7

MONETARY POLICY, MONEY, CREDIT AND INTEREST RATES

7.1 Overview

Considering well contained inflation and inflation expectations, the Central Bank was able to ease monetary policy to support growing economic activity during the year. The easing of monetary policy, which commenced in December 2012 with the Central Bank proactively reducing the Repurchase rate and the Reverse Repurchase rate of the Central Bank by 25 basis points and allowing the ceiling imposed on credit expansion by licensed banks to expire, continued in 2013. Considering the downward rigidity in market interest rates and the continued decline in headline and core inflation, the Central Bank reduced policy interest rates further in May and October 2013, by a total of 100 basis points, and engaged in dialogue with financial institutions to ensure that market interest rates decline reflecting the easing of monetary policy. In order to strengthen this process by reducing banks' cost of funds and by enhancing market liquidity, the Central Bank also reduced the Statutory Reserve Ratio (SRR) applicable on all rupee deposit liabilities of commercial banks by 2 percentage points effective July 2013. While monetary expansion decelerated gradually towards desired levels during the year, credit obtained by the private sector slowed down more than anticipated, partly due to the sluggish adjustment in market lending rates and the decline in pawning advances. However, by the final quarter of the year, responding to declining market interest rates, some signs of a gradual pick up of credit disbursements to the private sector were visible. Meanwhile, within the total domestic credit expansion in 2013, credit to the government from the banking sector was above the expected level, although net credit to the government (NCG) from the Central Bank declined substantially. Benefitting by favourable weather conditions and cost reflective prices introduced by the government for Ceylon Petroleum Corporation (CPC) and Ceylon Electricity Board (CEB) early during the year, the expansion of credit obtained by public corporations decelerated in the second half of the year. At the beginning of 2014, the Central Bank renamed its Repurchase rate as Standing Deposit Facility Rate (SDFR) and decided to uncollateralise the facility effective February 2014, while renaming its Reverse Repurchase rate as Standing Lending Facility Rate (SLFR) and reducing the latter by 50 basis points with effect from 02 January 2014. The compression of the Standing Rate Corridor (SRC) is expected to reduce the volatility of the short term interest rates further while facilitating the reduction in the spread between market lending and deposit rates.

Reflecting the easing of monetary policy stance during the year, rupee liquidity in the domestic money market remained in excess during much of 2013 compared to a more balanced level seen in 2012, although the effect of higher liquidity was mostly observed at the short end of the interest rate structure. Increased liquidity was a result of the proceeds from several international bond issuances by licensed commercial banks (LCBs) and licensed specialised banks (LSBs) being released to the market from time to time as well as the reduction of the SRR by 2 percentage points to 6 per cent with a view to supplement the reduction in the policy rates. Reflecting these developments, the interbank call money market rates, which remained marginally above the upper bound of the policy rate corridor by end 2012, decreased during the year towards the middle of the corridor. Substantial reductions in the average weighted prime lending rate (AWPR) and Treasury bill rates were observed, although longer term lending rates as well as deposit rates continued to increase in the first few months of the year before declining gradually thereafter.

Inflation, which came close to double digits at the beginning of the year, declined gradually to reach mid single digit levels reflecting the effect of prudent monetary policy measures as well as benign supply conditions. Global commodity prices remained relatively stable during the year while domestic supply of most food items improved. The lag effect of tight monetary conditions in the previous year was reflected in both headline and core inflation, where core inflation declined to record lows. Given well anchored inflation expectations, the upward revision of energy and transport prices in the first half of 2013 had minimal influence on inflation, with no second round effects being recorded.

In 2014, maintaining inflation at mid-single digits as already announced to the market will remain the focus of monetary policy, and the prevailing domestic economic conditions are likely to allow the continuation of the current monetary policy stance, which would enhance private sector activity without overheating the economy. Rapidly improving physical infrastructure of the country along with recovering export markets provide ample investment opportunities for the private sector. At the same time, the prevailing monetary conditions are conducive for such medium and long term investments in productive economic activity. Therefore, going forward, envisaged increase in credit disbursements to the private sector accompanied by ongoing fiscal consolidation would help expand the domestic production base, supporting sustained economic and price stability.

7.2 Monetary Policy

Amidst continued deceleration in inflation and favourable inflation expectations, monetary policy in 2013 focused on supporting economic activity, which had moderated somewhat due to the measures taken in 2012 by the Central Bank and the government to ensure macroeconomic stability. The Central Bank signalled to the market the end of the tight monetary policy cycle, by reducing the Repurchase rate and the Reverse Repurchase rate by 25 basis points each, on 12 December 2012, and allowing the ceiling on rupee denominated credit growth by licensed banks to expire at end 2012. Having observed the slow growth in credit disbursements to the private sector by commercial banks and continued moderation in inflation, the Central Bank reduced the Repurchase rate and the Reverse Repurchase rate by 50 basis points each, in May 2013 and further by 50 basis points each, in October 2013. Consequently, the Repurchase rate and the Reverse Repurchase rate were at 6.50 per cent and 8.50 per cent, respectively, by end 2013. In addition, SRR was also reduced by 2 percentage points to 6 per cent with a view to supplement the reduction in the policy rates and to facilitate a reduction in the spread between deposit and lending rates in commercial banks. With these revisions, the interest rate structure moved downwards in an orderly manner and credit obtained by the private sector increased towards end 2013. The money market continued to remain liquid throughout 2013 and the monetary aggregates moved towards the projected path as the year progressed.

Table 7.1 Recent Monetary Policy Measures

Date	Measure
11-Jan-2011	Repurchase rate reduced by 25 bps to 7.00% and Reverse Repurchase rate reduced by 50 bps to 8.50%.
12-Apr-2011	Statutory Reserve Requirement increased by 1 percentage point to 8% (effective from the reserve week commencing 29-Apr-2011).
3-Feb-2012	Repurchase rate and Reverse Repurchase rate increased by 50 bps to 7.50% and 9.00%, respectively.
9-Feb-2012	Greater flexibility in the determination of the exchange rate allowed.
12-Mar-2012	Direction issued to licensed banks to limit rupee denominated credit growth to 18% or Rs. 800 mn. Additional 5% (23% or Rs. 1 bn) allowed to banks that bridge the gap with funds raised abroad.
5-Apr-2012	Repurchase rate increased by 25 bps to 7.75% and Reverse Repurchase rate increased by 75 bps to 9.75%, respectively.
12-Dec-2012	Repurchase rate and Reverse Repurchase rate reduced by 25 bps to 7.50% and 9.50%, respectively.
31-Dec-2012	Ceiling on rupee denominated credit growth allowed to expire.
10-May-2013	Repurchase rate and Reverse Repurchase rate reduced by 50 bps to 7.00% and 9.00%, respectively.
26-Jun-2013	Statutory Reserve Requirement reduced by 2 percentage points to 6% (with effect from 1-Jul-2013).
15-Oct-2013	Repurchase rate and Reverse Repurchase rate reduced by 50 bps to 6.50% and 8.50%, respectively.
2-Jan-2014	The Policy Rate Corridor was renamed as the Standing Rate Corridor (SRC), and the Repurchase rate and Reverse Repurchase rate of the Central Bank were renamed as the Standing Deposit Facility Rate (SDFR) and Standing Lending Facility Rate (SLFR), respectively. SLFR reduced by 50 bps to 8.00%. The Standing Deposit Facility (SDF) was uncollateralised (with effect from 1-Feb-2014).

Source: Central Bank of Sri Lanka

Further to these developments during the year, the Monetary Board, at its last meeting in 2013, decided to establish a Standing Rate Corridor in place of the current policy rate corridor from January 2014. Accordingly, the Repurchase rate of the Central Bank was replaced by the Standing Deposit Facility Rate, and the Reverse Repurchase rate of the Central Bank was renamed as the Standing Lending Facility Rate. Considering ample liquidity in the money market and to facilitate greater stability in short term interest rates and lower interest rate spreads in the financial market, the Central Bank compressed the SRC to 150 basis points by reducing the SLFR by 50 basis points to 8.00 per cent with effect from 02 January 2014. Subsequently, effective February 2014, the Standing Deposit Facility (SDF) was uncollateralised.

Whilst maintaining inflation at single digits remained the focus of monetary policy, the framework for the conduct of monetary policy was based on monetary targeting with reserve money as the operating target and broad money as the intermediate target. The desired rate of expansion of broad money in the monetary programme was set at 15 per cent, consistent with the projected real GDP growth of 7.5 per cent and the expected implicit GDP deflator of 7.0 per cent for the year, while the annual average growth of reserve money was set at 16.5 per cent. The higher growth projection for reserve money was due to the base effect of low reserve money growth in 2012. However, the reduction in SRR with effect from 01 July 2013 and the resultant higher money multiplier necessitated a downward revision to the reserve money path to maintain broad money along the targeted level. Within this monetary targeting framework, which broadly guided monetary operations of the Central Bank, the recommendations of the Monetary Policy Committee (MPC) to the Monetary Board

BOX 9 Recent Changes Introduced to the Framework for Conducting Monetary Operations

Since the commencement of more active open market operations (OMO) in March 2003, the Central Bank of Sri Lanka (CBSL) has introduced a series of operational changes in the recent past with a view to improving the framework for monetary policy implementation[1]. One such change was the extension of the period of reserve maintenance by licensed commercial banks in June 2013. Another measure was the streamlining of the Policy Rate Corridor of the CBSL and renaming it as the Standing Rate Corridor in January 2014. The rationale underlying these changes is discussed below.

1. Extension of the Reserve Maintenance Period (RMP)

A well-designed reserve requirement is beneficial to the financial sector where reserves provide a buffer against liquidity shocks and minimise undue fluctuations in short term interest rates. In Sri Lanka, all commercial banks are required to hold as reserves a specific percentage (Statutory Reserve Ratio (SRR)) of their deposit liabilities, as a cash deposit with the Central Bank. The SRR as well as the method of reserve calculation is defined and adjusted from time to time, keeping abreast of the developments in the economy and with the advances taking place in the monetary policy implementation framework. Prior to May 2013, the reserve maintenance period (RMP) for commercial banks was maintained as a seven day cycle starting Friday each week, and ending on Thursday, the following week. In order to manage liquidity more effectively, commercial banks were allowed to average their reserves over this reserve week rather than meeting the required reserve on a daily basis, thereby granting greater flexibility in maintaining the required reserve levels. However, the developments taking place in financial markets and expanding economic activities have necessitated banks to be more efficient in their intermediation process, and in turn, efficacy in management of liquidity. In this context, the relatively short span of the seven day RMP, was seen as a restriction on commercial banks to smooth out unexpected liquidity shortfalls, and also could pressurise short term interest rates. With the objective of facilitating more robust liquidity management by commercial banks and preventing excessive volatility in short term market interest rates, the CBSL reviewed the existing RMP, and took steps to lengthen the RMP with effect from 01 June 2013. Accordingly, the reserve calculation and maintenance period was revised to approximately two weeks and each calendar month was divided into two periods, the first from 1st to 15th (Period A), and the second from 16th to the end of each month (Period B). Reserves required to be maintained for the computation of SRR for the 1st to 15th of the month will be based on the average deposit liabilities held by the bank during Period A of the preceding month. The reserve requirement for the 16th day to the end of the month will be calculated based on the average deposit liabilities for Period B of the preceding month.

2. Establishment of the Standing Rate Corridor (SRC)

The policy interest rate corridor of the CBSL, an important feature of the OMO, was restructured in January 2014 and renamed as the Standing Rate Corridor (SRC) in order to streamline the conduct of monetary operations further. The CBSL, in its "Road Map: Monetary and Financial Sector Policies for 2014 and Beyond," announced the following measures approved by the Monetary Board:

1. The establishment of a Standing Rate Corridor (SRC) in place of the current Policy Rate Corridor with effect from 02 January 2014. In order to implement these measures, the following changes were effected:

    a) The Repurchase (Repo) facility of the Central Bank that was used for the placement of overnight excess funds of the banking system after the conduct of OMO auctions was renamed as the Standing Deposit Facility (SDF). The corresponding Standing Deposit Facility Rate (SDFR) was pronounced the lower bound of the SRC.

    b) The Reverse Repurchase (Reverse Repo) facility of the Central Bank that was used for the lending of overnight funds to the banking system after the conduct of OMO auctions was renamed as the Standing Lending Facility (SLF). The corresponding Standing Lending Facility Rate (SLFR) was pronounced the upper bound of the SRC.

    c) OMO auctions would continue unchanged with Repo and Reverse Repo auctions, depending on liquidity conditions in the domestic money market.

1 *Prior to March 2003, the Central Bank's OMOs were "passive" in nature, i.e., relying solely on market participants to place excess funds with (or obtain shortages from) the Central Bank voluntarily, rather than the Central Bank absorbing excess liquidity (supplying shortages of liquidity) more actively through OMO auctions.*

2. The compression of the SRC from 200 basis points to 150 basis points by reducing the SLFR by 50 basis points to 8.00 per cent and maintaining SDFR at 6.50 per cent.
3. An uncollateralised SDF with effect from February 2014. However, all other OMO transactions would remain collateral-based.

These decisions were based on the reasons discussed below.

Renaming Policy Interest Rates as Standing Rates and the Uncollateralisation of the SDF: Central banks use different names for their policy interest rates. Prior to 02 January 2014, the CBSL used the terms Repurchase rate and the Reverse Repurchase rate for the key policy interest rates under which liquidity was absorbed when there was an excess, or liquidity was injected when there was a shortage, respectively, through a collateralised lending/ borrowing agreement with OMO participants. The CBSL conducted Repo/Reverse Repo auctions to maintain market liquidity at desired levels. After the conclusion of auctions, OMO participants were allowed to access the Repo/Reverse Repo standing facility to deposit/borrow any residual funds at the policy interest rates of the Central Bank. However, it was felt that a clearer distinction between rates at auctions and standing facilities could benefit the general understanding of the process of monetary policy implementation. In this context, it was observed that central banks such as the Bank of England, European Central Bank, the Federal Reserve System, Bank Negara Malaysia, Monetary Authority of Singapore, etc., operate a Deposit facility (uncollateralised) instead of a Repo facility to absorb excess liquidity from the money market, while a Lending facility (collateralised) was used to address overnight liquidity shortages. The terminology of Deposit facility and Lending facility is clearer than the previous terminology used by the CBSL to distinctively identify standing facilities.

The main purpose of offering collateral by the Central Bank under the Repo facility at the time of introducing the facility was to generate wider market acceptance and to offer a marketable instrument to OMO participants for the placement of excess funds with the Central Bank. However, after 10 years of active OMO, the domestic financial market as well as the Central Bank's financial position has also evolved prompting a review of the requirement to provide collateral by the Central Bank to OMO participants when absorbing liquidity. Capital funds of the Central Bank have been increased substantially since 2008, and in comparison to the contributed capital of the Central Bank of Rs. 15 million at the inception of the Central Bank in 1950, capital funds of the Central Bank amounted to Rs. 35 billion as at end 2013. Considering the Central Bank's responsibilities and recent trends in the economy, the Budget 2014 proposed to increase the capital of the Central Bank further to Rs. 50 billion, by capitalising its reserves. While this development reinforced the financial strength of the Central Bank, the unique nature of a central bank as the monetary authority of the country with zero credit risk in domestic currency denominated transactions, prompted the Monetary Board to uncollateralise the liquidity absorption facility. This brought the SDF in line with deposit facilities offered by major central banks in the world.

Uncollateralisation of the SDF was also informed by the fact that the standing facility is an overnight facility, and as such, market participants cannot use the allocated security for relending purposes. Therefore, uncollateralisation has no adverse impact on OMO participants.

The Compression of the SRC: The Central Bank adjusts the width of the policy interest rate corridor from time to time depending on market conditions and expected macroeconomic outcomes, and the width of the corridor remained at 200 basis points since April 2012. The decision to compress the SRC to 150 basis points from the previous width of 200 basis points was based on the Central Bank's desire to streamline the volatility of interest rates in the short term money market further. Moreover, a narrower corridor was also deemed to be in line with the easing of the monetary policy stance since December 2012, and improved macroeconomic conditions.

It was also expected that this compression would facilitate the reduction of the interest spread of banks over time, without affecting the deposit rates offered by banks to their customers.

Conclusion

The changes to the framework of monetary operations announced in 2013 and at the beginning of 2014 are a part of a series of continuous improvements that the CBSL has been making to the process of monetary policy formulation and implementation. This is an ongoing process, and it is expected that these improvements will strengthen monetary policy transmission enabling the Central Bank to ensure economic and price stability while supporting financial system stability.

of the Central Bank continued to be based on comprehensive monetary and economic analyses of the economy. Regular discussions were also held with various stakeholders of the economy, including the Monetary Policy Consultative Committee (MPCC), to incorporate sentiments of the private sector in the process of monetary policy formulation.

Inflation moderated steadily during the year underpinned by prudent monetary policy, muted global commodity prices and improved domestic supply conditions. Food inflation, which tended to be volatile in the past, was relatively low at 3.5 per cent by end December, compared to its average of 7.1 per cent in the last 4 years. The absence of major disruptions to food production and distribution contributed to the stabilisation of domestic food prices towards end 2013. Headline inflation, on a year-on-year basis, declined to 4.7 per cent in December compared to 9.2 per cent at end 2012, and on an annual average basis, declined to 6.9 per cent in 2013 from 7.6 per cent in the previous year. Meanwhile, core inflation, which excludes selected volatile items and items where prices are administratively determined, decelerated to its lowest level of 2.1 per cent by end 2013 from 7.6 per cent at end 2012, reflecting the absence of demand driven inflationary pressures. Annual average core inflation declined from 5.8 per cent at end 2012 to 4.4 per cent at end 2013.

The Central Bank used its communication policy extensively to enhance the transparency of monetary policy decisions, and to facilitate effective decision making of stakeholders. Considering the importance of market awareness for the success of macroeconomic policies, the Central Bank continued to make available information on key macroeconomic developments to all stakeholders on a regular basis. The review of the monetary policy stance of the Central Bank was issued on a monthly basis. The CBSL continued to issue periodic press releases on macroeconomic developments. Publications of the Central Bank, such as the Annual Report and the Recent Economic Developments provided in-depth analyses of macroeconomic data, in addition to data dissemination. As customary, the Central Bank announced its plans and policy direction for 2013 in the "Road Map: Monetary and Financial Sector Policies for 2013 and Beyond" at the beginning of the year, thus increasing the predictability of policy decisions.

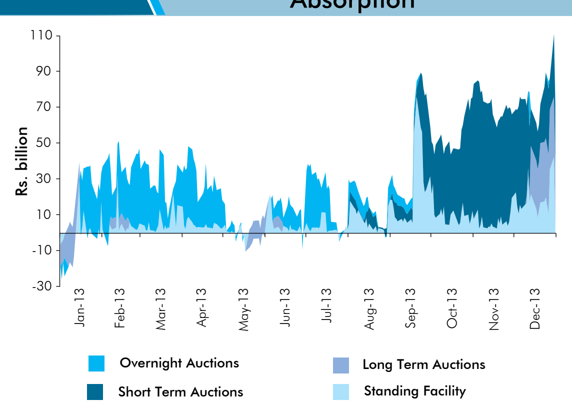
7.3 Developments in Money and Credit

Money Market Liquidity

Rupee liquidity in the domestic money market remained high throughout 2013 and the Central Bank absorbed excess liquidity on a continuous basis through overnight and longer term open market operations (OMO). Except for few days where the market was in a deficit, excess rupee liquidity during the year averaged around Rs. 23 billion, which reflected the gradual easing of monetary conditions in 2013. The absorption of foreign currency by the Central Bank from the domestic foreign exchange market following the issuance of international bonds by licensed banks and corporate debt and equity to foreign investors by the private sector, injected substantial amounts of rupee liquidity to the market in 2013. In the first half of the year, Bank of Ceylon (BOC) raised US dollars 500 million from the international market and a part of the proceeds of the bond was purchased by the Central Bank. This, together with the purchases of Treasury bills from the primary market, which were subsequently retired, mainly contributed to enhancing surplus liquidity in the domestic money market during the first five months of the year. Although market liquidity returned to a broadly balanced position towards end June 2013, the reduction in the SRR applicable on all rupee deposit liabilities of commercial banks by 2 percentage points with effect from July 2013 injected additional liquidity of around Rs. 48 billion. In September, the National Savings Bank (NSB) issued an international bond amounting to US dollars 750 million, and following the utilisation of these proceeds, excess liquidity in the domestic money market recorded its highest level for the year (Rs. 88 billion) in September 2013.

In the environment of continued surplus liquidity, the Central Bank conducted OMOs aggressively on an overnight basis and introduced term repurchase auctions from the third quarter onwards with a view to absorb liquidity on a long term basis. These measures were complemented by the outright sales of Treasury bills held by the Central Bank, reducing Treasury bill holdings of the Central Bank by Rs. 163 billion to Rs. 5.2 billion by end 2013. As the stock of Government securities available for OMOs depleted, the Central Bank utilised borrowed securities in order to absorb excess liquidity in the money market. The availability of sufficient liquidity in the money market enabled the Central Bank to remove the restriction placed on access to the repo standing

Chart 7.1 Rupee Liquidity in the Domestic Money Market and Liquidity Absorption



facility (Rs. 100 million per participating institution), on days when reverse repurchase auctions were offered, with effect from 01 June 2013. Further, the Central Bank extended the period of reserve maintenance by LCBs to facilitate a more robust liquidity management. Accordingly, the seven day reserve calculation and maintenance period was increased to two periods a month, the first from 1st to 15th, and the second from 16th to the end of each month.

Reserve Money

Reserve money expansion in 2013 was broadly in line with the quarterly projections in the monetary programme. The year-on-year growth of reserve money was 10.7 per cent on average during the first half of the year. In terms of liabilities, the growth of reserve money in the first half of 2013 was mainly due to the increase in commercial bank deposits with the Central Bank as currency in circulation declined during this period. Aggressive deposit mobilisation efforts by financial institutions caused the increase in commercial bank deposits with the Central Bank by around Rs. 20 billion during this period. Increased opportunity cost of holding non-interest bearing assets caused a reduction in currency in circulation although it displayed the usual seasonal pattern of peaking in March 2013 prior to the festive season, declining by end April, and increasing gradually thereafter. With the reduction in the SRR with effect from 01 July 2013, the growth of reserve money turned negative, warranting a revision to the quarterly reserve money projections. The reduction in SRR resulted in a sharp decline in commercial bank deposits with the Central Bank, and by end 2013, the total decline amounted to Rs. 17.5 billion. The overall increase in currency in circulation in 2013 amounted to Rs. 21.7 billion, compared to the expansion of Rs. 24.8 billion in the previous year. Reflecting these developments,

Table 7.2 Developments in Monetary Aggregates

Rs. billion

Item	End 2012	End 2013 (a)	Change 2012 Amount	Change 2012 %	Change 2013 Amount	Change 2013 %
1. Currency Outstanding	318.1	339.8	24.8	8.5	21.7	6.8
1.1 Currency held by the Public	251.5	264.6	8.7	3.6	13.1	5.2
1.2 Currency with Commercial Banks	66.5	75.2	16.2	32.1	8.6	13.0
2. Commercial Banks' Deposits with the Central Bank	166.3	148.8	20.0	13.7	-17.5	-10.5
3. Government Agencies' Deposits with the Central Bank (b)	…	…	…		…	
4. Reserve Money (1+2+3)	**484.4**	**488.6**	**44.9**	**10.2**	**4.2**	**0.9**
5. Demand Deposits held by the Public with Commercial Banks	198.5	220.0	2.7	1.4	21.5	10.8
6. Narrow Money Supply, M_1 (1.1+5)	**450.0**	**484.6**	**11.3**	**2.6**	**34.5**	**7.7**
7. Time and Savings Deposits held by the Public with Commercial Banks	2,143.1	2,574.2	389.2	22.2	431.1	20.1
8. Broad Money Supply, M_2 (6+7)	**2,593.2**	**3,058.8**	**400.6**	**18.3**	**465.6**	**18.0**
9. Foreign Currency Deposits (c)	335.9	359.1	36.7	12.3	23.2	6.9
10. Consolidated Broad Money Supply, M_{2b} (8+9)	2,929.1	3,417.9	437.3	17.6	488.8	16.7
Money Multiplier, M_{2b}	**6.05**	**7.00**				
Velocity, M_{2b} (d)	**2.75**	**2.71**				

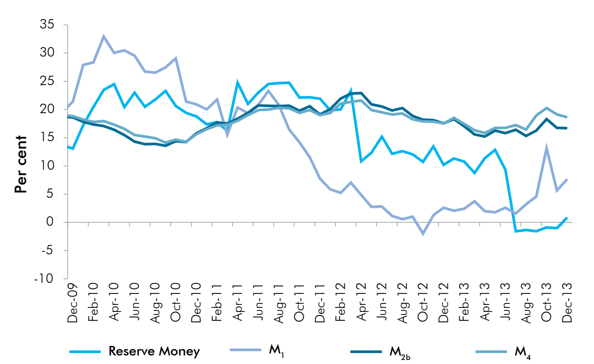
(a) Provisional
(b) Government Agencies' Deposits with the Central Bank amounted to Rs. 13.9 million at end 2012 and Rs. 4.7 million at end 2013
(c) Includes deposits of the Resident Category of Offshore Banking Units and a part of foreign currency deposits with Domestic Banking Units
(d) During the year

Source: Central Bank of Sri Lanka

the average daily reserve money in 2013 stood at Rs. 489.2 billion, recording a growth of 4.1 per cent from Rs. 469.8 billion in 2012 and remained within its revised average projection for the year.

In terms of assets, the reduction in net domestic assets (NDA) of the Central Bank partially offset the expansion of net foreign assets (NFA), thereby containing the growth of reserve money during 2013. NFA of the Central Bank increased by Rs. 132.7 billion in 2013 mainly due to the increase in foreign funds provided to the Central Bank under forex swap arrangements and foreign exchange purchases from the domestic market. NDA of the Central Bank contracted by Rs. 128.4 billion during the year. The decrease in the stock of Treasury bills held by the Central Bank in 2013, which amounted to Rs. 163 billion resulted in this decline in NDA. The decline in Treasury bill holdings of the Central Bank was prominent in the second half of the year, where the sterilisation of additional liquidity caused Treasury bill holdings to decline from Rs. 108 billion at end June to Rs. 5.2 billion at end 2013. At end 2013, the outstanding amount of provisional advances to the government from the Central Bank was Rs. 109.2 billion, Rs. 2.1 billion lower than the level at end 2012. Consequently, net credit to the government (NCG) declined by Rs. 164.8 billion reversing the adverse development of high NCG from the Central Bank that was observed in the two previous years. The increase in other assets of the Central Bank on a net basis by Rs. 22.4 billion was caused mainly by a reduction in international reserve

Chart 7.2 Year-on-Year Growth of Monetary Aggregates



revaluation, which is considered a liability of the Central Bank, by Rs. 26.7 billion.

The money multiplier, which links reserve money and broad money (M_{2b}), expanded during the second half of the year due to the reduction in SRR. Compared to 6.05 at end 2012, the money multiplier was higher on average at 6.21 during the first half of the year, as the currency to total deposits ratio continued to decline as a result of competitive deposit mobilisation by commercial banks. In the second half of the year, the key reason for the expansion of the money multiplier further was the reduction in SRR, and accordingly, the money multiplier was recorded at 7.07 on average during the period.

Narrow Money (M_1)

Narrow money supply (M_1), which grew at a slow pace during the first eight months of the year, gathered pace thereafter as the opportunity cost of holding narrow money declined with the gradual downward adjustment of market interest rates during the year. As a result, narrow money supply, which comprises currency and demand deposits held by the public, recorded a year-on-year growth of 7.7 per cent by end 2013, compared to 2.6 per cent at end 2012. Currency held by the public grew by 5.2 per cent, on a year-on-year basis, by end 2013 from 3.6 per cent in the previous year, while demand deposits held by the public grew by 10.8 per cent during the year as opposed to a tepid growth of 1.4 per cent in 2012. The decline in market deposit rates along with increased economic activity towards the end of the year, led to the increase in demand deposits held by the public.

Broad Money (M_{2b})

The moderation of year- on- year growth of broad money (M_{2b}) continued in 2013, although the overall monetary expansion remained somewhat higher than the projected level of 15 per cent for 2013. Accordingly, the growth of broad money at end 2013 was at 16.7 per cent compared to 17.6 per cent at end 2012. The average growth of broad money in 2013, which stood at 16.5 per cent, remained significantly lower compared to 20.2 per cent in 2012, impacted by the lag effect of restrictive monetary policy measures adopted in 2012.

On the liabilities front, the growth of broad money during the year was driven by the increase in both narrow money and quasi money of the banking system. Quasi money, which includes time and savings deposits held by

Table 7.3 Sources of Reserve Money and Broad Money (M_{2b})
(Computed as per the Monetary Survey)

Rs. billion

Item	End 2012 (a)	End 2013 (b)	Change 2012 Amount	Change 2012 %	Change 2013 Amount	Change 2013 %
Reserve Money	**484.4**	**488.6**	**44.9**	**10.2**	**4.2**	**0.9**
Net Foreign Assets of the Central Bank	396.5	529.1	56.4	16.6	132.7	33.5
Net Domestic Assets of the Central Bank	87.9	-40.5	-11.5	-11.6	-128.4	-146.1
Broad Money (M_{2b})	**2,929.1**	**3,417.9**	**437.3**	**17.6**	**488.8**	**16.7**
Net Foreign Assets	-25.8	-76.3	-123.9	-126.3	-50.5	-195.5
Monetary Authorities	396.5	529.1	56.4	16.6	132.7	33.5
Commercial Banks	-422.3	-605.5	-180.3	-74.5	-183.2	-43.4
Net Domestic Assets	2,954.9	3,494.2	561.2	23.4	539.3	18.3
Domestic Credit	3,696.1	4,200.8	658.2	21.7	504.7	13.7
Net Credit to the Government	1,045.2	1,301.3	211.6	25.4	256.1	24.5
Central Bank	278.8	114.0	16.1	6.1	-164.8	-59.1
Commercial Banks	766.4	1,187.3	195.5	34.2	420.9	54.9
Credit to Public Corporations	292.5	365.1	94.0	47.3	72.6	24.8
Credit to the Private Sector	2,358.4	2,534.3	352.6	17.6	175.9	7.5
Other Items (net)	-741.2	-706.6	-96.9	-15.0	34.6	4.7

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

7

MONETARY POLICY, MONEY, CREDIT AND INTEREST RATES the public, grew by 18.3 per cent (year-on-year) in 2013 compared to 20.7 per cent in 2012, and contributed 93 per cent of the growth of broad money supply in 2013 compared to around 97 per cent in the previous year. In absolute terms, the expansion of quasi money amounted to around Rs. 454.3 billion during 2013 compared to Rs. 426 billion in 2012.

Viewed from the assets side, the expansion in domestic credit caused the higher than projected growth of broad money supply in 2013, while its growth was dampened somewhat by the decline in NFA of the banking system. NDA of the banking system grew at a slower pace of 18.3 per cent in 2013 compared to the growth of 23.4 per cent in the previous year. This was largely on account of the slower growth of credit extended to the private sector, which was impacted by high market lending rates and a sharp decline in pawning related advances. Accordingly, the contribution of private sector credit to the year-on-year growth of broad money declined to 36 per cent in 2013 from 80.6 per cent in 2012. Similarly, the increase in credit obtained by public corporations slowed compared to the previous year following interim repayments made by two key state owned enterprises (SOEs), although credit to other public corporations increased. However, the substantial increase in NCG from the banking system during the year led to broad money growth remaining at levels above projected. The crowding out impact of NCG has been lower in recent years than in the past, as a substantial portion of the increase in NCG from commercial banks has been through funds sourced from abroad. NFA of the banking system declined for the fourth consecutive year in 2013, entirely on account of the diminution in NFA of commercial banks and helped partly offset the expansion in broad money.

The growth of credit extended to the private sector showed signs of a turnaround towards the latter months of the year as the effects of monetary policy easing were transmitting gradually to the economy. Impacted by the tepid expansion in credit in early 2013 and the high base effect, year-on-year growth of credit to the private sector slowed to 7.3 per cent in November 2013 from 17.6 per cent at end 2012, before accelerating marginally to 7.5 per cent at end 2013. Downward rigid market lending rates, marked contraction in pawning activity due to low gold prices in the international market and the sluggish global growth were main reasons for the slow recovery in private sector credit. Further, the gradual liberalisation of foreign exchange regulations encouraged the private sector to pursue alternative sources of finance in the form of foreign borrowing, while a substantial amount of funds were also raised domestically through debenture issuances. Nevertheless, the

Chart 7.3 Annual Increase in Domestic Credit (2000 - 2013)

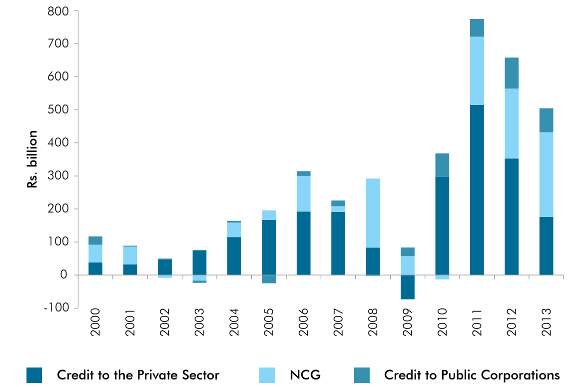
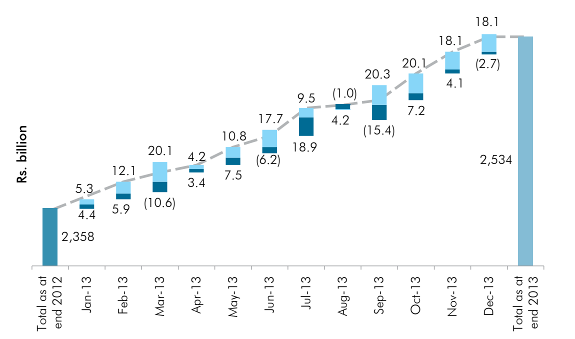


Chart 7.4 Volume of Loans and Advances granted to the Private Sector by DBUs and OBUs of Commercial Banks



net increase in private sector credit during the last quarter of 2013, which amounted to Rs. 64.9 billion compared to Rs. 111.1 billion in the first nine months of the year, indicated a rebound of demand for bank credit by the private sector, underpinned by the gradual downward adjustment of market lending rates following monetary policy easing since December 2012. Further, the continuation of the relaxed monetary policy stance and increased domestic economic activity are likely to provide an impetus to the growth of private sector credit in 2014.

Sectoral distribution of credit granted by commercial banks to the private sector, as measured by the Quarterly Survey of Loans and Advances, indicates that year-on-year growth of credit to the Industry and Services sectors increased during the year, while credit extended to the Agriculture and Fishing, and Personal Loans and Advances sectors contracted. In absolute terms, credit extended to the Industry and Services sectors increased by around Rs. 201 billion in 2013 compared to around Rs. 167 billion in the previous year. However, the decline in outstanding pawning advances for agriculture and consumption related purposes impinged the overall expansion in credit to the private sector, which amounted to only Rs. 171 billion during the year. In 2013, credit to the Industry sector increased by around Rs. 109.9 billion compared to Rs. 102.7 billion in 2012, recording a year-on-year growth of 13.9 per cent during the year. The increase in credit obtained by Construction, Food and Beverages, and Textiles and Apparel sub sectors drove the growth of credit obtained by the Industry sector. Credit extended to the Services sector rose by Rs. 91.2 billion relative to the increase of Rs. 64.3 billion in 2012, expanding by 17.3 per cent during the year. The growth in credit obtained by the Services sector was underpinned by increases in credit extended to the Wholesale and Retail Trade, Tourism, Transport, and Shipping, Aviation and Freight Forwarding sub sectors, although it was subdued somewhat with the decline in credit obtained by the sub sectors of Financial and Business Services, and Communication and Information Technology. Overall, by end 2013, the share of outstanding credit to the Industry and Services sectors rose to 59.8 per cent, while credit to Agriculture and Fishing, and Personal Loans and Advances categories declined.

Table 7.4 Classification of Outstanding Loans and Advances Granted by Commercial Banks (a)(b)

Rs. billion

Sector	End 2012	End 2013 (c)	% Share 2013	% Change 2013
Agriculture and Fishing	**321.8**	**304.9**	**12.0**	**-5.2**
of which, Tea	43.1	54.3	2.1	26.1
Rubber	14.6	18.9	0.7	29.4
Coconut	5.1	7.0	0.3	37.4
Paddy	12.6	14.8	0.6	17.1
Vegetable, Fruit and Minor Food Crops	14.0	14.7	0.6	4.8
Fisheries	10.4	10.4	0.4	-0.2
Industry	**789.7**	**899.6**	**35.5**	**13.9**
of which, Construction	329.6	384.2	15.2	16.6
Food and Beverages	53.5	60.6	2.4	13.3
Textiles and Apparel	96.3	106.0	4.2	10.1
Fabricated Metal Products, Machinery and Transport Equipment	72.4	86.0	3.4	18.8
Services	**525.5**	**616.6**	**24.3**	**17.3**
of which, Wholesale and Retail Trade	183.2	233.8	9.2	27.6
Tourism	54.2	63.0	2.5	16.2
Financial and Business Services	121.1	117.7	4.6	-2.8
Shipping, Aviation and Supply, and Freight Forwarding	6.2	14.2	0.6	130.5
Personal Loans and Advances (d)	**702.7**	**684.8**	**27.0**	**-2.5**
of which, Consumer Durables	60.5	74.9	3.0	23.8
Pawning	339.4	292.9	11.6	-13.7
Safety Net Scheme Related (e.g., Samurdhi)	**24.3**	**29.0**	**1.1**	**19.2**
Total	**2,364.0**	**2,535.0**	**100.0**	**7.2**

(a) Based on the Quarterly Survey of commercial banks' loans and advances to the private sector
(b) Includes loans, overdrafts and bills discounted and excludes cash items in the process of collection
(c) Provisional
(d) Excludes personal housing loans, which have been included under 'Construction' classified under 'Industry'

Source: Central Bank of Sri Lanka

The maturity analysis of outstanding credit to the private sector by commercial banks, as per the Quarterly Survey, indicates a notable relative

Table 7.5 Maturity Analysis of Outstanding Credit to the Private Sector by Commercial Banks (a)(b)

Item		December 2012 % Share	December 2012 % Growth	December 2013 % Share	December 2013 % Growth
Agriculture and Fishing	Short Term	10.8	22.5	9.1	-9.8
	Medium Term	2.1	31.5	2.1	8.2
	Long Term	0.7	-6.3	0.8	23.4
Industry	Short Term	12.7	11.7	13.7	15.7
	Medium Term	8.9	31.8	9.2	10.1
	Long Term	11.7	7.8	12.6	14.9
Services	Short Term	10.8	18.3	11.7	17.2
	Medium Term	6.9	10.4	7.5	16.4
	Long Term	4.6	9.8	5.1	19.2
Personal Loans and Advances	Short Term	21.3	25.8	15.4	-22.6
	Medium Term	5.1	22.7	7.6	58.6
	Long Term	3.3	1.7	4.1	32.7
Safety Net Scheme Related (e.g., Samurdhi)	Short Term	0.3	32.4	0.5	71.1
	Medium Term	0.4	12.9	0.3	-8.2
	Long Term	0.4	-58.8	0.3	0.9

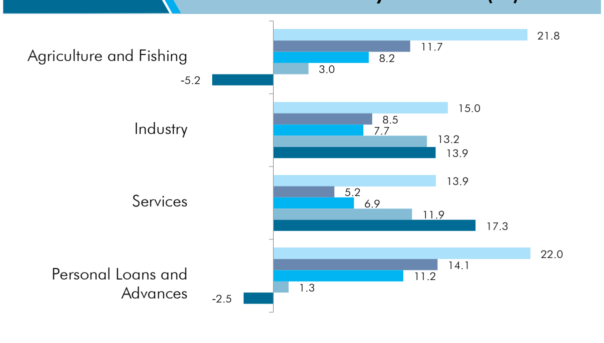
(a) Based on the Quarterly Survey of commercial banks' loans and advances to the private sector
(b) Classification of credit is based on original maturity and is as follows: up to one year - Short term, between one and five years - Medium term, over five years - Long Term

Source: Central Bank of Sri Lanka

growth in both medium and long term lending during 2013. This reflects the gradual reduction in market lending rates during the year together with improved business sentiment in view of the favourable economic outlook. However, short term lending to the sectors of Agriculture and Fishing, and Personal Loans and Advances, declined during the year. Nevertheless, short term credit still accounts for a larger share of outstanding credit to all major sectors.

NCG from commercial banks, which was higher than expected in 2013, was contained by the sharp decline in NCG by the Central Bank. Recording the third consecutive year of NCG exceeding Rs. 200 billion, NCG increased by around Rs. 297 billion during January-August 2013, but reduced somewhat by end 2013, resulting in an overall increase of around Rs. 256 billion. NCG by commercial banks increased by around Rs. 421 billion during the year compared to Rs. 196 billion in the previous year, accounting entirely for the overall increase in NCG by the banking system. This was largely due to domestic banking units (DBUs) increasing its holdings of Treasury bills (net of repos) by around Rs. 198 billion and Treasury bond holdings (net of repos) by around Rs. 109 billion during 2013. Moreover, loans and advances to the government rose by around Rs. 21 billion during the year. Investments in Sri Lanka Development Bonds (SLDBs) by DBUs also increased by around Rs. 43 billion during this period, while those of offshore banking units (OBUs) increased by around Rs. 56 billion. During the year, the outstanding government overdraft balance with the two state commercial banks declined by around Rs. 10 billion. NCG by the Central Bank declined by around Rs. 165 billion with the significant decline in Treasury bill holdings (net of repos) amounting to around Rs. 163 billion, partly as a result of early retirement of government securities to absorb excess rupee liquidity in the domestic market, while provisional advances declined by around Rs. 2 billion during the year.

Chart 7.5 Year-on-Year Growth of Outstanding Credit to Key Sectors (%)



The expansion of credit to public corporations in 2013 was lower at Rs. 72.6 billion compared to the increase of Rs. 94 billion in 2012. Credit to public corporations, which increased by Rs. 72 billion during the first eight months of the year, contracted to around Rs. 16 billion by end November 2013, following interim repayments made by the two key SOEs reflecting their improved financial performance. However, by end 2013, credit obtained by public corporations rose sharply with increased demand for credit by the CPC for the purpose of settlement of overdue taxes. Also, part of the funds was utilised to pay for increased oil import requirement owing to drought conditions towards the end of the year. Nevertheless, credit obtained by CPC was lower at around Rs. 22 billion on a net basis in 2013, compared to Rs. 54 billion in the previous year. The reduced borrowing reflects improved financial performance of the CPC owing to revisions in both the general fuel prices in February and the price of furnace oil charged by CPC on procurements by the CEB in April 2013. Credit obtained by CEB increased marginally by around Rs. 3 billion in 2013 as opposed to the increase of Rs. 31 billion in the previous year. Cost reflective tariff revisions in mid-April and lower reliance on petroleum for thermal power generation as a result of favourable weather conditions during most parts of 2013, aided the moderation in credit obtained by the CEB. Credit obtained by the two fertilizer corporations, which increased by around Rs. 16 billion on a net basis during the year, compared to Rs. 4 billion in 2012, could be attributed to the increase in imports of fertilizer during the latter half of the year. In addition, credit obtained by SriLankan Airlines increased by about Rs. 6 billion in 2013. Credit obtained by other public corporations, which expanded only by Rs. 5.3 billion in 2012, increased substantially by Rs. 24 billion in 2013.

NFA of the banking system contracted by Rs. 50.5 billion during 2013. NFA of commercial banks declined substantially by Rs. 183.2 billion during the year with the increased utilisation of funds obtained from abroad for domestic activity, part of which was directed towards investment in SLDBs, while forex swap agreements were entered into with the Central Bank to place the surplus funds. However, the net settlement of foreign currency loans obtained by the CPC during the year mitigated the downward trend of NFA of the banking system. NFA of the Central Bank, which declined during the first seven months of the year, improved thereafter, recording an increase of Rs. 132.7 billion by end 2013. The net absorption of foreign exchange from the domestic foreign exchange market as well as forex swaps with banks, contributed to the increase in NFA of the Central Bank during the latter part of the year.

Broad Money (M_4)[1]

The year-on-year growth of broad money as measured by the financial survey (M_4), increased to 18.6 per cent in December 2013 compared to 17.5 per cent at end 2012. In absolute terms, M_4 increased by Rs. 686.8 billion during 2013, and this increase was entirely driven by an increase in NDA by Rs. 851.7 billion while NFA declined by Rs. 164.9 billion during the year. Credit granted by LSBs to the government increased substantially by Rs. 130.3 billion in 2013 compared to Rs. 17.7 billion increase in the previous year, mainly due to utilisation of the NSB bond proceeds in the form of investment in Government securities. Meanwhile, credit to the private sector in M_4 increased by 8.6 per cent, contributing 31.7 per cent to the overall increase in NDA. In absolute terms, credit to the private sector expanded by only Rs. 269.8 billion during the year compared to Rs. 559.1 billion recorded in 2012. This was mainly due to slow growth in credit to the private sector by

[1] Financial survey provides a broader measure of liquidity, covering LSBs and licensed finance companies (LFCs), in addition to LCBs and the Central Bank.

Table 7.6 Sources of Broad Money (M_4)
(Computed as per the Financial Survey)

Rs. billion

Item	End 2012 (a)	End 2013 (b)	Change 2012 Amount	Change 2012 %	Change 2013 Amount	Change 2013 %
Financial Survey (M_4)	3,685.0	4,371.9	549.2	17.5	686.8	18.6
Underlying Factors						
Net Foreign Assets	-35.1	-200.0	-127.5	-138.0	-164.9	-470.2
Monetary Authorities	396.5	529.1	56.4	16.6	132.7	33.5
LCBs	-422.3	-605.5	-180.3	-74.5	-183.2	-43.4
LSBs & LFCs	-9.2	-123.7	-3.6	-63.8	-114.4	-1,238.2
Net Domestic Assets	3,720.1	4,571.9	676.7	22.2	851.7	22.9
Domestic Credit	4,829.1	5,568.8	888.4	22.5	739.7	15.3
Net Credit to the Government	1,389.9	1,787.2	235.3	20.4	397.2	28.6
Monetary Authorities	278.8	114.0	16.1	6.1	-164.8	-59.1
LCBs	766.4	1,187.3	195.5	34.2	420.9	54.9
LSBs	327.6	458.0	17.7	5.7	130.3	39.8
LFCs	17.0	27.8	6.0	54.0	10.8	63.4
Credit to Public Corporations	292.5	365.1	94.0	47.3	72.6	24.8
LCBs	292.5	365.1	94.0	47.3	72.6	24.8
Credit to the Private Sector	3,146.7	3,416.5	559.1	21.6	269.8	8.6
LCBs	2,358.4	2,534.3	352.6	17.6	175.9	7.5
LSBs	354.5	380.2	48.0	15.7	25.7	7.2
LFCs	433.8	502.0	158.5	57.6	68.2	15.7
Other Items (net)	-1,109.0	-996.9	-211.7	-23.6	112.1	10.1

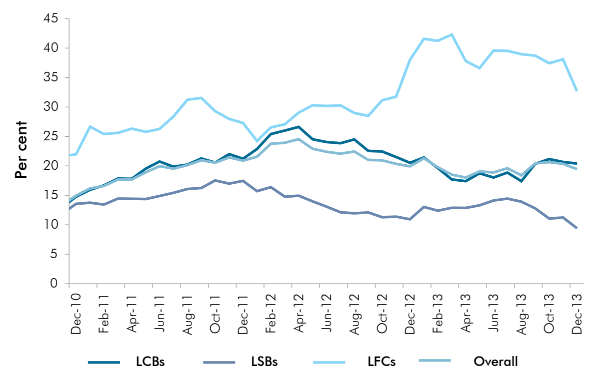
(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

LCBs and Licensed Finance Companies (LFCs) during 2013. Credit to the private sector by LFCs in absolute terms increased by Rs. 68.2 billion during the year, while increase in credit extended by the LSBs amounted to Rs. 25.7 billion, contributing to 9.5 per cent of the overall increase in private sector credit. The contraction in NFA of LCBs and LSBs caused the decline in NFA in M_4, although NFA of the Central Bank increased during the latter part of 2013.

As per the financial survey, the growth of quasi money, which comprises time and savings deposits, decreased marginally to 19.5 per cent by end 2013 from 19.9 per cent by end 2012, largely on account of the gradual decline seen in market deposit rates. In absolute terms, overall quasi money increased by Rs. 633.9 billion during the year. On a year-on-year basis, the increase in quasi money of LFCs was 32.7 per cent by end 2013 recording an increase of Rs. 83.9 billion during the year, compared to the growth of 38 per cent at end 2012. The year-on-year growth of quasi money with LSBs decelerated to 9.4 per cent by end 2013 from 10.9 per cent growth recorded at end 2012, and in absolute terms, quasi money of LSBs increased by Rs. 53 billion during 2013 contributing 8.4 per cent to the overall increase in quasi money.

Chart 7.6 Year-on-Year Growth of Savings and Time Deposits



7.4 Interest Rates

Money Market Rates

Interest rates in the interbank call money market declined gradually in 2013 reflecting the easing of monetary policy since December 2012 as well as the increased levels of liquidity in the domestic money market in the latter half of the year. The average weighted call money rate (AWCMR), which fluctuated around the upper bound of the policy rate corridor until the first week of June, moved towards the middle of the corridor as the Central Bank reaffirmed the direction of monetary policy by reducing the policy interest rates in May 2013, while excess liquidity in the money market also increased. With the reduction in policy interest rates in October 2013 and the substantial increase in money market liquidity from September 2013, AWCMR declined further and hovered around the middle of the policy rate corridor in the last quarter of 2013. Accordingly, the decline in AWCMR during the year amounted to 217 basis points, registering 7.66 per cent by end 2013. The overnight Sri Lanka Interbank Offered Rate (SLIBOR) moved downwards along with AWCMR. Weighted average interest rates at OMO auctions also decreased during 2013, following the downward adjustment in policy rates and call money market rates. Meanwhile, a Standing Rate Corridor (SRC) was established with effect from

Chart 7.7 Average Weighted Call Money Rate and Policy Interest Rates

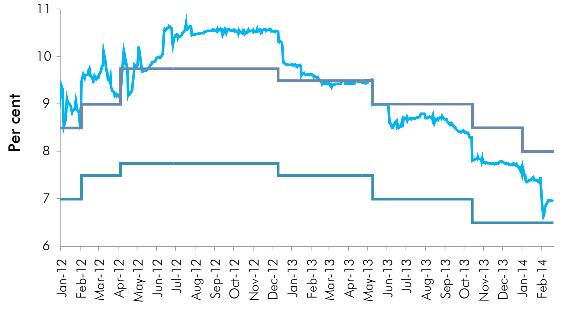


Table 7.7 Selected Money Market Rates

Per cent per annum

	Average Weighted Call Money Rate		SLIBOR- Overnight		SLIBOR-12 Month	
	End Period	Average for the month	End Period	Average for the month	End Period	Average for the month
Dec-11	8.97	8.69	9.01	8.77	10.28	10.15
Dec-12	9.83	10.22	9.92	10.30	14.34	14.41
Mar-13	9.44	9.43	9.52	9.50	13.81	13.98
Jun-13	8.72	8.59	8.75	8.65	12.92	12.89
Sep-13	8.44	8.54	8.50	8.64	12.43	12.31
Dec-13	7.66	7.73	7.76	7.80	11.09	11.39

Source: Central Bank of Sri Lanka

02 January 2014 in place of the policy rate corridor to guide interbank call money market transactions, and the SRC was compressed to 150 basis points by reducing the Standing Lending Facility Rate (SLFR) of the Central Bank by 50 basis points to 8.00 per cent. Following this change, AWCMR reduced further to 7.35 per cent by 30 January 2014.

Deposit and Lending Rates

The rise in interest rates on deposits offered by the financial sector since early 2012 continued into mid 2013, although a gradual downward adjustment was observed by end of the year. The lagged effects of tight liquidity conditions and tight monetary policy stance in 2012, coupled with increased competition in the banking sector resulting in aggressive deposit mobilisation led to the average weighted deposit rate (AWDR) and the average weighted fixed deposit rate (AWFDR) to increase by 64 basis points (to 10.74 per cent) and 69 basis points (to 13.90 per cent), respectively, by end May 2013.[2] However, impacted by the series of monetary policy easing measures in 2013 and following continued dialogue with the financial sector stakeholders, deposit rates commenced adjusting downwards from mid-2013. As a result, AWDR decreased by 73 basis points to 9.37 per cent during the year from 10.10 per cent at end 2012

[2] AWDR is compiled monthly based on all outstanding interest bearing deposits of LCBs while AWFDR is compiled based on the stock of all term deposits held by LCBs.

while AWFDR decreased by 143 basis points to 11.78 per cent by end 2013 from 13.21 per cent at end 2012.

The Legal rate and the Market rate of interest determined by the Monetary Board and published in the Government Gazette at the end of each year, were 10.34 per cent for 2014 compared to 8.59 per cent for 2013.[3] These rates are computed in December each year based on the weighted average rates of interest bearing rupee deposits held by the public with commercial banks during the twelve months immediately preceding.

Although with a considerable time lag, lending rates of commercial banks displayed a downward trend during 2013, reflecting the relaxed monetary policy stance, increased liquidity, and declining cost of funds. The weekly average weighted prime lending rate (AWPR), which indicates the average lending rates charged by commercial banks from their most creditworthy customers, was quick to respond to monetary policy and liquidity conditions, and declined by 427 basis points to 10.13 per cent by end 2013, compared to 14.40 per cent at end 2012. AWPR calculated on a monthly basis, declined by 433 basis points to 9.96 per cent. The average weighted lending rate (AWLR), which is calculated based on all outstanding loans and advances disbursed to the private sector by commercial banks, decreased by 80 basis points to 15.18 per cent in December 2013 from 15.98 per cent at end 2012, reflecting the reduction in overall interest rates in the market. Lending rates against most types of securities decreased during the period under review. Interest rates on loans and advances secured by Government securities, stocks in trade, trust receipts and shares, bonds, debentures, and life insurance policies decreased significantly. However, an increase in lending rates on leasing and hire purchase agreements, tractor and motor vehicles and gold and other precious metals under pawning was also observed during 2013. Lending rates against gold and other precious metals under pawning increased by 116 basis points to 18.67 per cent by end 2013 from 17.52 per cent at end 2012, reflecting increased risk of pawning related lending following the decline in international gold prices during the year.

Meanwhile, the Central Bank placed a cap on penal interest rates charged on loans and advances by financial institutions on 26 July 2013. As excessive penal interest rates hindered entrepreneurship development and burdened overdue borrowers unduly, the Central Bank requested banks to reduce penal rates of interest charged on all new and existing loans and advances to a level not exceeding 2 per cent per annum while

[3] The Legal rate is defined under the Civil Procedure Code (Amendment) Act No. 6 of 1990 and is applicable to any action for the recovery of a sum of money. The Market rate is defined under the Debt Recovery (Special Provisions) Act No. 2 of 1990 and applies only in relation to actions instituted by lending institutions for the recovery of debt exceeding Rs. 150,000 arising out of commercial transactions, where there is no agreed rate of interest.

Deposit and Lending Rates (a)

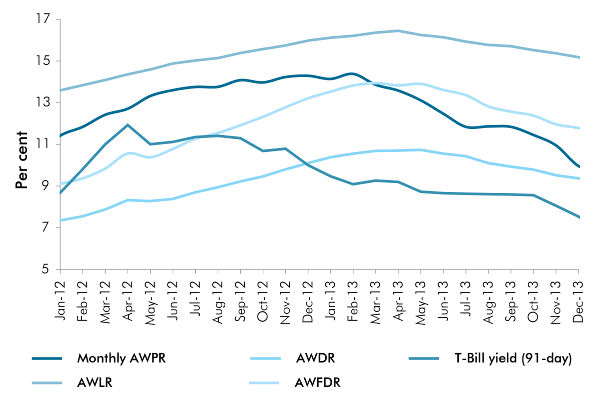
Per cent per annum

Institution	End 2012	End 2013
Licensed Commercial Banks		
Interest Rates on Deposits		
Savings Deposits	0.75-10.50	0.75-9.14
1-year Fixed Deposits (b)	5.00-17.00	6.00-16.00
Average Weighted Deposit Rate (AWDR)	10.10	9.37
Average Weighted Fixed Deposit Rate (AWFDR)	13.21	11.78
Interest Rates on Lending		
Average Weighted Prime Lending Rate (AWPR)	14.29	9.96
Average Weighted Lending Rate (AWLR)	15.98	15.18
Other Financial Institutions		
Interest Rates on Deposits		
National Savings Bank		
Savings Deposits	5.00	5.00
1-year Fixed Deposits	12.50	9.50
Licensed Finance Companies (c)		
Savings Deposits	7.79-9.69	6.67-8.86
1-year Fixed Deposits	14.94-16.66	12.66-14.35
Interest Rates on Lending		
National Savings Bank (d)	14.00-15.50	14.00-15.50
State Mortgage and Investment Bank (d)	17.00-19.00	12.75-17.50
Licensed Finance Companies (c)		
Finance Leasing	17.12-26.07	18.04-24.78
Hire Purchase	16.60-23.83	19.47-22.89
Loans against Real Estate	20.87-24.75	20.00-23.60

(a) Based on the rates quoted by commercial banks and other selected financial institutions
(b) Maximum rate is a special rate offered by certain commercial banks
(c) Average rates, based on the maximum and minimum rates quoted by LFCs
(d) Lending for housing purposes only

Source: Central Bank of Sri Lanka

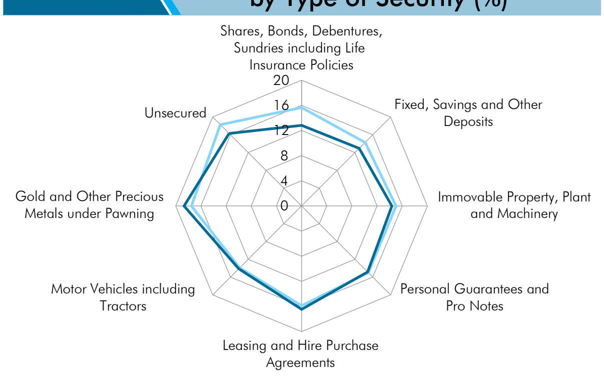
Chart 7.8 Movement of Selected Market Interest Rates



finance and leasing companies were requested to reduce the penal rate to 3 per cent per annum.

Interest rates applicable on foreign currency deposits remained stable, albeit at low levels during 2013, mainly due to the continued relaxed monetary policies adopted by advanced economies to promote economic activity in the aftermath of the global financial crisis. The US dollar denominated savings deposits were in the range of 0.015-2.665 per cent during 2013 compared to 0.015-2.709 per cent in 2012, while US dollar denominated time deposits remained in the range of 0.25-5.00 per cent during 2013, compared to 0.15-6.00 per cent range in 2012. The pound sterling denominated savings deposits remained unchanged from 2012, within a range of 0.10-3.50 per cent during 2013. The interest rate applicable on pound sterling denominated time deposits recorded a decline in 2013 and was in the range of 0.25-4.25 per cent in 2013, compared to that of 0.375-5.25 per cent in 2012.

Chart 7.9 Average Weighted Lending Rates by Type of Security (%)



Yield Rates on Government Securities

Yield rates on Government securities in the primary market decreased throughout the year, as a result of the downward adjustment in policy rates, excess liquidity in the domestic money market and moderating inflation and inflation expectations. The Treasury bill yields of all three tenors decreased by 246 to 347 basis points in 2013. Yield rates of 91-day and 364-day Treasury bills decreased to 7.54 per cent and 8.29 per cent, respectively, by end 2013. In a bid to increase the depth of the yield curve, the Central Bank issued 20-year and 30-year Treasury bonds in the primary market commencing end May 2013. The yields on 20-year and 30-year Treasury bonds were at 12.13 per cent and 12.50 per cent, respectively, at end 2013. Overall, the yield rates for primary market bond maturities for the short end of the yield curve (3 years and 5 months) and the longer end of the curve (30 years) ranged from 10.87 per cent to 12.50 per cent, reflecting the downward shift in the yield curve for 2013.

The secondary market yield curve for Government securities, which increased in 2012, shifted downwards during 2013, reflecting the easing of monetary policy and the favourable inflation environment. Secondary market yields on Government securities, which remained broadly stable during the first five months of 2013, witnessed a significant downward adjustment thereafter. Overall, yields on Treasury bills of all maturities decreased by 248 to 343 basis points by end 2013 compared to those at end 2012. Accordingly, yields on 91-day, 182-day and

Table 7.9 Yield Rates on Government Securities

Per cent per annum

Instrument	End 2012	End 2013
Primary Market		
Treasury bills		
91-day	10.00	7.54
182-day	11.32	7.85
364-day	11.69	8.29
Treasury bonds		
2-year	13.62 (a)	-
3-year	13.50 (a)	10.87 (b)
4-year	14.10 (a)	-
5-year	14.15 (a)	11.00 (b)
Secondary Market		
Treasury bills		
91-day	10.10	7.63
182-day	11.30	8.05
364-day	11.65	8.23
Treasury bonds		
2-year	11.70	8.83
3-year	11.75	9.10
4-year	11.95	9.08
5-year	11.85	9.69

Source: Central Bank of Sri Lanka

(a) For 2012, the last auction for 2-year Treasury bonds was held in July, for 3-year Treasury bonds was held in May, for 4-year Treasury bonds was held in July and for 5-year Treasury bonds was held in June.
(b) For 2013, the last auction for 3-year Treasury bonds was held in August 2013 and for 5-year Treasury bonds was held in November.

364-day Treasury bills were at 7.63 per cent, 8.05 per cent and 8.23 per cent, respectively, in December 2013. Secondary market yields on Treasury bonds also followed a similar pattern during the year aided by the investors' preference for longer maturities. The secondary market yields showed some convergence in the latter part of the year, and decreased significantly within a range of 217-288 basis points by end 2013, compared to levels that prevailed at end 2012.

Chart 7.10 Secondary Market Yield Curve for Government Securities

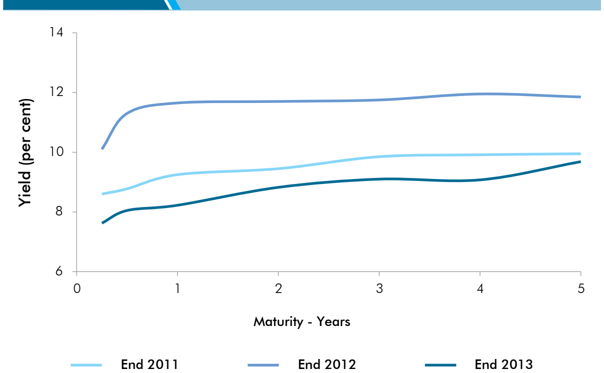
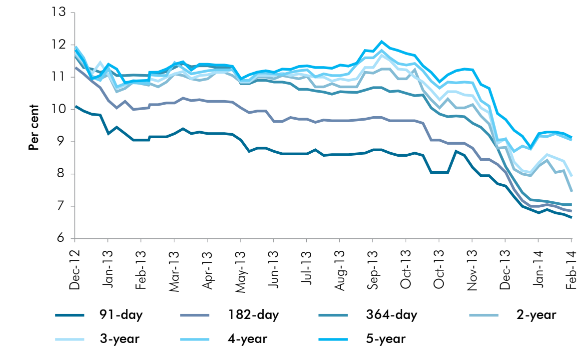


Chart 7.11 Weekly Movement of Secondary Market Yields for Government Securities



Yield Rates on Corporate Debt Securities

Although adjusted downwards, rates on corporate debt securities remained relatively high in comparison to other market interest rates. Interest rates pertaining to commercial paper, a short term debt instrument, moved within a range of 8.50 per cent to 22.00 per cent, widening the interest rates spread further from 11.25 per cent to 22.00 per cent in 2012. There were twenty four Initial Public Offerings (IPOs) of corporate debentures for the year, with multiple maturities up to 12 years with fixed interest rates payable ranging from 8.00 per cent to 20.00 per cent, and floating interest rates payable as well.

7.5 Future Developments, Challenges and Outlook

Given well contained inflation and inflation expectations, monetary policy in 2014 is expected to remain accommodative supporting increased private sector led economic activity. As announced in the "Road Map: Monetary and Financial Sector Policies for 2014 and Beyond", the Central Bank envisages inflation at 4-6 per cent during the year, and the current inflation projections are in line with this desired mid-single digit level. Continued price stability has facilitated maintaining policy interest rates at low levels for long periods, which would result in low and stable market lending rates conducive for medium to long term investments. With good quality infrastructure facilities put in place under the Public Investment Programme, such monetary environment is expected to result in sustained economic growth and continued macroeconomic stability.

The realisation of monetary projections for 2014 and beyond would largely depend on a substantial growth in credit to the private sector by commercial banks with a commensurate decline in credit obtained by the public sector from commercial banks. For credit to the private sector to increase, both demand and supply conditions in the credit market must improve. Alongside positive investor sentiments, market lending rates must also be competitive, and the ongoing technology improvements and financial sector consolidation efforts are likely to enhance efficiency, leading to such outcomes. In relation to the public sector, continued fiscal consolidation is expected to lower bank financing in the period ahead.

The envisaged continuation of the low interest rate regime, although favourable for investments, could impact on savers adversely. As savers are an important segment of the population, it is essential that the real value of savings is protected through continued low levels of inflation, so as not to discourage savings in the economy. In this regard, the Central Bank has already commenced discussions with financial sector institutions to introduce innovative and attractive long term savings and pension products, which could benefit vulnerable segments of the population by providing them with a continued flow of funds during retirement.

As advanced economies have begun tapering of extraordinary monetary policy measures while emerging markets have commenced tightening of monetary policy to contain the resultant adverse capital outflows, external developments are likely to have a greater bearing on domestic monetary policy in the period ahead. Precautionary action taken by the Central Bank early on in the global policy cycle has so far proved effective, and the Central Bank will continue to remain vigilant on these external developments to prevent any adverse consequences on domestic macroeconomic stability.

In recent times, the Central Bank has redoubled efforts to improve its forecasting and modelling framework to support the forward looking monetary policy decision making process. Regular comprehensive economic and monetary analyses, including global developments are carried out and presented at internal decision making committees. Econometric projections of inflation in the short to medium term as well as estimates of the output gap are analysed amongst projections of other macroeconomic variables. The process of developing Dynamic Stochastic General Equilibrium (DSGE) models, which could capture the dynamics of a rapidly evolving economy more closely, is underway.

The impact of monetary policy measures on the economy is dependent upon efficient transmission flow to financial markets and to the public at large. Therefore, the conduct of monetary policy will continue to focus on smoothing the deficiencies in the monetary policy transmission process. The Central Bank's communication policy is expected to play a major role in this dynamic process by reducing information asymmetries and lags in information transmission. The ongoing process of consolidation of the financial sector initiated by the Central Bank would make way towards the creation of more dynamic and stronger financial institutions capable of transmitting monetary policy signals to the economy more effectively. Global financial crises have repeatedly highlighted the necessity of financial system stability in tandem with economic stability, and that neither would be able to function in isolation. The consolidation process is therefore an important step towards effective monetary policy implementation as it safeguards financial system stability, which augments the Central Bank's ability to achieve its objective of economic and price stability and support the macroeconomic progression of the country.