

MONEY AND BANKING

Money Supply

Monetary developments during 1985 were characterised by a continuing deceleration in monetary aggregates for the second year in succession. This took place against a background of a sharp increase in net credit to government, a moderate increase in credit to the private sector and a decline in net external assets of the banking system. The narrow money supply (M_1), comprising currency and demand deposits held by the public increased by Rs. 1,937 million or 12 per cent during the year compared with an increase of Rs. 2,076 million or 14 per cent in 1984. Meanwhile, time and savings deposits of the private sector held with commercial banks (quasi-money) rose by Rs. 3,044 million or 11 per cent. In 1984, quasi-money grew by Rs. 4,095 million or 18 per cent. Consequently, the broad money supply (M_2) consisting of M_1 plus quasi-money, increased by Rs. 4,982 million or 11 per cent in 1985. The growth in M_2 in 1984 was much higher at Rs. 6,171 million or 17 per cent.

In 1985, the deceleration of M_1 was reflected in both currency and demand deposits held by the public. Currency in circulation increased by Rs. 1,255 million or 15 per cent whereas it rose by Rs. 1,361 million or 19 per cent in 1984. The highest monthly increase in currency was recorded in March (12 per cent). This increase was due to the seasonal demand for cash balances prior to the April festive season. Demand deposits held by the public increased moderately by Rs. 683 million or 8 per cent in 1985. The increase in 1984 was Rs. 715 million or 9 per cent. The share of demand deposits in M_1 declined from 49 per cent in 1984 to 48 per cent in 1985.

Although in absolute terms, quasi-money registered an increase of Rs. 3,044 million, the rate of growth declined from 18 per cent in 1984 to 11 per cent in 1985. The relatively low rate of growth was largely due to the downward revision of time and savings deposit rates effected by commercial banks on several occasions and the lower growth in income associated with the drop in external earnings during the year. The deceleration in quasi-money was largely in government corporation deposits which rose only by Rs. 301 million or 6 per cent. In comparison, the increase in 1984 was Rs. 1,428 million or 35 per cent. This was mainly due to the decline in such deposits of the two plantation corporations resulting from the decline in tea prices. Meanwhile, deposits of the other private sector constituents (OPSC) also declined. Notwithstanding this, the share of time and savings deposits in M_2 remained unchanged at 61 per cent.

In the wake of a decline in external banking assets (net), the most significant factor in the growth of money supply in 1985 was the substantial increase in domestic credit. The increase in net credit to government (NCG) largely accounted for the increase in domestic credit. It is noteworthy that NCG increased sharply by Rs. 6,137 million or 42 per cent as against a decline of Rs. 2,979 million or 17 per cent in 1984. Consequently, the share of NCG in total domestic credit rose from 29 per cent in 1984 to 35 per cent in 1985. The increase in NCG was the net result of

MONEY SUPPLY MONTHLY

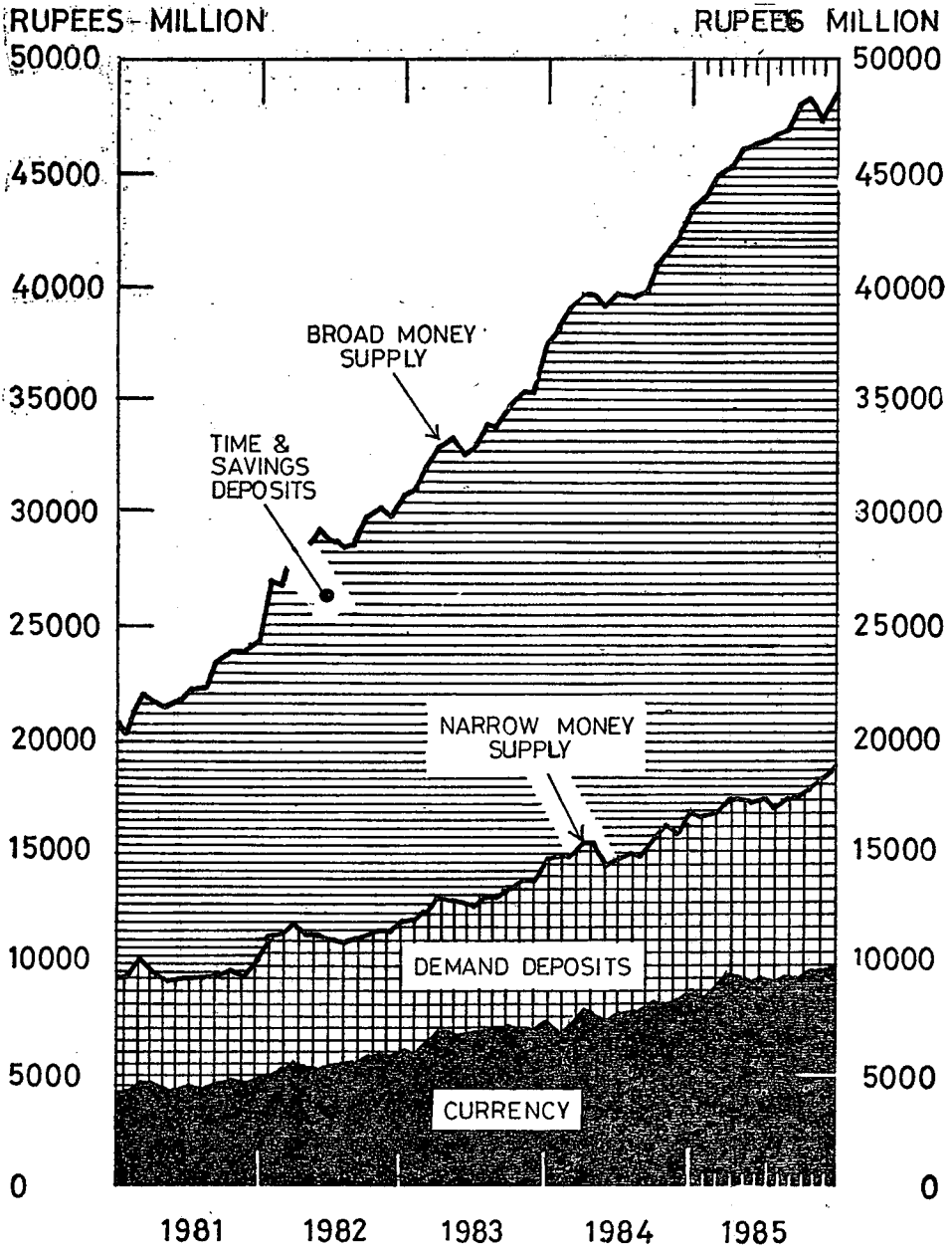


TABLE 1.43
Monetary Aggregates 1983 - 1985

Amount in Rs Million

	Narrow Money Supply M_1						Broad Money Supply M_2					
	1983	1984	1985	% Change 1983 over 1982	% Change 1984 over 1983	% Change 1985 over 1984	1983	1984	1985	% Change 1983 over 1982	% Change 1984 over 1983	% Change 1985 over 1984
January	11,852	14,964	16,522	+ 7.3	+ 26.3	+ 10.4	30,802	38,277	43,923	+ 14.5	+ 24.3	+ 14.8
February	12,234	14,939	16,595	+ 9.4	+ 22.1	+ 11.1	31,708	39,031	44,849	+ 18.5	+ 23.1	+ 14.9
March	12,986	15,439	17,237	+ 11.2	+ 18.9	+ 11.7	32,874	39,762	45,230	+ 16.4	+ 21.0	+ 13.8
April	12,842	15,317	17,332	+ 13.9	+ 19.3	+ 13.2	33,114	39,629	46,019	+ 16.6	+ 19.7	+ 16.1
May	12,606	14,331	17,208	+ 13.2	+ 13.7	+ 20.1	32,491	39,133	46,092	+ 11.5	+ 20.4	+ 17.8
June	12,589	14,768	17,339	+ 16.4	+ 17.3	+ 17.4	32,798	39,690	46,233	+ 14.1	+ 21.0	+ 16.5
July	12,964	14,901	16,969	+ 21.1	+ 14.9	+ 13.9	33,846	39,642	46,631	+ 18.9	+ 17.1	+ 17.6
August	12,977	14,811	17,232	+ 19.1	+ 14.1	+ 16.4	33,732	39,767	46,991	+ 18.4	+ 17.9	+ 18.2
September	13,322	15,549	17,460	+ 19.3	+ 16.7	+ 12.3	34,620	40,808	47,917	+ 16.2	+ 17.9	+ 17.4
October	13,572	16,041	17,768	+ 18.9	+ 18.2	+ 10.8	35,314	41,586	48,359	+ 17.1	+ 17.8	+ 16.3
November	13,544	15,678	18,187	+ 18.3	+ 15.8	+ 16.0	35,324	42,007	47,247	+ 18.3	+ 18.9	+ 12.5
December	14,748	16,824	18,761	+ 25.4	+ 14.1	+ 11.5	37,257	43,427	48,409	+ 22.1	+ 16.6	+ 11.4
Monthly Average	13,020	15,297	17,384	+ 16.1	+ 17.5	+ 13.7	33,657	40,230	46,492	+ 16.9	+ 19.5	+ 15.6

Source: Central Bank of Sri Lanka.

increases in gross credit to government by Rs. 7,837 million (43 per cent) and an increase in government deposits and cash balances by Rs. 1,700 million (47 per cent). Government borrowings from the Central Bank increased by Rs. 7,512 million or 49 per cent in contrast to a decline of Rs. 4,144 million or 21 per cent in 1984. This was mainly due to increases in provisional advances (Rs. 174 million) and holdings of government and government guaranteed securities, mainly treasury bills (Rs. 7,337 million). Credit to government by commercial banks rose by Rs. 326 million or 11 per cent when compared with an increase of Rs. 1,336 million or 85 per cent in 1984.

The main reason for the heavy recourse of the Government to bank credit was the considerable drop in revenue collection compared to the estimated revenue owing to the decline in tea ad-valorem tax and export duties. On the other hand, government spending continued to rise during the year mainly due to escalating defence related activities.

During 1985, gross credit to private sector (GCPS) rose by Rs. 3,163 million or 9 per cent when compared with an increase of Rs. 3,612 million or 11 per cent in 1984. The continuation of the credit ceilings imposed in March and May, 1984 and the reduced demand for credit in nominal terms due to the deceleration in the inflation rate resulted in a decline in GCPS. Bank credit to the other private sector constituents (OPSC) took the form of loans (Rs. 2,090 million), overdrafts (Rs. 689 million) and import bills (Rs. 133 million). Credit to co-operative institutions declined by Rs. 263 million or 17 per cent in continuation of a decline of Rs. 255 million or 14 per cent in 1984, mainly due to reduced marketing activities of the Paddy Marketing Board and reduction in cultivation loans granted under the Comprehensive Rural Credit Scheme during Maha 1984/1985 and Yala 1985 seasons.

Credit to government corporations increased by Rs. 290 million or 7 per cent in 1985 in contrast to a decline of Rs. 237 million or 6 per cent in 1984. This was mainly due to enhanced borrowings of the Ceylon Petroleum Corporation (CPC), the Co-operative Wholesale Establishment (CWE), the State Trading Corporation (STC) and the two state plantation corporations (SPC and JEDB). The increase was particularly sharp during the second half of 1985 when the decline in tea incomes of the plantation corporations and the shifting of CPC funding from foreign to domestic sources led to heavy borrowings from commercial banks.

Reversing the trend observed in the past two years, the external sector exerted a substantial contractionary impact on the monetary aggregates in 1985. External banking assets (net) declined by Rs. 691 million or 7 per cent in 1985 when compared with a sharp increase of Rs. 6,777 million or 213 per cent in 1984. As mentioned earlier, the drop in tea prices and the reduction in receipts from tourism were mainly responsible for the drop in external assets.

As in the previous year, domestic price levels recorded an appreciable deceleration thereby reducing the rate of inflation throughout the year. The Colombo Consumers' Price Index (CCPI) increased by only 1.5 per cent in 1985. The improvement in the agricultural commodity supply conditions coupled with the demand management policy measures effected by the Central Bank led to the decline in the general price level of the economy.

DOMESTIC CREDIT

MONTHLY

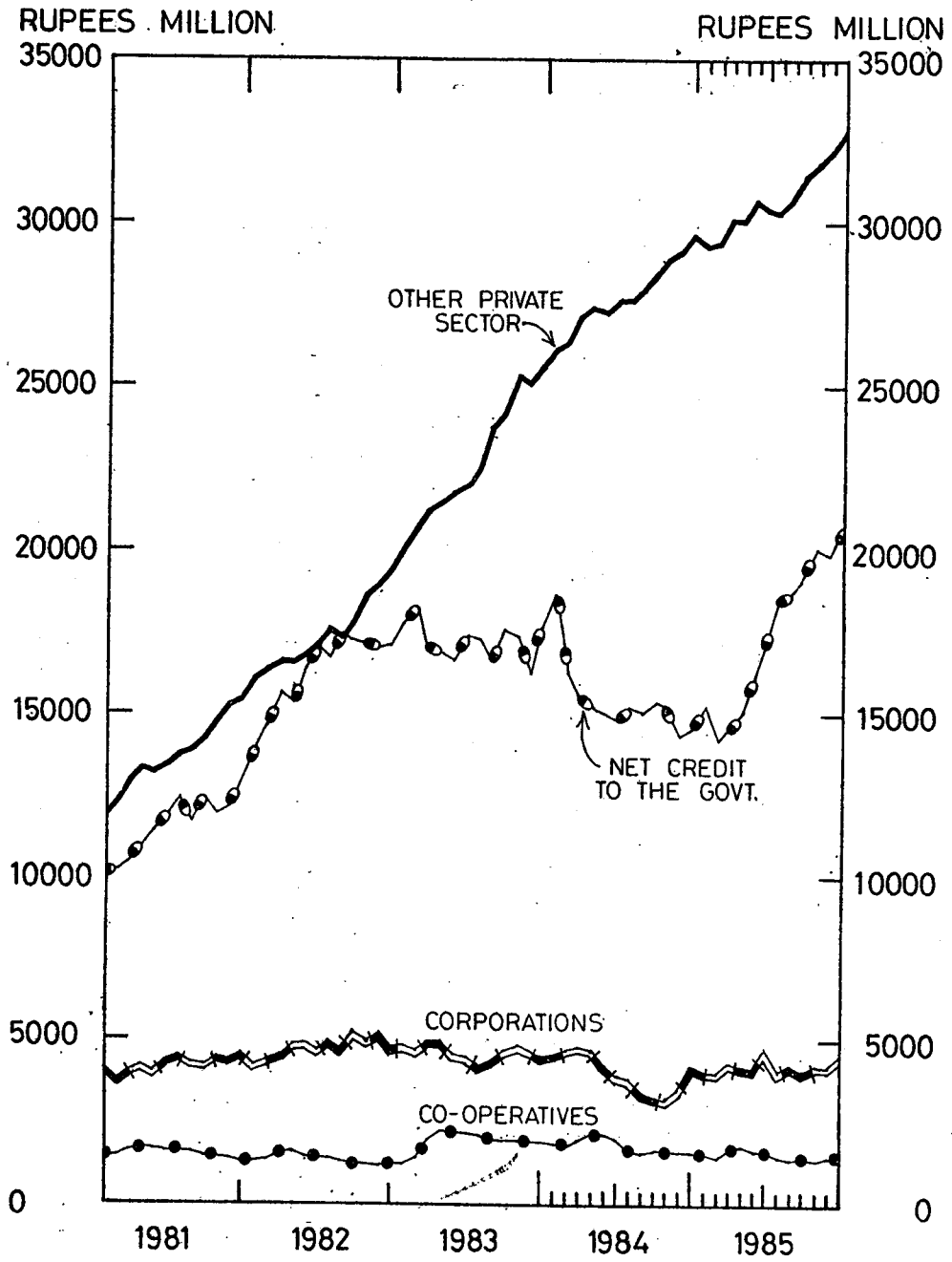


TABLE 1, 44

Monetary Aggregates and Underlying Factors

Amount in Rs Million

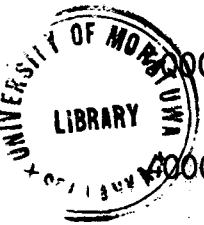
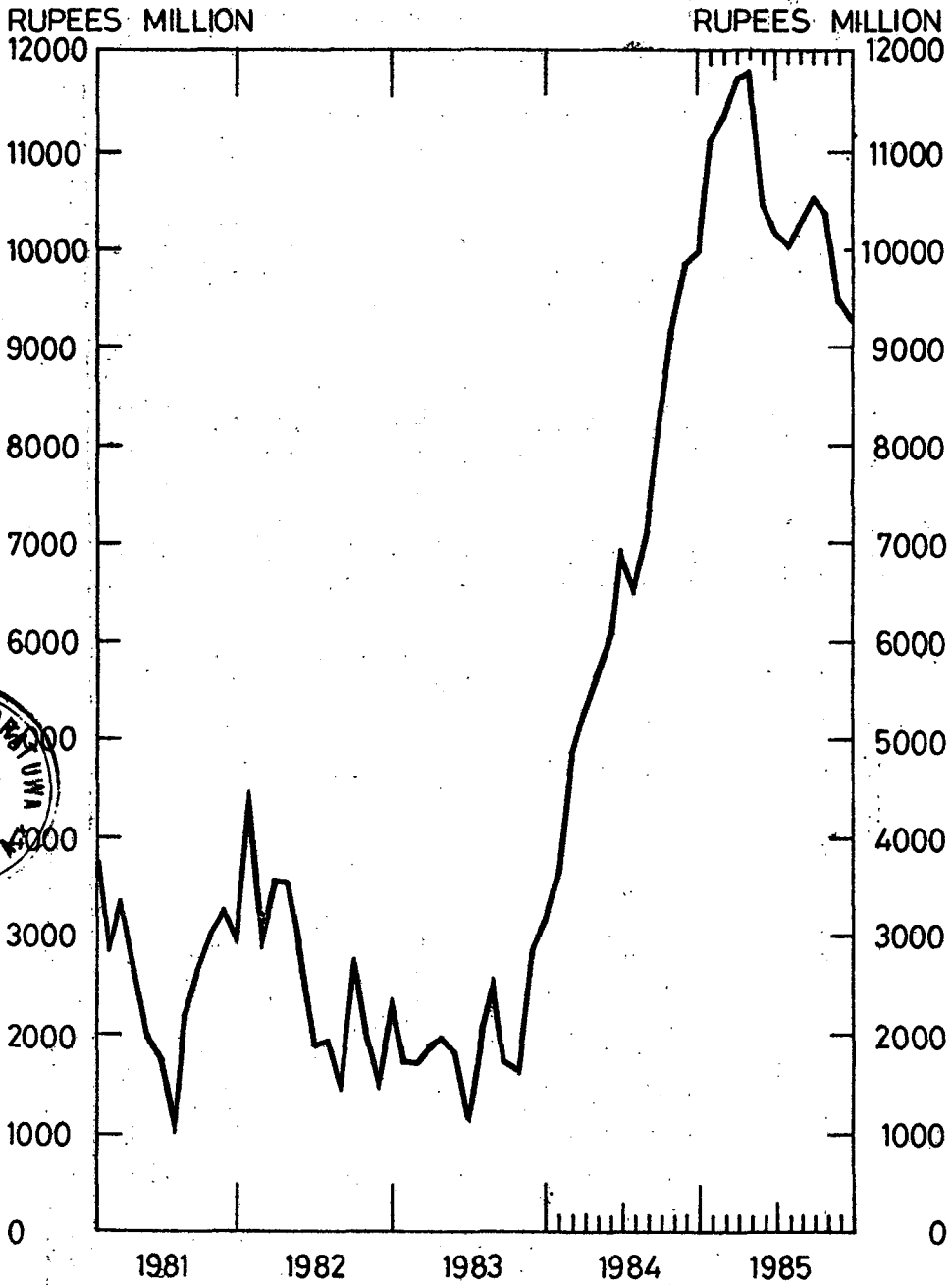
Item	December 1983	December 1984	December 1985	Change 1983/1984		Change 1984/1985	
				Amount	Percentage	Amount	Percentage
Monetary Aggregates							
1. Currency held by the public ..	7,200.1	8,560.9	9,815.5	+ 1,360.8	+ 18.9	+ 1,254.6	+ 14.7
2. Demand deposits held by the public ..	7,547.8	8,262.9	8,945.5	+ 715.2	+ 9.5	+ 682.6	+ 8.3
Narrow Money Supply (M ₁) ..	14,747.9	16,823.8	18,761.0	+ 2,076.0	+ 14.1	+ 1,937.2	+ 11.5
3. Time and Savings deposits of the private sector held with commercial banks ..	22,509.0	26,603.5	29,647.9	+ 4,094.5	+ 18.2	+ 3,044.4	+ 11.4
3.1 Co-operative Institutions ..	469.2	526.8	633.5	+ 57.6	+ 12.3	+ 106.7	+ 20.3
3.2 Government Corporations ..	4,081.1	5,508.8	5,809.5	+ 1,427.7	+ 35.0	+ 300.7	+ 5.5
3.3 Other Private Sector Constituents (a) ..	17,958.7	20,567.9	23,204.9	+ 2,609.2	+ 14.6	+ 2,637.0	+ 12.8
Broad Money Supply (M ₂) ..	37,256.9	43,427.3	48,408.9	+ 6,170.5	+ 16.6	+ 4,981.6	+ 11.4
Underlying Factors							
1. Domestic Credit ..	49,293.0	49,926.2	59,226.1	+ 633.2	+ 1.3	+ 9,299.9	+ 18.6
1.1 Net Credit to Government ..	17,533.1	14,554.4	20,691.4	- 2,978.7	- 17.0	+ 6,137.0	+ 42.2
1.1.1 Gross credit to Government by Central Bank ..	20,972.1	18,164.6	26,001.7	- 2,807.5	- 13.4	+ 7,837.1	+ 43.1
1.1.1.1 by Central Bank ..	19,393.0	15,249.1	22,760.6	- 4,143.9	- 21.4	+ 7,511.5	+ 49.3
1.1.1.2 by Commercial Banks ..	1,579.1	2,915.5	3,241.1	+ 1,336.4	+ 84.7	+ 325.6	+ 11.2
1.1.2 Government deposits and cash balances ..	- 3,439.0	- 3,610.2	- 5,310.3	- 171.2	- 5.0	- 1,700.1	- 47.1
1.2 Gross credit to the Private Sector ..	31,759.9	35,371.8	38,534.7	+ 3,611.9	+ 11.4	+ 3,162.9	+ 8.9
1.2.1 Co-operative Institutions ..	1,822.7	1,567.6	1,304.3	- 255.1	- 14.0	- 263.3	- 16.8
1.2.2 Government Corporations ..	4,385.1	4,148.2	4,437.9	- 236.9	- 5.5	+ 289.7	+ 7.0
1.2.3 Other Private Sector Constituents ..	25,552.1	29,656.0	32,792.5	+ 4,103.9	+ 16.1	+ 3,136.5	+ 10.6
2. External Banking Assets (net) ..	3,186.9	9,964.1	9,272.7	+ 6,777.2	+ 212.7	- 691.4	- 6.9
3. Other items (net) ..	- 15,223.0	- 16,463.0	- 20,089.9	- 1,239.9		- 3,626.9	
3.1 Other liabilities (net) of Central Bank ..	- 9,417.4	- 9,982.6	- 13,197.2	- 565.2		- 3,214.5	
3.2 Other liabilities (net) of Commercial Banks ..	- 6,319.3	- 6,506.3	- 7,186.9	- 186.9		- 680.7	
3.3 Adjustments for items in transit ..	513.7	25.9	294.2	- 487.8		+ 268.3	
Broad Money Supply (M ₂) ..	37,256.9	43,427.3	48,408.9	+ 6,170.5	+ 16.6	+ 4,981.6	+ 11.4

Note: Signs indicate the effect on M₂

(a) Excludes Non-Resident Foreign Currency Deposits.

Source: Central Bank of Sri Lanka.

EXTERNAL BANKING ASSETS (NET)
MONTHLY



Commercial Banking

Despite the substantial reduction in liquidity generated by external assets, commercial banks experienced an excess liquidity situation in 1985 primarily due to heavy domestic expenditure of the Government. Moreover, the inability of banks to lend to non-priority sectors due to credit restrictions, and the sluggish demand for credit from the private sector augmented the excess liquidity situation.

Transactions in the inter-bank call money market and Secondary Treasury Bill Market partly reflected the excess liquidity situation experienced by commercial banks. Reflecting the lower demand for short-term credit, the outstanding transactions in the inter-bank call money market dropped substantially in 1985. Accordingly, the monthly outstanding lending balances in this market fluctuated between Rs. 103 million and Rs. 376 million during the year. Consequently, the interest rates that prevailed at a range of 14 to 15.5 per cent per annum at end of 1984 declined to a range of 11 to 14 per cent per annum at end of 1985. Meanwhile, the transactions in the Secondary Treasury Bill Market, which is considered as a convenient outlet for investing excess funds, was reasonably active during the year. The outstanding net sales rose from Rs. 1,563 million at end of 1984 to a peak level of Rs. 3,806 million in October 1985 and dropped to Rs. 1,529 million at end of 1985.

The reduced demand for credit and the restrictive credit policy measures resulted in the average loan/deposit ratio of commercial banks fluctuating between 0.85 and 0.89 during the year. This compares with the range of 0.90 to 0.96 observed in the previous year.

During the second half of 1985 there was a greater demand for Certificates of Deposits (CDs) of commercial banks. This may have been an initial reaction to the announcement of a withholding tax of 20 per cent on earned interest income on savings and fixed deposits in the 1986 Budget. The outstanding amount of CDs increased by Rs. 168 million to reach Rs. 1,068 million at end of 1985.

At end of 1985 there were 25 Foreign Currency Banking Units (FCBUs) in Sri Lanka. Although the total assets/liabilities of FCBUs increased by Rs. 208 million to Rs. 20,079 million at end of 1985, they dropped marginally in US \$ terms due to the depreciation of the Sri Lanka Rupee vis a vis the US dollar. The operations of FCBUs largely included financing of projects under the Greater Colombo Economic Commission (GCEC) and other approved residents during the year.

During the year under review, total resources of commercial banks rose by Rs. 5,830 million compared with an increase of Rs. 6,171 million in the preceding year. Conforming to the pattern experienced in the past, a substantial part of the resource growth in 1985 (Rs. 5,361 million) was by way of deposit liabilities. Borrowings of commercial banks dropped by Rs. 263 million during the year which in part reflected an excess liquidity position.

With a view to facilitating customer services, several banks, including the two state banks, computerised their operations and extended banking hours of certain branches.

Bank Expansion

A new system of unit banks was established in 1985. Regional Rural Development Banks (RRDBs) were inaugurated with the objective of furthering banking services in the outstations and developing productive activities in those areas. The first RRDB was opened at Bulathsinhala in the Kalutara district on 13th July 1985. Subsequently, three more were opened in Kurunegala, Matara and Anuradhapura. These RRDBs in turn opened 16 branches within their respective districts during the year : 6 in Kurunegala, 5 in Matara, 2 in Anuradhapura and 3 in Kalutara. The Central Bank opened its third regional branch in Matale in December 1985.

In 1985 the rate of expansion of commercial bank branches was slow. The total number of commercial bank branches including relocated Agrarian Service Centre (ASC) branches increased by only 11 to 1,033 at end of 1985. The Bank of Ceylon opened 9 main branches in 1985 including the super grade branch at its new headquarters while two branches were closed for security reasons. Seven ASC branches were relocated during the year either by upgrading them as main branches or merging them with existing main branches. The Bank of Ceylon had 236 operating main branches at end of 1985. The People's Bank opened 3 new branches, closed down one and reopened another for business. The total number of its branches at end of 1985 was 293. No new branches were opened by the Commercial Bank of Ceylon, but one branch was sub-divided into two, *i. e.* City Office and Foreign Branch.

The National Savings Bank opened four new branches during the year under review, thus bringing the total number of its branches to 56 at end of 1985.

Interest Rates

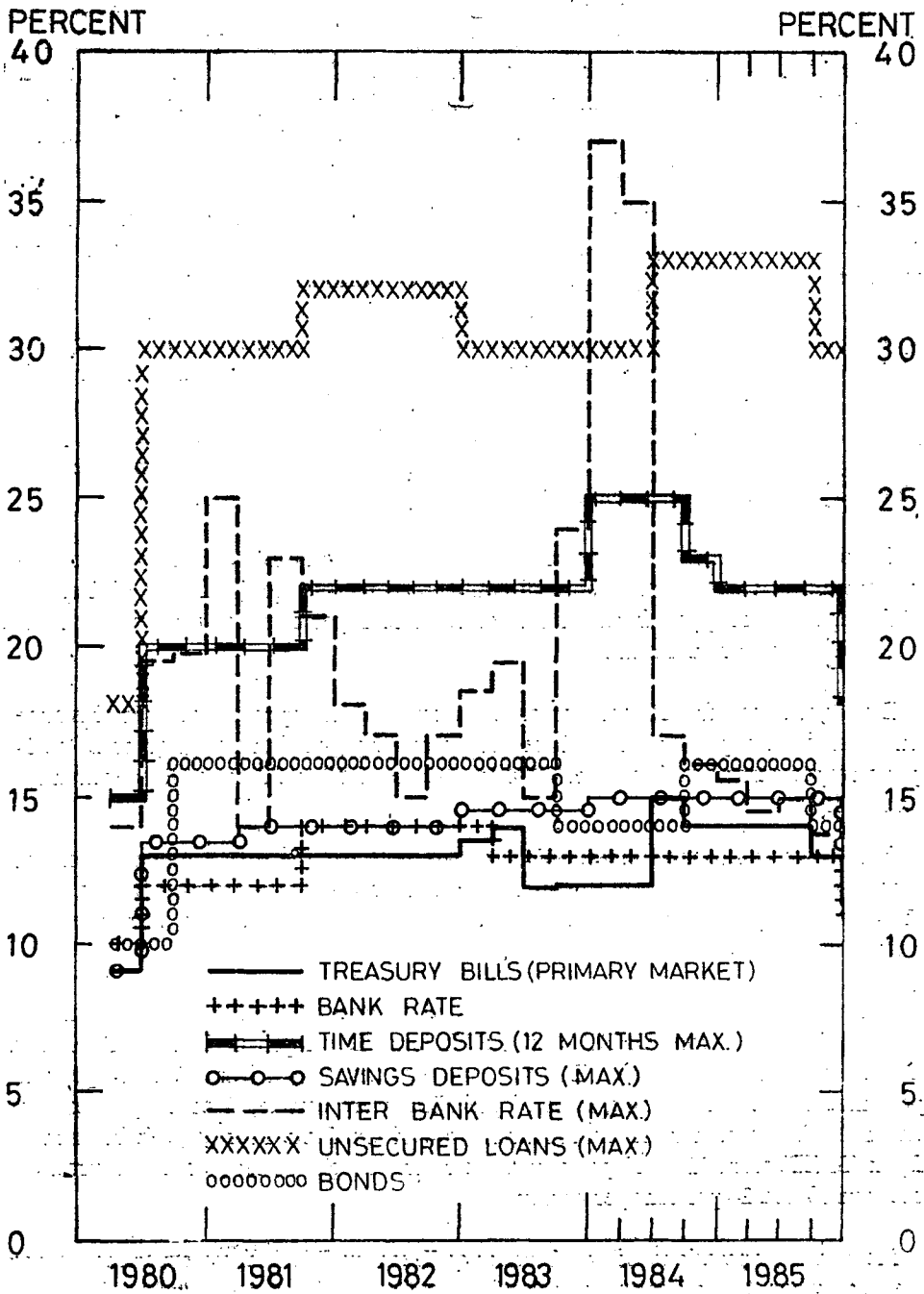
The changes in the interest rate structure in 1985 included a considerable drop in deposit rates of the National Savings Bank (NSB) and commercial banks and a marginal reduction in selective lending rates. Due to the substantial liquidity situation and the reduction in the inflation rate, the NSB reduced its deposit rates on one year deposits from 18 to 15 per cent per annum and set the pace for a reduction in deposit rates. Meanwhile, the Central Bank signalled its interest rate policy to the money market by reducing the Bank rate and lending rates on export refinance schemes thereby inducing commercial banks to bring down the level of interest rates to take account of the decline in the inflation rate.

Accordingly, effective 1st February, 1985, the refinance rate and the on-lending rate under the Supplementary Export Credit Refinance facility were reduced thus bringing down the effective lending rate by one per cent.

The reduction in deposit rates of the NSB, the excess liquidity situation and the decline in the inflation rate induced commercial banks to reduce their deposit rates by a range of 1-3 percentage points during the first half of 1985. The NSB reduced

INTEREST RATES

END QUARTERLY FIGURES



its 12 months fixed deposit rate from 18 to 15 per cent per annum and its six months' deposit rate from 14 to 13 per cent per annum in February, 1985. Accordingly, the 12 month deposit rates of commercial banks dropped to a range of 12 to 18 per cent per annum. Similarly, in response to the Central Bank's interest rate policy and the emerging market conditions, the Bank of Ceylon and the People's Bank reduced their lending rates by one percentage point each, effective April 1985. One year deposit rates of the other commercial banks gradually dropped from a range of 14 to 22 per cent per annum at end of March to a range of 12 to 18 per cent per annum by end of 1985.

In the second half of the year, with a view to absorbing excess liquidity and inducing commercial banks to bring down deposit and lending rates, the Central Bank increased statutory reserve ratios on deposit liabilities of commercial banks. The resulting further increase in cost of funds of commercial banks compelled them to reduce deposit rates initially and lending rates thereafter. Consequently, deposit rates of all commercial banks were further reduced by one per cent. In September, 1985 the state banks announced a reduction of lending rates in a range of 1 to 3 percentage points mainly on priority lendings which became effective from 1st October 1985. Lending rates of the other commercial banks slowly moved down from a range of 12 to 33 per cent to a range of 11 to 30 per cent per annum by end of 1985.

Following a further reduction in deposit rates by the NSB from 16 to 15 per cent per annum in October, and those of commercial banks, the Certificate of Deposits (CDs) rate too dropped from a range of 13 to 22.2 per cent per annum to a range of 8 to 20.5 per cent per annum.

During the year, finance companies also reduced their deposit rates. For instance, one year fixed deposit rates of these companies dropped from a range of 21 to 24 per cent per annum in December 1984 to a range of 18 to 22 per cent per annum at end of 1985.

Inter-bank call market rates, which in part reflected the excess liquidity position among commercial banks and other financial institutions, too dropped from a range of 14 to 15.50 per cent per annum at end of 1984 to a range of 11 to 14 per cent per annum at end of 1985.

Among long term lending institutions, lending rates of the Development Finance Corporation of Ceylon (DFCC) and the National Development Bank of Sri Lanka (NDB) remained unchanged. DFCC's lending rates ranged from 11 to 14 per cent per annum while the lending rates of the NDB were between 7 to 14 per cent per annum. The reduction in the minimum rate of the State Mortgage & Investment Bank (SMIB) from 12 to 10 per cent per annum brought its range of lending rates to between 10 and 24 per cent per annum.

Meanwhile, operations of the Secondary Treasury Bill Market expanded during the year when the average net sales by the Central Bank increased to Rs. 2,518 million from Rs. 1,013 million in 1984. However, at end of 1985, net sales by the Central Bank declined to Rs. 1,529 million due to seasonal demand for liquidity.

During the second half of 1985, the interest rates of treasury bills (primary and secondary) fell on several occasions. Also, towards end of 1985, the Bank Rate and most refinance rates of the Central Bank were revised downwards by two percentage point. (Details of these changes are discussed under the section on Monetary Policy).

Central Banking

The total assets/liabilities of the Central Bank at end of 1985 amounted to Rs. 41,159 million showing a considerable increase of Rs. 7,887 million (24 per cent) compared with a marginal increase of Rs. 175 million (0.5 per cent) in 1984.

On the assets side, the International Reserve (gross) of the Central Bank, which increased markedly by Rs. 5,317 million in 1984, declined by Rs. 1,134 million (9 per cent) in 1985 mainly on account of a decline in the holdings of cash and balances abroad by Rs. 1,515 million. Meanwhile, foreign securities and treasury bills increased by Rs. 384 million.

In contrast, domestic assets of the Central Bank, which declined by Rs. 4,777 million in 1984, increased substantially by Rs. 7,336 million in 1985. This was mainly due to a large increase in holdings of treasury bills by Rs. 7,337 million. Advances to commercial banks and other financial institutions declined by Rs. 175 million which was the combined outcome of a decline in short-term loans by Rs. 218 million and a marginal increase of Rs. 43 million in medium and long-term loans. The decline in short-term advances granted under refinance schemes was mainly due to the reduced demand for funds mainly under the export refinance facilities. The other assets and accounts of the Central Bank also increased by Rs. 1,685 million during this year. This was mainly the outcome of increases of forward sales of US dollars (Rs. 505 million), forward purchases of US dollars (Rs. 316 million) and guarantees issued by the Central Bank (Rs. 239 million).

On the liabilities side, monetary liabilities consisting of currency in circulation and deposits increased by Rs. 3,595 million (17 per cent) in 1985. Deposits of the Government, commercial banks and others increased by Rs. 776 million, Rs. 1,465 million and Rs. 601 million respectively, while those of international organisations, foreign governments and foreign banking institutions declined by Rs. 967 million. The considerable increase in deposits of commercial banks was mainly due to increases in statutory reserve ratios effected since 1984. Government deposits rose due to retention of a part of its borrowings in the form of deposits with the Central Bank. The decline in deposits of foreign organizations was primarily reflected in the reduction of deposits of the International Monetary Fund (IMF) Account.

During the year, there were eight issues of Central Bank securities and therefore, the outstanding Central Bank securities rose from Rs. 557 million at end of 1984 to Rs. 1,168 million at end of 1985. Meanwhile, other liabilities and accounts of the Central Bank increased by Rs. 3,687 million mainly due to an increase in the International Reserve Revaluation (IRR) Account by Rs. 1,374 million. Increases

in the profit and loss account, balances in the Asian Clearing Union Account and the Control Account Reserves, also accounted for the increase in other liabilities and accounts.

Monetary Policy

The contractionary impact exerted by external banking assets (net) on money supply was more than offset by the sharp increase in borrowings of the Government from the banking system. To cope with the liquidity situation of the economy during 1985, the Central Bank continued with the restrictive monetary policy package introduced in 1984. Within the overall context of policy measures directed towards demand management, supplementary selective measures were adopted to maintain a balance between the dual objectives of stability and growth. During the second half of 1985, action was initiated to reduce the level of interest rates, in particular, on commercial bank advances against the background of a decline in prices which in turn raised the real interest rates to substantially high levels.

During 1985 the Central Bank's credit policy directed credit towards priority areas and restricted credit expansion for non-priority sectors. Accordingly, the restrictions imposed on commercial bank credit for non-essential imports was further strengthened by extending restraints on lendings of finance companies. With effect from 21st January 1985 finance companies' loans and advances granted for the importation of non-essential goods were not to exceed such advances granted and outstanding as on 18th January 1985. Moreover, the lending capacity of finance companies was further regulated by the imposition of a higher liquidity ratio. Finance companies were requested to maintain a liquid assets ratio of 15 per cent of deposits received and outstanding on any particular day, with effect from 1st June 1985.

With a view to providing further concessions to the non-traditional export sector, the refinance and on-lending rates of the Supplementary Refinance Facility for non-traditional exports were reduced. The refinance rates were reduced from 8.75 to 7.8 per cent per annum and on-lending rates from 12.75 to 11.8 per cent per annum with effect from 1st February 1985. Meanwhile, to provide long-term capital to private sector development projects, in June 1985, commercial banks were permitted to maintain a part of the required reserves in the form of Development Finance Corporation of Ceylon (DFCC) bonds subject to the quantum of reserves so maintained by each commercial bank not exceeding a sum equal to one eighth of its reserves on time and savings deposit liabilities. This strengthened the liquidity base of the DFCC while at the same time it allowed commercial banks to earn an interest income on such bonds. At end of 1985, commercial bank investments in DFCC bonds amounted to Rs. 333 million.

Despite the reduction in deposit rates of commercial banks in mid-1984, no significant changes were observed in lending rates of commercial banks till September 1985. In order to absorb excess liquidity, statutory reserve ratios on deposit liabilities were raised further in August and September 1985. The ratios on savings

and demand deposits were raised from 8 to 10 per cent and 16 to 18 per cent, respectively. With a view to discouraging banks from holding time deposits of very short duration, the ratio in respect of time deposits not exceeding 90 days was raised on two occasions (August and September) from 8 to 14 per cent while the ratio for deposits exceeding 90 days was raised from 8 to 10 per cent.

Having considered the liquidity position, the drop in money market rates and the deceleration in the rate of inflation, the Central Bank in August 1985, recommended to the Government a reduction in interest rates on government securities from 16 to 14 per cent with the maturity period remaining at 6 years. Consequently, the treasury bill rates (primary and secondary) were also reduced on several occasions since September 1985. Accordingly, in 1985 the rate on primary bills was reduced from 14 to 11.5 per cent per annum while buying and selling rates on secondary treasury bills were reduced from 14.2 and 14.0 per cent per annum to 11.5 and 11.3 per cent per annum, respectively.

Meanwhile, with the intention of bringing down lending rates for priority purposes, the Central Bank announced on December 30th 1985 a two percentage point reduction in the Bank rate (*i.e.* from 13 to 11 per cent) and all refinance rates available to commercial banks and other participating institutions, except those in respect of loans for cultivation and marketing facilities. These reductions were expected to induce commercial banks to bring down lending rates. (Details of these changes are given in Part II of this report).

The National Credit Plan for 1985 formulated against the background of credit ceilings imposed on commercial bank credit to the private sector attempted to channel more credit to priority sectors since lending to such sectors (mainly exports and agriculture) was exempted from credit ceilings. After the formulation of a monetary survey for 1985, the permissible level of outstanding credit to the private sector by all commercial banks at end of 1985 was targetted at Rs. 38,807 million at the beginning of 1985. This was an increase of Rs. 3,435 million or 10 per cent against an increase of Rs. 5,129 million or 16 per cent targetted in 1984. Meanwhile, agriculture, exports and industry continued to be priority areas in sectoral allocation of credit.

The continuation of credit ceilings introduced in 1984 and other restrictive monetary policy measures introduced during the course of the year resulted in a decline in bank credit through all four quarters of the year when compared with initial quarterly targets. At the end of 1985, total outstanding credit to the private sector stood at Rs. 38,223 million compared to the original target of Rs. 38,807 million, showing a shortfall of Rs. 584 million or 2 per cent. The shortfall was more pronounced at end of September, when actual credit granted lagged behind the target by Rs. 1,162 million. However, with the enhanced seasonal demand for credit, this gap declined towards end of 1985. Despite the exclusion of exports and agricultural credit from credit ceilings, the outstanding credit granted for such purposes lagged behind the targets throughout the year. The reduced utilisation of export credit was largely due to the decline in export prices particularly of tea. The low

utilization of agricultural credit was mainly due to the limited role played by the Paddy Marketing Board in paddy procurement and the sharp decline in loans granted under the Comprehensive Rural Credit Scheme during Maha 1984/1985 and Yala 1985.

The continuation of credit restrictions, the issue of Central Bank securities and high cost of borrowings, contained the annual growth of private sector credit in 1985 to 9 per cent at end of 1985. This compares with an annual growth in private sector credit of 11 per cent at end of 1984. However, due to the sharp increase in borrowings by the Government from a negative 17 per cent at end of 1984 to a positive 42 per cent, domestic credit rose from 1 per cent to 19 per cent at end of 1985.

The main feature in price developments in 1985 was the deceleration of consumer prices. The increase in the Colombo Consumers' Price Index (CCPI) on a point to point basis declined from 9.5 per cent at end of 1984 to 1.5 per cent at end of 1985 and the average annual increase in CCPI declined from 17 per cent in 1984 to 1.5 per cent in 1985. The improvement in supply conditions, mainly those of food items, coupled with the continuation of restrictive monetary and credit policy measures by the Central Bank, resulted in these favourable price developments.