7

MONETARY POLICY, INTEREST RATES, MONEY AND CREDIT

7.1 Overview

With the objective of maintaining a tight monetary policy stance being realised, the Central Bank signalled an end to the monetary tightening cycle in April 2018, and adjusted to a neutral monetary policy stance during the remainder of the year. Accordingly, in consideration of the favourable developments in inflation, inflation outlook as well as the subpar performance in the real economy, the Central Bank reduced the Standing Lending Facility Rate (SLFR) by 25 basis points to 8.50 per cent in April 2018. In view of the developments in the global economy amidst the continued monetary policy normalisation in the United States and its impact on the stability of the external sector of the economy, the Central Bank maintained a neutral monetary policy stance thereafter. Meanwhile, the large and persistent liquidity deficit in the domestic money market, particularly since September 2018, compelled the Central Bank to inject liquidity on a permanent basis by way of reducing the Statutory Reserve Ratio (SRR) applicable on all rupee deposit liabilities of commercial banks by 1.50 percentage points in mid November 2018. Nevertheless, to neutralise the impact of the SRR reduction and maintain its neutral policy stance, the Central Bank increased the Standing Deposit Facility Rate (SDFR) by 75 basis points and the SLFR by 50 basis points, further narrowing the policy rate corridor. Despite the liquidity injection in November 2018, liquidity deficit in the domestic money market continued to persist at high levels. Accordingly, the Central Bank reduced the SRR by a further 1.00 percentage point to 5.00 per cent with effect from 01 March 2019, while maintaining the SDFR and SLFR unchanged at 8.00 per cent and 9.00 per cent, respectively.

In response to developments in the domestic money market and Open Market Operations (OMOs) of the Central Bank, the Average Weighted Call Money Rate (AWCMR) remained mostly in the middle of the policy rate corridor during the first half of 2018, but AWCMR moved to the upper bound of the policy rate corridor at times when credit to private sector accelerated and external sector pressures emerged. Yields in the government securities market, which showed mixed movements during the first nine months of 2018, witnessed a notable increase during the last quarter of 2018, reflecting changes in market sentiment due to political uncertainty as well as tight domestic liquidity and heightened domestic borrowings. Other market interest rates remained *high in both nominal and real terms. Although credit granted to the private sector by commercial banks moderated during the first eight months of 2018, the overall expansion in credit to the private sector was more than expected in 2018, in spite of tight market liquidity conditions and high interest rates. The government also relied more on domestic bank sources of financing, while increased borrowing by state-owned business enterprises also contributed to domestic credit expansion. However, driven by the contraction in net foreign assets of the banking sector, the year-on-year growth of broad money (M_{2b}) decelerated to 13.0 per cent by end 2018. Despite this, with nominal economic growth of 7.7 per cent, the available money supply did not restrict economic activity.*

In spite of the sharp depreciation of the rupee against major currencies and transitory price pressures due to upward revisions to domestic prices of petroleum products and other administratively determined prices, headline and core inflation remained subdued in 2018 as a result of well anchored inflation expectations under the enhanced monetary policy framework. Projections indicate that inflation is likely to remain within the desired 4-6 per cent range in 2019 and beyond, supported by the envisaged move to flexible inflation targeting (FIT) by the year 2020.

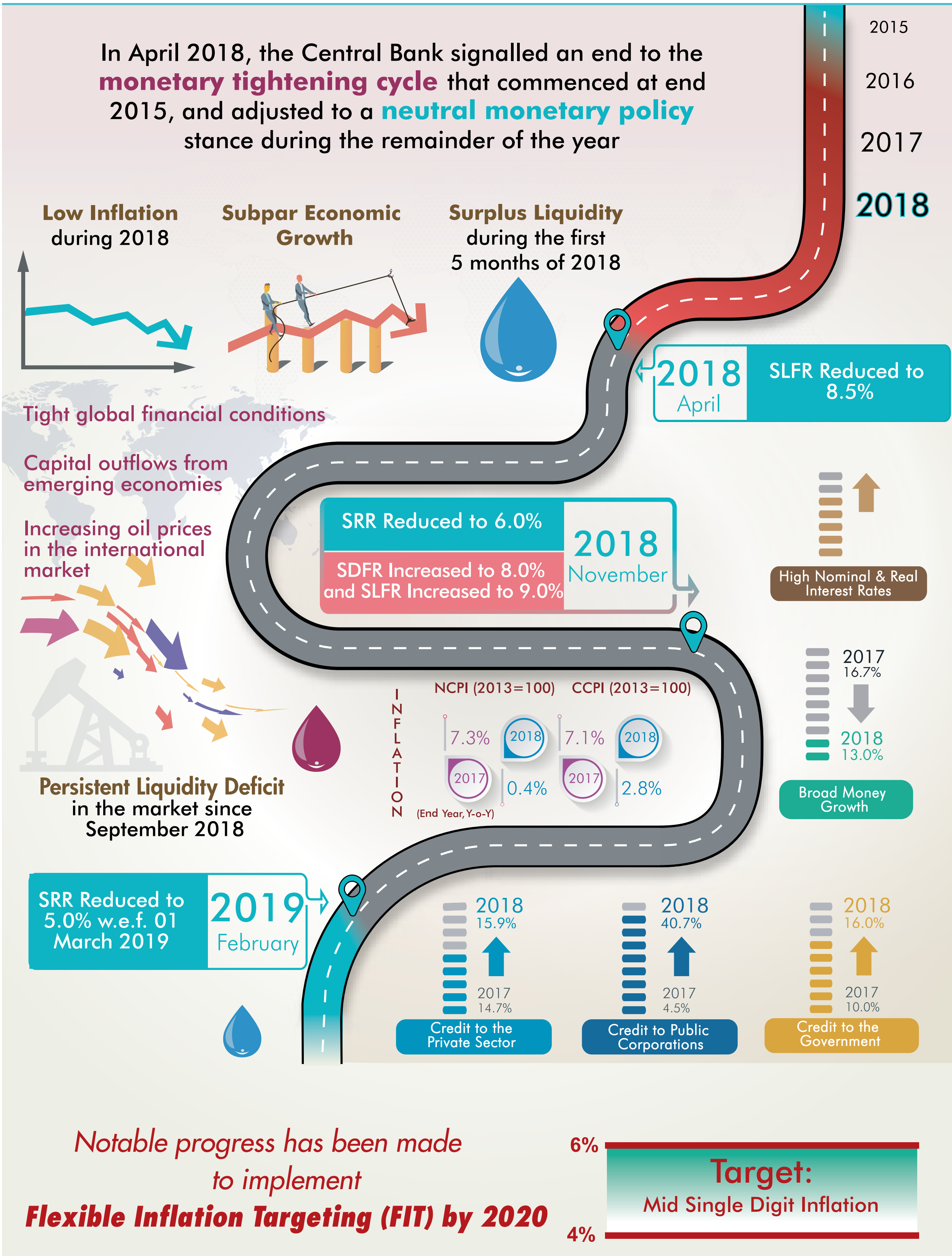
7.2 Monetary Policy Stance of the Central Bank of Sri Lanka

7

With the aim of maintaining inflation at low and stable levels, thereby supporting sustainable economic growth, the Central Bank continued to conduct monetary policy within an enhanced monetary policy framework, in an increasingly forward-looking and data driven manner, which was in line with its move towards flexible inflation targeting (FIT). Under this setup, the average weighted call money rate (AWCMR) serves as the operating target, while broad money (M_{2b}) remains a key indicative intermediate variable to guide the conduct of monetary policy with the aim of maintaining economic and price stability. During the year, significant progress was made towards the transition to FIT. The monetary policy formulation process has been upgraded since 2017 with the introduction of different levels of technical meetings. The Central Bank continued to improve its in-house modelling and forecasting capacity and infrastructure with technical assistance from the International Monetary Fund (IMF) to develop a comprehensive, model-based Forecasting and Policy Analysis System (FPAS) to enhance the monetary policy decision making process. The number of Monetary Policy Committee meetings per year has been limited to eight allowing sufficient space for deeper macroeconomic analysis. Meanwhile, notable progress was made in terms of initiating necessary amendments to the Monetary Law Act (MLA) with a view to improving governance of the Central Bank, strengthening its independence and facilitating the adoption of FIT as the monetary policy framework to ensure sustained price stability. Financial sector oversight is also to be strengthened under the proposed macroprudential policy framework. Accordingly, approval of the Cabinet of Ministers was obtained in principle for the concept paper on proposed MLA amendments during 2018. Sri Lanka received technical assistance from the IMF on required amendments to the existing MLA, and subsequently, in March 2019, the Cabinet of Ministers granted approval to draft legislation to repeal and replace the MLA to facilitate FIT, along with other amendments.

In spite of the sharp depreciation of the rupee against major currencies, consumer price inflation remained low in 2018 albeit with short term fluctuations arising from volatile food

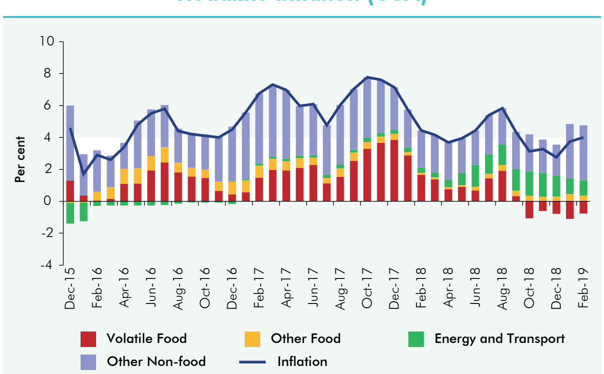
Figure 7.1 **Monetary Sector Developments**



7

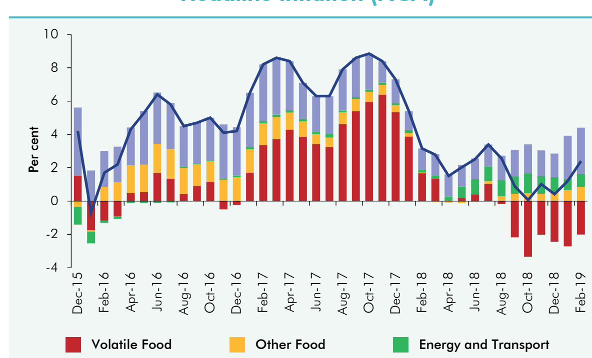
prices and administratively determined price adjustments. Headline inflation, as measured by the year-on-year change in the Colombo Consumer Price Index (CCPI, 2013=100), was broadly on a downward path in 2018, despite a peak recorded in August 2018. The surge in headline inflation during mid-2018 was explained by cost push factors arising from upward adjustments in domestic petroleum prices and volatile food prices. However, inflation decelerated significantly during the latter part of the year and reached levels even lower than the desired mid-single digit levels. This was primarily due to downward adjustments to fuel prices and selected administratively determined prices, lower food prices with the recovery of the agriculture sector as well as the reduction of the Special Commodity Levy and Telecommunication Levy on some selected imported items. The impact of the sharp depreciation of the rupee on inflation was limited during the period under review mainly due to well anchored inflation expectations, prices of a number of key imported items being determined administratively, improved domestic food supplies, as well as the diminishing role of the exchange rate as a nominal anchor under the enhanced monetary policy framework. Accordingly, year-on-year headline inflation based on the CCPI declined to 2.8 per cent by end 2018 from 7.1 per cent at end 2017. Headline inflation as measured by the year-on-year change in the National Consumer Price Index (NCPI, 2013=100) followed the same trend as the CCPI with a peak in July 2018 and continued to remain in low single digit levels thereafter. Year-on-year headline inflation based on the NCPI declined sharply to 0.4 per cent by December 2018, compared to 7.3 per cent recorded in December 2017. On an annual average basis, the CCPI based headline inflation decelerated to 4.3 per cent by end 2018 from 6.6 per cent recorded at end 2017, while the NCPI based annual average inflation decelerated to 2.1 per cent by end 2018 from 7.7 per cent at end 2017. Headline inflation as measured by the year-on-year change in both the CCPI and the NCPI showed some acceleration in the first quarter of 2019 mainly due to higher non-food inflation driven by increased expenditure on certain items such as house rentals and education. Accordingly, the year-on-year headline inflation as measured by the CCPI increased to reach 3.7 per cent in January 2019 and 4.0 per cent in February 2019, while the NCPI based headline inflation rose to 1.2 per cent in January 2019 and 2.4 per cent in February 2019. As per the Inflation Expectations Survey of the Central Bank, expectations of the corporate sector remained relatively high in the middle of 2018, but declined thereafter, partly in line with the decline in the actual headline inflation.

Figure 7.2
Contribution to Year-on-Year Headline Inflation (CCPI)



Source: Department of Census and Statistics

Figure 7.3
Contribution to Year-on-Year Headline Inflation (NCPI)

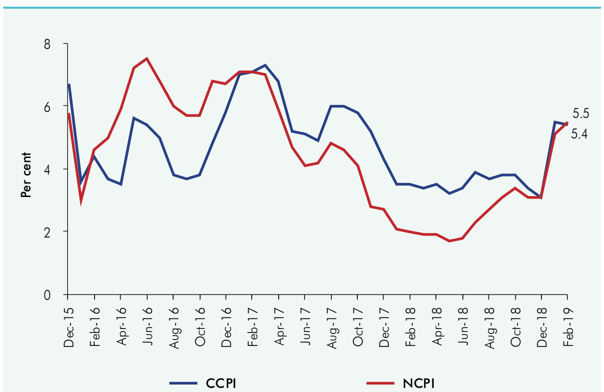


Source: Department of Census and Statistics

Inflation expectations of the household sector showed highly volatile behaviour during 2018 mainly due to the depreciation of the Sri Lankan rupee against the US dollar. Meanwhile, during 2018, inflation remained within the inner band stipulated under the IMF-Extended Fund Facility (EFF) Programme except during the last quarter of the year where average inflation was below the inner band.

Core inflation, which is a stronger measure of demand driven underlying inflation than headline inflation, remained at low single digit levels throughout 2018, reflecting the impact of the relatively tight monetary policy stance maintained during the past years and anchored inflation expectations. Year-on-year core inflation based on CCPI decelerated to 3.1 per cent by end 2018 compared to 4.3 per cent recorded at end 2017, reflecting subdued demand pressures in the economy. NCPI based year-on-year core inflation was 3.1 per cent by end 2018 in comparison to 2.7 per cent at end 2017. On an annual average basis, CCPI based core inflation decelerated to 3.5 per cent by end 2018, compared to the 5.9 per cent recorded in 2017, while NCPI based core inflation decelerated to 2.4 per cent by end 2018 from 4.9 per cent at end 2017. In January 2019, price increases in the non-food category, particularly

Figure 7.4
Movements in Year-on-Year Core Inflation



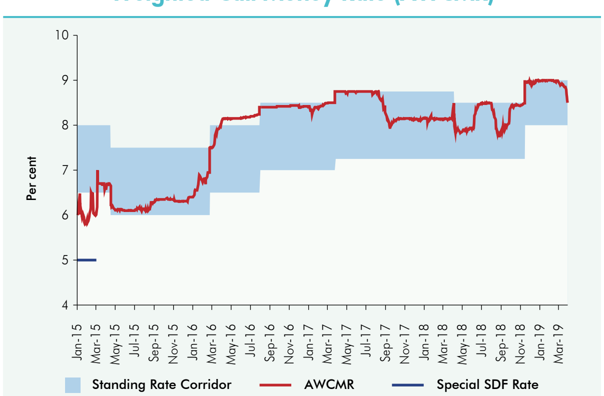
Source: Department of Census and Statistics

price adjustments in the housing and education sectors, contributed to an increase in underlying inflation, resulting in CCPI based year-on-year core inflation increasing to 5.5 per cent in January 2019, but decelerating marginally to 5.4 per cent in February 2019. Meanwhile, NCPI based year-on-year core inflation also picked up in the first two months of 2019, recording 5.5 per cent, in February 2019.

The year 2018 posed a challenge to monetary policymakers as several upside and downside risks on the domestic front had to be balanced against a rapidly evolving global environment. The tight monetary policy stance followed by the Central Bank, since end 2015, yielded the expected outcomes, particularly in terms of managing demand driven inflation and containing money and credit growth from the peak levels observed in 2016 and 2017. Such developments together with a favourable inflation outlook, amidst subdued performance in the real economy prompted the Central Bank to signal the end of its monetary tightening cycle. Accordingly, in April 2018, the Central Bank reduced the Standing Lending Facility Rate (SLFR) by 25 basis points to 8.50 per cent, while the Standing Deposit Facility Rate (SDFR) was kept unchanged at 7.25 per cent, thereby narrowing the policy interest rate corridor. As adverse developments in global economic conditions, amidst capital outflows with US monetary policy normalisation created pressure on the external sector of the economy and raised volatility in the domestic markets, the Central Bank followed a neutral monetary policy stance thereafter. Considering the large and persistent deficit liquidity conditions in the domestic money market since September 2018, the Central Bank reduced the Statutory Reserve Ratio (SRR) applicable on all rupee deposit liabilities of commercial banks by 1.50 percentage points, effective mid November 2018. This measure injected around Rs. 90 billion liquidity to the banking sector on a permanent basis. At the same time, the Central Bank increased the SDFR by 75 basis points to 8.00 per cent and the SLFR by 50 basis points to 9.00 per cent to neutralise the market impact of the SRR reduction and thereby maintain its neutral monetary policy stance. The upward adjustment in policy rates and reduction of SRR are also expected to help narrow the spread between deposit and lending rates in the market. Meanwhile, as the high and persistent liquidity deficit conditions in the domestic money market continued, the Central Bank reduced the SRR by a further 1.00 percentage point to 5.00 per cent, effective 01 March 2019, while signalling the maintenance of the neutral monetary policy stance.

The Central Bank conducted active Open Market Operations (OMO), responding to varying market conditions, in order to guide the overnight interest rate in line with the monetary policy stance. During the first five months of 2018, surplus liquidity in the domestic money market was mopped up by conducting overnight, short term, as well as long term repurchase transactions by the Central Bank, with the aim of maintaining the Average Weighted Call Money Rate (AWCMR) around the middle of the policy rate corridor. As rupee liquidity turned into a large and persistent deficit and the

Figure 7.5
Standing Rate Corridor and Average Weighted Call Money Rate (AWCMR)



Source: Central Bank of Sri Lanka

AWCMR moved toward the upper bound of the policy rate corridor, the Central Bank continued to supply liquidity to the market since September 2018 by way of conducting overnight, short term and long-term reverse repurchase transactions as well as outright purchases of government securities. Meanwhile, with a view to strengthening the signalling effect of OMOs, access of nonbank primary dealers to OMO auctions was withdrawn with effect from 25 September 2018.

Continuing the deceleration trend observed in 2017, the growth of broad money supply further decelerated in 2018 yielding envisaged outcomes of the tight monetary policy stance adopted by the Central Bank since end 2015, although the growth of credit to the private sector expanded more than expected particularly in the fourth quarter of the year. Contributing to the moderation in broad money (M_{2b}) growth, Net Foreign Assets (NFA) of the banking sector contracted considerably, particularly since August 2018, on account of the increase in Central Bank foreign currency liabilities to international agencies and the intervention in the domestic foreign exchange market in the wake of capital outflows, as well as the increase in foreign currency liabilities of commercial banks. The year-on-year growth of credit disbursed to the private sector continued to moderate during the first eight months of 2018, although credit growth picked up towards the latter part of 2018. Net credit to the government and credit to State Owned Business Enterprises (SOBEs) also expanded notably in 2018 contributing to the monetary expansion.

The Central Bank and the government implemented several additional measures during the year to curtail credit expansion, particularly in relation to imports. Accordingly, a 100 per cent minimum cash margin requirement, which was later raised to 200 per cent was imposed against Letters of Credit (LCs) for the importation of motor vehicles with effect from October 2018. Further, a 100 per cent cash margin was imposed on the invoiced value of imports of non-essential commodities against LCs and under documents against acceptance (DA) terms in October 2018. Meanwhile, opening of LCs for the importation of vehicles under the scheme for the issuance of motor vehicle permits on concessionary terms to state sector employees was suspended in September 2018. At the same time, loan to value ratios for credit facilities granted in respect of motor vehicles were also tightened in October 2018. However, margin requirements against LCs for the importation of vehicles and non-essential goods were withdrawn effective 07 March 2019 following the upward tax adjustments on vehicle imports through the government budget 2019.

Table 7.1
Recent Monetary Policy Measures

Date	Measure
02-Jan-2014	The Policy Rate Corridor renamed as the Standing Rate Corridor (SRC), and the Repurchase rate and the Reverse Repurchase rate of the Central Bank renamed as the Standing Deposit Facility Rate (SDFR) and Standing Lending Facility Rate (SLFR), respectively. SLFR reduced by 50 basis points to 8.00%. The Standing Deposit Facility (SDF) uncollateralised with effect from 01-Feb-2014.
23-Sep-2014	Access to the SDF of the Central Bank by OMO participants at 6.50% rationalised to a maximum of three times per calendar month. Any deposit at the SDF window exceeding three times by an OMO participant accepted at a special interest rate of 5.00%.
02-Mar-2015	The 5.00% special SDF rate was withdrawn.
15-Apr-2015	SDFR and SLFR reduced by 50 basis points to 6.00% and 7.50%, respectively.
03-Sep-2015	The exchange rate allowed to be determined based on demand and supply conditions in the foreign exchange market.
30-Dec-2015	SRR increased by 1.50 percentage points to 7.50% to be effective from the reserve period commencing 16-Jan-2016.
19-Feb-2016	SDFR and SLFR increased by 50 basis points to 6.50% and 8.00%, respectively.
28-Jul-2016	SDFR and SLFR increased by 50 basis points to 7.00% and 8.50%, respectively.
24-Mar-2017	SDFR and SLFR increased by 25 basis points to 7.25% and 8.75%, respectively.
04-Apr-2018	SLFR reduced by 25 basis points to 8.50%. Accordingly, the width of the SRC narrowed to 125 basis points from 150 basis points.
14-Nov-2018	SRR reduced by 1.50 percentage points to 6.00% to be effective from the reserve period commencing 16-Nov-2018. To neutralise the impact of SRR reduction, SDFR increased by 75 basis points to 8.00% and SLFR increased by 50 basis points to 9.00%. Accordingly, the width of the SRC narrowed to 100 basis points from 125 basis points.
22-Feb-2019	SRR reduced by 1.00 percentage points to 5.00% to be effective from the reserve period commencing 01-Mar-2019.

Source: Central Bank of Sri Lanka

Note : Macroprudential measures introduced in this period are shown in Table 8.26

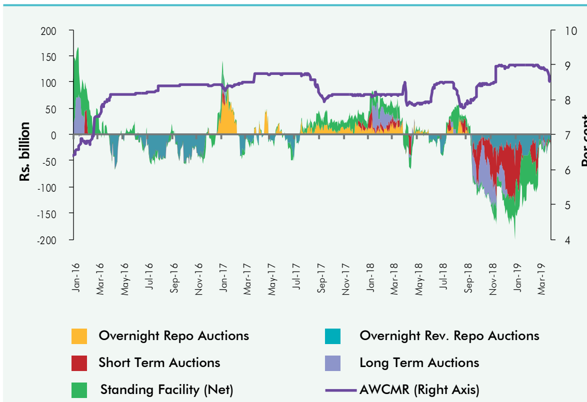
The Central Bank pursued several strategies to enhance its monetary policy communication to manage inflation expectations and communicate policy rationale with the overall aim of achieving its monetary policy objectives effectively. With a view to providing proper insights on monetary policy decisions to the general public and stakeholders, the analytical value and the forward looking content of the monetary policy press releases were further improved. The Central Bank also conducted programmes to educate journalists and other stakeholders on the move towards FIT. In addition, the Central Bank continued to publish its key publications including the Annual Report and the Recent Economic Developments Report to provide a comprehensive set of macroeconomic statistics and relevant analysis for the public. While improving the content and the format of key publications, the Central Bank website was revamped to enhance its user-friendly accessibility with more features, and macroeconomic statistics presented on a daily, weekly, monthly and quarterly basis on the website in all three languages. On a regular basis, the Central Bank communicated its policies and decisions via press releases, information notes, publications, bulletins, press conferences, meetings, seminars, lectures and speeches by the Governor and other key officials of the Central Bank, thus helping to build awareness amongst the general public and other key stakeholders and anchor their expectations in line with the envisaged low inflation trajectory.

7.3 Movements of Interest Rates

Market Liquidity and Short Term Interest Rates

Rupee liquidity in the domestic money market, which was in surplus during the first five months of 2018, turned to be persistently negative towards the fourth quarter of 2018. During the first five months of the year, market liquidity remained in surplus, averaging around Rs. 20 billion, largely supported by purchases of foreign exchange from the domestic foreign exchange market and purchases of Treasury bills by the Central Bank. The Central Bank conducted overnight, short and long-term repurchase auctions during this period to mop-up excess liquidity from the market with a view to maintaining AWCMR at desired levels. However, as a result of the early retirement of Treasury bills held by the Central Bank, the unwinding of short term swaps to improve the quality of international reserves and the foreign exchange sales of the Central Bank to prevent excess volatility in the exchange rate, domestic money market liquidity turned into a deficit during the period from June to mid July 2018. However, with foreign exchange forward transactions carried out by the government with the Central Bank, liquidity in the domestic money market improved to a temporary surplus during the period from mid-July to September 2018. Since then, liquidity returned to a deficit mainly due to the reversal of the forward transactions with the government, foreign exchange sales by the Central Bank and maturing of Treasury bills held by the Central Bank. Thereafter, there was a persistent and expanding deficit in liquidity in the domestic money market mainly due to the impact of foreign exchange sales by the Central Bank. To address the persistent liquidity deficit in the domestic money market, the Central Bank reduced the SRR applicable on all rupee deposit liabilities of commercial banks by 1.50 percentage points to 6.00 per cent, from 7.50 per cent, with effect from mid-November 2018. Although this policy intervention injected around Rs. 90 billion to the market on a permanent basis, liquidity in the money market continued to remain in deficit partly due to foreign exchange sales by the Central Bank. Imposition of the margin requirement on LCs on the importation of motor vehicles and the requirement that such deposits be maintained with the Central Bank also contributed to the liquidity deficit to some extent. Accordingly, from mid-September to end 2018, daily overnight liquidity deficit amounted to Rs. 57.4 billion on average, while the overnight liquidity deficit stood at Rs. 148.4 billion by end 2018. Consequently, the Central Bank conducted overnight, short term, long term reverse repurchase auctions and purchased Treasury bills on an outright basis to provide required liquidity to the domestic money market, thereby maintaining stability in short term interest rates. The Central Bank further reduced the SRR by 1.00 percentage point to 5.00 per cent effective 01 March 2019 as deficit liquidity conditions in the domestic money market persisted in the first two months of 2019.

Figure 7.6
Rupee Liquidity in the Domestic Money Market and Liquidity Management



Source: Central Bank of Sri Lanka

Overnight interest rates showed some mixed movements during 2018 reflecting the changes in market liquidity conditions and the monetary policy signals of the Central Bank. During the first three months of 2018, the AWCMR continued to remain mostly around the middle of the policy rate corridor, responding to surplus rupee liquidity levels in the domestic money market. Meanwhile, with the removal of withholding tax on the interest income on Treasury bills and Treasury bonds effective from 01 April 2018, a transitory increase in the AWCMR was observed towards end March 2018 due to a misinterpretation of the effect of withholding tax adjustments by commercial banks. However, with the reduction in SLFR in early April 2018, the AWCMR declined and remained around the middle of the policy rate corridor up to end May 2018. As liquidity conditions in the domestic money market turned to a deficit by mid-2018, the AWCMR adjusted upwards and hovered around the upper bound of the policy rate corridor. Although the AWCMR adjusted downwards towards the middle of the policy rate corridor during August to mid-September 2018 with surplus liquidity conditions, the AWCMR returned to the upper bound of the policy rate corridor thereafter. With the large liquidity deficit persistent in the money market and the increase in policy interest rates in mid-November 2018, the AWCMR moved closer to the upper bound of the policy rate corridor through appropriate OMOs. By end 2018, the AWCMR was 8.95 per cent compared to 8.15 per cent at end 2017. Moreover, the weighted average yields at the daily OMO auctions and Sri Lanka Inter Bank Offered Rates (SLIBOR) also moved in line with the movements in the AWCMR during 2018. Accordingly, weighted average yields at daily OMO reverse repurchase auctions increased to 8.98 per cent by end 2018 from 8.49 per cent by end June 2018. Overnight and 12-month SLIBOR were at 9.00 per cent and 11.80 per cent, respectively, by end 2018, compared to 8.15 per cent and 12.18 per cent, respectively, at end 2017. Further, with a view to strengthening the signaling effect of OMOs, thereby effectively managing the AWCMR, the access given to non-bank primary dealers to participate in OMO auctions was withdrawn by the Central Bank with effect from 25 September 2018.

Table 7.2
Selected Money Market Rates

Per cent per annum

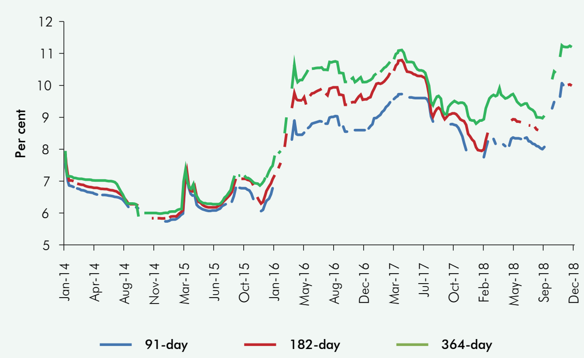
	AWCMR		Overnight OMO Auction		SLIBOR Overnight		SLIBOR 12 Month	
	End Period	Average for the Month	Repo	Reverse Repo	End Period	Average for the Month	End Period	Average for the Month
Dec-15	6.40	6.35	6.14	-	6.40	6.36	7.66	7.68
Dec-16	8.42	8.41	7.43	-	8.44	8.43	12.00	12.00
Dec-17	8.15	8.13	7.25	-	8.15	8.15	12.18	12.19
Mar-18	8.41	8.16	-	8.45	8.43	8.16	11.64	11.58
Jun-18	8.50	8.31	-	8.49	8.50	8.29	11.47	11.41
Sep-18	8.40	8.02	-	8.18	8.35	8.01	11.50	11.50
Dec-18	8.95	8.96	-	8.98	9.00	9.00	11.80	11.77

Source: Central Bank of Sri Lanka

Yields on Government Securities

Yields on government securities, which showed mixed movements during the first nine months of 2018, increased notably during the last quarter of 2018, reflecting changes in market sentiment as well as the funding requirement of the government amidst tight liquidity conditions. Yields on Treasury bills in the primary market showed an upward movement during the first quarter of 2018 due to the increased funding requirement of the government along with the delay in securing foreign financing by the government. Although some stabilisation in yields was observed since then with the receipt of US dollars 2.5 billion on account of the International Sovereign Bonds (ISBs) issued in April 2018, upward pressure on yields of government securities was observed by May 2018, partly due to outflows of foreign investments in government securities, in view of tightening global financial conditions. The upward pressure on yields eased

Figure 7.7
Primary Market Treasury Bill Yields (a)



Source: Central Bank of Sri Lanka

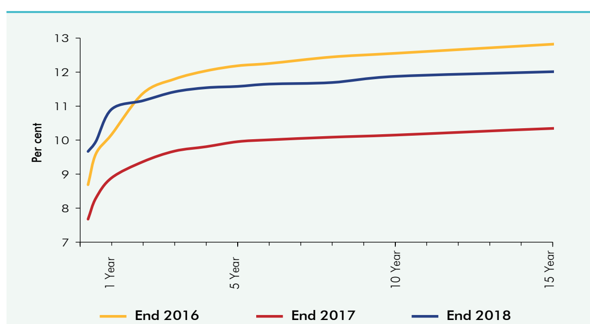
(a) Yields for some weeks are not available due to non- acceptance of bids or not offering relevant tenors

somewhat in July-August 2018, before re-emerging from September 2018, due to unfavourable market sentiments amidst capital outflows and tight liquidity conditions. Domestic political uncertainty caused yields in Treasury bills to remain elevated in the latter part of 2018. Reflecting these developments, during 2018, yields of 91-day, 182-day and 364-day Treasury bills increased by 232, 169 and 230 basis points to 10.01 per cent, 9.99 per cent, and 11.20 per cent, respectively, in comparison to yields that prevailed at end 2017. Since mid January 2019, yields on Treasury bills in the primary market eased gradually.

Yields on Treasury bonds in the primary market also displayed mixed movements during 2018. Following a trend similar to Treasury bills, yields on Treasury bonds in the primary market increased during the first quarter of 2018, in view of the high borrowing requirement of the government. However, mixed movements in the yields on Treasury bonds were observed thereafter, in line with market sentiments and the movement in market liquidity conditions. Yields on Treasury bonds displayed an overall increase by end 2018 as the domestic financing requirement increased notably with the delay in foreign financing amidst domestic political uncertainty. The government relied more on short to medium-term Treasury bond issuances during 2018, while Treasury bonds with longer maturities of 10 and 15 years were also issued occasionally. However, 2 year Treasury bonds were not issued in 2018 to address possible bunching issues. The government issued short and medium-term US dollar denominated Sri Lanka Development Bonds (SLDBs) at various fixed and floating rates, particularly during the first nine months of the year. Further, ISBs with maturities of 5 and 10 years were issued in April 2018 with a coupon of 5.75 per cent and 6.75 per cent, respectively, and marked Sri Lanka's twelfth US dollar benchmark offering in the international bond markets. In the meantime, ISBs with maturities of 5 and 10 years were also issued in March 2019 with a coupon of 6.85 per cent and 7.85 per cent, respectively.

The secondary market yield curve for government securities shifted upwards in 2018 in comparison to levels seen at end 2017 amidst tight liquidity conditions. Yields on 91-day, 182-day and 364-day Treasury bills in the secondary market increased by 199 basis points, 167 basis points and 202 basis points, respectively, to 9.67 per cent, 9.96 per cent and 10.91 per cent by end 2018, from levels that prevailed at end 2017. Treasury bond yields also increased within a range of 148 to 179 basis points by end 2018, compared

Figure 7.8
Secondary Market Yield Curve for Government Securities



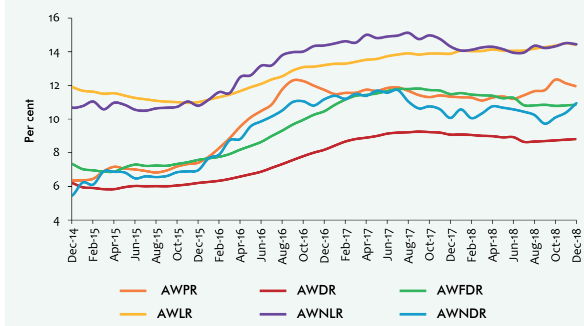
Source: Central Bank of Sri Lanka

to the levels observed at end 2017. However, some downward shift in the secondary market yield curve was observed in early 2019 as a result of improved sentiments and in response to the Central Bank's action to ease the liquidity shortage in the domestic market, along with the issuance of ISBs in March 2019.

Deposit and Lending Interest Rates

Amidst tight liquidity conditions and the tight monetary policy stance that was maintained until April 2018, most deposit interest rates of commercial banks remained at high levels during 2018. Overall, the Average Weighted Deposit Rate (AWDR), which captures the movements in interest rates of all outstanding interest bearing rupee deposits held with commercial banks, decreased by 26 basis points to 8.81 per cent by end 2018 from 9.07 per cent recorded at end 2017. Following a similar trend, the Average Weighted Fixed Deposit Rate (AWFDR), which is based on interest rates of all outstanding time deposits held with commercial banks, also decreased by 63 basis points to 10.85 per cent by end 2018 from 11.48 per cent at end 2017. Meanwhile, with a view to removing the impact of interest rates subsidised by the government on market interest rates, the AWDR and AWFDR were calculated by replacing senior citizens' special deposit rate of 15.0 per cent with relevant market interest rates since July 2018. Reflecting the commercial banks' attempt to mobilise deposits in an environment of tight liquidity conditions, the Average Weighted New Deposit Rate (AWNDR), which captures the interest rates offered on all new interest bearing rupee deposits during a month, increased by 88 basis points to 10.94 per cent by end 2018 from 10.06 per cent at end 2017. Further, the Average Weighted New Fixed Deposit Rate (AWNFDR), which is based on interest rates offered on all new time deposits

Figure 7.9
Commercial Bank Lending and Deposit Rates

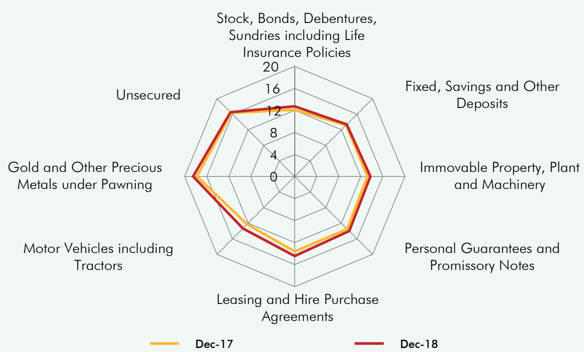


Source: Central Bank of Sri Lanka

during a month, increased by 62 basis points to 11.27 per cent by end 2018 from 10.65 per cent recorded at end 2017. Depositors continued to benefit from positive real rates of return during 2018 with inflation remaining considerably lower in comparison to deposit rates.

Tight liquidity conditions amidst continued high demand for credit caused lending rates of commercial banks to remain high in 2018. The weekly Average Weighted Prime Lending Rate (AWPR), which is computed based on interest rates applicable on short term loans and advances granted by commercial banks to their prime customers during a week, increased by 54 basis points to 12.09 per cent during 2018. The monthly average of weekly AWPR increased by 61 basis points to 11.94 per cent during the period under review. The Average Weighted Lending Rate (AWLR), which is based on interest rates of all outstanding loans and advances extended by commercial banks, increased by 52 basis points to 14.40 per cent during 2018. Meanwhile, bank-wise average weighted lending rates were in the range of 10.96-17.25 per cent at end 2018 compared to the range of 10.22-16.23 per cent observed at end 2017. Lending rates against most types of securities also increased during 2018. In particular, interest rates on loans and advances secured by motor vehicles, including tractors and

Figure 7.10
Average Weighted Lending Rates by Type of Security (%)



Source: Central Bank of Sri Lanka

leasing and hire purchase agreements, increased considerably during the year. Furthermore, the Average Weighted New Lending Rate (AWNLR), which captures interest rates of all new loans and advances extended by commercial banks during a month, increased by 13 basis points to 14.44 per cent during 2018. Also, with the low inflation environment, real lending rates remained elevated during 2018. In addition, the spread between deposit and lending rates were also high.

The Legal rate and the Market rate of interest,[1] as determined by the Monetary Board and published in the Government Gazette at the end of each year, were 11.50 per cent per annum for 2019, compared to 9.08 per cent per annum for 2018. The Legal rate and the Market rate for 2019 were computed based on simple averages of monthly AWDR and AWLR of commercial banks, which prevailed during the twelve months ending October 2018.[2]

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 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.

2 In 2018, the calculation method of the Legal Rate and Market Rate was revised. Accordingly, the rates for 2019 were calculated based on simple averages of monthly AWLR and AWDR, which prevailed during the twelve months ending October 2018.

Interest Rates on Debt Instruments

Interest rates on corporate debt instruments remained high, although some moderation was observed during 2018. Interest rates on commercial paper decreased to a range of 13.10-15.00 per cent by end 2018, compared to the range of 13.75-16.50 per cent recorded at end 2017. During 2018, reflecting banks' efforts to meet enhanced capital requirements as stipulated by the minimum capital requirement under the implementation of the Basel III framework, there were 21 listings of corporate debentures by 11 corporates with maturities of 3-10 years, compared to 13 listings reported in 2017. These debentures were issued at various fixed and floating interest rates. Fixed interest rates offered on these issues were in the range of 12.00-14.75 per cent by end 2018 compared to the range of 12.50-15.00 per cent at end 2017.

Interest Rates on Foreign Currency Deposits

Despite the gradual tightening of global financial conditions led by interest rate hikes in the USA, interest rates applicable on foreign currency deposits maintained with commercial banks showed mixed movements during 2018. The US Federal Reserve raised its Federal Funds target rate four times during the year by a total of 100 basis points to 2.25–2.50 per cent by end 2018. Bank of England also raised their bank rate by 25 basis points to 0.75 per cent during 2018, while the European Central Bank ended its asset purchasing programme by end 2018. Reflecting such developments, interest rates pertaining to US dollar denominated time deposits increased to a range of 0.25-6.00 per cent by end 2018, compared to the range of 0.15-5.03 per cent recorded at end 2017. However, interest rates on US dollar

Table 7.3
Movements of Interest Rates

Per cent per annum

Interest Rate	End 2017	End 2018
Policy Interest Rates		
Standing Deposit Facility Rate (SDFR)	7.25	8.00
Standing Lending Facility Rate (SLFR)	8.75	9.00
Average Weighted Call Money Rate (AWCMR)	8.15	8.95
Yield Rates on Government Securities		
Primary Market (a)		
Treasury bills		
91-day	7.69	10.01
182-day	8.30	9.99
364-day	8.90	11.20
Treasury bonds		
2-year	9.83	-
3-year	9.55	11.88
4-year	11.14	-
5-year	10.20	11.69
10-year	10.36	10.20
Secondary Market		
Treasury bills		
91-day	7.68	9.67
182-day	8.30	9.96
364-day	8.89	10.91
Treasury bonds		
2-year	9.37	11.16
3-year	9.68	11.42
4-year	9.81	11.54
5-year	9.96	11.58
10-year	10.15	11.87
Licensed Commercial Banks (b)		
Interest Rates on Deposits		
Savings deposits	0.50-9.50	0.50-8.50
1 Year Fixed Deposits (c)	4.89-15.00	4.53-15.00
Average Weighted Deposit Rate (AWDR) (d)	9.07	8.81
Average Weighted Fixed Deposit Rate (AWFDR) (d)	11.48	10.85
Average Weighted New Deposit Rate (AWNDR) (d)	10.06	10.94
Average Weighted New Fixed Deposit Rate (AWNFDR) (d)	10.65	11.27
Interest Rates on Lending		
Average Weighted Prime Lending Rate (AWPR)	11.33	11.94
Average Weighted Lending Rate (AWLR)	13.88	14.40
Average Weighted New Lending Rate (AWNLR)	14.31	14.44
Other Financial Institutions (e)		
Interest Rates on Deposits		
National Savings Bank		
Savings Deposits	4.00	4.00
1 Year Fixed Deposits	11.00	10.50
Licensed Finance Companies (f)		
Savings Deposits	5.43-7.99	5.21-7.77
1 Year Fixed Deposits	12.15-13.71	11.63-13.21
Interest Rates on Lending		
National Savings Bank	13.00-16.00	6.75-16.25
State Mortgage and Investment Bank (g)	10.50-20.00	10.50-20.00
Licensed Finance Companies (f)		
Finance Leasing	17.40-28.03	16.92-28.80
Hire Purchase	15.00-20.84	15.16-18.65
Loans against Real Estate	17.95-20.18	21.36-19.21
Corporate Debt Market		
Debentures	12.50-15.00	12.00-14.75
Commercial Paper	13.75-16.50	13.10-15.00

(a) Weighted average yield rates at the latest available auction.
(b) Based on the rates quoted by commercial banks
(c) Maximum rate is a special rate offered by certain commercial banks.
(d) Since July 2018, AWDR and AWFDR were calculated by replacing Senior Citizens' special deposit rate of 15 per cent with relevant market interest rates to exclude the impact of special rates which are subsidised by the government. Same method was applied to calculate AWNDR and AWNFDR since June 2018.
(e) Based on the rates quoted by other selected Financial Institutions.
(f) Interest rate ranges are based on the average maximum and average minimum rates quoted by LFCs which are applicable for deposits mobilised and loans granted during the respective months.Data for 2018 are provisional
(g) Lending for housing purposes only.

Sources: Colombo Stock Exchange
Respective Financial Institutions
Central Bank of Sri Lanka

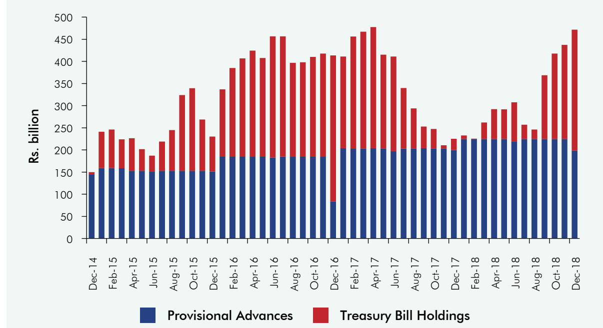
denominated savings deposits remained in a range of 0.02-4.12 per cent at end 2018, compared to the range of 0.02-4.38 per cent at end 2017. Interest rates applicable on pound sterling denominated time deposits were in the range of 0.10-3.50 per cent at end 2018, whereas the comparable rates were 0.20-4.57 per cent at end 2017. Meanwhile, interest rates on savings deposits denominated in pound sterling were in the range of 0.10-2.48 per cent at end 2018, in comparison to the range of 0.10-2.25 per cent recorded at end 2017.

7.4 Movements of Monetary and Credit Aggregates

Reserve Money

Reserve money recorded a moderate growth during 2018, particularly in the latter part of the year with the downward adjustment in SRR in November 2018. Accordingly, year-on-year reserve money growth decelerated to 2.3 per cent by end 2018 from 9.8 per cent recorded at end 2017. In absolute terms, reserve money increased only by Rs. 21.3 billion to Rs. 961.1 billion during 2018, compared to an expansion of Rs. 83.6 billion recorded in 2017. Based on the liability side of reserve money, the expansion during 2018 was entirely due to the increase in currency in circulation, while commercial banks' deposits with the Central Bank declined during 2018 as SRR was reduced in November 2018. Reflecting the continued high opportunity cost of holding currency with prevailing high interest rates, the year-on-year growth of currency in circulation moderated further to 7.2 per cent by end 2018 from 8.2 per cent recorded at end 2017. The overall increase in currency in circulation in 2018 amounted to Rs. 42.9 billion, in comparison to the expansion of Rs. 45.3 billion in the previous year. Meanwhile, commercial banks' deposits with the Central Bank, which recorded a cumulative increase of Rs. 43.1 billion during the first ten months of 2018, subsequently contracted by Rs. 64.7 billion in the months of November and December 2018, with the reduction in SRR to 6.00 per cent from 7.50 per cent effective mid November 2018. Meanwhile, the imposition of the margin requirement on LCs and imports on DA terms in October 2018 as a measure to curtail selected imports, with a requirement to maintain the margin deposits with the Central Bank, limited the impact of the SRR reduction on commercial banks' deposits with the Central Bank. Overall, commercial banks' deposits with the Central Bank declined by Rs. 21.6 billion in 2018 compared to an increase of Rs. 38.5 billion in 2017. Accordingly, commercial banks' deposits with the Central Bank declined by 6.3 per cent, year-on-year, by end 2018, in comparison to the growth of 12.7 per cent observed at end 2017.

Figure 7.11
Central Bank Treasury Bill Holdings and Provisional Advances to the Government



Source: Central Bank of Sri Lanka

As per the assets side of reserve money, the growth of reserve money was entirely due to the expansion in Net Domestic Assets (NDA) of the Central Bank. NDA of the Central Bank increased by Rs. 116.9 billion in 2018, in comparison to a sharp decline of Rs. 203.9 billion in the previous year. The expansion in NDA of the Central Bank was the result of a significant expansion in credit extended to the government on a net basis (NCG) by the Central Bank, reflecting an increase in the Treasury bill holdings of the Central Bank. Treasury bill holdings of the Central Bank (net of repurchase transactions), which contracted significantly by Rs. 304.5 billion to Rs. 25.6 billion by end 2017, increased notably by Rs. 247.4 billion to Rs. 273.0 billion by end 2018 mainly due to term and outright purchases of government securities by the Central Bank from the market in order to inject liquidity to the domestic money market. Provisional advances to the government, however, recorded a marginal decline of Rs. 1.2 billion by end 2018, and the outstanding amount of provisional advances to the government from the Central Bank was Rs. 198.6 billion. Consequently, during the year, NCG by the Central Bank increased by Rs. 246.3 billion in contrast to a decline of Rs. 187.9 billion in 2017. Moreover, the significant decline in other assets of the Central Bank on a net basis was mainly a result of notable international reserve revaluation, amidst the sharp depreciation of the rupee. Meanwhile, NFA of the Central Bank contracted by Rs. 95.6 billion in 2018, compared to the sharp increase of Rs. 287.5 billion observed in the previous year. This was mainly a result of the increase in foreign liabilities, in particular with international organisations. The contraction in NFA was also a result of the supply of foreign exchange by the Central Bank in the domestic foreign exchange market during 2018 to prevent a disorderly adjustment of the exchange rate.

The money multiplier, which reflects the link between reserve money and broad money (M_{2b}), increased in 2018 mainly due to the decline in the currency to deposit ratio in a high interest rate environment. The broad money multiplier increased to 7.42 by end 2018, compared to 6.71 recorded at end 2017, while on average, the money multiplier increased to 6.92 in 2018 compared to 6.63 in 2017. The currency to deposit ratio also declined from 7.5 per cent at end

2017 to 7.1 per cent by end 2018. The reduction in SRR with effect from 16 November 2018 also caused an increase in the money multiplier by increasing the ability of the banking system to create money.

Narrow Money (M_1)

Narrow money (M_1) expanded moderately in 2018. Narrow money, which comprises currency and demand deposits held by the public, grew by 4.7 per cent, year-on-year, by end 2018, compared to the growth of 2.1 per cent recorded at end 2017, largely on account of expansion in currency in circulation compared to the previous year. Continuation of the moderate narrow money growth for the third consecutive year reflected the increased opportunity cost of holding non-interest-bearing deposits and currency amidst high market interest rates. However, continuing the trend for high demand for cash as a payment means, currency held by the public increased by 7.7 per cent, year-on-year, to Rs. 473.1 billion by end 2018, in comparison to the growth of 2.3 per cent at end 2017, contributing around 90 per cent to the expansion in narrow money during the year, compared to the contribution of 59 per cent in 2017. Meanwhile, the growth in demand deposits held by the public with commercial banks remained subdued, recording a marginal increase of 1.1 per cent, year-on-year, by end 2018, compared to 2.0 per cent recorded at end 2017. In absolute terms, demand deposits held by the public increased marginally by Rs. 3.8 billion to Rs. 357.7 billion by end 2018, compared to Rs. 353.9 billion at end 2017.

Figure 7.12
Year-on-Year Growth of Monetary Aggregates

Source: Central Bank of Sri Lanka

Broad Money (M_{2b}) and Domestic Credit

Broad money (M_{2b}) growth, which gradually moderated since late 2017, maintained its decelerating trend throughout the year, largely on account of the contraction in NFA of the banking system. During 2018, the average growth of broad money was 14.7 per cent in comparison to 19.6 per cent in the previous year. The expansion in broad money during 2018 was entirely attributable to the expansion in NDA of the banking system, since NFA of the banking system recorded a contraction. The decline of foreign reserves of the Central Bank as well as the foreign currency financial position of commercial banks, amidst capital outflows and pressures on the exchange rate led to the decline in NFA of the banking sector.

As per the liabilities side of M_{2b}, the increase in time and savings deposits held by the public with commercial banks largely contributed to the expansion in M_{2b}. In response to high interest rates offered on deposits during 2018, time and savings deposits held by the public with commercial banks grew by 14.2 per cent, year-on-year, thus contributing around 95 per cent to the expansion in M_{2b}. High return on deposits offered by commercial banks attracted a considerable amount of deposits to the commercial banking system, as reflected in the expansion of time and savings deposits by Rs. 782.7 billion in 2018, following the increase of Rs. 885.8 billion in 2017.

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Table 7.4
Developments in Monetary Aggregates

Rs. billion

Item	End 2017	End 2018 (a)	Change 2017 Amount	Change 2017 %	Change 2018 Amount	Change 2018 %
1. Currency Outstanding	598.1	640.9	45.3	8.2	42.9	7.2
1.1 Currency held by the Public	439.4	473.1	9.9	2.3	33.7	7.7
1.2 Currency with Commercial Banks	158.7	167.9	35.4	28.7	9.2	5.8
2. Commercial Banks' Deposits with the Central Bank (b)	341.7	320.1	38.5	12.7	(21.6)	(6.3)
3. Government Agencies' Deposits with the Central Bank (c)	...	...				
4. Reserve Money (1+2+3)	**939.8**	**961.1**	**83.6**	**9.8**	**21.3**	**2.3**
5. Demand Deposits held by the Public with Commercial Banks	353.9	357.7	6.8	2.0	3.8	1.1
6. Narrow Money Supply, M_1 (1.1+5)	**793.3**	**830.8**	**16.7**	**2.1**	**37.5**	**4.7**
7. Time and Savings Deposits held by the Public with Commercial Banks	4,872.0	5,596.5	825.1	20.4	724.5	14.9
8. Broad Money Supply, M_2 (6+7)	**5,665.3**	**6,427.3**	**841.8**	**17.5**	**762.0**	**13.5**
9. Adjusted Foreign Currency Deposits (d)	642.7	701.0	60.7	10.4	58.2	9.1
10. Consolidated Broad Money Supply, M_{2b} (8+9)	**6,308.1**	**7,128.3**	**902.5**	**16.7**	**820.2**	**13.0**
Money Multiplier, M_{2b}	**6.71**	**7.42**				
Velocity, M_{2b} (e) (f)	**2.27**	**2.13**				

(a) Provisional
(b) Includes both Commercial Banks' Deposits with the Central Bank and balances of Primary Dealers with the Central Bank
(c) Government Agencies' Deposits with the Central Bank amounted to Rs.27.2 million at end 2017 and Rs. 47.6 million at end 2018
(d) Includes deposits of Resident Category of Offshore Banking Units (OBUs) and a part of foreign currency deposits with Domestic Banking Units (DBUs)
(e) Average for the year
(f) Revised

Source: Central Bank of Sri Lanka

Viewed from the assets side, reflecting a reversal compared to 2017, NFA of the banking system contracted in 2018 with the decline in NFA of both the Central Bank and commercial banks, thus contributing to a moderate growth in M_{2b}. NFA of the banking system, which turned positive since September 2017 returned to negative levels from October 2018. NFA of the banking system declined by Rs. 188.5 billion during 2018 in contrast to the notable increase of Rs. 352.8 billion recorded in 2017. NFA of the Central Bank contracted by Rs. 95.6 billion in 2018, compared to an increase of Rs. 287.5 billion in 2017, mainly due to increased foreign currency liabilities, with the receipt of funds under the Extended Fund Facility of the IMF and the increase in foreign currency liabilities in Deputy Secretary Treasury (DST) accounts as well as the increase in the allocation of Special Drawing Rights (SDR) by the IMF during the period under review. Although, Central Bank investments in foreign securities recorded an increase during 2018, its impact was negated by the supply of foreign exchange by the Central Bank in the domestic foreign exchange market. Meanwhile, NFA of commercial banks declined by Rs. 92.9 billion during 2018, compared to an increase of Rs. 65.2 billion in the previous year. NFA of domestic banking units (DBUs) of commercial banks decreased by Rs. 51.0 billion mainly due to the increase in foreign currency deposit liabilities of non-residents and the increase in borrowings from banks abroad, although there was an increase in placements with banks abroad. At the same time, NFA of offshore banking units (OBUs) also recorded a decline of Rs. 41.9 billion in 2018, due to higher foreign currency borrowings than placements with banks abroad during the period under review.

Table 7.5
Assets Side of Reserve Money and Broad Money (M_{2b})

Rs. billion

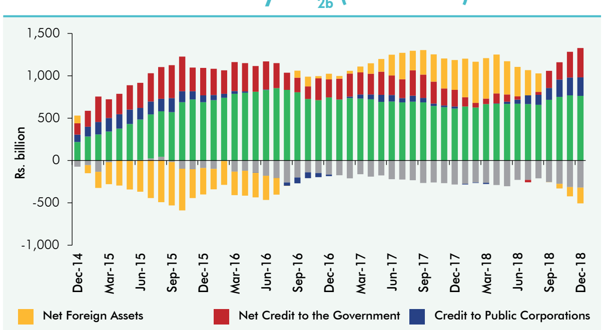
Item	End 2017	End 2018 (a)	Change			
			2017		2018	
			Amount	%	Amount	%
Reserve Money	**939.8**	**961.1**	**83.6**	**9.8**	**21.3**	**2.3**
Net Foreign Assets of the Central Bank	846.1	750.5	287.5	51.5	-95.6	-11.3
Net Domestic Assets of the Central Bank	93.7	210.6	-203.9	-68.5	116.9	124.8
Broad Money (M_{2b})	**6,308.1**	**7,128.3**	**902.5**	**16.7**	**820.2**	**13.0**
Net Foreign Assets	121.5	-67.0	352.8	152.6	-188.5	-155.1
Monetary Authorities (b)	846.1	750.5	287.5	51.5	-95.6	-11.3
Commercial Banks	-724.6	-817.5	65.2	8.3	-92.9	-12.8
Net Domestic Assets	6,186.5	7,195.3	549.7	9.8	1,008.8	16.3
Domestic Credit	7,504.7	8,832.0	833.0	12.5	1,327.3	17.7
Net Credit to the Government	2,168.5	2,515.2	196.4	10.0	346.7	16.0
Central Bank	225.1	471.3	-187.9	-45.5	246.3	109.4
Commercial Banks	1,943.4	2,043.9	384.3	24.6	100.5	5.2
Credit to Public Corporations (c)	537.0	755.4	23.2	4.5	218.4	40.7
Credit to the Private Sector (c)	4,799.2	5,561.4	613.4	14.7	762.1	15.9
Other Items (net) (d)	-1,318.2	-1,636.7	-283.3	-27.4	-318.5	-24.2

(a) Provisional
(b) This includes NFA of the Central Bank as well as the government's Crown Agent's balance reported by the Department of State Accounts
(c) Revised
(d) Computed as the difference between other assets and other liabilities

Source: Central Bank of Sri Lanka

Driven by increased credit flows to both private and public sectors, NDA of the banking sector expanded significantly, contributing entirely to monetary growth in 2018. In absolute terms, NDA increased significantly by Rs. 1,008.8 billion in 2018, compared to Rs. 549.7 billion recorded by end 2017. The expansion in NDA was mainly attributable to the considerable increase in credit flows to the private sector, as well as the surge in credit to the government and SOBEs during the year. Meanwhile, other liabilities of the banking sector also increased significantly during the year, partly on account of commercial banks' effort to enhance capital funds, as stipulated by the minimum capital requirement under the Basel III framework. This limited the expansion in NDA.

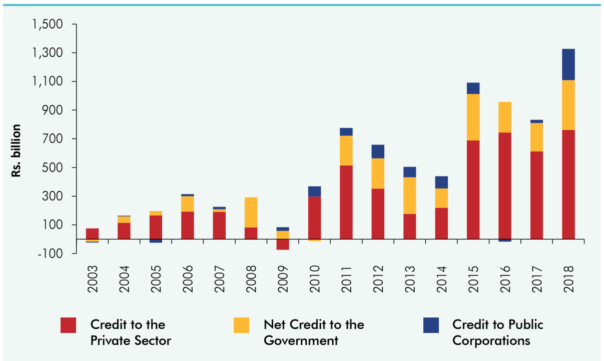
Figure 7.13
Contribution to Year-on-Year Change in Broad Money - M_{2b} (Assets Side)



Source: Central Bank of Sri Lanka

Net Credit to the Government (NCG) from the banking system increased substantially in 2018. During the first eight months of 2018, NCG increased only by Rs. 103.4 billion, but increased sharply thereafter, resulting in an overall expansion of Rs. 346.7 billion for 2018. This was mainly due to the increased reliance of the government on domestic financing amidst delays in the receipt of foreign financial flows and the shortfall in revenue collection, compared to budget estimates. The increase in NCG was driven by the expansion in credit from the Central Bank and commercial banks during the period under review. Accordingly, NCG from the Central Bank increased by Rs. 246.3 billion in comparison to a significant contraction of Rs. 187.9 billion in 2017. The increase in NCG from the Central Bank was reflected in the significant increase in Treasury bill holdings of the Central Bank (net of repurchase transactions) amounting to Rs. 247.4 billion in

Figure 7.14
Annual Increase in Domestic Credit



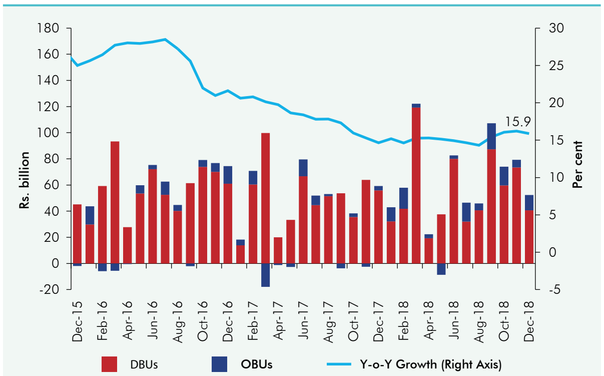
Source: Central Bank of Sri Lanka

order to inject rupee liquidity to the domestic market through OMOs, while provisional advances to the government recorded a marginal decline during the year. NCG from commercial banks increased by Rs. 100.5 billion in 2018 in comparison to the significant increase of Rs. 384.3 billion in 2017. Contributing to this expansion, NCG by DBUs increased by Rs. 66.6 billion, due to the increase in government overdraft balances with commercial banks by Rs. 100.3 billion and investments in SLDBs and Treasury bills by Rs. 90.0 billion and Rs. 18.8 billion, respectively, amidst a contraction in investments in Treasury bonds by Rs. 104.0 billion. At the same time, NCG by OBUs increased by around Rs. 33.9 billion due to the increase in direct loans to the government.

Reflecting the increased reliance on bank financing by most SOBEs, credit to public corporations increased substantially in 2018. Credit obtained by public corporations, which increased by Rs. 23.2 billion in 2017, expanded by Rs. 218.4 billion in 2018. During the year, credit obtained by two key SOBEs, namely, Ceylon Petroleum Corporation (CPC) and Ceylon Electricity Board (CEB) accounted for around 72 per cent of the overall expansion in credit to public corporations. Borrowings by CPC from the commercial banking sector increased by Rs.116.2 billion in 2018, particularly driven in the last quarter of 2018, in contrast to repayments made in the previous year. Despite borrowings by CPC, particularly from OBUs of commercial banks, a notable increase in rupee deposits of CPC at DBUs of commercial banks could also be witnessed during 2018. In addition, credit obtained by CEB, Road Development Authority (RDA), SriLankan Airlines (SLA) and National Water Supply and Drainage Board (NWSDB) increased by Rs. 40.2 billion, Rs. 30.9 billion, Rs. 16.0 billion and Rs. 15.3 billion, respectively, during 2018. Meanwhile, three other SOBEs, namely Ceylon Fertilizer Corporation, Colombo Fertilizer Corporation and Sri Lanka Ports Authority made a total repayment of around Rs. 13.0 billion in 2018.

Credit to the private sector by commercial banks, which is the largest component of domestic credit, grew at a slower pace during the first eight months of 2018, although some acceleration was witnessed in the last four months of the year. The year-on-year growth of credit extended to the private sector moderated to 14.3 per cent by end August 2018, compared to 14.7 per cent recorded at end 2017, but subsequently accelerated to 15.9 per cent by end 2018. Nevertheless, the average growth of credit to the private sector was 15.3 per cent in 2018, compared to 18.1 per cent recorded in 2017. During

Figure 7.15
Credit to the Private Sector by Commercial Banks



Source: Central Bank of Sri Lanka

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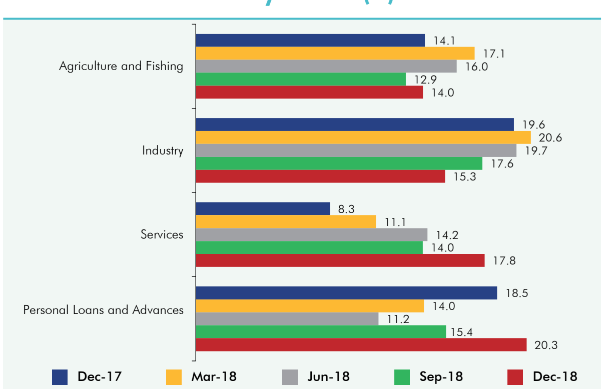
the last four months of 2018, credit growth averaged 15.9 per cent, as the private sector advanced their borrowings in anticipation of the government and the Central Banks' policies to curtail import related credit as well as the increase in import costs with currency depreciation. In absolute terms, credit to the private sector expanded by Rs. 762.1 billion during 2018, compared to Rs. 613.4 billion in 2017. As per the security-wise analysis of advances, credit granted against Immovable Property, Plant and Machinery, Personal Guarantees and Promissory Notes, Other Securities and Unsecured categories accounted for around 81 per cent of the overall expansion in private sector credit, while credit granted against government securities contracted during the year. Meanwhile, partly reflecting the impact of measures taken by the Central Bank and the government to curb vehicle imports, year-on-year growth of credit against Leasing and Hire Purchase Agreements, as reflected in security wise credit, decelerated to 3.7 per cent by end 2018, compared to 8.3 per cent recorded at end 2017.

As per the Quarterly Survey of Commercial Banks' Loans and Advances to the Private Sector, credit to the Services sector and Personal Loans and Advances expanded during 2018, although some moderation was observed in the growth of credit to the Industry sector and Agriculture and Fishing sector. Accordingly, growth of credit to the Industry sector decelerated to 15.3 per cent, year-on-year, by end 2018, from 19.6 per cent at end 2017. Contributing to the slowdown in credit to the Industry sector, credit to the Construction subsector, which accounts for around 48 per cent of the total credit flows to the Industry sector, recorded a moderate growth of 14.1 per cent, year-on-year, by end 2018, compared to a higher growth of 22.5 per cent at end 2017, reflecting the slowdown in construction related activities as well as input cost pressures from currency depreciation. Nevertheless, credit to Fabricated Metal Products, Machinery and Transport Equipment; Textiles and Apparel; Food

Figure 7.16
Year-on-Year Growth of Private Sector Credit to Key Sectors (%)



Source: Central Bank of Sri Lanka

Table 7.6
Classification of Outstanding Credit to the Private Sector Granted by Commercial Banks (a)(b)(c)

Rs. billion

Sector	End 2017	End 2018 (d)	% Share 2018	% Change 2018
Agriculture and Fishing	412.4	470.0	8.2	14.0
of which, Tea	91.0	100.0	1.7	9.8
Rubber	24.4	34.4	0.6	40.8
Coconut	20.4	24.5	0.4	19.9
Paddy	32.6	35.7	0.6	9.6
Vegetable and Fruit Cultivation and Minor Food Crops	29.3	37.9	0.7	29.1
Fisheries	17.5	20.1	0.4	15.0
Industry	2,041.4	2,354.4	41.1	15.3
of which, Construction	993.5	1,133.8	19.8	14.1
Food and Beverages	105.1	124.6	2.2	18.6
Textiles and Apparel	174.7	201.6	3.5	15.4
Fabricated Metal Products, Machinery and Transport Equipment	170.3	202.7	3.5	19.1
Services	1,393.9	1,641.4	28.6	17.8
of which, Wholesale and Retail Trade	435.8	486.7	8.5	11.7
Tourism	172.0	198.3	3.5	15.3
Financial and Business Services	306.5	396.3	6.9	29.3
Shipping, Aviation and Freight Forwarding	19.2	25.4	0.4	32.3
Personal Loans and Advances (e)	1,053.2	1,267.4	22.1	20.3
of which, Consumer Durables	210.2	228.4	4.0	8.7
Pawning	148.4	171.7	3.0	15.7
Credit Cards	91.5	106.6	1.9	16.5
Total	4,900.9	5,733.1	100.0	17.0

(a) Based on the Quarterly Survey of Commercial Banks' Loans and Advances to the Private Sector

Source: Central Bank of Sri Lanka

(b) Includes loans, overdrafts and bills discounted and excludes cash items in the process of collection
(c) Total values in this Table differ from credit to the private sector values in Table 7.5 due to differences in the compilation methodologies
(d) Provisional
(e) Excludes personal housing loans, which have been included under 'Construction' classified under 'Industry' and includes safety Net scheme relaed Loans

Table 7.7
Maturity Analysis of Outstanding Credit to the Private Sector by Commercial Banks (a)(b)

Sector	Maturity	December 2017		December 2018	
		% Share	% Growth	% Share	% Growth
Agriculture and Fishing	Short Term	5.6	17.6	5.1	6.4
	Medium Term	1.7	4.2	1.9	28.3
	Long Term	1.0	13.9	1.2	30.7
Industry	Short Term	14.0	21.4	14.2	18.5
	Medium Term	10.1	16.2	9.4	8.1
	Long Term	17.5	20.1	17.5	17.0
Services	Short Term	11.0	4.3	11.0	17.5
	Medium Term	10.0	9.7	9.5	11.0
	Long Term	7.4	12.6	8.1	27.3
Personal Loans and Advances	Short Term	8.8	18.8	9.3	23.5
	Medium Term	5.5	11.4	5.0	7.7
	Long Term	7.2	24.1	7.8	26.0
Total	Short Term	39.4	15.0	39.7	17.6
	Medium Term	27.4	12.0	25.8	11.5
	Long Term	33.2	19.0	34.5	21.7

(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 to five years - medium term, over five years - long term

Source: Central Bank of Sri Lanka

and Beverages subsectors recorded an expansion during 2018. Meanwhile, credit to the Agriculture and Fishing sector grew by 14.0 per cent, year-on-year, by end 2018 in comparison to the growth of 14.1 per cent at end 2017. Within this sector, credit flows to Rubber; Vegetable, Fruit Cultivation and Minor Food Crop subsectors recorded a notable expansion while credit flows to Tea; Coconut; Paddy; Livestock and Dairy Farming and Fisheries subsectors moderated in 2018. Credit to the Services sector grew notably by 17.8 per cent, year-on-year, by end 2018, compared to 8.3 per cent recorded at end 2017. Reflecting increased credit flows to leasing companies, finance companies and other financial intermediaries by the banking sector, credit to Financial and Business Services subsector grew by 29.3 per cent, year-on-year, by end 2018, compared to the negative growth of 0.5 per cent at end 2017. Further, credit expansion in the Services sector was also supported by lending to Transport and Shipping, Aviation and Freight Forwarding subsectors. However, expansion in credit to the Wholesale and Retail Trade and Tourism subsectors recorded some moderation during the year. Meanwhile, Personal Loans and Advances grew by 20.3 per cent, year-on-year, by end 2018, in comparison to the growth of 18.5 per cent at end 2017. Within Personal Loans and Advances, growth of pawning advances accelerated to 15.7 per cent, year-on-year, by end 2018, from 12.1 per cent at end 2017. Credit disbursed to purchase consumer durables as well as credit on account of credit cards also increased considerably in 2018. Moreover, in terms of maturity analysis of outstanding credit to the private sector by commercial banks, an increase was observed both in short term and long term credit, while a marginal slowdown was observed in medium term credit. Accordingly, both short term and long term credit growth accelerated to 17.6 per cent and 21.7 per cent, respectively, by end 2018, compared to 15.0 per cent and 19.0 per cent, respectively, observed at end 2017. Meanwhile, medium term credit growth moderated to 11.5 per cent by end 2018, in comparison to a growth of 12.0 per cent at end 2017.

Broad Money (M_4)

Growth of broad money as measured by the financial survey (M_4)[3] decelerated gradually in 2018, in line with the trend observed in broad

3 Financial survey provides a broader measure of liquidity, covering LSBs and LFCs in addition to LCBs and the Central Bank

money supply (M_{2b}). Year-on-year growth in M_4 declined to 12.0 per cent by end 2018, compared to a higher growth of 17.6 per cent recorded at end 2017. The growth in M_4 was driven entirely by the expansion in NDA. Increased credit disbursements to both the private and public sectors contributed to the expansion in NDA, while NFA recorded a contraction during the year.

On the liabilities side of M_4, the growth of quasi money, which contains time and savings deposits of licensed banks and licensed finance companies (LFCs), moderated to 12.7 per cent by end 2018, compared to 19.7 per cent recorded at end 2017. As per the institutional breakdown, the increase in time and savings deposits of LFCs was only 1.0 per cent, year-on-year, by end 2018, recording a sharp slowdown during the year, compared to the growth of 29.4 per cent at end 2017, partly attributing to the precautionary behaviour of savers. The year-on-year growth of time and savings deposits with Licensed Specialised Banks (LSBs) also decelerated to 11.3 per cent by end 2018, from 15.2 per cent growth recorded at end 2017.

As per M_4, the year-on-year growth of credit extended to the private sector was at 14.9 per cent by end 2018, compared to 14.6 per cent at end 2017. Credit growth averaged 15.2 per cent in 2018, compared to 17.5 per cent in 2017. In addition to the increase in credit to the private sector by commercial banks, as observed in M_{2b}, credit disbursements by LFCs contributed largely to the overall expansion in private sector credit under M_4. Credit disbursed to the private sector by LFCs grew

Table 7.8
Assets Side of Broad Money (M_4)
(Computed as per the Financial Survey)

Rs. billion

Item	End 2017	End 2018 (a)	Change 2017 Amount	Change 2017 %	Change 2018 Amount	Change 2018 %
Financial Survey (M_4)	7,795.9	8,729.6	1,165.7	17.6	933.7	12.0
Underlying Factors						
Net Foreign Assets	-34.2	-133.7	349.0	91.1	-99.5	-291.2
Monetary Authorities (b)	846.1	750.5	287.5	51.5	-95.6	-11.3
LCBs	-724.6	-817.5	65.2	8.3	-92.9	-12.8
LSBs and LFCs	-155.7	-66.7	-3.8	-2.5	89.1	57.2
Net Domestic Assets	7,830.1	8,863.3	816.6	11.6	1,033.2	13.2
Domestic Credit	9,841.8	11,355.1	1,078.5	12.3	1,513.3	15.4
Net Credit to the Government	2,778.9	3,098.6	223.1	8.7	319.6	11.5
Central Bank	225.1	471.3	-187.9	-45.5	246.3	109.4
LCBs	1,943.4	2,043.9	384.3	24.6	100.5	5.2
LSBs	545.6	518.6	30.0	5.8	-27.1	-5.0
LFCs	64.8	64.8	-3.3	-4.9	-0.03	-0.1
Credit to Public Corporations (LCBs) (c)	537.0	755.4	23.2	4.5	218.4	40.7
Credit to the Private Sector (c)	6,525.8	7,501.1	832.2	14.6	975.3	14.9
LCBs (c)	4,799.2	5,561.4	613.4	14.7	762.1	15.9
LSBs	676.8	753.8	114.6	20.4	77.0	11.4
LFCs	1,049.8	1,185.9	104.2	11.0	136.1	13.0
Other Items (net) (d)	-2,011.7	-2,491.8	-261.8	-15.0	-480.1	-23.9

(a) Provisional
(b) This includes NFA of the Central Bank as well as the government's Crown Agent's balance reported by the Department of State Accounts
(c) Revised
(d) Computed as the difference between other assets and other liabilities

Source: Central Bank of Sri Lanka

7

13.0 per cent by end 2018, compared to 11.0 per cent recorded at end 2017. In absolute terms, credit extended to the private sector by LFCs increased by Rs. 136.1 billion during 2018, compared to the increase of Rs. 104.2 billion in 2017. Nevertheless, credit expansion of LSBs moderated to 11.4 per cent by end 2018, compared to 20.4 per cent recorded by end 2017, while recording an increase of Rs. 77.0 billion during the year, compared to Rs. 114.6 billion in 2017.

7.5 Future Developments, Challenges and Outlook

After several years of debate and deliberations in academic and policy circles, the Central Bank of Sri Lanka is currently on the verge of adopting flexible inflation targeting (FIT) as its monetary policy framework. Following the approval of the Cabinet of Ministers for this transition, the required legal amendments are being drafted with revisions to the mandate of the Central Bank and the framework for fiscal-monetary coordination. These amendments to the MLA, which, in addition to introducing FIT, include limiting monetary financing of the government budget deficit and introduction of macroprudential authority, are expected to ensure the independence of the Central Bank in the conduct of monetary policy with enhanced accountability to the Parliament and the public as well as increased transparency. They will also strengthen the financial system oversight functions. Meanwhile, internal institutional arrangements with regard to monetary policy formulation are being streamlined further whilst improving the technical capacity of the Central Bank to support proactive data driven decision-making by producing improved macroeconomic projections in a timely manner. Most importantly, fiscal-monetary coordination needs to be enhanced further as inflation targets are expected to be decided jointly by the government and the Central Bank under the new policy framework. With a view to promoting transparency, awareness and credibility of monetary policy, the Central Bank continues to improve its external communications strategy by way of issuing regular forward looking monetary policy statements, which will be developed into Inflation Reports under the FIT framework. The improved communications strategy will help the general public to understand the framework for conducting monetary policy, thereby anchoring inflation expectations. Additionally, limiting monetary financing of the government budget will strengthen the conduct of OMOs to manage short term interest rates at desired levels. Although monetary policy will be increasingly effective in managing demand driven inflation and inflation expectations in the new FIT framework, transitory supply side disruptions to price pressures need to be addressed through timely intervention by the government. While the process of fiscal consolidation must continue to sustain inflation at desired levels in the medium term, the government is expected to play a key role to address short run disruptions to food supplies. The conduct of exchange rate policy with greater flexibility in the exchange rate will remain as the first line of defense to dampen the impact of external shocks and the policy interest rates are expected to increasingly focus on domestic developments.

With inflation expected to be maintained at mid-single digit levels on a sustained basis, it is likely that the economy will move to a low interest rate regime in future, and this highlights the need to introduce new financial products with reasonable rates of return for an ageing population. The proposed FIT framework entails maintaining inflation at mid-single digit levels in the medium term. This regime shift is likely to be accompanied by a gradual decline in nominal interest rates from their current high levels, which could potentially affect savers, particularly senior citizens who depend on interest income. In this background, it is essential that the general public is made aware of such a transition in advance

BOX 09

Choice of the Inflation Target for Flexible Inflation Targeting (FIT) in Sri Lanka

Introduction

In January 2017, the Central Bank of Sri Lanka (CBSL) announced its intention to adopt flexible inflation targeting (FIT) as its monetary policy framework by 2020, with a view to maintaining low and stable inflation in the medium term in a sustained manner. As Sri Lanka gradually fulfills the prerequisites to adopt FIT as the new monetary policy framework, the choice of the inflation target (the inflation metric) has become a key policy decision that remains to be taken. This choice requires deciding on several parameters such as which price index to target, at what level the inflation target should be set, what should be the

optimal inflation target bandwidth, over what time horizon should inflation be brought back to target in case of a deviation, and who should set the target. This article explains the thinking behind the CBSL's current deliberations on the choice of the inflation target, as an appropriate inflation metric is a key requirement for the successful implementation of FIT.

Table B 9.1 shows some examples of different inflation metrics used by selected emerging market economies as well as advanced economies.

Urban Price Index vs National Price Index

In selecting an appropriate price index to measure headline inflation, criteria such as the accurate representation of cost of living, volatility, predictability, inflation persistence, link with inflation expectations and continuity of the chosen price index must be considered. A consumer price index is used as a target measure in most inflation targeting economies since it covers the cost of living of households. A national consumer price index captures the expenditure patterns across a nation, whereas an urban consumer price index captures the expenditure patterns of consumers in urban areas only. A national consumer price index appears to be a good measure of inflation in terms of geographical coverage. However, an urban index could be a better reflection of price trends in the market since regional prices may fluctuate substantially primarily due to differences in consumption and lifestyle patterns.

In Sri Lanka, the National Consumer Price Index (NCPI) and the Colombo Consumer Price Index (CCPI) are compiled and published by the Department

Table B 9.1
Choice of Inflation Metric

Country	Target measure	Target	Target type	Target horizon	Target set by
Australia	HCPI	2.0% - 3.0%	Range	Medium term (Average)	G and CB
Brazil	HCPI	4.25% +/- 1.5 pp	P+T	Yearly target	G and CB
Canada	HCPI	2.0% +/- 1.0 pp	P+T	6 - 8 quarters	G and CB
Chile	HCPI	3.0% +/- 1.0 pp	P+T	Medium term (2 years)	CB
Czech Republic	HCPI	2.0% +/- 1.0 pp	P+T	12 - 18 months	G and CB
Hungary	HCPI	3.0% +/- 1.0 pp	P+T	Medium term	CB
India	HCPI	4.0% +/- 2.0 pp	P+T	5 years	G in consultation with the CB
Indonesia	HCPI	3.5% +/- 1.0 pp	P+T	Medium term (Yearly)	G and CB
New Zealand	HCPI	1.0 % - 3.0% (with future average inflation near the 2.0% target midpoint)	Range	Medium term	G and CB
Philippines	HCPI	3.0% +/- 1.0 pp	P+T	Medium term (2 years)	G and CB
Sweden	HCPI	2.0% +/- 1.0 pp	P+T	2 years	CB
Thailand	HCPI	2.5% +/- 1.5 pp	P+T	Medium term	G and CB
United Kingdom	HCPI	2.0%	P	Medium term	G

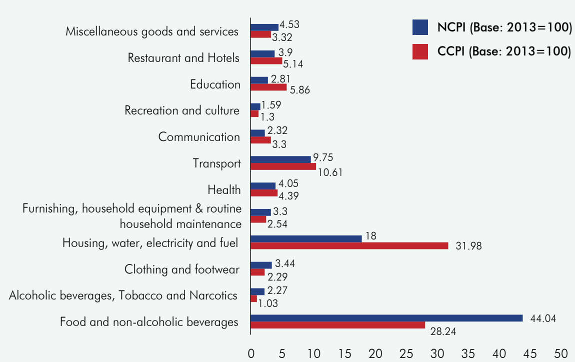
HCPI: Headline inflation, G: Government, CB: Central Bank, P: Point, T: Tolerance band, PP: percentage points
Source: Respective Central Banks

7

of Census and Statistics (DCS), to measure consumer price inflation.[1] The NCPI captures the island-wide price movements and consists of a slightly higher number of items than the CCPI, whereas the CCPI captures the price movements in urban areas of the Colombo district. In spite of the wider coverage, the NCPI may not properly capture the actual market price movements as a large share of rural population tend to consume food items produced by themselves, and the dependence on the market for such items is relatively less. Therefore, an urban price index, such as the CCPI, could capture market price movements better.

Furthermore, the weight of the food basket, which is largely subjected to supply shocks and less responsive to monetary policy, is high in the NCPI compared to the CCPI (Figure B 9.1). Urban consumers tend to spend more on non-food categories compared to their rural counterparts. With a larger food basket, the NCPI is more volatile than the CCPI, as the former is susceptible to short-term supply conditions of food items.

Figure B 9.1
Weights by Main Categories



Source: Department of Census and Statistics

Further, the role of inflation expectations in shaping actual inflation is widely recognised in the formulation of forward-looking monetary policy. The inflation indicator is, therefore, expected to be closely associated with inflation expectations, and at present, the correlation between the NCPI based inflation and inflation expectations is relatively weak in comparison to that of the CCPI (Table B 9.2). Moreover, the low volatility of the CCPI in relation to the NCPI makes the former easier to forecast, which is essential under FIT. Given these considerations, it may be appropriate to use CCPI, which is an urban price index, especially in the initial years of FIT.

1. NCPI is available from January 2014, while CCPI (on different base years) is available from January 1953.

Table B 9.2
Correlation between Inflation and Inflation Expectations

	1 Month	6 Month	12 Month
CCPI (Y-o-Y)	0.92	0.92	0.91
NCPI (Y-o-Y)	0.74	0.70	0.71

Source: Staff Calculations

Headline vs Core Inflation

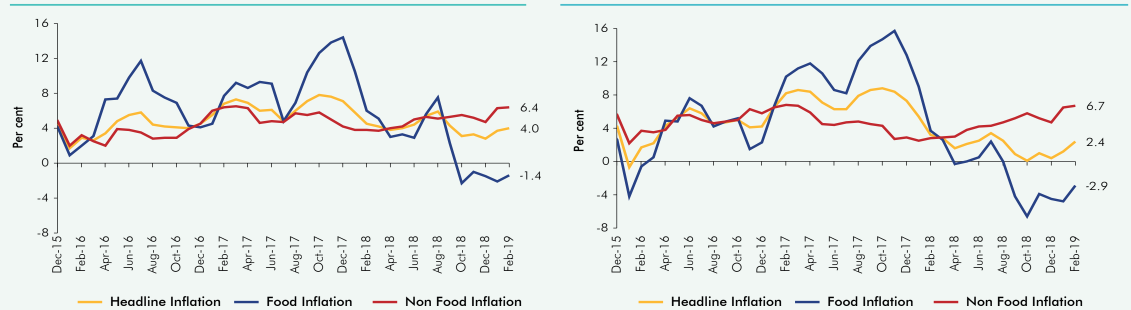
Most inflation targeting economies use headline inflation as the target measure. It captures changes in the cost of living reasonably well and it is easily understood by the general public. However, it is generally understood that the narrow measure of inflation known as core inflation, better reflects the demand driven component of inflation, as headline inflation could be driven by transitory supply side factors at times. Core inflation usually excludes transitory or temporary price volatility as in the case of some commodities such as food items, energy products, etc. According to Mishkin (2007), core inflation provides stronger signals about persistent movements in inflation than headline inflation, but may not be a good communication channel as the general public tend to base their decisions on the movements of headline inflation. Furthermore, literature finds that core inflation has a weaker relationship with inflation expectations compared to headline inflation, as headline inflation has a variety of sensible linkages to price volatility such as wages, social payments and return on investment (McCauley, 2007). Accordingly, Anand et al. (2015) show that headline inflation targeting improves welfare outcomes, compared to core inflation targeting.

In Sri Lanka, the food component accounts for a significant portion of the headline consumer price index. Hence, movements in food prices remain a key driver of inflation that could lead to deviations in actual inflation from targeted levels (Figure B 9.2). Excluding volatile food, and energy and transport components enables core inflation to have a stronger predictive power than headline inflation. However, movements in inflation expectations as per the Inflation Expectations Survey also suggest that headline inflation remains a more powerful communication device than the core measure of inflation. Its impact on inflation expectations also makes headline inflation a better index for the forward-looking policy formulation necessary under FIT. Hence, similar to several other economies, headline inflation measure appears to be a more appropriate target for inflation under FIT in Sri Lanka.

Figure B 9.2

Year-on-Year Inflation - Food and Non Food CCPI (Base: 2013=100)

Year-on-Year Inflation - Food and Non Food NCPI (Base: 2013=100)



Source: Department of Census and Statistics

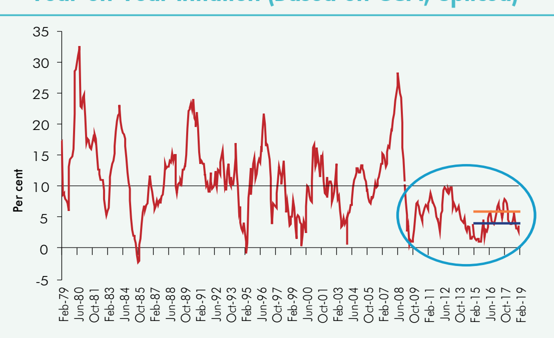
Type of the Inflation Target

Deciding on the optimal target level for inflation is also important. Inflation targeting economies have specified three types of targets: point, point with tolerance band or a target range. Countries with a point target for inflation specifies the target as a single number (E.g. 2 per cent). However, it is hard to pursue a point target for an economy like Sri Lanka as supply side factors have a significant influence on headline inflation. As it is difficult to attain an exact point target, many economies target a point complemented with a tolerance band. Therefore, if a central bank announces a point target with a tolerance band, the public would be aware of the possibility of any transitory deviations from the point target. On the other hand, a range target is specified with a lower and upper bound without any reference to a point target. In this setup, there is no requirement for the central banks to bring inflation back to the middle of the band. One disadvantage of this type of target is that anchoring inflation expectations firmly could be difficult as there is no point target. Therefore, most inflation targeting economies use a point target with a tolerance band (Table B 9.1).

Although Sri Lanka's inflation has been highly volatile prior to 2008, a notable reduction in volatility has been observed since then. The CBSL has been able to stabilise CCPI based headline inflation in single digits, and more recently within the implicit target range of 4.0-6.0 per cent (Figure B 9.3). The improved inflation performance is also partly due to the low inflation world that has prevailed since the global financial crisis (2008).

Figure B 9.3

Year-on-Year Inflation (Based on CCPI, Spliced)

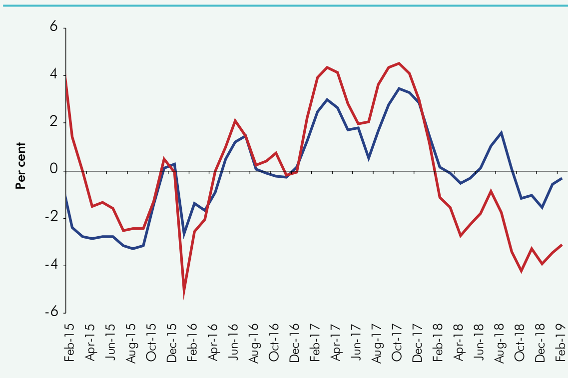


Source: Department of Census and Statistics

Under the current monetary policy framework, the CBSL has been able to maintain inflation based on both the CCPI and the NCPI at around 4.5 per cent, on average, since 2015. In terms of volatility, it has been observed that the standard deviation of NCPI based inflation is higher at 2.6 per cent when compared to the standard deviation of 1.9 per cent for CCPI based inflation (Figure B 9.4). Therefore, targeting a reasonably wide band with a midpoint of around 5 per cent would be suitable for Sri Lanka in the early stages of implementing FIT, and the band could be narrowed once the credibility of FIT improves over time.

Figure B 9.4

CCPI and NCPI (Deviation from the Mean)



Source: Staff Calculations

How should the target be set?

Another fundamental aspect when determining the appropriate inflation metric is deciding on how the inflation target should be set, i.e., what is the appropriate target horizon and which entity is responsible for setting the target.

In spite of the presence of a target band, maintaining inflation at desired levels could become challenging at times due to exogenous shocks emanating from the global and domestic developments. Moreover, the long and variable lags of monetary transmission require a considerable period of time for inflation to respond to monetary policy actions. While there are arguments favouring both longer and shorter policy horizons, setting an appropriate target horizon, which defines the time it takes for inflation to return to the target level following a deviation, is essential, thereby aiding the successful anchoring of inflation expectations and policy credibility (Plantier, 2002). The Reserve Bank of New Zealand, the pioneer inflation targeter, set its initial target horizon to 12 months, and revised it later to five years once inflation was successfully brought down to the desired level. The Czech National Bank, which had to cope with historically high levels of inflation, had a higher inflation target initially for the near term, which was then gradually lowered over time to rein in and guide inflation along the desired path. With inflation receding to desired low levels, the inflation target horizon was changed from near to medium term. The Reserve Bank of India, which adopted FIT in 2014, initially stipulated a time horizon of two years for the achievement of the inflation target (Reserve Bank of India, 2014). With inflation returning to desired levels, a medium term target for inflation was set thereafter. Considering the statistical relationships between short term interest rates, real output and inflation as well as the vulnerability of the Sri Lankan economy to supply shocks, a medium term target horizon of 2-3 years seems appropriate for Sri Lanka at the beginning.

While the long-term price stability objective is usually stipulated in the central bank legislation, there are three models as to who should set the medium term inflation target: the central bank alone, the government alone, or jointly by the central bank and the government. The argument that a central bank should conduct monetary policy to achieve a target set externally has prompted governments in several economies to intervene in setting medium term inflation targets. However, in a transitory period of disinflation, where inflation is not at its long-term target at the time of the adoption of the inflation targeting framework, the central bank may have far more expertise in technically evaluating the disinflation path and setting the medium term target, avoiding time inconsistent policies influenced by politicians (Hammond, 2011 and Mishkin, 2001). On the other hand, when inflation is sufficiently low and the medium term target is likely to be the same as the long term target, there are neither technicalities involved nor conflicts between who determines the inflation target, and the government could become the target setter. To bring in the technical expertise of the central bank in determining the medium term inflation target alongside the government's commitment to adhere to the inflation target, the current practice of various inflation targeting economies and relevant literature[2] suggest that the joint determination of the inflation target is preferable, especially for emerging market economies.

Conclusion

Following the announcement of the intention to adopt FIT by 2020, the CBSL is currently in the process of evaluating the available choices with regard to appropriate inflation metrics and other related decisions, vis-à-vis the international best practices. An initial assessment, as discussed above, shows that headline inflation based on an urban consumer price index, targeting mid-single digit level inflation with a reasonably wide tolerance band over a target horizon of 2-3 years, which is jointly decided by both the government and the CBSL would be appropriate for Sri Lanka. The forthcoming amendments to the Monetary Law Act requires a monetary policy framework agreement to be signed between the government and the CBSL to stipulate the above choices, enabling the operationalisation of FIT and facilitating the achievement of the monetary policy objective of price stability.

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2. As per the country study by Hammond (2011), which surveyed twenty seven countries that practiced fully fledged inflation targeting, the medium term inflation target of fifteen countries were jointly determined, while inflation targets of nine countries were determined solely by the central bank. Only three countries, namely Norway, South Africa and the United Kingdom, follow the practice of the government being the sole authority that determines the inflation target.

7

while encouraging the financial sector to introduce sustainable, long term financial products, which provide reasonable real returns to investors.

A key policy paradox that continues to puzzle policymakers is the continuation of domestic credit expansion despite elevated nominal and real interest rates, while economic growth remains subpar. With improvements in supply side factors, appropriate demand management policies of the Central Bank and the government's attempts towards fiscal consolidation, inflation remains subdued, while interest rates have remained high in both nominal and real terms for a considerable period of time. In spite of such high interest rates, credit obtained by the private sector has expanded notably in recent years. However, irrespective of credit expansion, economic growth has remained subpar and below potential for several consecutive quarters. The subpar growth may be partly attributed to the non-optimal allocation of credit towards less productive sectors with a bias towards consumption related imports. In order to ensure price stability as well as to achieve sustained economic growth, it is imperative that the research community, academia and policymakers investigate the policy paradox, thus giving rise to research-backed policies to promote investments in more productive sectors of the economy.