

## MONEY AND BANKING

### Money Supply

Growth in the various monetary aggregates increased appreciably in 1987. A high rate of domestic credit expansion and a resurgence in the growth of quasi-money were the main features of monetary developments in 1987. Narrow money supply ( $M_1$ ) consisting of currency and demand deposits held by public grew by Rs. 3,904 million or 18 per cent, compared with an increase of Rs. 2,418 million or 13 per cent in 1986. Meanwhile, time and savings deposits held by the public with commercial banks (quasi-money) expanded by Rs. 3,571 million. Consequently, broad money supply ( $M_2$ ) defined to include  $M_1$  plus quasi-money grew sharply by Rs. 7,475 million or 15 per cent, compared to a growth of Rs. 2,451 million or 5 per cent in the previous year.

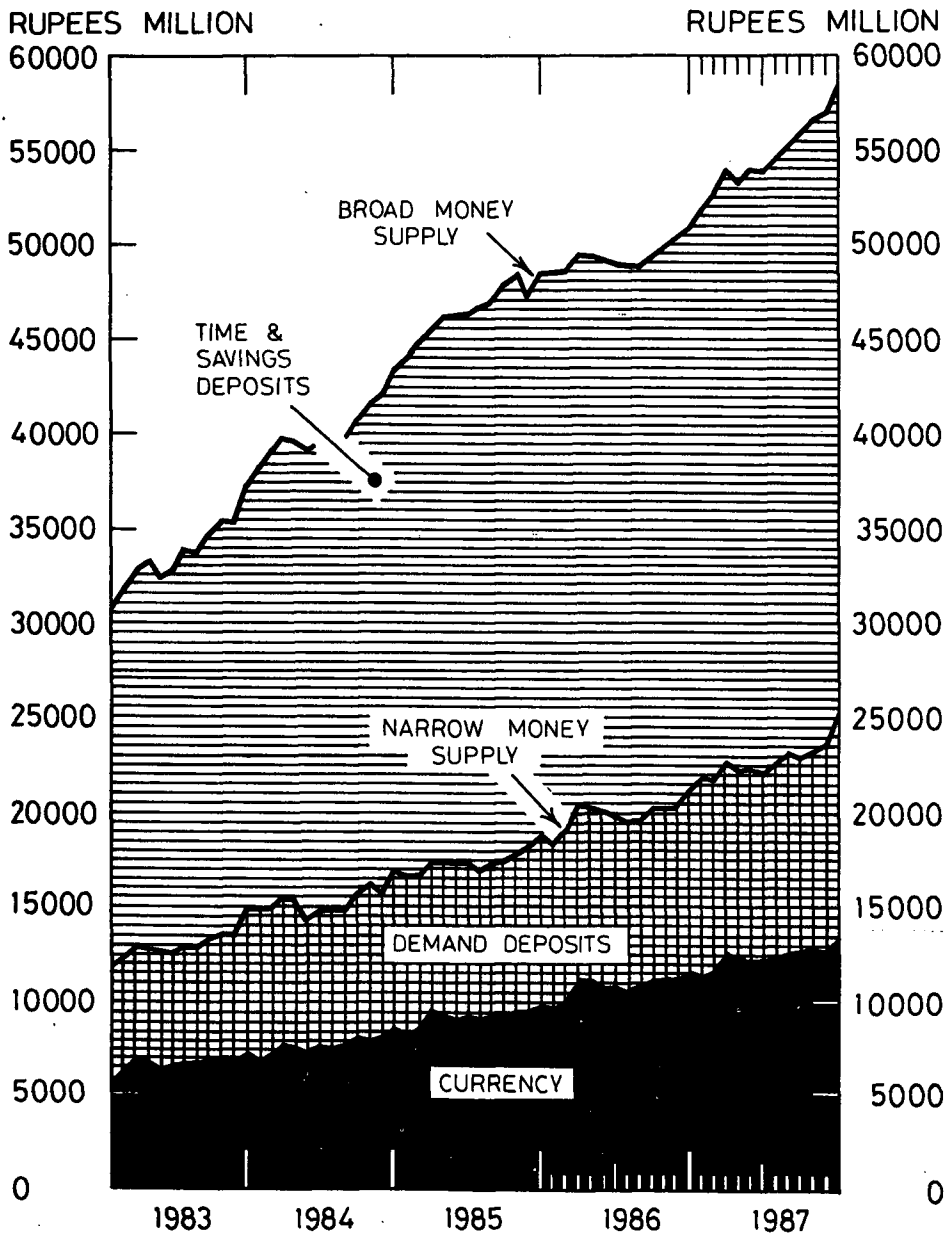
Both components of  $M_1$ , viz., currency and demand deposits, recorded sharp increases in 1987. The currency component rose by Rs. 1,925 million or 17 per cent, while the demand deposit component recorded a growth of Rs. 1,979 million or 21 per cent. The slightly higher growth in the demand deposit component of  $M_1$  resulted in a marginal increase in its share in  $M_1$  by 1 percentage point to 46 per cent at the end of 1987. However, the public's demand for currency, especially the currency notes in the denominations of Rs. 1,000 and Rs. 500, remained high reflecting the increased use of currency for high value transactions as well as the disruption of normal banking services in the Northern and Eastern Provinces. The share of these currency notes in the total currency issue rose from 56 per cent as at the end of 1986 to 61 per cent by the end of 1987.

During 1987, quasi-money increased by Rs. 3,571 million or 12 per cent compared to a marginal increase of Rs. 33 million in 1986. This growth was mainly reflected in time and savings deposits of the other private sector constituents (OPSC), i.e., private sector proper, which grew by Rs. 3,384 million or 14 per cent. Over 50 per cent of this increase occurred during the last quarter of the year. Relatively higher export prices in rupee terms largely due to the depreciation of the rupee and the narrowing of the gap between deposit rates of banks and other competing institutions were the major factors contributing to the substantial growth of private sector time and savings deposits during this period. Time and savings deposits of government corporations recorded a marginal increase of Rs. 119 million in contrast to a sharp decline of Rs. 1,067 million during the previous year. Similarly, time and savings deposits of co-operative institutions increased by Rs. 69 million during 1987.

With all components of broad money recording increases, the rate of growth in  $M_2$  accelerated from the 1986 low of 5 per cent to 15 per cent in 1987. The monthly movement of this monetary aggregate reveals that the annual rate of growth accelerated continuously through the year, reaching highest rate of 15 per cent as at the end of the year.

# MONEY SUPPLY

MONTHLY



The major contributory factor for the growth in  $M_2$  in 1987 was the substantial growth in credit. Domestic credit expansion (DCE) in 1987 was Rs. 11,457 million or 18 per cent, compared to an expansion of Rs. 4,883 million or 8 per cent in 1986. The growth in domestic credit (DC) comprised an increase of Rs. 4,502 million or 20 per cent in net credit to government (NCG) from the banking system and an expansion of Rs. 6,955 million or 17 per cent in gross credit to private sector (GCPS) by the commercial banks. The comparable increases in NCG and GCPS in the previous year were Rs. 2,198 million or 11 per cent and Rs. 2,684 million or 7 per cent respectively. The growth in NCG was reflected in an increase in its share in the total DC, which rose from 35 per cent in 1986 to 36 per cent in 1987. It must, however, be stated that the expansion in NCG in 1987 amounting to Rs. 4,502 million includes a special loan of Rs. 683 million from the Central Bank for meeting Sri Lanka's obligations to the I.M.F. consequent upon successive revaluation of liabilities to the Fund, which cannot be related to normal budgetary operations during the year.

Commercial banks made the larger contributions to the expansion in NCG mainly by way of investments in Treasury bills. Net credit to government from commercial banks rose by Rs. 3,035 million during 1987. Treasury bills continued to be an attractive form of investment for commercial banks for placing short-term funds following the expansion in liquidity consequent on the reduction of the statutory reserve ratios in August, 1987. Meanwhile, the increase in net credit to government from the Central Bank was limited to Rs. 1,468 million or 6 per cent during the year. As in the previous year, the transfer of the Central Bank's profits amounting to Rs. 1,723 million in February, 1987 helped the government to contain its borrowings from the Central Bank at this level.

During the year, the major share of the growth in GCPS amounting to Rs. 6,955 million was in respect of the other private sector constituents (OPSC). Compared with an increase of Rs. 2,263 million or 7 per cent in 1986, commercial bank credit to OPSC grew by Rs. 4,629 million or 13 per cent in 1987. The latter represented about two thirds of the growth in the total GCPS during the year. More than half of this increase occurred in the last quarter of the year. The higher utilisation of bank credit by the private sector was reflected in increased demand for export credit associated with relatively favourable prices and the provision of increased credit for imports and related trading activities to cover higher rupee values. Credit to OPSC mainly took the form of loans and overdrafts which recorded increases of Rs. 2,860 million and Rs. 1,318 million, respectively during the year.

During 1987, commercial bank credit to government corporations increased substantially by Rs. 2,627 million or 55 per cent, in comparison with marginal increases of Rs. 301 million in 1986 and Rs. 290 million in 1985. The corporations which recorded substantial credit growth in 1987 were the Sri Lanka State Plantations Corporation (SLSPC) (Rs. 288 million), Janatha Estate Development Board (JEDB) (Rs. 353 million), Ceylon Petroleum Corporation (CPC) (Rs. 1,308 million) and the Co-operative Wholesale Establishment (CWE) (Rs. 223 million). The effective implementation of the Medium Term Investment Programme (MTIP) for the development of state owned plantations was largely responsible for the increase in bank credit to SLSPC and JEDB. Increased utilisation of credit by the CPC were for both

TABLE 1.46

## Monetary Aggregates 1985-1987

Amount in Rs. Million

End of Period	Narrow Money Supply (M <sub>1</sub> )						Broad Money Supply (M <sub>2</sub> )					
	1985	1986	1987	% Change 1985 over 1984	% Change 1986 over 1985	% Change 1987 over 1986	1985	1986	1987	% Change 1985 over 1984	% Change 1986 over 1985	% Change 1987 over 1986
January ...	16,522	18,456	21,845	+ 10.4	+ 11.7	+ 18.4	43,923	48,498	51,887	+ 14.8	+ 10.4	+ 7.0
February ...	16,595	19,062	21,738	+ 11.1	+ 14.9	+ 14.0	44,849	48,587	52,799	+ 14.9	+ 8.3	+ 8.7
March ...	17,237	20,454	22,556	+ 11.7	+ 18.7	+ 10.3	45,230	49,410	53,855	+ 13.8	+ 9.2	+ 9.0
April ...	17,332	20,287	22,121	+ 13.2	+ 17.1	+ 9.0	46,019	49,335	53,278	+ 16.1	+ 7.2	+ 8.0
May ...	17,208	20,043	22,305	+ 20.1	+ 16.5	+ 11.3	46,092	49,119	53,972	+ 17.8	+ 6.6	+ 9.9
June ...	17,339	19,949	22,075	+ 17.4	+ 15.1	+ 10.7	46,233	48,959	53,942	+ 16.5	+ 5.9	+ 10.2
July ...	16,969	19,615	22,574	+ 13.9	+ 15.6	+ 15.1	46,631	48,882	54,624	+ 17.6	+ 4.8	+ 11.7
August ...	17,232	19,731	23,160	+ 16.4	+ 14.5	+ 17.4	46,991	48,771	55,236	+ 18.2	+ 3.8	+ 13.3
September ...	17,460	20,399	22,973	+ 12.3	+ 16.8	+ 12.6	47,917	49,430	55,927	+ 17.4	+ 3.2	+ 13.1
October ...	17,768	20,219	23,143	+ 10.8	+ 13.8	+ 14.5	48,359	49,868	56,560	+ 16.3	+ 3.1	+ 13.4
November ...	18,187	20,293	23,551	+ 16.0	+ 11.6	+ 16.1	47,247	50,057	56,916	+ 12.5	+ 6.0	+ 13.7
December ...	18,761	21,179	25,083	+ 11.5	+ 12.9	+ 18.4	48,409	50,860	58,335	+ 11.4	+ 5.1	+ 14.7
Monthly Average ...	17,384	19,974	22,760	+ 13.7	+ 14.9	+ 14.0	46,492	49,315	54,778	+ 15.6	+ 6.1	+ 11.1

Source : Central Bank of Sri Lanka.

# DOMESTIC CREDIT

MONTHLY

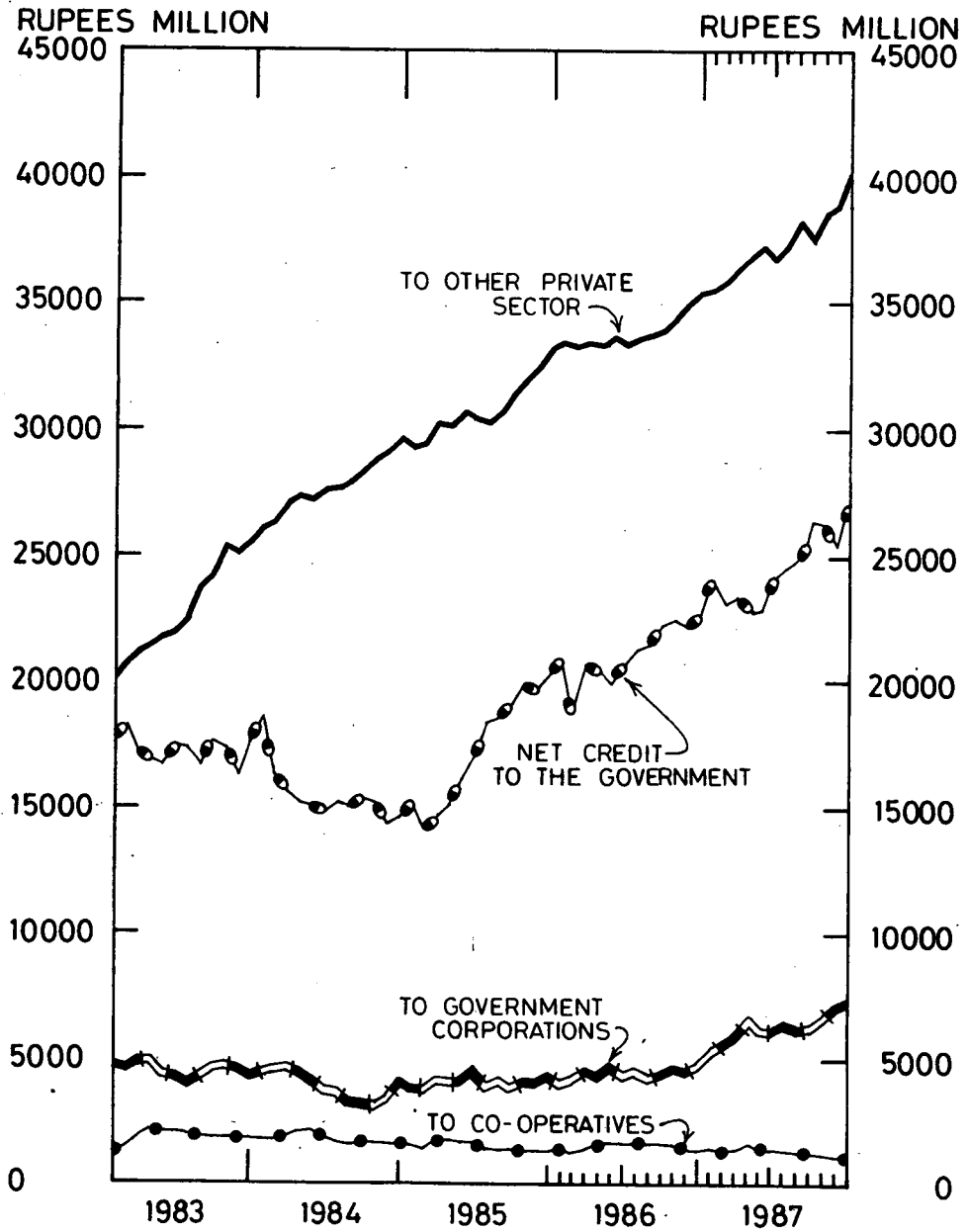


TABLE 1.47

## Monetary Aggregates and Underlying Factors

Amount in Rs. Million

Item	December 1985	December 1986	December 1987	Change 1985/1986		Change 1986/1987		
				Amount	Percentage	Amount	Percentage	
<b>Monetary Aggregates</b>								
1. Currency held by the public ...	9,815.5	11,570.0	13,495.3	+ 1,754.4	+17.9	+ 1,925.3	+ 16.6	
2. Demand deposits held by the public	8,945.5	9,609.3	11,588.0	+ 663.8	+ 7.4	+ 1,978.8	+ 20.6	
Narrow Money Supply (M <sub>1</sub> ) ...	18,761.0	21,179.3	25,083.3	+ 2,418.2	+12.9	+ 3,904.1	+ 18.4	
3. Time and Savings Deposits of the private sector held with commercial banks ...	29,647.9	29,681.0	33,251.7	+ 33.2	+ 0.1	+ 3,570.6	+ 12.0	
3.1 Co-operative Institutions ...	633.5	702.2	770.6	+ 68.7	+10.8	+ 68.5	+ 9.7	
3.2 Government Corporations ...	5,809.5	4,742.1	4,860.8	- 1,067.3	-18.4	+ 118.6	+ 2.5	
3.3 Other Private Sector Constituents(a)	23,204.9	24,236.7	27,620.3	+ 1,031.8	+ 4.4	+ 3,383.5	+ 13.9	
Broad Money Supply (M <sub>2</sub> ) ...	48,408.9	50,860.3	58,335.0	+ 2,451.4	+ 5.1	+ 7,474.7	+ 14.7	
<b>Underlying Factors</b>								
1. Domestic Credit ...	59,226.1	64,108.8	75,565.5	+ 4,882.7	+ 8.2	+11,456.6	+ 17.9	
1.1 Net Credit to Government ...	20,347.6	22,546.1	27,047.9	+ 2,198.5	+10.8	+ 4,501.8	+ 20.0	
1.1.1 Gross credit to Government by Central Bank ...	25,657.9	27,599.4	31,518.6	+ 1,941.5	+ 7.6	+ 3,919.3	+ 14.2	
by Commercial Banks ...	22,760.6	24,846.0	26,156.8	+ 2,085.5	+ 9.2	+ 1,310.8	+ 5.3	
1.1.2 Government deposits and cash balances	2,897.3	2,753.4	5,361.8	- 144.0	- 5.0	+ 2,608.5	+ 94.7	
1.2 Gross Credit to Private Sector	5,310.3	5,053.3	4,470.7	+ 257.0	+ 4.8	+ 582.5	+ 11.5	
1.2.1 Co-operative Institutions	38,878.5	41,562.7	48,517.6	+ 2,684.2	+ 6.9	+ 6,954.8	+ 16.7	
1.2.2 Government Corporations	1,304.3	1,424.5	1,123.4	+ 120.2	+ 9.2	- 301.1	- 21.1	
1.2.3 Other Private Sector Constituents	4,437.9	4,738.5	7,365.7	+ 300.6	+ 6.8	+ 2,627.2	+ 55.4	
	33,136.3	35,399.7	40,028.5	+ 2,263.4	+ 6.8	+ 4,628.7	+ 13.1	
2. External Banking Assets (net) ...	9,272.7	8,859.1	8,416.1	- 413.6	- 4.5	- 443.0	- 5.0	
3. Other items (net) ...	-20,089.9	-22,107.6	-25,646.6	- 2,017.7	-10.0	- 3,538.9	- 16.1	
3.1 Other liabilities (net) of Central Bank	-13,197.2	-15,332.4	-15,281.5	- 2,135.2		+ 50.8		
3.2 Other liabilities (net) of Commercial Banks	-7,186.9	-6,880.9	-10,413.2	+ 306.0		- 3,532.2		
3.3 Adjustments for items in transit	294.2	105.7	48.1	- 188.6		- 57.5		
Broad Money Supply (M <sub>2</sub> ) ...	48,408.9	50,860.3	58,335.0	+ 2,451.4	+ 5.1	+ 7,474.7	+ 14.7	

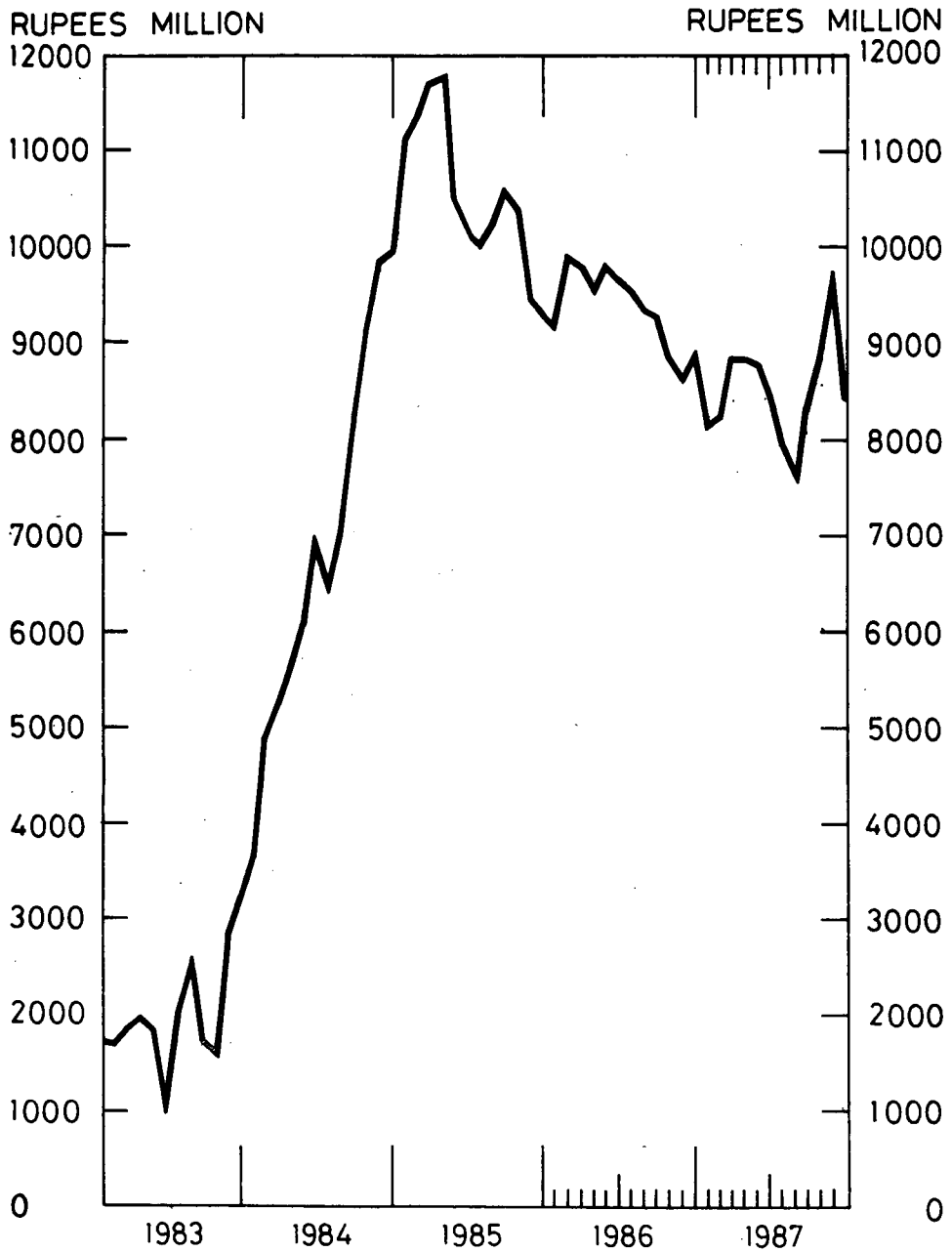
Note: Signs indicate the effect on M<sub>2</sub>

(a) Excludes Non-Resident Foreign Currency Deposits.

Source: Central Bank of Sri Lanka.

# EXTERNAL BANKING ASSETS (NET)

MONTHLY



the importation of crude oil at enhanced prices and for building up stocks of finished products to meet the demand during the closure of the refinery for maintenance purposes. Increase in credit to the CWE was largely due to the bulk importation of essential food items.

Credit to co-operative institutions dropped by Rs. 301 million or 21 per cent during 1987 in contrast to the increase of Rs. 120 million or 9 per cent in 1986. The reduction in lending activities for cultivation and marketing of agricultural products in areas affected by civil disturbances and the drought conditions experienced in certain districts were the main factors responsible for the decline in credit to this sector.

The operations of the external sector exerted a contractionary impact of Rs. 443 million or 5 per cent on  $M_2$  in 1987. This was the third successive year when the country's external banking assets (net) declined and underlines the continuing weakness of the balance of payments since the surplus year of 1984. The decreases in external banking assets (net) in 1985 and 1986 were Rs. 691 million or 7 per cent and Rs. 414 million or 4 per cent, respectively. The decline in net external banking assets in 1987 was the combined outcome of a decrease in net foreign assets of the Central Bank by Rs. 621 million and an increase in net foreign exchange holdings of commercial banks by Rs. 178 million.

The balance of payments out-turn in 1987 both in terms of the trade account and the current account has shown some improvement. However, due to certain lags in aid flows the overall balance remained in deficit and had to be financed by drawing on external assets. Hence, the contractionary impact on the money supply of external sector operations.

### **Commercial Banking**

Commercial banks experienced mixed fortunes with respect to liquidity in 1987; while some banks were highly liquid throughout the year compelling them to look for short-term investment outlets, some others experienced continued liquidity constraints forcing them to borrow in the inter-bank call market. However, the entirety of the liquidity requirements of deficient banks was met through market sources, obviating the need for resorting to Central Bank accommodation for augmenting liquidity.

The level of transactions in the call money market tended to remain low reflecting the moderate demand for funds in the market. The average monthly outstanding lendings in the call money market increased only by Rs. 109 million during the year to reach Rs. 815 million in 1987, while the interest rates in this market fluctuated between a range of 9.5–14.0 per cent per annum in 1986 and 5.0–21.0 per cent per annum in 1987. The latter reflect the sharp fluctuations in the liquidity position of some banks during the year.

During 1987, the Treasury bill market emerged as an attractive investment outlet to commercial banks for investing short-term funds. Treasury bill holdings of commercial banks rose from Rs. 1,171 million at the end of 1986 to reach Rs. 5,131 million at the end of September before dropping to Rs. 3,850 million by the end of

1987. This was the outcome of relatively attractive rates on primary Treasury bills, on the one hand, and certain reforms introduced in the recent past to improve the market for primary Treasury bills, on the other. The latter include weekly issues of Treasury bills specially aimed at mopping-up excess liquidity and to meet the situation arising from the depressed activities in the Secondary Treasury Bill Market (STBM) following the unattractive yields available on Central Bank's sales in this market. The outstanding net sales in the STBM dropped from Rs. 1,255 million as at the end of 1986 to Rs. 812 million as at the end of 1987. The progressive liquidation of Central Bank Securities held by commercial banks also helped to improve the market for primary Treasury bills during the year. The holdings of Central Bank Securities by commercial banks dropped from Rs. 1,905 million at the end of 1986 to Rs. 60 million at the end of 1987.

Consequent on the withdrawal of limits on outstanding amounts on Certificates of Deposits (CDs) issued by commercial banks, such deposits increased from Rs. 1,673 million at the end of 1986 to Rs. 2,032 million by the end of 1987, thereby augmenting the resource base of the commercial banks.

During 1987, commercial banks continued to improve customer services by extending banking hours, computerising banking operations and intensifying manpower development and training programmes. Meanwhile, the Bank which introduced the Automated Teller Machine facilities to Sri Lanka in 1986 extended this facility to foreign currency account holders as well during 1987.

At the end of 1987, there were 23 Foreign Currency Banking Units (FCBUs) operating in Sri Lanka. The total assets/liabilities of the FCBUs dropped by U. S. \$ 25 million in 1987. However, in Sri Lanka rupee terms total assets/liabilities increased by Rs. 786 million during the year to reach Rs. 20,465 million as at the end of 1987 due to the depreciation of the Sri Lanka rupee vis-a-vis the U.S. Dollar. The operations of the FCBUs continued to be concentrated in financing projects coming under the Greater Colombo Economic Commission and of other approved residents.

During the year under review, there was a sharp growth in the total resources of commercial banks which rose by Rs. 10,505 million, compared with an increase of only Rs. 3,927 million in the preceding year. A substantial part of the resource growth in 1987 amounting to Rs. 6,441 million was by way of deposit mobilisation. The growth in deposits consisted of increases in time and savings deposits (including long-term deposits of the two state banks) and demand deposits of Rs. 4,816 million and Rs. 1,625 million, respectively. In 1987, borrowings of commercial banks rose by Rs. 1,789 million. This comprised increases in inter-bank borrowings amounting to Rs. 640 million (including borrowings from the Central Bank) and foreign borrowings totalling Rs. 1,149 million. Borrowings of commercial banks from the Central Bank increased by Rs. 339 million during the year and these were under different refinance facilities operated by the Bank. Meanwhile, other liabilities and paid-up capital and reserves of commercial banks rose by Rs. 1,929 million and Rs. 545 million, respectively, in 1987 thereby enhancing the resource base.

TABLE 1.48

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

Sector	Rs. Million	
	End 1985/ End 1986	End 1986/ End 1987
1. Government	297.4	- 3,035.1
2. Central Bank	634.0	3,243.9
3. Government Corporations	- 1,670.0	- 1,652.0
4. Co-operative Institutions	21.5	472.5
5. Other Private	- 163.5	- 67.9
6. Inter-Bank	705.4	1,216.5
7. Foreign	175.2	- 177.9

Source : Central Bank of Sri Lanka

Note: Minus sign indicates net utilization of resources.

Table 1.48 presents the change in commercial banks' resources and their utilization on a net basis. During the year, the government sector took a major share amounting to Rs. 3,035 million of the net utilization of commercial banks' resources. Meanwhile, the government corporations absorbed resources to the tune of Rs. 1,652 million from commercial banks in 1987. The transactions in the foreign sector too resulted in a net outpayment of Rs. 178 million from commercial banks during the year.

The approach of the Central Bank towards commercial bank reserves changed in 1987. The reserve requirements were reduced. The Central Bank also withdrew the issue of its own securities to make Treasury bills more attractive. There was thus a net resource contribution from the Central Bank of Rs. 3,244 million to commercial banks. This was the combined effect of an increase in borrowings from the Central Bank (Rs. 339 million) and decreases in reserves held with the Central Bank (Rs. 1,060 million) and in holdings of Central Bank securities (Rs. 1,845 million). During the year, the net accrual of resources from the inter-bank sector amounted to Rs. 1,216 million, while the contribution of co-operative institutions amounted to Rs. 472 million.

#### **Bank Expansion**

The Sampath Bank Ltd., a newly incorporated domestic bank commenced operations in Colombo in March, 1987. This increased the number of commercial banks operating in Sri Lanka to 24 and the indigenous banks to 5. The Sampath Bank Ltd. was registered as a quoted public company and raised capital at two public issues amounting to Rs. 139 million.

The Bank of Ceylon opened two main branches at Galewela and Rikillagaskada by re-locating its two ASC branches and amalgamated the branch at Oruwala with the Kaduwela branch. Consequently, the total number of main branches of the Bank of

Ceylon increased to 239, while the number of ASC branches declined to 49 by the end of 1987. The People's Bank and the Hatton National Bank Ltd. opened one branch each in the Ratnapura town and at Kalutara, respectively, increasing their total number of branches to 298 and 33, respectively. Meanwhile, branch network of the Commercial Bank of Ceylon Ltd., remained unchanged at 15. Moreover, the total number of foreign bank branches remained unchanged at 23 by the end of 1987. Accordingly, the total number of commercial bank branches, excluding relocated ASC branches, stood at 700 at the end of 1987. Meanwhile, with the opening of two branches at Borella and Hakmana, the National Savings Bank had 62 branches operating in the country by the end of the year.

During 1987, four new Regional Rural Development Banks (RRDBs) were opened in the Kegalle, Galle, Puttalam and Kandy districts increasing the total number of RRDBs to 9. Except the RRDB in Matara, all the other RRDBs opened branches in their respective districts during the year. Consequently, there were 61 RRDB branches including head offices operating in the country by the end of the year.

**TABLE 1.49**  
**Distribution of Bank Branches**

Category	1985	1986	1987
<b>1. Commercial Banks</b>			
1.1 No. of Domestic Banks	4	4	5
1.2 No. of branches (a)	671	676	677
1.2.1 of which ASC Branches...	53	52	49
1.3 No. of Foreign Banks	21	19	19
1.4 No. of Branches	26	23	23
1.5 Total No. of Branches (a)	697	699	700
<b>2. RRDBs (b)</b>			
2.1 No. of RRDBs	4	5	9
2.2 No. of Branches	17	32	61

Source: Central Bank of Sri Lanka.

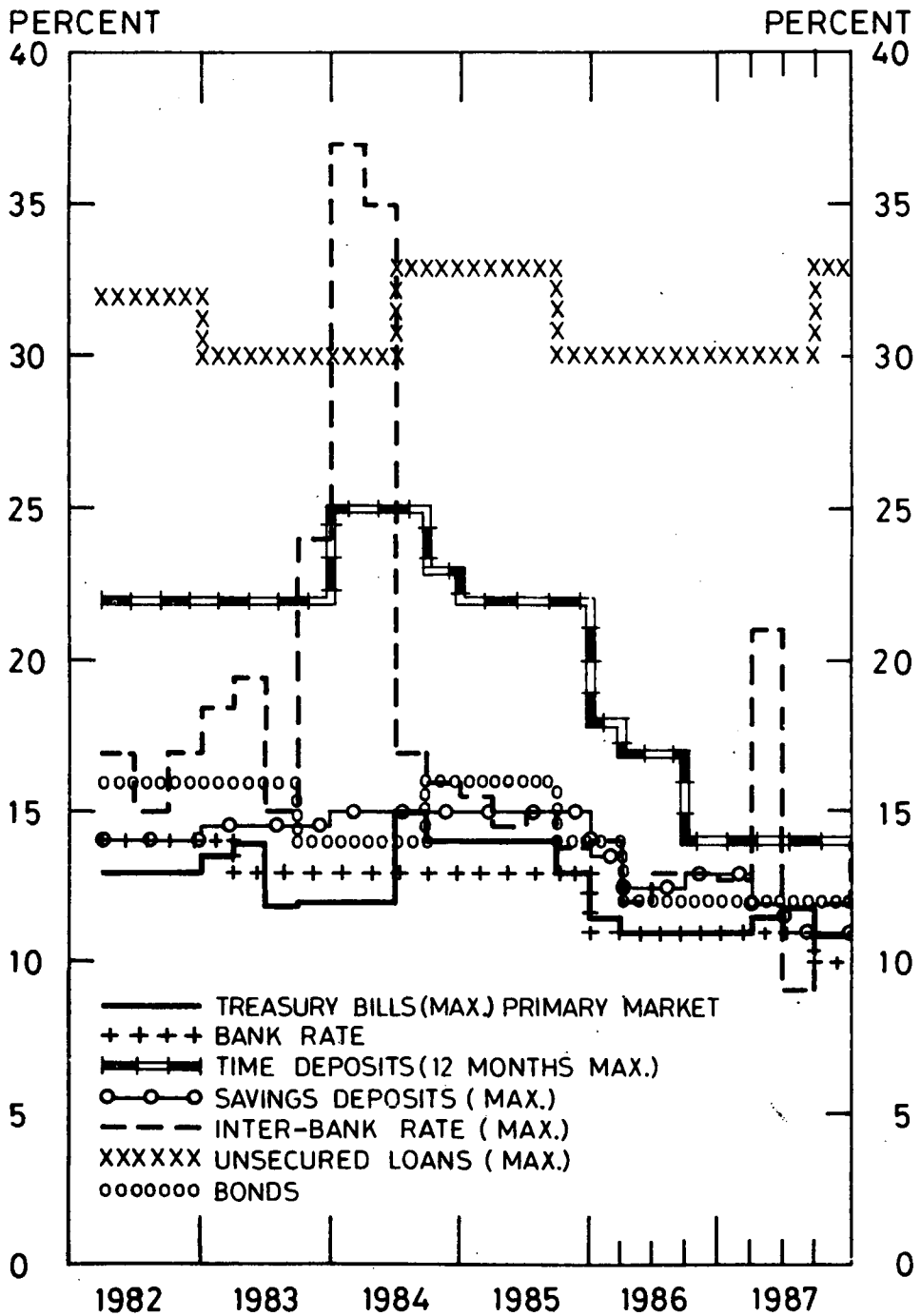
- (a) Includes Extension offices, Kachcheri branches, Pay Offices and Overseas branches and excludes relocated ASC branches.  
(b) Regional Rural Development Banks established under the RRDB Act No. 15 of 1985.

### Interest Rates

Conforming to the trends observed in the previous year, the interest rate structure tended to move downwards, though modestly, with further reductions in rates applicable to certain categories of advances and deposits. This partly reflected the excess liquidity position in the financial system arising mainly due to a low demand for credit in particular during the first half of the year. However, the interest rates failed to decline to the extent as was anticipated, largely due to the action on the part of the National Savings Bank (NSB) which maintained its rate on fixed deposits at 13 per cent per annum thereby compelling commercial banks to follow a more guarded policy with respect to revision of interest rates.

## INTEREST RATES

END QUARTERLY FIGURES



Although the National Savings Bank (NSB) did not effect any changes in its deposit rates, the two state banks lowered the interest rates offered on various types of deposits. For instance, the Bank of Ceylon which, as at the end of December 1986, offered 12 per cent per annum on savings deposits above Rs. 10,000 and 10 per cent per annum on deposits below that level, introduced a uniform rate of 10 per cent per annum on all savings deposits effective December, 1987. Meanwhile, the two banks effected marginal downward revisions in rates on term deposits of different maturities, towards the end of the year.

As in the previous years, finance companies continued to offer competitive rates on term deposits and Certificates of Deposits. For instance, during the last quarter of the year the one year deposit rate offered by some major finance companies ranged between 16 to 20 per cent per annum as against the interest rate offered by the commercial banks ranging between 8.5 - 14 per cent per annum. However, as from December, 1987, deposit rates of finance companies were subject to certain ceilings in terms of the directions issued by the Central Bank under the Control of Finance Companies Act. In terms of these directions, the maximum rate of interest which may be paid on a 12 month deposit is 17 per cent per annum and on deposits with a maturity period of longer than 12 months is 18 per cent per annum. However, given the present market rates of interest, at least the large finance companies are unlikely to find this ceiling a constraint.

During the year, short-term money market rates tended to decline further. In the primary Treasury bill market, market forces were allowed to play a greater role in determining the interest rates. Also, with a view to inducing investors to come to the primary Treasury bill market, the discount (selling) rate in the secondary Treasury bill market was substantially lowered. In the first 8 months of the year, the interest rates in the primary Treasury bill market ranged mostly between 8 to 12 per cent per annum. However, since then, the rates fluctuated within a narrower band of 8 to 11 per cent per annum conforming to the downward trend in the overall interest rates structure. Meanwhile, the coupon rate on Central Bank securities was lowered from 12 to 11 per cent per annum in March, 1987 and the maturity period was extended from six months to one year.

In keeping with the objective of letting interest rates reflect market conditions, Bank rate was reduced by 1 percentage point to 10 per cent in August, 1987. Also, with the reduction of the statutory reserve ratios which in turn lowered the implicit cost of funds to commercial banks, it was anticipated that the commercial banks would lower their lending rates further.

The Central Bank continued to publish the weighted average prime lending rate and the minimum prime lending rate of commercial banks on a weekly basis. During 1987, the weighted average prime lending rate fluctuated within a marginally lower range of 13.5 to 15.1 per cent per annum as against a range of 14.0 to 15.6 per cent per annum in the previous year. There is evidence to show that the lending rates of commercial banks have moved downward, though marginally. For instance, the weighted average lending rate of commercial banks which declined from 20.1 per

cent at the end of 1985 to 19.0 per cent at the end of 1986 decreased further to 18.4 per cent by the end of September, 1987. Meanwhile, the lending rates of long-term credit institutions remained, by and large, unchanged during 1987.

### Central Banking

The total assets/liabilities of the Central Bank as at the end of 1987 amounted to Rs. 45,444 million showing an increase of Rs. 2,280 million (5 per cent) during the year, compared with an almost similar expansion of Rs. 2,005 million (5 per cent) in 1986.

On the assets side, the International Reserve (gross) of the Central Bank declined for the third year in succession. The International Reserve dropped by Rs. 701 million (7 per cent) in 1987 mainly on account of a decline in the holdings of cash and balances abroad by Rs. 1,524 million. Meanwhile, investments in foreign securities and Treasury bills increased by Rs. 820 million.

Continuing the trend observed in the previous year, domestic assets of the Central Bank (excluding other assets and accounts) expanded by Rs. 1,695 million (6 per cent). This expansion was reflected in all major categories of domestic assets. Loans and advances to the government and investments in government and government guaranteed securities increased by Rs. 643 million and Rs. 668 million, respectively. Advances to commercial banks and other financial institutions also recorded an expansion of Rs. 344 million, of which the growth in short-term loans amounted to Rs. 87 million. During 1987, the Bank contributed a sum of Rs. 40 million to the Regional Rural Development Banks (RRDB's) increasing its contribution to other institutions to Rs. 200 million as at the end of 1987. Meanwhile, other assets and accounts of the Bank rose by Rs. 1,287 million largely owing to an expansion in forward foreign exchange transactions by Rs. 873 million.

On the liabilities side, monetary liabilities consisting of currency in circulation and deposits declined marginally by Rs. 108 million in 1987. However, since currency in circulation expanded by Rs. 2,200 million in 1987 the decline in monetary liabilities was entirely due to a drop in deposits by Rs. 2,308 million. Deposits of the government, commercial banks and, international organisations, foreign governments and foreign banking institutions decreased by Rs. 157 million, Rs. 998 million and Rs. 1,882 million, respectively. The decline in deposits of commercial banks (Rs. 998 million) was due to a reduction in statutory reserve ratios in August, 1987. Meanwhile, deposits of Government agencies and institutions, and others grew by Rs. 40 million and Rs. 690 million, respectively.

With a view to enhancing the refinance capacity under the Medium and Long-term Credit Fund (MLCF), a transfer of Rs. 250 million was made from the general reserves of the Bank in November, 1987, thus raising the total resources in the Fund to Rs. 1,275 million. During the year, the other liabilities and accounts of the Bank rose by Rs. 2,879 million mainly due to an increase in the International Reserve Revaluation Account (IRRA) by Rs. 1,426 million.

## Monetary Policy

The restrictive monetary policy stance in force since 1984 was relaxed to some extent in 1987. The relaxation was mainly through a downward revision in the statutory reserve requirements and a further augmentation in refinance facilities from the Central Bank. The easing of the monetary policy was facilitated by the stable conditions with respect to prices prevailing during the first half of the year. It was intended to provide a stimulus to economic activity especially in the private sector by allowing commercial banks to provide an adequate volume of credit at reasonable costs. Also, market forces were allowed to play a key-role in the determination of interest rates particularly, at the short end of the market.

In view of the slow growth in broad money supply ( $M_2$ ) largely caused by the reduced growth in domestic credit particularly to the private sector of the economy during 1986, the relaxation of monetary policy in 1987 was effected through reductions of statutory reserve requirements at different stages. This process began in early 1986 with the withdrawal of the requirement to maintain special reserves under a Tranche System introduced in late 1984. This was followed by the withdrawal with effect from June, 1987 of the requirement to maintain reserves against unutilised balances of overdrafts imposed in December, 1983. However, in a major revision effected in early August, the reserve ratio on demand deposits was lowered from 18 per cent to 10 per cent, while that on time deposits (not exceeding 90 days) was brought down from 14 per cent to 10 per cent, thus unifying the ratio at 10 per cent for all types of commercial banks' deposit liabilities. Consequent on the above revisions, the average reserve ratio on deposit liabilities declined from 12.3 per cent to 10.0 per cent. Accordingly, despite an increase in total deposits of commercial banks by Rs. 3,240 million in 1987, total required reserves dropped from Rs. 5,380 million by the end of 1986 to Rs. 4,594 million as at the end of 1987, recording a decline of Rs. 786 million or 15 per cent.

During the year, the Central Bank continued to provide refinance facilities to commercial banks and certain other financial institutions with a view to promoting short-term and medium and long-term lending in priority areas aimed at strengthening real economic activity in the economy. The total outstanding refinance provided by the Bank under various schemes expanded by Rs. 344 million in 1987 to reach Rs. 3,496 million by the end of the year. The demand for refinance funds provided under the Medium and Long-term Credit Fund (MLCF) which recorded a substantial growth of Rs. 257 million was largely responsible for the rise in refinance during the year. To promote medium and long-term investment, a transfer of Rs. 250 million was made to the MLCF from the general reserves of the Bank towards the end of the year, thus enhancing the refinancing capacity of the Fund to Rs. 1,275 million.

Since January, 1987 the determination of the yield on primary Treasury bills has been based on market forces, while by lowering the yield on secondary Treasury bills, the Bank induced commercial banks and other participants to engage more in primary market activities. Also, the continuation of the weekly issue of Treasury bills helped to guarantee a regular supply of short-term instruments for the invest-

ment of liquid funds of surplus institutions. Meanwhile, the reduction in the coupon rate of the Central Bank securities from 12 to 11 per cent and the extension of the maturity period from six months to one year in March 1987 made primary Treasury bills even more attractive. Consequently, Treasury bill holdings by non-Central Bank sources increased from Rs. 4,055 million at the end of 1986 to Rs. 7,562 million by the end of 1987.

During the year, the Central Bank monitored the direction of credit in terms of the sectoral allocation of credit under the National Credit Plan of 1987. This Plan covered lending to private sector by commercial banks and credit extended by six long-term credit institutions, i.e., the National Savings Bank (NSB), the National Development Bank of Sri Lanka (NDB), the State Mortgage and Investment Bank (SMIB), the Development Finance Corporation of Ceylon (DFCC), the National Housing Development Authority (NHDA), and the Housing Development Finance Corporation (HDFC), during the year. Commercial bank credit to the private sector (i.e., public corporations, co-operatives and the private sector proper) was planned to grow by Rs. 5,402 million or 13 per cent in 1987, against an expansion of Rs. 2,749 million or 7 per cent recorded in 1986. Based on the behaviour of the external sector and borrowing requirements of the Government from the banking system, the permissible level of private sector credit by commercial banks as at the end of the year was estimated at Rs. 46,432 million in the National Credit Plan of 1987\*. As in the past, agriculture, export and industry continued to be priority areas in the sectoral allocation of credit.

In contrast to a reduced level of credit utilisation in relation to credit plan estimates experienced in 1986, the outstanding level of utilisation of credit at the end of 1987 exceeded the target by Rs. 2,236 million or 5 per cent. High level of credit utilised for agricultural purposes in particular under the Medium Term Investment Programme (MTIP) for the development of state owned plantations, was almost entirely responsible for this situation. The substantial expansion of such credit was more pronounced during the last quarter of the year and hence the excessive utilisation of credit against the credit plan targets too was experienced during the same quarter of 1987. The growth of institutions and the expansion of priority needs may sometimes make it difficult to forecast credit requirements on a sectoral basis.

\* The definition of credit to Private Sector in the National Credit Plan differs from that in the monetary survey since, the former includes export bills, but excludes cash items in process of collection and commercial banks' investments in private companies.