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MONETARY POLICY, INTEREST RATES, MONEY AND CREDIT

7.1 Overview

The Central Bank tightened the monetary policy stance significantly during 2022 aimed at countering the soaring price pressures and persistent acceleration of inflation, while anchoring inflation expectations and reining in underlying demand pressures. Such tightening of monetary policy was warranted in addressing unprecedented vulnerabilities in the external sector amidst the worst balance of payments (BOP) stresses experienced in the post-independence economy and in offsetting the impact of the anomalous interest rate structure due to rising risk premia of yields on government securities amidst growing concerns about domestic debt restructuring. Price pressures spiralled up during the year due to a multitude of factors, including domestic supply side disruptions, long overdue adjustments to administrative prices in response to the hikes in global oil and commodity prices and their spillovers, faster passthrough of the significant depreciation of the currency, and lagged impact of monetary accommodation during the COVID-19 pandemic, among others. Reflecting the impact of the tight monetary policy stance, liquidity in the domestic money market remained in deficit, with elevated lending and deposit interest rates, thereby constraining the expansion of money and credit. Especially, market lending and deposit interest rates rose notably within a span of a few months, reflecting the rapid passthrough of tight monetary policy, large liquidity deficit levels, and elevated risk premia. In response, the expansion of broad money supply and credit slowed significantly, with credit obtained by the private sector suffering the most, as reflected by the continuous month-on-month contraction since June 2022. The impact of tight monetary conditions and improvements on the supply side with the abating BOP pressures helped contain price pressures towards late 2022. Headline inflation peaked in September 2022 and has been on a steady disinflation path since then. However, credit extended to the Government by the banking system remained considerably high during the year amidst subdued government revenue and limited access to foreign financing following the external debt standstill announcement in April 2022. The persistently large government borrowing requirement, together with concerns about domestic debt restructuring, caused the yields on government securities to soar and remained at extraordinarily high levels during the year, although some moderation was observed towards late 2022 with improving market sentiments on the successful finalisation of the Extended Fund Facility (EFF) arrangement from the International Monetary Fund (IMF). Meanwhile, market deposit interest rates as well as short term market lending interest rates began to decline gradually, in line with the monetary policy communication of the Central Bank that underscored the need to bring down excessive interest rates that moved alongside the yields on government securities. Further, the Central Bank initiated measures to ease liquidity stresses in the money market by providing liquidity on a long term basis, while reducing the banks' overreliance on standing facilities, thereby facilitating the gradual downward movement of the interest rate structure, which has overly responded with a disproportionate upward adjustment, compared to the magnitude of policy interest rate tightening thus far. Meanwhile, the Central

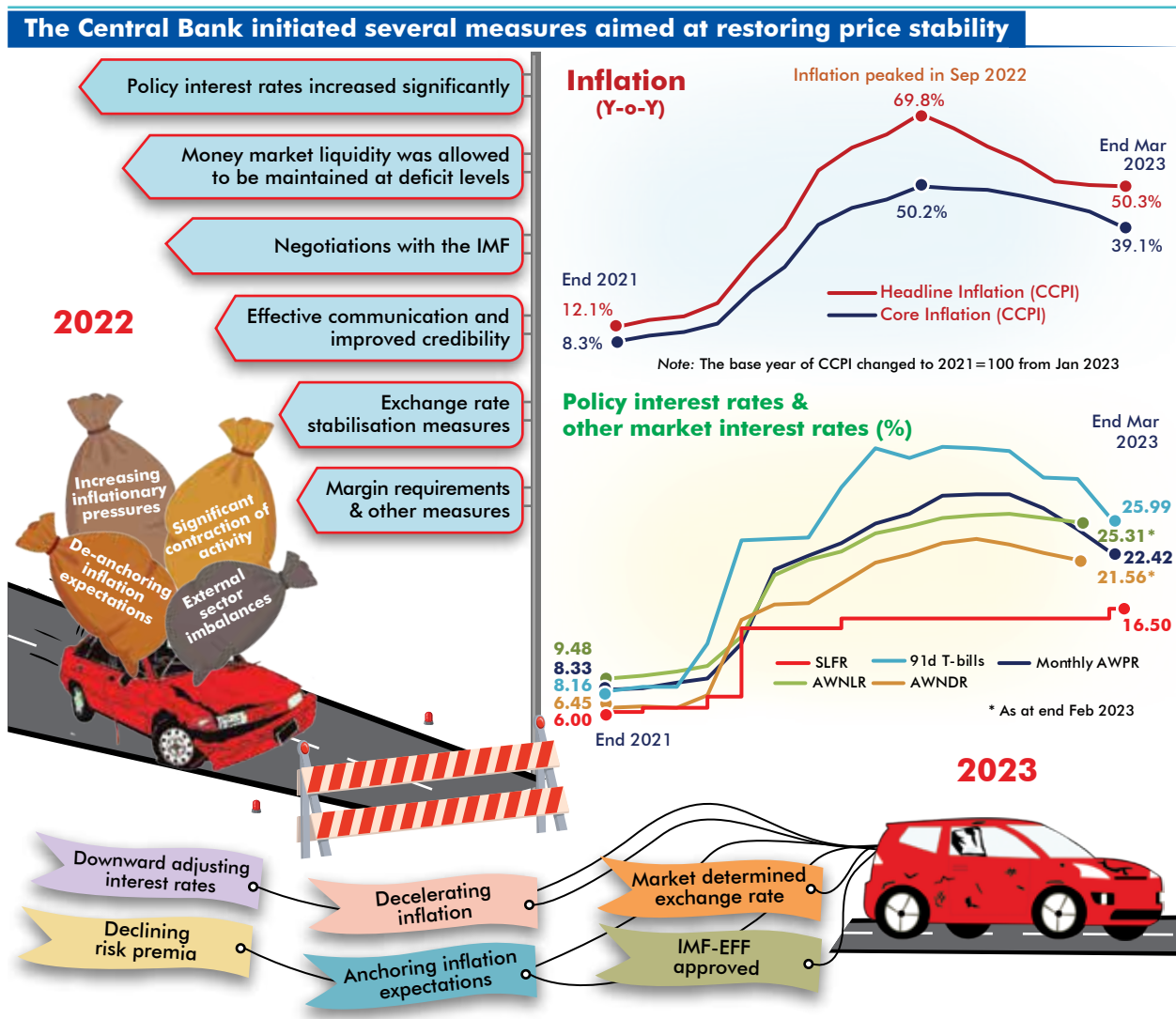
Bank increased the policy interest rates in March 2023 in fulfilling the remaining 'prior action' of the IMF-EFF arrangement. This helped lower the spread between policy interest rates and market interest rates further. Notwithstanding this increase in policy interest rates, the declining trend of market interest rates continued in keeping with the market guidance provided by the Central Bank since late 2022. Reflecting the impact of monetary policy and other measures, headline inflation is expected to return to a single digit level towards late 2023 and remain within the targeted level over the medium term. Most importantly, the downward adjustment of the market interest rates observed thus far is expected to continue in the period ahead, supported by declining inflation and more clarity that may become available on the options for domestic debt optimisation and the resultant reduction in high risk premia attached to the yields on government securities. This would help ease the significant tightness in monetary conditions and foster a gradual turnaround in credit to the private sector. Meanwhile, the expected enactment of the new Central Bank legislation is envisaged to provide further impetus in implementing monetary policy in the absence of fiscal dominance.

7.2 Monetary Policy Stance

The Central Bank continued the tight monetary policy stance that commenced in August 2021 through 2022 in view of arresting inflationary pressures and possible de-anchoring of inflation expectations. By considering the significant acceleration of inflation in the country and the large anomaly that existed between policy interest rates and market interest rates amidst external and fiscal sector imbalances, the Central Bank's key policy interest rates, i.e., the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR), were raised by 10 percentage points till end 2022, since the monetary tightening cycle that began in August 2021, and a larger portion of that adjustment, i.e., 7 percentage points, took place in April 2022. The extended period of monetary accommodation since the onset of the COVID-19 pandemic in early 2020 and a sharp depreciation of the Sri Lanka rupee against the US dollar during March 2022 resulted in significant upside risks to the inflation outlook, compelling the Central Bank to raise policy interest rates by 7 percentage points in April 2022 and a further 100 basis points in July 2022. Such tightening of monetary conditions helped arrest the build-up of demand driven inflationary pressures and preempt the escalation of adverse inflationary expectations, as well as

ease pressures on the external sector, while correcting the anomaly observed in the interest rate structure. In addition, maximum interest rates imposed on selected lending products as well as foreign currency deposits were removed, enabling the effective passthrough of policy interest rate changes to tighten monetary conditions. In order to support the tight monetary policy stance, overnight liquidity in the domestic money market was maintained at negative levels during 2022, although liquidity required for the operations of the money market was availed through the Standing Lending Facility (SLF). Liquidity in the domestic money market turned significantly negative during mid-2022 mainly due to the impact of foreign exchange transactions by the Central Bank in facilitating essential imports and external debt service payments of the Government. However, a gradual reduction of large negative liquidity levels was observed thereafter as a result of the primary market purchases of Treasury bills by the Central Bank to support the cashflow requirements of the Government and the return of currency to the banking system given the attractive deposit interest rates. Yields on government securities increased significantly during the year till around November 2022 driven by the sharp increase in the policy interest rates and elevated risk premia attached to government securities amidst uncertainties associated with debt restructuring

Figure 7.1
Monetary Sector Developments



Growth of credit to the private sector continued to decelerate

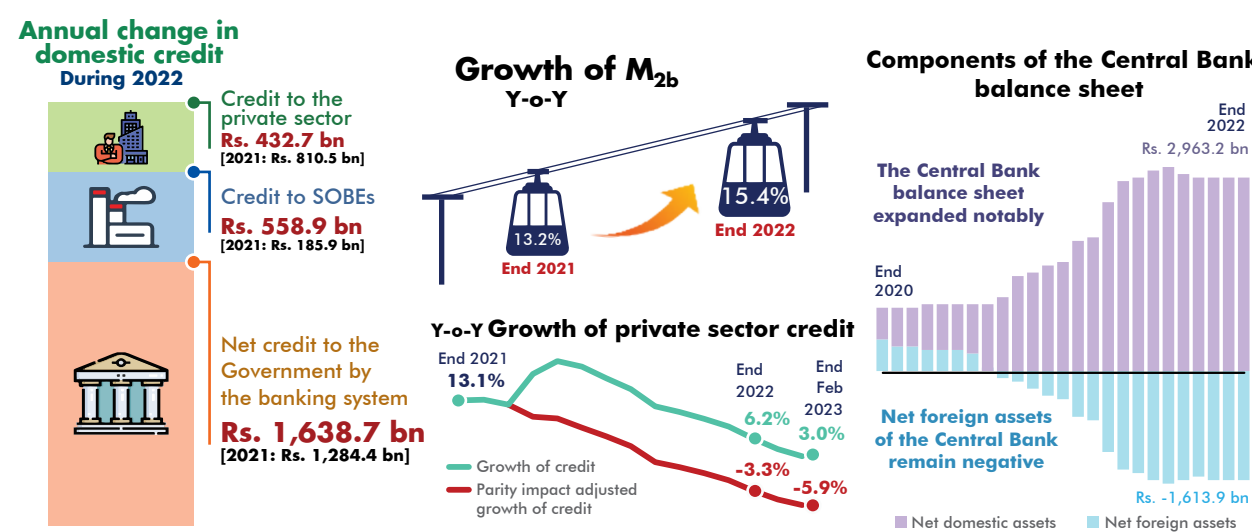


Table 7.1
Recent Monetary Policy Measures

Date	Measure
30 Jan 2020	SDFR and SLFR reduced by 50 basis points to 6.50% and 7.50%, respectively.
17 Mar 2020	SDFR and SLFR reduced by 25 basis points to 6.25% and 7.25%, respectively.
17 Mar 2020	SRR reduced by 1.00 percentage point to 4.00% to be effective from the reserve period commencing 16 March 2020.
27 Mar 2020	Introduced a concessional loan scheme, the Saubagya COVID-19 Renaissance Facility (Phase I - Refinance Scheme), up to a cumulative value of Rs. 50 billion at an interest rate of 4.00% to support the businesses and individuals affected by COVID-19.
03 Apr 2020	SDFR and SLFR reduced by 25 basis points to 6.00% and 7.00%, respectively, to be effective from the close of business on 03 April 2020.
06 May 2020	SDFR and SLFR reduced by 50 basis points to 5.50% and 6.50%, respectively, to be effective from the close of business on 06 May 2020.
16 Jun 2020	SRR reduced by 2.00 percentage points to 2.00% to be effective from the reserve period commencing 16 June 2020.
16 Jun 2020	Extended the concessional loan scheme introduced on 27 March 2020 up to Rs. 150 billion at an interest rate of 4.00% to support the businesses and individuals affected by COVID-19 (the Saubagya COVID-19 Renaissance Facility - Phase II)
09 Jul 2020	SDFR and SLFR reduced by 100 basis points to 4.50% and 5.50%, respectively.
19 Aug 2021	SDFR and SLFR increased by 50 basis points to 5.00% and 6.00%, respectively.
19 Aug 2021	SRR increased by 2.00 percentage points to 4.00% to be effective from the reserve period commencing 01 September 2021.
20 Jan 2022	SDFR and SLFR increased by 50 basis points to 5.50% and 6.50%, respectively.
04 Mar 2022	SDFR and SLFR increased by 100 basis points to 6.50% and 7.50%, respectively.
07 Mar 2022	A measured adjustment was allowed in the exchange rate.
08 Apr 2022	SDFR and SLFR increased by 700 basis points to 13.50% and 14.50%, respectively, to be effective from the close of business on 08 April 2022.
12 May 2022	Effective 13 May 2022, a middle rate of the USD/LKR exchange rate applicable for interbank foreign exchange market transactions was introduced together with the permitted USD/LKR variation margin, which is to be announced on a daily basis to facilitate orderly behaviour of the foreign exchange market and to manage undue intraday volatility in the exchange rate.
07 Jul 2022	SDFR and SLFR increased by 100 basis points to 14.50% and 15.50%, respectively.
02 Jan 2023	Effective 16 January 2023, the availability of the SDF to a particular LCB was limited to a maximum of five (05) times per calendar month. In addition, the availability of the SLF to a particular LCB was limited to 90 per cent of the SRR of such LCB at any given day.
03 Mar 2023	SDFR and SLFR increased by 100 basis points to 15.50% and 16.50%, respectively, to be effective from the close of business on 03 March 2023.
03 Mar 2023	Effective 07 March 2023, the issuance of market guidance through the announcement of a middle rate of the USD/LKR exchange rate and the variation margin was discontinued.

Source: Central Bank of Sri Lanka

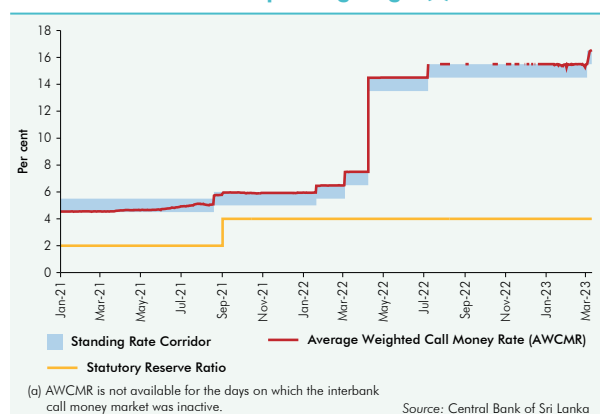
Note: The Central Bank imposed/revised caps on interest rates as follows:

- 27.04.2020: Imposed caps on interest rates on pawning advances of licensed banks
- 24.08.2020: Revised caps on interest rates (lightened) on selected lending products of licensed banks
- 26.11.2020: Imposed caps on interest rates on mortgage-backed housing loans of licensed banks
- 24.08.2021: Imposed caps on interest rates to be paid in respect of foreign currency deposit products of LCBs and NSB
- 30.12.2021: Revised caps on interest rates (linked to 364-day Treasury Bill yield) to be paid in respect of foreign currency deposit products of LCBs and NSB
- 31.12.2021: Revised caps on interest rates (linked to AWPR) on mortgage-backed housing loans of licensed banks
- 04.03.2022: Revised caps on interest rates (relaxed) on selected lending products of licensed banks
- 11.03.2022: Removed caps on interest rates to be paid in respect of foreign currency deposit products of LCBs and NSB
- 21.04.2022: Removed caps on interest rates on selected lending products of licensed banks

Delisted the Bank Rate from monetary policy instruments and it is to be considered as a policy instrument that the Central Bank uses as the lender of last resort (LOLR) to support the stability of the banking and financial system (effective 01.03.2023)

concerns. Reflecting a faster passthrough of tight monetary conditions, market interest rates rose significantly with most reaching historically high levels. However, this upward adjustment in market interest rates was disproportionate to the rise in policy interest rates due to the influence of the high risk premia attached to government securities on other market interest rates. This warranted some moral suasion by the Central Bank from November 2022 requesting banks to reduce overly excessive lending and deposit interest rates. Nonetheless, retail market interest rates remained high during 2022, despite some moderation observed from late 2022, in line with repeated requests by the Central Bank on the need to reduce excessive market interest rates, which were maintained at levels way above the policy interest rates. Growth of credit extended to the private sector by the banking system continued to moderate reflecting the tight monetary conditions and the moderation of overall economic activity amidst unprecedented economic stresses. Meanwhile, outstanding credit to the private sector contracted on a monthly basis from June 2022 through February 2023, reflecting the largest spell of contraction of credit on record. Consequently, the year-on-year growth of credit to the private sector moderated to 6.2 per cent by end 2022 and slowed further to 3.0 per cent by end February 2023, recording the lowest growth since July 2020. However, credit obtained by State Owned Business Enterprises (SOBEs) from the banking system expanded during the year, partly reflecting the impact of the depreciation of the exchange rate. Further, Net Credit to the Government (NCG) by the banking system also increased during 2022, driven mainly by NCG from the Central Bank amidst large scale monetary financing. The Central Bank was compelled to provide such monetary financing as a temporary measure to ease pressures on the government cashflow amidst dwindling foreign financing and

Figure 7.2
Movements in Key Policy Instruments
and the Operating Target (a)



revenue shortfalls. A large part of such monetary financing was routed back to the Central Bank to purchase foreign exchange needed to honour foreign currency debt servicing to multilateral lending agencies. However, new monetary financing would be restricted under the proposed Central Bank Act, thereby reinforcing monetary policy autonomy in the period ahead. Meanwhile, the Central Bank continued to maintain its tight monetary policy stance thus far in 2023 to ensure that underlying inflation and inflation expectations remain sufficiently restrained. However, the Central Bank provided liquidity on a long-term basis through open market operations in order to contain excessive pressures on market interest rates due to large deficit levels in the domestic money market for an extended period. Further, in order to promote activity in the domestic money market, which was hampered due to the large asymmetry in liquidity distribution, the Central Bank implemented regulatory actions limiting access to the standing facilities of the Central Bank effective mid-January 2023, thereby reducing the overdependence of Licensed Commercial Banks (LCBs) on standing facilities. Consequently, overnight liquidity in the domestic money market and activity in the interbank call and repo markets improved. Along with these developments and the improvement

in investor sentiment with the finalisation of the IMF-EFF arrangement, yields on government securities and other retail market interest rates commenced easing gradually, thereby easing monetary conditions to some extent, while narrowing the disorderly upward adjustment in market interest rates. Meanwhile, given the necessity of fulfilling all the 'prior actions' and to move forward with the finalisation of the EFF arrangement, amidst some differences in inflation projections of the Central Bank and the IMF staff, a consensus was reached in early March 2023 to raise the policy interest rates, by a notably lower magnitude, compared to the level of adjustment envisaged during the initial stage of negotiations. Accordingly, policy interest rates were increased by 100 basis points with effect from the close of business on 03 March 2023. This adjustment helped further narrow the spread between the policy interest rates and elevated market interest rates, while the moderation of market interest rates is expected to continue in the period ahead as more information becomes available with regard to the debt restructuring strategy of the Government. While such downward adjustment of the interest rate structure would help ease the unprecedented burden on small and medium scale businesses to stay afloat under extremely challenging economic circumstances, this is not expected to ease monetary conditions to levels that could generate inflationary pressures as economic activity already remained subdued.

The Central Bank's monetary policy communication strategy in 2022 remained aligned with the tight policy stance that was maintained throughout the year, while reiterating its commitment to restoring price stability amidst historic high levels of inflation. Monetary policy communication during a high inflation episode was extremely challenging, particularly amidst the lack of public confidence in the economy. Premature and

ill-conceived statements by some commentators about the direction of inflation and interest rates, including some reference to possible hyperinflation, prolonged economic crisis, etc., caused confusion among the public. The sharp adjustment of policy interest rates in April 2022 necessitated efficient policy communication to educate the public on the need for such adjustment and curb worsening inflation expectations. The over-adjustment of market interest rates, including the yields on government securities, mainly due to uncertainty over domestic debt restructuring under the IMF-EFF arrangement, highlighted the importance of frequent and clear communication to the public. In implementing its communication policy, the Central Bank continued to use conventional channels as well as social media and digital platforms. Timely policy communication via monetary policy press releases was continued and the publishing of the inflation fan chart was re-commenced during the year, amidst several risks and uncertainties on the inflation outlook. These monetary policy announcements were complemented by press conferences that were livestreamed to a wider audience via social media. With a view to anchoring inflation expectations, the Central Bank commenced publishing the inflation fan chart in monthly press releases on inflation developments as well. In addition, the Governor and senior officials of the Central Bank participated

in various interviews, conferences, seminars, invited lectures and webinars, attempting to increase the reach of policy communication and correct misconceptions of policy perspectives. Regular publications of the Central Bank, including the Annual Report and Recent Economic Developments, were completed timely in all three languages, while the Central Bank assisted the Government to undertake necessary fiscal policy measures by submitting the September 15th Report and several submissions of reports under sections 64 and 68 of the Monetary Law Act. Going forward, the Central Bank will be taking steps to align its publications as per the new Central Bank Act, which is expected to be enacted in the period ahead, where the publication of a bi-annual Monetary Policy Report will commence.

7.3 Developments in Inflation

Headline inflation accelerated significantly during the nine months ending September 2022, reaching a historically high level, before trending downward. The unprecedented acceleration of headline inflation was mainly due to the notable rise in food prices and other supply side disruptions, the sharp depreciation of the Sri Lanka rupee against the US dollar and the subsequent adjustments in administered prices, such as energy and

Figure 7.3
Contribution to CCPI based Headline Inflation (year-on-year) (a)

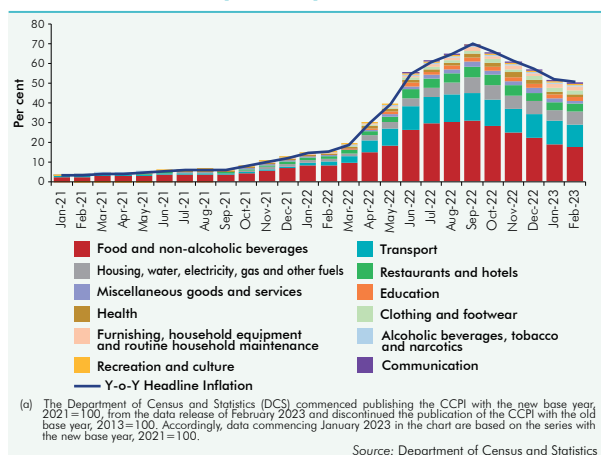
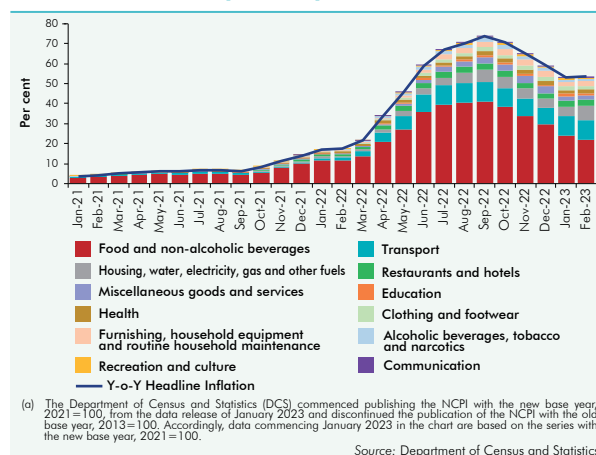
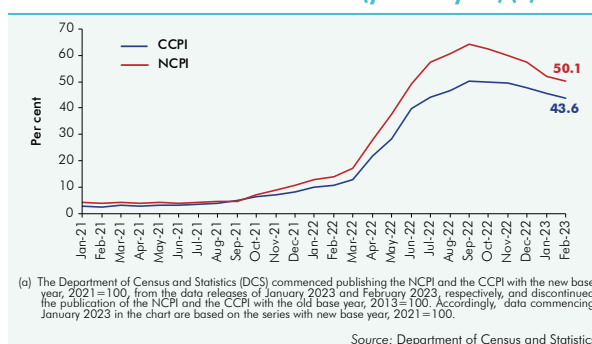


Figure 7.4
Contribution to N CPI based Headline Inflation (year-on-year) (a)



transport prices and their spillovers, and unabating aggregate demand pressures owing to the lagged impact of monetary accommodation during the past few years. As measured by the year-on-year change in the Colombo Consumer Price Index (CCPI, 2013=100), the transport sector recorded over 100 per cent inflation during the months of the second half of 2022 and peaked at 150.4 per cent in September 2022, while food inflation also peaked at 94.9 per cent in the same month. However, the easing of demand pressures owing to the lagged effects of monetary policy tightening as well as the softening of food and energy inflation caused headline inflation to decelerate from the latter part of 2022. Accordingly, headline inflation, as measured by the year-on-year change in the CCPI (2013=100) accelerated to 69.8 per cent in September 2022, from 12.1 per cent at end 2021, before moderating to 57.2 per cent by end 2022. Annual average inflation, based on the CCPI (2013=100), soared to 46.4 per cent in 2022, from 6.0 per cent in 2021. Year-on-year headline inflation, based on the National Consumer Price Index (NCPI, 2013=100), followed a similar trend and peaked at 73.7 per cent in September 2022, compared to 14.0 per cent at end 2021, before moderating to 59.2 per cent by end 2022. Annual average inflation, based on the NCPI (2013=100), was recorded at 50.4 per cent in 2022, compared to 7.0 per cent in 2021. The deceleration of inflation that started in October 2022 continued through early 2023. The Department of Census and Statistics (DCS) revised the base year for both CCPI and NCPI from 2013 to 2021, in order to accommodate the changing expenditure patterns and incorporate changes in goods and services available in the market. However, the deceleration trend of inflation remained broadly unaffected under both series despite this revision of the base year. Accordingly, year-on-year headline inflation, based on the CCPI (2021=100), decelerated to 50.6 per cent in February 2023, while that of NCPI (2021=100) was recorded at 53.6 per cent in February 2023.

Figure 7.5
Movements in Core Inflation (year-on-year) (a)



Reflecting the underlying demand driven pressures, core inflation also accelerated during the nine months ending September 2022, before moderating thereafter, albeit at a slower pace, compared to that of headline inflation. The rise of core inflation could be mainly attributed to the pent-up demand stemming from the lagged impact of monetary accommodation in the past, and price hikes in imported goods, coupled with the increase in costs of non-food categories, such as restaurants and hotels, health and education. Both CCPI and NCPI based year-on-year core inflation peaked in September 2022, and moderated thereafter. The pace of deceleration of core inflation was slower than that of headline inflation as a large portion of inflation deceleration was attributed to volatile food and energy components, which are excluded from the measurement of core inflation. The contraction of demand resulting from the monetary policy tightening was the main contributor for this deceleration of core inflation. Year-on-year core inflation, based on the CCPI (2013=100), accelerated from 8.3 per cent at end 2021 to 50.2 per cent in September 2022, before moderating to 47.7 per cent by end 2022. Annual average core inflation, based on the CCPI (2013=100), was recorded at 34.6 per cent in 2022, compared to 4.4 per cent in 2021. Core inflation (year-on-year), based on the NCPI (2013=100), also accelerated

Table 7.2
Movements of Inflation (year-on-year)

		2013 = 100						2021 = 100	
		Dec-17	Dec-18	Dec-19	Dec-20	Dec-21	Dec-22	Jan-23	Feb-23
Headline Inflation	CCPI	7.1	2.8	4.8	4.2	12.1	57.2	51.7	50.6
	Food Inflation	14.4	-1.5	6.3	9.2	22.1	64.4	60.0	54.4
	Non Food Inflation	4.2	4.8	4.3	2.0	7.5	53.4	47.9	48.8
	NCPI	7.3	0.4	6.2	4.6	14.0	59.2	53.2	53.6
	Food Inflation	12.8	-4.5	8.6	7.5	21.5	59.3	53.6	49.0
	Non Food Inflation	2.9	4.7	4.2	2.2	7.6	59.0	52.9	57.4
Core Inflation	CCPI	4.3	3.1	4.8	3.5	8.3	47.7	45.6	43.6
	NCPI	2.7	3.1	5.2	4.7	10.8	57.5	52.0	50.1

Source: Department of Census and Statistics

from 10.8 per cent at end 2021 to 64.1 per cent in September 2022 and moderated to 57.5 per cent by end 2022. The annual average core inflation, based on the NCPI (2013=100), was recorded at 43.9 per cent in 2022, compared to 5.5 per cent in 2021. Similar to headline inflation, core inflation also continued to trend downward during early 2023, as year-on-year core inflation, based on the CCPI (2021=100), decelerated to 43.6 per cent in February 2023, while year-on-year core inflation, based on the NCPI (2021=100), decelerated to 50.1 per cent in February 2023.

Inflation expectations broadly followed the trend of realised inflation, despite remaining elevated. The behaviour of near term inflation expectations of both the corporate and household sectors, which was mostly of an adaptive nature, remained broadly similar in 2022. A downward shift in expectations across all tenures was observed in recent months in line with the deceleration in actual inflation. As per the survey responses, the expected moderation of inflation in the period ahead would be mainly due to anticipated improvements in domestic supply conditions, relaxation of import restrictions, expected easing of global commodity prices, decrease in income levels, and tight monetary conditions.

7.4 Movements of Interest Rates

Market Liquidity and Short-Term Interest Rates

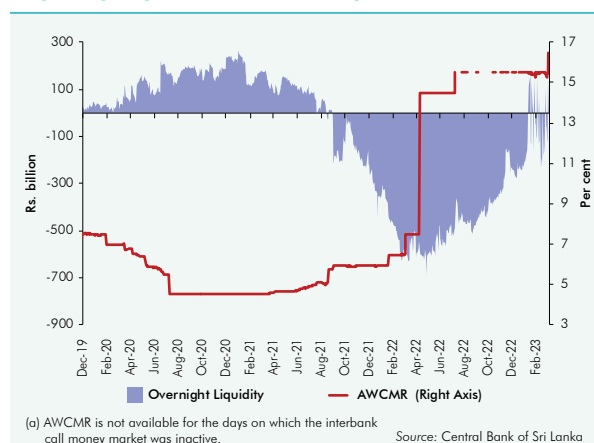
Liquidity in the domestic money market remained at high deficit levels during the first half of 2022, before improving gradually towards the end of the year. Liquidity in the domestic money market, which declined to negative levels following the upward adjustment in the Statutory Reserve Ratio (SRR) in September 2021, was allowed to remain at negative levels reflecting the need for maintaining tight monetary conditions amidst high inflation rates. Among the other major factors that contributed to such large negative liquidity in the money market include net foreign exchange sales by the Central Bank in facilitating the importation of essential goods, net foreign loan repayments of the Government by drawing down gross official reserves, net currency withdrawals by the public from the banking system, and maturities of foreign currency buy-sell swaps with domestic banks. The factors that contributed to the gradual improvement in domestic money market liquidity from May 2022 include the impact of the primary purchases of government securities by the Central Bank, an increase in currency deposits to the banking system with high deposit interest rates, and the long term

reverse repo auctions conducted from time to time to address significant liquidity constraints of certain banks. Accordingly, the daily average liquidity in the domestic money market recorded a deficit of around Rs. 279 billion during the last quarter of 2022, compared to a large daily average deficit of around Rs. 531 billion during the first half of 2022. Nevertheless, the distribution of money market liquidity demonstrated large asymmetries, where certain domestic banks, particularly state-owned commercial banks, recorded significant liquidity deficits reflecting their transactions with the Government and SOBEs, while foreign banks maintained large liquidity surpluses, reflecting prudential risk management concerns on Government exposure. As a result, several LCBs continued to rely on the standing facilities of the Central Bank without transacting in the interbank market. With the view to addressing the underlying overnight liquidity considerations of LCBs, the Central Bank decided to impose restrictions on the usage of standing facilities effective mid-January 2023.¹ Following this regulatory measure and the simultaneous conduct of long term reverse repo auctions and other liquidity providing facilities by the Central Bank, a notable improvement in overnight domestic money market liquidity was observed, where it turned to a surplus level in mid-January 2023 after 16 months. Subsequently, overnight liquidity in the domestic money market remained volatile, mainly reflecting the impact of the usage pattern of the Standing Deposit Facility (SDF) by banks with excess liquidity. Meanwhile, rupee liquidity in the domestic money market improved notably, primarily due to the moderation of forex sales by the Central Bank following the improvements in the liquidity in the domestic foreign exchange

market, and net forex purchases by the Central Bank, particularly in 2023 thus far. Accordingly, the average overnight liquidity deficit declined to around Rs. 72 billion during the first quarter of 2023.

In response to the tight liquidity conditions and the continuation of tight monetary policy, the Average Weighted Call Money Rate (AWCMR) remained around the upper bound of the Standing Rate Corridor (SRC). AWCMR, which hovered near the upper bound of SRC at the beginning of 2022, touched the upper bound of SRC mainly due to the continued large liquidity deficit of the banking system. Activity in the interbank money market saw a gradual reduction from April 2022 onwards, with the market remaining inactive for the most part following the policy interest rate adjustment in July 2022. The lacklustre activity in the interbank market was mainly due to the market uncertainty emanating from the domestic debt restructuring concerns amidst the asymmetric liquidity distribution and prudential risk management concerns, such as counterparty limits by foreign banks. However, with the measures taken by the Central Bank, such as the regular conduct of long-term reverse repo auctions and subsequent imposition of restrictions on the use of standing facilities, a gradual resumption of activity

Figure 7.6
Rupee Liquidity in the Domestic Money Market and AWCMR (a)



¹ With effect from 16 January 2023, the Standing Deposit Facility (SDF) (overnight deposit facility that allows LCBs to park excess liquidity and earn interest) was limited to a maximum of five (05) times per calendar month. At the same time, the Standing Lending Facility (SLF), which is the collateralised facility provided for LCBs to fulfill any further shortage of the liquidity requirements from the Central Bank at the end of the day, was also limited to 90 per cent of SRR of each LCB on any given day.

was observed in the interbank money markets. Consequently, AWCMR recorded a marginal reduction from the upper bound of SRC mid-January 2023 onwards. Accordingly, AWCMR rose by 9.55 percentage points during 2022 in response to the cumulative adjustment of 9.50 percentage points in the policy interest rates during 2022. Meanwhile, with the increase in policy interest rates by 100 basis points in March 2023, AWCMR increased to 16.46 per cent as of 07 March 2023 and remained around the upper bound of SRC by end March 2023.

Yields on Government Securities

The yields on government securities increased notably during 2022, reflecting the increased risk premia amidst concerns about domestic debt restructuring and significantly high borrowing requirements of the Government, along with the increase in policy interest rates by the Central Bank in view of containing burgeoning price pressures. Yields on government securities increased notably during 2022 as market sentiments were dampened by the Government’s continued reliance on domestic market sources with limited access to foreign financing and heightened concerns about domestic debt restructuring. A notable disparity was observed between the policy interest rates

Figure 7.7
Primary Market Treasury Bill Yields (a)

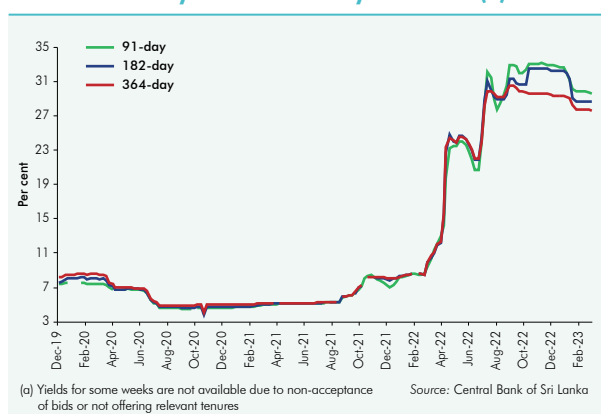
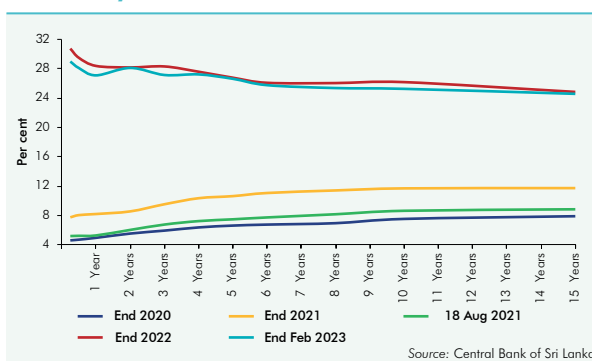


Figure 7.8
Secondary Market Yield Curve for Government Securities



and yields on government securities, while other market interest rates continued to edge up in line with the movements of the latter. The yields on Treasury bills in the primary market rose notably by around 22.30-25.00 percentage points across all tenures during the year up to their peak levels, as opposed to a 9.50 percentage points increase in policy interest rates during 2022. Towards the end of 2022 and early 2023, a notable moderation was observed in the yields on government securities as investor sentiment improved in anticipation of the finalisation of the IMF-EFF arrangement. Improved liquidity conditions in the domestic money market due to the measures taken by the Central Bank, including the restrictions on standing facilities and injection of liquidity through long term reverse repo auctions and other liquidity providing facilities by the Central Bank, supported the reduction in yields on government securities. Accordingly, the yields on Treasury bills in the primary market for 364-day maturity peaked in early September 2022, and the same for 91-day and 182-day maturities peaked in mid-November 2022. As such, yields on Treasury bills dropped by around 2.80-3.90 percentage points across all tenures by end-February 2023 from their peak levels. Market appetite for Treasury bills remained broadly intact, although increased appetite towards the shortest maturity was observed due to domestic debt restructuring concerns. However, a gradual improvement in

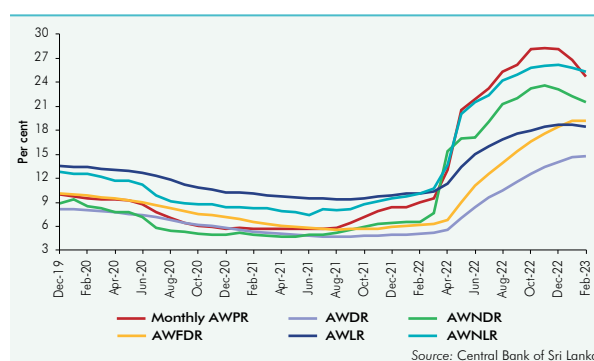
the appetite for all tenures was observed towards late 2022 and early 2023 due to improved market sentiments. Meanwhile, yields on Treasury bonds followed the trend observed in Treasury bills where the primary market yields increased significantly during the period from January to mid-November 2022, while a moderation was observed thereafter. Unlike Treasury bills, the market appetite was more towards the longer term Treasury bonds with a high yield. Secondary market yields on government securities also recorded substantial increases in line with the primary market yields but eased thereafter following the trend observed in the primary market.

Deposit and Lending Interest Rates

Deposit interest rates offered by LCBs increased significantly in 2022 reflecting the passthrough of monetary policy tightening measures taken by the Central Bank and the tight liquidity conditions in the domestic money market. The substantial increase in policy interest rates by the Central Bank, the surge in the yields on government securities driven by increased risk premia, and the large and persistent liquidity deficit in the domestic money market that heightened competition among licensed banks to retain existing deposits and promote new deposits caused deposit interest rates to adjust upward sharply. Amidst significant liquidity tightness in the domestic money market, banks offered novel deposit products with high rates of interest, particularly for short term tenures. Moreover, the large increase in the yields on government securities caused upward pressures on deposit interest rates. Given these developments, the Average Weighted Deposit Rate (AWDR)² reached 14.06 per cent by end December 2022, recording the highest level since

2 AWDR reflects the movements in interest rates pertaining to all outstanding interest bearing rupee deposits held with LCBs.

Figure 7.9
Movement of Selected Market Interest Rates



late 1991. The Average Weighted Fixed Deposit Rate (AWFDR)³ also followed a similar trend. Further, the Average Weighted New Deposit Rate (AWNDR)⁴ and the Average Weighted New Fixed Deposit Rate (AWNDR)⁵ rose to their highest levels on record, peaking at 23.63 per cent and 24.05 per cent, respectively, in November 2022. Accordingly, interest rates offered for new deposits, as measured by AWNDR and AWFDR, increased by around 17 percentage points during January-November 2022, disproportionate to the increase in policy interest rates by 9.50 percentage points during 2022. Having noted the excessive upward adjustment in market deposit interest rates in 2022, and the resulting impact on market lending rates, the Central Bank stressed the need for licensed banks to eliminate unhealthy competition in mobilising deposits, while taking measures to improve liquidity in the domestic money market, particularly in the latter part of 2022. Reflecting the impact of improved liquidity conditions towards the end of 2022, market deposit interest rates commenced moderating. Further, the measures adopted by the Central Bank to activate the interbank market in early 2023 helped improve liquidity in the domestic money market. With

3 AWFDR is based on interest rates pertaining to all outstanding interest bearing rupee time deposits held with LCBs.

4 AWNDR is based on interest rates pertaining to all new interest bearing rupee deposits mobilised by LCBs during a particular month.

5 AWFDR is based on interest rates pertaining to all new interest bearing rupee time deposits mobilised by LCBs during a particular month.

Table 7.3
Movements of Interest Rates

Interest Rate	End 2021	Per cent per annum	
		End 2022	Change in % pts
Key Policy Interest Rates			
Standing Deposit Facility Rate (SDFR)	5.00	14.50	9.50
Standing Lending Facility Rate (SLFR)	6.00	15.50	9.50
Average Weighted Call Money Rate (AWCMR)	5.95	15.50	9.55
Yield Rates on Government Securities			
Primary Market (a)			
Treasury bills			
91-day	8.16	32.64	24.48
182-day	8.33	32.20	23.87
364-day	8.24	29.27	21.03
Treasury bonds			
2-year	9.16 (b)	33.01 (c)	23.85
3-year	9.70 (b)	31.36 (c)	21.66
4-year	8.55 (b)	-	-
5-year	11.14 (b)	31.78 (c)	20.64
10-year	8.86 (b)	30.86 (c)	22.00
Secondary Market			
Treasury bills			
91-day	7.77	30.75	22.98
182-day	8.07	29.50	21.43
364-day	8.22	28.39	20.17
Treasury bonds			
2-year	8.58	28.19	19.61
3-year	9.55	28.32	18.77
4-year	10.38	27.60	17.22
5-year	10.66	26.78	16.12
10-year	11.71	26.18	14.47
Interest Rates on Deposits			
Licensed Commercial Banks (d)			
Savings deposits	0.05-6.35	0.25-6.00	-
1 Year Fixed Deposits (e)	0.15-15.00	4.50-30.00	-
AWDR (f)	4.94	14.06	9.12
AWFDR (f)	5.94	18.49	12.55
AWNDR (f)	6.45	23.07	16.62
AWNDR (f)	6.67	23.73	17.06
Other Financial Institutions (g)			
National Savings Bank			
Savings Deposits	3.50	3.00	-0.50
1 Year Fixed Deposits	5.50	12.00	6.50
Licensed Finance Companies (h)			
Savings Deposits	3.46-4.69(j)	4.63-8.03	-
1 Year Fixed Deposits	9.02-10.13	20.48-27.15	-
Interest Rates on Lending			
Licensed Banks (j)			
AWSR	10.49	20.73	10.24
AWNSR	10.04	26.91	16.87
Licensed Commercial Banks (d)			
AWPR (Monthly)	8.33	28.19	19.86
AWLR	9.87	18.70	8.83
AWNLR	9.48	26.20	16.72
Licensed Specialised Banks			
National Savings Bank	7.50-11.50	28.00-32.00	-
State Mortgage and Investment Bank (k)	7.50-12.50	18.00-27.25	-
Licensed Finance Companies (h)			
Finance Leasing	12.77-28.33	21.53-35.37	-
Hire Purchase	11.08-27.00	16.94-38.28	-
Loans against Immovable Properties	15.29-16.77(j)	26.80-28.43	-
Interest Rates on Foreign Currency Deposits (l)			
Savings Deposits - USD	0.03-4.60	0.10-7.77	-
Savings Deposits - GBP	0.03-3.00	0.20-4.83	-
Time Deposits - USD	0.02-7.00	0.02-11.50	-
Time Deposits - GBP	0.02-5.75	0.02-7.00	-
Corporate Debt Market			
Debentures	8.00-12.00	15.42-28.00	-
Commercial Papers	6.00-12.00	11.00-36.00	-

- (a) Weighted average yield rates at the latest available auction. Sources: Respective Financial Institutions
Colombo Stock Exchange
Central Bank of Sri Lanka
- (b) Last primary auction during 2021:
2 yr-11 Nov; 3 yr-13 Dec; 4 yr-30 Aug;
5 yr-12 Oct; 10 yr-29 Jul
- (c) Last primary auction during 2022:
2 yr-13 Dec; 3 yr-29 Dec; 5 yr-28 Oct; 10 yr-11 Nov
- (d) Based on the rates quoted by LCBs
- (e) Maximum rate is a special rate offered by certain LCBs.
- (f) Since July 2018, AWDR and AWFDR were calculated by replacing senior citizens' special deposit rate of 15% with relevant market interest rates to exclude the impact of special rates. Same method was applied to calculate AVNDR and AWNFDR since June 2018.
- (g) Based on the rates quoted by other selected Financial Institutions
- (h) 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 2022 are provisional.
- (i) Revised
- (j) Based on the rates quoted by LCBs and LSBs
- (k) Lending for housing purposes only
- (l) Interest rate ranges are based on the maximum and minimum rates quoted by LCBs and National Savings Bank

this and the notable moderation in the yields on government securities, particularly from January 2023, the declining trend in deposit interest rates is expected to continue in the period ahead.

Market lending interest rates also increased notably during 2022 in response to the tight monetary and liquidity conditions, while certain lending interest rates began to moderate towards end 2022. The unprecedented increase in the Central Bank's policy interest rates, the substantial liquidity deficit in the domestic money market that drove up deposit interest rates, the pricing in of elevated credit risk amidst the contraction of economic activity, and the elevated yields on government securities, mainly caused the rise in market lending interest rates in 2022. Certain market lending interest rates reached the highest levels on record in 2022. The Average Weighted Lending Rate (AWLR)⁶ increased by around 9 percentage points to 18.70 per cent by end 2022, while the Average Weighted New Lending Rate (AWNLR)⁷ recorded the historically highest value of 26.20 per cent in December 2022, increasing

6 AWLR is based on interest rates of all outstanding rupee loans and advances extended by LCBs.

7 AWNLR captures interest rates of all new rupee loans and advances extended by LCBs during a particular month.

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



by around 17 percentage points, compared to end 2021. Meanwhile, the monthly Average Weighted Prime Lending Rate (AWPR),⁸ the lending interest rate for prime customers, closely followed the yields on government securities and peaked at 28.25 per cent in November 2022, surpassing other lending interest rates. In view of the tight monetary conditions, the maximum interest rates imposed on credit card advances, pre-arranged temporary overdrafts, and pawning advances were revoked in April 2022, allowing interest rates applicable to these lending products to increase in line with other market lending interest rates. Average interest rates on loans to Small and Medium sized Enterprises (SMEs), as measured in the SME Credit Survey,⁹ broadly followed the trend of overall average lending interest rates of LCBs, with an added risk premium. Accordingly, the Average Weighted SME Lending Rate (AWSR)¹⁰ and the Average Weighted New SME Lending Rate (AWNSR)¹¹ increased by around 10 and 17 percentage points, respectively, during 2022. However, along with the improvements in market liquidity and a notable downward shift in the yields on government securities towards the end of 2022, some market lending interest rates showed signs of moderation by end 2022. In particular, the monthly AWPR dropped by 348 basis points during January-February 2023. Downward movements in other market lending interest rates are also expected in the period ahead.

8 AWPR is based on interest rates applicable to short term rupee loans and advances granted by LCBs to their prime customers during a particular week.

9 For the purpose of the monthly SME Credit Survey, banks are requested to consider lending to enterprises with an annual turnover not exceeding Rs. 1 billion and employing less than 300 employees.

10 AWSR is based on interest rates of all outstanding rupee loans and advances extended by licensed banks to the SME sector, excluding refinance schemes of the Government and the Central Bank.

11 AWNSR captures interest rates of all new rupee loans and advances extended by licensed banks during a particular month to the SME sector, excluding refinance schemes of the Government and the Central Bank.

The Legal Rate and the Market Rate of Interest,¹² which are published in the Government Gazette at the end of each year, were determined at 16.97 per cent per annum for 2023 by the Monetary Board, compared to 7.48 per cent per annum for 2022. The Legal Rate and the Market Rate for 2023 were computed based on the simple averages of monthly AWLR of LCBs, which prevailed during the six months prior to December (i.e., for the period from June to November 2022), with a view to reflecting the prevailing market interest rates.¹³

Interest Rates on Foreign Currency Deposits

Interest rates on foreign currency deposits recorded a sharp upward adjustment in 2022 reflecting the tightening of global financial conditions, elevated country risk premium as well as increased competition among licensed banks to mobilise foreign currency deposits amidst significant liquidity shortages in the domestic foreign exchange market. Central banks in most advanced economies pursued tight monetary policies in order to fight rising global inflation and to avoid de-anchoring of inflation expectations, resulting in an increased tightness in financial conditions in most parts of the world. The US Federal Reserve, the European Central Bank, and the Bank of England increased their policy interest rates substantially during 2022. Meanwhile, licensed banks offered attractive interest rates to mobilise foreign currency deposits, in response

12 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.

13 In 2022, the calculation method of the Legal Rate and Market Rate was revised considering the prevailed high interest rate structure. Accordingly, the rates for 2023 were calculated based on simple averages of monthly AWLR, that prevailed during the six months ending November 2022.

to the acute shortage of foreign currency liquidity among the banks, amidst significant BOP pressures. With the continued increase in market interest rates on rupee denominated deposit products following the implementation of tight monetary policy from August 2021, the cap imposed on foreign currency deposit interest rates offered by LCBs and the National Savings Bank was removed in March 2022. This allowed a significant upward adjustment in interest rates on foreign currency deposits of licensed banks in line with both global and domestic market conditions. Accordingly, interest rates offered for US dollar and pound sterling denominated domestic savings and time deposits, among others, increased by end 2022, compared to end 2021.

7.5 Movements in Money and Credit Aggregates

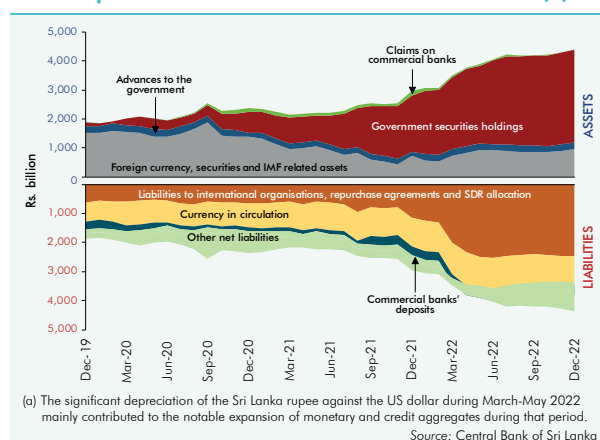
Reserve Money

Reserve money, which is the monetary base of the economy, recorded a moderate growth during 2022, particularly in the latter part of the year, with subdued growth in currency in circulation as well as deposits of LCBs with the Central Bank, compared to 2021. Currency in circulation remained at elevated levels during the first half of 2022 as transaction demand for currency by the public rose on account of the increased spending requirements owing to rising inflation and increased preference to holding physical currency for contingent purposes amidst supply shortages of selected essential commodities. However, following significant monetary tightening during the year, currency in circulation started to gradually decline towards the end of 2022, reflecting the high opportunity cost of holding currency amidst increasing market interest rates. Accordingly, currency in circulation increased moderately by Rs. 21.5 billion during the year to

Rs. 1,026.6 billion by end 2022, over the expansions of Rs. 170.3 billion recorded in 2021 and Rs. 156.8 billion during 2020 amidst the COVID-19 pandemic. Meanwhile, the deposits of LCBs maintained at the Central Bank recorded a marginal increase during the year with SRR remaining unchanged during 2022. By end 2022, deposits of LCBs with the Central Bank increased by Rs. 22.1 billion to Rs. 322.8 billion, compared to the notable expansion of Rs. 171.1 billion recorded in 2021. Accordingly, reserve money grew by 3.3 per cent, year-on-year, to Rs. 1,349.4 billion by end 2022, compared to the growth of 35.4 per cent, year-on-year, in 2021. In absolute terms, reserve money increased by Rs. 43.6 billion during 2022, compared to the notable increase of Rs. 341.4 billion in 2021. Meanwhile, high volatility was observed in reserve money balances on a daily basis from the beginning of 2023, reflecting the impact of administrative measures taken by the Central Bank to reduce the overdependence of LCBs on standing facilities of the Central Bank, with restrictions limiting access to SDF and SLF. Accordingly, the limited access to SDF resulted in LCBs maintaining excess reserves with the Central Bank at irregular intervals, creating volatility in daily reserve money balances.

Viewed from the assets side of the Central Bank's balance sheet, the expansion of reserve money was entirely due to the increase in Net Domestic Assets (NDA), while Net Foreign Assets (NFA) declined notably during 2022. The expansion in NDA of the Central Bank was mainly driven by NCG, which increased by Rs. 1,338.4 billion to Rs. 3,432.5 billion by end 2022, compared to the increase of Rs. 1,225.2 billion in 2021. This reflects a considerable increase in the Central Bank's holdings of government securities (net of repurchase transactions) during 2022. This increase in the holdings of government securities by the Central Bank reflects the continued purchases of Treasury bills from the primary market and the direct allocation of Treasury bills to the Central Bank as the

Figure 7.11
Composition of the Central Bank Balance Sheet (a)



Government continued to rely on monetary financing amidst subdued government revenue, limited access to foreign financing due to the debt standstill, and diminished market appetite for government securities amidst domestic debt restructuring concerns. Accordingly, the holdings of government securities by the Central Bank (net of repurchase transactions) increased by Rs. 1,251.7 billion to Rs. 3,197.1 billion by end 2022. Meanwhile, the balances transferred to the Government as provisional advances also increased during the year, contributing to the increase in NCG by the Central Bank. However, the decline in the Central Bank's claims on LCBs resulting from foreign exchange losses associated with foreign currency swaps, and the repayment of concessionary loans that were extended by the Central Bank through LCBs to support businesses and individuals during the pandemic, suppressed the increase in NDA of the Central Bank. Accordingly, NDA of the Central Bank increased by Rs. 1,270.2 billion during 2022, compared to the increase of Rs. 1,255.4 billion during 2021. Meanwhile, NFA of the Central Bank contracted notably by Rs. 1,226.6 billion during 2022 following the contraction of Rs. 914.0 billion during the previous year, which caused NFA to turn negative from August 2021. During 2022, the foreign assets of the Central Bank declined mainly due to the utilisation of a large part of the foreign assets of the Central Bank to provide liquidity to the domestic foreign

exchange market to facilitate essential imports and meet the external debt obligations of the Government, particularly during early 2022. As the outstanding foreign liabilities outweighed the foreign assets of the Central Bank, the sharp depreciation of the Sri Lanka rupee against the US dollar led to a larger increase in foreign liabilities over the increase in foreign assets, further deteriorating NFA of the Central Bank in 2022. The extension of the settlement periods applicable for international swaps entered into by the Central Bank and the deferment of the outstanding amount payable to Asian Clearing Union (ACU) also contributed to an expansion of foreign liabilities of the Central Bank. Meanwhile, an accumulation of Central Bank foreign assets was also observed toward the end of 2022 due to the increased purchase of foreign exchange by the Central Bank from licensed banks under the requirement to sell residuals of the repatriated export proceeds and workers' remittances, which were subjected to mandatory conversions.

The money multiplier, which is the ratio between broad money supply (M_{2b}) and reserve money, increased in 2022 as a result of the significant expansion of broad money supply (M_{2b}), while the expansion of reserve money remained moderate. Accordingly, the money multiplier based on broad money (M_{2b}) increased to 9.11 by end 2022 from 8.15 recorded at end 2021, due to the expansion of M_{2b} reflecting increased public sector borrowings and the valuation impact that arose from the rupee depreciation, amidst a tepid expansion of reserve money during the year. Meanwhile, the currency to deposits ratio decreased to 6.4 per cent by end 2022 from 8.0 per cent recorded at end 2021, due to the combined effect of decreasing currency held by the public and a notable increase in time and savings deposits held by the public during 2022 compared to the preceding year.

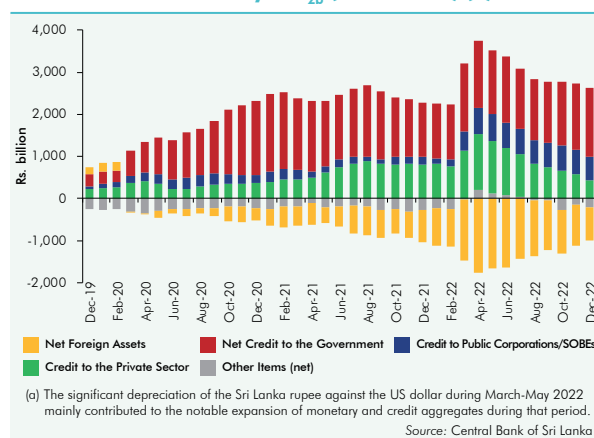
Broad Money (M_{2b}) and Domestic Credit

Despite the substantial expansion of credit to the public sector and the augmentation of domestic credit of the banking system in rupee terms following the depreciation of the exchange rate (i.e., the revaluation effect), the growth of broad money supply (M_{2b}) decelerated in 2022 driven by the significant contraction of credit to the private sector. The year-on-year growth of M_{2b} , which decelerated gradually since early 2021 supported by the tight monetary conditions, accelerated notably in early 2022 to peak at 20.0 per cent by end April 2022 mainly due to the revaluation effect of foreign currency denominated domestic credit amidst the steep depreciation of the Sri Lanka rupee against the US dollar. However, despite the substantial expansion of credit to the public sector, particularly NCG by the banking system, a decelerating trend was observed in the growth of M_{2b} from May 2022 mainly driven by the contraction of credit to the private sector owing to the substantial tightening of monetary conditions. As a result, the year-on-year growth of M_{2b} moderated to 15.4 per cent by end 2022. Once adjusted for the depreciation of the Sri Lanka rupee against the US dollar,¹⁴ the year-on-year growth of M_{2b} is estimated to have decelerated to around 7 per cent by end 2022.

7 On the liabilities side of M_{2b} , the increase in time and savings deposits held by the public with LCBs largely contributed to the monetary expansion during 2022. Compared to the contribution of 77 per cent recorded in 2021, the increase in time and savings deposits contributed largely to the year-on-year expansion of M_{2b} in 2022. A marginal expansion of demand deposits held by

¹⁴ Under this scenario, the growth of money supply is estimated by valuing all foreign currency denominated balances using the exchange rate that prevailed at end February 2022.

Figure 7.12
Contribution to Year-on-Year Change in Broad Money - M_{2b} (Assets Side) (a)



the public with LCBs was also recorded during 2022, while currency held by the public contracted during the year owing to the high opportunity cost of holding currency amidst high market interest rates. Reflecting the impact of high deposit interest rates offered by LCBs amidst tight liquidity conditions, time and savings deposits of LCBs increased significantly by Rs. 1,648.6 billion in 2022, recording a growth of 17.9 per cent, year-on-year, compared to the increase of Rs. 958.8 billion recorded in 2021. Meanwhile, the year-on-year growth of demand deposits decelerated to 5.3 per cent by end 2022 amidst high interest rates and subpar economic activity, compared to the growth of 26.0 per cent at end 2021. Currency held by the public contracted by 5.4 per cent, year-on-year, by end 2022, compared to the notable growth of 22.4 per cent, year-on-year, by end 2021.

On the assets side of M_{2b} , continuing the trend observed in 2021, NFA of the banking system contracted significantly during 2022 driven by the decline in NFA of the Central Bank, while NFA of LCBs recorded an improvement during the second half of the year. NFA of the Central Bank continued to contract notably by Rs. 1,226.6 billion during 2022 following the contraction of Rs. 914.0 billion in the previous year, as foreign currency liabilities increased

Table 7.4
 Developments in Monetary Aggregates

Item	End 2020	End 2021	End 2022 (a)	Change					
				2020		2021		2022	
				Amount	%	Amount	%	Amount	%
1. Currency Outstanding	834.8	1,005.1	1,026.6	156.8	23.1	170.3	20.4	21.5	2.1
1.1 Currency held by the Public	641.0	784.4	742.0	146.8	29.7	143.4	22.4	-42.4	-5.4
1.2 Currency with Commercial Banks	193.8	220.6	284.5	10.0	5.5	26.9	13.9	63.9	28.9
2. Commercial Banks' Deposits with the Central Bank (b)	129.6	300.7	322.8	-125.0	-49.1	171.1	132.0	22.1	7.4
3. Government Agencies' Deposits with the Central Bank (c)	0.03	0.01	0.01						
4. Reserve Money (1+2+3)	964.4	1,305.8	1,349.4	31.8	3.4	341.4	35.4	43.6	3.3
5. Demand Deposits held by the Public with Commercial Banks	536.1	675.4	711.6	164.9	44.4	139.3	26.0	36.1	5.3
6. Narrow Money Supply, M_1 (1.1+5)	1,177.2	1,459.9	1,453.6	311.7	36.0	282.7	24.0	-6.3	-0.4
7. Time and Savings Deposits held by the Public with Commercial Banks	7,318.6	8,179.0	9,043.5	1,271.4	21.0	860.4	11.8	864.4	10.6
8. Broad Money Supply, M_2 (6+7)	8,495.8	9,638.9	10,497.1	1,583.1	22.9	1,143.1	13.5	858.1	8.9
9. Adjusted Foreign Currency Deposits (d)	909.9	1,008.4	1,792.6	198.5	27.9	98.5	10.8	784.2	77.8
10. Consolidated Broad Money Supply, M_{2b} (8+9)	9,405.7	10,647.3	12,289.6	1,781.6	23.4	1,241.6	13.2	1,642.3	15.4
Money Multiplier, M_{2b}	9.75	8.15	9.11						
Velocity, M_{2b} (e)	1.84	1.73	2.05						

Source: Central Bank of Sri Lanka

(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. 30.4 million at end 2020, Rs. 5.5 million at end 2021 and Rs. 11.6 million at end 2022

(d) Includes deposits of Resident Category of Offshore Banking Units (OBUs) and a share of foreign currency deposits with Domestic Banking Units (DBUs)

 (e) Velocity of money is computed based on annual average M_{2b} and rebased GDP estimates (base year 2015) by the Department of Census and Statistics

notably outweighing the increase in foreign currency assets along with the impact of exchange rate depreciation. Foreign currency liabilities of the Central Bank increased owing to the increase in foreign currency payables to international counterparts following the extension of the settlement of the international swaps entered by the Central Bank with regional peers and the large accumulation of payables to ACU. Although foreign currency assets of the Central Bank increased due to the purchase of foreign exchange from LCBs under the mandatory sales requirement of repatriation of export proceeds and converted worker's remittances, these assets were utilised to provide foreign exchange to facilitate essential imports amidst significant BOP pressures, and to meet the Government's foreign currency debt service obligations, particularly during early 2022. Nevertheless, with the gradual improvement of forex liquidity in the market, forex purchases by the Central Bank in building up the gross official

reserves helped improve NFA of the Central Bank. Meanwhile, NFA of LCBs improved by Rs. 441.8 billion during 2022 over the increase of Rs. 141.5 billion recorded in 2021 with the expansion in NFA of offshore banking units (OBUs), while NFA of domestic banking units (DBUs) contracted during the year. NFA of OBUs increased notably in 2022 mainly due to the increase in placements with banks abroad and lending to non-residents along with the contraction in foreign liabilities, particularly due to the settlement of short term liabilities. In contrast, NFA of DBUs contracted during 2022 mainly on account of the increase in foreign currency liabilities in terms of deposit liabilities of non-residents outweighing the increase in foreign currency placements with banks abroad.

NCG by the banking system increased significantly during 2022, leading to an expansion in NDA. Continuing the same trend observed in 2021, the Government's increased

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

Item	End 2021	End 2022 (a)	Change				Rs. billion
			2021		2022		
			Amount	%	Amount	%	
Reserve Money	1,305.8	1,349.4	341.4	35.4	43.6	3.3	
Net Foreign Assets of the Central Bank	-387.3	-1,613.9	-914.0	-173.5	-1,226.6	-316.7	
Net Domestic Assets of the Central Bank	1,693.1	2,963.2	1,255.4	286.8	1,270.2	75.0	
Net Credit to the Government	2,094.1	3,432.5	1,225.2	141.0	1,338.4	63.9	
Claims on Commercial Banks	143.2	-11.5	28.7	25.1	-154.6	-108.0	
Other Items (net) (b)	-544.2	-457.8	1.5	0.3	86.4	15.9	
Broad Money (M_{2b})	10,647.3	12,289.6	1,241.6	13.2	1,642.3	15.4	
Net Foreign Assets	-982.0	-1,766.8	-772.5	-368.8	-784.8	-79.9	
Monetary Authorities (c)	-387.3	-1,613.9	-914.0	-173.5	-1,226.6	-316.7	
Commercial Banks	-594.7	-153.0	141.5	19.2	441.8	74.3	
Net Domestic Assets	11,629.3	14,056.4	2,014.1	20.9	2,427.2	20.9	
Domestic Credit	14,002.0	16,632.3	2,280.8	19.5	2,630.3	18.8	
Net Credit to the Government	5,832.4	7,471.1	1,284.4	28.2	1,638.7	28.1	
Central Bank	2,094.1	3,432.5	1,225.2	141.0	1,338.4	63.9	
Commercial Banks	3,738.3	4,038.6	59.2	1.6	300.3	8.0	
Credit to Public Corporations/SOBES	1,188.1	1,747.0	185.9	18.6	558.9	47.0	
Credit to the Private Sector	6,981.4	7,414.1	810.5	13.1	432.7	6.2	
Other Items (net) (b)	-2,372.7	-2,575.8	-266.7	-12.7	-203.2	-8.6	

(a) Provisional

Source: Central Bank of Sri Lanka

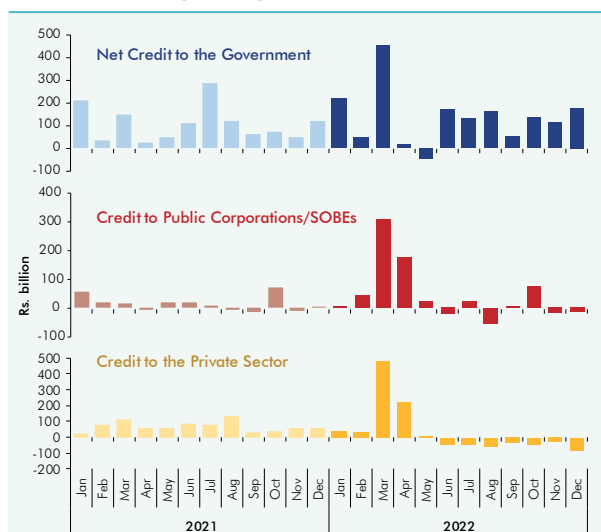
(b) Computed as the difference between other assets and other liabilities

(c) This includes NFA of the Central Bank as well as the Government's Crown Agent's balance reported by the Department of State Accounts

funding requirement in 2022 was largely met through the domestic banking system, mainly the Central Bank, due to lower-than-expected revenue mobilisation of the Government and limited access to foreign financing. The sharp

increase in NCG by the banking system signifies the crowding out of private sector investments during the period under review. During 2022, NCG by the banking system increased significantly by Rs. 1,638.7 billion, compared to the expansion of Rs. 1,284.4 billion in 2021. NCG by the Central Bank increased by Rs. 1,338.4 billion during 2022, contributing to over 80 per cent of the overall expansion in NCG. The Central Bank provided finances to the Government in terms of Treasury bill purchases from the primary market subscribing to under-allocations of auctions, in addition to the direct allocations of Treasury bills to the Central Bank in meeting cashflow shortfalls, as well as provisional advances. NCG of LCBs also increased by around Rs. 300 billion during 2022, driven by investments in Treasury bills, Treasury bonds as well as in Sri Lanka Development Bonds (SLDBs). The Government has reduced the overdraft balances with LCBs significantly during the year.

Figure 7.13
Monthly Change in Domestic Credit (a)



(a) The significant depreciation of the Sri Lanka rupee against the US dollar during March-May 2022 mainly contributed to the notable expansion of monetary and credit aggregates during that period.

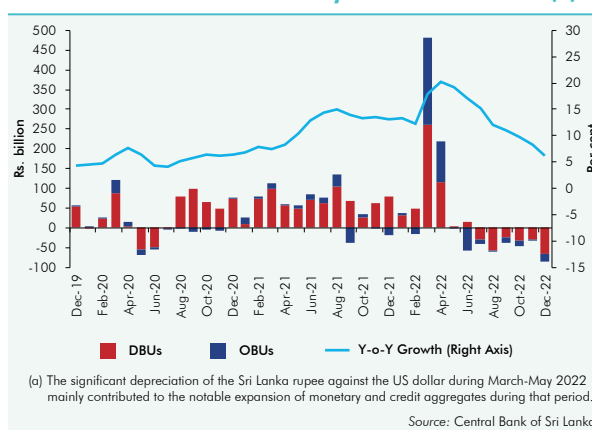
Source: Central Bank of Sri Lanka

Credit obtained by SOBEs from the banking system expanded in 2022, mainly on account of the revaluation effect of their foreign currency denominated borrowings, while the weak financial performance of SOBEs necessitated continuous borrowings from LCBs. Compared to the expansion of Rs. 185.9 billion in 2021, credit obtained by SOBEs from the banking system increased notably by Rs. 558.9 billion during 2022, of which over 70 per cent was on account of the revaluation effect of foreign currency denominated debt that arose as a result of the substantial currency depreciation. Reflecting the increased financial need to facilitate fuel importation, credit obtained by the Ceylon Petroleum Corporation (CPC) increased by Rs. 477.3 billion during 2022 largely contributing to the overall expansion of credit obtained by the SOBEs. Moreover, credit obtained by SriLankan Airlines rose by Rs. 36.5 billion, while that of the Ceylon Electricity Board (CEB) increased by Rs. 31.9 billion during the year. In addition, credit obtained by the Ceylon Shipping Corporation, National Water Supply & Drainage Board (NWS&DB), Urban Development Authority (UDA) and Road Development Authority (RDA) also increased considerably during 2022. Meanwhile, Colombo Commercial Fertilizer (CCF), Paddy Marketing Board (PMB) and State Pharmaceuticals Corporation (SPC) made net repayments to LCBs in 2022. Accordingly, outstanding credit to SOBEs rose to Rs. 1,747.0 billion by end 2022.¹⁵

In response to the tight monetary conditions and the moderation in economic activity, outstanding credit extended to the private sector by LCBs continued to contract from mid-2022. Outstanding credit to the private sector by LCBs increased notably during early 2022 mainly on account of the revaluation effect of foreign currency denominated debt amidst the substantial currency depreciation and organic growth of credit. However, with the sharp upward adjustment in market lending

¹⁵ This does not reflect the transfer of the outstanding balance of the government guaranteed foreign currency debt of the CPC to central government debt amounting to Rs. 884.1 billion that took effect in December 2022.

Figure 7.14
Credit to the Private Sector by Commercial Banks (a)

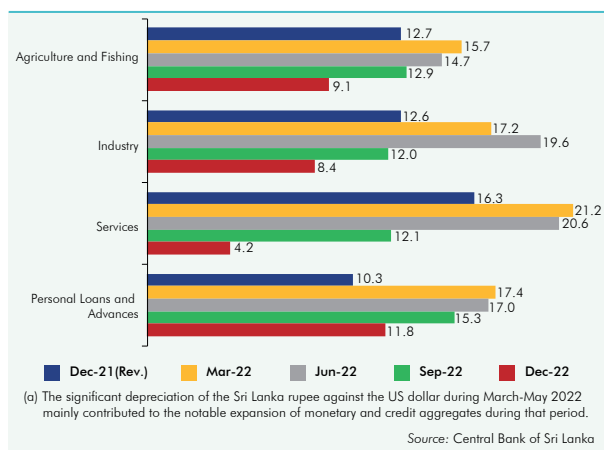


interest rates from April 2022 reflecting the significant tightening of monetary policy and the dearth of liquidity in the banking system, credit to the private sector started contracting notably on a month-on-month basis from June 2022. In particular, the cumulative contraction of credit to the private sector by LCBs during June-December 2022 amounted to Rs. 340.7 billion. Consequently, the annual expansion of credit to the private sector by LCBs was limited to Rs. 432.7 billion during 2022, compared to the expansion of Rs. 810.5 billion recorded in 2021. Accordingly, the year-on-year growth of credit to the private sector decelerated to 6.2 per cent by end 2022 from 13.1 per cent recorded at end 2021. Excluding the valuation impact arising from the exchange rate depreciation,¹⁶ credit extended to the private sector is estimated to have contracted by Rs. 231.1 billion in 2022 over the previous year, recording a contraction of 3.3 per cent, year-on-year, by end 2022.

As per the Quarterly Survey of Commercial Banks' Loans and Advances to the Private Sector, year-on-year growth of credit to all major economic sectors moderated notably during 2022, particularly in the second half of the year, reflecting the impact of tight monetary conditions, subdued economic activity, and significant fiscal reforms, among others. During the first half of 2022,

¹⁶ Under this scenario, the growth of credit to the private sector is estimated by valuing all foreign currency denominated credit at the exchange rate that prevailed at end February 2022.

Figure 7.15
Year-on-Year Growth of Private Sector Credit to
Key Sectors (%) (a)



the year-on-year growth of outstanding credit by LCBs to all major economic sectors increased primarily on account of the revaluation effect of foreign currency denominated credit. This increase was more prominent in the Industry and Services sectors as they accounted for a larger volume of foreign currency denominated credit. However, this trend reversed in the second half of 2022, with subdued economic activity along with supply shortages, the sharp upward adjustment in market lending interest rates amidst tight monetary conditions and significant fiscal reforms resulting in a deceleration of credit to all major economic sectors by end 2022. In terms of sectoral credit, the year-on-year growth of credit to the Industry sector decelerated to 8.4 per cent by end 2022 from 12.6 per cent at end 2021. Within the Industry sector, reflecting subdued construction related activities during the year amidst the shortage of building materials and high input costs along with the decline in demand under high interest rates, growth of credit to the Construction subsector decelerated notably to 3.1 per cent, year-on-year, by end 2022 from 13.1 per cent at end 2021. The year-on-year growth of credit to the Textiles and Apparel subsector also decelerated notably to 7.6 per cent by end 2022 from 16.1 per cent at end 2021, owing to subdued global demand conditions and supply side disruptions. The growth of credit extended to the Services sector also

Table 7.6
Sectoral Distribution of Loans and Advances Granted
by Commercial Banks (a)(b)

Sector	Rs. billion			
	End 2021 (c)	End 2022 (d)	% Share 2022	% Change 2022
Agriculture and Fishing	551.7	601.7	7.7	9.1
of which, Tea	101.2	108.2	1.4	6.9
Rubber	41.4	59.1	0.8	42.7
Coconut	33.7	30.0	0.4	-11.0
Paddy	44.4	38.9	0.5	-12.5
Vegetable and Fruit Cultivation and Minor Food Crops	30.9	32.2	0.4	4.1
Fisheries	24.0	26.4	0.3	10.0
Industry	2,860.9	3,100.6	39.8	8.4
of which, Construction	1,525.1	1,571.9	20.2	3.1
Food and Beverages	174.7	214.6	2.8	22.8
Textiles and Apparel	273.1	293.8	3.8	7.6
Fabricated Metal Products, Machinery and Transport Equipment	152.8	144.9	1.9	-5.1
Services	1,996.5	2,079.6	26.7	4.2
of which, Wholesale and Retail Trade	570.2	563.7	7.2	-1.1
Tourism	288.2	372.8	4.8	29.4
Financial and Business Services	437.2	446.6	5.7	2.2
Shipping, Aviation and Freight Forwarding	30.3	32.0	0.4	5.9
Personal Loans and Advances (e)	1,799.8	2,013.0	25.8	11.8
of which, Consumer Durables	375.0	368.5	4.7	-1.7
Pawning	302.4	423.4	5.4	40.0
Credit Cards	144.8	149.3	1.9	3.2
Total (f)	7,208.8	7,794.8	100.0	8.1

(a) Based on the Quarterly Survey of Commercial Banks' Loans and Advances to the Private Sector
(b) Includes loans, overdrafts and bills discounted and excludes cash items in the process of collection
(c) Revised
(d) Provisional
(e) Excludes personal housing loans, which have been included under 'Construction' classified under 'Industry' and includes Safety Net Scheme related loans
(f) Total credit to the private sector as per the Quarterly Survey differs from that in the Monetary Survey due to differences in the compilation methodologies.
Source: Central Bank of Sri Lanka

decelerated notably to 4.2 per cent, year-on-year, by end 2022 from 16.3 per cent at end 2021. Within the Services sector, reflecting subdued activity related to trade, transport and communication along with rising input costs, credit to the Wholesale and Retail Trade, Transport, and Communication and Information Technology subsectors contracted by 1.1 per cent, 27.1 per cent and 21.8 per cent, respectively, on a year-on-year basis, by end 2022. Moderation in the Services sector credit was also supported by a lower level of lending to Financial and Business Services amidst rising interest rates. Nevertheless, reflecting the gradual improvement in tourism related activities along with the extended debt moratoria and other concessionary measures, credit to the Tourism subsector expanded, recording a year-on-year growth

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

Sector	Maturity	December 2021 (c)		December 2022 (d)	
		% Share	% Growth	% Share	% Growth
Agriculture and Fishing	Short Term	4.6	17.4	4.8	12.0
	Medium Term	1.6	9.2	1.6	3.0
	Long Term	1.4	2.4	1.4	6.5
Industry	Short Term	12.2	19.5	12.4	9.8
	Medium Term	8.4	10.8	7.9	1.8
	Long Term	19.1	9.4	19.5	10.4
Services	Short Term	9.3	21.7	9.8	14.1
	Medium Term	8.8	9.9	7.7	-5.5
	Long Term	9.6	17.5	9.2	3.4
Personal Loans and Advances	Short Term	9.8	19.4	11.1	23.2
	Medium Term	5.0	3.5	5.2	11.4
	Long Term	10.2	6.0	9.5	1.2
Total	Short Term	35.9	19.7	38.1	14.8
	Medium Term	23.9	8.7	22.3	5.1
	Long Term	40.2	10.1	39.5	6.3

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

Source: Central Bank of Sri Lanka

(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

(c) Revised

(d) Provisional

of 29.4 per cent by end 2022. With respect to credit to the Agriculture and Fishing sector, the year-on-year growth of credit decelerated to 9.1 per cent by end 2022, compared to the growth of 12.7 per cent by end 2021. Within this sector, credit flows to the Coconut and Paddy subsectors contracted during 2022, while some improvement in credit flows to the Tea and Rubber subsectors was witnessed during the year. Reflecting increased consumption related credit, the year-on-year growth of credit extended in the form of Personal Loans and Advances accelerated to 11.8 per cent by end 2022, compared to the growth of 10.3 per cent at end 2021. Reflecting the difficulties faced by the public amidst the increased cost of living, Pawning related advances expanded by around Rs. 121.0 billion, recording a notable growth of 40.0 per cent, year-on-year, by end 2022, compared to the growth of 21.6 per cent recorded in 2021. Credit granted under Consumer Durables contracted by 1.7 per cent, year-on-year, by end 2022, compared to a growth of 13.3 per cent at end 2021. The growth of Credit Card advances also decelerated to 3.2 per cent, year-on-year, by end 2022, compared to a growth of 13.3 per cent at end 2021. Meanwhile, the maturity-wise analysis of outstanding credit to the private sector by LCBs reflects increased

market appetite towards short term loans over other tenures amidst the high interest rate environment, although a slowdown in the year-on-year expansion of credit was observed across all tenures by end 2022 compared to end 2021.

Outstanding credit to the SME sector, as reflected by the monthly SME Credit Survey,¹⁷ contracted during 2022 in line with the overall moderation in credit to the private sector by LCBs. On a year-on-year basis, credit to the SME sector by both LCBs and Licensed Specialised Banks (LSBs) contracted by 8.3 per cent by end 2022, compared to the growth of 21.7 per cent at end 2021. The significant increase in interest rates applicable on loans to the SME sector by licensed banks amidst tight monetary conditions, subdued aggregate demand conditions, limited availability of raw materials for certain industries and cost escalations, the cautious approach adopted by licensed banks amidst elevated credit risks with rising non-performing loans (NPLs), and subdued business sentiments, among others, contributed to the deterioration in credit extended

¹⁷ A monthly survey conducted by the Central Bank since July 2020 with the objective of identifying the average cost and the quantum of loans granted to SMEs by LCBs and LSBs.

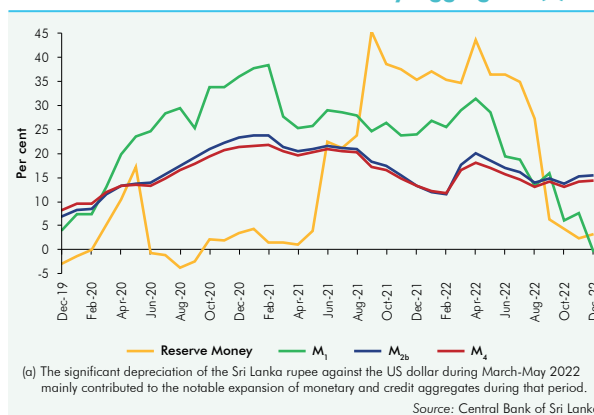
to the SMEs. In terms of sectoral credit to the SME sector, the outstanding amount of credit extended to the Agriculture, Industry and Services sectors contracted by 6.1 per cent, 6.5 per cent and 11.1 per cent, respectively, on a year-on-year basis, by end 2022. With regard to the new loans granted to the SME sector in 2022, a greater share of loans extended was for short tenures, while a notable decline was observed in the share of medium to long term loans, compared to 2021. This indicates that the new loan disbursements during the year were more towards working capital purposes and less towards investment purposes reflecting the subdued economic activity, in comparison to the previous year.

Broad Money (M_4)

Growth of broad money supply (M_4), as measured by the Financial Survey,¹⁸ accelerated during 2022, following a similar trend observed in broad money supply (M_{2b}). The year-on-year growth of M_4 accelerated to 14.3 per cent by end 2022 from 13.3 per cent recorded at end 2021. Viewed from the assets side, the expansion of M_4 was driven entirely by the expansion in NDA. Within NDA, domestic credit by LSBs increased by Rs. 102.3 billion, while that of Licensed Finance Companies (LFCs) rose by Rs. 106.8 billion during 2022. The expansion of NCG based on M_4 amounted to Rs. 1,699.3 billion during the year, of which Rs. 37.0 billion was through LSBs and Rs. 23.7 billion was through LFCs. Further, reflecting mainly the impact of the significant currency depreciation, credit extended to the private sector by licensed banks and LFCs increased notably till April 2022, followed by a moderation thereafter underpinned by tight monetary conditions. Accordingly, growth of credit

¹⁸ The Financial Survey provides a broader measure of liquidity, covering all deposit taking institutions, including LSBs and LFCs, in addition to LCBs and the Central Bank.

Figure 7.16
Year-on-Year Growth of Monetary Aggregates (a)



extended to the private sector by licensed banks and LFCs grew by 6.2 per cent, year-on-year, by end 2022, compared to 12.7 per cent, year-on-year, at end 2021. Credit extended by LSBs to the private sector increased by Rs. 65.4 billion in 2022, recording a growth of 6.0 per cent, year-on-year. Meanwhile, credit extended by LFCs to the private sector rose by Rs. 83.1 billion in 2022, recording a growth of 6.6 per cent, year-on-year. However, the overall NFA, as per M_4 , contracted by Rs. 768.2 billion during 2022, reflecting the decline in NFA of the Central Bank, while NFA of LSBs increased by Rs. 16.6 billion during the year due to the settlement of foreign liabilities.

Viewed from the liabilities side of M_4 , the growth of time and savings deposits held by the public with licensed banks and LFCs increased during 2022. The overall growth of time and savings deposits, as per M_4 , accelerated due to the high interest rates offered by licensed banks and LFCs, particularly during the latter part of the year. Accordingly, the year-on-year growth of time and savings deposits, as per M_4 , accelerated to 16.0 per cent by end 2022, compared to 11.6 per cent at end 2021. Time and savings deposits held with LFCs grew by 11.5 per cent,

Table 7.8
Assets Side of Broad Money (M₄)
 (Computed as per the Financial Survey)

Item	End 2021	End 2022 (a)	Change				Rs. billion
			2021		2022		
			Amount	%	Amount	%	
Financial Survey (M₄)	12,985.4	14,839.8	1,523.5	13.3	1,854.4	14.3	
Underlying Factors							
Net Foreign Assets	-998.6	-1,766.8	-781.5	-360.0	-768.2	-76.9	
Monetary Authorities (b)	-387.3	-1,613.9	-914.0	-173.5	-1,226.6	-316.7	
LCBs	-594.7	-153.0	141.5	19.2	441.8	74.3	
LSBs	-16.6	0.0	-9.0	-117.9	16.6	-	
Net Domestic Assets	13,984.0	16,606.6	2,305.0	19.7	2,622.6	18.8	
Domestic Credit	17,296.4	20,135.8	2,643.9	18.0	2,839.4	16.4	
Net Credit to the Government	6,769.3	8,468.6	1,403.6	26.2	1,699.3	25.1	
Central Bank	2,094.1	3,432.5	1,225.2	141.0	1,338.4	63.9	
LCBs	3,738.3	4,038.6	59.2	1.6	300.3	8.0	
LSBs	844.5	881.5	102.3	13.8	37.0	4.4	
LFCs	92.4	116.0	16.9	22.4	23.7	25.6	
Credit to Public Corporations/SOBEs (LCBs)	1,188.1	1,747.0	185.9	18.6	558.9	47.0	
Credit to the Private Sector	9,338.9	9,920.2	1,054.4	12.7	581.2	6.2	
LCBs	6,981.4	7,414.1	810.5	13.1	432.7	6.2	
LSBs	1,093.7	1,159.1	157.3	16.8	65.4	6.0	
LFCs	1,263.8	1,346.9	86.7	7.4	83.1	6.6	
Other Items (net) (c)	-3,312.4	-3,529.2	-339.0	-11.4	-216.8	-6.5	

(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) Computed as the difference between other assets and other liabilities

Source: Central Bank of Sri Lanka

year-on-year, by end 2022, compared to the growth of 5.5 per cent in 2021. However, time and savings deposits held with LSBs grew only by 6.8 per cent, year-on-year, by end 2022, compared to the growth of 13.5 per cent recorded

in 2021. The moderate growth of time and savings deposits held with LSBs could be attributed to relatively high interest rates offered by LCBs and LFCs in competing for deposits amidst tight liquidity conditions.

