7

MONETARY POLICY, MONEY, CREDIT AND INTEREST RATES

7.1 Overview

The Central Bank of Sri Lanka eased its monetary policy stance further in 2010. Broad money expansion continued to moderate during the first three quarters of 2010, indicating subdued demand pressures. Supply-side developments meanwhile, were also favourable, as domestic supplies increased during the year, while commodity prices in international markets including petroleum prices moderated towards mid-2010. The outlook for prices therefore was benign, supporting a further relaxation of the monetary policy stance to promote economic activity. Accordingly, policy interest rates of the Central Bank were reduced further, in July and August 2010. The targeted growth of broad money in 2010 was also revised upward in July 2010, in order to facilitate the smooth functioning of economic activity, as it became evident by mid-year that the domestic economy was expanding at a higher rate in 2010 than originally projected. Following the reduction of the Central Bank's policy interest rates, market interest rates adjusted further downwards during the second half of 2010, providing additional impetus to economic activity. This declining trend in interest rates continued into 2011 as well, as the Bank reduced its policy interest rates further in January 2011.

Credit obtained by the private sector regained momentum during the year 2010 in view of the improved outlook for economic activity and the continued accommodative monetary policy stance of the Central Bank. Year-on-year growth of credit granted by commercial banks to the private sector, which was at a negative 5.8 per cent at end 2009, turned positive in March 2010, and thereafter continued to increase at a robust rate to reach 25 per cent in December 2010. This expansion was reflected in credit flows to all sectors of the economy. Nevertheless, average growth of broad money (M_{2b}) during the year 2010 remained around the targeted level of 15 per cent by year-end, as net foreign assets of the banking system declined gradually during the year along with increased financing of imports, while net credit obtained by the government from the banking system also declined towards the end of the year. Year-on-year growth of daily average reserve money in 2010 was also consistent with the target stipulated in the monetary programme for 2010.

Persistently high rupee liquidity was a challenge in conducting monetary policy in 2010. Mainly as a result of foreign capital inflows to both the government and the private sector and subsequent purchases by the Central Bank, the money market continued to have excess liquidity in 2010. Hence, the Central Bank continued to absorb the excess liquidity through open market operations in order to ensure that interest rates remain stable and that reserve money would remain at targeted levels.

Measures being taken by the Central Bank to strengthen financial system stability, meanwhile, will enhance monetary policy transmission in the years ahead. As has been the case with central banks the world over in the period following the recent global financial crisis, the Central Bank of Sri Lanka too has taken steps to strengthen regulation of financial institutions operating in the country, their governance as well as the legal framework within which they operate. These measures, while helping to strengthen financial system stability, are also likely to help stabilise economic activity along business cycles, and thereby help prevent sharp fluctuations in credit conditions including market interest rates, over time, which in turn, would help enhance economic stability. Recent fiscal measures relating to financial services, including those aimed at facilitating long-term funding of viable economic activity, meanwhile, would raise the effectiveness of financial intermediaries, improve monetary policy transmission as well as complement other policy measures adopted by the government to accelerate economic development and remove supply bottlenecks, thereby helping reduce supply side pressures on prices. The recent exchange control liberalisation by the Central Bank would also further enhance resource availability for domestic economic activity, by enabling the private sector to raise funds in international markets. More diverse sources of financing would also promote deepening of domestic financial markets.

7.2 Monetary Policy

The Central Bank of Sri Lanka continued to operate within a monetary targeting framework in conducting monetary policy. Accordingly, broad money (M_{2b}) continued to be the intermediate target for monetary policy while reserve money, which is linked to broad money through a multiplier, remained the Bank's operating target for monetary policy. In implementing monetary policy, the policy rate corridor formed by the Repurchase rate and the Reverse Repurchase rate was the primary monetary policy instrument used by the Bank to signal its monetary policy stance and maintain stability in short-term interest rates at an appropriate level within the corridor by conducting open market operations (OMO), in order to achieve monetary policy targets. Further, the statutory reserve ratio (SRR) applicable to all rupee deposit liabilities of commercial banks was maintained at 7 per cent since early 2009, as this level was considered compatible with the Bank's monetary policy stance. Moral suasion meanwhile, was used to encourage

Table 7.1 Recent Monetary Policy Measures (2007-2010)

Per cent per annum

Date	Repurchase Rate	Reverse Repurchase Rate	Statutory Reserve Ratio (a)	Penal Rate on Reverse Repos
23 February 2007	10.50	12.00	-	-
21 November 2007	-	-	-	19.00 (b)
13 October 2008	-	-	9.25 (c)	-
25 November 2008	-	-	7.75 (d)	-
12 January 2009	-	-	-	17.00
11 February 2009	10.25	11.75	-	16.50
24 February 2009	-	-	7.00 (e)	-
18 March 2009	-	-	-	14.75
22 April 2009	9.00	-	-	13.00
21 May 2009	-	11.50	-	Removed
16 June 2009	8.50	11.00	-	
11 September 2009	8.00 (f)	10.50 (f)	-	
18 November 2009	7.50	9.75	-	
09 July 2010	7.25 (f)	9.50 (f)	-	
20 August 2010	-	9.00	-	

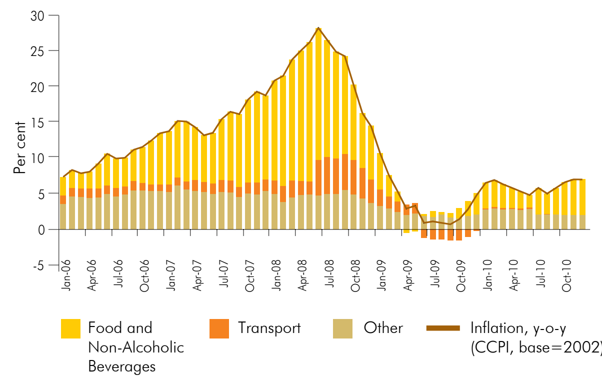
Source: Central Bank of Sri Lanka

(a) To be maintained as a percentage of rupee deposit liabilities.
(b) Effective from 03 December 2007.
(c) Effective from the reserve week commencing 17 October 2008.
(d) Effective from the reserve week commencing 28 November 2008.
(e) Effective from the reserve week commencing 27 February 2009.
(f) Effective from the close of business.

banks to fall in line with policy rate adjustments by reducing their lending rates and extending credit to the private sector. The Bank's monetary operations continued to be guided by its monetary programme, which is prepared taking into account the projected key macroeconomic developments.

The Bank's monetary programme was initially prepared stipulating the targets for annual average growth of broad money and reserve money at 14.5 per cent each. Subsequently, the Central Bank revised the monetary programme for the year taking into account several new developments. Projections pointed to a higher rate of growth of economic activity in 2010 than originally expected. The need to include information from the national budget for 2010, which was presented to the Parliament in June 2010, also necessitated a revision to the monetary programme. Accordingly, the targeted growth of broad money in 2010 was revised upward to 15 per cent in July 2010. Meanwhile, a notable increase in the 'currency held by the public' component within the money supply, particularly in view of the restoration of economic activity in the Northern and Eastern provinces, led to an increase in the currency to deposit ratio, in turn leading to a decline in the money multiplier. Taking into account this development, the target for year-on-year growth of daily average reserve money was raised to 21.2 per cent, in July 2010, parallel to the upward revision to the targeted level of broad money.

Chart 7.1 Inflation and Contribution to Inflation from Key Categories



Following the favourable price developments in 2009, inflation was broadly stable in 2010. Inflation, as measured by the year-on-year change in the Colombo Consumers' Price Index (base=2002) was at 6.9 per cent by end 2010, in comparison to 4.8 per cent a year earlier. Annual average inflation increased gradually during the year to reach 5.9 per cent by year-end from 3.4 per cent in the previous year. While there were no signs of significant demand pressures in the economy, the favourable supply-side developments helped contain inflationary pressures in the economy.

Table 7.2 Developments in Monetary Aggregates

Rs. billion

Item	End 2009	End 2010 (a)	Change 2009 Amount	Change 2009 %	Change 2010 Amount	Change 2010 %
1. Currency Outstanding	217.4	255.7	31.3	16.8	38.2	17.6
1.1 Currency held by the Public	181.8	216.5	26.8	17.3	34.7	19.1
1.2 Currency with Commercial Banks	35.6	39.1	4.5	14.5	3.5	9.9
2. Commercial Banks' Deposits with the Central Bank	86.1	104.9	3.8	4.6	18.8	21.8
3. Government Agencies' Deposits with the Central Bank	…	…	…	…	…	…
4. Reserve Money (1+2+3)	**303.5**	**360.5**	**35.1**	**13.1**	**57.0**	**18.8**
5. Demand Deposits held by the Public with Commercial Banks	154.9	190.6	32.6	26.6	35.8	23.1
6. Narrow Money Supply, M_1 (1.1+5)	**336.7**	**407.2**	**59.4**	**21.4**	**70.5**	**20.9**
7. Time and Savings Deposits held by the Public with Commercial Banks	1,200.0	1,405.8	195.2	19.4	205.8	17.1
8. Broad Money Supply, M_2 (6+7)	**1,536.8**	**1,813.0**	**254.6**	**19.9**	**276.2**	**18.0**
9. Foreign Currency Deposits (b)	269.4	278.4	28.8	12.0	9.0	3.3
10. Consolidated Broad Money Supply, M_{2b} (8+9)	**1,806.2**	**2,091.4**	**283.4**	**18.6**	**285.2**	**15.8**
Money Multiplier, M_{2b}	**5.95**	**5.80**				
Velocity, M_{2b} (c)	**2.90**	**2.92**				

(a) Provisional
(b) Includes deposits of resident category of Offshore Banking Units and a part of foreign currency deposits with Domestic Banking Units.
(c) During the year

Source: Central Bank of Sri Lanka

BOX 14

Strengthening the Framework for Monetary Policy

The Central Bank of Sri Lanka has conducted its monetary policy within a monetary targeting framework since the 1980s. While demand for money in Sri Lanka has remained broadly stable[1], broad money aggregates computed for Sri Lanka help predict domestic inflation. Hence, the Bank has been able to continue its monetary operations within a monetary targeting framework. Accordingly, the Bank attempts to achieve price stability, the final objective of monetary policy, by guiding reserve money, its operational target, along a path that is compatible with the targeted growth of broad money, the intermediate target for monetary policy. The monetary programme, which guides the Bank's monetary policy, sets out the annual targets for broad money and reserve money. The target for broad money is determined on the basis of the projected growth of economic activity and a desirable rate of increase in the general price level, as measured by the GDP deflator. The target for reserve money is thereafter derived on the basis of the projected money multiplier for the period under consideration. This framework has served the Bank well in its endeavour to secure price stability, particularly as the Bank has continued to take measures to strengthen its operations within this policy framework.

In an economy undergoing significant changes, monetary policy responses to price developments would need to be carefully calibrated. The implications of expected economic developments for domestic prices need to be taken into consideration in formulating monetary policy. The implications of expected developments in the economy for monetary policy transmission, including the relative effectiveness of different channels of monetary policy transmission, also need to be given due consideration in formulating monetary policy. In view of these considerations, the approach to monetary policy formulation has been further strengthened, taking two perspectives into account. The Bank now carries out more in-depth analyses of economic and monetary developments in order to ensure that relevant information is taken into consideration in analysing risks to price stability.

Economic Analysis

The Bank's economic analysis includes an analysis of macroeconomic developments as well as an analysis of developments in the financial sector. Accordingly, a more detailed analysis of the output gap would be undertaken by the Bank. In this regard, the contributory factors in shifts in the potential output would be carefully analysed. Accordingly, developments in the labour market, trends in external demand for different types of goods and services, capacity utilisation in existing industries, the potential of emerging industries as well as the catalytic role played by infrastructure being built or to be built in the ensuing period would be analysed. A comprehensive analysis of the financial sector, meanwhile, would enable the Bank to deduct the implications of emerging trends highlighted by macro-prudential indicators in relation to diverse aspects of financial system stability including capital adequacy, liquidity, profitability and solvency. Further, an analysis of trends in asset prices would help identify market expectations in relation to domestic prices and the value of the Sri Lanka rupee vis-à-vis other currencies, in addition to highlighting potential risks to economic stability. The Bank will also carry out a broader analysis of conditions in domestic as well as international markets with a view to identifying emerging price pressures either due to evolving supply-side developments or due to inbuilt structural weaknesses.

The domestic economy may also be subject to unforeseen supply-side shocks from time to time. For example, the recent volatility in the international prices of petroleum products due to natural calamities and geo-political tensions in some parts of Africa and the Middle East, if protracted, could impact upon domestic prices. The country may also face supply side shocks that originate domestically. For example, the recent floods that devastated crops resulted in significant increases in vegetable prices. Circumstances arising from supply side shocks such as these would need to be managed primarily through supply-side measures. However, if second round effects are witnessed in prices due to such shocks, the Central Bank would

[1] If the velocity with which money changes hands in the economy remains broadly stable, that indicates stability of demand for money balances. Demand for real money balances (real money balances are derived by adjusting nominal money balances so as to remove the effect of inflation) generally depends on i) the level of economic activity, as reflected by the real gross domestic product, as money is required to carry out various transactions; and ii) the opportunity cost of holding money, which could be approximated by a representative market interest rate adjusted for expected inflation.

need to take monetary policy action. Hence, the economic analysis would also include an analysis of the implications of supply-side shocks.

Monetary Analysis

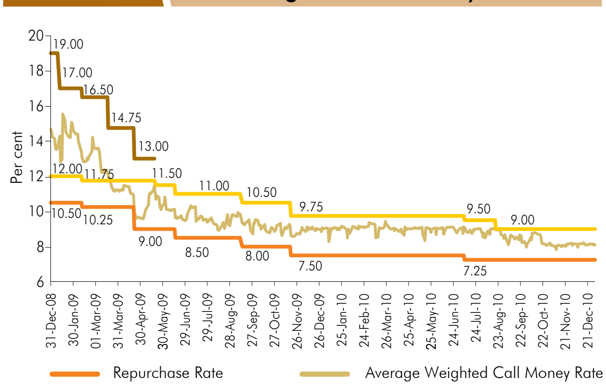
Alongside the analysis of economic developments, the Bank will continue to carry out an analysis of monetary developments, with a short-to-medium-term focus, in order to identify pervasive risks to price stability. Trends in measures of the money supply and their components, help gauge aggregate demand. In Sri Lanka, M_{2b}, that is, broad money, which includes currency held by the public and deposits held by the public with commercial banks, is the measure of money that is used for monetary policy purposes. While M_{2b} is also calculated from the perspective of sources of money, an analysis of trends in net foreign assets, net credit obtained by the government from the banking system, and credit granted to the private sector by the banking system, which comprise broad money (M_{2b}), help identify sources of a potential build-up of demand pressures. A further disaggregation of these monetary aggregates helps identify evolving economic trends as well as emerging demand pressures in different sectors of the economy. Given that prices respond to monetary policy with time lags which are variable depending on the prevailing macroeconomic conditions, the monetary analysis plays a vital role in monetary policy formulation. Trends in monetary aggregates help identify early, emerging demand pressures in the economy.

Conclusion

In formulating monetary policy, the broader and more in-depth analyses of economic and monetary developments help the Bank organise, evaluate and cross-check information and examine the inter-play of demand and supply side factors. This process would, in turn, strengthen the Bank's monetary policy formulation.

The Bank reduced the policy interest rates in the second half of 2010 with a view to spurring the growth of credit to support economic activity. The Bank reduced both the Repurchase rate and the Reverse Repurchase rate by 25 basis points in July while the Reverse Repurchase rate was reduced by a further 50 basis points in August. Following these changes, the policy interest rate corridor of the Central Bank narrowed and by the end of the year 2010, the Repurchase rate was at 7.25 per cent while the Reverse Repurchase rate was 9.00 per cent.

Chart 7.2 Policy Interest Rates and the Average Weighted Call Money Rate



Money market liquidity has continued to be in excess in 2010 and the Central Bank continued with its efforts to manage market liquidity so as to stabilise interest rates and maintain reserve money along the targeted path. Following a turnaround in the liquidity position in the domestic money market around mid-2009, the money market continued to experience an excess liquidity position throughout 2010. The build-up of excess liquidity was largely due to the absorption of foreign exchange inflows to the country by the Central Bank, with a view to preventing undue appreciation of the rupee. Considering the importance of managing market liquidity and maintaining money market interest rates at an appropriate level, to curb potential future inflation, the Central Bank employed several instruments to absorb the excess liquidity. As the stock of government securities held by the Central Bank depleted, the Bank issued its own securities to absorb liquidity on overnight and term bases. The remaining government securities were utilised to enter into overnight repurchase agreements with commercial banks and primary dealers, that is, institutions participating in the monetary operations of the Central Bank. Foreign exchange swap agreements, adopted under OMO in 2009, were also utilised to absorb a part of the excess liquidity. In October 2010, the Central Bank implemented a bond-borrowing programme and the borrowed bonds were used in the Bank's OMO during the last three months of the year. Meanwhile, from 20 October 2010, the overnight and term auctions under OMO were discontinued as the primary market yield on three-month Treasury bills declined to levels below the Bank's Repurchase rate, an outcome of intense competition among banks with a large volume of excess liquidity to acquire short-term government securities to manage their portfolios. Subsequent to the suspension of OMO auctions, the excess money market liquidity has continued to be placed with the Central Bank through its standing facility.

The Central Bank views its communication with the general public as an essential aspect of implementing monetary policy successfully. The continued dialogue with key stakeholders in formulating monetary policy, and coherently conveying to the public the rationale for the Bank's policy actions help bridge the gap between the expectations of the Central Bank and the expectations of the public. Towards this end, the Central Bank has continued to publish its strategies for the upcoming year as well as the medium term at the beginning of each year, in its *Road Map*. Policy decisions in relation to monetary policy continued to be communicated through regular press releases. The general public is also continually updated on policies and strategies of the Central Bank through statutory and other publications of the Central Bank including its *Annual Report* and the *Recent Economic Developments*. Further, the Bank is represented at various fora at which the Bank's officers update members of the public on economic developments and their implications for monetary policy. During the year, the Central Bank also engaged in regular policy dialogue with its Monetary Policy Consultative Committee to benefit from views and perceptions of a cross-section of the private sector and academia.

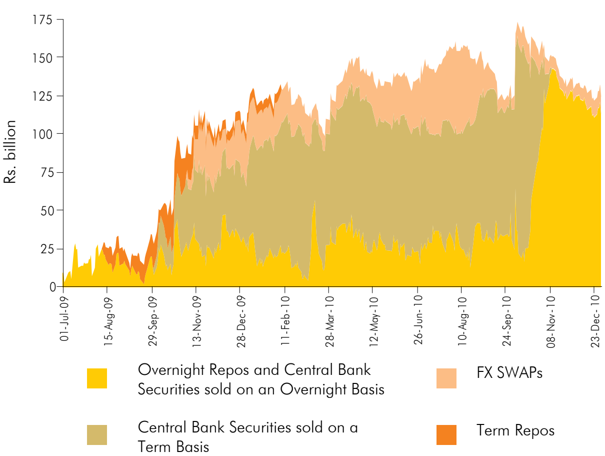
7.3 Developments in Money and Credit

Money Market Liquidity

Rupee liquidity in the domestic money market was in surplus throughout the year. The issue of a sovereign bond worth US dollars one billion in October at the international capital market and the sale of a part of the funds thus raised to the Central Bank by the government, so as to be able to settle some of its rupee liabilities to commercial banks, resulted in an increase in rupee liquidity in the market. During the first three quarters of the year, net inflows of foreign funds to both the government and the private sector, including net foreign investments in Treasury bonds and Treasury bills resulted in an excess of foreign exchange in the domestic foreign exchange market, which the Central Bank purchased to prevent any undue appreciation of the rupee. During the last quarter of the year however, the Bank sold foreign exchange to the market, mainly to facilitate the settlement of bills relating to oil imports. Hence, for the year 2010 as a whole, the Bank was a net supplier of foreign exchange to the market, thereby absorbing some liquidity. Meanwhile, there have been occasional purchases of Treasury bills in the primary market by the Central Bank, while the Central Bank transferred its profits to the government, which also added some liquidity to the money market. By end 2010, the overall excess liquidity in the money market amounted to Rs. 124.3 billion compared to Rs. 105.6 billion at end 2009.

The Central Bank absorbed the excess market liquidity employing a range of instruments. In addition to repurchase agreements on an overnight basis, with Treasury bills serving as the underlying security, in conducting OMO, the Bank used its own securities extensively to mop up excess liquidity on both overnight and term bases. The Bank's own securities were used in OMO as the amount of government securities held by the Bank was limited. Accordingly, permanent

Chart 7.3 Excess Money Market Liquidity absorbed through OMO



absorption of liquidity through the sale of government securities was also minimal, totalling Rs. 13.25 billion in 2010. Foreign exchange swap transactions (FX SWAP transactions) were also continued by the Bank to absorb excess liquidity in the money market on a term basis. Meanwhile, government securities borrowed by the Bank under the bond-borrowing programme were also used for the purpose of absorbing excess market liquidity, given the relatively lower absorption cost involved.

As the yields on Treasury bills with a short-term maturity of three months in the primary market fell to levels below the Central Bank's Repurchase rate by October, the conduct of OMO repo auctions as well as auctions for the sale of Central Bank securities, were discontinued from the 20th of October. Since then, participating institutions continue to place their excess funds with the Central Bank through its standing facility, at the Bank's Repurchase rate.

Reserve Money

Year-on-year growth of daily average reserve money in 2010 was at a level consistent with the target stipulated in the monetary programme revised in July 2010 following revisions to key underlying assumptions. In the first few months of the year, currency in circulation increased by a substantially higher rate than in the corresponding months of the previous years, thereby causing reserve money to expand at a higher rate than initially projected. This phenomenon was attributed to the increased transactions demand for money in the domestic economy along with the pick-up in economic activity, particularly in the Northern and Eastern provinces, following the end to the conflict. The result of the higher than expected increase in currency in circulation was a decline in the money multiplier. In July 2010 therefore, the monetary programme was revised, taking into consideration the higher than expected expansion in economic activity and the unexpected decline in the money multiplier, setting the target for year-on-year growth of daily average reserve money at 21.2 per cent. It was observed that the growth of reserve money moved close to the targeted path in the revised monetary programme during the second half of the year, enabling the Bank to achieve its target for reserve money despite the substantially higher annual average growth of currency at about 24 per cent, in 2010.

Viewed from the source side, the expansion of reserve money during the year 2010 was entirely due to an increase in Net Foreign Assets (NFA) of the Central Bank. NFA expanded mainly as the government used a part of the funds (US dollars 492 million) it raised by issuing a sovereign bond in international markets to retire Treasury bills held by the Bank amounting to Rs. 55 billion and sold a further US dollars 386 million thus raised to the Central Bank, which enabled it to settle some of its liabilities to commercial banks. During the year, NFA of the Central Bank expanded by about Rs. 93 billion. Net Domestic Assets (NDA) of the Central Bank decreased by about Rs.36 billion in 2010, which reflected largely the retirement of Treasury bills held by the Bank. Government securities on the Bank's balance sheet decreased from around Rs. 37.5 billion at end 2009 to about Rs. 2 billion by end 2010. Following these developments, reserve money amounted to Rs. 360.5 billion by end 2010, compared to Rs. 303.5 billion at end 2009.

Narrow Money (M_1)

The narrow money supply increased further in 2010 following its increasing trend from the second half of 2009, reflecting the recovery and subsequent expansion of economic activity. Narrow money (M_1), which consists of currency and demand deposits held by the public, recorded a 20.9 per cent growth in 2010 in comparison to the growth of 21.4 per cent in 2009. The high growth of M_1 could be attributed to the expansion of economic activity. Partly reflecting the relatively higher transactions demand for money in the Northern and Eastern provinces of the country, currency held by the public increased by 19.1 per cent during the year, a higher rate when compared with the 17.3 per cent growth in 2009. Demand deposits held by the public also grew by 23.1 per cent in 2010 as against the growth of 26.6 per cent recorded in 2009.

Broad Money (M_{2b})

Annual average growth of broad money (M_{2b}) was 15.3 per cent in 2010, thus remaining consistent with the targeted growth of 15 per cent. By end-December 2010, M_{2b} recorded a year-on-year growth of 15.8 per cent. On the use side, the growth of broad money was reflected in the increases in both currency held by the public as well as deposits, particularly demand deposits. Interest bearing deposits, that is, savings and time deposits (quasi money) held by the public with commercial banks increased at a slower pace than in 2009. Quasi money with commercial banks grew by 14.6, year-on-year, in 2010, compared to the growth of 18.0 per cent in 2009.

On the source side, the expansion of broad money was driven mainly by the expansion of credit obtained by the private sector from commercial banks. Credit granted to the private

Chart 7.4 Growth of Monetary Aggregates

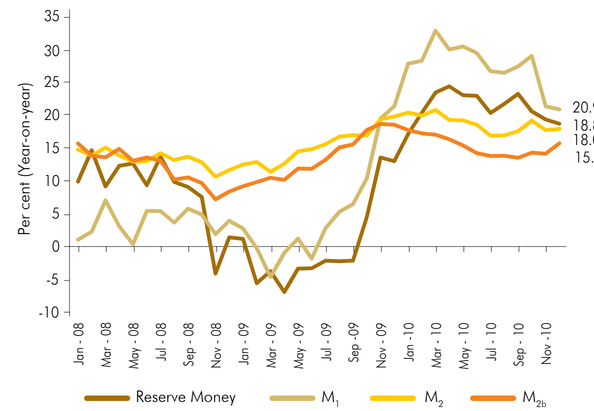


Table 7.3 Sources of Reserve Money and Broad Money (M_{2b}) (Computed as per the Monetary Survey)

Rs. billion

Item	End 2009 (a)	End 2010 (b)	Change 2009 Amount	Change 2009 %	Change 2010 Amount	Change 2010 %
Reserve Money	**303.5**	**360.5**	**35.1**	**13.1**	**57.0**	**18.8**
Net Foreign Assets of the Central Bank	412.2	505.5	264.0	178.2	93.3	22.6
Net Domestic Assets of the Central Bank	-108.7	-145.0	-228.9	-190.4	-36.3	-33.4
Broad Money (M_{2b})	**1,806.2**	**2,091.4**	**283.4**	**18.6**	**285.2**	**15.8**
Net Foreign Assets	401.9	377.4	324.2	417.2	-24.4	-6.1
Monetary Authorities	412.2	505.5	264.0	178.2	93.3	22.6
Commercial Banks	-10.3	-128.0	60.1	85.3	-117.7	-1,140.2
Net Domestic Assets	1,404.3	1,714.0	-40.8	-2.8	309.7	22.1
Domestic Credit	1,907.7	2,262.9	10.2	0.5	355.1	18.6
Net Credit to the Government	640.3	627.2	57.4	9.9	-13.1	-2.1
Central Bank	109.0	76.9	-108.3	-49.8	-32.1	-29.5
Commercial Banks	531.3	550.3	165.8	45.3	19.0	3.6
Credit to Public Corporations	73.2	141.5	26.2	55.8	68.3	93.2
Credit to the Private Sector	1,194.2	1,494.2	-73.4	-5.8	300.0	25.1
Other Items (net)	-503.5	-548.9	-51.0	-11.3	-45.4	-9.0

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

sector, which contracted in 2009 with the downturn in economic activity, expanded at a rapid rate during the second half of 2010, making the largest contribution to the growth of broad money in 2010, in the face of the negative contribution made by NFA of the banking system to broad money expansion.

NFA of commercial banks accounted entirely for the contraction of NFA of the banking system to Rs. 377.4 billion by end-2010, a contraction of around Rs. 24 billion compared to the previous year. The diminution in NFA of commercial banks was partly a result of the decline in placements overseas by commercial banks, along with an increase in their investments in Sri Lanka Development Bonds (SLDBs) during the year. Contributing to this decline was the foreign currency borrowings by the Ceylon Petroleum Corporation (CPC) from commercial banks to settle its oil import bills. The Central Bank was a net supplier of foreign exchange to the domestic foreign exchange market in 2010, as it made net sales of foreign exchange particularly in the last quarter of the year. However, NFA of the Central Bank improved during the year, following the purchase of foreign currency receipts by the government.

NDA of the banking system increased significantly when compared with the previous year, along with notable increases in credit granted to the private sector as well as public corporations. Following negative year-on-year growth during the first quarter of 2010, credit flows to the private sector rebounded strongly during the rest of the year and recorded a year-on-year growth of 25.1 per cent by December. In absolute terms, credit granted by commercial banks to the private sector increased by around Rs. 300 billion during the year. Domestic Banking Units (DBUs) accounted for the bulk of this increase, while the contribution of the Offshore Banking Units (OBUs) was trivial. The reduction of lending rates by commercial banks, following the downward revision to policy rates twice during the year, along with factors such as improved post-conflict economic conditions in the country, enhanced business confidence among entrepreneurs and the recovery under way in the global economy helped spur credit flows to the private sector. Furthermore, the aforementioned factors are likely to have helped ease the heightened risk averseness observed among commercial banks during the previous year, thus encouraging lending activities.

Net credit granted to the government (NCG) by the banking system during the year 2010 took on a negative value of around Rs. 13 billion, although it was expected that NCG would be around Rs. 45 billion in 2010, as per the national budget for 2010. Relatively lower claims of commercial banks on the government in 2010 partly on account of the settlement of a part of the liabilities of the

Table 7.4 Sectoral Distribution of Loans and Advances granted by Commercial Banks (a)(b)

Rs. billion

Category	End 2009	End 2010(c)	% Share 2010	% Change 2010
Agriculture and Fishing	**154.0**	**216.8**	**14.3**	**40.8**
of which, Tea	34.3	45.5	3.0	32.4
Rubber	10.4	14.4	0.9	38.1
Coconut	2.3	4.7	0.3	103.6
Paddy	6.9	13.8	0.9	99.5
Vegetable and Fruit Cultivation, and Minor Food Crops	5.6	6.9	0.5	21.8
Fisheries	2.9	4.1	0.3	42.8
Industry	**493.2**	**547.3**	**36.2**	**11.0**
of which, Construction	196.4	234.2	15.5	19.3
Food and Beverages	44.2	31.4	2.1	-28.9
Textiles and Apparel	88.2	85.3	5.6	-3.2
Fabricated Metal Products, Machinery and Transport Equipment	33.4	41.8	2.8	24.9
Services	**242.9**	**320.4**	**21.2**	**31.9**
of which, Wholesale and Retail Trade	94.1	108.4	7.2	15.2
Tourism	30.2	32.4	2.1	7.2
Financial and Business Services	39.0	65.8	4.4	68.5
Shipping, Aviation and Supply, and Freight Forwarding	8.5	11.7	0.8	37.4
Personal Loans and Advances (d)	**302.5**	**404.6**	**26.7**	**33.7**
of which, Consumer Durables	34.2	35.2	2.3	3.0
Pawning	111.0	166.3	11.0	49.9
Safety Net Scheme Related (e.g., Samurdhi)	**15.9**	**23.4**	**1.5**	**47.7**
Total	**1,208.4**	**1,512.5**	**100.0**	**25.2**

(a) Includes loans and advances of Offshore Banking Units.
(b) Loans and advances include overdrafts and bills discounted and exclude cash items in the process of collection.
(c) Provisional
(d) Excludes personal housing loans classified under 'Construction'.

Source: Central Bank of Sri Lanka

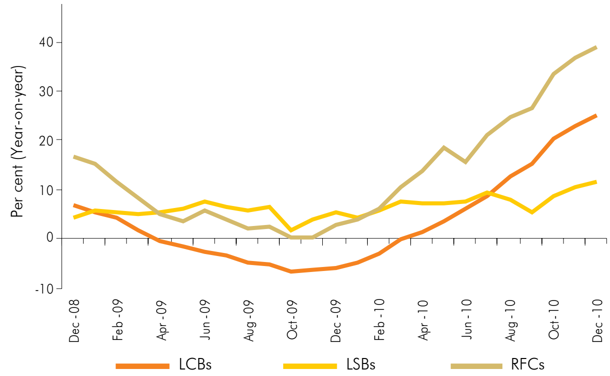
government to commercial banks using proceeds from the sovereign bond, the retirement of a large portion of the Treasury bills held by the Central Bank, as well as an increase in the balances of a government-held deposit in a commercial bank following the receipt of proceeds from the sale of a plot of land for a hotel project, resulted in NCG taking on a negative value by the end of the year. While NCG from the Central Bank decreased by around Rs. 32 billion during the year, NCG from commercial banks increased by around Rs.19 billion with DBUs increasing their holdings of Treasury bills, and also with an increase in the overdraft facilities extended to the government. OBUs of commercial banks meanwhile, also contributed to the increase in NCG by commercial banks, by increasing their holding of SLDBs.

Credit granted to public corporations increased during the year, thereby contributing to the monetary expansion in 2010. Credit obtained by public corporations increased from around Rs.73 billion at end 2009 to around Rs.141 billion by end December 2010. Credit granted by OBUs mainly accounted for this increase, on account of credit granted to the Ceylon Petroleum Corporation (CPC).

Broad Money (M_4)

Growth of broad money (M_4), computed on the basis of the financial survey, decelerated during 2010, up to November, before picking up somewhat in December. Year-on-year growth of M_4, which was 18.8 per cent in December 2009,

Chart 7.5 Growth of Credit granted to the Private Sector by LCBs, LSBs and RFCs



declined to 14.3 per cent by November 2010 and thereafter picked up, to 15.6 per cent in December. Given the decline in NFA of the banking system, this growth was entirely due to an increase in the NDA of the banking system and Registered Finance Companies (RFCs), on account of an increase in their claims on both the private sector and the government. Credit granted to the private sector increased rapidly during the second half of 2010, following a period of negative growth from May 2009 to February 2010. Year-on-year growth of credit granted to the private sector increased to 24.3 per cent by end 2010 from the negative growth of 3.7 per cent recorded at end 2009. Credit extended by RFCs to the private sector increased notably during 2010, contributing to about 13 per cent of the year-on-year increase in M_4. Claims of Licensed Specialised Banks (LSBs) on the government meanwhile, accounted for about 9 per cent of the year-on-year increase in M_4.

Table 7.5 Sources of Broad Money (M_4) (Computed as per the Financial Survey)

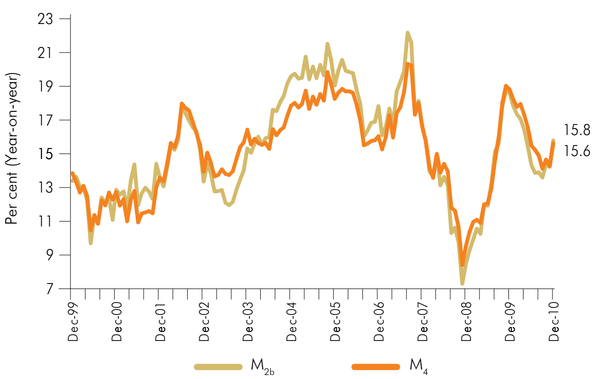
Rs. billion

Item	End 2009(a)	End 2010(b)	Change 2009 Amount	Change 2009 %	Change 2010 Amount	Change 2010 %
Broad Money (M_4)	**2,280.0**	**2,636.0**	**361.3**	**18.8**	**356.0**	**15.6**
Net Foreign Assets	378.1	354.5	322.0	573.0	-23.6	-6.2
Net Domestic Assets	1,901.8	2,282.0	39.3	2.1	380.1	20.0
Domestic Credit	2,513.9	2,973.9	84.5	3.5	460.0	18.3
Net Credit to the Government	911.5	932.4	116.9	14.7	20.9	2.3
Credit to Public Corporations	73.2	141.5	26.2	55.8	68.3	93.2
Credit to the Private Sector	1,529.1	1,900.0	-58.7	-3.7	370.9	24.3
Other Items (net)	-612.1	-691.9	-45.1	-8.0	-79.9	-13.1

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

Chart 7.6 Growth of Broad Money



Viewed from the use side, it is observed that savings and time deposits of the public held with RFCs expanded at a high rate of around 22 per cent, year-on-year, by December 2010. With respect to LSBs, there was a gradual deceleration in the expansion of deposits, in 2010. Deposits held by the public with LSBs recorded an increase of 13.5 per cent, year-on-year, by December 2010, whereas by end 2009, the increase recorded was 20.2 per cent.

7.4 Interest Rates

Market interest rates adjusted downwards in 2010 in response to the easing of the Central Bank's monetary policy stance. Following the significant downward adjustment of its policy rates in 2009, the Bank relaxed its monetary policy stance further in July and August 2010, with a view to providing further impetus to reviving economic activity. The Repurchase rate and the Reverse Repurchase rate were reduced by 25 basis points each in July 2010. The Reverse Repurchase rate was reduced by a further 50 basis points in August 2010. In turn, benchmark yield rates on Treasury bills adjusted downwards, leading other market interest rates on a downward sloping path.

Money Market Rates

Inter-bank rates declined in 2010, having responded positively to the reduction of policy interest rates by the Central Bank. During the year, the average weighted call money rate (AWCMR) continued to hover around the middle of the policy interest rate corridor, thus contributing to the effective transmission of monetary policy. The Sri Lanka Inter-Bank Offered Rates (SLIBOR), which reflect the rates offered by commercial banks when borrowing in the inter-bank call money market, moved parallel to the call money market rates.

As there was excess liquidity in the money market, the average weighted yield rate at the daily OMO repo auctions of the Central Bank remained closer to the lower bound of the policy rate corridor of the Central Bank until these auctions were discontinued in October 2010. It was at 7.68 per cent at the last auction held on 19 October 2010. Auctions under OMO to absorb excess market liquidity were discontinued from 20 October 2010 as it was observed that, by then, the primary market yields on 91-day Treasury bills had declined to a level below the Bank`s Repurchase rate. Since then, commercial banks have placed their excess liquidity with the Central Bank through its standing facility at the Bank's Repurchase rate.

Several auctions were held under open market operations for the outright sale of Treasury bills during the first ten months of the year 2010, to absorb excess liquidity on a permanent basis, while auctions for the sale of Central Bank securities with term maturities were also continued during this period. At the last OMO auction for the outright sale of Treasury bills, held on 12 October 2010, Treasury bills amounting to Rs. 1 billion with a remaining maturity of 16 days were auctioned. At this auction, the weighted average yield rate determined was 7.85 per cent. The last OMO auction for the sale of Central Bank securities with a term maturity was

Table 7.6 Selected Money Market Rates

Per cent per annum

Period	Weighted Average Repo Auction Rate	Average Weighted Call Money Rate		SLIBOR-Overnight	
		End Period	Average for the Month	End Period	Average for the Month
Dec-08	10.96	14.66	15.13	13.74	15.57
Dec-09	8.24	9.07	9.00	9.03	9.10
Mar-10	8.13	9.05	9.13	9.07	9.15
Jun-10	8.18	8.89	9.00	9.07	9.06
Sep-10	7.86	7.97	8.41	8.80	8.83
Dec-10	- (a)	8.03	8.13	8.15	8.17

(a) CBSL discontinued Repo auctions from 20 October 2010.

Source: Central Bank of Sri Lanka

held on 13 October 2010. While Central Bank securities amounting to Rs. 4.1 billion, with a maturity of 28 days were auctioned, the average weighted yield rate determined at this auction was 7.96 per cent (8.84 per cent with tax).

FX SWAPs continued to be an instrument used by the Central Bank for mopping up excess money market liquidity, following their introduction in November 2009. FX SWAPs outstanding by end 2010 amounted to Rs. 4.4 billion. On a weighted average basis, the swap cost payable by the Central Bank on the last FX SWAP transaction done in December 2010 was 15 basis points, in comparison to the weighted average swap cost of 50 basis points incurred in January 2010.

Yield Rates on Government Securities

Following the easing of the Central Bank's monetary policy stance, benchmark yields on government securities declined during the year 2010, although there was some increase in the yield rates during the first four months of the year. The primary market yields on 91-day, 182-day and 364-day Treasury bills were 7.24 per cent, 7.35 per cent, and 7.55 per cent, respectively, by the end of the year, having declined by 49 basis points, 138 basis points and 178 basis points, respectively, during the year.

Chart 7.7 Secondary Market Yield Curve for Government Securities

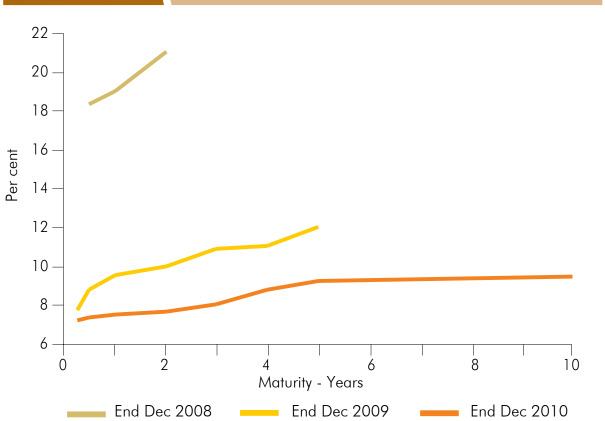


Table 7.7 Yield Rates on Government Securities

Per cent per annum

Instrument	End 2009	End 2010
Primary Market		
Treasury Bills		
91 days	7.73	7.24
182 days	8.73	7.35
364 days	9.33	7.55
Treasury Bonds		
2 years	9.55	8.27(a)
3 years	12.83 (b)	8.15
4 years	9.78	8.60
Rupee Securities	12.60 (c)	-
Secondary Market		
Treasury Bills		
91 days	7.78	7.26
182 days	8.78	7.36
364 days	9.58	7.55
Treasury Bonds		
2 years	10.00	7.65
3 years	10.88	8.03
4 years	11.08	8.78

Source: Central Bank of Sri Lanka

(a) The last auction for 2-year Treasury Bonds was held in August 2010.
(b) The last auction for 3-year Treasury Bonds was held in July 2009.
(c) Rupee Securities issued in March 2009.

Yield rates pertaining to government securities with longer maturities also displayed a declining trend in 2010. The primary market yield on 2-year Treasury bonds declined from 9.55 per cent at end 2009 to 8.27 per cent by end 2010. Similar movements were seen in yield rates pertaining to Treasury bonds of other maturities as well. Treasury bonds with long-term maturities of nine and ten years were also issued during the second half of 2010. The average weighted yield on 10-year Treasury bonds issued on 13 September 2010 was 9.30 per cent.

The secondary market yield curve for government securities, whilst shifting downward, extended to longer maturities in 2010. Secondary market yields on government securities, which were in a range of 7.78 per cent to 12.07 per cent at the beginning of the year, decreased significantly to a range of 7.26 per cent to 9.45 per cent by end 2010. This downward shift in the rate structure can be attributed to the relaxation of the monetary policy stance of the Central Bank, the continued excess liquidity in the money market as well as the benign outlook for inflation that prevailed.

Deposit and Lending Rates

Commercial banks reduced their deposit rates gradually during the year 2010 in response to the easing of the monetary policy stance by the Central Bank. The average weighted deposit rate (AWDR), which reflects the movement of interest rates pertaining to all interest bearing deposits held by the public with commercial banks, declined by 178 basis points during the year, that is, from 8.01 per cent in December 2009 to 6.23 per cent in December 2010. A sharp decline was witnessed in the average weighted fixed deposit rate (AWFDR) in 2010, which is computed in respect of fixed deposits maintained by the public with commercial banks. The AWFDR declined by 271 basis points during the year, that is, from 10.91 per cent in December 2009 to 8.20 per cent in December 2010.

The Legal Rate and the Market Rate, which are determined by the Monetary Board and published in the Government Gazette at the end of each year, reflected the decline in market interest rates[1]. The Legal Rate and the Market Rate applicable for the year 2011 are 7.26 per cent, each. As they are computed to be equal to the weighted average interest rate applicable to all interest bearing deposits held by the public with commercial banks, during the twelve months immediately preceding, they declined by 407 basis points from the respective rates applicable to the previous year.

As the cost of funds of commercial banks declined, lending rates were also brought down gradually by commercial banks. The average weighted lending rate (AWLR), which reflects the movement of interest rates pertaining to all loans and advances granted by commercial banks to the private sector, declined significantly by 261 basis points to 14.8 per cent by end 2010. The monthly average weighted prime lending rate (AWPR) which reflects the rates applicable to loans and advances granted by commercial banks to their prime customers, declined by 185 basis points to 9.27 per cent by December 2010 from 11.12 per cent in December 2009. The declining trend in the interest

Table 7.8 Deposit and Lending Rates (a)

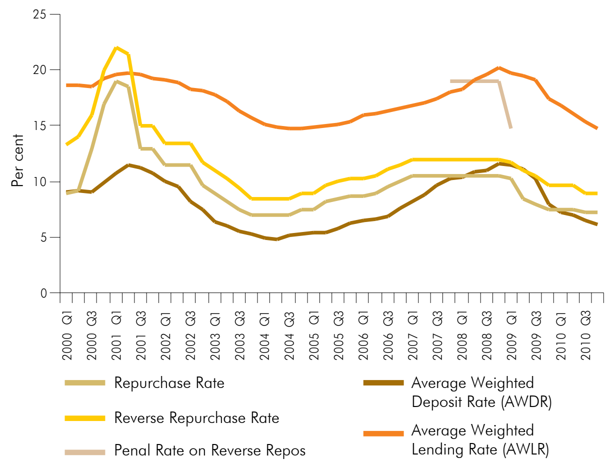
Per cent per annum

Institution	End 2009	End 2010
Commercial Banks		
Interest Rates on Deposits		
One year Fixed Deposits	7.25-19.00	5.05-17.00(b)
Savings Deposits	1.50-10.50	1.50-9.50
Average Weighted Deposit Rate (AWDR)	8.01	6.23
Average Weighted Fixed Deposit Rate (AWFDR)	10.91	8.20
Interest Rates on Lending		
Average Weighted Prime Lending Rate (AWPR)	11.12	9.27
Average Weighted Lending Rate (AWLR)	17.41	14.80
Other Financial Institutions		
Interest Rates on Deposits		
National Savings Bank		
Savings Deposits	5.00	5.00
One year Fixed Deposits	9.50	8.50
State Mortgage and Investment Bank		
One year Fixed Deposits	10.00	8.50
DFCC Bank		
One year Fixed Deposits	9.50	8.50
Interest Rates on Lending		
National Savings Bank (c)	12.00-15.00	11.00-14.00
State Mortgage and Investment Bank (c)	16.50-20.00	12.00-14.00
DFCC Bank	14.00-16.00	9.00-11.50
National Housing Development Authority (c)	11.00	11.00

(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) Lending for housing purposes only.

Source: Central Bank of Sri Lanka

Chart 7.8 Policy Interest Rates and Deposit and Lending Rates of Commercial Banks



1 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 Provision) 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.

rates charged by long-term lending institutions also continued in 2010. Meanwhile, the Central Bank requested all banks to take appropriate measures to reduce interest rates pertaining to housing loans to a level not exceeding 14 per cent, while they were also requested to bring down the penal rates of interest charged on the outstanding balances in respect of credit cards to a level not exceeding 24 per cent, by the end of October 2010.

Interest rates applicable to foreign currency denominated deposits held with commercial banks in 2010 remained at low levels as the low interest rate regimes in the major economies continued. Interest rates applicable to US dollar denominated savings deposits were in a range of 0.1 per cent to 2.66 per cent by end 2010, compared to a range of 0.1 per cent to 2.64 per cent by end 2009. By end 2010, depositors holding US dollar denominated time deposits were paid interest at rates ranging from 0.1 per cent to 5.6 per cent by commercial banks. Corresponding rates were in a range of 0.2 per cent to 5.6 per cent by end 2009.

Yield Rates on Corporate Debt Securities

Debt instruments issued by the corporate sector also carried lower rates of interest in 2010, following the sharp decline in market interest rates during 2009. Accordingly, interest rates pertaining to commercial paper, a short-term debt instrument, also declined. Interest rates pertaining to commercial paper issued by banks during the last quarter of 2010 were in a range of 7.30 - 13.15 per cent. They were in a range of 9.52 - 15.75 per cent during the last quarter of 2009.

There were two listings of corporate debentures in 2010. While these debentures, both with a maturity period of 5 years, were issued in June and October 2010, investors were given several options with regard to the yield from these bonds. The fixed rates of interest, payable annually, pertaining to these two bonds were 11.00 per cent and 11.50 per cent, respectively.

7.5 Future Developments, Challenges and Outlook

Along with accelerated growth and development, aggregate demand would pick up. The Bank's monetary policy therefore, would be designed to hold in check any undue build-up of demand pressures, while facilitating the realisation of the economy's potential.

In the global economy, recent geo-political tensions in some parts of the Middle East and Africa and natural calamities have led to volatility as well as uncertainty with regard to international commodity prices, trade and capital flows. Spill-over effects of these developments on the domestic economy will continue to be closely monitored by the Bank, in order to discern implications for monetary policy, if any.

Continued foreign exchange inflows, while helping the Central Bank to build up a healthy level of foreign currency reserves, have increased domestic money market liquidity to a historic high. While the resultant excess liquidity in the money market provides room for further expansion of private sector credit, persistent excess liquidity could lead to unwarranted interest rate volatility and excessive credit growth, posing a threat to monetary and financial system stability. Hence, the Bank will continue to manage the excess liquidity so as to be able to achieve its monetary targets as well as maintain interest rate stability.

The ongoing fiscal consolidation efforts have created further room for private sector expansion, while impacting favourably on inflation expectations. Crowding out of private investment has become significantly less through both greater availability of credit and lower interest rates. However, the fiscal sector improvements need to be supported and sustained, for fiscal consolidation to have a long-term impact on inflation expectations as well as real activity.

The Central Bank will continue to make further improvements to its framework for monetary policy. At the beginning of 2011, the Bank adopted a more dynamic dual approach to its monetary policy analysis. The Bank now carries out a broader and more in-depth analysis of economic developments parallel to its analysis of monetary developments. With the structural changes that are taking place in the economy, it is imperative that policy decisions are based on expected developments and aimed at influencing expectations. Also, a greater understanding of the impact of monetary policy changes on other sectors of the economy, for example, downward nominal rigidities in wholesale and retail sectors, wage behaviour in formal and informal sectors, working of the wage-price spiral – areas that could directly affect the transmission process – is required. The new approach is expected to supplement the existing monetary targeting framework and strengthen the control over demand driven inflationary pressures.