t is essential for us in Sri Lanka to keep up with financial developments taking place outside the region, particularly in the bond and fixed-income securities markets. This is needed to guard against marginalization and the kinds of severe crises that hit many parts of Asia. Sri Lanka has been liberalizing its economy for many years now by moving away from a public sector to a private sector orientation. We are very pleased that we are being assisted in this process by the International Finance Corporation (IFC), the World Bank Group’s private sector lending institution.

We started opening up the Sri Lankan economy in 1977, long before many other countries did so. Transforming a highly state-dominated and controlled economy to an essentially private sector led economy is an extremely difficult task, however, and should not be underestimated. As pioneers in the field, we had no well-defined path or ready-made plan to follow. Our first major obstacle was to liberalize trade, domestic transactions and the real sector of the economy, and to get the private sector involved in activities earlier dominated by the government.

Although the real sector of the economy was important, in retrospect we could have done much more by concentrating equally, and from the beginning, on the financial sector. We did not think that the financial sector was a high priority and put most of our emphasis on improving the banking system. We were trying to make the banking
sector more efficient, more competitive, and less directed by the state. However, to reduce the government’s role in the banking sector, and reduce directed lending, turned out to be a major task. But today, as a result of this effort, the government plays a much smaller role in the commercial banking sector, while the private sector is being encouraged to take on increasing responsibilities.

As we slowly moved ahead with our banking reforms, we also tried to restart a rudimentary stock market. With modern technology, this project moved quite fast, although for a number of reasons the stock market has remained small. Recently, we hosted a seminar for international fund managers in Colombo, to identify the next steps required to develop equity markets in the country. An important aspect of all these reforms—of moving away from a state-dominated economy to a private economy—is the underlying macroeconomic policies. As we quickly learned, downsizing a government that plays such an overwhelming part in the economy is a tricky job, particularly when the general public has come to expect the government to provide it with extensive services.

The slow, steady progress toward liberalization received a jolt after the recent economic crisis. We began to realize that we could no longer take our time in making our financial markets more efficient. We have serious problems with capital inflows and outflows alike. Fortunately, we managed to survive this crisis, but the fact of the matter is that we are now a feature of the world economy. All this time we have been complacently depending on official bilateral markets. One lesson we have to learn is that we have to improve the risk management and efficiency of our institutions. At present, Sri Lanka is incapable of adequately intermediating in these markets. The problem is that so many things need to be done simultaneously. It is mind-boggling for those of us who have to carry out these reforms. How do we sift through this vast array of reforms to sequence them? How should we move forward?

Building market infrastructure does not automatically create a market, just as putting up a school building does not necessarily mean the children in it will get a good education. So much more needs to be done and we are still not sure how to go about doing it. As I just mentioned, how does one sequence these reforms? How does one take into account objective realities on the ground? What
is the best way to create a secondary market in public debt? We have created many market makers or market dealers, but we still find that the market has yet to take off. I think that we as regulators and as promoters have not properly understood the problem.

In Sri Lanka, we had outside experts look at our markets, but the traditional public sector fears these people or does not understand the language they use, or has a defensive attitude that makes it difficult to move ahead. In the past, we have difficulty getting our public and private sector to talk with one another, but something like a dialogue is just beginning on how to improve the private markets, particularly debt securities. In the public sector, we have regulators and promoters who are extremely competent in their own spheres of micro or macro management, but who find it difficult to relate to the market players, and who are rooted in a different discipline. As a result, many people do not understand the market. I am sorry to confess that even my own people are reluctant to “talk to” the market, and when they do talk, sometimes their understanding of the issues is poor, partly because we come from a long tradition of having the central government operating in the markets. We were lord of the market, and the private sector came to us on bended knees to get things done. That old master-slave relationship is no more. I suspect that the public sector is in some measure still inimical to market development. That is why we need to create a climate, a culture in which the public and private sectors can interact in an efficient and mutually rewarding way. In other words, the attitudes of regulators and other people in the public sector need to change.

However, the public sector is not the only one failing to talk to the market. The private sector, too, has an extremely negative attitude. With the exception of one or two firms that set the standards and provide some intelligent observations, financial analysts in the private sector seem to have little understanding of the markets.

A further problem we face is the overhang of huge social security funds in the market. In the past, the government once dictated what happened in our markets. Today the social security fund essentially decides what the market should be. Is that acceptable? We say that we have a competitive market, but who is actually behind the decisions on the social security funds? What should be done about the thinness of this market? We need to reform the social se-
curity funds and we need to reform the pension funds. The government has committed to such reform—in fact, we just had a few seminars on the subject, and we are working out a plan or road map for pension reforms—but we need to move forward with this quickly. We also need to look at why we do not have mutual funds, and why we still perpetuate rent losses introduced more than 50 years ago.

There are indeed many impediments to market development in this country: the laws, the conventions, the customs, and even our cultural and other attitudes to public and private sector development. The public sector must realize that it has to create the conditions conducive to the development of markets and the private sector must enter into a close dialogue with the public sector because the regulator will be there whether they like it or not. Financial markets fail for a variety of reasons, so somebody has to be there to guard the system. Remember, it is not only the private markets in the financial sector that can fail. The government can also fail.

I would like to see Sri Lanka put together a “road map” for development of our fixed income markets. It may differ from the markets in India and Pakistan, but there are considerable similarities in the areas we need to address. Malaysia and Korea provide us with striking examples. This country information will be helpful for the work that our central bank, securities commission, stock exchange, and many others are now trying to do in our markets. Their ideas are spreading throughout Sri Lanka. However, their ideas and efforts need to be coordinated because the markets are interrelated. One market should not be developed faster than another; rather, there must be a holistic approach to these problems.