

## MONETARY AND BANKING DEVELOPMENTS

### Money Supply

Substantial deceleration in the rate of monetary expansion after two successive years of rather sharp increases in money supply was the principal feature of monetary developments in 1978. The money supply, which is the sum total of currency and demand deposits held by the public, increased by Rs. 570 million or 11 per cent during the year. This compared with annual increases of 35 per cent and 29 per cent in 1976 and 1977, respectively. The year-on-year increase in money supply which exceeded 25 per cent throughout 1977 over the levels in the corresponding months of the previous year, exceeded this level only during the first four months of the year in 1978. As observed from Table 1.15, the annual rate of monetary expansion in 1978 declined progressively from 35 per cent in January to 14 per cent in July and had somewhat stabilised around this level thereafter. In December, 1978 however, it registered a further noticeable decrease reaching a level of 11 per cent. Underscoring the slowing down of the rate of monetary expansion, the monthly average rise in money supply which was 2.1 per cent in 1977 declined to 0.9 per cent in 1978, while the monthly average increases over the corresponding levels of the previous year decreased from 32 to 20 per cent.

Major underlying factors for the deceleration in the rate of monetary expansion were the contraction resulting from the fiscal operations of the government sector and the very substantial build-up of time and savings deposits by the non-bank private sector. During the year, Government revenue plus non-expansionary sources of borrowing exceeded total expenditure by a significant margin. Consequently, government sector operations, including changes in Central Bank's other liabilities and accounts (net), resulted in a contractionary impact of Rs. 1,520 million on the money supply. On the other hand, despite a record increase in bank credit to private sector amounting to little over Rs. 3,000 million during the year, the expansionary impact of this sector's operations was confined to Rs. 688 million, largely owing to a very substantial build-up of time and savings deposits by other private sector constituents within this sector. The latter was the result of the high interest rate policy pursued during the year.

The monetary developments in 1978 also seem to suggest the re-emergence of some element of seasonality into the pattern of monetary growth. Generally, bank credit to co-operative institutions rise somewhat sharply during the first half of each year and tend to decline equally sharply during the fourth quarter. In 1978, bank credit to this sector rose to Rs. 1,922 million by June, but declined to Rs. 1,675 million by December. The seasonal pattern in the movement of bank credit in this sector would have been much more pronounced, but for the fact that the commercial banking system held a sum of Rs. 297 million in suspense on behalf of the Paddy Marketing Board pending liquidation of matured Goods Receipts and a further Rs. 171 million of past-due Goods Receipts. The amount held in suspense was unusually high this year because the magnitude of maturing Goods Receipts during the last quarter was high, reflecting heavy paddy purchases during the first half of the year. However, elements

**TABLE 1.15**  
**Changes in Money Supply 1976-78**

| End Period            | Money Supply - Rs. Million |       |       | Monthly Changes % |       |       | Change over previous year% |                |                |
|-----------------------|----------------------------|-------|-------|-------------------|-------|-------|----------------------------|----------------|----------------|
|                       | 1976                       | 1977  | 1978  | 1976              | 1977  | 1978  | 1976 over 1975             | 1977 over 1976 | 1978 over 1977 |
| January .. ..         | 3,127                      | 4,203 | 5,679 | + 0.3             | + 0.9 | + 5.8 | + 6.4                      | + 34.4         | + 35.1         |
| February .. ..        | 3,213                      | 4,429 | 5,830 | + 2.7             | + 5.4 | + 2.7 | + 9.7                      | + 37.9         | + 31.6         |
| March .. ..           | 3,391                      | 4,710 | 6,001 | + 5.5             | + 6.3 | + 2.9 | + 11.4                     | + 38.9         | + 27.4         |
| April .. ..           | 3,516                      | 4,764 | 6,025 | + 3.7             | + 1.2 | + 0.4 | + 15.4                     | + 35.5         | + 26.4         |
| May .. ..             | 3,582                      | 4,808 | 5,876 | + 1.9             | + 0.9 | - 2.5 | + 20.5                     | + 34.2         | + 22.2         |
| June .. ..            | 3,728                      | 4,947 | 5,864 | + 4.1             | + 2.9 | - 0.2 | + 23.2                     | + 32.7         | + 18.5         |
| July .. ..            | 3,666                      | 4,893 | 5,570 | - 1.7             | - 1.1 | - 5.0 | + 23.0                     | + 33.5         | + 13.8         |
| August .. ..          | 3,851                      | 4,912 | 5,523 | + 5.1             | + 0.4 | - 0.8 | + 31.3                     | + 27.5         | + 12.4         |
| September .. ..       | 3,889                      | 5,024 | 5,804 | + 1.0             | + 2.3 | + 5.1 | + 28.9                     | + 29.2         | + 15.5         |
| October .. ..         | 3,988                      | 5,062 | 5,835 | + 2.5             | + 0.7 | + 0.5 | + 30.9                     | + 26.9         | + 15.3         |
| November .. ..        | 4,019                      | 5,254 | 5,955 | + 0.8             | + 3.8 | + 2.1 | + 31.9                     | + 30.7         | + 13.3         |
| December .. ..        | 4,166                      | 5,366 | 5,936 | + 3.7             | + 2.1 | - 0.3 | + 34.9                     | + 28.8         | + 10.6         |
| Monthly Average .. .. | 3,678                      | 4,864 | 5,825 | + 2.5             | + 2.1 | + 0.9 | + 22.4                     | + 32.5         | + 20.2         |

Source: Central Bank of Ceylon

of a seasonal character displayed in the flow of bank credit to this sector was completely obliterated by the behaviour of other sectors, which were devoid of any seasonality. In particular, the growth in external banking assets which registered large increases during all quarters except the second and the impact of government sector's financial operations which exerted substantial contractionary influences in each of the four quarters dampened any seasonal bias in the growth of money supply during the year.

The composition of money supply and the underlying factors responsible for the monetary expansion in 1978 are shown in Table 1.16. During the year, demand deposits of the non-bank private sector rose by Rs. 347 million, while the currency held by the public rose by Rs. 224 million. A sharp increase in external banking assets and the expansion in bank credit to private sector were the major

Table 1.16  
Changes in Money Supply and Causal Factors 1976 – 1978

| Rs. million  |                              |                              |                              |  |
|--|------------------------------|------------------------------|------------------------------|--|
|  | End 1976<br>over<br>End 1975 | End 1977<br>over<br>End 1976 | End 1978<br>over<br>End 1977 |  |
| <b>1. Composition</b>  |                              |                              |                              |  |
| 1.1 Demand deposits ..   | + 607                        | + 489                        | + 347                        |  |
| 1.2 Currency ..  | + 471                        | + 711                        | + 224                        |  |
| <b>2. Net Change in Money Supply</b> ..                          | <b>+1,077</b>                | <b>+1,200</b>                | <b>+ 570</b>                 |  |
| <b>3. Analysis</b>   |                              |                              |                              |  |
| 3.1 External Banking Assets (Net)* ..                            | + 470                        | +1,943                       | +1,523                       |  |
| 3.2 Private Sector ..  | + 70                         | - 70                         | + 688                        |  |
| 3.2.1 Commercial Bank Credit                                     |                              |                              |                              |  |
| - to Government Corporations ..                                  | + 43                         | + 614                        | + 693                        |  |
| - to Co-operatives ..  | + 113                        | + 568                        | + 443                        |  |
| - to other private sector ..                                     | + 427                        | + 618                        | +1,890                       |  |
| 3.2.2 Time & Savings Deposits                                    |                              |                              |                              |  |
| - of Government Corporations ..                                  | + 42                         | - 294                        | - 200                        |  |
| - of Co-operatives ..  | - 21                         | - 45                         | - 54                         |  |
| - of other private sector ..                                     | - 487                        | - 856                        | -1,351                       |  |
| 3.2.3 Other Assets & Liabilities<br>(Net) of Commercial banks .. | - 46                         | - 676                        | - 733                        |  |
| 3.3 Government Sector ..   | + 541                        | - 676                        | -1,520                       |  |
| 3.3.1 Commercial bank credit ..                                  | + 367                        | + 132                        | - 113                        |  |
| 3.3.2 Central Bank credit ..                                     | + 363                        | - 187                        | + 38                         |  |
| 3.3.3 Bank deposits and cash balances ..                         | - 273                        | - 223                        | -1,050†                      |  |
| 3.3.4 Other Assets & Liabilities<br>(Net) of Central Bank ..     | + 83                         | - 398                        | - 304                        |  |
| 3.4 Items in transit ..  | - 3                          | + 4                          | - 121                        |  |

Signs indicate effect on Money Supply.

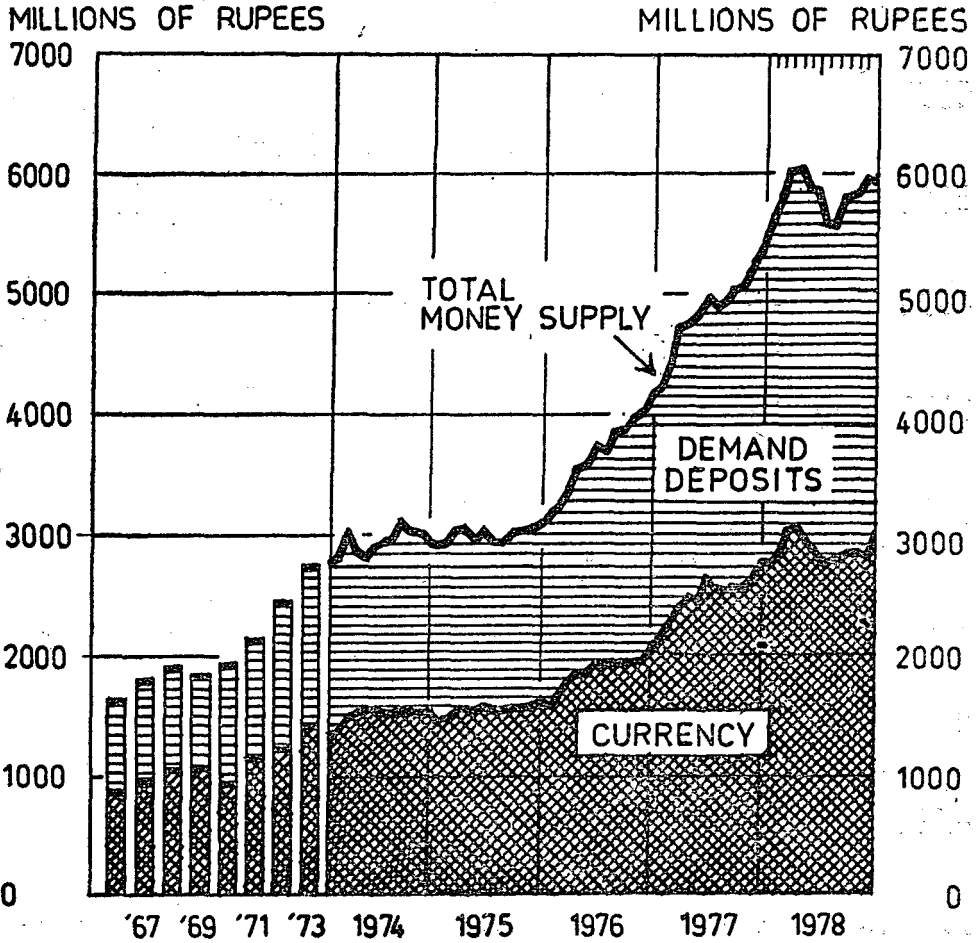
Source: Central Bank of Ceylon.

\* Changes in extranal banking assets attributable to exchange rate changes with contra entry in other liabilities and accounts (net) of Central Bank have been excluded from the analysis. The respective changes in 1977 and 1978 were + Rs. 1,655 million and + Rs. 361 million.

† A sum of Rs. 390 million transferred by the Government to the Central Bank for the National Development Bank is included.

# MONEY SUPPLY

1966-73 END YEAR FIGURES, 1974 ONWARDS END MONTH FIGURES



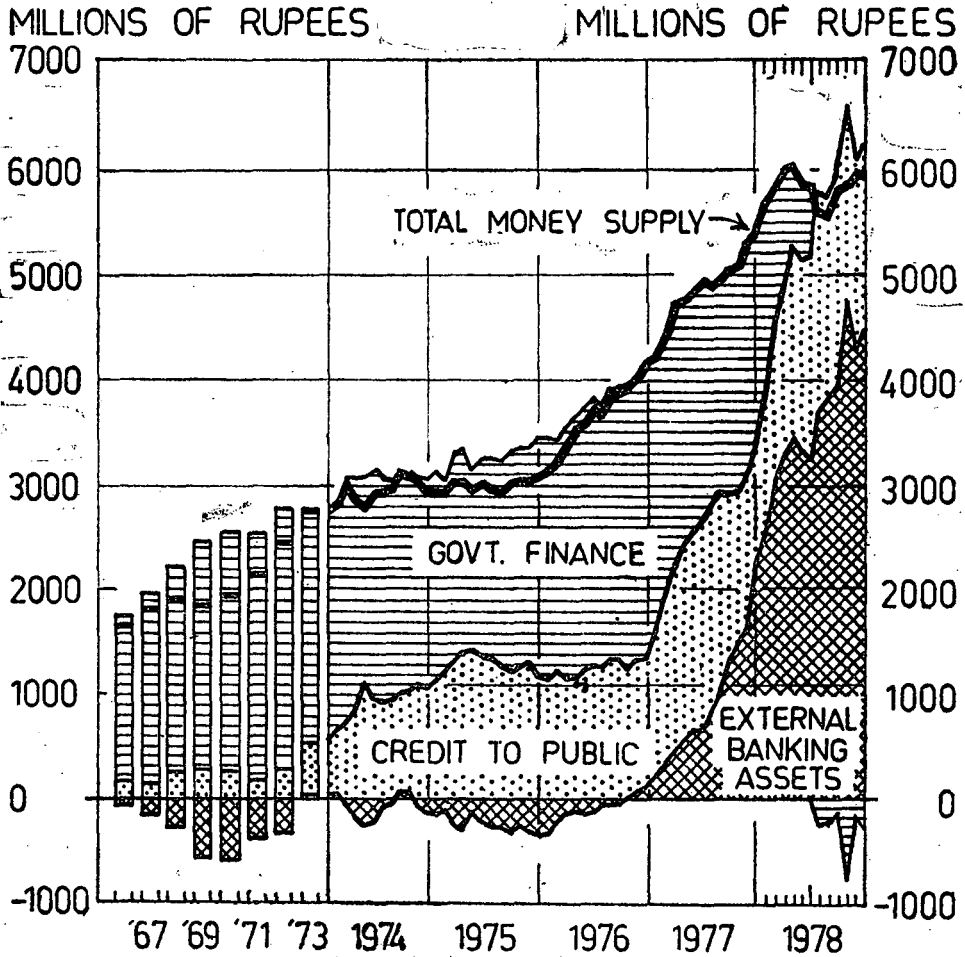
Dept. of Economic Research

Source: Central Bank of Ceylon

Money Supply is defined as "all currency and demand deposits owned by persons other than commercial banks and the Government".

## SOURCES OF MONEY SUPPLY

1966-73 END YEAR, 1974 ONWARDS END MONTH FIGURES



Dept. of Economic Research

Source: Central Bank of Ceylon

This chart indicates the origin of Money Supply in Sri Lanka

- (a) "Government Finance" shows the claims of the banking system on the Government net of rupee cash holdings of the Government.
- (b) "Credit to public" shows the claims of the banking system on the private sector net of time and savings deposits.

When net external banking assets were negative, the total money supply line is below the line limiting Government finance and when the Government's contribution is negative, the total money supply line is below the line limiting credit to public.

Changes in external banking assets attributable to exchange rate changes with contra entry in the International Reserve Revaluation Account have been excluded commencing January, 1977.

contributory factors for the growth in money supply in 1978. This was the third successive year, when the external sector exerted a significant expansionary influence on the money supply. The net external banking assets (after allowing for changes in exchange rates) which recorded increases of Rs. 470 million and Rs. 1,943 million in 1976 and 1977, respectively rose by a further Rs. 1,523 million in 1978. As usual, the major share of the increase was reflected in the International Reserve of the Central Bank. The growth in external banking assets was entirely due to increased resources available in the capital account of the balance of payments. Although the current account recorded a substantial deficit, partly reflecting the liberalization of imports and payments since mid-November, 1977 the resources available in the capital account were more than adequate to meet this deficit, and the surplus went on to strengthen the country's external assets position.

In sharp contrast to the experience in 1977 when the transactions of the private sector, inclusive of government corporations and co-operative institutions, resulted in a contractionary impact of Rs. 70 million, the operations of this sector in 1978 were expansionary on the money supply to the extent of Rs. 688 million. A very sharp increase of Rs. 3,026 million in commercial bank credit to this sector was the major contributory factor for this development. During the year, bank credit to "other private sector" constituents increased by a record of Rs. 1,890 million, while credit to government corporations and to co-operative institutions rose by Rs. 693 million and Rs. 443 million, respectively. Thus, "other private sector" which exerted a contraction in money supply during the previous year, reversed its role in 1978, exerting an expansionary impact of Rs. 539 million, despite a substantial increase of Rs. 1,351 million in its time and savings deposits. The sharp rise in bank credit to this sector could be explained by the increased credit requirements following the reorientation of economic policy in November, 1977.

In 1978, credit operations of government corporations resulted in an expansionary impact of Rs. 493 million. This was the outcome of an increase in borrowings from commercial banks of Rs. 693 million, offset partly by a rise in their time and savings deposits of Rs. 200 million. The increase in bank credit to these corporations during 1978 was the highest ever on record for any single year. The major share of this increase occurred during the first half of the year. The rise during the first half was Rs. 539 million, as compared with Rs. 154 million during the second half. The slow down during the second half could be partly attributed to the restraining influence of credit ceilings operative during this period. The increased dependence of government corporations on the banking system during the year could be explained partly by higher import commitments following the import liberalization and partly by increased working capital requirements by some corporations.

Commercial bank credit to co-operatives which registered a record increase of Rs. 568 million during the previous year, showed a further rise of Rs. 443 million in 1978. As in the previous year, the major share of the increase was in respect of advances for Paddy purchases under the Guaranteed Price Scheme

(G.P.S.), which recorded an increase of Rs. 349 million. But, this increase was largely statistical than real, because the banking system was holding in suspense a sum of Rs. 297 million at the end of December on behalf of the Paddy Marketing Board, pending liquidation of matured Goods Receipts. When allowance is made for this sum, the net increase in GPS advances during the year would indeed be very marginal. However, the improved performance shown in the financing of GPS purchases was made possible by a transfer of Rs. 340 million to the Paddy Marketing Board by the Treasury during the last quarter of 1978 for the purpose of meeting maturing Goods Receipts and for holding buffer stocks. Cultivation and other loans increased by Rs. 49 million and Rs. 45 million, respectively. Another important policy decision which had a sobering influence on the amount of bank credit utilised by this sector was the withdrawal of the 75 per cent guarantee in respect of loan defaults, effective October, 1978.

In sharp contrast to the development in the external sector and the private sector, the government sector operations resulted in a substantial contractionary influence on the money supply in 1978. In all, government financial operations with the banking system, including changes in Central Bank's other liabilities and accounts (net), brought about a contractionary influence of Rs. 1,520 million on the money supply. This was the second year in succession when the Government's financial operations resulted in a considerable contractionary impact on the money supply. This had been the combined outcome of an increase in Government's deposits with the banking system and to a lesser extent, a decrease in bank credit. Altogether, Government's deposits with the banking system registered a record increase of Rs. 1,050 million during the year. This, however, included a sum of Rs. 390 million deposited with the Central Bank, being the Government's contribution to the capital of the National Development Bank. Commercial bank credit to Government during the year decreased by Rs. 113 million, while credit from the Central Bank rose by Rs. 38 million, recording a net reduction of Rs. 75 million in bank credit to Government. These transactions, together with an increase of Rs. 394 million in Central Bank's other liabilities and accounts (net) resulted in the Government sector exerting an overall contractionary influence of Rs. 1,520 million on the money supply during the year.

Summarising, a substantial rise in external banking assets and a record increase in bank credit to the private sector were the main underlying factors for the monetary expansion in 1978. However, the substantial contraction arising from the government sector together with the considerable build-up of time and savings deposits by the non-bank private sector helped to moderate the rate of monetary expansion during the year. Had it not been for these favourable developments, the much desired deceleration in the rate of monetary expansion would have been further postponed. However, in view of the monetary expansion which had already taken place before this deceleration came about, there was a considerable pressure on prices throughout the year, which was mitigated somewhat by the inward flow of imports after the import liberalization.

## Commercial Banking

The year 1978 witnessed a significant growth in the resources of commercial banks for the third successive year. The increase in total resources during the year was Rs. 3,585 million or 35 per cent, as compared with 24 per cent in 1976 and 56 per cent in 1977. Following the pattern observed in recent years, growth in deposits provided the main thrust to the resource build-up in 1978. Of the increase in deposits, time and savings deposits contributed the major share. This was a continuation of a favourable development commenced in the previous year when the flow of time and savings deposits into the banking system registered a sharp upward trend, following the 1977 interest rate reform. Resource accruals were further enhanced by increases in paid-up capital, reserve funds and undistributed profits, inter-bank and foreign borrowings and in other liabilities. Alongside this considerable resource build-up was an even larger increase in the demand for credit by the non-bank private sector. In all, commercial bank credit to non-bank private sector rose by a record Rs. 3,026 million during the year, pushing the ratio of loans and overdrafts to total deposits from 69 per cent in 1977 to 80 per cent in 1978. Consequently, despite the large accrual of resources, the liquidity of commercial banks deteriorated somewhat by the end of 1978. This is reflected in most liquidity ratios, the more conspicuous of which being a decline in the ratio of liquid assets to demand deposits from 88 to 85 per cent and in the ratio of liquid assets to total deposits from 44 to 37 per cent. Also, commercial bank borrowings from the Central Bank at Bank rate (and at the penal rate) which were almost non-existent at the end of 1977 stood at Rs. 255 million at the end of 1978.

As mentioned previously, commercial bank resources increased by Rs. 3,585 million in 1978. The increased resources were in turn used for providing accommodation to "other domestic private sector", government corporations and co-operative institutions and for financing inter-bank transactions. Altogether, commercial bank credit to "other private sector" increased by Rs. 1,890 million. However, the net outflow of resources to this sector was confined to Rs. 350 million, owing to an increase of Rs. 1,540 million in this sector's deposits with the banking system. The higher resource utilisation by this sector was a reflection of higher level of activity in that sector, following the new economic policies. Government corporations increased their borrowing by Rs. 693 million, but their net resource intake was reduced to Rs. 282 million by a rise of Rs. 411 million in their deposits with commercial banks. Co-operative institutions too utilised a larger volume of resources; the net increase during the year was Rs. 452 million. Utilisation of resources within the banking system amounted to Rs. 467 million, and mainly took the form of increases in fixed and other assets and till cash. Table 1.17 summarises the resources and utilization of commercial banks on a net basis.



**TABLE 1.17**  
**Changes in Commercial Banks' Resources and their Utilization**

|                              |    | Rs. Million           |                       |                       |
|------------------------------|----|-----------------------|-----------------------|-----------------------|
| Sectors                      |    | End 1975/<br>End 1976 | End 1976/<br>End 1977 | End 1977/<br>End 1978 |
| 1. Government                | .. | - 104.9               | 25.6                  | 220.8                 |
| 2. Central Bank              | .. | - 251.2               | 197.6                 | 126.1                 |
| 3. Government Corporations   | .. | 182.8                 | -197.3                | - 282.0               |
| 4. Co-operative Institutions | .. | - 27.7                | -474.9                | - 451.8               |
| 5. Other Private Sector      | .. | 332.2                 | 546.1                 | - 350.5               |
| 6. Inter Bank                | .. | 34.3                  | 541.0                 | 722.3                 |
| 7. Foreign Sector            | .. | - 165.0               | -637.7                | 15.0                  |

Source: Central Bank of Ceylon

### Bank Branch Expansion

During the year under review the total number of branches of commercial banks rose by 22 as compared to an increase of 76 in 1977. The branch expansion was wholly confined to Sri Lanka banks and was equally shared between the two state sector banks. The Bank of Ceylon opened 11 new full branches during the year and the total number of its full branch offices amounted to 90 at the end of 1978. There were no new Agricultural Service Centre branches opened during the year and the total remained at 390. Thus, at the end of 1978, total number of branch offices of Bank of Ceylon stood at 480. The People's Bank opened 11 new branches during the year bringing the total number of its branches to 216 at the end of 1978. The National Savings Bank opened 2 branch offices during 1978, bringing the total number of its offices to 27, the new branches being in the Colombo district.

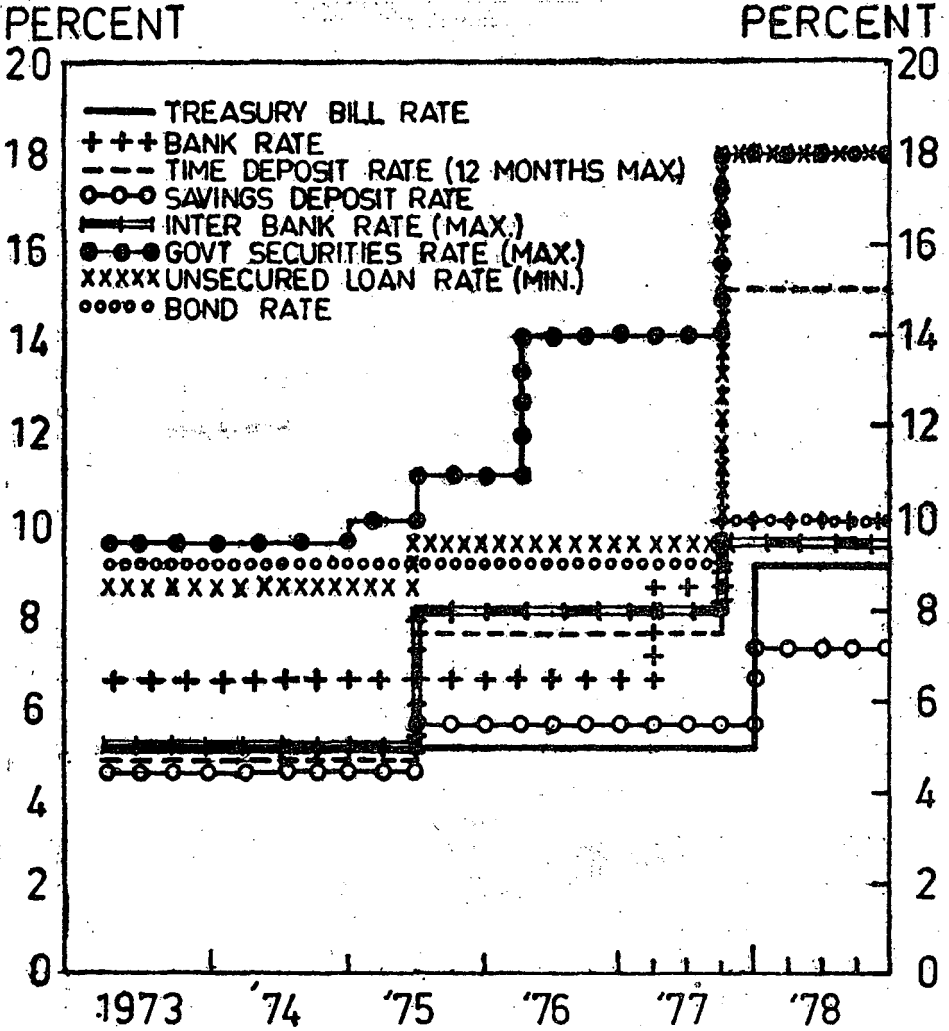
The Annual Report for 1977 drew attention to a number of issues relating to the speedy lateral expansion of the banking network in recent years. Among these was the question of security, arising from the location of branches in distant rural areas. In 1978, this problem became serious when a number of small banks were robbed. As a result, operations in 97 branches (of which, 81 were at Agricultural Service Centres) were temporarily suspended by the Bank of Ceylon, the People's Bank and the National Savings Bank by transferring their business to nearby cities for greater security.

### Interest Rates

As mentioned in the last Annual Report "in 1977, there was a fundamental change in Sri Lanka's interest rate policy, resulting in a movement to a considerably higher plateau of rates against a background of wide-spread inflationary pressures in the economy." The highlights of the changes were an upward revision in Bank rate, sharp increase in the time deposit rates at the National Savings Bank (NSB) inducing a parallel change in the deposit rates of commercial banks, upward movement in the Treasury bill rate and the rate on interbank call loans, appreciable rise in the lending rates of commercial banks and a nearly unchanged position in the lending rates of long-term credit institutions.

# MONEY RATES

END QUARTER FIGURES



During 1978, there were no noticeable changes in either the level or the structure of interest rates. Both the Bank rate and the Treasury bill rate remained unchanged at 10 per cent and 9 per cent, respectively. There were hardly any changes in the rates offered by commercial banks on time and savings deposits or those charged on loans and advances. Interest rates on time and savings deposits at the NSB also, by and large, remained unchanged but some modifications to the facilities available at the NSB were introduced during the year. These included payment of monthly interest on time deposits at 14.4 per cent per annum on one year deposits from July 2, 1978 and at 16.8 per cent on 18 months deposits from October 1, 1978 subject to a minimum deposit of Rs. 5,000. From October 1, 1978 the monthly interest on one year deposits exceeding Rs. 100,000 was raised to 15 per cent. The NSB also announced the part payment of interest on new time deposits effected after July 2, 1978 on premature withdrawals of such deposits. Until then, premature withdrawal of time deposits resulted in a complete loss of interest. The lending rates of the State Mortgage Bank, Development Finance Corporation and the National Housing Department remained unchanged in 1978. There were also no changes in the lending rates of the Medium and Long-term Credit Fund of the Central Bank. The lending rates of the Agricultural and Industrial Credit Corporation which recorded a 3 percentage points increase in November, 1977 declined marginally by one percentage point in June, 1978. Another change observed in the lending rates was a single percentage point increase by the NSB on building and other loans, from May, 1978. The rate on government bonds (10-12 year bonds) which rose from 9 per cent to 10 per cent in September, 1977 also remained unchanged during the year. Although no change was recorded in the rate on interbank call loans too, there were indications of increased pressure in this market during the second half of the year, driving the operative rate towards the maximum of 9.5 per cent.

Although the lending rates of commercial banks remained high throughout the year, there was no evidence to show that the demand for credit by the private sector had been unduly hampered. In point of fact, bank credit to private sector registered a record increase in 1978. This seems to suggest that the adverse effects of high interest rates, if any, on the demand for credit had been completely over-shadowed by other favourable factors, such as the liberalization of imports and the promising business climate.

A significant development following the 1977 interest rate reform had been a sharp acceleration in the rate of deposit mobilisation by the institutional sector. During the 4 month period ended December, 1977 total time and savings deposits of the non-bank private sector with commercial banks rose by Rs. 513 million, as compared with an increase of Rs.613 million during the first 8 months of the

year and Rs. 466 million in 1976. The momentum of deposit mobilisation by commercial banks continued in 1978 when the year ended with a total collection of Rs. 1,572 million. The success at increased mobilisation of deposits was a very significant factor in achieving the much desired deceleration in the rate of monetary expansion observed during the year.

### Central Banking

The total assets/liabilities of the Central Bank which registered an unprecedented increase of Rs. 4,963 million or 76 per cent in the previous year, rose by a further Rs. 2,711 million or 23 per cent in 1978. Following the pattern of the previous year, the rise was more marked in foreign assets. In all, the foreign assets (International Reserve) of the Bank increased by Rs. 1,806 million, while domestic assets rose by Rs. 905 million. The major part of the increase in the International Reserve during the year arose from the transactions with the International Monetary Fund. While there was a net drawing of Rs. 348 million during the year, a sum of Rs. 778 million was also received in respect of the Trust Fund loan. These, together with long-term capital flows in excess of the current account deficit in the balance of payments resulted in a considerable rise in the foreign assets of the Bank during the year.

Major underlying factors for the expansion in domestic assets of the Bank in 1978 were the increases in "other assets and accounts" and in advances to commercial banks. Altogether, other assets and accounts rose by Rs. 676 million in 1978. Increases of Rs. 264 million in claims under the Asian Clearing Union<sup>1</sup> and Rs. 267 million in the value of guarantees issued on behalf of the Government were the major factors contributing to the rise in other assets. Among the other items which registered noticeable increases during the year was the increase of Rs. 412 million in provisional advances to Government. In comparison, Central Bank's holdings of government and government guaranteed securities decreased by Rs. 300 million and special loans to Government by Rs. 73 million. The outcome of these changes was a net increase of Rs. 38 million in Central Bank credit to Government during the year. Bank's accommodation to commercial banks which rose rather sharply by Rs. 496 million in the previous year, increased by a further Rs. 191 million in 1978.

In sharp contrast to the behaviour of assets where the increase was largely reflected in foreign assets, the growth in Central Bank's liabilities during 1978 was wholly confined to domestic liabilities. As in the previous year, a major

1. Asian Clearing Union is a clearing mechanism of facilitating the settlement of payments among participating countries, which are Sri Lanka, India, Pakistan, Nepal, Iran, Bangladesh, and Burma. Under this arrangement, all payments due from a member are set off against receipts on a multilateral basis and the net balance is settled at bi-monthly intervals. Outstanding balances pending settlement and recording lags feature among the other assets/liabilities of the Central Bank.

contributory factor for the increase in domestic liabilities in 1978 was the rise in "other liabilities" of the Bank. The "other liabilities" which rose by Rs. 3,084 million in 1977 increased by a further Rs. 1,344 million in 1978. Allocation of Special Drawing Rights (Rs. 375 million) and a rise in the value of guarantees issued on behalf of the Government (Rs. 267 million) which has a contra entry under "other assets", were the major factors contributing to the growth in these liabilities. Apart from the rise in "other liabilities", another item which showed a major increase in 1978 was deposits. Altogether, deposits held with the Central Bank rose by Rs. 1,473 million during the year. This was mainly reflected in the deposits of the Government which increased by Rs. 944 million. The currency issue of the Bank which registered an increase of Rs. 812 million in the previous year rose by Rs. 289 million in 1978. The considerably slower increase in the currency issue was a reflection of the significant deceleration in the rate of monetary expansion experienced during the year.

A noteworthy feature of the changes in the Central Bank's liabilities in 1978 was a net decrease of Rs. 85 million in external liabilities. Considered against the sharp increase in foreign assets of the Bank during the year, this reduction in foreign liabilities, though small, would further amplify the country's strong balance of payments position which emerged during the year. All in all, the growth pattern of Central Bank's assets and liabilities during 1978 indicates that only a smaller share of the increase in assets had been acquired in exchange for the Bank's own liabilities while the major share had been financed with liabilities accepted on behalf of others. This would mean that the expansionary impulse resulting from the growth of the Bank's assets was considerably lower than what is indicated by the total growth in assets.

### Rural Credit

The amount of credit granted under the Comprehensive Rural Credit Scheme, the Rural Banks Scheme and credit channelled by The Bank of Ceylon sub-offices at Agrarian Service Centres, declined by 29 per cent from Rs. 448 million in 1977 to Rs. 320 million in 1978. Of the loans granted this year, Rs. 254 million or 79 per cent was for crop cultivation. The People's Bank accounted for the major share by granting Rs. 148 million or 46 per cent of the total loan disbursement; the share of the Bank of Ceylon sub-offices was Rs. 142 million or 44 per cent.

Paddy loans accounted for Rs. 177 million or 55 per cent of the total credit and the bulk of this was provided under the Comprehensive Rural Credit Scheme. The loans for cultivation of subsidiary food crops accounted for Rs. 61 million or 19 per cent, while the share of sugar cane and cotton amounted to Rs. 16 million or 5 per cent. Loans granted by rural banks and sub-offices of the Bank of Ceylon at Agrarian Service Centres for miscellaneous purposes such as

housing, electrification and water supply amounted to Rs. 17 million. There was a substantial increase in the loans granted by the sub-offices of the Bank of Ceylon for purchase of machinery and equipment, from Rs. 1 million in 1977 to Rs. 30 million in 1978.

By end of the year, total credit extended for paddy cultivation under the Comprehensive Rural Credit Scheme for the incomplete Maha 1978/79 season stood at Rs. 23 million. This was a fraction of the credit granted during the comparative period last year of Rs. 293 million. Similarly, loans for subsidiary food crops, sugar cane and cotton also recorded a more than four-fold decrease. As the Maha season continues until about April, the total commitment for the entire season may be marginally higher; but substantially lower than in the previous Maha season.

TABLE 1-18

Cultivation Loans Granted under Rural Credit Scheme<sup>1</sup>

(as at 31st December 1978)

Rs. million

| Cultivation Year           | Loans Granted  |              |                | Recoveries   |              |              | Percent of Recoveries |             |             |
|----------------------------|----------------|--------------|----------------|--------------|--------------|--------------|-----------------------|-------------|-------------|
|                            | Paddy          | Other Crops  | All Crops      | Paddy        | Other Crops  | All Crops    | Paddy                 | Other Crops | All Crops   |
| 1967/68-1969/70 ..         | 180.1          | 19.4         | 199.5          | 128.6        | 15.5         | 144.1        | 71.4                  | 79.9        | 72.2        |
| 1970/71-1972/73 ..         | 88.2           | 24.8         | 113.0          | 57.2         | 19.0         | 76.2         | 64.8                  | 76.6        | 67.4        |
| 1973/74 ..                 | 111.1          | 26.2         | 137.3          | 58.7         | 15.3         | 74.0         | 52.8                  | 58.4        | 53.9        |
| 1974/75 ..                 | 85.6           | 27.3         | 112.9          | 43.6         | 15.5         | 59.1         | 50.9                  | 56.8        | 52.3        |
| 1975/76 ..                 | 72.2           | 36.4         | 108.6          | 42.4         | 16.5         | 58.9         | 58.7                  | 45.3        | 54.2        |
| 1976/77 ..                 | 98.8           | 78.8         | 177.6          | 43.6         | 21.3         | 64.9         | 44.1                  | 27.0        | 36.5        |
| 1977/78 ..                 | 452.7          | 81.4         | 534.1          | 97.3         | 18.4         | 115.7        | 21.5                  | 22.6        | 21.7        |
| <b>Total</b> ..            | <b>1,088.7</b> | <b>294.3</b> | <b>1,383.0</b> | <b>471.4</b> | <b>121.5</b> | <b>592.9</b> | <b>43.3</b>           | <b>41.3</b> | <b>42.9</b> |
| <sup>2</sup><br>1978/79 .. | 23.3           | 2.1          | 25.4           | 0.3          | ...          | 0.3          | 1.3                   | ...         | 1.2         |

Sources: People's Bank,  
Bank of Ceylon,  
Hatton National Bank Limited.

1. Loans up to 1973 were granted under the new Agricultural Credit Scheme. Since then, loans have been granted under the Comprehensive Rural Credit Scheme, which replaced the former scheme.

2. Incomplete data, Maha season only.

The relaxation of eligibility criteria for the Maha 1977/78 season brought forth in 1977 the largest expansion in cultivation loans granted under the Comprehensive Rural Credit Scheme. Since this expansion was not associated with an efficient system of recovery, the highest rate of default was also recorded

for loans granted for the same season. Consequently, the rate of default of agricultural loans increased sharply in 1978. The total amount of paddy loans granted by the banking sector since the inception of the New Agricultural Credit Scheme and subsequently under the Comprehensive Rural Credit Scheme amounted to Rs. 1,089 million upto Maha 1977/78. Of this amount, Rs. 617 million or 56 per cent were in default as at end of 1978.

The tremendous expansion in cultivation loans granted in 1977 and early 1978 and the alarming rate of default associated with it compelled the Government to restructure the Comprehensive Credit Scheme in 1978. Lending-criteria for the Yala 1978 season were tightened up. In order to obtain loans for Yala 1978, farmers were required to pay their Maha 1977/78 loans in full. In the case of loans taken prior to Maha 1977/78, a minimum of 10 per cent down-payment of the outstanding loans had to be paid. These conditions continued to be effective for the Maha 1978/79 season as well. In addition, farmers were required to pay their Yala, 1978 loans in full to obtain loans for the Maha season. These requirements meant a complete reversal of the previous year's liberalized scheme of loans.

The withdrawal of the 75 per cent credit guarantee operated by the Central Bank was another major change in the Comprehensive Rural Credit Scheme. The guarantee was introduced along with the New Agricultural Credit Scheme in 1967. Under the guarantee scheme, 75 per cent of the amount in default of cultivation loans granted by commercial banks was reimbursed by the Central Bank on behalf of the government. The scheme facilitated the expansion of cultivation loans over the years; but it is probable that such a high rate of guarantee also made lending banks less concerned about loan recovery. The absence of the guarantee will compel the banks to be more cautious about lending, and is likely to cause a significant contraction of agricultural credit, perhaps to pre-1977 levels. Undoubtedly, the sudden liberalization of agricultural credit in late 1977 was an inadvisable move. Naturally, abuses of agricultural loans were legion. But the reaction to such abuse by subjecting agricultural credit to the criteria of normal commercial bank lending, as has happened, appears to be too drastic. It may have been preferable if the guarantee was withdrawn in stages, enabling the banks to develop credit supervision facilities in a short period.

### Monetary Policy

As reported in the Annual Report for 1977, a series of monetary measures were introduced in 1977 against the background of a very sharp monetary expansion for the second consecutive year. The highlights of these were a Bank rate of 10 per cent from August 31, 1977 restrictions on Central Bank accommodation to commercial banks at Bank rate and a penal rate of 15 per cent for accommodation in excess of this ceiling, a gradual reduction and a complete withdrawal of till-cash concession from December 2, 1977 and a continuation of the ceiling on advances for non-essential purposes and to non-bank companies engaged in lending money and hire purchase activities, imposed in 1976. Another

important policy measure implemented in that year was a sharp upward revision of the deposit rates of the National Savings Bank from September 7, 1977 which, in turn, triggered off an increase in the deposits and lending rates of commercial banks.

During 1978 there were no major changes either by way of intensification or relaxation of the above monetary policy package. On March 27, 1978 the restriction on commercial bank credit to non-bank companies engaged in the business of lending money or hire purchase activities was relaxed to exclude credit granted for financing capital equipment and new commercial vehicles. From June, 1978 an attempt was made to restrict commercial bank credit to government corporations and statutory boards, by way of an overall ceiling on such credit at the level outstanding as on June 28, 1978. This, however, gave rise to certain difficulties and the ceiling had to be modified on a number of occasions to accommodate increased credit requirements of these institutions. This ceiling was raised by 5 per cent from July 13 and by 12 per cent from August 7, making a total of 17 per cent by which commercial bank advances to government corporations and statutory boards (other than finance and lending institutions), could be increased over the level of such advances as at June 28, 1978.

Some modifications to the facilities available at the NSB were also introduced in 1978, to which reference was made earlier. These included payment of monthly interest on one year time deposits at 14.4 per cent per annum and on 18 months deposits at 16.8 per cent per annum (subject to a minimum deposit of Rs. 5,000 in each case) and payment of interest on new time deposits (which did not opt for monthly interest) on premature withdrawals of such deposits at rates varying with the period for which the time deposit had been maintained.

As discussed previously, the year 1978 witnessed a substantial moderation in the rate of monetary expansion in Sri Lanka. The annual rate of monetary expansion declined from 35 per cent in January, 1978 to as low as 11 per cent by December, 1978. There is evidence to show that the tight monetary policy pursued during the year helped in no small way towards moderating the rate of monetary expansion. Although government financial operations had been the major underlying factor for the deceleration in the monetary expansion, a substantial build up of time and savings deposits by the non-bank private sector with the banking system had also been a very significant factor contributing to this development. In all, time and savings deposits of the non-bank private sector with commercial banks rose by Rs. 1,605 million during the year. This enabled the commercial banks to accommodate the sharply increased credit requirements of the private sector without generating undue inflationary pressures. Thus, despite the record increase in bank credit to private sector during the year amounting to Rs. 3,026 million, the expansionary impact of this sector's operations was contained at Rs. 688 million. Also, the monetary measures such as the withdrawal of the till-cash concession enabled the Central Bank to impound a



substantial volume of funds from the commercial banks which would otherwise have formed a basis for credit creation. The operation of the penal rate discouraged commercial banks from resorting to Central Bank credit on an extensive scale.

The foregoing would show that had it not been for the monetary policy measures put into operation in 1977 and continued throughout 1978, the rate of monetary expansion during the year would have been considerably higher and the much desired deceleration in the rate of monetary expansion would have been further postponed. The rationale for the 1977 monetary policy package and its continuance throughout 1978 have to be viewed against this background. There were occasional complaints of both non-availability of and high cost of credit. The former could arise from the credit controls that were in force, but the substantial credit expansion during 1978 indicated that the banking system was able to meet the emerging higher credit needs of the economy. Complaints regarding high cost of credit appear to be the reaction of those who had got accustomed to low cost credit over a long period of time. In the background of persistent two-digit inflation since 1976, it is inconceivable how cheap money policies could be adopted without seriously affecting savings incentives and resource mobilization. The current short-term high interest rate policies are essentially the price the economy has to pay for extricating itself from the clutches of inflation and re-establishing monetary stability which is essential for sustained economic growth.