operate their branches as independent units working to any rigid rules regarding cash or liquidity ratios. Their management is probably more akin to that of a branch bank operating in the same country as the Head Office. This is all the more likely because the colonial governments impose no rules regarding the distribution of the assets of the banks. The pound sterling is equivalent to the domestic currency of any colony, and as long as the banks held sterling assets they merely had to buy a particular domestic currency whenever their holdings of that currency were dangerously low. For the rest, it was immaterial in what country they held their assets; and in the absence of developed security markets and acceptable banking collateral in the colonies they fought shy of domestic loans and investments (10).

A more accurate description of the process of currency issue taking into account the above consideration would run as follows:

«When the country has an adverse balance of payments on current account which is not offset by a movement of capital on official or private account, the banks' sales

(10) Cf. Post-War Development Proposals (Government of Ceylon, 1946), p. 24: «Owing to lack of investment outlets, banking business has been mainly confined to the collection of deposits and finding investment for the bulk of such deposits outside the island». This situation has been altered with the floatation of loans by the Ceylon Government in the war and post-war period.

of foreign exchange are greater than their purchases. Their deposit liabilities and foreign assets decline by the same amount and their cash ratios rise. This process goes on until the banks feel obliged to conserve their external assets by meeting any further demands for foreign exchange by turning over rupees to the Currency Board. Then only does the gross circulation contract. The reverse process of a rise in foreign assets, an increase in deposits and a fall in the cash ratio takes place when there is a surplus in the balance of payments. The gross circulation expands only when a part of the surplus is monetized at the Currency Board».

It follows therefore that even in an economic system where «the use of cheques is not highly developed», an adequate account of changes in the monetary circulation must pay attention to the behaviour of the banking system. Their reaction to the excess demand or excess supply of foreign exchange determines the immediate effect on the gross circulation. The criticism of the colonial exchange standard is not that it is inflexible, but that it depends for its flexibility not on any official authority but on the actions of private profit-seeking institutions. The «independence» of the circulation from the balance of payments depends on the degree of flexibility of the banks' foreign assets and cash-holdings. The «independence», therefore, is very limited. A prolonged surplus or deficit must sooner or later lead to a change in the gross circulation though not necessarily of the same magnitude. Nonetheless, it is clear that the connexion between day to day or short period changes (11) in the gross circulation and the state of the balance of payments is very remote.

From the economic point of view, however, what is important is not the gross circulation but the *active circulation*, for it is the latter which affects and is affected by the level of economic activity. The active circulation is the amount of currency in the hands of the public. A movement in the gross circulation of itself is of no consequence

(11) As opposed to cyclical changes which are here considered as long-period.

if the active circulation is unchanged (12). It merely means that the cash reserves of the banks are increasing. Likewise, stability of the gross circulation is of no significance if the active circulation is changing through a change in the cash holdings of the banks. The proposition that the currency circulation is automatically responsive to the state of the balance of payments is inaccurate and misleading. It is inaccurate because it does not allow for the behaviour of the banks. It is misleading because it tends to focus attention on what is undoubtedly a subsidiary factor in economic fluctuations. If, however, we define *money supply* in a broader sense to include both currency and bank deposits held by the public, the proposition seems to be more in accord with facts. Changes in the money supply may then be brought about by the following factors:

- (i) Changes in the external assets of the banking system;
- (ii) Changes in the external assets of the Currency Board;
- (iii) Domestic credit creation by the commercial banks;
- (iv) Changes in the government's holdings of rupee cash;
- (v) Changes in the volume of fixed and savings deposits.

When there is a Central Bank in the country, (ii) will be replaced by (iia) — changes in the external assets of the Central Bank. There will in addition be a sixth item (vi) Changes in the domestic assets of the Central Bank. These might be called the *determinants* of the money supply.

Now, changes in the external assets of the commercial banks or of the Central Bank are the result of a surplus or deficit in the balance of payments and lead to an equivalent change in the money supply (13). For example, a surplus in the balance of payments means that the local banks are exchanging the surplus foreign earnings of the country

(12) Changes in the gross circulation, of course, affect the liquidity of the commercial banks.

(13) i.e. currency and bank deposits in active circulation. This is the counterpart of the increased national income brought about by the balance of payments surplus.

into domestic currency — either bank deposits or cash. (In this case it is immaterial whether it is the commercial banks or the Currency Board which effects the conversion). The effect on the money supply is the same. The money supply will vary with the balance of payments provided there is no change in item (iii), that is, in the amount of credit created by the commercial banks.

There is, of course, no reason to assume that the amount of bank credit will remain unchanged. On the other hand, the increased liquidity of the banks caused by their acquisition of external assets during a boom (which assets can at all times be converted into rupees at the Currency Board) will be an inducement to the banks to expand credit both to the Government and to the private sector of the economy. The amount of the increase will depend on the demand for credit — on the availability of satisfactory investment outlets in the private sector or the Government sector. Where, as in Ceylon, bank credit is mainly extended to the foreign trade and export sector, the main determining influence will be the value of exports and imports. If the government chooses to engage in extensive borrowing operations at such a time, the banks will readily invest in government securities.

Similarly, a balance of payments deficit leads to an equivalent reduction in bank deposits and foreign assets. The reduced liquidity of the banks might lead to further contraction of credit and a tightening of money.

The normal behaviour of the banks will tend to reinforce the expansionary or contractionary influence of the balance of payments. This would be true, not of short-period changes in the balance of payments, but where a surplus or deficit is at all prolonged; that is, in Ceylon, during booms and slumps in raw material prices. The size and significance of this secondary expansion or contraction is, however, apt to be exaggerated. In so far as the main outlets for bank credit are in foreign trade and the export industries, there will be an automatic change in the demand for credit. To the extent that other fields of activity dependent on bank credit

are geared to the export sector, they, too, will curtail their demand for bank loans. Banks will exercise an independent influence only in so far as they are tempted by their enhanced liquidity to lower their security canons and interest rates (during a boom), or to put up rates or refuse loan applications which would otherwise have been considered sound (during a slump). There will not be a strict correspondence between these changes, but merely movements in the same direction. This is no more than saying that in an export economy the money supply increases during a boom and decreases during a slump.

The tendency for the money supply to vary in this manner is not peculiar to the Currency Board system. Under any form of monetary organisation the foreign balance will affect the money supply (the gold standard is the extreme case). It is merely that in export economies the influence of the foreign balance swamps the other determinants of the money supply. The foreign balance, as we have seen, not only leads directly to a change of bank deposits but also influences the demand for credit (through national income fluctuations), and the ability of the banks to create credit by affecting their liquidity.

In passing, it might be noted that liquidity of banks and other financial institutions in export economies fluctuates «*per-versely*» during a cycle. In an advanced type of economy the progress of a boom is attended by a general tightening of credit and a tendency for interest rates to rise while a slump is characterized by monetary ease and low interest rates. In an export economy, however, a boom brings with it an addition to monetary reserves which leads to low interest rates and monetary ease, while a slump is accompanied by a loss of reserves and a «*tightness*» of money. In an export economy, however, where the national income is itself determined primarily by the balance of payments such fluctuations are also the most important determinants of the money supply. The argument of the remainder of this article is that both on the basis of theo-

retical reasoning and the experience of over three years of central banking in Ceylon, these fluctuations in the money supply are largely inevitable in an unregulated export economy such as Ceylon's.

II.

Central Banking.

The traditional role of the Central Bank in the face of monetary fluctuations brought about by the forces mentioned above is to vary its own holdings of non-cash domestic assets in an opposite direction (item vi above). This would usually be done by engaging in open market operations. It could also take steps to influence the amount of commercial bank credit (item v above) by changing its discount rate or the rate at which the banks lend (14). The limitations of these methods in backward economies with undeveloped money markets are now widely recognised (15). What is here argued is that compensatory action by the Central Bank, even if it were possible, can play only a limited role in an export economy because such monetary fluctuations usually represent an adjustment to basic economic forces.

The claim is often made that a Central Bank enables the pursuit of «*an independent monetary policy*». In an export economy, however, there are very strong limitations on such a policy. It has been argued that «*the greatest significance of the central bank lies in the power of the bank consciously to influence the supply, availability and cost of money in Ceylon*» and that «*the bank will be able to use its domestic credit operations to augment or offset the effects on the economy of its foreign exchange operations*» (16).

The Central Bank of Ceylon started operations in August 1950. It should be useful

(14) There is no necessary connexion between the Central Bank's discount rate and the banks' leading rates as there is in the London money market.

(15) Cf. PLUMPTRE: *Central Banking in the British Dominions*, passim; ed. Sayers: *Banking in the British Commonwealth*, Ch. 12; S. N. SEN.: *Central Banking in Undeveloped Money Markets*, passim.

(16) Sessional Paper XIV of 1949 (Ceylon), pp. 4-5.

to examine briefly its working in the light of the above paragraphs. The monetary experience of Ceylon since August 1950 can be divided into two distinct phases. Up to March 1951, we had a period of inflation caused by the devaluations of the previous year and the outbreak of the Korean War. In fact, this phase began at the end of 1949 before the establishment of the Central Bank. From March 1951, we have experienced a slump in export prices. Incomes and money supply rose up to March 1951 and have since maintained a downward trend.

The Table No. II gives the changes in the total money supply in both these phases and the causes of the change in terms of the determinants of the money supply listed earlier. For convenience the data for the second phase have been presented in three columns — one for March 1951 to the end of the year and one column each for the years 1952 and 1953.

TABLE II

CAUSES OF CHANGES IN MONEY SUPPLY (*)
(millions of rupees)

	30.9.50 to 31.3.51	31.3.51 to 31.12.51	31.12.51 to 31.12.52	31.12.52 to 31.12.53
Money supply.	+222.4	- 21.4	-112.0	- 67.4
(i) External assets of commercial banks and Central Bank.	+283.4	- 81.7	-375.1	-132.6
(ii) Domestic assets of the Central Bank.	+ 6.1	+ 1.0	+142.4	+ 58.3
(iii) Commercial bank credit to government.	+ 25.8	- 46.7	+ 67.3	- 18.8
(iv) Commercial bank credit to private sector.	- 3.1	+ 73.5	- 32.2	+ 18.0
(v) Fixed and Savings Deposits.	- 17.7	- 11.2	- 12.1	- 5.5
(vi) Government rupee cash.	- 62.0	+ 37.7	+ 92.5	+ 7.1

(*) Sources: Annual Reports and Monthly Bulletins of the Central Bank of Ceylon.

In both phases, the chief cause of variations in the money supply is to be found in changes in the external assets of the banking system and of the Central Bank. In the first period the money supply increased by Rs. 222.4 million. This was Rs. 61 million less than the addition to external assets. Other

factors making for an increase were an expansion in the domestic assets of the Central Bank by Rs. 6.1 million and an extension of commercial bank credit to government amounting to Rs. 25.8 million. The disinflationary forces were an increase of Rs. 62 million in the government's cash holdings and a contraction of commercial bank credit to the private sector of Rs. 3.1 million.

Although the money supply increased by almost as much as the balance of payments surplus, the Central Bank did not consider it necessary to take measures to offset the increase (17). In contrast to the previous year when there was an increase in commercial bank credit to the private sector, there was a slight contraction in our first phase. The attitude of the Central Bank towards the increase in the money supply was that such an increase was necessary to finance the larger volume and value of foreign and internal trade.

The Bank's Annual Report for 1950 referring to the expansion in bank credit the previous year states that « its investigations have disclosed that the bulk of this credit has been essential to finance the growing volume of Ceylon's trade in recent months ». Then again, « as the value of exports rises due to a rise in their prices and an increase in their volume it is to be expected that there will be an extension of credit to finance them. This type of credit expansion is one of the least harmful to an economy, because it is short-term credit to enable the commercial movement of goods. If the value of exports contracts, credit will also contract. Thus the new money will disappear if and when the time comes, just as naturally as it first appeared » (18).

The statement above recognises an important fact about an export economy. It reco-

(17) On the other hand, the Bank actually increased its domestic assets by Rs. 6.1 million thus adding to the money supply.

(18) This statement is reminiscent of the views of the Banking School and of the more recent theories of « productive credit ». In an export economy they seem to have greater validity in that export and import prices are determined outside the system and the demand for credit adjusts itself accordingly.

gnises that the bulk of the credit extended by the banks is to the export sector and as such its volume fluctuates with changes in the quantity and price of exports. The same argument applies to an extension of credit to finance an increase in the value of imports.

One would go further and state that during a boom a larger monetary circulation is necessary not only to finance the growing value and volume of foreign trade but also to finance the increased turnover of domestic goods and services (19). It is clear that during a boom the money supply must of necessity increase. The problem which confronts the Central Bank is how far it ought to take offsetting action and how far it is justified in tightening credit by raising interest rates and engaging in open market operations. If it is granted that an increase in the quantity of money is necessary in order to support the higher price and income structure during a boom, it will be realised that offsetting action will be confined within very narrow limits.

The second problem is much less easy to resolve. A balance of payments surplus leads to a rise in the liquidity of the banking system through an increase in cash and external assets. Thus, there is considerable scope for a secondary expansion of credit. In discussing the necessity for restrictive central bank action one has to bear in mind the almost exclusive connexion of the banking system with the foreign trade sector of the economy. Banks in Ceylon were first established to meet the requirements of a « plantation » economy (exporting raw materials and importing manufactured goods) and they still, by and large, confine themselves to their original functions. Whatever credit outlets that exist in the domestic sector of the economy tend to be affected by the prosperity of the export industries owing to the dependence of the entire national income on the size of the

(19) An increase in income will be divided between savings and expenditure on imports and on domestic goods and services. Only the last will influence employment and prices at home. To the extent that domestic production is inelastic, there will be a rise in the « domestic » price-level. This too requires an increased monetary circulation.

export income. All except one of the major banks in Ceylon are « Exchange Banks » and are interested in loans to the domestic sector only if they are likely to lead to a sale or purchase of foreign exchange at some later date. Following the traditions of British banking, they insist on a type of security against loans that is difficult to come by. Only a small fringe of business is at all developed along the lines of Western capitalist enterprise. The bulk of whatever production there is outside the export sector is still organised along primitive lines. There is only a very small « private enterprise » sector catering for a purely domestic market. As a result, banks during a boom find that they have few reliable credit outlets to absorb their surplus liquidity.

This view is supported by a passage in the Central Bank's Annual Report for 1951 (20), which, referring to the entire inflationary period, says:

« At no time during the year did the banks hold less than Rs. 53 million in excess reserves and at one time they held Rs. 92.8 million. Moreover the figures understate the total liquid reserves of the commercial banks since some of them, as just indicated, held large balances overseas that could be brought to Ceylon in case of need. In most other countries Central Banks have had to restrain credit expansion to the private sector in order to check inflation. In Ceylon the Central Bank did not need to.

In one way the reluctance of the banking system to lend has been an advantage; it has made Central Bank policy easier during a period when inflationary pressures were strong. But from a long-run point of view, it is a discouraging commentary on Ceylon banking as well as on Ceylon enterprise, that in a year when the country was unusually prosperous, when banks' resources were large and when the Central Bank was imposing no really important curb on the creation of private credit, the increase in such credit was so small. From December 1950 to December 1951, bank extension of private credit in one form or another increased by only Rs. 76 million. Much of this increase can be accounted for by the necessity for financing imports and exports at higher prices. A major task of the Central Bank in the years to come will be to stimulate the commercial banks to extend a larger volume of credit to the private sector of the Ceylon economy ».

(20) Paragraphs 38 and 39.

It is not often that one finds a Central Bank complaining that banks have not extended enough credit during a boom. This seeming paradox can only be explained by the underdeveloped nature of the Ceylon economy and its reliance on a banking system which is totally unsuited to the structural environment. From a short-term point of view, the Central Bank's objective would be to tighten credit during a boom in order to check, in so far as it is possible, the upsurge of the price-level. But from a long-run point of view, an underdeveloped economy, if it is at all capable of unaided development, should find a boom period particularly favourable to economic expansion. And such an expansion should undoubtedly receive the blessings of the Central Bank. This is a dilemma of credit policy in a backward export economy which seems incapable of solution along traditional lines.

In a backward economy such as that of Ceylon where there is a hard core of under-employment and unemployment in the rural sector, a mechanical anti-inflationary policy during a boom is definitely ill-advised. It is only during a boom that this sector experiences even a slight increase in employment and activity in the form of increased production and trade. There appears a tendency for the pressure of the population on the land to be eased and there is a drift towards other occupations primarily in the urban areas. At the same time the increased profitability of production attracts those who are kept away at normal times owing to the high risks of business inherent in an under-developed country. In the circumstances, making credit prohibitively expensive may not amount to killing the boom, but it does prevent the domestic sector of the economy from sharing, however indirectly, in the fruits of the export boom.

Faced with this dilemma, the Central Bank is liable to find the scope and efficacy of quantitative controls extremely limited. On the other hand, it must lean heavily on qualitative or direct controls of which there are several in its armoury. Not all of them are likely to be equally effective.

During the inflationary phase the Central Bank took two major steps to curb the expansion of the money supply. In December 1950, it raised the reserve requirements against demand deposits from 10 per cent to 14 per cent. In spite of this move, the banks at no time had less than Rs. 53 million in excess reserves. This attempt at quantitative control, therefore, could not have bothered the banks overmuch.

The other move was an example of « moral suasion ». The Bank « informed the commercial banks that it did not wish to encourage them at this time to bring their balances to Ceylon from overseas. Repatriation of such balances would only serve to increase the commercial banks' excess reserves and tempt them to engage in non-essential lending, thus further increasing the money supply » (21). As long as the bank's overseas assets were convertible into domestic currency at the Central Bank, it is doubtful whether this measure could really have been a deterrent to credit expansion had there been sufficiently attractive outlets for bank loans. Moreover, the fact that the Banks had considerable excess reserves of cash indicates that the level of liquid assets was not an important influence on the amount of their lending.

On the other hand, the request that the banks should not create « non-essential, particularly speculative credit » is likely to have had some effect. Measures to control the direction of credit rather than its quantity are likely to be much more fruitful in Ceylon's economic climate. The power to fix « ceilings » on particular types of loans was not used in this period although it is undoubtedly one of the most powerful weapons at the Bank's disposal. It is likely that this method of credit control will be in increasing evidence in the future.

The net effect of the boom was that the money supply increased almost as much as the balance-of-payments surplus. There was a rise in prices both of imports and of domestic or home-trade goods. One cannot but

(21) Annual Report of the Central Bank for 1950, para. 17.

conclude that on the first occasion that it was tested the Central Bank was able to make very little impression on the monetary and financial situation. Considering the context in which it had to operate and the conventional nature of its weapons and objectives it is doubtful whether it could have done a great deal more. Unfortunately, its record of achievement in the ensuing period is no more encouraging.

Although the post-Korean boom had reached a peak by the first quarter of 1951, the year as a whole ended with a surplus in the balance of payments; the large credits in the first quarter and the very much smaller one in the fourth quarter offsetting the deficits during the second and third quarters. Between March 1951 and December 1951, the money supply declined by Rs. 21.4 million while external assets fell by 81.7 million. The important offsetting factors were an expansion of bank credit to the private sector of Rs. 73.5 million and a decline in government rupee cash by Rs. 37.7 million. The domestic assets of the Central Bank, in contrast, increased by a mere Rs. 1 million.

By the end of the year deflationary forces were well under way. The Central Bank reacted by lifting its « moral embargo » on the repatriation of the banks' overseas assets and in fact actively encouraged such repatriation (22). Since mid-1951 there has been a heavy fall in export prices and a worsening of the terms of trade accompanied by a loss of external assets and a fall in the money supply. The money supply during 1952 declined by Rs. 112 million but external assets fell by Rs. 375.1 million. The chief factor countering the deflationary effect of the balance of payments was government finance. There was a considerable short-fall of revenue over expenditure. Government borrowed from the Central Bank to the tune of Rs. 142.4 million and as much as Rs. 67.3 million from the commercial banks. It depleted its holdings of rupee cash by Rs. 92.5 million. On the other hand, bank credit to the

(22) Cf. Annual Report of the Central Bank, 1951, para. 37.

private sector declined by Rs. 32.2 million in sympathy with the fall in export prices and national income. The failure of the Central Bank to prevent a decline in the volume of bank credit, let alone stimulate an increase of borrowing, although the banks at all times had excess reserves, serves again to underline the high degree of correlation between bank advances and variations of export incomes.

Owing to the budget deficit of the government, the Bank itself did not need to engage in open market operations on any appreciable scale. The role of the Central Bank was to serve as an engine of the government's policy of deficit-spending. In other words, in the absence of a Central Bank the government would have had to rely solely on the commercial banks for raising loans. The Bank made the task easier by itself making short-term loans to the government and by buying government securities which eventually added to the reserves of the commercial banks and enabled them to subscribe to the new loans that the government was floating.

The same monetary trend continued throughout 1953. External assets declined by Rs. 132.6 million and the money supply by Rs. 67.4 million. The main factor serving to counteract the deflationary effect of the fall in foreign assets was again the increase in the domestic assets of the Central Bank amounting to Rs. 58.3 million. These consisted largely of short-term advances to the Treasury.

The contribution of the Central Bank towards monetary stability during the period was certainly negligible. Its chief function was to enable the government to run a deficit. During the two financial years 1952-1953 Government ran a deficit of Rs. 483.5 million. Towards this the Central Bank contributed over one-half — Rs. 255.5 million by increasing its holdings of domestic assets (provisional advances to government and government securities). The rest was subscribed by the commercial banks and by non-bank (mostly institutional) investors. It is significant, that during this same period the Central Bank's holdings of government securities increased more than did the entire non-cash

assets of the commercial banks (23). Table III shows how the deficit was financed.

TABLE III

Deficit financing	million
Central Bank	255.2
Commercial Banks	34.6
Non-bank investors	93.8
Drawing down of cash balances . .	99.9
	483.5

The experience of this period illustrates the difficulties of running a budget deficit during a slump in a backward economy. A compensatory monetary or fiscal policy comes up against severe balance-of-payments difficulties (24). Owing to the high marginal propensity to import, a large fraction of an increase in income is spent abroad and contributes to the already existing drain on foreign reserves. The scope for deficit-spending is thus limited by the size of the foreign reserves and the minimum to which they can be allowed to all.

Having been an accessory of government financial policy, the Bank remarks in its Annual Report for 1952 that the uninterrupted and heavy drain on the country's external assets was due to this very policy. Government policy, it argues, helped maintain consumption and imports during a slump and thus prevented the automatic corrective of income-deflation from operating (25). Now

(23) The figures are:

— Central Bank's holdings of government securities: + Rs. 142.5 million.

— Commercial banks' non-cash assets: + Rs. 58.8 million.

(24) Between January 1952 and January 1954 the country's external assets have fallen at a monthly rate of about Rs. 30 million.

The budget deficits incurred during the years 1949-54 were not strictly anti-cyclical or compensatory spending. They were part of a programme of long-run development — the Six Year Plan. The bulk of this expenditure fell during a period of falling export prices and balance of payments deficits and thus amounted in fact to compensatory spending in the Keynesian sense. The budget speeches of the Hon. the Finance Minister have not always showed an awareness of the differences in the problems which arise in the two types of deficit-financing.

this automatic corrective was part of the mechanism of the Currency Board System where money could not be created against domestic assets. What the Bank is complaining of is that monetary events did not conform to the pattern that would have obtained had there been no Central Bank. This is a frank admission of the weakness of orthodox central banking in a backward export economy. It is just as well that this admission comes so early in the Bank's life.

No doubt the Central Bank can within limits prevent an excessive contraction or expansion of credit. It can prevent a « non-essential or speculative expansion of credit » and the financing of mushroom ventures. It can contribute towards healthy banking practices by bank supervision. It can advise the government on financial and economic matters. In all these fields it can achieve a lot (26). But in the major tasks of central banking — the stabilisation of incomes, prices and the money supply — it fares very badly. This is the lesson of recent experience.

What then is the future of central banking in Ceylon to be? The above reflections suggest that if the Bank follows orthodox methods and conventional policies it can be little more than a spectator watching the economy tossed backwards and forwards between boom and slump by the current of world events. The root cause of this situation is the undeveloped nature of the economy itself — the abject dependence of its National Income on fluctuations in export prices. Measures have to be taken, to stabilise export prices so far as it is possible (27). The economy must be developed and diversified. Central banking must be integrated with policies of long-run development. Orthodox central banking of the British model or even the more elaborate

(25) Cf. Central Bank's Report for 1952, para. 23. A fall in the foreign balance leads to a multiple fall in incomes, which leads to a fall in imports (depending on the marginal propensity to import). This constitutes an automatic adjustment of the balance of payments. To the extent that incomes and expenditure are maintained through credit creation imports are maintained while export values are falling. This causes the drain on external assets to increase cumulatively.

(26) Prof. R. S. SAYERS in his *Modern Banking* (3rd edn.), Ch. 12 stresses these « ancillary functions ».

(27) A recent attempt to achieve greater stability in the price of rubber is the long-term pact with China.

American-inspired models can do very little in the context of a backward export economy. It is beyond the scope of this article to discuss the methods by which the development that is so urgently needed might be secured. But it is clear that an overall Investment Programme must be undertaken. It must be a Plan which will draw into employment the surplus population in the rural areas and widen the ambit of modern credit institutions. National credit policy must be subordinated to that Plan. This implies a rigid and direct control of expenditure, bank loans and foreign payments and perhaps, price-

control and rationing. The older methods of central banking might have their use but newer and more appropriate instruments must be forged. All this implies a radical change of outlook on the part of the Central Bank. It is only with the help of such policies that the economy can be jolted out of its lethargy. Then only can central banking be really effective. Until then the balance of payments must continue to dominate not only the money supply but also the entire National Income of the country.

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