

MONEY AND BANKING

Money Supply

A considerable acceleration in the rate of growth of money supply, mainly resulting from a substantial expansion in domestic credit, was the salient feature of monetary developments in 1988. The annual rate of growth of narrow money supply (M_1), consisting of currency and demand deposits held by the public, which stood at 18 per cent as at the end of 1987, increased to 29 per cent by the end of 1988. In absolute terms, the narrow money supply rose substantially by Rs. 7,296 million in 1988, compared with an increase of Rs. 3,904 million in the previous year. Meanwhile, the time and savings deposits of the public held with commercial banks (quasi-money) increased at a slower rate of 7 per cent in 1988, compared with a 12 per cent growth in 1987. Consequently, the broad money supply (M_2), defined to include M_1 plus quasi-money, grew by Rs. 9,611 million or 16 per cent in 1988, compared with a growth of Rs. 7,475 million or 15 per cent in the preceding year.

The substantial growth in M_1 during 1988 was mainly reflected in the currency holdings of the public, which rose by Rs. 4,992 million or 37 per cent. The corresponding increase in 1987 was Rs. 1,925 million or 17 per cent. Consequently, the share of the currency component in M_1 rose from 54 per cent in 1987 to 57 per cent in 1988, largely reflecting the public's preference for liquid assets to meet unforeseen emergencies arising from the sporadic civil disturbances in the country. At the same time, the public's demand for currency notes of higher denominations of Rs. 1,000 and Rs. 500, continued to remain high, reflecting the increased use of high value notes for transaction purposes against a background of continuing inflationary pressures. Accordingly, the share of these notes in the total currency issue rose from 61 per cent at end of 1987 to 66 per cent by the end of 1988.

During 1988, quasi-money increased by Rs. 2,315 million or 7 per cent. This was reflected largely in time and savings deposits of the other private sector constituents (OPSC), which grew by Rs. 2,100 million or 8 per cent. In comparison, time and savings deposits of government corporations recorded a marginal increase of Rs. 242 million or 5 per cent. Meanwhile, time and savings deposits of co-operative institutions declined marginally by Rs. 27 million, in contrast to an increase of Rs. 68 million during 1987.

A sharp growth in domestic credit (DC) amounting to Rs. 21,302 million or 28 per cent was the underlying factor for the sharp increase in the monetary aggregates in 1988. Comparable growth in 1987 was Rs. 11,457 million or 18 per cent. The growth in DC in 1988 comprised an increase of Rs. 9,017 million or 33 per cent in net credit to government (NCG) from the banking system and an expansion of Rs. 12,285 million or 25 per cent in gross credit to the private sector (GCPS) by commercial banks. The comparable increases in NCG and GCPS in the previous year were Rs. 4,502 million or 20 per cent and Rs. 6,955 million or 17 per cent respectively.

Against the background of a growing budget deficit, the government's recourse to borrowings from the banking system rose considerably during 1988. The gross credit to government from the banking system rose by Rs. 12.8 billion in 1988, as

MONEY SUPPLY MONTHLY

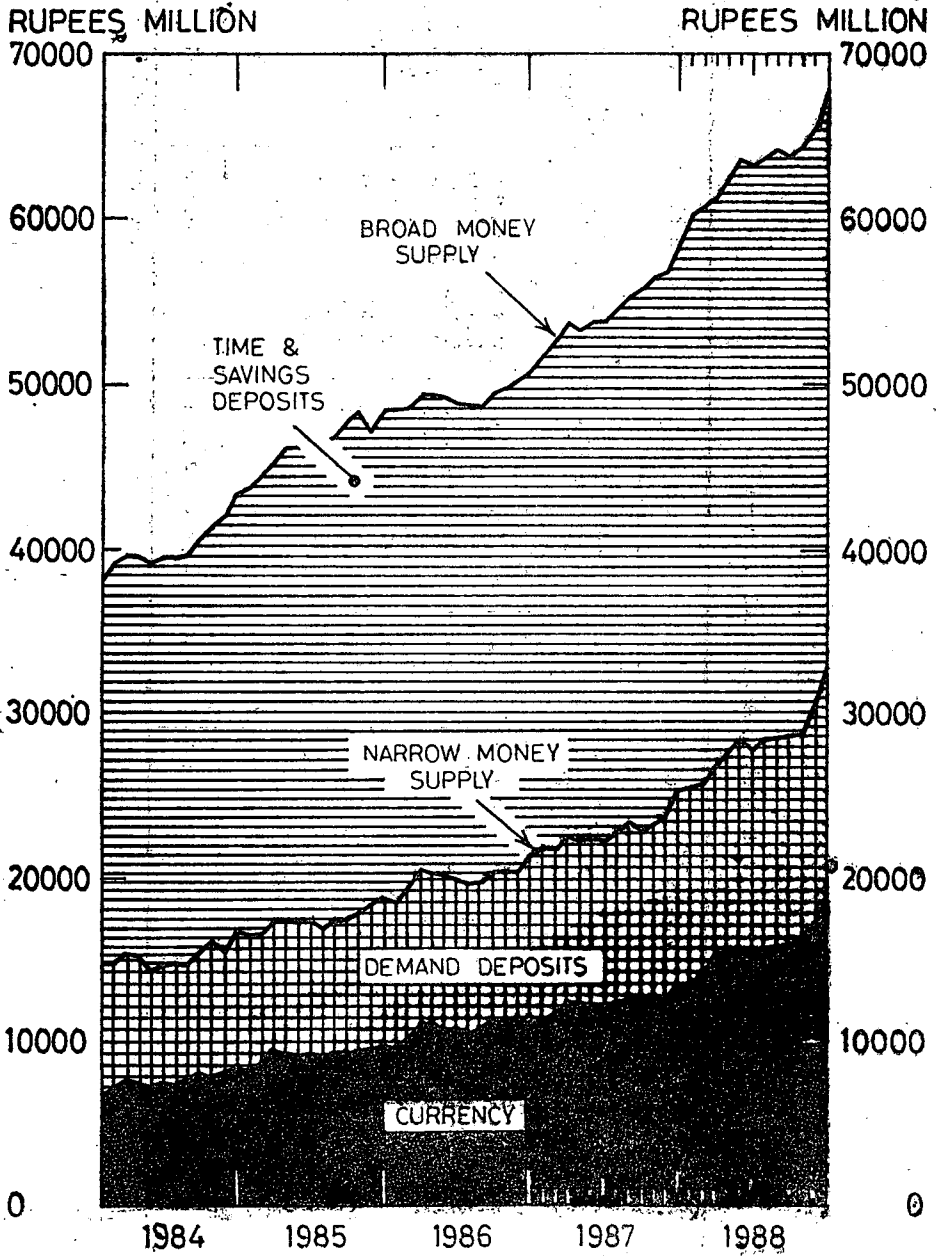


TABLE 1 . 46

Monetary Aggregates 1986—1988

Amount in Rs. Million

End of Period	Narrow Money Supply (M ₁)						Broad Money Supply (M ₂)					
	1986	1987	1988	% Change 1986 over 1985	% Change 1987 over 1986	% Change 1988 over 1987	1986	1987	1988	% Change 1986 over 1985	% Change 1987 over 1986	% Change 1988 over 1987
January	18,456	21,845	25,336	+ 11.7	+ 18.4	+ 16.0	48,498	51,887	60,060	+ 10.4	+ 7.0	+ 15.8
February	19,062	21,738	25,672	+ 14.9	+ 14.0	+ 18.1	48,587	52,799	60,846	+ 8.3	+ 8.7	+ 15.2
March	20,454	22,556	26,640	+ 18.7	+ 10.3	+ 18.1	49,410	53,855	61,081	+ 9.2	+ 9.0	+ 13.4
April	20,287	22,121	27,467	+ 17.1	+ 9.0	+ 24.2	49,335	53,278	62,465	+ 7.2	+ 8.0	+ 17.2
May	20,043	22,305	28,178	+ 16.5	+ 11.3	+ 26.3	49,119	53,972	63,687	+ 6.6	+ 9.9	+ 18.0
June	19,949	22,075	27,792	+ 15.1	+ 10.7	+ 25.9	48,959	53,942	63,118	+ 5.9	+ 10.2	+ 17.0
July	19,615	22,574	28,053	+ 15.6	+ 15.1	+ 24.3	48,882	54,624	63,645	+ 4.8	+ 11.7	+ 16.5
August	19,731	23,160	28,234	+ 14.5	+ 17.4	+ 21.9	48,771	55,236	64,116	+ 3.8	+ 13.3	+ 16.1
September	20,399	22,973	28,453	+ 16.8	+ 12.6	+ 23.8	49,430	55,927	63,932	+ 3.2	+ 13.1	+ 14.3
October	20,219	23,143	28,684	+ 13.8	+ 14.5	+ 23.9	49,868	56,560	64,371	+ 3.1	+ 13.4	+ 13.8
November	20,293	23,551	30,379	+ 11.6	+ 16.1	+ 29.0	50,057	56,916	66,088	+ 6.0	+ 13.7	+ 16.1
December	21,179	25,083	32,379	+ 12.9	+ 18.4	+ 29.1	50,860	58,335	67,946	+ 5.1	+ 14.7	+ 16.4
Monthly Average	19,974	22,760	28,106	+ 14.9	+ 14.0	+ 23.4	49,315	54,778	63,446	+ 6.1	+ 11.1	+ 15.8

Source : Central Bank of Sri Lanka.

DOMESTIC CREDIT
MONTHLY

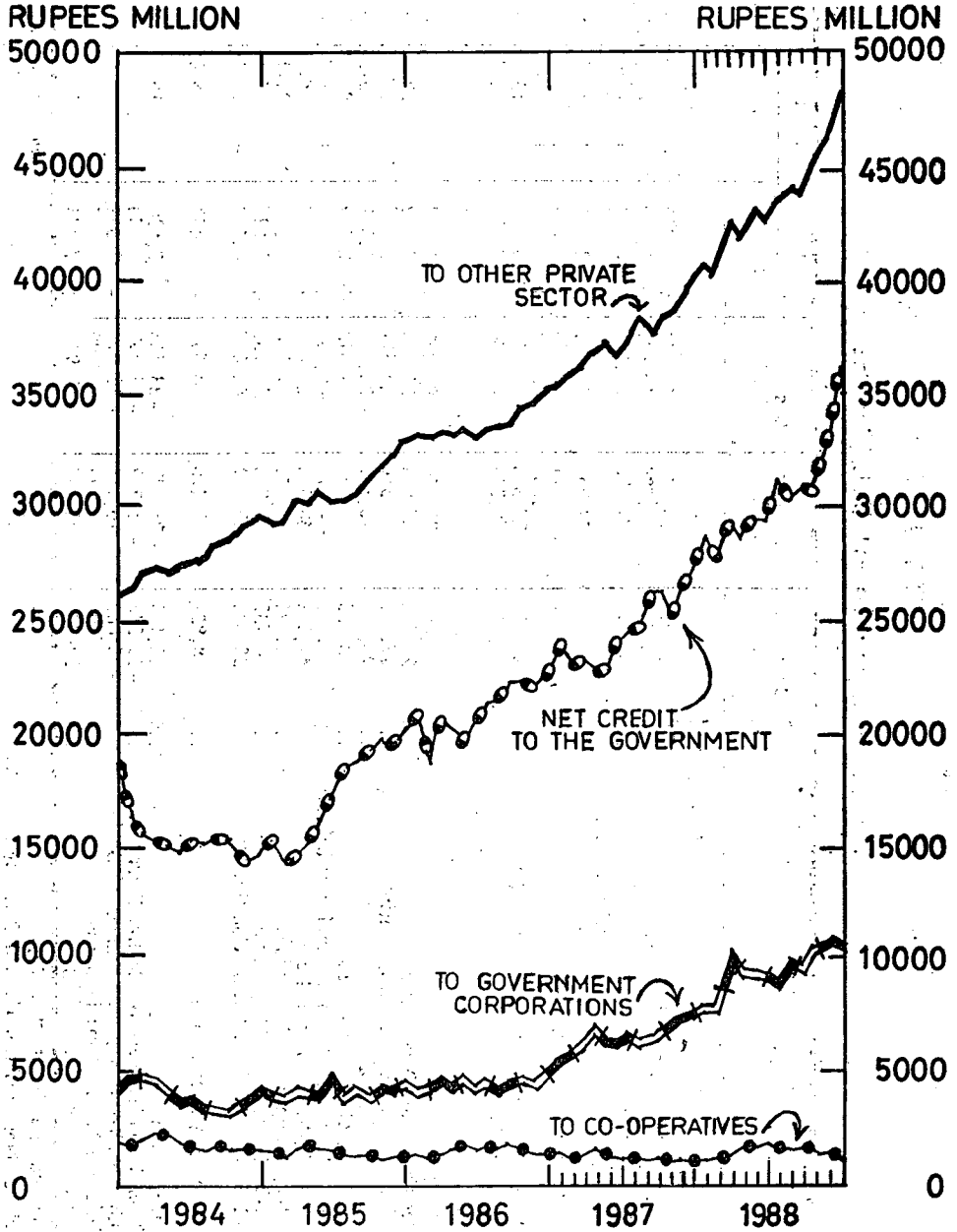


TABLE 1.47

Monetary Aggregates and Underlying Factors

Amount in Rs. Million

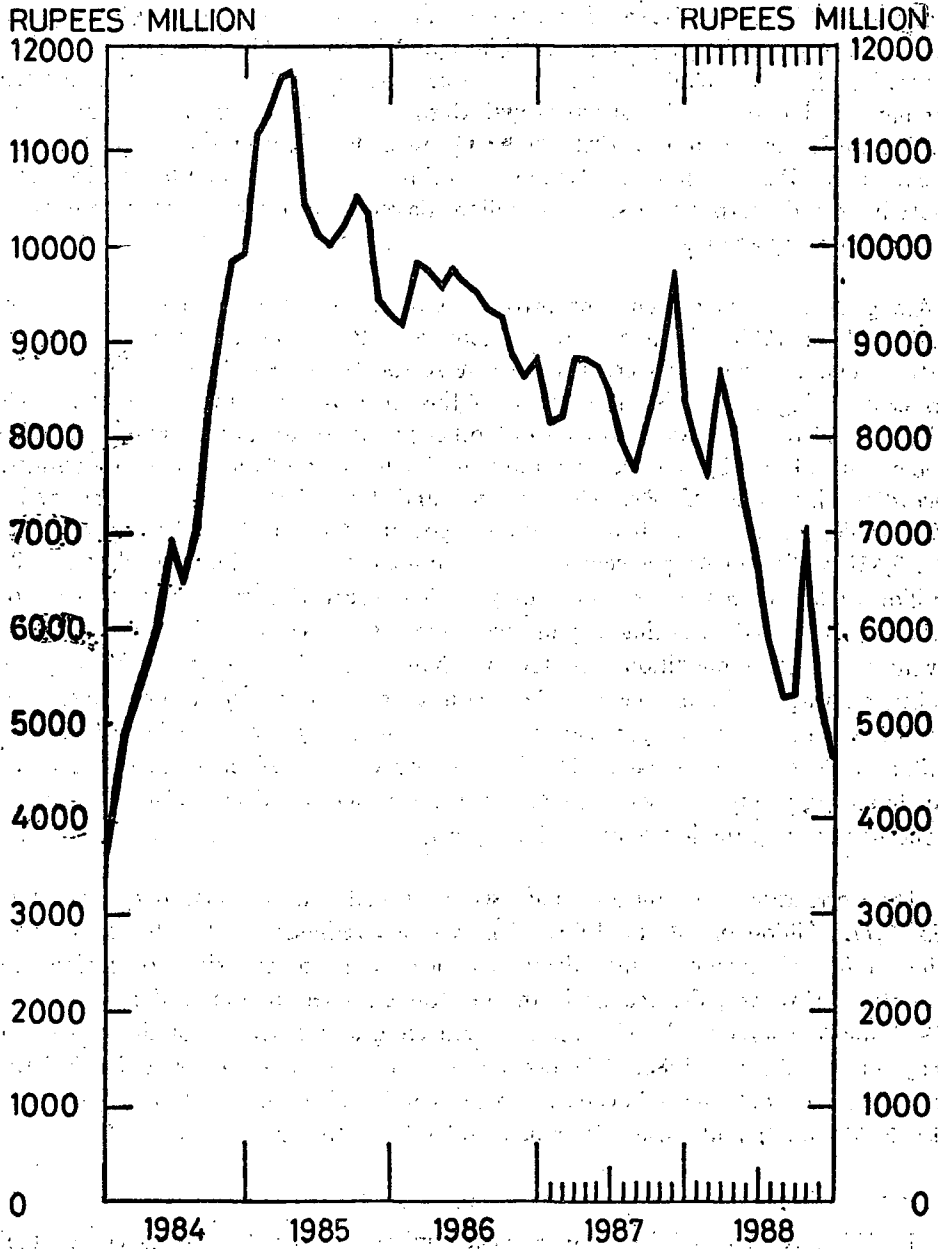
Item	December 1986	December 1987	December 1988	Change, 1986/1987		Change 1987/1988		
				Amount	Percentage	Amount	Percentage	
Monetary Aggregates								
1. Currency held by the public ..	11,570	13,495	18,487	+ 1,925	+ 16.6	+ 4,992	+ 37.0	
2. Demand deposits held by the public ..	9,609	11,588	13,892	+ 1,979	+ 20.6	+ 2,304	+ 19.9	
Narrow Money Supply (M ₁) ..	21,179	25,083	32,379	+ 3,904	+ 18.4	+ 7,296	+ 29.1	
3. Time and Savings Deposits of the private sector held with commercial banks ..	29,681	33,252	35,567	+ 3,571	+ 12.0	+ 2,315	+ 7.0	
3.1 Co-operative Institutions ..	702	771	743	+ 69	+ 9.7	- 27	- 3.6	
3.2 Government Corporations ..	4,742	4,861	5,103	+ 119	+ 2.5	+ 242	+ 5.0	
3.3 Other Private Sector Constituents (a) ..	24,237	27,620	29,721	+ 3,383	+ 13.9	+ 2,100	+ 7.6	
Broad Money Supply (M ₂) ..	50,860	58,335	67,946	+ 7,475	+ 14.7	+ 9,611	+ 16.4	
Underlying Factors								
1. Domestic Credit ..	64,109	75,566	96,867	+ 11,457	+ 17.9	+ 21,302	+ 28.2	
1.1 Net Credit to Government ..	22,546	27,048	36,065	+ 4,502	+ 20.0	+ 9,017	+ 33.3	
1.1.1 Gross credit to Government by Central Bank ..	27,599	31,519	44,311	+ 3,920	+ 14.2	+ 12,792	+ 40.6	
by Commercial Banks ..	24,846	26,157	36,439	+ 1,311	+ 5.3	+ 10,282	+ 39.3	
1.1.2 Government deposits and cash balances ..	2,753	5,362	7,872	+ 2,609	+ 94.7	+ 2,510	+ 46.8	
1.2 Gross Credit to Private Sector ..	-5,053	-4,471	-8,246	+ 582	+ 11.5	- 3,775	- 84.4	
1.2.1 Co-operative Institutions ..	41,563	48,518	60,802	+ 6,955	+ 16.7	+ 12,285	+ 25.3	
1.2.2 Government Corporations ..	1,424	1,123	1,318	- 301	- 21.1	+ 195	+ 17.4	
1.2.3 Other Private Sector Constituents ..	4,739	7,366	10,787	+ 2,627	+ 55.4	+ 3,421	+ 46.4	
2. External Banking Assets (net) ..	35,400	40,029	48,697	+ 4,629	+ 13.1	+ 8,669	+ 21.7	
3. Other items (net) ..	8,859	8,416	4,644	- 443	- 5.0	- 3,772	- 44.8	
3.1 Other liabilities (net) of Central Bank ..	-22,108	-25,647	-33,566	- 3,539	- 16.1	- 7,919	- 30.9	
3.2 Other liabilities (net) of Commercial Banks ..	-15,332	-15,282	-14,693	+ 50		+ 588		
3.3 Adjustments for items in transit ..	- 6,881	-10,413	-18,472	- 3,532		- 8,059		
Broad Money Supply (M ₂) ..	105	48	400	- 57		- 448		
	50,860	58,335	67,946	+ 7,475	+ 14.7	+ 9,611	+ 16.4	

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



against a rise of Rs. 3.9 billion in the previous year. Of this increase, an overwhelmingly large contribution of Rs. 10.3 billion or 80 per cent was accounted for by the Central Bank. This was a worrisome development from the view-point of sound monetary management and containing inflationary pressures. The need to borrow from the banking system was more marked during the closing months of 1988, arising from a sharply deteriorating fiscal situation. Upto the end of October, Government's borrowings from the banking system increased at a slow pace, with some marginal fluctuations, but recorded a sharp growth during the last two months of the year. During the first ten months of 1988, the NCG rose by Rs. 3,758 million or by a monthly average of Rs. 376 million. However, during the last two months of 1988, the NCG increased sharply by Rs. 5,259 million, thereby exerting considerable pressure on the monetary aggregates.

Alongside the Government, the private sector too resorted to increased use of bank credit in 1988. Compared to an increase of Rs. 6,955 million or 17 per cent in the previous year, gross credit to private sector rose by Rs. 12,285 million or 25 per cent during 1988. The large bulk of this increase, amounting to Rs. 8,669 million or 71 per cent, was in favour of "other private sector constituents" (OPSC). The credit utilised by this sector mainly took the form of loans and overdrafts, recording increases of Rs. 3,347 million and Rs. 2,761 million, respectively. Meanwhile, commercial bank credit to government corporations expanded by Rs. 3,421 million or 46 per cent in 1988, compared with an increase of Rs. 2,627 million or 55 per cent in the previous year. The sharp rise in credit to this sector reflected increased working capital requirements of certain key corporations owing to unsettled conditions, on the one hand, and rising costs, especially the enhanced wage bills, on the other. Credit to co-operative institutions increased by Rs. 195 million or 17 per cent during 1988, in contrast to a decline of Rs. 301 million or 21 per cent in 1987. This increase was entirely reflected in credit granted for financing paddy purchases, the settlement of which was delayed due to unsettled conditions during the last quarter of the year.

The operations of the external sector exerted a contractionary impact of Rs. 3,772 million on M_2 in 1988. This was a continuation of a trend observed since 1985 on account of the adverse balance of payments situation facing the country. However, the decline in the net foreign assets of the banking system in 1988 was the largest of such decreases, reflecting a worsening of the balance of payments position in 1988. The decline in net external banking assets in 1988 was the combined outcome of decreases in net foreign assets of the Central Bank by Rs. 2,977 million and those of commercial banks by Rs. 795 million.

Commercial Banking

In 1988, commercial banks experienced mixed fortunes with respect to their liquidity position. The work-to-rule campaign of the bank employees in the early part of the year, the increase in the Central Bank's reserve requirements and the disturbances in the country during the latter part of the year, adversely affected the liquidity position, particularly of the two state banks. Meanwhile, due to the

improved deposit mobilization and the adjustments to lending portfolio through investment of funds in liquid assets, some banks managed to maintain satisfactory liquidity positions. On the other hand, the high interest rates prevailing in the inter-bank call money market aggravated the problems of deficit banks. In December, the Central Bank established a scheme to grant special accommodation to commercial banks as a temporary measure to overcome the liquidity problems caused by an escalation of civil disturbances during the last quarter of 1988.

During the year, the volume of transactions in the inter-bank call money market dropped substantially, reflecting a movement of funds from the call market to the Treasury bills market. Accordingly, the average monthly outstanding lending balances in the call market declined by Rs. 140 million during the year to reach Rs. 675 million at the end of 1988. The reduced supply of funds in the market was reflected in an increase in the interest rates from a range of 5-21 per cent per annum in 1987 to 6-30 per cent per annum in 1988. In 1988, Treasury bills provided an attractive investment outlet for commercial banks to invest their short-term funds. Treasury bill holdings of commercial banks rose from Rs. 3,850 million at the end of 1987 to Rs. 4,857 million by the end of 1988. The outstanding value of Certificates of Deposit (CDs) issued by commercial banks increased considerably by Rs. 367 million in 1988 to reach Rs. 2,399 million by the end of the year. Two more banks—the Seylan Trust Bank and the Indian Bank—entered the CDs market, thereby increasing the total member banks operating in this market to 23.

During the year under review, total resources of commercial banks rose by Rs. 18,989 million or 25 per cent, compared with an increase of Rs. 10,505 million or 16 per cent in the preceding year. A substantial share of the resource growth in 1988, amounting to Rs. 7,929 million or 42 per cent was by way of deposit mobilization. The comparable increase in 1987 was Rs. 6,441 million or 15 per cent. The growth in deposits in 1988 consisted of increases in time and savings deposits (including long-term deposits) and demand deposits, totalling Rs. 3,477 million and Rs. 4,452 million, respectively.

In 1988, borrowings of commercial banks rose marginally by Rs. 178 million. This included an increase in the borrowings from the Central Bank of Rs. 427 million, offset by a decline in the borrowings from banks and other financial institutions amounting to Rs. 366 million. During the year, substantial increases in other liabilities and paid-up capital and reserves of Rs. 10,213 million and Rs. 820 million, respectively, contributed to enhance the resource base of commercial banks.

Table 1.48 presents the changes in selected items of commercial banks' resources and their utilization on a net basis. During the 1988, "the other private sector" emerged as the major user of commercial bank resources, utilizing a sum of Rs. 4,198 million. This was a combined result of an increase in deposits totalling Rs. 4,470 million and growth in advances and investments amounting to Rs. 8,668 million. Meanwhile, government corporations utilized commercial bank resources to the tune of Rs. 3,183 million.

TABLE 1.48

**Changes in Selected Items of Commercial Banks, Resources and their
Utilization, on a Net Basis**

Sector	Rs. Million	
	End 1986/1987	End 1987/1988 (a)
1. Government ..	- 3,034.7	- 700.4
2. Central Bank ..	2,970.7	- 647.2
3. Government Corporations ..	- 1,652.0	- 3,183.3
4. Co-operative Institutions ..	472.5	- 130.2
5. Other Private ..	- 68.1	- 4,198.3
6. Inter-Bank ..	1.1	72.2
7. Foreign ..	- 178.1	794.7
8. Miscellaneous Items ..	1,488.6	7,992.5

Source : Central Bank of Sri Lanka.

Note : Minus sign indicates net utilization of resources.

(a) The data for 1988 have been severely distorted due to the escalation of civil disturbances during the last quarter of 1988, which affected the normal operations of the banking system. This resulted a high value for the category of Miscellaneous items.

In 1988, the net accrual of resources from the inter-bank sector to the commercial banks amounted to Rs. 72 million. Meanwhile, the foreign sector contributed towards the net resources build-up of commercial banks to the extent of Rs. 795 million. This consisted of increases in borrowings (Rs. 117 million) and deposits (Rs. 1,288 million), partly off-set by a decline in foreign balances, including export bills (Rs. 610 million).

During 1988, commercial banks took further steps to improve the efficiency of customer services. The measures taken included extension of banking hours, computerization of banking operations and the intensification of manpower development and training programmes. The two state banks commenced an "Agency Banking Scheme" to disburse more credit to small borrowers in the rural sector through agents.

The number of Foreign Currency Banking Units (FCBUs) operating in Sri Lanka increased to 24 with the establishment of a FCBU by the Seylan Trust Bank in July 1988. The total assets/liabilities of the FCBUs dropped by US. \$ 9 million during the year to US. \$ 654 million as at the end of 1988. During 1988, the FCBUs

increased their lending to the non-resident category, mainly the foreign banks, by US. \$ 40 million. However, the outstanding lendings to the resident category fell by US. \$ 81 million, while the GCEC enterprises increased their borrowings by US. \$ 2 million and the approved enterprises outside the GCEC lowered their borrowings by US. \$ 33 million. Both the resident and the non-resident categories recorded decreases in their deposits with the FCBUs of US. \$ 4 million and US. \$ 37 million, respectively. Non-resident foreign banks, emerged as the largest net user of FCBU funds, viz. US. \$ 36 million, during the year.

Bank Expansion

The Seylan Trust Bank Ltd., a newly incorporated domestic bank, commenced operations in Colombo in March, 1988. With this, the number of commercial banks operating in Sri Lanka increased to 25 and the indigenous banks to 6.

During 1988, the Bank of Ceylon (BC) initiated a branch rationalisation program. It relocated its Keppetipola branch at Welimada ; the branch at the Colombo Central Road was amalgamated with the branch at Colombo Central Super Market and the branch at Ginigathhena with the branch at Nawalapitiya. It also upgraded the Agrarian Service Centre (ASC) branches at Mawathagama and Wattagama to 'C' grade main branches and re-located the Pasgoda ASC branch at Kamburupitiya. The Bank of Ceylon also shifted its branches at Deraniyagala, Borella, Kegalle Bazaar, Galgamuwa and Tangalle to comparatively better business locations. Following these changes, the total number of main branches of the Bank of Ceylon remained unchanged at 239, while the number of ASC branches declined to 47 as at the end of 1988. The Commercial Bank of Ceylon opened a branch at Maharagama, increasing its total number of branches to 16. The Sampath Bank, which commenced operations in 1987, opened three branches at Pettah, Nugegoda and Borella, raising its branch network to 4 by the end of 1988. Meanwhile, the branch network of the People's Bank and foreign banks remained unchanged at 298 and 22, respectively. Accordingly, the total number of commercial bank branches, excluding the relocated ASC branches, stood at 700 at the end of 1988. Meanwhile, with the opening of two branches at Horana and Narahenpita, the National Savings Bank had 64 branches operating in the country by the end of the year.

During 1988, two new Regional Rural Development Banks (RRDBs) were opened in the Nuwara Eliya and Moneragala districts, increasing the total number of RRDBs to 11. Except for the RRDB at Anuradhapura all other RRDBs opened branches in their respective districts during the year. Consequently, there were 80 RRDB branches, including head offices, operating in the country by the end of the year.

TABLE 1.49
Distribution of Bank Branches

Category	1986	1987	1988
1. Number of Institutions	28	33	36
1.1. No. of Commercial Banks	23	24	25
1.1.1 No. of Domestic Banks	04	05	06
1.1.2 No. of Foreign Banks	19	19	19
1.2 No. of RRDBs (a)	05	09	11
2. Number of Branches*	791	823	844
2.1 No. of Commercial Bank Branches	699	699	700
2.1.1 No. of Domestic Bank Branches (b)	676	677	678
2.1.1.1 No. of ASC Branches	52	49	47
2.1.2 No. of Foreign Bank Branches	23	22	22
2.2 No. of RRDB Branches	32	61	80
2.3 No. of NSB Branches	60	62	64

Source : Central Bank of Sri Lanka.

(a) Regional Rural Development Banks established under the RRDB Act No. 15 of 1985.

(b) Includes Extension Offices, Kachcheri Branches, pay Offices and Overseas Branches but excludes ASC Branches functioning as extension offices of main branches.

* Includes head offices.

Agency Banking

As a forerunner to the promotion of "Agency Banking" in Sri Lanka, the two state banks—the Bank of Ceylon and the People's Bank—implemented from October 1988 a scheme whereby the services of rural money lenders were enlisted to provide small loans to borrowers on simplified and easy terms. This scheme was aimed at easing the burden on borrowers by adopting only a minimum amount of documentation and charging comparatively lower rates of interest than those prevailing in informal money markets. Under the scheme, the two state banks are expected to appoint agents and grant loans for on-lending to prospective small borrowers. However, the agents are not expected to mobilise deposits on behalf of the banks. The loans are granted by banks to the agents at an annual rate of 18 per cent. The agent would, in turn, re-lend these monies at a rate of interest of 30 per cent per annum. The maximum size of a loan to a borrower will be Rs. 5,000 with a maximum maturity of one year. Repayments can be made daily, weekly, monthly or half yearly.

Under this scheme, loans can be obtained for the purposes of agriculture, industry (small scale), commerce, consumption and purchase of durables and for other miscellaneous purposes. By the end of 1988, 100 agents had been appointed by the Bank of Ceylon and 65 by the People's Bank.

Interest Rates

In 1988, there was a general upward trend in the interest rate structure in Sri Lanka, reflecting growing inflationary pressure. The rise in interest rates was most prominent in those markets where interest rate determination was largely influenced by market forces.

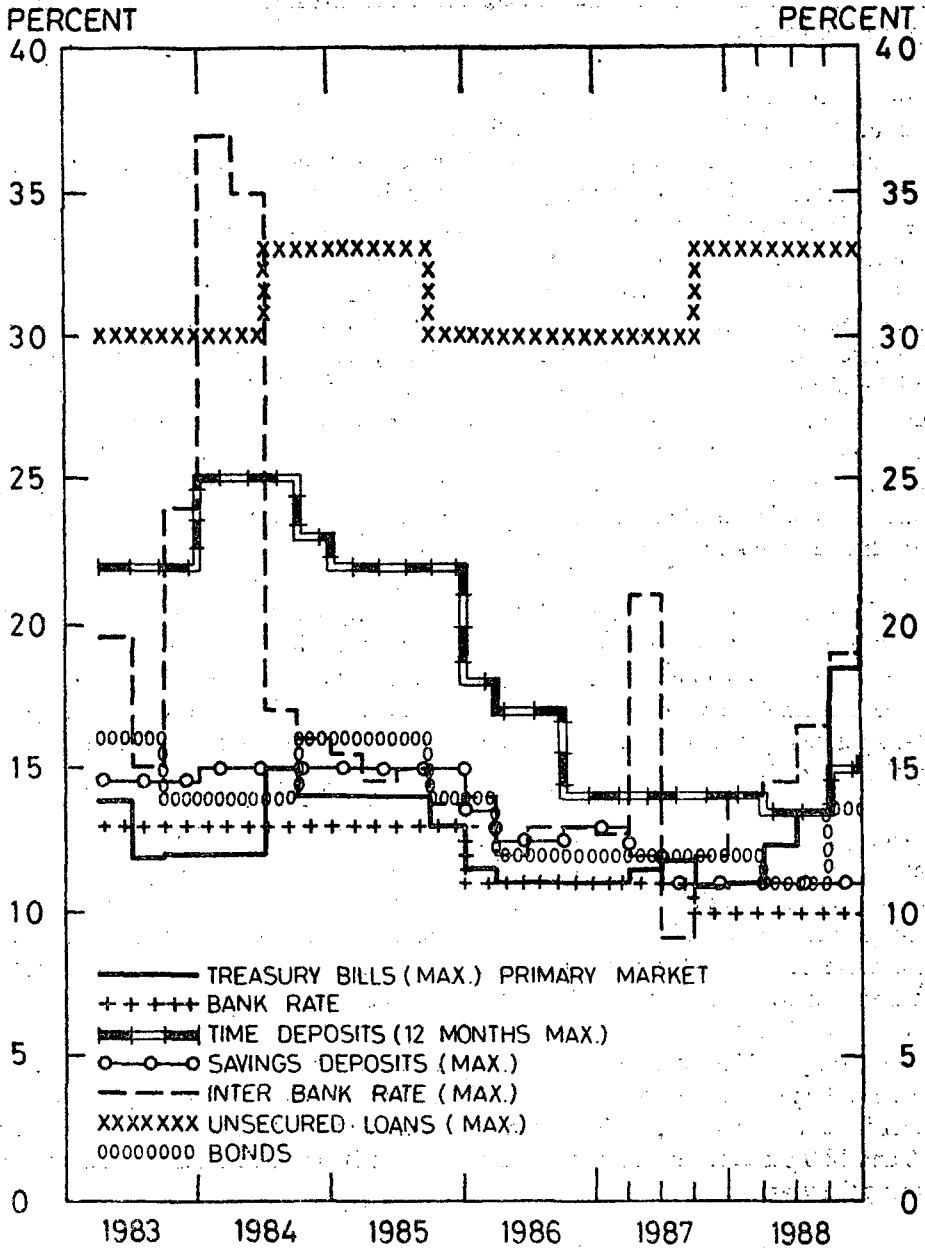
In the primary Treasury bills market, the interest rates became increasingly market determined, with only minor interventions by the authorities. Reflecting primarily the substantially increased demand for funds by the government, the interest rates in this market rose to significantly high levels, particularly during the last four months of 1988. The weighted annual average yield on Treasury bills rose from 10.77 per cent at the end of 1987 to 18.86 per cent by the end of 1988. Following the developments in the primary Treasury bills market, the interest rates in the secondary Treasury bills market also underwent somewhat similar changes. The discount and rediscount rates on secondary Treasury bills, which were 7.26 and 11.26 per cent per annum, respectively, at the end of 1987, rose to 18 and 23 per cent per annum by the end of 1988. Meanwhile, in keeping with market developments, the coupon rate on Central Bank securities rose from 11 to 14 per cent in September, and the yield on these securities rose to 16.2 per cent per annum at the last auction held in September, from a range between 12.19 and 14.0 per cent per annum applicable to previous issues.

Reflecting the impact of the higher level of interest rates in other sub markets and the increased demand for short term funds within the commercial banking system, the interest rates in the inter-bank call money market recorded a significant increase during the year. The interest rates in this market rose from a range of 11-14 per cent per annum at the end of 1987 to a range of 16-21 per cent per annum by the end of 1988.

During the year, several revisions were effected by commercial banks in their deposit rates. The maximum and minimum rates on one year deposits, which declined marginally from a range between 8.5 and 14.0 per cent per annum to a range between 8.5 and 13.5 per cent per annum in the first quarter of 1988, rose to a range between 9.0 and 15.0 per cent per annum in November. These rates further rose to a range between 9.0 and 15.5 per cent per annum in December, 1988. Meanwhile, interest rates offered by the banks on Certificates of Deposit rose from a range of 7.0 to 13.0 per cent per annum at the end of 1987 to a range between 8.0 and 14.9 per cent per annum by the end of 1988. The finance companies recorded a marginal increase in interest rates offered on CDs from a range between 8.0 and 18.0 per cent per annum to a range between 10.0 and 18.0 per cent per annum during the year.

In view of the adverse developments in some finance companies in the recent past, the deposit rates of finance companies continued to be regulated by the Central Bank in 1988. In terms of the direction issued on 10th June, 1988 under the Control of Finance Companies Act No. 27 of 1979, the maximum rate which may be paid on 12 months' deposits was raised from 17 to 20 per cent per annum. It was also

INTEREST RATES END QUARTERLY FIGURES



stipulated that the maximum rate of discount to be allowed on instruments issued at a discount should not exceed 16.7 per cent per annum. These ceilings were raised again on 8th August, 1988, when it was stipulated that the maximum interest rate payable on deposits repayable after a maturity of less than 24 months may be the simple interest rate of 21 per cent per annum, and on deposits with longer maturities a rate of 24 per cent per annum. These same maximum rates were applicable for discounting rates on bonds and other instruments of which, the price was less than the redeemable value at maturity.

The Central Bank continued to publish the weighted average prime lending rate of commercial banks on a weekly basis. Similar to the trends in other interest rates, the weighted average prime lending rate was on a rising trend, indicative of an increase in the cost of funds for commercial banks, as well as the increased pressure for short term funds. The weighted average prime lending rate fluctuated within a range of 12.9 to 17.2 per cent per annum during 1988, compared with a range between 13.5 and 15.1 per cent per annum during the preceding year.

During the year, changes were observed in medium and long-term lending rates as well. In the Rupee securities market, two series of government securities, one with an interest rate of 12 per cent per annum and a maturity period of 6-8 years and the other with an interest rate of 14 per cent per annum and a maturity period of 2 years, were introduced in the third quarter of the year, replacing the series which carried an interest rate of 11 per cent per annum and a maturity period of 6 years. A shorter maturity period was fixed for securities carrying a higher rate of interest, since it was felt that the medium-term inflationary expectations were lower than those in the short run.

Of the long-term lending institutions, the National Development Bank (NDB) effected important changes to link its interest rates to market rates. For instance, under the small and medium industries (SMI) Project III, which came into effect in mid 1988, a variable refinance rate was introduced. The arrangement was to arrive at the refinance rate to be effective in a 6 month period, by subtracting 6 percentage points from the average weighted prime lending rate of commercial banks (AWPR) during the preceding 6 months. However, the on-lending rate was not specified, thereby giving the lending institutions the freedom to decide their own margins, based on operational costs and project risk. In the case of direct lending for projects, fixed and variable rates which were linked to the (AWPR) were introduced. The borrowers were given the option of selecting a variable or a fixed interest rate. Meanwhile, the lending rates applicable to equipment financing, loans for construction of commercial buildings and working capital and bridging finance were increased from 1st January, 1988. Accordingly, the lending rates in respect of these categories rose from a level of 14 per cent per annum at the end of 1987 to a range between 15 and 18 per cent per annum in 1988. The State Mortgage and Investment Bank (SMIB) and the National Savings Bank (NSB) made marginal upward revisions in their lending rates for housing purposes. The lending rates of the other long-term lending institutions remained more or less unchanged during the year.

Central Banking

The total assets/liabilities of the Central Bank as at the end of 1988 amounted to Rs. 55,332, recording an increase of Rs. 9,888 million (22 per cent) during the year, compared with an expansion of Rs. 2,280 million (5 per cent) in 1987.

On the assets side, the International Reserve (gross) of the Central Bank declined for the fourth consecutive year. The International Reserve dropped by Rs. 1,223 million (14 per cent) in 1988 primarily on account of a decline in investments in foreign securities and Treasury bills by Rs. 701 million. In addition, the holdings of cash and balances abroad fell by Rs. 522 million.

Continuing the trend observed in the previous two years, domestic assets of the Central Bank (excluding other assets and accounts) expanded sharply by Rs. 10,659 million (36 per cent). The increase was reflected in all major categories of domestic assets. Loans and advances to the government and investments in government and government guaranteed securities rose by Rs. 926 million and Rs. 9,356 million, respectively. Advances to commercial banks and other financial institutions also recorded an increase of Rs. 358 million, of which the growth in short-term loans amounted to Rs. 216 million. During 1988, the Bank contributed a sum of Rs. 20 million to the Regional Rural Development Banks (RRDBs), increasing its contribution to other institutions to Rs. 220 million by the end of 1988. Meanwhile, other assets and accounts of the Bank rose by Rs. 451 million.

On the liabilities side, monetary liabilities consisting of currency in circulation and deposits rose by Rs. 10,608 million in 1988. Currency in circulation increased by Rs. 5,308 million and deposits by Rs. 5,300 million. Deposits of the government, commercial banks and international organization /foreign governments/foreign banking institutions increased by Rs. 1,960 million, Rs. 986 million and Rs. 3,323 million, respectively. With the upward revisions in statutory reserve ratios in February and September, 1988 commercial banks' deposits increased by Rs. 986 million. Meanwhile, deposits of government agencies and institutions and others declined during the year.

With a view to enhancing the refinance capacity of the Medium and Long-term Credit Fund (MLCF), a transfer of Rs. 600 million was made from the general reserves of the Bank in December, 1988, thus raising the total resources of the Fund to Rs. 1,875 million. During the year, other liabilities and accounts of the Bank rose by Rs. 229 million.

Monetary Policy

In the context of excessive growth in monetary aggregates primarily caused by domestic credit expansion, the monetary policy during 1988 was directed at siphoning-off excess liquidity in the economy, primarily through open market operations. The measures implemented included intensification of activities in the Treasury bills market, the establishment of a Repurchase Market for Treasury bills, issue of Central Bank securities and upward revision of the statutory reserve requirements of commercial banks.

In the primary Treasury bills market, the non-Central Bank investors were encouraged to increase their participation by continuing with the weekly issues of Treasury bills and by allowing interest rates to move in keeping with market conditions. The weighted average yield on Treasury bills rose from 10.8 per cent at the beginning of 1988 to 13.52 per cent in June, and further to 18.9 per cent at the end of the year.

The new policy stance with regard to open market operations was to allow the rate of return on Treasury bills to move in line with market conditions. As a result, Treasury bills became more attractive to the public, who increased their investments significantly in 1988. This somewhat eased the burden falling on the Central Bank to subscribe to a growing volume of fresh issues of Treasury bills. An additional measure initiated to make Treasury bills more attractive to the public was the opening of a repurchase window at the Central Bank for the purpose of discounting Treasury bills prior to maturity. Consequent on the implementation of these measures, the magnitude of Treasury bills held by non-Central Bank sources increased from Rs. 8.2 billion at the end of 1987 to Rs. 11.4 billion as at end 1988, recording a growth of 39 per cent.

Similarly, taking into account the changes in market conditions, interest rates and the maturity periods of government securities were revised during 1988, introducing short maturity securities with high interest rates, while continuing with issues of long-term securities at a relatively lower rate of interest.

In order to further reinforce the contractionary monetary policy, the statutory reserve requirements of commercial banks were raised on two occasions in 1988. First, in February, 1988 the statutory reserve ratio was raised by 3 percentage points to 13 per cent. This was further raised by 2 percentage points to 15 per cent in September, 1988. However, on both occasions, in order to cushion the commercial banks of high intermediation costs, the increases were permitted to be maintained in the form of Sri Lanka government Treasury bills. Along with the revision of the reserve ratio in February, 1988 the amount of reserves that can be maintained in the form of bonds issued by the Development Finance Corporation of Ceylon (DFCC) and held by commercial banks was reduced from one-eighth of the required reserves in respect of time and savings deposits to one-tenth of such reserves.

The Central Bank recommenced issuing its own securities in March, 1988 to absorb excess liquidity in the system. The coupon rate on such securities remained unchanged at 11 per cent during the first half of 1988 but the yield was allowed to move depending on the market conditions. Accordingly, the yield on these securities increased from 12.5 per cent in 1987 to 14 per cent in the first half of 1988. At the same time, the maturity period was shortened from 1 year to 6 months. In September, the coupon rate was raised to 14 per cent resulting in a rise in the yield to 16.2 per cent per annum. The outstanding amount of Central Bank securities rose from Rs. 20 million at the end of 1987 to Rs. 513 million in June, 1988. Thereafter, however, the volume of such securities outstanding declined progressively, as the emphasis in open market operations was concentrated on Treasury bills.

Although the monetary conditions demanded so, the stringent monetary policy stance had to be relaxed on three occasions during 1988 to meet emergency needs for relief. First, a few finance companies in distress had to be assisted with refinance, in order to maintain their viability and to revive confidence. This refinance facility was made available through commercial banks at a 12 per cent annual interest rate and a maturity period of maximum 7 years. Also credit institutions were permitted to keep a margin not exceeding 3 per cent per annum. The outstanding amount of refinance granted under this scheme was Rs. 82 million at the end of 1988. Further, two relief measures were introduced late in the year in view of the problems faced by industrialists and exporters, due to the intensification of civil disturbances during the last quarter of 1988. First, in view of the liquidity problems faced by commercial banks due to these disturbances, the Central Bank in terms of Section 83(1)(c) of the Monetary Law Act, granted temporary accommodation to affected banks. This took the form of advances to such banks at a special interest rate of 15 per cent per annum. In order to ensure that the measure was in keeping with the overall policy stance of restraining monetary expansion, it was restricted to banks that were net borrowers in the inter-bank call money market and those which did not have a portfolio of Treasury bills in excess of what was required to fund the bank's reserve requirement. Second, an additional temporary facility was granted to exporters adversely affected by the civil disturbances during the last quarter. Under this facility, which was to be obtained through commercial banks, the period of refinance granted by the Central Bank to commercial banks on account of pre-shipment advances to exporters, was to be extended from the usual period of 3 months to 5 months. This facility was restricted to those exporters unable to fulfil their export contracts owing to work disruptions. Both measures were short-term measures and were expected to lapse at the end of January, 1989.

The National Credit Plan for 1988 was prepared for the eighth such successive year, as a guide to credit operations. This year's plan covered lending to private sector by commercial banks and by long-term credit institutions. Though the monitoring of the progress of the credit plan was made difficult by the unsettled situation in the country, especially during the last quarter of the year, the credit allocations made in the plan provided a valuable guideline for commercial banks when channelling bank credit to different sectors in the economy.