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Press Release

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Monetary Policy Review – January 2014

The continued easing of monetary policy through 2013 amidst low and stable inflation has brought about the desired macroeconomic outcomes. Available leading indicators show that real GDP growth is set to record around 7.2 per cent growth for 2013. Monetary aggregates moved towards the projected path. Both current and capital accounts of the Balance of Payments (BOP) improved, resulting in a stronger exchange rate and an international reserve position. Meanwhile, both headline and core inflation moderated further, reaching 4.7 per cent and 2.1 per cent (Y-o-Y), respectively, in December 2013. Average headline and core inflation for 2013 were at 6.9 per cent and 4.4 per cent, respectively, compared to 7.6 per cent and 5.8 per cent, respectively, in 2012.

Broad money (M_{2b}) growth decelerated to 16.7 per cent (Y-o-Y) in November 2013 bringing the average growth of broad money to 16.5 per cent, down from 20.2 per cent during 2012. Responding to the reduction in market interest rates and improved business confidence, credit obtained by the private sector from commercial banks increased by Rs. 22.2 billion during the month of November 2013 following the increase of Rs. 27.2 billion observed in October. Accordingly, in addition to the

funds raised by the private sector through domestic and international debt and equity markets and borrowing from other domestic financial institutions, credit extended by commercial banks to the private sector during January-November 2013 amounted to Rs. 160.6 billion. Public corporations continued to repay the banking sector for the third consecutive month, resulting in credit to public corporations declining by Rs. 18.8 billion in November 2013. Net credit to the Government also declined by Rs. 3.5 billion during the month, as expected.

In the external sector, earnings from exports, which increased by 24.7 per cent (Y-o-Y) in November 2013, exceeded US dollars 1 billion for the second consecutive month, resulting in cumulative earnings of US dollars 9.4 billion during January-November 2013. With cumulative expenditure on imports declining by 2.5 per cent to US dollars 17.2 billion, the cumulative trade deficit contracted by 10.7 per cent to US dollars 7.8 billion during the period. Increased inflows from services exports and workers' remittances strengthened the current account further while substantial foreign capital inflows resulted in the BOP recording a surplus of over US dollars 700 million in 2013 compared to the surplus of US dollars 151 million in 2012. Reflecting the improved external sector performance, Gross Official Reserves increased to US dollars 7.1 billion (provisional) by end 2013. The Sri Lankan rupee strengthened gradually since early September 2013, having effectively faced the global market turmoil caused by the announcement of possible tapering of quantitative easing by the US Federal Reserve.

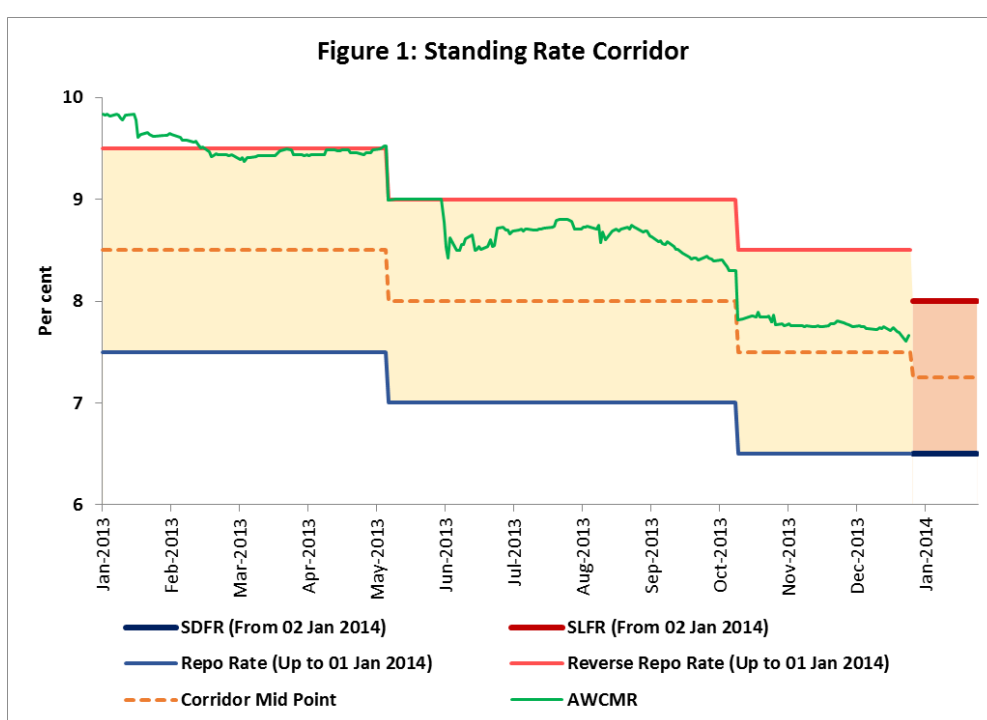
Going forward, economic growth is expected to accelerate further during the new year, while inflation is projected to remain in mid-single digits. With the expected improvement in Net Foreign Assets of the banking sector, continued fiscal consolidation and increased growth of credit to the private sector of around 16 per cent, broad money is projected to expand by about 14 per cent in 2014. This will be sufficient to facilitate expected economic growth without fuelling demand driven inflationary pressures. The external sector is also envisaged to improve further, with

the expected recovery in advanced economies and structural measures adopted domestically to strengthen the sector.

In view of these developments and expectations, the Monetary Board, at its meeting held on 27th December 2013 decided to adopt the following monetary policy measures:

1. The Monetary Board decided to establish a Standing Rate Corridor (SRC) in place of the current Policy Rate Corridor with immediate effect (See Figure 1). Accordingly, the following changes will take place:
 - a. The current Standing Repurchase Facility will be renamed as the Standing Deposit Facility (SDF), and the Standing Deposit Facility Rate (SDFR) will be the rate for the placement of overnight excess funds of the banking system
 - b. The current Standing Reverse Repurchase Facility will be renamed as the Standing Lending Facility (SLF), and the Standing Lending Facility Rate (SLFR) will be the rate for the lending of overnight funds to the banking system
 - c. Open Market Operation (OMO) auctions will continue unchanged, with Repurchase and Reverse Repurchase auctions, depending on liquidity conditions in the domestic money market
2. The Monetary Board was of the view that the requirement of providing collateral by the Central Bank to OMO participants under the Standing Deposit Facility was unnecessary, since the Central Bank is the monetary authority of the country. Accordingly, in consideration of the Central Bank's zero credit risk in rupee transactions, the Monetary Board decided that, with effect from 1st February 2014, the Standing Deposit Facility will be uncollateralised. However, all other OMO transactions will remain collateral-based, as at present.

3. The Monetary Board also observed that the volatility in the interbank call money market has reduced substantially over time, and was of the view that a compression of the Standing Rate Corridor is now warranted. Accordingly, the Monetary Board decided to reduce the Standing Lending Facility Rate of the Central Bank by 50 basis points to 8.00 per cent with immediate effect, thereby compressing the Standing Rate Corridor to 150 basis points from the current 200 basis points. It is expected that this compression will facilitate the reduction of the interest spread of banks over time, without affecting the deposit rates offered by banks to their customers.



4. The Monetary Board also reviewed the minimum cash margin requirement of 100 per cent against Letters of Credit opened with commercial banks for the import of certain categories of motor vehicles, imposed on 30th August 2013. Considering the improvement in the external sector, the Monetary Board decided to remove this requirement with immediate effect.

The date for the release of the next regular statement on monetary policy would be announced in due course.