7

MONETARY POLICY, MONEY, CREDIT AND INTEREST RATES

7.1 Overview

The relatively relaxed monetary policy stance was continued in 2014 to support economic activity through stimulating private sector credit growth, given the sustained low inflation environment. In January 2014, the Central Bank renamed its policy interest rates, the Repurchase rate and the Reverse Repurchase rate, as the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR), respectively. The SLFR was lowered by 50 basis points effective 02 January 2014. Reflecting accommodative monetary conditions in the economy, liquidity levels in the domestic money market remained high throughout 2014 and most market interest rates reached historically low levels. During 2014, the growth of monetary aggregates remained broadly consistent with projections. Accordingly, the average growth of broad money (M_{2b}) was maintained at 13.3 per cent in 2014, compared to 16.5 per cent in 2013. Credit to the private sector by commercial banks recorded a contraction in the first eight months of 2014 while a significant improvement in net foreign assets (NFA) of the banking sector during the period contributed to the growth in broad money. In September 2014, in order to encourage commercial banks to utilise high excess liquidity in the money market to expand credit for productive economic activity, the Central Bank effected a special Standing Deposit Facility Rate of 5 per cent per annum when commercial banks access the Standing Deposit Facility (SDF) more than three times in a calendar month. Towards the latter part of the year, the growth in credit to the private sector by commercial banks strongly rebounded to 8.8 per cent as at end 2014, contributing to the broad money expansion. In 2014, net credit to the government surpassed the budgeted levels although the expansion was relatively low compared to 2013. Credit to public corporations also increased in 2014 despite the contraction recorded during the early part of the year due to repayment of loans by certain public corporations. With the revival of private sector credit growth, the special SDF rate of 5 per cent was removed with effect from 02 March 2015. To address concerns over the behaviour of market interest rates inconsistent with inflation as well as the investment needs of the country, the Central Bank reduced the SDFR and the SLFR by 50 basis points each to 6.00 per cent and 7.50 per cent, respectively, with effect from 15 April 2015 to further relax the monetary policy stance.

7.2 Monetary Policy

The Central Bank continued to maintain a relatively relaxed monetary policy stance during 2014, resulting in the longest period of monetary policy easing cycle since 2004. Effective 02 January 2014, the Central Bank renamed the Repurchase rate of the Central Bank as the Standing Deposit Facility Rate (SDFR)[1], and the Reverse Repurchase rate of the Central Bank as the Standing Lending Facility Rate (SLFR)[2]. At the same time, the Central Bank compressed the band of the Standing Rate Corridor (SRC) to 150 basis points by lowering the SLFR by 50 basis points to 8.00 per cent effective 02 January 2014, considering ample money market liquidity, with the aim of facilitating greater stability in short term interest rates and lowering interest rate spreads in financial markets. Since then, the SDFR and the SLFR remained unchanged throughout the year at 6.50 per cent and 8.00 per cent, respectively. Furthermore, taking into consideration the Central Bank's zero credit risk in rupee transactions, the Standing Deposit Facility (SDF) was uncollateralised with effect from 01 February 2014, waiving off the previous obligation of the Central Bank to provide collateral in absorbing liquidity from commercial banks. SLFR related transactions remained collateral based. In addition to these policy measures, having considered the improvements in the external sector, the Central Bank removed the minimum cash margin requirement of 100 per cent against opening of letters of credit (LCs) with commercial banks for the import of certain categories of motor vehicles that was imposed on 30 August 2013, with effect from 02 January 2014.

The framework for the conduct of monetary policy was aimed at maintaining economic and price stability, while broad money continued to remain as the intermediate target to guide monetary policy. At the beginning of the year, broad money was expected to record an end year growth of 14 per cent, while credit to the private sector was also expected to increase at a similar rate. However, broad money expansion moderated to some extent with the contraction in private sector credit, particularly during the first eight months of 2014. The slowdown in private sector credit growth was mainly due to the decline in pawning advances of commercial banks since 2013 in response to low international gold prices. In addition, increased access to alternative finance sources and the utilisation of internal funds by the corporate sector also led to low credit growth. The lower than anticipated credit growth to the private sector during this period necessitated a revision of the Monetary Programme for 2014 although the significant improvement in NFA of the banking sector offset the impact of low private sector credit growth on broad money. Accordingly, the growth of average broad money for the year was lowered to 13.5 per cent from the previous projection of 14 per cent. In comparison to projections, the average broad money growth was 13.3 per cent in 2014 and on a year-on-year basis, broad money grew by 13.4 per cent as at end 2014.

The Central Bank adopted measures to encourage commercial banks to utilise the high level of excess money market liquidity to increase credit flows to the private sector. Despite the large excess liquidity in the money market, some rigidity in lending rates was observed during the early part of the year, and private sector credit growth remained sluggish. The OMO participants continuously placed excess liquidity with the Central Bank using the SDF at the SDFR of 6.50 per cent, rather than

1 Effective 02 January 2014, SDFR provides the floor rate for the absorption of overnight excess liquidity from the banking system by the Central Bank.

2 SLFR is the interest rate applicable on reverse repurchase transactions of the Central Bank with commercial banks on an overnight basis under the Standing Facility, providing the ceiling rate for the injection of overnight liquidity to the banking system by the Central Bank.

utilising liquidity for credit disbursements. In order to limit the OMO participants from placing excess liquidity with the Central Bank using the SDF and to encourage commercial banks to utilise the ample liquidity to channel credit flows for productive economic activity, on 23 September 2014, the Central Bank placed a limit of three times per calendar month on the use of the SDF by an OMO participant at the SDF rate of 6.50 per cent. An OMO participant accessing the SDF more than three times per month was allowed to place funds at a special interest rate of 5.00 per cent per annum, per transaction. Meanwhile, for the remainder of the month of September 2014, access to OMO at the SDFR of 6.50 per cent was limited to two times per participant. The rationalisation of the SDF indirectly resulted in the special rate of 5.00 per cent being depicted as the effective lower bound of the SRC, thus causing the call money market rates to shift below the SDFR and other market interest rates to fall significantly. As such, following the rationalisation of the SDF, the AWCMR declined to 5.72 per cent at the beginning of October 2014.

The relatively relaxed monetary policy stance maintained throughout the year was expected to lower the interest rate spread of banks further without lowering deposit rates excessively. In 2014, the policies of the Central Bank induced a further downward adjustment in market lending rates and a clear downward shift in the interest rate structure was observed in the short term. Owing to the adjustments initiated to spur credit growth, commercial banks' credit to the private sector began to increase, particularly during the last four months of 2014. With the revival of growth in credit to the private sector by commercial banks in the latter part of 2014, the Central Bank removed the restriction placed on access to the SDF effective 02 March 2015, expecting to stabilise overnight interest rates within the SRC. In April 2015, the Central Bank reduced the SDFR and the SLFR by 50 basis points to address concerns over the behaviour of market interest rates inconsistent with inflation as well as the investment needs of the country.

Chart 7.1 Policy Interest Rates and Average Weighted Call Money Rate

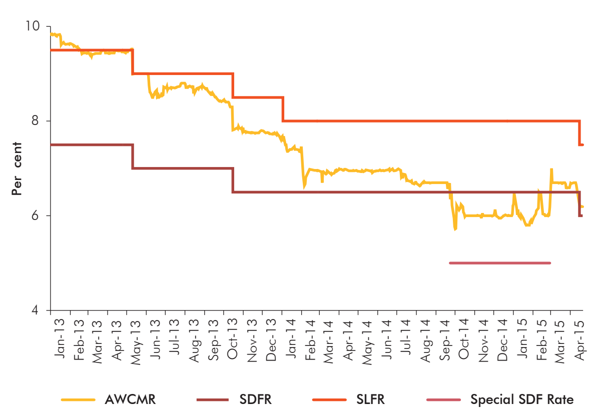

Table 7.1 Recent Monetary Policy Measures

Date	Measure
03-Feb-2012	Repurchase rate and Reverse Repurchase rate increased by 50 bps to 7.50% and 9.00%, respectively.
09-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.
05-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 denominanted 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.
02-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.
23-Sep-2014	Access to the SDF of the Central Bank by OMO participants at 6.50% was rationalised to a maximum of three times per calendar month. Any deposits at the SDF window exceeding three times by an OMO participant was accepted at a special interest rate of 5.00%.
02-Mar-2015	The 5.00% special SDF rate was withdrawn.
15-Apr-2015	The SDFR and SLFR reduced by 50 bps to 6.00% and 7.50%, respectively.

Source: Central Bank of Sri Lanka

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MONETARY POLICY, MONEY, CREDIT AND INTEREST RATES

Consumer price inflation remained subdued, at low single digit levels throughout 2014, largely on account of effectively managed demand pressures and favourable international commodity prices. Headline inflation as measured by the year-on-year change in Colombo Consumers' Price Index (CCPI, Base: 2006/07=100) remained subdued at 2.1 per cent by end 2014 compared to 4.7 per cent in December 2013 and 9.2 per cent at end 2012. On an annual average basis, headline inflation declined to 3.3 per cent in December 2014 from 6.9 per cent in December 2013 and 7.6 per cent at end 2012. The reduction of administered prices of electricity and fuel during the last quarter of the year contributed largely towards lowering inflation significantly. Although some supply disruptions anticipated during the year due to adverse weather conditions resulted in some price pressures, proactive policy measures that included tariff adjustments encouraging rice imports, were instrumental to counterbalance food inflation to a great extent. Meanwhile, core inflation, which excludes selected items with volatile prices and administratively determined prices, and hence directly measures underlying inflation pressures, remained low during the year reflecting well contained demand pressures. Core inflation, which peaked at 3.9 per cent on a year-on-year basis in August 2014, continued on a declining trend thereafter to record 3.2 per cent by end December 2014 compared to 2.1 per cent at end 2013 and 7.6 per cent at end 2012. Annual average core inflation declined from 4.4 per cent at end 2013 to 3.5 per cent by end 2014.

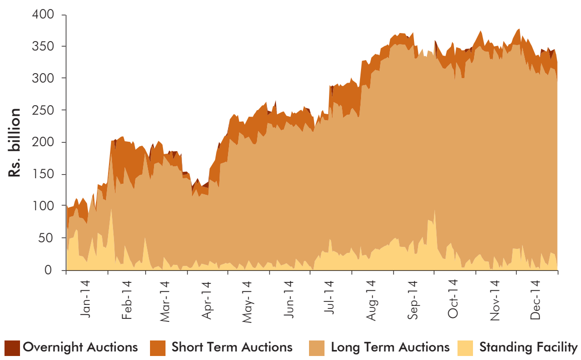
During the year, the Central Bank continued its efforts to use its communication policy extensively to enhance transparency of monetary policy decisions, and to improve awareness of the general public and market participants. At the beginning of the year, the Central Bank made available its broad policies and strategies in advance through the *"Road Map: Monetary and Financial Sector Policies for 2014 and Beyond"*. During the year, the Central Bank issued regular and occasional communiqués, conducted press conferences, seminars and lectures to communicate information on key macroeconomic developments for the benefit of all stakeholders. Periodic press releases on macroeconomic developments were issued, while the key publications of the Central Bank, including the Annual Report and the Recent Economic Developments facilitated the dissemination of information in a comprehensive manner. In 2014, the Central Bank also initiated publishing a macroeconomic chart pack consisting of a snapshot of useful economic information on the Central Bank website with a view to facilitate the information dissemination process further.

7.3 Developments in Money and Credit

Money Market Liquidity

Excess rupee liquidity in the domestic money market remained high throughout 2014. Market liquidity increased further during the year, mainly due to net purchases of foreign currency by the Central Bank from the domestic foreign exchange market. In 2014, the Central Bank purchased around US dollars 545 million from the domestic foreign exchange market on a net basis thereby injecting around Rs. 71 billion to the domestic money market. In addition, liquidity was injected to the market by way of the Central Bank entering into swap arrangements with commercial banks and the purchases of a part of the proceeds of the International Sovereign Bond issued in January 2014. During the year, overnight excess liquidity ranged from Rs. 0.9 billion to Rs. 107.2 billion, while it averaged Rs. 29.1 billion. Meanwhile, the total excess liquidity in the domestic money market remained at Rs. 330.9 billion by end 2014 compared to Rs. 71.7 billion by end 2013.

Chart 7.2 Rupee Liquidity in the Domestic Money Market and Liquidity Absorption

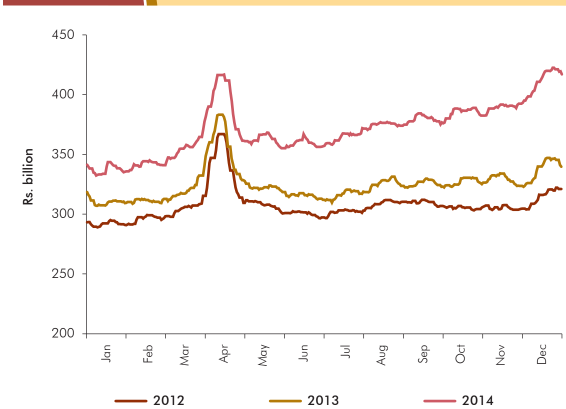


The Central Bank actively engaged in absorbing excess liquidity in the market on overnight, short term and long term bases during the year. The OMOs were conducted to maintain overnight liquidity at a desirable level without causing undue volatility in the overnight interest rates. Term repurchase transactions as well as outright sales of Treasury bills were also used to absorb excess market liquidity during 2014. In the meantime, since the Central Bank's holding of government securities, which amounted to Rs. 121.8 billion by end 2014, was relatively low compared to the total liquidity level of Rs. 330.9 billion by end 2014, Treasury bonds borrowed from the Employee's Provident Fund under the Government Security Borrowing Programme were utilised as the underlying security to manage excess liquidity. At the same time, several measures were taken to improve liquidity management further during 2014. Amongst such measures, the SDF was uncollateralised considering the zero credit risk of the Central Bank. In addition, given the sluggish private sector credit growth, access to the SDF at the SDFR was rationalised in September 2014 although daily OMO operations remained unchanged during the year. Under the Standing Facility, average daily net absorption was Rs. 21.5 billion during the year.

Reserve Money

The growth of daily reserve money accelerated to 18.3 per cent on a year-on-year basis by end 2014, compared to the marginal growth of 0.9 per cent recorded at end 2013. The significant expansion in reserve money was due to increases in both currency in circulation and the commercial banks' deposits with the Central Bank. The low deposit rate environment is likely to have contributed to the increase in currency in circulation as the opportunity cost of holding currency remained low. Currency in circulation increased further towards the end of the year due to demand for currency during the festive season as well as the expenditure related to the 2015 presidential election. Accordingly, currency in circulation increased by Rs. 77.1 billion to Rs. 416.9 billion in 2014 compared to Rs. 339.8 billion in 2013. The year-on-year growth of commercial banks' deposits with the Central Bank, which decreased by around 10.5 per cent in 2013 with the lowering of the Statutory Reserve Requirement (SRR) from 8 per cent to 6 per cent in July 2013, increased by 8.2 per cent to Rs. 161 billion in 2014. Meanwhile, the year-on-year growth of average quarterly reserve money moderated in the first two quarters of 2014. As a result, on a

Chart 7.3 Daily Currency in Circulation



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MONETARY POLICY, MONEY, CREDIT AND INTEREST RATES

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MONETARY POLICY, MONEY, CREDIT AND INTEREST RATES

Table 7.2 Developments in Monetary Aggregates

Rs. billion

Item	End 2013	End 2014 (a)	Change 2013 Amount	Change 2013 %	Change 2014 Amount	Change 2014 %
1. Currency Outstanding	339.8	416.9	21.7	6.8	77.1	22.7
1.1 Currency held by the Public	264.6	329.4	13.1	5.2	64.8	24.5
1.2 Currency with Commercial Banks	75.2	87.5	8.6	13.0	12.3	16.4
2. Commercial Banks' Deposits with the Central Bank	148.8	161.0	-17.5	-10.5	12.2	8.2
3. Government Agencies' Deposits with the Central Bank (b)	...	...	...		...	
4. Reserve Money (1+2+3)	**488.6**	**577.9**	**4.2**	**0.9**	**89.3**	**18.3**
5. Demand Deposits held by the Public with Commercial Banks	220.0	282.7	21.5	10.8	62.8	28.5
6. Narrow Money Supply, M_1 (1.1+5)	**484.6**	**612.2**	**34.5**	**7.7**	**127.6**	**26.3**
7. Time and Savings Deposits held by the Public with Commercial Banks	2,574.2	2,848.4	431.1	20.1	274.2	10.7
8. Broad Money Supply, M_2 (6+7)	**3,058.8**	**3,460.6**	**465.6**	**18.0**	**401.8**	**13.1**
9. Adjusted Foreign Currency Deposits (c)	359.1	415.3	23.2	6.9	56.2	15.7
10. Consolidated Broad Money Supply, M_{2b} (8+9)	**3,417.9**	**3,875.9**	**488.8**	**16.7**	**458.0**	**13.4**
Money Multiplier, M_{2b}	**7.00**	**6.71**				
Velocity, M_{2b} (d)	**2.71**	**2.70**				

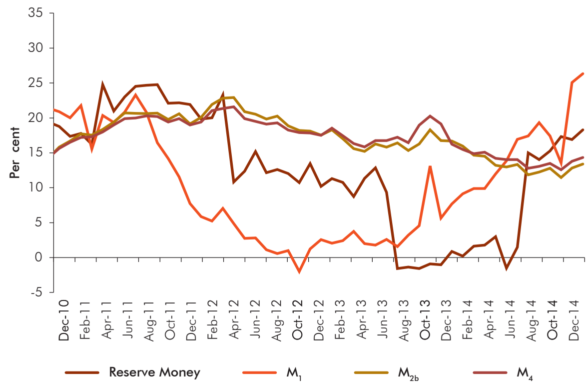
Source: Central Bank of Sri Lanka

(a) Provisional
(b) Government Agencies' Deposits with the Central Bank amounted to Rs. 4.7 million at end 2013 and Rs. 7.3 million at end 2014
(c) Includes deposits of the Resident Category of Offshore Banking Units (OBUs) and a part of foreign currency deposits with Domestic Banking Units (DBUs)
(d) During the year

quarterly average basis, reserve money grew marginally by 0.5 per cent and 1.0 per cent to Rs. 497.6 billion and Rs. 523.8 billion, respectively, in the first and second quarters of 2014. However, average reserve money recorded a significant increase during the last two quarters of 2014 due to the base effect of the SRR reduction. Accordingly, the average quarterly reserve money grew significantly by 14.3 per cent and 16.5 per cent to Rs. 531.3 billion and Rs. 557.9 billion, respectively, during the third and fourth quarters of 2014.

During 2014, from the assets side, the growth of reserve money was entirely attributable to the expansion in NFA of the Central Bank. The NFA of the Central Bank in 2014 increased by Rs. 158.9 billion to Rs. 688 billion compared to Rs. 529.1 billion in 2013. The increase in NFA was mainly due to net purchases of foreign exchange in the domestic foreign exchange market by the Central Bank, purchases of a part of the proceeds of the International Sovereign Bond, as well as entering into foreign currency swap arrangements with commercial banks. Net domestic assets (NDA) of the Central Bank continued to contract in 2014 similar to the previous year although the contraction was contained at around Rs. 70 billion in 2014 compared to the contraction of Rs. 128 billion recorded in 2013. Despite the increase in NCG by the Central Bank, the significant increase in other liabilities, which increased by around Rs. 107 billion, caused a decline in NDA during the year. In 2014, NCG from the Central Bank increased by Rs. 35.7 billion due to the increase in provisional advances to the government. Other liabilities of the Central Bank increased mainly due to increase in borrowed bonds by the Central Bank to manage excess liquidity in the domestic market in view of lower Treasury bill holdings of the Central Bank. The Treasury bill holding of the Central Bank (net of repurchase transactions), which contracted significantly by

Chart 7.4 Year-on-Year Growth of Monetary Aggregates



Rs. 163 billion to Rs. 5.3 billion by end 2013, compared to Rs. 168.2 billion in 2012, continued to remain low at Rs. 6.1 billion by end 2014.

The money multiplier, which reflects the link between reserve money and broad money (M_{2b}), declined by end 2014 mainly due to the increase in currency to deposits ratio in a low interest rate environment. Accordingly, end-year broad money multiplier decreased to 6.71 by end 2014 compared to 7.00 recorded at end 2013. However, on average, the money multiplier increased to 6.93 in 2014 compared to 6.64 in 2013.

Narrow Money (M_1)

Narrow money (M_1), which comprises currency and demand deposits held by the public, grew at a higher rate of 26.3 per cent by end 2014 compared to 7.7 per cent at end 2013. The year-on-year growth of narrow money, which averaged around 14 per cent during January - October 2014, exceeded 25 per cent in the last two months of 2014. Accordingly, the last two months of 2014 accounted for one half of the total increase in narrow money recorded for the year. The significant increase in narrow money towards end 2014 is attributed to the substantial increase in currency in circulation in view of the seasonal effect arising from festive demand and the expenditure related to the presidential election held in January 2015. Currency held by the public increased by 24.5 per cent, on a year-on-year basis, by end 2014 from 5.2 per cent in the previous year. Meanwhile, along with the seasonal effects observed towards end 2014, and the impact of the low interest rate environment, demand deposits held by the public grew by 28.5 per cent at end 2014 compared to a growth of 10.8 per cent by end 2013. In absolute terms, narrow money increased by Rs. 127.6 billion in 2014 compared to the increase of Rs. 34.5 billion in 2013.

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

Rs. billion

Item	End 2013 (a)	End 2014 (b)	Change 2013 Amount	Change 2013 %	Change 2014 Amount	Change 2014 %
Reserve Money	488.6	577.9	4.2	0.9	89.3	18.3
Net Foreign Assets of the Central Bank	529.1	688.0	132.7	33.5	158.9	30.0
Net Domestic Assets of the Central Bank	-40.5	-110.1	-128.4	-146.1	-69.6	171.6
Broad Money (M_{2b})	3,417.9	3,875.9	488.8	16.7	458.0	13.4
Net Foreign Assets	-76.3	15.1	-50.5	-195.5	91.5	-119.8
Monetary Authorities	529.1	688.0	132.7	33.5	158.9	30.0
Commercial Banks	-605.5	-672.9	-183.2	-43.4	-67.4	11.1
Net Domestic Assets	3,494.2	3,860.7	539.3	18.3	366.5	10.5
Domestic Credit	4,200.8	4,640.1	504.7	13.7	439.4	10.5
Net Credit to the Government	1,301.3	1,435.9	256.1	24.5	134.6	10.3
Central Bank	114.0	149.7	-164.8	-59.1	35.7	31.3
Commercial Banks	1,187.3	1,286.2	420.9	54.9	98.9	8.3
Credit to Public Corporations	365.1	446.0	72.6	24.8	80.9	22.2
Credit to the Private Sector	2,534.3	2,758.2	175.9	7.5	223.9	8.8
Other Items (net)	-706.6	-779.4	34.6	4.7	-72.8	10.3

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

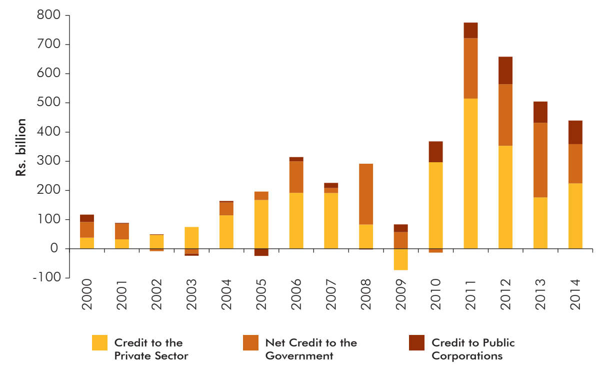
Broad Money (M_{2b})

Broad money (M_{2b}) expanded as expected during 2014. Broad money increased by 13.4 per cent by end December 2014 compared to 16.7 per cent at end 2013. Meanwhile, the annual average growth of broad money was 13.3 per cent, remaining consistent with the revised projected average growth of 13.5 per cent for the year.

From the liabilities side, the growth of quasi money, which includes time and savings deposits held by the public, accounted for 72.1 per cent of the growth in broad money compared to around 92.9 per cent in the previous year. Having impacted by low deposit rates offered by commercial banks, the growth of quasi money decelerated to 11.3 per cent on a year-on-year basis in 2014, from 18.3 per cent in 2013. As a result, the expansion in quasi money was limited to Rs. 330.4 billion in 2014 compared to an increase of Rs. 454.3 billion in 2013.

With regard to the assets side, broad money expansion during 2014 was caused by increases in both NFA and NDA of the banking sector. The increase in NFA of the banking sector by Rs. 289 billion accounted entirely for the increase in broad money during the first eight months of the year as NDA recorded a contraction of Rs. 64.7 billion. During this period, NFA of the Central Bank increased mainly due to net absorption of foreign exchange from the domestic foreign exchange market amounting to Rs. 138.6 billion and the purchase of foreign exchange amounting to US dollars 541 million (Rs. 72 billion) from the proceeds of the International Sovereign Bond. NFA of commercial banks increased by Rs. 26.8 billion in the same period following settlements of foreign currency loans obtained

Chart 7.5 Annual Increase in Domestic Credit



by certain public corporations and the reversal of foreign currency swaps with the Central Bank, which were subsequently invested abroad. However, NFA recorded a contraction of Rs. 134.4 billion in the last quarter of 2014 mainly due to the sale of foreign exchange by the Central Bank to the domestic foreign exchange market. As a result, the overall expansion in NFA of the banking sector was limited to Rs. 91.5 billion during the year. Meanwhile, in absolute terms, NDA of the banking sector increased by Rs. 366.5 billion during 2014, of which Rs. 300.6 billion was recorded during the last quarter of 2014. The contraction in credit to the private sector, the major component in domestic credit, contributed to the contraction in NDA of the banking sector during the first eight months of 2014. The reduced reliance on bank funding by public corporations, and NCG by the banking system remaining at budgeted levels also contributed to dampening the impact of NDA on broad money growth. However, NDA increased towards the latter part of the year with a rebounding of credit to the private sector as well as increased credit disbursements to the government and public corporations.

Credit extended to the private sector rebounded towards end 2014 despite recording a contraction in the first eight months of 2014. The contraction in credit extended to the private sector despite the reduction in lending rates during the first eight

Chart 7.6 Volume of Loans and Advances Granted to the Private Sector by Commercial Banks

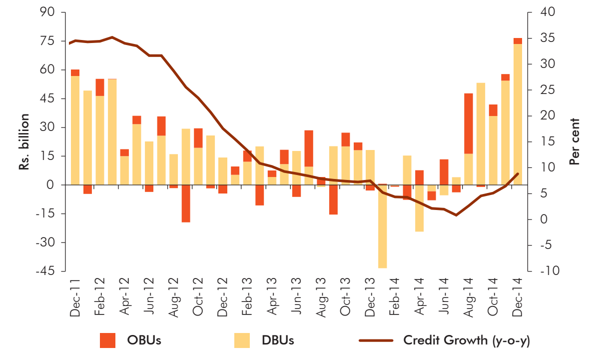
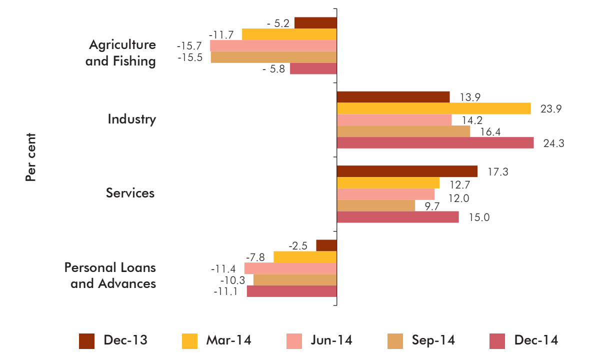


Chart 7.7 Year-on-Year Growth of Credit to Key Sectors



months of the year was due to a confluence of factors. The lower cost of borrowing and its likely positive impact on credit flows were dampened to a large extent by the impact of the contraction in pawning advances. In addition, subdued credit demand was partly due to the utilisation of internal funds and access to alternative funding sources by the corporate sector. Consequently, credit granted to the private sector recorded a contraction of Rs. 52.4 billion during the first seven months of 2014, while on a year-on-year basis, credit flows to the private sector recorded a marginal growth of 0.8 per cent by end July 2014. Although credit granted to the private sector recorded a substantial increase in August, on a cumulative basis, private sector credit recorded a contraction in the first eight months of 2014. However, with the dissipating impact of the contraction in pawning advances on overall credit, and supported by further reduction in market lending rates, growth in the credit granted to the private sector rebounded as expected during the latter part of the year. Accordingly, the increase in private sector credit during the last two quarters of the year amounted to Rs. 100.2 billion and Rs. 176.3 billion, respectively. On a year-on-year basis, growth of credit to the private sector increased by 8.8 per cent by end December 2014 recording an overall expansion of Rs. 223.9 billion, compared to the growth of 7.5 per cent observed at end 2013.

As per the Quarterly Survey of Commercial Banks' Loans and Advances to the Private Sector, the expansion of private sector credit was driven largely by loans to the Industry and the Services sectors. Accordingly, credit granted to the Industry and the Service

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

Rs. billion

Sector	End 2013	End 2014 (c)	% Share 2014	% Change 2014
Agriculture and Fishing	**304.9**	**287.3**	**10.4**	**-5.8**
of which, Tea	54.3	68.5	2.5	26.2
Rubber	18.9	20.8	0.8	9.8
Coconut	7.0	7.8	0.3	11.6
Paddy	14.8	16.9	0.6	14.0
Vegetable, Fruit and Minor Food Crops	14.7	16.4	0.6	11.7
Fisheries	10.4	11.7	0.4	12.8
Industry	**899.6**	**1,118.0**	**40.4**	**24.3**
of which, Construction	384.2	469.8	17.0	22.3
Food and Beverages	60.6	71.1	2.6	17.3
Textiles and Apparel	106.0	148.5	5.4	40.2
Fabricated Metal Products, Machinery and Transport Equipment	86.0	101.0	3.7	17.5
Services	**616.6**	**709.3**	**25.6**	**15.0**
of which, Wholesale and Retail Trade	233.8	230.8	8.3	-1.3
Tourism	63.0	76.8	2.8	21.9
Financial and Business Services	117.7	147.5	5.3	25.3
Shipping, Aviation and Supply, and Freight Forwarding	14.2	13.9	0.5	-2.2
Personal Loans and Advances (d)	**684.8**	**608.7**	**22.0**	**-11.1**
of which, Consumer Durables	74.9	92.0	3.3	22.8
Pawning	292.9	172.7	6.2	-41.0
Safety Net Scheme Related	**29.0**	**42.9**	**1.6**	**47.9**
Total	**2,535.0**	**2,766.2**	**100.0**	**9.1**

(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

sector increased by Rs. 218.4 billion and Rs. 92.7 billion, respectively, in 2014. However, credit flows to the Agriculture sector contracted in 2014 although some sub-sectors such as Tea and Paddy recorded an increase. Credit in the form of Personal Loans and Advances continued to decline in 2014. The substantial decline in pawning advances for both agricultural and consumption purposes following the sharp reduction in gold prices in international markets continued to have an adverse effect on Personal Loans and Advances and credit granted to the Agriculture sector.

In terms of the original maturity of loans and advances as per the Quarterly Survey, loans with long term maturities increased across all sectors in 2014. The significant reduction in the interest rate structure including long term rates is attributed to the relatively higher demand for long term loans. The decline in the growth of short term loans in the Agriculture, Fishing and Personal loans, reflecting the sharp decline in pawning advances, also contributed to the increase in the share of long term loans. Consequently, the share of long term loans across all sectors increased to 26 per cent in 2014 compared to 23 per cent in the previous year. Loans with medium to long term maturities accounted for the majority of loans granted to Industry and Services sectors, while short term loans dominated the maturity profile for loans granted to the Agriculture sector and Personal Loans and Advances.

NCG from the banking sector increased by Rs. 134.6 billion in 2014. NCG from the Central Bank increased by Rs. 35.7 billion, which was mainly attributed to the increase in provisional advances as the stock of Treasury bill holdings (net of repurchase agreements) of the Central Bank increased marginally from the levels that prevailed at end 2013. Although the NCG from commercial banks increased by Rs. 98.9 billion, this was a sharp reduction compared to the increase of Rs. 420.9 billion in 2013. The decomposition of NCG of commercial banks indicates a significant increase in the holdings of Treasury bonds (net of repurchase agreements) by commercial banks amounting to Rs. 193.2 billion, while the outstanding government overdraft balance with the two state commercial banks increased by Rs. 27.5 billion. The increased holdings of long term maturities of government securities by commercial banks were partly due to the Central Bank's continued issuances of medium to long term Treasury bonds in place of Treasury bills along with investors' preference for holding Treasury bonds.

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

Sector	Maturity	December 2013		December 2014	
		% Share	% Growth	% Share	% Growth
Agriculture and Fishing	Short Term	9.1	-9.8	7.1	-14.5
	Medium Term	2.1	8.2	2.3	17.4
	Long Term	0.8	23.4	1.0	30.5
Industry	Short Term	13.7	15.7	14.7	16.9
	Medium Term	9.2	10.1	11.2	32.7
	Long Term	12.6	14.9	14.5	26.2
Services	Short Term	11.7	17.2	11.7	8.9
	Medium Term	7.5	16.4	8.1	18.4
	Long Term	5.1	19.2	5.8	24.2
Personal Loans and Advances	Short Term	15.4	-22.6	11.9	-15.3
	Medium Term	7.6	58.6	5.7	-17.2
	Long Term	4.1	32.7	4.3	16.1
Safety Net Scheme Related	Short Term	0.5	71.1	0.8	67.3
	Medium Term	0.3	-8.2	0.4	46.5
	Long Term	0.3	0.9	0.4	20.7

(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

Table 7.6

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

Rs. billion

Item	End 2013 (a)	End 2014 (b)	Change 2013 Amount	Change 2013 %	Change 2014 Amount	Change 2014 %
Financial Survey (M_4)	4,283.3	4,897.7	598.2	16.2	614.4	14.3
Underlying Factors						
Net Foreign Assets	-200.0	-136.7	-164.9	-470.2	63.3	31.6
Monetary Authorities	529.1	688.0	132.7	33.5	158.9	30.0
LCBs	-605.5	-672.9	-183.2	-43.4	-67.4	-11.1
LSBs and LFCs	-123.7	-151.9	-114.4	-1,238.2	-28.2	-22.8
Net Domestic Assets	4,483.3	5,034.4	763.1	20.5	551.2	12.3
Domestic Credit	5,568.8	6,291.9	739.7	15.3	723.1	13.0
Net Credit to the Government	1,787.2	2,010.4	397.2	28.6	223.2	12.5
Monetary Authorities	114.0	149.7	-164.8	-59.1	35.7	31.3
LCBs	1,187.3	1,286.2	420.9	54.9	98.9	8.3
LSBs	458.0	514.8	130.3	39.8	56.8	12.4
LFCs	27.8	59.7	10.8	63.4	31.8	114.3
Credit to Public Corporations (LCBs)	365.1	446.0	72.6	24.8	80.9	22.2
Credit to the Private Sector	3,416.5	3,835.5	269.8	8.6	419.0	12.3
LCBs	2,534.3	2,758.2	175.9	7.5	223.9	8.8
LSBs	380.2	474.4	25.7	7.2	94.3	24.8
LFCs	502.0	602.9	68.2	15.7	100.9	20.1
Other Items (net)	-1,085.5	-1,257.5	23.5	2.1	-172.0	-15.8

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

As a result, Treasury bill holdings (net of repurchase agreements) of commercial banks contracted by Rs. 136.3 billion. The investments in Sri Lanka Development Bonds (SLDBs) by both domestic banking units (DBUs) and offshore banking units (OBUs) of commercial banks increased by Rs. 11.6 billion and Rs. 17 billion, respectively, contributing to the overall increase in NCG in 2014 but at lower amounts compared to Rs. 42.9 billion and Rs. 55.8 billion, respectively, in 2013.

Credit granted to public corporations increased by Rs. 80.9 billion in 2014. Credit granted to public corporations contracted by Rs. 38.2 billion during the first seven months of the year due to partial settlement of loans obtained by the Ceylon Petroleum Corporation (CPC) from both the DBUs and OBUs of commercial banks. Credit obtained by the Ceylon Electricity Board was contained at Rs. 4.9 billion during this period. Nevertheless, credit obtained by public corporations increased notably by Rs. 82.2 billion during the last quarter of 2014, of which, 75 per cent of the increase was attributed to borrowings by the CPC from commercial banks in foreign currency, although, during the year, CPC's financial position remained favourable with substantial rupee deposits being maintained. Among others, credit obtained by the Road Development Authority (Rs. 35.0 billion), the Ceylon Fertilizer Corporation (Rs. 8.7 billion) as well as the Sri Lanka Ports Authority (Rs. 4.7 billion) were the main contributors to the increase in credit to public corporations.

Broad Money (M_4)

Following the same trend observed in broad money supply (M_{2b}), the year-on-year growth of broad money as measured by the financial survey (M_4)[3], increased by 14.3 per cent in 2014 compared to 16.2 per cent in 2013. During the year, in absolute terms, M_4 increased by Rs. 614.4 billion and the growth of M_4 in 2014

3 The financial survey provides a broader measure of liquidity, covering licensed specialised banks and licensed finance companies, in addition to licensed commercial banks and the Central Bank

was largely driven by an increase in NDA by Rs. 551.2 billion. The increase in NDA was due to increases in both public sector and private sector credit by the banking system and licensed finance companies (LFCs). Meanwhile, NFA increased by Rs. 63.3 billion in 2014.

On a year-on-year basis, the growth of quasi money, which contains time and savings deposits in all licensed banks and LFCs, decelerated to 12.7 per cent in December 2014 from 17.5 per cent in December 2013, mainly due to the declining trend in market deposit rates. Although quasi money of domestic banking units of the LCBs recorded a moderate growth, on a year-on-year basis, quasi money with respect to licensed specialised banks (LSBs) increased by 15 per cent in 2014 compared to 9.4 per cent registered at the end of 2013. At the same time, quasi money with respect to LFCs decelerated on a year-on-year basis to 22.5 per cent by the end of 2014 from 32.7 per cent recorded at end 2013.

As per the financial survey, year-on-year growth of credit extended to the private sector, increased to 12.3 per cent by end 2014 from 8.6 per cent at end 2013. Although a significant contraction in private sector credit was recorded during the period January to July 2014, a considerable increase was registered from August to December 2014. As a result, in comparison to the increase of Rs. 223.9 billion in credit to the private sector in M_{2b}, private sector credit under the Financial Survey increased by Rs. 419 billion driven by the increases in credit disbursed by LSBs and LFCs. On a year-on-year basis, credit extended to the private sector by LSBs and LFCs increased by 24.8 per cent and 20.1 per cent, respectively in 2014, compared to 7.2 per cent and 15.7 per cent, respectively, in 2013. In absolute terms, credit extended to the private sector by LSBs and LFCs increased by Rs. 94.3 billion and Rs. 100.9 billion, respectively, during 2014. This was mainly due to the increase in loans and advances disbursed for infrastructure development and manufacturing by LSBs, including credit granted to public corporations and increased loans and advances as well as leasing facilities of LFCs.

7.4 Interest Rates

Benefitting from the continued relatively relaxed monetary policy stance and high excess liquidity, market interest rates declined to historically low levels during 2014. On 02 January 2014, the Central Bank reduced its SLFR by 50 basis points to 8.00 per cent, while SDFR remained unchanged at 6.50 per cent during the year. Furthermore, the Central Bank rationalised access to its SDF at the SDFR of 6.50 per cent and imposed a special rate of 5.00 per cent with effect from 23 September 2014. As a result, overnight market interest rates declined notably below the lower bound of the policy rate corridor followed by a reduction in several other market interest rates to historic lows.

Money Market Rates

Interbank call money market rates declined significantly in 2014 due to high levels of excess liquidity in the domestic market. With the reduction in SLFR in January 2014, the AWCMR declined to 7.46 per cent by end January 2014 from 7.66 per cent at end 2013. Reflecting high levels of excess liquidity in the money market, AWCMR declined further to 6.95 per cent by end February 2014 and thereafter settled between 6.63-6.99 per cent until end August 2014. Following the

Table 7.7 Selected Money Market Rates

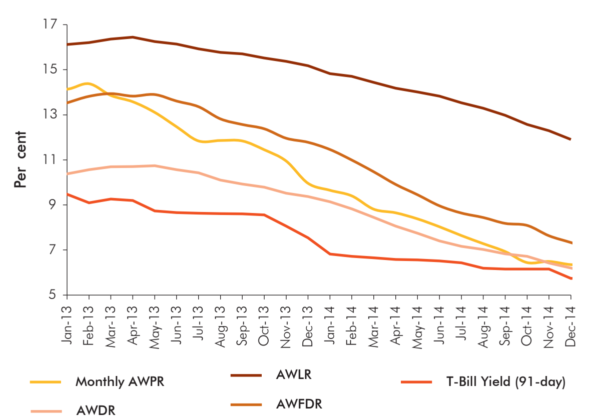
Per cent per annum

	AWCMR		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
Dec-13	7.66	7.73	7.76	7.80	11.09	11.39
Mar-14	6.97	6.91	7.00	7.00	9.23	9.34
Jun-14	6.96	6.96	7.00	7.00	8.88	8.88
Sep-14	5.77	6.55	5.92	6.64	7.31	7.99
Dec-14	6.21	6.01	6.10	6.02	7.15	7.12

Source: Central Bank of Sri Lanka

rationalisation of access to the SDF in September 2014, the AWCMR declined below the SDFR and recorded a lower level of 5.72 per cent by the beginning of October 2014. Thereafter, it stabilised around 6.00 per cent during the remainder of the year. At the end of 2014, the AWCMR was 6.21 per cent compared to 7.66 per cent at end 2013 declining by 145 basis points. Meanwhile, the weighted average yields at the daily OMO auctions also declined responding to the rationalisation of access to the SDF facility and higher market liquidity during 2014. The Sri Lanka Interbank Offered Rate (SLIBOR) also declined in line with the AWCMR in 2014. Accordingly, overnight

Chart 7.8 Movement of Selected Market Interest Rates



and 12-month SLIBOR declined by 166 basis points and 394 basis points to 6.10 per cent and 7.15 per cent, respectively, by end 2014.

Deposit and Lending Rates

Deposit interest rates declined at a faster pace in 2014. The average weighted deposit rate (AWDR), which reflects the movement of interest rates pertaining to all interest bearing deposits held with commercial banks, declined by 317 basis points during 2014 to 6.20 per cent from 9.37 per cent by end 2013. The average weighted fixed deposit rate (AWFDR), which is based on term deposits maintained with commercial banks, also declined significantly by 445 basis points from 11.78 per cent by end 2013 to 7.33 per cent by end 2014. As inflation continued to remain below the deposit interest rates offered by many financial institutions, depositors have benefitted from positive real rates of return. Nevertheless, addressing the concerns raised by depositors, especially senior citizens regarding the difficulties faced by them due to the low deposit rate environment, a special scheme targeting the senior citizens was introduced in the Budget 2015. Accordingly, a 12 per cent special annual interest rate scheme for fixed deposits maintained at licensed banks by citizens over 60 years of age, and up to a maximum of Rs. 2.5 million was introduced with effect from 01 January 2015. Furthermore, according to the proposal made in the government's Interim Budget 2015, the Central Bank issued instructions to banks on behalf of the government with the approval of the Ministry of Finance to offer a special interest scheme for senior citizens. Accordingly, one year rupee fixed deposits of up to Rs. 1 million in total opened in banks by resident Sri Lankan citizens above 60 years of age on an individual basis are eligible to an interest of 15 per cent per annum with effect from 16 January 2015 under this special interest scheme. At the same time, senior citizens who opened fixed deposits up to Rs. 2.5 million prior to 16 January 2015 under the previous scheme, will receive an interest of 12 per cent per annum.

The Legal rate and the Market rate of interest,[4] as determined by the Monetary Board and published by the Government Gazette at the end of each year, were 7.76 per cent per annum for 2015 compared to 10.34 per cent per annum published for 2014. 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.

With the relatively relaxed monetary policy stance and high excess liquidity in the market supported by efforts of the Central Bank to encourage financial institutions to adjust interest rates, lending rates further declined during 2014. The average weighted prime lending rate (AWPR), which reflects the rates applicable on loans and advances granted by commercial banks to their prime customers and computed on a weekly basis, declined by 387 basis points to historically low levels of 6.26 per cent by end 2014 from 10.13 per cent at end 2013. The AWPR, computed on a monthly basis also declined by 361 basis points to 6.35 per cent by end December 2014 from 9.96 per cent recorded at end December 2013. Further, reflecting the declining trend in lending rates, the average weighted lending rate (AWLR), which is calculated based on all outstanding loans and advances extended by commercial banks to the private sector declined by 327 basis points to 11.91 per cent by end 2014 from 15.18 per cent at end 2013. Bank wise AWLR declined to a range of 5.66-16.57 per cent by end 2014 compared to

4 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.

Table 7.8 Movements of Interest Rates

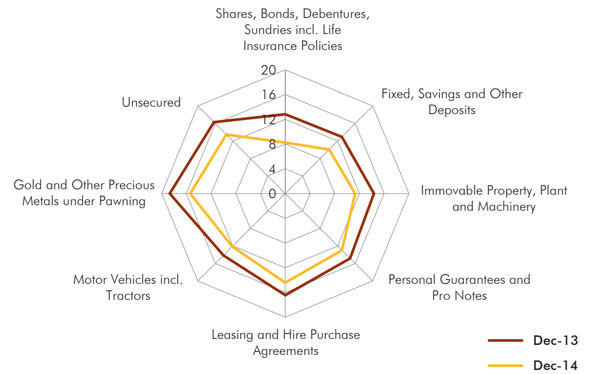
Per cent per annum

Interest Rate	End 2013 (a)	End 2014 (b)
Policy Interest Rates (c)		
Standing Deposit Facility Rate	6.50	6.50
Standing Lending Facility Rate	8.50	8.00
Average Weighted Call Money Rate (AWCMR)	7.66	6.21
Yield Rates on Government Securities		
Primary Market		
Treasury bills		
91-day	7.54	5.74
182-day	7.85	5.84
364-day	8.29	6.01
Treasury bonds		
2-year	-	-
3-year	10.87	-
4-year	-	-
5-year	10.64	8.93
10-year	11.80	7.88
Secondary Market		
Treasury bills		
91-day	7.52	5.72
182-day	7.83	5.86
364-day	8.27	6.04
Treasury bonds		
2-year	8.86	6.22
3-year	9.05	6.94
4-year	9.54	7.14
5-year	10.29	7.26
10-year	10.89	7.99
Licensed Commercial Banks (d)		
Interest Rates on Deposits		
Savings Deposits	0.75-9.14	0.50-8.00
1- year Fixed Deposits (e)	6.00-16.00	3.95-12.00
Average Weighted Deposit Rate (AWDR)	9.37	6.20
Average Weighted Fixed Deposit Rate (AWFDR)	11.78	7.33
Interest Rates on Lending		
Average Weighted Prime Lending Rate (AWPR)	9.96	6.35
Average Weighted Lending Rate (AWLR)	15.18	11.91
Other Financial Institutions		
Interest Rates on Deposits		
National Savings Bank		
Savings Deposits	5.00	5.00
1-year Fixed Deposits	9.50	6.50
Licensed Finance Companies (f)		
Savings Deposits	6.67-8.86	5.17-6.81
1-year Fixed Deposits	12.66-14.40	8.56-10.27
Interest Rates on Lending		
National Savings Bank (g)	14.00-15.50	8.00-13.00
State Mortgage and Investment Bank (g)	12.75-17.50	7.59-14.25
Licensed Finance Companies (f)		
Finance Leasing	18.04-24.78	15.45-23.15
Hire Purchase	19.47-22.89	16.36-20.42
Loans against Real Estate	20.00-21.67	17.00-21.20
Corporate Debt Market		
Debentures	8.00-20.00	6.88-15.50
Commercial Paper	8.50-22.00	6.44-12.50

(a) Revised
(b) Provisional
(c) The Repurchase rate and the Reverse Repurchase rate of the Central Bank were renamed as the Standing Deposit Facility Rate (SDFR) and Standing Lending Facility Rate (SLFR), respectively, w.e.f. 02 January 2014.
(d) Based on the rates quoted by commercial banks and other selected financial institutions.
(e) Maximum rate is a special rate offered by certain commercial banks.
(f) Average rates, based on the maximum and minimum rates quoted by LFCs
(g) Lending for housing purposes only.

Source: Central Bank of Sri Lanka

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



10.14-19.52 per cent at end 2013. All security wise lending rates also declined significantly during 2014.

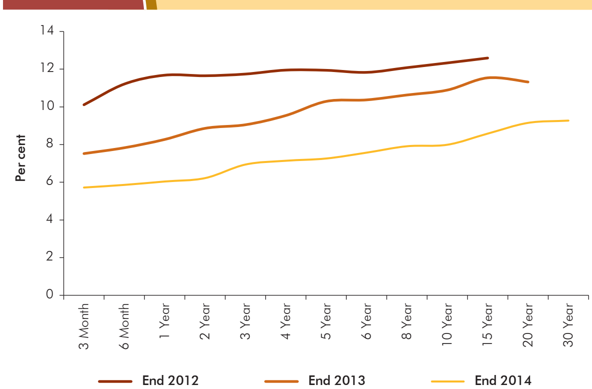
Reflecting the low interest rate structure that prevailed in the market, interest rates pertaining to new loans and new deposits continued to adjust downward in 2014. The average weighted new deposit rate (AWNDR),[5] which reflects the movement of interest rates pertaining to all new interest bearing deposits held with commercial banks during the month, declined to 5.45 per cent by December 2014 from 6.55 per cent in April 2014. Meanwhile, the average weighted new lending rate (AWNLR), which is based on all new loans and advances extended by commercial banks to the private sector during the month also declined to 10.68 per cent in December 2014 from 12.93 per cent in April 2014, reflecting fast downward adjustment in interest rates pertaining to lending.

Interest rates applicable on foreign currency deposits with commercial banks remained low during 2014 reflecting the low interest rate environment in advanced economies. Interest rates on US dollar denominated savings deposits were in the range of 0.01-3.25 per cent during 2014 compared to 0.02-3.75 per cent in 2013, while US dollar denominated time deposits remained in the range of 0.06-4.25 per cent during 2014, compared to 0.25-5.00 per cent in 2013. Meanwhile, interest rates offered by commercial banks on pound sterling denominated savings deposits were in the range of 0.05-2.25 per cent during 2014 compared to a range of 0.10-3.50 per cent by end 2013. Interest rates applicable on pound sterling denominated time deposits were in the range of 0.20-4.25 per cent during 2014, compared to the range of 0.25-4.50 per cent by end 2013.

Yield Rates on Government Securities

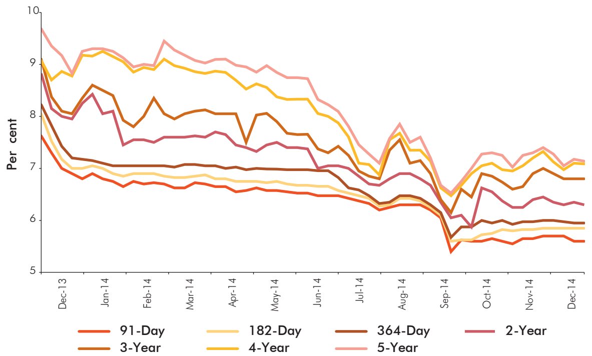
Following the movements in other market interest rates, yield rates on government securities in the primary market also declined to low levels during 2014. Low yield rates were also supported by excess liquidity in the domestic market and low levels of inflation and inflation expectations throughout the year. During 2014, yield rates on 91-day, 182-day and 364-day Treasury bills declined by 180 basis points, 201 basis points and 228 basis points to 5.74 per cent, 5.84 per cent and 6.01 per cent, respectively. However, at the auctions held in the early part of 2015, Treasury bill rates showed some upward trend reflecting the movements of other short term money market rates. Following the trend in short term government securities, yield rates

Chart 7.10 Secondary Market Yield Curve for Government Securities



5 The Central Bank commenced compilation of average interest rates for new deposits and new loans in April 2014.

Chart 7.11 Weekly Movement of Secondary Market Yields for Government Securities



on Treasury bonds also declined during the year 2014. Reflecting the increased demand towards long term Treasury bonds and also with a view to extend the yield curve, the government issued Treasury bonds with longer maturities. Accordingly, Treasury bonds with a 20-year maturity were issued in March 2014 at a yield rate of 11.32 per cent, while Treasury bonds with a 30-year maturity were issued in March and May, at a yield rate of 11.75 per cent. Overall, yield rates on Treasury bonds in the primary market ranged from 8.65 per cent on 5- year Treasury bonds to 11.75 per cent at the long end of 30-year Treasury bonds. Treasury bonds below 5-year maturity were not issued in 2014.

The secondary market yield curve for government securities shifted further downwards during 2014. The secondary market yield rates on Treasury bills of all maturities decreased by 180 to 223 basis points during the year compared to end 2013. Accordingly, yield rates on 91-day, 182-day and 364-day Treasury bills were in the range of 5.72-6.04 per cent by end 2014, compared to the range of 7.52-8.27 per cent observed at end 2013. Reflecting the investor preference for longer maturities, the secondary market yields on Treasury bonds also declined during 2014 to a range of 6.22-9.27 per cent from a range of 8.86-11.54 per cent at end 2013.

Yield Rates on Corporate Debt Securities

Interest rates pertaining to corporate debt securities also adjusted downwards. Interest rates on commercial paper declined within a range of 6.44-12.50 per cent during 2014 compared to a range of 8.50-22.00 per cent observed at end 2013. During 2014, there were 46 listings of corporate debentures by 20 corporations with maturities of 3-10 years. Interest rates offered on these issues were in the range of 6.88-15.50 per cent at end 2014 compared to 8.00-20.00 per cent at end 2013.

7.5 Future Developments, Challenges and Outlook

The prevailing low interest rate environment is expected to facilitate increased credit flows to the private sector from the banking sector. The relatively relaxed monetary policy stance pursued by the Central Bank throughout 2014 amidst improved inflation outlook and contained inflation expectations, has helped to bring down the entire interest rate structure to historically low levels. Benefiting from prevailing low interest rates in the economy, private sector credit growth has picked up and, it is expected that private sector credit would continue to increase. In this context, financial institutions are encouraged to facilitate adequate access to mobilise financial resources by the private sector and ensure the utilisation of such resources for productive economic activity. In line with the continued expansion in private sector credit, monetary aggregates are expected grow at a rate consistent with the medium term macroeconomic policy framework designed to place the economy on a higher growth trajectory, while maintaining inflation at low and stable levels.

Given the continued expansion in private sector credit, maintaining public sector borrowings from the banking sector at the envisaged levels is vital in containing demand

driven inflationary pressures. Excessive credit demand by the government or public corporations poses significant challenges to the conduct of monetary policy. In particular, undue monetary expansion caused by the accommodation of excessive demand for public sector credit could threaten the realisation of the projected low inflation path, while exerting upward pressure on market interest rates and disturbing the smooth flow of private sector credit. In this respect, it is important for the government to maintain fiscal targets without significant deviations. It is observed that the performance of key public corporations has historically been affected by movements in international commodity prices such as crude oil and fertiliser posing additional burden on such entities. Accordingly, public corporations would need to focus on improving their financial performance by implementing more market driven pricing mechanisms as well as enhancing operational efficiency to reduce their reliance on the domestic banking sector.

In the context of increasing private sector credit, persistently high surplus liquidity in the domestic money market could pose challenges for monetary management. During 2014, the Central Bank has been absorbing high excess rupee liquidity in the market through OMOs on an overnight basis as well as on short term and permanent basis in order to manage the stability in market interest rates. Also, it is expected that existing high liquidity would be gradually absorbed with the revival of private sector credit growth and monetary expansion. At the same time, the Central Bank would continue to conduct its monetary operations to maintain market liquidity at appropriate levels.

The current environment has provided a timely opportunity for the introduction of new financial products and schemes providing relatively high benefits to senior citizens, in the medium to long term. Considering the concerns raised by the senior citizens in a low interest rate environment, special interest schemes were introduced by the government in order to address the difficulties faced by senior citizens. Nevertheless, as such measures would provide a temporary relief, long term solutions would need to be implemented in order to mitigate the impact of low interest rates environment, on certain segments of the economy. In this regard, financial institutions are encouraged to introduce innovative financial products including superannuation schemes and new insurance products yielding attractive yields in the near future, which would further address the short term challenges faced by senior citizens who mainly rely on bank interest income.

Significant monetary policy changes could take place in advanced and key emerging market economics during 2015, thus having an impact on other emerging market countries. Major advanced economies, such as the United States and the United Kingdom are expected to tighten monetary policy stance in 2015, as their economies show signs of recovery, while the Euro area could ease monetary policy further due to sluggish nature of economic activity. Among major emerging economies, the Chinese economy would also require some significant policy changes in 2015 in view of the slowdown in economic activity. Further, the Russian economy, which has suffered heavily from low oil prices and depreciation of the ruble along with sanctions in place, may also consider introducing a policy stimulus in 2015. Amidst such complex environment, the spillover effects of mixed policy responses in key advanced and major emerging economies could pose some risks to Sri Lanka. In particular, monetary policy normalisation process in the United States could create pressures on the external front due to possible capital reversals, thereby leading to increased volatility in exchange rates and posing challenges to monetary management through significantly changing liquidity conditions.

Nevertheless, it is expected that global spillovers could also lead economies to follow a portfolio reallocation strategy thus mitigating the impact on the external and financial sectors of such vulnerable emerging economies.

The Central Bank would continue to adopt appropriate monetary policy measures to maintain inflation at low single digits. The impact of significant reductions in domestic energy and petroleum prices following lower international energy prices as well as reductions in the prices of some major essential commodities, is likely to result in low inflation, particularly in the first half of the year. Thereafter, inflation is expected to remain at around mid-single digit levels by end 2015. In the medium term, inflation is expected to be maintained in the range of 3-5 per cent. Nevertheless, possible reversal in international commodity prices as well as demand pressures emanated from the expansion in money and credit aggregates and wage pressures could pose upward risks to inflation projections. In such circumstances, the Central Bank would adopt timely policy measures to arrest building up of demand pressures and support the government's efforts to improve supply conditions and productivity, thereby creating a conducive environment to sustain the low inflation regime going forward.

Considering the importance of managing inflation expectations of the general public, the Central Bank will pursue monetary policy actions in a forward looking framework. The Central Bank commenced conducting inflation expectation surveys on a regular basis since 2006 and the results of these expectation surveys have only been used by the Central Bank for its internal purposes. As such, the results of monthly expectation surveys are used as inputs for the meetings of the Monetary Policy Committee for the purpose of reviewing and recommending an appropriate monetary policy stance, which is then presented to the Monetary Board to make better informed monetary policy decisions. The Central Bank would continue to conduct these expectations surveys and consider publishing the results on a regular basis in order to avoid building up of adverse inflation expectations among the general public and to guide the monetary policy formulation and conduct.

The Central Bank would strengthen its efforts to improve the monetary policy framework to ensure greater macroeconomic stability. During the last three decades, the monetary policy framework in Sri Lanka has been based on a monetary targeting strategy that was introduced in the early 1980s. Since then, the monetary targeting framework has been gradually developed and modified and it has also been instrumental in maintaining domestic price stability, particularly in the last six years. Nevertheless, as the country graduates to the upper middle income levels, the monetary policy framework needs to be further strengthened in line with current global best practices with a view to sustain domestic price stability in a dynamic economic environment. Accordingly, identifying the need for modifying the current monetary policy framework, the Central Bank has fulfilled several prerequisites over the past few years to move towards an enhanced monetary policy framework. As the current low inflation provides a conducive environment to pursue an enhanced monetary policy framework, built on such fulfilled prerequisites, the monetary policy conduct of the Central Bank would be increasingly aligned with a Flexible Inflation Targeting (FIT) framework in the period ahead. Under this framework, the Central Bank would be primarily concerned with key macroeconomic variables, mainly inflation and economic growth. Also, while broad money aggregates would continue to remain as the key indicative variables to guide the conduct of monetary policy, the Central Bank would increasingly rely on the overnight interbank interest rate as its operating target.