TABLE 1.44

Major Sources of Foreign Loans — 1984

Rs. million

Sources	Project Loans	Commodity Loans	Other Loans	Total
Asian Development Bank	875·5	—	—	875·5
Canada	260·6	—	—	260·6
Euro currency	—	—	880·3	880·3
France	146·4	73·1	—	219·5
Federal Republic of Germany ..	783·0	89·3	—	872·3
International Development Association ..	2,034·1	—	—	2,034·1
Japan	608·5	255·6	—	864·1
Manufactures Hanover Trust Company ..	415·6	—	—	415·6
Saudi Arabian Fund	195·4	—	—	195·4
Skandinaviska Enskilda Bankens – Sweden ..	295·0	—	—	295·0
United States of America	870·7	667·3	—	1,538·0
Other	292·3	95·1	—	387·4
Total Gross Receipts ..	6,777·1	1,180·4	880·3	8,837·8
Less: Repayments ..	276·5	551·0	637·8	1,465·3
Net Receipts ..	6,500·6	629·4	242·5	7,372·5

Source: Central Bank of Ceylon.

MONEY AND BANKING

Money Supply

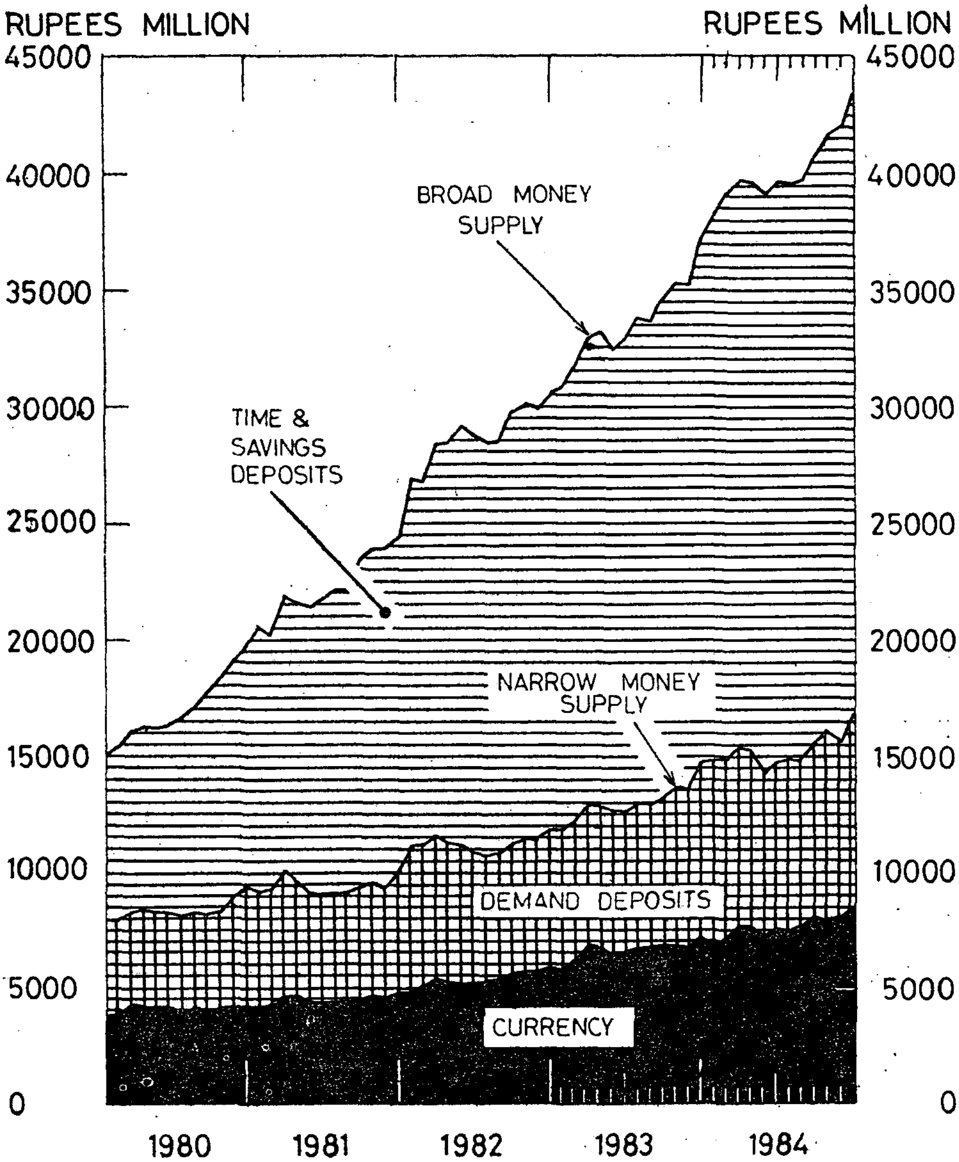
The most notable development observed in the monetary sector during 1984 was the sharp deceleration in money and credit aggregates when compared with the previous year. The narrow money supply (M_1), consisting of currency and demand deposits held by the public increased by Rs. 2,076 million (14 per cent) during the year compared with a much higher increase of Rs. 2,988 million (25 per cent) in 1983. Quasi-money, consisting of time and savings deposits of the private sector held with commercial banks increased by Rs. 4,095 million (18 per cent) in 1984 compared with an increase of Rs. 3,759 million (20 per cent) in 1983. Consequently, broad money (M_2) consisting of M_1 plus quasi money rose by Rs. 6,171 million (17 per cent) during the year compared with an increase of Rs. 6,747 million (22 per cent) in the previous year and stood at Rs. 43,427 million.

The recorded expansion in money supply during 1984 was the outcome of a deceleration in domestic credit and a continuous increase in external banking assets (net). The sharp decline in net credit to government was the most significant factor in reducing the rate of expansion in domestic credit. Meanwhile, gross credit to private sector also decelerated in response to credit restrictions imposed by the Central Bank on non-essential advances.

Detailed analysis of the composition of the monetary aggregates reveals that the main reason for the moderate increase in M_1 during the year was the significantly lower growth in demand deposits when compared with the previous year. The demand deposit component of the money supply increased by 10 per cent in 1984 compared with 31 per cent in 1983. Consequently, the share of demand deposits in M_1 declined from 51 per cent in 1983 to 49 per cent in 1984. Meanwhile, currency

MONEY SUPPLY

MONTHLY



Central Bank of Ceylon.

held by the public increased by 19 per cent during the year compared with 20 per cent in 1983. As in the previous year, the highest monthly increases in currency holdings were recorded in March (8 per cent) and December (5 per cent) reflecting the enhanced demand for cash during festive seasons.

The increase in quasi-money was largely due to the build up of time and savings deposits of government corporations by Rs. 1,428 million or 35 per cent in 1984 in contrast to a decline of Rs. 177 million or 4 per cent in the previous year. Time and savings deposits held by the other private sector constituents (OPSC) rose by 15 per cent in 1984 when compared with 27 per cent in 1983. The reduced rate of expansion in OPSC deposits was in part caused by the outflow of deposits from commercial banks to other deposit mobilising institutions, such as, the National Savings Bank (NSB) and finance companies in response to relatively larger reductions effected in deposit rates by commercial banks. The growth of deposits of co-operative institutions held with commercial banks also decelerated from 31 per cent in 1983 to 12 per cent in 1984.

The most significant factor that contributed to the growth in money supply in 1984 was the substantial accumulation of external banking assets (net) largely due to enhanced export earnings from tea. External banking assets (net) rose markedly by Rs. 6,777 million in 1984 compared with a moderate increase of Rs. 815 million in 1983. In contrast, the expansion in domestic credit was significantly lower than that of the previous year which was the major reason for the deceleration in monetary growth in 1984. Domestic credit increased by Rs. 633 million (1 per cent) in 1984 compared with an increase of Rs. 6,895 million (16 per cent) in 1983. Other items (net) of the banking system increased by Rs. 1,240 million in 1984 compared with an increase of Rs. 964 million in the previous year thereby exerting a contractionary impact on the money supply. The increase in other items (net) during the year was largely reflected in increases in other liabilities of the Central Bank on account of Central Bank Securities issued since June, 1984.

External banking assets (net) continued to rise throughout the year which was the outcome of a significant improvement in the country's Balance of Payment (BOP) position. Central Bank holdings of cash and balances abroad increased by Rs. 3,839 million while investments in foreign government securities and Treasury bills increased by Rs. 1,493 million. The increase in cash and balances abroad largely reflected the increased net purchases of foreign exchange by the Central Bank from commercial banks arising from enhanced export earnings.

The deceleration in domestic credit (DC) was caused predominantly by the decline in net credit to government (NCG) which nearly offset the expansionary impact of the increase in gross credit to private sector (GCPS). NCG declined by Rs. 2,979 million or 17 per cent in 1984 in contrast to an increase of Rs. 383 million or 2 per cent in 1983. Consequently, the share of NCG in the total domestic credit declined from 36 per cent in 1983 to 29 per cent in 1984 indicating the Government's reduced reliance on the banking system. The decline in NCG was the net result of a decline in gross credit to government by Rs. 2,808 million (13 per cent)

TABLE 1.45

Monetary Aggregates 1982 — 1984

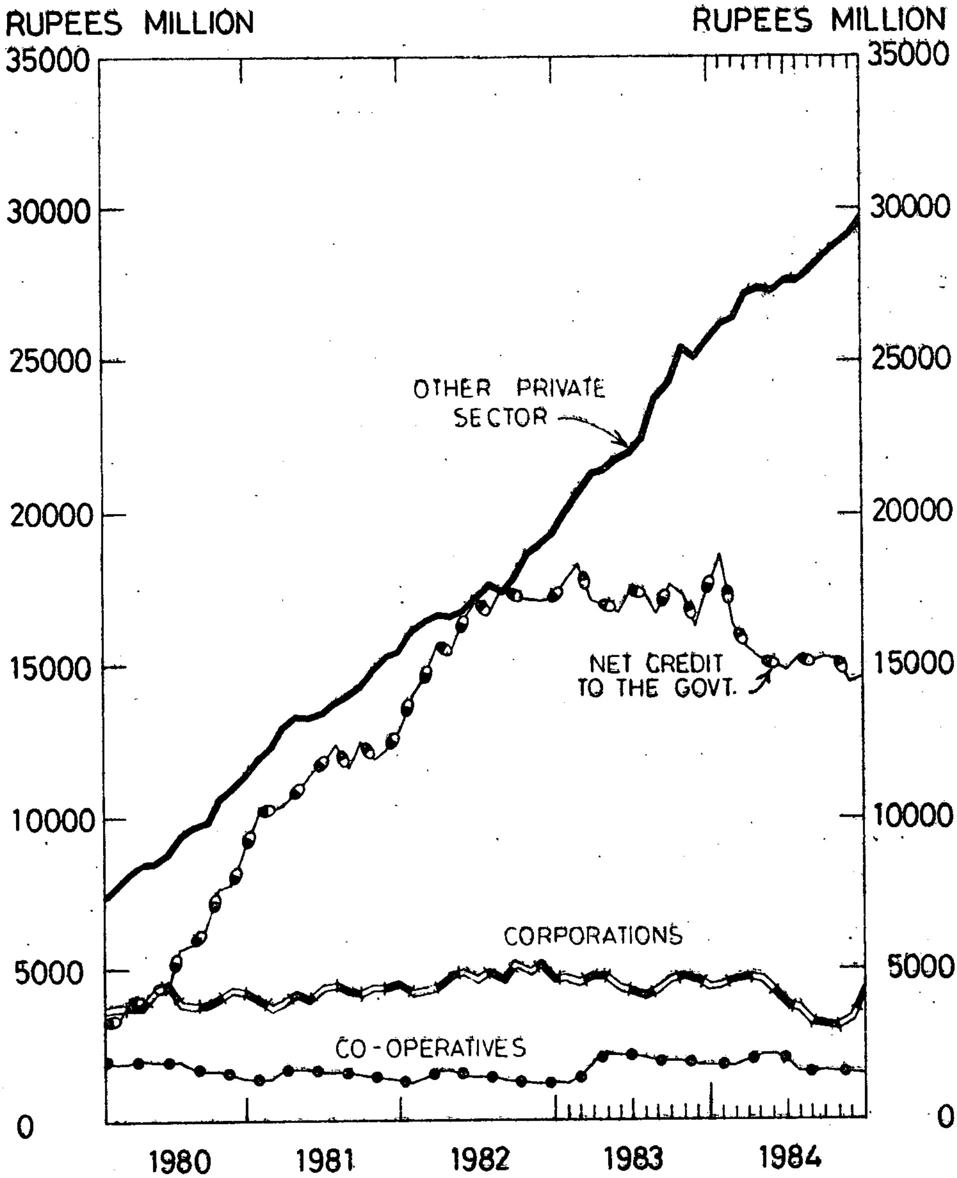
Amount in Rs. Million

	Narrow Money Supply M1						Broad Money Supply M2					
	1982	1983	1984	% Change 1982 over 1981	% Change 1983 over 1982	% Change 1984 over 1983	1982	1983	1984	% Change 1982 over 1981	% Change 1983 over 1982	% Change 1984 over 1983
January ..	11,046	11,852	14,964	+20·0	+ 7·3	+26·3	26,890	30,802	38,277	+31·0	+14·5	+24·3
February ..	11,178	12,234	14,939	+20·4	+ 9·4	+22·1	26,758	31,708	39,031	+32·5	+18·5	+23·1
March ..	11,671	12,986	15,439	+15·3	+11·2	+18·9	28,240	32,874	39,762	+28·5	+16·4	+21·0
April ..	11,276	12,842	15,317	+17·8	+13·9	+19·3	28,395	33,114	39,629	+31·8	+16·6	+19·7
May ..	11,132	12,606	14,331	+21·5	+13·2	+13·7	29,128	32,491	39,133	+35·9	+11·5	+20·4
June ..	10,815	12,589	14,768	+19·8	+16·4	+17·3	28,739	32,798	39,690	+32·6	+14·1	+21·0
July ..	10,710	12,964	14,901	+17·8	+21·4	+14·9	28,459	33,846	39,642	+29·0	+18·9	+17·1
August ..	10,892	12,977	14,811	+18·5	+19·1	+14·1	28,494	33,732	39,767	+28·6	+18·4	+17·9
September ..	11,171	13,322	15,549	+18·3	+19·3	+16·7	29,781	34,620	40,808	+27·0	+16·2	+17·9
October ..	11,413	13,572	16,041	+19·9	+18·9	+18·2	30,161	35,314	41,586	+26·6	+17·0	+17·8
November ..	11,452	13,544	15,678	+21·1	+18·3	+15·8	29,860	35,324	42,007	+25·3	+18·3	+18·9
December ..	11,760	14·748	16,824	+17·4	+25·4	+14·1	30,510	37,257	43,427	+24·9	+22·1	+16·6
Monthly Average ..	11,210	13,020	15,297	+18·9	+16·1	+17·5	28,785	33,657	40,230	+29·3	+16·9	+19·5

Source : Central Bank of Ceylon.

DOMESTIC CREDIT

MONTHLY



Central Bank of Ceylon.

and an increase in government deposits and cash balances by Rs. 171 million or 5 per cent. Government borrowings from the Central Bank declined substantially by Rs. 4,144 million (21 per cent) in 1984 in contrast to an increase of Rs. 1,393 million (8 per cent) in 1983. This was the net result of a decline in the holdings of government and government guaranteed securities by Rs. 5,393 million and an increase in provisional advances by Rs. 1,249 million. Meanwhile, gross credit to government by commercial banks increased by Rs. 1,336 million (85 per cent) in 1984 in contrast to a decline of Rs. 140 million (8 per cent) in 1983. The increase in government borrowings from commercial banks mainly took the form of holdings of Secondary Treasury bills amounting to Rs. 1,404 million indicating the flow of commercial banks' excess funds into this market.

Several factors helped the Government to reduce its recourse to the banking system. First, the increase in government revenue by 50 per cent during the year increased the resources available to the Government. Second, the transfer of Central Bank profits amounting to Rs. 1,650 million in February, 1984 was utilized to liquidate some of the outstanding government liabilities to the Central Bank. Third, the increase in external aid further enhanced the resources of the Government. Fourth, the increased subscriptions to rupee securities by non-bank sources enabled the Government to reduce its reliance on bank financing.

GCPS increased by Rs, 3,612 million or 11 per cent in 1984 when compared with a much higher increase of Rs. 6,512 million or 26 per cent in 1983. The deceleration in GCPS was largely attributable to the selective credit control measures introduced by the Central Bank in March and May 1984 through which restrictions were imposed on non-priority lendings. Moreover, the rising incomes of the export sector reduced the demand for investment funds. Bank credit to OPSC rose by Rs. 4,104 million (16 per cent) in 1984 compared with an increase of Rs. 6,170 million (32 per cent) in 1983. The increase in credit to the OPSC took the form of loans (Rs. 2,861 million), overdrafts (Rs. 988 million) and import bills (Rs. 116 million). Bank credit for imports and consumption recorded a drop while, credit for export, retail and wholesale trading, commerce and industry rose during the year. Commercial bank credit to co-operative institutions declined by Rs. 255 million (14 per cent) in 1984 in contrast to a substantial increase of Rs. 635 million (54 per cent) in the previous year. The decline in borrowings of co-operatives was mainly on account of the drop in goods receipt advances granted to the Paddy Marketing Board (PMB) for the purchase and marketing of paddy by Rs. 331 million. The decline in credit to the PMB was the result of its reduced role in marketing activities and the limit placed on refinance by the Central Bank in March, 1984. Bank credit to government corporations declined by Rs. 237 million (6 per cent) in 1984 compared to a decline of Rs. 292 million (6 per cent) in 1983. This decline was the net result of a drop in overdrafts by Rs. 522 million and increases in loans, cash items and import bills, by Rs. 285 million. The major contributory factor for the decline in overdrafts was the repayment of outstanding debt to commercial banks by the two plantation corporations due to their improved financial position. In addition,

EXTERNAL BANKING ASSETS (NET)

MONTHLY

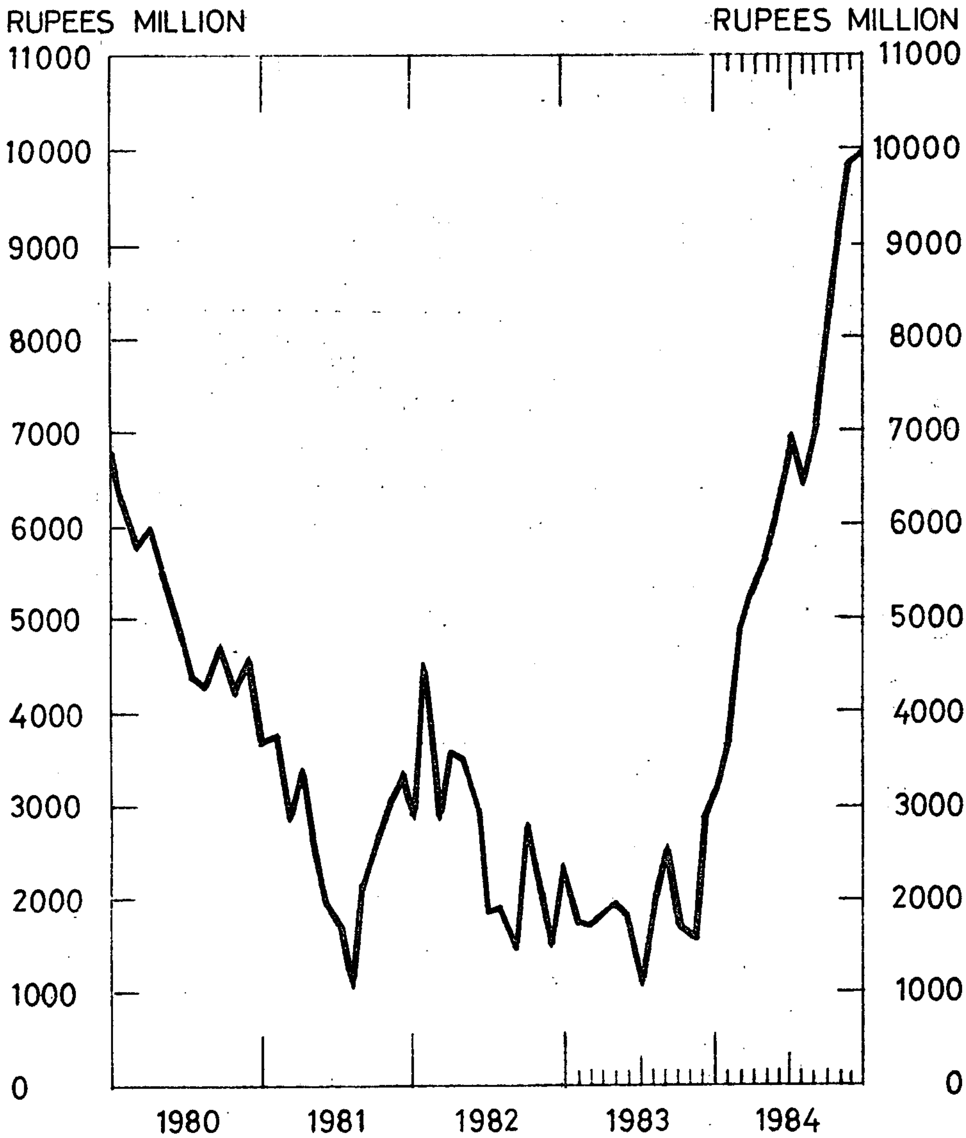


TABLE 1.46

Monetary Aggregates and Causal Factors

Amount in Rs. million

Item	December 1982	December 1983	December 1984	Change 1982/1983		Change 1983/1984	
				Amount	Percentage	Amount	Percentage
Monetary Aggregates							
1. Currency held by the public	5,987.7	7,200.1	8,560.9	+ 1,212.4	+ 20.3	+ 1,360.8	+ 18.9
2. Demand deposits held by the public	5,772.1	7,547.8	8,262.9	+ 1,775.7	+ 30.8	+ 715.2	+ 9.5
Narrow Money Supply (M_1)	11,759.8	14,747.9	16,823.8	+ 2,988.1	+ 25.4	+ 2,076.0	+ 14.1
3. Time and Savings deposits of the private sector held with Commercial banks	18,750.1	22,509.0	26,603.5	+ 3,758.9	+ 20.0	+ 4,094.5	+ 18.2
3.1 Co-operative Institutions	357.3	469.2	526.8	+ 111.9	+ 31.3	+ 57.6	+ 12.3
3.2 Government Corporations	4,257.8	4,081.1	5,508.8	- 176.7	- 4.2	+ 1,427.7	+ 35.0
3.3 Other Private Sector Constituents (a)	14,135.0	17,958.7	20,567.9	+ 3,823.7	+ 27.1	+ 2,609.2	+ 14.6
Broad Money Supply (M_2)	**30,509.9**	**37,256.9**	**43,427.3**	**+ 6,747.0**	**+ 22.1**	**+ 6,170.5**	**+ 16.6**
Causal Factors							
1. Domestic Credit	42,397.6	49,293.0	49,926.2	+ 6,895.4	+ 16.3	+ 633.2	+ 1.3
1.1 Net Credit to Government	17,150.2	17,533.1	14,554.4	+ 382.9	+ 2.2	- 2,978.7	- 17.0
1.1.1 Gross credit to Government ..	19,719.8	20,972.1	18,164.6	+ 1,252.3	+ 6.4	- 2,807.5	- 13.4
by Central Bank	18,000.5	19,393.0	15,249.1	+ 1,392.5	+ 7.7	- 4,143.9	- 21.4
by Commercial Banks	1,719.3	1,579.1	2,915.5	- 140.2	- 8.2	+ 1,336.4	+ 84.7
1.1.2 Government deposits and cash balances ..	- 2,569.6	- 3,439.0	- 3,610.2	- 869.4	- 33.8	- 171.2	- 5.0
1.2 Gross credit to the Private Sector	25,247.4	31,759.9	35,371.8	+ 6,512.4	+ 25.8	+ 3,611.9	+ 11.4
1.2.1 Co-operative Institutions	1,187.7	1,822.7	1,567.6	+ 634.9	+ 53.5	- 255.1	- 14.0
1.2.2 Government Corporations	4,677.4	4,385.2	4,148.2	- 292.3	- 6.2	- 236.8	- 5.5
1.2.3 Other Private Sector constituents ..	19,382.3	25,552.1	29,656.0	+ 6,169.8	+ 31.5	+ 4,103.8	+ 16.1
2. External Banking Assets (net)	2,371.8	3,186.9	9,964.1	+ 815.1	+ 34.4	+ 6,777.2	+ 212.7
3. Other items (net)	- 14,259.5	- 15,223.0	- 16,463·0	- 963.5		- 1,239.9	
3.1 Other liabilities (net) of Central Bank ..	- 9,382.7	- 9,417.4	- 9,982.6	- 34.6		- 565.2	
3.2 Other liabilities (net) of Commercial Banks ..	- 4,891.2	- 6,319.3	- 6,506.3	- 1,428.1		- 186.9	
3.3 Adjustments for items in transit	14.4	513.7	25.9	+ 499.3		- 487.8	
Broad Money Supply (M_2)	**30,509.9**	**37,256.9**	**43,427.3**	**+ 6,747.0**	**+ 22.1**	**+ 6,170.5**	**+ 16.6**

Note: Signs indicate the effect on M_2

(a) Excludes Non Resident Foreign Currency Deposits.

Source: Central Bank of Ceylon.

as in the previous years, some major corporations, such as, the Ceylon Petroleum Corporation, Ceylon Shipping Corporation and the Sri Lanka Cement Corporation continued to resort to foreign borrowings during the year, thereby reducing the reliance on domestic bank credit.

There was an appreciable deceleration in the domestic price levels during the year resulting in a reduction in the rate of inflation. The M_1 and M_2 velocities dropped from 8.29 and 3.20 in 1983 to 7.40 and 2.83 respectively, in 1984 thereby indicating the reduced demand pressure on price levels. This was reflected in the moderate increase in the Colombo Consumer's Price Index (CCPI) by 9 per cent (on a point to point basis) when compared with 21 per cent in 1983. However, the annual average increase in the CCPI amounted to 17 per cent in 1984 compared with 14 per cent in 1983, largely reflecting considerable pressure on prices during the first half of the year.

Commercial Banking

The most noticeable feature observed in commercial banking was the excess liquidity position experienced by banks throughout the year. This was primarily caused by the continuous inflow of liquidity through enhanced external earnings and increased mobilization of deposits at the begining of the year through high deposit rates. The withdrawal of temporary accomodation granted by the Central Bank to commercial banks under the penal rate in late 1983 compelled the commercial banks to improve their liquidity position through increased mobilization of deposits. Accordingly, most banks, including the two state banks, increased interest rates on both time and savings deposits in early 1984, especialy on short-term deposits. Consequently, the time and savings deposits of the private sector rose by Rs. 2,413 million, during the first half of the year. Moreover, the credit restrictions on lending to non-priority sectors limited the lending activities of commercial banks which contributed to the excess liquidity situation.

The transactions in the inter-bank call money market were more indicative of the excess liquidity situation of commercial banks. Reflecting the drop in demand for short-term funds, the transactions in this market declined towards the second half of the year. Similarly, the interest rates in the call market that prevailed at a range of 20-37 per cent per annum at end 1983 declined to a range of 14.0-15.5 per cent per annum by end 1984. The excess liquidity position of commercial banks was also reflected in the enhanced transactions in the Secondary Treasury bill (STB) market. Most banks found the STB market a convenient outlet for their excess funds and hence, net sales in this market rose markedly from Rs. 59 million at end 1983 to Rs. 1,563 million at end 1984. The increase in the ratio of liquid assets to demand deposits from 128 per cent at end 1983 to 136 per cent at end 1984, also reflected the excess liquidity position experienced by commercial banks.

Commercial banks continued their deposit mobilization drive also through the issue of Certificates of Deposits (CDs) thereby attracting hoarded money into the banking system. The outstanding amount of CDs as at end 1984 amounted to Rs. 908 million, when compared with Rs. 610 million in 1983. Some banks extended their business hours in certain branches thereby improving banking services.

During the year, the two merchant banks i.e. the People's Merchant Bank Limited and the Merchant Bank of Sri Lanka Limited continued to expand their operations. The People's Merchant Bank promoted export oriented manufacturing projects, project identification and loan syndication, while the Merchant Bank of Sri Lanka Limited, diversified its consultancy and advisory services into equipment leasing, discounting of trade bills and broking.

With the opening of a Foreign Currency Banking Unit in the Middle East Bank, the number of Foreign Currency Banking Units (FCBUs) operating in Sri Lanka rose to 25 at end 1984. As in the previous year, the activities of FCBUs recorded a moderate growth. The total assets/liabilities of FCBUs amounted to Rs. 19,870 million (US. $ 756 million) at the end of the year.

The increase in total resources of commercial banks was lower at Rs. 6,171 million in 1984 when compared with a higher increase of Rs. 10,188 million in 1983. During the year, total deposits rose by Rs. 5,843 million. In 1984, borrowings of commercial banks, both, domestic and foreign declined by Rs. 395 million and Rs. 106 million, respectively, reflecting the increased liquidity situation of banks.

The changes in commercial banks' resources and their utilization on a net basis is presented in Table 1.47. During the year, government corporations and co-operative institutions made a net contribution of Rs. 1,732 million and Rs. 331 million, respectively, towards the resource build-up of commercial banks. Meanwhile, the other private sector utilized a sum of Rs. 895 million in 1984 compared with Rs. 1,018 million in 1983, reflecting the reduced demand for credit. The Government utilized Rs. 754 million of commercial bank resources in 1984 thus reversing its contribution towards the build up of resources of commercial banks in 1983. During the year, there was a net outflow of resources amounting to Rs. 1,118 million from commercial banks to the Central Bank largely due to increases in statutory reserves and repayment of debt.

TABLE 1.47

Changes in Commercial Banks' Resources and their Utilization

Rs. Million.

Sector	End 1982/ End 1983	End 1983/ End 1984
1. Government	278·0	- 754·1
2. Central Bank	- 41·6	-1,117·9
3. Government Corporations	532·3	1,732·5
4. Co-operative Institutions	- 527·5	331·2
5. Other Private	-1,018·3	- 895·2
6. Inter Bank	1,243·8	485·0
7. Foreign	- 466·7	218·5

Source: Central Bank of Ceylon.

Note : Minus sign indicates net utilization of resources.

Bank Branch Expansion

A noteworthy development observed during the year was the merger and temporary relocation of a number of bank branches with the main branches in the North, North Central and Eastern Provinces mainly due to security considerations. A number of branch offices were relocated and shifted to more spacious and convenient locations with the approval of the Ministry of Finance and the Central Bank.

The total number of commercial bank branches including relocated Agrarian Service Centre branches, declined by 12 during 1984 partly due to mergers and stood at 1,022 as at end 1984. During the year, 24 branches of commercial banks were merged, of which 16 belonged to the People's Bank, 7 to the Bank of Ceylon, and 1 to the Hatton National Bank Ltd. Meanwhile, commercial banks opened 13 branches during the year. This was made up of 5 new branches opened by the Bank of Ceylon, 4 by the People's Bank, 2 by the Hatton National Bank Ltd. and 1 each by the Commercial Bank of Ceylon Limited and the Bank of Credit and Commerce International (BCCI). The People's Bank closed its Colombo Harbour Branch during the year. The BCCI opened a branch in the Katunayake Investment Promotion Zone in May, 1984. Meanwhile, the American Express International Banking Corporation was granted approval for the establishment of its Regional Office for Asia in Colombo which commenced business in May, 1984. The National Savings Bank opened two new branches thus bringing the total number of its branches to 52 at the end of the year.

Interest Rates

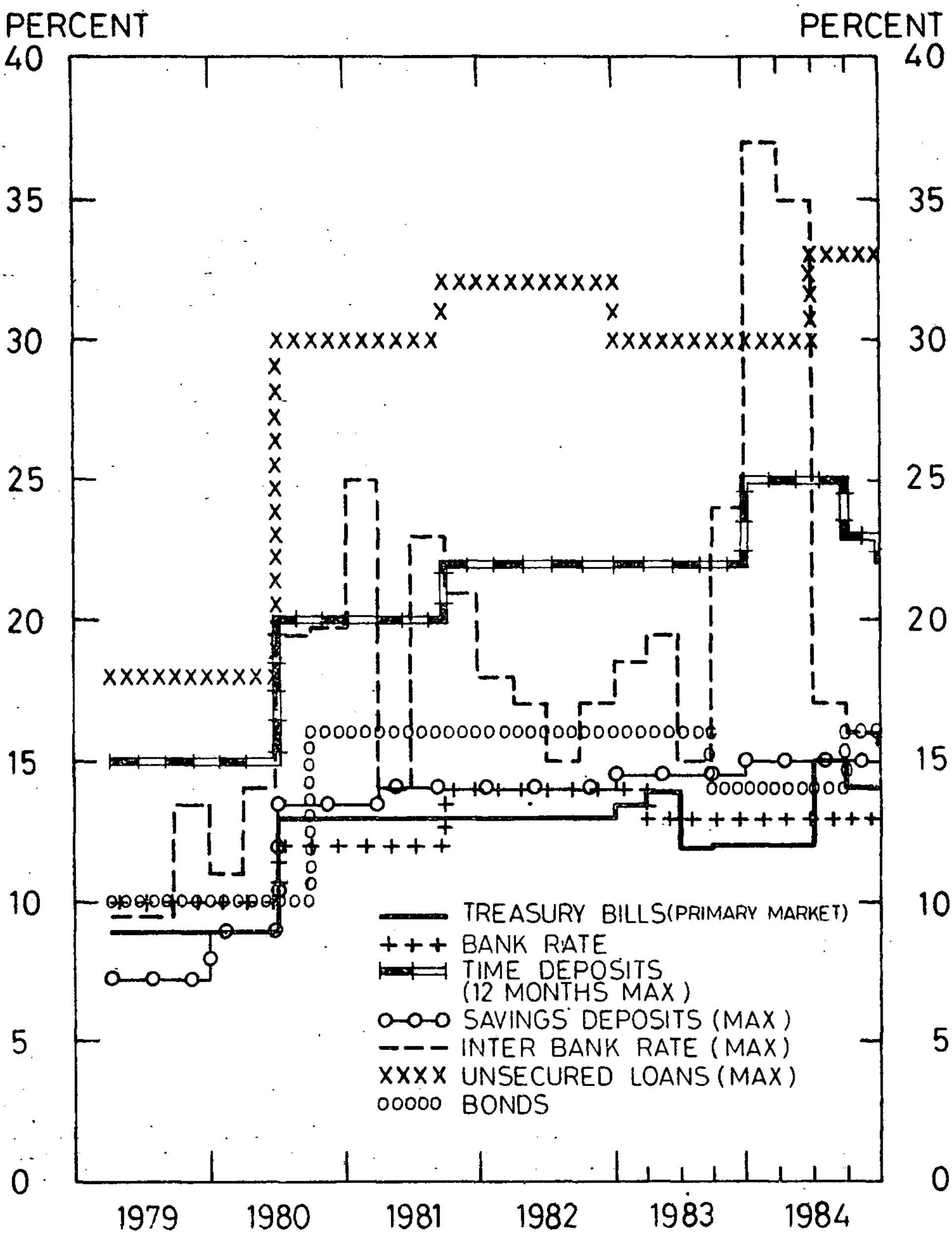
In the context of the overall interest rate policy, the year 1984 saw considerable changes in deposit rates but only marginal changes in lending rates. The interest rate revisions introduced in 1977 along with the liberalized economic policies underwent some changes both in 1983 and 1984. The cost of funds emerged as the main determining factor of deposit and lending rates of commercial banks. This was more prominent in 1984 when some banks reduced their rates while the others continued with high rates.

The Central Bank effected a major change in its interest rate policy with the introduction of the Interest Rebate Scheme to encourage speedy repatriation of export proceeds in March, 1984. The effective lending rates on borrowings under the preshipment export credit refinance facility was reduced by 1 percentage point to 12 per cent per annum. Similar adjustments were made in the supplementary refinance facility where the effective lending rate was reduced by 1 percentage point to 8.75 per cent per annum. The rates on cultivation and marketing refinance facilities remained unchanged except in the case of refinance granted to the PMB which was raised by 2 percentage points for refinance above Rs. 400 million in order to restrict drawings under the facility and to discourage the PMB from resorting to extention of refinance periods.

The intervention of the authorities in the determination of interest rates was reduced during the year. This signalled the money market to follow market forces and determine rates according to liquidity requirements and the cost

INTEREST RATES

END QUARTERLY FIGURES



Central Bank of Ceylon.

of funds. The National Savings Bank (NSB) was allowed the freedom to fix its deposits and lending rates in April, 1984 indicating a departure from the practice followed hitherto, in fixing its deposit rates with the approval of the Ministry of Finance and Planning. This policy change has been effected in the context of reduced borrowing requirements of the Government and also to allow the NSB to diversify its assets portfolio thus venturing into investment in profitable outlets. Accordingly, the NSB reduced its twelve-month fixed deposit rate (at maturity) from 20 to 18 per cent per annum with effect from July, 1984. The rate on six - month fixed deposits was also reduced by one percentage point to 14 per cent per annum.

In response to monetary and credit policy measures that were effected during the fourth quarter of 1983 and the rising demand for funds from the tea exporters for short term working capital requirements, some commercial banks attempted to build up a liquidity cushion through mobilizing deposits at high interest rates. However, once the deposit mobilization targets were met, rates were reduced to levels that prevailed in the last quarter of 1983 and were further reduced during the second half of 1984. Therefore, following the excess liquidity situation and the reduction in rates by their competitor, the NSB, majority of commercial banks reduced deposit rates by varying amounts and at different times, thereby bringing the entire short term deposit rate structure to a lower level. However, certain banks continued to offer high rates on a selective basis.

The continuous declining trend in the call market rates and the simultaneous increase in net-sales in the Secondary Treasury bill market, indicated the growing excess liquidity in the banking sector. In this context, market forces may bring down deposit rates further during the first half of 1985.

Although banks could be expected to react promptly to their increased liquidity position by an adjustment to their lending rates, this did not happen. In fact, there has been no general reduction in lending rates by any commercial bank except, the isolated and marginal adjustments effected on a selective basis. Commercial banks reduced deposit rates throughout the second half of the year. It was however, evident that there has been a reduction in the cost of mobilization towards the end of the year and the begining of 1985 due to the maturity of six month deposits and the acceptance of new deposits at lower rates. In the absence of adequate savings and investment outlets, the public's preference to hold on to interest bearing financial assets i.e. savings and fixed deposits, is quite evident in the case of Sri Lanka. This is especially so, at times in which inflationary expectations are reduced. In this context, commercial banks are still in a position to attract financial savings at reduced rates.

The increased reserves, including special deposits with the Central Bank reduced the credit creating capacity of commercial banks and also signalled the market to re-align interest rates. In consequent to the monetary policy measures and the changing market conditions, commercial banks reduced deposit rates. However, it was evident that an immediate general reduction in lending rates was not feasible due to two major reasons. First, the cost of mobilization remained high due to the banks being locked into contractual deposits mobilized at high rates. Second, enhanced security arrangements and increased establishment costs kept the cost of funds at high levels.

Interest rates applicable on government debt (government securities and Treasury bills) were revised upward during the year thereby reducing the gap between the government borrowing rates and market lending rates. These revisions were primarily the result of the Government's intention to borrow at market rates with a view to reflecting the true cost of funds. Accordingly, the rate on government securities was increased by 2 percentage points to 16 per cent per annum while extending the maturity period from 5 to 6 years in August, 1984. Also, the rate on Treasury bills moved upwards by two percentage points to 14 per cent per annum in both, primary and secondary Treasury bill markets during the year. The new Treasury bill rate was highly competitive with three and six month fixed deposit rates of commercial banks while the new rate on government securities was comparable with the twelve-month fixed deposit rates offered by most commercial banks.

Central Banking

The total assets/liabilities of the Central Bank as at end 1984 stood at Rs. 33,272 million recording a marginal increase of Rs. 175 million (0.5 per cent) compared with an increase of Rs. 2,930 million (10 per cent) in the previous year. This was mainly due to a marked increase in the International Reserve (IR) of the Central Bank by Rs. 5,317 million and a decline in domestic assets by Rs. 5,142 million.

On the assets side, the most significant factor was the external sector which brought in a substantial increase in the IR compared with a smaller increase of Rs. 151 million in 1983.The build up of the IR was principally due to an increase in the holdings of cash and balances abroad (Rs. 3,839 million) and foreign government securities and Treasury bills (Rs. 1,493 million). The increase in the former was largely due to a considerable increase in the net purchases of foreign exchange from commercial banks. The holdings of Special Drawing Rights however, declined by Rs. 15 million.

In contrast to the considerable build up of the IR, the other notable development on the assets side was the substantial decline of domestic assets of the Central Bank by Rs. 5,142 million as against an increase of Rs. 2,779 million in 1983. This was predominantly due to the significant fall in the holdings of government and government guaranteed securities by Rs. 5,393 million. Transactions in the Secondary Treasury bill market escalated in 1984 and the net sales by the Central Bank amounted to Rs. 1,563 million in 1984 compared with Rs. 59 million in 1983. Another factor that dampened the growth of domestic assets was the decline in loans to commercial banks and other financial institutions by Rs. 633 million. This was the net result of a decline in short term advances by Rs. 659 million and a marginal increase in medium and long-term loans by Rs. 26 million. The decline in short-term advances was mainly due to the reduction in refinance credit afforded to the Paddy Marketing Board under the Guaranteed Price Scheme (GPS) and the withdrawal of the general accommodation facility made available to the commercial banks. Furthermore, the other assets and accounts of the Central Bank also declined by Rs. 366 million in 1984.

On the liabilities side, monetary liabilities consisting of currency in circulation and deposits increased by Rs. 1,826 million in 1984 compared to an increase of Rs. 3,074 million in 1983. Currency in circulation increased by Rs. 1,426 million during the year at approximately the same rate of increase as in 1983. Government deposits with the Central Bank declined by Rs. 414 million compared to an increase of Rs. 732 million while those of commercial banks rose by Rs. 612 million in 1984 compared to an increase of Rs. 1,170 million in 1983. Borrowings abroad and other liabilities and accounts declined by Rs. 1,860 million and Rs. 349 million respectively. Borrowings abroad were almost negligible in 1984 reflecting the build up of the external reserve position of the country.

Monetary Policy

Monetary policy measures introduced in 1984 represented a conscious attempt to achieve monetary stability as well as development objectives against the background of a high liquidity situation in the economy. For this purpose, the policy measures introduced in 1983 were continued with further intensifications during the year in response to various developments observed in the monetary sector.

The Central Bank placed an upper limit of Rs. 400 million on the marketing refinance facility available to the PMB with effect from 1st March, 1984 in order to mitigate the adverse consequences associated with the growth of reserve money (monetary base). The general accommodation facility, made available to commercial banks at the Bank rate was withdrawn and the pre-shipment export credit refinance facility was enhanced by an equivalent amount. In addition, the Central Bank resorted to a number of selective credit control measures in order to contain the demand for funds for non-priority purposes on the one hand, and ensure adequate credit facilities for priority sectors on the other. In an attempt to achieve supply promotional and hence, growth objectives, the Central Bank enhanced the export credit refinance facility to stimulate credit flows to the export sector. The refinance facility on pre-shipment exports was further enhanced by Rs. 108 million and an additional amount of Rs. 350 million exclusively for tea exports was provided in order to meet the increased working capital requirements, resulting from high export prices. With these changes, the overall limit of the export credit refinance facility was raised to Rs. 1,778 million.

In addition to the enhancement of the refinance facility, certain other policy measures were also effected in respect of the export sector. First, in order to cover exporters against exchange risks due to currency fluctuations and to prevent speculation on the exchange rate, the Central Bank instructed all exporters to sell forward their export proceeds to commercial banks with effect from 26th, March 1984. However, the small exporters whose exports are less than Rs. 500,000 in value were excempted from this requirement. On same date, the period of pre-shipment refinance loans was reduced from 90 to 60 days. Along with these changes, the Central Bank introduced an Interest Rebate Scheme (IRS) as an added incentive to exporters to repatriate export proceeds on time. With the introduction of the IRS, the Central Bank refinance rate on the pre-shipment export credit facility was raised from 10 to 13 per cent per annum while the on-lending rate was raised from 13 to 16 per cent. However, with an interest rebate of 4 per cent per annum, where export proceeds are repatriated within the stipulated period the effective cost of borrowing to the exporter was reduced by one percentage point. Similar adjustments were made in respect of the supplementary refinance facility where the discount rate was raised from 7 to 10 per cent per annum while the on-lending rate was raised from 9.75 to 12.75 per cent per annum. Therefore, with the interest rebate of 4 per cent per annum, the cost of borrowing under this scheme too was reduced by 1 percentage point.

In order to restrict credit expansion for non-essential imports, the Central Bank imposed a ceiling on commercial bank credit for such imports. Accordingly,the commercial banks were informed that the total amount of their advances granted for the importation of goods, other than food and foodstuffs, raw materials, components and intermediate goods, drugs and pharmaceuticals, books and pamphlets, capital goods and parts thereof, should not exceed the total amount of such advances granted and outstanding as on 23rd March, 1984. In addition, the banks were requested not to afford forward exchange facilities for non-essential imports and not to provide credit to a single importer beyond the level reached on 23rd March, 1984 for such imports.

In 1984, the Central Bank implemented certain policy measures to safeguard the interests of depositors of finance companies. Compared to high reserve requirements imposed on commercial banks, the liquidity ratio of 5 per cent of total deposits imposed on finance companies was considered inadequate to safeguard the interests of their depositors. Therefore, the Central Bank instructed all finance companies to maintain a minimum of 10 per cent of their total deposits in the form of liquid assets in order to maintain a prudent liquidity ratio in meeting their obligations. In addition, finance companies were also required to maintain their assets in the form of Sri Lanka Government Treasury bills and securities equivalent to 3 per cent of the average of their month end deposit liabilities during the twelve months of the last financial year. These measures were made effective from 1st September, 1984.

During the first three months of 1984, credit to the private sector increased at a rate exceeding 20 per cent as compared with the corresponding months of the previous year. With a view to reducing the rapid expansion in credit to this sector, the Central Bank resorted to further selective credit controls thereby strengthening the policy measures that were already in force.

Effective 16th May, 1984 commercial banks were informed that until further notice, the amount of loans and advances granted and outstanding to the private sector, excluding those for exports and agriculture, should not exceed more than

5 per cent of the amount of such advances granted and outstanding as on 11th May 1984. This measure was introduced to ensure adequate credit flows to priority sectors while containing credit for non-priority sectors at desirable levels.

The sharp increase in liquidity, aggravating inflationary pressures in the economy, called for further corrective measures. Therefore, it was felt necessary to take action to mop up excess liquidity which otherwise would have accelerated the rate of monetary expansion with adverse consequences on prices. Accordingly, as a major device for siphoning off excess liquidity and a supportive measure to the demand management policies, the Central Bank decided to issue its own securities in terms of Section 91 (1) (*b*) of the Monetary Law Act. The issues effected until the end of the year, had the impact of absorbing Rs. 557 million.

In order to siphon off excess liquidity further and to restrict the credit creation capacity of commercial banks, the banks were instructed on 14 November, 1984 to keep special reserves with the Central Bank in respect of their incremental deposits in addition to the statutory reserve requirement already maintained. The special reserves were determined under a Reserve Tranche System (RTS). Details of the system are given in Part II of this report under "Accounts and Banking Operations".

In response to these policy measures, a substantial part of the excess liquidity, both in the hands of the non-bank private sector and commercial banks was reduced and this resulted in a reduction in the credit creating capacity of commercial banks.

With regard to the interest rate policy of the Central Bank there were no major changes in 1984 except the changes made in the rates of both the pre-shipment export credit refinance facility and the supplementary refinance facility with the introduction of the IRS in March, 1984. Moreover, the Central Bank raised the rate on marketing refinance granted to the PMB under the GPS by 2 percentage points.

The monetary and credit policy measures introduced during the first half of 1984 largely influenced both the volume and direction of credit during the year. Credit ceilings imposed in the months of March and May, were aimed at curtailing the undue expansion of credit to the private sector. However, commercial bank credit channelled for exports and agriculture was further encouraged by exempting them from the credit ceilings and providing enhanced refinance facilities at concessional interest rates.

The National Credit Plan for 1984 formulated by the Central Bank, for the fourth year in succession, attempted to redirect commercial bank credit to the private sector within the broad framework of monetary and credit policies of the Central Bank. Having considered the impact of the Government budgetary operations and the external sector on monetary aggregates, the total permissible level of outstanding credit to the private sector by all commercial banks at end 1984 was targetted at Rs. 36,537 million at the outset of the year. Consequently, private sector credit was estimated to increase by Rs. 5,129 million or 16 per cent during 1984. As in the previous year, agriculture, industry and export sectors continued to be the priority areas in sectoral deployment of credit.

The restrictive monetary and credit policy measures introduced by the Central Bank in early 1984 resulted in a decline in bank credit compared with the initial quarterly targets. Shortfalls were recorded in the utilization of credit in all sectors, except housing, during the year. However, industrial and export sectors received about 95 per cent of the total credit allocation in 1984. It is noteworthy to mention that despite the exemption from credit ceilings, agricultural credit lagged behind the targets throughout the year. This sector recorded the largest shortfall in credit utilisation which amounted to about Rs. 545 million or 13 per cent. The role played by the commercial banks in lending activities for agriculture was largely confined to the provision of short-term working capital, including marketing where the funds were mostly available under the Central Bank refinance facilities and no appreciable attempts were made to channel credit to most needy medium and long term investments in the agricultural sector. The poor performances in agricultural lending was highlighted at credit plan review meetings and banks were requested to play a more active role in agricultural lending in the forthcoming years.

The restrictive credit policy measures that were in effect during 1984 were successful to a large extent in containing the annual growth in domestic credit towards the latter part of the year. The rate of growth of domestic credit which was at 16 per cent at end 1983 decelerated gradually to a level of 1 per cent by end 1984. This appreciable deceleration in credit expansion, particularly in the private sector and the partial absorption of excess liquidity in the banking system were largely attributable to the policy measures introduced during the year. The increase in credit to the private sector which stood at 26 per cent at end 1983 was progressively reduced to a rate of 11 per cent by the end of the year through selective credit control measures.

The year 1984 witnessed a substantial moderation in the rate of increase in monetary aggregates and the price levels. The moderation was more pronounced in narrow money. On the price front, there was a significant abatement in the rate of inflation. Along with the moderate increase in the Colombo Consumers' Price Index, the rate of increase in the Wholesale Price Index also registered a substantial drop. The expansionary impact of the increased foreign assets and the inflationary pressures in the economy were somewhat neutralized through the monetary policy measures adopted during the year. Meanwhile, the fiscal policy measures of the Government effectively complemented the monetary policy measures. The considerable reduction in government borrowings from the banking sector, contributed in restraining undue monetary expansion. Nonetheless, these favourable achievements were not reflected fully in the real sector largely due to structural and institutional deficiencies.