the balance of Rs 533 million reflected the increase in liability due to exchange rate changes in the major international currencies. Parity changes in international currencies also introduced an element of instability into our external indebtedness.

The better export earnings in 1976 led to a decline in the external debt service ratio (the external debt service payments as a percentage of exports of goods and non-factor services) from 22.9 per cent in 1975 to 20.1 per cent in 1976. However, the high external debt ratio and the interest burden of the domestic debt are causes for concern. The repayments and interest on public debt amounted to Rs 1,432 million or 52 per cent of the gross loan proceeds in 1976, as compared to 61 per cent in 1975.

MONETARY AND BANKING DEVELOPMENTS

Money Supply

At the end of 1976 the money supply as shown in Table 15 had increased by Rs 1,077 million compared to the end 1975 position. This represented an increase of 34.9 per cent compared to increases of 4.8 per cent in 1975 and 6.0 per cent in 1974. The average of the monthly money supply figures (which as an index embodies the characteristics of the money supply movement over the entire year) rose by 22.4 per cent in 1976 compared to increases of 1.9 and 18.1 per cent in 1975 and 1974 respectively.

The usual pattern of seasonal fluctuation in money supply was not displayed in 1976; except for the month of July, the money supply showed a continuous upward movement. During the year, effects of government's deficit financing and increased external assets were large enough to obscure the seasonal changes that occurred. Some of the factors generating seasonal changes did not show up at all. For instance, the level of advances under the Guaranteed Price Scheme, which are generally seasonal, rose to Rs 371 million in July 1976 and continued to remain high during the rest of the year.

Comparison of monthly money supply figures for 1976 with the figures for the corresponding months of the previous year shows a rate of increase ranging from 6.4 per cent in January to 34.9 per cent in December with an almost continuous increase through the year; the largest such increase in 1975 was 6.1 per cent.

The principal factors responsible for the increase in money supply during the year were the financial operations of the government and the increase in net external banking assets. During the year, government financial operations with the banking system resulted in an expansionary impact of Rs 540 million on the money supply. The Government had heavy recourse to financing from the banking system in an attempt to maintain a high level of capital and recurrent expenditure including welfare subsidies in the face of a sluggish increase in revenue. There was a sharp expansion in bank credit in favour of the government, which was offset to some extent by an increase in its deposits with the banking system. Altogether, commercial bank credit to government increased by Rs 366 million during the year. While commercial

TABLE 15

Change in Money Supply and Underlying Factors – Dec. 1975/Dec. 1976

Rs. Million

Composition			
(a) Change in demand deposits held by the public	... ...	+ 606.7	
(b) Change in currency held by the public	... ...	+ 470.7	
Net Change in Money Supply	...		+ 1,077.4
Analysis			
1. External Banking Assets (net)	... ...		+ 470.1
2. Private Sector	... ...		– 14.2
(a) Commercial bank credit to co-operative institutions	...	+ 112.8	
(b) Commercial bank credit to other private sector constituents		+ 426.7	
(c) Time and savings deposits of co-operative institutions	...	– 21.4	
(d) Time and savings deposits of other private sector constituents		– 486.6	
(e) Other liabilities and accounts (net) of commercial banks		– 45.7	
3. Semi-Government Sector	... ...		+ 84.1
(a) Commercial bank credit to Government corporations	...	+ 42.6	
(b) Time and savings deposits of Government corporations	...	+ 41.5	
4. Government Sector	... ...		+ 540.5
(a) Commercial banks' holdings of Treasury Bills, Government and Government guaranteed securities and Government import bills	... ...	+ 315.4	
(b) Cash items purchased on Government account	...	+ 51.4	
(c) Central Bank's holdings of Treasury Bills and Government and Government guaranteed securities	... ...	+ 351.7	
(d) Central Bank's advances	... ...	+ 11.5	
(e) Central Bank's other liabilities and accounts (net)	...	+ 83.2	
(f) Government deposits with banking system and cash balances with the Treasury and Kachcheries	...	– 272.6	
5. Adjustments for items in transit	... ...		– 3.1
Net Change ...	...		+ 1,077.4

Note: Signs indicate effect on Money Supply.

Source: Central Bank of Ceylon

banks' holdings of Treasury bills, government and government guaranteed securities and government import bills rose by Rs 315 million, cash items purchased by the commercial banks on government's account increased by Rs 51 million. Borrowings by the Government from the Central Bank increased by Rs 363 million owing to an increase of Rs 352 million in the Central Bank holdings of Treasury bills and government and government guaranteed securities, and a rise of Rs 11 million in the Bank's provisional advances to government. Movements in the Central Bank's other liabilities and accounts (net) were also expansionary to the extent of Rs 83 million. An increase of Rs 273 million in government deposits with the banking system constituted the only off-setting factor on the monetary expansion resulting from government's financial operations. This was in sharp contrast to the experience in 1975, when the movements in government deposits with the banking system and in cash balances with the Treasury brought an expansionary impact on the money supply to the tune of Rs 120 million.

The need for resorting to the banking system by the government arose from the fact that the budgetary outturn for 1976 showed a significant departure from the estimates made in the Budget. According to original estimates, the deficit of Rs 2,296 million in the 1976 Budget was expected to be bridged in full from non- expansionary sources of financing. However, as the year proceeded, actual receipts and expenditure flows showed marked deviations from the original estimates. The budgetary outturn for 1976 shows that the overall expenditure has risen by Rs 1,373 million while the compensating increase in revenue was only Rs 94 million. Accordingly, the Budget deficit for the year rose to Rs 3,576 million, which was well beyond the capacity of the domestic non-expansionary sources of financing to bridge, thus necessitating recourse to expansionary financing.

Growth in net external banking assets was the second most important contributory factor for the monetary expansion during the year under review. After substantial declines in 1974 and 1975 amounting to Rs 179 million and Rs 214 million, respectively, the external banking assets (net) rose by Rs. 470 million in 1976. The increase in these assets was largely reflected in the foreign assets of the Central Bank, which increased by Rs 305 million, and mainly took the form of an increase in liquid balances of the Bank held abroad. In addition, the net foreign exchange holdings of commercial banks recorded an increase of Rs 165 million, in contrast to the decline of Rs 7 million in the previous year. The rise in the net foreign assets of the Central Bank was the outcome of increases in cash and balances abroad, foreign government securities, holdings of Special Drawing Rights, offset to some extent by the deposits of international organisations and borrowings abroad. In all, cash and balances abroad increased by Rs 331 million, while foreign government securities and holdings of Special Drawing Rights rose by Rs 26 million and Rs 28 million, respectively. However, on account of an increase in the deposits of international organisations by Rs 73 million, largely due to the increased purchases from the International Monetary Fund, and in borrowings abroad by Rs 7 million, the expansionary influence of the Bank's foreign exchange operations amounted to Rs 305 million.

The growth in net foreign exchange holdings of commecial banks had been the outcome of an increase in gross foreign exchange holdings by Rs 176 million, slightly offset by a rise in gross foreign exchange liabilities by Rs 12 million. The former was the result of increases in commercial banks' holdings of foreign currency by Rs 3 million, cash with banks abroad by Rs 12 million and export bills by Rs 163 million, offset marginally by a decrease of Rs 1 million in overdrafts to banks abroad. Following the experience in the previous year, the increase in gross foreign exchange liabilities was almost wholly due to an increase in borrowings from banking institutions abroad.

In 1975, the private sector, defined to include government corporations and co-operative institutions, played a very moderate role in generating expansionary pressures on the money supply, as compared with the previous year. In 1976, the operations of this sector were even less expansionary. Whereas the net expansionary effect on the money supply of the operations of the private sector in 1974 and 1975 were Rs 533 million and Rs 131 million, respectively, in 1976 the net expansionary impact of this sector's operations was only Rs 70 million.

Interest Rates

Although the changes in interest rates during 1976 were less marked than in the previous year, changes that did occur indicated a movement towards higher lending rates. Major revisions in the commercial banks' deposit rates had already been made in the previous year following the introduction of the April, 1975 measures. Furthermore, there was no compelling reason for commercial banks to have their deposit rates revised upward during 1976, as their efforts at mobilising deposits at existing rates were very successful during the year. The deposit rates of the National Savings Bank, the Treasury bill rate and the Bank Rate also remained unchanged during the year. (The latter rate was however revised upwards by two percentage points to 8½ per cent with effect from January 26, 1977).

The maximum and minimum rates on inter-bank call loans remained unchanged at 8 per cent and 5 per cent, respectively, during the year. However, there was pressure in this market towards the end of the year, pushing the average rate towards the maximum. This was a sequel to the gradual reduction in the proportion of required reserves that the commercial banks are permitted to maintain in the form of Sri Lanka currency notes and coins, commencing from October, 29, 1976. The commercial banks' discount rate on commercial bills moved up at the beginning of the year, the maximum rate rising from 12 per cent to 13 per cent. Information on lending rates of commercial banks is available only on the basis of security furnished by the respective borrowers. The maximum rates on loans and overdrafts secured by several categories of securities moved up in January 1976, i.e. before the bank deposits started building up. The maximum rate on loans and advances secured by government securities rose from 11 per cent to 14 per cent,shares of joint stock companies from 12 per cent to 13 per cent, stock in trade from 13 per cent to 14 per cent, immovable property from 12 per cent to 14 per cent and 'others' from 13 per cent to 14 per cent. Thus, whereas the maximum rate of 14 per cent applied to only the unsecured advances in 1975, the maximum rate in respect of most of the secured advances moved upto 14 per cent in 1976.

Commercial Banking

The year 1976 witnessed a sharp expansion in the resources of commercial banks. In contrast to the experience in the previous year, growth of deposits provided a very substantial increase in resources. During the year, demand deposits increased by Rs 8C9 million, while time and savings deposits rose by Rs 463 million. Resources provided through increased deposits were marginally augmented by increases in foreign borrowing, paid up capita,l reserve funds and undistributed profits, and in other liabilities. A reduction in the level of Central Bank accommodation constituted the only change during the year which contributed to reduce the resources available to commercial banks. Following the trend observed in the previous year, the monthly average ratio of liquid assets to total deposits and the monthly average ratio of cash to total deposits declined during the year - the former from 32.6 per cent to 29.6 per cent and the latter from 13.8 per cent to 11.3 per cent. These changes however, should not be interpreted to mean an overstretching of commercial banks' lending capacity. In point of fact, average ratio of loans and advances to total deposits declined from 97.5 per cent in 1975 to 91.0 per cent in 1976.

Commercial bank credit to the private sector (including government corporations and co-operative institutions) rose by Rs 730 million or 19.6 per cent in

1976. This was in sharp contrast to the experience in 1975 when bank credit in favour of this sector increased by only Rs 181 million or by 5.1 per cent. The increase in bank credit during 1976 was mainly reflected in loans which rose by Rs 539 million. In comparison, export bills rose by Rs 163 million, overdrafts by Rs 72 million and cash items in process of collection by Rs 67 million. On the other hand, commercial banks' holdings of import bills declined by Rs 111 million during the year. Bank credit to all sub-sectors within the private sector increased but the largest increase of Rs 575 million was in respect of other private sector constituents. Bank credit to co-operative institutions rose by Rs 113 million while credit to government corporations increased by Rs 43 million. The sharp increase in bank credit in favour of other private sector constituents should be viewed in the background of a substantial build-up of time and savings deposits of this sector with the banking system. Altogether these deposits rose by Rs 487 million which meant that the net increase in credit was Rs 88 million. As in the previous year, Sri Lanka banks were almost wholly responsible for the increase in bank credit in 1976. Of the total increase, Sri Lanka banks accounted for Rs 724 million or 99.2 per cent.

Commercial Bank Branch Expansion

The drive towards rapid expansion of the commercial bank branch network observed in recent years continued in 1976 and altogether 77 branch offices were opened during the year. The whole of this increase was confined to Sri Lanka banks; there was no change in the number of offices operated by foreign banks. Although the overall number of bank offices opened during the year was somewhat lower than the number opened in 1975 (105) and 1974 (154), this was not indicative of a slackening in the rate of expansion of commercial bank offices in the country. Of the 77 branch offices opened during the year, only 42 consisted of Agricultural Service Centre branches opened by the Bank of Ceylon, which meant that as many as 35 of the new branch offices were full branches. In contrast, in the previous year the number of full branches constituted only 8 out of a total of 105 new branches opened during the year. As at the end of 1976, the number of Agricultural Service Centre branches totalled 341. In addition to Agricultural Service Centre branches, the Bank of Ceylon opened 2 new full branches and also converted 3 kachcheri branches as full branches, raising the total number of its full branches to 70 by the end of 1976.

The outstanding feature of commercial bank branch expansion observed in 1976 was the most aggressive expansion programme pursued by the People's Bank. Altogether, the People's Bank opened 29 new branches during the year bringing the total number of its branches to 187 as at the end of the year. In comparison, the number of branch offices opened by this bank in the previous year was only 5. The People's Bank branches opened during the year were distributed widely throughout the country. The Hatton National Bank also opened a new branch during the year increasing its total number of branches to 23 as at the end of 1976.

Rural Credit

In 1976, the total credit disbursements under the Comprehensive Rural Credit Scheme, the rural banks scheme and credit channelled by the Bank of Ceylon sub-offices amounted to Rs 161.9 million. This was an increase of 25.6 per cent over the corresponding amount disbursed in the previous year. Of these total loans, 49.4 per cent has been granted by rural banks and multi-purpose co-operative societies under the Comprehensive Rural Credit Scheme.

Purpose-wise, Rs 130.8 million or 80.8 per cent of the total loan disbursement under these three schemes was for crop cultivation and was an increase of Rs 24.8 million over the amount in the previous year. Paddy cultivation loans accounted for 72.3 per cent of the total crop cultivation loans or 58.4 per cent of the total loan disbursement for all purposes given under these three schemes. As in previous years, of the total sum given for paddy cultivation, the major proportion or Rs 69.1 million has been disbursed by the People's Bank under the Comprehensive Rural Credit Scheme through rural banks and multi-purpose co-operative societies. Loans granted for subsidiary food crops amounted to Rs 32.2 million or 24.6 per cent of the total loans granted for crop cultivation or 19.9 per cent of the total loan disbursement for all purposes under these three schemes. Loans granted by rural banks and Bank of Ceylon sub offices at Agricultural Service Centres for housing, electrification and digging of wells, amounted to Rs 13.7 million.

The total amount of paddy loans granted by the People's Bank since the inception of the new Agricultral Credit Scheme in 1967 and subsequently under the Comprehensive Rural Credit Scheme, amounted to Rs 498.9 million up to Maha 1975/76. As reported at the end of 1976, of this sum, Rs 204.1 million or 40.9 per cent of paddy loans were in default. At the end of 1976, the total amount of loans granted under the cultivation loan scheme for all crops amounted to Rs 653.2 million.

The high rate of defaults in agricultural loans continues to be the major problem in cultivation loans. While adverse weather conditions were a factor reducing the repayment capacity of farmers in recent years, this alone cannot be held responsible for the continuously low rates of recovery. Institutional factors in the administration of the scheme would need to be examined and improved in order to ensure a higher rate of recovery.

Monetary Policy

Against a background of a very sharp monetary expansion, certain monetary policy measures were introduced during the year with a view to exercising a restraining influence on the grant of credit by commercial banks. First, commencing from October 29, 1976, the proportion of reserve requirement that the commercial banks were permitted to hold as till cash, was gradually reduced. Secondly, a ceiling on bank credit for non-essential purposes was imposed with effect from October 4, 1976. Although an upward revision of the Bank Rate was also considered, implementation of this was postponed until January 26, 1977, when the Bank Rate was raised by two percentage points to 8½ per cent.

The decision not to impose stiff monetary measures was due to the fact that the monetary expansion in 1976 was not accompanied by an undue expansion of bank credit to the private sector. In the circumstances, it was more meaningful to pursue a selective monetary policy which would check the growth of bank credit in favour of non-essential purposes. Government fiscal operations and the growth in external banking assets were the main causes of the monetary expansion in 1976. In this context, monetary policy per se is of limited usefulness in combating it. During 1976, bank credit (net) in favour of the private sector, which includes government corporations and co-operative institutions, increased by only Rs 70 million. In a situation where monetary expansion has not been accompanied by an undue expansion of bank credit in favour of the private sector, a tight monetary policy can prove to be counter-productive in restraining price increases. The rather mild monetary policy pursued in 1976 in the midst of a very sharp monetary expansion should be viewed in this context.